

DOCUMENT OF INTERNATIONAL MONETARY FUND  
AND NOT FOR PUBLIC USE

**FOR  
AGENDA**

MASTER FILES  
ROOM C-525

0451

EBS/95/68

CONFIDENTIAL

April 17, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Albania - Staff Report for the 1995 Article IV Consultation  
and Midterm Review Under the Second Annual ESAF Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1995 Article IV consultation with Albania and the midterm review under the second annual ESAF arrangement, which is tentatively scheduled for discussion on Friday, May 5, 1995. A draft decision appears on page 24.

Mr. S. Brown (ext. 38431) or Ms. McNeilly (ext. 38824) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Commission (EC), the European Investment Bank (EIB), and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

Att: (1)

Other Distribution:  
Department Heads



INTERNATIONAL MONETARY FUND

ALBANIA

Staff Report for the 1995 Article IV Consultation and  
Midterm Review under the Second Annual ESAF Arrangement

Prepared by the European I and  
Policy Development and Review Departments

(In consultation with other departments)

Approved by Jacques R. Artus and Jan van Houten

April 14, 1995

	<u>Contents</u>	<u>Page</u>
I.	Introduction	1
II.	Background and Performance under the ESAF Arrangement	2
	1. Developments through mid-1993 and the medium-term economic strategy	2
	2. Economic performance from July 1993 to end-1994	3
III.	The Economic Program for 1995	9
	1. Objectives and strategy	9
	2. Monetary and exchange rate policy and financial sector reform	10
	3. Fiscal policy	13
	4. Exchange and trade systems	15
	5. Other structural reforms	16
	6. Balance of payments and external financing for 1995	17
	7. Medium-term external outlook and capacity to repay the Fund	18
	8. Technical assistance, environmental, social and statistical issue	19
	9. Program monitoring	20
IV.	Staff Appraisal	20

	<u>Contents</u>	<u>Page</u>
<u>Text Tables</u>		
1.	Schedule of Disbursements Under the ESAF Arrangement, 1993-96	25
2.	Projections of IMF Position During the Period of the ESAF Arrangement	26
3.	Macroeconomic Indicators and Targets, 1991-97	27
4.	Evolution of Medium-Term Projections	28
5.	Summary of Fiscal Accounts, 1992-95	29
6.	Selected Money and Credit Aggregates, 1992-95	30
7.	Medium-Term Balance of Payments and Financing Flow, 1993-2000	31
8.	Incomes Policy Developments, 1992-95	32
9.	Capacity to Repay the Fund	34
10.	Social and Demographic Indicators	35
<u>Charts</u>		
1.	Nominal and Real Effective Exchange Rate	8
<u>Appendices</u>		
I.	Relations with the Fund	36
II.	Relations with the World Bank Group	46
III.	Social and Environmental Issues	48
IV.	Statistical Issues	50
<u>Annex</u>	Letter of Request and Memorandum of Economic and Financial Policies	53
<u>Annex Tables</u>		
1.	Quantitative Benchmarks and Performance Criteria for the Second Annual Arrangement under the ESAF, 1994	63
2.	Structural Prior Actions, Benchmarks, and Performance Criteria Through End-1994	64
3.	Quantitative Benchmarks for the Second Annual Arrangement under the ESAF, 1995	66
4.	Structural Prior Actions and Benchmarks Through June 1995	67

## I. Introduction

Discussions for the 1995 Article IV consultation and midterm review of Albania's second annual arrangement under the enhanced structural adjustment facility (ESAF) were held in Tirana during December 1994 and February-March 1995. 1/ The staff team met with Prime Minister Meksi; Mr. Vrioni, Deputy Prime Minister and Minister of Finance; Mr. Shehi, Deputy Prime Minister and Minister of Construction; the Ministers of Agriculture, Labor, Industry and Trade, and Mining and Construction; Bank of Albania Governor Luniku; and other government officials.

In a letter dated April 10, 1995 (annexed to this report), with attached Memorandum of Economic and Financial Policies, the Government of Albania outlines its economic and financial policies for 1995, requests waivers for the nonobservance of certain structural performance criteria for the second half of 1994, and requests completion of the midterm review under the second annual ESAF arrangement. The staff recommends the approval of these requests. The Executive Board approved a three-year arrangement under the ESAF totalling SDR 42.36 million (120 percent of quota) on July 14, 1993, along with the first annual arrangement. 2/ The second annual arrangement was approved on September 21, 1994. Three ESAF disbursements totalling SDR 24.00 million have been made to date; a fourth disbursement of SDR 7.06 million is to become available upon completion of this midterm review (Tables 1 and 2).

The last Article IV consultation with Albania was concluded on April 1, 1994. At that time, Executive Directors indicated that they were encouraged at the consistent application of financial discipline which--accompanied by sweeping price, trade, and exchange liberalization and privatization--had contributed to rapid growth and a substantial reduction of inflation. Directors noted, however, that the situation remained fragile, and stressed the need for a further increase in public sector savings and the acceleration of structural measures in the areas of financial sector reform, privatization of large enterprises, the establishment of a land market, and other aspects of the legal framework for a market economy.

Albania became a member of the Fund in October 1991. It maintains exchange restrictions subject to approval under Article VIII, in the form of outstanding obligations under inoperative bilateral payments agreements.

---

1/ Staff participating in one or both missions were S.B. Brown (head), C. McNeilly, D. Schiesser, and N. Koliadina (all EURI), J. King (FAD), P. Mathieu (PDR), and L. Li (Assistant-EXR). J. Laursen (EC2CO-World Bank) participated in many of the discussions, and the team was assisted by W. Ding, Resident Representative in Albania.

2/ At the same time, the Executive Board cancelled Albania's stand-by arrangement, which had been implemented successfully up to then.

Albania's relations with the Fund and World Bank are summarized in Appendices I and II, respectively; Appendix III discusses social and environmental issues; and statistical issues are covered in Appendix IV.

## II. Background and Performance under the ESAF Arrangement

### 1. Developments through mid-1993 and the medium-term economic strategy

The demise of central planning came later and was more disorderly in Albania than in other Central and Eastern European countries. By the time the first democratically-elected, non-Communist government assumed office in April 1992, real GDP is estimated to have dropped by almost half from its 1990 level. The authorities immediately took steps to restore public order and began putting in place mechanisms to control budgetary expenditures, credit, and money growth; these were complemented by a wholesale dismantling of domestic controls and sweeping exchange and trade liberalization. The economic program for 1992/93, which was supported by a stand-by arrangement with the Fund, succeeded in arresting the decline of output, reducing inflation, strengthening the external position, and beginning the transition toward a market economy (Table 3).

Building on these initial achievements, in mid-1993 Albania adopted a comprehensive program of macroeconomic and structural adjustment covering the period through mid-1996, which is being supported by an ESAF arrangement. The program is intended to create the conditions for a sustained revival of growth with declining inflation and further progress toward external viability. This is to be achieved through further increases in domestic savings and investment in combination with comprehensive structural reform, facilitated by a targeted social safety net and supported by foreign assistance on terms appropriate to Albania's low level of income and debt servicing capacity. 1/ Monetary policy is the principal nominal anchor, supported by an incomes policy in the public sector. Restraint over the expansion of money and credit is based on reductions in the domestic financing requirement of the budget and strict limitation of credit to the public enterprises. Structural elements of the program are intended to reduce sharply the Government's role in production and employment and its interference in pricing and resource allocation, while establishing the legal and institutional framework for private initiative and foreign investment.

---

1/ Per capita GDP, estimated at about US\$550, is the lowest in Europe.

2. Economic performance from July 1993 to end-1994 <sup>1/</sup>

Albania had a strong record of macroeconomic performance during the first 18 months of its ESAF arrangement. Real GDP growth and external adjustment exceeded expectations, and the winding down of inflation proceeded more rapidly than initially envisaged. These developments reflected a front-loading of many aspects of the adjustment effort, relative to the trajectory foreseen under Albania's first annual ESAF arrangement (see Table 4), and lent greater credibility to medium-term objectives that were initially viewed as highly ambitious. The experience with structural reform has also been quite positive, although the pace slowed during 1994.

Real GDP has grown more rapidly in Albania than in other transition economies during 1993-94 (see below), albeit from a very low base following the collapse of production in the state-owned agricultural and industrial sectors. Growth is estimated at 11.0 percent in 1993 and 7.4 percent in 1994, led by construction, transportation, and other private services. <sup>2/</sup> Unemployment, which peaked at over 30 percent of the labor force, fell to 19 percent by end-1994.

Selected Countries in Eastern and Central Europe:  
Growth and Inflation Performance

	Albania	Bulgaria	Hungary	Poland	Romania
	<i>(percent change)</i>				
Real GDP					
1990-92 (average)	-16.2	-8.2	-6.1	-5.3	-10.2
1993	11.0	-2.4	-2.3	3.8	1.4
1994	7.4	0.3	2.6	6.0	3.4
Consumer prices (end-year)					
1992	237	79	22	44	199
1993	31	64	21	38	295
1994	16	122	21	29	62
Unemployment rate (end-year)					
1992	30	15	12	14	8
1993	22	16	12	16	10
1994	19	13	10	16	11

Sources: Recent IMF staff reports, Albanian authorities, and staff estimates.

<sup>1/</sup> Developments in 1993/94 (July 1993-June 1994) and the targets for 1994/95 are described in "Albania--Request for the Second Annual Arrangement under the Enhanced Structural Adjustment Facility" (EBS/94/168, 8/24/94).

<sup>2/</sup> Data on private sector economic activity are particularly weak. Thus, while there are widespread indications of a strong upturn in economic activity in 1993-94, quantitative estimates cannot be considered definitive.

Agricultural output, which now accounts for 50-60 percent of Albania's GDP, grew by 13 percent a year in 1992-93 following the privatization of most agricultural land. This expansion slowed to 7 percent in 1994, despite a sharp increase in livestock production, due mainly to the effects of a drought on crops. With the exception of vegetables and livestock, the recovery of the agricultural sector in 1992-94 has not yet restored output to its 1990 levels. Recent growth has been based on increases in acreage planted rather than improvements in productivity. Constraints on more efficient production include the small size of farm plots (averaging 1.2 hectares); low use of fertilizer, pesticides and mechanization; poor quality of seeds; and weak transport and marketing infrastructure. The response to these problems is hampered by the underdeveloped financial system and lack of a rural land market.

Industrial production declined by a further 2 percent in 1994. There was a modest increase in production at private manufacturing enterprises and joint ventures, primarily for foodstuffs. Most state enterprises outside the chromium, electric power, and cement sectors continued to shrink. In addition, production in these sectors was disrupted in late 1994 by shortages of hydroelectric power, caused by the drought and exacerbated by unusually cold weather in December.

The experience with inflation in Albania has also been relatively favorable. The decontrol of most prices contributed to increases in the CPI of 104 percent in 1991 and 237 percent in 1992; since then inflation has moderated steadily to 16 percent by end-1994, despite major adjustments of bread, energy, and public utility prices. The authorities have thus been able to put price distortions largely behind them without generating significant inflationary momentum. Factors contributing to this outcome included: (i) discipline over the expansion of credit--including strict observance of the limits for domestic financing of the budget and credit to public enterprises; (ii) an incomes policy that restrained public sector wages; (iii) the absence of indexation in the economy at large; (iv) the strong domestic supply response to price decontrol and the privatization of small businesses and agricultural land; (v) the availability of imports following early exchange and trade liberalization; and (vi) a relatively stable market-determined exchange rate, reflecting financial discipline and Albania's access to concessional external resources.

Staff estimates suggest that domestic investment rebounded in 1993 and strengthened further in 1994, led by private construction (and, in 1993, the accumulation of inventories). There was nevertheless a sharp reduction in the external current account deficit, due to the behavior of domestic savings. The improvement in domestic savings performance in 1993-94 reflected a combination of fiscal adjustment, the imposition of hard budget constraints on public enterprises, and rapidly rising incomes from private sector activity.

The status of observance of the quantitative benchmarks and performance criteria in the second half of 1994 is summarized in Table 1 of the Annex.

Continuing the strong performance observed under the first annual ESAF arrangement, Albania met all of the quantitative performance criteria at end-December following small slippages with respect to two of the end-September benchmarks. Of the benchmarks, the floor for gross official international reserves was not observed due to delay in a disbursement of external assistance, and the limit for the net domestic assets of the banking system was exceeded largely for technical reasons (as explained in paragraph 8 of the authorities' policy memorandum).

The original medium-term strategy for fiscal consolidation relied to a considerable extent on increases in tax revenues, but these have been smaller than expected owing to the continuing decline of the public enterprise sector and delays in the implementation of measures to improve tax and customs administration. The authorities were still able to meet their budgetary targets through larger-than-programmed reductions of current expenditure (Table 5). 1/ This has been facilitated by the decline in unemployment and reforms of the budget process, including the development of a system of treasury management. In addition, between mid-1992 and February 1995 government employment was reduced by 65,000 (or about 28 percent).

Fiscal developments during 1994 followed very closely the pattern of the previous year. The adoption of the budget was again delayed until March, and both tax collections and expenditure during the early months of the year were well below the expected levels. As the shortfall in expenditures was more pronounced, the domestic financing requirement of the budget amounted to less than 3 percent of GDP in the first half.

Fiscal revenues and expenditures were both roughly in line with projected levels during the second half. Improvements in customs administration adopted in late 1993 and the early months of 1994 began to be reflected in customs duty collections. 2/ In addition, unanticipated growth of transit trade generated further increases in excise tax receipts, import duties, and the "road tax" on retail sales of petroleum. Nontax revenues (particularly from privatization and sales of commodity aid) again exceeded expectations. These gains (some from non-recurring sources) were partially offset by continued shortfalls in revenues from other taxes, notably the profits tax and the new property tax.

Expenditures also rose sharply in the second half, while their composition shifted towards investment, operations and maintenance, and interest. The planning and execution of public investment improved as a

---

1/ The improvement in budgetary performance has come despite the expansion of the social safety net and the "fiscalization" of much of the quasi-fiscal deficit--through the assumption of interest obligations on nonperforming bank loans and the decline in tax collections from public enterprises, following the limitation of their access to bank credit.

2/ These included the introduction of minimum dutiable values for many imported items, and a strengthening of collection procedures at the borders.

result of the preparation in late 1993 of a Public Investment Program (PIP) for 1993-96 and the establishment in mid-1994 of a Cabinet agency to follow it up. Nevertheless, late in the year it became evident that control over expenditure commitments needed to be strengthened, as substantial unauthorized contracts for projects outside the approved PIP came to light (especially for housing). For the year as a whole the fiscal deficit reached 14 percent of GDP, with domestic bank financing equivalent to just under 8 percent of GDP (the program target).

Developments in other components of domestic credit were also consistent with the program targets: there was virtually no change in net credit to the public enterprises, while net credit to the private sector rose by 50 percent. As a result, the growth of broad money declined to 41 percent (from 74 percent in 1993) despite a sharp increase in the net foreign assets of the banking system (Table 6). As explained in previous staff reports and discussed in greater detail in the forthcoming background paper, interest rates are not market-determined and monetary policy relies primarily on credit controls. The authorities have begun taking steps to develop a money market and the instruments of indirect monetary control, including the initiation of treasury bill auctions in July 1994. Interest rates on commercial bank loans and deposits with a maturity of six months or longer are maintained at levels that are positive in real terms in relation to underlying inflation. 1/

There was a larger-than-programmed increase in gross official international reserves during 1994, as well as an increase of about US\$90 million in the net foreign assets of the commercial banks, despite a shortfall in external assistance (Table 7). This was due in part to a more rapid reduction of the current account deficit, but also to larger-than-expected inflows from private remittances and unrecorded transit trade. There was a further delay in an expected disbursement of balance of payments assistance from the EU, the causes of which now appear to have been resolved. Albania regularized its financial relations with the Paris Club creditors early in 1994, and concluded the last bilateral agreement in September. Discussions to resolve arrears to commercial creditors resumed in May, and Albania later began to make periodic payments to reduce the arrears of the state telecommunications enterprise.

Albania has maintained a unified, floating exchange rate since July 1992. After depreciating to about lek 130 per U.S. dollar at the time of unification, the exchange rate appreciated to around lek 100 per U.S. dollar

---

1/ Underlying inflation, estimated by adjusting changes in the CPI for the effects of adjustments in administered prices, was under 10 percent at end-1994. Since September 1994, guideline interest rates for 6- and 12-month bank deposits have been set at 13.5 and 16.5 percent, respectively, with mandatory minimum rates 150-200 basis points lower. Guideline rates for 6- and 12-month bank loans (not enforced) are 17 and 20 percent, and actual lending rates are significantly higher.

by late 1992, where it remained broadly stable through the first half of 1994 (Chart 1). In response to an unexpected increase in foreign exchange inflows to the private sector, a marked appreciation began in June and gathered momentum during the summer, with the exchange rate reaching lek 84 per U.S. dollar in mid-September. As reported previously in the context of Albania's request for the second annual ESAF arrangement (EBS/94/168), the authorities responded by reducing official interest rates, stepping up purchases of foreign exchange by both the Bank of Albania and the state-owned commercial banks, and taking steps to deepen the foreign exchange market. The lek subsequently depreciated again to 95 lek/dollar by late November. Preliminary staff calculations suggest that there was a real effective appreciation of the exchange rate on the order of 40 percent in 1993 and a further 8-10 percent by February 1995. 1/

The trading system has been highly liberal since late 1992, with no quantitative restrictions on imports. Nevertheless, trade liberalization has continued under the ESAF arrangement. The number of export categories subject to licensing or prohibition was reduced from 21 to 8 in mid-1993, then to 5 in March 1994, and further to 2 in March 1995. A simplification of import tariffs to three rate categories, in conjunction with the elimination of major import tariff exemptions, has been proposed in the context of the 1995 budget and is to be enacted by Parliament prior to Executive Board consideration of this review.

Measures were also taken in a number of other structural areas during 1994, including pricing, privatization, and the establishment of the legal basis for a market economy. Key steps during the first half included sharp reductions in price distortions and subsidies for energy products, the beginning of operations of the Enterprise Restructuring Agency (ERA), further progress in the privatization of small and medium-sized enterprises (SME's), and the preparation of a draft Civil Code and land registration law (which were enacted by Parliament in late July).

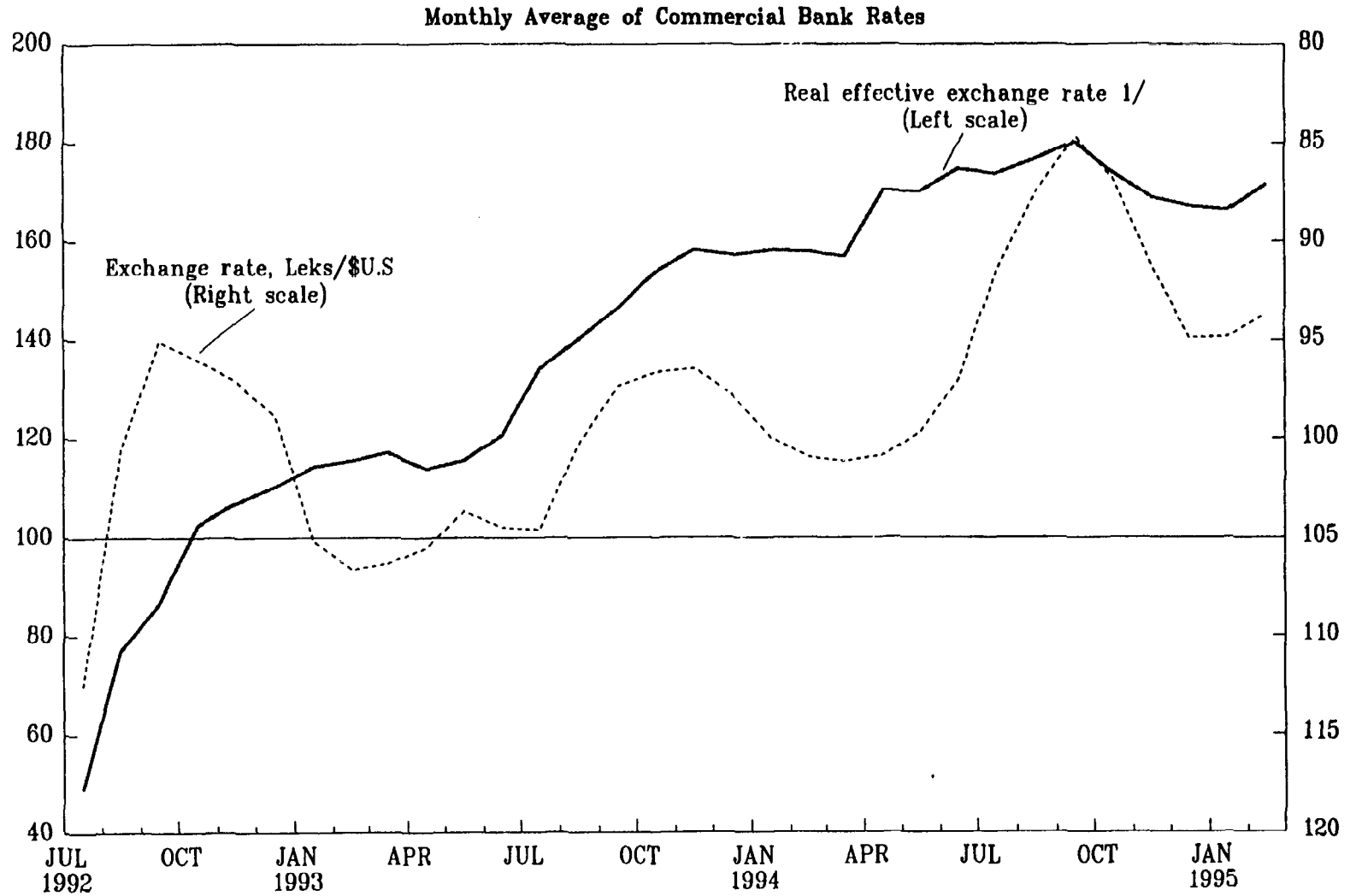
Owing largely to political events, the implementation of structural reforms during the second half of 1994 was less satisfactory, as described in detail in paragraphs 5, 10 and 11 of the authorities' policy memorandum and Annex Table 2. During the summer, the Government decided to submit a proposed new Constitution to a popular referendum, following a failure to secure its passage in Parliament during the preceding year. The defeat of this proposal in early November was followed by a period of turmoil within the majority political party, including a fundamental reassessment of economic and foreign policy. The end results have been largely positive--a reaffirmation of market-oriented economic policies, and actions to reduce tensions with neighboring countries. However, there were delays in a number

---

1/ Exchange rate developments need to be interpreted with caution: the currency market is relatively inefficient and largely cash-based, while estimates of the real exchange rate are complicated by uncertainties about the direction of trade.

CHART 1

Albania: Nominal and Real Effective Exchange Rate  
July 1992 - February 1995



Sources: Data provided by the authorities and staff estimates.

1/ Index, January 1991=100. Staff estimate based on provisional direction of trade data; an increase indicates an appreciation.

of important measures, including reductions in budgetary employment, the updating of the Public Investment Program, and the development of draft legislation for the planned customs tariff reform and the next steps in the development of a land market. Remedial measures have already been taken in a number of areas, and are to be in place prior to Board consideration of this review for all measures that constituted performance criteria in the second half of 1994.

### III. The Economic Program for 1995

#### 1. Objectives and strategy

Albania's economic program for 1995 represents a continuation of the medium-term strategy that has been pursued successfully since mid-1993. It maintains most of the key economic assumptions and objectives laid out at the time of approval of the second annual ESAF arrangement (EBS/94/168), including: (i) real GDP growth of 6.0 percent in 1995 and 5-6 percent a year thereafter; (ii) reducing inflation to 10 percent (December/December) in 1995 and single-digit rates in subsequent years; and (iii) a further strengthening of the international reserve position and progress toward external viability, including the resolution of external arrears problems. While the growth assumptions may appear ambitious, an expansion of real GDP of 5-6 percent a year over the next few years should not be out of reach, given the scope for efficiency gains in agriculture and the plans for infrastructure development. 1/ Sustained long-term growth will also require the creation of efficient new domestic manufacturing and tourism sectors, with a significant role for foreign direct investment.

The strategy for achieving these goals continues to be based on removing obstacles to private sector activity, further improving public sector savings and investment, strictly limiting credit expansion, incomes policy in the public sector, deepening market-oriented structural reforms, and mobilizing external support on highly concessional terms. The program envisages further improvements in domestic savings sufficient to permit significant increases in domestic investment while strengthening the external position. Public investment is expected to account for most of the increase, reflecting the need to improve Albania's severely deficient infrastructure in the areas of transportation, telecommunications, health, electricity, and water systems. Despite the import requirements associated with the rehabilitation and development of infrastructure, the external current account deficit is to be progressively reduced to less than 10 percent of GDP by 1997. The transition to a market economy is to be continued through a further redefinition of the role of government, enterprise reform and privatization, creation of a modern financial system, and further development of the legal and institutional underpinnings.

---

1/ Because future growth is likely to be based to a considerable extent on productivity gains in agriculture, it may not be as effective in bringing about a rapid further reduction of unemployment.

2. Monetary and exchange rate policy and financial sector reform

Monetary policy continues to play a key role in the effort to reduce inflation. The growth of broad money is targeted to decline to 23 percent during 1995, implying a decrease in the velocity of circulation of about 2 percent. This would be consistent with the accumulation of a further US\$20 million in gross official international reserves 1/ and a modest further expansion of the net foreign assets of the commercial banks, along with a 26 percent increase in net domestic credit. Credit to the private sector will be limited to 1 percent of GDP (an increase of 22 percent from end-1994), while credit to public enterprises will be held to 0.2 percent of GDP. The remainder will be used to cover the domestic financing requirement of the budget, which is targeted at 7 percent of GDP (compared with 8 percent of GDP in 1994). 2/

This pattern of credit growth reflects a number of factors. First, and perhaps most importantly, Albania's commercial banks have demonstrated that they are not capable of effective financial intermediation to the private sector at present. The nonperforming loans of the state-owned banks have continued to grow rapidly, mainly reflecting lending to the private sector during the last two years. 3/ Lending practices are extremely poor, and little attention has been paid to customer service or loan collection. The few foreign-owned banks have shown little interest in domestic lending, other than short-term trade credits in foreign currency. Second, the financing requirements of legitimate business are being met to a considerable extent through other channels, including informal lending, capital inflows, and specialized lines of credit from foreign donors--whose importance is expected to grow in 1995. Third, the authorities have judged that rapid expansion of infrastructure is vital to the further development of the private sector, and have thus budgeted for a substantial further increase in public investment spending. While this strategy appears to be appropriate under the current circumstances, in the coming years it will be necessary for Albania to develop the capacity for effective financial intermediation to the private sector, while reducing reliance on the banking system to finance the budget deficit.

---

1/ After allowance for the use of Albania's reserves in conjunction with a possible debt buyback agreement.

2/ The authorities intend, for the first time, to limit overdraft credit from the Bank of Albania (BOA) to less than 10 percent of the previous year's budgetary revenues (about 2.5 percent of GDP), as called for in the BOA Law. The remainder of the financing requirement is to be met through placements of T-bills. This underscores the importance of measures to strengthen the T-bill market, including those being taken as prior actions.

3/ The ratio of nonperforming loans to credit granted since the reorganization of the banking system in mid-1992 reached 27 percent by the end of 1994.

Efforts to restructure the banking system have been stymied by the difficulty of reaching agreement on a comprehensive strategy and the lack of banking skills in Albania. Thus, while the Bank of Albania has been able to improve gradually the quality and timeliness of information on money and credit and tighten control over the extension of credit by the state-owned commercial banks, otherwise the financial system remains fundamentally as it was at the beginning of the ESAF arrangement.

Bank reform is now proceeding on three fronts, with the support of the World Bank and other donors. First, a renewed attempt to reform the state-owned commercial banks began in early 1995. The authorities hope that at least one of the banks can be transformed into an effective financial intermediary. However, based on the unsuccessful earlier attempt to rehabilitate the Rural Commercial Bank (RCB), with substantial external technical assistance, as well as experiences in other transition economics, the staff has cautioned that significant improvements in performance may be difficult to achieve, and urged that efforts be concentrated on improving the efficiency of the state banks as a payments mechanism. Recent steps included the appointment of new management at the National Commercial Bank (NCB) and the Savings Bank (SB), and the establishment of a department at the Ministry of Finance to exercise more actively the Government's ownership responsibilities. More broadly, the authorities are seeking to clarify the balance sheets of the banks and reduce their operating losses, improve services to clients, and strengthen loan collection; during 1995 they also intend to privatize some bank branches. For the immediate future, the NCB is likely to serve mainly as transactions agent for the Government and the SB mainly as a means to channel funds from depositors into the T-bill market. Options being considered for the RCB include closure, merger with another state bank, or acquisition by a foreign investor.

The second front is the entry of new private and foreign financial institutions. The authorities agree with the staff's view that good banks are most likely to develop under private ownership, but are concerned that this may not take place quickly enough. No applications for banking licenses have been submitted following the enactment of new licensing regulations in early 1994, and these are now being reviewed to see if further streamlining of procedures can be achieved without unduly lowering standards. Discussions with the existing foreign banks suggest that uncertainty over the profitability of domestic lending and concern over the ability to enforce loan collections also remain deterrents to entry. The staff has suggested that the authorities facilitate the entry of new institutions through the privatization of some of the most desirable branches of the state banks. A third track is the development of nonbank financial intermediaries and other sources of financing for the private sector. Donors have shown particular interest in expanding lines of credit for SME's, and the Kreditanstalt für Wiederaufbau has proposed establishing a specialized institution for this purpose that would be transformed subsequently into a bank.

While the inefficiency of the banking system is a serious impediment to economic development in Albania, this has also made it easier to avoid large-scale credit expansion to support nonviable public enterprises. Moreover, although the entry of new banks and the expansion of the operations of existing foreign banks may take some time, a banking system which grows in line with the development of legal institutions and supervisory capacity may stand a better chance of being a sound one. This underscores the urgency of progress on all fronts--managerial reforms, training, financial market development, legal framework, and bank supervision.

Owing to the underdevelopment of the financial system, interest rates in the banking system are not market-determined and interest rate developments provide little insight on monetary conditions. 1/ The authorities and the staff have attempted to use information on inflation and real economic activity, supplemented by anecdotal information about interest rates in the informal credit market, to help gauge the stance of monetary policy.

Movements in the real and nominal exchange rate are also important monetary indicators. Since early 1993, the growth of broad money has frequently exceeded the program target, despite the success in keeping the growth of credit within the program ceilings. This has reflected the decision to permit the net foreign assets of the Bank of Albania and the commercial banks to grow more rapidly than programmed in response to unexpectedly large inflows of foreign exchange, apparently reflecting strong money demand. In addition, as evidenced by developments in the second half of 1994, the authorities have taken large, rapid exchange rate movements into account in setting the level of interest rates in the banking system.

Given the role which export growth and efficient import-substitution are expected to play in Albania's economic development strategy, as well as the need for further improvements in the balance of payments position, the authorities have watched closely the apparent real appreciation of the lek. To a considerable extent, the appreciation through end-1993 reflected a correction of the overshooting which occurred when the exchange rate was first unified and floated. By early 1993, the uncertainty about social stability and inflation prospects had been substantially reduced, and by early 1994 Albania had virtually eliminated its dependence on emergency food imports. The modest further real appreciation since then has been a source of some concern, although the current level of the real exchange rate is

---

1/ While the interest rate on treasury bills is established by auction, there have been very few participants in T-bill auctions and most purchases have been made by one institution, the Savings Bank. As summarized in paragraphs 18 and 19 of their policy memorandum and described in the forthcoming background paper, the authorities are taking further steps in 1995 to increase the flexibility of the T-bill market, deepen participation, and develop the capability for indirect monetary control.

considered broadly appropriate. The authorities have judged that large private capital flows, the small size and inefficiency of the foreign exchange market, and uncertainty about the impacts of interest rate changes render explicit exchange rate targeting inadvisable. There is little remaining scope to use interest rate policy actively to resist further real appreciation, and the development of instruments to sterilize foreign exchange purchases is still at an early stage. Thus, the staff underscored the desirability of being prepared to tighten fiscal policy, if necessary, to help offset higher-than-programmed increases in international reserves.

### 3. Fiscal policy

The Government expects that fiscal policy will make an important further contribution to the effort to increase national savings and investment in the coming years. The 1995 budget relies on reductions of current expenditure for further progress in fiscal consolidation. Although total revenues for 1994 were roughly in line with the program, this was done to a considerable extent to non-recurring sources of revenue, while the underlying trend in tax revenues remained weaker than expected. In view of the implications for revenue performance in 1995 and also of the authorities' determination to accelerate the creation of public infrastructure, it proved necessary to reassess the fiscal targets for 1995 (a possibility that was presaged in the staff report for Albania's second annual ESAF arrangement, EBS/94/168, p.10). As described above, it proved feasible to accommodate a domestically-financed budget deficit of 7 percent of GDP within the monetary program, without increasing the growth rate of broad money or weakening the target for international reserves.

While this represents a significantly larger domestic financing requirement than envisaged in the original medium-term macro framework of July 1993 (5 percent of GDP, with only 4 percent from the banking system), the program for 1995 still represents a continuation of fiscal adjustment. In particular, the government's current balance is budgeted to improve by 3 percent of GDP, and its domestic financing requirement to fall by 1 percent of GDP.

For the coming years, however, the staff has underscored that a major improvement in tax revenue performance will be essential if Albania is to achieve the targeted further improvement of public savings and reduction of the domestically-financed fiscal deficit. This will need to depend primarily on broadening the tax base, as the scope for raising revenues by increasing the rates of existing taxes is now very limited. 1/ However,

---

1/ Import tariffs are relatively high, and excise taxes on electricity will need to be reduced once the capability of the electricity company to make effective use of internally-generated investment funds has been established. Profits tax revenues will continue to shrink as a percentage of GDP--at least, until a significant part of recently-established private sector activity becomes liable to the tax in the late 1990s.

significant increases in revenues from most new taxes are unlikely in the near term, in part due to the difficulty of administration. The solution that has been adopted for 1995 has been to reduce exemptions from taxes on domestic consumption and imports and, with the assistance of the IMF/World Bank Tax Administration Modernization Project, to replace the present complex and inefficient turnover tax with a VAT, with a single rate and minimal exemptions. The VAT is now expected to be introduced in late 1995.

An important element of expenditure restraint in 1995 is the decision to increase wages in budgetary institutions by only 10 percent, and to offset much of the cost of this increase through further reductions in public employment. This reflects a continuation of the use of incomes policy both as a supplementary nominal anchor of the program--particularly at potential turning points in inflation performance--and as a means of restructuring wages in the public sector. As noted in Table 8, by mid-1992 average real wages in the budgetary institutions had been reduced to only about half of their 1990 level, while those in public enterprises were considerably higher. Subsequently incomes policy has led to a gradual recuperation of civil service salaries and widening of salary differentials for senior public servants, while further reducing real wages in the public enterprises. Employment in budgetary institutions, which averaged about 174,000 in 1994, is to be reduced to no more than 160,000 by June 1995. Another element of expenditure restraint is a significant compression of operations and maintenance expenditures, mainly reflecting the non-recurrence of certain extraordinary expenditures at end-1994.

The Government now plans to finalize its updated Public Investment Program in April 1995, in preparation for a donor meeting under G-24 auspices in mid-May. To help safeguard the targeted increase in public investment, the program ceilings for net credit to government and net domestic assets of the banking system will be adjusted downward for any under-execution of domestically-financed investment expenditures; these ceilings will also be reduced as previously, for shortfalls in expenditures by the ERA for enterprise reform and for larger-than-programmed receipts of balance of payments assistance to the budget.

Total revenues are budgeted to decline by about 1 percent of GDP in 1995, reflecting a decline of 2 percent of GDP in nontax revenues (including counterpart receipts from food aid sales) and a modest increase in tax collections, as described in paragraphs 14-15 of the authorities' policy memorandum. Import duties are expected to be the most important source of revenue gains, as a result of the tariff reform and further administrative

improvements. 1/ Measures are also being taken to reduce exemptions from the turnover tax and adjust excise and small business tax rates, to help cushion the decline in collections from public enterprises; and there is a renewed effort to enforce the property tax (in collaboration with local authorities, who will be allowed to retain 60 percent of the revenues). The state electricity company has recently initiated a program to improve the collection of electricity bills and discourage energy theft, which would improve its ability to meet tax obligations on a timely basis; however, this could also set the stage for future reductions in taxes on electricity in exchange for the elimination of direct support for electricity investments through the public investment program.

The improvements in budgetary monitoring and control that were achieved in 1994, including the incorporation of the revenues and expenditures of the Social Security Institute and the National Housing Agency into a single budget process, will be continued. These procedures will also be extended to the new Health Insurance Institute, and procedures will be implemented by the Treasury to improve the monitoring of externally-financed project expenditures.

#### 4. Exchange and trade systems

Albania's exchange system is free of restrictions on payments and transfers for current international transactions, other than outstanding obligations under inoperative bilateral payments agreements, which are subject to approval under Article VIII. Albania hopes to be able to accept the obligations of Article VIII by end-1995. In view of the openness of the economy, the authorities are also considering the abolition of capital controls. The authorities will maintain the market-determined floating exchange rate system, and will continue efforts to foster the institutional development of the foreign exchange market.

To facilitate sustainable export development, the Government will maintain an open trade regime designed to promote access to imported inputs and equipment, finish the privatization of the state trading sector, continue to establish a policy and legal framework conducive to foreign investment, improve infrastructure and utility services, and seek to

---

1/ The reform involves the elimination of exemptions for investment goods and medical equipment, which will increase the tax base by about 25 percent; the introduction of the Harmonized System tariff nomenclature at the 6-digit level, in place of the present (modified) 2-digit nomenclature; and the replacement of the present tariff rate structure, which consists of rates of 5, 10, 20 and 35 percent, with a simpler structure with rates of 10, 25, and 40 percent. In addition, the effort to strengthen customs administration, with the assistance of resident experts under the IMF/World Bank Tax Administration Modernization Project, will continue. Plans are being developed to introduce UNCTAD's computerized system of customs data, ASYCUDA, in 1996.

maximize access to external markets by joining the WTO. The only remaining quantitative trade restrictions are a licensing requirement for exports of unprocessed wood and a prohibition on exports of certain types of metal scrap. By mid-1995 the Government intends to eliminate the export licensing requirement for wood; the prohibition on scrap metal will remain for 1995, to help guard against the looting of certain large state enterprises. Following the impending reform of the import tariff regime, a further simplification to 1-2 tariff rate categories is being considered for 1996.

#### 5. Other structural reforms

Other key areas for structural reform during 1995 are the restructuring and privatization of public enterprises and further development of the legal framework for a market economy, including the ability to exercise effective ownership of land. The divestiture of agricultural land and small shops was largely completed in 1993, and the majority of small and medium-sized enterprises (SME's) were estimated to have been privatized by late 1994. However, there has been a virtual standstill of SME privatization since mid-February 1995, pending the outcome of discussions with World Bank staff of a possible mass-privatization scheme. The emerging outlines of this proposal, which could go into operation during the second half of 1995, include (i) the resumption of auction-based privatization for small enterprises; (ii) the transformation of the remaining public enterprises into joint stock companies; (iii) an initial mass distribution of "privatization vouchers" during the summer, to be followed by additional distributions in future years; and (iv) a series of auctions of shares in non-strategic large enterprises and the more valuable medium-sized enterprises, with the majority of shares to be sold in exchange for vouchers.

While encouraged that concrete plans are now emerging for the privatization of most large state enterprises, the staff has underscored the importance of resuming SME privatization as soon as possible and proceeding with ERA action plans. It has also conveyed its concern that the mass-privatization scheme not be designed in a way that diffuses effective control of enterprises, or leads to budgetary expenditures or directed credit to perpetuate the operations of nonviable firms. The administrative complexity of the scheme is also a disadvantage, which the authorities hope to address in part through external technical assistance. An update on developments in this area will be provided prior to the Executive Board discussion.

Plans for the privatization of "strategic" enterprises (natural resource-based firms and public utilities) remain essentially as described in the latest PFP (EBD/94/145, 8/25/94). Non-core subsidiaries will be divested and privatized in the general scheme, and an attempt made to identify strategic domestic or foreign investors for the core activities (either as majority owners or through joint ventures). Subsequently a minority stake could also be made available for the mass-privatization program.

To help backstop efforts to restructure the banking and enterprise sectors, the authorities are seeking to introduce a modern bankruptcy law. An initial draft is now under review by Fund and World Bank staff, and a Fund technical mission (LEG) is planned for late spring.

The authorities are taking action to address one of the key impediments to private and foreign investment in Albania--the lack of clear assignment of land ownership and a land market. The Government intends to formalize the previous distribution of agricultural land by completing the issuance of ownership certificates by end-May. Many issues relating to the sale, lease, and mortgaging of land have been addressed in recent months, and the legal basis for urban land transactions appears to be in place. A comprehensive draft law on the sale of rural land is expected to be approved later this month by the Council of Ministers. A land registry is being established with technical assistance from the United States; while its finalization will take a number of years, it is expected that the results in selected regions will help to form a basis for the initiation of a more formal market in rural land.

6. Balance of payments and external financing for 1995

Albania's external current account deficit is expected to decline to about US\$225 million or just over 11 percent of GDP in 1995 (Table 7). This projection incorporates a continued rapid recovery of exports from their depressed 1992 base, import growth associated in particular with the development of infrastructure, a decline of external interest obligations as a result of debt restructuring, and no change in the inflow of private remittances from its 1994 level. Taking into account the projected net inflow of private capital, a reduction of US\$61 million in arrears to non-Paris Club bilateral creditors and suppliers, 1/ and an increase of US\$68 million in gross international reserves of the Bank of Albania (before taking into account any use of reserves in connection with a debt buyback operation--see below), the external financing requirement is estimated at about US\$315 million.

This financing requirement is expected to be met through disbursements of external financing and debt relief, both on highly concessional terms. Debt relief from non-Paris Club bilateral creditors is projected at about US\$50 million. Multilateral disbursements would include US\$18 million from the ESAF, US\$35 million from IDA, and US\$30 million from the EBRD and other multilateral agencies. Assistance from bilateral donors and the European Union is projected at US\$180 million, including US\$20 million of additional

---

1/ This reduction would come mainly through debt reduction and rescheduling. Arrears to Paris Club creditors, who are also major donors to Albania, were eliminated during 1994.

project-related assistance that is expected to be mobilized for the second half of 1995 through a G-24 donor meeting later this spring. There is not estimated to be any residual financing requirement for the first half of 1995.

Table 7 also assumes that there will be a solution to external arrears to commercial bank creditors early in the second half of 1995, entailing payments of about US\$90 million by Albania to eliminate US\$480 million of arrears. Sources of financing already identified include up to US\$48 million of foreign exchange reserves previously constituted for this purpose, and US\$20 million already committed by the IDA Debt Reduction Facility. Albania intends to seek other financing on highly concessional terms to support this operation, once the terms are finalized.

7. Medium-term external outlook and capacity to repay the Fund

Notwithstanding a continued strong performance, Albania's external position remains fragile. Continued progress towards external viability will depend on the energetic pursuit of the structural and financial reforms underpinning the development of export activity and efficient import substitution; sustained concessional support from international donors; and the conclusion of a restructuring of Albania's remaining external payments arrears on terms appropriate to Albania's low level of income and limited debt servicing capacity. Under these conditions, the updated medium-term outlook continues to suggest that external viability could be achieved towards the end of the decade.

The external current account deficit is projected to decline somewhat further over the medium term from US\$240 million in 1994 (14 percent of GDP) to about US\$215 million (6 percent of GDP) in 2000. Export growth is expected to taper off over the medium term from recent rates of around 20 percent a year to about 13 percent. Imports, which declined by about 7 percent in real terms in 1994 with the elimination of the food-aid need, are expected to increase broadly in line with GDP growth over the medium term as the large capital investment needs are somewhat counterbalanced by a modest development in efficient import substitution. The services balance is projected to improve sharply, largely reflecting a reduction in debt service obligations following a commercial arrears buyback and rescheduling of other non-Paris Club bilateral arrears later in 1995.

Expatriate remittances are a source of particular uncertainty over the medium term. Their recent growth has been an important source of support for domestic consumption and has helped to underpin the growth of imports. In this scenario, remittances are projected to remain unchanged in nominal terms from recent levels, reflecting a leveling-off of the number of emigrant workers. Under the impulse of the normalization of external financial relations and the pursuit of the structural reforms, including privatization, foreign direct investment is expected to grow modestly. Albania is also expected to have access to limited short-term trade financing.

On these assumptions, and with the maintenance of official reserves at just over 3 months of imports, the gross external financing requirement is expected to be reduced to about US\$200 million in 1996 and to stabilize at about US\$170 million a year over the medium term, a level which could reasonably be expected to be covered by concessional external assistance.

The debt service burden would be reduced to about 10-11 percent of export proceeds in 1995-97 and about 8 percent in 1998-2000. The external debt burden would drop to about 31 percent of GDP (240 percent of exports) at end-1995 and stabilize at about 25 percent of GDP (175 percent of exports) over the medium term. Without a buyback of the commercial arrears on highly concessional terms, the external outlook would not show a convergence to viability.

As summarized in Table 9, Albania's capacity to service its obligations to the Fund is not materially different from that presented at the time of the second annual arrangement (EBS/94/168; 8/24/94). Debt service to the Fund would peak in nominal terms at SDR 8.6 million (1.9 percent of GNFS exports) in 2002; while debt to the Fund would peak with the final ESAF purchase in 1996, at 236 percent of exports (3 percent of GDP). The first repurchases of Fund ordinary resources purchased under the 1992/93 stand-by arrangement are falling due in late 1995, and should be met without difficulty. The continued solid improvements in the external performance bode well for Albania's capacity to pay the Fund, and on the assumptions noted above, servicing these obligations would not be a great burden.

#### 8. Technical assistance, environmental, social and statistical issues

Technical assistance from both bilateral and multilateral sources has made a major contribution to the design and implementation of Albania's adjustment effort, and the availability of appropriate resources for this purpose has been an important determinant of the speed and sequencing of reforms. Among the largest sources have been the European Union, Germany, the United Nations system, and the United States. Such assistance has covered a broad range of economic, legal, and institutional areas; the activities of the Fund are summarized in Appendix I. Taking into account its limited administrative capacity, Albania has a relatively positive record on the implementation of technical recommendations. Recognizing that recent high levels of technical assistance will be difficult to sustain, the authorities place a high priority on the training of Albanian residents and the utilization of domestic experts in conjunction with the planning and implementation of projects supported by external donors.

The initial expansion of social safety net expenditures from the budget under the program has helped to reduce the human cost of transition and maintain the consensus in favor of reform. Environmental concerns have shaped a number of recent policy initiatives. An update on social and environmental issues is provided in Appendix III. As described in Appendix IV, considerable progress has been made--with technical assistance from the IMF and other sources--in introducing new price, employment, monetary,

fiscal, trade, and balance of payments statistics. Nevertheless, many of these series are still subject to significant deficiencies and reporting lags, which complicate the formulation and monitoring of economic policy.

#### 9. Program monitoring

Quantitative benchmarks have been established through June 1995 for the following variables: (i) net domestic assets of the banking system; (ii) net bank credit to the Government; (iii) net bank credit to the state enterprises; (iv) the gross international reserves of the Bank of Albania; (v) contracting or guaranteeing of nonconcessional external loans with maturities of 1-12 years and 1-5 years, respectively; (vi) public and publicly-guaranteed external debt with maturities of up to one year; and (vii) external payments arrears. The proposed quantitative benchmarks are shown in Table 3 of the Annex.

Table 4 of the Annex summarizes the structural prior actions and benchmarks. The prior actions relate to the preparation of an updated public investment program for 1995-97; the enactment by Parliament of legislation for the customs tariff reform and VAT; approval by the Council of Ministers of a draft law on rural land sales; and measures to introduce greater flexibility in the T-bill market. Structural benchmarks comprise completing the distribution of certificates of land ownership; approval of a draft law on the expedited settlement of land disputes; the implementation of an action plan to improve financial management and collection performance by the state energy company, and reductions in its overdue bills; the programmed further reduction in budgetary employment; the securitization of a portion of the Government's debt to the Bank of Albania; actions relating to the reform of the state-owned commercial banks; approval of a draft bankruptcy law; and the elimination of the export licensing requirement for wood.

#### IV. Staff Appraisal

Albania again made substantial progress during 1994 in the transition from rigid central planning toward a market economy. Financial policies were broadly satisfactory; implementation and monitoring capacity was improved; there was further reform of the already highly liberal exchange and trade systems; the relatively few remaining domestic pricing distortions were reduced; the privatization of small- and medium-sized public enterprises proceeded rapidly; and some steps were taken towards the establishment of an appropriate legal framework, including the adoption of a modern civil code. This was reflected in strong growth performance, further declines in unemployment and inflation, and another significant reduction of the external current account deficit and buildup of international reserves.

However, Albania remains by far the poorest country in Europe, with uncomfortably high unemployment. Addressing these challenges requires the creation of an enabling environment for private economic activity and foreign investment. The continuation of the adjustment process will thus

need to entail both continued financial discipline and a more determined effort to develop the institutions of a market economy, while increasing infrastructure investment. In this context, recent further slippages in the implementation of growth-oriented structural reforms--most notably in privatization and banking sector reform--are particularly unfortunate. The authorities should make the most of opportunities in 1995 to energize lagging structural reforms and lay the groundwork for future progress.

Fiscal policy is at a similar crossroads. A major source of Albania's better-than-expected economic performance in 1993-94 has been the strong response of private savings to the new economic environment. For the coming years, however, it will be necessary for the authorities to rely more on improvements in public savings, to permit higher investment while moderating inflation and continuing progress toward a sustainable balance of payments position. The achievement of the fiscal targets in 1993-94 and the strategy for 1995 have depended mainly on the compression of current expenditures, but improvements in public savings are unlikely to be attainable in subsequent years without better revenue performance. This should rely on establishing a simpler, more efficient, and more transparent tax system rather than increases in tax rates. The enactment of a revised customs tariff code and VAT legislation are crucial steps in this process.

The development and updating of a medium-term Public Investment Program have made a major contribution to public expenditure management, but the experience in 1994 demonstrates the importance of more continuous monitoring of the execution of the investment budget and the avoidance of non-budgeted expenditures. It will also be necessary to maintain discipline over current expenditures, including personnel costs. The decision to increase the wages of budgetary employees by no more than the targeted rate of inflation in 1995 is important both for fiscal reasons and to help safeguard against a resurgence of inflationary pressures, following the rapid expansion of money and credit in the second half of 1994. Over the medium term, however, addressing the widespread deficiencies in public administration--in efficiency and professionalism, in statistical systems and monitoring capacity, and in the availability of specialized expertise--is likely to entail further significant real increases in government salaries, with differentiation for senior officials. Reconciling this with fiscal consolidation will require further rationalization of employment.

Control of inflation will require a progressive reduction in the rate of growth of the money supply, through restraint over the expansion of domestic credit, supplemented by public sector wage policy. While the pattern of credit growth envisaged for 1995 appears broadly appropriate, as a sound financial system develops it will be important to leave greater scope for the expansion of lending to the private sector.

The authorities coped relatively well in the past year with the uncertainties of monetary policy in the transition, in part by taking exchange rate developments appropriately into account in their policies toward the accumulation of international reserves and the level of

controlled interest rates. During the coming year, the authorities should stand ready to strengthen financial policies in response to any signs of deteriorating inflationary expectations; and in any event, they should make the most of opportunities to offset any further larger-than-expected reserve increase through open market operations and, if necessary, a reduction of the target for the domestically-financed budget deficit. To guard against a weakening of money demand, it will be important for interest rates on bank deposits to be maintained at levels that are positive in real terms, in relation to underlying inflation.

The authorities will also need to continue efforts to develop the instruments of indirect monetary control, including the establishment of a deeper and more flexible treasury bill market and the securitization of government liabilities to the central bank. Recent initiatives to improve the state-owned commercial banks and develop a complementary legal framework, with the assistance of the World Bank and other donors, need to be followed up quickly and resolutely. However, putting these banks on a sound commercial basis is likely to be a lengthy process, and in the interim the authorities will need to do their best to encourage the entry of private and foreign financial institutions through the transparent application of the new licensing standards.

Completing the privatization of small- and medium-sized public enterprises and extending the privatization process to the large enterprises are critical steps for the coming year, as it will be important to put the assets to more productive uses and eliminate the temptation to subsidize enterprises. Widespread ownership of privatized assets, including through mass privatization, can provide important economic benefits while helping to consolidate public support for the transition to a market economy. However, it is essential that any mass-privatization scheme contribute to, rather than delay, the effective transformation of ownership and the downsizing or closure of nonviable enterprises. In addition, to help ensure the full realization of the potential benefits of privatization and economic liberalization, the further legislative and administrative measures needed to establish markets for urban and rural land should be implemented as quickly as possible.

The staff welcomes the authorities' intention to further streamline Albania's already relatively liberal exchange and trade systems. The intention to accept the obligations of Article VIII, sections 2, 3, and 4, in the foreseeable future is particularly encouraging, and will be monitored closely in light of the progress in discussions toward eliminating outstanding balances under inoperative bilateral payments agreements, which constitute restrictions subject to approval under Article VIII. In the absence of a clear timetable for removal, the staff does not recommend approval of these restrictions at this time.

The external outlook has continued to improve since the evaluation done at the time of consideration of the second annual arrangement under the ESAF. Nevertheless, Albania's capacity to repay the Fund remains dependent

on the continued availability of highly concessional external assistance over the medium term. The attainment of external viability also depends on resolving the commercial arrears problem on terms that can be supported by the IDA debt reduction facility; the staff would underscore the importance of the authorities' making the most of the opportunity afforded by the recent intensification of negotiations with the banks. The staff strongly urges donors to continue financing Albania's program with the projected volume of concessional resources, and fully supports the authorities' expected request for cofinancing of the IDA grant for the proposed commercial debt reduction operation.

As noted in previous staff appraisals, the difficult transition process, Albania's limited administrative capacity, and the regional security situation all pose risks to the program. However, Albania has a noteworthy record of macroeconomic performance and structural adjustment, the authorities have repeatedly demonstrated their commitment to reform, and external support remains substantial. All of the quantitative performance criteria for end-December 1994 were met, and the authorities have taken actions to remedy the unfortunate slippages in the implementation of measures constituting structural performance criteria. Under the circumstances, the staff recommends approval of the authorities' request for a waiver of the nonobservance of these performance criteria and the completion of the midyear review under the second annual ESAF arrangement.

It is expected that the next Article IV consultation will take place on the standard 12-month cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. Albania has consulted with the Fund in accordance with paragraph 2(d) of the second annual arrangement under the Enhanced Structural Adjustment Facility (EBS/94/168, Supplement 2, 9/23/94) and the final paragraph of the letter of the President of the Republic of Albania dated August 22, 1994.

2. a. The letter of the President of the Republic of Albania dated April 10, 1995 and the memorandum annexed thereto shall be attached to the first annual arrangement, and the letter dated August 22, 1994 and the memorandum annexed thereto shall be read as supplemented and modified by the letter of April 10, 1995 and its annexed memorandum.

b. Accordingly, the indicators referred to in paragraph 3(a) of the second annual arrangement shall include the benchmarks set out in Table 3 and Table 4 (Section II) of the memorandum attached to the letter dated April 10, 1995.

3. The Fund determines that the midterm review specified in paragraph 2(d) of the second annual arrangement has been completed, and that Albania may proceed to request the disbursement of the second loan under the second annual arrangement, notwithstanding the nonobservance of the structural performance criteria referred to in subparagraphs 2(b)(ii), 2(b)(iii), and 2(b)(iv) of the second annual arrangement.

Table 1. Albania: Schedule of Disbursements Under the  
ESAF Arrangement, 1993-96

Amount of Disbursement	Available on or After (actual date)	Conditions for Disbursement
1. SDR 8.47 million (24 percent of quota)	July 30, 1993	Disbursed upon approval of ESAF arrangement
2. SDR 8.47 million (24 percent)	February 1994 (April 15, 1994)	Disbursed upon completion of mid-term program review
3. SDR 7.06 million (20 percent)	September 1994 (October 4, 1994)	Approval of second annual ESAF arrangement
4. SDR 7.06 million (20 percent)	February 1995 (exp. May 95)	Compliance with end- December 1994 performance criteria, and completion of mid-term program review
5. SDR 5.65 million (16 percent)	August 1995	Approval of third annual ESAF arrangement
6. SDR 5.65 million (16 percent)	February 1996	Compliance with end- December 1995 performance criteria, and completion of mid-term program review

Table 2. Albania: Projections of IMF Position During the Period of the ESAF Arrangement

	<u>1993</u>	<u>1994</u>		<u>1995</u>		<u>1996</u>
	July- Dec.	Jan.- June	July- Dec.	Jan.- June	July- Dec.	Jan.- June
<u>(In millions of SDRs)</u>						
Transactions under tranche policies						
Purchases	--	--	--	--	--	--
Ordinary resources	--	--	--	--	--	--
Substituted resources	--	--	--	--	--	--
Repurchases	--	--	--	--	0.78	2.42
Transactions under Special Facilities	--	--	--	--	--	--
Transactions under ESAF	<u>8.47</u>	<u>8.47</u>	<u>7.06</u>	<u>7.06</u>	<u>5.65</u>	<u>5.65</u>
Disbursements	8.47	8.47	7.06	7.06	5.65	5.65
Repayments	--	--	--	--	--	--
Total Fund credit outstanding (end of period)	<u>21.60</u>	<u>30.07</u>	<u>37.13</u>	<u>44.19</u>	<u>49.05</u>	<u>52.28</u>
Tranche policies	13.13	13.13	13.13	13.13	12.34	9.92
Special facilities	--	--	--	--	--	--
ESAF	8.47	16.94	24.00	31.06	36.71	42.36
<u>(In percent of quota)</u>						
Total Fund credit outstanding (end of period)	<u>61.2</u>	<u>85.2</u>	<u>105.2</u>	<u>125.2</u>	<u>139.0</u>	<u>148.1</u>
Tranche policies	37.2	37.2	37.2	37.2	35.0	28.1
Special facilities	--	--	--	--	--	--
ESAF	24.0	48.0	68.0	88.0	104.0	120.0

Source: IMF staff estimates.

Table 3. Albania: Macroeconomic Indicators and Targets, 1991-97

	1991	1992	1993	1994		1995 Proj.	1996	1997
				Program <u>1/</u>	Est.			
<u>(Percent change from previous period)</u>								
GDP and prices								
Real GDP	-27.7	-9.7	11.0	8.0	7.4	6.0	5-6	5-6
Retail prices (average)	36	226	85	27	23	11	9	8
(End of period)	104	237	31	24	16	10	9	7
Broad money								
Real broad money	--	-25	33	7	20	12	6	7
Domestic credit <u>2/</u>	170	113	56	33	32	23	15	14
External current account <u>3/ 4/</u>								
	-22	-66	-33	-17	-14	-11	-10	-9
Savings and investment								
Foreign savings <u>5/</u>	20	61	31	18	14	14	13	11
National savings								
Government <u>6/ 7/</u>	-13	-55	-18	-2	-1	5	10	14
Nongovernment	-27	-24	-10	-7	-6	-3	2	5
	14	-32	-8	7	6	9	8	9
Domestic investment								
Government <u>7/</u>	6	5	13	15	14	19	23	25
Nongovernment	6	4	7	8	7	11	14	15
	--	1	6	7	7	8	9	10
General government								
Revenue	31	25	28	27	28	27	28	30
Of which: Tax revenue	27	18	20	21	22	23	27	28
Expenditures & on-lending	62	47	45	43	41	40	40	40
Overall balance <u>8/</u>	-44	-22	-16	-17	-14	-14	-12	-10
Domestic financing	44	22	10	8	8	7	4	2
Broad money/GDP <u>9/</u>								
Velocity <u>10/</u>	69	58	44	40	42	43	43	43
	1.7	2.6	2.8	2.7	2.5	2.5	2.5	2.5
<u>(In millions of U.S. dollars)</u>								
Gross usable external reserves <u>4/</u>								
(Excluding gold)	11	30	142	182	205	225	235	245
(Weeks of imports) <u>11/</u>	1.4	2.5	9.7	12.5	14.4	14.5	14.3	14.2

Sources: Information provided by the Albanian authorities; and staff estimates.

1/ As presented in EBS/94/168.

2/ Change in percent of broad money stock at end of previous year.

3/ Excluding official transfers.

4/ Baseline scenario (assumes debt buyback in 1995).

5/ Current account excluding net factor income and official transfers.

6/ Excludes counterparts of food aid.

7/ Data for 1992-93 and program projection for 1994 have been revised to exclude imputed expenditures associated with the channeling of foreign commodity loans to public enterprises.

8/ Including net repayment of arrears.

9/ End-year broad money divided by annual GDP.

10/ Annualized GDP in last quarter divided by end-year broad money.

11/ Imports of goods and non factor services.

Table 4. Albania: Evolution of Medium-term Projections 1/

	1993	1994	1995	1996	1997
	(Percent change from previous year)				
Real GDP <u>2/</u>					
I	3.7	4.0	4.5	5.0	...
II	11.0	8.0	5-6	5-6	5-6
Current	11.0	7.4	6.0	5-6	5-6
Consumer prices <u>3/</u>					
I	40	21	17	15	...
II	31	24	10	9	7
Current	31	16	10	9	7
	(In percent of GDP)				
External current account <u>4/</u>					
I	-47	-36	-26	-19	...
II <u>5/</u>	-33	-17	-14	-12	-10
Current <u>5/</u>	-33	-14	-11	-10	-9
Domestic investment					
I	12	16	20	21	...
II	12	15	21	22	24
Current	13	14	19	23	25
National savings					
I	-30	-15	-1	5	...
II	-18	-2	6	10	13
Current	-18	-1	5	10	14
Government savings <u>6/</u>					
I <u>7/</u>	-12	-7	-3	3	...
II <u>7/</u>	-9	-7	-2	4	6
Current	-10	-6	-3	2	5
Domestically-financed budget deficit					
I	11	7	4	2	...
II	10	8	4 <u>8/</u>	2 <u>8/</u>	1 <u>8/</u>
Current	10	8	7	4	2

Sources: Albanian authorities, and staff estimates.

1/ "I" indicates projections at the time of the request for the first annual ESAF arrangement (EBS/93/93,6/16/93); "II" indicates projections at the time of the request for the second annual ESAF arrangement (EBS/94/168,8/24/94).

2/ Annual average.

3/ December/December.

4/ Excluding official transfers.

5/ Including the effects of a future debt buyback operation, for 1995 onward.

6/ Excludes counterpart from sales of food aid.

7/ Program projections and data for 1993-94 have been revised to exclude expenditures associated with the channelling of foreign commodity loans to enterprises.

8/ EBS/94/168 presaged a possible upward revision of out-year financing requirements, in view of lagging revenue performance.

Table 5. Albania: Summary of Fiscal Accounts, 1992-95 <sup>1/</sup>

	1992	1993	1994				1995		
			First Half	Second Half (Prog.) <sup>2/</sup>	Second Half (Est.)	Full Year (Prog.) <sup>2/</sup>	Full Year (Est.)	First Half (Prog.)	Full Year (Prog.)
(In billions of leks)									
Total revenue plus grants	12.5	32.2	20.6	25.9	25.5	46.1	46.0	24.2	53.4
Counterpart revenues from commodity aid	2.9	4.5	2.2	1.4	2.0	3.7	4.2	1.1	2.1
Tax revenue	8.7	22.8	15.6	24.7	20.3	37.2	36.0	19.9	45.3
of which:									
Turnover and Profits taxes <sup>3/</sup>	3.7	9.0	4.0	5.6	3.7	9.7	7.7	3.7	8.6
Social security	1.7	3.2	3.0	3.0	3.4	5.8	6.4	3.8	8.5
Customs	1.5	3.6	2.7	3.2	3.6	5.9	6.3	4.2	9.7
Excise tax	1.3	4.3	3.6	5.0	5.9	8.6	9.5	5.3	11.0
Other taxes <sup>4/</sup>	0.5	3.6	3.2	5.7	5.9	8.8	9.0	2.9	7.5
Nontax revenue	0.8	4.9	2.7	2.8	3.2	5.1	5.9	3.2	6.0
Total expenditure	23.4	50.4	26.1	45.6	42.1	72.6	68.3	36.0	80.7
Current expenditure	21.3	38.6	20.4	32.7	31.7	53.6	52.1	26.1	56.3
of which:									
Personnel	5.4	10.1	7.0	7.8	8.4	14.8	15.4	8.8	17.9
Operations and maintenance	5.1	7.6	3.5	6.0	7.1	9.4	10.6	4.2	10.0
Interest	0.7	2.9	0.9	2.3	3.5	3.6	4.4	2.2	6.1
Enterprise subsidies	2.3	--	--	--	0.3	--	0.3	--	--
Social safety net	7.1	16.8	9.0	14.4	11.9	23.5	20.9	10.8	22.2
Enterprise support	--	1.2	0.0	1.2	0.5	1.3	0.5	0.1	0.1
Capital expenditure	2.2	8.2	3.3	10.4	8.4	14.0	11.7	9.0	22.6
of which:									
Investment expenditure	2.2	8.2	3.3	10.0	8.4	13.6	11.7	8.3	20.2
Net lending of external loans <sup>5/</sup>	--	3.6	2.4	2.6	2.0	4.9	4.4	0.9	1.8
Overall balance (commitment basis)									
Before grants	-13.8	-22.7	-7.8	-21.1	-18.6	-30.2	-26.4	-12.9	-29.4
After grants	-10.9	-18.3	-5.6	-19.7	-16.7	-26.5	-22.2	-11.8	-27.3
Change in arrears (increase, -)	0.1	0.2	-1.0	-0.7	-0.2	-1.4	-1.1	-0.2	-0.6
Overall balance (cash basis)	-10.8	-18.1	-6.5	-20.4	-16.8	-27.9	-23.3	-12.0	-27.9
Foreign financing (net)	0.2	6.7	4.9	9.4	5.3	14.8	10.1	7.0	13.9
Domestic financing (net)	10.7	11.4	1.6	10.9	11.5	13.1	13.2	5.0	14.0
(In percent of GDP)									
Total revenue plus grants	25.2	28.5	25.8	28.8	29.4	27.3	27.7	25.5	26.8
Counterpart revenues from commodity aid	5.9	4.0	2.8	1.5	2.3	2.2	2.5	1.2	1.1
Tax revenue	17.7	20.2	19.7	27.5	23.4	22.0	21.6	20.9	22.7
of which:									
Turnover and Profits taxes <sup>3/</sup>	7.5	7.9	5.1	6.3	4.2	5.7	4.6	3.9	4.3
Social security	3.4	2.8	3.8	3.3	3.9	3.4	3.8	4.0	4.3
Customs	3.0	3.2	3.4	3.6	4.1	3.5	3.8	4.4	4.9
Excise tax	2.6	3.8	4.6	5.6	6.8	5.1	5.7	5.6	5.5
Other taxes <sup>4/</sup>	1.1	3.2	4.0	6.3	6.8	5.2	5.4	3.0	3.8
Nontax revenue	1.6	4.3	3.4	3.1	3.7	3.0	3.5	3.4	3.0
Total expenditure	47.3	44.6	32.8	50.8	48.6	43.0	41.0	37.9	40.5
Current expenditure	42.9	34.1	25.7	36.4	36.5	31.7	31.3	27.4	28.2
of which:									
Personnel	10.9	9.0	8.8	8.7	9.7	8.8	9.3	9.2	9.0
Operations and maintenance	10.3	6.7	4.4	6.7	8.2	5.5	6.4	4.4	5.0
Interest	1.3	2.6	1.1	2.5	4.0	2.2	2.6	2.3	3.1
Enterprise subsidies	4.6	--	--	--	0.3	--	0.2	--	--
Social safety net	14.4	14.8	11.3	16.1	13.7	13.9	12.6	11.4	11.1
Enterprise support	--	1.0	0.0	1.3	0.6	0.8	0.3	0.1	0.1
Capital expenditure	4.3	7.3	4.2	11.5	9.7	8.3	7.1	9.5	11.3
of which:									
Investment expenditure	4.3	7.3	4.2	11.2	9.7	8.0	7.1	8.8	10.1
Net lending of external loans <sup>5/</sup>	--	3.2	3.0	2.9	2.3	2.9	2.6	0.9	0.9
Overall balance (commitment basis)	--	--	--	--	--	--	--	--	--
Before grants	-28.0	-20.1	-9.8	-23.5	-21.5	-17.9	-15.9	-13.6	-14.7
After grants	-22.0	-16.2	-7.0	-21.9	-19.2	-15.7	-13.4	-12.4	-13.7
Change in arrears (increase, -)	0.2	0.1	-1.2	-0.7	-0.2	-0.8	-0.7	-0.2	-0.3
Overall balance (cash basis)	-21.8	-16.0	-8.2	-22.7	-19.4	-16.5	-14.0	-12.6	-14.0
Foreign financing (net)	0.3	5.9	6.1	10.5	6.1	8.8	6.1	7.4	6.9
Domestic financing (net)	21.5	10.1	2.1	12.1	13.3	7.8	7.9	5.2	7.0
Memorandum items:									
ERA expenditures (current and capital)	--	1.0	0.2	1.7	1.2	1.1	0.7	0.4	0.3
Domestically financed investment	4.3	4.5	0.9	4.3	6.6	2.8	3.9	2.9	4.5

Sources: Information provided by the Albanian authorities; and IMF staff estimates.

<sup>1/</sup> Central government accounts, defined to include the State Budget, including the social security budget, all extrabudgetary accounts, social assistance accounts, and the accounts of local governments (which are not allowed to borrow directly from the banking system).

<sup>2/</sup> As presented in EBS/94/168.

<sup>3/</sup> Including transfer of amortization.

<sup>4/</sup> Including the road tax (previously included under excises) and some minor taxes (previously included under nontax revenues).

<sup>5/</sup> Includes purchases of imports under the World Bank Critical Import Loan, and certain other commodity loans (previously divided between current and capital expenditures).

Table 6. Albania: Selected Money and Credit Aggregates, 1992-95

	1992	1993	1994				1995		
			H1 Prel. 1/	H1 Revised	H2 Prog. 1/	H2 Est.	Q1 Prog.	Q2 Prog.	H2 Proj.
<u>(In billions of leks; end of period)</u>									
Net Foreign Assets of Banking System	-38.5	-33.8	...	-31.9	-32.9	-24.7	-23.3	-23.7	-24.7
Net Foreign Assets of BoA 2/	-42.5	-41.9	-41.0	-41.9	-43.0	-40.2	-39.0	-39.6	-41.1
Net Foreign Assets of Commercial Banks	4.0	8.1	...	10.1	10.1	15.4	15.7	15.9	16.4
Net Domestic Assets 3/	71.2	92.1	97.6	98.6	109.7	110.1			
(new definition) 3/						94.7	97.8	100.6	111.1
Net domestic credit	31.8	47.9	51.9	52.1	64.0	64.0	67.1	69.8	80.3
To government 4/	20.2	31.9	34.0	34.5	44.6	44.9	47.9	49.9	58.9
To nongovernment 5/	11.5	16.0	17.9	17.6	19.4	19.0	19.2	19.9	21.4
Of which: State enterprises	10.2	10.3	10.3	10.3	10.6	10.4	10.4	10.6	10.8
Private sector	1.4	5.8	7.6	7.3	8.9	8.6	8.7	9.3	10.6
Broad money	28.8	50.2	56.6	56.6	66.8	70.0	74.5	76.9	86.4
(Percent change during period)	152.7	74.4	12.9	12.9	17.9	23.6	6.5	3.2	12.3
<u>(Change in percent of broad money at start of period)</u>									
Net Domestic Assets	149.2	72.3	12.9	13.0	21.4	20.4	4.4	3.7	13.6
Net domestic credit	112.9	56.0	8.0	8.4	21.4	20.9	4.4	3.7	13.6
To government 4/	110.4	40.4	4.3	5.3	18.7	18.4	4.2	2.7	11.8
To nongovernment 5/	2.5	15.6	3.7	3.1	2.7	2.5	0.2	1.0	1.9
Of which: State enterprises	-5.3	0.3	0.1	0.0	0.4	0.2	0.1	0.2	0.3
Private sector	7.8	15.3	3.6	3.1	2.3	2.3	0.2	0.8	1.6
<u>(Real percent change during period) 6/</u>									
Net domestic credit	-50.1	15.1	-7.9	-7.5	17.0	24.8	0.1	2.3	11.5
To government 4/	-21.5	20.2	-9.3	-8.0	24.4	32.4	1.7	2.4	14.5
To nongovernment 5/	-69.5	6.1	-5.2	-6.7	3.0	9.9	-3.7	2.1	3.9
Of which: State enterprises	-72.0	-23.0	-14.5	-14.9	-2.8	2.9	-4.1	-0.4	-1.2
Private sector	-16.3	221.0	11.2	7.8	11.0	19.7	-3.3	5.0	9.7
Broad money	23.9	33.2	-4.1	-4.1	11.8	25.6	1.7	1.3	8.9
Memorandum items:									
Velocity 7/	2.6	2.8	3.0	3.0	2.7	2.5	2.5	2.5	2.5
Real GDP growth (during period)	-9.7	18.3	5.7	5.4	1.5	1.0	1.0	3.0	5.6
Inflation (during period)	236.6	30.9	17.7	17.7	5.4	-1.6	4.7	1.8	3.2

Sources: Bank of Albania; and staff estimates.

1/ As presented in EBS/94/168.

2/ Valued at constant exchange rates at 100 lek per U.S. dollar and June 1992 U.S. dollar cross rates for other currencies.

3/ Due to data deficiencies, Net Domestic Assets was defined as Broad Money minus the Net Foreign Assets of the Bank of Albania for program purposes. Data and reporting have improved sufficiently that starting in 1995 NDA will be monitored excluding the NFA of the banking system.

4/ Includes lek 1.9 billion of government bonds issued to replace loans to former agricultural cooperatives written off in October 1992.

5/ Excludes lek 1.9 billion of loans to former agricultural cooperatives written off in October 1992.

6/ Deflated by the change in the consumer price index.

7/ Annualized quarterly GDP at current prices divided by end-quarter broad money.



Table 8. Albania: Incomes Policy Developments, 1992-95

Date	Budgetary Institutions	Public Sector Enterprises
<u>Background</u>	Real wages in the public sector fell sharply during the economic crisis of 1990-1992. However, the pattern of changes was uneven: public enterprises provided ad hoc increases that limited the decline in real wages to 30 percent from their end 1990 level; military and police personnel were granted increases that nearly kept pace with inflation; but civilian budgetary employees faced a real wage decline of about 50 percent. Since August 1992 the Government has followed an incomes policy designed to permit a gradual recovery of real wages for civilian budgetary employees without exacerbating inflationary pressures, while bringing salary levels for other public sector employees back into line. This was also an important channel for financial discipline in the enterprises.	
<u>1992</u> Second Half	<u>Policy:</u> In conjunction with food price liberalization in August, a monthly compensation of leks 280 per employee and a monthly family allowance of leks 200 per dependent was to be introduced 1/. Wage restructuring in September was to result in an average wage increase of 33.1 percent. <u>Outcome:</u> Actual average wages exceeded the target by 9.5 percent.	<u>Policy:</u> Subject to wage ceilings. 2/ Enterprise salaries were to be reduced, to equal those in the budgetary institutions. Policy on food compensation same as for budgetary institutions. <u>Outcome:</u> Level of average wage proved to be 48 percent higher than the program target. Reaching alignment with budgetary institutions thus proved impossible, and was instead pursued through wage policy in subsequent periods.
<u>1993</u> First Half	<u>Policy:</u> An increase of 28 percent in the basic wage (excluding food price compensation) in February. <u>Outcome:</u> Basic wages were raised by 25 percent in February. An additional 3 percent of the wage bill was reserved for performance bonuses.	<u>Policy:</u> Wage freeze for most enterprises, with a margin of up to 12 percent for enterprises fulfilling strict performance conditions. 3/ <u>Outcome:</u> Largely observed. The margin for well performing enterprises was raised to 20 percent in early 1993.
<u>1993</u> Second Half	<u>Policy:</u> Basic wages were to be increased in July by 8 percent, with an additional 2 percent of the wage bill for performance bonuses; monthly bread price compensation of lek 219 per person and dependent to be introduced. <u>Outcome:</u> Basic wages were increased by 10 percent in July 1993. Compensation as agreed.	<u>Policy:</u> Unchanged ceilings, with a margin of 25-30 percent for enterprises fulfilling performance conditions. Temporary monthly bread price compensation of lek 164 per person to state enterprise workers and dependents, and of lek 150 per person to former state farm workers and dependents. <u>Outcome:</u> Observed.

Table 8. Albania: Incomes Policy Developments, 1992-95

Date	Budgetary Institutions	Public Sector Enterprises
<p><u>1994</u> First Half</p>	<p><u>Policy:</u> Average basic wage was to be increased by 30 percent, with differential salary increases of up to 80 percent for senior officials. <u>Outcome:</u> In January, the average basic wage was increased by 34 percent, with increases of up to 80 percent for senior officials. This was followed by the integration of food and dependent compensation into the basic wage. Energy compensation of leks 350 was introduced in April 1994, in conjunction with the sharp adjustment of energy prices.</p>	<p><u>Policy:</u> Average wage ceilings to be increased by 15 percent. The margin over the average wage ceiling was raised from 25-30 to 30 percent for enterprises that met performance conditions. <u>Outcome:</u> Observed. The margin for well performing enterprises was raised to 40 percent. Energy compensation of leks 300 per employee was introduced in April 1994.</p>
<p><u>1994</u> Second Half</p>	<p><u>Policy:</u> Increase in basic wage of 10 percent in July, contingent on satisfactory revenue performance (to be granted retroactively, after revenue assessment in September). <u>Outcome:</u> Average basic wages were increased by 10 percent effective October 1994, including increase of 8 percent across-the board and 20-40 percent for senior officials. Temporary increase in electricity compensation of leks 150 was granted for November-March 1995.</p>	<p><u>Policy:</u> Ceiling of constant real wages (increase of about 20 percent in nominal terms) for year as a whole. Budgetary bread price compensation to be discontinued from July 1. <u>Outcome:</u> Observed. The margin for well performing enterprises was raised from 50 percent effective October 1994.</p>
<p><u>1995</u></p>	<p><u>Policy:</u> Base wage increase of 10 percent on April 1, 1995, which is to be followed by the integration of the energy and dependent compensation into the base wage.</p>	<p>No across-the-board increase. Firms meeting strict criteria may continue to pay wages up to 50 percent over ceiling.</p>

Source: Ministries of Labor and Finance. See Statistical Appendix tables for further detail on wage levels and changes in real wages.

- 1/ Excluding military and police personnel, who received large wage increases in early 1992.
- 2/ Ceilings on average wages were imposed for each state enterprise, with differentiation by sectors.
- 3/ The enterprises must be profitable, reporting financial results on a timely basis, and have avoided the accumulation of new inter-enterprise and tax arrears. Only a few enterprises could meet these requirements.

Table 9. Albania: Capacity to Repay the Fund <sup>1/</sup>

	1994	1996	1998	2000	2002	2004	2006	2008	2010
	Est.			Projections					

(In millions of U.S. dollars, unless otherwise indicated)

Current account deficit, excluding official transfers (in percent of GDP)	13.5	10.4	7.5	6.2	4.9	4.0	3.4	2.7	1.9
Gross financing requirement	- -	197	159	170	153	145	144	142	118
Debt service ratio (in percent of GDP)	3.0	1.4	1.1	1.2	0.9	0.7	0.4	0.4	0.4
(in percent of GNFS exports)	24.0	10.9	8.0	8.3	5.8	4.6	2.8	2.4	2.1
of which: service to the Fund	0.5	3.1	0.4	1.6	1.9	1.1	- -	- -	- -
Debt/Export ratio	491.3	217.4	190.2	174.4	168.4	161.1	155.7	145.5	130.7
of which: the Fund	23.6	23.1	15.1	9.5	4.0	0.7	- -	- -	- -
Debt/GDP ratio	61.9	28.9	27.1	25.9	25.2	24.5	24.2	23.2	21.5
of which: the Fund	3.0	3.0	2.2	1.4	0.6	0.1	- -	- -	- -

(In millions of SDRs)

Memorandum items

Debt service to the Fund	0.8	6.5	1.1	5.7	8.6	6.0	0.6	- -	- -
Principal	- -	5.7	0.9	5.5	8.5	5.9	0.6	- -	- -
Charges and interest	0.8	0.8	0.2	0.2	0.1	0.1	- -	- -	- -

Sources: Data provided by the Albanian authorities; and staff estimates and projections.

<sup>1/</sup> Assumes commercial debt reduction under IDA debt reduction facility in the second half of 1995, with debt relief for remaining payments arrears and gap financing on highly concessional terms.

Table 10. Albania: Social and Demographic Indicators

	Around 1960 <u>1/</u>	Recent <u>1/</u>
<u>Total area</u> (in thousand square kilometers)		28,748
Arable land (in percent of total area)	15.9	24.5
<u>GDP</u> (1990) (in millions of SDRs)	...	1,549
GDP per capita (1990) (in SDRs)	...	471
GDP (1994) (in millions of SDRs)	...	1,227
GDP per capita (1994) (in SDRs)	...	387
GNP per capita (1994) (in SDRs)	...	442
<u>Population and vital statistics</u>		
Population in thousands (1993)	1,607	3,168
Urban population (percent)	29	36
Population density per square km. of agricultural land (1990)	268	463
Percentage of population under 15 years of age (1993)	41	34
Average annual population growth rate (1993)	2.9	-0.7
Life expectancy at birth (in years)	65	72
Female	66	75
Male	64	69
Infant (under 1 years of age) mortality per 1,000 live births (1990)	83	43
Child (under 5 years of age) mortality per 1,000 live births (1989)	14	3
Fertility rate (births per woman) (1993)	6.3	4.1
Deaths per 1,000 inhabitants (1993)	10.4	5.4
<u>Labor force (1993)</u>		
Domestic labor force, in thousands	...	1,356
Females in labor force, in thousands	...	757
Female labor force participation rate (working age women in labor force)	...	92
<u>Food and nutrition</u>		
Per capita agricultural production index in 1990 (1989 = 100)	64	96
Per capita supply of calories per day (1990)	2,439	3,115
Per capita protein intake in grams per day (1988)	77	100
<u>Health and health care</u>		
Doctors per 1,000 inhabitants (1993)	3.0	1
Hospital beds per 1,000 inhabitants (1990)	5.4	5.8
<u>Education (1989)</u>		
Primary school enrollment (percent of age group)	...	100
Secondary school enrollment (percent of age group)	...	64
Primary school student/teacher ratio	32	19
Illiteracy rate of population over 10 years of age (1989)	...	7.9

Sources: Directorate of Statistics, Statistical Yearbook of Albania 1991 and Population and Housing census 1989, Principal Results; and IMF staff estimates.

1/ Unless otherwise indicated, 1950-70 for around 1960, and 1985-90 for recent period.

Albania--Relations with the Fund

(As of February 28, 1995)

I. Membership status

(a) Date of Membership October 15, 1991  
 (b) Status Article XIV

(A) Financial Relations

II. General Department (General Resources Account)

	<u>(In millions of SDRs)</u>	<u>(In percent of quota)</u>
(a) Quota	35.3	100.0
(b) Total Fund holdings of currency	48.43	137.2
(c) Fund credit	13.13	37.2
Credit Tranche	13.13	37.2
(d) ESAF	24.00	68.0
(e) Reserve tranche position	0.01	--

III. SDR Department

	<u>(In millions of SDRs)</u>
(a) Net cumulative allocation	--
(b) Holdings	0.01

IV. Financial Arrangements:

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
SBA	08/26/92	08/25/93 <u>1/</u>	20.00	13.13
ESAF	07/14/93	07/13/96	42.36	24.00

V. Overdue Obligations: None.

---

1/ Cancelled on July 14, 1993 and replaced by arrangement under the ESAF.

VI. Projected Payments to the Fund (SDR million): Assuming that all drawings under the present ESAF arrangement are made, the following obligations would arise:

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Principal							
Repurchases	0.8	5.7	5.8	0.9	--	--	--
Repayments	--	--	--	--	2.5	5.5	7.9
Charges and interest <u>1/</u>	0.7	0.8	0.5	0.2	0.2	0.2	0.2
Total obligations	1.5	6.5	6.3	1.1	2.7	5.7	8.1
(percent of quotas)	(4.3)	(18.5)	(17.7)	(3.1)	(7.8)	(16.1)	(22.8)

(B) Nonfinancial Relations

VII. Exchange Rate Arrangement

On July 1, 1992 the Albanian authorities announced the removal of virtually all exchange and trade restrictions, unified the exchange markets, and adopted a floating exchange rate system (an independent float). The unified exchange rate stood at 92.7 lek per U.S. dollar at the end of February 1995.

VIII. Article IV and Article XIV Consultations

The 1994 Article IV consultation with Albania, was concluded at Executive Board meeting 94/29 (4/1/94). Directors were encouraged by the consistent application of financial discipline, which--accompanied by sweeping price, trade, and exchange rate liberalization and rapid privatization--had contributed to rapid growth of private economic activity with a substantial reduction in inflation. Directors noted, however, that the economic situation remained fragile. They stressed the need to further increase public sector savings, which would require a further strengthening of tax and customs administration. Directors urged the authorities to quicken structural measures in the areas of financial sector reform, privatization of large enterprises, the establishment of a land market, and other aspects of the legal framework for a market economy.

---

1/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the GRA, and on current interest rates for SAF, ESAF, and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.

IX. Resident Representative

A Fund resident representative, Mr. Wei Ding, has been posted in Tirana since April 1993. Mr. Franz Drees will replace Mr. Ding in mid-April, 1995.

X. Technical Assistance

Successful economic reform in Albania requires institutional changes in virtually every sector. To assist the authorities in designing and implementing these changes, a major international effort of technical assistance is under way, with key contributions from the Fund.

MAE developed a strategy to transform the former State Bank of Albania into a full-fledged central bank, assisted (in collaboration with LEG) in drafting the banking laws approved by Parliament in May 1992, and provided *advice in the design of exchange system reform*. The MAE-led assistance team has included experts from the central banks of Denmark, Finland, Italy, Portugal, Spain and the United States. An MAE staff member has made periodic visits to advise the Governor of the Bank of Albania, and two resident advisors to the Bank of Albania are in place. LEG and MAE helped to draft laws to improve the payments system and to permit the introduction of a treasury bill market.

FAD has focused its assistance on the design and implementation of changes in tax policy and tax administration, including through the placement of two long-term resident experts in customs and tax administration beginning in late September and early October 1994. One short-term advisor assumed his duties in the beginning of November 1994 supporting the implementation of a VAT and the strengthening of tax administration. Additional assistance is under way to develop treasury functions in the Ministry of Finance, with supporting reforms in government accounting and banking practices.

STA has assisted the Albanian authorities in virtually all statistical areas. The multi-topic mission in November 1992 made extensive recommendations to improve the monetary and balance of payments statistics following preliminary work by STA's staff participating in other departments' missions. Since then, assistance has been given in the design and composition of a new consumer price index, and in money and banking, international trade, and balance of payments statistics.

LEG has provided assistance in drafting the banking laws, foreign exchange regulations, and other legal reforms including the formulation of a new civil code and review of the draft bankruptcy law.

INS provided a course on macroeconomic and financial policies in Tirana in January 1992. A second course was held in May 1994, and was followed by a brief seminar for senior policy officials.

## Albania: Technical Assistance, 1991-95

Department	Subject/Identified Need	Action	Timing	Counterpart	Mission Chief/ Coordinator/Expert	Product	Status
MAE/LEG	General assessment and banking legislation	Mission	Sept.-Oct. 1991	BA	Mr. Short	Aide-Memoire Draft Laws	Completed
MAE	Strategy for creating a full-fledged central bank	Mission	December 1991	BA	Mr. Short	<u>"Albania: Strategy to Reform the State Bank of Albania into a Full-Fledged Central Bank"</u>	Completed <u>March 1992</u>
MAE	Visit by Operational Advisor to SBA's Chairman	Staff Visit	March 1992	BA	Mr. Mehran	Aide-Memoire	Completed
MAE	Implementation of strategy for creating a full-fledged central bank	Mission	April-May 1992	BA	Mr. Short	<u>"Albania: Notes on improving Operations of the Bank of Albania"</u> <sup>1/</sup>	Completed
MAE	Visit by Operational Advisor to SBA's Chairman	Staff Visit	June 1992	BA	Mr. Mehran	Aide-Memoire	Completed
MAE	Implementation of strategy for creating a full-fledged central bank	Mission	Jul.-Aug. 1992	BA	Mr. Short	<u>1/</u>	Completed
MAE	Accounting and operations	Resident advisor	Began in October 1992	BA	Mr. Seng		Extended through September 1994
MAE	Implementation of monetary and foreign exchange policy	Mission	November 1992	BA	Mr. Abrams	<u>"Albania: Issues in Modernizing the Albanian Financial System"</u>	Completed

<sup>1/</sup> Report related to both missions.

Albania: Technical Assistance, 1991-95

Department	Subject/Identified Need	Action	Timing	Counterpart	Mission Chief/ Coordinator/Expert	Product	Status
MAE	Monetary operations	Expert visit	February 1993	BA	Mr. Kostiainen	Aide-memoire	Completed
MAE	Monetary operations	Resident advisor	Began in March 1993	BA	Mr. Kostiainen		Extended through June 1995
MAE	Development of government securities market; payments system; foreign exchange operations and banking supervision	Mission	March-April 93	BA	Mr. Abrams	Aide-memoire	Completed
MAE	Foreign exchange operations	Expert visit	May 1993	BA	Mr. Goncalves	Aide-memoire	Completed
MAE/LEG	Payments and clearing systems; treasury bill markets and laws on checks and on bills of exchange in June 1993	Expert visit	June 1993	BA	Mr. Vangell and Mr. Colombatto		
MAE	Banking supervision	Expert visit	Aug.-Sept. 1993	BA	Mr. Gammaldi	Back-to- office	Completed September 1993
MAE	Central bank operations; Government securities; banking supervision; payments and clearing systems	Mission	October 1993	BA	Mr. Abrams	" <u>Moderniz- ation of the Bank of Albania</u> "	Completed December 1993
MAE	Foreign exchange market	Expert visit	November 1993	BA	Mr. Goncalves		
MAE	Banking supervision	Expert visit	Feb/March 1994	BA	Mr. Gammaldi		

## Albania: Technical Assistance, 1991-95

Department	Subject/Identified Need	Action	Timing	Counterpart	Mission Chief/ Coordinator/Expert	Product	Status
MAE	Check clearing house	Expert visit	March-May 1994	BA	Mr. Fernelius	Training manuals for BoA	Completed
MAE	Improving liquidity monitoring, foreign exchange market, bank supervision and payments system.	Mission	May 1994	BA	Mr. Cottarelli	"Liquidity control, Monetary Instruments, and Other Topics in the Modernization of the BOA"	Completed July 1994
MAE	Check clearing house	Expert visit	Aug.-Sept. 1994	BA	Mr. Fernelius		
MAE	Organization and personal planning	Expert visit	September 1994	BA	Mr. Mehran	Back-to-office	
MAE	Central bank operations	Mission	Nov.-Dec. 1994	BA	Mr. Cottarelli	Back-to-office	
MAE	Central bank operations; reform of BA law; T-bill market; organization and personal management	Mission	March 1995	BA	Mr. Cottarelli	"Base Money Programming, T-bill Market, and other Selected Topics in Central Banking"	Completed April 1995
FAD	Strategy for creating a tax and customs system	Mission	September 1991	MOF	Mr. Chand	"Albania: A Strategy for Tax and Customs Reform"	Completed Nov. 1991
FAD	Tax and customs, follow-up	Mission	December 1991	MOF	Mr. Chand	Aide-Memoire	Completed
FAD	Tax and customs; implementation	Resident experts	April 1992	MOF	Mr. Goorman Mr. Robson		

Albania: Technical Assistance, 1991-95

Department	Subject/Identified Need	Action	Timing	Counterpart	Mission Chief/ Coordinator/Expert	Product	Status
FAD	Reform of income taxes and tariffs	Mission	September 1992	MOF	Mr. Chand	<u>"Tax and Customs Reforms in Albania: One Year Later"</u>	Completed October 1992
FAD	Public expenditure management	Mission	Oct.-Nov. 1992	MOF	Mr. Chand	<u>"Towards More Effective Control of Public Expenditure and State Enterprise Arrears"</u>	Completed
FAD	Treasury management	Short-term expert (multiple visits)	Oct. 1992	MOF	Mr. Garamfalvi	Aide-Memoire	First part complete
FAD	Treasury management	Short-term expert	May 1993	MOF	Mr. Desai		
FAD	Treasury management	Short-term expert	September 1993	MOF	Mr. Desai	Aide-Memoire	Completed September 1993
FAD	Tax administration training	Short-term expert (multiple visits)	Nov. 1992	MOF	Mrs. Casanegra-Jantscher	Training	First part complete
FAD	Tax administration Land tax	Short-term expert	Nov. 1992	MOF	Mrs. Casanegra-Jantscher	Aide-Memoire	First part complete
FAD	State enterprise monitoring unit	Short-term (multiple visits)	January 1993	MOF	Mr. Chand	Aide-Memoire	
FAD	Tax administration training	Short-term expert	Jan-Feb 1993	MOF	Mr. Cardoza		

Albania: Technical Assistance, 1991-95

Department	Subject/Identified Need	Action	Timing	Counterpart	Mission Chief/ Coordinator/Expert	Product	Status
FAD	Review of FAD resident experts' work; assessment of additional technical assistance needs	Staff visit	March 1993	MOF	Mr. Chand		
FAD	Macroeconomic Policy Management	Mission	May 1993	MOF	Mr. Van Can Thai	Aide-memoire	
FAD	Tax and Customs administration	Mission	June 1993	MOF	Mr. Crotty	Specific action program	Confirmed
FAD	Macroeconomic Forecasting Unit	Staff visit	September 1993	MOF	Mr. van Can Thai		
FAD	Tax and Customs Administration	World Bank Mission	November 1993	MOF	Mr. Bodin	Executing Agency Agreement	
FAD	Budget Department	Expert visit	May 1994	MOF	Mr. Sarraf	Budget Manual	
FAD	Budget Department	Expert visit	July 1994	MOF	Mr. Sarraf	Budget Manual	Completed
FAD	Tax and customs administration	Mission	Aug.-Sept. 1994	MOF	Mr. Bodin	<u>"Albania: Strengthening Tax &amp; Custom Administration and Implementing the VAT"</u>	
FAD	Tax administration	Resident advisor	Began in September 1994	MOF	Mr. Decroix		Through September 1995
FAD	Customs administration	Resident advisor	Began in October 1994	MOF	Mr. Cruickshank		Through September 1995
FAD	Tax system	Resident advisor	November 1994	MOF	Mr. Kloeden		Through April 1995

Albania: Technical Assistance, 1991-95

Department	Subject/Identified Need	Action	Timing	Counterpart	Mission Chief/ Coordinator/Expert	Product	Status
LEG	Legal system reform	Expert visit	January 1992	SBA	Mr. Liuksila	Draft Civil Code	Completed
LEG	Legal system reform	Mission	April 1992	BA	Mr. Liuksila	Draft Civil Code	
LEG	Legal system reform	Mission	November 1992	BA	Mr. Liuksila	Proposed Civil Code	
LEG/MAE	Payments system reform; Treasury bill market; BoA legislation	Mission	April-May 1993	BA	Mr. Abrams	Draft Law of checks; Draft Law on Promissory Notes; Corrections to Law of the BoA; Draft BoA Charter	
LEG	Profit tax	Expert visit	November 1993	MOF	Mr. Cooper	Draft Profit Tax Law	
LEG	Profit tax	Expert visit	January 1994	MOF/OECD	Mr. Cooper	Draft Profit Tax Law	
LEG	VAT tax	Expert visit	March 1994	MOF	Mr. Williams	Draft VAT law	Completed
STA	Price statistics	Mission	November 1991,	Directorate of statistics (DOS)	Mr. Sundgren	" <u>Report on the Construction of an Interim Consumer Price Index for Albania</u> "	Completed April 1992
STA	Price statistics	Mission	February 1992	Institute of Statistics (IOS)	Mr. Smith	Aide-memoire	
STA	External trade statistics	Mission	October 1992	DOS/customs	Mr. Gurgun	Aide-memoire	Completed

Albania: Technical Assistance, 1991-95

Department	Subject/Identified Need	Action	Timing	Counterpart	Mission Chief/ Coordinator/Expert	Product	Status
STA	Multitopic	Mission	November 1992	BA	Mr. Hides	Aide-Memoire	Completed November 1993
STA	Price statistics	Mission	November 1992	IOS	Mr. Sundgren	"Albania: report on the CPI Review Mission (Nov. 9-17, 1992)"	Completed
STA	External trade statistics	Mission	March 1993	IOS/customs	Mr. Harbrow	Back-to- office	Completed
STA	Balance of Payments statistics	Mission	August 1993	BA	Mr. von Numers	Aide-Memoire	
STA	External trade statistics	Mission	August 1993	IOS/customs	Mr. Pownall	Back-to- office	Completed October 1993
STA	Price statistics	Mission	February 1994	IOS	Mr. Smith	Aide-Memoire	
STA	Money and banking statistics	Mission	March 1994	BA	Ms. Kurose	Aide-Memoire	Completed July 1994
STA	Balance of Payments Statistics	Mission	November 1994	BA	Mr. von Numers	Aide-Memoire	Completed
INS	Macroeconomic Policies and Financial Programming	Mission	Jan.21-Feb.1 1992	MOF	Mr. Tith	Back-to- office	Completed
INS	Macroeconomic Policies and Financial Programming	Mission	May 9-20, 1994	MOF	Mr. Martin	Course	
INS	Seminar for high-level officials	Mission	May 23-24, 1994	MOF	Mr. Lanyi	Seminar	

Albania--Relations with the World Bank Group 1/

(As of March 25, 1995)

I. Background

Albania joined the World Bank Group in October 1991. Since then, the Bank has been actively involved in the design and implementation of Albania's reform program through its operations and policy advice in various sectors. The Bank's central lending objective is to contribute to long-term poverty alleviation and help eliminate the major obstacles to growth and private sector development, such as the lack of adequate infrastructure.

The World Bank has included Albania in the list of countries eligible for IDA resources. The first credit for a Critical Imports Project was made in June 1992, and to date, 15 more IDA operations have been approved by the Board, totaling SDR 132.2 million or US\$185 million. These operations are supporting priority investments in transport, housing, water supply and energy; they also focus on rural poverty alleviation, social safety net, labor market development, technical assistance for economic reforms, and adjustment in agriculture and in the state enterprise and banking sectors.

II. Medium-term initiatives

In the medium-term, IDA support will give priority to infrastructure, with emphasis on power as well as transport, water supply and housing, providing investment capital and helping to improve the institutional and policy environment in these sectors. Alongside traditional infrastructure projects, efforts to reach the poorest segments of the population--both through small-scale public works and microcredits--are an important component of IDA's strategy.

Total IDA allocation for Albania for fiscal years 1996-98 is SDR 97.3 million. In fiscal year 1996, IDA operations will support transport infrastructure along the east-west corridor and power transmission and distribution systems. In fiscal year 1997, IDA operations will concentrate on forest management, water supply, and housing and land development. In fiscal year 1998, IDA aims to support agricultural processing as well as economy-wide investment.

---

1/ Prepared with assistance from World Bank staff.

III. Status of World Bank Group Operations in Albania

A. STATEMENT OF IDA CREDITS

(As of March 25, 1995)

Credit No.	Fiscal Year	Borrower	Project	US\$ Million	
				Credit	Undisbursed <sup>1/</sup>
2404	1992	Republic of Albania	Critical Imports Project	41.1	5.9
2461	1993	Republic of Albania	Rural Poverty Alleviation	2.4	0.2
2492	1993	Republic of Albania	Technical Assistance for Economic Reform	4.0	3.3
2499	1993	Republic of Albania	Transport/Infrastructure	18.0	16.4
2524	1993	Republic of Albania	Agriculture Sector Adjustment	20.0	11.2
2534	1994	Republic of Albania	Housing	15.0	7.0
2543	1994	Republic of Albania	Social Safety Net	5.5	4.4
2544	1994	Republic of Albania	Labor Market Development	5.4	4.6
2610	1994	Republic of Albania	Durres Water Supply	11.6	11.4
2633	1994	Republic of Albania	School Rehab. and Capacity Building	9.6	9.8
2646	1995	Republic of Albania	Tax Administration Modernization	4.0	4.0
2649	1995	Republic of Albania	Enterprise and Financial Sector Adjustment	15.0	8.2
2652	1995	Republic of Albania	Irrigation Rehabilitation	10.0	9.2
2659	1995	Republic of Albania	Health Service	12.4	12.8
2677 <sup>2/</sup>	1995	Republic of Albania	Power Loss	5.0	5.1
2680 <sup>2/</sup>	1995	Republic of Albania	Rural Development	6.0	6.1
Total				185.0	
Of Which: Repaid				—	
Total Now Held by IDA				185.0	
Total Amount Sold				0.0	
Of Which: Repaid				0.0	
Total Undisbursed					<u>119.6</u>

B. STATEMENT OF IFC INVESTMENTS

(As of March 25, 1995)

There are no IFC operations in Albania

<sup>1/</sup> Reflects the US\$ equivalent of undisbursed SDRs as of March 25, 1995.

<sup>2/</sup> Not yet effective.

Social and Environmental Issues

The rapid pace of price liberalization in Albania and reductions of employment in the government and state enterprises during 1991-93 led to a shift in the distribution of income, from the state sector toward the rural market economy and urban private sector. Partly in response, government expenditures for price subsidies to households, pensions and unemployment compensation, and other forms of social assistance rose from 8-10 percent of GDP in the late 1980's to 14-15 percent of GDP. This expansion of social safety net expenditures from the budget under the program helped to reduce the human cost of transition and maintain the consensus in favor of reform. Remittances by family members overseas also formed an important buffer. As the economic recovery continues, the Government is taking steps to reduce the fiscal cost, primarily through better targeting and screening out ineligible recipients, in order to increase the scope for spending on public services and infrastructure.

The major change in the social safety net during 1994 was the introduction of budgetary transfers to households to help cushion the impact of the sharp increase in energy prices in April. 1/ Increases in average pensions and unemployment benefits were broadly in line with targeted inflation; there were particularly large increases in minimum pensions, which nevertheless remained low in absolute terms. 2/ Overall budgetary expenditures for unemployment benefits fell by nearly 50 percent, due to a decline in the unemployment rate from 29 percent at end-1993 to under 20 percent at end-1994 and the expiration of eligibility for most long-term unemployed. To induce local authorities to enforce eligibility requirements, social assistance was shifted from an entitlements basis to block grants during 1994, with the aim of keeping average benefits roughly unchanged in real terms while weeding out the estimated 40 percent of beneficiaries who were ineligible.

For 1995, social assistance be administered through block grants, with an unchanged nominal total, while unemployment and pension benefits are being increased in line with targeted inflation of 10 percent. The Government has dedicated funding under the public investment program to the rehabilitation of hospitals and has also instituted a limited system of national health insurance.

---

1/ Energy compensation from the budget was initially established at the level of leks 350 per month for most recipients, with a maximum of leks 700 per household. Those eligible for full compensation included government employees, urban pensioners, and recipients of social assistance; while state enterprise employees, rural pensioners, and some other rural families received partial compensation. An additional, temporary increase of leks 150 per recipient was provided for many groups during the November 1994-March 1995 winter heating season.

2/ The minimum urban pension at end-1994 was leks 2,200 per month, while that for rural pensioners was only leks 700 per month.

Although environmental degradation in Albania is less acute than in other Eastern European countries, soil erosion, chemical contamination, and deforestation are observed in many parts of the countryside. The public investment program gives a high priority to the improvement of water systems, since the most important urban environmental problem is the contamination of drinking water (there was an outbreak of cholera in the summer of 1994). The Government is seeking to promote environmentally sustainable management of potential tourist zones, forest, and fishery resources. Environmental concerns have also helped to shape a number of other economic policy measures taken by the Albanian authorities, such as the decision to return to forest or pasture usage roughly 16 percent (about 113,000 hectares) of the agricultural land initially scheduled for privatization, to help combat soil erosion. Industrial air and water pollution is a problem in some areas, in particular: oil producing areas; large industrial plants from the previous regime (an important factor in the ERA's decision to close the nickel/cobalt smelter in Elbasan); and Lake Shkodra on the northern border (leakage from petroleum smuggling). The removal of expired, toxic chemicals shipped to Albania during the crisis of 1990-91 was initiated in late 1994, with external assistance.

Albania: Statistical Issues

Albania shares the problems faced by many other formerly centrally planned economies of converting the compilation of economic statistics to a system appropriate to a market economy. This task was further complicated by the collapse of many of the old reporting systems during the chaotic period from 1990 to mid-1992. In the three years since the beginning of Albania's transition to a market economy, considerable progress has been made in introducing new price, employment, monetary and banking, fiscal, trade, and balance of payments statistics, with technical assistance from bilateral and multilateral sources. However, many of these series are still subject to deficiencies and significant reporting lags. The most serious remaining gaps relate to the measurement of real activity, particularly national accounts.

Daily or weekly data are generally available on a timely basis for the financing of the budget, exchange rates, and official international reserves. Normally data are available within one week of the close of the month for the consumer price index, and with a lag of one month for tax revenues, revenues and expenditures of the Social Security Institute, foreign trade, and the foreign exchange cash flow and net foreign assets of the Bank of Albania (BOA). Monthly data on fiscal revenues and expenditures, the monetary survey, and commercial bank balance sheets, plus quarterly balance of payments estimates, are reported with at least a six week lag.

Due to the data limitations, still weak administrative capacities, and extreme telecommunication difficulties, no regular reporting has yet been established for International Finance Statistics (IFS), Government Finance Statistics (GFS) or Direction of Trade Statistics. An IFS correspondent was recently nominated by the authorities, and training is being provided for GFS compilers. Regular monthly reporting on major data series is provided to headquarters and institutions in Tirana through the IMF Resident Representative.

Price Statistics

With the assistance of two missions from the Statistics Department (STA), a new consumer price index was designed and implemented in January 1992. A November 1992 mission revealed a need for improvements in price collection and imputation methods which were subsequently addressed. Using the results of a family living survey, a February 1994 STA mission assisted in revising the consumer market basket and linking it to historical series. STA discussed with the Institute of Statistics the intended strategy for construction of a producer price index and the potential need for technical assistance in this area.

### Money and Banking

In August 1992, the central and commercial banking functions of the former State Bank of Albania were separated. The commercial banks were required to report their balance sheets on a monthly basis to the BOA using report forms based on recommendations of missions from the Money and Exchange Affairs Department (MAE). A multitopic statistical mission of November 1992 assisted in preparing a revised framework for compiling the analytical accounts needed for monetary analysis. Particular attention was given to ensuring the accuracy of the data for foreign assets and liabilities. A follow up money and banking statistics mission in March 1994 found that a new accounting system had been successfully implemented at the BOA. It was expected that a new accounting system for commercial banks would be implemented by January 1995; it is now planned for mid-year. Other data improvements have included revision of the BOA balance sheet to more clearly identify unusual items which were aggregated into other items net; reporting operations of the commercial banks involving the onlending of foreign loans to the BOA; and reporting by joint venture banks to the BOA.

### Balance of Payments Statistics

A multitopic statistical mission of November 1992 made a preliminary assessment of Albania's organizational requirements for compiling balance of payments statistics. Further assessments were made by a follow-up mission in July-August 1993. A November 1994 STA mission found that considerable progress has been made at the BOA and the Customs Department in the compilation of balance of payments statistics and trade statistics, respectively. Progress at other agencies that share responsibility was considerably less, with the result that a substantial portion of transactions with nonresidents were not captured. Monitoring of external borrowing has been strengthened but there are still deficiencies. The envisaged introduction of a 6 digit harmonized customs tariff system will improve the available data.

### Public Finances

Thanks to several missions of the Fiscal Affairs Department (FAD) and-- since mid 1992, a resident expert from the US Treasury Department-- statistics on central government operations are now fairly good. There is little information available on local governments but so far they also have only limited activities. Reporting on public sector enterprises has largely broken down aside from information of financial relations with the banking sector and the budget. In the fall of 1994, FAD placed three resident experts--financed by the World Bank--to strengthen the tax and customs administration and support the implementation of a VAT, which should further improve the available data.

National Accounts and Other Real Sector Statistics

Real sector statistics are the weakest area in the Albanian statistical system. There are no recent official national accounts data. Statistics on agricultural output--which accounts for more than 50 percent of GDP--are quite good, as extensive work on sampling and surveys has been done with extensive technical assistance from the United States and EU-Phare. Data on industrial activities strongly rely on state enterprises. However, the Institute of Statistics is preparing a questionnaire for capturing both state and private sector industrial production. Data on other sectors is virtually nonexistent. A business register was established recently as a first step in broadening the statistical base. The authorities are acutely aware of the importance of having better information on which to base policies, and are seeking external technical assistance to initiate surveys of private activity and build national accounts.

April 10, 1995

Dear Mr. Camdessus:

The Government of Albania has conducted discussions for the mid-term review under Albania's second annual arrangement under the Enhanced Structural Adjustment Facility (ESAF).

It is my pleasure to confirm that the economic program has been implemented broadly as described in my letter dated August 22, 1994. The budget deficit was again kept within the program limits during 1994, with a significant increase in domestically-financed public investment; the growth of money and credit has been controlled; and growth, inflation, and balance of payments performance continues to meet or exceed our expectations. The Government of Albania remains strongly committed to a market-oriented transformation of the economy, and delays in the implementation of certain structural reforms are being addressed. Accordingly, we request a waiver of the nonobservance of the associated performance criteria, as explained in the attached memorandum of economic and financial policies.

To continue the growth-oriented adjustment process, we have formulated the economic and financial program for 1995 that is described in the attached memorandum. We are confident that the policies and measures described in the attached memorandum are sufficient to achieve the objectives of the program, and we stand ready to take any additional measures that may be necessary for this purpose. We will consult with you on the adoption of any measures that may be appropriate, in accordance with the policies of the Fund on such consultations. In support of Albania's continuing adjustment effort, we request the completion of the mid-term review under the second annual arrangement.

I look forward to continued close collaboration with you and your institution.

Sincerely,

/s/ Sali Berisha  
President  
The Republic of Albania

Michel Camdessus  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431

Tirana, Albania  
April 10, 1995

Memorandum of Economic and Financial Policies

1. We have conducted discussions with the Fund staff for the mid-term review of the program supported by Albania's second annual arrangement under the Enhanced Structural Adjustment Facility (ESAF). This review covered economic developments and policy implementation during the first six months of the program (the second half of 1994) and the economic objectives and policies for 1995, as described below. In addition, understandings were reached on program benchmarks for the period through end-June, 1995.

Economic Performance in the Second Half of 1994

2. Favorable economic performance continued during the second half of 1994. Real GDP expanded at an annual rate of about 7.4 percent, owing to the expansion of private activities in the agricultural and services sectors. This was slightly below the 8.0 percent growth rate originally assumed in our economic program, due mainly to the effects of a drought on grain yields and, toward the end of the year, on the availability of hydroelectric power. Due in part to a temporary appreciation of the exchange rate during the summer of 1994, the inflation rate was only 15.8 percent (December/December) compared with the targeted 24.0 percent. Strong foreign exchange inflows to the private sector associated with the appreciation of the exchange rate made it possible to achieve the programmed increase in official international reserves, despite delays in disbursements of external assistance.

3. Financial policies were implemented broadly as described in our letter and memorandum of economic and financial policies dated August 22, 1994. As noted in Table 1, all of the quantitative performance criteria for end-December 1994 were observed. Two of the quantitative benchmarks for end-September were missed by small amounts: the floor on gross official international reserves (owing to delay in a disbursement of official assistance), and the ceiling on net domestic assets of the banking system (largely for technical reasons as explained in paragraph 8). The status of observance of structural benchmarks and performance criteria is summarized in Table 2, and discussed in more detail below. On the basis of the remedial actions described in this memorandum, we request waivers of the nonobservance of the structural performance criteria relating to the public investment program (PIP), approval of draft laws relating to the land market, and the reduction of employment in budgetary institutions.

4. The budget outcome during the second half of 1994 was in line with our intentions, as fiscal revenues reached the program target of 29 1/2 percent of GDP. Tax and social security revenues recovered to 23 1/2 percent of GDP (from 20 percent of GDP in the first half), with significant increases in excise and customs tariff revenues more than offsetting shortfalls in profits tax collections from the public enterprises and the failure to

implement fully the new land tax. Non-tax revenues were maintained at 6 percent of GDP, largely reflecting counterpart from sales of food aid, privatization proceeds, and income of budgetary institutions. The additional revenues were used mainly to finance higher expenditures for operations and maintenance and public investment, including amounts retained by budgetary institutions under incentive programs. The ceilings on domestic financing of the budget deficit, adjusted for lower-than-programmed spending by the Enterprise Restructuring Agency (ERA) and for higher inflows of balance of payments support to the budget, were observed. For the full year, domestic financing of the budget deficit was slightly below the program ceiling of 8 percent of GDP.

5. We have continued working to strengthen the planning and execution of the budget and the structure of public administration. Our policy commitments in this area formed the basis for 3 of the 4 structural performance criteria for the second half of 1994. One of these performance criteria was observed: all off-budget activities of the Government are reflected in the 1995 budget. With regard to the other two structural performance criteria in this area, by end-October 1994 we had intended to finalize an updated public investment program (PIP) for 1995-97 and to reduce employment in budgetary institutions to no more than 168,000. We now expect that the PIP will be completed, in consultation with the World Bank staff, in April 1995 (and in any event, prior to IMF Executive Board consideration of the present review). Budgetary employment was about 172,000 at end-October 1994, but it has since been reduced to 166,000 as of end-February, 1995 and will be cut to no more than 160,000 by end-June. Structural benchmarks in budget-related areas included steps to strengthen administrative oversight of the social security system, which were taken in late 1994, and reforms of the customs tariff system. The tariff reform, which is to comprise the elimination of exemptions for investment machinery and equipment, medical equipment, and agricultural machinery, initiation of a 6-digit classification system, and establishment of a new 3-tier rate system of 10/25/40 percent, is crucial to the 1995 budget. Draft legislation for the tariff reform will be approved by the Council of Ministers in early March 1995, and is to be enacted by Parliament prior to Board consideration of this review.

6. We have implemented a number of administrative measures to improve revenue collection during 1994, and further progress is expected in 1995. To assist in these efforts and, especially, in the preparations for the introduction of a VAT, long-term advisors in tax and customs administration, supervised by the Ministry of Finance and the IMF staff and financed by the World Bank Tax Administration Modernization Project, began working in Albania in September.

7. Credit to both the public and private sectors remained within the program targets during the second half of 1994, and a small excess in credit to the public enterprises at end-September was reversed before end-December. However, owing to increases in the international reserves of the banking sector associated with the summer foreign exchange inflows, broad money grew

more rapidly than projected. The Bank of Albania reduced interest rates on three occasions between early August and late September, in part to help moderate the upward pressure on the exchange rate, and purchased foreign exchange from both the banking system and the foreign exchange bureaus. The exchange rate began to depreciate from its most appreciated level of 84 leks per U.S. dollar in September, and reached about 95 leks/dollar by late November. Throughout the period, interest rates on commercial bank loans and time deposits of six month or longer maturity were maintained at levels that were positive in real terms in relation to underlying inflation.

8. Notwithstanding the moderate growth of domestic credit, the ceiling on the net domestic assets (NDA) of the banking system was exceeded by a small amount at end-September. The NDA ceilings were defined to include the net foreign assets of the commercial banks, due to data deficiencies, and the monetary program envisaged that their net foreign assets would rise only slightly during the second half of 1994. Mainly due to their participation with the Bank of Albania in purchases of foreign exchange from the private sector during the summer of 1994, the net foreign assets of the state-owned commercial banks are now estimated to have increased by lek 2.4 billion in the third quarter, significantly more than the amount by which the NDA ceiling was exceeded. For 1995, we judge that the quality and timeliness of data for the commercial banks have improved sufficiently to enable us to monitor net domestic assets more directly, excluding the net foreign assets of both the Bank of Albania and the rest of the banking system. We intend to continue efforts to improve monetary, fiscal, and balance of payments data, based inter alia on Fund technical assistance recommendations, and are seeking assistance for the development of a producer price index and national accounts.

9. In the absence of a well-performing banking system and money market, the conduct of monetary policy must continue to rely on bank-by-bank credit ceilings for the present. Indeed, the further deterioration of loan portfolios highlights the urgency of restructuring the state-owned commercial banks during the coming year and attracting private entry. Meanwhile, we have continued to take steps to develop the foundations for a money market and the capability for indirect monetary control. Treasury bill auctions, which were initiated on a monthly basis in July, have generally been held twice a month since September, with offerings at both three- and six-month maturities. With technical assistance from the Fund, the European Union, and bilateral donors, the Bank of Albania has continued working to improve bank supervision and statistical reporting, introduced a courier system, and initiated a pilot project in the use of checks to pay its employees.

10. Progress in implementing other key structural reforms has been uneven. The privatization of small and medium-sized enterprises (SMEs) continued at a steady pace, and while the program benchmark for privatization of SME state trading companies and agro-processing enterprises by end-1994 was not observed, this process is now expected to be completed by end-May 1995. The ERA initiated a request to the courts for the liquidation of three

enterprises under its jurisdiction, but plans for the privatization or rehabilitation of at least five others were delayed by administrative problems and, subsequently, by a review of the privatization strategy. However, reductions of employment in the enterprises continued. In recent months, one of the 32 ERA enterprises has been privatized by auction, five others received no bids and are having their minimum prices reduced in anticipation of a second auction, and parts of three firms have been sold.

11. The fourth and final structural performance criteria related to the approval by the Council of Ministers, by end-October 1994, of draft laws on mortgages and collateral, land leasing, and administrative or legal mechanisms to resolve land disputes, in preparation for the introduction of a land market during the summer of 1995. We have now established the right to lease or mortgage land for those who have received certificates of land ownership (*tapis*). The legal framework for the use of land as collateral for lending operations is thus largely in place, although the ability to enforce such provisions through the courts is still limited by backlogs and the need for an authoritative interpretation of the legislation. The distribution of certificates of ownership will be completed by end-May 1995. A draft law on the sale of rural land is now in preparation, and will be approved by the Council of Ministers for submission to Parliament prior to Board consideration of this review. A draft law on the expedited settlement of land disputes is to be approved by the Council of Ministers by end-June 1995.

12. Albania's external financing requirement for the second half of 1994 was originally estimated at US\$160 million, roughly equivalent to the projected current account deficit plus the change in arrears and gross international reserves. We had expected that this requirement would be met through disbursements of concessional development financing and balance of payments support from official sources. In the event, the current account deficit was somewhat smaller than programmed, while external assistance totalled only about US\$115 million. Remittances and unidentified foreign exchange inflows (which are believed to have reflected unrecorded transit trade) were sufficient to bridge the gap while permitting a larger-than-programmed increase in international reserves and payments of external arrears. For the full year, external disbursements included US\$22 million from the IMF ESAF, US\$35 million from IDA, US\$22 million from the EBRD and other multilateral institutions, and about US\$150 million from the EU and bilateral donors. With regard to external debt negotiations, following the first meeting in May 1994 between Albania's external debt committee and a representative group of commercial bank creditors, a bank advisory committee has been formed, and four follow-up meetings have been held. Albania continued to meet its restructured obligations to Paris Club creditors, who are also major donors, and initiated payments to regularize the external arrears of Albania Telecom.

Economic Objectives and Policies for 1995

13. The economic program for 1995 maintains the key economic assumptions, objectives, and strategy spelled out in our policy memorandum of August 22, 1994. Financial policies are based on assumed real GDP growth of 6 percent, and are designed to achieve a reduction of inflation to 10 percent (December/December) along with further progress toward external viability. In view of the unsatisfactory experience with banks' lending practices and loan recovery, emergency expenditures associated with the severe shortage of hydroelectric generating capacity, and the desire to accelerate the pace of infrastructure investment, we have decided to reallocate the expansion of credit during 1995 more toward the public sector. The program thus targets a reduction in the Government's domestic financing requirement in 1995 to no more than 7 percent of GDP--higher than the limit of 4 percent of GDP originally envisaged almost two years ago in our medium-term framework of July, 1993, but still below the domestic financing requirement in 1994. Gross international reserves would increase by a further US\$20 million (taking into account the possible use of Albania's international reserves in connection with a commercial debt buyback operation), to the equivalent of 3.4 months' imports of goods and nonfactor services. The external current account deficit (excluding official transfers) would be reduced to 12 percent of GDP from 14 percent in 1994.

14. The 1995 budget envisages a modest increase in tax revenues, compared with the full-year outcome for 1994, due to the reform of customs tariffs. Other policy measures to increase tax revenues include the elimination of new turnover tax exemptions introduced in 1994, increases in excise tax rates for alcohol and tobacco, and the harmonization of the tax rate for small business at 10 percent. Nonetheless, revenues from many taxes are expected to decline as a result of privatization and tax incentives for new private and foreign investors; and the excise tax rate for electricity is being reduced to provide the state electricity company (KESH) with additional revenues to help underpin the rehabilitation of the energy sector. Nontax revenues (and thus total revenues) are projected to decline, mainly as a result of reduced counterpart from food aid sales and the widespread use of vouchers in privatization.

15. Efforts to strengthen revenue administration will continue, focusing on the introduction of a VAT by July 1995, computerization of the tax and customs departments, and measures to improve collection performance by KESH and reduce its nontechnical losses (electricity theft). The enactment by Parliament of a VAT law--embodying a single rate and exemptions only for exports and certain services--will take place prior to Board consideration of this review. The action plan for KESH adopted in late February envisages a reorganization of billing systems, incentive-based compensation of KESH employees, and aggressive action against energy theft and systematic nonpayment of electricity bills. We have established targets for the reduction of overdue electricity bills, as reflected in Table 4.

16. The structure of fiscal expenditures will continue to shift away from subsidies and social benefits and toward public investment. Price subsidies are to be held to less than 1 percent of GDP. The cost of social benefits is being moderated by declines in unemployment and in the number of persons eligible for unemployment insurance; means-testing; and the use of block grants to local authorities to promote better targeting. The average wages of budgetary employees, which rose by about 30 percent in real terms during 1994, will be increased during 1995 in line with projected inflation of 10 percent.

17. We are seeking to increase public investment from 7 percent of GDP in 1994 to at least 10 percent of GDP in 1995. Priority sectors include water and sewage, transportation, agriculture, energy, education, and health. While the increase would result mainly from a higher level of concessional foreign financing, domestically-financed public investment will rise to 5.7 percent of GDP (from 4 percent of GDP in 1994). To help safeguard the targeted level of public investment, the program ceilings for net credit to government and net domestic assets of the BOA will be adjusted downward for any underexecution of domestically financed investment expenditures, with housing investment maintained at the same level as in 1994; these ceilings will also be reduced as previously, for shortfalls in expenditures by the ERA and higher than expected balance of payments support to the budget (Table 3).

18. The growth of broad money is targeted to decelerate to 23 percent from 41 percent in 1994, assuming a further small decrease in velocity from the level reached at end-1994. Credit to the Government (including bank purchases of T-bills) will be limited to no more than 7.0 percent of GDP, and net credit to public enterprises to about 0.2 percent of GDP. In conjunction with the targeted change in the net foreign assets of the banking system, this will leave scope for an increase of 22 percent in credit to the private sector. Financing for private activity will also be provided through the World Bank's rural credit program and SME lines financed by KfW and the EU. As a further step in the development of instruments of indirect monetary control, an initial lek 5 billion of the interest-bearing debt of the Government to the BOA is to be securitized by end-April in forms that would permit its sale to commercial banks for use in liquidity management.

19. The Government will continue its efforts to promote the placement of T-bills with both the bank and non-bank sectors, inter alia through the introduction of 12-month T-bills and by allowing higher yields through appropriate restraint in the rejection of bids. Thus, for example, the Ministry of Finance will normally accept all bids for 12-month T-bills within its intended auction amount, as long as they do not entail yields that are more than 2 percentage points above the minimum bank deposit rate at the 12-month maturity. The level of commercial bank interest rates will be reviewed at least quarterly, with deposit rates at maturities of six months or more being maintained at levels that are positive in real terms, relative to underlying inflation.

20. In recent months, we have reinforced our efforts to improve the performance of the commercial banking system, which are being supported under the World Bank enterprise and financial sector credit (EFSAC). New management has been appointed at the Savings Bank (SB) and National Commercial Bank (NCB), internal monitoring systems have been strengthened, and a department established in the Ministry of Finance to exercise more actively the Government's ownership responsibilities. Following the completion of a diagnostic study of the Rural Commercial Bank, the Government will intensify negotiations toward its privatization. In addition, the privatization of at least two branches of the SB and NCB will be initiated by end-June. In the coming months we will continue to explore avenues for the promotion of private financial intermediaries, including the simplification of licensing procedures, the establishment of cooperative banks, and initiatives building on donor-financed SME credit lines. To help support the restructuring of the banking system, and in the interest of transparent fiscal management, the Government will close its accounts at all banks other than the NCB and the central bank, and will maintain the existing policy of not extending government guarantees on new domestic bank loans to enterprises (including interest guarantees).

21. Following a review of the privatization strategy, the Government is preparing to initiate a wider program of voucher privatization under legislation adopted in late February, 1995. Vouchers have been issued since August 1994 to former political prisoners, and are being used in partial payment of SME privatizations. Under the wider scheme, vouchers will also be issued to former landowners who have not benefitted from restitution, and to all other urban adult citizens who have not already benefitted from the distribution of small enterprises or agricultural land. The use of vouchers will be required as partial payment for SME privatizations, and will become a major vehicle for the privatization of most large enterprises. In light of the disappointing results of attempts to rehabilitate ERA enterprises, action plans for the remaining ERA enterprises will aim toward their rapid privatization or liquidation. Severance payments are being used to facilitate closures. To assist in both enterprise restructuring and the development of financial markets, we expect to submit draft bankruptcy legislation to the Parliament by end-June 1995. Structural benchmarks in these and other areas for the first half of 1995 are summarized in Table 4.

22. The strategy to achieve external viability is based on maintaining liberal exchange and trade regimes and openness to foreign direct investment. We will continue a market-determined, floating exchange rate system, and will not introduce new exchange restrictions or intensify existing ones. Albania's exchange system is free of restrictions on the making of payments and transfers for current international transactions, and Albania expects to accept the obligations of Article VIII of the Fund's Articles of Agreement and thereby establish full current account convertibility by end-1995.

23. To help promote sustainable export development, the Government will maintain an open trade regime designed to facilitate access to imported inputs and equipment, privatize the state trading sector, establish a policy and legal framework conducive to foreign investment, improve infrastructure and utility services, and seek to maximize access to external markets by joining the WTO. In December 1994, Albania submitted a memorandum to the WTO describing its foreign trade regime, as an initial step toward seeking WTO membership. We will continue this process by providing annexes describing in greater detail the regime for trade in agricultural products, services, and intellectual property by end-April 1995, with the aim of completing all requirements for WTO membership by the end of the year. In early January 1995, licensing requirements for exports of tobacco and petroleum products were eliminated, and the Government intends to remove the licensing requirement for wood exports in May 1995. The remaining export restriction--a prohibition for certain types of metal scrap--will be reviewed by end-1995, in light of the progress in the privatization of large state enterprises.

24. We intend to promote a rapid resolution of external arrears and to limit future debt servicing costs to levels consistent with Albania's low per capita income and limited payments capacity. The external financing strategy is thus designed to take maximum advantage of opportunities to finance the development of infrastructure with highly concessional resources. The Government expects that it will be possible to conclude negotiations to solve the external arrears problem with commercial banks in mid-1995; these efforts are being supported by the IDA Debt Reduction Facility and will require a solution on terms that are compatible with the support of the IDA facility and Albania's difficult external payments situation. Subsequently the Government hopes to conclude negotiations to settle outstanding balances under the now-inoperative bilateral clearing arrangements on a similar basis, and to conclude rescheduling discussions with other non-Paris Club bilateral creditors. With such a resolution of arrears problems, external viability would be a realistic goal by the end of the decade, assuming a sustained inflow of development assistance from external donors on highly concessional terms. Reflecting this strategy, a target for the reduction of external payments arrears and ceilings for the stock of short-term debt and the contracting or guaranteeing of new nonconcessional external loans have been established through end-June 1995.

25. The external financing requirement for the first half of 1995 is estimated at US\$115 million. Disbursements from international financial institutions (including the IMF ESAF) are projected at US\$45 million, and disbursements under existing commitments from the EU and bilateral donors at US\$70 million. The Government intends to approach donors for further assistance on highly concessional terms to finance infrastructure development during 1995-97, and thereby to close the residual financing of

about US\$20 million for the second half of 1995. It will also seek additional support to help conclude a debt buyback operation with commercial creditors, once the terms have been finalized. A G-24 donor meeting is tentatively scheduled for May 1995.

/s/ Aleksander Meksi  
Prime Minister

/s/ Dylber Vrioni  
Deputy Prime Minister  
and Minister of Finance

/s/ Dashamir Shehi  
Deputy Prime Minister  
and Minister of Construction

/s/ Gjergj Konda  
Director, Department of  
Economic Development and  
Aid Coordination

/s/ Kristaq Luniku  
Governor  
Bank of Albania

Table 1. Albania: Quantitative Benchmarks and Performance Criteria for the Second Annual Arrangement under the ESAF, 1994

	Stock on June 30, 1994		Program Targets	
	Estimate	Actual	Cumulative change from June 30, 1994 September 30, 1994 Benchmarks	December 31, 1994 Performance criteria
(In billions of leks)				
Change in net domestic assets of the banking system <u>1/ 2/</u>	97.6	98.6		
Original target			4.4	12.6
Adjusted target			3.5 <u>8/ 9/ 10/</u>	12.2 <u>9/</u>
Outcome			5.1	11.5
Change in net credit of the banking system to the Government <u>1/ 2/ 3/</u>	34.0	34.5		
Original target			3.9	10.9
Adjusted target			3.0 <u>8/ 9/ 10/</u>	10.5 <u>9/</u>
Outcome			1.8	10.5
Change in net credit of the banking system to State Enterprises <u>1/</u>	10.3	10.3		
Original target			0.2	0.3
Outcome			0.3	0.1
(In millions of U.S. dollars)				
Change in gross international reserves of the Bank of Albania <u>4/ 5/</u>	168.0	167.6		
Original target			14.0	25.5
Outcome			5.3	35.5
Contracting or guaranteeing of nonconcessional external debt with maturities of 1-12 years <u>1/</u>	...	...		
Original target			10.0	10.0
Outcome			--	--
o/w 1-5 years <u>1/</u>	...	...		
Original target			5.0	5.0
Outcome			--	--
Public and publicly guaranteed external debt with maturities of up to one year <u>1/ 6/</u>	...	...		
Original target			10.0	10.0
Outcome			--	--
Change in external payments arrears <u>1/ 7/</u>	409	409		
Original target			-7.0	-9.0
Outcome			-9.1	-11.1

Source: Data from Albanian authorities and IMF staff estimates.

1/ Limit/ceiling.

2/ These limits were to be adjusted downward for higher-than-programmed balance of payments support to the budget. If total foreign financing (excluding project loans and commodity loans) to the budget exceeded lek 425 million during June 30 - September 30, 1994 and lek 800 million during June 30 - December 31, 1994, the limits were to be adjusted downward correspondingly.

These limits were to be adjusted downward by any shortfall of enterprise support expenditures through the ERA from the programmed amounts of lek 550 million during June 30 - September 30, 1994 and lek 1,524 million for June 30 - December 31, 1994.

These limits were to be adjusted downward for any shortfall of domestically-financed non-ERA investment expenditures from the programmed amounts of lek 1.6 billion during June 30 - September 30, 1994 and lek 3.5 billion during June 30 - December 31, 1994.

These limits were to be adjusted downward for any T-bill sales to the nonbank public in excess of lek 1 billion.

3/ Includes any drawing on domestic commercial bank loans with principal or interest guaranteed (or interest paid) by the Government. Excludes any bonds that may be issued after April 9, 1993 to allow the writing off of bad enterprise or state farm credits from bank balance sheets.

4/ Floor; excludes valuation changes.

5/ These floors were to be lowered by the amount of any payments from Albania's own reserves in connection with a debt buyback agreement with commercial creditors up to a maximum of U.S. \$30 million.

6/ Excluding import-related trade credits.

7/ Excludes interest accrued after end-1991 and balances under bilateral payments arrangements; the limit also prohibits the accumulation of new external payments arrears.

8/ Foreign financing (excluding project and commodity loans) was lek 616 million during July 1 - September 31, 1994.

9/ ERA spending during July 1-September 30, 1994 was lek 0.3 billion and during July 1-December 31, 1994 was lek 1.1 billion.

10/ Domestically financed non-ERA investment expenditures during July 1-September 30, 1994 were leks 1.2 billion.

Table 2. Albania: Structural Prior Actions, Benchmarks,  
and Performance Criteria Through End-1994

Prior actions

1. Initiation of treasury bill auctions (July) Status: Done mid-July.
2. Establishment of new BOA rediscount facilities, in line with IMF staff technical recommendations (July) Status: Done in late July.
3. Enactment by Parliament of Civil Code and land registration law, establishing the principle of unrestricted ownership, sale, and lease of both urban and agricultural land Status: Done in late July.
4. Placement of long-term advisors in tax and customs administration (August-September) Status: Done in late September.
5. Decision on second-half civil service wage and benefit increases, in consultation with Fund staff (August-September) Status: Agreement reached in early September, implemented in October.

Benchmarks/Performance Criteria

1. Clarify responsibilities for the collection of all tax and nontax revenues and strengthen the input of the Tax and Budget Departments in the operations and policy of the Social Security Institute, through increased representation of the Ministry of Finance on the SSI board and monthly reporting of SSI revenues and expenditures (Before end-December, 1994) Status: Role of Ministry in SSI strengthened and monthly reporting in place.
2. Consolidation of all central administration operations (including e.g., the National Housing Authority and Social Security Institute) by end-1994, in the preparation of the 1995 budget (performance criterion) Status: Done as from early November.
3. Submit memorandum on foreign trade regime to GATT/WTO, as required in the context of application for membership, by end-December 1994 Status: Done.
4. Prepare updated PIP for 1994-97, in consultation with World Bank staff, by October 1994; as specified in paragraph 19 of the MEFP and paragraph 39 of the PFP (performance criterion) Status: Under preparation with World Bank assistance; to be completed in March 1995.

Table 2 (concluded). Albania: Structural Prior  
Actions, Benchmarks, and Performance  
Criteria Through End-1994

5. Approval by Council of Ministers of draft laws on mortgages and collateral, land leasing, and administrative or legal mechanisms for resolving land disputes by end-October 1994--including the establishment of the legal framework for land leasing and the use of land as collateral for loans, the enforcement of contractual provisions for collateral, and the timely resolution of land ownership (performance criterion)  
Status: Issues of mortgages and collateral have been addressed in early 1995. Dispute resolution to be addressed in part through law on rural land sales, to be completed in March-April 1995.
6. Privatization of all small and medium-sized state trading companies depending on the Ministry of Industry and Trade, and all SME agro-processing companies, along with the adoption of a timetable for the privatization of the large enterprises in these sectors (end-December 1994) Status: Privatization accelerated, but was not completed by end-1994.
7. Finalize liquidation of the three firms already identified by ERA and initiate the action plans for at least five other firms (condition for completing midterm review) Status: Petition submitted to courts for liquidation of 3 firms in July 1994. All of one firm and parts of three others had been privatized by February 1995; unsuccessful auctions held for 5 firms, with plans to resubmit to auction following a reduction in the minimum bid.
8. Customs tariff reform, a tariff rate system with no more than three rates and elimination of exemptions for investment machinery and equipment, medical equipment, and agricultural machinery, by end-October 1994; as specified in paragraph 23 of the MEFP. Status: Draft law expected to be approved by Council of Ministers in March 1995.
9. Selective reduction in budgetary employment to no more than 168,000 by end-October 1994 (performance criterion). Status: Not achieved in 1994; employment reduced to 166,000 by end-February 1995.

- 66 -

Table 3. Albania: Quantitative Benchmarks for the Second Annual Arrangement under the ESAF, 1995

	Stock on December 31, 1994	Program Benchmarks	
		Cumulative change from December 31, 1994 to:	
		March 31, 1995	June 30, 1995
		(Indicative targets)	
(In billions of leks)			
Change in net domestic assets of the banking system <u>1/ 2/ 3/</u>	94.7	3.1	5.9
Change in net credit of the banking system to the Government <u>1/ 2/ 3/ 4/</u>	44.9	2.9	5.0
Change in net credit of the banking system to State Enterprises <u>1/</u>	10.4	0.1	0.3
(In millions of U.S. dollars)			
Change in gross international reserves of the Bank of Albania <u>5/ 6/</u>	204.7	14.0	40.0
Contracting or guaranteeing of nonconcessional external debt with maturities of 1-12 years <u>1/</u> o/w 1-5 years <u>1/</u>	...	10.0 5.0	10.0 5.0
Public and publicly guaranteed external debt with maturities of up to one year <u>1/ 7/</u>	...	10.0	10.0
Change in external payments arrears <u>1/ 8/</u>	529.8 <u>9/</u>	--	-2.0

Source: Data from Albanian authorities and IMF staff estimates.

1/ Limit/ceiling.2/ Net domestic assets of the banking system is defined to exclude the net foreign assets of the Bank of Albania and of the commercial banks.3/ These limits will be adjusted downward for balance of payments support to the budget in excess of lek 1 billion during the year. If total foreign financing (excluding project loans and commodity loans) to the budget exceeds lek 700 million during December 31, 1994 - March 31, 1995, lek 700 million during December 31 - June 30, lek 300 million during June 30 - September 30, or lek 300 million during June 30 - December 31, 1995, the limits will be adjusted downward correspondingly.

These limits will be adjusted downward by any shortfall of enterprise support expenditures through the ERA from the programmed amounts of lek 130 million during December 31, 1994 - March 31, 1995, lek 380 million December 31 - June 30, lek 110 million during June 30 - September 30, or lek 220 during June 30 - December 31, 1995.

These limits will be adjusted downward for any shortfall of domestically-financed investment expenditures from the annual total of lek 8.5 billion excluding ERA and lek 7 billion excluding ERA and housing). If domestically-financed investment (excluding ERA and housing) is less than the programmed amounts of lek 800 billion during December 31, 1994 - March 31, 1995, lek 1800 billion during December 31 - June 30, lek 2100 billion during June 30 - September 30, or lek 5200 billion during June 30 - December 31, 1995, the limits will be adjusted downward accordingly.

4/ Includes any drawing on domestic commercial bank loans with principal or interest guaranteed (or interest paid) by the Government. Excludes any bonds that may be issued after April 9, 1993 to allow the writing off of bad enterprise or state farm credits from bank balance sheets.5/ Floor; excludes valuation changes.6/ These floors would be adjusted downward by the amount of any payments from Albania's own reserves in connection with a debt buyback agreement with commercial creditors up to U.S. \$48 million.7/ Excluding import-related trade credits.8/ Excludes reductions in connection with commercial debt buyback negotiation and reschedulings with other official creditors; the limit also prohibits the accumulation of new arrears.9/ Bilateral clearing account balances have been converted at official exchange rates.

Table 4. Albania: Structural Prior Actions  
and Benchmarks Through June 1995

Prior actions

1. Prepare updated PIP for 1995-97, in consultation with World Bank staff, by April 1995, as specified in paragraph 5 of the MEFP.
2. Approval by the Council of Ministers and enactment by Parliament of customs tariff reform, including a new tariff rate system (10/25/40 percent), adoption of 6-digit classification, and elimination of exemptions for investment machinery and equipment, medical equipment, and agricultural machinery.
3. Enactment by Parliament of the VAT law, including a single tax rate and exemptions only for exports and certain services.
4. Approval by Council of Ministers of draft law on rural land sales, as specified in paragraph 11 of the MEFP.
5. Implement procedures providing for greater flexibility in treasury bills yields, including the introduction of 12-month T-bills and a provision that the Ministry of Finance would not normally reject bids within its planned auction amount for 12-month T-bills, as long as the yields were no more than 2 percentage points above the minimum commercial bank deposit rate at the same maturity.

Benchmarks

1. Complete the distribution of certificates of land ownership, and approval by the Council of Ministers of a draft law converting certificates "in use" to certificates of ownership, by end-May 1995.
2. Council of Ministers approval of draft law on expedited settlement of land disputes, by end-June 1995.
3. Implement action plan to improve financial management and collection performance by the state energy company, as specified in paragraph 15 of the MEFP, and reduce overdue bills of the state energy company from lek 2.9 billion at end-1994 to no more than lek 1.0 billion by end-June 1995.
4. Reduce employment in budgetary institutions to no more than 160,000 by end-June 1995.
5. Securitize lek 5 billion of the Government's interest-bearing debt to the Bank of Albania by end-April 1995.

Table 4 (concluded). Albania: Structural Prior  
Actions and Benchmarks Through June 1995

6. Complete diagnostic study of Rural Commercial Bank, with support of World Bank and U.K. Know-How Fund, and initiate privatization or liquidation by end-June 1995.
7. Initiate privatization of at least two branches of the NCB or SB by end-June 1995.
8. Close all Government bank accounts other than those in the NCB and the Bank of Albania, by May 1995.
9. Council of Ministers approval of a draft Bankruptcy Law, by end-June 1995.
10. Eliminate export licensing requirement for wood, by May 1995.