April 14, 2020
Approval: 4/21/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/5-2

11:05 a.m., January 23, 2019

2. Albania—2018 Article IV Consultation

Documents: SM/19/2 and Correction 1; and Supplement 1

Staff: Martijn, EUR; Sommer, SPR

Length: 57 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	I. Mannathoko (AE)
	F. Sylla (AF)
	R. Morales (AG), Temporary
	G. Khurelbaatar (AP), Temporary
	B. Saraiva (BR)
	X. Cai (CC), Temporary
	M. Mulas (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
	A. Castets (FF)
	K. Merk (GR)
S. Gokarn (IN)	
D. Fanizza (IT)	
	Y. Saito (JA)
	M. Saadaoui (MD), Temporary
	P. Al-Riffai (MI), Temporary
	V. Rashkovan (NE)
	Karjanlahti (NO), Temporary
	A. Tolstikov (RU), Temporary
M. Mouminah (SA)	
	K.Tan (ST)
P. Inderbinen (SZ)	
	T. Hemingway (UK), Temporary
	P. Pollard (US), Temporary

G. Tsibouris, Acting Secretary
H. Malothra, Summing Up Officer
V. Sola, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Communications Department: G. Vilkas. European Central Bank: A. Meyler. European Department: R. Lafarguette, J. Martijn. Legal Department: J. Ams. Strategy, Policy, and Review Department: M. Sommer. World Bank Group: K. Smits.

Alternate Executive Director: M. Siriwardana (IN). Senior Advisors to Executive Directors: Y. Danenov (SZ), K. Karjanlahti (NO). Advisors to Executive Directors: L. Cerami (IT), M. Coronel (BR), M. Ismail (AE), M. Mehmedi (EC), F. Rawah (SA), M. Sylvester (CO).

2. ALBANIA—2018 ARTICLE IV CONSULTATION

The staff representative from the European Department submitted the following statement:

> This statement provides information that has become available since the issuance of the staff report. The information does not alter the thrust of the staff appraisal.
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> National accounts data for the third quarter of 2018 show real (yoy) GDP growth of 4.5 percent, somewhat higher than was embedded in the 4 percent growth estimate for 2018 in the staff report. This mostly reflected strong electricity production. Staff has revised its growth estimate for 2018 to 4.2 percent, while the projections for 2019 and beyond remain broadly unchanged. CPI inflation amounted to 1.8 percent (yoy) in December 2018, 0.2 percentage points lower than expected. The staff's medium-term inflation projections remain similar to those presented in the staff report.
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> The authorities have communicated preliminary data indicating that the fiscal deficit in 2018 was smaller than reported in the staff report by 0.4 percentage points of GDP. The lower deficit reflects lower-than-expected spending in December, in particular on investment.
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> Staff's preliminary assessment is that, guided by the approved budget for 2019, the fiscal path will remain broadly in line with the staff report. Preliminary debt data show end-2018 public debt (excluding arrears) at 67.2 percent of GDP, 1.7 percentage points lower than expected in the staff report, owing to the lower deficit as well a more appreciated exchange rate. These one-off effects are expected to be permanent, thus lowering the projected debt levels over the medium term.
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> On January 16, parliament confirmed the replacement of seven ministers in Prime Minister Rama's cabinet, including the Minister of Finance and Economy. On December 28, the Prime Minister announced the replacement of eight ministers, one of which remains to be finalized.

Mr. Fanizza and Mr. Di Lorenzo submitted the following statement:

> On behalf of our Albanian authorities, we thank staff for the constructive engagement in the context of the Article IV mission and for the excellent paper. The authorities welcome staff's acknowledgement of Albania's strong economic performance and agree on the need to combine

fiscal consolidation with monetary accommodation, while strengthening the economic fundamentals and updating the policy frameworks. The uncertain external environment poses downside risks that leave little scope for complacency. This calls for cementing fiscal and financial stability and stepping up efforts to make growth more inclusive and enhance productivity.

Recent economic developments and outlook.

The Albanian economy is reaping the benefits from past and ongoing economic reforms. A sound macro-policy mix and continued structural reforms have sustained a steady growth performance, in the context of a, so far, favorable external environment. Official data show that the pace of economic growth accelerated to 4.5 percent in the third quarter of 2018, led by growth in industry, energy, construction, and services. This broad-based performance is underpinned by a favorable financial environment, robust business confidence, strong FDI inflows, and continued export growth. The economic expansion has made a dent on unemployment rate, now at a historical low. The external position has strengthened, with a narrowing current account deficit, rising external reserves and a declining external debt in percentage of GDP. The appreciation of the exchange rate experienced during the summer, on account of continued structural improvement and temporary foreign exchange inflows, does not seem to have hurt exports, but fueled additional headwinds against the BoA inflation target of 3 percent. In response, the BoA decided to further cut its policy rate as well as to intervene temporarily and transparently in the FX market, in order to avoid disorderly market conditions and to re-establish two-sided movements in the exchange rate. Such interventions have been consistent with its inflation targeting framework and, of course, with its commitment to a fully floating exchange rate.

A fiscal strategy based on gradual, but steady, fiscal consolidation.

The fiscal position has strengthened. Fiscal operations have delivered a primary surplus for the third year in a row in 2018. Despite excises and customs-revenue losses from the exchange rate appreciation, the overall deficit as a ratio of GDP is set to record the lowest level ever, with an expected over performance of 0.4 percent of GDP (comparing with the target), placing the public debt-to-GDP ratio on a firm downward path. Financial markets have fully appreciated the progress in fiscal consolidation. The risk premia have dropped: Albania recently issued a 500 million EUR 7-year Eurobond at 3.5 percent interest rate, 2.2 points below the 5-year issuance in 2015. A partial buyback of the 2015 Eurobond has improved the debt profile.

The authorities' debt strategy will aim at diversifying the investors' base, limiting the foreign-denominated borrowing, and further extending the average maturity.

The 2019 budget continues the path of fiscal consolidation, but also aims at improving the quality of spending. The budget prudently targets a deficit of 1.9 percent of GDP, the lowest targeted level in the last two decades, mainly through new taxes measures, further improvements in tax-administration and contained total expenditures, while accommodating a relatively high level of capital expenditures. The risk-based approach to tax controls is producing results, for instance, in raising collection from the buoyant tourism sector. E-invoicing and the new system for data integration are bound to further enhance tax compliance. Our authorities agree with staff that designing a simple, efficient and fair tax system is paramount. They intend to prepare a medium-term revenue strategy with the technical assistance from the Fund. The budget keeps capital spending at 5 percent of GDP, implying a significant increase in real terms, in order to narrow the infrastructure gap and facilitate interconnectivity. Moreover, the budget allocates more resources to education as requested by the students.

The authorities are taking steps to safeguard the integrity of the PPP process and to increase the efficiency of investment spending. To contain risks from PPP projects, the payments for PPP-related projects will be maintained well below the limit of 5 percent of tax revenues. The Parliament is examining a new law reforming all the aspects for the governance of PPP. A recently launched centralized database enables the Ministry of Finance to improve its decision-making process and all the steps of the public investment management.

The authorities acknowledge that government arrears hurt economic activity and need to be quickly addressed. The central government has already started to clear the arrears on the projects and remain committed to avoid new arrear accumulation. The largest chunk of arrears reflects delayed VAT refunds to three large energy projects. The tax administration has announced that these refunds will be paid by the first quarter of 2020, while the already operational reverse-charge mechanism will help to prevent their reoccurrence. Moreover, the ongoing review of the PFM, aligned with PEFA recommendations, should help in this direction. To raise awareness of possible fiscal risks, the budget for 2019 has introduced, for the first time, a statement on their extent. As recognized in the PEFA, extensive efforts to implement PFM reforms have been done, but capacity constraints remain a challenge.

Monetary and financial policies focus on achieving the inflation target and preserving macro-financial stability.

Our authorities intend to maintain an accommodative monetary policy stance, in line with staff advice. The BoA lowered the policy rate to 1 percent in June 2018, through a 25 basis points cut. The central bank is providing adequate guidance to markets about the expected path of normalization of its monetary stance, which should remain data-dependent and ready to respond to shocks flexibly. The BoA believes its expansionary monetary stance is affecting the economy. Low interest rates are supporting the expansion of credit. Net of the effects of exchange rate and the loans write-off, the private credit sector grew by 4.9 percent in the third quarter. However, the level of the credit of the economy is still below its potential. The central bank acknowledges impediments to the transmission mechanism coming from high financial and real sector euroization as well as low risk appetite among commercial banks, especially the EU ones. The new higher reserve requirements for foreign currency deposits together with the new strict requirements for transparency on unhedged foreign currency lending should help strengthen the monetary-policy transmission.

The authorities also agree with staff that the overall financial system remains sound, but that ongoing changes require a careful monitoring. Over the last years, banks' balance sheets have strengthened. The NPLs decreased to 12.7 percent of the total loans in November 2018, from a peak level of close to 25 percent in 2014. NPL ratios below 10 percent are already recorded in most of the banks. The BoA has carefully monitored the process of restructuring and consolidation in the banking sector, while devoting large resources to supervision to keep the financial sector safe and stable. The harmonization of regulation with best international practices has progressed, with the establishment of a fund for bank resolution. Moreover, the BoA signed two Memoranda of Cooperation on banking supervision and resolution with the European Central Bank and the Single Resolution Board, to facilitate the exchange of information and coordinate actions. As regard the AML/CFT deficiencies recently identified by Moneyval evaluation report, all the relevant stakeholders are implementing an action plan that follows up on the recommended priority actions; furthermore, implementation of the EU framework is ongoing.

Maintaining momentum in structural reforms.

The expected opening of EU membership negotiations provides a focal point to continue with the implementation of the structural reforms agenda.

The ongoing efforts to address governance weaknesses should pave the way for the opening of the negotiations for the EU accession. The comprehensive judicial system reform is in full swing with more than 100 judges already vetted. At the same time, the new institutions that will guarantee the independent self-governing of the judiciary have been established. These achievements follow months of hard work and challenges to implement a unique reform aimed at overhauling the previous system, guaranteeing full independence to judges and prosecutors, consolidating the rule of law, and improving access to justice. The fight against corruption is also being strengthened by the establishment of a special structure in charge of investigating and fighting organized crime and acts of corruption.

Significant strides have been made in reforming and modernizing the energy sector, a government's top priority. The five-year financial recovery plan prepared with the World Bank envisions the clearance of inter-enterprise arrears, a further reduction of distribution losses, and a better targeting of investments, while the authorities are working on measures to diversify energy sources toward gas and renewable resources. To make growth more inclusive, the government intends to reform health care and social programs. The aim is to better target the beneficiaries, and to balance social and financial sustainability. Finally, it is worth noting that Albania has been ramping up in the Doing Business ranking, moving from the position no. 120 in 2007 to no. 63 in 2018, narrowing the gap with the average of the region.

Mr. Ostros, Mr. Rashkovan, Mr. Etkes, Mrs. Karjanlahti, and Ms. Skrivere submitted the following joint statement:

The current economic recovery and the government's majority in the Parliament offers the Albanian authorities a great opportunity to reinvigorate reform efforts for sustainable growth, consolidation of public finances, and a business-friendly investment climate. We thank staff for the comprehensive report and appendices, including the Growth at Risk analysis, as well as Mr. Fanizza and Mr. Di Lorenzo for the informative BUFF statement. We broadly concur with staff's appraisal and we would like to offer the following points for emphasis.

The Albanian authorities should accelerate their fiscal consolidation efforts and use the strong economic growth period to build fiscal buffers. We commend the authorities for the progress achieved under the Fund's three-year Extended Arrangement. However, there is no time for complacency and the reform progress should continue, especially given the vulnerabilities related to public debt. We note with caution that gross financing needs remain above 20 percent of GDP over staff's forecast horizon, and we concur with staff on the importance of frontloading fiscal consolidation. We share staff's views on the benefits of a simple, predictable, and transparent tax system, and we are particularly concerned with the fragmentation of the VAT and corporate taxes, which might provide opportunities for tax arbitrage and harm growth. Further efforts to broaden the tax base, improve compliance, and strengthen tax administration capacity are welcome.

A broad structural reform agenda should be implemented to improve the business environment, attract foreign investment, and boost productivity, helping Albanian exporters to improve competitiveness. We concur with staff's analysis and suggestions on reform priorities, in particular, the importance of strengthening the rule of law by advancing judicial and governance reforms. Prospects for the opening of EU accession negotiations should serve as an additional motivation and guide the challenging, but necessary, reform implementation process.

Infrastructure shortages negatively affect competitiveness and trade; however, the efficiency of investment should be closely monitored. The poor quality of the national road and rail network and the need to improve regional connectivity justifies additional investment. However, procurement and public investment administration efficiency, transparency, and accountability should be further strengthened to prevent fiscal risks from accumulating over the medium term, especially given the authorities' ambitious PPP program. Improving the electrical network's reliability is crucial to support businesses, in particular, energy-intensive manufacturing firms. The Trans-Adriatic Pipeline project should help diversify Albania's electricity generation sources and reduce reliability on hydropower, which is subject to sizable climate events.

Albania's export structure remains dependent on a few export markets and relatively unsophisticated and concentrated in a few sectors. The Growth at Risk analysis neatly documents the importance of macro conditions in Italy and Greece as the most important determinants of Albania's growth. Thus, diversifying the target markets could not only enhance growth, but also reduce dependency on neighboring markets. The accession to the EU could also enhance exports to EU countries. We note that Albania lags behind its peers in terms of the quality and overall level of spending on education. Additional investment will help equip people with the skills needed in the labor market, spurring innovation, and developing higher-value added sectors.

To ensure the effective transmission of monetary policy, more determined efforts are needed to remove impediments to credit growth and to tackle the high degree of euroization. Non-performing loan levels, while declining, remain high and constrain credit growth. Additionally, structural factors, such as large informality and weaknesses in the judicial system hinder financial inclusion and credit deepening. The importance of credit for activity, particularly in bad times, is also documented in the Growth at Risk analysis. The Albanian authorities should pursue vigorous reforms to remove these obstacles so that renewed credit growth can spur economic recovery, while carefully monitoring financial stability.

Mr. Benk and Mr. Mehmedi submitted the following statement:

We thank staff for the comprehensive report, and Mr. Fanizza and Mr. Di Lorenzo for their in-depth buff statement. We positively note Albania's continued robust economic growth and that the Fund's Extended Arrangement which concluded in 2017, helped restoring fiscal discipline, and securing financial sector stability. Nonetheless, per capita income remains at only a quarter of the EU average and major structural bottlenecks, including a weak business environment and governance issues, are impeding growth and investment. We therefore join staff in urging the authorities to advance with the growth-enhancing structural reform agenda. We trust that an accelerated EU accession process will provide a strong reform anchor and support a faster income and institutional convergence with the EU. We share the thrust of staff's appraisals and advice, and would like to provide the following comments for emphasis.

A gradual and well-paced fiscal consolidation underpinned by revenue mobilization measures is critical to further reduce public debt and build fiscal buffers. We commend the authorities for achieving a sizable fiscal adjustment during the 2015-17 program period, bringing down the deficit to 2 percent of GDP due to a combination of spending cuts and revenue measures. Nonetheless, achieving the authorities' objective of reducing public debt to 60 percent of GDP by 2021 and creating fiscal space for priority sectors such as health and education will require the implementation of a well sequenced and revenue-based fiscal consolidation. While we acknowledge the tax measures introduced in the context of the 2019 budget, we note that the tax revenue-to-GDP ratio is expected to decrease over the medium term, as illustrated in Table 2a. Hence, further intensifying the efforts in mobilizing domestic revenue, including through excise-rate indexation, environmental taxation, and further broadening of the tax base, seems warranted. At the same time, specific and measurable policy actions aimed at phasing out tax exemptions and enhancing revenue performance of the tax and customs administration, need to be implemented. Staff's comments on the Fund's technical assistance provided to the tax and customs administration in the area of revenue mobilization are welcome.

The fiscal framework should be improved in tandem with the implementation of structural fiscal reforms to reduce fiscal risks. Considering that the current Organic Budget Law provides no operational guidance for near-term budget targets, we see merit in adopting a quantitative debt reduction rule which could be complemented with a fiscal deficit rule. At the same time, weaknesses and shortcomings in the public financial management system should be urgently addressed to reduce fiscal risks. In this vein, we underscore the importance of enhancing budget execution, clearing and preventing the accumulation of arrears, and improving the VAT refund system. The increasing reliance on public private partnerships (PPPs) for infrastructure projects, with the stock of PPPs at 31 percent of GDP, has resulted in rising contingent liabilities. Therefore, strengthening the PPP framework, including through consolidating the decision-making processes and ensuring a competitive procurement process are essential. Staff's comments on the nature of PPP projects foreseen in the 2019 budget are welcome. We also wonder whether the authorities have considered requesting the Fund's Public Fiscal Risk Assessment Model diagnostic tool to better evaluate PPP fiscal costs, and identify and mitigate the fiscal risks?

An accommodative monetary policy stance is warranted as long as inflation expectations are well anchored and financial risks remain contained. However, the weak monetary transmission system calls for prompt implementation of the BOA's strategy on de-euroization. In this context, reducing the unhedged FX-denominated loans in the banking system and promoting the use of the Lek in economic and financial transactions remains essential. At the same time, we concur with staff that the authorities should consider possible further prudential measures following the evaluation of the recent steps aimed at tackling the high degree of euroization. Staff's comments on the recent appreciation of the Lek and its implication on external competitiveness, including exports, are welcome.

Strengthening the resilience of the financial sector and reviving credit will require measures aimed at addressing vulnerabilities stemming from the high level of non-performing loans (NPLs). While the BOA's efforts in reducing the high level of NPLs over the last three years have started yielding results, the NPL ratio is still high at 13 percent necessitating further policy actions. We underscore the urgency of enacting the regulatory framework for out-of-court settlement agreements, enforcing the new bankruptcy law, and implementing the private bailiffs' reform. In view of the existing deficiencies in the AML/CFT framework, as identified in the 2018 MONEYVAL Mutual Evaluation Report for Albania, we call on the authorities to implement their action plan in strengthening the AML/CFT framework.

Strengthening the rule of law, improving governance, and enhancing the business environment are essential components for boosting growth and productivity. We commend the authorities for the implementation of the ongoing judicial reform and note that its successful completion is essential in reducing judicial corruption, strengthening the rule of law, improving contract enforcement, and protecting property rights. In view of low productivity, reforms aimed at improving the educational outcomes and reducing skill mismatches should be prioritized. This in turn will require a comprehensive strategy aimed at identifying supply- and demand-side constraints to close the skills gaps, promoting vocational secondary education, and better aligning curricula and internships with industries and trades. Considering the importance of the tourism sector for the Albanian economy, we would have welcomed a discussion in the staff report on the tourism potential and the needed measures aimed at boosting the sector.

Mr. Tan and Ms. Rauqeuqe submitted the following statement:

We thank staff for the insightful report and Messrs. Fanizza and Di Lorenzo for their informative buff statement. Ongoing reforms, robust external and domestic demand, as well as an investment upswing have yielded strong growth and employment outcomes, despite lagging productivity and remaining structural bottlenecks. In this context, the EU accession process, together with favorable near-term growth prospects, provide a valuable anchor for deepening structural reforms and tackling the still-high public debt and NPL levels. As we share the thrust of staff's assessment, the following comments are made for emphasis.

Further efforts are needed to sustainably put debt on a downward trajectory and rebuild policy buffers. Adopting an operational primary/overall balance target would prove useful for better anchoring fiscal discipline and debt sustainability, especially as meeting the 60 percent of GDP debt target by 2021 is deemed challenging. In light of the limited scope for expenditure rationalization, we take good note of the authorities' efforts to bolster oversight of public investment and PPPs, while safeguarding pro-growth spending. Taken together, these policies would strengthen the quality of public spending. Additionally, broadening the tax base, improving tax efficiency and avoiding ad hoc tax policy changes should remain an important complement to the policy agenda. Concrete actions in this regard will go a long way toward supporting the revenue-based fiscal consolidation recommended by staff, yielding a stable and predictable tax system that is central to investment growth, and helping Albania lift its revenue performance close to its regional peers.

Financial sector stability will benefit from continued NPL resolution and improved supervision and regulation. Strengthening the NPL resolution framework, including enforcing the collateral execution and out-of-court restructuring agreements, will help with reinvigorating anemic credit growth and completing banks' balance sheet repair. The authorities have taken preemptive steps to mitigate cross-border lending risks and plan to introduce Basel III-compliant supervisory instruments. This bodes well for regulatory vigilance as EU bank deleveraging and bank consolidation continues.

It is encouraging that the authorities are committed to advancing key structural reforms. Ongoing judicial reforms will help improve public service delivery, support anti-corruption efforts and attract investments needed to reduce informality. In order to improve productivity and the inclusiveness of growth, further investments in human and physical capital are needed to address skills mismatches, close the infrastructure gap and strengthen connectivity. In moving forward, we wonder if the latest cabinet reshuffle noted in the staff representative's statement will affect the reform momentum. Staff's comments are welcome.

Mr. Merk and Ms. Fritsch submitted the following statement:

We thank staff for an informative report and Mr. Fanizza and Mr. Di Lorenzo for their insightful buff statement. Notwithstanding the country's encouraging growth performance over the last years, considerable vulnerabilities and macroeconomic imbalances remain, including legacies and unfinished ends from the last Fund supported program. As staff rightly points out, the authorities should make best use of the currently favorable economic circumstances to further establish stability-oriented macroeconomic policies and tackle persistent structural impediments to growth.

Albania's elevated public debt level continues to pose serious risks to economic stability. Although debt reduction has been an integral objective of the authorities' adjustment strategy for years, actual progress remains somewhat underwhelming as the goal of reducing public debt below the threshold of 60 percent of GDP has been postponed time and again. We thus reiterate our call on the authorities to frontload meaningful additional consolidation efforts in order to enhance fiscal resilience and build up buffers against the substantial downside risks the country faces. To this end, the authorities appear well advised to follow a stable and consistent approach of continuously streamlining public expenditure and realizing existing potential to sustainably enhance revenues towards levels realized by regional peers. We would be interested in staff's assessment of the revenue potential of increased taxation of the informal sector, as mentioned by the authorities. In a similar vein, how does staff assess the budgetary potential of additional efforts in tax compliance and anti-corruption? We welcome staff's recommendation to support the necessary consolidation through strengthening the fiscal rule and structural fiscal reforms to improve cash and debt management, not least with a view to fiscal risks stemming from contingent liabilities in the PPP sector. As staff, we encourage the authorities to address the increase in government arrears since 2016 without delay.

The Bank of Albania's expansionary stance appears broadly appropriate. However, lags in the transmission mechanisms call for increased vigilance in order to not risk falling behind the curve when the withdrawal of monetary stimulus will be called for in the future. Concerning the issue of credit growth, we would be interested in additional staff comments on possible explanations for the slump on the demand side. We note that the flexible exchange rate regime and Albania's robust reserve coverage provide important shock-absorbers and we welcome the BoA's commitment to limiting interventions to unwinding disorderly market tensions. Could staff provide additional comments on potential drivers behind the sustained upward pressure on the LEK observable since mid-2015?

Notwithstanding welcome progress in reinforcing financial stability, remaining vulnerabilities require close monitoring and determined policy action. We support staff's call for further efforts to lower the still elevated level of NPLs and to ensure effective supervision and regulation. Continuing financial sector reform should help restore private credit growth and accelerate financial intermediation. We urge the authorities to address AML/CFT deficiencies without delay.

Ambitious structural reforms will be of the essence to safeguard strong and sustainable growth, external stability and foster political and economic convergence to the European Union. As staff rightly points out, measures to enhance economic governance and transparency will be key to improve the business climate. The ongoing judiciary reform appears of special importance in this regard and overall progress seems encouraging so far. However, important steps remain, and we call on the authorities to not let up in their reform efforts. Strengthening property registration and property rights could improve tax administration, facilitate financial sector development and enhance private sector credit. Meaningful progress is also necessary in the fight against corruption, organized crime and money laundering. We welcome the authorities renewed commitment to reforms in these important areas.

Mr. Saito and Mr. Minoura submitted the following statement:

We thank staff for the informative reports and Mr. Fanizza and Mr. Di Lorenzo for their insightful statement. We welcome that Albania has continued its strong growth and has mitigated the immediate macroeconomic vulnerabilities that emerged after the Euro-area crisis. On the other hand, public debts and non-performing loans (NPLs) on bank balance sheets still remain at a high level and structural bottlenecks have hindered investments. Against this background, we encourage the authorities' continued efforts to progress fiscal consolidation and growth-promoting structural reforms to maintain macroeconomic and financial stability and build stronger buffers to counter potential shocks. As we agree with the thrust of the staff appraisal, we will limit our comments to the following points:

Fiscal Policy

We agree with the staff's appraisal that Albania needs to continue its fiscal consolidation to achieve the debt objective and create larger fiscal buffers. We take note of the differences of the view between the authorities and staff regarding revenue projections. While the authorities assume additional improvements in revenue administration, including new systems for data integration and tackling informality, as a source of higher revenue, how does staff see impacts of the administration reforms on revenues? Given the lower tax revenue compared to regional peers and the need for upgrading education, health care, and infrastructure towards European standards, we agree with staff that the authorities should strengthen expenditure efficiency and take additional revenue measures, including a mix of excise-rate indexation, environmental taxation, and further broadening of the tax base, while ensuring the level of spending in priority areas. While we commend the authorities that progresses have been made in compliance-risk management and information technology systems with the Fund assistance, it is important to refrain from recurrent tax policy amendments to lock the ongoing progress. We encourage the authorities' efforts to strengthen the fiscal rule and address the increase in government arrears.

Infrastructure and Structural Policy

Given the serious public infrastructure gap of Albania, it is essential to consolidate the decision-making processes and strengthen the public investment management. At the same time, as the rapid increase in Public-Private Partnerships (PPPs) has raised fiscal risks, we share the staff's view that it is important to take further steps to control risks stemming from PPPs. In this light, we welcome the planned amendments to the PPP legislation to enhance the role of the Ministry of Finance and Economy as a gatekeeper and the inclusion of a fiscal risk assessment in recent budgets, and encourage the authorities' further efforts in this field. We also urge the authorities to improve economic governance and transparency, which is critical for sustaining high economic growth.

Monetary and Financial Sector Policy

Given the negative output gap and subdued inflation, the Bank of Albania (BoA)'s accommodative monetary policy stance remains appropriate. However, as the transmission of accommodative monetary policy to the real economy is delayed, we underscore the importance of the authorities' continued efforts to mitigate obstacles to monetary transmission, including the high degree of euroization. Noting the staff's suggestion of administrative government action to promote the use of local currency for the pricing and payment of non-tradable goods, we appreciate staff's evaluation on the authorities' strategy of de-euroization in light of international best practices? Regarding the exchange rate, we note that the Albanian lek has appreciated sharply in March. Could staff elaborate on backgrounds behind the sharp appreciation? We agree with staff that the interventions should be phased-out once disinflation risks recede, and thus welcome the authorities' commitment to maintain the flexible exchange rate regime and limit interventions temporarily.

While it is encouraging that Albania's banking sector is well capitalized, liquid and profitable, further efforts to reduce in NPLs and to strengthen supervision and regulation framework will be essential to preserve the stability of Albania's financial sector. At the same time, the development of capital markets is important to deepen financial intermediation and support funding of economic growth. Regarding the AML/CFT, we urge authorities' swift implementation of its action plan aimed at addressing deficiencies identified in its 2018 AML/CFT assessment to address vulnerabilities.

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the papers and Messrs. Fanizza and Di Lorenzo for the helpful buff statement. Albania's economy is enjoying solid growth and gradually declining public debt, benefitting from the hard work of past reform. The most recent data in the staff statement, revising up growth and revising down the fiscal deficit and public debt figures for end-2018, is encouraging. Nonetheless, persistent efforts across the broad range of fiscal, monetary, financial and structural reforms, as recommended by staff, would serve Albania well. We agree with the thrust of the staff report and offer several comments for emphasis.

Fiscal. We welcome that Albania continues on a path of fiscal consolidation to reduce public debt to a more sustainable level and appreciate the authorities' aim to achieve a simple, predictable tax system based on low rates. To this end, we underscore staff's advice to focus on base-broadening and avoid ad hoc exemptions. We encourage the authorities to follow through in developing a medium-term revenue strategy, with technical assistance from the Fund. Reducing arrears was a significant accomplishment of the last IMF program, and we urge the authorities to take steps recommended by staff to more decisively address this recurring problem.

Investment Management. Continued strengthening of investment management, including vigilance about contingent liabilities from the substantial stock of PPPs, will be important. We welcome the new centralized database for public investment at the Ministry of Finance, described in the buff statement. Competitive procurement practices also need to become entrenched. We noted the authorities' consideration of establishing a development bank, and urge them to carefully weigh fiscal, financial and governance risks, as suggested by staff.

Banking Sector. We encourage the authorities to continue efforts to address the overhang of non-performing loans (NPLs), including by prioritizing moving forward on the NPL resolution framework. We echo staff's constructive advice to strengthen banking supervision to preempt potential risks from the increased role of domestic banks as foreign banks deleverage. We welcome the authorities' attention to following up on priority items to address AML/CFT deficiencies, noted in the buff statement.

Governance and Anti-Corruption. We applaud Albania's focus on judicial reform and welcome the progress to date. We also welcome Albania's attention to anti-corruption more broadly, and their effort to measure progress against their anti-corruption strategy.

Mr. Inderbinen and Mr. Danenov submitted the following statement:

We thank staff for a valuable report and Mr. Fanizza and Mr. Di Lorenzo for their insightful buff statement. We take positive note of the pace of economic growth in Albania. It is critical that the government use the continued recovery to advance the reform agenda on macroeconomic and structural policies to lift potential growth and position the country to benefit from potential EU accession. We broadly agree with the report's analysis and the policy advice on the mix of monetary accommodation and fiscal restraint, combined with significant structural reforms. It is reassuring that the authorities broadly agree with the assessment and the priorities going forward.

Further fiscal consolidation is required to build buffers against risks to growth, and for reducing public debt. We take note of the fiscal deficit reduction achieved over the last years. This said, the underperformance of revenue underlines the need to increase efforts to tackle important structural deficiencies in tax administration. The VAT refund delays are at a worrying level and negatively impact on Albania's investment climate. We welcome the shared stance of the staff and the authorities on the need for a simple, efficient and fair tax system, and encourage Fund technical assistance to prepare the medium-term revenue strategy envisaged by the authorities. On the expenditures side, the level of spending for education and health remains low, both in terms of GDP and as a percentage of the total budget. This is not consistent with the prioritization of these sectors and efforts to increase productivity. We support staff's call for an operational fiscal target.

Public Private Partnerships are becoming an important source of fiscal risk. We acknowledge the ongoing need to close the infrastructure gap. Also, we welcome the work underway to mitigate risks associated with PPPs, as emphasized in the buff statement. Nonetheless, PPP processes would benefit from further improvement. Besides strengthening the legal and regulatory framework, increased administrative capacity is needed in the Ministry of Finance, as well as in the line ministries and agencies that deal with the PPPs.

We agree that the accommodative stance of monetary policy remains appropriate. Inflation targeting has served Albania well, yielding low and stable inflation and anchoring macroeconomic stability. We note staff's appraisal of recent exchange rate interventions, given the relatively small size of the foreign exchange market and the need to avoid disorderly monetary conditions. At the same time, we underline the importance of maintaining exchange rate flexibility for the mitigation of external shocks.

We welcome the overall soundness of the financial sector. Banks are well capitalized, profitable and liquid. This does, however, also reflect weak lending, a critical obstacle to the development of the sector and to economic growth. To rectify this, it would be important to address the root-cause of NPLs, which remain at a relatively high level. We note staff's call to further increase capacity at the Bank of Albania, building on past achievements, among which the early warning system for risk-based supervision and the development of a macro-prudential policy toolkit stand out. Despite some positive developments in capital market segments, the lack of an established secondary market for government securities represents a key drawback. In this regard, we see the Market Makers pilot program as a very relevant initiative.

Structural reforms are critical for ensuring strong and sustainable growth. The judicial reform and the ongoing anti-corruption efforts are determinant factors of the long-term perspectives of the country. In a broader perspective, enhancing the business environment would sustain growth, attract FDI, and help restrain emigration. In this regard, we believe that the issue of emigration, including its implications for the loss of skills, would deserve more extensive discussion.

Mr. Sun and Ms. Cai submitted the following statement:

We thank staff for the well-written report and Messrs. Fanizza and Di Lorenzo for their helpful buff statement. With strong economic growth over the past two decades and prospect of EU accession, Albania is well positioned to further advance reforms on various fronts. We broadly share staff's appraisal and would limit our comments to the following.

Continued fiscal consolidation is warranted to place public debt on a downward path. A remarkable fiscal adjustment was achieved from 2015 to 2017, but consolidation appeared to have stalled since. We encourage the authorities to resume the reform momentum, and pursue efforts including enhancing revenue administration to better mobilize domestic resources. A thorough assessment of the current tax system could be useful for identifying gaps to fill in order to be in line with international best practices. In this regard, Fund's technical assistance is encouraged. We welcome staff's recommendation to set a target for the annual primary or overall balance to strengthen the fiscal rule. We commend the authorities for maintaining growth-enhancing infrastructure investment to narrow the wide public infrastructure gap. Public investment management should also be enhanced to contain possible fiscal risk emanating from PPP projects.

We agree with staff that the current monetary policy stance remains appropriate, and further policy actions should be data dependent. More efforts are needed to address the issues related to high degree of euroization and impaired bank balance sheets. We encourage the authorities to double their efforts to develop the local capital market to better facilitate de-euroization. Meanwhile, we welcome the authorities’ commitment to the flexible exchange rate regime as well as a well-communicated unscheduled FX purchase program. As for the banking sector, more efforts are warranted to further reduce the NPL ratio and strengthen supervisory and regulatory framework.

Advancing structural reforms is key to unleash growth potential. To this end, a set of holistic reforms is needed to move away from high concentration of exports in low-value manufacturing products and upgrade Albania’s position in the global value chain. On strengthening governance, we take positive note that an anti-corruption strategy is being implemented and encourage the authorities to continue strengthening the AML/CFT and asset declaration regimes.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. de Villeroché, Mr. Castets and Mr. Rozan submitted the following statement:

We would like to thank staff for their comprehensive report as well as Messrs. Fanizza and Di Lorenzo for their insightful buff statement. Albania has been enjoying strong growth over the last two decades, and authorities have managed to mitigate vulnerabilities. We share the staff assessment and would like to make the following comments.

In order to safeguard macroeconomic stability in the medium term, we encourage the authorities to continue on their path of fiscal consolidation in order to ensure that countercyclical policies can be led if downside risks were to materialize. We agree with staff assessment that further consolidation is warranted to ensure that the government’s objectives are met, through efficiency measures and better revenue mobilization performances. We commend authorities for the progress achieved in revenue administration over the recent years, and encourage them to avoid frequent ad-hoc changes that undermine the system’s efficiency. In addition to enlarging the scope of activities covered by the VAT, could staff elaborate on other revenue-enhancing measures that it would recommend?

Social and capital expenditures should continue to be prioritized to increase the growth potential and tackle the skills and infrastructure gaps. We encourage the authorities to exercise caution regarding the already high volume of PPP projects, and encourage them to enhance the prioritization and risk management framework; the new legal framework recently put in place is a first welcome step in this regard. Finally, mitigating fiscal risks requires enhancing cash (including arrears payment) and debt management, and we encourage the authorities to continue progress in these areas, with adequate technical assistance from international actors.

On the monetary side, we concur with staff assessment that the accommodative monetary policy remains justified. Likewise, we note the delayed transmission of monetary policy, which results in a sluggish credit pattern. We concur with staff assessment on steps to take to alleviate these obstacles, in particular on tackling euroization, on repairing banks' balance sheets, and on reducing informality. More generally, we encourage the authorities to continue to enhance supervision and regulation of the financial sector.

Structural reforms and higher productivity should continue to be pursued to ensure that Albania's future growth relies less on internal consumption and remittances and more on exports and investments. Important progress has been made (in particular the ongoing justice system reform), but more needs to be done on the rule of law, on e-administration, on reducing informality and enhance governance (in particular, corruption) and on anti-money laundering. Tourism represents a significant potential driver for future growth. Labor market efficiency remains an issue, and we encourage authorities to continue to enhance skills and vocational training.

Mr. Di Tata and Mr. Morales submitted the following statement:

We thank staff for the well-written report and informative statement, and Mr. Fanizza and Mr. Di Lorenzo for their insightful BUFF statement.

Albania has enjoyed robust growth for the last two decades, and this trend has accentuated in recent years. Prudent macroeconomic policies have helped mitigate vulnerabilities that arose after the Euro-area crisis and inflation has remained below the central bank 3-percent target, helped by currency appreciation. Against these positive developments, the staff's focus on macroeconomic and structural policies to help Albania safeguard growth and macro-fiscal sustainability appears appropriate. This is especially important given the risks highlighted in the staff's Growth-at-risk exercise, which include Albania's exposure to downward risks to growth in Europe and the country's vulnerability to tighter global financial conditions because of its still-high debt burden. Could staff elaborate on the main reasons behind the marked increase in exports to Italy that has taken place in the last two decades (Figure 2)?

Fiscal performance has been satisfactory, with the staff's update indicating that, based on preliminary information, the fiscal deficit declined below 2 percent of GDP in 2018. Notwithstanding this good overall performance, tax revenue has fallen short of expectations, which is a concern given that Albania's tax revenue lags that of regional peers. Recurrent tax policy amendments focusing on sectoral objectives have prevented a sustained improvement in revenue while distorting resource allocation. In this regard, we welcome the authorities' plans to prepare a comprehensive medium-term revenue strategy with technical assistance from the Fund. In the meantime, every effort should be made to strengthen tax administration and to avoid introducing further measures that may have an adverse effect on revenue collections. A stronger revenue effort would also help address the high level of budgetary arrears more effectively. In this connection, we welcome the authorities' intention to regularize VAT refunds by the first quarter of 2020 and prevent their recurrence. Proper attention should also be paid to containing fiscal risks from PPP projects. The new law being examined by Parliament, which seeks to reform all aspects related to the governance of PPPs, provides a good opportunity to address this issue.

A medium-term strategy aimed at building fiscal buffers would put Albania's public debt on a sustained downward path. Such a strategy would help meet the targets stipulated in the EU Stability and Growth Pact and Albania's Organic Budget Law, namely a decline in the public debt to GDP ratio to 60 percent by 2021 and 45 percent by 2026. We agree with staff that additional efforts may be needed to achieve this reduction within the envisaged time frame, including through the introduction of a stronger fiscal rule incorporating targets for primary and overall fiscal balances. A comprehensive tax reform complemented by restructuring of state-owned enterprises, together with the implementation of the five-year financial recovery plan for the electricity sector (prepared with World Bank Support), would go a long way in buttressing fiscal sustainability. By contrast, we are unconvinced that establishing a development bank would have a significant impact on enhancing the quality of capital spending. The international experience with development banks is mixed, and these institutions are not a good substitute for attracting project financing under more favorable terms through efficient investment management. Further staff comments on this matter would be welcome.

The central bank's accommodative monetary policy stance appears appropriate in the face of low inflation and a still-negative output gap. In addition, as indicated in Mr. Faniza and Mr. Di Lorenzo's statement, the foreign exchange purchases carried out by the central bank to avoid disorderly market conditions have helped reverse the sharp appreciation of the lek that drove the exchange rate above levels justified by fundamentals. Going forward, we welcome the authorities' commitment to a flexible exchange rate regime as well as their assurances that interventions in the foreign exchange market would be limited and temporary in nature. We also notice that the impact of the accommodative monetary policy stance on credit growth appears to have been mitigated by Euroization and deleveraging by EU banks. In this connection, the Chart on page 17 shows that foreign currency deposits have increased faster than domestic currency deposits in recent months, which could amplify the currency risks entailed by the relatively high degree of unhedged borrowing reported by staff. In this respect, we agree with staff that more frequent on-site inspections and targeted reviews of the credit portfolios of banks that pose elevated risks, including currency risks, are essential to prevent a deterioration in the quality of the banking system's loan portfolio.

We concur with staff on the need to address infrastructure and labor skill gaps. Additional investment is necessary to raise productivity to levels consistent with a sustained increase in Albania's per capita income, which is equivalent to about a quarter of the EU's average. In addition, strengthening the rule of law and economic institutions would contribute to a more attractive business environment that may encourage skilled workers to seek opportunities at home rather than abroad. The recent significant improvement in Albania's Doing Business ranking by the World Bank should help build momentum for undertaking these reforms. Decisive institutional reforms should complement sound macroeconomic policies to allow opening negotiations for EU accession on a sound footing.

We commend the authorities for the implementation of an ambitious anti-corruption strategy. As indicated by Mr. Fanizza and Mr. Di Lorenzo in their statement, such strategy includes the establishment of a special structure in charge of investigating and fighting organized crime and acts of corruption. Also, recent decisive steps aimed at judicial reform and the protection of property rights are encouraging. In addition, we welcome the authorities' intention to give high priority to the implementation of the action plan to address AML/CFT deficiencies identified in the 2018 AML/CFT assessment.

With these remarks, we wish the Albanian authorities success in their policy endeavors.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for the well written reports and Mr. Fanizza and Mr. Di Lorenzo for their informative buff statement. We welcome the steady improvement in Albanian economy, with robust growth, low inflation, the improved current account deficit and increased reserves, achieved against a backdrop of broad-based reforms implemented in the recent past. Notwithstanding this improvement, several challenges remain. Hence, the continuation of the reform process utilizing the current momentum will be critical in maintaining macroeconomic stability, achieving fiscal sustainability, strengthening financial stability and improving competitiveness. We welcome the authorities' commitment to reforms, expressed in the buff statement, by indicating that the current condition "leave little scope for complacency". We broadly agree with the thrust of the staff assessment and the policy recommendations, and offer following remarks for emphasis.

The efforts to reduce public debt have borne fruit, but we agree with staff on the need for creating larger fiscal buffers through a growth friendly fiscal policy amidst high refinancing needs. When driving the reform momentum forward, focusing on revenue mobilizing measures while avoiding frequent ad-hoc tax policy changes is essential to reinforce recent gains and enhance credibility of fiscal policy. The intended medium-term revenue strategy will support this. However, the optimization and greater efficiency of spending should not come at the expense of education, health and priority capital spending. We note the staff's recommendation for a more front-loaded fiscal adjustment. Could staff comment on this as well as the implied attenuation of the fiscal adjustment plans in the more recent past? Given the risks faced by Albania, as a small open economy with greater links with neighboring countries, particularly in terms of trade, remittance flows and banking sector ties, further strengthening of fiscal rules as proposed by staff should be considered in the context of its ability to respond shocks. Staff comments are welcome. In the context of arrears, we positively note the authorities' commitment to clear them. Staff comments are welcome on the effectiveness of the reverse charge mechanism for contractors and sub-contractors in avoiding new arrears accumulation.

The staff report raises an important question related to addressing serious public infrastructure gaps to facilitate interconnectivity and managing fiscal risks of PPPs in Albania. In this context, we would like to have staff's comments on the proposal to halt the acceptance of unsolicited PPP proposals to reduce fiscal risks. We commend the plans to reform all the aspects of the governance of PPPs.

Given inflation below target and the negative output gap, we find merit in the current accommodative monetary stance. The continuation of macroeconomic stability as well as macro and micro prudential measures will be important to reduce the still high euroization, which will also help monetary policy transmission in the future.

We agree that developing a stable and resilient financial system is important to support growth. Albania's financial system remains liquid and well capitalized, with positive profitability ratios. The contraction in the private sector credit and sluggish performance in bank lending, despite low interest rates and ample liquidity, is a matter of concern that needs addressing institutional obstacles and resolving lending-related problems to revive credit. The declining but still high level of NPLs and the pockets of vulnerability need close attention with further improvements in NPL resolution framework. We noted that extensive unhedged FX loans pose challenges to the stability of the banking system and the conduct of monetary policy. In this regard, the new higher reserve requirements for foreign currency deposits and the new strict requirements for transparency on unhedged foreign currency lending indicated in the buff statement, are encouraging developments. We concur with staff on the need for swiftly implementing the action plan aimed at addressing AML/CFT deficiencies identified in the 2018 AML/CFT assessment to avoid it being publicly listed by the FATF.

Continued structural reforms will play a crucial role in harnessing Albania's potential growth. In this context, we encourage the authorities to further improve the business climate to enhance its stability and predictability, and sustain inward FDIs. The renewed attention is particularly important in addressing factors that hamper the competitiveness of the economy, which includes issues in the energy sector, property rights and land registration, human capital gap, rule of law and governance. Reforms in the judicial sector and anti-corruption laws are also important to complement this. We note that these will be key to unlocking the country's talks on EU accession. We also encourage the authorities to fast track their efforts to improve labor force participation of youth and women in Albania.

With these remarks, we wish Albanian authorities all success in their future endeavors.

Mr. Sylla, Ms. Nankunda and Mr. Ndong Ondo Bilee submitted the following statement:

> We thank staff for the concise report, and Mr. Fanizza and Mr. Di Lorenzo for their informative buff statement.
>
> The Albanian economy continued to grow strongly, with a real GDP growth projected at 4 percent in 2018, mostly driven by domestic demand. Inflation remained below the 3 percent target in the same period. However, the public debt remains high and the current account deficit still high albeit some improvements. Going forward, we encourage the authorities to step up efforts for further fiscal consolidation and structural reforms, including improving the business environment. We broadly concur with the staff's appraisal and would like to emphasize the following points.
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> On fiscal policy, we commend the authorities for their fiscal adjustment efforts in recent years, including the measures envisaged in the 2019 budget to further reduce the deficit. However, given the need to ensure Albania meets its public debt target of 60 percent of GDP by 2021 and to increase fiscal space to accommodate the needed infrastructure investment in the energy sector, we agree that a faster consolidation pace would be justified over the medium-term. Moreover, to support further consolidation efforts, we see ample scope to increase domestic revenue given Albania's performance compared to its regional peers. In this regard, measures should include the mix of excise-rate indexation, environmental taxation, and further broadening of the tax base, as suggested by staff.
>
> We note the accumulation of the government arrears and welcome the authorities' endeavored steps to rapidly clear the current ones, as well as their commitment at preventing further buildup, as indicated in Mr. Fanizza and Mr. Di Lorenzo's buff statement. Given the risk these arrears posed to fiscal credibility, we encourage the authorities to seek technical support from development partners to help meet the capacity needs faced by Albania to improve debt management.
>
> We agree that the authorities' current accommodative monetary policy stance is appropriate given the context of low inflation, weak private sector credit growth, and a negative output gap. We note, however, the persistence of weak policy transmission to longer-term rates and private sector credit availability due to various structural impediments. We therefore, encourage the authorities to undertake the necessary reforms to strengthen the transmission mechanism including by closely considering the need for de-

euroization. We also welcome the authorities' decision to limit interventions in the foreign exchange.

The financial sector is broadly stable, and we encourage the authorities to continue implementing legal, regulatory and supervisory reforms to reduce NPLs, minimize risks arising from the withdrawals of Non- Albanian Banks specifically risks on related party and cross border lending while increasing credit growth. To safeguard the stability and integrity of the financial sector, we emphasize the need to strengthen supervisory capacity and address the issue of AML/CFT which remain important challenges. Staff's comments on specific policies to resolve structural obstacles to private sector credit growth will be appreciated.

Continued progress on structural reforms is necessary to unleash the country's growth potential. More efforts are needed to address remaining inefficiencies in the reform policies aimed at promoting economic growth. We encourage the authorities to continue restructuring the power sector, strengthening governance effectiveness, particularly on reducing corruption and proper implementation of legal reforms, while improving regional integration.

Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for a well-focused report and Mr. Fanizza and Mr. Di Lorenzo for their helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

GDP growth momentum continues, but challenges remain. It is encouraging to note that GDP growth continued to pick up over the last couple of years and that fiscal and external deficits declined. Although the public debt ratio has declined, it remains high, while inflation remains below its target. At the same time, credit to the private sector is weak and income per capita remains much below the EU average and that of new member states (NMS). Going forward, safeguarding growth and fiscal sustainability through the implementation of macroeconomic and structural policies, while preserving financial sector stability and continuing financial sector reforms, are warranted.

We see merit in staff's recommendation on pursuing further fiscal consolidation. Notably, steadfast pursuit of a good mix of revenue mobilization and expenditure rationalization would help in achieving a further reduction in the public debt ratio and therefore building the needed fiscal buffers to strengthen economic resilience against potential shocks. Building fiscal buffers could also benefit from improving cash and debt management and strengthening the fiscal rule framework to achieve budget targets in an operational manner as rightly noted by staff. That said, we take positive note of the authorities' efforts to safeguard fiscal sustainability, including the steps taken to preserve the integrity of PPP process and enhance investment efficiency.

We welcome the authorities' commitment to clear arrears but would like to encourage them to continue to improve public financial management to prevent the accumulation of new ones. This is especially important given the issue of arrears recurrence. In this context, enhancing the capacity of revenue forecasting is important and therefore we welcome the authorities' intention to prepare a medium-term revenue strategy with Fund's technical assistance, as indicated in the buff statement.

Finally, safeguarding financial stability remains a priority and efforts to address the structural bottlenecks to credit growth should be sustained. In this context, enhancing the supervisory and regulatory framework while addressing the still high NPL level will be critical, and therefore we welcome the authorities' measures in this regard. As noted in the staff report, low level of financial inclusion hinders credit growth and thus we would appreciate staff's elaboration on the authorities' plan to address this issue since it was not covered.

With these remarks, we wish the authorities further success.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for the well-written report and Mr. Fanizza and Mr. Di Lorenzo for their informative BUFF statement. Supported by prudent macroeconomic policies and benefiting from past and ongoing economic reforms, Albania's recent economic performance has been encouraging. Growth has accelerated to more than 4 percent in 2018, unemployment has declined to a historically low level, while inflation remains subdued. Current account deficit and fiscal deficit are narrowing, and the financial sector is strengthening. At the same time, elevated public debt and high euroization present significant vulnerabilities in light of possible deterioration of external environment. Against such a backdrop, the authorities are rightly advised to continue fiscal consolidation and maintain accommodative monetary policy, while pressing ahead with growth-enhancing structural reforms.

The authorities need to address fiscal vulnerabilities associated with high public debt and substantial gross financing needs. Economic upturn provides a good opportunity to put public debt on a firmly downward path through upfront fiscal consolidation based on improved revenue performance. The authorities are well-advised to refrain from introducing ad-hoc measures that create distortions in the tax system. They should also step up their efforts to address the recent increase in the government arrears.

Albania’s poor quality of infrastructure remains a bottleneck for economic growth and calls for substantial additional investment. At the same time, there is a need to enhance public investment management in order to make investment more efficient. The fiscal risks associated with the PPP projects should be carefully assessed and contained.

On monetary policy, we broadly agree that current accommodative monetary policy stance is appropriate as inflation remains persistently below the authorities’ target. The normalization of monetary policy should be data dependent. There is also a need to improve efficiency of the transmission mechanism of the monetary policy. High euroization remains one of the main impediments in this regard. While addressing euroization requires continued macroeconomic stability, introduction of additional prudential measures to strengthen incentives to use local currency should also support this process. The authorities should also implement further reforms to remove impediments to credit growth and financial inclusion.

While the banking sector remains well-capitalized, liquid, and profitable, the still high NPL level remains a drag on banks’ lending activity. Further strengthening of the NPL resolution framework will accelerate the ongoing process of NPL reduction. Staff highlight the increasing role of non-EU banks as an additional challenge for supervisory authorities in mitigating cross-border lending risks. If so, additional efforts in establishing stronger cooperation with the host country supervisory authorities are needed, as well as further improvements in domestic supervisory and regulatory framework.

Ms. Levonian, Ms. McKiernan and Mr. Sylvester submitted the following statement:

We thank staff for a useful report and Messrs. Fanizza and Di Lorenzo for their insightful buff statement. We commend the Albanian authorities for their continued macroeconomic progress in the post-Extended Arrangement period. However, while growth has remained strong and the outlook is favorable, the balance of risks is tilted to the downside and vulnerabilities persist, requiring steadfast efforts to make growth more sustainable and inclusive. We note positively that staff and the authorities are in broad agreement on the key policy priorities going forward. We offer the following additional comments for emphasis.

Like staff, we urge the authorities to use the current upswing to build fiscal buffers and put debt on a firm downward trajectory. While the authorities have made progress from a fiscal standpoint, further efforts are needed to build resilience against shocks. We are encouraged by the authorities' strong commitment to keep debt on a declining path, including through revenue and expenditure efficiency reforms. Efforts to contain fiscal risks from the rapid increase in public-private partnerships (PPPs) and from the energy sector will also be critical in reducing fiscal and debt vulnerabilities, as will the implementation of a medium-term revenue strategy.

We support the authorities' efforts to strengthen inflation targeting and the transmission of monetary policy. Staff has assessed the current monetary policy stance as appropriate. However, reforms are needed to improve monetary policy transmission. We welcome the authorities' commitment in this regard. We note in the report that the flexible exchange rate regime has served the authorities well in mitigating the impact of shocks on the economy. Accordingly, we welcome their commitment to only intervene in the foreign exchange market when it is deemed necessary to avoid disorderly market conditions.

The financial sector continues to strengthen, but much more needs to be done. We encourage the authorities to press ahead with their efforts to reduce NPLs and to further bolster financial sector supervision and regulation. In this regard, we stress the importance of staff's call for the authorities to swiftly implement their action plan aimed at addressing AML/CFT deficiencies as identified in the 2018 AML/CFT assessment.

The authorities are urged to pick up the momentum in the implementation of their structural reform agenda. We note from the report that progress in implementing recommended structural reforms has been limited in critical areas. We urge the authorities to swiftly implement key reforms aimed at improving the business climate and strengthening governance, including reducing corruption.

Mr. Moreno and Ms. Mulas submitted the following statement:

We thank staff for its insightful report and Mr. Fanizza and Mr. Lorenzo for their informative buff statement.

The Albanian economy continues to recover at a fast pace. We welcome the recent upward revision of staff growth estimate for 2018 to 4.2 percent. A benign external environment, structural reforms, and a sound fiscal and monetary policy mix have sustained the momentum. Likewise, the authorities are committed to continue the path of fiscal consolidation and the implementation of the structural reform agenda. We commend authorities for this commitment and their achievements. We encourage them to use the good times and the government's majority in Parliament to maintain and deepen the current reform momentum, to further consolidate progress made on judicial reform, and to enhance the fight against corruption in the prospects for the opening of EU accession negotiations.

Albania's outlook remains positive, but risks over the medium term are tilted to the downside. As highlighted by staff, Albania faces several external risks, as well as limited buffers and significant domestic vulnerabilities. However, as noted in the staff report, there are also some upward risks such as a visible progress toward EU accession or a greater-than-expected increase in domestic energy production if large oil reserves prove economical to extract. Could staff elaborate on those upside risks and on the reasons why they are not included in the Risk Matrix Assessment?

On fiscal policy, we agree on the need to utilize the current upswing to build fiscal buffers. Addressing the high level of public debt remained the focus of fiscal policy, although the pace of consolidation has slowed down. We continue to believe that the objective of reducing debt over GDP below 60 percent in 2021 should anchor fiscal policy in the medium term. We are concerned about the differences between the authorities' and staff's projections for the fiscal path. To avoid any mismatch, we encourage them to stay the course of fiscal consolidation and press ahead with revenue-based fiscal adjustments and reforms in tax administration, public investment and debt management.

The stability of the banking system improved as the number of NPLs was reduced, but bank lending to businesses remains sluggish. The authorities have come a long way in the reduction of NPLs and have also improved insolvency and resolution frameworks. Yet, the level of NPLs is still high compared to regional peers. While we acknowledge that reducing the stock of NPLs is a lengthy process, we encourage authorities to continue addressing this problem to foster the provision of lending.

To support long-term growth, Albania should pay attention to reducing the informal economy. Despite the measures taken, the informal economy is still high. This is causing tax revenue losses, a lack of labor protection and unfair competition among firms. Ineffective contract enforcement, uncertain property rights and the prevalence of corruption are major concerns repeatedly expressed by businesses. Progress on judicial reform needs to be translated into a more favorable business environment. Better governance, a more predictable tax system, consistent enforcement of rules, and more efficient delivery of public services would substantially improve the business environment. Besides, the reform and liberalization of the electricity sector and the adoption of a land registry need to be accelerated. Also, further improvements are needed in macroeconomic statistics.

Ms. Mannathoko and Mr. Ismail submitted the following statement:

We thank staff for their report and debt sustainability assessment, and Messrs. Fanizza and Di Lorenzo for their informative buff statement. We commend the Albanian authorities on the sustained economic recovery seen over the past five years; achieved with the help of a Fund arrangement. The recovery is robust, coming in the wake of a steep decline in growth after 2008 due to the Euro crisis. Nevertheless, more needs to be done and we encourage the authorities to maintain a commitment to implementing the remaining policy reforms needed to address unresolved fiscal and financial imbalances. Furthermore, we highlight the need to improve business climate and governance indicators – including the rule of law, and to address other structural bottlenecks hampering sustainable and inclusive growth.

We have the following comments on the staff assessment with respect to fiscal policy and debt, monetary and financial sector policies and structural reforms.

Fiscal Policy and Debt Management

With growth supported by external demand, we encourage the authorities to take this opportunity to build buffers. Priority should be given to revenue mobilization and the development of a simple and effective tax system that will help to reduce the size of the informal sector. This in turn will support the fiscal consolidation needed to build fiscal buffers and reduce the high public debt to GDP ratio. We encourage the authorities to strengthen their public financial management, including improving revenue forecasting, cash management, and commitment control to prevent the accumulation of arrears and support fiscal consolidation efforts. We welcome the authorities’ intention to prepare a comprehensive medium-term revenue strategy noting the potential distortionary effects of some of the tax measures proposed in the 2019 budget, and we support the permanent tax policy measures and strengthened fiscal rule recommended by staff. Do staff have thoughts on how the 2019 budget concerns might be addressed without undermining fiscal credibility?

Debt related risks are high and remain a concern. Both the debt level and gross financing needs are still above the relevant thresholds, and despite an improved maturity profile, rollover risks are also high. We also note that the 2018 decline in the debt ratio was due to exchange rate appreciation which reflected the conversion of bank capital into Lek (that translated into a temporary capital inflow); it was not due to debt reduction measures or strengthening of the economy. We therefore encourage authorities to regain the momentum on debt reduction needed to meet their 2021 target of 60 percent of GDP. We would appreciate staff's clarification on why the high public debt levels and large financing gaps are not included in the Risk Assessment Matrix - though it does highlight rollover risk, given the extent of short-term public debt. We would also welcome staff elaboration on the planned establishment of a development bank to finance public investment.

We welcome the steps being taken by the authorities to address the risks stemming from Public-Private Partnership projects and to eliminate outstanding government arrears, given their adverse impact on private sector performance.

Monetary and Financial Sector Policies

We agree with staff that concerted efforts are needed to address obstacles to the transmission of monetary policy to the real economy, including measures to support de-euroization of the economy.

In the financial sector, despite its soundness and profitable banking institutions, risks stemming from high non-performing loans (NPLs) and low credit growth require vigilance. We commend the authorities' progress in reducing NPLs and encourage them to sustain their efforts with a view to improving bank balance sheets and converging on the regional norm. We also urge the authorities to address deficiencies in the AML/CFT framework identified in the 2018 assessment.

External Sector

On the current account, could staff indicate the reason for the drop in current transfers over time (depicted in Figure 2 on Page 7)? With transfers dominated by remittances, it is also unclear why remittances are projected to decline over time (Table 3a, footnote 1).

Structural Reforms

Sustained efforts to strengthen governance and the business environment are imperative. We urge the authorities to prioritize strengthening the rule of law, including completion of the ongoing judicial reforms and scaling up of anti-corruption efforts.

With these comments, we wish the Albanian authorities success.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their report and Mr. Fanizza and Mr. Di Lorenzo for their buff statement.

The transmission of monetary policy could be strengthened by fostering the use of the domestic currency. Monetary policy remains accommodative while inflation and inflation expectations are below target. In this context, Staff consider that the current monetary policy stance will remain appropriate until inflation is on track to become sustainable around the target. We concur with Staff that the high degree of asset and liability euroization is a potential impediment to monetary policy transmission and that strengthening the use of the domestic currency could be supported by government action. The measures already undertaken to encourage the use of the lek are welcome as they tackle both credit as well as deposit euroisation. Promoting the use of the domestic currency would not only improve the transmission of monetary policy, but also help to reduce financial stability risks and reduce seigniorage losses. Thus, we agree with Staff that following an evaluation of recent steps, additional prudential measures could be considered. Moreover, the potential measures in the remit of the government as mentioned by Staff (such as promoting the use of local currency for the pricing and payment of non-tradable goods) would certainly benefit the efforts of the Bank of Albania to strengthen the use of the lek. As promoting the use of the domestic currency is typically a lengthy process that also hinges on long-term macroeconomic stability, it is important to act now to yield results in the medium term.

Ongoing fiscal adjustment efforts are necessary to build on the achievements made thus far and to create larger fiscal buffers, while fiscal risks related to contingent liabilities should be tackled. Notwithstanding the significant fiscal adjustment achieved from 2015 to 2017, further deficit reduction is required to sustainably decrease the high public debt stock and to build larger fiscal buffers for times when the external and domestic environment becomes less benign. In addition, while we welcome the efforts to improve the public infrastructure, the large-scale use of PPPs raises fiscal risks. Therefore, it is important that planned PPP projects are subject to thorough and realistic cost-benefit analyses in order to carefully assess their economic viability and the corresponding fiscal risks.

With respect to financial sector policies, NPL reduction and the development of domestic capital markets remain key priorities. Like Staff, we commend the authorities for their significant efforts to clean banks' balance sheets, but also agree that further reduction in NPLs is needed. The stability of the banking system has improved through a decline of credit risk, as the ratio of non-performing loans to total loans was reduced substantially. Nevertheless, as Staff rightly points out, pockets of vulnerability remain and the NPL ratio is still high compared to regional peers. Therefore, we encourage the authorities to implement the remaining measures included in the NPL action plan in order to tackle structural obstacles to NPL resolution, and to strictly monitor the asset quality of restructured and new loans in order to prevent a renewed build-up of NPLs going forward. In addition, we concur with Staff that the development of domestic capital markets could help deepen financial intermediation. In view of the current low level of financial depth and the difficulties of corporates to obtain credit from local banks, a further development of the non-bank financial sector might help to broaden access to finance for corporates. To achieve this, the strengthening of the primary bond market and the development of a liquid domestic secondary bond market should be the main focus. A liquid and dynamic market for government bonds would not only support the development of corporate bond and equity markets, but also help to reduce the government's dependency on financing from local banks.

Enhancing the rule of law and tackling corruption would improve framework conditions and support living standards and could also help reduce the obstacles to credit growth which hinder the credit allocation process. In addition to the obstacles to credit growth cited by Staff in the report (Page 17), weaknesses in the rule of law and an elevated level of corruption could also play a role. They may increase banks' reluctance to lend, as they tend to hamper the execution of collateral, leading to higher borrowing costs to account for the increased risk as well as high collateral requirements. In this context, it is crucial to continue to implement the judicial reform and to resolve the deadlock around more efficient operations of private bailiffs.

The Acting Chair (Mr. Zhang) noted that two years earlier, Albania successfully completed an Extended Arrangement with the Fund. But the country still had a large reform agenda on the way forward, as it remained one of the poorest countries in Europe, with high debt and serious weaknesses in governance. In tackling those challenges, the country had been guided by its ambitions to integrate more closely with the European Union (EU). It was important to use the current favorable economic environment to advance growth-enhancing reforms covering a wide range of areas.

Mr. Hemingway made the following statement:

I thank the staff for the informative papers and Mr. Fanizza and Mr. Di Lorenzo for their informative buff. We did not issue a gray statement because we essentially shared the staff's analysis. We welcomed the strong economic performance in recent years, including since the end of the extended arrangement. The big theme across the staff recommendations was strengthening institutions to support long-term growth. We welcome the efforts the authorities are making on governance weaknesses and the commitments to respond to the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) mutual evaluation recommendations on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT). Several gray statements picked this up as well, but we would agree that strengthening the rule of law, improving governance, and enhancing the business environment are essential components to boosting growth and productivity in the medium and long term.

We also encourage the authorities to think about what more could be done in this area of strengthening institutions. Several of the gray statements picked up on the public-private partnership (PPP) analysis that the staff undertook, and we share those recommendations. Our sense from the papers was that more could be done in some core fiscal and monetary policy frameworks, and we encourage the authorities to pursue those points.

Finally, I wanted to dwell on the staff's tax analysis. Like Ms. Pollard and Ms. Crane, we would encourage the authorities to follow through in developing a medium-term revenue strategy, supported by technical assistance (TA) from the Fund. We noted in the informational annex there have been roughly monthly TA missions on tax administration but less frequent but still fairly regular missions on tax policy. I would welcome the staff's comments on the integration between the TA and the staff's recommendations in this report, and perhaps a bit more understanding about how the recommendations are supported by TA at and what actually goes on in those TA missions. Albania is a good example of a country which has had all three pillars of the Fund's activity in the last three or four years, so I would like to understand how those have complemented each other in pursuing those wider goals of building domestic resource mobilization and building tax revenues.

With that, we wish the authorities well.

Mr. Saraiva made the following statement:

I thank the staff for the report. We did not issue a gray statement, but we share the bulk of the staff appraisal. It is remarkable, the strong economic performance of Albania. We understand the results of the continued implementation of an agenda of reforms. There is still a long way to go to strengthen institutions and ensure a declining path for public debt.

It comes also on the back of strong external demand, which may not be the case moving forward, which remains a source of risk. But we have robust growth of around 4 percent—which both staff and the government project to remain around this mark for the next few years—subdued inflation, but still high public debt. That is what gives the basis for the recommendation of furthering fiscal consolidation, of maintaining an accommodative monetary policy, and continuing the growth-enhancing structural reforms.

I have two questions. One refers to the pace of the decline in public debt, as presented in the selected economic indicators. There is a much steeper decline in 2019 and then it slows in 2020. I could not find a clear explanation for that. I would appreciate the staff's elaboration.

The other issue regards de-euroization. This was one of the issues that was touched on by the European Central Bank (ECB) representative. I have two questions. First, what is the importance attached by the authorities to this issue, given the importance of increasing the traction of monetary policy? The second question regards the process of de-euroization itself. The international experience referred to by staff, I am not so sure if it will be very clarifying to the case of Albania. There is very low inflation in Albania. There was a process of a strong appreciation of the lek in the past few years, especially in the middle of this month. I would like to hear a bit more on what would be a proper approach for carrying out de-euroization in the case of Albania.

Mr. Morales made the following statement:

We thank the staff for a well-written report and Mr. Fanizza and Mr. Di Lorenzo for the informative buff statement. We are also thankful for the response to our questions.

It is clear that Albania's growth momentum is promising, which would provide an opportunity to address the downside risks associated with uncertainty in the external environment that leaves little scope for complacency, as indicated by Mr. Fanizza and Mr. Di Lorenzo in their buff statement.

Regarding external and domestic risks, tightening financial conditions and a change in sentiment could have an impact on the cost of debt service and the capacity to roll over short-term debt. We appreciate the response provided by the staff on the risks related to Albania's public debt. We understand that the three risks highlighted by the staff are associated with shocks to the cost of borrowing, to the extent of rollover, and to a possible disruption in the event of a disorderly exit by foreign banks. We would like to ask a few follow-up questions.

First, with regard to external financing, we agree that the fact that the main sources of external financing are concessional and official loans, and Eurobond financing provides some stability to the external outlook. We also know that other capital flows have been negative since 2016, according to Table 4, and that the staff projects that they will continue to be negative in the coming years. We would like to invite the staff's comments on the reasons behind these recent trends and the rationale behind the staff's projection of continuous outflows in the coming years.

Regarding domestic debt, we know that it represents 55 percent of total public debt, mostly short term and in domestic currency. The report suggests that commercial banks are still the main holders of domestic currency government securities, as reported in the last Financial Sector Assessment Program (FSAP). Banks also not only show low credit growth but a relatively low loan-to-deposit ratio, at about 50 to 60 percent. This means that a pickup in credit growth, if it happens, by commercial banks may also put pressure on domestic currency debt. We were wondering if the staff has any views on these risks.

Ms. Pollard made the following statement:

We issued a gray statement. I want to make four points in addition to the points in our gray statement and that are reflections based on some of the answers to the technical questions.

The first is on broadening the tax base. Albania has been making steady progress in improving fiscal management, but recent ad hoc fiscal measures risk undermining that progress. We encourage the authorities to reconsider some of the sectoral tax exemptions, for example. We also agree with the staff that a simplified structure for small taxpayers and startups could help reduce informality.

On government arrears, as the staff pointed out in the answer to question 13, the reverse charge mechanism, which the authorities plan to rely on to reduce the recurrence of government arrears, is a short-term, quick fix, which could unintentionally increase other risks to tax compliance. We would underscore the point from our gray statement, urging the authorities to persist in tackling the root causes of the arrears, including institutional weaknesses in revenue forecasting, cash management, and budgetary controls.

On PPPs, we took note in the answer to Question 15 that the majority of PPPs are user-funded and do not involve government payments. Nonetheless, the use of PPPs seems to be extensive in Albania. We hope that the data deficiencies and capacity constraints that have limited the usefulness of the public financial risk assessment model tool can be overcome with additional efforts.

Regarding the new PPP legislation, could the staff comment on the authorities' rationale for excluding the energy sector and ports and airports from the prohibition on unsolicited bids? Why would not these sectors also benefit from stronger competitive practices?

Finally, on capacity development, we were interested to learn in the answer to Question 5 about some of the areas where Fund capacity development has gained traction. Particularly considering that Albania has been receiving extensive TA, we, like Mr. Hemingway, would encourage staff to integrate more information on capacity development into the staff report, itself, beyond the list of TA missions in the informational annex.

Mr. Merk made the following statement:

Albania's elevated public debt level continues to pose risks to economic stability and needs to be put on a firm downward trajectory.

Capitalizing on the favorable economic conditions, this seems to be the right time for the authorities to frontload consolidation efforts and enhance fiscal resilience.

Ambitious structural reforms will be crucial to support strong and sustainable growth and to foster political and economic convergence to the EU.

Lastly, as the staff rightly points out, progress has been made, but measures to further enhance governance and transparency will be important to improve the business climate and strengthen economic growth.

Mr. Inderbinen made the following statement:

We take note of the favorable economic outcome in Albania. Like others, we emphasize that the good times should be used to implement reforms that would increase potential growth and further strengthen policy frameworks, building on the achievements over the past years.

On fiscal policy, we welcome the further reduction in the deficit that is expected for 2018. We also acknowledge the goal of the authorities, of maintaining the small size of the government with a low tax burden. But the underperformance of revenue does point to structural weaknesses in tax administration. Here, the delayed VAT refunds stand out. We note that the large share of overdue refunds is related to the three large energy projects, but the delay is also symptomatic of the limitations of the authorities' target-based collection practice. Importantly, the VAT refund delays do have a considerable negative impact on the investment climate in Albania.

My second point relates to PPPs. We acknowledge the large need of the Albanian authorities to improve infrastructure. But as we emphasized in our gray statement, PPPs are an important source of risk to the fiscal position. We welcome the efforts to improve the governance of PPPs, including the legislation that is currently before parliament, as mentioned in Mr. Fanizza's buff statement. But while necessary, an improved legal framework will not in and of itself be sufficient to ensure the better handling of PPP projects. What is also needed is increased administrative capacity, not only in the Ministry of Finance and Economy, but also in the line ministries and agencies that actually implement the projects, like the Ministry of Energy and Infrastructure.

What could also be considered is the further integration of all PPP-related processes in a special designated agency, which might also bring further improvement. We thought this would also be worth consideration and would welcome the staff's comments.

Ms. Mannathoko made the following statement:

We have already issued a gray statement, where we are in general agreement with the thrust of the staff's appraisal. We just wish to follow up on a few issues.

With respect to the issue of the poor monetary policy transmission, we noted that the authorities have recently been intervening in foreign exchange markets to mitigate the impact of the recent strong appreciation.

Jeffrey Frankel did an analysis for the G20 some time back, where he looked at the interplay between reserve accumulation or depletion and central bank interventions and how those impact the influence of monetary policy. In his model, increasing reserve accumulation actually serves to boost the influence of monetary policy. It increases monetary policy autonomy.

We noticed that the recent decision to increase the foreign exchange reserve accumulation may help explain the authorities' observation of early signs of an improvement in the transmission of the policy rate pass-through to lending rates. We were wondering if the staff could consider investigating this as well.

On the issue of credit and banks' risk aversion, their reluctance to lend, I assume this is an information issue. Banks do not have an adequate line to information. But this is more for information. I was wondering whether there is no national credit rating mechanism or how information issues are dealt with by the banks.

Beyond this, we wanted to encourage the authorities to strengthen governance but also to prioritize debt reduction—because the debt burden is still sizable—so that it does not undercut the rest of the reform program.

With that, we wish the Albanian authorities success in their reforms.

Mr. Castets made the following statement:

I thank Mr. Fanizza for his helpful buff statement and the staff for the reports. We issued a gray statement, so I will just make a few comments for emphasis.

Like other Directors, we note the stronger growth performance but also the challenges of accelerating convergence toward the European average.

As mentioned by Mr. Merk, a key issue for Albania is to maintain public debt on a diminishing path. We share the staff's recommendation that putting public debt on a firmly downward path requires further fiscal consolidation. We encourage the authorities to do it in a growth-friendly manner, while not endangering inclusiveness.

Given the social but also the infrastructure needs that have been mentioned, it means that it should mainly go through higher tax revenues. Mr. Inderbinen mentioned the possible expansion of the VAT revenue that is also underlined by the staff in the report.

A second issue that has been raised by Mr. Hemingway and Ms. Pollard is the large exposure to PPP projects. We share Ms. Pollard's assessment that the landscape—with limited access to data amid large exposures—raises questions. More selectivity will be needed. We commend the authorities for the new legal framework recently implemented to give more institutional power to the Ministry of Finance.

Finally, I would like to add my voice to Mr. Hemingway's and Ms. Pollard's request for more detailed information on TA in Article IV reports.

The staff representative from the European Department (Mr. Martijn), in response to questions and comments from Executive Directors, made the following statement:[1]

As was mentioned, we have issued a statement with written answers to several technical questions in the gray statements. At this point, I would like to comment on some of the remaining issues that we did not yet answer and the questions that were raised in the Board.

There was a question about upside risks. Albania is believed to have substantial oil reserves, but the exact size and the economics of extraction are

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

uncertain. Shell, the major international oil company in Albania, is doing exploratory drilling but has not reached a decision on extraction. Even though the upside could be substantial, it is, at present, a low probability with a long-run payout at best. It would take at least five years, for example, for any royalties to reach the public finances.

We also highlighted the upside risks of the possibility that further integration into the EU might move faster than expected, with an acceleration of the reform momentum and economic prospects. A key marker for that will be the decision by the EU in June this year on commencing formal accession discussions.

These upside risks are presented in the staff report. They are not in the risk assessment matrix (RAM). In the RAM, we presented a subset of risks, focusing on those that would entail adverse effects in the short to medium term, and related to which, we see a need for addressing policy gaps or a need for building buffers to mitigate the risks or their impact on the economy or for preparing contingent policy responses.

There was also a question about the authorities' fiscal adjustment plans and the staff's recommendation for a more frontloaded fiscal adjustment. In the authorities' recent medium-term budget framework, they see the deficit declining to 1.9 percent of GDP in 2019 and 1.2 percent by 2021. These planned deficits are larger than in the authorities' plans from a year ago, when they foresaw a decline to 1.7 percent in 2019 and 0.5 percent by 2021. The staff's recommendation is to accelerate the consolidation much in line with the numbers of the authorities' plans from a year ago to build a larger buffer while growth is still strong and to help reduce the country's large refinancing requirements.

The preliminary deficit result for 2018 was better than budgeted, and we hope that would offer a useful starting point for that faster consolidation. But as we also discussed in the staff report, the quality of the adjustment is at least as important.

In this context, there was a question about concerns with the 2019 budget. With rather optimistic revenue projections, the main risks to the 2019 budget might be reflected in a potential need to underspend again in order to meet the deficit target. Albania has a strong record of meeting its deficit targets but often at the expense of ad hoc underspending, especially at the end of the year, which may adversely impact the areas of social and infrastructure spending.

Moreover, given the large infrastructure and human development gaps, we see a need to increase spending in those areas. In the most recent few weeks, the government has been discussing ways to improve higher education but lower costs for students.

Closing the infrastructure in education gaps, combined with a need for further consolidation and the need to offset further revenue shortfalls, all point to the importance of strengthening the revenue base.

We have, in the report and to the authorities, recommended several tax policy measures, such as a broadening of the tax base, reversing some of the recently implemented tax breaks, that would also help improve tax efficiency. In this effort, we have been drawing on the TA provided by the Fund.

In this context, we welcome the authorities' intention to prepare a medium-term revenue strategy with Fund TA. This was one of the recommendations of past TA. We believe that this strategy can help strengthen the tax system and avoid the repeated ad hoc amendments that we have seen in the past two years.

Maybe this is also a good time to say a few more words about the question that was just asked about the integration of TA in the tax area and the surveillance on fiscal policy. Collaboration between the country team that is doing the surveillance and the TA team from the Fiscal Affairs Department (FAD) is very close. We discuss directly with them what they see as the gaps and the recommendations, and those also feed directly into our surveillance recommendations. I just mentioned the examples of the revenue measures that we have been proposing to strengthen the revenue base.

Technical assistance has been quite effective in the area of tax administration, where there has been a significant amount of strengthening. Many reforms have been implemented and are on track. At the same time, the concerns that we mentioned in the report and that are also coming out of the TA advice are more on the policy side, where the ad hoc exemptions and sectoral preferences make it harder to implement the advice on the administration side. That is one of the reasons why the TA advisers would be very happy to have stronger engagement on a medium-term strategy underpinned by TA.

A few gray statements asked about the authorities' plans for creating a development bank to prepare and finance public investment projects using public assets and financing from IFIs. The authorities have prepared draft legislation for such a bank, and they have been discussing their plans with the European Bank for Reconstruction and Development (EBRD). We have cautioned the authorities about the pitfalls of such undertakings based on experiences in other countries. We would stand ready to offer further advice at the authorities' request.

We have also noted that, given the weaknesses in the existing public investment management systems, both for capital spending through the budget and for spending through PPPs, it is important to address those weaknesses first and to avoid diverting the scarce capacity at the Ministry of Finance to other new initiatives if those existing weaknesses would be left alone.

There was also a question in the gray statements about the design of fiscal rules, taking into account the risks faced by the Albanian economy and the importance of its ability to respond to shocks. Our advice in this area follows a selected issues paper on this topic that was part of last year's consultation. In that selected issues paper, it was argued that Albania's main fiscal challenge is to restore sustainability and to rebuild buffers, and so that should be the key objective of its fiscal rules. However, given the large volatility in the numbers and forecast errors, the debt ratio as such could not be the sole core marker of a fiscal rule. In addition, this volatility also greatly complicates the use of a structural fiscal balance as the main instrument. Therefore, the staff has recommended using the overall or primary balance as the operational target anchored on a safe debt level.

Furthermore, that selected issues paper from a year ago argued that, given the macroeconomic volatility, Albania should be really in selecting the debt-to-GDP ratio that anchors the fiscal rule to make sure that the debt dynamics remain under control, even if bad shocks occur.

The paper also emphasized the importance of an automatic correction mechanism to account for deviations and for escape clauses to deal with exceptional circumstances.

The last question from the gray statements that I want to mention is about the cabinet reshuffle that has taken place in the past few weeks. I can provide one update since our written statement, which is that the reshuffle was completed yesterday when the prime minister was sworn in to also function as the minister of foreign affairs. Because these changes in the cabinet are recent and occurred well after our mission, we are not in a position to assess if they might affect any government policies.

I want to continue with some of the questions that were asked in the Board. There was a question about de-euroization and the authorities' policies in that area. This is definitely a priority for the authorities. They are aware of the impact of euroization in weakening monetary policy transmission. That is why they have developed a strategy of the central bank, plus the Ministry of Finance.

International experience is varied in this area, but there are other countries that also have achieved macro stability and low inflation and that then still looked for additional measures to push de-dollarization or de-euroization further. An example would be Peru. Those are the examples that we have been looking at when we explore options with the Albanian authorities. We suggested that one option could be to make sure that pricing and the quoting of prices in ads and payments might be done in domestic currency or in euros and domestic currency, which would be one option to also change the cultural habit of using the euro as the main currency, especially for large transactions.

There was a question about foreign financing and the capital outflows that were noted in the tables. These outflows are primarily driven by the placement of substantial euro deposits overseas, and those deposits are largely driven by the substantial inflows of FDI, tourism, and concessional financing.

Another question was about the composition of public debt on the domestic debt side, the debt that is issued in lek, and whether there might be a risk of financing constraints going forward. At this stage, we do not see those risks as pressing. First, the financial system is very liquid in Albania. They have ample opportunities for more lending in domestic currency. At the same time, the government has been and is still switching away from domestic currency financing toward foreign currency financing. Those constraints that could theoretically happen, especially if domestic currency credit would pick up toward the private sector, we do not see as a pressing issue right now.

Another question was about the proposed changes in the PPP legislation. They are still amended, that have not yet been adopted by parliament. While some sectors were excluded from the revision that would no longer allow unsolicited bids for PPPs to be accepted, the sectors of energy, ports, and airports would be excluded from this change. We discussed this with the authorities. One issue that they mentioned is that those could be complicated projects that require a lot of expertise and for which feasibility studies might be difficult to undertake without outside assistance. Having these projects prepared by a company that had that expertise already might be a way of making sure that the feasibility study is done correctly.

There was a question about foreign exchange interventions and what they mean for monetary transmission. That is definitely an area that we are looking into and hope to look into further. One consideration is the weakness of credit growth in Albania both to the government and to the private sector also and relatively weak growth, which could be one of the reasons why the appreciation is such a persistent phenomenon. In that context, interventions could be helpful by supporting the growth of M2.

There was a question about client information for banks. There is no national credit bureau operating in Albania. We take note of the request for more info on TA in Article IV reports. Of course, it is a broader issue, but we definitely will take note of that for our future reports.

Mr. Fanizza made the following concluding statement:

I will start by thanking Directors for their supportive and encouraging statements. I will pass the message on to my Albanian authorities.

The consultation discussions were quite open and frank. I could not attend them, but I received favorable feedback. The staff provided useful input in policymaking. I believe that the report reflects the authorities' views very well. We are thankful to the team for their efforts.

I also thank staff from the TA departments who have provided essential inputs to capacity building in the country. They are key in fostering the economic performance of the country.

Since the last Article IV consultation, Albania has strengthened its macroeconomic performance, with a higher rate of economic growth and employment. Albania's pace of economic growth has steadily accelerated over the last five years. This is remarkable. However, as many Directors and the staff have highlighted, many challenges remain, which the authorities are fully aware of and on which they are working on, in collaboration with the staff.

In particular, over the recent months, the country has seen growing popular protests because many favorable trends in economic data have not translated sufficiently into widespread economic opportunities. The response to these protests, there was a cabinet reshuffling that tried to increase the momentum of the economic reform and remove the obstacles to the implementation of policies that are more friendly from a societal perspective. In a sense, the reshuffle can be seen as a response to the legitimate demand for increased social inclusion.

There have been questions about whether the momentum in economic reform would slow down as a result. The authorities do not think so because a slowdown in reforms would have an adverse impact on the prospects for starting accession talks with the EU, and Albania would like to engage with the EU.

Making growth stronger and more inclusive while cementing macroeconomic stability requires putting together, in a wise manner, a prudent fiscal approach, sound monetary policy, and structural reforms.

On the fiscal side, let me say that the 2019 budget, which stays on the consolidation path, has served Albania well so far.

Moreover, the budget's overperformance in 2018 lowered the debt-to-the GDP ratio about two percentage points below what the staff had envisaged. This result puts the authorities' target of taking the public debt to the GDP ratio below 60 percent by 2021 clearly within reach. We believe that they are on their way to get there.

When it comes to monetary accommodation in support of economic activity while maintaining low and stable inflation, Bank of Albania supervisory activities continue to support sound credit growth. We are pleased that Directors share the authorities' and the staff's views that recent foreign exchange interventions were justified by disorderly market conditions in the second half of 2018. In fact, starting from the third quarter of 2016, interventions have tapered off, a sign of the commitment to the existing floating exchange rate regime.

On the structural reforms, the crack in the authorities' agenda is judicial reform. The Commissioner for Enlargement and European Neighborhood Policy recently stated that Albania has achieved concrete results in this area. The restructuring of the judiciary will be completed shortly. All judges and prosecutors across the country are undergoing an investigation into their integrity, competence, and criminal background. Only half of the roughly 100 officials who have been going through the vetting process have been confirmed. The process is serious. Our authorities believe that the progress in this area will fulfill the conditions set by the European

Council for opening talks.

There is the likelihood of opening up talks for accession, which not included in the RAM, which is not a big deal. But the problem the authorities put forward is that the same prospect was included in the RAM for northern Macedonia, which was just discussed. There is an issue of evenhandedness. This is not a major problem; but if it is included in the RAM for northern Macedonia, it should have also been included for Albania.

I would like to conclude my remarks by expressing my authorities' appreciation for the work of the team, led by Mr. Martijn, and for the work also of the resident representative office, which has provided valuable contributions to policymaking in Albania.

The Acting Chair (Mr. Zhang) noted that Albania is an Article VIII member and maintained an exchange restriction. The staff did not recommend approval of those restrictions; and thus, no decision was proposed for adoption under Article VIII.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Albania's continued economic growth. Directors encouraged the authorities to use the current favorable economic environment to further advance policies and structural reforms to entrench macroeconomic stability, build buffers, and foster sustainable and inclusive growth.

Directors encouraged additional fiscal consolidation to build stronger buffers. Accordingly, they recommended lowering the fiscal deficit further and accelerating the reduction in public debt, including through stronger revenue measures. Directors welcomed the authorities' aim to achieve a simple, predictable tax system and encouraged them to focus on broadening the tax base and to avoid ad-hoc tax measures that create distortions in the tax system.

Directors recommended containing fiscal risks, including those stemming from public-private partnerships (PPPs). They highlighted the need to consolidate and strengthen the decision-making processes in public investment management and underscored the importance of ensuring value for money for PPP projects through competitive bidding. Directors also called for determined measures to halt the persistent build-up of government arrears, as these hurt private economic activity and undermine trust in the public sector.

Directors agreed that the accommodative monetary policy stance remains appropriate. They considered that the normalization of monetary policy should remain data dependent, aimed at reaching the inflation target over the medium term. Directors welcomed the authorities' commitment to maintain exchange rate flexibility and agreed that interventions should be temporary and limited to preventing disorderly market conditions and a destabilization of inflation.

Directors called for strong measures to address the bottlenecks to credit growth and to improve the effectiveness of monetary transmission. They encouraged the authorities to expedite the implementation of de-euroization measures, and to address structural weaknesses in the provision of credit, including continued high NPLs. Strengthening property rights and insolvency regimes will be helpful in this regard.

Directors emphasized that the authorities should continue to strengthen financial supervision to safeguard financial stability within the changing architecture of the banking sector. They also encouraged the authorities to continue to enhance the AML/CFT framework.

Directors called for resolute structural reforms to improve the business climate, with emphasis on strengthening the rule of law. Welcoming the progress thus far, they underscored that it is important to complete the ongoing judicial reform and strengthen anti-corruption efforts. Directors emphasized the need to reduce the pervasive informality, by maintaining a simple and fair tax system, sustaining improvements in tax collection, and by increasing the quality of public services.

It is expected that the next Article IV Consultation with Albania will be held on the standard 12-month cycle.

APPROVAL: April 21, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. As noted in the staff report, there are also some upward risks such as a visible progress toward EU accession or a greater-than- expected increase in domestic energy production if large oil reserves prove economical to extract. Could staff elaborate on those upside risks and on the reasons why they are not included in the Risk Matrix Assessment?

- Staff will respond to this question during the Board meeting.

2. We would appreciate staff's clarification on why the high public debt levels and large financing gaps are not included in the Risk Assessment Matrix - though it does highlight rollover risk, given the extent of short-term public debt.

- The RAM mentions three risks related to Albania's public debt: (i) the impact of tightening financial conditions on the cost of servicing the debt; (ii) risks of financial disintermediation putting pressure on demand for public debt; and (iii) rollover risks due to concerns about debt sustainability, combined with the relatively short-term nature of domestic debt. Through these three channels, the RAM aims to capture the main risks that are the result of the level and composition of Albania's public debt.

- While financing needs are large, the sources of financing are to a large degree concessional loans from IFIs and bilateral partners, combined with Eurobond financing. It is also worth noting that portfolio flows are quite small, thus refinancing risks due to the flight of hot money are not significant.

3. On the current account, could staff indicate the reason for the drop in current transfers over time (depicted in Figure 2 on Page 7)? With transfers dominated by remittances, it is also unclear why remittances are projected to decline over time (Table 3a, footnote 1)

- Current transfers averaged about 7 ½ percent of GDP between 2014 and 2017. We project that these transfers, including remittances, will grow at a rate equal to the average of the last decade over the medium-term. However, with the expected level of GDP growth, transfers as a percentage of GDP will gradually decline (after growth over the past decade was depressed by the sharp slowdown of 2012-15).

4. ***In moving forward, we wonder if the latest cabinet reshuffle noted in the staff representative's statement will affect the reform momentum. Staff's comments are welcome.***

- Staff will respond to this question during the Board meeting.

Tax policies and tax administration

5. ***Staff's comments on the Fund's technical assistance provided to the tax and customs administration in the area of revenue mobilization are welcome***

- Albania has benefited from the extensive IMF TA in many areas, including tax administration and tax policies (see the Informational Annex of the Staff Report for a more detailed list of TA). The TA in tax administration has had noticeable traction and there has been a good progress in modernizing the administration of the tax system and in strengthening the core revenue administration. The General Directorate of Taxation (GDT) has actively worked on addressing the weaknesses identified in 2016 TADAT assessment in the three components of the administration – people, processes and technology, delivering tangible outcomes.

- Two processes/outcomes are particularly noteworthy:

  (a): Business process changes that supported the transition to a more modern tax administration, particularly in compliance risk management (CRM) and arrears collection, and,

  (b): The implementation of the Information Technology system in 2015, which is providing a platform for more efficient and effective internal operations of the GDT and increased availability of e-services for taxpayers. For instance, the increased use of online services (including the use of the e-Albania portal for tax payments and tax certificates) is facilitating a shift from face-to-face contact with taxpayers for more routine matters.

- Regarding tax policy, the focus of TA in recent years was on reforming property taxation, strengthening policies related to international tax treaties, reforming the fiscal regime for the petroleum sector, and assessing the government's tax reform plans. The progress was particularly notable in property taxation.

6. ***We would be interested in staff's assessment of the revenue potential of increased taxation of the informal sector, as mentioned by the authorities. In a similar vein, how does staff assess the budgetary potential of additional efforts in tax compliance and anti-corruption?***

- The high level of informality impacts adversely on domestic resource mobilization in Albania by reducing the tax base. In particular, it undermines compliance, and distorts the level playing field for tax-compliant firms.

- Tackling informality is high on the authorities’ agenda. Since 2015, several phases of an anti-informality campaign have been implemented, focused on three key components:

✓ **Communication**: public awareness and business awareness, on the relevance of the fight against informality. Part of the public awareness campaign focuses on legal economic activities that are subject to standard user fees and taxes, but which simply avoid their tax obligations through various means;

✓ **Legislation**: tightening legal measures against those operating outside the tax system, and a 2017 law to introduce incentives to taxpayers for becoming tax compliant through an amnesty program; and,

✓ **Sectoral analysis**: identification of high-risk business sectors that will be analyzed and inspected by a joint task force of administrative agencies (General Directorate of Taxation, General Directorate of Customs, Sector against Economic Crime, and Labor Inspectorate).

- Staff has emphasized the case for a more balanced approach that would lean towards more simplicity and clarity of the legislative framework as an incentive for improving compliance. Many countries seek to design special tax provisions to address informality with the view to minimizing small businesses’ tax compliance burden. This approach would assist especially start-up firms to grow their business.

7. While the authorities assume additional improvements in revenue administration, including new systems for data integration and tackling informality, as a source of higher revenue, how does staff see impacts of the administration reforms on revenues?

- The tax administration reforms are crucial in facilitating revenue mobilization, and the authorities’ progress in this area have been commendable and should be continued. However, the revenue potential from revenue administration improvements is undermined by the recent tax policy reforms, that have narrowed the tax base and complicated tax administration.

8. In addition to enlarging the scope of activities covered by the VAT, could staff elaborate on other revenue-enhancing measures that it would recommend?

- Staff recommends continued efforts towards improving tax administration and strengthening tax policy specifically through the measures discussed in the Staff Report and summarized in the text box (page 12 of the Staff Report). The recommended policies include: indexation of excise rates to inflation, increasing plastic waste packaging taxes, and broadening the VAT base.

- Staff also recommends refraining from introducing ad-hoc tax cuts, exemptions, or preferential treatments and to rolling back those already implemented. Without consistent and supportive tax policies, the efforts to strengthen tax administration may produce only limited positive outcomes.

Fiscal policy and debt sustainability

9. We note the staff's recommendation for a more front-loaded fiscal adjustment. Could staff comment on this as well as the implied attenuation of the fiscal adjustment plans in the more recent past?

- Staff will respond to this question during the Board meeting.

10. Do staff have thoughts on how the 2019 budget concerns might be addressed without undermining fiscal credibility?

- Staff will respond to this question during the Board meeting.

11. Given the risks faced by Albania, further strengthening of fiscal rules as proposed by staff should be considered in the context of its ability to respond shocks. Staff comments are welcome.

- Staff will respond to this question during the Board meeting.

12. Further staff comments on the establishment of a development bank to finance public investments would be welcome.

- Staff will respond to this question during the Board meeting.

13. Staff comments are welcome on the effectiveness of the reverse charge mechanism for contractors and sub-contractors in avoiding new arrears accumulation.

- Given that the bulk of VAT arrears are with large-energy sector investors, the authorities have decided to introduce a reverse charge mechanism with the largest three to limit the further build-up of VAT arrears. Under this mechanism, a zero VAT rate will be applied to imports and domestic supplies of goods and services to those investors; thus, they will not be eligible for VAT refunds. Staff has cautioned that while the reverse charge initiative may reduce the further build-up of VAT refund arrears, it may also introduce complex taxpayer compliance risks in the domestic supply chain involved in operations of these three companies, particularly if their suppliers also trade with other businesses outside the chain. Moreover, the "reverse charge-type" arrangement is a short-term/quick fix to a long-standing set of institutional deficiencies in the forecasting of net tax revenues which, combined with wider weaknesses in cash management and budgetary controls, have been at the root of recurrent VAT refund problems (see also Annex V of the Staff Report).

PPPs

14. Staff's comments on the nature of PPP projects foreseen in the 2019 budget are welcome .

- For the last decade, Albania has been actively using PPPs to facilitate public investment. As discussed in the staff report, the existing stock of PPPs is about 31 percent of GDP (covering more than 220 projects, including concessions in energy of more than 23 percentage points). The 2019 budget documents foresee a pipeline of potentially new PPPs capped at 15 percentage points of GDP. This pipeline includes projects in transportation infrastructure (road, airports), health care, and education.

15. We wonder whether the authorities have considered requesting the Fund's Public Fiscal Risk Assessment Model diagnostic tool to better evaluate PPP fiscal costs, and identify and mitigate the fiscal risks.

- Most of the PPPs are user-funded (in particular, concessions), where a private party receives a license to utilize a publicly owned resource (e.g., land, existing road, water resources) with the right to collect fees from users, and often pays to the government an annual concession fee for this right. Our estimates indicate that only 12 of the PPP contracts are government-funded, where the private party provides public goods and services in exchange for government payments (e.g., availability payments, or payments per volume of service).

- The authorities have utilized extensive IMF, WB and EC technical assistance to introduce the Public Fiscal Risk Assessment Model diagnostic tool. However due to data constraints and limited technical capacity this process has not yet generated tangible assessment results.

16. ***We would like to have staff's comments on the proposal to halt the acceptance of unsolicited PPP proposals to reduce fiscal risks.***

- Staff has recommended ending the practice of accepting unsolicited PPP proposals, in which a project proposal and its feasibility study are prepared by a private party, which was then been given preference in the bidding process. The staff recommendation aimed to ensure that only projects in line with the government priorities are procured, that there is consistent decision making on public investments regardless of procurement and financing modalities, and that procurement is conducted in a competitive way.

- Recently tabled amendments to the PPP legislation envisage halting the acceptance of unsolicited bids in most sectors, but still allow their usage in the energy sector and for ports and airports. Based on the new rules, companies proposing unsolicited proposal will no longer get preference in the bidding process, but can receive direct compensation for the cost of preparing the project.

Monetary policy transmission de-euroization strategy, credit growth

17. ***Concerning the issue of credit growth, we would be interested in additional staff comments on possible explanations for the slump on the demand side.***

- Aggregate credit growth has two main drivers: first, the aggregate volume of loans requested by households and firms and, second, the capacity and inclination of banks to accept loans application. The latter, which determines how much credit demand is bankable, is limited, due to several factors, including, borrowers' risk, banks' risk appetite, and the fact that banks can only extend credit based on formal financial statements.

- To understand and estimate the demand for credit, twice a year, the authorities conduct a financial survey of household and corporates investigating their financial situation and borrowing.[2] These surveys suggest that demand for credit is moderate at best, which might reflect the very low level of industrialization in Albania, the high level of informality (see also the answer to question 6), and also the distribution of firms size, with micro-firms (1-4 employees) representing 90 percent of the total number of registered firms.[3,4]

[2] https://www.bankofalbania.org/Financial_Stability/Financial_Stability_Reports/Financial_Stability_Reports/

[3] See World Bank, "Job Dynamics in Albania" (2018)

[4] Survey results of the financial situation and borrowing of households and survey results on the financial situation and borrowing of enterprises, box 4.1 and 4.2 respectively in the 2018 H1 BoA financial stability report

- As a separate issue, the high degree of NPL within corporate loans (17 percent in 2018 H1, from 26 percent in 2013) also helps explain the weak effective demand for credit, as the high degree of NPLs suggests that the intrinsic capacity of these corporates to service their debt is weak.

18. Staff's comments on specific policies to resolve structural obstacles to private sector credit growth will be appreciated.

- Staff has suggested different policies to support the resolution of structural obstacles to credit growth (see in particular the paragraph 31 and 35 in the staff report):

  (i) Repair bank's balance sheets, in particular by tackling NPLs, to unlock credit provision. Such policies include a strong enforcement of the new bankruptcy law, enactment of the regulatory framework for out-of-court settlement agreements to resolve NPLs, resolving the deadlock around more efficient operations of private bailiffs, and rules to accelerate loan write offs.

  (ii) Further efforts to reduce the high level of informality in Albania including through adjustments in the tax system (see question 6), given that banks can only extend credit based on formal financial statements.

  (iii) Bolster financial inclusion, in particular through financial education, with specific actions from the financial authorities to the general public (for details, see the response to question 20).

  (iii) Continue the development of capital markets, including by developing a second pillar of the pension system, which would deepen capital markets and support new, longer-term funding options.

19. Noting the staff's suggestion of administrative government action to promote the use of local currency for the pricing and payment of non-tradable goods, we appreciate staff's evaluation on the authorities' strategy of de-euroization in light of international best practices?

- To support de-euroization, in 2017, the Ministry of Finance and Economy (MoFE) and the Bank of Albania (BoA) signed a "Memorandum of Cooperation on Increasing the Use of the National Currency (ALL) in the Albanian financial system and economy.

[5] cf. for instance International Experience of De-Dollarization (BBVA 2016), Euroization Drivers and Effective Policy Response (IMF 2017), De-Dollarization of Credit in Peru (BCRP 2016)

- The de-euroization strategy is built on two pillars: first, strengthening the Albanian macro-financial framework, including via prudent fiscal policy, and the commitment to the inflation targeting regime; second, targeted measures implemented by the central bank such as differentiated reserves requirements for local and FX deposits, as well as negative remuneration on the required reserves in FX, and transparency obligations to banks to communicate currency risks to unhedged borrowers. Specifically, the BoA, with IMF technical assistance, was one of the first central banks in the world to introduce a negative remuneration on its required reserves in foreign currency.

- As discussed in the Staff Report, although it is too early to assess the effectiveness of the BoA's actions, staff has suggested that these could be complemented with administrative measures to promote the use of local currency for the pricing and payment of non-tradable goods, as well as improvement in financial education.

- International experience[5] suggest that de-dollarization policies using other types of instruments can be successful as well, including: inflation-indexed instruments in Chile and Israel, a de-dollarization repo in Peru, public debt de-dollarization in Mexico, or targeted policies to curb corporate FX exposure in Indonesia. However, there might not be one size fits all solution, and any measure should be adapted to Albania's characteristics.

20. As noted in the staff report, low level of financial inclusion hinders credit growth and thus we would appreciate staff's elaboration on the authorities' plan to address this issue.

- The authorities plan for fostering financial inclusion relies strongly on improving financial literacy through education, with specific actions by the financial authorities in schools and events towards the general public (public awareness campaign). The BoA has designed a plan[6] to support financial education, including: training seminars for high school teachers of applied economics, meetings with high school students, designing a competition about the "real value of money", publishing educational brochures, training seminar for social workers in Tirana, and delivering lectures in universities.

[5] cf. for instance International Experience of De-Dollarization (BBVA 2016), Euroization Drivers and Effective Policy Response (IMF 2017), De-Dollarization of Credit in Peru (BCRP 2016)

[6] "Education, the new challenge of the bank of Albania" https://www.bankofalbania.org/rc/doc/Education_The_new_challenge_of_the_Bank_of_Albania_5501_2_7032.pdf

- The authorities are also supporting new alternatives to bank financing to diversify funding sources. The Albanian financial authorities have licensed two new investment funds in 2018 as well as a stock exchange (which is, so far, a trading platform for government bonds). The authorities have adopted a careful approach to these new channels, to mitigate financial stability concerns.

- It should also be noted that the income and education gaps between rural and urban areas effectively limit relative financial inclusion in the latter areas.

Exchange rate policies, competitiveness

21. Could staff elaborate on the main reasons behind the marked increase in exports to Italy that has taken place in the last two decades (Figure 2)?

- The increase largely reflects substantial Italian investment in the textile and footwear sectors and the associated export of such goods back to Italy for either domestic consumption or re-export to other countries.

22. Could staff provide additional comments on potential drivers behind the sustained upward pressure on the LEK observable since mid-2015 and the recent sharp appreciation?

- Between January 2015 and December 2018, Albania effective exchange rate has appreciated by 16.7 percent in nominal terms and 16.9 percent in real terms, while the bilateral exchange rate lek/euro has appreciated by 10.9 percent and 11.3 percent in nominal and real terms respectively, reflecting low inflation both in the euro area and in Albania.

- As mentioned in the staff report, large idiosyncratic capital inflows (including the conversion of commercial bank capital into Lek) spurred the appreciation of the exchange rate against the euro during March-June 2018. Other flows, such as remittances and tourism inflows have also contributed. Moreover, the local FX market is quite thin (daily turnover around EUR 25 million) and dominated by 3 or 4 large players, which can result in large price changes. Finally, sluggish private credit growth in Lek combined with a switch to public debt issuances into Euro (Eurobonds) rather than Lek, have dampened the relative supply of lek, which could contribute further to the exchange rate appreciation.

- The BoA decomposed the appreciation of the exchange rate between two trends:[7] from 2015-2017, the appreciation "was dictated mainly by fundamental factors and during this period the exchange rate did not have large deviations from its equilibrium". However, according to the BoA, the appreciation since the beginning of 2018 was largely caused by "specific developments in the foreign exchange market, which have induced a change in some of the agents' behavior, producing a temporary imbalance of supply and demand". Against this background, the temporary intervention of the Bank of Albania in the foreign exchange market since June 2018 has "reduced misbalances in the supply and demand for foreign currency, calmed the functioning of the foreign currency market and decelerated the rapid appreciation of the lek[8] ".

23. Staff's comments on the implication of the recent appreciation of the Lek for external competitiveness, including exports, are welcome.

- Export growth has been quite robust in 2018 despite the recent acceleration in the real appreciation of the Lek. Albania has benefitted from strong external demand, a rebound in electricity production, and relative cost competitiveness, including low labor costs. If appreciation persists, however, we would expect to see a weakening of external competitiveness and a decline in demand for the more price elastic Albanian export goods and services.

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[7] cf. Box 1, BoA monetary policy report, 2018 III, page 25

[8] cf. BoA monetary policy report, 2018 IV, page 23