IMF Country Report No. 13/7

ALBANIA

2012 ARTICLE IV CONSULTATION

January 2013

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Albania, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 2, 2012, with the officials of Albania on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 16, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Staff Statement**
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its December 3, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Albania.

The document listed below has been or will be separately released.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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ALBANIA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

November 16, 2012

KEY ISSUES

Context: Albania has successfully avoided a serious economic slowdown since the outbreak of the global crisis four years ago. But now, policy buffers are absent, and macroeconomic imbalances persist. With the ongoing eurozone problems, the economy has slowed, and the financial sector is exposed to domestic and external risks.

Fiscal Policy: Arresting the upward trend in public debt in the near term to anchor market expectations, and undertaking sustained but gradual fiscal consolidation over the medium term would strike an appropriate balance between signaling the government's commitment to debt sustainability, and limiting the adverse impact of fiscal consolidation on the weak economy. Adjustment could entail modest increases in tax rates, as well as trimming current spending. Improving the debt trajectory would also mitigate fiscal financing risks emanating from high rollover needs.

Financial Sector: Containing spillovers from the eurozone crisis and minimizing negative feedback from a slowing economy will require close banking supervision and continued close cooperation with foreign regulatory authorities. The problem of rapidly rising nonperforming loans should be addressed by clearing unpaid government bills and improving collateral execution. Work on deepening public debt markets and lengthening maturity should continue.

Structural Reform: Strengthening property rights, improving contract enforcement, and simplifying the tax system would encourage investment and medium-term growth.

Approved By
Aasim M. Husain and Masato Miyazaki

Discussions were held in Tirana on September 19-October 2, 2012. The staff team comprised Mr. Ilahi (head), Mr. Gaertner, Mr. Ioannou, and Ms. Tambunlertchai (all EUR), and Ms. Araujo (SPR), and was assisted by Ms. Spahia (local office). Mr. Husain (EUR) joined some of the policy discussions. The mission met with the Prime Minister, Finance Minister, Bank of Albania Governor, other senior officials, banks, private sector representatives, unions, and parliamentarians.

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CONTEXT: UNFINISHED REBALANCING AND REFORMS

1. After successfully avoiding a serious decline in growth and financial instability since 2009, the economy is weakening and macroeconomic imbalances are elevated. Albania has largely avoided a sharp fall in output since the crisis broke, kept inflation low and stable, and maintained banking system stability, thanks to a fiscal stimulus, sound monetary policy and effective macroprudential actions. But today, policy buffers are exhausted, macroeconomic imbalances persist, and with the ongoing eurozone problems, the economy has slowed. The financial sector is exposed to domestic and external risks, and incomplete investment climate reforms constrain medium term growth.

2. Implementation of earlier Article IV consultation recommendations has been mixed. The authorities have strengthened financial sector supervision, crisis preparedness, and bank resolution frameworks in line with 2011 Article IV consultation recommendations, but have made limited headway toward sustained fiscal consolidation.

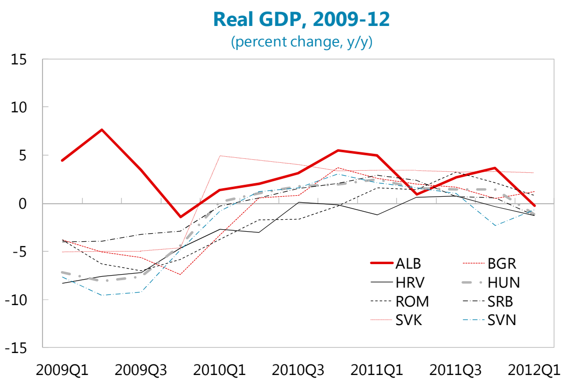
3. The possibility of EU accession is an anchor for consensus on reforms, but the upcoming election season could polarize positions. In October 2012, the European Commission recommended that Albania could be granted EU candidate status, subject to completion of key measures in the areas of judicial and public administration reform and revision of the parliamentary rules and procedures.[1] While there appears to be wide support for moving toward EU membership, bipartisan consensus on reforms is unlikely in the run up to parliamentary elections in June 2013.

RECENT DEVELOPMENTS: EUROZONE CRISIS TAKING A TOLL

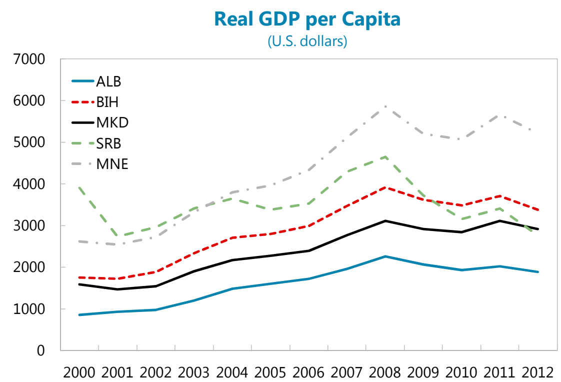
A. The Economy: Weakening Amidst Elevated Imbalances

4. Albania has so far managed the headwinds from the global crisis reasonably well. The growth shock was less severe than elsewhere in Europe, thanks in part to the use, albeit modest, of the public sector balance sheet, which partially offset weak private demand. Monetary accommodation also helped mitigate the impact on domestic demand. Other factors, notably exports of hydroelectricity in 2010 and crude oil in 2011—driven by good rains and coming on stream of oil production, respectively—also helped. The financial system has proved broadly resilient, notwithstanding the preponderance of foreign banks, thanks largely to strong macroprudential regulations.

[1] http://ec.europa.eu/enlargement/pdf/key_documents/2012/package/al_conclusions_2012_en.pdf



Source: WEO, Albanian authorities, and IMF staff calculations



Source: WEO

5. **The eurozone crisis is weighing down on the economy.** Output grew by 1.0 percent during 2012:H1 (in part because of severe winter weather), compared to 2.7 percent in the same period in 2011, and could slow further, in line with other countries in the region. Core inflation has also been on a declining trend. Credit growth fell sharply between January and August, as consumer and investor confidence weakened with the worsening outlook in eurozone neighbors. As a result, the economy is expected to operate below potential (about 2.6 percent growth) in 2012. While the current account deficit has begun to adjust on account of weakening imports (Figure 1), the narrow export base and sluggish external demand limit the extent of the correction. Heavy exposure of exports and remittances to Italy and Greece carries near-term risks (Box 1).

B. Public Finances: In Need of Adjustment

6. **There are no fiscal buffers to stimulate the economy.** At nearly 60 percent of GDP, the debt-GDP ratio today has reached the statutory ceiling and is among the highest in the region. As a result, new debt-financed fiscal stimulus would be counterproductive.

- *Tax revenues continue their downward trend.* Since 2008, revenues have fallen steadily, by about 1.5 percentage points of GDP, and budgetary projections have repeatedly proven optimistic. The economic slowdown has affected tax revenues, but tax reform, motivated by the need to enhance competitiveness—such as the introduction of a flat personal income tax and a low corporate income tax in 2007–08—has also limited the scope for additional revenues.

Albania: General Government Operations, 2010-12
(Percent of GDP)

	2010		2011		2012	
	Budget	Outturn	Budget	Outturn	Budget	Proj.
Total revenue and grants	28.2	25.8	27.1	25.1	25.6	24.8
Tax revenue	25.7	23.3	24.9	23.0	23.4	22.7
VAT	9.9	9.2	10.2	9.0	9.2	9.0
Profit tax	1.5	1.4	1.4	1.5	1.6	1.2
Excise tax	3.3	3.1	3.3	3.1	3.1	2.8
Personal income tax	2.6	2.2	2.4	2.1	2.1	2.0
Social insurance contributions	4.8	4.4	4.4	4.3	4.3	4.3
Other	2.5	2.5	2.2	2.0	2.2	2.1
Total expenditure	32.1	29.6	30.6	28.5	28.6	27.9
Current expenditure	24.9	24.2	24.1	23.2	23.2	23.3
Personnel cost	5.1	5.3	5.2	5.1	5.1	5.2
Social insurance outlays	8.4	8.6	8.7	8.6	8.8	8.9
Capital expenditure	6.4	5.8	6.2	5.4	5.0	4.4
Other	0.8	-0.5	0.4	0.0	0.3	0.2
Overall balance	-3.9	-3.7	-3.5	-3.5	-3.0	-3.1
Memorandum Items:						
Public debt	…	57.8	…	58.6	…	60.9
Domestic general government	…	32.9	…	33.3	…	34.1
External	…	24.9	…	25.3	…	26.8
Share of capital expenditure (% total exper	20.0	19.6	20.2	18.8	17.6	15.8
Social security financing gap	-3.6	-4.2	-4.3	-4.3	-4.5	-4.5
GDP (in billions of leks)	1,279	1237	1,335	1319	1,390	1357

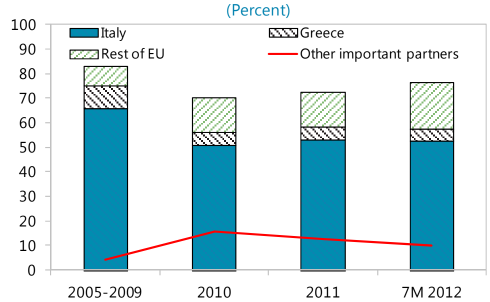
Source: Albanian authorities; and IMF staff estimates and projections.

Box 1. Spillovers from the Eurozone Crisis

Albania's close export, banking and migration links with the eurozone make it vulnerable. So far the direct effects of export and banking shocks from the eurozone have largely been contained or dealt with, but the worsening outlook in Europe and declining remittances have affected confidence and demand, and possibly added to joblessness.

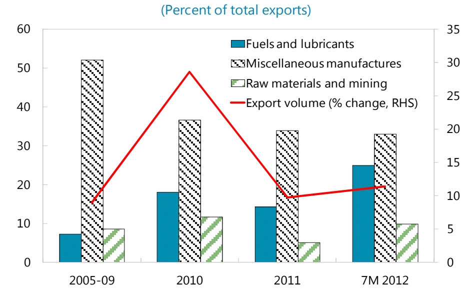
Despite Albania's strong export links with the crisis-affected countries, to date direct trade spillovers have not been as severe as would be expected. Near 80 percent of Albania's exports go to the EU, with Italy alone accounting for about 60 percent. Weakening demand in the eurozone, particularly in Italy, is expected to affect Albania's exports. However, direct trade related spillovers have been rather modest so far. While Albania's traditional exports (e.g., textiles and clothing), which typically have high employment content, have fallen since 2008, there has been a reorientation to new products (e.g., oil and minerals exports) and markets (e.g., China and Turkey). As a result, aggregate exports have not declined. The relatively low share of exports in Albania's GDP also means that direct trade related spillovers in future could have a muted impact on growth.

Destinationof Exports, 2005-12
(Percent)



Source: Bank of Albania, and IMF estimates.

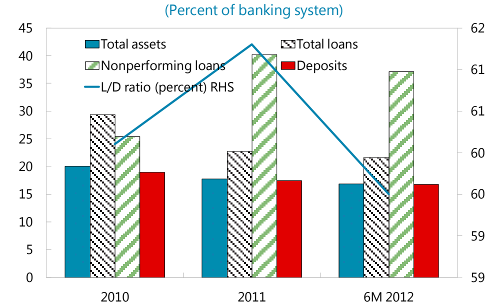
Merchandise Exports, 2005-12
(Percent of total exports)



Source: Bank of Albania, and IMF staff estimates and projections

Banking spillovers are also broadly contained, despite the preponderance of European banks. The banking crisis in Greece has impacted Greek subsidiaries (Greek banks account for one-fifth of Albania's banking system), though the effects have been mitigated. Even though Greek subsidiaries constitute less than 1 percent of their parents' assets, they experienced some parent funding stress, deterioration in asset quality (in part because of problem loans to entities connected to Greece) and falling remittances, and decline in profitability. Greek subsidiaries responded by shrinking their balance sheets and slowing lending. They now rely mainly on domestic funding. Interbank market operations in Albania have also not seen stress. Low pre-crisis reliance on external funding meant other European subsidiaries in Albania did not face deleveraging as in other countries in the region.

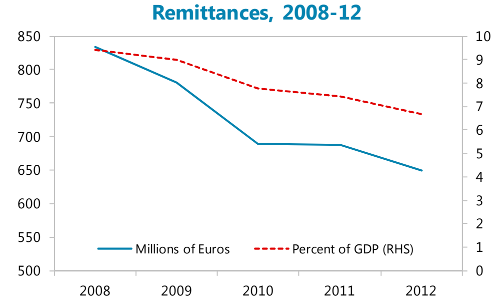
Greek Subsidiaries Indicators, 2010-12
(Percent of banking system)



Sources: Bank of Albania, and IMF staff estimates

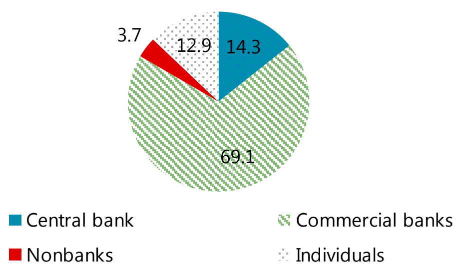
Migration links with Greece and Italy have affected Albania; indirect confidence effects have been strong. Remittances from Greece and Italy comprise more than two thirds of all remittances. While the crisis has adversely impacted remittances, which have been falling since 2008, the magnitude of the impact may be masked by the repatriation of returning emigrants' savings. Nevertheless, the loss of permanent remittance income has affected domestic consumption, while return migration, particularly from Greece, could have added to joblessness. An important spillover has been indirect—a worsening economic outlook in Greece and Italy has dampened consumer and investor confidence in Albania.

Remittances, 2008-12



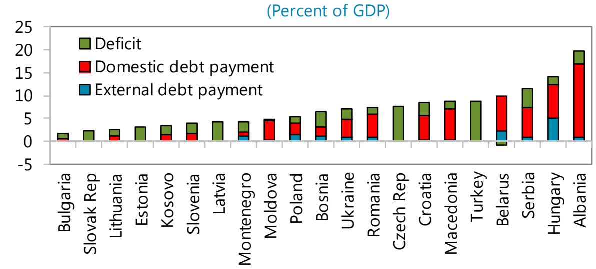
Source: Bank of Albania, and IMF staff estimates and projections.

Public Domestic Debt by Creditor, 2011
(Percent of total)



Source: Albanian authorities and IMF staff estimates.

Fiscal Financing Needs, June-December, 2012
(Percent of GDP)



Source: IMF staff estimations and projections.
1/ For Czech Rep., Estonia, Latvia, Turkey, and Ukraine, there is no breakdown available. Full year figures for Bosnia, Estonia, and Turkey.

- *Most of the expenditure cuts have been unplanned,* and *focused on capital.* With revenue tending to disappoint by midyear, the authorities, in an attempt to restrict fiscal deficits ex post, have been curtailing capital spending, as scope for cuts to discretionary spending has been limited. In 2012, the government has also accumulated liabilities in the form of unpaid bills to contractors (about 1–2 percent of GDP).

7. Fiscal financing risks are elevated. Albania's fiscal financing needs are the highest in the region, and with short-term debt representing more than half of public debt, the government faces significant rollover risks. About 70 percent of public debt is held by commercial banks, some of whom have recently been under pressure to shed exposure to public securities (Appendix II), although with ample bank liquidity and limited credit demand, rollover risk has moderated somewhat recently.

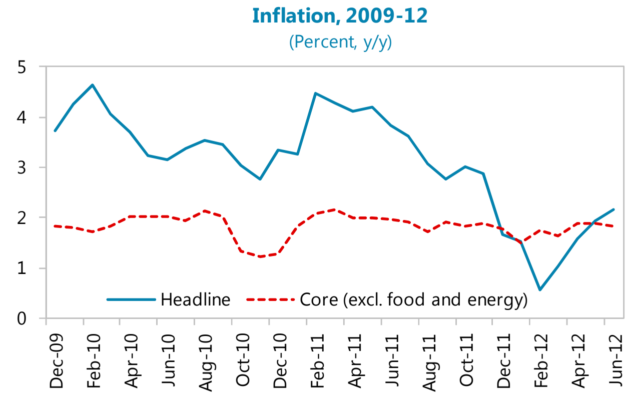
C. Banking System: Stability Amidst Continued Risks

8. The banking system has been resilient so far, but domestic and external spillover risks are concerns (Figure 4). Unlike many regional countries, Albania did not experience a big boom-bust credit cycle, in large part because of prudent limits on external borrowing prior to the crisis. Banks today exhibit high liquidity and solvency ratios (Table 5), supported by continued stringent liquidity and capital requirements. Nonetheless, NPLs have risen sharply over the last two years and now exceed one fifth of all outstanding loans, the highest ratio in SEE (80 percent of NPLs are in the corporate sector—largely in trade, construction and manufacturing). Further, a large pool of "watch loans"—representing the leading edge of possible new NPLs—could add another 5–10 percentage points down the road. Provisioning has been adequate, but bank profitability has suffered, and some banks are shrinking their loan portfolios to meet capital requirements.

9. Exposure to Greece is a near-term risk. Greek bank subsidiaries have made considerable progress in re-aligning lending with their domestic deposit base and increasing capital (Box 1). However, economic distress in Greece could adversely affect parents' ability to inject new capital in their Albanian subsidiaries, if needed. To address possible risks, the Bank of Albania (BoA) has applied more stringent capital and liquidity requirements on Greek banks, and heightened coordination with Greek authorities.

D. Monetary Policy: An Anchor of Stability

10. Albania's success at maintaining low inflation has been vital in buttressing macroeconomic stability. The inflation targeting regime has been highly effective in overcoming various shocks and keeping inflation low and stable. Not surprisingly, despite a global food and commodity price-related uptick in inflation recently, expectations remain well anchored within the BoA's 3±1 percent annual target range. With the economy showing signs of weakness, the BoA has lowered its policy rate (1-week reverse repo rate) five times since August 2011, to a historic low of 4 percent (Appendix III).



Source: INSTAT, IMF staff estimations and projections

E. Structural Reforms: Potential Largely Unexploited

11. Progress in reforming the business climate has been limited. Albania ranks 85th out of 185 countries on the World Bank's Doing Business indicator, a deterioration of 8 places over the past three years (Figure 5). Continued weaknesses in the legal framework (e.g., property rights and contract enforcement), along with known difficulties in obtaining construction permits, paying taxes, and accessing electricity affect Albania's investment climate. Moreover, perceptions of corruption and weak governance affect the view of Albania as an investment destination. Arbitrariness of tax collection undermines the attractiveness of Albania's low tax rates for businesses.

12. Energy security has deteriorated recently, and poses fiscal risks. With hydropower accounting for 95 percent of electricity production, Albania's energy security hinges on adequate rainfall, and output is often inadequate to meet domestic demand. A brewing dispute between the privatized distributor and the public power generation company over cross claims, the inadequacy of the former's infrastructure investments and a lack of tariff adjustment by the regulator also threaten electricity supply.[2] These problems pose fiscal and growth risks—the government has thus far committed about 0.7 percent of GDP in 2012 in loans and guarantees for energy imports.

[2] The World Bank is providing assistance to resolve the ongoing dispute.

REPORT ON THE DISCUSSIONS

A. Outlook and Risks

13. **Staff expects weak confidence to affect growth over the near term.** Staff expects growth to decline to about 0.5 percent in 2012, from 3 percent in 2011, as weakness in Albania's external partners exacerbates sluggish domestic demand. Staff's projection for Albania is broadly consistent with those in other neighboring countries. Inflation would remain within the central bank's 3±1 percent target range.

14. **The authorities expect a more modest slowdown.** While agreeing with staff that economic growth was slowing, the authorities ascribed the economic weakness in 2012:Q1 to exogenous factors (weather) and expect a more robust recovery in 2012:Q4 than staff. They expect 2012 GDP growth at about 1–2 percent.

Real Growth Projections, 2012–14

(Percent)

	2012	2013	2014
Albania	**0.5**	**1.3**	**2.5**
Regional Average	0.7	1.9	2.6
Bosnia and Herzegovina	0.0	1.0	2.5
Bulgaria	1.0	1.5	2.5
Croatia	-1.1	1.0	1.5
Kosovo	3.8	4.1	3.2
Macedonia, FYR	1.0	2.0	3.5
Montenegro	0.2	1.5	2.0
Romania	0.9	2.5	3.0
Serbia	-0.5	2.0	2.5
Main Trading Partners			
Greece	-6.0	-4.0	0.0
Italy	-2.3	-0.7	0.5

Source: WEO and IMF staff projection

15. **Staff sees unchanged policies as yielding anemic growth over the medium term.** Staff expects only a mild pickup in economic activity in 2013, aided, to some extent, by monetary easing, a modest recovery in confidence in H2 and progress in alleviating financial market stress. Under the baseline (unchanged medium term policies) scenario, the economy would recover but remain weak as high deficit and debt constrain growth. In particular, until 2017 actual output could hover below potential (which has been experiencing a secular decline in recent years) and would reach potential by 2017 only.[3] This is largely because:

- *A strong rebound in external demand is unlikely.* Although immediate risks have recently receded in the euro area, economic weakness is likely to persist, affecting external demand as well as domestic confidence, including through weak remittances.

- *Financial sector problems could feed back to the real economy.* High and rising NPLs are likely to unwind only gradually, keeping credit rather tight and affecting the corporate outlook.

16. **The authorities' view of the medium term outlook is more sanguine.** They pointed to the country's untapped natural resource wealth, notably mining and hydroelectricity, which promises opportunities for new investment. They also underscored the flexibility in Albania's productive base, which has led to some export diversification, thereby limiting the adverse impact of a protracted

[3] Declining total factor productivity and a loss of reform momentum are the primary reasons for the secular decline in Albania's potential growth (see Article IV staff report, 2011).

slowdown in Europe. They agreed with the need for structural reforms, particularly those related to property rights, but noted the constraints imposed by lack of political consensus.

17. Staff and the authorities agreed that reducing external vulnerabilities would require further improvements in competitiveness. In the absence of well-coordinated efforts to boost competiveness, staff estimates that the real exchange rate, which has contributed to maintaining competitiveness and stability, thanks in part to a cumulative nominal depreciation of 20 percent since 2008, could become moderately overvalued over the medium term (Box 2). Non-price factors—such as the high cost of doing business emanating in part from perceptions of governance problems, and business environment distortions—could, if left unaddressed, also affect competitiveness. The authorities considered the stability of the real exchange rate, the minor loss in export share (which is still higher than in 2009), and the ability to sustain FDI given the country's natural resource wealth, as limiting the risk of a disorderly current account adjustment.

18. Staff sees risks to the outlook as largely weighted to the downside. Spillovers could transmit through trade, remittances and banking channels (Box 1). A larger-than-expected deterioration in the eurozone could significantly worsen Albania's growth outlook and debt sustainability, and weaken the financial sector. Ongoing domestic weaknesses, including an erosion of fiscal discipline and political uncertainty in the run up to elections could also adversely affect the fiscal outlook and lead to a sudden reversal of investment sentiment. Potential government funding problems, particularly the large rollover need, could exert a negative feedback to banks (Appendix II, and Table 6).

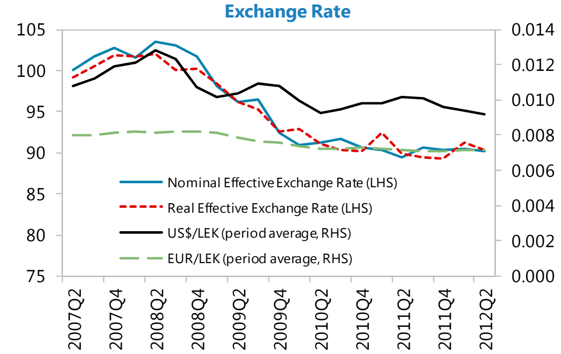
19. The authorities saw some upside to the baseline scenario. While they agreed with staff on the risks emanating from high debt and rollover needs, they did not see these as excessive; they pointed to Albania's high pre-crisis level of funding need. The authorities also saw a significant upside to the baseline scenario emanating from the privatization of the state oil company, Albpetrol, receipts from which they expect as early as Q4: 2012.[4]

[4] A winning bid has been announced and subsequent discussions are ongoing.

Box 2. Albania: Exchange Rate Assessment

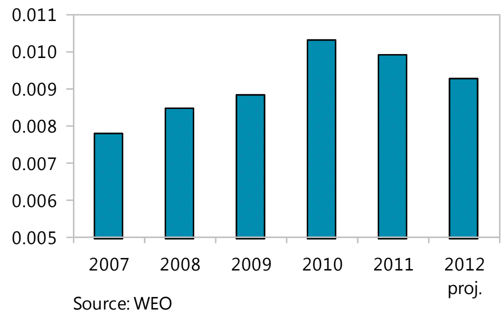
Competitiveness indicators remained broadly unchanged in 2011 and 2012:H1. The average lek-euro value has been largely flat in 2011 and first half of 2012, contributing to a stable average REER relative to a year earlier. Nonetheless, after gaining world trade market share till 2010, Albania's export share decreased slightly in 2011 and could decline further in 2012.

Exchange Rate



Source: WEO, IMF staff calculations

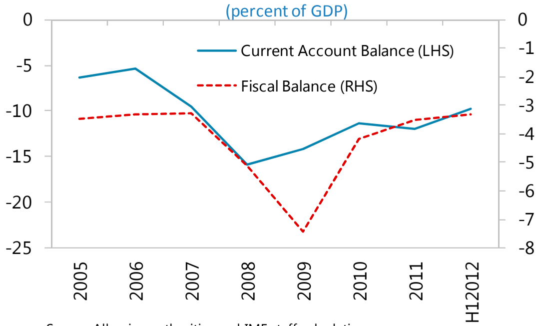
Albania's Export Share in World Trade
(percent)



Source: WEO

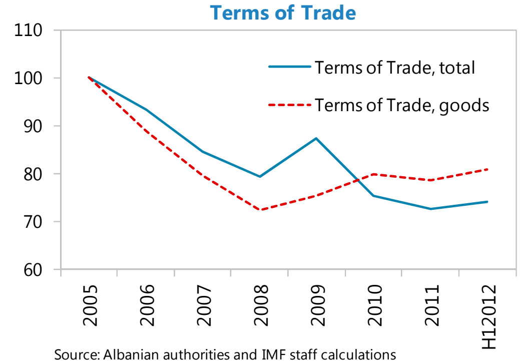
However, in recent years, persistent fiscal deficits and worsening terms-of-trade have put pressure on the current account balance. Relative to the 2005–2006 period, the current account has deteriorated, reflecting, a twin-deficit phenomenon as well as a downward trend in the terms-of-trade. Most recently, in the first half of 2012, the current account and trade deficits narrowed because of weak imports of goods and services.

Current Account and Fiscal Balances
(percent of GDP)



Source: Albanian authorities and IMF staff calculations

Terms of Trade



Source: Albanian authorities and IMF staff calculations

This real exchange rate assessment is based on three different methodologies: the Equilibrium Real Exchange Rate (ERER), the Macroeconomic Balance (MB), and the External Sustainability (ES) approaches.[1] The ERER is estimated as a function of terms of trade, relative productivity, government consumption, and remittance inflows. In the MB approach, the current account is estimated as a function of a set of macroeconomic fundamentals—population and output growth, oil trade balance, fiscal balance, net foreign assets (NFA) and aid inflows. The ES approach computes the current account balance-GDP ratio required to stabilize Albania's NFA-GDP ratio at its end-2010 level.[2]

	Current Account Balance	Current Account Norm	Real Effective Exchange Rate	Equilibrium Real Exchange Rate	Real Exchange Rate Overvaluation
MB Approach	-5.8	-3.6	-	-	9.5
ERER Approach	-	-	91.1	89.7	1.5
ES Approach	-5.8	-1.7	-	-	18.0

Source: IMF staff projections and calculations. Current account elasticity with respect to the real effective exchange rate is estimated to be -0.23.

Staff estimates point to a modest exchange rate overvaluation. The three approaches point to a modest prospective medium-term overvaluation of the real exchange rate by about 10 percent. However, Albania's ability to sustain FDI implies that the current account norm calculated under the MB and ES approaches could be lower than estimated.

[1] The methodologies, discussed in Lee et al. (2008), are in line with the analysis of the Consultative Group on Exchange Rate Issues (CGER).

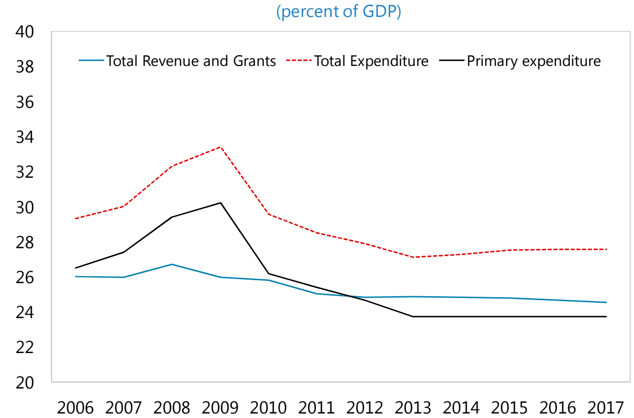
[2] In the MB and ERER approaches, a panel regression model is estimated for a sample of 184 economies over the period of 1973–2011. See Vitek (2012) for an extension of the CGER methodology applied here to a larger sample of developed and developing countries.

B. Advancing Fiscal Sustainability through a Credible Anchor

Background

20. Unchanged fiscal policies would not address underlying fiscal vulnerabilities. Under staff's baseline (unchanged) policy scenario, where the primary fiscal position would register a surplus of about 1 percent of GDP, public debt would remain near the 60 percent of GDP statutory limit over the medium term. In this scenario rollover risk would remain elevated.

General Government Total Revenue and Grants and Total Spending
(percent of GDP)

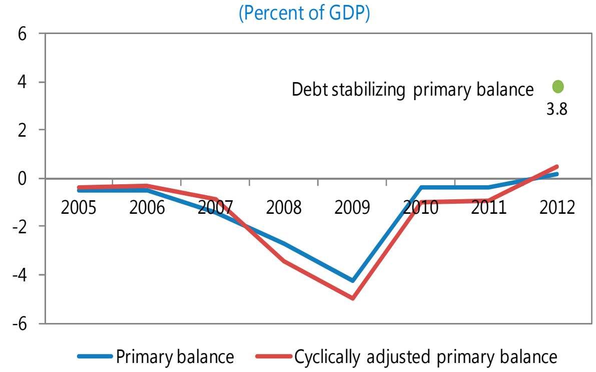


Source: Albanian authorities and IMF staff estimates.

Staff advice

- **Re-commit to a credible debt ceiling and consolidation path to re-anchor fiscal policy**. The first priority should be to arrest the upward trend in public debt and other government obligations (including unpaid bills) by preparing a 2013 budget that stabilizes debt at the 2012 level and extinguishes the outstanding obligations. This would entail a cyclically-adjusted improvement of the primary balance by 0.8 percent of GDP—a pace of consolidation that, in staff's view, would strike an appropriate balance between the need for debt stabilization and limiting the adverse impact on growth, financial sector stability and social outcomes. Strengthening the economy's resilience to shocks should take priority over the medium term, but this objective should also be tempered by the economic weakness and financial sector risks. Staff proposed reducing public debt to 40 percent of GDP by 2022 (about 53 percent by 2017)—a target it believes would allow for an appropriate gradual pace of adjustment during the period the economy is operating below potential (till 2017), while also enabling Albania to restock its fiscal buffers to a higher than the pre-crisis level so as to reduce rollover risk. This target would entail a gradual yet sustained cyclically-adjusted annual consolidation of the primary balance averaging about 0.3 percent of GDP till 2017 (Figure 6).[5]

Fiscal Indicators, 2005-12
(Percent of GDP)



Source: IMF staff estimations and projections.

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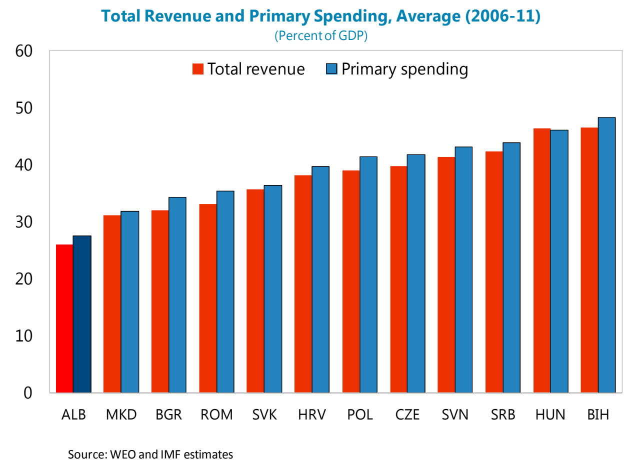
[5] Staff projections under the adjustment scenario are consistent with a fiscal multiplier in the moderate range (0.4–0.7), reflecting the impact of tax and capital expenditure increases and current expenditure reductions. As a

(continued)

- **Increase tax rates and simplify the system.** Albania's tax revenue and primary spending to GDP ratios are low, yet the country has significant medium-term development needs. Staff proposed that the burden of future fiscal adjustment should fall largely on revenues. With Albania's VAT rate already relatively high, increasing the personal and corporate income tax rates will be necessary. The proposed rate increase would likely not affect Albania's ability to attract investment, particularly if arbitrariness in collection is reduced, local "nuisance" taxes—which are inefficient and effectively add to the tax burden—are streamlined in a revenue neutral manner,[6] and the priority business climate issues are addressed (see below).



- **Address the fiscal burden of social security.** Given Albania's young population and the dramatic rate of aging expected in the coming decades, the current large social security burden—in part the result of contribution rate cuts in 2006 and 2009, and the recent unfunded increases in pension benefits and social insurance outlays—is unsustainable. Widening the net of contributors, including those in agriculture, and removing the asymmetry between contributions and benefits, will help.[7] Ad hoc increases in wages and pensions, which has been recent practice, should be avoided, and instead a rules-based system that uses inflation as the upper bound should be used.

- **Avoid cuts to capital and other priority expenditure.** Albania's high development needs and weak cyclical position call for avoiding cuts to investment and targeted social spending. Staff suggested increasing the volume and quality of capital spending over time, and ensuring adequate funding for social safety nets that effectively protect the vulnerable.

- **Utilize privatization receipts in a balanced manner**. To the extent natural resource wealth belongs to current and future generations of Albanians, the bulk of privatization receipts should be used to retire debt. Given the weak state of the economy today, and the recent buildup of unpaid bills and VAT refunds, part of the receipts could also be used to clear the backlog, which will support growth in the near term.

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result, the proposed fiscal consolidation would have a marginal impact on annual growth (about 0.1–0.2 percentage points over the medium term, with a somewhat higher effect in 2013).

[6] These taxes could be replaced by other measures such as streamlining VAT exemptions and raising property taxes.

[7] Worker contributions vary with income and the highest can be as much as five times the lowest contribution, while benefits are at most twice the minimum benefit. This encourages high income earners to evade the pension system.

- **Manage short-term rollover risks.** Progress is needed on deepening public debt markets by diversifying government paper holdings away from banks, including by following Fund TA advice, and lengthening maturity of public securities.

Authorities' views

- **The current statutory debt ceiling has been useful but needs to be used flexibly.** The authorities saw Albania's fiscal record as having been prudent despite the crisis—they pointed to the moderate post-2008 increase in Albania's public debt—and that debt service is manageable. The large domestic component also makes the debt less risky than the headline public debt number would suggest. They felt the statutory 60 percent debt limit had provided an anchor for fiscal policy, but felt that using it as a hard target in the near term is inappropriate, especially given the weak cyclical position of the economy.

- **The current low level of income taxes has helped reduce informality.** The authorities explained the recent decline in tax revenues as largely cyclical—resulting from automatic stabilizers and weak confidence related to the eurozone crisis—and expected tax collection to recover as the outlook improved. They feared an increase in tax rates could harm Albania's investment competitiveness. Instead, they preferred to focus on improving tax administration.

- **Social insurance reform is necessary**. The authorities agreed on the need for smaller increases in the public wage and pension bills, and adding those employed in agriculture into the contribution net. However, they also cautioned about the lack of political consensus on the issue.

- **Higher capital expenditure is desirable, but future increases have to take debt sustainability into account**. The authorities will increase capital spending if and when privatization receipts (or other non-debt-creating flows) are available and other priority spending (unpaid bills and emergency electricity imports) are accounted for. In the absence of such flows, they will cut capital spending further, if necessary, to achieve debt sustainability. They rejected the idea of increasing tax rates to finance higher capital spending.

- **Rollover is high, but does not necessarily pose a high risk in the current environment.** The authorities agreed with staff's suggestion to take measures to lengthen maturities and deepen public securities markets. However, they also pointed to the commercial banks' ample liquidity and limited lending opportunities as helping to mitigate rollover risks.

C. Maintaining Financial Stability in the Face of Continued Challenges

Background

21. Eurozone spillover risks are a concern, but significant actions have been taken. The preponderance of foreign subsidiaries in Albania and banking troubles in Europe raise the specter of potential spillovers to the country's banking system. However, the low reliance on external funding and greater dependence on local deposits prior to the crisis (the loan-to-deposit ratio of the Albanian banking system has remained below 65 percent in the past decade) has helped to mitigate the risks. Also, regulatory changes introduced in late 2011 have helped to protect against possible contagion effects, particularly related to Greece (Box 1 and Figure 4).[8]

22. Asset quality deterioration has both cyclical and structural reasons. The increase in NPLs is explained by the economic slowdown, which has been exacerbated, in part, by the increase in the government's nonpayment of supplier's bills. In addition, banks' efforts to resolve problem loans have been hindered by an inefficient collateral execution process, including lengthy legal procedures, weak judicial enforcement of creditors' rights and a regulated floor on real estate prices at auctions, which hinders foreclosure sales. Banks appear to be relatively well-provisioned against NPLs, but not surprisingly, the increase in NPLs has adversely affected both their profitability and their ability to extend credit. If NPLs continue to rise, some nonsystemic banks may need to bolster capital or shed assets. Given that the system is dominated by European subsidiaries, it may be ambitious to expect parents to fully satisfy additional capital needs, if necessary.

Staff advice

- **Strictly monitor capital and liquidity**. Supervisors should be vigilant to ensure that banks continue to proactively recognize and provision against nonperforming loans and, based on stress test results, ensure that capital and liquidity levels provide appropriate buffers. Close coordination with other national regulators about evolving challenges, including regional deleveraging, should also continue. Following up on the considerable progress made in recent years with Fund technical assistance, the priority should be to develop contingency plans for individual banks, and develop simulations to test the authorities' preparedness. Staff encouraged the authorities to request an update on the 2005 FSAP.

- **Intensify efforts to arrest the deterioration in asset quality**. Concrete actions to ease collateral execution, reduce delays in the legal process, and clear unpaid government bills and VAT refunds are essential. In particular, allowing property prices to adjust to market forces by removing the regulated price floor at auctions would help facilitate foreclosures sales,[9] while backloading the fees paid to bailiff offices would create greater incentives for timely execution. Implementation of the guidelines on loan restructuring, recently issued by the BoA (and prepared in cooperation with the World Bank), should also encourage increased out-of-court workouts of nonperforming loans.

[8] Foreign bank branches were converted to subsidiaries and the required ratio of liquid assets to short-term liabilities raised from 20 to 25 percent, with a more restrictive definition of liquid assets, and haircuts applied to eligible assets based on their credit rating. The regulation on related party exposure was tightened, and the risk-weighting on unhedged foreign currency lending increased from 100 to 150 percent.

[9] The direct impact of a decline in real estate prices on banks' balance sheets would be limited as the amount banks are required to provision is unrelated to the estimated value of underlying collateral.

Authorities' views

23. The authorities concurred that the near term priority is to contain possible Eurozone spillovers. They viewed continued close bank supervision and cooperation with regional regulatory authorities as having been critical in containing risks so far and planned to further strengthen these efforts. They also indicated a readiness to reinforce the regulatory framework and contingency plans, guided by stress test results. They plan to request an FSAP update for late 2013.

24. Reducing NPLs is a priority. There was broad agreement about the causes of rising NPLs and the need to reduce their level. At the same time, the authorities noted that with adequate capitalization, the increase in NPLs had been rather manageable so far, and even if it were to increase further, only a handful of nonsystemic banks would fall below regulatory capital requirements. The authorities were also confident about the ability of parent banks to bring in additional capital, if needed. Instead, they expressed concern about the tendency of European banks to ascribe high risk weights to Albanian government securities. They saw scope for more aggressive execution of collateral but also underscored the social sensitivities associated with rapid foreclosure sales.

D. Use of Monetary Policy to Ease the Economic Slowdown

Background

25. Despite significant monetary easing, credit growth is weak. Despite repeated cuts in the policy rate, credit has remained sluggish. With fiscal buffers absent, there appears to be persistent pressure on the BoA to continue to ease monetary policy. A slowdown in credit has sparked a debate about creating a public development finance institution that channels credit to the underserved microfinance sector and small and medium enterprises (SMEs).

Staff advice

- **The scope for further monetary policy easing is nearing its limits.** Staff advised that in the event of further weakening of domestic demand and drying up of credit, the authorities could consider additional monetary easing, provided inflation expectations remained well anchored. In this regard, the BoA could accept inflation rates at the upper end of its tolerance band. However any further monetary policy easing may provide only a limited boost to domestic demand unless market confidence improved.

- **Further monetary easing also carries risks.** Since monetary transmission operates primarily through the exchange rate (Appendix III), continued monetary easing runs the risk of generating exchange market pressures and adversely impacting bank balance sheets, the latter primarily because of unhedged foreign currency lending (although significant foreign currency deposits provide a cushion).

- **In setting up a development finance institution to channel credit to underserved sectors, risks should be taken into account.** While such an institution could help improve SME's access to finance, a well-defined mandate with careful governance and independent oversight is essential to ensure that lending decisions are on commercial lines and fiscal risks are minimized.[10]

Authorities' views

- **The authorities agreed to exercise caution on further easing.** They felt the recent monetary easing had some beneficial effect on domestic demand, and economic conditions would have been worse without it. However, they agreed to proceed cautiously with further easing by assessing implications for financial stability.

E. Accelerating Reforms to Boost Medium-Term Growth

Background

26. Private sector-led growth could unleash the country's potential. The downward trend in potential growth in recent years has coincided with the deceleration of structural reforms. In the absence of structural reforms, staff sees potential growth to continue to decline over the medium term. Staff envisages substantially higher medium-term economic growth than under the baseline, particularly in the outer years, if there is significant macroeconomic and structural adjustment (adjustment scenario; Figure 6). Attracting investment is key for transferring technology and innovation, and boosting productivity and high-wage employment. In particular, structural reforms could help broaden the productive base, reduce the informal economy, and diversify exports. Energy, mining, tourism, and agricultural sectors offer high potential for growth.

Staff advice

- **Reduce existing macroeconomic vulnerabilities in order to support private sector growth.** Undertaking sustained but growth friendly fiscal consolidation would allow the crowding in of private sector credit and investment and increase infrastructure-related capital spending. The scenario would also result in a gradual improvement in the current account imbalance as higher investment strengthens export capacity (adjustment scenario, Figure 6).

- **Proceed with targeted reforms to improve the investment climate**. Staff argued for renewed focus on correcting weaknesses in property rights, land titling, and contract enforcement. Reducing arbitrariness in tax collection would lower the effective tax burden on businesses.

- **Implement improvements in the post-privatization regulatory framework of key industries, notably electricity**. Given the importance of the energy sector for growth and risks,

[10] International experience on the effectiveness of such institutions is largely unfavorable, with low repayment rates often translating into a much larger eventual drain on budget resources than initially anticipated.

staff advised the authorities to continue to work closely with the World Bank to correct existing impediments in the functioning of the electricity market. Staff underscored the importance of a self sustainable model which does not depend on government involvement (e.g., energy imports, or investment).

- **Continue improvements in economic statistics.** Improving data accuracy and timeliness, particularly in national and external accounts, will contribute toward better surveillance and policymaking. Adequate resources should be made available to ensure effective use of Fund TA.

Authorities' views

- **Attracting foreign investment requires further upgrading of infrastructure.** While agreeing on the need for FDI to achieve and sustain high medium-term growth, the authorities emphasized the importance of continued infrastructure development to attract investment. They appeared optimistic about the prospects for renewed investment flows, once conditions in Europe stabilized.

- **Resolving energy sector problems is critical.** The authorities ascribed the existing weaknesses to the failure of the distributor to make the required investments, and did not see adjustments in retail prices as necessary, since tariffs in Albania are broadly comparable to those in neighboring countries. Until these problems are addressed, government support, including financing emergency electricity imports, will be essential to avoid power cuts.

- **The authorities agreed on the need for continued improvements in economic statistics**. They acknowledged that annual national account statistics on expenditure basis have not been published since 2008, while quarterly GDP statistics are subject to considerable revisions and often available with significant lag. They are committed to continue working with Fund technical assistance in order to develop capacity.

STAFF APPRAISAL

27. Until this year Albania had weathered the Eurozone crisis relatively well. Between 2008 and 2011, Albania avoided a sharp fall in output and was able to maintain banking system stability, thanks to a fiscal stimulus, sound monetary policy and effective macroprudential actions.

28. The economy is now slowing at a time when external risks remain high. GDP growth is expected to decline sharply in 2012, on the back of low consumer and business confidence emanating from the weak outlook for Greece and Italy. The ongoing eurozone crisis could continue to bear both direct and indirect headwinds in 2013, resulting only in a modest recovery growth in Albania.

29. Underlying imbalances and vulnerabilities are elevated. The large share of short–term public debt translates to high fiscal financing risks. In the medium term, rising public debt could also hamper growth prospects by crowding out private credit and investment, and limiting the government's ability to finance crucial development projects. While the current account deficit has begun to decline, it remains high.

30. **Fiscal consolidation is essential for lowering elevated debt risk.** The statutory debt limit of 60 percent of GDP has served Albania well in anchoring the economic policy debate. While strict adherence to this ceiling may have no particular economic rationale, the authorities would be well served to recognize that there is no debt financing fiscal buffer available. Breaching the limit could undermine market confidence in the government's commitment to macroeconomic stability and debt sustainability, something which Albania can ill afford, given the high public debt rollover need.

31. **The authorities should commit to a credible long-term debt anchor, and firm near- and medium-term fiscal consolidation paths.** A feasible long-term debt target that ambitiously lowers the debt-GDP ratio would strengthen the economy's resilience to shocks, while allowing for a gradual adjustment to accommodate development needs. For 2013, the government's immediate priority should be to commit to a budget that is consistent with maintaining the debt-GDP ratio at the 2012 level. This would strike an appropriate balance between consolidation and growth, financial sector stability, and social outcomes. Building consensus on the medium term consolidation path would also ensure sustainable growth and macroeconomic stability.

32. **Tax and expenditure reforms are needed to help achieve the long-term debt target, while supporting growth.** With inflexibility in a large part of expenditures, lowering the fiscal deficit would require higher revenues over a sustained period of time. While tax administration efforts would help, increases in tax rates will be essential. Social security reform and restraint on current spending would also be key. Revenue increases and current spending restraint are also required for a much-needed increase in capital spending, in a way that does not magnify fiscal risks or crowd out private investment. Needed capital spending should not rely on privatization inflows alone, which any way should be utilized mainly to reduce debt and clear unpaid bills. Utilizing realistic ex ante revenue estimates, would make for effective fiscal policy, and help avoid the accumulation of unpaid bills.

33. **Monetary policy has anchored macrofinancial stability, but its ability to support the economy is reaching its limits.** If domestic demand were to weaken further and credit to contract, the authorities could consider further monetary easing, provided inflation expectations remain well anchored and financial stability is not threatened. However, sluggish credit demand and bank risk aversion would likely limit effectiveness. It could also risk exchange market pressures and adverse impact on bank balance sheets. While the authorities' frustration with weak credit growth is understandable, any attempts to direct credit to preferred sectors should take into account the weak credit demand in the economy, and the budgetary impact of such an action.

34. **Despite the preponderance of European bank subsidiaries, the banking system has proved resilient, but continued vigilance is needed.** Stress tests should continue to guide decisions on capital and liquidity buffers, while close cooperation with foreign supervisory authorities is key to mitigating cross-border risks. The rising level of non-performing loans is a

concern and requires prompt action. Not all of the recent increase in NPLs can be ascribed to the slowing economy. Removing structural distortions in collateral execution—including streamlining legal processes, strengthening judicial enforcement of creditors' rights , and increasing the efficiency of private bailiff offices—and clearing unpaid government bills and VAT refunds would be important.

35. Business environment weaknesses are an obstacle to investment and hence medium term growth. Continued weaknesses in the legal framework, notably in property rights and contract enforcement, should be tackled urgently. Tax collection should be made less arbitrary. Remedying structural impediments in the electricity market is essential for putting the sector on a self-sustainable path, supporting growth and avoiding fiscal risks. Improvements in data accuracy and timeliness, particularly in national and external accounts, will contribute toward better surveillance and policymaking.

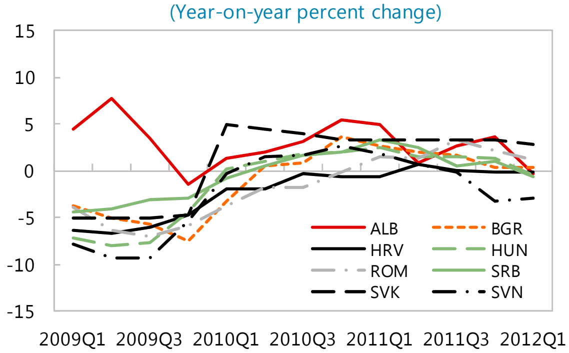
36. It is recommended that the next Article IV consultation with Albania be held on the standard 12-month cycle.

Figure 1. Albania: Background and Outlook

Albania successfully avoided recession since 2009…

Albania: Real GDP, 2009-12

(Year-on-year percent change)

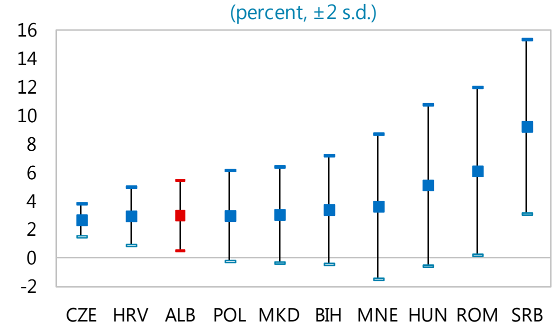


Source: WEO and IMF staff calculations

…while inflation was kept low and stable.

Average Annual Inflation, 2006-11

(percent, ±2 s.d.)

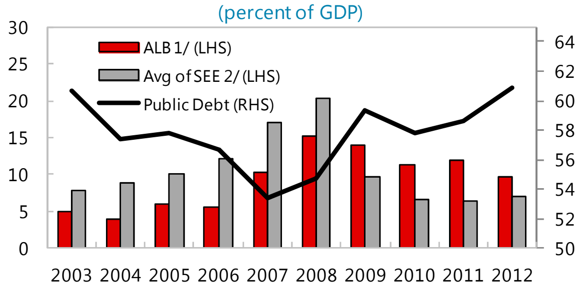


Source: WEO

But the crisis has consumed buffers and worsened external imbalances, which are only now beginning to correct.

Current Account Deficit

(percent of GDP)



1/ 2012 H1

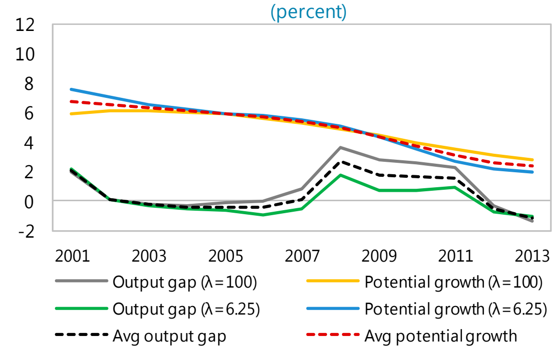
2/ 2012 full-year projection

Source: WEO and IMF staff calculations

The economy is expected to slow down…

Output Gap and Potential Growth

(percent)

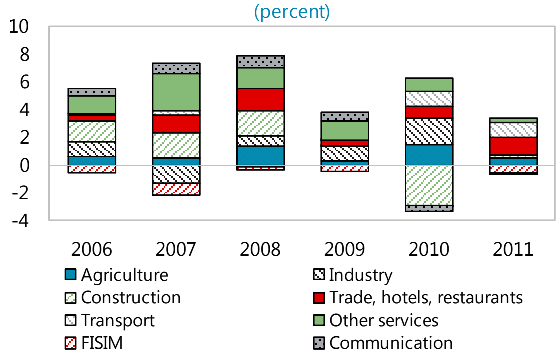


Source: IMF staff calculations

…because of weakening construction, industry, and services…

Contributions to growth

(percent)

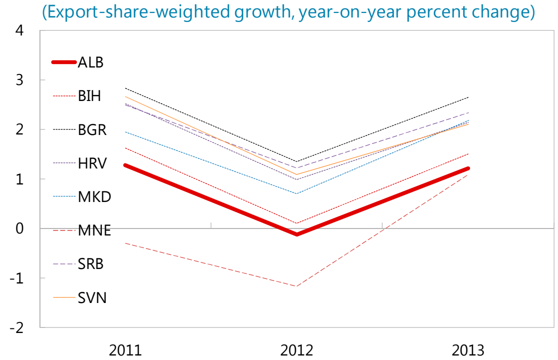


Source: INSTAT and IMF staff calculations

…as well as sluggish partner growth.

External Partner Growth in Southeast Europe, 2011-13

(Export-share-weighted growth, year-on-year percent change)

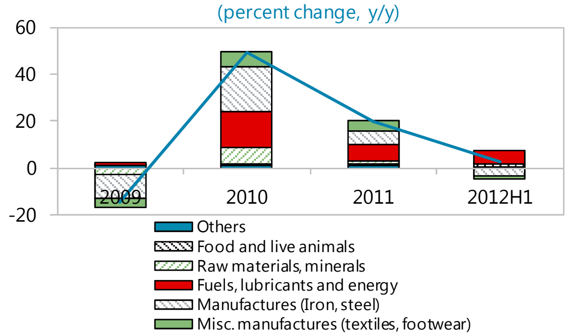


Source: Directions of Trade database, WEO, and IMF staff calculations

Figure 2. Albania: External Sector Developments

After strong performance in 2010, exports decelerated…

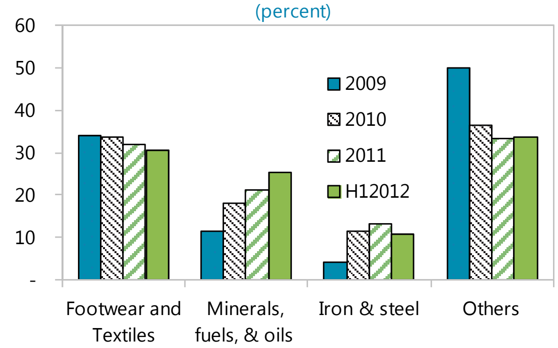
Export Growth
(percent change, y/y)



Source: Albanian authorities and IMF staff calculations

…but continued to grow, mostly due to commodity exports…

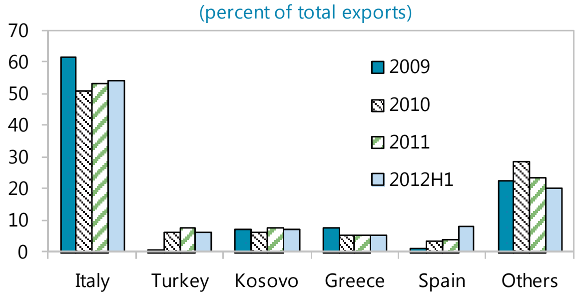
Export Composition
(percent)



Source: Albanian authorities and IMF staff calculations

…and resilience of trade with Italy and new trading partners.

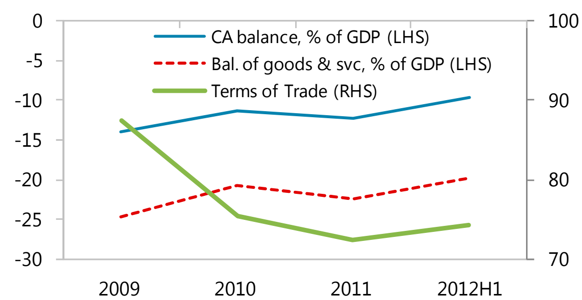
Top Trading Partners
(percent of total exports)



Source: Albanian authorities and IMF staff calculations

Notwithstanding, trade and current account balance deteriorated along with terms of trade in 2011 but started to adjust in 2012H1

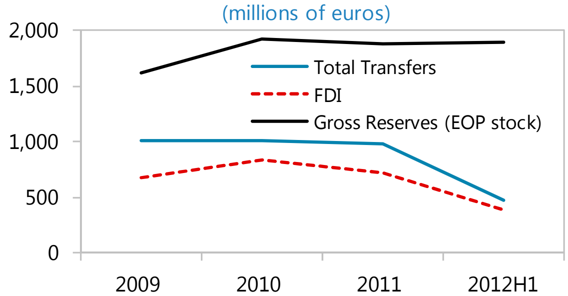
External Balance and Terms of Trade



Source: Albanian authorities and IMF staff calculations

Apart from transfers, FDI remains the main source of financing the current account deficit.

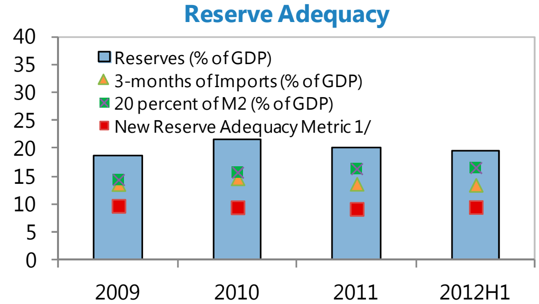
Trade Balance Financing Sources
(millions of euros)



Source: Albanian authorities and IMF staff calculations

International reserves have remained adequate.

Reserve Adequacy



1/ Composed of 30% of Short-term Debt, 10% of other portfolio liabilities, 5% of M2 and 5% of exports. Short-term debt data excludes deposits due to data limitations.

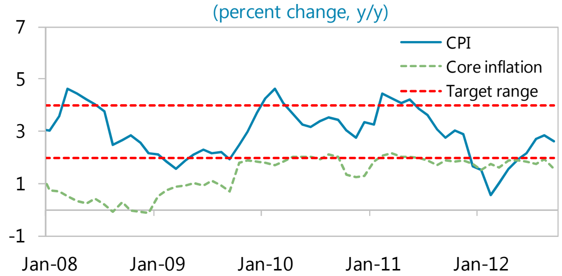
Source: Albanian authorities and IMF staff calculations

Figure 3. Albania: Inflation and Monetary Developments

Inflation has remained largely within the central bank's target range in recent years…

Inflation

(percent change, y/y)

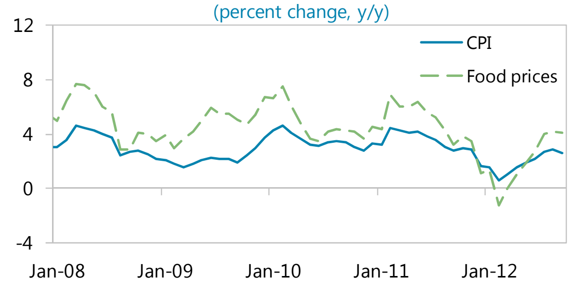


Source: INSTAT and IMF staff calculations

… with recent fluctuations mostly reflecting changes in food prices, which account for 40% of the basket.

Inflation

(percent change, y/y)

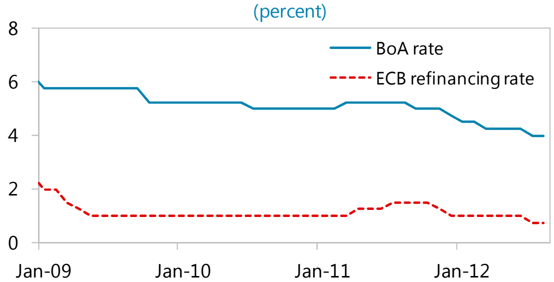


Source: INSTAT and IMF staff calculations

Interest rate cuts since 2009 have largely followed the direction set by the ECB …

Interest Rates

(percent)

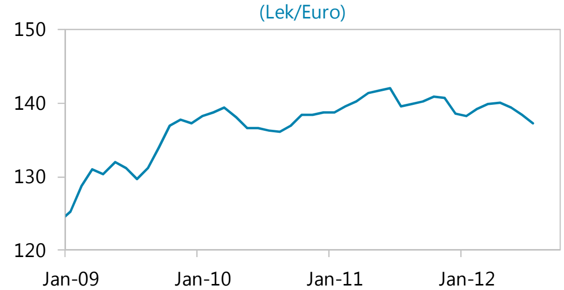


Source: Albanian authorities, ECB, and IMF staff calculations

… helping to stabilize the exchange rate …

Exchange Rates

(Lek/Euro)

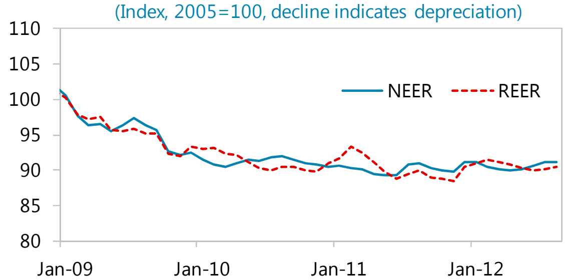


Source: IFTS database

… and keeping the real exchange rate little changed since 2010.

Effective Exchange Rates

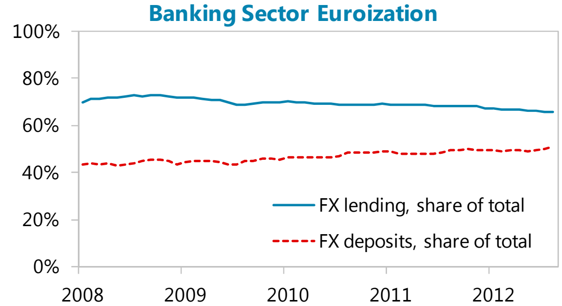
(Index, 2005=100, decline indicates depreciation)



Source: IMF staff calculations

The financial system remains highly euroized, which magnifies the balance sheet impact of exchange rate moves.

Banking Sector Euroization



Source: Albanian authorities and IMF staff calculations

Figure 4. Albania: Financial Sector Developments

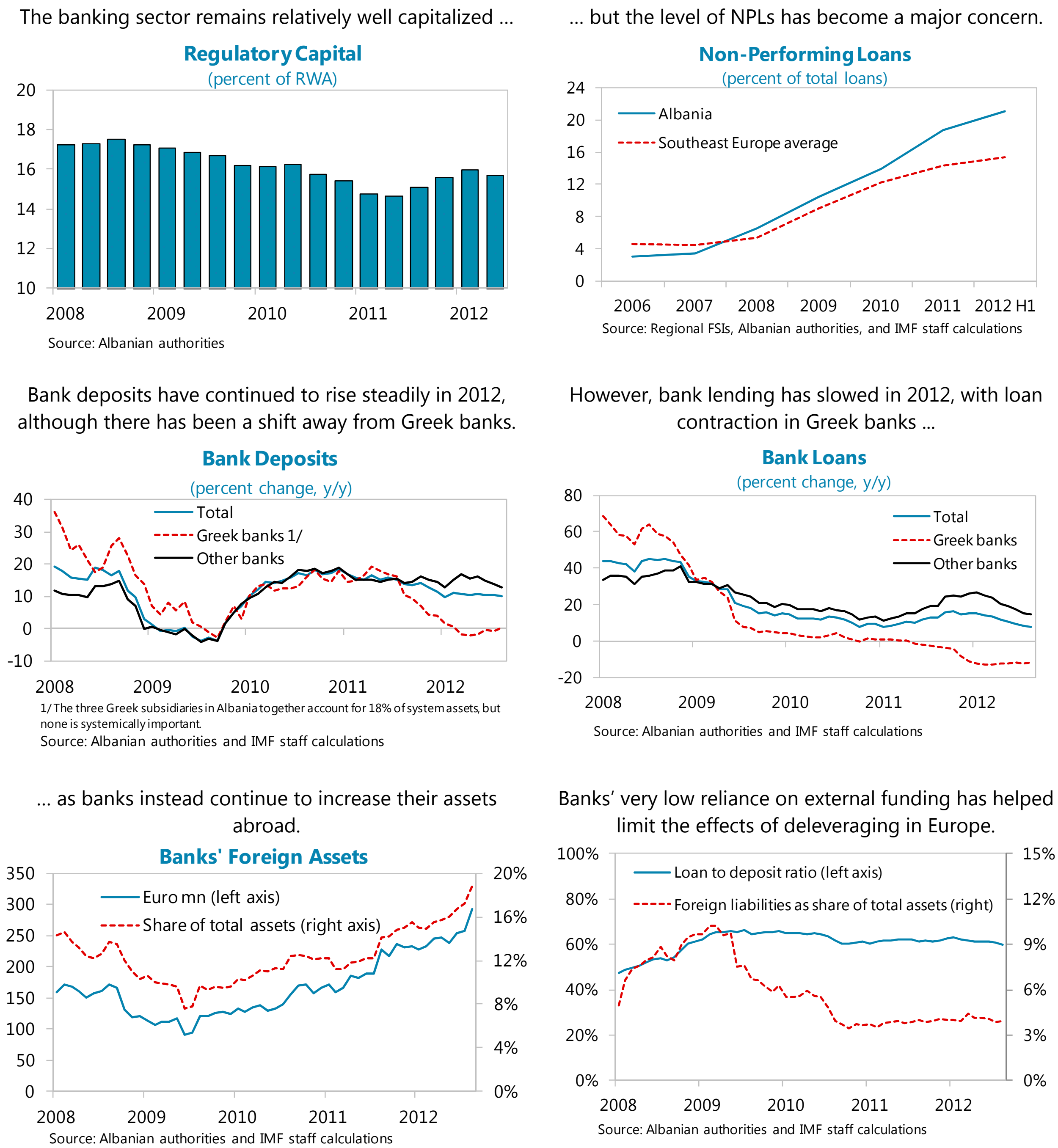
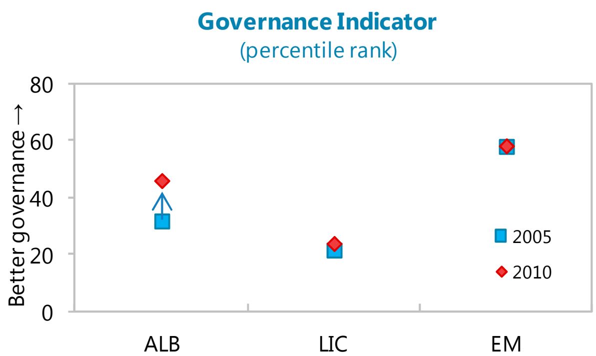


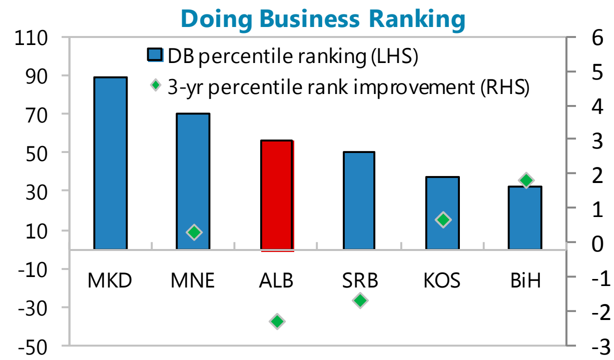
Figure 5. Albania: Governance, Business Environment, and Labor Market

Governance in Albania has improved, albeit from a low base…



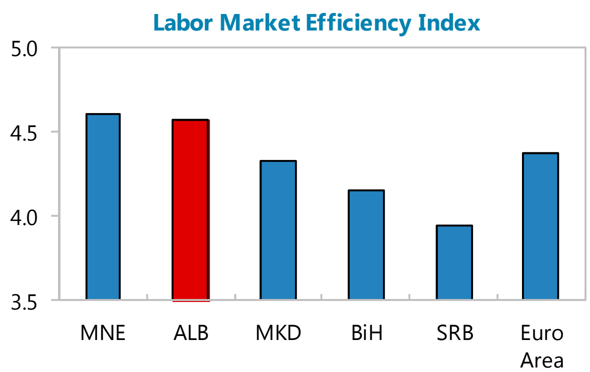
Source: Worldwide Governance Indicators (government effectiveness, regulatory quality, rule of law and control of corruption);and IMF staff calculations

…though overall indicators of business environment show some weakening.



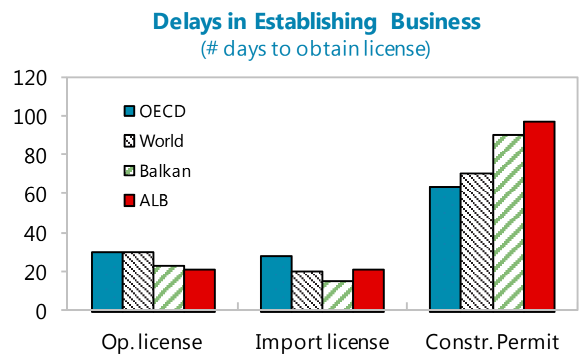
Source: Doing Business (2013) and IMF staff calculations

Labor market efficiency index are not weak.



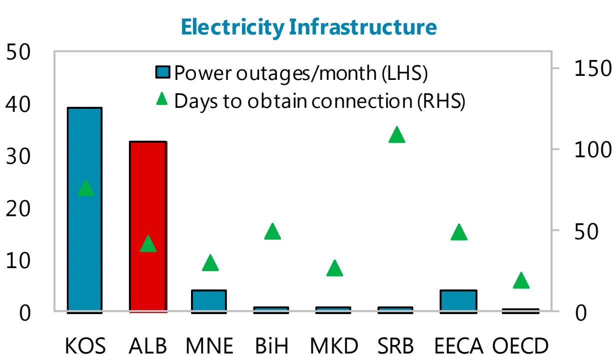
Source: Global Competitiveness Report (2011)

Business environment could be boosted through reducing delays in obtaining construction permits,…



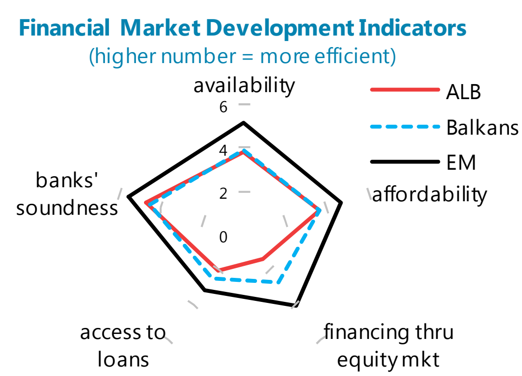
Source: World Bank Enterprise Survey (2009)

…improving the quality of infrastructure, especially electricity,…



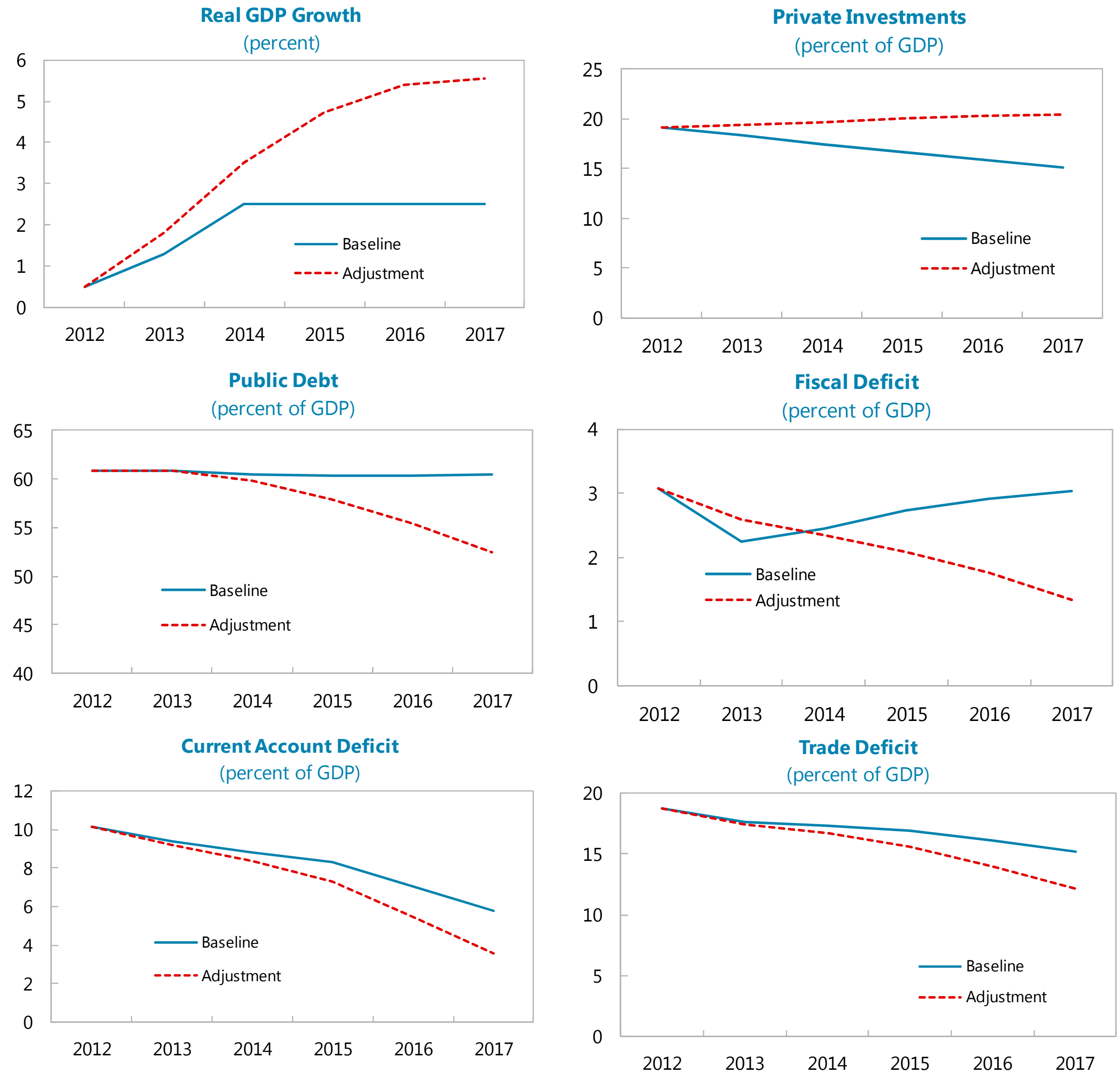
Source: World Bank Enterprise Survey (2009)

…and enhancing access to finance, including from non-bank sources.



Source: Global Competitiveness Report (2011)

Figure 6. Albania: Baseline and Adjustment Scenarios[1]



Source: IMF staff estimates and projections.

[1]The adjustment scenario is based on the following assumptions: 1) faster growth, driven by the most critical structural reforms (e.g., property rights, business climate) and fiscal consolidation, which boost private investment; 2) fiscal consolidation, notably a tax rate increase, zero real growth in the wage and pension bills, and higher capital spending; 3) reduction in public debt to 40 percent of GDP by 2022; and 4) gradual reduction in the external current account deficit, as higher investment strengthens export capacity, and interest payments decline as a result of lower debt.

Table 1. Albania: Basic Indicators and Macroeconomic Framework, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Est.			Projections			
				(Growth rate in percent)					
Real GDP 1/	3.3	3.5	3.0	0.5	1.3	2.5	2.5	2.5	2.5
Consumer Price Index (avg.)	2.2	3.6	3.4	2.2	3.2	3.0	3.0	3.0	3.0
Consumer Price Index (eop)	3.7	3.4	1.7	3.4	3.0	3.0	3.0	3.0	3.0
GDP deflator	2.3	3.8	3.5	2.4	3.1	2.8	2.8	2.8	2.9
				(Percent of GDP)					
Saving-investment balance									
Foreign savings	14.0	11.4	11.9	10.1	9.4	8.8	8.3	7.1	5.8
National savings	16.2	15.4	13.7	13.9	13.0	12.7	12.4	12.9	13.4
Public	1.0	1.2	1.6	1.1	0.9	0.7	0.4	0.2	0.1
Private	15.2	14.2	12.1	12.8	12.1	12.1	12.0	12.7	13.3
Investment	30.3	26.8	25.6	24.0	22.3	21.5	20.7	19.9	19.1
Public	10.1	6.7	6.0	4.9	4.0	4.0	4.0	4.0	4.0
Private	20.2	20.1	19.6	19.1	18.3	17.5	16.7	15.9	15.1
Fiscal sector									
Revenues and grants	26.0	25.8	25.1	24.8	24.9	24.8	24.8	24.7	24.6
Tax revenue	23.5	23.3	23.0	22.7	22.7	22.7	22.6	22.5	22.4
Expenditures	33.4	29.6	28.5	27.9	27.1	27.3	27.5	27.6	27.6
Primary	30.2	26.2	25.4	24.7	23.7	23.7	23.7	23.7	23.7
Interest	3.2	3.4	3.1	3.2	3.4	3.5	3.8	3.8	3.9
Overall balance (including grants)	-7.4	-3.7	-3.5	-3.1	-2.2	-2.4	-2.7	-2.9	-3.0
Primary balance (including grants)	-4.3	-0.4	-0.3	0.2	1.1	1.1	1.0	0.9	0.8
Net domestic borrowing	0.9	0.9	2.0	1.8	0.7	1.9	2.5	3.0	3.9
Privatization receipts	2.4	0.4	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Foreign financing	3.7	2.1	1.6	1.4	1.5	0.6	0.3	-0.1	-0.9
Public Debt	59.3	57.8	58.6	60.9	60.8	60.5	60.4	60.4	60.5
Domestic	36.1	32.9	33.3	34.1	33.4	33.5	34.3	35.5	37.6
External (including publicly guaranteed)	23.2	24.9	25.3	26.8	27.4	27.0	26.1	24.9	22.8
Monetary indicators									
Broad money growth	6.8	12.5	9.1	6.1	4.4	5.3	5.4	5.4	5.4
Private credit growth	10.3	10.1	10.4	2.1	4.5	5.8	4.7	3.8	0.4
Velocity	1.3	1.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Interest rate (3-mth T-bills, end-period)	6.3	5.3	5.3	…	…	…	…	…	…
				(Percent of GDP unless otherwise indicated)					
External sector									
Trade balance (goods and services)	-24.6	-20.7	-22.4	-18.8	-17.6	-17.3	-16.9	-16.2	-15.2
Current account balance (including official transfers)	-14.0	-11.4	-11.9	-10.1	-9.4	-8.8	-8.3	-7.1	-5.8
Current account balance (excluding official transfers)	-14.7	-11.9	-12.2	-10.8	-10.1	-9.5	-9.0	-7.8	-6.5
Official transfers	0.7	0.5	0.2	0.7	0.7	0.7	0.7	0.7	0.7
Gross international reserves (in millions of Euros)	1,621	1,926	1,879	1,976	2,065	2,101	2,160	2,296	2,495
(In months of imports of goods and services)	4.1	4.4	4.4	4.5	4.5	4.4	4.4	4.5	4.5
(Relative to external debt service)	10.9	5.0	8.8	8.2	6.5	5.3	2.8	5.0	5.5
(In percent of broad money)	26.0	27.0	24.9	24.4	24.6	24.0	23.6	24.0	24.8
Change in real exchange rate (eop, in percent)	-7.8	-2.6	0.7	…	…	…	…	…	…
Memorandum items									
Nominal GDP (in billions of lek) 1/	1,151	1,237	1,319	1,357	1,417	1,493	1,574	1,659	1,749

Sources: Albanian authorities; and IMF staff estimates and projections.
1/ GDP data for 2008–09 are from the official national accounts.

Table 2a. Albania: General Government Operations, 2009–17
(Percent of GDP)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Est.	Rev. Proj.			Projection		
Total revenue and grants	26.0	25.8	25.1	24.8	24.9	24.8	24.8	24.7	24.6
Tax revenue	23.5	23.3	23.0	22.7	22.7	22.7	22.6	22.5	22.4
VAT	9.6	9.2	9.0	9.0	9.0	8.9	8.9	8.8	8.7
Profit tax	1.5	1.4	1.5	1.2	1.3	1.3	1.3	1.3	1.3
Excise tax	2.9	3.1	3.1	2.8	2.8	2.8	2.8	2.8	2.8
Small business tax	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Personal income tax	2.3	2.2	2.1	2.0	2.0	2.0	2.0	2.0	2.0
Customs duties	0.7	0.6	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Other taxes	1.2	1.5	1.6	2.0	2.0	2.0	2.0	2.0	2.0
Property and local taxes	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Social insurance contributions	4.3	4.4	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Non-tax revenue	2.1	2.1	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Grants	0.4	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Total expenditure	33.4	29.6	28.5	27.9	27.1	27.3	27.5	27.6	27.6
Current expenditure	24.6	24.2	23.2	23.3	23.6	23.8	24.0	24.1	24.1
Personnel cost	5.4	5.3	5.1	5.2	5.2	5.2	5.2	5.2	5.2
Interest	3.2	3.4	3.1	3.2	3.4	3.5	3.8	3.8	3.9
Of which: domestic	2.7	2.9	2.6	2.3	2.3	2.4	2.5	2.6	2.7
Operations & maintenance	2.8	2.7	2.5	2.3	2.3	2.3	2.3	2.3	2.3
Subsidies	0.2	0.3	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Social insurance outlays	8.6	8.6	8.6	8.9	8.9	8.9	8.9	8.9	8.9
Local government expenditure	2.9	2.5	2.1	2.0	2.0	2.0	2.0	2.0	2.0
Social protection transfers	1.7	1.5	1.4	1.5	1.5	1.5	1.5	1.5	1.5
Capital expenditure	8.8	5.8	5.4	4.4	3.5	3.5	3.5	3.5	3.5
Lending minus repayment	0.0	-0.5	0.0	0.2	0.0	0.0	0.0	0.0	0.0
Reserve and contingency funds 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-7.4	-3.7	-3.5	-3.1	-2.2	-2.4	-2.7	-2.9	-3.0
Current balance including grants	1.4	1.6	1.9	1.5	1.3	1.1	0.8	0.6	0.5
Financing	7.4	3.7	3.5	3.1	2.2	2.4	2.7	2.9	3.0
Domestic	3.3	1.4	1.9	1.6	0.7	1.9	2.5	3.0	3.9
Privatization receipts	2.4	0.4	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Net borrowing	0.9	0.9	2.0	1.8	0.7	1.9	2.5	3.0	3.9
Foreign	3.7	2.1	1.6	1.4	1.5	0.6	0.3	-0.1	-0.9
Accumulation of Arrears	0.5	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items:									
Primary balance	-4.3	-0.4	-0.3	0.2	1.1	1.1	1.0	0.9	0.8
Current balance excluding grants	1.0	1.2	1.6	1.1	0.9	0.7	0.4	0.2	0.1
Public debt	59.3	57.8	58.6	60.9	60.8	60.5	60.4	60.4	60.5
Domestic general government	36.1	32.9	33.3	34.1	33.4	33.5	34.3	35.5	37.6
External	23.2	24.9	25.3	26.8	27.4	27.0	26.1	24.9	22.8
GDP (in billions of leks)	1151	1237	1319	1357	1417	1493	1574	1659	1749

Sources: Albanian authorities; and IMF staff estimates and projections.

1/ Spending contingencies are reported according to their economic classification at outturn.

Table 2b. Albania: General Government Operations, 2009–17
(Billions of leks)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Est.	Rev. Proj.	Projection				
Total revenue and grants	299.0	319.6	330.4	337.2	352.6	371.0	390.2	409.2	429.5
Tax revenue	270.8	288.8	303.9	308.2	322.2	338.9	356.4	373.7	392.0
VAT	110.1	114.0	119.2	122.4	127.3	133.6	140.0	145.8	151.8
Profit tax	17.1	17.6	19.7	16.4	18.0	19.0	20.0	21.1	22.2
Excise tax	33.5	38.8	40.4	37.9	39.6	41.7	44.0	46.3	48.9
Small business tax	2.5	2.3	2.6	1.9	2.1	2.2	2.3	2.4	2.6
Personal income tax	26.8	27.1	28.0	27.5	28.7	30.2	31.8	33.6	35.4
Customs duties	7.9	7.3	6.9	6.1	6.3	6.6	6.9	7.2	7.4
Other taxes	13.4	18.4	21.4	27.4	28.6	30.2	31.8	33.5	35.3
Property and local taxes	9.7	9.6	9.2	10.1	10.6	11.2	11.8	12.4	13.1
Social insurance contributions	49.8	53.8	56.6	58.5	61.0	64.3	67.8	71.4	75.3
Non-tax revenue	23.7	26.2	22.7	23.6	24.6	26.0	27.4	28.8	30.4
Grants	4.4	4.6	3.8	5.4	5.8	6.1	6.5	6.7	7.1
Total expenditure	384.4	365.8	376.2	378.9	384.3	407.4	433.2	457.4	482.6
Current expenditure	282.9	299.9	305.6	316.7	334.3	354.8	377.7	399.0	420.9
Personnel cost	62.4	65.8	67.4	70.9	74.0	78.0	82.2	86.6	91.3
Interest	36.3	41.6	41.1	44.0	47.8	52.9	59.5	63.7	67.8
Operations & maintenance	32.1	33.3	33.0	31.1	32.4	34.2	36.0	38.0	40.0
Subsidies	2.0	3.5	3.3	2.0	2.0	2.1	2.2	2.3	2.4
Social insurance outlays	98.4	106.2	113.9	120.2	125.5	132.2	139.3	146.9	154.8
Local government expenditure	33.6	30.8	28.1	27.0	29.0	30.5	32.2	33.9	35.7
Social protection transfers	19.1	18.7	18.7	19.8	21.0	22.2	23.4	24.7	25.9
Capital expenditure	101.4	71.6	70.6	60.0	49.9	52.6	55.5	58.4	61.6
Lending minus repayment	0.1	-5.6	0.0	2.3	0.0	0.0	0.0	0.0	0.0
Reserve and contingency funds 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-85.4	-46.2	-45.7	-41.7	-31.7	-36.5	-43.0	-48.2	-53.1
Current balance including grants	16.1	19.7	24.8	20.5	18.2	16.2	12.5	10.3	8.5
Financing	85.4	46.2	45.7	41.7	31.7	36.5	43.0	48.2	53.1
Domestic	37.5	16.7	24.9	22.1	10.4	27.7	38.8	50.0	68.0
Privatization receipts	27.6	4.5	0.4	1.0	0.0	0.0	0.0	0.0	0.0
Net borrowing	9.9	11.1	27.0	24.1	10.4	27.7	38.8	50.0	68.0
Foreign	42.4	25.4	20.9	19.7	21.3	8.8	4.2	-1.8	-14.9
Accumulation of Arrears	5.5	4.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items:									
Primary balance	-49.1	-4.6	-4.6	2.3	16.1	16.5	16.5	15.5	14.7
Current balance excluding grants	11.6	15.1	21.0	15.1	12.5	10.0	6.0	3.5	1.4
Public Debt	682.5	715.3	772.3	826.2	862.0	903.2	950.3	1001.7	1057.1
Domestic general government	415.0	407.4	438.6	462.7	473.1	500.8	539.6	589.5	657.6
External	267.5	308.0	333.7	363.5	388.9	402.4	410.7	412.2	399.5
Direct government external debt	227.2	268.1	286.6	310.6	330.5	338.6	341.3	337.5	319.1
Government guaranteed external debt	40.3	39.9	47.1	53.0	58.4	63.9	69.3	74.8	80.4

Sources: Albanian authorities; and IMF staff estimates and projections.

1/ Spending contingencies are reported according to their economic classification at outturn.

Table 3a. Albania: Balance of Payments, 2009–17
(Percent of GDP)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Est.	Projections					
Current account	-14.0	-11.4	-11.9	-10.1	-9.4	-8.8	-8.3	-7.1	-5.8
Balance of goods and services	-24.6	-20.7	-22.4	-18.8	-17.6	-17.3	-16.9	-16.2	-15.2
Exports	28.7	32.6	33.6	34.0	34.7	35.1	35.4	35.7	36.1
Goods	9.0	13.1	15.0	15.5	16.0	16.2	16.4	16.5	16.6
Services	19.7	19.5	18.6	18.5	18.8	18.9	19.1	19.2	19.5
Imports	53.2	53.3	56.0	52.8	52.4	52.4	52.3	51.8	51.3
Goods	35.0	36.3	38.8	36.5	35.9	35.8	35.5	35.0	34.5
Services	18.3	16.9	17.2	16.3	16.5	16.7	16.8	16.8	16.8
Income balance	-1.0	-1.0	0.5	-0.2	-0.8	-0.8	-0.7	-0.2	0.0
Of which: Interest due	0.8	0.8	0.9	1.0	1.1	1.1	1.2	0.9	0.8
Private transfers 1/	11.0	9.8	9.8	8.2	8.4	8.5	8.6	8.6	8.7
Official transfers	0.7	0.5	0.2	0.7	0.7	0.7	0.7	0.7	0.7
Financial account	11.2	12.9	9.9	9.6	8.8	7.7	7.5	6.9	6.1
Direct investment	7.7	9.2	7.6	6.5	6.1	5.9	5.9	5.8	5.7
Other capital	-0.4	1.4	0.6	1.6	1.2	1.3	1.3	1.3	1.3
Private loans (incl.net trade credits)	0.8	1.6	1.5	1.3	1.3	1.3	1.4	1.4	1.4
Other financial flows	-1.2	-0.2	-0.8	0.3	-0.1	0.0	-0.1	-0.1	-0.1
Of which: Change in NFA of DMBs (increase = -) 2/	-1.9	-4.6	-3.3	-2.0	0.0	0.0	0.0	0.0	0.0
Medium- and long-term loans (net)	3.9	2.3	1.6	1.6	1.5	0.6	0.3	-0.1	-0.9
New borrowing	4.5	5.3	2.4	2.4	2.7	2.0	4.7	1.6	0.8
Multilateral loans	1.5	1.2	1.8	1.9	1.5	0.9	0.9	0.4	0.4
World Bank	0.3	0.2	0.4	0.3	0.3	0.0	0.0	0.0	0.0
EBRD	0.4	0.2	0.4	0.3	0.3	0.3	0.3	0.2	0.2
Other	0.7	0.8	1.0	1.3	0.9	0.5	0.7	0.1	0.1
Bilateral loans	0.9	0.7	0.6	0.5	1.2	1.2	1.0	0.4	0.4
Commercial debt	2.2	3.3	0.0	0.0	0.0	0.0	2.7	0.8	0.0
Amortization	-0.6	-3.0	-0.8	-0.8	-1.2	-1.5	-4.4	-1.7	-1.6
Errors and omissions 3/	1.8	2.3	1.7	1.6	1.6	1.5	1.4	1.4	1.3
Net balance	-1.0	3.9	-0.4	1.0	1.0	0.4	0.6	1.2	1.7
Available financing	0.5	-3.5	0.4	-1.0	-1.0	-0.4	-0.6	-1.2	-1.7
Change in net reserves (increase = -) 2/	0.5	-3.5	0.4	-1.0	-1.0	-0.4	-0.6	-1.2	-1.7
Financing gap 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Ministry of Finance; Bank of Albania; donors; and Fund staff estimates and projections.

1/ Bank of Albania data plus IMF estimate (to capture some unrecorded inflows not captured in the BOA estimate).

2/ Net of valuation changes in 2008–11. In projections for 2012–17, valuation effects are assumed to be zero.

3/ Net errors and omissions include unidentified flows of private transfers.

4/ The financing gap, if any, is expected to be fully covered by arrears rescheduling.

Table 3b. Albania: Balance of Payments, 2009–17

(Millions of Euros)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Est.			Projections			
Current account	-1,225	-1,019	-1,122	-989	-944	-926	-913	-810	-696
Balance of goods and services	-2,148	-1,852	-2,107	-1,831	-1,776	-1,817	-1,857	-1,857	-1,830
Exports	2,504	2,922	3,153	3,318	3,499	3,692	3,889	4,098	4,349
Goods	785	1,172	1,406	1,511	1,609	1,702	1,796	1,895	1,999
Services	1,718	1,751	1,747	1,807	1,890	1,990	2,093	2,203	2,350
Imports	4,652	4,774	5,260	5,149	5,275	5,509	5,745	5,954	6,179
Goods	3,054	3,255	3,647	3,559	3,616	3,759	3,901	4,021	4,150
Services	1,598	1,519	1,613	1,589	1,660	1,750	1,844	1,933	2,029
Income balance	-91	-90	48	-21	-85	-79	-76	-24	4
Of which: Interest due	67	71	87	100	111	118	133	103	95
Private transfers 1/	957	877	916	795	846	894	942	987	1,043
Official transfers	58	45	21	68	71	76	78	83	87
Financial account	977	1,160	927	935	884	813	821	795	740
Direct investment, net	672	827	717	630	612	615	653	663	688
Other capital	-34	124	60	153	121	136	139	144	155
Private loans (incl.net trade credits)	70	144	138	129	132	138	148	156	168
Other financial flows	-105	-19	-78	25	-11	-2	-10	-11	-13
Of which: Change in NFA of DMBs (increase = -) 2/	-169	-415	-312	-199	1	1	1	1	1
Medium- and long-term loans (net)	340	208	150	152	151	62	30	-12	-103
New borrowing	396	474	221	233	267	215	517	183	92
Multilateral loans	127	111	165	185	148	90	104	43	44
World Bank	30	22	38	28	34	2	0	0	1
EBRD	33	14	36	32	26	33	29	28	28
Other	63	75	91	124	88	56	75	15	15
Bilateral loans	77	62	56	49	119	125	114	45	48
Commercial debt	193	300	0	0	0	0	300	95	0
Amortization	-57	-266	-71	-82	-116	-153	-488	-196	-195
Errors and omissions 3/	159	209	157	157	157	157	157	157	157
Net balance	-88	349	-38	102	97	44	65	141	201
Available financing	47	-314	38	-102	-97	-44	-66	-141	-201
Change in net reserves (increase = -) 2/	47	-314	38	-102	-97	-44	-66	-141	-201
Financing gap 4/	0	0	0	0	0	0	0	0	0
Arrears Rescheduling	0	0	0	0	0	0	0	0	0
Memorandum items:									
GDP in Euros	8,737	8,960	9,389	9,756	10,072	10,511	10,978	11,490	12,044
Gross usable reserves	1,621	1,926	1,879	1,973	2,062	2,099	2,159	2,297	2,496
(months of imports of goods and services)	4.1	4.4	4.4	4.5	4.5	4.4	4.4	4.5	4.5
Balance of goods and services (percent of GDP)	-24.6	-20.7	-22.4	-18.8	-17.6	-17.3	-16.9	-16.2	-15.2
Current account (percent of GDP)	-14.0	-11.4	-11.9	-10.1	-9.4	-8.8	-8.3	-7.1	-5.8
Debt service (percent of exports of goods and services) 5/	4.0	9.7	2.8	3.1	3.1	3.0	11.3	2.1	1.7
Debt service (percent of central government revenues) 5/	4.8	13.1	3.8	4.3	4.4	4.3	16.4	3.1	2.5
Total external debt stock (percent of GDP) 6/	32.9	33.9	34.9	37.1	38.1	37.6	36.6	35.1	33.1
Volume of Exports of Goods and Services (percent change)	-5.9	24.8	11.1	0.7	5.0	6.5	5.2	5.0	6.0
Volume of Imports of Goods and Services (percent change)	0.8	-4.3	5.0	-6.8	1.0	4.5	3.9	6.0	7.0
Terms of trade (percent change) 7/	4.2	5.8	0.3	0.4	0.1	0.0	0.6	0.4	0.4

Sources: Ministry of Finance; Bank of Albania; donors; and IMF staff estimates and projections.

1/ Bank of Albania data plus IMF estimate (to capture some unrecorded inflows not captured in the BOA estimate).
2/ Net of valuation changes in 2008–11. In projections for 2012–17, valuation effects are assumed to be zero.
3/ Net errors and omissions include unidentified flows of private transfers.
4/ The financing gap,if any, is expected to be fully covered by arrears rescheduling.
5/ Public and publicly guaranteed debt only.
6/ Public and private external debt, including arrears. Debt stock converted into Lek at the e-o-p exchange rate.
7/ Fund Staff estimates and projections.

Table 4a. Albania: Monetary Aggregates, 2009–13

(Percent of GDP)

	2009	2010	2011	2012	2013
			Projections		
	Dec.	Dec.	Dec.	Dec.	Dec.
Monetary survey					
Broad money	75.7	79.3	81.2	83.6	83.6
Currency outside banks	18.2	15.8	14.8	15.2	15.2
Deposits	57.6	63.5	66.4	68.4	68.4
Domestic currency deposits	32.1	33.1	34.3	35.3	35.3
Foreign currency deposits	25.5	30.4	32.1	33.1	33.1
Net foreign assets	21.2	27.4	29.5	31.5	31.6
Bank of Albania	18.6	20.4	19.4	19.7	20.2
Commercial Banks	2.6	7.0	10.1	11.8	11.4
Net domestic assets	54.5	51.8	51.7	52.1	52.1
Claims on government (net of deposits)	29.2	27.6	27.2	27.6	26.9
BOA financing	5.8	4.5	4.1	4.0	3.8
Of which : gross credit	6.7	5.2	4.9	4.8	4.5
Other (including T-bills)	23.5	23.1	23.1	23.6	23.1
Claims on state enterprises and farms	1.0	0.8	1.4	1.4	1.3
Claims on the private sector	36.7	37.6	38.9	38.6	38.6
In leks	11.6	12.1	13.4	13.5	13.6
In foreign currency	25.1	25.5	25.5	25.6	25.9
Other items, net	-12.5	-14.1	-15.9	-15.4	-14.8
Memorandum items					
Reserve money	24.7	22.9	22.0	21.8	21.8
M1	24.7	22.3	21.0	22.0	22.0
M2	50.2	48.9	49.1	51.5	51.5

Sources: Bank of Albania; and IMF staff estimates.

Table 4b. Albania: Monetary Aggregates, 2009–13
(In billions of leks unless otherwise indicated; end-period)

	2009	2010	2011	2012	2013
			Projections		
	Dec.	Dec.	Dec.	Dec.	Dec.
Monetary survey					
Broad money	871.5	980.5	1070.3	1135.4	1185.6
Currency outside banks	209.0	195.1	194.9	206.8	216.0
Deposits	662.4	785.5	875.3	928.6	969.7
Domestic currency deposits	369.1	409.7	452.2	479.1	500.3
Foreign currency deposits	293.3	375.8	423.1	449.5	469.4
Net foreign assets	244.4	339.4	389.1	427.6	447.5
Bank of Albania	214.5	252.8	255.7	267.5	286.1
Commercial Banks	30.0	86.6	133.4	160.1	161.4
Net domestic assets	627.0	641.1	681.2	707.8	738.1
Claims on government (net of deposits)	336.3	340.9	358.6	374.4	381.2
BOA financing	66.4	55.4	54.0	54.0	54.0
Of which: gross credit	77.3	64.4	64.5	64.5	64.5
Other (including T-bills)	269.9	285.5	304.6	320.4	327.2
Claims on state enterprises and farms	12.1	9.4	18.7	18.7	18.7
Claims on the private sector	422.3	465.0	513.2	524.1	547.5
In leks	133.3	149.1	176.8	182.7	192.6
In foreign currency	289.0	315.8	336.4	347.6	366.7
Other items, net	-143.6	-174.1	-209.3	-209.3	-209.3
	(change as a percent of beginning of period broad money)				
Broad money	6.8	12.5	9.1	6.1	4.4
Currency outside banks	1.6	-1.6	0.0	1.1	0.8
Deposits	5.2	14.1	9.2	5.0	3.6
Domestic currency deposits	1.2	4.7	4.3	2.5	1.9
Foreign currency deposits	4.0	9.5	4.8	2.5	1.8
Net foreign assets	4.6	10.9	5.1	3.6	1.8
Bank of Albania	1.6	4.4	0.3	1.1	1.6
Commercial Banks	3.0	6.5	4.8	2.5	0.1
Net domestic assets	2.2	1.6	4.1	2.5	2.7
Claims on government (net of deposits)	2.1	0.5	1.8	1.5	0.6
BOA financing	0.7	-1.3	-0.1	0.0	0.0
Of which: gross credit	-0.1	-1.5	0.0	0.0	0.0
Other (including T-bills)	1.5	1.8	1.9	1.5	0.6
Claims on state enterprises and farms	-0.1	-0.3	0.9	0.0	0.0
Claims on the private sector	4.8	4.9	4.9	1.0	2.1
In leks	2.9	1.8	2.8	0.5	0.9
In foreign currency	2.0	3.1	2.1	1.0	1.7
Other items, net	-4.7	-3.5	-3.6	0.0	0.0
Memorandum items					
Reserve money (billions of Lek)	284.8	283.5	289.8	295.5	308.5
M1 (billions of Lek)	284.5	275.4	276.9	299.2	312.1
M2 (Billions of Lek)	578.2	604.5	647.0	699.0	729.5
Annual broad money growth	6.8	12.5	9.1	6.1	4.4
Annual growth in private sector credit	10.3	10.1	10.4	2.1	4.5
Private sector credit as a percent of GDP	36.7	37.6	38.9	38.6	38.6
Annual change in credit as a percent of GDP	1.5	0.9	1.3	-0.3	0.0
Annual M2 growth	4.2	4.6	7.0	8.0	4.4
Velocity (annual GDP/BM)	1.3	1.3	1.2	1.2	1.2
Money multiplier (absolute values)	3.1	3.5	3.7	3.8	3.8
Currency/Broad Money ratio	24.0	19.9	18.2	18.2	18.2
Foreign currency deposits/total deposits	44.3	47.8	48.3	48.4	48.4
Gross reserves (millions of euros)	1621.0	1925.7	1879.4	1975.7	2064.9
In percent of broad money	26.0	27.0	24.9	24.4	24.6
U.S. dollar exchange rate (end of period)	95.8	104.0	107.5	…	…
Euro exchange rate (end of period)	138.0	138.8	138.9	…	…
3-month T-bill rate (in percent)	6.3	5.3	5.3	…	…
BoA repo rate (in percent)	5.3	5.0	4.8	…	…

Sources: Bank of Albania; and IMF staff estimates.

Table 5. Albania: IMF Core Indicators of Financial Soundness, December 2005–June 2012

	Dec-05	Dec-06	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Feb-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
I Capital-based																			
(i) Regulatory capital as a percent of risk-weighted assets	18.6	18.1	17.1	17.2	17.3	17.5	17.2	0.0	16.9	16.7	16.2	16.2	15.4	14.8	14.6	15.1	15.6	15.9	15.7
(ii) Regulatory Tier 1 capital as a percent of risk-weighted assets	18.1	17.1	16.0	16.3	16.5	16.6	16.3	0.0	16.1	15.9	15.3	15.3	14.5	13.9	13.6	13.9	14.3	14.7	14.5
(iii) Capital as a percent of total assets																			
Regulatory Tier 1 capital as a percent of total assets	5.4	5.9	5.8	6.1	6.2	6.5	6.7	0.0	8.7	8.8	8.7	8.5	8.6	8.2	8.0	8.1	8.1	8.3	8.0
Regulatory capital as a percent of total assets	5.6	6.2	6.2	6.4	6.5	6.8	7.0	0.0	9.2	9.3	9.2	9.0	9.1	8.7	8.7	8.7	8.8	9.0	8.6
Shareholders' equity as a percent of total assets	6.6	6.8	7.6	7.9	7.9	8.0	8.6	0.0	9.3	9.3	9.6	9.5	9.4	9.1	8.6	8.7	8.7	8.7	8.6
(iv) Nonperforming loans net of provisions as a percent of capital																			
Nonperforming loans net of provisions as a percent of regulatory Tier 1 capital	4.4	7.2	12.0	13.7	16.7	14.2	27.2	0.0	30.4	27.2	29.9	35.3	38.1	40.4	51.2	55.3	56.6	58.8	60.5
Nonperforming loans net of provisions as a percent of regulatory capital	4.3	6.8	11.2	13.0	15.9	13.5	25.7	0.0	29.1	25.9	28.2	33.3	35.9	38.1	47.4	51.2	52.0	54.2	55.8
Nonperforming loans net of provisions as a percent of shareholders' equity	3.6	6.3	9.1	10.6	12.9	11.5	21.1	0.0	28.5	25.8	27.1	31.4	34.8	36.2	47.6	51.6	52.6	56.0	56.3
(v) Return on equity (ROE) (annual basis)	22.2	20.2	20.7	16.3	16.6	16.3	11.4	0.0	1.8	1.8	4.6	2.8	7.6	2.9	2.4	1.9	0.8	8.0	4.8
(vi) Net open position in foreign exchange as a percent of capital																			
Net open position in foreign exchange as a percent of regulatory Tier 1 capital	9.5	5.5	1.8	9.9	-0.6	5.7	4.5	0.0	4.6	5.1	4.1	5.0	5.3	3.0	4.0	-3.3	4.3	4.3	6.5
Net open position in foreign exchange as a percent of regulatory capital	9.3	5.2	1.7	9.4	-0.6	5.4	4.3	0.0	4.4	4.9	3.9	4.7	5.0	2.8	3.7	-3.0	3.9	4.0	6.0
Net open position in foreign exchange as a percent of shareholders' equity	7.8	4.8	1.4	7.6	-0.4	4.6	3.5	0.0	4.3	4.8	3.7	4.4	4.9	2.7	3.7	-3.1	4.0	4.1	6.1
II Asset-based																			
(vii) Liquid assets as a percent of total assets (Liquid-asset ratio) 1/	62.6	57.6	49.8	48.9	47.0	45.9	42.8	0.0	40.9	41.3	27.6	27.8	25.9	26.6	25.5	26.3	26.5	29.0	35.9
(viii) Liquid assets as a percent of short-term liabilities 1/	75.2	69.5	55.6	54.4	52.3	50.8	104.7	0.0	111.6	116.1	32.6	32.8	30.6	31.4	30.2	31.3	33.1	36.1	36.0
(ix) Return on assets (ROA) (net income to average total assets) (annual basis)	1.4	1.4	1.6	1.3	1.3	1.3	0.9	0.0	0.2	0.2	0.4	0.3	0.7	0.3	0.2	0.2	0.1	0.7	0.4
(x) Nonperforming loans (gross) as a percent of total loans	2.3	3.1	3.4	3.9	4.3	4.1	6.6	0.0	8.7	9.7	10.5	11.8	14.0	14.7	17.0	18.4	18.8	20.1	21.1
(xi) Sectoral distribution of loans to total loans	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na
III Income and expense-based																			
(xii) Interest margin to gross income	84.0	92.6	92.7	100.0	99.2	97.7	106.5	0.0	129.1	131.5	119.6	135.3	118.9	137.2	146.6	147.6	147.7	119.7	129.5
(xiii) Noninterest expenses to gross income	76.3	65.7	58.5	73.3	72.1	62.9	69.6	0.0	90.7	91.3	83.0	87.1	75.5	85.1	88.4	89.4	91.3	71.7	80.4
IV Memorandum items																			
Other (noncore) indicators:																			
Customer deposits as a percent of total (non-interbank) loans	342.5	265.5	215.5	201.9	187.7	183.9	162.6	0.0	151.7	153.7	154.3	156.5	166.4	164.6	163.7	166.3	163.2	164.0	168.1
Foreign currency-denominated loans to total loans	75.5	71.9	72.5	73.1	73.1	73.7	72.6	0.0	70.8	70.0	70.2	70.4	69.8	69.4	68.7	68.8	67.9	68.2	67.1
Foreign currency-denominated liabilities as a percent of total liabilities	41.0	44.0	46.9	47.8	48.1	50.2	48.5	0.0	47.5	48.3	48.9	49.2	51.0	50.2	50.3	52.1	51.9	52.1	52.3
Other indicators:																			
Risk weighted assets as a percent of total assets	30.0	34.6	36.4	37.2	37.4	38.9	40.8	0.0	54.3	55.6	56.7	55.5	59.2	58.7	59.3	58.1	56.5	56.3	55.2
Total loans as a percent of total assets	25.7	31.7	39.4	40.7	43.0	44.1	47.6	0.0	50.7	50.6	50.8	50.4	49.6	50.0	50.1	49.6	50.5	50.2	49.4
Total loans as a percent of shareholders' equity	387.0	469.5	516.4	517.4	541.4	550.9	555.1	0.0	542.9	542.9	530.2	529.4	527.0	547.9	580.2	572.3	581.9	578.8	575.5

Source: Data provided by Bank of Albania.

1/ Definition of liquid assets and short term liabilities were changed in October 2009.

Table 6. Albania: Risk Assessment Matrix[1]		
Source of Risks	**Overall Level of Concern**	
	Relative Likelihood of Severe Realization of Threat in the Next 1–3 Years (high, medium or low)	Impact if Realized (high, medium or low)
1. Strong intensification of the euro area crisis.	**Medium** Heightened financial stress could further reduce consumer and business confidence and stifle growth. European banks subsidiaries could suffer greater losses as a result of higher nonperforming loans, making it difficult to meet capital requirements.	**High** Negative impact on export demand, tourism, remittances, and foreign direct investment. Albania's foreign-dominated banking system may be directly hit, including through deleveraging.
2. Weakening confidence in the banking system.	**Medium** • Continued uncertainty in Greece and Italy, could trigger deposit withdrawals, especially in their subsidiaries. • Weak bank profitability, to a large extent because of persistently high non performing loans, may further weaken credit.	**High** A worsening of liquidity pressures will lead to a contraction in bank lending, which will further weaken domestic demand. Lower revenues could adversely impact public finances and debt sustainability, while funding pressures and higher interest rates could further exacerbate the situation.
3. Rollover of government debt.	**Medium** Uncertainty about economic conditions, especially in the run up to elections, and concerns about debt sustainability, may make banks hesitant to rollover government debt, a large part of which is short term.	**High** Higher borrowing costs will exacerbate debt sustainability and possibly lead to a disorderly fiscal adjustment that will further weaken growth prospects.
4. Sharp increase in oil prices.	**Low** Geo-political risks could lead to a sharp increase in oil prices.	**Medium** Higher energy prices would depress domestic and external demand. Economic activity and public finances would suffer. The external current account deficit would worsen, putting pressure on the exchange rate and reserves, while inflation would rise.

1/The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of the staff). The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities. The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline.

Appendix I. Debt Sustainability Analysis

Although external debt will remain sustainable over the medium term, concerns about public debt sustainability could undermine the government's capacity to rollover its debt. Shocks could lead to a further deterioration of debt indicators.

Public Debt Sustainability

1. Under the baseline scenario, public debt is expected to remain broadly unchanged at about 60 percent of GDP. Debt at that level will require primary surpluses of 1 percent of GDP to stabilize. More importantly, that level of debt constitutes about 245 percent of revenues, which could cast doubts on the government's ability to rollover its debt.

2. Various stress tests highlight the possibility for further deterioration of the debt-to-GDP ratio. The biggest deterioration would come from a one–time depreciation of the real exchange rate by 30 percent, which would lead to an increase in the debt–to–GDP ratio to 73 percent by 2017. Also, noteworthy is the impact of growth deceleration. If growth were to slow down to an average of 1.5 percent over the medium term (compared to 2.5 percent under the baseline scenario), the debt-to-GDP ratio would rise to 65 percent. Finally, a worsening of the primary deficit by 0.7 percentage point would lead to an increase in the public debt to 64 percent of GDP.

External Debt Sustainability

3. External debt appears sustainable in the medium-term, although it is expected to rise in relation to GDP in the short-term as economic growth slows and public external borrowing takes place to smooth the adjustment to the external shock. Over the medium-term, the external current account is expected to decline as: (1) import growth slows down due to moderating demand pressures; and (2) remittances recover from global shock, though converging to a lower level than before the crisis. Foreign direct investment and external borrowing are expected to be just sufficient to finance the projected level of the external current account deficit in the coming years.

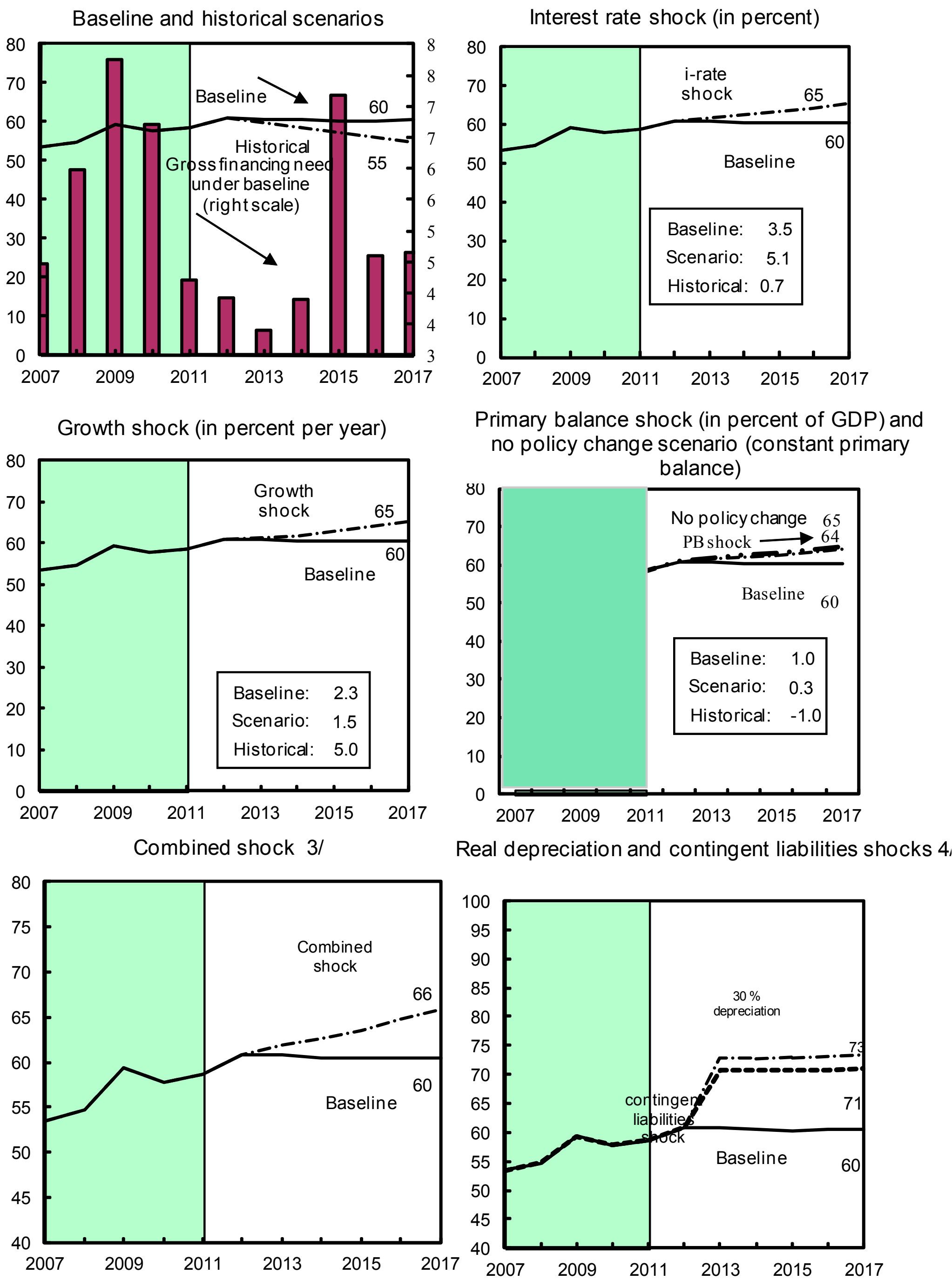
4. External debt would remain sustainable under shocks represented by standard bound tests. A combined shock to interest rates, real GDP growth, and the external current account deficit of ¼ of a standard deviation around historical averages would bring the ratio of external debt to GDP to 40 percent in 2013 through 2016. A one-time 30 percent nominal depreciation in 2013 would increase external debt to 55 percent of GDP in that year, but it would fall to 48 percent by 2017.

Table 1. Albania: Public Sector Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual						Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing primary balance 9/**
1 **Baseline: Public sector debt 1/**	56.7	53.4	54.7	59.3	57.8	58.6	**60.9**	**60.8**	**60.5**	**60.4**	**60.4**	**60.5**	**1.0**
o/w foreign-currency denominated	17.1	15.2	17.9	23.2	24.9	25.3	26.8	27.4	27.0	26.1	24.9	22.8	
2 Change in public sector debt	-1.2	-3.3	1.3	4.6	-1.5	0.8	2.3	-0.1	-0.3	-0.1	0.0	0.1	
3 Identified debt-creating flows (4+7+12)	-1.9	-1.3	1.1	7.9	1.5	0.7	1.5	-0.3	-0.6	-0.4	-0.2	-0.1	
4 Primary deficit	0.5	1.4	2.7	4.3	0.4	0.3	-0.2	-1.1	-1.1	-1.0	-0.9	-0.8	
5 Revenue and grants	26.0	26.0	26.7	26.0	25.8	25.1	24.8	24.9	24.8	24.8	24.7	24.6	
6 Primary (noninterest) expenditure	26.5	27.4	29.4	30.2	26.2	25.4	24.7	23.7	23.7	23.7	23.7	23.7	
7 Automatic debt dynamics 2/	-2.8	-4.3	-2.2	1.7	1.1	0.4	1.6	0.8	0.5	0.7	0.7	0.8	
8 Contribution from interest rate/growth differential 3/	-1.2	-2.4	-3.1	0.2	-0.8	-0.5	1.6	0.8	0.5	0.7	0.7	0.8	
9 Of which contribution from real interest rate	1.7	0.7	0.5	1.9	1.2	1.2	1.9	1.5	1.9	2.1	2.2	2.2	
10 Of which contribution from real GDP growth	-2.9	-3.0	-3.6	-1.7	-1.9	-1.6	-0.3	-0.8	-1.4	-1.4	-1.4	-1.4	
11 Contribution from exchange rate depreciation 4/	-1.5	-1.9	0.9	1.5	1.9	0.8	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.3	1.6	0.5	1.9	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.3	1.6	0.5	2.4	0.4	0.0	0.1	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	-0.5	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	0.8	-1.9	0.2	-3.3	-3.0	0.0	0.8	0.3	0.3	0.3	0.2	0.1	
Public sector debt-to-revenue ratio 1/	217.9	205.5	204.8	228.3	223.8	233.7	245.0	244.5	243.5	243.5	244.8	246.1	
Gross financing need 6/	3.8	4.5	6.0	7.7	6.7	4.2	3.9	3.4	3.9	7.2	4.6	4.7	
in billions of U.S. dollars	0.3	0.5	0.8	0.9	0.8	0.5	0.5	0.4	0.5	1.0	0.6	0.7	
Scenario with key variables at their historical averages 7/							**60.9**	**59.6**	**58.5**	**57.3**	**56.1**	**55.0**	**-2.1**
Scenario with no policy change (constant primary balance) in 2012-2017							**60.9**	**61.8**	**62.4**	**63.2**	**64.1**	**64.9**	**1.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline													
Real GDP growth (in percent)	5.4	5.9	7.5	3.3	3.5	3.0	0.5	1.3	2.5	2.5	2.5	2.5	
Average nominal interest rate on public debt (in percent) 8/	5.3	5.1	6.1	6.1	6.1	5.7	5.7	5.8	6.1	6.6	6.7	6.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.3	1.5	1.4	3.8	2.2	2.3	3.3	2.7	3.4	3.8	3.9	3.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	10.0	13.8	-6.2	-7.9	-7.9	-3.3	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.0	3.6	4.7	2.3	3.8	3.5	2.4	3.1	2.8	2.8	2.8	2.9	
Growth of real primary spending (deflated by GDP deflator, in percent)	10.1	9.4	15.5	6.2	-10.3	-0.1	-2.4	-2.5	2.5	2.5	2.5	2.4	
Primary deficit	0.5	1.4	2.7	4.3	0.4	0.3	-0.2	-1.1	-1.1	-1.0	-0.9	-0.8	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi$ (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Albania: Public Debt Sustainability: Bound Tests 1/ 2/
(Public debt in percent of GDP)



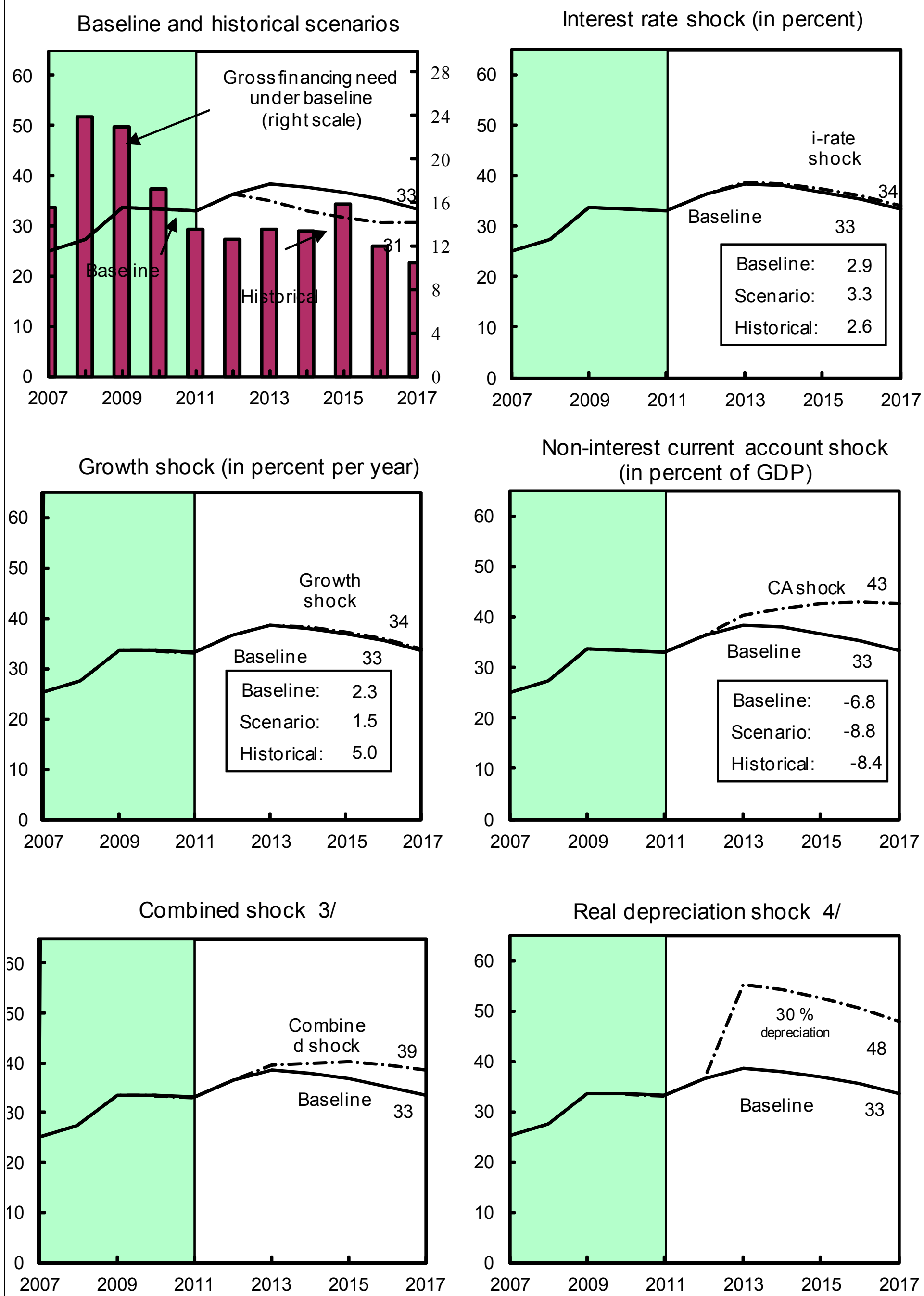
Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2012 with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 2. Albania: External Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	25.1	27.5	33.6	33.4	33.1	**36.4**	**38.4**	**37.8**	**36.8**	**35.4**	**33.4**	**-6.4**
Change in external debt	-0.1	2.4	6.1	-0.2	-0.3	3.3	2.0	-0.6	-1.0	-1.4	-2.0	
Identified external debt-creating flows (4+8+9)	0.3	4.0	8.2	2.9	1.6	3.5	2.8	2.0	1.5	0.4	-0.8	
Current account deficit, excluding interest payments	9.5	14.4	13.3	10.6	11.1	9.1	8.3	7.7	7.1	6.2	5.0	
Deficit in balance of goods and services	26.8	26.6	24.6	20.7	22.6	18.7	17.7	17.3	16.9	16.2	15.2	
Exports	28.2	29.3	28.7	32.6	33.8	33.9	34.8	35.2	35.4	35.7	36.1	
Imports	55.0	55.9	53.2	53.3	56.4	52.5	52.5	52.5	52.4	51.8	51.3	
Net non-debt creating capital inflows (negative)	-6.1	-6.7	-7.7	-9.2	-7.7	-6.4	-6.1	-5.9	-5.9	-5.8	-5.7	
Automatic debt dynamics 1/	-3.1	-3.7	2.6	1.6	-1.8	0.9	0.6	0.2	0.3	0.0	-0.1	
Contribution from nominal interest rate	0.9	0.7	0.8	0.8	0.9	1.0	1.1	1.1	1.2	0.9	0.8	
Contribution from real GDP growth	-1.2	-1.6	-1.0	-1.2	-0.9	-0.2	-0.5	-0.9	-0.9	-0.9	-0.8	
Contribution from price and exchange rate changes 2/	-2.7	-2.9	2.9	2.0	-1.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-0.4	-1.6	-2.1	-3.1	-1.9	-0.2	-0.8	-2.7	-2.5	-1.8	-1.2	
External debt-to-exports ratio (in percent)	88.9	93.6	117.2	102.4	97.8	107.5	110.4	107.5	103.8	99.2	92.4	
Gross external financing need (in billions of US dollars) 4/	1.7	3.1	2.8	2.0	1.8	1.6	1.7	1.7	2.1	1.7	1.5	
in percent of GDP	15.6	23.9	22.9	17.2	13.5	12.5	13.5	13.4	15.9	11.9	10.4	
Scenario with key variables at their historical averages 5/						**36.4**	**35.0**	**33.1**	**31.6**	**30.8**	**30.6**	**-8.3**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.9	7.5	3.3	3.5	3.0	0.5	1.3	2.5	2.5	2.5	2.5	
GDP deflator in US dollars (change in percent)	12.2	13.0	-9.4	-5.6	5.9	-4.8	-0.9	1.5	1.5	1.7	1.9	
Nominal external interest rate (in percent)	4.3	3.6	2.6	2.3	3.1	3.0	3.0	3.1	3.3	2.5	2.3	
Growth of exports (US dollar terms, in percent)	31.6	26.5	-8.6	11.2	13.1	-4.2	3.2	5.2	4.8	4.9	5.7	
Growth of imports (US dollar terms, in percent)	31.0	23.6	-10.9	-2.2	15.5	-10.9	0.3	4.1	3.8	3.2	3.4	
Current account balance, excluding interest payments	-9.5	-14.4	-13.3	-10.6	-11.1	-9.1	-8.3	-7.7	-7.1	-6.2	-5.0	
Net non-debt creating capital inflows	6.1	6.7	7.7	9.2	7.7	6.4	6.1	5.9	5.9	5.8	5.7	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 2. Albania: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



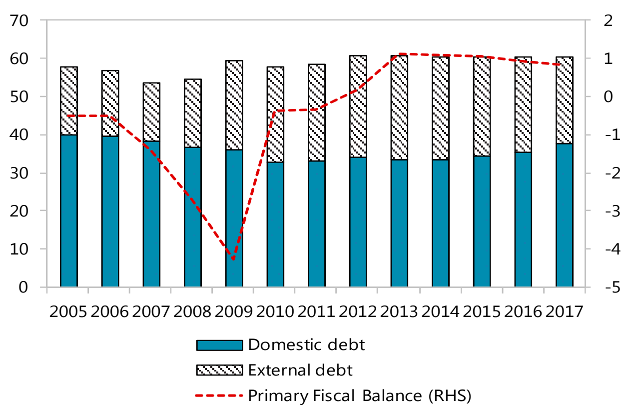
Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs.

Appendix II. Albania: Fiscal Deficits, Rollover Risk, and Banking System Stability

If left unaddressed, Albania's high public debt could pose significant challenges in the current environment. Rollover risk could worsen because of large financing needs, which banks may be unable to cover, and inward shocks to the domestic debt market. These problems could also have feedback effects on banking stability.

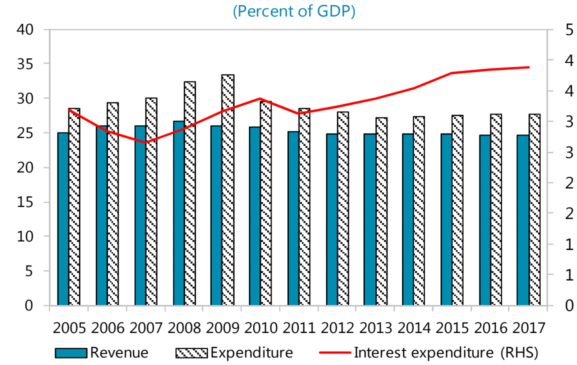
1. **Albania's key challenge is to put its public debt on a downward trajectory**. Under the baseline scenario, even if the authorities maintain a small primary fiscal surplus over the medium term, the debt burden will not improve. Instead, it will hover around the statutory ceiling of 60 percent of GDP by 2017, because of rising interest spending.

Primary Fiscal Balance and Public Debt, 2005-17
(Percent of GDP)



Source: IMF staff estimates and projections.

Public Finances, 2005-17
(Percent of GDP)

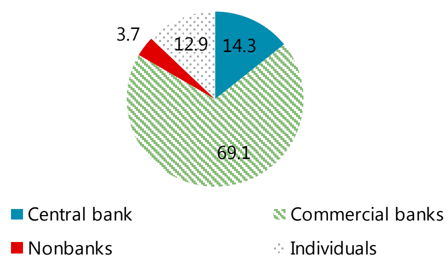


Source: IMF staff estimates and projections.

2. **With an adverse external environment, the government will have to rely increasingly on raising money domestically.** The prospects for external financing are not rosy today—Albania's five-year Eurobond spread was about 665 basis points at end-September 2012—and are likely to continue to be relatively unfavorable over the near term, till eurozone markets return to stability. The government would therefore continue to rely on the more expensive, albeit safer domestic financing over the medium term, not only to finance the deficit, but also to retire maturing external debt. As a result, the domestic debt stock could rise from about 33 percent of GDP in 2011 to about 38 percent by 2017 (with domestic debt accounting for 62 percent of total).

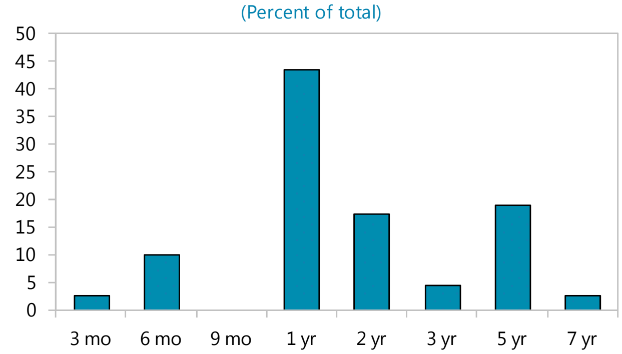
3. **Most of Albania's domestic public debt is short term, and largely held by commercial banks.** About 56 percent of the 2011 debt stock was of 12-month maturity or less. Longer term debt is primarily in the form of 5-year and 2-year notes. Almost the entire stock of domestic debt is in local currency. Commercial banks are by far the largest holders—with the nonbanking system accounting for only about 15 percent of the debt stock.

Public Domestic Debt by Creditor, 2011
(Percent of total)



Source: Albanian authorities and IMF staff estimates.

Public Domestic Debt by Instrument, 2011
(Percent of total)

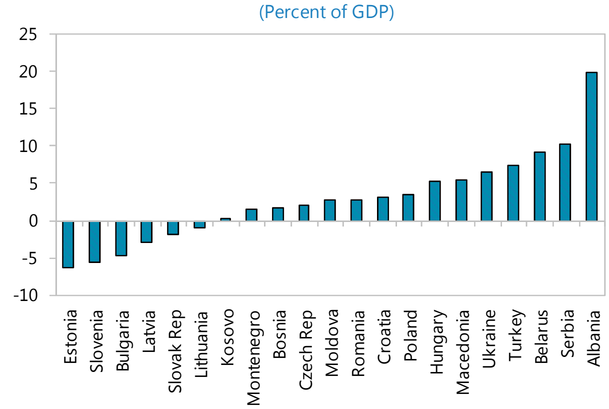


Source: Albanian authorities and IMF staff estimates.

4. **The government's ability to continue to attract investors in the future is subject to considerable risks**. There has already been a significant shift in bank balance sheets away from public debt over the past five years—the share of government securities in total assets has fallen by 10 percentage points over the period. Going forward, the projected baseline increase in public domestic debt over the medium term poses significant rollover risks mainly because of:

- *Inward spillover*. Given the predominance of foreign-owned banks in Albania's banking system (about 90 percent of assets), unexpected stress in parent European banks could potentially spill over into Albanian subsidiaries, in turn putting at risk the government's ability to rollover and issue new public debt. The recent offloading of government paper by a major foreign bank subsidiary is a case in point[1]

Fiscal Financing Needs Net of Fiscal Buffer, Jun-Dec 2012
(Percent of GDP)



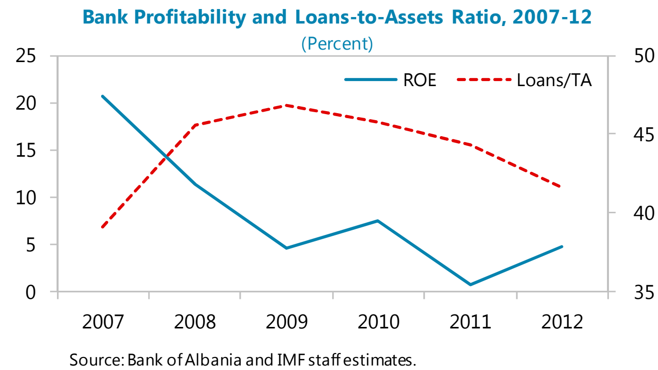
Source: IMF staff estimations and projections.
1/ Full year figures for Bosnia, Estonia, and Turkey.

- *Changes in perceived riskiness of government securities*. If public debt were to increase—above the publicly known statutory debt limit—potential creditors might reassess the risk profile of government securities. An explicit downgrade may force creditor banks to reallocate their securities portfolios—recently, banks appear to be moving away from government securities, driven by their internal risk models.

[1] Following the decision of the parent bank (based in the Euro area) to reduce its risk-weighted assets—ostensibly to meet more stringent capital requirements at home—the subsidiary, which is the biggest bank in Albania with about one third of domestic public debt, reduced exposure to Albanian government paper by 150 million euro (about 5 percent of public securities maturing in 2012). In the event, another bank picked up most of the offloaded securities.

- *Profitability pressures*. Because of the economic downturn and more stringent liquidity requirements, banks have shrunk their loan portfolios, which in turn has impacted their profitability. To boost profitability, banks may in the future decide to gradually reduce their exposure to the relatively lower-yielding government securities in search of higher returns.[2]

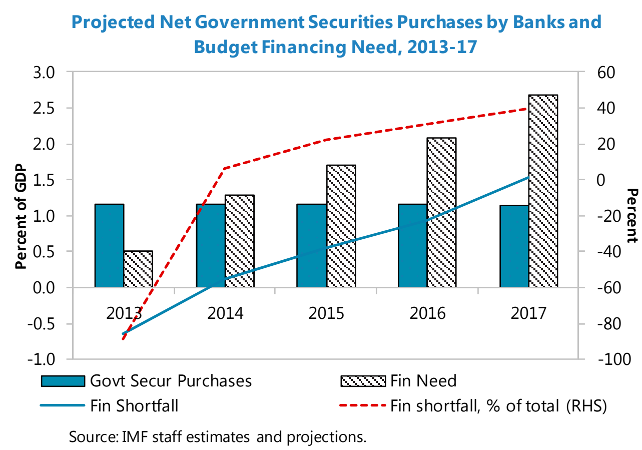
- *Financial innovation*. Over the long term, the introduction of new savings schemes is likely to lead to a shift in savings away from traditional bank deposits. As a result, the availability and reliability of government funding could suffer.



Source: Bank of Albania and IMF staff estimates.

5. The government's projected financing needs over the medium term will likely be too large to be covered by commercial banks. An examination of bank balance sheets suggests that if the stock of government securities continues to increase by the annual historical average of 5 percent, banks would be able to pick up only 60 percent of the issuances needed to meet financing needs over the medium term.

6. Uncertainty about the government's ability to finance its budget deficit could exacerbate pressures in the domestic debt market, and affect banking system stability. Given the expected shortfall in financing, government security yields could rise, putting further pressure on the fiscal deficit and public debt. If left unaddressed, investor nervousness could ultimately lead to an adverse shift in perceptions. A disorderly fiscal adjustment could then trigger bondholder losses and banking system instability.



Source: IMF staff estimates and projections.

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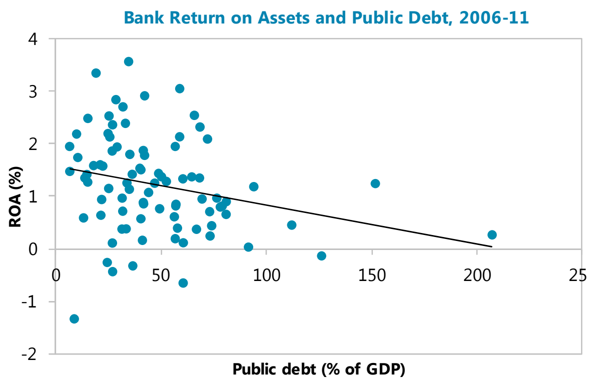
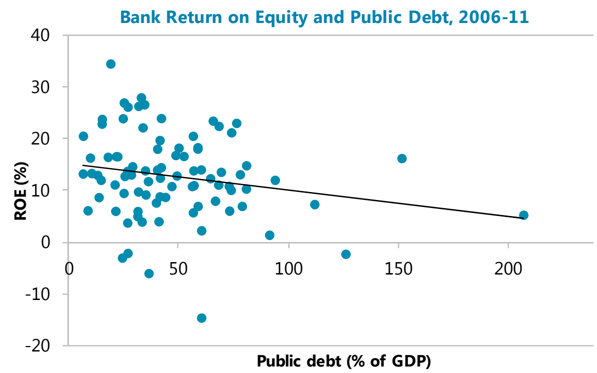
2 The average bank lending rate was 12.4 percent in 2011, compared with an average of 8.0 percent return on government bonds, and 6.5 percent on treasury bills.

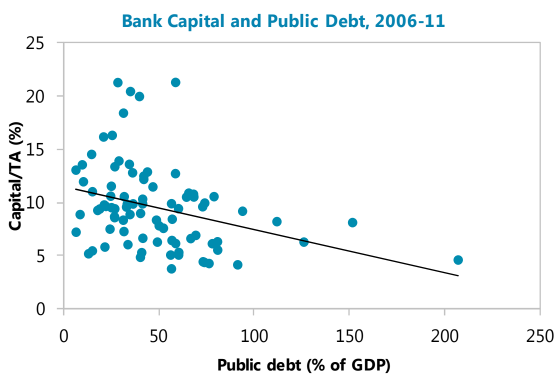
7. Cross-country experience confirms the potential negative effects of high public debt on banking system stability.[3] Foremost, higher public debt is associated with lower return on assets and equity for the banking system. This association may be driven by higher interest rates, which hamper borrowers' ability to stay current on loans. Cross country evidence also shows that high public debt is associated with low provisioning and capitalization.



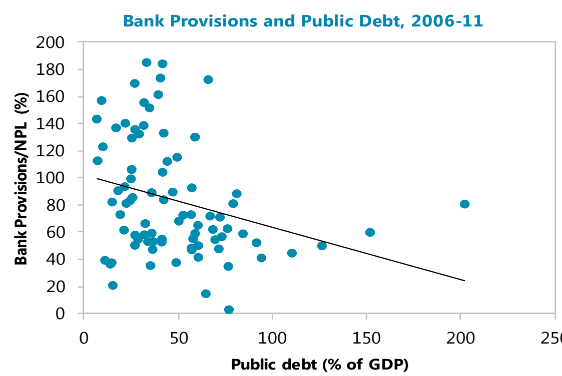
Source: IFS and IMF staff estimates.



Source: IFS and IMF staff estimates.



Source: IFS and IMF staff estimates.



Source: IFS and IMF staff estimates.

[3] The analysis uses data from 89 countries from all regions, excluding sub-Saharan Africa.

Appendix III. Inflation Targeting in Albania

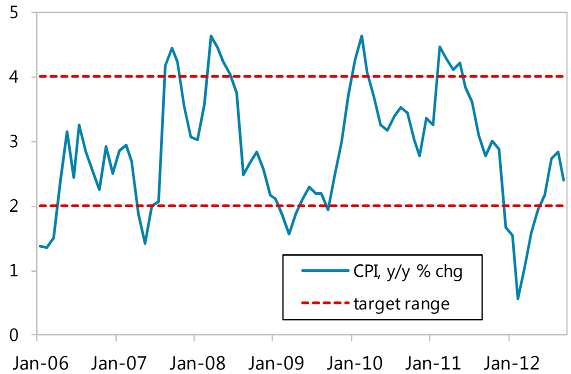
1. Albania's record on inflation since the move to inflation targeting has been impressive. Inflation has remained within the central bank's target range of 2–4 percent for most of the period since 2006, a performance that compares favorably to other countries in the region, including other inflation targeters such as Poland, the Czech Republic, Serbia and Romania (Figure 1).

2. The inflation targeting framework has evolved gradually since the shift to inflation targets in 2000. The central bank has moved from quantitative targets for monetary aggregates toward an interest-rate based monetary policy, while gradually eliminating direct credit to the government and building the analytical capacity needed for a full-fledged inflation targeting regime. The monetary policy stance under the current framework is signaled by the central bank's reference rate, with open market operations used to align short-term interbank rates with that rate. The annual growth rate of broad money (M3) is monitored as an intermediate target, along with a floor for international reserves (4 months' import cover). While the target range applies to headline inflation, the central bank also closely monitors core inflation; food accounts for nearly 40 percent of the basket, making headline inflation highly sensitive to supply shocks.

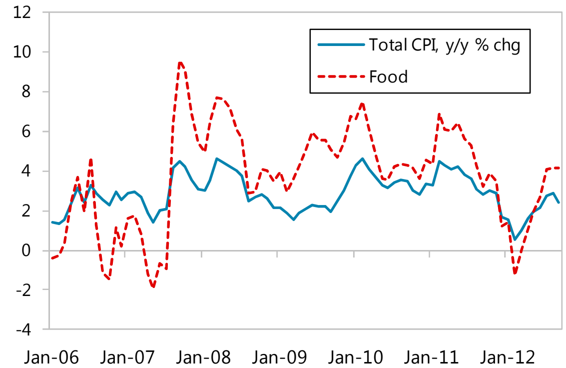
3. As a small, open and highly euroized economy, inflation in Albania remains closely linked to exchange rate movements. Half of bank deposits and two-thirds of lending are in foreign currency, while imports of goods and services amount to roughly 55 percent of GDP, ensuring that changes in exchange rates have an immediate balance sheet effect and pass through relatively quickly into domestic prices. In addition, the effect of interest rates on domestic demand through the credit channel remains relatively modest (bank loans amounts to only 40 percent of GDP, well below regional comparators), while the high level of liquidity in the banking system limits the scope for a significant impact on lending activity through changes in domestic interest rates.

4. As a result, interest rate policy works primarily through the exchange rate. While the credit channel continues to strengthen as the level of financial intermediation rises with the development of the financial system, at the moment, the most significant transmission of interest rate changes is through their impact of the exchange rate. Interest rate cuts have largely followed the course set by the ECB over the past two years, maintaining a sufficient differential to stabilize the exchange rate against the euro after the depreciation in the wake of the financial crisis in 2009, and keep inflation close to eurozone levels.

Figure 1. Albania: Recent Inflation and Monetary Developments

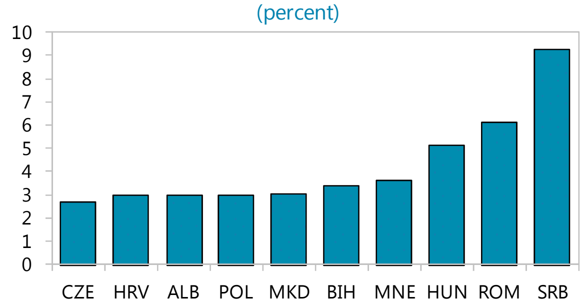


Source: Albanian authorities and IMF staff calculations



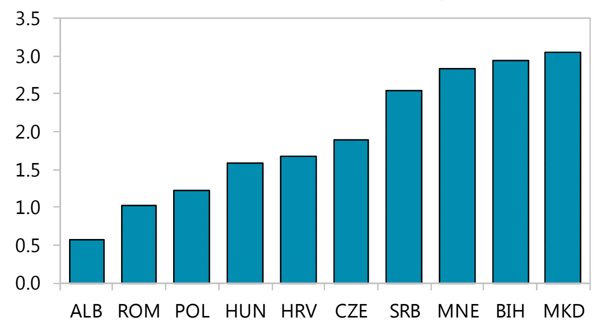
Source: Albanian authorities and IMF staff calculations

Average annual inflation, 2006-2011
(percent)



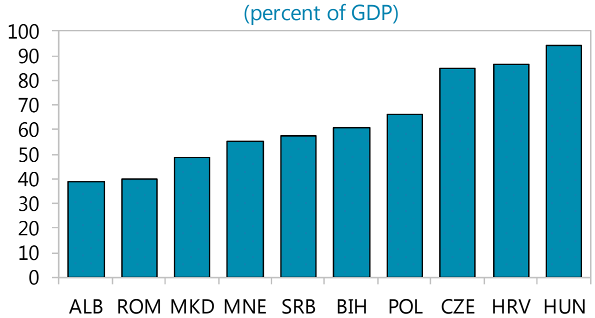
Source: International Financial Statistics and IMF staff calculations

Standard deviation of annual inflation, 2006-2011

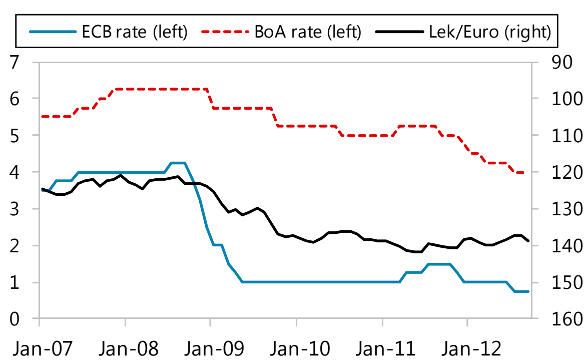


Source: International Financial Statistics and IMF staff calculations

Credit to the private sector, end-2011
(percent of GDP)



Source: International Financial Statistics and IMF staff calculations



Source: International Financial Statistics and IMF staff calculations

INTERNATIONAL MONETARY FUND

ALBANIA

November 16, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(in consultation with other departments)

CONTENTS

I. FUND RELATIONS

(As of September 30, 2012)

I. Membership Status: Joined: 10/15/1991; Article XIV

II. General Resources Account:	SDR Million	Percent Quota
Quota	60.00	100.00
Fund holdings of currency	60.93	101.55
Reserve tranche position	6.18	10.30

III. SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	46.45	100.00
Holdings	46.96	101.11

IV. Outstanding Purchases and Loans:	SDR Million	Percent Quota
Extended Arrangement	7.10	11.84
ECF Arrangements	16.19	26.99

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF[1]	2/01/2006	1/31/2009	8.52	8.52
EFF	2/01/2006	1/31/2009	8.52	8.52
ECF[1]	6/21/2002	11/20/2005	28.00	28.00

[1] Formerly PRGF.

VI. Projected Payments to the Fund (Expectation Basis)

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal	0.10	6.81	5.80	4.32	2.90
Charges/Interest	0.02	0.07	0.07	0.05	0.03
Total	0.12	6.88	5.88	4.37	2.93

VII. Safeguards Assessments:

The latest safeguards assessment of the Bank of Albania, completed on July 14, 2006, found that some weaknesses existed in the central bank's safeguards framework. The main vulnerabilities identified by the assessment concerned the quality of the external audit, poor oversight of the external and internal audit functions and the system of internal controls, and certain weaknesses in the controls over the Fund data reporting process. Subsequent to the assessment completion, external audit quality has been improved by adding cosignature from the larger office of the audit firm, and the data reporting process was modified as recommended. The authorities are working to address remaining vulnerabilities in the areas of governance oversight and internal audit function.

VIII. Exchange Rate Arrangement:

On July 1, 1992 the Albanian authorities adopted a floating exchange rate system. The de jure exchange rate system is classified as free floating, but the de facto exchange rate arrangement is floating, with the monetary authorities occasionally intervening in the foreign exchange market in order to avoid excessive and short-term disruptions in the functioning of the market and to accumulate reserves. The country still avails itself of the transitional arrangements under Article XIV and maintains an exchange restriction in the form of outstanding debit balances on inoperative bilateral payment agreements, which were in place before Albania became a Fund member. These relate primarily to debt in nonconvertible and formerly nonconvertible currencies. Staff is currently assessing Albania's exchange system for potential exchange restrictions and multiple currency practices. The exchange rate stood at lek 109.57 per U.S. dollar on November 16, 2012.

IX. Article IV Consultation:

The conclusion of the 2011 Article IV consultation took place in September 2011 (IMF Country Report No. 11/313).

X. FSAP Participation and ROSCs:

An FSAP was carried out in early 2005. The Financial System Stability Assessment was considered by the Executive Board on August 1, 2005 concurrently with the staff report for the sixth review of the PRGF-supported program and financing assurances review. An action plan for implementing the FSAP recommendations has been prepared in consultation with the IMF. A data module ROSC was published on the Fund's website in June 2000. A fiscal ROSC was completed in June 2003. Albania participates in the General Data Dissemination System (GDDS), and a complete set of GDDS metadata for the external, financial, fiscal, and real sectors, as well as for the socio-demographic indicators is posted on the Fund's Dissemination Standards Bulletin Board (http://dsbb.imf.org). A data module ROSC reassessment using the Data Quality Assessment Framework was conducted in March 2006. A ROSC for assessing the Financial Action

Task Force (FATF) recommendations for Anti-Money Laundering (AML) and Special Recommendations on Combating the Financing of Terrorism (CFT) was conducted in November 2010 and the report was published in July 2011.

XI. Technical Assistance:

The Fund, other multilateral organizations and donors have provided extensive assistance for institutional development in Albania. The Fund has sent several technical assistance missions to Albania every year since 1991. The extent and focus of Fund TA since FY 2008 is briefly listed below.

Table 1. Albania—Technical Assistance since FY2008

Department	Purpose	Date
FAD	Cash Management and Public Finance Strategy	May 2008
	Cash Forecasting and Management	October 2012
	Revenue Administration	October/November 2008
	Advice on IT Strategy and Business Process Reengineering	April 2009; March 2010
	Tax Administration	April 2009; March 2010, April 2011
	Capacity Building in Taxpayer Compliance and Information Technology	November 2011
LEGAL	Review of the Albanian AML/CFT law	August 2007
	TA on Repurchase Transactions Law	March 2008
	Banking Seminar for Judges and Bank Regulators	November 2008
	TA in Central Banking Law	April 2009
	TA on Payments Systems	May 2009
	ROSC on AML and CFT	Nov 2010
MCM	Monetary Policy	25 visits between June 2007 and April 2010;
	Management	June, July 2007
	Credit Registry	October 2007; January 2008
	Modeling and Forecasting	October 2007; March 2008
	Monetary Policy Strategy for Small Countries	December 2007;

Department	Purpose	Date
	Banking Supervision	13 visits between February 2008 and March 2010;
	Delivery vs. Payment	April/May 2008
(together with LEGAL)	Central Bank Law	April 2009: February 2010
	Treasury Bill Registry	November 2009
	Modeling of Monetary Policy	December 2009; March, April, September 2010, January 2011, October 2011
	Stress testing, liquidity testing	April 2011, July 2011, September 2011
	Contingency planning and Crisis Management	September 2011
Department	Purpose	Date
STATISTICS	Balance of Payment Statistics	September-October 2007
	GDDS: Consultation	October 2007
	STE: Consumer Prices/Producer Price	November 2007
	LTE: Government Finance Statistics	February 2008
	STE National Accounts Statistics	5 visits between February 2008 and November 2009
	SDDS: Assessment	April, July 2010
	National Accounts Statistics	March 2011
	LTE: National Account Statistics	June 2012

XII. Resident Representative

A Fund resident representative was posted in Tirana from April 1993 to August 2009. Ms. Ann-Margret Westin filled the position from August 2005 to August 2009.

II. WORLD BANK RELATIONS

Albania: Bank-Fund Joint Management Action Plan Matrix
(As of October 2012)

Title	Product	Provisional Timing of missions	Expected Delivery date
A. Mutual information on relevant work programs			
The World Bank work program in the next 12 months	1. Financial Stability & Modernization Loan, September 2. Land Administration & Management Project (LAMP) , Implementation Support Mission for Component a, Security of Tenure & Registration of Immovable Property Rights 3. IDF Grant Strengthening Aarhus Convention Implementation Project, 4. Education Excellence & Equity Project, 5. Albania Improved Natural Resources Management 6. Social Assistance Modernization Project, October 7. Disaster Risk Mitigation & Adaptation Project	September 24–October 5, 2012 October 1–5, 2012 October 8–9, 2012 October 3–12, 2012 October 15–19, 2012 October 22–26, 2012 October 8–15, 2012	Ongoing Ongoing Ongoing Ongoing Ongoing Ongoing Ongoing
The Fund work program in the next 12 months	Surveillance: 2013 Article IV Consultation Staff visit for review of recent developments FSAP, 2nd half of 2013 Technical assistance: *Monetary and Financial sector* Strengthening bank supervision Monetary policy modeling Government foreign exchange payments Internal auditing Stress testing Contingency planning	 September 2013 April 2013 3 missions 1 missions 2 missions 1 missions 1 missions 1 missions	 Board meeting in December 2013 Ongoing Ongoing Ongoing Ongoing Ongoing Ongoing

	Fiscal sector Strengthening Tax Compliance Public financial management *Statistics* National accounts statistics	 1 mission 1 mission 1 mission	 Ongoing Ongoing Ongoing
B. Requests for work program inputs (as needed)			
Fund request to Bank	Growth diagnostics, assessment of competitiveness, and related structural reforms (e.g., electricity sector) Fiscal governance and PEM Public expenditure reform needs (in particular civil service and pension reforms) Nonbank financial sector development		
Bank request to Fund	Periodic macro updates Joint approach to advisory work on institutional reform at the MoF in debt management Debt Sustainability Analysis		

III. STATISTICAL ISSUES

October 17, 2012

A. Assessment of Data Adequacy for Surveillance

General: Data provision has some shortcomings, but is broadly adequate for surveillance. The main obstacles are in real sector statistics.

National Accounts: National accounts are compiled from insufficient and poor quality sources. While technical assistance has been provided on methodological procedures, source data still do not provide sufficient information to compile reliable estimates on the unobserved economy. In November 2005, the Institute of Statistics (INSTAT) released major revisions of the national accounts estimates for 1996–2003 and updates for 2004, reflecting methodological improvements.

INSTAT has benefited from technical assistance from the Fund and the European Union, mainly to address weaknesses in methodology, basic data sources, and coverage of the private sector. STA continued to provide technical assistance through peripatetic missions in 2010 and 2011. The Labor Force Survey was incorporated into the estimates of the unobserved economy in the annual national accounts while attempts were made to use the Household Budget Survey to develop a new benchmark estimate of private consumption. A new methodology for gross fixed capital formation based on a commodity flow approach was developed. Quarterly national accounts were compiled during the project and are now being published and revised. Due to severe resource constraints at INSTAT, the improvement in the national accounts has been relatively slow.

Price statistics: Compilation generally follows international standards, and the estimation of imputed rent within the CPI was improved in 2003. In December 2007, INSTAT has updated the CPI weights using the results of a new national-level HBS conducted during the period October 2006-September 2007. PPI has been published only quarterly due to financial constraints. The weights were derived from the 1998 annual Structural Business Survey.

Government finance statistics: GFS generally follow the *Government Finance Statistics Manual 1986*. External donor financed-projects that do not pass through the treasury system represent a weakness in source data. There are adequate source data to establish a *GFSM 2001* presentation for Albania, but data on financial assets need to be compiled and further disaggregation of debt instruments is necessary to report a financial balance sheet of government that reconciles stocks and flows.

Monetary statistics: The monetary data compilation framework conforms to the methodology recommended in the *Monetary and Financial Statistics Manual (MFSM) 2000*. The depository corporations survey covers the Bank of Albania (BoA) and all the other deposit-taking institutions (commercial banks and savings and loans associations (SLAs)). The accounts of the SLAs, with the exception of loans, are produced on a cash basis, which contrasts with the *MFSM*'s recommendations of accrual accounting. Another deviation from the *MFSM*'s methodology is that the BoA's and commercial banks' holdings of nontradable long-term securities are recorded at book value.

External sector statistics: The Balance of payments data compiled by the BoA are methodologically sound, although some of the estimates, particularly for international transactions outside the banking system need to be refined. Problems remain in the areas of service transactions and remittances, and in the monitoring of financial account transactions, foreign assistance (grants from abroad to regional and local governments are underreported), and external debt.

A September–October 2007 mission noted strong progress in adopting earlier recommendations but advised that estimation methods for transactions outside the banking system (mostly remittances and investment transactions by nonresident Albanians) require further improvement.

The external debt database ensures timely and accurate reporting of external government debt (including commitments of state-owned enterprises). However, there have been some irregularities in the recording and presentation of external arrears. The collection of data on external grants is not timely, with lags of several months frequently encountered.

B. Data Standards and Quality

Albania participates in the General Data Dissemination System (GDDS).	Data ROSC published on October 2006.

Albania: Table of Common Indicators Required for Surveillance
As of October 17, 2012

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of reporting[7]	Frequency of publication[7]	Memo Items:	
						Data Quality – Methodological Soundness[8]	Data Quality – Accuracy and Reliability[9]
Exchange Rates	10/17/12	10/17/12	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	10/12/12	10/17/12	D	W	M		
Reserve/Base Money	10/12/12	10/17/12	D and M	W and M	M	O, O , O , LO	O, LO, LO, O, O
Broad Money	August 12	10/1/12	M	M	M		
Central Bank Balance Sheet	September 12	10/15/12	M	M	M		
Consolidated Balance Sheet of the Banking System	August 12	10/1/12	M	M	M		
Interest Rates[2]	10/17/12	10/17/12	D	D	D		
Consumer Price Index	September 12	10/10/12	M	M	M	O, LO, O, LO	LO, LO, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	September 2012	10/17/12	M	M	M	LO, O, O, O	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	September 2012	10/17/12	M	M	M		

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of reporting[7]	Frequency of publication[7]	Memo Items:	
						Data Quality – Methodological Soundness[8]	Data Quality – Accuracy and Reliability[9]
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June 2012	08/15/12	Q	Q	A		
External Current Account Balance	2012Q2	09/10/12	Q	I	I	O, O, O, LO	LNO, O, LO, LO, O
Exports and Imports of Goods and Services	August 2012	10/1/12	M	M	M		
GDP/GNP	2012Q2	10/12	Q	Q	Q	O, LNO, O, LO	LNO, O, LNO, LO, LO
Gross External Debt	2012Q1	09/10/12	Q	I	Q		
International Investment position[6]	2010	7/15/12	A	A	A		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents. The IIP is currently being developed by the Albanian authorities and is not yet published. The authorities will publish the data once quality checks have been completed.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC published on October 31, 2006, and based on the findings of the mission that took place March 8–22, 2006, for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Mr. Montanino, Executive Director for Albania and Mr. Spadafora, Senior Advisor to the Executive Director Executive Board Meeting December 3, 2012

On behalf of the Albanian authorities, we thank staff for the continued close and constructive cooperation, as well as for the very informative report.

Main Issues

Albania weathered the global crisis better than most other regional and European economies. A timely fiscal response, sound monetary policy, and effective macroprudential actions have allowed escaping a recession despite the challenging external environment which affects that specific geographical area.

After years of severe recession in some neighboring countries, Albania is now being increasingly affected by the slowdown in the euro area. Output growth slowed to 1.0 percent during the first half of 2012 (from 2.7 percent in the same period of 2011), as consumer and investor confidence suffered from worsened external conditions, remittances declined, and credit growth fell sharply. Part of the economic weakness was due to exogenous factors (severe winter weather).

The authorities expect a more robust recovery than staff starting in the current quarter. Some **upside to the baseline scenario emanates from the privatization of the state oil company (Albpetrol) and further positive effects might come from stabilization in external conditions expected from the initiatives agreed on November 26 by the Eurogroup on Greece.**

Public finances remain manageable. The authorities' conduct of fiscal policy during the crisis was prudent, as **public debt-to-GDP ratio remained fairly stable around 60 per cent of GDP during the last years**.

In the medium term, the authorities value the country's untapped natural resource wealth (notably mining and hydroelectricity). Also, flexibility in the Albania's productive base shows capacity to reorient export to new products and markets.

Fiscal Policy

The statutory 60 percent debt limit is an anchor for fiscal policy, but it needs to be used in a flexible manner in the near term. Given the current economic environment, an **excessively**

rigid rule might be procyclical, with counterproductive effects on growth, particularly if investment is cut further in order to comply with the rule.

The authorities are aware of the rollover requirements and agree with the staff's suggestion to take measures to lengthen debt maturities and deepen public securities markets. However, they consider the debt service as manageable: rollover risks are mitigated by the fact that about 70 percent of public debt is held by commercial banks, which have ample liquidity and face limited lending opportunities.

The overall balance is expected to improve in 2012, as fallen tax revenues have been more than offset by cuts in capital expenditure. The authorities consider a prevailing part of the fall in revenues as cyclical, resulting from automatic stabilizers and weak confidence related to the eurozone crisis. Almost all the decrease in the tax revenue-to-GDP ratio between 2009 and 2011 might be explained by the reduction in VAT receipts. **Tax collection is thus expected to recover as the outlook improved**.

In the authorities' view, the current low level of income taxes has helped reduce informality. They are thus concerned that an increase in tax rates could harm Albania's investment competitiveness, and prefer to focus on improving tax administration.

While recognizing the desirability of higher capital expenditure, the authorities reject the idea of increasing tax rates to finance it. Increases in capital spending are conditioned to the availability of privatization receipts (or other non-debt-creating flows) and to the financing of other priority spending (unpaid bills and emergency electricity imports).

The authorities agreed that social insurance reform is necessary and on the need for smaller increases in the public wage and pension bills. However, they also cautioned about the lack of political consensus on the issue.

Monetary Policy and Financial Sector

With the economy showing signs of weakness, the Bank of Albania (BoA) has lowered its policy rate five times since August 2011, to a historic low of 4 percent. Against this background, **the authorities share the staff's call for caution on further monetary easing, given the implicit risks for financial stability**. In fact, since monetary transmission operates primarily through the exchange rate, continued monetary easing runs the risk of generating exchange market pressures that may adversely impact bank balance sheets, because of unhedged foreign currency lending (although significant foreign currency deposits provide a cushion).

The financial system is dominated by foreign banks, and has proved resilient thanks largely to strong macroprudential regulations by the central bank. In fact, prudent limits on external borrowing prior to the crisis avoided a large boom-bust credit cycle. **Banks exhibit high liquidity and solvency ratios, supported by continued stringent regulatory requirements.** Risks are further mitigated by the banks' low reliance on external funding and greater dependence on local deposits (the loan-to-deposit ratio of the Albanian banking system has remained below 65 percent in the past decade).

However, potential spillovers from the euro area to the country's banking system are a concern, and the authorities concurred that the near term priority is to contain these spillovers. In particular, the banking crisis in Greece has impacted Greek subsidiaries, which account for one-fifth of Albania's banking system, though the effects have been mitigated. Greek subsidiaries responded by shrinking their balance sheets and slowing lending, so that they now rely mainly on domestic funding.

To address possible risks, the BoA has applied more stringent capital and liquidity requirements on Greek banks, and heightened coordination with Greek authorities. More generally, the authorities view continued close bank supervision and cooperation with regional regulatory authorities as critical in containing risks so far and planned to further strengthen these efforts. They also indicated a readiness to reinforce the regulatory framework and contingency plans, guided by stress test results. They plan to request an FSAP update for late 2013.

The sharp rise of NPLs over the last two years is another source of concern, given the impact on bank profitability and the ability to extend credit, although provisioning has been adequate. **The authorities share the staff's views on the causes (cyclical and structural) of rising NPLs and the need to reduce their level**. At the same time, the authorities noted that with adequate capitalization, the increase in NPLs had been rather manageable so far, and even if it were to increase further, only a handful of non-systemic banks would fall below regulatory capital requirements. They saw scope for more aggressive execution of collateral but also underscored the social sensitivities associated with rapid foreclosure sales.

Structural Reforms

The authorities agree that a favorable investment environment is a vital condition for further attracting large-scale international investors and boosting productivity. They thus agree on the need for structural reforms, particularly those related to property rights; further improvements in competitiveness are also critical so as to reducing external vulnerabilities. The authorities however noted the constraints imposed by lack of political consensus.

The authorities emphasized the **importance of continued infrastructure development to attract investment.** They are broadly confident about the prospects for renewed investment flows, once conditions in Europe stabilized.

The authorities recognize the importance of resolving problems in the energy sector, but they ascribed the existing weaknesses to the failure of the distributor to make the required investments; they did not see adjustments in retail prices as necessary, since tariffs in Albania are broadly comparable to those in neighboring countries. Until these problems are addressed, government support, including financing emergency electricity imports, will be essential to avoid power cuts.

Finally, the authorities agreed on the need for continued improvements in economic statistics. They are committed to continue working with Fund technical assistance in order to develop capacity.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 13/02
FOR IMMEDIATE RELEASE
January 11, 2013

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with Albania

On December 3, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Albania.[1]

Background

Albania has successfully avoided a serious economic slowdown since 2009, but with euro zone problems persisting, the economy slowed considerably in the first half of 2012. Credit growth fell sharply between January and August, as consumer and investor confidence weakened. Inflation has been low and relatively stable, largely within the central bank's 2-4 percent target range. The current account deficit has begun to adjust on account of weakening imports but still remains high. Heavy exposure of exports and remittances to Greece and Italy carries near-term risks.

Fiscal imbalances are rising. At nearly 60 percent, the debt-GDP ratio has reached the statutory ceiling and is among the highest in the region. Tax revenues have been trending downward, partly due to cyclical conditions, while most expenditure cuts have been focused on capital. Rollover needs are high as more than half of public debt is short term.

The banking system has been resilient so far, with banks having high liquidity and capital ratios. Strong macroprudential actions have mitigated risks. However, nonperforming loans have risen sharply over the last two years and now exceed one fifth of all outstanding loans—the highest ratio in the region. Greek bank subsidiaries,

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

which account for one-fifth of bank assets, have made considerable progress in re-aligning lending with their domestic deposit base and increasing capital.

Progress in reforming the business climate—critical for attracting investment and achieving sustained growth over the medium term—has been limited. Albania has dropped 8 places on the World Bank's Doing Business Index to a rank of 85.

Executive Board Assessment

Executive Directors commended the authorities for prudent policies that have supported growth in the midst of the global financial crisis. However, Directors noted that the economy is slowing, policy buffers have been depleted, and macroeconomic imbalances persist. Against this backdrop, they recommended actions on a variety of fronts to preserve fiscal sustainability, safeguard financial soundness, and improve the investment climate.

Directors underscored the importance of a sustained fiscal adjustment that would reduce the debt-to-GDP ratio over the medium term without unduly dampening growth. Budgetary consolidation should center on both tax and expenditure reforms. Taking note of proposed legislation to remove the statutory debt limit, Directors agreed on the need for a renewed commitment to a credible ceiling for public indebtedness to anchor the authorities' fiscal plans. Improvements in debt management are also a priority, given rollover risks. In this regard, Directors encouraged the authorities to utilize prospective privatization receipts mainly for debt reduction and clearance of unpaid bills.

Directors observed that inflation targeting in the context of a flexible exchange rate regime has been effective in keeping inflation low and stable. However, they noted that the scope for easing monetary policy further is limited by weakness in the economy as well as the risk of an adverse impact on unhedged positions in banks' balance sheets. Directors took note of the staff's assessment that the real effective exchange rate is modestly overvalued, and urged the authorities to accelerate fiscal and structural reforms to foster competitiveness and external adjustment.

Directors commended the authorities for policies that have safeguarded the soundness of the financial system. At the same time, they recognized that financial risks remained elevated, and called for continued supervisory vigilance. In particular, Directors encouraged the authorities to take action against rising nonperforming loans at banks, including by clearing unpaid government bills and improving collateral execution. Directors welcomed the authorities' request for an update in 2013 under the Financial Sector Assessment Program.

Directors stressed the need to accelerate structural reforms in many areas to boost potential growth. Priorities include strengthening property rights and contract enforcement which would enhance the investment climate. Impediments in the energy sector also need to be addressed to make the sector self-sustaining and lower fiscal risks. Directors highlighted the importance of further improving Albania's economic statistics, particularly as regards the national and external accounts, to help policy design and evaluation.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with Albania is also available.

Albania: Basic Indicators and Macroeconomic Framework, 2009–12

	2009	2010	2011 Est.	2012 Proj.
	(Growth rate in percent)			
Real GDP 1/	3.3	3.5	3.0	0.5
Consumer Price Index (avg.)	2.2	3.6	3.4	2.2
Consumer Price Index (eop)	3.7	3.4	1.7	3.4
GDP deflator	2.3	3.8	3.5	2.4
	(Percent of GDP)			
Saving-investment balance				
Foreign savings	14.0	11.4	11.9	10.1
National savings	16.2	15.4	13.7	13.9
Public	1.0	1.2	1.6	1.1
Private	15.2	14.2	12.1	12.8
Investment	30.3	26.8	25.6	24.0
Public	10.1	6.7	6.0	4.9
Private	20.2	20.1	19.6	19.1
Fiscal sector				
Revenues and grants	26.0	25.8	25.1	24.8
Tax revenue	23.5	23.3	23.0	22.7
Expenditures	33.4	29.6	28.5	27.9
Primary	30.2	26.2	25.4	24.7
Interest	3.2	3.4	3.1	3.2
Overall balance (including grants)	-7.4	-3.7	-3.5	-3.1
Primary balance (including grants)	-4.3	-0.4	-0.3	0.2
Net domestic borrowing	0.9	0.9	2.0	1.8
Privatization receipts	2.4	0.4	0.0	0.1
Foreign financing	3.7	2.1	1.6	1.4
Public Debt	59.3	57.8	58.6	60.9
Domestic	36.1	32.9	33.3	34.1
External (including publicly guaranteed)	23.2	24.9	25.3	26.8
Monetary indicators				
Broad money growth	6.8	12.5	9.1	6.1
Private credit growth	10.3	10.1	10.4	2.1
Velocity	1.3	1.3	1.2	1.2
Interest rate (3-month T-bills, end-period)	6.3	5.3	5.3	…
	(Percent of GDP, unless otherwise) noted			
External sector				
Trade balance (goods and services)	-24.6	-20.7	-22.4	-18.8
Current account balance (including official	-14.0	-11.4	-11.9	-10.1
Current account balance (excluding official	-14.7	-11.9	-12.2	-10.8
Official transfers	0.7	0.5	0.2	0.7
Gross international reserves (in millions of euros)	1,621	1,926	1,879	1,976
(In months of imports of goods and services)	4.1	4.4	4.4	4.5
(Relative to external debt service)	10.9	5.0	8.8	8.2
(In percent of broad money)	26.0	27.0	24.9	24.4
Change in real exchange rate (eop, in percent)	-7.8	-2.6	0.7	…
Memorandum items				
Nominal GDP (in billions of lek) 1/	1,151	1,237	1,319	1,357

Sources: Albanian authorities; and IMF staff estimates and projections.
1/ GDP data for 2008–09 are from the official national accounts.

Statement by the IMF Staff Representative on Albania
Executive Board Meeting
December 3, 2012

1. This statement provides information that has become available since issuance of the Staff Report. The information does not alter the thrust of the staff appraisal.

2. Negotiations on a contract agreement for Albpetrol privatization could not be concluded within the stipulated 30-day period (since the announcement of the winning bid on October 3). The deadline has been extended by thirty days.

3. Recent data (January–October) indicate that the fiscal deficit was 1.9 percent of annual GDP, compared to 2.4 percent of annual GDP in the first 10 months of 2011. Revenues grew by 2 percent (y-o-y), while spending was broadly unchanged, largely because of a 15 percent reduction in capital spending.

4. Under the budget approved by the Council of Ministers on November 19, the 2013 fiscal deficit would increase to 3.4 percent of GDP, from the authorities' projected 2012 deficit of 3 percent. Tax revenues are projected to increase by 5.4 percent, more than double their expected rate of growth in 2012. Pensions will continue to rise well above inflation, though wage bill growth is expected to be contained. Capital spending is projected to rebound strongly. No privatization receipts are assumed in the draft budget. Public debt would to climb to 62.4 percent of GDP next year.

5. Earlier this month, the Albanian Regulatory Entity (ERE) decided to proceed with revoking the private electricity distributor's (CEZ) license because of the latter's failure to abide by the terms of the privatization contract (e.g., loss reduction and investments to improve the grid). CEZ has 30 days to rectify the situation.

6. Financial soundness indicators for September suggest that nonperforming loans rose further to reach 22.7 percent of gross loans. The profitability of the banking system weakened further in the third quarter, while provisioning was broadly unchanged. Credit to the economy grew by 5.5 percent, compared to 14.5 percent in the first 9 months of 2011.