INTERNATIONAL MONETARY FUND

ALBANIA

2010 Article IV Consultation

Preliminary Conclusions of the Mission

March 10, 2010

Strong policy stimulus softened the blow from the global crisis…

1. In the face of strong headwinds, the Albanian economy has weathered the global crisis fairly well so far. Despite severe economic downturns and confidence shocks in much of Europe and other advanced economies, and associated drops in Albanian exports and remittances, Albanian GDP is estimated to have registered some 3 percent growth in 2009. Moreover, confidence in the financial sector has returned, as evidenced by the resumption of deposit growth. Meanwhile inflation expectations have remained well-contained and both remittances and exports begun to recover.

2. Fiscal and monetary stimuli were an important factor in explaining this favorable economic performance. In the budget, the full play of automatic stabilizers—mainly the reduction of revenues—was supplemented by major expenditure increases. Monetary policy provided timely support via two cuts in the policy rate and liquidity injections while the exchange rate served its function as a shock absorber. A record of prudent supervision and regulation helped ensure that banks entered the crisis in good shape and could rely on substantial solvency and liquidity buffers. These were further boosted by foreign parent-bank support. In addition, the impact of the crisis was mitigated through the limited importance of the export channel in Albania and its smaller reliance on market financing.

… but now buffers must be rebuilt and fiscal policy be pulled back in order to safeguard continued macroeconomic stability.

3. Fiscal stimulus has now become a risk, as it aggravates already existing vulnerabilities. The fiscal deficit, which hovered around 3 percent of GDP up to 2007, has climbed to some 7 percent since, as sharp government expenditure growth has outpaced revenue collections—though privatization receipts limited curtailed the borrowing requirement. This was an important factor in propelling public debt to close to 60 percent of GDP, and in 2009 triggered an accumulation of expenditure arrears of 0.4 percent of GDP. Largely driven by these factors, the current account deficit reached 15 percent of GDP in 2009, a level well in excess of projected future financing sources. These trends risk crowding out private investment and undermining debt sustainability. In addition, buffers in the financial sector need further strengthening to deal with new challenges to set the stage for a sustainable resumption of credit growth.

4. The external environment remains challenging. The global recovery is proceeding at different speeds in the various regions, with growth in industrial countries and Europe projected to remain sluggish and heavily dependent on policy stimulus. Meanwhile, the situation in global financial markets, though improving, remains fragile in many advanced countries. The buoyant times during the boom years are thus a matter of the past.

5. It is therefore essential that quick progress be made in redressing internal and external imbalances. With private sector adjustment already under way, the budget must achieve a significant turnaround to bring down the current account deficit and make space for credit extension to the private sector. Monetary and financial sector policies will have to remain prudent in the face of new headwinds, while the business environment needs to improve further in order to attract required investment, both from inside and outside of Albania.

Rebalancing growth in a slowly improving external environment, and against significant risks,…

6. The baseline is for a V-shaped recovery, albeit to a lower post-boom potential. After the estimated GDP contraction in the fourth quarter of 2009, low growth is projected to resume in the first quarter of 2010 and then gradually gain strength, with annual GDP growth in the range of 2 – 2½ percent in 2010. This mainly reflects developments in construction and some service sectors on the back of tightening credit and demand. Over the medium term, growth should be able to reach potential, which, however, will be somewhat lower than observed in the boom over much of the last decade. Administrative price increases may drive headline inflation temporarily above the 3±1 percent target band in the near term. However, underlying inflation is expected to remain well contained, and annual inflation is projected at 3.4 percent in 2010 and 3 percent in the medium term. Helped by the recent depreciation of the real exchange rate, the current account deficit can narrow from 15 to 13 percent this year, as private consumption continues to adjust, and should decline further over the medium term to reach a sustainable level.

7. Downward risks to the outlook are, however, significant. Apart from risks stemming from the external environment, domestic vulnerabilities remain. A large part of domestic public debt needs to be rolled over every month while the privatization program is unlikely to generate significant proceeds. Banks will also need to keep pace with the new outlook given by weaker credit demand, worsening loan portfolios, and resulting lower profitability. Faltering confidence of households and enterprises may decrease consumption and investment more than anticipated.

… with the budget carrying the largest adjustment burden.

8. Fiscal tightening has to be quickly effected as the buoyant and fast recovery projected in the 2010 budget and medium-term fiscal framework is unlikely to take place. In spite of the significant cuts to the 2010 budget that were proposed in the Government's new Medium Term Macroeconomic Framework—some 30 billion *lek* or 2.5 percent of GDP—the ongoing revenue trends imply a 2010 deficit of 5.6 percent of GDP. A budget review in the next months should target reducing the deficit to some 3 percent of GDP. This would lower the financing requirement, support the current account adjustment, and mark a first step toward

bringing within credible reach the government's appropriate goal of cutting public debt back to 50 percent of GDP by the end of its mandate in 2013. Both revenue increases and expenditure cuts should be on the agenda.

- Revenue expectations have yet to adjust to the leaner post-boom environment. As in much of Eastern Europe and the region, tax revenue has declined as tax bases that were inflated during the boom—notably by very high imports, consumption, and real estate prices—are now adjusting to new, permanently lower levels. Therefore, past tax and contributions cuts that were based on boom revenue growth should be reviewed. For example, there is little evidence that last year's cut in social security contributions improved compliance as was expected at the time; on the other hand, it aggravated the pension deficit to 2.5 percent of GDP, a high level when placed into the context of Albania's fairly young population. While tempting in the current environment—by holding out the prospect of a one-time boost in revenue—a tax amnesty should nevertheless be only considered as a last resort, as it threatens to undermine future tax compliance and the credibility of the tax system.

- The recent growth of expenditure has cast doubt on the government's ability to maintain a small public sector. In the first instance, this calls for not spending all 0.4 percent of GDP of remaining contingency reserves in the 2010 budget. More fundamentally, and with more lasting impact, it is important that public investment be scaled back to more financeable and administratively manageable levels after the completion of the Reshen-Kalimash road. Equally important, current spending needs to be revisited with a view to rightsizing the civil service, and keeping wages and pensions in check. This could be helped by indexing in the latter to only inflation.

9. Given the heavy reliance on short-term domestic financing, the authorities are appropriately seeking to place a Eurobond. However, heightened uncertainty in international markets may have an impact on the size and pricing of the issue, and the authorities are well advised to keep other options on the table.

10. Medium-term fiscal policy should be governed by a credible and monitorable fiscal rule. Limiting real expenditure increases to 2 percent could achieve the aforementioned debt reduction to 50 percent by 2013. This rule would preferably be augmented by a mechanism that would trigger lower spending growth in the event of an unexpected revenue shortfall. In contrast, positive surprises should translate into fiscal savings, reducing the risk of ever exceeding the debt ceiling.

Helping the financial system cope with new challenges

11. Financial sector supervisors need to continue to stay ahead of evolving challenges and risks. Past strong supervision has paid ample dividends in the global crisis as the banks could draw on large liquidity and capital buffers to weather the storm. However, different risks are emerging, notably as more loans on banks' balance sheets can be expected to sour while capital inflows remain slow. In this context, supervisors should keep on monitoring developments closely and continuously, elaborate contingency plans that deal with tail risks, adapt the macroprudential toolkit to address any developing risks to financial stability early

on, and thereby lay the foundation for a sustainable resumption of credit growth. Banks should help the needed economy-wide restructuring and real estate price correction by aggressively executing collateral of non-performing loans.

12. The monetary policy framework and the flexible exchange rate have served the economy well. Hence, we encourage the Bank of Albania to continue with its cautious stance, with a strong focus on anchoring inflation expectations. While interest rate decisions should be governed by actual and projected inflation developments with respect to the inflation target, monetary policy makers should remain mindful of financial stability considerations and macroprudential needs.

Structural reforms: taking over from macro stimulus to secure medium-term growth.

13. Going forward, the Albanian economy needs to broaden its sources of growth and strengthen competitiveness. This calls for further rapid improvements to the business environment and investor protection to bring about greater domestic and foreign investment to raise productivity and help Albania's export to climb up the value-added ladder. Priorities for action are the considerable implementation and enforcement gaps for formal rules; the lack of secure property rights (including for land tenure); and the informal economy. Funding sources for such investment could be boosted by finding new institutional investors, for instance, via accelerated pension reforms.

14. The success of past privatization needs some nurturing to harvest the hoped for efficiencies and maintain Albania's improved reputation for large-scale investment. In this context, we encourage the quick resolution of the regulatory issues regarding OSSH. Furthermore, the after its privatization ARMO has been incurring tax and inter-enterprise arrears, which put a successful privatization of Albpetrol—and thereby the conclusion of the strategic privatization program—at risk. We recommend that Albpetrol enter legal proceedings to recover its claims from ARMO.

15. Sound macroeconomic statistics are essential for competent policy making and investor confidence. The national statistical agency INSTAT has made formidable progress over recent years, for example, by starting to publish quarterly national accounts and continuously upgrading their quality. However, considerable scope for further improvement remains. In particular, the authorities should consider a significant increase of resources for INSTAT, including with a view to enhancing the quality of available data sources—not only outside but also inside public administration—and facilitating data processing, management, and analysis. The intention to subscribe to the IMF Special Data Dissemination Standard is commendable.

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We thank the authorities for their excellent cooperation and warm hospitality.

Table 1. Albania: Basic Indicators and Macroeconomic Framework, 2007–15

	2007	2008	2009	2010	2011	2012	2013	2014	2015
			Proj.						
			(Growth rate in percent)						
Real GDP 1/	6.0	7.8	2.8	2.3	3.2	3.6	4.2	4.7	5.0
Retail prices (avg.)	2.9	3.4	2.2	3.5	2.9	3.0	2.9	3.0	3.0
Retail prices (end-period)	3.1	2.2	3.5	2.9	2.9	2.9	2.9	3.0	3.0
			(Percent of GDP)						
Saving-investment balance									
Foreign savings 2/	10.3	15.3	15.7	13.1	11.8	8.0	6.9	6.6	5.3
National savings	19.1	17.8	13.5	12.3	14.3	18.2	19.6	19.9	21.4
Public 3/	2.2	3.2	1.1	-0.6	-1.1	-1.2	-1.2	-1.3	-1.1
Private	16.8	14.6	12.4	12.9	15.5	19.4	20.8	21.1	22.5
Investment	29.4	33.0	29.1	25.4	26.1	26.2	26.5	26.5	26.7
Public	5.9	8.6	8.3	5.5	5.2	5.2	5.2	5.2	5.2
Private	23.5	24.4	20.8	19.9	20.9	21.0	21.3	21.3	21.5
Fiscal sector									
Revenues and grants	25.7	26.8	26.0	25.2	25.0	25.4	25.7	25.9	26.0
Tax revenue	23.6	24.3	23.5	22.9	22.9	23.3	23.7	23.9	24.0
Expenditures	29.6	32.3	32.9	30.8	31.0	31.5	31.9	32.1	32.1
Primary	26.9	29.4	29.7	27.5	27.3	27.7	28.0	28.1	28.1
Interest	2.6	2.9	3.1	3.3	3.8	3.8	3.9	4.0	4.0
Overall balance (including grants)	-3.9	-5.5	-6.9	-5.6	-6.0	-6.1	-6.1	-6.2	-6.1
Primary balance (including grants)	-1.2	-2.7	-3.8	-2.3	-2.3	-2.3	-2.3	-2.2	-2.1
Net domestic borrowing	1.8	1.7	3.7	2.7	3.7	5.6	6.0	6.4	6.3
Privatization receipts	1.6	0.5	2.4	0.0	0.0	0.0	0.0	0.0	0.0
Foreign financing	0.5	3.3	0.8	2.9	2.3	0.5	0.1	-0.2	-0.2
Public Debt	53.9	55.2	59.7	63.0	63.8	65.6	66.9	68.2	66.5
Domestic	38.2	36.8	36.0	36.8	38.3	41.4	44.6	47.6	50.3
External (including publicly guaranteed) 4/	15.7	18.4	23.7	26.2	25.5	24.2	22.3	20.6	16.2
Monetary indicators									
Broad money growth	13.7	7.7	6.8	6.7	7.5	12.5	12.5	12.5	10.0
Private credit growth	48.2	32.1	10.3	9.8	11.3	6.4	4.4	4.2	5.1
Velocity	1.3	1.3	1.3	1.3	1.3	1.2	1.2	1.1	1.1
Interest rate (3-mth T-bills, end-period)	6.3	6.3	6.3	…	…	…	…	…	…
			(Percent of GDP unless otherwise indicated)						
External sector									
Trade balance (goods and services)	-26.7	-26.8	-25.4	-22.6	-22.5	-19.3	-18.7	-18.7	-17.7
Current account balance (including official transfers)	-10.3	-15.3	-15.7	-13.1	-11.8	-8.0	-6.9	-6.6	-5.3
Current account balance (excluding official transfers)	-11.3	-15.9	-16.0	-13.8	-12.5	-8.7	-7.6	-7.2	-5.8
Official transfers	1.0	0.7	0.3	0.7	0.8	0.7	0.7	0.6	0.5
Gross international reserves (in millions of Euros)	1,467	1,721	1,621	1,519	1,294	1,381	1,593	1,856	1,887
(In months of imports of goods and services)	4.1	4.2	4.1	4.0	3.3	3.3	3.5	3.7	3.5
(In percent of broad money)	23.3	26.1	26.0	22.9	18.2	17.3	17.8	18.4	17.0
Change in real exchange rate (e.o.p., in percent)	0.5	-0.6	…	…	…	…	…	…	…
Memorandum items									
Nominal GDP (in billions of lek) 1/	966.6	1,087.8	1,152.6	1,216.8	1,295.0	1,383.6	1,486.8	1,604.5	1,735.0

Sources: Albanian authorities; and IMF staff estimates and projections.
1/ GDP data for 2007–08 are from the official national accounts.
2/ Negative of current account including official transfers.
3/ Revenue excluding grants less wages, local government expenditure, and operations and maintenance.
4/ Includes arrears and excludes IMF repurchase obligations.