

**REPUBLIC OF ALBANIA**

**ECONOMIC AND FISCAL PROGRAMME  
2006-2008**

**Tirana, 1 December 2006**

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## INTRODUCTION

As of 2006, the potential candidate countries for accession into the European Union, Albania being one of them, in the framework of increased economic cooperation with the European Union shall forward a medium-term Economic and Fiscal Program. This Program is one of the most important documents which includes the formulation of economic, and fiscal policies as well as structural reforms for the medium-term period. It prepares the necessary institutional and analytical capabilities required for participation in the economic and monetary supervision procedures of the European Union.

The Economic and Fiscal Program (EFP) 2006 is a document drafted by the Albanian Government and Bank of Albania, which presents an assessment of the economic situation of Albania and efficiency of the structural reforms undertaken in the course of 2006. This document gives clear information on the economic policies and medium term priorities of the country in the framework of the structural reforms which are programmed to be implemented during 2007-2008, aiming at macro-economic stabilization and ensuring a high economic growth, as well as the establishment of a regulatory framework and sector policies in accordance with the European standards.

The Economic Program contained in this document pertaining to the period 2006-2008 is based on the Government Program 2006-2009, the Medium-Term Budgetary program 2007-2009, the National Strategy for Economic and Social Development (NSSD) of November 2001 and on Progress Reports of NSSD May 2003, May 2004 and July 2005. The 2006-08 economic and fiscal program will be in full compliance with the new National Strategy, called the National Strategy for Development and Integration (NSDI). The medium term economic and fiscal policy is in full compliance with the policies of the program supported by the three year agreement PRGF/EFF financed by IMF.

The NSDI, with a planning horizon of 7 years, determines the strategies and short and long term objectives of each sector based on a national perspective. NSDI shall rely on a comprehensive sector strategy and shall be oriented by a selected group of inter-sector strategies. The national strategy shall come up as a synthesis of the strategic

sector documents prepared for all the sectors. The planning processes for European integration and accession into NATO shall be constituent part of the reviewed and amended national strategy. NSDI is in the process of preparation and shall be available in the first semester of 2007.

The EFP document contains the main priorities of Albanian economy. In the first chapter it is described the present situation and economic developments of the real sector, of the monetary sector, fiscal and external sector. In the second chapter, there is introduced the medium term program of the economy broken down into three parts, dealing with the forecasts of the real sector, inflation, monetary developments and exchange rate course and the external sector. In chapter 3 a detailed description of the medium term framework of the public finance is given. This chapter starts with a short description of the relationship existing among the different levels of governance and their development in the upcoming years. This chapter focuses specifically on the forecasts of budgetary revenues and expenses for the medium term period, as well as a treatment of the public debt strategy. The chapter ends with the sources of the financing of the deficit and fiscal risks which the economy might encounter in the medium-term period. Chapter 4 presents the most important structural reforms which shall be undertaken by Government of Albania in the field of competition, reforms for attracting foreign investment, privatization of strategic sectors, financial sector, labor market and administrative reforms.

The implementation of the economic and structural reforms provided in EFP 2006 shall ensure a more rapid economic growth and a swifter and safer economic and social development; it will support foreign investments in the country; will boost the competing capability of our economy thus ensuring a better living standard towards a quicker convergence to the European economy.

## 1. RECENT ECONOMIC DEVELOPMENTS

The electrical energy crisis which the Albanian economy encountered in the course of the period October – November 2005 had an impact on the prognosis of macro-economic indicators for 2006, reflected in an economic increase of 5% compared to 5.5% in 2005. The progress so far of the economic developments and the expectations for the last semester of 2006 lead to an assessment of the economic growth above the foreseen level, however, it is sure that it is going to be at least 5%. The economic growth in 2006 will be led by the construction sector and that of industry, while the sectors of agriculture, transport and services are expected to mark modest progress of economic growth.

The economic growth continues to be led mainly by the internal demand, which has relied on a quick increase of crediting of economy. During the 9-months period of 2006, the economic growth has relied upon the improvement of production of the energy sector and an increase of exports. The general development of the economic activity during the first 6-month period of the year, represented by the indicator of the sale of enterprises has marked an annual increase of about 17.1 percent. The most evident contribution in the annual increase of the indicator of sales has been made by the sector of services. Even in the sector of industry annual basis sales have increased by 3.4 %, where the excavation industry and the processing industry have marked in annual terms an increase of sales, respectively of 5.81% and 7.24%.

The developments in the sector of agriculture in the first six months of 2006 support the forecasts for an increase of the agricultural production by 3% this year. Thus, during the six month period, the agro-industrial production has increased by 1% compared to one year earlier. The increase of the agricultural production during 2006 shall be influenced mainly by the higher contribution given by of tree cultivation sector.

Even though the index of sales in the construction sector for the second semester of this year has decreased compared to 2005, the high pace of investments in important projects in the field of infrastructure during the second half of the year shall produce an increase to the level foreseen for this sector. Important indicators on the planned level are evidenced in the transport sector, where during the first half of the year, the investments carried out in this sector have increased by 37.9% compared to the last year. Even the other indirect indicators which have been used for the evaluation of the activity in this sector for the first half of the year are positive and consistent among them. Thus, (i) the air transport in terms of passengers turns out to have increased by an annual percentage of 9.82%, (ii) number of passengers using the sea transport has

increased by 0.9 %, while the volume of loads-unloads in the ports has increased by about 9.18%.

In the course of the first months of the year, the number of employees decreased by 4000 people, thus decreasing the unemployment rate to the level to 13.9%, from 14.2% by the end of 2005. During this period there has been an increase of employees in the private sector and a decrease of employees in the public sector. The increase of employment in the private sector during the second semester of 2006 was 4000 people compared to the same semester of 2005. At the same time 2006 is characterized by an increase in the number of the employees included in the social insurance schemes. Thus at the end of August the number of employees in the social insurance schemes was increased by 30 thousand compared to the end of 2005, with an increase of 13.6%.

The structure of unemployment is characterized by the persons, whose education does not exceed the elementary school and being above 50 years old. The average salary in the state sector marked again an increase following a period of standstill in the first semester of the year. Thus the average salary in the second semester of this year was 3.7 percent higher, compared to the same semester of last year. During the second semester there was an increase in the level of the pensions, which has been differentiated between the pensions in the countryside and in the cities. Thus the pensions of the village were increased by 20% and those of the cities (state pensions) by 5%.

Along with the increase of the incomes available to the individuals, the indicators of the third quarter mark a rapid boosting of crediting in Lek for the individuals stimulating the increase of consumption. The credit growth in annual terms during this period was 60.2%. In August the level of credit reached 18.1% of the GDP compared to 14.6% in December 2005.

These favorable developments of the incomes available to the individuals have supported the consumption growth, but their impact on the inflation rate did not have any important role. The inflation rate of this period has fluctuated around the objective of the Bank of Albania. After reaching the level of 3.2 in July, the annual change of the consumption prices followed a falling tendency in the two other months amounting to 2.6% later in September. However, the forecasts indicate that the inflation rate during 2006 shall remain within the level foreseen by the Bank of Albania 3+/-1%.

For the first 8 month period of 2006, we see that the main contribution to the annual change of CPI has been provided by the group "Rent, water, heating materials,

energy” During this period the contribution of this group in the annual rate of inflation was in average 1.24%. During the first quarter of 2006, the annual inflation of the group “Rent, water, heating materials, energy” has fallen reflecting the decrease of prices of rent and inputted rent. In August 2006 the contribution of this group in the annual rate of inflation marked the value of 2.08% as a consequence of the energy price by 13.7% compared to the same month last year. In addition to this group, the increase of the annual rate of inflation has been influenced by the impact of the group “Alcoholic drinks and tobacco” and the group “Transport” which have marked respectively an increase of 6.6% and 2.6%. The increase of the diesel price, although it consists a potential cost in the Albanian market, during the 8 month period of the current year has transmitted weak pressures on the index of prices of the consumption through the indirect channels. Most of the impact of the increase of the fuel price in CPI has been caused through the direct channel.

The development of the **exchange rate** during the period January-September 2006 has reflected the developments in the international markets. The average exchange rate of Lek to Euro during the period January – September 2006 marked the level of 122.95Lek/Euro, while the average exchange rate to the US dollar was 98.83 Lek/USD.

The strengthening of Lek towards the main foreign currencies has had an impact in slowing down the increase of inflation rate, preventing that imported inflation from our neighboring countries, our main commercial partners, Greece and Italy, be reflected in the internal market.

Among the main foreign factors which have had an impact on the developments of the exchange rate we, can mention: (i) monetary policies undertaken on the interest rates, (ii) unsteady developments in international oil markets, as well as situation in the Middle East, (iii) economic situation in some European countries.

From the internal factors, we can mention: (i) consolidation of economic situation in the country, (ii) monetary policy followed by the Bank of Albania with an increase of the basic rate of interest (iii) real interest rates in Lek higher than the rates in foreign currency (iv) strengthening of the public trust in the financial system and business in the local currency, (v) increase of incoming influx of the foreign currency into the country as a result of the tourist session, (vi) increase of the crediting of business and specifically for the consumers.

The economic growth during the first 9 month period of 2006 was influenced also by the monetary policy followed by the Bank of Albania, which in July strained the money cost, through increasing by 0.25% of the basic interest rate. The increase of the basic interest rate aims at bringing about the monetary circumstances in accordance with the

medium term objectives of the inflation. The increase of the basic interest rate influenced, among others, quick steps in extending the credit to the economy, narrowing the difference of interest rate and the currency and the expectations for the concentration of the budgetary expenses in the remaining part of the year.

The straining approach of the monetary policy has been followed even in the operations of the Bank of Albania in the money markets. The change of the basic interest rate has been implemented in the weekly Repo rates for retrieving the liquidity of the system and in the interests of supporting instruments. Banking system has reacted through the increase of the interest rates. Same as it was expected, this reaction was quicker in the inter-banking market and in the treasury bonds yield. The interest rate of weekly transactions in the inter-banking market was increased by 0.17 points percentage. On the other hand the increase of borrowing by the government and preserving the high levels of crediting in Lek have brought about a decrease of liquidity in the system. This situation has been reflected in the increase of treasury bonds yield by 1.0 points percentage. Under these circumstances, Bank of Albania has brought liquidities into the system aiming at decreasing its fluctuations and balancing the demand. This injection has smoothed the pressure on the treasury bonds yield.

Parallel to the operations in the money market, the interventions in the currency market have complemented the seasonal demand for liquidities by about 4.5 billion Lek, during the months July – August. The increase of the interest rates has been a factor even in the deposit interests in Lek, where during August there was marked an increase of 0.31 points in percentage<sup>1</sup>. In the meantime, further increase in these interests have been marked in September. The presence of Bank of Albania in the money markets through the monetary operations, during the third semester, has made possible preservation of the indicators within its scope of objectives.

The aggregates M1 and M2 have increased in accordance with the demand of economy for monetary means in annual terms as well as during the third quarter. On the other hand, M3 has increased in evident pace, due to the seasonal influx of remittances, in the form of currency deposits. Time composition of aggregate M2 was oriented towards the liquid component, money outside the banks, as a consequence of high demand for money in circulation, during the summer months. The annual rhythm of increase of M3 was 10.4 percent. The increase of the monetary offer has been supported by the demand of the private sector for monetary means, expressed in the increase of credits in the banking system for the private sector. However, during the

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<sup>1</sup> The average pondered interest for the time deposits in Lek

month of August, the monetary offer has been influenced evidently by the seasonal increase of the currency deposits.

The monetary data of August prove the increase of demand of economy for liquidity through the increase of 33.5% of the money ratio outside the banks to the aggregate M2, 1.0 points percentage higher than in May. At the same time, the expected increase of the deposits in foreign currency due to the influx from abroad, was fully focused in August, increasing the ratio to M3 by 28.7% or by 1.1 points percentage during the summer months.

The total of deposits of the system, in August, were increased by 12.2% in annual terms. The highest increase for deposits in Lek and those in foreign currency has been marked by the deposits not limited to time periods in the system, by respectively 34.2% and 19.5%. The ratio of time deposits to the deposits not subjected to time periods at the end of the third semester was 2.26 towards 2.33 at the end of the second semester. However, the latest introduction in interest rates, in Lek and foreign currency, have increased the cost of keeping money in cash and of deposits not subject to time periods. On the other hand, the gap between the interests of Lek and foreign currency has been narrowed considerably, thus having an impact on the savings ratios in economy.

The crediting for the economy even during 2006 continues to increase quickly, incited mainly from the crediting in Lek for individuals. In annual terms the increase of the credit during this period has been in average 60.2%, where the granting of the new credit in summer months has continued in high rates. Only for the period July-August there have been granted in total 24 billion Lek new credit, about 20% more than one year earlier. In the structure of the new credit there is seen a stronger orientation of the banks towards crediting in Lek. In August the level of credit reached 19.1% of GDP out of 14.1% of GDP in December 2005. The high crediting rates have increased the part taken up by the credit portfolio compared to the other actives of the banking system to 29.2%, out of 25.1% which was marked in end of 2005.

The credits for individuals consist 33% of the credit portfolio, the bulk of which is granted for purchase of immovable properties. The crediting to this effect makes up 64% of the credit for individuals in August<sup>2</sup>. Compared to the end of 2005, the credit for purchase of immovable properties marked an increase of 46.2%. The consumer's

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<sup>2</sup> In June 2006, Bank of Albania, aiming at making a detailed analysis of the intensive developments of granting of credits, presented to the second level banks 3 new forms for the credit. The methodology of reporting in these forms is thought to be subject to the changes in the future.

credits<sup>3</sup>, for the same period, makes up 26% of the credit for individuals compared to December of 2005, reflecting an increase of 59%.

The increase of credits to the business by an annual percentage of 56%, has made the highest contribution in the expansion of the credit. Mainly, the credit for businesses has financed the purchases of equipments and new machineries, making up 44% of the total of this credit, in August. Compared to the end of 2005, this credit is 48% higher, marking a monthly increase of 5% per month.

The impact of the strict monetary policy in the money market was seen initially in the inter-banking market, in the market of securities and later in the market of deposits and credits in Leks. However, the present level of the interests in the banking system, turns out to be lower than the end of the third semester of last year. The interest rates in the inter-banking market have fluctuated within the new corridor of interests of supporting facilities, close to the basic interest rate.

In the primary market of the treasury bonds and 2 year obligations of the government, the increase of interest rates have been higher than the increase forecasted by the Bank of Albania. This excess is due to the increase of the loan taking of the government and preservation of quick progress of crediting in Lek, which have brought about shortages of liquidity in the system. This situation has been reflected in the increase of the treasury bonds yield by 1.0%. Compared to one year earlier, the present level of treasury bonds yield and 2 year obligations remains in lower levels. At the end of the third quarter, the level of treasury bonds yield for the 3, 6 and 12 months TB reached respectively 5.96%, 6.43% and 7.13%.

The restrictions of monetary policy has become a factor even in the interest rates for deposits in Lek. The adjustment in time of the deposits market has been in line with the position of this market in the mechanism of transmission of the monetary policy. According to the initial information, at the end of the third trimester 2006, the level of the interests of deposits 6, 12 and 24 month periods, turned out respectively 4.3%, 5.2% and 5.7%.

The market of credits in Lek, which is influenced by the competition, structure of crediting, risk rate of crediting, as well as the expectation on the development of the interest rates, etc, adjusts itself slowly to the signals of the monetary policy. However, for the third trimester of this year, it was seen an increase of interests for the time limited credit up to 6 months and for the credits above 3 years.

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<sup>3</sup> Consumers credit includes the overdraft for the individuals.

The cost of mediation, expressed as a difference between the interests of the credits and deposits in Lek, has had a falling tendency compared to one year earlier. However, compared to the previous trimester this cost has increased, reflecting the reaction in different extents of the markets to the restrictions of the monetary policy. In August 2005, the mediation cost for the instrument of 6-month period was 10.6% while in August 2006 it was 7.7%. While, for the instrument of 12-month period the cost of mediation was respectively 8.6% and 6.8%.

The preliminary data of the trade balance for the first half of 2006 indicate that the deficit of the trade balance for goods has reached about 830 million Euro or about 22% more than during the same period one year earlier. The support of the demand for consumption and investments with imported goods and the continuous increase which the level of credit for economy had during the last years are the two main factors which have had an impact on the increase of imports. At the same time, an important factor for the boosting of imports during 2006 is connected to the structural improvements in the administration of revenues which have had a direct and evident impact in including imports which were previously not registered. The increase of 22% of the deficit of the trade balance during the half of 2006 contains also the registration of the imports not registered earlier, which have made it difficult to make the comparison directly with the previous period. The development of Lek towards the currencies of the partner countries of this period has had the same direction as one year earlier, not being an important factor in determining the competing positions of the internal economy to the economies of partner countries<sup>4</sup>.

During the first half of the year, the value of exports reached about 310 million Euro or 17% more than the value of exports during the same period of 2005. The increase of exports has been distributed to almost all the groups of exports, but the groups of agricultural products, mineral products and wood processed products have reached a higher rate than the average. In the meantime, the textile articles and the foot wear, the two groups having the heaviest weight, have increased slower than the total of exports. The imports of goods, in the period January – June, increased by 21% compared to the same period of one year earlier, attaining the value of 1139 million Euro. Even for the imports there is a general distribution in increase, but the groups of mineral products, valuable metals, products of chemical industry, as well as the groups

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<sup>4</sup> With reference to the nominal effective exchange rate, calculated by Bank of Albania

of the food products, have experienced an increase above the average increase rate of imports.

The basic *cash* indicators show that the total revenues of the state budget for the 9 month period are 162.3 milliard Lek or 98.5% of the level planned for this period and 70.6% of the annual planned level. The tax revenues, making up about 92% of the total of budgetary revenues turn out 149.2 milliard Lek, or about 99.8% of the planned level for this period and 70.3% of the annual planned level. The highest contribution to the state budget consist of VAT revenues, contribution of social and health insurance, tax on profit of corporations and excise. The revenues from VAT are about 33% of the total revenues. In the course of 9-month period VAT revenues were 52.4 billion Lek or 98.% of the planned level for this period and 69% of the annual planned level. Compared to the same period of the last year, they have increased by 16% thus reflecting the economic growth and the fight against fiscal evasion.

The revenues from the contributions of social insurance which make up 18% of the total budgetary revenues during the 9-month period of the year reached 29.2 billion Lek or 102.4% of the planned level for this period and 78.4% of the annual planned level. It is important to highlight that starting from 01.09.2006, at the levels of the monthly salaries from 14 000 Lek up to 70 000 Lek, there is applied a social insurance rate of 32.9%, this being split into 21.7% which is paid by the employer and 11.2% which is paid by the employee. Considering that prior to this date this percentage was 41.9%, it is going to have a decrease of 9%. The decrease of 9% shall be applied on the payment of the employer. Compared to the same period of the last year the revenues from the social and health insurance have increased by 3.3 billion Lek or about 13%, which is the outcome of the performance of the tax administration. At the same time, we add that compared to 2005, in August 2006 it turns out that the number of the entities registered has increased to 25.5% this being equal to about 14,000 entities, while the number of contributors has increased by 13.6%, being equal to about 30,000 contributors.

The revenues from excise tax which make up about 10% of the total budgetary revenues during the 9-month period turn out to be 16.5 billion Lek or 102.3% of the planned level for this period and 68.3% of the annual planned level. At the same time to the effect of combating fiscal evasion the government increased the excise duty for some goods subject to this tax, such as tobacco, alcoholic beverages and coffee which entered in force on 1 September 2006. The excise increase was modest in some beverages and the coffee, while an evident increase was experienced by the tax for tobacco which was increased from 25 Lek per package to 40 Lek per package.

The revenues from the corporate profit tax which are about 10% of the total of budgetary revenues during the first 9 month period of 2006, turned out in 16.6 billion Lek or 102.3% of the planned level for this period and 79.3% of the annual planned level. The profit tax rate in 2006 was reduced to 20% from 23% which it was in 2005. Compared to the same period of the previous year, the revenues from the profit tax increased by about 22%. The positive results in this kind of tax are connected to the increase of the level of the self declaration by the taxpayers and to the strengthening of the control and its results from the tax administration.

The revenues from the local government during the first 9 month period of 2006 are 8.1 billion Lek or about 5% of the total of the budgetary revenues. The tax on the small business is still collected by the General Tax Department and it has been foreseen that next year the collection of this tax be within the powers of the local government.

The total of the budgetary expenditure during the 9-month period for 2006 amounted up to 152.2 billion Lek or about 93.8% of the planned level for this period and 57% of the annual planned level. Most of the budgetary expenses consist of the expenses for social insurance (pensions and benefits connected to them) and health insurance with about 22.6% of the total of expenses and along with the other social expenses (social allowance and unemployment allowance) they consist more than 27% of the total expenditure. During the first 9 month period of the year 2006 the expenditure for the social and health insurance amount to 43.4 billion Lek or about 100% of the planned level for this period and 72% of the annual planned level. Compared with the same period of the previous year the expenditure for the social and health insurance have increased by 7% or 2.8 billion Lek. While the expenditure for the economic allowance and unemployment allowance for the 9-month period of 2006 amounted to 2.7 billion Lek or about 57% of the planned annual level.

The expenditure for personnel salaries (not of the local administration) which consist of more than 22% of the total expenditure of the state budget for the first 9 month period of the year amount to 39.4 billion Lek or 98% of the planned level for this period and 66.6% of the planned annual level. The expenses of the public debt which consist about 11-12% of the total of expenses of the state budget for the first 9-month period of the year are 19.4 billion Lek or about 71% of the planned annual level. The bulk of the expenses for the interests, about 93% belongs to the interest of the internal public debt; this being a reflection of the structure of the public debt. The public debt of Albania is evaluated at the level of 55% of the GDP, out of which about 17% of the GDP is external debt and about 38% is internal public debt.

The operating expenditures and those of maintenance which consist of about 8.5% of the total of the expenses of the state budget, during the first 9 month period turn out in 13.4 billion Lek or 60% of the planned annual level. While subsidies which make up about 1% of the total of budgetary expenses amount to 1.7 billion Lek or 67% of the annual planned level.

The expenditures of the local government consist about 9% of the total of expenses of the state budget during the 9 month period of the year 2006 which amount to 12.6 billion Lek or about 55% of the annual planned level. About 25% of the total of expenses of the local government budget goes to the capital investment while the other part for salaries, operating expenses and others.

While the capital expenditure of the central government which consist of about 20% of the total of expenses during the first 9 month period of 2006 turned out in 14.9 billion Lek or about 69% of the planned level for this period. Along with the public expenses of the local government the level of capital public investments during the first 9 month period of 2006 turns out in 18.3 billion Lek. The capital expenses are foreseen to be increased considerably during the last trimester of 2006. The low level of the capital expenditures during this period reflects the absence of projects of investments as well as their orientation towards the productive projects avoiding the practice of their fragmentation into small and non-productive projects.

During the 9 month period of 2006 the budget balance turned out with a budgetary deficit of about 10 billion Lek reflecting the increase of the budgetary revenues and non-realization of public investments in accordance with the plan of this period. The favorable fiscal situation during 2006 has had a positive impact on the improvement of the structure of the internal debt providing the possibility to the Ministry of Finance to issue long term obligations. During 2006, starting from January, every month there have been offered the respective amounts of 2 and 3 years obligations which have increased reflecting the variable tendencies of the market for them. At the end of 2006 the total amount of financing with obligations for this year is deemed to be about 33.3 billion Lek.

The existence of the instrument of obligations in the internal market has helped increasing the flexibility and a better management of the risk of re-financing of the debt. Thus, the short term treasury bonds during 2006 shall be decreased by 11.3 billion Lek improving the indicators of the risk of re-financing of the debt in general. Following the 3 year obligations, during this year for the first time there are offered 5 year obligations, an instrument which is required in the market and its amount and characteristics shall

be in accordance with the development of the market and its requirements for long term instruments. This way, in the aspect of managing the internal debt, the objectives of meeting the needs of new annual borrowing only through long term instruments shall be achieved.

## **2. THE MACROECONOMIC FRAMEWORK**

### **2.1 Real Sector**

For performing the forecasts of the indicators which are included in the macroeconomic framework there have been used the various evaluations and assumptions which have been made by INSTAT for the structure of the GDP use as well as the sector composition of it during the period 1999 – 2004 from IMF for some of the main indicators expressed in GDP terms from the Medium Budgetary Program (MTBP), Sector Strategy of Public Finance (SSPP) 2007 – 2013 as well as the forecast models which are used the Department of Macroeconomics in the Ministry of Finance for the forecast of GDP and other indirect indicators. The medium term projections of the fiscal development preserve the same line with those foreseen in MTBP. The future developments in the external trade have been foreseen in the balance of payments. The respective assumptions have been forwarded in the charts provided in the part of annex.

The achievement and preservation of macroeconomic stability until the current year as well as the commitment of the government for its further strengthening through the increase of fiscal discipline, improvement of the administration of resources, boosting of efficacy of public expenses and establishment of sufficient stimuli to the favor of development of private sector within a political comprehensive and ambitious program consists a guarantee for the success of the implementation of the measures and planned policies in medium term period and increase of quality of forecasts of indicators which are contained within EFP.

Making use of the assumptions on the future developments in the external economic environment the internal measures planned to be undertaken in the framework of the economic policies and institutional and legal improvements for the period 2006 – 2008, foresee that the real growth shall be 6.0 percent. Nominal GDP for the year 2006, 2007 and 2008 has been respectively designed at the level of 899.7 billion Lek, 982.2 billion Lek and 1075.7 billion Lek. The relationship between the development of

forecasts of nominal GDP and the real GDP for the years 2006, 2007 and 2008 generates a deflator of GDP expressed in the form of a coefficient<sup>5</sup>, respectively at the levels 1.21, 1.25 and 1.28. This trend of coefficient of the GDP deflator expresses mainly the assumption of not encountering any serious energy crisis, absence of quick and unexpected increase of the oil prices in the world market, or the stability of exchange of local currency to the US dollar and Euro and consequently preservation of inflation rate within the target (3-1, 3+1) in the medium term.

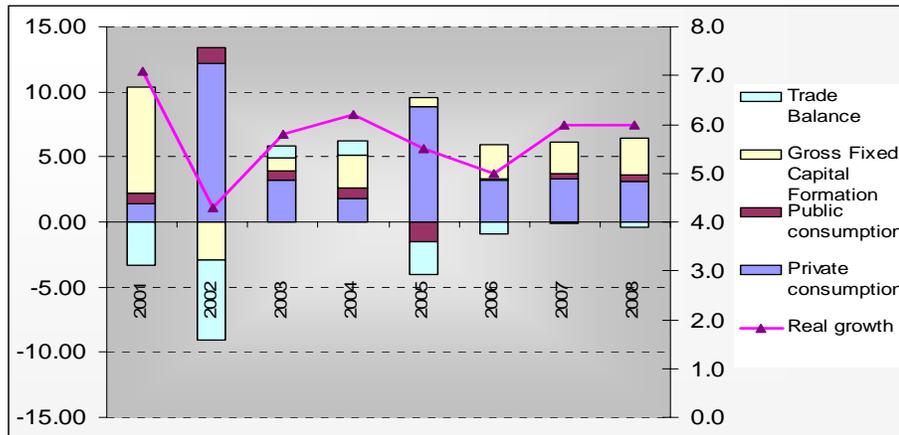
Under the condition of harmonization of expectations given above with the forecast of the rate of increase of the population in an average of 0.69% for the period 2006 – 2008 our projections for the annual increase of GDP per capita are 3 150 USD, 3 175 USD and 3 200 USD, for each of the years of the period included in this program, reflecting an increasing rate of nominal GDP higher than the rate of increase of population.

From the perspective of the aggregate demand (or use of GDP) we find out that the highest pressure in realization of the increase of the economic activity during the time interval 2001 – 2006 was provided by the total consumption reflecting not only its considerable weight in the total internal expenses, but also the relatively steady increases of the sources of available revenues. The main resources of the available revenues continue to remain: (i) revenues from remittances, (ii) increase of the labour productivity through prioritization the public investments in the sector of education and consequently the increase of the real salaries, (iii) the increasing support through credits of families and individuals (iv) increase of the level of the efficacy of the social protection of the population by the government (only for the period 2006 – 2008 the unemployment allowance and economic allowance together is expected to be increased in annual terms in average by 7.01% until reaching the level 12 517 million Lek in 2008) (v) improvement of the regulation of housing market etc.

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<sup>5</sup> In this case there has been expressed the ratio of nominal GDP to the real GDP

**Contribution of the components of the aggregate demand (in percentage points) in forming the real growth rate**



In 2005 there is an increase of the impact of the private consumption on the economic increase (about 8.9%) different from the two preceding years as this indicator turned out in average 3.26%. The explanations of this change are connected to the decrease of the market rate interest and increase of the consumer's credit from the banking system (the average annual increase of the surplus of the credit granted to individuals for the fourth trimesters of the year 2005 was almost 31%). The private consumption is expected to be the main engine of increase of GDP foreseeing an average rate of its contribution to the increase of the real GDP for the period 2006 – 2008 at the amount of 3.24%, as well as reflecting a relatively stable tendency due to the rationalization of the decision of the consumers to distribute there incomes between the consumptions and saving under the circumstances of expectations for a real positive rate.

As a consequence of the decrease of public current expenditures for salaries and goods and services during the last part of 2005 the influence of the public consumption in the expansion of the economic activity in 2005 was negative (about - 1.5%). In accordance with the MTBP projections for the increase of this item in average by 7.15% during the foreseen period there is expected that its contribution in the economic increase mark a slight increasing tendency attaining the level 0.5% in 2008.

Despite the fall of the contribution of the formation of gross capital in the aggregate demand of 2005, which has mainly been caused by the fall of the public investments,

the influence of the total investments<sup>6</sup> in the economic growth rate for the years 2006 – 2008 is foreseen to be increased to reach in 2008 the level 2.78%. This tendency shall rely on:

(i) increase of public capital expenditures owing to the improvement of the public investment management and (ii) increase of private investments as a consequence of smoothing the fiscal policy, increase of the scale of integration into the European markets, strengthening of the functioning of institutions and general improvement of the climate of foreign and local investment. As a result of the effect of these measures, our prognosis show that the average ratio of the gross investments to GDP for the period 2006 – 2008 shall be 32.1%, out of 21.8% which it was in average for the three previous years.

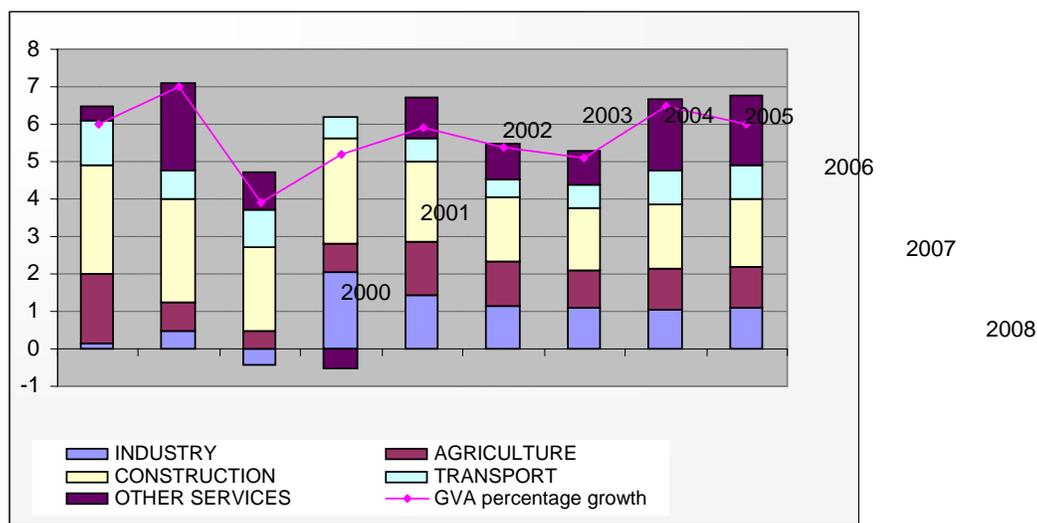
The expectations for a higher growth of exports compared to that of the imports for 2006 is expected to have an impact on the fall of trade deficit and consequently even in the change of the contribution of foreign demand in the increase of GDP from 2.53% in 2005 to -0.9% in 2006. The expectations for an increased rate of exports higher than that of imports and the yield of the real effect of the use of machineries and equipment imported during the past years (as an important part of their structure), improvement of the infrastructure circumstances, increase of the popularity of local tourism and the continuous deepening of the structural reforms in the circumstances of preserving the economic increase of the Euro zone almost in the levels of the last years shall bring about for the period taken into consideration within this program a more appropriate distribution of the structure of the aggregate demand, increasing the influence of the external demand.

The gross added value projections for the medium term is based on the production method, which remains the statistically most acceptable method for the very nature of our economy in the framework of the proportion of the formal to the informal part. The forecasted values of the indirect taxes and subsidies are calculated as an harmonisation between the respective projections of MTBP and the index prices of consumption having as basis the year 2000. At the same time, our model of forecasting relies on the assumption that the structure of the economy shall not change in medium term, regardless of the presence of the slight increase of the weight of the sector “Other services”.

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<sup>6</sup> Assuming that the increase rate of total investments is represented by “Gross Fixed Capital Formation”.

**Sector Contribution in real GDP growth and the growth rate of GVA**



The percentage of the annual growth of gross value added (GVA) is foreseen to be lower than the growth rate of real GDP during the period 2006 – 2008. However, the correlation between them is relatively high, marking a level of 0.91%. The biggest gap between these two indicators is expected to be in 2008 registering the level 0.7%. The explanation of this difference stems from the assumption that the rate of increase of indirect net taxes (net tax – subsidies) shall be higher than the rate of increase of gross added value, due to the increase of the taxable basis of indirect taxes and the reduction of the financial support to the state enterprises (due to the privatisation of many of them and improvement of the efficiency of the functioning of the remaining part).

The biggest contribution in average terms on the real GDP for the programmed period shall be foreseen to be provided by the construction sector, services sector, and that of agriculture, respectively with the values 1.74%, 1.54% and 1.05%. The influence of the sector of services and transport in the general real activity is expected to demonstrate a more various dynamics than the other sectors expressing (i) improvement of wellbeing of the population, (ii) improvement of the activity of tourism owing to the promotion of tourist potentials, modernization of infrastructure and reduction of the administrative obstacles (iii) increase of investments in the energy sector, infrastructure and transport, (iv) increase of efficiency in the functioning of the sector of

telecommunication and insurance market as a consequence of privatization of Alb-Telecom and INSIG (v) increase of the scale of mediation of financial sector etc.

The sector of industry is expected to demonstrate a decrease of the contribution in the formation of the real growth rate in 2006 due to the negative effect of the reduction of the supply with electrical power in autumn 2005 on the industrial activity of the first months of the current year. The development of the index of sales signalizes for fading away of this effect in the first months of 2006. However, the contribution of this sector in the real expansion of economy for 2007 and 2008 has been projected to preserve more or less the same value which turned out in 2005 due to: (i) improvement of the operational efficiency of ARMO and Alb Petrol (ii) preservation of the volume of the activity of textile industry which relies on the fall of customs duties of the imports of initial materials and improvement of the productivity/salary ratio in this sector etc.

With regard to the agricultural activity we evaluate that regardless of the fall of its weight in the Gross Domestic Production during the latest years the respective contribution in the increase rate for years 2007 and 2009 is foreseen to turn out in average 1.09%. We support this forecast on the assumptions that (i) productivity of the production factors shall be increased owing to the increase of the import of agricultural mechanics and intensification of the integration process of the country into EU (ii) there shall decrease the scale of informality of economy (iii) land shall be object of market in its full meaning (iv) there shall be consolidated the schema of support to agriculture through credits granted by the banking sector (v) there shall be increased the presence of fiscal presence to the effect of the absorbing the external shocks.

## **2.2 Inflation**

Albania has shown impressive results in terms of price stability. Inflation has been distinguished generally by lower rates relative to other transition economies. In the last four years, inflation has stabilized at moderate levels as measured both at the end and average period figures, though it sometimes diverges from the target due to unforeseen shocks and speculative factors that are mainly beyond the central bank's control.

Consumer prices have been relatively stable in recent years, marking a positive period in terms of meeting the primary BoA target, achieving and maintaining price stability. The annual inflation rate resulted 2.0 percent at end of 2005, while the average annual inflation rate was 2.4 percent. The rise in living cost indicators fell in comparison with the previous year, fluctuating around the lower limit of the target. Annual inflation stayed within the 2 – 4 percent band along the major part of the year.

The revival of economic activity during 2005, macroeconomic policies oriented to maintaining macroeconomic stability, exchange rate stability and moderate rise of salaries, have all contributed to inflationary pressures control. On the other hand, price performance over 2005 was also impacted by some factors of shock nature, such as oil price rise and grave electricity situation. These factors impacted on inflation rise during the second semester of the year, but without compromising the observance of inflation target and long-term price stability perspective.

Average annual inflation rate in the first half of 2006 resulted in about 2 per cent. The period of low and stable inflation until March 2006 was followed by the upward trend of this indicator. Annual inflation rate in June marked 2.4 per cent. The –1.1 per cent monthly inflation was significantly lower than the rate of -0.5 per cent marked in June 2005, due to the early impact of seasonal factors, which exert pressure over the fall of foodstuffs prices.

Although the deep upward tendency observed over April – May 2006 was somehow smoothed over June, the second quarter of 2006 recorded a higher annual rate than the same period the previous year (+0.6 percentage points). The increase in the annual inflation rate mostly reflected the contribution of the price rise in the agricultural products for this year. The latter is assessed to be a consequence of the reduced supply of the domestic agricultural production in the domestic market, due to poor weather conditions.

The inflationary pressures intensified over the second quarter of the year as a result of the influence of other factors, despite the seasonal ones. Smoother appreciation of the Lek against the euro, the upward tendency of import prices due to inflation increase in partner countries and the oil price rise over May and June 2006 have all further intensified the influence of pro-inflationary factors on economy.

Nevertheless, moderate rise of consumer prices in recent years has been favored by the fruitful coordination of monetary and fiscal policies. These policies helped in controlling the domestic demand by creating a favorable macroeconomic environment. Monetary policy has been successful in creating appropriate monetary conditions for controlling inflation rate. Prudential implementation of fiscal policies, by observing the planned parameters of fiscal indicators, has not transmitted excessive inflationary

pressures and has contributed to maintaining price stability. Also, developments in the external economic environment characterized by appreciation of exchange rate of the Lek against the euro and by steady inflation rates in partner countries, have not exerted inflationary pressures.

#### *Expected CPI Inflation for the 2006-2008 period*

Average CPI inflation has fluctuated within the 2-4% target band of the Bank of Albania during the past 3 years. The average annual inflation rate for this period has been 2.5%.

According to the BoA inflation projections for 2007, annual inflation in 2007 will be around 3% or very close to the point target. However, the dynamic developments of the Albanian economy and the financial markets in particular, present challenges to the monetary policy in maintaining inflation close to the 3% point target. Among the factors that are envisaged to influence the CPI inflation over the next 3 years are: rapid expansion of credit to the private sector, the expected increase in foreign exchange inflows, increases in administered prices, and probably pressures from developments in commodity goods markets.

The current arrangement between the Albanian Government and the IMF provides a consistent policy framework that assists the macroeconomic stability in general and price stability in particular. The monetary policy pursued by the Bank of Albania over the next few years will be targeted towards achieving this inflation target. The Bank of Albania will steer short term interest rates with the aim of maintaining monetary conditions in the economy in line with price stability over the medium-run. At the same time, we will consistently try to develop further our analytical capabilities and monetary policy framework. The stated aim of the Bank of Albania is to adopt a fully-fledged Inflation Targeting framework which will provide a more sophisticated approach towards policy-making and will help the BoA to anchor inflation expectations.

### **2.3 Monetary Policy and Exchange Rate**

In view of the monetary policy, the Bank of Albania compiles annually a monetary program, which serves as an orienting scenario of desired economic and monetary

conditions. In compliance with the targeted inflation rate of 3 percent, the monetary program defines the short-term framework of monetary developments. Based on the assumptions of increasing credit to the economy and expectations of large foreign currency inflows, the 2005 monetary program provided an annual money supply growth of 14.1 percent.

Money supply expansion would support the economy growth of nearly 5-6 percent and the maintaining of inflation close to the 3 percent targeted rate. In 2005, monetary developments were in compliance with the monetary policy target for maintaining inflation over the mid-term period close to 3 percent. Therefore, the money supply growth of 13.8 percent reflected the intensification of the country's financial expansion and the acceleration of credit to the economy. However, due to decreased money velocity, money supply growth did not transmit excessive inflationary pressures to the economy.

In the first half of 2006, private sector of economy continued to be the main factor influencing on the monetary expansion, while the public sector has generally been characterized by a reduced demand for monetary assets. The net influence has resulted in the maintenance of the money supply growth rate within 10 to 12 percent over the first five months of 2006. Monetary developments have reflected the constant performance of macroeconomic indicators and the growth within the targeted objective of price level in the economy. The Bank of Albania has pursued a neutral monetary policy over the first semester of 2006.

The constant maintenance of the core interest rate began in March 2005, when the Bank of Albania decreased it by 0.25 percentage points. Starting from this month, the interest rate applied on repurchase agreements was 5.0 per cent. However, the interest rates in the money markets have maintained slight downward tendencies. The average weighted interest rate of deposits in the system decreased by 0.3 percentage points in May, compared to 4.46 in December. However, the Treasury bills interest rates of 3-month and 12-month maturity decreased by about 0.3 and 1.3 percentage points, respectively, over the first semester of 2006. The downward tendencies are assessed to be a result of the shift of securities portfolio to two and three-year maturity. In deposits market, the moderate downward tendency was encouraged by the enhancement of competition and the decline of market concentration among large banks.

The constant preservation of base interest rates started in March 2005, when the Bank of Albania lowered them by 0.25%. Starting from this month, the interest rate applied in the repurchase agreements was 5%. However, interest rates in the money markets

have preserved slight decreasing trends. The average interest rate in the system during May fell to 0.3% compared to 4.46 percent in December 2005. Interest rates for 3 and 12 months TBs during the first semester of 2006 decreased respectively by 0.3 and 1.3 percent. The decreasing trend is deemed to be a result of the shift in the treasury obligations portfolio to long term obligations (2, 3 years).

Over the past three years the Albanian Lek has maintained appreciating trends against the main foreign currencies. At the end of 2005 it was appreciated on average by about 23 percent against the US dollar and 11 percent against the Euro, compared to three years ago. The constant ALL appreciation has mostly reflected the positive performance of the balance of payments, particularly considerable foreign currency inflows through private transfers. Furthermore, this appreciation is also an expression of the ALL - foreign currency interest rates spreads. Also, economic data suggest the effect of productivity improvement of tradable goods sector (Balassa-Samuelson<sup>6</sup>) as a possible factor that should have led to the Lek appreciation, a characteristic of the developing countries.

Pursuing of an easing monetary policy by the Bank of Albania until March 2005 brought about the narrowing of the ALL-foreign currency interest rate spread, therefore weakening the support of this factor in the Lek appreciation. However, even though interest rates were constantly falling, low inflation rates contributed to holding high real interest rates in ALL. In nominal effective terms, at end of 2005, the Lek had depreciated by 0.8 percent against the year before.

In the first half of 2006, the Lek has been relatively stable against the euro, while displaying appreciating tendencies to the dollar. In annual terms, the Lek continued to appreciate against both main currencies, the dollar and the euro, by about 4.4 and 0.4 per cent, respectively.

The Bank of Albania will maintain the current exchange rate framework and policies over the next three years. The Lek will be a freely-floating currency whose market exchange rate is determined by market forces. Under the current regulation, the Bank of Albania retains the right to intervene in the market to curb short-term disturbances and to build-up its foreign exchange reserves. These interventions are not intended to influence the long-term trend of the Lek and they are carried out in the market in this spirit. In this framework, a numerical forecast of the expected exchange rate developments would be unrealistic. However, we do expect that the aforementioned factors will remain operative in the up-coming period, though their intensity and their overall impact are hard to determine.

## 2.4 External Sector

Large inflows of current transfers and positive service balances in recent years have helped dampen the rising trade deficits with a slight improvement of balance of payments position. Although Albania has been characterized by large current account deficit throughout most of the transition period, only recently its size has become a matter of concern. The current account deficit may still be sustainable in the short run, however its long run sustainability may be questionable if certain measures, such as structural reform that boost the competitiveness of Albanian exports are not undertaken.

In 2005 and the beginning of 2006, the external sector of the economy has experienced a deterioration of the current account balance, caused by a high trade deficit. The ratio of current account deficit (excluding official transfers) to GDP reached 7.7 percent in 2005, up from 5.7 percent in 2004. Capital inflows have generally been sufficient for compensating the current deficit, enabling an overall positive balance sheet. The growth of exports slowed down during 2005 at an estimated rate of 9 percent, compared to 23 percent in the previous year. Apart from the exchange rate appreciation that may have reduced the competitive position, the deceleration of export growth is generally perceived to have resulted from an increased competition in the textile sector, with the opening of European markets towards China and India. It should be stated that textiles and shoes have represented on average 64 percent of Albania's exports during the period of 2000-04. The degree of their share to total exports reduced to 58 percent in 2005 down from 61 percent in 2004.

At the same time, high oil prices in international markets and growth of lending have led to a rise of imports by 16 percent. About 58 percent of total imports consist of capital and intermediate merchandise imports, while the demand for imported consumer goods continues to remain high.

Merchandise exports continue to suffer from a low degree of diversification, even though modest positive signs are noticed in this direction. Most of it is represented by exports of textile products, footwear, and base metals. It is noted that textile products have maintained almost the same level in the past two years, while exports of the other two categories have increased.

Although private investments are usually associated with a rise in production capacities for exports, low level of exports remains a striking feature of the economy.

In the past year, exports accounted for almost 8 percent of GDP, and could cover about 26 percent of imports in the economy.

Private sector's high demand for capital goods is a positive indicator for the level of investments, for the renovation of technology basis and its productivity. Imports of raw materials for the domestic active process industry – focusing mainly on textile products, footwear and metals – have recently increased their share slightly to 15 percent of the total. The developments of these imports are also reflected in the re-exporting performance.

The European Union remains the main destination for the Albanian products, constituting 88 percent of total exports. Sales in the European markets have recorded an annual growth of E 30 million or 7 percent against the previous year. However, this market has lost some grounds in favor of the market extensions to the regional countries.

Albania remains committed to a liberal trade regime and will continue toward concluding a Stabilisation and Association Agreement with EU and achieving an Albanian-EU free trade area. During 2003 and the first quarter of 2004 six new free Trade Agreements were ratified by Parliament, including a free trade agreement with Kosovo.

Exports with region countries of the South-eastern Europe, with which Albania trades under free trade agreements, have increased by 19 percent compared to the previous year, extending the Albanian export market in this area from 8.5 to 9.2 percent of total exports. Kosovo and Macedonia represent the largest markets for exporting Albanian products.

With regard to imports, trading geography presents a larger variety of markets. The European Union satisfies around 60 percent of the domestic needs for imports and during 2005 imports increased by 5.7 percent. Italy and Greece remain the main trading partners of Albania. Imports from both countries constitute  $\frac{3}{4}$  of total imports from the European Union. Imports from the regional South-eastern European countries included in the process of creating free trading area, have reflected a considerable growth, about 31.5 percent and their share to total imports has increased by 2 percentage points to 14.8 percent in 2005.

Large inflows of remittances from Albanians working abroad represent an important source that backs the Albanian economy, providing a continuous financing of current account deficit. During 2005 the net flow of current transfers was estimated at approximately E 1 billion, where more than 90 percent of that is the contribution of remittances from abroad. Total remittances are estimated at 939 million or 14 percent

of GDP over 2005, and their contribution to the smoothing down of trade deficit is estimated at about 64 percent.

Also, net capital inflows recorded a level of E 423 million, thus able to finance 93 percent of the current account deficit. This led to a rise in foreign reserves held by the monetary authority to E 1.204 billion in 2005, which is sufficient for covering around 4.7 months of imported goods and services. It should be mentioned that capital inflows in the form of privatization have recently been a factor that determines the size and character of foreign investments in the country. Capital inflows in the form of FDIs are seen as an important source for covering the current account deficit as well as the fiscal deficit. Over the medium term, however, as business climate improves, current account improvements should be driven by rising foreign and domestic export-oriented investment.

### **3. PUBLIC FINANCE**

#### **3.1 Fiscal architecture and governance**

The current Albanian governance structure is a two level one, with a Central government and a Local government (art. 108 of Albanian Constitution). Intergovernmental fiscal relations are defined by the Constitution (art. 157) and by law no. 8652, dated 31.07.2000 "On Organization and Functioning of Local Government". According to the regulatory framework on fiscal relations, institutions in Albania can also be classified in: (i) extra budgetary institutions, i.e. the social and health insurance institutions and (ii) independent institutions, i.e. the ones under the authority of the legislative body (Parliament).

There is a strong statement in the Albanian Constitution concerning inter-institutional fiscal relations, according to which: "taxes, tariffs, and any other kind of financial obligation and the relative collection, as well as exemptions and facilities to specific categories of taxpayers, can only be introduced by law. In this case, the law doesn't have effects for facts which have occurred before its approval.

Government fiscal relations are mainly defined in the organic budget law, no. 8379, date 29.7.1998. According to this law, Ministry of Finance is responsible for drafting laws and regulations in the area of public finance. Albanian government is currently formulating the new organic budget law, expected to be presented in Parliament for

approval in December 2006. It will reflect and regulate a number of ongoing processes taking place since 1998, such as, the MTBP process, fiscal relations among central and sub national governments, the process of strengthening public expenditures management, adoption of best practice on public accounting and public financial statistics standards, the public administration reform aimed at increasing accountability and fiscal transparency.

Inter-institutional fiscal relations are of four types: (i) those between central and local government, (ii) central and extra budgetary institutions, (iii) council of ministers and institutions under Parliament authority and, (iv) those between council of ministers institutions. They are all based in the law.

In the second type of relation, the central government allocates resources to the extra budgetary institutions, to the extent that their expenditures equal revenues. In the third type of relation, the approach is almost the same as for the above, with the distinction that budget discussion is carried out in parliamentary commissions and the personnel number and structure of these institutions is defined by law. The last type is based on financing priorities, as they are determined in several documents, like the National Strategy for Development and Integration, sector strategies and the Government program. Funds allocation between institutions depends on priorities and available resources. Budget implementation is carried out according to the law provisions.

Financial relations between central government and sub national governments are significantly complicated and represent an important development in Albania's governance. Decentralization has experienced significant progress in Albania, towards clear definition of the increasing taxing and spending powers of local government. Some of the most important steps include membership in the European Document for local self governance, adoption of the national strategy for decentralization, adoption of law on "Organization and functioning of local government". Functions and responsibilities have been transferred to the local government in areas such as, infrastructure and public services, regional economic development, public order and social protection.

Transfer of responsibilities and functions has implied additional transfer of resources from the central government and increased authority to raise and mobilize revenues to local government bodies. The main sources of local budget revenues come from unconditional transfers from the central government and, own local revenues from

taxes and tariffs. Progress has been made in the allocation formula for unconditional grants, with respect to past years. In 2006, unconditional transfers were reached 10,1 billion of Lek, with a significant increase of 38% from the last year 7,3 billion. Funds for rural and urban roads were included in that. The analysis of investments distribution among different regions, communes and municipalities for the years 2000-2005, reveals systematic absence of objective criteria for distribution, unpredictability and lack of transparency, the consequence being a huge disparity of per capita investment. Thus, in 2006 budget, the distribution of the investment grant for city and villages roads was formula based.

The allocation formula for 2007 takes into account average per capita investments for the period 2000-2005 in different communes and municipalities for city and villages roads. Local units which have been granted resources for investments for an amount exceeding the national per capita average will contribute (receiving less) for local units receiving less than the average. After the consultation process with the representatives of local governments, the coefficient for this kind of equalization was determined at the level of 0,6 (60%). This policy has granted benefits to 263 local units and penalized 110 local units. Other changes concerning the formula for unconditional grants are:

1. Equalization of urban services coefficient with that of communes areas, removing inequality in the financial treatment between communes and municipalities;
2. Improvement of fiscal equalization, to balance efforts to increase own revenues by local governments with contribution to those local units unable to raise sufficient revenues;
3. Decrease of Fiscal equalization coefficient from 35% in 2005 to 30% in 2006;
4. No local unit receives fewer grants than in 2005. 88% of local units received more in 2005 compared to the previous year;
5. Number of mountainous communes increased compared to 2005, from 170 to 178;
6. Number of communes classified as being in difficult situation increased compared to 2005, from 30 to 39;
7. Number of municipalities classified in difficult situation increased compared to 2005, from 30 to 39. Classification and selection of these two types of local units is based on objective criteria and therefore horizontal equalization has improved.

8. The population data used in the above process of selection is based on population registration for the elections of July 3, 2005, with some adjustments to correct the 2001 INSTAT population census.
9. Data on communes' areas are based on the Albanian Geographical Institute data, instead of previous practices of approximate calculations on a district level.

Starting from January 2007, responsibility for collection and management of small business tax revenues belongs to local administration. If managed properly, this is a positive step towards increased fiscal autonomy of local government. The new legislative provisions increase local government power and flexibility to raise revenues, improve management of vested business interests, and increase scope for tax policy formulation to introduce incentives, aimed at regional development in different levels.

According to current legislation, local government can determine the level of local taxes, within the boundaries and on the basis of the base level determined by law, administrative procedures and collection tools, exemption of specific communities, destination of the revenues collected.

## **The decentralization process and current situation**

### **Status of own functions**

In most areas of own functions communes and municipalities have achieved full authority and discretion, in line with government program and objectives. These are: Enforcement of public order & local acts; Civil defense; Local economic development; Regulation of market places and local trade; Small business development; Fairs, information, advertisements; Veterinary service; Local transit and public transportation services; Cemetery and funeral services; Protection of local forests, pastures and natural resources; Protection of local cultural, historic values; Recreational activities; Social service (including orphanages, day care centers, elderly homes); Housing; Water supply;; Sewage and drainage system and [flood] protection canals in the residential areas; Local roads, sidewalks and squares; Public lighting; City/village decoration; Parks & public spaces; Waste management; Urban planning, land management.

*Water supply, sewage and drainage system.* Property and responsibility for water operators have been transferred to the local government during 2006, on the basis of

an agreed working plan with local representatives, taking into consideration the specific circumstances for each case. The process is expected to be completed at the end of 2006. The current status of the water companies will be preserved.

*Urban planning and urban land management.* Law no. 8991, date 23.01.2003 "On some amendments to the law on Urban Planning" has transferred the responsibility for urban planning to local units. Local government can exercise own functions in this area, such as creation and functioning of the Councils of Territorial Adjustment, issuance of construction licenses, control of constructions legality, etc. In most of the municipalities (round 55) and in 35 communes these councils have already been set up.

*Transfer of property to local government.* The process of transferring to local governments ownership of the assets related to the functions they perform is planned to be completed within two years and it is still on going. Registration of public immovable property in the territorial jurisdiction of 130 communes and municipalities is completed. The same process for other 40 communes and municipalities is being completed by the local units' councils. 25 communes and municipalities are waiting for the Council of Ministers' approval of their lists of immovable assets.

### **Shared functions and responsibilities**

*Pre school and pre university education, priority health care and public health protection.* Transfer of local responsibilities in the areas of health and education is based on Council of Ministers decisions. Investment grants for these sectors for 2007 will be allocated on a competitive basis (the process of competitive allocation started in 2006 with the creation of the conditional investment grant pool).

*Social assistance and poverty alleviation (including operation of relevant institutions).* Legislative framework has been improved in this area, in cooperation with the Ministry of Labor and Equal Opportunities. Expenditures for social assistance services delivered by local government units are financed by transfers from the central government and own local revenues. Transfers from the central government are allocated in the form of conditional grants, according to local needs and relative projects and programs. Communes and municipalities administer social assistance services through social assistance centers, from which residents can benefit.

### **3.2 Medium term fiscal framework 2006-2008**

Tax and expenditure policy for the period 2006-2009 was approved by the Strategic Planning Committee, formed by some of the government ministers and led by the prime minister. This framework will be reviewed yearly (January-March).

The current fiscal framework objectives and policies aim at:

- Reduction of some tax rates, all over the three years, starting from the first semester of 2007 (no provision of tax reduction is introduced in the 2007 annual budget);
- Wage increases in some sectors of the economy, and pensions increase.

For the expenditure policy, the objectives set in the government program are to increase wages in the education sector (pre university education), health sector and pensions.

Tax and expenditure policy will be aligned with the strategic objectives set in the National Strategy for Development and Integration 2007-2013, which defines short, medium and long term national objectives for each of the sectors, based on the national vision for development and integration. The NSDI, expected to be approved in April 2007, will lead the MTBP process for next year. It also reflects the objectives for European Integration and NATO membership.

Fiscal policy for the coming three years is reflected in the Medium Term Budget Program for 2007-2009, formulated by the Ministry of Finance at the end of October and presented to the Parliament for reporting purposes. The strategic component of the MTBP is reflected in the Program Policy Review of each line ministry and other institutions, which links strategic objectives and budget expenditures.

Fiscal policy is also linked with the policy programs of three year arrangement under PRGF/EEF with the IMF. Structural reforms in public and private sector will have the financial support of the World Bank, through the Development Policy Loan for 2006-2009, signed at the end of 2005. This loan agreement provides for further progress in reforms aiming long term development, through increased investments in the private sector, enlargement of the export base, development of human capital and strengthening of institutional quality.

The main objective of the fiscal policy for the coming three years is the maintenance of a small but efficient government, by strengthening fiscal management. This will help in raising efficiency, reduce weaknesses and support policies in other areas, such as improvement of business climate and attraction of foreign direct investments.

Reduction/elimination of corruption in the revenue agencies and reduction of compliance costs will have a major role in the achievement of the strategy objectives. Therefore, in the area of fiscal policy, efforts will focus on administrative issues of revenue collection, debt management capacities and expenditure quality.

The other strategic objective is fiscal consolidation, which is reflected in the target of reducing public debt as a percentage of GDP until 2010, and reduction of the stock of domestic debt. According to this debt policy, domestic borrowing aims at a level of 2.4% of GDP in 2008 and 2.3% in 2010, from the level 2.7% of GDP in 2005. Public savings will increase from 1.5% of GDP in 2005 to 3% of GDP in 2009 (budget primary advance).

Budget expenditures will reach 30% of GDP at the end of 2008. To improve expenditure quality, their structure will change in the next three years in favour of increasing capital expenditures and channelling them to quality investments, as in infrastructure, health and education, in order to sustain economic growth.

The sustained increase in revenues will be supported by improvements in tax and customs administration, reduction of informality and tax evasion as well as raising voluntary compliance of taxpayers.

### **Budgeting process**

The Medium Term Budget Program, covering a period of three years, was introduced six years ago and is currently the main instrument for public expenditure management and a key component of the integrated planning system. Its main components are the Program Policy Review and Expenditure Planning. Expenditures are planned by line ministries according to expenditure ceilings defined in the macro framework of the MTBP document and approved by the Strategic Planning Committee. The MTBP approval process has three steps. This is a document which informs the parliament and the public about government expenditure plans for the next three years in relation to government objectives. It also sets the framework for the annual budget.

Ministry of Finance has the responsibility to prepare the MTBP document and to give a clear view of the financial resources available. The document provides also a framework for planning and allocation of expenditures (including current and capital expenditures). This approach of expenditure planning has already improved, to a certain extent, planning of investments and management capacities, and has helped to avoid the past practice of small fragmented projects for capital investments. The major benefit of having a medium term budget program is to create a link between policies

and programs with expenditures, taking into account the amount of resources available for investments (including recurrent and maintenance costs of investment projects).

MTBP formulation is performance based. This implies that resource allocations are done on the basis of products and outputs of each line ministry to achieve policy objectives. The benefits of this approach are: measurable outputs; contribution of outputs to achieve policy objectives; costed activities; resource allocation on the basis of performance.

Government efforts to improve public expenditure quality are reflected in the preparation of the new Organic Budget Law, expected to be presented in Parliament in December 2006.

### **Tax policy**

Tax policy framework for the next three years is defined in the Strategic Planning Committee document, approved in April 2006. Tax policy reforms directed at reducing tax rates will be introduced at a measured pace, to ensure that revenue gains are sustainable. Emphasis will be put on further reduction of the tax wedge on labour, mainly through cuts in social security taxes (started in 2006 with the reduction of employer's contribution by 9 percentage points), which remain the highest in the region, while taking care of the sustainability of the pension system. Following World Bank recommendation, there might be scope for eliminating health contribution on behalf of both employer and employee. Tax policy reforms will also include efforts to improve tax administration and business climate to attract foreign direct investments. In this context, a task force for the regulatory reform has been set up, to formulate and monitor regulatory reforms in the area of business development and foreign investment attraction.

The Action Plan for the regulatory reform was approved by the Council Of Ministers, and includes four pillars: (i) development of a regulatory management system (institutions and procedures); (ii) improve quality of existing regulations (reduction of administrative and regulatory barriers); (iii) improve quality of new regulations (through impact assessment of the regulatory framework); (iv) set up of a framework for periodic monitoring and assessment of reforms. World Bank has already approved a \$9.3 million loan to support some of the activities of the action plan.

The target for end 2008 is to create a "one stop shop" system in Albania for licensing and registration of a new business. The campaign of "Albania one Euro" will also contribute to make the country attractive for investments (domestic and foreign), mainly in highly strategic sectors, like production for export, energy sector, creation of industrial areas, investments in less developed regions, etc. The main component of

this policy is the possibility for investors to use public assets and services for a symbolic price of one Euro. The basic condition for this to work is the creation of a clear and transparent framework of requirements and criteria for the eligibility of the companies. This is to avoid any kind of distortion of free competition.

### **Budget Revenues**

High and sustained economic growth will support fiscal consolidation. Government policies will aim at prudent fiscal policies, based on increasing revenues and improving public expenditure management. Projected revenues for 2008 reach 27.6% of GDP, increasing from 24.4% of GDP in 2005. Two major factors are expected to contribute in the projected growth in revenues: economic growth, especially in the non agricultural sector, and improvements in revenues administration, which will reduce informality and broaden the tax base. Tax policy will also be oriented towards simplification of the tax system and increasing of taxpayers' compliance.

The main source of budget revenues in Albania is tax revenues. Their sustainability is ensured from the projection for the coming three years of tax revenues at the level of 90-91% of GDP, compared to 85% of GDP during 2000-2005. The increase in the tax revenues as a percentage of GDP protects government from risks stemming from other sources of revenues, not under government control, such as grants or transfer of profits from the Bank of Albania. At the end of 2008 tax revenues are projected at 24.23% of GDP, from 21.06 in 2005. This increase accounts reductions of the small business tax, of the profit tax and of the social insurance tax.

#### **Budget revenues in 2005-2008**

In % of GDP	2005	Budget 2006	Proj. 2007	Proj. 2008
Total revenues	24.4	25.6	25.8	26.8
Grants	0.7	0.7	0.6	0.8
Total tax revenues	21.9	23.1	23.4	24.2
Tax and Customs	16.2	17.7	17.7	17.9
Vat	7.7	8.5	8.7	8.6
Profit tax	2.3	2.3	2.3	2.3
Excise tax	2.2	2.7	2.8	2.8
Personal income tax	0.88	1.0	1.1	1.4
National taxes and others	1.5	1.6	1.6	1.6
Custom tax	1.6	1.6	1.2	1.1
Local government revenues	1.4	1.2	1.4	1.4
Small business tax	0.5	0.3	0.3	0.3
Local taxes	0.98	0.96	1.1	1.1

Social insurance contribution	4.3	4.2	4.4	4.9
Non tax revenues	1.7	1.8	1.7	1.7

Structural reforms undertaken by the government and differentiated growth among sectors are also reflected in the composition of budget revenues. Revenues from custom taxes will decline following SAA signature and fulfillment of obligations in the framework of WTO membership, from 6.7% of total tax revenues in 2005 to only 4.7% in 2008.

Forecasts of profit tax revenues are pretty conservative, taking into account the decline of the tax rate from 23 to 20% in 2006 and the historical trend. In 2008 profit tax revenues will slightly decrease in comparison to 2005 (from 2.3% of GDP to 2.29% of GDP). Nevertheless, revenues from profit tax are expected to be larger than the forecasted, because of the administrative gains. This component has not been considered in the projection, because the government policy is that of using administrative gains for reducing the tax burden.

Trend in the excise revenues reflects also administrative improvements. In the first 6 months of 2006, revenues from excise tax increased by 2.1 billion Lek compared to the same period of the previous year. On the basis of this administrative performance and the increase in the excise tax for some excisable goods, the revenues projected for 2008 will be 2.84% of GDP, from 2.21% of GDP in 2005.

Social insurance contributions are a key component of budget revenues, as well as a critical factor for the sustainability of the pension and health care schemes. It is projected that revenues from this tax will increase, from 4.32% of GDP in 2005 to 4.93% of GDP in 2008, despite the reduction of the employee contribution by 9 percentage points. Presumably, this measure will increase the number of contributors in the scheme and help reducing informality and tax evasion, which is very high in this area.

Formalization and reduction of tax evasion will also help increase revenues from personal income tax. These are projected at the level of 1.44% of GDP at the end of 2008, from 0.88% of GDP in 2005.

### **Budget Expenditures**

Total projected expenditures for the MTBP 2007-2009 are in line with projected revenues and financing support from domestic and foreign borrowing, to ensure fiscal stability. At end 2008, projected expenditures will reach 30.74% of GDP, increasing from 27.76% of 2005. Both current and capital expenditures will increase, but the latter more, in percentage of GDP. Local government expenditures will also have an

increasing trend, reaching 2.83% of GDP in 2008, from a 2.39% in 2005. Considering government policy to transfer some capital expenditures to the local government through competitive allocation of investment grants in health and education, local government expenditures will increase further, to 3.2% of GDP.

There are several reasons behind this change of budget expenditures structure for the years to come. Some of them are:

- A significant reduction of subsidies as a component of expenditures, to 0.25% of GDP in 2009. This is in line with the government policy to create a favorable environment for private sector development and release of financial resources in support of poverty reduction and other strategic components of expenditures.
- A relative reduction of operational and maintenance expenditures (from 2.93% of GDP in 2005 to 2.55% in 2008), included in the MTBP program of Planning, Management and Administration. There will be a greater distribution if this component of among other budgetary programs.
- A reduction of payments for interests (from 3.11% of GDP in 2005 to 2.95% in 2008), which reflects the policy of reduction of the stock of debt in relation to GDP for the coming years.

The above changes will help increasing capital expenditures, which are of vital importance to sustain economic growth.

#### **Budget expenditures in 2005-2008**

In % of GDP	2005	Budget 2006	Proj. 2007	Proj. 2008
Total expenditures	27.76	29.65	30.57	30.74
Current expenditures	23.18	23.09	22.89	23.04
Personnel	6.41	6.59	6.19	6.39
Interests	3.11	3.06	3.01	2.95
Domestic	2.89	2.71	2.60	2.55
External	0.22	0.34	0.42	0.40
Operation & Maintenance	2.93	2.47	2.46	2.55
Subsidies	0.44	0.28	0.27	0.24
Social and health expend.	6.68	6.70	6.82	6.65
Local government exp.	2.39	2.57	2.63	2.83
Social transfers	1.22	1.39	1.46	1.26
Others	0.00	0.03	0.05	0.05
Capital expenditures	4.59	6.11	7.09	7.23
Domestic sources	2.91	3.87	3.79	4.56
External	1.68	2.24	3.30	2.68
Contingency	0.00	0.44	0.59	0.46

Government policy for personnel expenditures is to keep them under the level of 6.5% of GDP for the medium term. For 2008 they are projected at 6.39% of GDP. Personnel expenditures include wages, salaries and social and health contributions for public employees of the central government. The amount projected for 2006-2008 for personnel expenditures does not include additional expenditures from the contingency fund for government policy on public wages and salaries. In mid 2007, it is expected an increase of wages in education and health sectors of 20% and of 5% in other sectors of central government, financed by the Reserve Fund for Pensions and Wage policy.

In the medium term it is expected a decreasing trend of expenditures for interests on public debt. Interests on domestic debt will decline from 2.89% of GDP in 2005 to 2.55% in 2008. The declining trend follows government policy to use privatization receipts to reduce the stock of domestic debt, and reduction of domestic borrowing in relation to GDP. Payments on external debt are projected to be 3.1 billion Lek in 2006. Government will continue to benefit from concessional loans from external sources, but less than in the past. Interests on foreign debt will slightly increase, from 0.34% of GDP in 2006 to 0.4% of GDP in 2008. Government policy for the medium and long term aims at reducing the burden of interest payments in the budget and re-direct resources towards priority expenditure and poverty reduction expenditures.

One of the major government objectives for the medium term is the increase of capital expenditures. This will be achieved through the increase in revenues, the reduction of tax evasion and the capacity of the economy to access and absorb non concessional credit. Increased public investment through formalization of the economy (increased revenues) and external borrowing will improve infrastructure and help in private sector development, avoiding recourse to domestic market liquidities. In the medium term government will also benefit from a current advance of 3% of GDP.

Externally financed public investments are also of crucial importance for the future. For the next two years it is expected an increase of investments financed by both concessional and non concessional external borrowing, from 1.68% of GDP in 2005 to 2.68% of GDP in 2008. The bulk of investments will be in the infrastructure, which are deemed crucial for raising economic activity efficiency, reducing transaction costs and increasing trade and tourism. Expenditures in the infrastructure will reflect the objectives set in the National Strategy of Transportation. One of the key components of this strategy is the funding of Durres-Morine corridor, which links the greatest Albanian port of Durres with Kosovo and southern Balkans. The funding will be split by half between domestic and external sources.

New budget procedures will be implemented during 2006-2008 in order to have a policy based budgeting process in Albania. Important changes will also occur in the area of identification and evaluation of public investment projects, as defined in the action plan for the Improvement of the Public Investment Management, agreed with the World Bank. The above measures will contribute in improving the management capacities of the government to use resources efficiently, by minimizing its informational and managerial limitations. The main objective is to stop the practice of fragmentizing large investments into many small unproductive projects and move towards large efficient investment projects. Domestically financed public investments will increase from 2.91% of GDP in 2005 to 4.96% in 2008.

Budget classification in Albania is aligned with Government Fiscal Statistics Manual.

### **3.3 Public Debt Management**

#### **Debt management strategy**

Ministry of Finance has recently completed the formulation of the public debt management strategy<sup>7</sup>. The main purpose of the strategy is to manage government borrowing to meet Government essential financing needs, but in a manner which reduces the costs and risks of public debt in the medium and long term.

The strategy aims to: (i) provide access to liquidity and capital markets for the government financing needs, in a cost-effective and transparent manner; (ii) define acceptable limits of risk, for domestic and external borrowing. Risks include Weighted Average Maturity, rollover risk, and risks related to budgetary and financial distress; (iii) develop an efficient financial market to meet individual and institutional needs; (iv) develop policies aimed at reducing interest rates volatility; (v) allow government to develop flexible budget policies, considering different risk parameters of debt portfolio; (vi) minimize costs of debt service; (vii) monitor structural and liquidity developments of financial markets and develop adequate responses to those developments.

The main component of the strategy is the issuance of government debt for financing needs of the annual budget. The initial point is the set of macroeconomic projections and the annual budget. Then, it assesses the deficit or advance of government budget, and monthly and seasonal cash flow. Based on the previous elements, it defines a debt issuance schedule which satisfies refinancing and additional debt needs. In doing this, several risks are taken into account, such as maturity, exposure to exchange rate risk, capital market liquidity, operational risk, and investors' diversification.

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<sup>7</sup> The strategy is available at the Ministry of Finance website for consultation: [www.minfin.gov.al](http://www.minfin.gov.al).

The strategy provides also for monitoring and reporting differences between budget outturn and the original approved budget, as well as deviations from the original calendar of debt issuance. Regular and timely communication between Ministry of Finance and Bank of Albania is a crucial component of the strategy. Ministry of Finance needs to know on a continuous basis the market liquidity situation and the relative risks and opportunities, while Bank of Albania needs to know the current status of debt issuance.

Performance review of the debt strategy at the end of each year is important for increasing communication between participants in the process, and to have a sound budgeting process and debt management. Achievement of strategy objectives requires strong commitment by the Ministry of Finance, to build capacities for debt management, treasury/cash management and have a highly professional staff for each area of responsibility. The strategy will also provide a “working plan” for the debt directory. The strategy covers a three year period, it is reviewed and approved by the Minister of Finance and delivered for approval by the Council of Ministers, together with medium term budget projections.

### **Directorate of Debt Management**

The Debt Directorate ensures the necessary funds for the Government’s operations and assesses short and long term risks of borrowing. The Debt Directorate activity aims at the development and expansion of government bond market, the broadening of investors’ base and diversification of financial instruments.

The Debt Directorate is responsible for drafting the schedule of internal and external debt issuance. Ministry of Finances has the task of reducing portfolio risk by decreasing borrowing ratio to GDP and costs for interests’ ratio to GDP.

The Debt Directorate exchanges information on a continuous basis with all departments involved in fiscal and monetary policy issues, in order to keep debt level under adequate control. The Directory will also ensure that macro and fiscal departments are well informed about the impact of Government’s financing needs and the level of debt cost. Some of these indicators are public debt ratio to GDP and tax revenues.

Activities of the Debt Directorate will aim at:

1. Increase of the staff number and capacities, market monitoring and management of institutional relations.
2. Minimize risk by monitoring activities on continuous bases. This involves monitoring of operations and debt profile.

3. Assessment of risks which are due to Government debt.
4. Debt Directorate will propose, monitor and manage the optimal ratio between market risks, the cost of risk management and scope for hedging in the market.
5. Risks management will be carried out separately, based on the methodology for risk monitoring and assessment. The approach used involves simulations of different market conditions and access to Reuter's data on financial markets.
6. Debt profiles and market risks analysis.

The government has to refinance the matured debt (refinancing) and issue new debt to meet expenditure needs each year. The rollover risk implies that usual buyers of Government debt are not able or not willing to participate in the additional government borrowing. On the other hand, market conditions may not allow for refinancing during a specific period. To reduce rollover risk, the Ministry of Finance must develop access to different sources of financing and not rely on a single entity or group of entities. Furthermore, possibility to increase/issue debt in several financial markets raises flexibility and decrease rollover risk. Other risks to be considered are: exchange rate risk, financial market liquidity, and operational risk.

The strategy stresses the need for daily information on cash management and strong cooperation with the Treasury directorate. Cash management is based on the annual budget, approved by the parliament. Budget expenditures include current and capital expenditures. Treasury directorate has frequent communications with line ministries and it defines two monthly allotments to line ministries which serve as a guideline for available funds, by using different historical and seasonal data on expenditures. Treasury is also working in cooperation with the macroeconomic directorate to draft a schedule on projected revenues. The Minister of Finance approves the final monthly forecasts of budget revenues and expenditures.

### **Assumptions for 2007-2009 Debt Management Strategy**

The main macroeconomic factors affecting public debt are: budget deficit/advance, real GDP growth, inflation rate, interest rates, and change in exchange rate.

**Budget deficit.** According to Ministry of Finance projections (macroeconomic directorate), budget deficit is expected to be 4.7% of GDP in 2007 and 4.0% of GDP in 2008.

**GDP growth.** GDP in real terms is expected to grow by 5-6% during 2007-2009, if the current growth rates are sustained.

**Inflation.** Inflation is expected to remain at 3% rate

**Changes of the exchange rate.** These will be affected by internal and external developments.

**Interest rates.** At the beginning of 2006, interest rates were reduced due to liquidity surplus in the banking sector and decrease of government borrowing needs. During the second half of 2006, changes in liquidity situation of the banking system, deposits' transfers from one bank to another, the increase of the borrowing demand due to deficit increase and budget expenditures, were accompanied by temporary increases of interest rates. These factors were taken into account for the debt service forecasting. Interest rates projections for 2007 are as follows: 7,50% for 2 year notes, 8,50% for 3 year notes and 9% for 5 year notes.

Cost minimizing of public debt in a long term will be closely related to the following risks:

1. Rollover risk
2. Inflation and interest rate risk
3. Liquidity risk
4. Exchange rate risk
5. Operational risk

The objective of cost minimizing implies two important aspects:

- Reduction of borrowing risk and cost by increasing reliance on long term instruments in the total stock of debt, appropriate choice of currency mix for external debt, and issuance of new debt instruments.
- Organization and infrastructure of Government bonds market, aiming at operational risk reduction and contribution to increase liquidity and decrease level of yield.

The main assumptions concerning risks in the medium term are as follows.

**Rollover risk: assumptions**

- 2% reduction of the domestic public debt ratio to GDP during 2007-2009;
- Net domestic borrowing is expected to decline from 2.5% of GDP in 2006 to 2.3% of GDP
- Increased maturity of domestic debt; improvement of long term/short term debt ratio. Long term debt ratio to total public debt will reach respectively: 30.35% in 2007, 37.95% in 2008 and 44.55% in 2009. For 2006 projections, not only new borrowing is considered, but also the conversion of existing public debt into long term debt. To this aim, 5 year notes were issued for the first time in the second half of 2006. For

2006, it is expected that 20% of public debt will be issued in notes. The average maturity days will be around 233 days (not including the portfolio of the Bank of Albania of 237 days) against 195 days by the end of 2005 (224 days without the Bank of Albania).

- Use of other instruments for domestic borrowing, through negotiations of mutual and multi mutual agreements with stakeholders in the domestic financial market or through Government bonds issued in foreign currencies.
- Development of an appropriate mix of currencies for external debt.

#### **Interest rates risk: assumptions**

- Development of the domestic market for Government bonds, through expansion and diversification of financial instruments and investors' base.
- Improvement of balance between domestic and external debt.
- Reduction of the stock of domestic debt by 2.1% relative to GDP during 2007-2009 and increase of external debt stock by 4%.

#### **Operational risk: assumptions**

- Improvement of the organizational structure of auctions procedures, through Reuters system.
- Cash accounts management.

#### **Risk of exchange rate: assumptions**

The way of implementing the aforementioned target may change due to restrictions resulting from exchange rate risk, macro-economic assumptions for external debt growth, external debt ratio to total debt and the situation of domestic and external capital markets. Future increase in external borrowing is closely related to the government objective for sustained economic growth and European integration. During the three years covered by this Strategy, government will be committed to ambitious policies, consisting in important investment in priority sectors, such as infrastructure, health and education. It follows that an increase in external funds flow might be desirable and expected in the future, in the form of both foreign direct investments and other external financing instruments.

Targets concerning external borrowing are:

- Lowering of the cost of debt service through: increased access to foreign official financing and gradual access to long term external commercial instruments sources; reduce reliance on domestic bonds, without distorting the demand and supply in this market.
- Improvement of domestic debt parameters, through reduction of rollover and interest rates risk; better balanced debt distribution in the medium term, which is expected to have a positive impact on the deficit follow-up.

### **Implications of the debt strategy**

#### **Efficiency, transparency and development of government's bonds market.**

Government bonds market has recently undergone important changes, like diversification of instruments and broadening of investors' base. This is an important development in relation to the main financing objective of the debt strategy. There need to be further consolidation of rules and procedures for government bonds issuance, looking also at other countries best practice. The main features of the process in Albania are: (i) bonds and securities issuance and debt transactions are transparent and timely publicized. Debt Directorate has the responsibility of preparing the borrowing schedule at the beginning of the year, based on borrowing needs projections, with some level of detail about financing instruments. At every auction, the schedule is updated. It represents an important debt management tool; (ii) use of market mechanisms; (iii) simply structured instruments (nominal, fixed and variable interest rates); (iv) debt issuance is proportioned with rollover risk and market development status; (v) a certain number of standard instruments are issued on a continuous and periodic basis (3,6,12 months maturity; 2, 3, 5, years maturity); and (vi) gradual development of investors' base.

The entire process is open to consultation with the Bank of Albania, so that debt transactions are in line with domestic financial market development objectives, particularly the securities market.

Further improvements are due in the area of market efficiency. The main policies are: (i) expand issuance of medium and long term financing instruments. This requires preparation of an appropriate schedule, which informs and adapts at any time market demand and offer, additional auctions or expansion of existing ones to meet borrowing and cash management needs; (ii) development of the electronic market of government securities. Completion of auction procedures using Reuters system is expected in

2007. This will contribute in increasing transparency and accountability, as well as velocity and communication. The project, if successfully completed, will help expanding bank participation in the government financial market.

#### **Development of current auctions system, expansion of investors' base.**

Currently, individuals can participate in the auction through second level banks and the central bank. Thus, banks, on the basis of a special license issued by the Securities Commission, enter the auction for the amount of debt they are willing to purchase, and for the amount that individuals are willing to purchase. Cost and quality of the process are crucial to the development of securities market, towards transparency, liquidity and competition, in the existing institutional and legislative framework. Second level banks will be the major actors in the government securities market, serving also individuals willing to invest in government debt.

Important changes have occurred: (i) improvements in the legislative framework; (ii) set up of the Register of Individuals within commercial banks and the relative software; and (3) control and monitoring of the service to individuals.

Participation of individuals in the primary and secondary market of government bonds is a serious concern of the ministry of finance, as well as individuals' involvement in the long term instruments market. To this aim, it will encourage participation through post offices and the necessary regulatory and technical changes.

#### **Efficient communication with market participants**

Barriers to communication and lack of information seriously impede proper functioning of the market, affecting negatively demand and price formation. Ministry of Finance is committed to ensure efficient communication with investors, both domestic and foreign. This is expected to contribute in market development and cost reduction.

#### **Improve cash management**

Currently, line ministries and the other budgetary institutions project monthly cash expenditures, in line with their approved annual budget. This is a step in the right direction for sound cash forecasting and management. It raises accountability for budget implementation and debt management. Nevertheless, the projection needs to be reviewed during the year.

#### **Future issuance in international financial markets.**

Presence in the international financial market is a possible development after ensuring credit rating for Albania. In this regard policies will aim to: (i) offer the right financial

instrument, as for maturity, currency and structure, to satisfy investors' demand. This has to take into account debt risk, interest rate risk, rollover risk and exchange rate risk; and (ii) issue a relatively large and liquid debt. The reference value for one issuance might be of the range of €100-200 million.

### **Modernize Debt Management Directory**

This is a very important task for the successful implementation of the action plan for debt management. The main directions for improvement are: (i) the institutional framework. Debt directory will be a general directory; (ii) the internal organizational structure and the staff. Staff number and capacities will increase. Front office and middle office structures will be soon efficient, to improve communication with investors; (iii) information technology. Activity in 2007 will be focused on improvement of external debt software and its consequent extension to the domestic debt. Part of the strategy for this area is also the adoption of Reuters system for auctions procedures and full access to information on domestic and external market. Coordination of debt management with the monetary policy and frequent communication with the bank of Albania are key to debt management improvement.

### **The public debt legal framework**

One of the most important developments is the drafting of the law "On public borrowing, public debt and guarantees". The law is ready for Parliament approval procedure. It is a modern debt management law, which regulates in an integrated approach domestic and external debt and provides for the issuance of different debt instruments. The draft law on local borrowing is also being discussed and will be soon sent for approval to the Council of Ministers.

### **Operational targets for debt strategy implementation.**

*The relative weight of external borrowing.* According to the government fiscal policy and the debt strategy, public debt structure is expected to change in favor of external borrowing. The projected external borrowing for 2007 is 37% of total borrowing, from 32.1% of 2006. This includes only the direct external financing of investment projects. For the future, issuance of Euro bonds in the international market and foreign currencies instruments in the domestic will further contribute to increase the ratio of external borrowing to 42-45% of the total.

*Domestic debt refinancing.* Maturity structure for domestic debt will improve. The ratio short term/long term debt is projected at 69% to 31% at end 2007, from 78% to 22%

expected at the end of 2006. The objective for 2009 is 55,5% for short term debt (to the total domestic debt) and 44,5% for long term debt.

*Average number of days to maturity.* Following issuance of long term government securities and their expansion, according to the projections, average number of days to maturity of public debt is expected to increase to 280 at end 2007 (with a margin of 10 days) from 233 days expected for end 2006. The objective for 2009 is to reach 365 days of maturity. This is for the base scenario of public borrowing, which considers as external borrowing the direct financing of investment projects, while domestic borrowing consists of medium-long term (2,3 and 5 years of maturity). The other scenario for domestic borrowing is that of syndicated loans, which might perfectly fit with our investment policy, budget trends and domestic financial market. The use of these loans for at least 50% of domestic borrowing will contribute in improving debt and cash management.

Domestic borrowing instruments in foreign currency will be issued, initially in small amounts, in line with the latest developments in the liquidity market and government financing needs. This will increase the scope to ensure financing (their issuance value might reach €100 million), decrease interest rates, improve management of existing portfolio, accounting also for the currency risk.

Developments in the public debt situation are strongly affected by the primary deficit, debt service and economic growth. For 2007-2009, an improvement of the primary deficits is expected, to +0,82% - +0,85% of GDP, compared to an +0,53% of GDP projected in 2006. Total debt service is sustainable, slightly decreasing to 3,01% of GDP and 2,97% of GDP. Growth of GDP affects positively debt ratio to GDP.

#### **The dynamics of the stock of debt**

	2004	2005	2006	2007	2008	2009
Stock of domestic debt (mnl Lek)	295.200	315.853	339.649	364.649	391.049	418.649
Stock of foreign debt (mnl Lek)	128.765	140.711	154.243	168.162	185.251	200.212
Stock of foreign debt (mnl €)	1.019	1.147	1.251	1.378	1.518	1.641
Exchange rate €/Lek	126,35	122,58	123,24	122,0	122,0	122,0
GDP (mln Lek)	775.864	836.879	899.700	982.200	1.075.700	1.176.600
Stock of domestic debt/GDP	38,05	37,74	37,75	37,13	36,35	35,58
Stock of foreign debt/GDP	16,60	16,81	17,14	17,12	17,22	17,02
Total stock of debt (mln Lek)	423.965	456.564	493.892	532.811	576.300	618.861
Total stock of debt/GDP	54,64	54,56	54,89	54,24	53,57	52,59
<b>Mln Lek</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Debt service (1+2+3)	31.446	29.393	31.134	35.000	37.763	41.479
Debt service, interests only (1+2)	28.422	26.029	25.830	29.600	32.365	34.965

1. Domestic debt service	26.710	24.184	23.400	25.500	27.400	28.500
2. Foreign debt service	1.712	1.845	2.430	4.100	4.965	6.465
3. Principal foreign debt	3.024	3.364	5.304	5.400	5.398	6.514
GDP	775.864	836.879	899.700	982.200	1.075.700	1.176.600
Debt Service (1+2+3)/GDP	4,05	3,51	3,46	3,56	3,51	3,53
Debt service, interests only (1+2)/GDP	3,66	3,11	2,87	3,01	3,01	2,97
Foreign debt service (2+3)/GDP	0,61	0,62	0,86	0,97	0,96	1,10

### 3.4 Deficit financing

Budget deficit is financed by privatization receipts, net domestic borrowing, net external borrowing, concessional and non-concessional loans. Revenues from privatization of strategic sectors are not included in 2007 and 2008 annual budget. Half of privatization receipts will be used for priority sectors investments and the other half to reduce stock of domestic public debt. Without considering this option, net domestic borrowing in 2008 will decline from 2.6% of GDP to 2.5% of GDP in 2007. In 2008 new debt purchased by the government in the domestic market will be 26,400 million Lek, from 25,000 million projected for 2007. Foreign financing for 2008 is projected at 14,194 million Lek (0.6% of GDP) from 4,878 million Lek in 2005 (1.3% of GDP).

#### Deficit financing 2005-2008

In % of GDP	2005	Proj. 2006	Proj. 2007	Proj. 2008
Budget deficit financing	3.4	4.1	4.8	4.0
Domestic	2.8	3.0	2.7	2.7
Privatization receipts	0.1	0.4	0.1	0.2
Foreign	0.6	1.1	2.1	1.3
Net borrowing	2.5	2.5	2.6	2.5

### 3.5 Fiscal risks

Fiscal risks affecting budget indicators are closely related to economic, social and political developments, internal and external. One major risk of economic growth sustainability in Albania is the level of remittances. So it has been for several years, although it has always remained at the level of potential risk. For the coming years, its potential impact on economic growth is somewhat weakened because of the expected increase in external financing. Other potential risks to sustainability of economic growth are:

- Constraints from problems in the power sector due to: (i) significant growth of domestic demand; (ii) unfavorable situation of the power sector in the region; (iii) late effects of the investments in power sectors.
- Oil price volatility in the world market. The increasing demand and vulnerability of the geo political situation create a climate of uncertainty for private sector activity and consumers' demand.
- Potential worsening of trade balance following Stabilization and Association Agreement. Consequently, domestic market will absorb more of European products, while exports will not be able to compensate for the increased imports.

#### **4. STRUCTURAL REFORM OBJECTIVES**

##### **4.1 Enterprise sector**

*The current enterprise situation and increase of exports.* The reference of the increase with 13% annually of the exports has been based on the indicators of the latest years and in the improvement of the energy situation in the country, investments in infrastructure etc, which are positive signs for stability in the production and that for the export.

In 2005 the export of goods reached the value of 65.6 billion Lek (0.7 billion USD or 0.6 billion Euro) marking an increase of 8.1 percent compared to the year 2004 and making up 7.9% of the GDP, a ratio almost stable for many years. Thus, the tendency of the Albanian economy to export remains in low levels. This situation has brought about having a very deep trade deficit.

This situation existing for a very long time and under the circumstances when the export of services remains even at low levels, although these last years this sector indicates satisfactory increase, consists a concern for the normal development of the economy of the country.

In the total of the trade volume of goods the exports make up 20%, while imports have, during all the last years, remained generally at the ratio: 1 unit export to 4 units import.

*The composition of exports according to the production origin for 2005* (based on the specific weight) is at the ratio 29.5% internal production and 70.4% from the production with the ordered material (Facon), with a more evident increase from the local production, with 30% to the year 2004, while Facon with a very slow increase.

*Exports from the internal production consist of:* articles from steel-pig iron, remains of copper, aluminum, lead at the amount of 37%, medicinal plants 9%, various drinks 3.5%, tobacco 3%, minerals (chromium) bitumen, coals, salts, construction materials 17.5%, leather and leather articles 5.2, wood and its articles 4% etc.

*Export with Facon (ordered materials)* has made up 70.4% of the total and it consists of textile confections 30.5%, foot wear (shoes) 28%, fish tins with 2.5% and others. The entire production with Facon is realized with European partners and it has as destination mainly the EU countries. The main line of the exports with Facon, textile and confection is experiencing a decrease and it has many reasons, among which the most important are: lack of stability of supplies of electrical powers and competition for this sector which comes from China and India.

*According to the two big groups: agricultural and industrial (non-food)* exports consist of:

- Agricultural products of the food industry 8.2% (a considerable weight for these years) with an increase in 2004 of 9% and which is considered the internal product with most of potential for the export.
- Industrial products (non-food) with 91.8%, which have been dominated in more than 60% by Facon, while the other part consists of: metal and its articles and information equipment 19% mainly from the local production and a part of the assembling of the information equipment, with an increase in '04 of 17%.
- Mineral products 5.2% (internal products, chromium mineral), bitumen, coal etc) and an increase of 38%,
- leather and its articles 2% (local production), with a fall of 4%,
- Wood and its articles with 1.6% (local production), with an increase of 9% etc.

*According to the destination country, the exports go in most of the cases towards the EU countries with 88.6% (dominated by Italy, Greece and Germany), where with these countries work is done through ordered material, with the countries we have Free Trade Agreements (region) there is realized 7.5% of the export (dominated by Kosovo, Macedonia, Serbia, and Montenegro), while the other part is done mainly with Turkey 1.7% (mainly different leathers), USA 1% (mainly export of sage) etc.*

#### *Potentials of products for export*

Among the main potentials and with comparing advantages compared to the other economies and markets of the region, EU and others, which make possible the increase of the volume and variety of Albanian exports are:

**The agricultural, livestock and agro-processing products** are a considerable potential for increasing the export figures. This sector has a lot of preferential products specifically from the markets EU countries, and a considerable part of the producing and managing capacities have not been utilized. In this sector a lot of fresh and processed products have a very specific taste and very much preferred by the foreign and local consumers. The Albanian exporters can make use of the opportunity of the time when the foreign market has a high demand for these products and offers or other competitors in the market are late in time with their products.

**Minerals** in Albania consist another potential, at the same time being considerable and guaranteeing not only the improvement and smoothing of the trade deficit, but also a sector for a steady increase of the economy in general, increase of employment, GDP and family incomes etc. With regard to the evaluation of the situation of minerals in Albania, it turns out that many minerals like: chromium, copper, nickel, biocides, and some other rare minerals like platinum, wolfram, gold etc, are in high quantities and percentages in our country. At the same time, with the increasing potentials are also the construction materials, already tested in export, like cement, lime, different decorating stones etc. Non-utilization so far is connected to many factors, among which: absence of investments and new technologies in extracting and enriching, knowing and contacting foreign markets, legal framework in privatization, utilization etc, which is incomplete and not clear.

At the same time, a potential here remains the considerable **water resources** owned by Albania, specifically under the circumstances of increasing needs and demands of the other countries for this product.

Another possibility to have a considerable effect on the foreign commerce indicators of Albania is also ***production with Fason*** in some specific sectors like: foot wear – shoes, confections, furniture, enchovies, IT equipment and assembling. Regardless of the very high world competition existing in these sectors, our country presents specific advantages, such as the geographic distance and speed of sending to big markets (EU), low cost of labor, and accumulated experience, population of young age, and capability to learn the new technologies and skills, improvements in the general infrastructure of the country, these being of massive consumption and continuous, which means that the demand in the market for them shall be steady.

In all the factors which are quoted above, as contributors to the export and as potential for the increase of exports, there have been included in a lot of projects, initiatives of not only general character but also specific and in determined fields. All these initiative affect not only the legislative aspect, but also the institutional, facilitating, promoting aspect.

#### *Measures foreseen to be taken in increasing the production and export*

In the forecasts and plans for the realization of the indicators of the external commerce in the upcoming years, and specifically in export and increase of the internal production of the Albanian economy, there have been foreseen and deemed to take some concrete measures and steps in the interest of the production and exports. Along with the measures of general character (indirect) there have been taken specific measures in special sectors and fields of the economic and social activities of our country, which are important and have their impact on the production and export. The following are some measures of direct character in the sectors of production, mainly exports.

#### *Legislative measures*

- Harmonization and the systemizing of the entire legislation which has to do with the production for export, financing and movement of goods, based on the directives and legislation of EU, and WTO, which for the export and movement of the goods have defined the specific rules and norms of productions destined for export.

- Harmonizing the legislation in the production, service and sale of all the products produced in the country in accordance with the EU etc, such as: agricultural products and agro-processing products, use of pesticides, treatment of animals, non-food products (for children and adults), productions of various household equipment and those of a scale of danger, in utilization of minerals, in utilization of properties and of the protection of the environment etc.
- Preparation and implementation of the legal basis which makes possible the setting up of institutions in the service and control of business and different products (financial, controlling certifying institutions, etc).

*Institutional measures (of financial character, quality, analysis, control, conformity)*

**Setting up and functioning of a Crediting Agency for Export**, which is evaluated as a financial institution indispensable for the development of exports. This institution exists in many other countries in the world (regardless of its form) and is considered an instrument of considerable impact in the field of export of each country. Thus a financial instrument of assistance to the local companies which to export and which has an impact in crediting and guaranteeing the exporting companies. It helps and incites the investors to invest in the production for export. it has an impact n knowing many international practices and providing assistance to the Albanian companies in knowing the international markets of many fields, paving the way for new perspectives for the products and services which are offered by the Albanian companies etc.

*Ensuring the grant schemes for the development of marketing of the products and services*

The general objective of the grant schemes is to support the expansion and development of the market of exports, for the products and services. The specific objective of this grant scheme is to promote the performance and competitiveness of the enterprises, exporters in international markets. Granting of these grants shall be done to the effect of assisting the exporting companies to make use of their possibilities to expand the export market for the products and services they offer. There shall benefit those companies which can not afford to pay for the marketing activities fully 100% with their own funds.

*The financial support in the form of grant to be ensured by Albinvest*

This financial scheme in the form of grant shall be implemented by Albinvest. It is a stimulating mechanism for the exporting companies, covering up to 50% of the costs of expenses of their for the implementation of strategies and programs of marketing for the products and services which they offer in the international market.

The consolidation and the setting up of the state and private institutions which deal with the evaluation and certification of the quality of the products and services, starting from the initial materials, conditions of production, manipulation, up to the circumstances of storing and consumption. In these institutions, there shall be included those: Metrology-Certification, Standards, Conformity, Accreditation, Laboratory and Microbiological Tests, Codification etc. All these institutions participating in the infrastructure of quality shall be evaluated as very indispensable to make possible and increase safety and chances of the Albanian products not only to go to export, but also for the internal market.

The establishment and consolidation of institutions and inspectorates making possible the registration, certification of the producing entities and different businesses in Albania. These institutions shall deal with: registration of animals, fruit trees, cadastre of land and its composition, registration and certification of establishments of livestock, farms, processing of food products, tinning of vegetables, fish, meat, establishments of exploitation of minerals, industrial production and products, and abiding by the environment norms, etc. These institutions and their information boost the safety, facilitate and make possible these products in the EU markets.

*Measures of consulting, organizational, information, infrastructural and marketing character*

The organization of seminars and programs for establishing a system of effective marketing and management of quality of the product, putting the product within the standards and norms required by the foreign market, establishment of the data base and exchange of information with the foreign markets, stimulation of the setting up of research offices, agencies and professional consultants for the business, providing assistance with regard to organization, management, marketing etc. Along with the

role of METE, a functional duty shall remain with the more specialized institutions and connected closely to this field: such as Albinvest, regional agencies of development of business, department of development of agriculture and food in prefectures, research offices, private consultants of business, various assistance projects, etc.

The establishment of Collection Centers for the manipulation, processing, standardization, packaging, originating, as well as supply-distribution in the retail market and export of the agricultural and livestock products, as well as construction of butchers', and treatment of the meat of livestock and poultry in the entire territory of the country (mainly in the villages based on zones) (Put differently the Catalyst Centers of the Agricultural and Livestock Production), which are deemed to be set up within 2008.

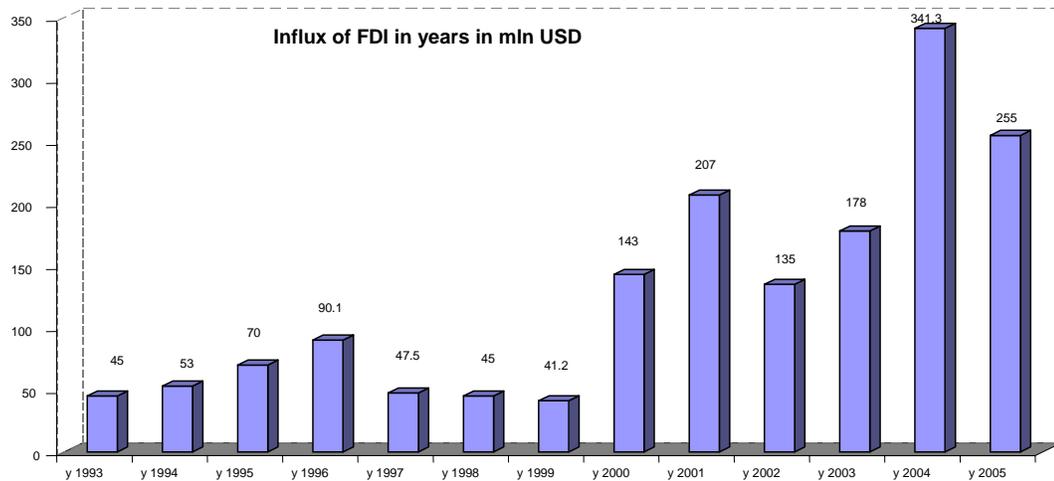
**Import of goods** in general is evaluated to be more stable in these there upcoming years and in the forecast for the years 2006 – 2007, there has been taken into consideration the pace of increase of 12% while for the 2008, it has been foreseen with 14%. In 2008 and in some of the net years, it is deemed that imports shall undergo an immediate increase, based even on a lot of reforms and facilities which are being provided with regard to investments in general and foreign ones (including here even the 1 Euro initiative etc), investments in the electro-energy sector etc. All these investments shall require the importing of the technologies and different equipment. Such an increase of import sup to 2008-2009 and dominated in machineries, equipment, some initial materials are considered with a very positive sense which shall bring abort in the following years to the immediate softening of the commercial deficit.

**Trade balance in the three following years** shall continue to be negative and with a high deepening pace in absolute value, since the expected investments shall continue to stimulate evidently the import of the machineries and equipment. In the general aspect of payment balance with abroad this kind of commercial deficit is not a negative sign and of concern, but on the opposite they are assets which increase the changes even more for the increase of production and export, as well as at the same time, we have to take into consideration in the case of foreign direct investments, we have at the same time influxes of entry of currencies in different forms by these investors.

## Foreign direct Investments (FDI)

### Development of the foreign direct investments in Albania

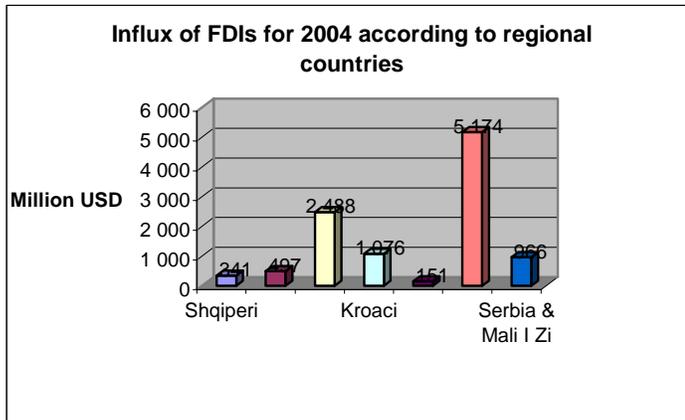
Although the influxes of foreign investments in Albania have increased continuously, they remain at very low levels compared with the Region. This, as a consequence of a negative succession of harming considerably the climate of business, due to the considerable administrative obstacles, spread corruption, regulating shortcomings, as well as the political and economic perceived risk of the country.



Source: Bank of Albania

The foreign direct investments in the recent years, as it can be seen in the above graphic have undergone a considerable increase and specifically during 2004, owing to the privatization of the former Savings bank, the influx of FDIs for this year reached the value of 341 million USD. For 2005, foreign direct investments to the effect of absence of privatizations decreased to 255 million USD.

With regard to the Region, Foreign Direct Investments underwent a considerable increase only in 2003, and within 2 years, owing even to big privatization, they were tripled, reaching in 2004 the amount of about 11 billion USD.

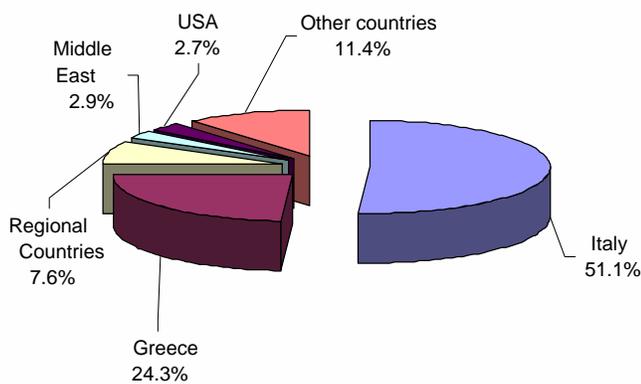


Source: Bank of Albania

Bulgaria and Romania are the countries which have absorbed above 70% of the influx of FDIs of the entire region for 2004. Only Romania for 2004, has FDIs equal to five other countries of the region taken together, reaching a value of more than 5 billion USD.

In the aspect of succession or origin, Italy and Greece preserve a prevailing position in the foreign direct investments in Albania. 51 percent of the enterprises of direct investment are with participation of foreign Italian capital and 24 percent with foreign Greek capital. Next on the row is the Turkish capital (4 percent) and the American capital (3 percent). In the meantime, we find out an opening towards the middle east, accompanied with the increase of the influx of the capital from these countries.

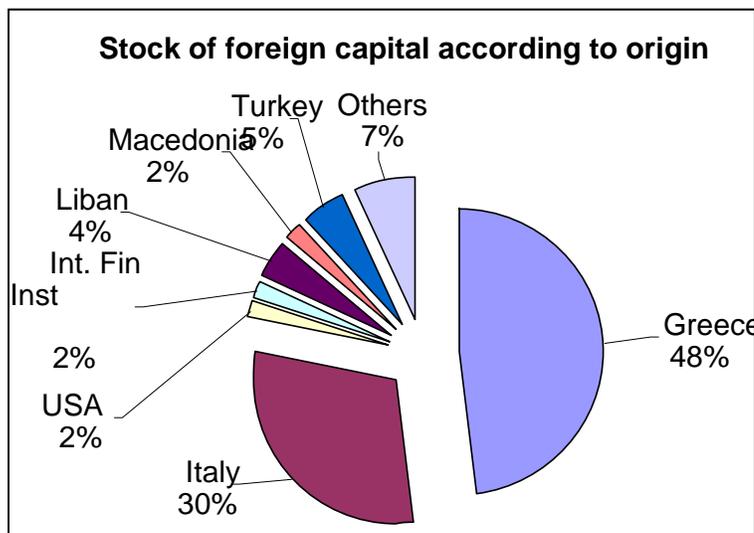
**FDIs according to countries of origin**



Source: Bank of Albania

With regard to the stock of foreign capital, in the end of 2004, not less than 82 percent of this stock was on behalf of the European Union countries, with the main investors Greece (with 48 percent of the stock of foreign capital later 2004) and Italy (with 30 percent). Greece and Italy have increased their presence in the stock of foreign capital in the country. The short geographical distance of Albania to these two countries, as well as a strong economic cooperation with EU are among the main reasons for the prevailing of the investors from these countries.

The increase of the stock of foreign capital over the years seems to have been more evident with regard to the Greek capital. The latter by the end 2004 is evaluated to be 18 billion Lek out of 7 billion Lek in 2001. The Greek capital is concentrated mainly in the communication sector (68 percent) which has come about as a result of the involvement in privatisations during 2000-2001 and wholesale trade (13 percent). Over the last years, there has faded somewhat its presence in the clothing industry. The Italian capital for the observed period (2001-2004) has preserved its representation at 60-65 percent with investments in processing industry. In end-2004, the stock of Italian capital is evaluated with 11.3 billion Lek out of 3.8 billion Lek for 2001.

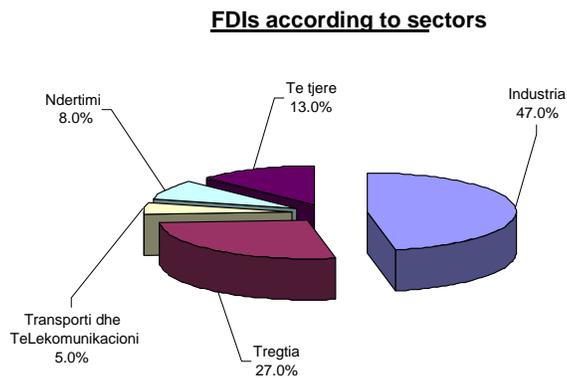


Source: Bank of Albania

With regard to the geographic distribution of FDIs in Albania, there is seen their concentration in Tirana (52%) and in the western part of the country. The zones where FDIs have concentrated are: the zone with the highest revenues and developed

infrastructure. The internal central part and the eastern-northern part of the country are the less interesting for the foreign investors. In addition to the undeveloped infrastructure of these zones and the missing marketing, an important role there is deemed to have been played the internal and external migration, which makes more difficult the qualified labour there. However, a considerable percentage of FDIs, are in the border districts with Greece like Korca and Gjirokaster.

The sector distribution of the foreign direct investment in Albania, indicates a high scale of concentration in the processing industry and field of trade.



*Source: Bank of Albania*

The investments in industry have aimed the sectors of high concentration of labour and not those of concentration of capital or technology, leaving narrow room to the role of the foreign investments in the transfer of technology and boosting of technological capacity of production in the country, minimising the positive side effects of these investments in the other sectors of production.

### ***Problems encountered by the sector***

Low levels of FDI in Albania may partially attributed to:

(i) problems of ownership on the land and conflicts, bureaucratic procedures for the registration of the ownership titles, for the approval and granting of construction permits have always created a barrier for the foreign investment.

- (ii) slow process of privatisation, medium and big enterprises of the state in the industrial sectors with intensive capital and strategic sectors such as energy, telecommunication.
- (iii) Perception of a political and economic risk of the country from the potential foreign investors.
- (iv) Poor functioning of the public institutions, corruption, trafficking and poor implementation of law.
- (v) Absence of efficacy and high cost of infrastructure (transport, energy, water), as well as absence of industrial parks for FDI oriented by export and tourism. Although there exists a law providing for the establishment of free zones and industrial parks, so far in Albania there has not been created any free zone or industrial park.
- (vi) Insufficiency of financial, banking, non-banking services (low level of crediting, low quality of financial services for international commerce, high rate of interest, high requirements for collateral, services of insurance companies etc).

**Albania as an attractive country for FDI, SWOT analysis**

<p>Possibilities</p> <p>European Integration</p> <p>Regional Economic Integration (Cefta)</p> <p>Broad Diaspora</p> <p>Reform of Education System</p> <p>Reconstruction of Infrastructure</p>	<p>Strong Points</p> <p>Geographic short distance to the majority of regions and markets in Europe</p> <p>Qualified labour with low cost</p> <p>Labour culture</p> <p>Mineral resources</p> <p>Natural and tourist attractions</p> <p>Acceptable legal environment for investment</p>
<p>Weak points</p> <p>Small local markets</p> <p>Low income per capita</p> <p>Poor infrastructure</p> <p>Outdated industrial technology</p> <p>Poor financial sector</p>	<p>Risks</p> <p>Competition of neighbouring countries</p> <p>Salary increases and lossing of the competing advantage of the low cost of labour</p>

## **Objectives**

Increase of the influx of FDI through the acceleration of the process of privatization and concessions; process of privatization and specifically that of the strategic sectors of the economy shall be a main source of the increase of FDI in the short and medium term. In the period 2007-2008, there shall be concluded the privatizations and concessions in the electro-energy sector, in the sector of oil-gas, in the sector of transport and SMEs.

The increase of the influx of FDI in separate sectors such as in the industry of shoes and clothing, business of services and construction materials. With reference to the sector researches performed with the assistance of CARDS program, the project "Support for promotion and regulation of commerce" turned out that Albania has a competing advantage in these sectors, which have an immediate need for promoting activities. the increase of investment influx, even in the potential sectors, such as in the mines sector, gas and oil, agro-business and tourism have also been subject to some observations from the experts of this project, but the promoting activities in these sectors have to be carried out only after the performance of the pure sector researches on the possibilities of investments.

The strengthening of the capacity of promoting and implementing capacities of the strategies and governmental policies in the field of inciting business and investments; By the law no 9497, dated 20.3.2006 there was set up the Albanian Agency for Business and Investment and so far there has been done its restructuring as a consequence of merging three agencies (agency for promotion of foreign investment, for small and medium enterprises and that for the promotion of exports). To the effect of implementing the politics and strategies in a more efficient way it is indispensable to strengthen this agency wit human resources (recruitment and training of staff) as well as financial resources.

The setting up of industrial parks with the necessary infrastructure and services decreases costs of investment in a considerable way in a country like Albania where the problems of ownership and infrastructure remain an obstacle for the absorption of foreign investors.

In the period 2005-2009, half of the needs for investment of Albanian economy shall be covered by FDI; The implementation of the program of government 2005 – 2009, strengthening of the regulatory capacity on the market, establishment of competition and elimination of informality in economy, guaranteeing of the ownership titles and solution of the inherited conflicts, liberalization of procedures for entering the market and a more quick integration with the regional markets and those of EU shall make possible that in the four upcoming years half of the needs for investment of the Albanian economy be covered by FDI.

The improvement of the image of Albania as the most attractive country for investment in the region every promoting activity to the potential investors would fail if it is not known in advance the perception of the image of the country to the latter. Although there has not been a research to define the image of Albania in the world it is more than clear that in this respect there is a lot to be done specifically in the neighboring European countries such as Italy, Greece, but also Austria and Germany, the regional countries with which the business relations are more intensive and of reciprocal interest.

### **Measures to be implemented**

The acceleration of the process of privatization as a main source of increasing FDIs in short time periods (within 2009)

Drafting and approval of the new law in concessions (by 2006);

Training of the staff of Albinvest to the effect of developing the capacities in the function of reaching the objectives of promotion and service to the investors and other activities which serve for the strengthening of the capacities of this agency (within the first half of 2007);

Promoting activities in countries like: Italy, Germany, Austria for the promotion of the industry of shoes and clothing, services business, and construction material in accordance with the program determined in advance.

Identification of markets and possibilities of investments in potential sectors such as that of electro-energy, mines, gas and oil, agro business and tourism (within 2007).

Improvement of business climate: simplification of procedures for registration of business, simplification of licensing, simplifying the customs and tax procedures, solution of the problem of land and construction, improvement of the administrative review, reduction of the informal economy shall have a positive effect in increasing investment in the country.

### **Establishment of industrial parks**

Guaranteeing the infrastructure of business is a very attractive element for the investors, specifically the physical infrastructure, connected to the system of transport, energy, technologies of communication and information. Modernizing of such an infrastructure for the conditions of Albania is of course a long term process. One of the priorities in this respect and which is going to have a quick impact is **establishment of industrial parks**. In cooperation with the authorities of local government there shall be worked for identifying the industrial zones considering this as one of the most important tasks in the plans of the development of the territory. Being aware of the missing funds, with the support of foreign donors and contribution of private sector, businesses will know to orientate themselves for their investments.

In this framework, it is indispensable the identification of the appropriate strategic zones, about 30-50 ha or more and later through the private-public partnership or through the establishment of a development fund with the support of the banking sector, and in cooperation with the local authorities and private entities there has to be established the first industrial park (time period: within 2007).

Identification of groups and countries where to act for the improvement of the image of Albania as well as the determination of the respective activities (time period: within 2007).

Services to the existing investors as source for the generation of new investments (aftercare service).

### **Specific programs/activities**

### **Initiative “Albania 1 Euro”**

Albania 1 Euro is a project aiming at encouraging new investments in production and in strategic sectors, encouraging the foreign and local investments. This project shall be oriented in Priority Sectors and Priority Regions and it finds its main support in offering the state owned property (assets, natural resources, economic activities, fees for public services etc) with 1 Euro.

The essence of this initiative consists of a whole legislative and institutional reform where for its implementation there is being worked for drafting a concrete program of measures to the effect of inciting investments in the production and infrastructure sectors. The interventions have been concentrated in renting the sites, storing houses, bases which are public property, towards a symbolic rent, in privatization with priority of all the state assets where there are carrying out their activity the companies involved in productive activities in total and export specifically, as well as acceleration of the registration of the process of immovable properties and the process of restitution and compensation of the properties.

### **Privatisation of state owned companies**

The value of assets and services of the main enterprises which are presently state property and which are on the way of privatization within 2007, consists in the quick privatization of all these assets, but being closely connected with the process of restitution and compensation of properties to the legal owners.

At the same time the process of privatization is closely connected to some initiatives launched by the government to increase considerably the investments, offering the state property with very attractive prices in favor of investments.

Presently, zone of the biggest state companies like Alb-TeLekom, Armo Sh.A, INSING-Sh.A, KESH-Sh.A distribution part etc, are on the way of complete privatization.

**Privatization of Albtelecom Sh.A** is foreseen to be done within 2007 and the revenues in the budget is deemed to vary within 10-15 billion Lek.

**Privatization of ARMO Sh.A**, for this company the selection of the privatization form is in process, granting in concession. In the event of privatization of this company it is foreseen that in the second half of 2007 or the first for 2008 and it is evaluated to be 10.7 billion Lek.

**Privatization of the company of Electrical Distribution (KESH)**, with reference to the program for restructuring and privatization of KESH Sh.A, the process of privatization of the part of the company for the distribution of the electrical power is expected to take place within 2008. The amount of revenues can not be foreseen for the moment, since it is expected to be done the division of this part from KESH Sh.A.

At the same time, with reference to the changes in the law on concessions, in the spirit of these changes there has been foreseen the granting on concession of many hydropower stations (HEC) which presently exist and of the new constructions for the production of ht electrical power.

### **The Administrative Reform**

The Albanian regulatory environment has reflected problems with regard to the quality of the legal framework having an impact on the development of business this being accompanied even with high cost for its development and enhancement, inciting the latter to remain in the informal market. This has affected the competition ability of the Albanian economy reducing even the scale of attraction of foreign investors.

For this the Albanian Government has undertaken a comprehensive regulatory reform which consists a dynamic and all-inclusive program to create an attractive regulatory environment for new local and foreign investments. Upon the order of the Premier Nr 170, dated 31.10.2005, there was set up the Task Force for steering and monitoring this reform, which is presided over by the Premier. In the framework of this reform, there have been created even technical groups, which are presided over by the deputy ministers, in accordance with their coverage fields. These technical groups under the authority of the Ministry of Economy, Trade and Energy have drafted the Plan of the Regulatory Reform Action, approved upon Council of Ministers Decision 517, dated 15.3.2006. This action plan intertwines the short term measures for reducing the

administrative obstacles to the business with the long term objectives to be reached by the regulatory reform.

Novelties of this reform:

- Increase of level of its steering from the Minister to the PM,
- Focusing not only on improvement and elimination of the existing administrative obstacles but also in not allowing the creation of new obstacles. To this effect there shall be worked for drafting and implementing of (i) good governance principles<sup>8</sup> and (ii) principles of regulatory quality;
- Establishment of the system for the management of such reforms and this complex. This is going to guarantee for the reform to be long term and steady.
- The Task Force presided over by the PM has established the necessary institutional framework which is going to make possible the coordination and management of the regulatory reform. So far, there have been reached evident results with regard to the improvement of the field of the registration and licensing of business. At the same time there has been institutionalized the dialogue and consultation with business continuously for all the policies launched in the framework of this reform. In these round tables, in addition to the experts involved are also all the institutions set up in the framework of the Regulatory Reform.

**Registration of business** is one of the directions of Regulatory Reform for the improvement of the climate of business, as a priority commitment of great impact in the business activity. The Objectives of the Government in this respect are of a short term and long term nature.

**Short term are:** (i) Emergency improvements of organizational nature for the good functioning of the Office of commercial register, (ii) improvement in the respective legislation for facilitating the administrative procedures for shortening the registration time periods and equal treatment of foreign and local business, meeting of reciprocal obligations for notifying the respective offices of taxation and commercial register.

*In registration of business, there has been foreseen the respective legislation, as well as there have been taken the measures of the administrative nature. Thus it has been achieved:*

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- Shortening of the time period of registration of a business from 30 to 8 days, (ii) improvement of the procedures of forwarding the request, (iii) taking of measures for avoiding the duplication of the personal data of managers of different commercial companies.
- Equalizing the fees for the registration of business as well as performance of the notary acts for the local and foreign businesses.
- There has started the work for the entire computerization of the commercial register, involving to this effect about 40 persons with temporary contract. The process of computerization is foreseen to end later June this year.

**In the long term**, there is aimed the improvement of the quality of service and efficiency in the course of offering this service as well as reduction of corruption for registering the business. This is going to be achieved through the setting up of a completely new model, which is going to realize the registration of business at one time.

In a three year period, there shall be done functional the National Business Centre, which shall serve as a one stop shop for the registration of business, implementing the project on Behalf of Millennium Challenge. These measures shall bring about the reduction of registration days from 47 days into 1 day, reduction of the percentage of the business paying bribery during the registration and offering the on-line services.

In accordance with the Action Plan for the Regulatory Reform, in the system of licensing, the work shall be done in two phases: (i) complete review of the licensing system for reducing the existing administrative obstacles, (ii) detailed review of the legal framework for every sector determining the present status with regard to the compatibility to Acquis Communautaire as well as identifying the measures for their harmonization.

So far there has been amended the legal framework for licenses in the mining, oil and public work sector. At the same time there have ended the analysis in the transport sector and work is being done for the health sector and also for the preparation of the respective reports. Until later 2006 there is foreseen to end the review in accordance with the first phase objectives.

In the long term, the licensing aims at simplifying and harmonizing the licensing procedures in all the sectors making use of the principles of good governance and such experiences as Guillotine, administrative simplification, self-declaration principle and self –certification etc. The Albanian government shall aim at providing the services

for the business according to the experiences of one stop shop, evaluating the OECD for licensing.

Relying on the Articles of SAA on the freedom of establishment, Albania must, upon the entry into force of the agreement, guarantee not a less favorable treatment for the companies from the EU countries, same as the treatment offered to the local companies or companies from their countries. To this effect, there has been eliminated the discrimination. At the end there can be said that work is oriented in accordance with the above mentioned objectives of establishment to guarantee the performance of obligations in accordance with SAA.

#### **4.2 Financial Sector Reform**

In the period 2003-2005, the banking system in Albania experienced some evident achievements with regard to the increase of the volume of assets, increase of banking products and increase of the number of the banks and their network. In the course of this period, the assets of the banking system were increased by 157.3 billion Lek, or 13.5 percent as annual average. In the years 2003, 2004 and 2005, there were licensed three other banks, increasing the total number of banks to 17.

The increase of the banking activities was highlighted through the evident increase of their loan activities, total increase of assets and expansion of the bank networks in the other regions of the country, where services were missing earlier. In addition to this, the services of the client have gone through the considerable evolution through the final installation of the electronic terminal, accompanied with an increase in the circulation of the number of electronic cards.

In the end of 2005, the number of bank branches reached 127, while the number of the banking agencies reached 113. The number of employees in the banking industries was increased approximately by 22 percent per year. Such developments indicate a perception improvement of the investing environment in Albania by the banks.

The banking system reports a positive increase result from 4.45 billion Lek in 2003 to 6.60 billion in 2005. The main indicators, profitability, return on average assets (RoAA) and return on average equity (RoAE) have indicated an increasing tendency during this period, indicating a qualifying improvement in the profit making banking system. At the same time, regardless of the high profitability of the capital, there is no evidence on

the distribution of the profit among the share holders. On the contrary, retaining the profits support the activity of the bank as a capital injection.

The credits towards the economy have experienced a quick increase. During this period, the unpaid credits of the banking system reached 88.35 billion Lek or 48 percent as an annual average. The highest percentage of the increase uncovers the extension of the loans from the banking system, such as the event of the previous Savings Bank, which was privatized by the International Group Raiffeisen.

The indicator “unperformed loans in unpaid loans (net)” which measures the net coverage of the credit risk, indicates low risk levels and even a decreasing tendency. The tendency has been influenced by the quick increase of the new credit percentage (rate).

The privatization of the Savings Bank has improved the service standards and it has brought competition in the banking system. At the same time, this process marked the end of the process of privatization of banks with 100% of the state owned capital. The Albanian government has sold its own shares to the Italian Albanian Bank, and it is going through the same process for its shares of United Bank of Albania.

### **Regulation**

The medium term strategy of Bank of Albania has included the priorities of the regulatory and legal structure of the supervision, for the banks operating in Albania. The changes in this structure shall aim at supporting the integration process and are directly connected to the implementation of “National Plan for implementation of SAA”.

During May 2006, Bank of Albania prepared the draft law “On Banks in the Republic of Albania” which was approved by the Council of Ministers in June 2006 and presently it is being discussed in Parliament. This draft law relies on the obligations which stem from the Stabilization and Association Agreement and Basel Principles.

The draft law on the banking provides for the main conditions for the establishment of banks and financial institutions, granting and revoking of licensing, requirements on the capital, conditions for carrying out the activity and the criteria for the supervision. The majority of the Provisions of the Directive 2000/12/EC have been adopted in the draft law in question.

Technical instruments of careful supervision provided for by the draftlaw are:

- **Own funds:** According to Article 59 of the draft law for carrying out the activity in a safe and steady way and for meeting the obligations to the creditors the bank keeps the regulatory capital at a sufficient level. The structure, the constituent elements, the method of calculating the regulatory capital shall be determined by subordinate legal acts approved by the Bank of Albania.
- **Payment rates:** In Albania is recognized as the sufficiency norm of the capital. The sufficiency ratio of capital as a general rules is not less than 12 percent. Bank of Albania is entitled to determine a sufficient ratio of capital higher than the above mentioned, if it finds out that a bank carries out or is involved in an activity or high risk. The sufficiency ratio of capital is calculated on individual or consolidated basis.
- **Large exposures:** The exposure of the bank to a single client or related clients shall be restricted to a maximum of 25% of the own funds. All the large exposures (equal or more than 10% of the regulatory capital) shall be reported to the Bank of Albania. If the person or group of persons related is the mother company, the branch of the bank or one or more branches of the mother company, the exposure shall be reduced to 20%. At the same time the Bank shall not undertake exposures which taken together exceed 700 percent of the regulatory capital.
- **Supervision on a consolidated basis:** The supervision of the banking group is provided for the first time in this draft law. With reference to Article 82 of the draft law BA supervises the banking groups and financial ones on the basis of consolidated financial statements and supervision reports. The provisions of the draft-law determine the existence of a banking group, administration of risk in a banking group, preparation and forwarding the financial consolidated statements of the banking group as well as notifications on the banking group and the ensure group (regardless of the activity of the company consisting it) as well as the authority of BA to ask for the consolidation of separate lines of the activity of the group.

The review of the regulatory structure in the medium term period, for the reasons of the new law "On banks in the Republic of Albania" connects the implementation of the reviewed principles of the Basel Committee for an effective control and new concepts

included in the new Basel Agreement shall be under the focus of the strategy and its priorities. Thus, some of the modifications in the regulatory structure shall be:

- Regulatory drafting on the transparency of banks. The transparency of banks with public and supervisory information shall be considered as promoter of safety and stability of the banking system. This is an important element included in the third column of the new Basel Agreement.
- Regulatory drafting on the credit consumers, to the effect of protecting the consumers and depositors. This is going to protect the Albanian consumers and it is going to regulate better the activity of consumer credits and housing credits, specifying the regulatory structure of this activity further to the instructions of Council of Europe and better implementation of these instructions in this field.
- The strengthening of the control of the banks and conclusion of the supervisory structure. The conclusion of the regulatory structure shall be accompanied with the conclusion of the supervisory structure (controls on the spot, analysis and reciprocal cooperation and agreements). This process is at the same time accompanied by the opening of the new branches outside the territory of Albania.
- The inclusion of the operating risk in the sufficiency level of the capital. The first column of the new Capital Agreement with regard to the re-conception of the risk of the credit and the evaluating effects on the sufficiency of the capital of the bank, includes making use of the additional necessary capital dedicated only to the operating risk. The changes included in the Agreement are connected to the fact that the necessary capital to cover this risk shall not be included in the ratio of 8% of the sufficient capital, but it is going to be divided and calculated with one of the methods ensured in the regulatory package. The amendment shall be done in accordance with the requirements of the existing capital;
- The preparation of the necessary amendments in the procedural and regulatory structure for aiming at implementing the Standards of the Financial International Report.

## Financial Sector Reform Program

In the course of medium term period 2006 – 2008, the Albanian authorities shall continue with the further developments of the reform in the financial system.

The successful development of this reform shall ask for the involvement of some institutions, among which the Bank of Albania is more interested in this process. The reform of the banking system shall aim at establishing an effective competition and of the financial market for the economic development of the country. The reform of the financial sector shall focus on the following aspects:

*Implementing a licensing policy of the selected types*, providing priority to these banks which have the possibility of stability and success in the banking activity, preparation of the final regulatory structure for the licensing of banks specialized as development banks, investment banks, as well as for the branches of foreign banks.

*Strengthening the supervisory and regulatory capacities of the Bank of Albania* during the further development of the Supervision Department; approximation of banking legislation with the European legislation; conclusion of the process of transfer to the supervision with risk orientation and preparation for the implementation of specific standards in the new Basel Agreement, as well as improvement and control of powers.

*Establishment of Credit Register in the Bank of Albania*, which shall increase the scale of information of banks about clients; it is going to diminish the risk in the process of loan taking and shall provide for more security of clients in the banks.

*Encouraging the full competition* in the financial system, as a part of the joint efforts with the Ministry of Finances and the ministry of Economy.

*Strengthening the supervision on the financial institutions which have not been licensed by the Bank of Albania*. This shall be achieved with the creation of the Financial Supervisory Authority, from the merging of the Insurance Supervisory Authority, Securities Commission and Inspectorate of the Private Institutes of Supplementary Pensions. This authority shall be a mechanism for increasing the financial non-banking sector and for a better supervision of this sector.

*Establishing the collateral credit schema* as an institution which shall assist in encouraging the loan taking towards the economy, development of the banking system, close connections to the other part of the economy and improvement of the mechanisms of the transmission of banking intermediaries.

Strengthening the powers of Bad Asset Resolution Trust (BART), as part of the attempts for strengthening the financial discipline in the market, increasing the requirements for reporting and transparency of this agency.

*Review of the Law “On Bookkeeping”* for the incitement of a comprehensive meeting of the International Accounts Standards.

*Privatization of insurance company of state owned capital* shall assist in the increase of this competing market and in the extension of active participation of this segment of this financial market in the economic life.

*Strengthening of the powers of the Authority of the Prevention of Money Laundering* and close cooperation with the Bank of Albania. As supervisory and regulatory authority, the Bank of Albania is interested to have the banking system in accordance with the effective rules and it is protected from being involved in illegal activities.

### **Strengthening of legal and regulatory basis**

Strengthening of the legal and regulatory basis in its composition is an important object for forecasting and minimizing the legal risk of carrying out the activity of the Bank of Albania, in reaching the primary objective, for e.g. maintaining the stability of prices.

In reaching this objective it is necessary to take the measures of legal and implementing character.

The legislative measures include the drafting of laws and instructions or improvement of the effective acts.

As it is provided in the National Plan for implementing the SAA, the legal structure and law shall be strengthened in drafting and approval of the draft law “On regime of currency researches” (2007-2009).

The draft law "On regime of currency exchange" shall establish the legal framework for liberalizing the capital account, in accordance with the commitment undertaken in Articles 61 and 62 of the SAA. Presently, the acts in capital account and current account are regulated in the Standing rules "On currency related activities" approved upon the decision 64, dated 30.07.2003 of the Supervisory Board of the Bank of Albania.

Considering the minimizing of the risk of the law, regulation of the provisions of legal services by the Legal Department of the Bank of Albania and other organizational structures is considered as an indispensable measure.

This rule shall focus on the definition:

- Procedures previous legal opinions;
- Procedures on the supervision of laws and instructions of Bank of Albania and Personnel,
- Standards connected to the issues and ensuring of legal opinions connected to them, as well as procedures for supervising their implementation,
- Maintaining of registers on legal opinions and legal data to the effect o of their unification for similar issues.

At the same time the regulation of the legal services shall make possible the formatting of the legal opinion of the Bank of Albania, as a regulatory entity in the banking system and consolidation of the banking law, which shall be strengthened as a consequence of ht reputation of the Bank of Albania.

The implementing measures which might have been undertaken have been of a organizational and preparatory character for completing the draft-acts, among which we mention:

- Establishing the working group for their drafting,
- Benefits in the country and foreign experiences in the fields where draft acts are aimed at being regulated,
- Organization of training workshops.

At the same time during 2006 there was made possible the unification of the supervision of the financial non-banking supervision, under the same authority called Authority of Financial Supervision. This activity was jointed by Securities Commission, Insurance Supervisory Authority and Private Pensions Inspectorate. In order to support the independence of this new institution, the director and the steering board of the institution are appointed by the Parliament, who have been appointed on 27.09.2006. The council of Ministers has approved the structure of this authority with two main departments, that of licensing and monitoring, and the inspections department. With the assistance of the World Bank, Ministry of Finances is reviewing the legal framework o insurance, at the same time with the assistance of GTZ there has been finished the first draft of the law on securities and public offer.

### **4.3 Labor Market**

#### **Policies**

The state policies of employment include measures for encouraging employment (Active policies) as well as providing the support through financing (passive policies).

#### **Active policies of labor market**

The active policies of the labor market include: (i) employment services, (ii) programs of opening new jobs, (iii) programs of professional training.

The active policies of employment in Albania were for the first time presented in 1995 in the law no 7995, dated 20.09.1995, „On inciting employment“ establishing the first basis for a package of programs such as: (i) mediation for employment and profession, (ii) advice for employment and profession, (iii) professional training, (iv) programs for inciting employment etc.

The main objective of the employment policies is the support of job seekers in finding an appropriate job. The employment policies are an important means for the improvement of the situation of the labor market, but however, they have a limited impact in decreasing unemployment. This comes as a result of some factors in the labor market which are connected to the fact that the policies of the labor market are expensive and they require people to implement them.

## **Employment services**

The employment services include the activities: (i) information on vacancies, (ii) mediation in employment, (iii) advising and orienting for jobs and profession.

The public service of employment in the labor market shall be implemented by the National Service of employment (NSE). The National Service of Employment is a public autonomous service, with the status of a state central administration which is responsible to the Minister of Labor, Social Issues and Equal Chances.

Despite the progress with regard to going over from passive to active policies the fact that the employment services should be oriented towards controlling and improvement of the employment market is evident. Presently, about 47% of the total number of employees in the Employment Services work and offer services for 149 000 job seekers as unemployed people registered with the registration offices, while in the EU countries this percentage is at the amount of 62-65%.

In this context the scope of NSE for 2006-2009 is improving the ratio of services employees from 47% to 55%, compared to the auxiliary personnel.

The improvement of the level of the Public Service of Employment in Albania has been subject to analysis of the CREP report compiled by ILO and Council fo Europe in 2004. Recommendations of the report are focused on:

*(i) Improvement of relations with the business, commerce chambers and the development of the labor fairs.* For the implementation of this recommendation in the framework of the Strategy 2006 – 2009, the expected result is the realization every year of an annual meeting at regional level with the participation of the Employment Office, representatives of Business, Commerce Chamber, Local Authorities to present the situation of the labor market and professional training at regional level. Another result which is expected are the employment fairs in 6 pilot regions during 2007 (Tirane, Durres, Vlore, Fier, Korce dhe Shkoder). The extension of this experience to 6

other regions in 2008. Starting from 2009 and on, the holding of employment fairs has to be done permanently.

(ii) *Extension of the training of the staff focused in improving the capacities of the staff to offer individual consulting, competence and evaluation of needs, and follow up of the process for the persons registered in NSE.* This is true for the vulnerable groups, concerning the social and employment exclusion.

(iii) *Boosting the role of the social partners in all the labor levels of the National Employment Service (drafting, implementation and monitoring of policies and programs) etc.* Boosting the role of partnership shall be realized through the amendment of the legal basis to improve the ratio of representation in KAT in favor of social partners.

Establishment of a qualitative system of service makes indispensable the following:

a) *Establishment of a computerized information system of employment services.* Although there have been realized some pilot schemes, through the assistance and support of various projects, such as that of the world Bank, UNOPS, ESCO Marche, still NSE does not have a steady information system on the labor market. For the realization of such a service NSE is presently implementing a project with the National Board of labor Market of Sweden with the title "Efficient Employment Services in Albania" with the financing of the Swedish government. The main object of this project is the establishment of a computerized system concerning vacancies and the data base of unemployed job seekers having as an option even the data base of employers. More about the development of IT in the system of SHKP shall be dealt with in par 3 under the topic "IT development in Employment Services".

b) Initial and continuous training of the NSE. During 2001 – 2005 the training of the staff has been done specifically in close partnership with the national Agency of Employment of France, with the Albanian administration training center, but mainly this has been done only with the staff at the central level and in some pilot offices, while the level of training at local offices is still very poor. The strategic objective for 2006 – 2009, in the field of services of employment services is the modernization of services, transforming NSE continuously from an institution offering administrative services to an institution offering services to its two main clients: unemployed jobseekers and business.

For the realization of this objective there is needed: (i) to strengthen and develop institutionally the system of employment services, (ii) establishing a modern and unique of employment services in all the country through the improvement and development of the work method and managerial capacities of the staff, (iii) increasing employment and decrease unemployment through the implementation of active policies of employment, (iv) to establish and develop strong relations of partnership with other actors operating in the labor market specifically with the social partners.

Sub-objectives which have been set and are being implemented for the realization of these main objectives, there can be grouped as follows:

*Establishment of a modern and unique system of the employment services allover the country through the improvement and development of the working method.*

- a) Unification of the employment services and raising of the working level of the specialists in the work with the clients, focusing mainly in the local employment offices to upgrade them at the level offered at the Office of Registering Unemployment.
- b) Review of capacities, distribution and geographic extension of the employment services. Upgrading the Employment Offices and number of specialists performing services with the clients and regulation of the ratio between the service employees and other specialists, in favor of the former. (Objective is passing over from 47% to 55% the ratio of specialists working directly with the clients).

The strategic objective with regard to this issue is the management with more efficiency of the existing human resources considering the possibility of opening the Services Agencies in those Municipalities where the level of population and unemployment makes this indispensable.

- c) Further improvement of the monitoring and evaluation of services of employment. This shall be realized in a more transparent way after the installation of the Data base of Vacancies and Register of Jobseekers.
- d) The qualitative increase of the short term research in the Labor Market where there is included a detailed description of the situation of the labor market in all the components it contains; a forecast of its development which is going to contain the risk of unemployment, tendencies of employment, needs for training. Based on

these, there shall be foreseen the necessary measures for further intervention with the labor market.

- e) At the same time starting from 2004 in accordance with CARDS project 2002, there has been performed the medium term research of the skilled required in the labor market. Based on the methodology used by CARDS program, this research shall be performed by the employment offices every two years.

*Establishment and development of the partnership relationship with other actors in the labor market*

- a) for increasing cooperation with business, being partners in their activity, employers and the employment offices have their rights and obligations, which they have to develop for the improvement and interventions into the labor market.
- b) Cooperation with Universities, INSTAT, Social Partners, research institutes and different donors shall attract more attention for researches and applications in the field of labor market, boosting of capacities of developing the human resources and professional training.

*Developing of IT in the services of the employment as a key factor for improving the quality of services.*

The general infrastructure of IT today in NSE and in the Employment Offices is completely insufficient and it does not have any central administration with regard to the IT equipment, which means that there are different conditions in different conditions. There is no specific separate budget for IT. This is the reason why one of the short term objectives of this strategy is the establishment of a computerized system of information on labor market. The introduction of a technological system of information for supporting the information of labor market requires among others even the improvement of the quality of collected data from the investments and employers, since very often these data or information are not sufficient or reliance.

In this context, for the development of the IT system SHP is implementing the project with the title "Efficient Employment Services in Albania". The expected result of the development of the system of IT in NSE shall be" Establishment of the data base of vacancies, Data base of unemployed jobseekers until later 2007 in the Central Offices

of the National Services of Employment, in the pilot regional offices of Tirana and Korca.

The main output of the implementation of the this computerized system shall be: (a) better services for the unemployed job seekers, offering to them a wide range of employment offers at country level (information system to access Internet), (b) better services for the employers, ensuring appropriate candidates for their vacancies.

The strategic objective for NSE for 2006 – 2009 is the extension of IT system to all the Employment Office in the country. This shall be realized through the eventual support of the CARDS funds (2005-2006) of EU and with funds made available by the Albanian Government.

### **Private services of employment**

The main aims for the improvement of the situation of private agencies of employment in the labor market are:

- increase of cooperation with the public employment services,
- stricter control at the moment of licensing, to the effect that those which are licensed be capable of carrying out the services they have to;
- in cooperation with ILO/migrant project they have to set up the forum of private agencies of employment to the effect that these agencies adopt a code of ethics and exchange their experiences. In this forum, there shall be representatives of public services for orienting and exchanging the experience with these private agencies.

### **Employment encouraging programs**

The main aim of these programs is: (i) opening of new jobs and decreasing of unemployment, (ii) professional training of unemployed jobseekers specifically in the zones where the training capacities are missing, (iii) support to the enterprise for enhancing its activity and make a better selection of the work power, (iv) direct encouragement of employment for a part of the trained people, (v) minimizing the illegal employment, (vi) involvement into these programs of unemployed jobseekers beneficiaries from the support schemas to the effect of decreasing the costs of these

programs, (vii) encouragement of employment of young people and specific groups of unemployed.

### **New programs in the labor market**

*Professional practices* shall be a new program in the labor market. This program shall focus on the category of young people who have just graduated from the university or high school, in the country or abroad and are unemployed, as a consequence of the missing professional experience. For this reason, these young people shall be included in professional practices programs (internships) in enterprises or institutions, be those private or public. the young people shall have the possibility to get the necessary experience to have later a long term employment.

The state/public institutions shall receive the unemployed jobseekers who have just graduated. While the latter shall receive a financial support and the 6 month period shall be considered to be an insurance period for the effects of age, family and invalidity pension.

*Program for the disabled persons (LAP)*. The aim of this program is that in accordance with the law for encouraging the employment law (Article 17) regulate the obligation of the employer to employ LAPs and in case he does not do this pay to the fund of NSE a minimal salary for every person he has not employed.

The collected funds shall be used for the opening of new jobs for these persons. The forms of support shall be: (i) financing at the level of minimal salary at country scale and mandatory insurance for each employee. This is going to help the employers that initially to take these persons free of charge in the premises of enterprises, institutions for a certain period and later on, after they have become able, to keep that job. (ii) subsidies for adjusting or equipping the work station. This support is provided in cases when the enterprise/institution has the possibility to employ LAPs, but it needs to adjust or equip the working station, (iii) payment of fees for the in service training is going to assist LAPs to learn an appropriate profession and later be employed in that profession. (iv) opening of new protected jobs where are massively employed disabled persons (atelier and joint employment centers).

## **Employment of separate groups**

### **Disabled persons**

Labor ode prohibits any kind of discrimination in employing and professional treatment of the disabled persons. At the same time law no 7995, dated 20.09.1995 “On incitement of employment” ensures and supports the employment, consultation and professional training for LAP.

The obligation for employing a LAP in every 25 employees has not been implemented neither in the private business not in the institutions or corporation. Presently in the country there prevail small business with less than 25 employees. At the same time, there do not exist (the Labor Inspectorate controls the implementation of this article) and the practices for the appropriate implementation of the law in question. For the implementation of the law there was not the necessary awareness with the tax and employers authorities.

There have been undertaken the attempts for establishment of protected businesses for the employment of disabled persons. There has been financial support from NGO and government for the production of movement means by LAPs themselves. There are some successful initiatives for the employment of disabled persons and other vulnerable groups. But for the future and for these activities there has to be ensured continuity and employment for disabled persons has to be promoted.

The objectives according to the National Strategy of LAP in the field of education, employment and professional training are:

1. Improvement and implementation of policies and programs for the employment of LAP,
2. Improvement and implementation of policies and programs for the training and professional training of LAP,
3. Boosting the possibilities for the employment of LAP and boosting of possibilities for education and professional training to the effect of increasing their individual capacity for employment;
4. Encouragement of the disabled persons for the development of the support possibilities for the employment and professional training,

5. Information and education of employers for the possibilities of disabled persons to work,
6. Ensuring information about career possibilities, ways how to generate income and for the necessary support to be provided to disabled persons,
7. Insurance for the disabled persons to enjoy the same employment conditions, rights and privileges as all the others, including the provisions for a minimal payment and work for comparable productivity.

### **Gender equality and equal chances**

However, the National Employment Service has to ensure the measures for supervising the possibilities and equal treatment between men and women in the field of employment services, professional training and support through income in case of unemployment.

The main aims of the gender integration in the framework of signing up to the conventions and international agreements such as Human Rights Convention CEDAW, Platform for action of Peking, MDG are:

- Active participation of women, representatives of NGOs and all target groups for the formulation of policies, guaranteeing the responsibilities and needs for the discriminated social groups,
- Use of statistics and data according to the sex making use of more detailed forms in order to point out the data in accordance with the gender affiliation,
- The data shall be complemented and collected by all the implementing units of the country to the effect of enriching the data at national level,
- Gender budgeting has to be done on the equal gender benefits. This has to be done after the reporting so far to draft even contributing policies but also equally benefiting ones.

Separate policies shall be followed for vulnerable groups of women. In addition to the policies mentioned above, there shall be new policies connected to:

Women heads of families, victims of trafficking, there shall be taken measures for ensuring the professional training at the public centers of the professional training (service is free of charge), as well as employment measure for their employment. This is done also the preventing the trafficking phenomenon.

For the women of Roma and Egyptian community there shall be worked for awareness among the employees of employment offices for the implementation of the existing programs of inciting employment for these groups (Council of Ministers Decision 632) as well as measures provided for in the National Strategy for the integration of Roma Community.

### **Employment of young people**

In addition to the professional practices, which shall be a new program in the labor market with regard to the encouragement of the employment of young people, there is aimed at:

1. Continuous implementation of the professional practices which shall be a new program in the labor market where the young people shall have a priority,
2. Implementation with efficiency of the advisory program for work and profession including mobile programs of advice in schools, universities and employment office,
3. For specific groups of young people there shall be taken measures for their professional training with reduced fees, or free of charge in the public centers of the professional training.

### **Employment and professional training for Roma community**

A considerable part of the unemployed and non-active persons of the Roma community have been unemployed for a period of many decades and among them the majority of them are not able to find a job. The main reasons for the high long term unemployment rates of the Roma community is connected to (i) missing education, (ii) regional disadvantages, (iii) discrimination, (iv) low efficiency of the active policies of employment of Roma community, due to the reason that the majority of them have not been registered as unemployed.

The professional training free of charge or with reduced fees is one of the priorities of the ministry for increasing the changes of employment of this community. At the same time an important step is: (i) identification of professionals which can be learned by Roma people and (ii) opening of professional training courses for the identified professions in public and private centers of the professional training.

Establishment by the employment offices of connections to the unemployed people from Roma community, (not only of those registered in these offices). Making the public works program functional for opening new jobs for Roma unemployed jobseekers which do not need qualifications. the implementation of the existing programs (specifically Council of Ministers Decision 632) for inciting employment for Roma community. At the same time the use of facilitating policies for the companies employing members of Roma community aims at: (i) possibility of financing the companies where the employers and employees are from the Roma community (ii) providing for fiscal benefits for those companies which open jobs for Roma people as well as (iii) support through material means, premises, financial means and human resources or those businesses which have as destination the products of Roma people tradition.

### **Passive programs**

#### **Unemployment allowances**

The unemployment allowance shall be granted for one year to the persons who have paid the contribution for at least 12 months. In order to incite the training during the unemployment period the unemployment allowance can be extended to 18 months, upon the condition that they do not receive any salary or any other benefit during the training period. In the convention 168 there has been foreseen that the amount of unemployment allowance be 50% of the minimal salary at country level. In order to achieve this, there is needed that the unemployment allowance be increased gradually and hand in hand with the minimal salary at country level. With reference to the latest research of the labor market done by NSE for the upcoming years the tendency of unemployment is not going to have any considerable increase, since only few are the economy branches which are going to be restructured or privatized.

#### **Professional training**

*The following objectives* of the Professional Training Agency (PTA) take into consideration the latest developments, not only in Albania, but also in the region and broader, as well as they refer to the important international instruments connected to the specifics of PTA sector. They are in full compliance with the commitment of

CARDS Program and EU which supports the reforming of PTA in Albania and in the upcoming years.

*The increase of flexibility of the offer, possibilities of acceptance, progress and vertical and horizontal mobility in PTA, shall be achieved through:*

- a) Establishment of a National Framework of Professional Qualifications (NFPQ)
- b) Restructuring the PTA levels based on NFPQ,
- c) Establishment of a separate cycle for providing the general culture of the students going through the level of trained worker, to offer the professional maturity diploma,
- d) Establishment of a post-secondary level of professional orientation for the students doing the middle general education and seeking to have professional training.

*The modernizing of the curriculums model to approximate it to the requirements of the labor worlds and for increasing the degree of flexibility shall be achieved through:*

- a) The institutionalization of a Curricula structure of PTA of two degrees with a curricula skeleton (as international standard) drafted at central level and curricula at school level/centre, based on the respective curricula skeleton, real requirements of the regional labor market and the concrete possibilities of the school/centre,
- b) Gradual modeling of the Curricula of PTA to facilitate the integration of the competences and professional standards and for making possible the accumulation, transfer and knowing the received credits in different ways and forms,
- c) the institutionalization of the methodology of drafting the PTA curricula which is based on the analysis of professions, which considers the drafting of a curricula as a continuous process and with many levels and involves all the interested in this process,
- d) Support of PTA curricula with “integral texts” which are used for a relatively long time, by a considerable number of users not only of one level or professional direction, decreasing evidently the costs of their production.

*Development of institutional mechanisms for performing the new functions and support of present functions of PTA shall be achieved through:*

- a) Strengthening of the role of National Council of PTA (specialized commissions and its secretariat) as an advisory three-party authority (government, employer, employee), in support of the development of reforming policies of PTA.
- b) Establishment of National Agency of PTA to perform the inter-sector functions which are presently not covered by AF institutions.
- c) Strengthening of the boards /centers with social partners (employers and employees),
- d) Establishment of departments (on professional basis) in schools/centers as units of adjusting and developing the curricula at school level, as well as of internal training of teachers and instructors,
- e) Establishment of a national mechanism for the professional and advisory orientation for the career with the support of even social partners.

*Development of teaching powers and management of AP personnel shall be achieved through:*

- a) Establishment of an institutional mechanism for the training (pre-service) for the basics of pedagogy and psychology of young teachers and instructors of PTA,
- b) Strengthening of the institutional present mechanisms (at central and school level) for in-service, methodological and professional training of all teachers and instructors of PTA,
- c) Strengthening of the present institutional mechanisms for the training of the managers of schools/centers with regard to the specifics of management of PTA.

*Supplementing the legal normative framework of PTA reacting to the reforming changes in this sector shall be achieved through:*

- a) Drafting a specific act for the “National Framework of professional Training” as well as other bylaw acts in support of this important component for a modern system of PTA.
- b) Establishment of a legal normative framework more appropriate for the development of non-public PTA,
- c) Establishment of a legal normative framework allowing a grater commitment of the schools/centers in the economic activities, to the effect of increasing quality of training and generating additional income and in the

field of professional training the improvement of the schema of financing from financing for the inputs towards the financing for outputs,

- d) Other legal and bylaw acts in support of the development in the PTA system.

*Quantity and quality development of buildings, premises and teaching equipment in support of the foreseen qualitative and quantitative increase of PTA offer shall be achieved through:*

- a) Renovation of existing premises for the theoretical and practical teaching in schools/centers, being careful about the disabled persons,
- b) Supply with the necessary material and didactic equipment for the theoretical and practical teaching,
- c) Establishment of the schools/new centers, transformation of some general schools in professional schools as well as creation of the mobile centers in those regions where the demand is higher. these shall be accompanied even by other interventions like, reconstruction of buildings, creation of new workshops and equipment of the existing ones, review of the training offered, etc.
- d) Optimizing the distribution and size of schools/centers to adjust the offer to the demand, to increase flexibility of the offer and lower the cost of this public service (establishment of schools, regional or national centers). This shall be accompanied with reconstructions, additional constructions, setting the forcefully occupied buildings, as well as a better use of the existing capacities.
- e) Institutionalization of cooperation between PTA and local business to make effective use of the infrastructure of these stakeholders to the effect of professional training of young people and adults.
- f) Establishment of an information system on demand/offer in PTA, through the introduction of internet in the educational system, computerization of centers of professional training, employment offices and regional departments of education.

The achievement of these objectives as well as the realization of other reforming interventions in accordance with the situation which shall come into being shall contribute to the evident increase of quality and quantity of PTA in the context of fulfilling the mission of this important sector of the development of human resources.

## **Measures for the improvement of the situation in the informal market**

Main measures shall be:

1. Control of labor market which shall be ensured through the cooperation of Labor Inspectorate (LI), tax authorities, police and customs system,
2. Approval of the law of LI and giving priority to its role in controlling the illegal labor which shall have an impact on minimizing the informal market of labor,
3. Strengthening of banking system, monetary circulation through banks and registration of the circulation of money in cash is going to minimize the informal market, fiscal evasion and illegal employment market,
4. Consolidation of private business is going to bring about a transparent competition in the labor market according the demand and offer,
5. Extension of the control zones not only in the urban zones, but it has to extend to the rural ones, relying on the implementation of ratified ILO conventions.
6. Establishment of a computerized system as an important element in receiving a permanent information and establishment of a computer system control on the register of employers of private market of labor,
7. Improvement of the legal framework on which there shall rely the cooperation among the executive institutions,
8. Improvement of means and methods of control.
9. Konsolidimi i biznesit privat do te sjelle nje konkurrence transparente ne tregun e punes sipas kerkese ofertes.

For the realization of the above mentioned policies there have been foreseen in the medium term budget (MTBP) the necessary funds as follows:

**In million Lek**

In million Lek	Budgetary program	600 Salaries	601 Social insurance	602 Goods Services	603 Subsidies	606 Assistance for families	231 Investment in capital	Total
2006 Budget	Labor market	190	52	55	120	1.040	79	1.536
2007 Ceiling	Labor market	242	48	78	120	1.102	87	1.677
2008 Ceiling	Labor market	192	30	86	200	1.080	204	1.793

2009 Ceiling	Labor market	192	27	91	200	1.140	216	1.867
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(Source: Medium Term Draft Budget 2007-2209 of the Ministry of Labor, Social Issues and Equal Chances for the Labor Market)

With reference to the above data, it is evident that the Ministry of Labor, Social Issues and Equal Chances for the Labor Market has highlighted the Programs of Encouraging the Employment for which it has required for the period 2007 – 2009 200 million Lek each year. At the same time there are foreseen to increase the funds for investment in capital through which there shall continue the work which started for the establishment of the big regional centers in the town Fier and Elbasan and there shall be supported the establishment of new centers of public professional training in the towns Durres, Korce. At the same time, there shall be invested in the improvement of the infrastructures of the regional and local offices of employment.

#### **4.4 Administrative Reform**

The reform in the public administration includes:

- 1- Functional – structural reform,
- 2- Deepening and expansion of the reform in the civil service,
  - a- expansion of the scope of implementation of the legislation of civil service,
  - b- reform in the field of salaries (but extended not only for the civil service).

##### *1. Functional – Structural Reform*

Later 2005 and in a process which was extended to the first semester of 2006 the new government changed the format with 14 ministries out of 17 which they were earlier, this change of the number of ministries there was accompanied with the decrease of the politically appointed employees by 21%, a decrease which was followed even by the respective decrease of auxiliary for these political functions (secretaries, drivers, bodyguards etc.).

The change of the format of the government was accompanied by such a deep organizational and functional foreign of the line ministries. This reform aimed

determining the main governmental functions, through the reformulation and rationalizing the roles, missions, strategic objectives, functions and organizational structures. In the framework of this reform, there started to be implemented a new structural system for the ministries of the line. This stereotype provides for the functions in the ministries be grouped into four main pillars: 1. Policy making, 2. Regulator, 3. Offering services, and 4. Auxiliary services. In every pillar there have been grouped the same departments and functions, or in the case of multifunctional structures in accordance with the priority of functions led by a general director. In this way, we have a decrease of the number of reporting persons to the General Secretary and a grouping of functions under the same "roof". Thus, there is not going to be any confusion among the roles and a considerable number of resources shall focus on the policymaking processes and of drafting the strategies, processes which have limped and have not yielded the expected results in the previous years. At the same time it is aimed at establishing another possibility for extending the experience since focusing on the same process would turn out in the gaining of the experience and in the increasing the capacities of the civil servants in a short term period.

All this process was accompanied with the implementation of the objective of the government for setting up small and effective institutions. The turn out of the process was the diminishing by 16% of the number of positions of the civil service in the line ministries and by 38% of the auxiliary positions in the same institutions, or put differently, 263 positions of civil employees and 260 auxiliary positions less.

*- Interventions in depending institutions:*

The reform in central institutions was accompanied by an intervention even in the depending institutions. In the context of functional review of the depending institutions there has been performed a deep reform in all the system of institutions depending from the Agriculture, Food and Consumers Protection, a reform which started to yield its fruits. Thus there have been abolished some institutions of restricted activity, such as Institute of Vegetables, Patato, Institute of Fruit Trees, Institute of Maize, and there have been set up 5 centers of the Transfer of Agricultural Technology; there has been created the Institute of Food and Veterinary Safety as a consequence of merging two previous institutes; there have been reviewed the ways of functioning and organization of a series of other centers, which have either been merged or transferred under the authority of the universities for scientific research.

At the same time, there have been utilized the researches done in the framework of functional review of ministries, in the institutions under the authority of the Ministry of Economy and Energy, there have been performed important interventions, which consist in:

- Setting up of the Technical Central Inspectorate, as a consequence of merging three previous inspectorates;
- Establishment of the agency Albinvest as are result of merging three existing agencies,
- Establishment of the National Agency of natural Resources as a result of merging four existing institutions operating in this field.

All these interventions have been accompanied with the decrease of the number of employed persons and lowering of the operating expenses for the activity of the institutions.

The activity of functional review shall continue in all the dependant institutions during 2007 and afterwards, until all the institutions be organized in accordance with the generally accepted principles for the institutions of the public administration.

## *2. Deepening and expanding the reform in the civil service*

2.a In reliance to th Institutional Reform and in the Public Administration, during the three year period and on there is aimed at deepening and extending the reform in the civil service. This plan aims at achieving the same standards and comparable to the professionalism and stability in all the institutions which perform essential and priority public functions in the Albanian public administration. The extension of the reform in the civil service provides for the amendments in the legislation of the civil employees, in two main directions: extension of the field of the effect of the legislation of the civil service to some groups of institutions, as well as improvement of the procedures of recruitment in the civil service and other means of management of human resources. The extension of the scope of effect of the law is foreseen to take place in some phases in accordance with the implementation of the functional and structural review of the institutions in the ministerial systems.

### *2-b Reform in the field of salaries*

Closely connected to the expansion of the reform in the civil service with regard to the amendments of the legislation of civil service, as well as with the functional and structural review of institutions in the ministerial systems, there is foreseen to deepen in the three upcoming years the reform in the field of salaries.

For 2006, the reform which was realized had some directions:

- A. Institutions which had a deep reform in the structure and level of salaries,
- B. Institutions which benefited a considerable increase of level of salaries, as well as
- C. Institutions reformed earlier, which had only an increase of only 5% of the salaries.
- D. Considerable increase of the level of salaries for the pre-university system and in the system of health.

**A. Institutions having had a deep reform in the structure and level of salaries**

Among the institutions having had a deep reform in the structure and in the level of salaries, we can mention two big groups:

- ***Institutions under the authority of Council of Ministers***

Increase of the salaries of employees in these institutions varies from 51.89% to 121.73%, an increase which was done and realized upon the approval of the decision 371, dated 14.6.2006 of the Council of Ministers, "For the approval of the structure and level of salaries of the employees in some institutions under the authority of Council of ministers/Premier". From increase there have benefited 320 employees with an average increase of 70.7%.

- ***Institutions under the line ministries.***

In this group of institutions there were included the majority of the institutions under the line ministries, or under the authorities of central institutions and line ministers. The reform in the salaries of employees of institutions under the authority of the line ministries was done upon the approval of the decision no 407, dated 21.06.2006, of the Council of Ministers "On approval of structure and level of salaries of employees of some institutions under the line ministers", from which there benefit about 4621 employees and the average increase of salaries 45.9%.

Reform in the salaries system was done even for structures of special status, such as:

- Prison Police, a structure which starting from 1 July 2006, shall be treated with a salary in the system with rang same as state police, with an average increase of salaries at the amount of 20.66% and there have benefited 1982 police employees in accordance with the respective ranks they have,
- employees of the tax system, who starting from 1 July 2006 shall receive a salary in accordance with the salaries structure of the civil employees benefiting an allowance for employment circumstances. From this there have benefited about 1530 employees of this system and the average increase of salaries is calculated in average at the amount of 34.48%. From the change of structure and increase of the level of salaries of the employees of the tax system, there has been foreseen a relatively higher increase of salaries compared to the other sectors, to the effect of including in the salary a part of the rewards distributed to these employees during or at the end of the year.
- Guard of Republic, for which there has been done the restructuring of the salaries, in accordance with the respective ranks.
- Employees of State Police for whom there has also been undertaken a reform in determining their salaries in accordance with the ranks.

Excluded from this group are the research institutes under the ministries since these institutions are in the process of restructuring, and their salaries shall be reviewed in a second phase.

#### **B. Institutions having benefited a considerable increase from level of salaries**

Among the institutions which have benefited a considerable increase of the level of salaries and not restructuring, i.e., the structure of salaries has not been changed, we can mention:

- Employees of Construction police;
- employees of customs system,
- employees of Forest police;
- employees of National Information Service.

For realization of the increase of salaries of employees in all these institutions, there have been approved separate decision by the Council of Ministers. The average increase of salaries for the employees of these institutions vary ffrom 10.07% (which belongs to the employees of SHIK) up to 20.17% (which belongs to the employees of

construction police). The number of benefiting employees of these institutions taken together is about 3000 employees.

An exception in this group of institutions is the customs system, since for the employees of this system there has been applied a considerable of the level of salaries. From the change of salaries of the employees of the customs service, there benefit about 1000 employees, and the average increase of the salaries of employees is in average calculated 62.4%.

We highlight that for the employees of this system, there has been foreseen a relatively high increase of salaries to the effect of including in the salary a part of the rewards which are distributed during or at the end of the year.

### **C. Previously reformed institutions having benefited only an increase of 5% of the salaries**

In this group there are mainly civil employees of the line ministries, of the administration of the President and Parliament, of independent institutions, of the institutions of judiciary, as well as other depending institutions reformed earlier during the period 2001 – 2006, the salaries of which increased by 5.5%.

Following this, the high salaries and more concretely the determined salaries approved for a group of budgetary employees increased to the amount of 5%.

In this group there have been included the structures of armed forces of the Republic of Albania, where regardless of the increase in a differentiated way within the different ranks, since in the increase of this year there has been taken into consideration to consider the salary for the rank “major”, the average increase for the structures of armed forces is at the level of 5%.

At the same time, there has been considered with priority the increase of low salaries, mainly the salaries of the categories in both systems, with 10 categories and 14 categories.

All the salaries per category in these two systems have been increased in average with 15%. We say on average 15%, since following the order of Premier, during the approval of the draft decision “On the minimal salary at country scale”, it was determined that the minimal salary at country level from 13750 Lek per month which it was foreseen earlier, it was approved 14000 Lek per month. This brought about that the minimal salary be increased on average by 18% and as a result of domino effect even the salaries for the closest categories are increased by 18%. From this increase there benefit all the auxiliary employees of the institutions of the public administration,

where we can mention the cleaning personnel, cashiers, maintenance, drivers, technicians of different specializations, accountants etc.

**D. For implementing the objective for the priority increase of the salaries in the educational pre-university system and health system there was done:**

In the sector of health:

- a general increase of salaries for the nurses in health sector on average 25% from which there benefit about 1200 nurses of the health system.
- considerable increase of the salaries of the employees of high education of this system on average 20% from which there benefit about 2900 doctors and specialists of different fields working in the health sector.

In the pre university education sector

- **increase of the value of group salary** for each of the categories of the employees of the system, in accordance with the diplomas they have not only for avoiding clashes with the employees having the same structure of salaries, but also for reaching a satisfactory level in general.
- **increase of the surplus per position for each of the categories of the teachers.** In this increase there have been treated with priority in general, all the employees in pre-university education of the middle schools and eight year schools, as one of the priority sectors. The increase per position varies from 34 to 40%.
- **differentiation of teachers of mathematics, physics and informatics in middle schools and teachers of mathematics and physics in 8 year schools,** compared to their colleagues. The differentiation has been done through the surplus for working conditions, which has been approved at the amount of 1200 per month.
- **including the 13<sup>th</sup> salary in the monthly salary** for each employee of the pre university system to give a better motivation in their work during the school year.

In general for all the pre-university employees, taking into consideration what we mentioned above, the average increase is at the level of 27% and the beneficiaries are about 36 200 teaching staff.

In a summary, the policy of salaries done for the year 2006, is provided as follows:

No.	Institution (or group of institutions)	Number of beneficiary employees	Average increase in %
1	Institutions under Council of Ministers/Premier	320	70.7%
2	Institutions under the line ministries	4621	45.9%
3	Prison Police	1.982	20.66%
4	Tax employees	1.530	34.48%
5	Guard of Republic	992	12.5%
6	Employees with the status of State Police	11.934	14.75%
7	SHISH	1.059	10.07%
8	Employees of Construction Police	185	20.17%
9	Employees of Forest Police	1.000	13%
10	Employees of customs police	1.000	62.4%
11	Employees of auxiliary to the structures of ministries, Premier's office and institutions under the Premier and line ministries (system with 10 and 14 categories)	12.872	15%
12	Pre university system	36.200	27%
13	Nurses in health system	12.200	25%
14	Higher education in the health system	2.900	20%
	Total number of employees having benefited from the increases with priority due to the reform of structure of salaries, as well as priorities of government	88.795	
15	Other part of state employees (political functionaries, armed forces, civil employees etc)		5%

Finally, we can say that from the increase of the levels of salaries in a differentiated way and the restructures of the structure of salaries of employees of budgetary institutions, there benefit all the budgetary employees, with a general average increase at the amount of 19.8%, with an financial effect of 5.2 billion Lek.

Even in the upcoming years, there shall continue to remain a priority the increase of the level of salaries in the pre-university education system and in the system of health, to the effect of increasing the salaries of employees of these systems making them comparable to the levels of salaries of civil employees, as well as the increase of the salaries of the auxiliary employees, who continue to be paid in a categorized system.

For 2007, the policies in the field of salaries shall consist in:

- 1- Average increase of 20% for the employees of the pre-university and the systems of health,
- 2- Average increase of 20% for the auxiliary staff who continue to be paid in the system with categories,
- 3- Average increase of 7% of the employees of different policies and armed forces,
- 4- Average increase of 11% of the professors of universities and other higher schools,
- 5- Average increase of 5% of the part for whom reform is over.

At the same time, for 2007 there shall be seen with priority:

- 1- possibility of applying the reward of post university studies and scientific degrees and titles of employees working in the administration (i.e., not in the research and scientific institutions or universities or other higher schools),
- 2- conditioned by the conclusion of the reforming of the research and scientific institutions and under the line ministers, there shall be reviewed their system of salaries, aiming at equalizing the reward for scientific degrees and titles of employees in these institutions with those working in the universities and other higher schools.

In total the effect of these reforms for 2007 has been calculated to be about 3.5 billion Lek.

### **Reform in the Judiciary**

Government has considered as indispensable part of its activity the issues which have to do with the judiciary in general and the judicial administration specifically. In the context of implementing the short term and long term policies, the Government and

Ministry of Justice of Albania aim at undertaking and implementing the important legal reforms aiming at the well functioning and improvement of the system of administering justice, improvement of quality of the adjudication process, guaranteeing a fair, equal and honest judicial process.

In the context of these policies connected directly to the judiciary system, for the period 2006 – 2008, there is aimed at implementing:

- *Reorganization of the courts of judicial circles and appeal courts, reorganization which is expected to be finalized upon the decree of the President of Republic.*

Reorganization of the courts of judicial circles and later on the reorganization of appeal courts is at the beginning of the process. It is thought for this process to last for the two upcoming years.

This reorganization is directly connected to the recommendation coming from the research of the specialists of the ministry of justice, where it is suggested that the powers of some small courts be transferred to bigger courts making possible the expansion of the judicial circle, including in the territorial of the court of the judicial circle to be expanded even the territorial power of one or two smaller courts. A re-organization of this kind would not affect the affect the access of public to the courts, since the small courts are going to exist as branches of the main court.

Concerning the above the reorganization of the judicial circle courts would bring about an evident improvement in the management of the courts and judicial cases and it would make possible the elimination of delegation of judges from one court to another, gaining time and decreasing the expenses. In this framework there shall take place a balancing of workload in the courts among the judges and the administrative personnel.

Such a reorganization is going to have an impact on the improvement of professionalism of judges and quality of proceedings, as a consequence of their specialization. A bigger court provides for more opportunities for the specialization of judges, which brings about a better quality of trials, expansion of the possibilities for professional discussions among the judges and a more competitive situation, which could contribute to the quality and uniformity of the judicial practice.

All these shall have an impact on reliability in the judicial system, as well as in the increasing of the efficiency of the judiciary in general, which is the main aim of this reorganization. Such a thing is going to have a positive impact in strengthening the judiciary fighting against such phenomena like corruption, and boosting transparency of this power in administering justice.

- *Drafting a strategy for identification of the needs in infrastructure of the courts, as well as for determining the basic directions of improvement of this infrastructure*

Concerning the above, such an objective can be realized in close cooperation with the Office of Administration of Judicial Budget and the other authorities tasked by law.

Drafting such a strategy is going to have a direct effect on the realization of another long term objective which is going to have as its aim the partial and full intervention with the buildings of the courts of judicial circles and appeals, to the effect of their improvement for providing for more favorable conditions for the work of judges and administrative personnel of courts.

Taking into account the novelties of reorganization of the judiciary (in courts of judicial circles and appeal courts), improvement of the infrastructure of the judiciary is considered as a priority objective.

- *Improvement of the status of judicial administration*

Further to deepening and improvement of the reforms of the judicial circle to the effect of improvement and functioning and its efficiency in general as well as improvement of efficiency of judicial authorities in the fight against the serious phenomena of criminality and to respond directly to the need for facing these phenomena successfully, a special attention is being paid to the improvement of the status of judicial administration.

The judicial administration is an important part of the judiciary and plays an important role in the administration of justice.

From this perspective, our attention is focused in the improvement not only of the structure, but also of the methodology of the judicial administration.

We take into account the idea of review or improvement from the legal point of view of the status of the judicial administration seen as a complex package which would regulate not only the procedures of reduction or employment of the administration, but also of a more appropriate financial treatment and in accordance with the importance of this part of the judicial system.

In order to have a professional judicial administration, with integrity and committed to work, it is indispensable to improve its status. Such a thing would have a positive impact on the strengthening of the judiciary, fighting against such phenomena as corruption, as well as boosting the transparency of this power in administering the justice.

Considering that these measures undertaken by the Albanian executive would be encouraging, we thin that they would impact also the improvement of the quality of the work of the judicial administration, as well as it would create strong basis for the recruitment of a more qualified staff and more positive among its ranks.

- *Training of judiciary*

Another important objective which is worth mentioning is the issue of training the judges and the judicial administration, an objective which is considered as a priority.

In this framework, ministry of justice is going to cooperate strongly with the School of Magistrates and this cooperation has been very fruitful even in the past.

Parallel to the School of Magistrates there shall be worked for drafting a strategy for the identification of the needs which the judicial administration has for training and based on the latter the respective trainings have to be organized.

- *Performing the legal amendments with regard to a more clear definition of the status of judges*

As it is known it is more than necessary to work out more precise provisions in some essential aspects connected directly to the status of the judges, such as with regard to the career of the judges, his protection, financial treatment etc.

Such an objective is aimed at being accomplished undertaking the respective changes in the law "On organization and functioning of judicial power in the Republic of Albania".

In this context there have been received comments, opinions and suggestions of different opinions in the field of judiciary, the recommendations of which shall be taken into consideration in the changes and continuous changes to be done to the draft law.

- *Launching of initiatives in cooperation with the High Council of Justice connected to the improvement of legislation with regard to the payment of judicial service offered by the court, identifying clearly and fully its constituent elements and the final costs, guaranteeing the collection of all the judicial expenses, as well as making sure that that monetary value be used for improving the quality of service in the future.*

This is an important objective (still under discussion) which Ministry of Justice thinks of carrying out in cooperation with the High Council of Justice. In the upcoming years there shall be submitted a detailed schema of this project, which has under its focus the collection of all the judicial expenses, ensuring that that monetary value be used for improving the quality of the service in the future.

**Table 1: Growth and associated factors**

Percentages unless otherwise indicated	ESA Code	2000	2001	2002	2003	2004	2005	2006	2007	2008
1. GDP <i>growth</i> at <i>constant</i> market prices (14+15+16)	B1g	6.5	7.1	4.3	5.8	6.2 <sup>9</sup>	5.5	5.0	6.0	6.0
2. GDP <i>level</i> at <i>current</i> market prices <sup>10</sup>	B1g	532,977	590,282	631,338	696,950	755,320	836,871	899,713	982,179	1,075,718
3. GDP deflator		1.00	1.034	1.060	1.108	1.155	1.181	1.210	1.246	1.287
4. CPI change (annual average)		0.0	3.1	5.2	2.4	2.9	2.4	3.0	3.0	3.0
5. Employment growth *										
6. Labour productivity growth **										
7. Gross capital formation <sup>11</sup> ratio (% of GDP)		21.2	25.6	22.8	23.0	31.0	30.3	32.6	31.9	31.9
<b>Sources of growth: percentage changes at constant prices</b>										
8. Private consumption expenditure	P3		7.6	-0.9	0.8	8.4	6.5	5.9	8.1	7.6
9. Government consumption expenditure	P3		7.1	16.0	6.1	6.5	8.0	0.8	4.1	5.7
10. Gross fixed capital formation	P51		14.0	-5.0	-1.6	11.1	5.3	11.5	11.1	9.8
11. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53									

<sup>9</sup> Semi - final estimation.

<sup>10</sup> In million Lek.

<sup>11</sup> Eshte pasqyruar “gross capital formation” si tregues i perafert me treguesin “investment” (% of GDP), per shkak te mosparashikimit ne terma neto te ketij te fundit nga modeli yne. “Gross capital formation” perfaqeson shumen e “exogenous investment”, “corporate savings” dhe “household funds”. “Exogenous investment” perfshin “government capital formation” dhe “direct investment”.

12. Exports of goods and services <sup>12</sup>	P6		15.2	-3.0	8.7	13.1	8.2	12.3	13.5	13.6
13. Imports of goods and services	P7		10.7	-1.9	1.2	11.5	8.4	9.7	11.8	11.3
14. Tourism receipts			11.1	1.2	7.2	28.8	27.1	27.0	29.0	24.0
<b>Contribution to GDP growth</b>										
15. Final domestic demand			8.66	145.29	2.82	6.91	4.95	4.84	4.54	5.13
16. Tourism receipts			0.87	-26.31	2.51	2.06	2.33	1.86	3.23	2.83
16. Change in inventories and net acquisition of valuables as a % of GDP	P52+P53									
17. External balance of goods and services	B11		-2.43	-114.68	0.37	-2.27	-1.78	-1.70	-1.77	-1.96
<b>Growth of Gross Value Added</b>										
18. Agriculture			3.4	5.8	12.0	2.5	9.8	5.5	7.8	8.2
19. Industry (excluding construction)			4.9	0.7	40.0	26.0	16.8	13.6	6.5	6.8
6.720. Construction			40.8	23.3	27.4	9.2	16.5	12.9	13.6	13.9
21. Transport			22.3	-9.6	-18.5	10.4	10.6	9.6	13.1	13.4
21. Services			8.8	7.8	5.8	7.7	8.4	5.2	8.5	8.8

<sup>12</sup> Eksport of goods and non-travel services.

in % of GDP	2005	2006 Plan	2007 Budget Proposal	2008 Projection
<b>TOTAL EXPENDITURES</b>	27.76	29.65	30.57	30.74
Current expenditures	23.18	23.09	22.89	23.04
Staff expenditures	6.41	6.59	6.19	6.39
Interests	3.11	3.06	3.01	2.95
Domestic	2.89	2.71	2.6	2.55
Foreign	0.22	0.34	0.42	0.4
Operational and Maintenance	2.93	2.47	2.46	2.55
Subsidies	0.44	0.28	0.27	0.24
Social and Health Insurance Expenditures	6.68	6.7	6.82	6.65
Local Power Expenditures	2.39	2.57	2.63	2.83
Social Transfers	1.22	1.39	1.46	1.26
Others	0	0.03	0.05	0.05
Capital Expenditures	4.59	6.11	7.09	7.23
Domestic	2.91	3.87	3.79	4.56
Foreign	1.68	2.24	3.3	2.68
Reserve and Contingency	0	0.44	0.59	0.46
<b>in % of GDP</b>	2005	2006Plan	2007	2008 Projection
			Budget	
			Proposal	

TOTAL OF REVENUES	24.4	25.56	25.8	26.76
Subventions	0.74	0.67	0.65	0.8
Total of Tax Revenues	21.96	23.05	23.42	24.23
From tax and customs	16.2	17.67	17.71	17.94
VAT	7.71	8.45	8.69	8.62
Profit tax	2.3	2.33	2.33	2.29
Excise	2.21	2.69	2.75	2.84
Income Tax	0.88	1	1.1	1.44
National and other taxes	1.47	1.62	1.63	1.64
Customs	1.63	1.58	1.2	1.1
Local Power Revenues	1.44	1.23	1.35	1.37
Tax on small business	0.45	0.28	0.27	0.27
Local tax	0.98	0.96	1.07	1.09
Social and Health Insurance Contributions	4.32	4.15	4.36	4.93
Non-tax revenues	1.69	1.84	1.73	1.73
		2006 Supplementary	2007 Budget Proposal	2008 Projection
in % of GDP	2005			
BUDGET DEFICIT FINANCING	3.4	4.1	4.8	4.0
Domestic	2.8	3.0	2.7	2.7
Revenues from privatization	0.1	0.4	0.1	0.2
Net borrowing	2.5	2.5	2.6	2.5
Foreign	0.6	1.1	2.1	1.3
Domestic Financing of the Deficit	2.8	3.0	2.7	2.7

**Participation in TB auctions by years in % to the Total**

	<b>2004</b>	<b>2005</b>	<b>2006</b>			
<b>Bank of Albania</b>	36.28	39,82	42.59			
<b>Raiffeisen Bank</b>	44.29	32.59	25.9			
<b>Individuals</b>	5.99	7,2	6,26			
<b>Other banks of the second level</b>	12.47	19.67	23.56			
<b>Insurance Institutes</b>	1,01	0,71	1,69			
Debt holders	2005	2006				
		(14.09.2006)				
<b>Bank of Albania</b>	19.98	19.86				
<b>Raiffeisen Bank</b>	44.42	39.68				
<b>Other banks</b>	27.75	32.85				
<b>Other individuals</b>	7.85	7.62				
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Foreign Debt Stock (in million leks)	128,765	140,711	154,243	168,162	185,251	200,212
Foreign Debt Stock in EURO (million)	1,019.11	1,147.91	1,251.50	1,378.37	1,518.45	1,641.08
Exchange rate EURO/ Leks	126.35	122.58	123.24	122	122	122
GDP (million leks)	775,864	836,879	899,700	982,200	1,075,700	1,176,600
Domestic Debt Stock/GDP,(in %)	38.05	37.74	37.75	37.13	36.35	35.58
Foreign Debt Stock/GDP, (in %)	16.6	16.81	17.14	17.12	17.22	17.02
Total Debt Stock (in million leks)	423,965	456,564	493,892	532,811	576,300	618,861
Total Debt Stock / GDP, (in %)	54.64	54.56	54.89	54.24	53.57	52.59

	2004	2005	2006	2007	2008	2009
Domestic Debt Stock	295,200	315,853	339,649	364,649	391,049	418,649
Foreign Debt Stock (in million leks)	128,765	140,711	154,243	168,162	185,251	200,212
Foreign Debt Stock in EURO (million)	1,019.11	1,147.91	1,251.50	1,378.37	1,518.45	1,641.08
Exchange rate EURO/ Leks	126.35	122.58	123.24	122	122	122
GDP (million leks)	775,864	836,879	899,700	982,200	1,075,700	1,176,600
Domestic Debt Stock/GDP,(in %)	38.05	37.74	37.75	37.13	36.35	35.58
Foreign Debt Stock/GDP, (in %)	16.6	16.81	17.14	17.12	17.22	17.02
Total Debt Stock (in million leks)	423,965	456,564	493,892	532,811	576,300	618,861
Total Debt Stock / GDP, (in %)	54.64	54.56	54.89	54.24	53.57	52.59
Debt Service	423,965					

million leks

in million leks	2004	2005	2006	2007	2008	2009
Total Debt Service(1+2+3)	31,446	29,393	31,134	35,000	37,763	41,479
Debt Service (1+2) interests only	28,422	26,029	25,830	29,600	32,365	34,965
1.Domestic Debt Service	26,710	24,184	23,400	25,500	27,400	28,500
2.Foreign Debt Service	1,712	1,845	2,430	4,100	4,965	6,465
3.Principal Payments of Foreign						
Debt	3,024	3,364	5,304	5,400	5,398	6,514
GDP	775,864	836,879	899,700	982,200	1,075,700	1,176,600
Debt Service (1+2+3)/GDP (in%)	4.05	3.51	3.46	3.56	3.51	3.53
Debt Service (1+2)/GDP (in %)	3.66	3.11	2.87	3.01	3.01	2.97
Foreign Debt Service/GDP (2+3) (in %)	0.61	0.62	0.86	0.97	0.96	1.1

**Tab 3. Developments of the foreign sector**

<i>mln euro</i>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Current account balance	<b>-582.2</b>	<b>-632.6</b>	<b>-631.3</b>	<b>-623.5</b>
1.0 Current account balance (% PBB)	-8.6%	-8.6%	-7.9%	-7.4%
2.0 Export of goods(f.o.b)	530.2	601.0	679.0	767.0
3.0 Import of goods(c.i.f)	2,083.9	2,339.2	2,441.6	2,568.9
Import of goods (f.o.b)	<b>-1,994.2</b>	<b>-2,238.6</b>	<b>-2,336.6</b>	<b>-2,458.4</b>
4.0 <b>Trade balance</b>	<b>-1,464.1</b>	<b>-1,637.6</b>	<b>-1,657.6</b>	<b>-1,691.4</b>
5.0 Export of services	967.0	1,225.0	1,486.0	1,847.0
6.0 Import of services	-1,108.0	-1,334.0	-1,658.0	-2,093.0
7.0 <i>Service balance</i>	-141.0	-109.0	-172.0	-246.0
<b>Balance in goods and services</b>	<b>-1,605.1</b>	<b>-1,746.6</b>	<b>-1,829.6</b>	<b>-1,937.4</b>
<b>Balance in goods and services (% GDP)</b>	<b>-23.8%</b>	<b>-23.9%</b>	<b>-22.9%</b>	<b>-22.9%</b>
8.0 Net interest payments from abroad	43.9	40.9	50.9	46.5
9.0 Other net factor income from abroad	126.0	199.7	210.0	226.8
10.0 Current transfers	896.9	914.3	988.3	1,087.1
Foreign direct investments (excluding income from privatization)	224.1	262.0	299.8	337.7
13.0 Foreign reserves	1,204.0	1,230.0	1,335.3	1,489.4
14.0 Foreign debt	1,147.9	1,326.0	1,630.0	1,828.8
15.0 <i>ow public</i>	972.9	1,091.2	1,360.0	1,548.4
<b>GDP euro</b>	6,738.2	7,314.6	7,985.4	8,464.5
Transfers by immigrants	802.1	990.5	1,049.9	1,112.9

**Table 4: General government budgetary developments**

Percentages of GDP	ESA code	2005	2006	2007	2008	2009
<b>Net lending (B9) by sub-sectors</b>						
1. General government	S13					
2. Central government	S1311					
3. State government	S1312					
4. Local government	S1313					
5. Social security funds	S1314					
<b>General government (S13)</b>						
6. Total receipts	ESA	24.40	25.56	25.80	26.76	27.30
7. Total expenditures	ESA	27.76	29.65	30.57	30.74	31.26
8. Budget balance	B9	-3.37	-4.09	-4.77	-3.97	-3.96
9. Interest	D41	-3.11	-3.06	-3.01	-2.95	-2.82
10. Primary balance		-0.26	-1.01	-1.76	-1.02	-1.14
<b>Components of revenues</b>						
11. Taxes	D2+D5	17.64	18.91	17.71	19.30	19.50
12. Social contributions	D61	4.32	4.15	4.36	4.93	4.32
13. Other		2.44	2.50	3.73	2.53	2.48

14. Total receipts	ESA	24.40	25.56	25.80	26.76	27.30
<b>Components of expenditures</b>						
15. Collective consumption	P32	9.31	9.06	8.65	8.94	9.06
16. Social benefits in kind	P31	1.22	1.39	1.46	1.39	1.33
17. Social transfers other than in kind	D62	2.35	2.56	2.46	1.72	1.31
18. Interest	D41	3.11	3.06	3.01	2.95	2.82
19. Subsidies	D3	0.44	0.28	0.27	0.24	0.22
20. Gross fixed capital formation	P51	4.59	6.11	7.09	7.23	7.61
21. Other		6.74	7.19	7.63	8.27	8.90
22. Total expenditures	ESA	27.76	29.65	30.57	30.74	31.26