



COMMISSION OF THE EUROPEAN COMMUNITIES

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2003/0330 (CNS)

Proposal for a

**COUNCIL DECISION**

**providing macro-financial assistance  
to Albania and repealing Decision 1999/282/EC**

(presented by the Commission)

## EXPLANATORY MEMORANDUM

### 1. INTRODUCTION

In the period 1992-1996, the EC provided Albania with grant macro-financial assistance of € 70 million<sup>1</sup> and €35 million<sup>2</sup> in the context of its IMF-supported stabilisation and reform programmes. This exceptional support, which came in addition to regular assistance under the PHARE programme, was provided at a time when the country made important progress in liberalising its economy and initiating essential structural reforms.

In April 1999, the Council decided to provide Albania with a third macro-financial assistance facility of up to €20 million<sup>3</sup>. Its purpose was to support Albania's balance of payments in the context of the IMF-supported economic programme covering the period May 1998-June 2001. This third macro-financial assistance was to be provided in the form of a loan since it was on top of targeted EC grant support to the budget (some €20 million through PHARE and the EC Food Security programmes) and exceptional grant budgetary support of some €33 million to help the country to cope with the costs linked to the presence of refugees during the Kosovo crisis.

Eventually, the Kosovo crisis turned out to be relatively short, refugees returned home relatively quickly and the country's balance of payments position was better than expected. Therefore, the Albanian authorities indicated to the Commission services (in late 1999 and again in 2000) that they did not require the release of this Community macro-financial assistance. As a result, the Commission deprogrammed this assistance in 2001<sup>4</sup>.

As far as political matters are concerned, the EC-Albania Trade and Co-operation Agreement entered into force in 1992. Since then, the relations between Albania and the EU continued to intensify, more particularly in trade-related issues. More recently, in the context of the Stabilisation and Association process for the countries of south-eastern Europe, the EU/Albania High Level Steering Group, set up immediately after the November 2000 Zagreb Summit, recommended in June 2001 the opening of the negotiations for a EU/Albania Stabilisation and Association Agreement. In October 2002, the EU Council formally gave to the Commission the mandate to start these negotiations, which it officially did in January 2003.

Since 2001, the Community Assistance for Reconstruction, Development and Stabilisation (CARDS) programme has been the main EC financial instrument for co-operation for the Balkan countries, and for Albania in particular. For the period 2001-2004, €181.4 million has been earmarked for Albania. The main priorities are justice and home affairs, administrative capacity building, economic and social development, environment and natural resources, and democratic stabilisation. The 2003 CARDS annual programme foresees commitments of € 46.5 million for Albania. Additionally, EC humanitarian aid to Albanian has been provided through ECHO since 1992 reaching a global amount of €142 million in 2002, and the EIB has signed loans worth €149 million.

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<sup>1</sup> OJ L 287, 2. 10. 1992, p. 25.

<sup>2</sup> OJ L 380, 2. 12. 1994, p. 17.

<sup>3</sup> OJ L 110, 28. 4. 1999, p. 13.

<sup>4</sup> See Report to the Council and the Parliament on the implementation of EC macro-financial assistance in 2001– COM(2002) 352.

In June 2002, the IMF approved a second PRGF-supported 3-year programme covering the period June 2002-June 2005. The main priorities of the programme were ensuring fiscal sustainability, promoting private sector development, and supporting the development of the energy sector. The Albanian authorities made good progress in the first programme year, in particular in improving the business environment and in implementing the energy sector Action Plan. In this context, reviews under this programme were successfully completed in January and July 2003. During the latest review, the IMF identified for 2004 a residual external financing gap of some US\$ 46 million, after taking into account interventions of International Financial Institutions. Subsequently, the Albanian authorities have addressed to the Commission a request for exceptional EC macro-financial assistance.

In these circumstances, and following the consultation of the Economic and Financial Committee, the Commission is now proposing to the Council to adopt a Decision aiming at (i) cancelling the above mentioned outdated Council Decision of 1999 and (ii) providing macro-financial assistance to Albania of up to €25 million, including €16 million grant and €9 million loan.

## **2. RECENT ECONOMIC PERFORMANCE**

Real GDP growth is estimated to have reached 4.7% in 2002, compared to 6.5% in the previous year and a 9% average over the 1998-2000 period. The reduction in growth reflected the continuing impact of the energy crisis on most sectors of activity, failed privatisations which led to a cut in public investment expenditure, as well as a modest 2% expansion in agricultural output, as a result of flooding in September 2002. In 2003, GDP growth is expected to increase to 6%, on the basis of higher private investments and net exports. First quarter data pointed to a higher level of economic activity, compared to the first quarter of 2002. This includes a significant increase in energy consumption and higher sales indices in almost all major sectors.

In 2002, the average inflation rate rose to 5.4%, compared to 3.1% in 2001. This was due to specific factors such as the energy crisis, a temporary increase of demand linked to the euro changeover and the September floods. Concerns about the rising inflation pushed the central bank to tighten its monetary policy, so that end-of-year inflation was limited to 2.1% in 2002, against a 2-4% target. This declining trend was confirmed in the first months of 2003. In April, the year-on-year inflation reached 2¾, which encouraged the central bank to ease its monetary policy through a lowering of its repo rate by 50 basis points in early May and by another 50 basis points in July, to 7.5%. The two reductions partly reversed the 1.5 percentage point increases of early 2002. For 2003 as a whole, inflation is expected to stay within the same 2-4% target, supported, as in the recent years, by cautious monetary policies.

The fiscal deficit, excluding grants, reached 6.9% of GDP in 2002, compared to a 7.7% target. Lower-than-expected collection of tax and customs revenues – mainly due to the slowdown in GDP growth, the changes in government and the September flooding - were more than compensated by spending cuts, which were designed to minimise the impact on poverty alleviation efforts. Expenditures in priority areas such as education, health, and infrastructure were broadly maintained at their original level after the budget review that took place in May 2002. In the first quarter of 2003, tax collection fell short of indicative programme targets by about 6%, despite the implementation of some agreed measures for strengthening revenue collection, such as computerisation programmes in the tax and customs directorates. However, due to lower expenditures, the overall deficit for the first quarter remained below the budget. For 2003 as a whole, the budget deficit is projected to reach 6.4% of GDP, on the basis of further improvements in the tax and customs systems, through an expansion of the tax base and intensified efforts to combat tax evasion, fraud and smuggling.

The 2002 current account deficit, excluding official transfers, is estimated to have widened to 9.1% of GDP, from 6.3% in 2001. This worse-than-expected outcome was due to a larger trade deficit (reflecting adverse supply shocks, more particularly in the energy sector), a lower surplus in the balance of services and a decline in remittances, which nevertheless remain the main source of hard currency inflows. The comparison with 2001 is however not fully relevant, as an end-year surge in remittances, linked to the introduction of the euro, lowered the 2001 current account deficit by about 2 percentage points of GDP. In 2003, according to the IMF, the current account deficit is projected to decrease to 8.5% of GDP. This slight improvement should be based on a corresponding increase, relative to GDP, of the trade balance. It is indeed expected that the improved provision of electricity will support export performance already in 2003. The balance of services is also projected to improve, more particularly because of increased receipts from tourism, however without significant impact on the current account, given its small size relative to GDP. The EU is Albania's main commercial partner, representing about 75% of Albania's total imports and around 90% of the total exports. Since September 2000, Albania has been benefiting from exceptional trade measures, granting free access to the EU for all Albanian industrial products and most of the agricultural ones.

At end-2002, owing to debt forgiveness related to a debt restructuring agreement with Russia, external debt slightly decreased to USD 1,183 million (some 25% of GDP), compared to USD 1,199 in 2001 (some 28.2% of GDP). The stock of external debt is expected to slightly increase to USD 1,216 million (22% of GDP) in 2003, a level that remains however relatively low by international standards.

### **3. MEDIUM TERM ECONOMIC POLICY FRAMEWORK**

In April 2003, in the context of discussions on the second review under the 3-year PRGF-supported programme (June 2002-June 2005), the IMF staff mission agreed with the authorities that the second year of the programme (June 2003-June 2004) be given a strong focus on strengthening governance and the integrity and competence of public institutions. Thereby they aim to improve the business climate and taxpayer morale, and to remove obstacles to investment and economic growth. Particularly concerned, given the impact on the resources of the state, are the tax administrations, where a strengthening in transparency and consistency of procedures and regulations are envisaged. Other main priorities for the second year of the programme will be fiscal consolidation, both on revenue and expenditure sides, the implementation of the energy sector action plan and the strengthening of the financial sector.

Owing to continuing effects of the electricity situation and limited foreign investments, projected real GDP growth has been revised downwards from 7% to around 6% per annum for the period 2003-2005. Investments, both private and in public infrastructure, emerging service sectors and strong industrial growth should drive growth. These growth prospects, which will depend on the continuation of the privatisation process and steady demand in the construction sector, are however also subject to downside risks, such as political instability, uncertain electricity supply and possible delays in structural reforms.

On the fiscal side, the 2003 budget deficit, excluding grants, is projected to reach some 6.4% of GDP. Budgeted tax and customs receipts are targeted to increase by about 15%, compared to the estimated 2002 outcome, assuming both tax policy measures and further improvements in tax and customs administration. However, the authorities have committed themselves to prepare contingency plans, which would allow them not to endanger the overall deficit ceilings, in case the above targets are not met. Areas where expenditure could be reduced, if necessary, would be in particular electricity subsidies, as well as operations and maintenance. A further reduction in the overall deficit, to 6% of GDP, is projected for 2004. As far as the financing of the budget deficit is concerned, current projections indicate that foreign finance would amount to 3.2%, domestic financing to 2.5% and privatisation receipts to 0.3%.

A gradual easing of the monetary policy is envisaged – and has already started in the first half of 2003- following the tightening in 2002 and the return of monetary stability. The medium-term framework assumes monetary stability, inflation in line with a 2 to 4% target, and a reserves-to-imports ratio of some 4 ½ months. The key instrument of the monetary policy will remain the repurchase agreement rate, whose impact on market rates should be improved through open market operations. Given the quasi monopolistic banking sector, the authorities have announced plans to develop a new marketing channel for treasury bills outside the banking system, which should contribute to a diversification of the demand and, thereby, a reduction of the important interest margin relative to deposit rates.

In terms of structural reforms, further progress in several areas is planned in the second programme year to ensure that Albania can achieve its growth potential.

First, the Albanian authorities plan to improve the business environment, by eliminating barriers to investment - such as arduous licensing and tax procedures, abuse of power by officials and weak law enforcement. The envisaged measures should be considered as part of the fight against corruption, which has been identified as the main policy priority for the remainder of the programme. The authorities are also continuing with the creation of new agencies for the promotion of foreign investments, exports and small business development. This should contribute to the strengthening of the export sector and to attracting foreign and domestic investors. Land reform, which should contribute to the development of the agricultural sector, is also expected to progress with the completion of land registration by end-2004 and the preparation of a law regulating land ownership.

In view of their privatisation, a restructuring of the remaining State-owned bank and of the telecommunications company Albtelekom will first have to take place. Concerning the Savings Bank, whose privatisation recently failed, prospects are now for a streamlining and strengthening of the bank, in consultation with foreign partners, in preparation for a second privatisation attempt. Following the transfer of all pension functions to Albapost, other specific measures include further efforts to move the bank's fiscal functions to other banks and a further consolidation of its rural offices so as to ensure the provision of basic banking services in remote areas after the bank's privatisation.

The authorities are committed to implementing the 2003-2004 Action Plan for the reform of the electricity sector. The main targets under this Action plan are the phasing out of subsidies to the electricity company KESH for electricity imports by end-2004, the progressive liberalisation of electricity tariffs (however taking into account the need for measures to alleviate the impact of higher prices on vulnerable households), the completion of the process of installation of electricity meters by mid-2004. Other measures aiming at an exit of the energy crisis by 2004 will include significant improvements in infrastructure (through projects financed or supported by the World Bank and the EBRD) and, last but not least, a deep restructuring of KESH.

#### **4. EXTERNAL FINANCING REQUIREMENTS OF ALBANIA IN 2004**

The second year of the PRGF supported programme runs from June 2003 to June 2004, with the third programme year running from June 2004 to June 2005. Whereas it is currently not foreseen that there will be a residual financing gap in 2003, it is projected that a residual financing gap will appear in 2004.

Indeed, the IMF balance of payments projections foresee for 2004 a current account deficit of US\$ 482 million, representing some 8.5% of GDP. Taking into account amortisation payments on medium and long term obligations of US\$ 36 million, changes in arrears, as well as a programmed gross foreign exchange reserves increase of US\$ 34 million – with a view to keeping the reserves level at the equivalent of 4.3 months of imports -, the gross financing requirements are projected to reach US\$ 582 million.

These financing needs are expected to be largely covered by foreign direct investment (US\$ 180 million), official capital transfers (US\$ 138 million), as well as other capital inflows (US\$ 155 million). After also taking into account short term private financing flows, debt rescheduling (expected to be provided by Hungary, the Czech Republic and the Slovak Republic for a total amount of US\$ 21 million), and errors and omissions, the gross financing gap is projected to reach US\$ 65 million.

Taking into account macro-economic financing by International Financial Institutions (IMF and World Bank) of an expected US\$ 19 million, a residual external financing gap of some US\$ 46 million has been identified in the 2004 balance of payments. It is expected to be covered by the EC and other bilateral donors.

#### **5. POSSIBLE COMMUNITY MACRO-FINANCIAL ASSISTANCE AND MAIN CHARACTERISTICS OF THIS ASSISTANCE**

Since Council Decision 1999/282/EC of 22 April 1999 is now outdated and the loan assistance has been deprogrammed in 2001, the Commission proposes to repeal it. At the same time, the Commission is proposing that the Community makes available to Albania a new macro-financial assistance in the amount of up to EUR 25 million as a complement of the IMF 3-year PRGF. This exceptional macro-financial assistance would be provided in addition to regular CARDS assistance.

Given the country's relatively low level of development (Albania's GDP per capita stands at some US\$ 1400 and the country is still an IDA recipient), it is considered appropriate to provide a significant part of this assistance in the form of a grant (€ 16 million) and the remainder (€9 million) in the form of a loan. The proposed grant amount would be financed from budget line 01 03 02 02 (Macro-economic assistance in favour of Western Balkan countries).

Also in view of Albania's external constraints, the loan would carry a maturity of 15 years with a 10-year grace period, which is comparable to conditions of macro-financial assistance loans provided to other Western Balkan countries. The adoption of this assistance would require an additional provisioning of the Guarantee Fund for some €0.81 million, which is consistent with the existing margins in the reserve for guarantees (see Annex)<sup>5</sup>.

## **6. OTHER CONSIDERATIONS LINKED TO PROVIDING MACRO-FINANCIAL ASSISTANCE**

With regard to the recommendations made in the Discharge on the budget execution for 2001 and also in the Court of Auditors' Special report n° 1/2002 concerning macro-financial assistance to third countries, the Commission services have given due consideration to the five Genval criteria (exceptional character, political pre-conditions, complementarity, conditionality and financial discipline).

On other budgetary and financial management conditions, the Commission services are taking action in order to fulfil requirements implied by the new Financial Regulation. This is reflected by having made an ex-ante evaluation of this proposed assistance. It is also reflected by inserting fraud proofing provisions in the Council Decision as well as at the level of implementation. In particular, before proceeding with the actual implementation of this assistance, the Commission services plan to check (with the help of external consultants) the reliability of Albania's financial circuits, administrative procedures, internal and external control mechanisms that are relevant to this type of assistance.

## **7. PROPOSED DECISION**

The Council is requested to adopt the attached proposal for a Decision providing macro-financial assistance to Albania and repealing the Council Decision 1999/282/EC of 22 April 1999.

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<sup>5</sup> In this context, it is worth noting that the cancellation of the 1999 Council Decision does not have a new impact on the budget, since the de-provisioning of the Guarantee Fund, for an amount of €2.80 million, already took place in 2002.

Proposal for a

## **COUNCIL DECISION**

### **providing macro-financial assistance to Albania and repealing Decision 1999/282/EC**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 308 thereof,

Having regard to the proposal of the Commission<sup>6</sup>,

Having regard to the opinion of the European Parliament,

Whereas:

- (1) The Commission consulted the Economic and Financial Committee before submitting its proposal;
- (2) The Council, by Decision 1999/282/EC<sup>7</sup>, approved, in the aftermath of the Kosovo crisis, macro-financial assistance for Albania of up to EUR 20 million in the form of a long-term loan facility. In the light of better-than-expected balance of payments situation, the Albanian authorities did not request the release of this assistance; therefore, the Commission deprogrammed it in 2001;
- (3) Within the Stabilisation and Association process, the framework for EU relations with the region, it is desirable to support efforts to sustain political and economic stabilisation in Albania, with a view to evolving towards the development of a full co-operation relationship with the Community; this is also the aim of the Stabilisation and Association Agreement which is currently under negotiations between Albania and the EU;
- (4) The International Monetary Fund (IMF) approved on 21 June 2002 in favour of Albania a three-year programme supported by a Poverty Reduction and Growth Facility (PRGF) for an amount of about USD 36 million, to support the authorities' economic programme over the period June 2002 - June 2005; out of this amount, USD 11 million are projected to be disbursed in 2004;
- (5) In the framework of the new 3-year Country Assistance Strategy (CAS) adopted by the World Bank Board on 20 June 2002, USD 8 million are projected to be disbursed in 2004 under the Poverty Reduction Support Credit;

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<sup>6</sup> OJ C [...], [...], p. [...].

<sup>7</sup> OJ L 110, 28. 4. 1999, p. 13.



- (6) Over and above these estimated financial supports projected to be provided by the International Monetary Fund and the World Bank, a significant residual financing gap remains in 2004, to be covered to support the policy objectives attached to the authorities' reform efforts;
- (7) The Community already provided macro-financial assistance to Albania; the authorities of Albania have requested further financial assistance from the international financial institutions, the Community, and other bilateral donors;
- (8) Community macro-financial assistance to Albania is an appropriate measure to help the country meet its external financing needs, including through a reinforcement of its reserves and budget support;
- (9) Financial assistance from the Community in the form of a combination of a long-term loan and a straight grant is an appropriate measure to support the sustainability of Albania's external financial position, given the country's relatively low level of development;
- (10) In order to ensure efficient protection of the Community's financial interests linked to the present macro-financial assistance, it is necessary to provide for appropriate measures by Albania related to the prevention of fraud and other irregularities linked to this assistance, as well as for controls by the Commission and audits by the Court of Auditors;
- (11) The inclusion of a grant component in this assistance is without prejudice to the powers of the budgetary authority;
- (12) This assistance should be managed by the Commission in consultation with the Economic and Financial Committee;
- (13) The Treaty does not provide, for the adoption of this Decision, powers other than those of Article 308.

HAS DECIDED AS FOLLOWS:

*Article 1*

1. The Community shall make available to Albania a macro-financial assistance in the form of a long-term loan and a straight grant with a view to helping the country meet its external financing needs, including through a reinforcement of its reserves and budget support.
2. The loan component of this assistance shall amount to a maximum principal of € 9 million with a maximum maturity of 15 years. To this end, the Commission is empowered to borrow, on behalf of the Community, the necessary resources that will be placed at the disposal of Albania in the form of a loan.
3. The grant component of this assistance shall amount to a maximum of € 16 million.

4. This Community financial assistance shall be managed by the Commission in close consultation with the Economic and Financial Committee and in a manner consistent with the agreements reached between the IMF and Albania.
5. The Community financial assistance shall be made available for two years starting from the first day after the entry into force of this decision. However, if circumstances so require, the Commission, after consultation of the Economic and Financial Committee, may decide to extend the availability period by a maximum of one year.

#### *Article 2*

1. The Commission is empowered to agree with the authorities of Albania, after consultation with the Economic and Financial Committee the economic policy and financial conditions attached to this assistance to be laid down in a Memorandum of Understanding. These conditions shall be consistent with the agreements referred to in Article 1(4).
2. Before proceeding with the actual implementation of the Community assistance, the Commission shall check the reliability of Albania's financial circuits, administrative procedures, internal and external control mechanisms that are relevant for this Community macro-financial assistance.
3. The Commission shall verify at regular intervals, in collaboration with the Economic and Financial Committee and in co-ordination with the IMF, that economic policies in Albania are in accordance with the objectives of this assistance and that its economic policy and financial conditions are being fulfilled.

#### *Article 3*

1. The loan and grant components of this assistance shall be made available by the Commission to Albania in at least two instalments. Subject to the provisions of Article 2 and a satisfactory assessment in accordance with Article 2(2), the first instalment is to be released on the basis of a satisfactory track record of the macro-economic programme of Albania under the present Poverty Reduction and Growth Facility with the IMF.
2. Subject to the provisions of Article 2, the second and any further instalments shall be released on the basis of a satisfactory implementation of the above-mentioned programme, and not before one quarter after the release of the previous instalment.
3. The funds shall be paid to the Central Bank of Albania. The final recipient of the funds will be the Central Bank of Albania, to the extent that the assistance is intended to reinforce the country's reserves, or the Ministry of Finance if it is intended for budgetary support purposes.

#### *Article 4*

The implementation of this assistance shall take place in accordance with the provisions of the Financial Regulation applicable to the General Budget of the European Communities and its implementing rules. In particular, the memorandum of understanding to be agreed with the authorities of Albania shall provide for appropriate measures by Albania related to the prevention of fraud and other irregularities linked to this assistance. It will also provide for controls by the Commission, including the European Anti-Fraud Office (OLAF), with the right to perform on-the-spot checks and inspections and for audits by the Court of Auditors, where appropriate, to be carried out on the spot.

#### *Article 5*

1. The borrowing and lending operations referred to in Article 1 (2) shall be carried out using the same value date and must not involve the Community in the transformation of maturities, in any exchange or interest rate risks, or in any other commercial risk.
2. The Commission shall take the necessary steps, if Albania so requests, to ensure that an early repayment clause is included in the loan terms and conditions and that it may be exercised.
3. At the request of Albania, and where circumstances permit an improvement in the interest rate of the loan, the Commission may refinance all or part of its initial borrowings or restructure the corresponding financial conditions. Refinancing or restructuring operations shall be carried out in accordance with the conditions set out in paragraph 1 and shall not have the effect of extending the average maturity of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.
4. All costs incurred by the Community that are directly related to the borrowing and lending operations under this Decision shall be borne by Albania.
5. The Economic and Financial Committee shall be kept informed of developments in the operations referred to in paragraph 2 and 3.

#### *Article 6*

At least once a year, and before September, the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation on the implementation of this Decision in the previous year.

*Article 7*

Council Decision 1999/282/EC providing macro-financial assistance to Albania is hereby repealed.

*Article 8*

This Decision shall take effect on the day of its publication in the *Official Journal of the European Union*.

Done at Brussels, [...]

*For the Council*  
*The President*

## ANNEX

### BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 2004 AND MARGIN UNDER THE RESERVE FOR LOANS AND LOAN GUARANTEES IN FAVOUR OF THIRD COUNTRIES

(IN EURO MILLION)

Operations	Basis of the Calculation <sup>8</sup>	Provisioning of the Fund <sup>9</sup>	Reserve Margin
<b>EIB's decided operations</b>			221.0
2000-2007 general lending mandate	2953.0(a)	172.8	48.2
Special Turkey reconstruction facility	(a)	0.0	48.2
Baltic Sea Russia special action	60.0 (b)	5.4	42.8

#### **EIB's corrections**

*To be introduced in 2004*

2000-2007 general lending mandate  
Special Turkey reconstruction facility  
Baltic Sea Russia special action

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<sup>8</sup> The basis of calculation represents 65% (a) or 100% (b) of the nominal amount of the EIB loans, 100% (c) of the macro-financial assistance loans and 100% (d) of the Euratom loans.

<sup>9</sup> According to the Council Regulation (EC, Euratom) n° 2728/94 of 31 October 1994 amended by the Council Regulation (EC, Euratom) n° 1149/99 of 25 May 1999, the provisioning rate has been fixed to 9%.

**EC macrofinancial assistance**

Possible operations	241.0(c)	21.7	21.1
Albania	9.0(c)	0.8	20.3

**EC macrofinancial assistance corrections**

*To be introduced in 2004*

**Euratom loans**

Provisional estimates			
Romania	223.5(d)	20.1	0.2

**Euratom loans corrections**

*To be introduced in 2004*

## FINANCIAL STATEMENT

### 1. TITLE OF OPERATION

Macro-financial assistance to Albania.

### 2. BUDGET HEADING INVOLVED

a) Grant component of the assistance (in €)

Budget line: 01 03 02 02 (draft budget 2004)

	Commitment Appropriations	Payment Appropriations
Draft Budget 2004	65 000 000	80 000 000
<i>Albania, proposed EC macro-financial assistance</i>	<i>16 000 000</i>	<i>16 000 000</i>

b) Loan component of the assistance

01 04 01 07 – “EC guarantee for the borrowing programmes contracted by the Community to provide assistance to the countries of the Western Balkans”

### 3. LEGAL BASIS

Article 308 of the Treaty

### 4. DESCRIPTION AND JUSTIFICATION OF THE ACTION

a) Description of the action

Provision of a Community loan (to be financed by Community borrowings in the international capital markets) in the amount of up to EUR 9 million and a Community grant of up to EUR 16 million (to be financed from the General Budget) to Albania with a view to supporting the government’s reform efforts and ensuring a sustainable balance-of-payments situation.

b) Justification of the action

The sustainability of the beneficiary country’s economic stabilisation and reform achievements heavily depends on external financial assistance from official sources at concessional terms.

### 5. CLASSIFICATION OF THE EXPENDITURE

a) Grant component: non-compulsory, differentiated.

b) Loan component: compulsory

## 6. NATURE OF THE EXPENDITURE

- a) Straight grant (100% subsidy), which would be released in at least two successive instalments.
- b) Potential activation of budget guarantee for the Community borrowing aimed to fund the loan.

## 7. FINANCIAL IMPACT

- a) *Method of calculation*

The evaluation of the amount of the assistance deemed necessary is based on the present estimates of the beneficiary country's residual external financing needs.

For the loan component of the assistance, it is expected that the budget guarantee will not be called.<sup>10</sup> However, the Guarantee Fund for external actions has to be provisioned according to the Fund Regulation, for an amount corresponding to 9% of the amount of the guaranteed loan (EUR 9 million). As a result, a transfer of EUR 0.81 million from the Reserve (budget line 01 04 01 13) to the Guarantee Fund (budget line 01 04 01 14) will be compulsory after the Decision has been adopted. This is consistent with the existing margin in the reserve for loans guarantee (budget line 01 04 01 13) in the draft budget 2004.

- b) *Effect of the action on intervention credits*

For the grant element, the credits under budget line 01 03 02 02 will be used subject to compliance with a number of policy conditions to be agreed with the authorities of Albania.

The budget entry reflecting the budget guarantee for the loan component of the assistance will be activated only in the case of an effective call on the guarantee.

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<sup>10</sup> In this context, it is worth noting that the cancellation of the 1999 Council decision does not have a new impact on the budget, since the deprogramming of the Guarantee Fund, for an amount of € 2.80 million (€20 million at a rate of provisioning of 14%), already took place in 2002 (transfer appropriations n° 13/2002).



c) *Financing of intervention*

(i) Grant

The following schedule of appropriations to be financed within the limits of Category 4 of the present Financial Perspective is proposed (in EUR):

	2004
Commitment appropriations	16 000 000
Payment appropriations	16 000 000

(ii) Eventual call on the budget guarantee

Recourse to the Guarantee Fund established by Council Regulation (EC, EURATOM) No. 2728/94 of 31 October 1994, most recently amended by Regulation No. 1149/1999 of 25 May 1999. According to the Fund Regulation, the provisioning will take place via a transfer of EUR 0.81 million from the Reserve to the Fund.

In case the Guarantee Fund did not contain sufficient resources, additional payments would be called up from the budget by transfer:

- of any margin remaining in the Reserve for guarantees, according to the provisions of Article 18 of Council Regulation (EC) No 2040/2000 of 26 September 2000 on budgetary discipline;
- [of any overdue payments to the budget for which the budget guarantee had been activated, provided that these payments have not been recorded as revenues;]
- of any margin available under the ceiling of category 4 of the financial perspectives or redeployment therein. In this case, the budget line 01 04 01 07 “European Community Guarantee for the borrowing programmes contracted by the Community to provide financial assistance to the countries of the Western Balkans” would be activated.

In order to fulfil its obligations, the Commission can provisionally ensure the debt service with funds from its treasury. In that case, Article 12 (3) of the Council Regulation (EC, EURATOM) No 1150/2000 of 22 May 2000 will apply.

## **8. FRAUD PREVENTION MEASURES**

Before the implementation of this assistance, the Commission services, with the support of duly mandated experts, will check the reliability of financial circuits and administrative procedures of the Albanian central bank and Ministry of Finance. This will cover areas like management structure and organisation, reporting tools, management and control of funds, IT process and security, internal and external audit capacity, as well as the independence of the central bank.

This review, the purpose of which will be announced and clearly explained to the authorities concerned, will take place in the context of the ongoing process of operational assessment of these circuits and procedures in all third countries benefiting from macro-financial assistance, in order to fulfil requirements implied by the Financial Regulation applicable to the General Budget of the European Communities. It will also take into consideration available conclusions of IMF Safeguard Assessments and of other relevant reports by the IMF and the World Bank.

A reference to fraud prevention measures has been inserted in the text of the legal basis (Article 4). These measures will be further detailed in the memorandum of understanding and possibly complemented with additional necessary measures identified in the context of the operational assessment.

Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

## **9. ELEMENTS OF COST-EFFECTIVENESS ANALYSIS**

### **a) Grounds for the operation and specific objectives**

By supporting the country's macro-economic reform efforts and complementing financing by the International Community provided to this country in the context of the IMF-supported programme, this assistance would underpin its transition towards a market economy.

### **b) Monitoring and evaluation**

This assistance is of macro-economic nature and its monitoring and evaluation is undertaken in the framework of the IMF-supported stabilisation and reform programme that the beneficiary country is implementing. In particular, the monitoring of the action by the Commission services will take place on the basis of a genuine system of macro-economic and structural policy indicators to be agreed with the authorities of the beneficiary country. In this process, the Commission services may also monitor key areas identified in the above-mentioned operational assessment. Finally, they will remain in close contact with the IMF and World Bank services to benefit from their assessment of the recipient country's stabilisation and reform.

An annual report to the European Parliament and to the Council is foreseen in the proposed Council decision, which will include an evaluation of the implementation of this operation.

Furthermore, an independent ex-post evaluation of the assistance is planned to be carried out by the Commission or duly authorised representatives one to two years after the assistance has been implemented and the authorities of the country are committed to supply all necessary information.

#### **10. ADMINISTRATIVE EXPENDITURE**

This action is exceptional by nature and will not involve an increase in the number of Commission staff.

**EX ANTE EVALUATION STATEMENT**

**MACRO-FINANCIAL ASSISTANCE TO ALBANIA**

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## **1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT**

Real GDP growth in Albania is estimated to have reached 4.7% in 2002, compared to 6.5% in the previous year and a 9% average over the 1998-2000 period. In 2003, it is expected to increase to 6%, on the basis of higher private investments and net exports. The fiscal deficit, excluding grants, reached 6.9% of GDP in 2002, compared to a 7.7% target. For 2003, it is projected to reach 6.4% of GDP, on the basis of further improvements in the tax and customs systems, through an expansion of the tax base and intensified efforts to combat tax evasion, fraud and smuggling.

The 2002 current account deficit, excluding official transfers, is estimated to have widened to 9.1% of GDP, from 6.3% in 2001. In 2003, according to the IMF, it is projected to decrease to 8.5% of GDP.

### **1.1. Medium term economic outlook**

Owing to continuing effects of the electricity situation and limited foreign investments, projected real GDP growth has been revised downwards from 7% to around 6% per annum for the period 2003-2005. A further reduction in the fiscal deficit, to 6% of GDP, is projected for 2004. As far as the financing of the budget deficit is concerned, current projections indicate that foreign finance would amount to 3.2%, domestic financing to 2.5% and privatisation receipts to 0.3%.

The IMF balance of payments projections foresee for 2004 a current account deficit of US\$ 482 million, representing some 8.5% of GDP. Taking into account amortisation payments on medium and long term obligations of US\$ 36 million, changes in arrears, as well as a programmed gross foreign exchange reserves increase of US\$ 34 million – with a view to keeping the reserves level at the equivalent of 4.3 months of imports –, the gross financing requirements are projected to reach US\$ 582 million

These financing needs are expected to be largely covered by foreign direct investment (US\$ 180 million), official capital transfers (US\$ 138 million), as well as other capital inflows (US\$ 155 million). After also taking into account short term private financing flows, debt rescheduling, and errors and omissions, the gross financing gap is projected to reach US\$ 65 million.

Taking into account macro-economic financing by International Financial Institutions (IMF and World Bank) of an expected US\$ 19 million, a residual external financing gap of some US\$ 46 million has been identified in the 2004 balance of payments. It is expected to be covered by the EC and other bilateral donors.

## **1.2. Structural reforms in the context of the IMF Poverty Reduction and Growth Facility**

In terms of structural reforms, further progress in several areas is planned in the second year of a three-year IMF Poverty Reduction and Growth Facility programme to ensure that Albania can achieve its growth potential. Main elements include the improvement of the business environment through the elimination of barriers to investment, the completion of land registration by end-2004 and the preparation of a law regulating land ownership, the restructuring/privatisation of the remaining State-owned bank and of the telecommunications company Albtelekom, and the implementation of the 2003-2004 Action Plan for the reform of the electricity sector.

## **2. OBJECTIVES AND RELATED INDICATORS OF THE MFA OPERATION**

### **2.1. Objectives**

By supporting the country's macro-economic reform efforts and complementing financing by the International Community provided to this country in the context of the IMF supported programme, this assistance would underpin Albania's transition towards a market economy. In this context and given the challenges and needs identified above the objectives of the proposed MFA operation are to:

- Contribute to covering the residual external financing gap of some US\$ 46 million in the 2004 balance of payments;
- Facilitate and encourage efforts of Albanian authorities to implement reforms (including in context of Stabilisation and Association process).

Macroeconomic and structural reform objectives will be further developed and detailed in the Memorandum of Understanding with the Albanian government. However, possible sub-objectives related to structural reform include:

- restructuring/privatisation of the strategic sectors
- reform of public administration (in particular tax and customs depts)
- improvement of legal framework relating to development of private sector

### **2.2. Indicators**

Quantitative benchmarks included in IMF programmes represent a first category of indicators of a macro-economic nature. Performance indicators will be specified in the aforementioned Memorandum of Understanding, in agreement with the authorities of the beneficiary country.

### **3. ALTERNATIVE DELIVERY MECHANISMS AND RISK ASSESSMENT**

#### **3.1. Delivery mechanisms**

Macro-financial Assistance is provided either in the form of a loan, a grant or a combination of the two. Given the country's relatively low level of development (Albania's GDP per capita stands at some US\$ 1400 and the country is still an IDA recipient), it is considered appropriate to provide a significant part of this assistance in the form of a grant (€16 million) and the remainder (€9 million) in the form of a loan.

Macro-financial assistance is an untied and undedicated macro-economic support, which helps the country meet its external financing needs, including through a reinforcement of reserves and budget support. Project support would not be able to fill this need in the same way, since it could for example not be used for servicing the country's external debt or strengthening its reserves position. Moreover, as experienced with similar operations, including in Albania, the economic policy conditionality attached to this support strengthens the stabilisation and reform process.

#### **3.2. Risk assessment**

There is a risk that macro-financial assistance, which is not dedicated to specific expenses (contrary to project financing, for example), would be used in a fraudulent way. Generally speaking, this risk is related to factors such as the independence of the central bank, quality of systems and procedures related to the management, control and processing of such assistance, IT security and internal/external audit capacity. Although the provision of assistance in the form of project support may seem to be an alternative, it does not fulfil the country's need for unaffected financing under the IMF programme and also carries other risks of fraud.

To mitigate the risks of fraudulent use, macro-financial assistance is paid to clearly identified accounts of the central bank or the government. Moreover, before the release of this assistance, the Commission services, with the support of duly mandated experts, will check the reliability of Albania's financial circuits, administrative procedures, as well as internal and external control mechanisms that are relevant to this type of assistance (see Financial Statement, section 8).

Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.



#### **4. ADDED VALUE OF COMMUNITY INVOLVEMENT**

In June 2002, the IMF approved a second PRGF-supported 3-year programme covering the period June 2002-June 2005. The main priorities of the programme were ensuring fiscal sustainability, promoting private sector development, and supporting the development of the energy sector. The Albanian authorities made good progress in the first programme year, in particular in improving the business environment and in implementing the energy sector Action Plan. Without the EC complementary macro-support, there is a risk that the stabilisation and reform programme supported by the IMF PRGF could not be fully implemented, that popular support for the necessary adjustment efforts could dwindle and that reforms could stall.

Furthermore, this assistance would encourage and support efforts that are considered of particular importance for the EC. This may include conditions included in the IMF/WB programmes, as well as priorities identified in the context of the Stabilisation and Association process.

Finally, macro-financial assistance complements the Community Assistance for Reconstruction, Development and Stabilisation (CARDS) programme which since 2001 has been the main EC financial instrument for co-operation for the Balkan countries, and for Albania in particular. For the period 2001-2004, €181.4 million has been earmarked for Albania. The main priorities are justice and home affairs, administrative capacity building, economic and social development, environment and natural resources, and democratic stabilisation. The 2003 CARDS annual programme foresees commitments of €46.5 million for Albania.

#### **5. LESSONS FROM THE PAST**

In the past, macro-financial assistance to Albania and other countries has proven to be instrumental in supporting strong stabilisation and reform programmes and it has become clear that a proper articulation between EC and IMF conditionality is necessary to ensure complementary and mutual support but to avoid a too heavy cross conditionality.

Although macro-financial assistance was initially provided mainly in the form of loans, presently assistance often combines loans and grants, taking into account the country's level of income and the reimbursement capacity.

With regard to the recommendations made in the Discharge on the budget execution for 2001 and also in the Court of Auditors' Special report n° 1/2002 concerning macro-financial assistance to third countries, the Commission services have given due consideration to the five Genval criteria (exceptional character, political pre-conditions, complementarity, conditionality and financial discipline).

## **6. PLANNING FUTURE MONITORING AND EVALUATION**

This assistance is of macro-economic nature and its monitoring and evaluation is undertaken in the framework of the IMF-supported stabilisation and reform programme that the beneficiary country is implementing.

### **6.1. Monitoring**

The monitoring system is ensured by the provision of reports and data by the authorities as set out in the memorandum of understanding and the organisation of review missions in the country concerned. Although this assistance is centrally managed, where appropriate, Commission delegations on the spot may also be called to provide reporting.

In particular, the monitoring of the action by the Commission services will take place on the basis of a genuine system of macro-economic and structural policy indicators to be agreed with the authorities of the beneficiary country. In this process, the Commission services may also monitor key areas identified in the above-mentioned operational assessment. Finally, they will remain in close contact with the IMF and World Bank services to benefit from their assessment of the recipient country's stabilisation and reform.

An annual report to the European Parliament and to the Council is foreseen in the proposed Council decision, which will include an evaluation of the implementation of this operation.

### **6.2. Evaluation**

An independent ex-post evaluation of the assistance will be carried out by the Commission or duly authorised representatives one to two years after the assistance has been implemented and the authorities of the country are committed to supply all necessary information.

## **7. ACHIEVING COST-EFFECTIVENESS**

The Commission is proposing that the Community makes available to Albania a new macro-financial assistance in the amount of up to EUR 25 million as a complement of the IMF 3-year PRGF, in the form of a grant (€16 million) and the remainder (€9 million) in the form of a loan.

In view of Albania's external constraints, the loan would carry a maturity of 15 years with a 10-year grace period, which is comparable to conditions of macro-financial assistance loans provided to other Western Balkan countries. The adoption of this assistance would require an additional provisioning of the Guarantee Fund for some € 0.81 million, which is consistent with the existing margins in the reserve for guarantees.<sup>11</sup>

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<sup>11</sup> In this context, it is worth noting that the cancellation of the 1999 Council Decision does not have a new impact on the budget, since the de-provisioning of the Guarantee Fund, for an amount of €2.80 million, already took place in 2002.

This action is exceptional by nature and will not involve an increase in the number of Commission staff.

The loan and grant components of this assistance will be made available by the Commission to Albania in at least two instalments, with the first instalment being released on the basis of a satisfactory track record of the macro-economic programme of Albania under the present Poverty Reduction and Growth Facility with the IMF. The second and any further instalments shall be released on the basis of a satisfactory implementation of the aforementioned programme and of the economic policy and financial conditions attached to the assistance as laid down in the Memorandum of Understanding.