



COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

COUNCIL DECISION

**providing macro-financial assistance
to Albania**

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. INTRODUCTION

After the breakdown of the Communist regime, in 1992 the Albanian authorities initiated efforts of macroeconomic stabilisation and structural adjustment under IMF-supported programmes. Until mid 1995, the country made important progress in liberalising the economy and initiating essential structural reforms. In this context, Albania benefited from two Community macro-financial assistance initiatives to comfort the country's official reserve position, respectively of ECU 70 million (decided in September 1992) and ECU 35 million (decided in November 1994).

From mid-1995, however, the pace of reform slowed down, important budgetary policy slippages appeared, inflation rose and the current account deficit worsened. The collapse of a number of pyramid schemes in late 1996 triggered widespread rioting and the central Government lost control over large parts of the country. Civil society was seriously affected and economic activity was severely disrupted. The nature and extent of the Albanian crisis confirmed the existence of major deficiencies of the financial sector, of the institutional and legislative framework, and more generally of normal state functions, including the provision of security and the administration of justice.

The international community was mobilised and three meetings were convened (a high-level meeting on May 26 1997, the International Conference on Albania on July 31 1997 and the Ministerial Conference on October 17 1997) to assist the Albanian authorities in designing and implementing the recovery from the crisis. In June 1997 elections were held in Albania and in July a new Government took office. Since then the country has made considerable efforts to address the serious effects of the crisis and its underlying structural determinants. The Government has generally succeeded in improving the security situation, although public order and security are not yet fully assured in certain parts of the country. The regional context is also a reason for concern, as there is a risk that the situation in the Kosovo may have spill-over effects on Albania, despite the resolute moderating role of the present Albanian Government.

Albania has successfully implemented a six-month (October 1997-March 1998) emergency programme, under which it has taken the first urgent measures to recover from the aftermath of the crisis. Building upon the positive results achieved and in line with the recovery strategy set out in the paper "Albania - Directions for Recovery and Growth" (jointly prepared by the European Commission, the World Bank and the EBRD, in consultation with the IMF), the Albanian authorities have reached an understanding with the IMF on a medium-term macroeconomic and structural reform programme. The programme is backed by an Enhanced Structural Adjustment Facility (ESAF), adopted by the Board of the IMF on May 13 1998.

On March 19 1998, at a G-24 Meeting in Brussels, the IMF and the World Bank outlined Albania's medium-term programme. The IMF indicated the need for the international community to help ease, at this critical juncture, the country's external financing constraints under the first year of the programme. The Albanian authorities are now seeking such support.

2. ECONOMIC DEVELOPMENTS AFTER THE CRISIS AND THE SIX MONTH EMERGENCY PROGRAMME (OCTOBER 1997-MARCH 1998)

While the crisis only marginally affected the output of the agricultural sector (which accounts for over half of GDP), industrial output collapsed in the first half of 1997. As a result, for 1997 as a whole real GDP is estimated to have declined by 8 %. Inflation surged

to 50 %. Fiscal revenues fell and the domestically financed fiscal deficit, which was already high before the crisis (10.5 % of GDP in 1996), increased to 13 % of GDP. Remittances from abroad, which amounted to US\$ 490 million in 1996, were halved to US\$ 250 million in 1997.

Throughout the crisis the Albanian authorities maintained a cautious reserve policy. Despite the sharp fall in the exchange rate of the lek, they refrained from intervening in the market with a few exceptions for very limited amounts. Having fluctuated heavily during the crisis, the lek depreciated by some 40 % relative to its end-1996 value. Official reserves at end-December 1997 were US\$ 306 million. Starting in October, the authorities satisfactorily implemented a six-month emergency programme agreed with the IMF. Budgetary performance under the emergency programme was also satisfactory: revenue collection increased, also because of an improved system of customs collection set in place with technical assistance from the European Community. The quantitative benchmarks of the programme were met and in some cases even outperformed.

Structural reforms were also launched under the emergency programme. Initial measures were taken to establish a functioning land market and to restructure the state-owned banking sector (one bank has been liquidated, a second bank will be administrated by a foreign chief executive in view of privatisation or liquidation in the second half of 1998, while the last bank has temporarily discontinued credit operations). With regard to institutional development and the reform of the public administration, where substantial progress is still required, two achievements are worth mentioning: the State Control Service was transformed into a Supreme Audit Institution and a new organic law for the budget will be presented to the Parliament in early June 1998.

The Government has taken steps to solve the problems which arose from the pyramid schemes. Technical assistance to this end is being provided by a group of donors (including the European Community) and it is being managed by the World Bank through a trust fund. The Government appointed administrators of international repute to manage, in the interest of the claimants, the five companies which had operated pyramid schemes and have not yet been declared bankrupt. In February 1998 the administrators submitted to the Council of Ministers a report presenting estimates of the value of the retrievable assets. The foreign administrators are now proceeding to the recovery of the assets, which will be the only possible source of compensation for the claimants. A law establishing the principles for the distribution of the recovered assets was submitted to Parliament at the end of April. Legislation preventing the resurgence in the future of any such companies is being elaborated, including a Law on Money Laundering.

3. THE MEDIUM-TERM ECONOMIC REFORM PROGRAMME

The macroeconomic objectives of the IMF-supported medium term macroeconomic and structural reform programme are to revive rapid economic growth (targeting annual GDP growth of 8 % on average during the programme period), pursue the reduction of the inflation rate to 10 % at the end of 1998 and to the level of Albania's main trading partners by the year 2001, contain the external deficit at sustainable levels and maintain a sufficient level of reserves. In order to achieve the inflation reduction foreseen over the medium-term, it is necessary to continue the reduction of the fiscal deficit. Accordingly, the authorities will cut the domestically financed deficit to 6.5 % of GDP in 1998 (as established in the 1998 budget) and 5 % in 1999, through an overhaul of direct taxation and continued restraint in expenditures. The Central Bank will maintain real positive deposit rates and enforce strict credit ceilings on banks whose portfolio contains a high ratio of non-performing loans.

The programme also envisages an ambitious structural reform agenda. Amongst the foremost priorities is to rigorously pursue reforms in the banking sector and to secure and enforce property rights. The Bank Asset Resolution Trust, which was recently established by law, is to begin operations shortly. Banking legislation is being revised and a new Banking Law and a law on collateral will be finalised in the first programme year with technical assistance from the IMF. Additional efforts will be made with regard to the enforcement of legislation. The supervisory framework is being reviewed and capital adequacy requirements and licensing requirements for banks will be reformulated and strengthened.

Other areas of reform include the public administration, agricultural reform with particular emphasis on the land market reform and the implementation of the new privatisation strategy. The Government will pursue its Public Administration Reform Programme, in line with the recommendations of the European Commission and the World Bank. With the approval by Parliament of a package of laws clarifying and simplifying the legal framework for land transactions, all obstacles to the creation of a functioning agricultural land market should have been removed and the Government will now have to implement the measures it has taken. The privatisation strategy, approved by Parliament in March 1998, envisages the sale or liquidation of all remaining small and medium-sized enterprises by the end of 1998, the liberalisation of a number of strategic sectors (telecommunications, power, oil and gas, mining, transport), and the subsequent opening of the state-owned companies to investors during the first programme year.

4. THE NEED FOR COMPLEMENTARY FINANCIAL SUPPORT AND PROPOSED COMMUNITY MACRO-FINANCIAL ASSISTANCE

Despite progress made in economic recovery and macroeconomic stabilisation, Albania's balance of payments remains fragile. Exports can only increase gradually, while the pick-up in economic activity and the accrued needs for reconstruction and investment have already started inducing a rise in imports. The increase in private remittances is a major unknown, since it is linked to improvements in security and the development of a sound financial sector. As for foreign direct investment, it will clearly depend upon creating and maintaining a secure and stable environment for economic stability.

Moreover, although in December 1993 Albania rescheduled its short-term obligations and in March 1994 it repaid in full its medium-term debts to Paris Club creditors, it still has to reconcile and eventually reschedule its debts vis-à-vis Russia (now a member of the Paris Club) and a number of non-Paris Club countries (China, former Yugoslavia, the Czech Republic, the Slovak Republic and Romania). Arrears with Russia are estimated (at this stage and subject to reconciliation) at some US\$ 141 million (principal and interest). The medium-term programme will pave the way to the solution of these issues.

In the first programme year under the ESAF (April 1998-March 1999), the IMF would provide some US\$ 16 million to Albania, a third of the country's quota. In addition, the World Bank is likely to provide financial support to Albania amounting to US\$ 17.5 million (US\$ 7.5 million second instalment of the financial sector loan and US\$ 10 million first instalment of a US\$ 20 million Structural Adjustment Credit).

The residual financing gap (after IMF and World Bank contributions) for the first year of the ESAF is estimated at US\$ 202.5 million. This is expected to be filled by some US\$ 141 million through Paris Club debt relief, as well as by complementary financing from bilateral donors. Assuming that the Government were to obtain favourable terms on the rescheduling of arrears which it has requested to the Paris Club, this would leave a remaining external financing gap of US\$ 62 million, to be covered by complementary bilateral support.

Some of the pledges already made at the Donors' Conference on October 22 1997 should help cover part of this amount, but the IMF has estimated that new balance-of-payments and budget support for an amount of US\$ 30-35 million would be needed to close the remaining gap.

The Community has so far committed ECU 24.5 million targeted support to the 1998 budget under the PHARE Special Assistance (ECU 14.5 million) and under the Community Food Security programme (ECU 10 million). The first instalment (ECU 5 million) of the Food Security assistance was disbursed under the emergency programme.

It is now proposed that the Community make available to Albania a balance of payments loan of up to ECU 20 million. The Community's support under the first year of the ESAF would thus reach up to ECU 39.5 million, taking into account the targeted support to the 1998 budget provided under the PHARE Special Assistance and under the second instalment (5 MECU) of the Food Security assistance.

When the long-term loan is considered in combination with the grant support provided under the PHARE Special assistance and the Food Security programme, the overall degree of concessionality of the Community assistance package to Albania appears to be appropriate. On the one hand, Albania's debt-servicing capacity will remain limited, especially over the next few years. On the other hand, it is important to take into account:

- (i) the high degree of concessionality of previous Community assistance to Albania which until now took exclusively the form of grants;
- (ii) the fact that the IMF and the World Bank, as well as some bilaterals, are supporting Albania's balance of payments with loans (albeit soft loans);
- (iii) the expected gradual increase of Albania's debt-servicing capacity over the medium/long term through the implementation of economic reform programmes;
- (iv) and the need to encourage financial discipline.

5. MAIN FEATURES OF THE LOAN

The Commission proposes to make available to Albania a balance of payments facility of up to ECU 20 million with a maximum duration of fifteen years. This duration of the loan is consistent with the medium and long-term balance of payments outlook for Albania, which is expected to face substantial financing needs in the years to come. The assistance would be granted in the context of the present ESAF and would complement resources made available by the International Financial Institutions and other bilateral donors.

The assistance would be released in two instalments, subject to a satisfactory track record of the programme agreed with the IMF and to the fulfilment of additional specific conditions, consistent with this programme, notably progress in the implementation of the PHARE Special Assistance.

As in the case of similar operations in favour of other partner countries, the Community would provide the funds through market borrowing with a guarantee by the general budget. Albania would subsequently borrow from the Community. The borrowing and lending operations would be perfectly matched and without risk for the Community.

In accordance with the Guarantee Fund mechanism, the budgetary implications of the decision to make available assistance of up to ECU 20 million to Albania would imply an ECU 2.8 million provisioning of the Fund, to be drawn from the 1998 reserve for guarantees relating to external actions.

Proposal for a
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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 235 thereof,

Having regard to the proposal of the Commission,

Having regard to the opinion of the European Parliament¹,

Whereas the Commission has consulted the Monetary Committee before submitting its proposal;

Whereas Albania has made substantial progress on the path to recovery from the effects of the economic and social crisis of early 1997; whereas it has successfully implemented an economic recovery programme to address the immediate effects of the crisis;

Whereas trade, commercial and economic links between the Community and Albania are developing within the framework of the Co-operation Agreement;

Whereas Albania has agreed with the International Monetary Fund (IMF) on a comprehensive set of stabilisation and policy reform measures to be supported by a loan under the Enhanced Structural Adjustment Facility (ESAF);

Whereas Albania has agreed with the World Bank on a set of measures supporting banking reform and employment promotion, which are backed by a highly concessional Rehabilitation Loan; whereas it is intended that a Structural Adjustment Credit will support further structural adjustment measures;

Whereas Albania is undertaking fundamental reforms to promote economic reform and build institutions with a strong implementation capacity; whereas the focus of reforms will be strongly centred on institution-building, on public administration and judicial reforms, on the development of a strong and performing banking sector, on the establishment of a functioning agricultural land market and accelerating enterprise privatisation; whereas the Government is firmly committed to a speedy winding up of the pyramid scheme companies and to combating corruption;

Whereas the authorities of Albania have requested financial assistance for the first year of the medium-term programme from the international financial institutions, the Group of 24 industrialised countries (G-24), and the Community; whereas over and above the estimated financing which would be provided by the IMF and the World Bank, an important residual financing gap remains to be covered; whereas Paris Club rescheduling and undisbursed

pledges made at the Donors' Conference in October 1997 should help cover part of the external financing needed during the first year of the medium-term programme;

Whereas assistance from the Community shall be instrumental in supporting Albania's institutional and structural reforms; whereas a Community long-term loan to Albania is an appropriate measure to help ease the country's external financial constraints, support the balance of payments and strengthen the reserve position;

Whereas Albania is a low-income country eligible to highly concessional loans and facilities from the World Bank and the IMF; whereas the Community will provide under the first year of the medium-term programme ECU 19.5 million support to the budget in the form grants through the PHARE Special Assistance and the Community Food Security programme; whereas, in these circumstances, the proposed ECU 20 million loan allows overall Community macro-financial support under the first arrangement under the ESAF to reach an appropriate degree of concessionality;

Whereas the Community loan should be managed by the Commission;

Whereas the Treaty does not provide, for the adoption of this decision, powers other than those of Article 235,

HAS DECIDED AS FOLLOWS:

Article 1

1. The Community shall make available to Albania a long-term loan facility of a maximum principal amount of up to ECU 20 million with a maximum maturity of fifteen years, with a view to ensuring a sustainable balance of payments situation and consolidating the country's reserve position.
2. To this end the Commission is empowered to borrow, on behalf of the European Community, the necessary resources that will be placed at the disposal of Albania in the form of a loan.
3. This loan will be managed by the Commission in close consultation with the Monetary Committee and in a manner consistent with any agreement reached between the IMF and Albania.

Article 2

1. The Commission is empowered to agree with the authorities of Albania, after consultation with the Monetary Committee, the economic and institutional policy conditions attached to the loan. These conditions shall be consistent with the agreements referred to in Article 1(3).
2. The Commission shall verify at regular intervals, in collaboration with the Monetary Committee and in co-ordination with the IMF, that the economic and institutional policy in Albania is in accordance with the objectives of this macro-financial assistance and that its conditions are being fulfilled.

Article 3

1. The macro-financial assistance shall be made available to Albania in two instalments. , Subject to the provisions of Article 2, the first instalment shall be released on the basis of a successful completion of the mid-term review of the first year of the programme supported by a 3-year ESAF arrangement between the IMF and Albania.
2. Subject to the provisions of Article 2, the second instalment shall be released on the basis of a satisfactory track record in the implementation of the ESAF programme and not before one quarter after the disbursement of the first instalment.
3. The funds shall be paid to the Central Bank of Albania.

Article 4

1. The borrowing and lending operations referred to in Article 1 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 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 on 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 related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by Albania.
5. The Monetary Committee shall be kept informed of developments in the operations referred to in paragraphs 2 and 3 at least once a year.

Article 5

At least once a year 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.

Done at

For the Council
The President

FINANCIAL STATEMENT

1. Title of Operation

Macro-financial assistance to Albania.

2. Budget heading involved

Heading B0-211 reflecting the European Community guarantee for borrowing programmes contracted by the Community to provide financial assistance for non-member countries in central and eastern Europe.

3. Legal basis

Article 235 of the Treaty

4. Description and justification of the action

a) *Description of the action*

Provision of Community loans (to be financed by Community borrowings in the international capital markets) in the amount of up to ECU 20 million, to the beneficiary country with a view to supporting its Government's reform efforts.

b) *Justification of the action*

The sustainability of the beneficiary country's economic and institutional reforms depends on external financial assistance from official sources.

5. Classification of the expenditure

Obligatory

6. Nature of the expenditure

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

A token entry is proposed given that the amount and timing of any call on this budget line cannot be calculated in advance and because it is expected that the budget guarantee will not be called.

b) *Effect of the action on intervention credits*

Activated only in the case of an effective call on the guarantee.

c) *Financing of intervention expenditure in case of call on the budget guarantee*

In case of call on the budget guarantee:

- Recourse to the Guarantee Fund established by Council Regulation (EC, EURATOM) n° 2728 of 31 October 1994

- 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;
- of any late payments to the budget for which the budget guarantee has been activated (under Article 27(3) of the Financial Regulation);
- of any margin available under the ceiling of category 4 of the financial perspectives or redeployment therein.

- In order to fulfil its obligations, the Commission can provisionally ensure the debt service with funds from its treasury. In that case, Article 12 of the Council Regulation (EC, EURATOM) n° 1552/89 of 29 May 1989 will apply.

8. Fraud prevention measures

The funds will be paid directly to the Central Bank of the beneficiary country only after verification by the Commission services, in consultation with the Monetary Committee and in liaison with the IMF and World Bank services, that the macro-economic policies implemented in these countries are satisfactory and that the specific conditions attached to this assistance are fulfilled.

9. Elements of cost-effectiveness analysis

a) *Grounds for the operation and specific objectives*

By supporting the beneficiary 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 the 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 adjustment and reform programme that Albania is implementing.

The Commission services will monitor the action on the basis of a genuine system of macro-economic and institutional/structural policy indicators to be agreed with the authorities of the beneficiary country. They will also remain in close contact with the IMF and World Bank services and will benefit from their assessment of economic and institutional reform achievements in Albania.

10. Administrative expenditure

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

ANNEX

BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE
GUARANTEE FUND IN 1998 AND MARGIN UNDER THE RESERVE FOR LOANS
AND LOAN GUARANTEES IN FAVOUR OF THIRD COUNTRIES

(IN ECU MILLION)

<u>Operations</u>	<u>Basis of the Calculation</u> ¹	<u>Provisioning of the Fund</u> ²	<u>Reserve Margin</u>	<u>Residual lending capacity</u> ⁴
			338,0 ³	2414
<u>Decided operations</u>				
Project-related assistance				
EIB/CEEC	665,7	93,2	244,8	
EIB/PVDALA	190,55	25,46	219,3	
EIB/SOUTH AFR.	17,5	2,45	216,9	
EIB/MED	728,6	102,00	114,9	
Macro-financial assistance				
Algeria (Suspension)	-100	-14,00	128,9	
<u>Proposed operations</u>				
Project-related assistance				
EIB/FYROM ⁵	42	5,88	123,0	
EIB/Turkey ⁶	105	14,70	108,3	
EIB/ Croatia ⁶	56	7,84	100,5	
EIB/Bosnia ^{6,7}	7	0,98	99,5	
EURATOM ⁶	260	36,40	63,1	
Macro-financial assistance				
Ukraine-III ⁵	150	21,00	42,1	301
Albania ⁵	20	2,80	39,3	281
Bosnia ⁵	30	4,20	35,1	251

¹ The basis of calculation represents 70% of the nominal amount of the EIB loans and 100% of the macro-financial assistance loans.

² According to the provisioning rules provided in the Council regulation (EC, Euratom) n° 2728/94 of 31 October 1994. The Fund having reached its target amount in 1997, the rate of provisioning for new operations has been decreased from 15 % to 14%.

³ Reserve amount in 1998 under the financial perspective.

⁴ For 100% guarantee loans.

⁵ Commission proposal.

⁶ Tentative estimates.

⁷ On the basis of loans to be signed in 1998.

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