Statement by Mr. Federico Giammusso, Executive Director for Albania and Ms. Laura Cerami, Advisor to the Executive Director
December 7, 2022

We thank staff for the candid and constructive dialogue with our Albanian authorities during the 2022 Article IV Consultation and for the close coordination with multiple Technical Assistance (TA) missions. Albania has greatly benefited from Fund's TA and the authorities look forward to the Fund's continued help for the design of structural reforms, that will be critical to further strengthen Albania's macroeconomic stability and climate resilience. Furthermore, the recent start of accession negotiations with the EU has reinforced the authorities' commitment to accelerate convergence to European living standards. The Albanian authorities greatly appreciate staff's analysis and timely policy advice in this report, which helped inform the preparation of the 2023 budget.

I. Outlook and Risks

The authorities welcome that the staff's report gives credit to their macroeconomic policy mix for the considerable resilience shown by the Albanian economy in the face of consecutive shocks, from the devastating earthquake of 2019 to the COVID pandemic and the Russian invasion of Ukraine. They appreciate staff's assessment that their steadfast measures undertaken to reduce imbalances and strengthen the banking sector in the years before the pandemic, combined with a comprehensive policy response to the emergencies and external financial assistance, including by the Fund, were key to mitigate the impact on the population and the economy and engineer a robust recovery already in 2021 and continuing, albeit more moderate, this year.

The Albanian economy grew by 8.5 per cent in 2021 and is projected to remain on a solid growth path of around 4 per cent this year and above 2 per cent in 2023. Despite the expected slowdown in the near-term, the outlook remains overall favorable, benefiting from the strong performance of tourism, services, manufacturing, and construction. **Inflation has risen to 8.3 per cent in October, driven by food and energy prices but increasingly broad-based.** The projected economic slowdown and the timely monetary policy tightening are expected to gradually bring the inflation back to the Bank of Albania (BOA)'s target of 3 per cent in 2024.

The limited direct exposures of Albania to Russia and Ukraine are an important mitigating factor around the uncertain outlook. However, the authorities share staff's concerns for the possible indirect impact of the ongoing conflict particularly through higher and more persistent imported inflation, further tightening of financial conditions, and the economic slowdown in Europe. **Given unprecedented uncertainty, the authorities are preparing contingency measures for alternative scenarios.** In this respect, they see merit in maintaining a flexible approach to policy making and building adequate buffers to cushion the economy from the materialization of downside risks. In an adverse scenario, they stand ready to reprioritize spending, use their 2021 SDR allocation, and seek external financing.

II. Fiscal Policy

The fiscal position improved significantly in 2021, with the deficit shrinking from 6.7 to 4.5 per cent, well below staff's projection in 2021 Article IV report. The sizeable fiscal

adjustment reflects both revenue overperformance, driven by the robust economic recovery, and restrained spending. **The 2023 budget targets a primary balance, meeting one year ahead the deadline established by the Organic Budget Law.** The targeted primary balance is underpinned by conservative revenue projections, which factor in a deceleration in economic growth as well as new tax mobilization measures, which will be enacted in 2023. These include amendments to the Income Tax Law to broaden the scope to self-employed professionals, a windfall tax on independent energy producers, and reforms of the property tax and of the gambling sector. Furthermore, the authorities are determined to further strengthen the tax and customs administrations with the aim of increasing VAT compliance in the construction and high-risk sectors, and on the excise duty on fuels.

These reforms build on the articulated recommendations from the much-appreciated TA provided by the Fund to develop a comprehensive **Medium Term Revenue Strategy (MTRS)**. The authorities have already implemented about 30 per cent of staff's recommendations despite a temporary pause due to the pandemic emergency. Work on tax reforms has resumed and further measures beyond those already announced for 2023 are envisaged in the next years. The authorities remain committed to consider all recommendations from the TA report. They agree with staff that, in general, announcing a clear MTRS outlining all the envisaged measures, the timeline for their introduction, and the overall revenue objective, can help increase fiscal transparency and credibility, and thus support the fiscal adjustment process. However, they highlight the unusual uncertainty surrounding the near-to-medium term economic and fiscal projections, which suggest that a more flexible approach to a revenue-driven fiscal consolidation could deliver a larger payoff.

On the spending side, the budget provides for continued support to mitigate the impact of still high energy prices on vulnerable households and businesses through direct support to the electricity sector state-owned enterprises (SOEs). However, **the authorities acknowledge the need to develop a comprehensive reform of the electricity sector** and will consider staff's recommendations on reducing inefficiencies and gradually raising the tariffs to cost- recovery levels. They consider these reforms as critical not only for their fiscal benefits but, importantly, for promoting greater competition and a more diversified energy mix, consistent with the national climate goals.

The authorities are equally committed to advancing the implementation of the outstanding recommendations from the 2016 **Public Investment Management Assessment (PIMA)** and strengthening the coordination with the framework for managing **Public Private Partnerships (PPP).** Further reforms to improve fiscal transparency and accountability and strengthen fiscal risks management are being considered in the context of a new **Public Financial Management Strategy, that is planned to be costed with the assistance of the Fund next year.**

III. Monetary and Financial Sector Policies

The Bank of Albania (BOA) has timely started to normalize monetary policy by ending the provision of unlimited liquidity to banks in February 2022 and gradually **raising the policy interest rate from the historical low level of 0.5 per cent in March to 2.75 per cent in November**. With still negative real policy rates and persistent inflationary pressures, driven by global food and energy surprises and supported by solid economic and credit growth, the BOA is prepared to further tighten its monetary policy stance to bring inflation and inflation expectations back on target. Monetary policy decisions will be informed by incoming data and

clearly communicated to the markets and the public. The BOA is satisfied with the functioning of the monetary policy transmission mechanism and highlights that, in the context of still elevated euroization, such mechanism will be reinforced by the ongoing monetary policy tightening by the European Central Bank.

The BOA has successfully intervened in the foreign exchange market to support the lek from short lived downward pressures in the immediate aftermath of the Russian invasion of Ukraine. Since then, the lek has remained stable around its moderately appreciating trend against the euro, supported by FDI and remittances. **The BOA is committed to preserving exchange rate flexibility** and limiting interventions to restore orderly market conditions and contain exceptional volatility.

The banking sector has shown remarkable resilience, as demonstrated by sound balance sheets and healthy credit growth. The BOA acknowledges the need for enhanced vigilance under tightening financial conditions, and to this end will continue to closely monitor emerging risks, including in the growing real estate sector, and conduct focused asset quality reviews. Furthermore, the BOA remains committed to continue aligning its regulatory, supervisory, and accounting frameworks with European standards.

IV. Structural Policies

Completing the judicial reform, strengthening the anticorruption and the AML/CFT frameworks, and reducing the still high informality remain the top priorities of the authorities' structural reforms agenda. And important progress has been made on all fronts:

- The vetting of judges is proceeding expeditiously and is on track to meet the constitutional deadline of December 2024. **Around 70 per cent of judges have already been vetted, out of which more than two thirds have resigned or been dismissed or terminated**, and several initiatives are underway to address the resulting shortages of judges and prosecutors. Work to establish an advanced integrated case management system has proceeded more slowly due to lack of external funding.

- The authorities have finalized a comprehensive **National Anticorruption Strategy** and the newly established **Specialized Structure for Anti-Corruption and Organized Crime** (SPAK) has initiated investigations and prosecutions of high- profile cases.

- Most of the actions in the **FATF's Plan** has been addressed and the authorities remain committed to its full implementation and achieve the exit from the grey list.

- The MTRS includes several measures aimed at **reducing informality** and the authorities are grateful for staff's articulated advice in this respect. It is in this perspective that the authorities also envisage a tax amnesty law, which will promote formalization. The authorities are aware of the concerns expressed by staff and will carefully consider all design features of the law and establish a strong monitoring capacity to minimize the risks of moral hazard, as well as of money laundering and terrorism financing. Furthermore, the authorities have introduced measures to encourage formal employment, including the **Youth Guarantee Program**, which targets one of the most vulnerable segments of the labor force.

The authorities thank staff for the open discussion and their insightful analysis of **climate related risks**. They concur on the urgency of a more proactive approach to mitigation and adaptation but are constrained by limited financial resources. In this vein, they would appreciate Fund's advice to incorporate climate needs into their PFM and PIM frameworks, thereby facilitating their access to concessional climate financing.

V. Post Financing Assessment

The authorities welcome staff's proposal to terminate the Post Financing Assessment after Albania's fund outstanding credit falls below the threshold of 200 per cent of quota in February 2023. Staff's recommendation rests on the fully shared assessment that Albania capacity to repay the Fund remains adequate despite a more challenging external environment and heightened uncertainty. The authorities are confident to maintain their strong repayment record and to this end are committed to rebuilding buffers and addressing fiscal vulnerabilities.