COMMISSION OF THE EUROPEAN COMMUNITIES

COM(94) 112 final

Brussels, 29.03.1994

94/0102 (CNS)

Proposal for a

COUNCIL DECISION

Providing further macro-financial assistance

for Albania

(Presented by the Commission)

EXPLANATORY MEMORANDUM

Albania's request for further macro-financial assistance

On 28 September 1992, the Council of Ministers decided to grant Albania a macro-financial assistance up to a maximum amount of ecu 70 million in the form of a grant in the context of an initiative of the Group of Twenty-Four (G-24) aiming at mobilizing a total of US$ 165 million in assistance complementary to that provided by the IMF under a twelve-month stand-by arrangement approved in August 1992.

The Community grant was disbursed in two tranches. A first tranche of ecu 35 million was disbursed in December 1992, and, following a positive assessment of the economic situation and progress in the reform process in Albania, and a favourable opinion of the Monetary Committee, the disbursement of the second tranche was effected in August 1993.

The Albanian authorities have requested further macro-financial assistance from the EC/G-24 in the context of a new programme covering the first year of an ESAF arrangement that was approved by the IMF on 14 July. Financing from the IMF amounts to the equivalent of US$ 22 million for the first annual arrangement. The assistance requested from the EC/G-24 in this context amounts to US$ 72 million for 1993-94 (down from US$ 165 million for 1992-93). Albania's strong adjustment efforts merit continued financial support from the international community. The success of Albania's programme hinges crucially on external assistance in view of the country's precarious external position. However, in the context of the new programme, Albania is committed to normalise its relation with external creditors and to facilitate foreign direct investment, in order to allow an orderly phasing out of exceptional macro-economic assistance.

At the High Level meeting of the G-24 on Albania held on 16-17 November 1993, Senior Officials of the G-24 agreed with the assessment of the economic and financial situation in Albania given by the international financial institutions; and they recognized that Albania continued to face a very difficult external financing situation and to need balance of payments assistance from the G-24. In view of the weak creditworthiness of the country, they also agreed that assistance should continue to be made available in the form of grants or highly concessional loans.

Macro-economic programme and performance

Against a background of severe economic, social, and administrative dislocation, with fiscal and external imbalances much larger than in other countries in the region, the government of Albania has undertaken since mid-1992 the daunting task of stabilization and reform in the framework of an economic programme. Covering the period mid-1992 - mid-1993, the programme was supported by an IMF stand-by arrangement and complementary financial assistance from EC/G-24.

In view of the great difficulties and risks under which Albania embarked in its programme in mid 1992, achievements on the macroeconomic front have been remarkable. The slide into hyperinflation has been reversed, and the downward spiral of output has been corrected. By the first half of 1993, government domestic financing

requirement dropped (to 12 percent of GDP from 41 percent of GDP in the first half of 1992), while credit expansion was reduced sharply, well within the credit ceilings, and redirected in favour of the incipient private sector. Credit to non-performing public enterprises and state farms has been substantially curtailed since the beginning of 1993. In sharp contrast with the situation prevailing up to the end of 1992, state enterprise financial discipline has been enforced in 1993, and the sharp rise in inter-enterprise arrears that threatened the stabilization effort has been arrested, as the system of receivable orders has been abolished and the banks have been instructed not to accept any payment order not backed by sufficient funds. As a result of the tight budgetary and monetary policies, inflation was curbed (to a monthly rate of 1 percent during the first semester of 1993). Reflecting the strong domestic effort as well as large external support, foreign reserves were built up as planned (amounting to some $ 80 million equivalent to 1 1/2 months of imports at end-June 1993) and the (floating) exchange rate remained fundamentally stable, hovering around leks 100-105 per US dollar. The fall in production seems to have bottomed out since the end of 1992, albeit from a very low base, thanks to the good performance of the private sector (in agriculture, services and construction), whereas state-sector industrial output has continued to drop in 1993 owing to the imposition of financial discipline.

The stabilization gains of recent months remain, however, fragile and tentative and Albania will have to continue to rely heavily on foreign assistance in the short run. Exports ($ 70 million in 1992; $ 105 million in 1993) cover only a fraction of import needs ($524 million in 1992; $ 585 million in 1993). Furthermore, the external outlook remains clouded by Albania's large external debt, mainly with commercial banks ($ 834 million at end 1993, including accumulated arrears of $ 621 million), and Albania's very limited capacity to pay. Whether Albania is able to attain external viability in the medium term will depend critically on an early normalization of relations with commercial banks as well as with bilateral official creditors.

The Government of Albania now aims to sustain the momentum of stabilization process, promote growth and progress toward external viability. To that end, it has formulated a comprehensive medium-term economic strategy for 1993-96 and designed a detailed programme for the first year under this framework (mid-1993 to mid-1994).

The principal macro-economic objectives of the programme for 1993/94 are : a real growth of 3-4 percent; a reduction of the 12-month rate of inflation to 33 percent by mid-1994; and a further strengthening of the external position, including a build-up of official reserves to 3 months of imports by mid-1994. The adjustment strategy will remain centred on tight demand policies, supported by adequate external support and an early solution of the arrears problem.

In order to reduce macro-economic imbalances, fiscal adjustment remains a central element of the programme, together with the continuation of tight monetary and state-sector incomes policies. In view of the expected decline of food aid counterpart revenues and the need to attend to a number of critical expenditure needs (including investment and structural reforms) that can no longer be deferred, the commitment to reduce the domestic financing of the budget to 7 percent of GDP will constitute a major challenge. In support of the Albanian programme, the IMF approved in July 1993 an arrangement under the Enhanced Structural Adjustment Facility (ESAF), and the authorities have requested complementary assistance from the EC/G-24 of $ 72 million for the first year of the programme.

Macroeconomic performance under the new programme is encouraging. All performance criteria for end 1993 were met and the economic situation has continued to improve. GDP rose by an estimated 11 percent in 1993, albeit from a very low base. Inflation was contained to some 30 percent for the whole of 1993, owing to a tight fiscal and monetary policy. Exchange rate has remained stable and external reserves reached the equivalent of two months of imports by end-1993.

Structural reform

While making significant gains in macro-economic stabilization, Albania initiated in mid-1992 profound structural changes towards a market economy. Critical measures under its programme for 1992-93 included major reforms of the price and exchange regimes, liberalization of trade and foreign investment, and the start of other structural changes focusing on agriculture, state enterprises and the financial sector. During this period, progress was made in imposing financial discipline on state-owned enterprises and privatizing agriculture and small scale services and industry. However, reforms have proceeded at a slower pace in the fields of privatization of medium and large sized industrial enterprises and foreign direct investment. A new momentum of structural reforms has been built up in the wake of the preparation of the comprehensive medium-term economic programme for 1993-96 formulated in the Policy Framework Paper.

In the area of price reform, a new series of price rises was implemented in mid-1993, which included the doubling of the prices of wheat, flour and bread, a sensitive issue due to the importance of bread in the local diet and the dependence of the country on wheat imports. Other price rises initiated in mid-1993 include the twofold to threefold increase of public housing rents and household energy.

In agriculture, a key sector of the economy which accounts for half of the value added and employs around 60 per cent of the population, about 80% of the land area has been privatized to date, including nearly all former co-operative farms. The distribution of titles should be completed by the end of 1994. In an effort to facilitate the consolidation of the small holdings, the government plans to complete the legal framework concerning agricultural property, with rights to sell, lease and mortgage the land ,thus leading to the creation of a land market.

The reform of the public enterprise sector poses one of the greatest challenges to Albania's economic programme. At first, in 1992, reform was mostly confined to the privatization through direct sales to employees of the small units operating in the handicraft, transport and services sectors. Privatization in the enterprise sector had been delayed by the difficulty to establish a restitution policy. The passage of a law on the restitution or compensation for urban properties to previous owners in April 1992 have paved the way for the rapid implementation of a privatization strategy, to complement those operated in 1992.

The government is currently developing a multi-track approach that involves rapid privatization of small- and medium-sized industrial enterprises as well as longer-term procedures for large, more problematic enterprises.

The government is proceeding with the estimated 1200-1500 small and medium-size enterprises (up to 300 employees) quickly, without allowing fiscal revenue considerations to slow the process significantly. Some 300 enterprises have already been

identified for this immediate privatization. With regard to the 300 larger enterprises, the government is finalizing a strategy involving rapid privatization or liquidation for most enterprises. A small group of "strategic" firms will be sold by tender. Budgetary support will be minimised, focusing mainly on about 30 "problem" enterprises. To deal with those, the government has established, with the support of the World Bank, an Enterprise Restructuring Agency (ERA) placed under the authority of the Council of Ministers, that should formulate targets regarding privatization, liquidation or restructuring for all enterprises under its control in order to bring these enterprises into operating balance within 1-2 years.

In view of the very weak enterprise sector and the extremely limited outside contacts that Albania had before 1991, it has a particular need for foreign investment. Amendments to the 1992 Foreign Investment Law passed in December 1993, which eliminates separate authorization requirements for foreign investment and allows foreigners to participate in privatization of state assets.

Balance of payments and EC/G-24 macro-financial assistance

In 1992, the EC/G-24 acceded to the Albanian request for macro-financial assistance complementary to the twelve-month stand-by arrangement for US$ 27 million agreed with the IMF. A residual gap of US$ 165 million was to be financed by the G-24 on very concessional terms. The assistance committed by the G-24 under the 1992-93 programme has reached some 70 percent of the original gap, despite the fact that the assistance initially committed by Switzerland and the US was eventually used as tied aid (which does not fall within the G-24 macro-financial assistance scheme).

As a result of the shortfall in external assistance, the mix between domestic policy restraint and external support has differed from what was anticipated. Net domestic assets had to remain well below the programmed ceiling to preserve the external position in the face of the shortfall in balance of payments support. In 1992/93, imports were lower than programmed, despite the higher-than-expected share financed by private transfers; and the external current account deficit (excluding official transfers) is estimated at US$ 450 million, some US$ 150 million lower than programmed. Gross official reserves increased to the equivalent of 1 1/2 months of imports by mid-1993, notwithstanding the shortfall in foreign aid.

For 1993/94, the principal external policy objectives, as outlined before, are to reduce significantly Albania's dependence on emergency assistance and strengthen reserves, and to normalize relations with external creditors. In this context, balance of payments projections for the programme period (July 1993-June 1994) indicate a current account deficit of US$ 408 million (excluding official transfer).

In accordance with this, the Albanian authorities have requested further macro-financial assistance from the G-24 in the context of a new programme covering the first year of an ESAF arrangement that has been approved by the IMF on 14 July. Financing from the IMF amounts to the equivalent of US$ 22 million for the first annual arrangement and about US$ 38 million over the next two years. The assistance requested from the G-24 in this context amounts to US$ 72 million for 1993-94 (down from US$ 165 million for 1992-93).

Main features of the proposed operation

Pursuant to Albania's request, to preliminary discussions at the ECOFIN on 13 September 1993, and to the G-24 High level meeting, the Commission proposes a Community macro-financial assistance for Albania up to ecu 35 million in the form of a grant, covering approximately half of the residual financing gap, in line with practices regarding exceptional balance of payments assistance granted in the framework of the G-24. This initiative is consonant with the conclusions of the Council meeting in June 1993, that it will continue to recognize the opportunity of providing further financial assistance to Albania, a position that was endorsed by the Copenhagen European Council.

The grant would be disbursed in two tranches, with a first tranche of ecu 17.5 million conditional upon the successful completion of the mid-term review of the ESAF first-year arrangement. The second tranche would be made available not before the fourth quarter of 1994, subject to compliance with a number of performance criteria including satisfactory progress in the IMF ESAF arrangement to be assessed by the Commission in cooperation with the Monetary Committee.

The grant will be financed using the existing funds provided for under the budget line for economic restructuring of the countries of Central and Eastern Europe.

Proposal for a

COUNCIL DECISION

Providing further macro-financial assistance

for Albania

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 from the Commission[1], submitted following consultation with the Monetary Committee,

Having regard to the opinion of the European Parliament[2],

Whereas Albania is undertaking fundamental political and economic reforms and has decided to adopt a market economy model;

Whereas the said reforms are under implementation with the financial support from the Community and whereas the reform process needs to be strengthened and broadened;

Whereas trade, commercial and economic links between the Community and Albania will develop within the framework of the Cooperation Agreement;

Whereas financial assistance from the Community will be instrumental in supporting the adjustment and reform efforts of Albania, will strengthen mutual confidence and will bring Albania closer to the Community;

Whereas, by Decision 92/482/EEC of 28 September 1992[3], the Council decided to grant Albania financial assistance of a maximum amount of ECU 70 million, with a view to ensuring a sustainable balance of payments situation in that country;

Whereas, however, despite the government of Albania's courageous implementation of adjustment measures and structural reforms, the stabilization phase of the Albanian economy is still under way, and whereas further official support is required in order to support the balance of payments and consolidate the reserve position;

Whereas Albania is a low-income country eligible for highly concessional loans from the World Bank and the International Monetary Fund (IMF);

1

2

3 OJ N° L287, 2.10.1992, p. 25

Whereas the Albanian authorities have requested financial assistance from the IMF, the G-24 countries and the Community;

Whereas the IMF Executive Board has approved the first annual arrangements under a three-year Enhanced Structural Adjustment (ESAF) on 14 July 1993, and whereas the Group of 24 industrial countries (G-24) agreed to consider complementary financial assistance particularly through grants or loans on concessional terms;

Whereas, over and above the estimated financing which could be provided by the IMF, the World Bank and official bilateral creditors, a financing gap of some US$ 72 million remains to be covered in order to strengthen Albania's reserve position and avoid an additional degree of import compression which would jeopardize the achievement of the policy objectives underlying the Government's reform effort;

Whereas the Commission, as coordinator of assistance from the G-24 has invited them to provide highly concessional financial assistance to Albania in order to support that country's adjustment and reform efforts;

Whereas taking into account the economic and financial situation of Albania, this financial assistance intended to support that country's balance of payments should take the form of grants;

Whereas the Community grant 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 grant to Albania macro-financial assistance of a maximum amount of ECU 35 million in the form of a grant, with a view to ensuring a sustainable balance of payments situation and strengthening the reserve position of that country.

2. This grant 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 negotiate with the Albanian authorities, after consultation with the Monetary Committee, the economic policy conditions attached to the grant. These conditions shall be consistent with any agreement as referred to in Article 1 (2) and with arrangements made by the G-24.

2. The Commission shall verify at regular intervals, in collaboration with the Monetary Committee and in close coordination with the G-24 and the IMF, that the economic policy in Albania is in accordance with the objectives of this grant and that the conditions of the latter are being fulfilled.

Article 3

1. The grant shall be made available to Albania in two instalments. Subject to the provisions of Article 2 (1), a first instalment of ECU 17 million shall be released on the basis of a successful completion of the mid-term review of the First Annual Arrangement under the ESAF between Albania and the IMF. The second instalment shall be paid not before the fourth quarter of 1994, subject to the provisions of Article 2 (2) and subject to satisfactory progress being recorded in Albania's application of the ESAF.

2. The funds shall be paid to the National Bank of Albania.

Article 4

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 Brussels,

For the Council

the President

FINANCIAL RECORD

1. Budget lines concerned

   Article (B7-600) Aid for economic restructuring of the countries of Central and Eastern Europe.

2. References (legal base)

   Article 235 of the Treaty.

3. Classification of the Expenditure

   Non compulsory

4. Classification and Justification for the action

   a) Description of the action

      Provision of a grant from the Community Budget to Albania in view of supporting its balance of payments and strengthening the country's reserve position.

   b) Justification for the action

      The viability of Albania's balance of payments still heavily depends on external financial assistance from official sources.

5. Nature of the expenditure and method of calculation

   a) Nature of the expenditure

      Straight grant, which would be released in two tranches not before, respectively, the second quarter of 1994 and the 4th quarter of 1994.

   b) Method of calculation

      Approximately 50% of the residual balance of payments financing gap of Albania, as estimated in the 12-month IMF programme agreed in July 1993.

6. Effect of the action on intervention credits

   The budget entry will be activated subject to compliance with a number of economic conditions including satisfactory progress of an IMF ESAF arrangement.

7. Financing of intervention expenditure

   35 MECU on B7-600.

10

ISSN 0254-1475

COM(94) 112 final

DOCUMENTS

EN **11**

Catalogue number : CB-CO-94-125-EN-C

ISBN 92-77-67117-3

Office for Official Publications of the European Communities
L-2985 Luxembourg