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MINISTRIA E FINANCAVE

GENERAL DIRECTORATE OF PUBLIC DEBT

MEDIUM TERM

DEBT MANAGEMENT STRATEGY

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Acronyms

AFSA	Albanian Financial Supervisory Authority
WB	World Bank
EU	European Union
NCB	National Commercial Bank
CEB	Central European Bank
BoA	Bank of Albania
EUR	Currency of the European Union
IMF	International Monetary Fund
ATM	Average Time to Maturity
ATR	Average Time to Re-fixing
ALL	Local Currency *(Albanian Lek)*
NPL	Non Performing Loans
GDP	Gross Domestic Product
PBG	Policy Based Guarantee
PB	Basis Points
PP	Percentage Points
MTDMS	Medium Term Debt Management Strategy
USD	United States Dollar
YEN	National Currency of Japan
WAY	Weighted Average Yield

Summary

The overall objectives[1] of debt management are:

i. To ensure the government financing needs, as well as the needs for servicing the current debt with the lowest cost subject to maintaining a prudent degree of risks exposure.
ii. To develop the primary and secondary market of government securities.

In order to achieve the aforementioned objectives, it is prepared the Medium Term Debt Management Strategy (MTDMS) which is updated and published by the Ministry of Finance on an annual basis. The MTDMS is in line with macro-fiscal framework and monetary policies implemented by the Bank of Albania over the medium term 2016-2018. The MTDMS is a continuation of the previous strategy and it is characterized by the same objectives.

The MTDMS is responsible for the management of Central Government Debt, which includes the State Debt and the Guaranteed State Debt. The purpose of the MTDMS is to orientate borrowing towards instruments with favorable cost and subject to acceptable levels of risk exposure for certain levels of funding. Funding levels are determined in the macro-fiscal framework and Medium Term Budget Plan, which is divided in Annual Borrowing Plans.

Domestic debt management will continue to focus on the reduction of refinancing risk and interest rate risk, by further reducing the ongoing high level of short term securities. In this context, the MTDMS in the medium term 2016-2018 will realize domestic financing mainly through long-term securities with fixed interest rates. Interest rates at historical low levels make the implementation of this strategy less costly by guaranteeing an optimal relation between cost and risk.

Foreign financing will be based on soft term financing from international institutions for the existing development projects, for the new projects considered as priorities by the Government for the development of the country and as well on budgetary support granted by the WB and IMF. There is also a possibility that during the medium term 2016-2018 there will be a Eurobond issuing in the international capital markets in order to further extend maturity, create *benchmarks*[2] for long-term securities and decrease the borrowing pressure in the domestic market.

The further development of the primary securities market is another objective of the debt strategy. In this direction, over the medium term the focus will be to undertake the following specific activities:

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[1] Referring to Law No. 9665, dated 18.12.2006, as amended, on "State Borrowing, State Debt and State Loan Guarantees in the Republic of Albania"

[2] The explanation of technical terms is found at the end of the document, in the **Annex II** "Technical Vocabulary"

i. Reduction of demand segmentation for Government Bonds by withdrawing from the market one or several securities that compete with each other;
ii. Establishment of benchmark sizes for long-term government bonds by using more frequent re-opening of existing auctions;
iii. Maintain regular and continuous consultation with the main stakeholders of the market;
iv. Increase diversification and expansion of the base of investors.

I. DEVELOPMENTS OF CENTRAL GOVERNMENT DEBT

1. Debt Management and Realization of Objectives

The main objective of debt management during 2015 has been to provide the necessary funds in order to serve the obligations arising from existing debt, and obligations arising from the difference between income and expenditure in the Government budget. At the same time, very important for debt management has been the realization of the abovementioned objective in accordance with the strategic objectives for reducing the risk exposure and maintaining under control the costs associated with debt.

2015 was an intensive year for the debt management of the Republic of Albania due to the high funding level of the existing debt. It is worth mentioning the refinancing of approximately 60.3% of domestic debt and refinancing of Eurobond issued in 2010 in the amount of 41.6 billion ALL.
During 2015, by domestic and foreign debt instruments, it was funded in total an amount of ALL 544.2 billion or equal to 37.7% of GDP. *(Sub-chapter 4.)*

Despite the high level to be funded, debt management in cooperation with other structures responsible for liquidity management in the Ministry of Finance successfully funded all the needs of the Central Government by realizing at the same time the strategic objectives for:

(i) Reduction of risks exposure *(refinancing risk, interest rate risk and liquidity risk)*;
(ii) Reduction of debt cost;
(iii) Reduction of borrowing pressure in the domestic market;
(iv) Re-affirmation of Albania in international capital markets.

The Instruments that enabled the realization of strategic objectives are long-term bonds *(mainly 7 and 10 year bonds)* in the domestic market, as well as PBG and Eurobond in the foreign market.

In the context of risk reduction, debt management was focused on two main directions: (i) towards the increase of long-term instrument weight through the issuance of 7 year and 10 year bonds with fixed interest rates, and (ii) towards the reduction of instrument weight with a relatively low residual maturity, through the buyback procedure. This procedure was made possible by the additional amount (EUR 400 million) funded by PBG and Eurobond issuance. (Sub-chapter 3.2.)

Usually the reduction of risk exposure is accompanied with cost increase, but during 2015 debt management realized this objective by bearing a relatively low cost. This was made possible by exploiting the fall of interest rates for long-term securities in the domestic market and as well as by funding 700 million EUR *(PBG+Eurobond)* in the foreign market with an average cost of 3.5%[3] and average maturity of 7.25 years. *(Sub-chapter 3.1)*

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[3]A debt with similar risk characteristics in the domestic market would be funded with almost double the cost.

On the other side, the additional funding from PBG and Eurobond made possible the reduction of government supply for securities in the domestic market, by reducing the pressure on interest rates and stimulating the increase of private sector crediting.

The Eurobond Issuance in November, in addition to the refinancing of the previous Eurobond, also enabled the improvement of the domestic debt structure and served as an instrument for reputation improvement and re-affirmation of the country in international capital markets.

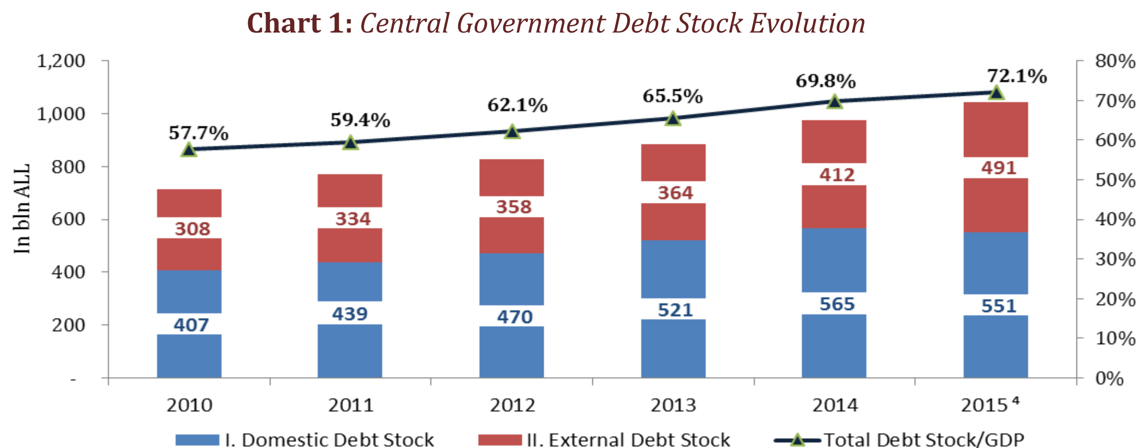
2. Central Government Debt Development

At the end of 2015, the level of Central Government debt stands at 72.1% of GDP.

Until 2012, the increase of debt is basically attributed to the expansion of budget deficit and to the slow economic increase. Meanwhile, starting from 2013 the recognition of unpaid obligations and invoices accumulated *(about 5 percent of the GDP) was the determinant factor that* led to the increase of debt to GDP ratio. Starting from 2014, the implementation of an economic fiscal program and the reforms undertaken especially in the energy area, have decreased the rate of debt accumulation and have accelerated the rate of economic growth. As result, the level of debt is expected to be reduced to 60% of the GDP by the end of 2019.

During 2015, the level of Central Government debt to GDP was increased by 2.3 pp and the whole weight of increase was held by the external debt. The increase of external debt came as a result of the favorable conditions in external markets and as a result of Government's initiative to reduce the pressure of domestic borrowing and to give breath to the private sector crediting. *(Chart 1)*

Chart 1: *Central Government Debt Stock Evolution*



Source: *Ministry of Finance*

[4] Priliminary data because of external debt revaluation. Changes that may accur are of low magnitude and they do not effect the analysis conducted in this document.

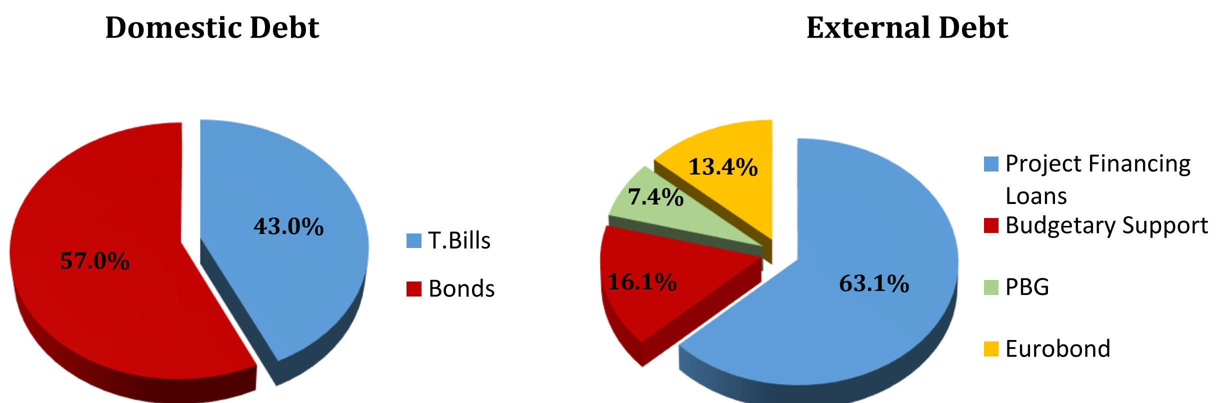
2.1. Government Debt Portfolio

In December 2015 the portfolio of Government debt is ALL 986.1 billion or 94.6 % of the Central Government debt portfolio. The ratio of domestic and external debt to total Government Debt is respectively 52.8% and 47.2%.

2.1.1. Composition by instruments

The domestic government debt consists 100% of tradable instruments, such as treasury bills and bonds. Meanwhile, the foreign Government debt consists of 86.6% of non-tradable instruments, such as loans for development projects, budget support and partially guaranteed loan by World Bank *(PBG)*. The remaining of 13.4% consists of tradable instruments in international markets such as Eurobond. *(Chart 2)*

Graphic Presentation 2: *Government debt stock composition by instruments*



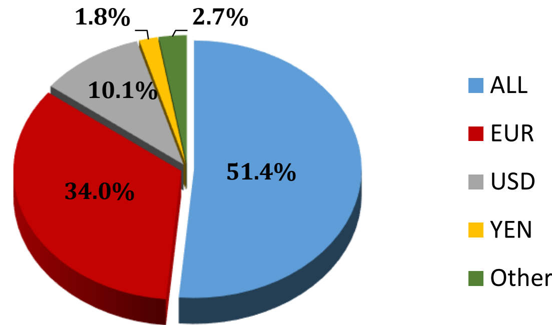
Source: *Ministry of Finance*

During the recent years, domestic debt was characterized by continuous increase in the weight of bonds, as part of debt management policies on the reduction of risks exposure.
Meanwhile, external debt is characterized by an increase in the weight of budgetary support. The increase of this instrument is linked to the policy of the Government for the clearance of arrears, aiming the decline of NPL level in economy and stimulating the increase of private sector crediting.

2.1.2. Composition by currency

At the end of 2015, about 51.4% of the Government debt is denominated in local currency, meanwhile the remaining is in foreign currency and Euro currency prevails in about 70%. *(Chart 3)* About 97.2% of domestic debt is denominated in local currency; meanwhile the external debt is completely denominated in foreign currency.

Chart 3: *Government debt stock composition by currency*

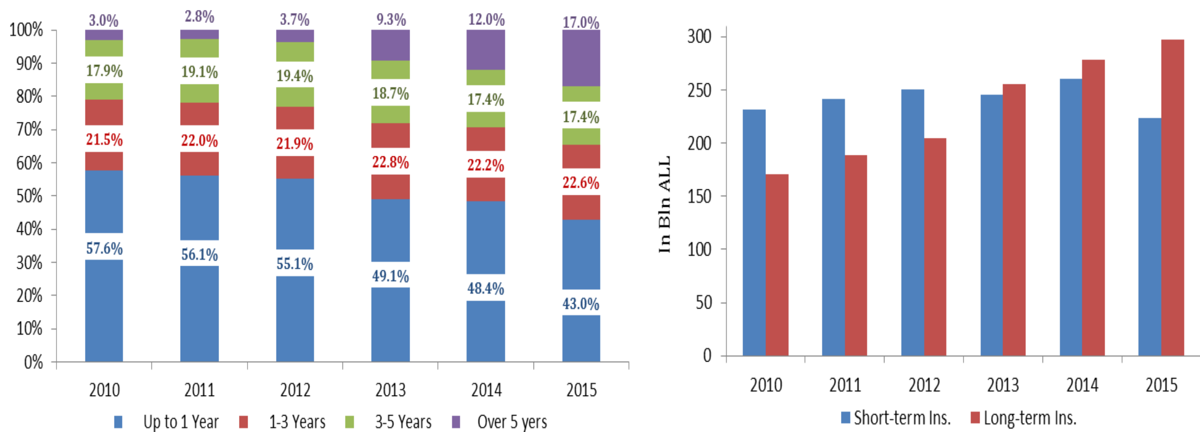


Source: *Ministry of Finance*

2.1.3. Composition by instrument maturity

In December 2015, approximately 77.3% of the Government debt consists of instruments with maturity greater than one year. The external debt entirely consists of instruments with long maturity, meanwhile at domestic debt long-term instruments cover approximately 57.0% of the portfolio. The average maturity of domestic and foreign debt are respectively 1.96 and 8.1 years. For domestic debt portfolio, 2015 has been a positive year, because compared to the previous year, the weight of long-term debt in portfolio has been increased with 5.4 pp. The increase of weight in the category of long-term instruments is mainly caused due to the successful issuance of the 10 year bond and also as result of the low level of maturities in this category of instruments.

Chart 4: *Government debt stock composition by instrument maturity*



Source: *Ministry of Finance*

2.1.4. Composition by interest type

At the end of 2015, about 68.2% of the Government debt portfolio is composed by fixed interest rates or about 77.4% of this portfolio is composed of commercial interest rates. Domestic debt is composed mostly by fixed rate instruments up to the extent of 86.1% and it

is fully issued with commercial interest rates. Meanwhile, the external debt is composed by 48.1% fixed interest rates and 47.9% concessional interest rates. *(Table 1)*

Table 1: *Government debt stock composition by interest type (2014-2015)*

Interest Type	2014			2015		
	Domestic Debt	External Debt	Total	Domestic Debt	External Debt	Total
Fixed Interest	85.4%	50.2%	**70.8%**	86.1%	48.1%	**68.2%**
Variable Interest	14.6%	49.8%	**29.2%**	13.9%	52.0%	**31.8%**
Concessional Interest	0.0%	51.8%	**21.6%**	0.0%	47.9%	**22.6%**
Commercial Interest	100.0%	48.2%	**78.4%**	100.0%	52.1%	**77.4%**

Source: *Ministry of Finance*

2.2. Guaranteed Debt Portfolio

In December 2015, the Guaranteed Debt Portfolio stands at ALL 56.0 billion, 3.9% of GDP or 5.4% of the Central Government Debt Portfolio. About 54.3% of the outstanding guaranteed debt portfolio is issued in the domestic market and 45.7% in the external market. Compared to the previous year, guaranteed debt increased with ALL 1.5 billion, due to the issuance of three new guarantees in the total amount of ALL 12.9 billion. *(Table 2)*

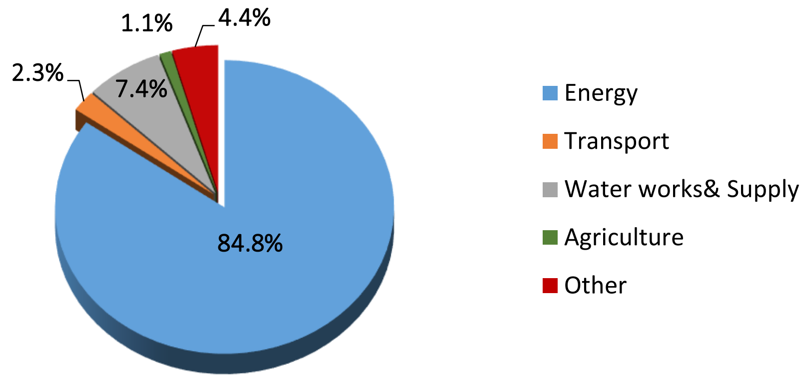
Table 2: *State guarantees issued during 2015*

Guaranteed Subject	Object of the Guarantee	Amount (in billion ALL)	Investor
KESH Sha.	Guaranteeing the existing lines of overdrafts	4.5	Domestic Banking System
OST	Energy efficiency	5.6	KfW
ART	Construction of numeric networks	2.8	Deutche Bank

Source: *Ministry of Finance*

About 95% of the Albanian state guarantees were issued in favor of the Energy Sector, Water works and Supply, and Transport Sector. *(Chart 5)*

Chart 5: *Government guaranteed debt by economic sector*



Source: *Ministry of Finance*

3. Costs and Risks of Government Debt

During 2015 the Government Debt portfolio was characterized by a stable relation between cost and risk, in accordance with strategic objectives. Debt costs mainly decreased due to the fall of interest rates in domestic and foreign markets. Debt structure has shown considerable improvements mainly within the framework of reducing the exposure toward refinancing risk and interest rate risk. In terms of exchange rate risk, it is observed a moderate increase of exposure.

3.1. Costs

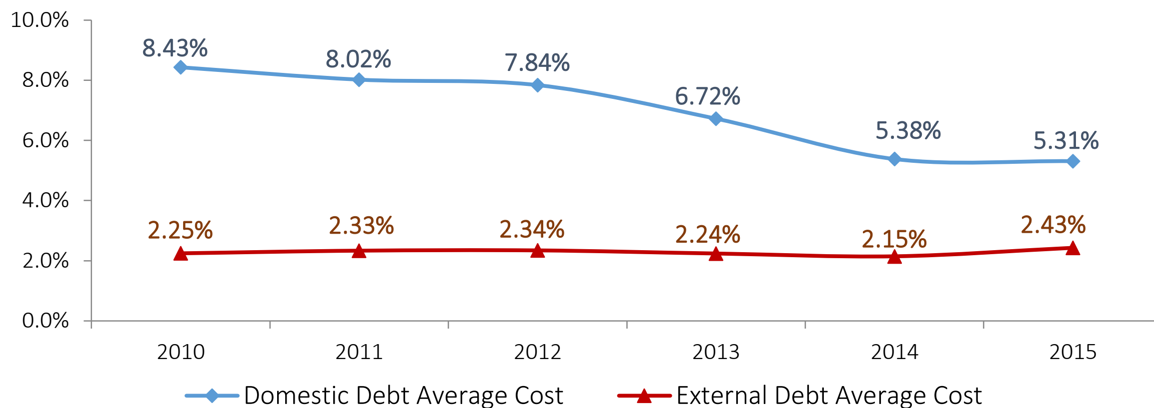
During 2015 the cost of Government Debt generated from the payments of interest is estimated in ALL 38.6 billion or 2.67% of the GDP, where 1.9% of GDP are payments for domestic debt interest and 0.78% of GDP for the external debt interest. During the recent years, the cost of debt have been characterized by a declining trend, which is mainly driven by the decrease in interest rates, especially in the domestic market.

Chart 6: *Government Debt interest payments*

Source: *Ministry of Finance*

Referring to *chart 7,* domestic debt appears to be more costly than the external debt, mainly due to the fact that domestic debt is issued with commercial terms and due to macro-economic conditions characterizing the country. However, the average cost of the domestic debt has been continuously reduced even though the weight of long-term instruments in the portfolio has been increased. In the meantime, the average cost of the external debt during the recent years has been more stable by fluctuating with max 10 bp. The year 2015 is an exception, because average cost of external debt has been increased with 29 bp, mainly due to the increase of debt weight contracted with commercial terms *(non-concessional).*

Graphic Presentation 7: *Average cost of domestic and external debt*



Source: *Ministry of Finance*

3.2. Risks

Within the framework of risk reduction 2015 has been a positive year. The risks associated to debt have been decreased and kept under control in accordance with the strategic objectives set in the previous strategy.

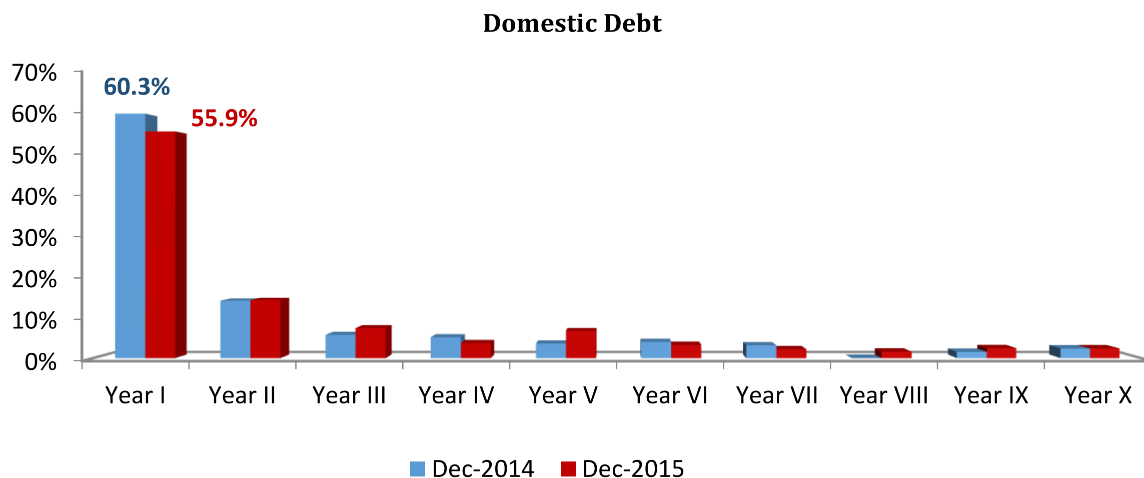
Reduction of refinancing risk and interest rate risk were mainly caused by the declining weight of short-term securities and securities with variable interest rates in the portfolio of domestic debt. In this direction, has contributed the decrease of domestic financing as result of the net increase in foreign financing by the use of instruments such as PBG *(+250 million Euro)* and Eurobond *(+150 million Euros),* as well as the satisfactory demand for long-term governmental securities. The reduction of domestic funding has not only reduced the pressure of borrowing in the domestic market for securities, but it has also enabled the chance to mature some of the securities *(maturity through the Buyback procedure)* with a relatively low residual maturity, by contributing in the improvement of the domestic debt structure beyond expectations.

Even though exchange rate risk has deviated from the initial strategic objective, it remains under control. The deviation has been moderate and the benefits from such deviation within the framework of reducing risk exposure toward refinancing and interest rate risk have been greater. On the other side, the increase of foreign financing has contributed on the reduction of interest rate pressure in the domestic market by decreasing debts costs.

3.2.1. Refinancing Risk

The reduction of refinancing risk, particularly in the domestic debt portfolio is one of the main objectives of debt management.
In this direction external debt represents less risk since it is composed by long-term maturity instruments and amortization profile is extended over time. Meanwhile, domestic debt is exposed in a higher degree toward this risk due to the considerable weight of short-term instruments. *(Chart 8)*
In December 2015 the domestic debt structure appears less exposed to refinancing risk, as there is an improvement in the distribution of liabilities arising from the repayment of existing debt. The weight of instruments *(in percentage of the total),* which are refinanced within one year is 55.9%, approximately 4.4 pp lower than in the end of the previous year, and 3.5 pp beyond the strategic objective. *(Chart 9)*

Ghart 8: *Government debt amortization profiles*



Source: *Ministry of Finance*

In December 2015 the average time in maturity *(ATM)* of the Government Debt portfolio is 4.9 years, respectively 2.0 years for domestic debt and 8.0 years for external debt. Compared to the end of the previous year, this indicator has an improvement of 0.7 years, respectively 0.2 years on the domestic debt and 0.5 years on the external debt. Strategic objectives were realized by exceeding with 0.2 years for the domestic debt and 0.1 years for the external debt. *(Table 3)*
The lifespan of domestic debt has increased as a result of the maturity of short-term instruments through buyback procedures and as well due to the increase in weight of long term instruments *(mainly 7 and 10-year notes)*. Meanwhile, the average maturity of external debt has increased due to the maturity of several instruments *(Eurobond 2010)* and substitution with new instruments with a greater maturity *(Eurobond 2015)*. In addition, the issuance of PBG in the amount of EUR 250 million and with an average maturity of 8.75 years has played an important role in the increase of external debt average maturity.

Table 3: *Refinancing risk indicators*

Indicator	2015			Strategic Objective		
	Domestic Debt	External Debt	Total	Domestic Debt	External Debt	Total
Debt matured within a year *(In % of total)*	55.9	4.3	**31.6**	59.4	5.5	**35.4**
ATM *(Years)*	2.0	8.0	**4.9**	1.8	7.9	**4.5**

Source: *Ministry of Finance*

The efforts to reduce refinancing risk will continue, as domestic debt remains yet exposed to this risk and there is need for further improvements in the context of increasing the share of long-term instruments and creating a smoother amortization profile.

3.2.2. Interest rate risk

During 2015 was made an obvious progress within the framework of reducing the interest rate risk exposure. In this aspect, keeping under control the share of instruments with variable interest rates and as well as reducing the share of short-term instruments in the portfolio, have been key factors.
The share of debt with fixed interest rate in the end of the year 2015 stands at 48.6% of the portfolio or 6.1 pp more than in the end of the previous year. In the domestic debt, this indicator has increased with 6.2 pp, mainly due to the reduction of short-term instruments from 48.4% to 43.0%. In addition, the weight of instruments which are re-fixed within the timeframe of a year decreased from 65.9% to 58.1%. Other than the domestic debt also the external debt has contributed to the improvement of this indicator, which is more stable after the maturity of several instruments with a relatively high weight and substitution with new instruments with relatively high average maturity.

Table 4: *Interest rate risk indicators*

Indicator	2015			Strategic objective		
	Domestic Debt	External Debt	Total	Domestic Debt	External Debt	Total
Fixed interest rate debt/total	43.2%	54.6%	**48.6%**	40.9%	55.8%	**48.8%**
Re-fixed debt in one year/total	67.7%	47.3%	**58.1%**	70.8%	46.7%	**60.1%**
ATR	1.82	4.8	**3.2**	1.63	4.6	**3.0**

Source: *Ministry of Finance*

Referring to *Table 4* it results that the strategic objectives for maintaining under control the interest rate risks have been successfully achieved.
The objective of further reducing the exposure to interest rate risk will continue to be among the main objectives of MTDMS, given that more than 58% of the Government debt portfolio is re-fixed over the course of a year and the public debt continues to have a relatively high exposure to interest rate movements. Interest rate shocks in the domestic and external markets may result to an increase in budget spending and to an increase in debt level.

3.2.3. Exchange rate risk

The stock of Government debt denominated in foreign currency increased from 43.1% of total in year 2014 to 48.6% in year 2015, by causing a moderate increase of exposure to the exchange rate risk. *(Table 5)*

Table 5: *Government debt stock in local and foreign currency*

Currency	2014		2015		Strategic objective
	In million ALL	In %	In million ALL	In %	In %
Local	524,995.6	**56.9%**	506,594.6	**51.4%**	**Min 55.0%**
Foreign	397,567.3	**43.1%**	479,536.0	**48.6%**	**Max 45.0%**

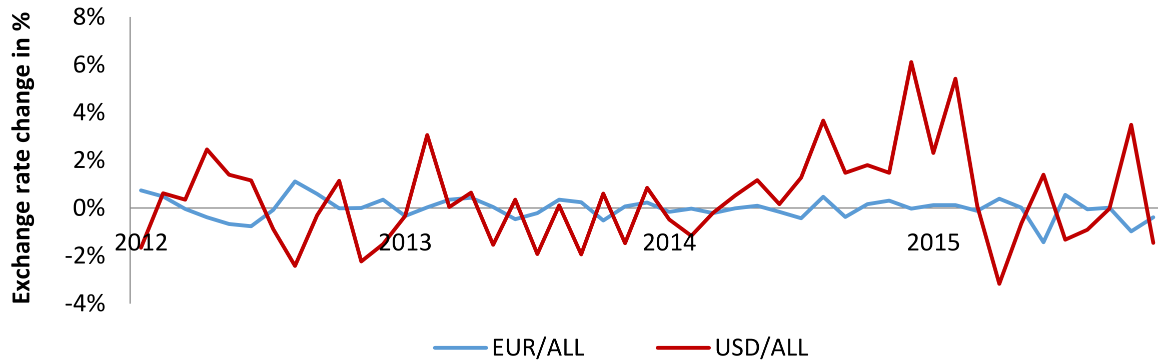
Source: *Ministry of Finance*

The increase of debt level denominated in foreign currency is mainly caused by the budgetary support used for the repayment of arrears, the World Bank's partial guarantee (PBG) and Eurobond. The 3.6% increase over the objective was as result of the favorable costs of borrowing in foreign markets, the further facilitation of the borrowing pressure in the domestic market and within the framework of reducing the exposure toward refinancing and interest rate risk.
About 70.0% of the foreign currency portfolio consists of the Euro currency, making this portfolio not much diversified. However, the great weight of the portfolio in the Euro currency is in compliance with the strategic objectives and with the aspirations of the country to be part of European Union in a near future.

On the other side, the lack of diversification has not constituted any concern during the recent years, because the Euro currency has not been much volatile in relation to the local currency, mainly due to the economic relations with the EU countries.

Referring to the *chart 9* it results that during the recent four years, the maximum exchange rate fluctuation between EUR and ALL has been 1.4%. Meanwhile, the local currency has had fluctuations reaching 6.0% against the USD, which is also the second most important currency regarding the weight in the debt portfolio.
During the recent years, the costs from the changes in the exchange rates have been moderate. Contribution in this regard has the movement in opposite directions between EUR and USD, and the fact that the debt denominated in foreign currency has a smooth redemption profile.

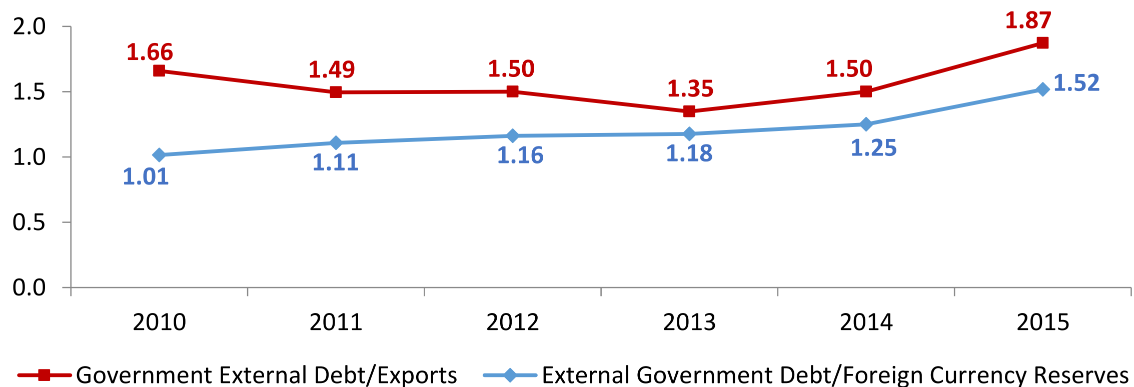
Chart 9: *Change in the exchange rate EUR/LEK and USD/LEK (2012-2015)*



Source: *Ministry of Finance*

Despite the not high exposure towards exchange rate risk, in the future it is very important to keep this risk under control, as it may effect negatively debt sustainability and the Government repayment capacity over liabilities in foreign currency.
The ratios of debt in foreign currency against exports and foreign currency reserves are very significant indicators, which evaluate the above aspect.
During the recent years, these two ratios have increased by showing a fall in the repayment capacity in foreign currency. Starting from 2013 the increase of debt in foreign currency has been higher than the increase of exports and foreign exchange reserves. *(Chart 10)*

Chart 10: *External debt to exports and to foreign currency reserves ratios*



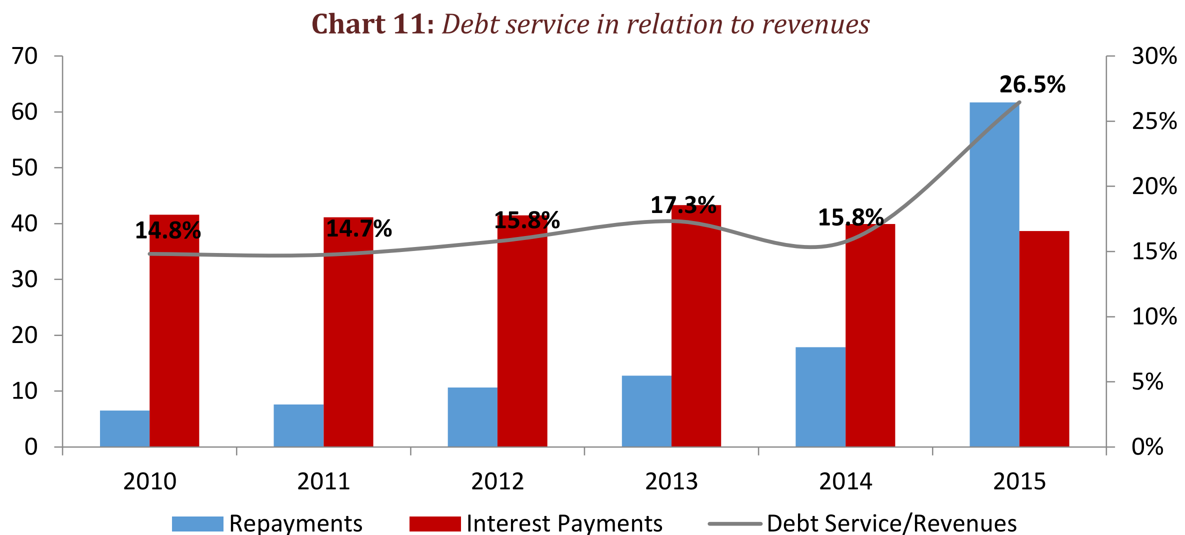
Source: *Ministry of Finance*

Even though the effects of the exchange rate have been moderate, in the future it is important that external debt to be increased proportionally with exports and foreign currency reserve.

3.2.4. Liquidity risk

Year 2015 was a year with high liquidity needs mainly due to the high level of debt repayments in the amount of ALL 489.5 billion, or ALL 80.0 billion more than in 2014. This is basically linked with the maturity of Eurobond in the amount of 300 million Euros *(about ALL 41.4 billion)*. Regardless the high refinancing needs, this year was successfully managed by not producing any delays in the payments of liabilities arising from the debt. Also, no extraordinary auctions were conducted, which may create confusion to investors and increasing pressure on interest rates. Key factors in the successful management was the good planning of financing, the good coordination with the unit *(Treasury Directorate)* responsible for cash management, and the use of new alternative sources in the external market *(PBG)* in order to give breath to the domestic market.
Despite the reduction of the debt cost per unit, the ratio indicator of debt service to income signals a growth of liquidity risk which is mainly driven by the increase of external debt repayments.

Chart 11: *Debt service in relation to revenues*



Source: *Ministry of Finance*

The improvement of this indicator is closely linked to debt reduction, consolidation of revenues in the budget and further reduction of the debt cost.
Regarding the strategic objectives for keeping under control the liquidity risk, it results that some of these objectives have been successfully achieved. It is worth mentioning the realization for the first time of buyback transactions which enabled the removal from the market of instruments with relatively low residual maturity. Regarding the redistribution of the weight for several instruments in different auctions, this objective has not been realized due to the issuance of the Eurobond in the second half of the year and keeping the PBG funding in the form of guarantee considering the worst-case scenario for the non-realization of Eurobond.

3.2.5. Operational Risk

Operational risk in the recent years has been improved in the framework of increasing capacities and improving the analytical tools used in debt management processes. Here we can mention the staff training and the ongoing cooperation with international institutions such as the World Bank and IMF in order to adopt the best international practices in debt management and development of the Government securities market. In addition, a draft manual has been prepared for the internal activities of the public debt management unit.

The existing staff possesses good technical skills, but it is below the optimum number required by the structure, increasing the key person risk. Domestic and external debt continue to be stored in separate databases, making the data reporting and processing difficult and with high risk. The system for the registration of external debt data *(DMFAS)* has not been updated yet to the new version, but are undertaken all the necessary procedures in order to update it during the next year.

4. Financing Sources

During 2015, debt financing served to cover the refinancing of existing debt instruments and as well as to cover the budget deficit.
In contrast to previous years, in 2015, innovation has been the use of PBG as well as the issuance of the Eurobond in the international capital markets.
These instruments were issued at favorable interest rates and enabled the decrease of borrowing pressure in the domestic market, with the aim of improving the structure of domestic debt. Furthermore, the issue of these instruments aimed the substitution of some domestic debt with debt with more favorable terms of cost and risk.

In 2015, the total financing need[5] was in the amount of ALL 545.7 billion or 37.8% of GDP, respectively ALL 410.4 billion through domestic sources and ALL 135.3 billion through foreign sources. About ALL 489.4 billion served for the refinancing of the existing debt and the rest to cover the budget deficit. In comparison with the previous year, refinancing of the existing debt was about 62.5 billion ALL higher, mainly due to the refinancing of the Eurobond issued in 2010. *(Table 6)*
Even though the amount to be financed with debt has been relatively high, the Ministry of Finance successfully managed it by using efficiently and in due time the domestic and foreign financing sources.

[5] Refers to gross financing by debt instruments

Table 6: *Financing by domestic and foreign instruments*

Financing Instruments	Dec-2014		Dec-2015	
	Amount	%	Amount	%
I. Financing with Domestic Debt	429,391.9	88.9%	**410,368.4**	**75.2%**
i.Treasury Bills (bills)	*337,433.2*	*69.8%*	*318,042.0*	*58.3%*
ii.Bonds	*91,958.7*	*19.0%*	*92,326.4*	*16.9%*
II. Financing with Foreign Debt	53,770.5	11.1%	**135,287.0**	**24.8%**
i.Budget Support	*30,508.6*	*6.3%*	*14,591.6*	2.7%
ii.PBG	-	*0.0%*	*34,897.5*	6.4%
iii.Eurobond	-	*0.0%*	*62,009.4*	11.4%
iv.Loan for Project Financing	*23,261.9*	*4.8%*	*23,788.5*	4.4%
Total of Financing	483,162.5	100.0%	**545,655.4**	**100.0%**

Source: *Ministry of Finance*

In the domestic market as a funding source were used treasury bills and bonds with the aim to increase the share of long-term instruments. This goal was fully realized after the issuance of the Eurobond in November, which provided the required liquidity and enabled the withdrawal of securities from the domestic market in the value of ALL 51.7 billion. Alternatives that enabled such withdrawal were the *buybacks* and maturity without refinancing or partially without refinancing the securities.

Through the buyback procedure was withdrawn the amount of ALL 19.65 billion, mainly treasury bills and bonds with a relatively low residual maturity. Meanwhile, through maturities was withdrawn the amount of ALL 32.0 billion, out of which ALL 21.5 billion through full maturities and ALL 10.5 billion through partial maturities.

In the foreign market, in addition to the above-mentioned instruments *(PBG, Eurobond)* it was used the budgetary support within the framework of the agreement with the IMF for the clearance of arrears and as well as the disbursement of the existing loans within the framework of financing development projects. In comparison with the previous year, the disbursements for financing projects were almost 5.5% lower. The sectors which have mostly benefitted were transport, energy and water supply sewerage, respectively with 31.8%, 28.7% and 20.1% of the total disbursements.

During this year, within the framework of project financing, the Republic of Albanian had dynamic relations with creditors, such as: KfW, IDB, IDA, IBRD, BERZH, CEB, etc, by signing new projects reaching the amount of EUR 526 million.

5. Primary Market Development

5.1. Evolution of auctions and demand for Government securities

During 2015 were organized 96 auctions in total for governmental securities, respectively 53 auctions for treasury bills and 43 auctions for bonds *(out of which 5 are re-openings)*. The supply for governmental securities was ALL 446.0 billion, meanwhile the demand of investors was relatively higher, approximately ALL 498.5 billion. The cover ratio *(Bid/Cover)* that evaluates the demand for Government securities was 1.12, meanwhile in 2014 this ratio was lower *(1.06)* despite the higher demand for securities. *(Table 7)*

The increase of this indicator during 2015 is as result of the supply reduction in a higher degree than the market demand.
Except January, August and October where the Bid/Cover was respectively 0.92, 0.91 and 0.97, in all the other months the market demand for securities was higher than the supply of the Ministry, by reflecting a ratio higher than 1. Market demand for treasury bills and notes was the same *(1.12)* by not reflecting any special preferences for Government securities.

Table 7: *Demand for Government securities in the primary market*

Period	Indicator	Treasury Bills	Bonds	Government Securities Total
2015	**No. of auctions**	53	43	96
	Amount required *(in million ALL)*	380,224	118,364	498,588
	Amount provided *(in million ALL)*	340,682	105,378	446,060
	Cover ratio	1.12	1.12	1.12

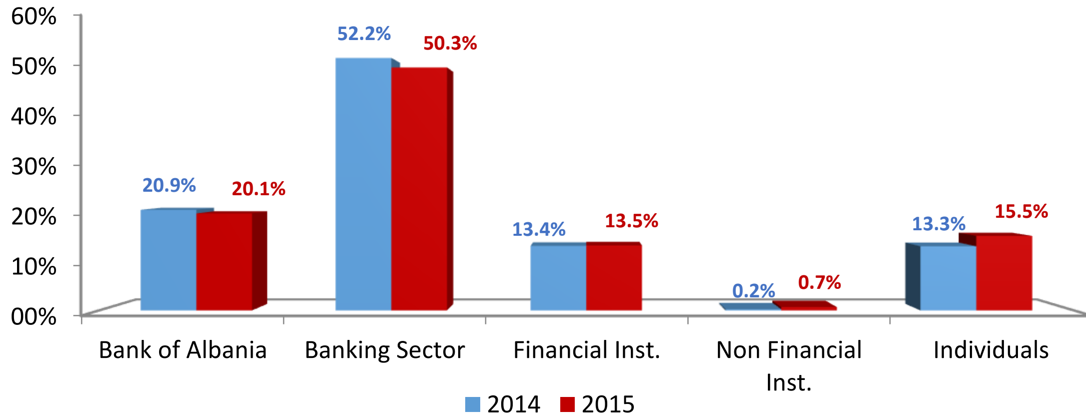
Source: *Ministry of Finance*

The main actors of the demand for governmental securities during 2015 were:

- Banking Sector with 50.3 %
- Bank of Albania 20.1%
- Individuals with 15.5%
- Financial Institutions with 13.5%
- Non-Financial Institutions with 0.7%

During 2015 there was a diversification of the demand for government securities that was characterized by a reduction in the banking system and an increase in individuals and non-financial institutions. However, the demand as during the previous year, continues to be focused in more than 50% in the banking sector. During 2015 there was a fall in the demand by this category of investors with 1.96 pp, meanwhile within the same category, there is a decrease of diversification due to the increase of concentration of the demand with 12 pp towards three main banks *(Raiffeisen Bank, BKT and Credins Bank)*. The decreasing demand from the banking system is mostly reflected in the segment of long-term instruments.
A characteristic for 2015 is the increase of demand by individuals and to a certain extent by non-financial institutions. The increasing demand by individuals has come as a result of the more favorable interests offered by government securities compared to bank deposits and also due to increasing information regarding the procedures of investing in government securities. The increasing demand by individuals is mostly concentrated towards long-term instruments.

Chart 12: Primary market *demand for Government securities*



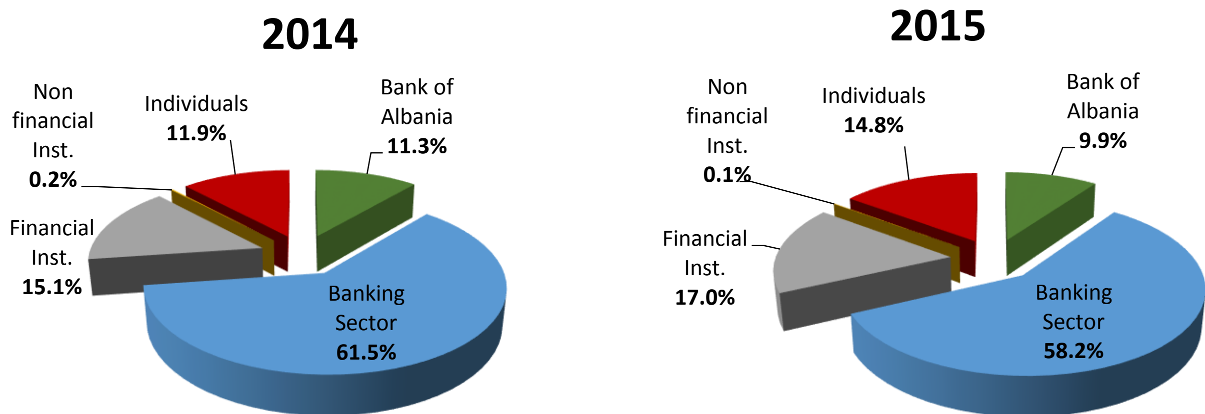
Source: *Ministry of Finance*

5.2. Debt holders

During 2015 the debt holders of the domestic debt portfolio almost reflect the characteristics of demand, associated with an increase in diversification in terms of decreasing the share of debt held by the banking system *(including the Bank of Albania)* and increasing the share of individuals and other financial institutions. *(Chart 13)*

The increase of diversification of debt holders minimizes the refinancing risk as it increases the independence to certain investors. On the other side, diversification of demand is associated with the increase in competition and it may result to downward pressure on interest rates.

Chart 13: *Domestic debt holders in the primary market for government securities*



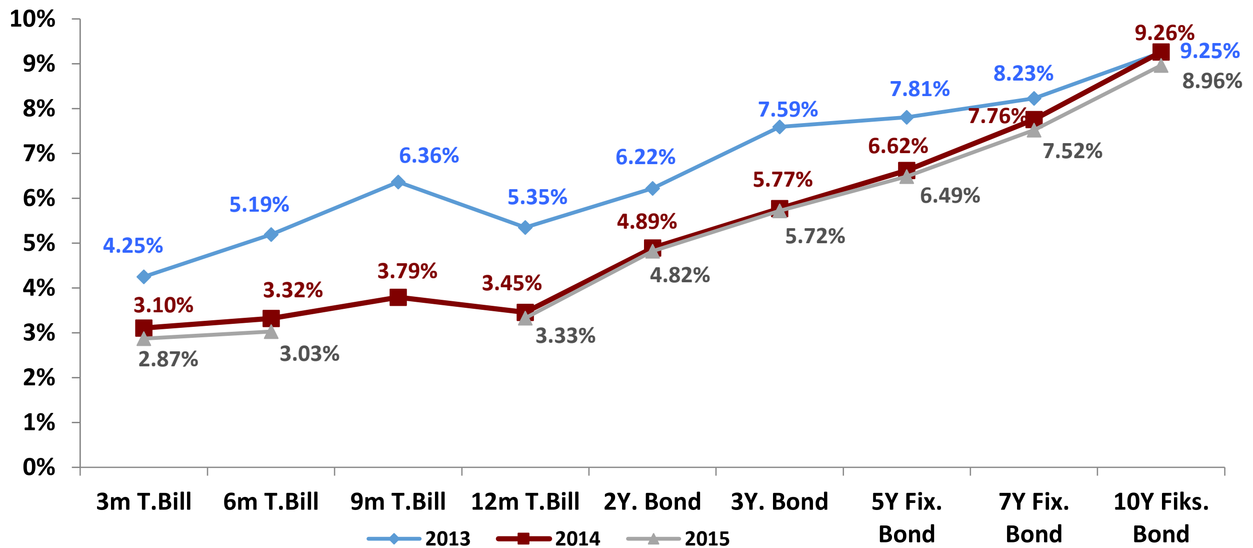
Source: *Ministry of Finance*

5.3. Interest rate evolution

During 2015 the interest rates for government securities incurred continuous fall. Such fall in interest rates during 2015 is attributed to the following factors:

- Relatively high liquidity available in the banking sector.
- Lack of alternative investments and limited crediting of the private sector by the banking sector.
- Reduction of the base interest rate to 1.75% by the Bank of Albania.
- Decrease of borrowing domestic needs by the government.
- Increase of demand from the category of Individuals due to more favorable rates compared to deposits.

Chart 14: *Interest rate evolution for governmental securities in the primary market*



Source: *Ministry of Finance*

II. DEBT MANAGEMENT STRATEGY

1. MTDS Objectives and Assumptions

1.1. General guidelines within the framework of borrowing

The Medium Term Debt Management Strategy aims to keep under control the exposure to risks and to establish the appropriate conditions for the development of the primary domestic market. In this framework, some guidelines have been drafted, in order to orientate the Government borrowing for the period 2016-2018:

- Reduction of refinancing risk exposure, by focusing the realization of domestic net borrowing mainly on long-term instruments. In this framework, it will be aimed to increase issuance volumes and issuance frequencies *(by using frequent re-openings)* mainly for 5, 7 and 10 year-bonds. Consequently, it will be aimed to reduce the yield curve fragmentation and the yield curve development in the segment of long-term instruments.
- Reduction of interest rate risk exposure, by limiting the debt amount issuances with variable interest rates and by withdrawing one or more instruments with variable interest rates.
- Contracting of foreign debt mainly in Euro currency or in composite currencies.
- Going public in international capital markets on opportunistic basis.
- Continuing the cooperation and maintaining stable relations with international financial institutions in order to take advantage from the financial products that these institutions provide.

1.2. Operational objectives within the framework of risk control

The reduction of costs per unit on public debt service by maintaining a prudent degree of risk is the general objective of debt management. In order to achieve the general objective, SAMB has set some operational *(indicative)* objectives related to the main risks, as follows at *table 8*

Table 8: *Objectives of the main risk indicators*

Risk Type	Risk Indicator	Indicator 2015	Objective* (2018)
Refinancing Risk	ATM Domestic Debt (in years)	2.0	Min. 2.2
	ATM Total Debt (in years)	4.9	Min. 4.7
	Domestic debt matured in 1 year (% of the total)	55.9%	Maks. 46.0%
	Total debt matured in 1 year (% of the total)	31.6%	Maks. 26.0%
Interest Rate Risk	ATR Domestic Debt	1.8	Min. 2.0
	ATR Total Debt	3.2	Min. 3.0
	Domestic debt reevaluated within 1 year (% of the total)	67.7%	Maks. 60.0%
	Total debt reevaluated within 1 year (% of the total)	58.1%	Maks. 55.0%
Exchange Rate Risk	Foreign Currency Debt (% of the total)	48.5%	50.0%-55.0%

Source: *Ministry of Finance*

Medium-term objectives have been revalued compared to the objectives of the previous strategy, due to the sensitive improvement of risk indicators (mainly refinancing risk indicators) beyond expectations. High impact on the performance of indicators has had the increase in foreign financing (150 million Euro in the Eurobond issue), which was not considered in the baseline scenario of the previous strategy. The above objectives will remain unchanged over the medium term and will not be updated unless there will be any unexpected events with high impact. The objectives will serve as point of reference in order to monitor the evolution of the indicators.

In the context of liquidity risk management, in December 2015 a Reserve (Cash buffer) was included in the regulatory basis and its implementation is expected.
This practice would contribute to avoid the extraordinary auctions, which can create confusion among investors and increase the pressure on interest rates.
On the other side, subject to the reduction of liquidity risk exposure in the medium term are the measures taken also for the reduction of refinancing risk, which contribute to the slowdown of liabilities arising from debt service *(principal and interest payments)*, by holding stable the ratio with the revenue growth in the budget. However, these measures are not sufficient to reduce liquidity risk and should be definitely accompanied by debt reduction and fiscal consolidation.

In the context of operational risk management, it is estimated that during the medium term 2016-2018 the following activities should be implemented:

- Update the data registration system *(DMFAS)*, and setup an integrated data basis for both domestic and external debt;
- Review and finalization of the draft manual developed for the Directorate General of Public Debt;
- Further increase of human capacities through specific trainings.

1.3. Financial resources for the medium-term 2016-2018

In the framework of existing debt service and in the framework of meeting the need for borrowing, the Medium Term Debt Management Strategy (MTDMS) has analyzed and assessed the conditions of the domestic market and international capital markets, defining the financial instruments most likely available in our country.
In the domestic market is maintained continuous contact with investors and mainly with the banking system in order to identify the characteristics of demand for government financial instruments and the appetite of investors for the long term securities.
Meanwhile, contact has also has been maintained with the external investors in order to identify the country risk perceived and all possible costs added by the risk.
In this context the analysis conducted estimates that in the medium term 2016-2018 the Albanian government will be able to use the following financing alternatives:

1.3.1. In the domestic market

- Treasury bills;
- Bonds;

In the domestic market, the banking system is characterized by satisfactory levels of liquidity and the credit risk perceived by investors is not high. This will enable the Albanian government to refinance the current debt and domestic deficit through the instruments listed above.

During 2016 the main investors *(the banking sector)* due to the orientation from mother banks, and within the provisions regarding liquidity ratios, the capital burden and exposure to sovereign debt will mostly tend to be orientated toward short term instruments. However, the banking sector orientation toward short-term securities will be compensated by the increase in demand from individuals and their orientation mostly towards long-term securities.

1.3.2. In international markets

- Eurobond
- PBG. It consists in a partial guarantee issued by World Bank in favor of Albanian government in order to borrow in international markets at a more favorable cost compared to the market.
- Loans for financing projects. This group includes all loans in the form of loans used to finance development projects which are defined as a priority by the government, with the aim to further develop strategic economic sectors of the country. There will mostly be available loans with commercial interest rates, but with a relatively high maturity.
- Budget support within the framework of the agreements with international financial institutions *(World Bank, IMF, etc)*.
-

1.4. Developments and medium term macroeconomic assumptions

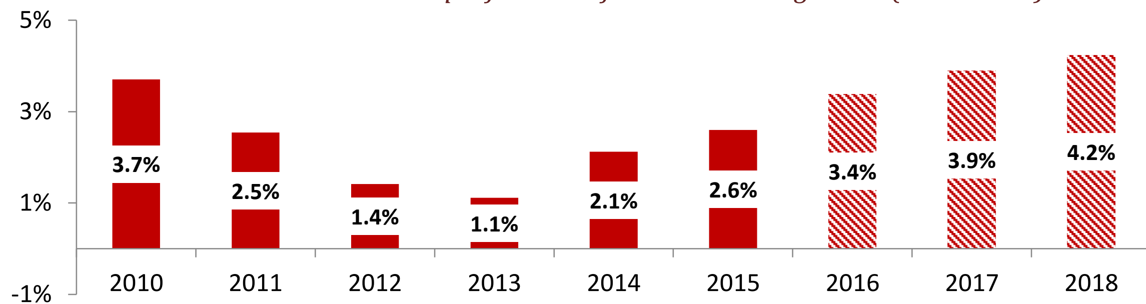
In this subchapter are presented some of the most important macroeconomic developments and as well as the main macroeconomic assumptions where the MTDS is based on the baseline scenario. Below are given the projections of macroeconomic indicators in the medium run, assuming that there would be no shocks and as a consequence neither changes to their parameters.

These assumptions are key factors and their change from the baseline scenario may have impact on the realization of the strategic objectives defined in the MTDS. They may have impact on the funding level and consequently on the debt costs and risks. In this context, it is very important that the primary balance stay at the same levels, budget revenues to be stimulated through fiscal policy consolidation, reduction of informality, etc.; economic growth to be stimulated by the increase on domestic production and foreign investment; currency stability to be ensured by sound monetary policies and to be associated with balance of payment improvement.

Throughout 2015, the economy continued to expand, mainly supported by the increase of investments and by the recovery of activity in the service sector. Based on preliminary estimates of the GDP by INSTAT, the real growth for the whole year 2014 resulted in 2.1%,

while for 2015 the growth accelerated to 2.6%. These data indicate that economic activity in the country is pursuing a positive development trajectory, while analysis and forecasts for the medium term suggest that the Albanian economy will continue to mark progressive growth up to 4.2%. (Chart 15)

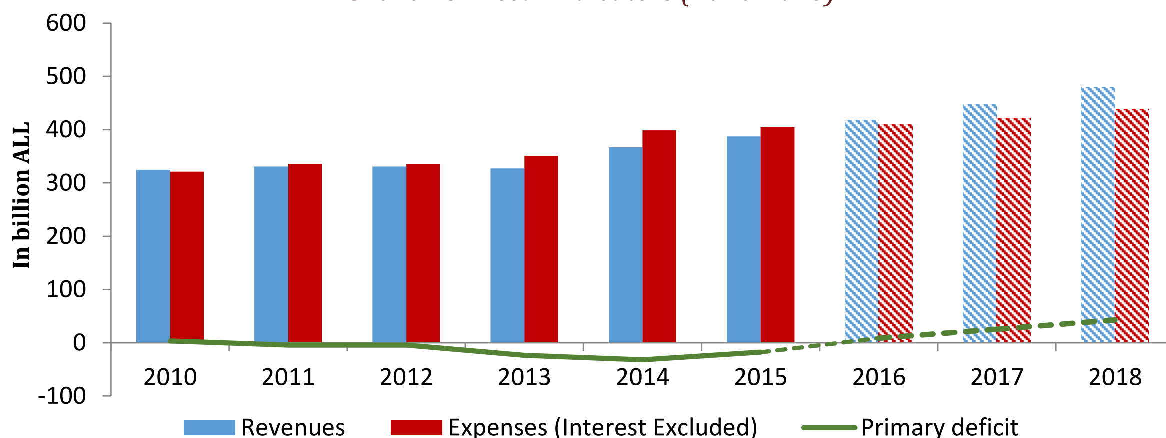
Chart 15: *Historic values and projections of real economic growth (2016-2018)*



Source: *Ministry of Finance*

The budget deficit will be accompanied by a decline, as forecasts show higher increase on the revenue side. Meanwhile, starting from 2016 the primary deficit is planned to be positive (*Chart 16)*

Chart 16: *Fiscal indicators (2016-2018)*



Source: *Ministry of Finance*

Part of the assumptions in addition to those illustrated in *table 9,* are also the interest rates on the domestic and external market instruments. Projections of interest rates for the domestic market were realized by taking into account the monetary policy of the Bank of Albania and the risk perceived by investors towards domestic financial instruments. Meanwhile, in external markets are taken in consideration the expectations of the financial institutions, such as the European Central Bank, World Bank, IMF etc.

|Medium term expectations on the interest rates, indicate a gradual increase *(starting from 2017)*, but still a moderate and below the historic average. A higher growth level is expected in the segment of short-term instruments *(T-bills)* and in the segment of variable rate instruments, the spread of which is subject to changes in the rates of 12-month treasury bills. During 2016, in the domestic market it is expected a stability of interest rates, taking into

account the policies undertaken by Bank of Albania in order to boost private sector crediting. Meanwhile, in the foreign market in 2016 it is expected a moderate increase, mainly in the segment of instruments with commercial interest rates.

The Exchange rate of national currency versus the Euro which is the currency with the greatest weight in the debt portfolio is expected to be stable, but in order to differentiate the different financing strategies that were analyzed from the risk point of view, it is assumed a gradual increase up to 146 LEK per EUR at the end of the year 2018.

The monetary policy of the Bank of Albania will support the economic growth and will be in line with the primary objective to maintain price stability. In the following years, the inflation targeted by the Bank of Albania will fluctuate in the intervals 2.6% -3.0%.[6]

The banking sector in the country is characterized by high levels of liquidity and it is well capitalized. In the medium term, the expectations are positive as regards the reduction of non-performing loans and the increase of credit growth towards private sector.

Table 9: *Macroeconomic assumptions in the medium term*

Indicators	2015	2016	2017	2018
PBB *(billion ALL)*	1,444.7	1,530.6	1,637.2	1,760.2
Real growth of the GDP *(%)*	2.6	3.4	3.9	4.2
General Balance *(% to the GDP)*	-4.0	-2.3	-1.4	-0.5
Primary Balance *(%to the GDP)*	-1.23	0.56	1.52	2.41
Exchange rate *(average)* ALL/ EUR	139.66	141.93	144.00	146.00
Inflation *(average %)*	1.8	2.3	2.7	3.0

Source: *Ministry of Finance*

1.5. Considerations referring to the existing debt, financial markets and macroeconomic factors

Exposure to refinancing risk and interest rate risk in the domestic market are the main sources of risk in the portfolio of government debt. Exposure to exchange rate risk although is relatively high due to the increase of debt in foreign currency and due to the low diversification of portfolio, it tends to smoothen. This is based on the fact that over 70% of the foreign debt is denominated in Euro, which is a currency that has a relatively low volatility towards the local currency and it is targeted by monetary policies of the Bank of Albania, due to the country's aspirations to enter the European Union.

Current market conditions allow the country to borrow in the domestic market, but also in foreign market, mainly through the instruments listed in the subchapter 1.3.
The domestic market is easier to access, it requires less procedures and avoids exposure to exchange rate risk.

[6]Referring to the information published by the Bank of Albania, date 03.02.2016,
https://www.bankofalbania.org/web/NJOFTIM_PER_SHTYP_7433_1.php?kc=0,26,0,0,0

However, continuous borrowing in the domestic market has implications arising from the relatively high level of debt refinanced by the government over the course of a year, *(over 350 billion ALL)* from the narrow base of investors comprising in more than 58% by the banking sector, from the not fully developed primary market and from the lack of a proper secondary market. Considering these factors, results that the high demand for funding from domestic sources accompanied with a high level of non-performing loans can reduce the private sector crediting, which is a very important factor in terms of economic growth, reduction of structural unemployment, as well as increase of productivity and competitiveness in the region and beyond. On the other side, the progressive increase of debt to be served in foreign currency is in considerable levels and the provision of foreign currency in the exchange market is limited and it may create implications in maintaining stability in the exchange rates of the national currency.

Foreign market offers unlimited funding sources and it is easily accessible by the Albanian government. Financing through foreign resources is a good alternative in order not to exploit domestic resources and to stimulate private sector crediting.
However, borrowing in foreign markets could also have implications related to factors that are beyond the control and influence of fiscal and monetary policies of our country, such as interest rates and exchange rates that mainly depend on fiscal and monetary policies of other bigger countries. These factors can escalate the increase of debt costs, the expansion of the deficit and thus involuntary increase debt. On the other side, an increase in the stock of debt when it is not accompanied by an increase in exports or foreign exchange reserves can put in trouble the country's ability to repay liabilities in foreign currency, risking the stability of the national currency and other macroeconomic indicators.

1.6. Baseline strategy

Referring to the above considerations *(sub-chapter 1.5.)*, cost/risk analysis *(Annex I)*, objectives to reduce the exposure of the portfolio to major risks *(Annex I)*, and the degree of market development that provides each of the alternative financing strategies, it results that the strategy based on increasing the share of long-term securities in the portfolio and in the reduction of domestic market segmentation *(Strategy 3, Annex I)* is the most appropriate strategy.

This strategy will focus on two main areas: a) in the reductions of risks exposure and **b)** in the development of primary government securities market.

In the context of risk reduction in the domestic market, the strategy will aim to reduce financing through short term instruments and increase financing through long-term fixed rate instruments.

As regards the primary market development of government bonds in the medium-term, the following activities will be aimed:

- Reduction of segmentation in the market of government bonds through gradual withdrawal of the 3 year-bond and as well as 7 and 10 year-bonds with variable interest rates. The

results of several surveys conducted have shown that the number of financial instruments issued in the domestic market are relatively higher compared to the level of development of the market. On the other hand some instruments are competing one another by fragmenting the demand, thus preventing the creation of a stable yield curve and making difficult for investors the process of price discovery.

- Setting up benchmark sizes for long-term government bonds by using a more frequent reopening of the existing auctions and avoiding the issuance of new auctions.

- Continuous and regular consultation with the main market stakeholders in collective and individual manner in order to exchange information about the financing plans of the Government and their investment plans in governmental securities.

- Increase of transparency in reporting and regular updating of information as regards the issuing of government securities.

- Expansion of the investor base in order to pave the way for the development of the secondary market through cooperation with the BoA, AFSA and other potential actors in the market.

In terms of cost, this strategy is relatively costly because it concentrates funding on long-term securities. However, taking into account the interest rates in the minimum historical levels, it results that it is a very convenient moment to implement this strategy with the lowest cost possible.

1.6.1. Limitations

The domestic primary market for governmental securities is not well developed, because of the limited base of investors which mainly consists on the banking sector, limited liquidity and the lack of clear benchmarks for long term instruments. On the other hand, the secondary market almost doesn't exist and almost no transactions take place.
The banking sector liquidity is at satisfactory levels, but the objectives are to maintain steady exposure toward sovereign debt and mainly toward long-term sovereign debt. According to these restrictions, it results that *strategy 3* may encounter difficulties in implementation as long as domestic financing is increases. However, in such cases it is perceived that the increasing pressure of domestic financing would be reduced by going public in the international capital markets *(in case that market conditions are favorable)* or through financial products provided by international institutions such as the World Bank and IMF. Despite the possibility of increasing foreign financing at certain moments, the rate of exposure to debt denominated in foreign currency will stay within the target presented in *sub-chapter 1.2*.

1.6.2. Financing

Referring to the baseline scenario, under which it will not be necessary any addition of foreign financing to support the implementation of the strategy, domestic financing for the period

2016-2018 will stand at the level of 90% -92% of total funding. Meanwhile, funding through long-term securities would aim to increase up to 30% -32% as end of 2018, from 17% estimated in 2015.

Foreign financing will stand at the level of 8%-10% of the total funding and it will be mainly based on the funding of existing projects as well as new development projects for which the Government is committed. In 2016 foreign financing will be also complemented by a budgetary support granted by World Bank and IMF. *(Table 10)*

Table 10: *Gross financing in relative terms according to instruments*

Financing	Instrument	2015	2016	2017	2018
Domestic	i. Treasury Bond	58.4%	63.0%	62.0%	60.0%
	ii. Notes	17.0%	27.0%	30.0%	32.0%
	Total	**75.4%**	**90.0%**	**92.0%**	**92.0%**
Foreign	i. Project Financing	4.0%	6.5%	8.0%	8.0%
	ii. Budget Support	9.1%	3.5%	0.0%	0.0%
	iii. Eurobond	11.5%	0.0%	0.0%	0.0%
	Total	**24.6%**	**10.0%**	**8.0%**	**8.0%**

Source: *Ministry of Finance*

ANNEX I

ANALYSIS OF ALTERNATIVE FINANCING STRATEGIES

The analysis of alternative financing strategies was conducted by taking into account the quantitative analysis (cost/risk), qualitative analysis (Sub-Chapter 1.5.) and the degree of market development that each of alternative financing strategies provides.

1. Methodology used in the quantitative analysis

Model used

The quantitative analysis *(cost/risk)* of alternative financing strategies was conducted by using an analytical model for the Medium-Term Debt Strategy (MTDS analytical tool) produced by the World Bank and IMF to assist debt management decision making process in developing countries. The model used is a deterministic model, whose outputs depend on the values and the initial parameters (current debt parameters). The model is designed in such a way as to project debt flows in the medium term depending on the inputs that are injected into the model for each of the strategies. The output of the model is the quantification of the cost and risk respectively for each of the strategies.

Inputs

The main inputs used in the model are **i)** debt flows *(interests and principal)* for the debt as end of 2015, **ii)** macroeconomic assumption variables *(primary deficit, GDP, foreign exchange reserves, exports)* which drive the country's financing needs, **iii)** alternative financing strategies, **iv)** financial variables *(interest rates and exchange rates)*.
Inputs for existing debt flows are injected into the model as they are preliminarily categorized into groups with similar risk characteristics. In the specific case, the flows of existing debt are categorized in 15 groups, respectively 9 groups for local currency instruments *(domestic debt)* and 6 groups for foreign currency instruments *(foreign debt)*.
Alternative financing strategies differ from each other by **i)** by the financing mix between domestic and external debt and **ii)** financing mix between groups with similar risk characteristics respectively for domestic and external debt.

Outputs

The output of the model consists of cost and risk quantification for each strategy taken into consideration. The model illustrates the results of each strategy taken under consideration, under the effect of financial variable scenarios, as well as provides information about the risks that the debt structure will carry at the end of the medium term for each one of the strategies considered.

Scenarios

i) The baseline scenario is defined as the scenario with the highest probability of occurrence *(the most probable scenario)* and it is used to determine the costs *(debt/GDP and interests/GDP, etc.).*

ii) Stress scenarios are defined as alternative scenarios and they are designed by the shocks that are applied on financial variables *(interest rates and exchange rates)*.
The deviation of cost in stress scenarios from the baseline scenario cost in each of the strategies defines the risk.
Theoretically can be applied an endless range of stress scenarios, while in the specific case, two stress scenarios are applied on interest rate, two stress scenarios on exchange rate and one stress scenario on both interest rate and exchange rate simultaneously.
For the stress scenarios on interest rates, the following have been applied **a)** uniform shock for all financial instruments (parallel shift of the yield curve) and **b)** diversified shock (shift and increase of the yield curve).

Timeframe

The timeframe of the analysis is 5 years. This is an optimal timeframe in order to make visible the effects on the structure of the debt and the risks carried. In shorter periods of time differentiation of debt under each of the strategies applied is not evident and makes the identification of costs and risks more difficult.

2. Alternative financing strategies

Referring to financing instruments available, as well as to the objectives for the reduction of the risks exposure, debt management has evaluated four possible financing strategies, out of which three consist in the management of the domestic financial instruments and one in the increase of foreign financing.

Strategy 1 is mainly based on the refinancing of existing instruments and domestic financing is conducted in over 70%, mainly through short-term instruments. This strategy has a relatively low cost in the baseline scenario and a relatively low exposure to exchange rate risk. On the other side, this strategy is characterized by high refinancing and interest rate risk, thus does not guarantees improvement of the domestic debt structure.

Strategy 2 aims at the reduction of domestic market segmentation through discontinuing of the 3 year bond and 7 and 10 year bonds with variable interest rates. In terms of cost and risk, this strategy is relatively similar to *Strategy 1*, but in contrast, it offers advantages within the development of domestic primary market, as well as increases the stability of interest rates in the long run. It provides no significant improvement in reducing the exposure to refinancing risk and interest rate risk.

Strategy 3 is also designed to reduce the segmentation of the financial securities market through the discontinuing from the market of the 7 and 10 year variable bonds. In contrast to

strategy 2 it aims to reduce financing through short-term instruments and increase the concentration of financing mainly in the segment of 7 and 10 year fixed rate bonds. In terms of cost it is a more costly than the first two strategies, but it has a distinctive advantage regarding the improvement of debt structure within the framework of reducing the exposure of refinancing and interest rate risk.

Strategy 4 aims to reduce the borrowing pressure in the domestic market by increasing borrowing in the foreign market, from 10% to about 20-25% of total borrowing. Borrowing in foreign market may consist on periodic appearance in the international capital markets or in other financial products offered by international financial institutions. The reduction of financing pressure in the domestic market can create appropriate conditions to improve the domestic debt structure by shifting borrowing from short-term instruments toward long-term instruments. In addition, this strategy may also serve as a catalyst in order to increase private sector crediting. In the aspect of cost, this strategy is relatively expensive *(especially when going public in international capital markets),* but it significantly improves the debt portfolio in terms of exposure to refinancing and interest rate risk. As regards exchange rate risk this strategy is the riskiest.
This strategy limits the development of domestic securities market since the reduction of domestic financing does not create many spaces for the creation of benchmark sizes.
A second use *(option)* of this strategy also can be for liability management purposes. In this case current external debt is substituted with new debt with lower cost and or better risk characteristics. This option would be accompanied by cost reduction and would have no effects in terms of exposure to the exchange rate, but in turn it would have lower efficiency as regards improving refinancing and interest rate risk compared to the first option of this strategy.

3. Cost / risk analysis and risk exposure

In terms of cost and risk the analysis demonstrates that in the baseline scenario the alternative strategies which mostly focus funding on long-term instruments *(strategy 3 and strategy 4)* provide improvement to refinancing risk and improvement in the amortization profile, in contrast to strategy 1 and strategy 2, which are mainly based on financing through short-term instruments. In the meantime, increased financing through long-term fixed rate instruments *(3 strategy and strategy 4)* brings distinctive improvement in the interest rate risk indicators (*ATR and instruments that are re-fixed within 1 year).* On the other side, from the analysis it results that the increase in maturity is associated with additional cost. In this respect, *strategies 3 and 4* are more costly.
Furthermore, from the analysis it results that the first three strategies have almost similar exposure to the exchange rate risk and relatively lower compared with *strategy 4*, which is characterized by an increase of foreign financing.

ANNEX II

TECHNICAL VOCABULARY (GLOSSARY)

Benchmark - An instrument that is traded frequently and at significant amounts. The rate of this instrument serves as a reference for the evaluation of the rates of other instruments *(e.g. 12-month Treasury Bills).*

Buyback – is the reverse issuance of a government security, which allows to mature an instrument before its original maturity date.

ATM – Is a debt refinancing risk indicator. ATM is the average period in years or in days that a debt portfolio needs to mature. The farther in time the maturity date of an instrument, the lower its refinancing risk is and the higher the value of this indicator is. ATM for debt instruments is calculated with the following formula:

$$\text{KMM} = \frac{\sum_{t \in T} t\, Nt}{\sum_{t \in T} Nt}$$

Out of which:

t – Maturity date;
T – Set of all maturity dates;
N_t – Nominal value to be paid on date t.

ATR- Is debt an interest rate risk indicator. It gives information on the debt portfolio exposure to changes in interest rates. ATR is interpreted as the average time (in years) it takes for a debt portfolio to redefine its interest rates. The larger the quantity of short-term instruments and the quantity of instruments with variable interest rates in a debt portfolio, the larger the interest rate risk and the smaller this indicator. This indicator was first introduced in 2005 to replace duration, which is an indicator that gives information on refinancing risk and interest rate risk at the same time. ATR for debt instruments is calculated with the following formula:

$$\text{KMR} = \frac{\sum_{r \in R} r\, Nr + \sum_{t \in T} t\, Nt}{\sum_{r \in R} Nr + \sum_{t \in T} Nt}$$

Out of which:

r – Date of coupon payment for variable interest rate instruments;
t – Maturity date for fixed interest rate instruments;
N_r – Nominal value of variable interest rate instruments;
N_t – Nominal value of fixed interest rate instruments;
R – The set of all maturity dates for variable interest rate instruments;
T – The set of all maturity dates for fixed interest rate instruments.

PBG – It is a guarantee issued by the World Bank and it fully or partially guarantees a debt in order to enable a more favorable cost than the one offered by the market.

Coverage ratio - The ratio between the amount asked *(by investors)* and the amount bid *(by the government)* in government financial instrument auctions. It serves to evaluate the level of auction completion and liquidity position.

Exchange rate risk - The impact of changes in currency exchange rates on the level of debt and its services at a certain amount above expectations.

Liquidity Risk - The risk associated to the loss of the State Budget ability to pay its current obligations and execute budget expenditures on time. In order to minimize this risk, the State needs to have access to a certain amount of liquid assets in order to ensure the availability of funds in case of temporary crisis, when the provision of funds becomes difficult or too costly.

Interest rate risk - The risk that debt service payments will change as a result of changes in interest rates. This risk arises from the need to service debt as it falls due and the payments of coupons of variable rate instruments in the future.

Operational risk - The risk associated with increased debt management cost or increased level of other risks resulting from human error, failure of electronic equipment, natural disasters, etc.

Refinancing risk - The risk associated to the ability to issue instruments or take loans in order to refinance and service current debt. The higher the volume of amounts that fall due and the closer in time, the higher the rollover risk is, and vice-versa. The rollover risk is affected by level of existing debt and the maturity profile. Increased debt maturity and distribution of maturity dates over time contribute to reducing the rollover risk.

Primary market – It is the physical or functional area in which the Albanian government issues securities for the first time.

Secondary market – It is the physical or functional space where transactions with securities are made after they have been issued in the primary market.

Government Securities – Are the treasury bills and bonds issued by the Ministry of Finance in accordance with Law no. 9665, dated 18.12.2006, “On government borrowing, government debt and guaranteed government debt in the Republic of Albania”, as amended; Law no. 9879 dated 21.02.2008 “On Securities”.