

## 4 MARKETS

### 4.1 FINANCIAL MARKET

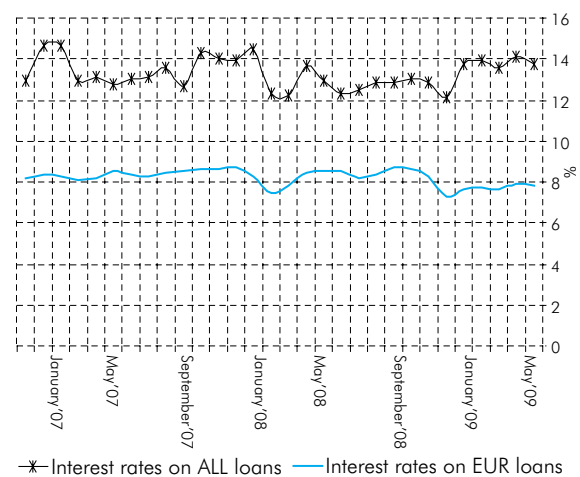
The Albanian financial market is dominated by the interbank, Government debt securities and foreign exchange market. The segment of this market that relates to the insurance and re-insurance and private pension funds, albeit upward, still has a low share to the total volume of the financial market activity. The latter was by and large stable over the course of the year 2008, with some segments having increased in terms of volume. This performance owes mainly to the increased activity in the primary market of Government debt securities and to the banking sector's higher demand for liquidity following the withdrawal of deposits in the last quarter. In order to meet the higher demand for liquidity, the Bank of Albania has conducted the necessary open market operations.

The performance of interest rates on deposits, loans and Government debt securities was reliant on the overall liquidity situation hence going through a relative increase.

Interest rates on ALL, EUR and USD deposits maintained an upward trend. Despite the decreasing interest rates of the main foreign currencies in the international market, banks have preferred to maintain relatively high interest rates on deposits in order to make them attractive to the public. The spread between the interest rates on deposits denominated in the Albanian Lek and in foreign currency remained positive and stable, reflecting the key interest rate and the banking sector's preferences with respect to the foreign currencies.

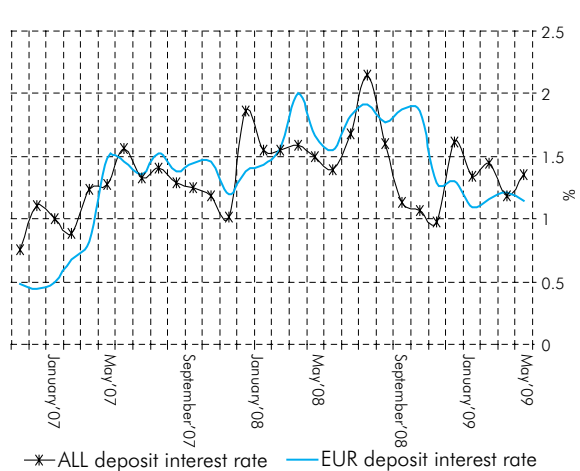
Unlike the performance of interest rates on deposits, loan interest rates showed a slight downward trend in 2008, leading to the narrowing of the spread between these two indicators and the relative decrease of the banking sector's intermediation cost. However, the unstable liquidity situation in the banking sector and the prudent selection of borrowers brought about the reduction in the amount of available funds for lending purposes and the increase of interest rates, being more evident in the first half of 2009. This year's tendency to lending in the domestic currency is considered positive and it should be further deepened by the banking sector through attractive incentive for the borrowers, which mainly relate with the loan price. In the medium run, it will help to establish a better balance in terms of the loan portfolio composition by currency.

Chart 40 Performance of interest rates on ALL and EUR loans



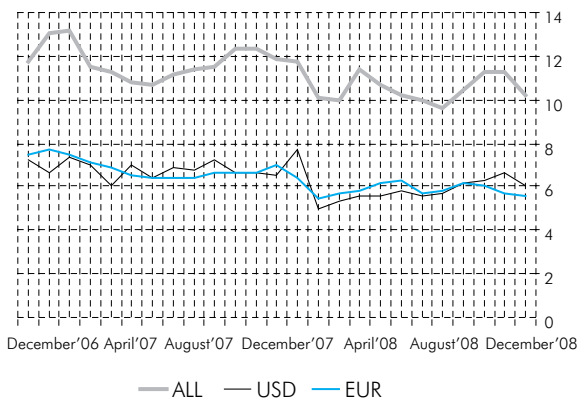
Source: Bank of Albania

Chart 41 Performance of interest rates on ALL and EUR deposits



Source: Bank of Albania

Chart 42 Loan-deposit interest rate spread by main currencies



Source: Bank of Albania

Foreign currency exchange market attested to stable trading volumes over the course of the year 2008. The traded volumes were mainly dominated by the banking sector in its relations with other non-bank financial institutions and customers. The volume of foreign exchange transactions from large public and private entrepreneurs grew over the last year. The prices of foreign currencies vis-à-vis the national currency have reflected the domestic situation of demand and supply with foreign currency and the developments in the international markets. The Albanian Lek exchange rate vis-à-vis its major counterparts was stable over the major part of the year. However, the pressure over the exchange rate began to go upward at year-end, reflecting the contraction of supply with foreign currency and the psychological effects triggered by the uncertain situation in the international financial markets.

As in the previous year, the insurance market structure consisted of ten insurance companies, out of which seven conducted non-life insurance activity, two life insurance and one life and non-life insurance. The year 2008 attested to positive developments in the insurance market, combined with the impact of the entry of foreign investors into this market, which allowed higher competition. This market's positive performance was materialized in higher assets, investments and payment of claims, as well as in higher income from gross written premiums dominated mainly by written premiums of compulsory insurance. However, based on the data of the Financial Supervisory Authority (FSA) for the first nine-month period of 2008, the claims payable as a percentage of premium income remains low at 29.1 percent for non-life insurance market and 8.9 percent for life insurance market.

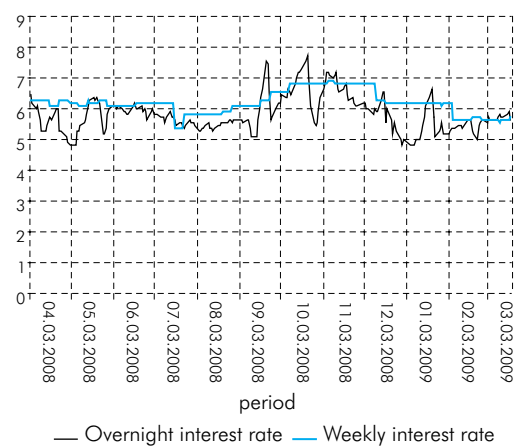
The private supplementary pension market witnessed the same level of development over the course of the year 2008 as in the previous year. Three private pension institutes continue to conduct their operations in Albania. Contributions in this market increased by 65 percent in 2008 relative to 2007, although this financial market segment remains at low development levels.

#### 4.1.1 INTERBANK MARKET

Lending in the Albanian Lek in the interbank market grew in 2008 compared with the previous year. As at September, average daily lending volume grew by ALL 2.3 billion from ALL 1.8 billion in the same period the previous year. Despite the higher traded volumes, the interbank market is characterized by a relatively high concentration of lent funds and considerable interbank trading constraints owing to the internal bank policies.

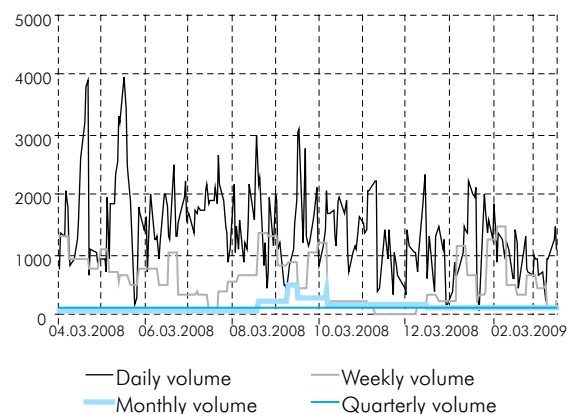
Interest rates on interbank market loans were more volatile than in 2007, reflecting the changes in the liquidity situation in the market. As at September, the interbank market interest rates fluctuated below the key interest rate while increasing during the banks' required reserve calculation and replenishment. The structural liquidity shortages during this period and the injected amount by the Bank of Albania drove the interest rates in the interbank market to get closer to the key interest rate and triggered interbank market activity, hence creating better conditions for the monetary policy transmission. The spread between the overnight interest rate and the key interest rate was approximately 70 basis points compared with 90 basis points the previous year. In the last quarter of 2008, the liquidity shortages triggered higher interest rates in the interbank market. In September to November, during the required reserve replenishment period (in September), the interest rate on overnight transactions increased to about 7.7 percent or 135 basis points above the interest rate on repurchase agreements. Consequently, the average interest rate on overnight transactions increased to 7.16 percent or about 90 basis points above the interest rate on repurchase agreements. Average lending volume in September to November was about ALL 1.6 billion, hence recording a fall owing to the preservation of the liquidity levels against a background of declining deposits. Against this backdrop, the Bank of Albania began to inject liquidity into the interbank market through its open market operations. The Bank of Albania intervention<sup>29</sup> triggered lower liquidity provision cost in the interbank market. In December, the interest rate on overnight lending dropped close to the average annual interest rate of about 5.85 percent.

Chart 43 Interbank market interest rates



Source: Bank of Albania

Chart 44 Interbank market lending volume (in million leks)



Source: Bank of Albania

#### 4.1.2 OPEN MARKET OPERATIONS DURING 2008

The wavering public confidence against a background of international financial crisis triggered the withdrawal of deposits from banks in the last quarter of 2008, hence deteriorating the liquidity situation in the banking sector. In order to ease the banking sector's liquidity situation and keep the market interest rates under check, the Bank of Albania began to inject liquidity into the interbank market through its open market operations (see Box 5). Reverse repurchase agreement of one-week maturity was the main instrument employed. Reverse repurchase agreement of one and three-month maturity was also employed in order to provide liquidity of longer maturity term. The

Bank of Albania made it clear for the central banks that the injection of liquidity would persist until the situation was fully normalized.

Prior to the last quarter of 2008, the central bank loan to commercial banks was provided through short-term Government debt securities (Treasury bills), which were held by them. In order to provide banks with larger liquidity amounts as per their needs, the types of Government debt securities were to be diversified. To this purpose, the Bank of Albania made a regulatory amendment, which allowed the use of long-term debt securities (bonds) of remaining maturity up to 12 months in addition to the Treasury bills. Until that moment, long-term Government debt securities could be employed only as collateral for other Bank of Albania instruments, namely overnight loan and intra-day loan.

Another regulatory amendment, which aimed at enhancing banks' flexibility in terms of managing unexpected liquidity needs, related to the increase of the required reserve use from 20 to 40 percent. Upon this amendment, banks could use up to 40 percent of the reserve placed with the Bank of Albania, provided that the monthly average required reserve at the end of the holding period equals the amount of required reserve as established by law.

In addition to augmenting the amount of liquidity, the volatility of interest rates in the interbank market was also to be kept under check. To this purpose, the Bank of Albania approved the temporary shift to an asymmetric corridor of benchmark interest rates, reducing the spread between the interest rate on overnight loan and the repurchase agreement from 175 basis points (1.75 percentage points) to 75 basis points (0.75 percentage points). Accordingly, the lending interest rates in the interbank market can now fluctuate within a narrower range.

#### *Box 5 (Monetary Policy) Open market instruments*

*Open market operations, which consist of the main operation, fine-tuning and structural operations are the basic operations for the liquidity management from the central bank. The dynamics of events in 2008 urged the use of all open market instruments:*

- The main market operation is represented by the repurchase agreement and the reverse repurchase agreement of one week maturity, which is conducted on weekly basis. During the past year, according to its positions of liquidity withdrawal or injection with the purpose of managing the liquidity situation in the market, the Bank of Albania withdrew liquidity through the repurchase agreement of one week maturity amounting to about ALL 3.6 billion a week; and injected an average of ALL 5.8 billion a week through reverse repurchase agreements of one week maturity.*
- The fine-tuning market operations. In contrast to the main market operation, the fine-tuning market operations are used with an undetermined frequency, in specific situations when the mitigation of interest rates fluctuations caused by unexpected*

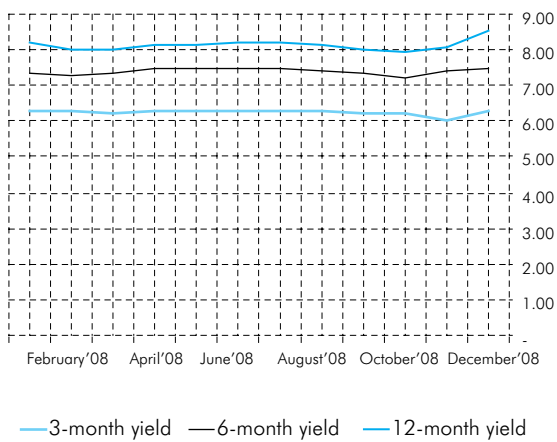
and/or long-term changes of the liquidity in the system is required. In the first quarter of 2008, repurchase agreements of one and three-month maturity were used to reduce the excess liquidity in order to dampen the pressures of the interest rates' decrease. The Bank of Albania, in order to alleviate the concern for the shortage of liquidity caused by psychological factors during the last quarter, along with the use of the main instrument, injected liquidity through reverse repurchase agreements of one and three-month maturity. The average amount injected was ALL 3.2 billion, respectively, in three one-month auctions and in two three-month auctions. One-month auctions had an average demand/supply ratio of 95 percent, while the same ratio for the three-month auctions was higher, 148 percent.

- *Structural market operations.* Structural operations are used to adjust the liquidity structure in the long-term. They are conducted through outright transactions of short-term government debt securities (Treasury Bills). In the beginning of 2008, in view of orienting the operations towards the establishment of a structural shortage of liquidity in the banking system, the Bank of Albania reduced its Treasury Bills portfolio by ALL 2 billion through one single auction. In the last quarter of 2008, structural interventions had a reverse direction, aiming at the injection of liquidity. The Bank of Albania, through the outright purchase of the Treasury Bills from commercial banks, increased their permanent liquidity by ALL 2.2 billion.
- *Standing facilities.* Standing facilities - overnight deposit and overnight loan - are instruments available to commercial banks to allow them to manage liquidity on daily basis. In theory, against a background of the regular presence of the central bank in the market (through its main instrument), a developed interbank market and the possibility to use the required reserve on daily basis, the use of standing facilities from commercial banks should be minimal. However, the relatively low development of the interbank market caused those banks that had excessive liquidity and which chose to place it with the Bank of Albania, to extensively use the overnight deposit facility. During 2008, the average daily amount deposited with the Bank of Albania was about ALL 3.6 billion, compared with ALL 1.6 billion in 2007. Worth noting is that in 2007, the Bank of Albania was present during the first half of the year by withdrawing the liquidity through its main instrument, hence reducing the banks' opportunities to use the overnight deposit facility. While, in 2008, the central bank intervened for about ten months by injecting the liquidity, hence the banks' possibilities of using the overnight deposit were larger. On the other hand, the injection of liquidity via the main instrument has reduced the need to use the overnight loan. Throughout the year, overnight loan was used in 21 working days, with an average use of ALL 0.3 billion. Overnight loan was higher in the last quarter of the year, mainly from the small banks in the system which, due to the trading limits, were faced with hard times to find the liquidity in other forms.
- *Additional liquidity providing instruments.* Lombard loan represents the last lending instrument of the Bank of Albania, which is granted to banks with temporary liquidity problems, provided that they are financially sound. This instrument found no use during 2008.

#### 4.1.3 GOVERNMENT DEBT SECURITIES' PRIMARY MARKET AND THE INTEREST RATE (YIELD) PERFORMANCE

The return rates on investment in Treasury Bills in the primary market, by maturity terms, have been relatively stable during the major part of the year 2008. In

Chart 45 Government securities' yield

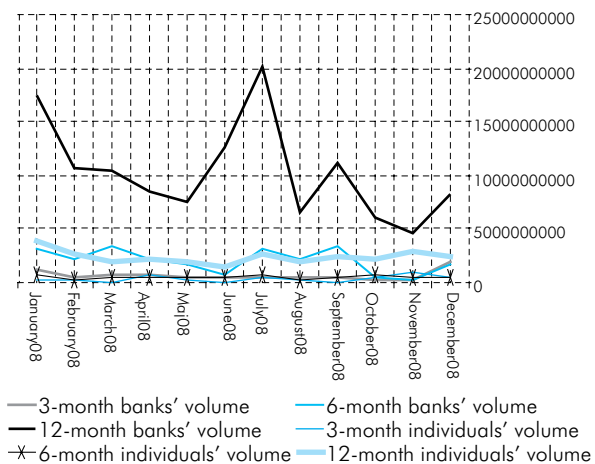


Source: Bank of Albania

the first months of the year, they have transmitted the increase of the Bank of Albania key interest rate in the end of 2007, showing an upward trend. In the third quarter, the return rates experienced a relative decline, following the massive liquidity excess generated in the market. The return rate on investment in Treasury Bills of 12-month maturity marked 7.94 percent in September compared with 8.23 percent in January. During the last quarter, the return rates increased, transmitting the tightening of the liquidity conditions in the banking sector and the increasing Government demand for domestic debt.

Particularly in the last two months of the year, banks were reluctant to invest in the Government debt securities' primary market to increase their investment or for reinvestment purposes. Against a background of low banks' participation in the auction and unstable meeting of Government demand for debt, the return rate on investment in Treasury Bills increased. In fact, in December, the return rate on investment in Treasury Bills of 12-month maturity marked 8.56 percent or 0.3 percentage points higher than the same period the previous year. During 2008, the same upward trend was shown in the return rate on investment in Treasury Bills of 6-month maturity, while the return rate on investment in Treasury Bills of 3-month maturity stood at an average of 6.25 per cent, almost close to the key interest rate of the Bank of Albania.

Chart 46 Banks and individuals' participation in Government securities' auctions, in ALL



Source: Bank of Albania

During the first part of the year, they had a stable downward performance, concentrated mainly in the third quarter. The spread between the return rates on securities of different maturities reduced, mitigating the slope of the curve. Worth noting is the narrowing of the spread between the return rate on investment in 5 and 2-year bonds, attesting to the lowering of the economic agents' perceived risk for these long-term securities. In the recent months, the banks' demand has been strongly reliant on liquidity-related issues in the market, along with a lower participation and requirements for higher return rate on investment. Thus, the average return rate on investment in 2-year bonds increased by 0.15 percent in 2008 y-o-y.

## 4.2 FOREIGN EXCHANGE MARKET AND THE EXCHANGE RATE PERFORMANCE

As at end 2008, the exchange rate of the ALL vis-à-vis the Euro and U.S. dollar reflected an annual decline of 0.37 and 10 percent, respectively, in nominal terms. This performance is mainly a reflection of developments in the international market. However, in average annual terms, the ALL appreciated by 0.66 percent vis-à-vis the Euro and by 7.23 percent vis-à-vis the U.S. dollar.

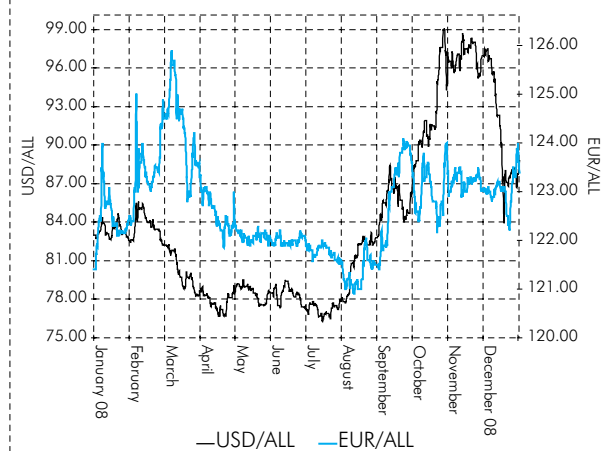
The exchange rate performance of the national currency vis-à-vis its major counterparts has been variable. The ALL has appreciated vis-à-vis its major counterparts in January to April, peaking in April when it appreciated by 6.2 percent in annual terms. In the second and third quarter, the annual appreciation rates slowed down to 1.4 percent in September. In the last quarter of the year, the exchange rate of ALL vis-à-vis its major counterparts depreciated by an average of 3.2 percent in annual terms.

The exchange rate performance of the ALL has by and large reflected the stable macroeconomic indicators at home, the positive spread of interest rates by currencies, the developments in the international foreign exchange market and the temporary shifts in the supply and demand for foreign currency in the domestic market.

The foreign exchange activity in the domestic market has shown a persistent growth, not only as a result of the expanded trading activity, which grew by a total of 31.1 percent in annual terms in 2008, but also of the improved expertise of the market participants. The latter are ever-increasingly maintaining a preceding behaviour with respect to the exchange rate seasonality.

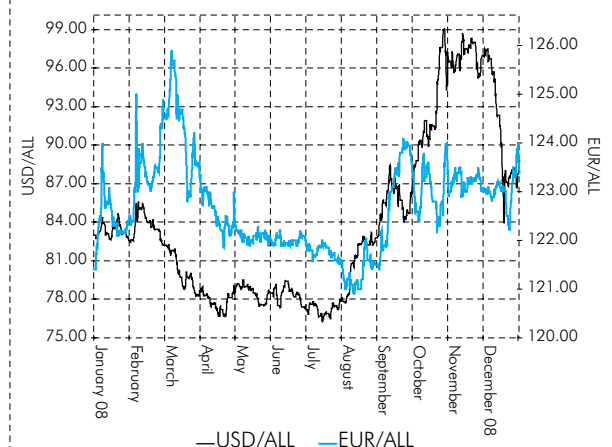
In the beginning of 2009, there were higher pressures over the depreciation of the ALL vis-à-vis its major counterparts. The decline of remittances in the last quarter of 2008, the lower exports and the international crisis were the economic and psychological factors altering the foreign currency demand and supply structure in the domestic market. The Bank of Albania has prudently monitored the situation and has conducted the necessary operations in the first quarter of the year, in order to reduce the volatilities and velocity of the exchange rate shifts, which may have an adverse impact

Chart 47 Daily performance of EUR/ALL and USD/ALL exchange rate



Source: Bank of Albania

Chart 48 Total volume of foreign currency trading in 2008



Source: Bank of Albania

over the behaviour of economic agents and inflation. In addition, the Bank of Albania has once more reminded all the economic, institutional and individual economic agents that the exchange rate is free-floating. To this purpose, all the economic agents need to recognize and assess the risk arising from the unfavourable exchange rate shifts and manage this risk by conducting the necessary operations.

### 4.3 REAL ESTATE MARKET

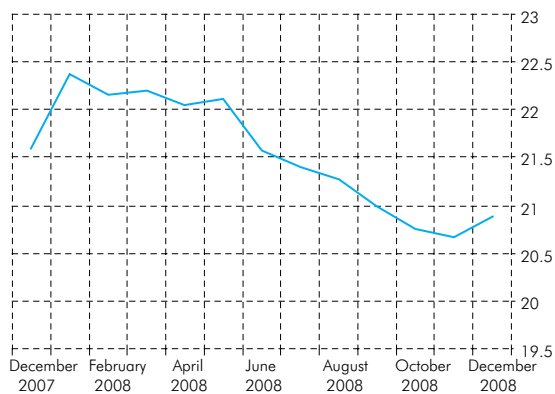
The housing market witnessed contained price rise rates and volatile rent index in 2008.

Average house price index for the district of Tirana dropped by 0.3 percent in annual terms, in contrast to its performance in the preceding three years

when the index marked substantial increase. The contained house price growth rates may associate with the lower house price and the higher supply. According to the lending activity survey, banks report a decline in demand for individual loans on housing purchase, as well as a contraction of the lending standards for this purpose. The tightening of lending conditions for housing, in particular in the second half of the year, may have affected the relative fall of this demand.

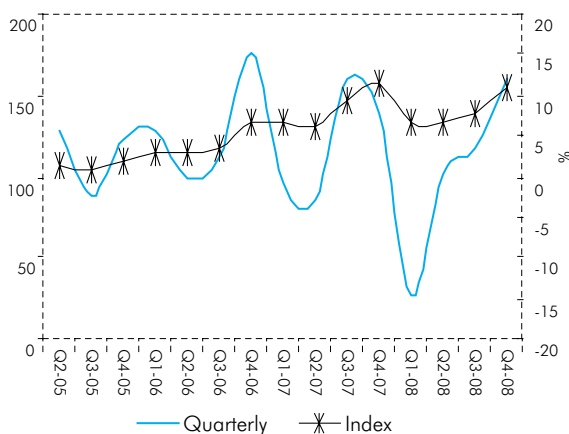
As far as supply is concerned, the number of new constructions increased in 2008, providing considerable impact over the containment of price rise. This is also attested by the performance of the real estate house index for the capital, Tirana, as shown in Chart 50.

Chart 49 Share of real estate loans as a percentage to outstanding loans



Source: Bank of Albania

Chart 50 House Price Index for Tirana



Source: Bank of Albania

Construction Cost Index, which assesses the performance of construction costs, did not seem to witness significant changes over the course of the year 2008. Compared with the same period the previous year, it increased by 1.4 percent in the last quarter of 2008. The rationale behind is the positive change of the price index of "direct expenses" by 0.2 percent from the previous quarter and by 2.4 percent from the last quarter of 2007. This group of expenses shares 67.6 percent of total construction expenses. Within this group, "personnel expenses" and "machinery expenses" rose by 1.6 and 0.3 percent, respectively. "Material expenses" fell by 0.2 percent in the last quarter of 2008, however this figure is 1.1 percent higher compared with the end of 2007. Within this subgroup, the construction

material prices fell by 0.3 percent. Electric material prices rose by 3.8 percent in the last quarter while being up by 7.8 percent compared with the end of 2007. There are no significant changes in the percentage of projected profits. The performance of this index shows that prices in the housing market did not completely reflect the performance of the construction cost, implying the lowering of the profit margins for the construction industry.

The performance of house prices is of great significance to the construction industry, the public and to the financial system at home. Given the important role of houses and other real estates to consumers' long-term consumption, the banking sector and the financial system, the recognition of their price performance and the factors affecting them is crucial. At present, in order to draw conclusions on the housing price performance trends in the future, the methodology of collecting the information needs to be improved. This would provide greater geographical coverage and a more accurate assessment in terms of types of housing, area, location, year of construction, way of financing and payment, etc.