# ANALYSIS OF INTEREST SPREAD BETWEEN INVESTMENTS AND DEPOSITS FOR YEAR 2000 AND THE FIRST QUARTER OF 2001

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*Keywords*
*- Intermediation cost - Lek deposits - Lek investments - T-bills -*

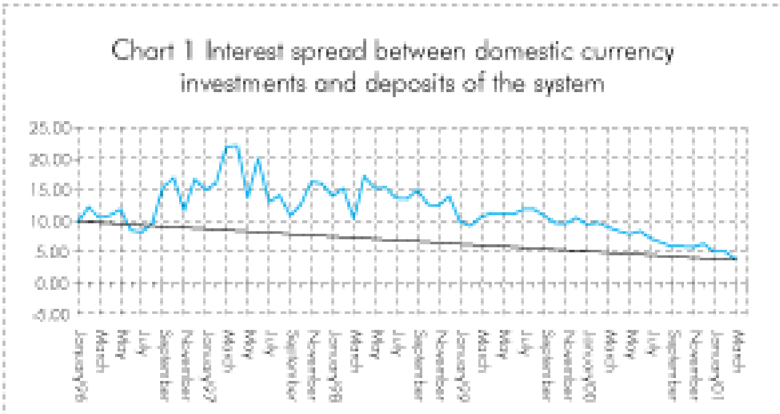
During 2000 and the first quarter of 2001, the financial intermediation cost of the banking system by the difference of the average weighted interest on the newly posted deposits in domestic currency and the average interest on new investments in domestic currency had a slight gradual reducing tendency monthly. More precisely, from the average of 10.65 percent in 1999, it reached to 7.56 percent in 2000, having an average reduction by 3.09 percentage points. Banks' financial intermediation cost also reduced during the first quarter of 2001, reaching to 4.67 percent.

From year 1996, the data comparison indicates that the banking system financial intermediation cost estimated according to the difference is characterized by declining tendencies and year 2000 represents the year when the banking system reached the lowest level shifting for the first time under one-digit figures.

Table 1 Average annual spread (in percentage)

| Years | Average annual spread |
|---|---|
| 1996 | 19.70 |
| 1997 | 16.20 |
| 1998 | 13.83 |
| 1999 | 10.65 |
| 2000 | 7.56 |

The difference between the average weighted for domestic currency investments (new credits and T-bills purchased in the primary auction) and the newly posted deposits in domestic currency in the banking system during 2000 oscillated at 9.76-5.82 percent.




The average weighted rate for the newly posted deposits in domestic currency decreased by 3.18 %, whereas the average interest of the newly extended credits in domestic currency and treasury bill investments in the primary auction decreased by 6.28 percent. For the first quarter of 2001, these reductions cite respectively 0.32 and 1.53%.

From the data it results that the reduction of average weighted interest for the newly accepted deposits has been lower compared to the reducing level of average weighted interest for the newly performed investments (for year 2000 by 6.28-3.18 = 3.09% and 3 ml 1.53-0.32 =1.21%).

The narrowing difference between the average weighted interest on newly performed investments and newly posted deposits in domestic currency is a deriving influence from a group of factors, affecting it. Amongst these factors, we may highlight:

- Bank of Albania's policy;
- Improvements in domestic banking system;
- Commercial banks' strategies in the area of domestic currency toward a more active management of domestic currency resources in the market;
- Banks' improving competition;
- Improvements towards the rising rate of Bank of Albania's transparency and cooperation with commercial banks relating to their appropriate understanding of monetary policy steps.

Thus, the Bank of Albania during 2000 has worked with respect to:

- Transmitting monetary policy signals to the market through fixed rate in Repo auctions. Considering it a core interest rate, it was intended to reduce market rates in accordance with the moving inflation and other monetary developments;
- Establishing Repo portfolio with such a size so that the changing size affects the level of Repo rates;
- The remuneration of required reserve, affecting the reduction of banks' financial cost;
- The management of banking system liquidity through the anticipation of government and banking system short-term needs;
- Triggering the development of interbank market;
- More active participation of second-tier banks in the market;
- Increasing the possibilities and the flexibility of Bank of Albania's interventions in the market;
- Improving the variety of second-tier bank instruments.

All these have influenced on enhancing market competition and on maintaining the economic, financial stability, producing effect on reducing the financial intermediation cost in the system, reaching the lowest level where the financial intermediates have moved appropriately to meet their expenditures and collect earnings.

From bank's viewpoint, the constant reduction of interest spread indicates that these banks have become more active in the market also in terms of funds management. Second-tier banks' visual track of this difference indicates that in some of these banks this trend has been downward, generally with slight oscillations at the line of this trend. The declining trend of this difference in these banks is an indicator of the rising rate in the management of domestic currency liquidity, constituting an indicator of the rising efficiency of their work against the domestic currency.

More detailed developments in the level of average weighted rate for the newly accepted deposits and new investments are presented below:

The average weighted rate for the newly posted deposits in domestic currency in the system reached the average of 5.14 percent for 2000 and 4.69 percent for January-March 2001 from 8.32 percent in 1999.

Such a reduction was affected by:

1. The decrease of the interest rate for domestic currency deposits. During 2000, the Bank of Albania pursued a modified policy in the area of interest rates. The peculiarity lies in the form of applied transmission of this monetary policy in the market during the year. In the first half of the year, the direct instrument of interests was applied, through cutting the required minimum for time deposit rates in domestic currency in January, March and May 2000. State-owned banks reacted with delay to these Bank of Albania's decisions. This delay was reflected in changing interest rates for domestic currency deposits even for other banks. As a result, the average level of deposit rates almost remained the same, decreasing only in May and June. In the Savings Bank, the average level of interest rates reached to 5.55 percent in June 2000, from 6.82 percent in January of the same year.

Press and media attack against the Savings Bank and the fast public reaction by withdrawing deposits, brought in consequence the Savings Bank hesitation to reduce the level of domestic currency deposit rates mainly in the first half of the year. Under these conditions, even other banks that followed with an average spread of 2 points higher than the Savings Bank did not haste to move their level of interest rates. The non-functioning of this mechanism made the level of average weighted rates for newly accepted deposits in the system reduce at low levels during the first half of 2000.

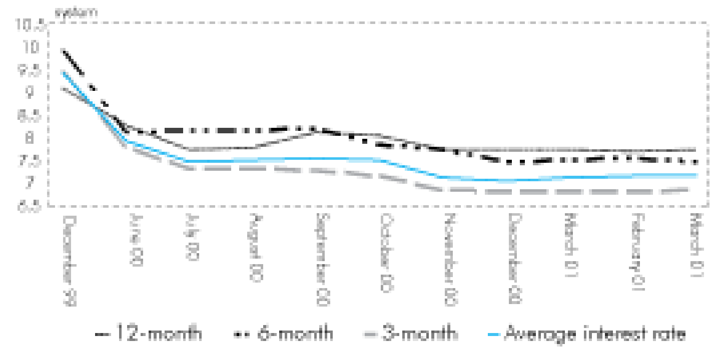
In the second half of the year, the Savings Bank set in motion, for the first time, repurchase agreements auctions. The interest offered by the Bank of Albania for the accepted amount in the auction had a declining trend. Initially it was 9 percent, whereas in the last quarter of the past year, it was stabilized at 6.5 percent. The Bank of Albania influenced the market through the management of Repo portfolio, making banks reduce interest rates.

Table 2 The monthly volume of excess reserves invested in REPO and average interest rate

| | Invested in Repo (in millions of Lek) | Monthly interest average (in %) |
|---|---|---|
| June '00 | 1,150 | 6,58 |
| August | 4,299 | 6,75 |
| September | 6,999 | 5,37 |
| October | 4,999 | 4,62 |
| November | 33,091 | 5,74 |
| Dec '00 | 23,216 | 6,45 |
| January | 20,994 | 5,20 |
| February | 34,000 | 6,10 |
| March '01 | 43,000 | 6,20 |

This fact comes out clearly in the gradual reduction of the average interest on domestic currency deposits after July 2000. So, only the Savings Bank managed to reduce the average interest on the newly accepted deposits, from 5.26 percent in July 2000 to 4.32 percent in December 2000 and 4.8 percent in March 2001. Only time deposits had reducing rates for the same periods, from 7.87 percent to 6.94 percent and 7.0 percent.

Chart 2 Weighted average interest rate for Lek time deposits




I. DEVELOPMENTS IN THE STRUCTURE OF THE NEWLY ACCEPTED DEPOSITS

The level of newly posted deposits is represented either by a growing tendency on time or demand deposits. However, from their comparison it comes out that the rising tendency in the new demand deposits has been higher than that of time deposits compared to 1999. Thus, changes in the structure of the newly posted domestic currency deposits in favour of demand deposits affected reduction of their average interest.

Table 3 Monthly average of the newly posted deposits in domestic currency (in millions of LEK)

| Deposits | 1999 | Year 2000 | Q III of `01 |
|---|---|---|---|
| 12-month | 3.419 | 3.580 | 5.570 |
| 6-month | 1.288 | 1.551 | 2.593 |
| 3-month | 12.576 | 14.095 | 16.616 |
| Total | 17.283 | 19.226 | 24.779 |
| Current accounts | 14.903 | 17.362 | 21.105 |

In the first quarter of 2001 the tendency is reverse: New time deposits have higher growth than the demand ones. A similar structure of the new deposits brought about increase of their average rates in domestic currency. Thus, from 4.18 percent in December 2000, this level went up to 4.83 percent, 4.72

and 4.51 percent, respectively for January, February and March 2001.

Different banks display a different structure for the newly accepted deposits. Banks having the largest share in domestic currency deposits presented the following structures:

During 2000 the National Commercial Bank continues to maintain the same structure of newly posted deposits as in 1999. The specific weight of current accounts to total newly posted deposits, accounts for 78-85 percent of the total of newly posted deposits. Therefore, even the cost of newly accepted deposits stands at very low levels (not more than 3.0 percent).

Notwithstanding the above, the composition of newly accepted deposits of a higher level of demand deposits indicates the high degree of liquidity in lek, making this bank be more exposed to risk.

The Savings Bank's structure of the newly posted time and demand deposits is presented in table 4:

Table 4 The structure of the newly accepted deposits in the Savings Bank

| Newly accepted deposits | 1999 | Year 2000 | Q I of 2001 |
|---|---|---|---|
| Total | 24.3 | 28.23 | 34.46 |
| Demand deposits | 8.77 | 11.41 | 13.68 |
| Time deposits | 15.60 | 16.82 | 20.78 |

For year 2000, the level of newly accepted deposits maintains the same tendencies as in 1999. Time deposits hold the largest weight to newly accepted deposits. New demand deposits have been increasing in comparison to the total. Even though the weight of the newly accepted time deposits is higher than the demand ones, the growth at higher levels of the demand deposits led to reduction of average weighted rates.

Excluding the Savings Bank and the National Commercial Bank, the rest of commercial banks reflect a gradual reduction of average interest on newly posted deposits in domestic currency.

Despite of that, these banks, in total, result with a higher cost on the newly accepted deposits, compared to the Savings Bank and the National Commercial Bank.

This is expected because of the level of time domestic currency deposit rates in these banks, which is above that of state-owned banks.

Table 5 The average level of newly accepted domestic currency deposits and their average weighted interest

| | Year 1999 | Year 2000 | Q I of `01 |
|---|---|---|---|
| Average weighted interest rate on private bank deposits | 7.2% | 6.0% | 4.39% |
| Monthly average rate on private bank deposits (in millions of ALL) | 3.22 | 4.35 | 7.10 |
| As a percentage to the total of accepted deposits in the system | 10.6% | 12.97% | 15.54% |

These banks' share to the total of newly accepted deposits in the system reflected a rising trend. The declining trend of the average weighted interest rate on domestic currency deposits and the rising trend of the monthly average on the newly accepted deposits confirm banks' improved competition in domestic currency deposit market.

*II. Banks' performed investments in the system reflected a constant decline of the average weighted interest in the banking system*. From table 6, it is evidenced that this level shifted to one-digit figures over the first quarter of 2001.

Table 6 Average weighted interest on domestic currency investments (in percent)

| | Year 1999 | Year 2000 | Q I of Year 01 |
|---|---|---|---|
| Average weighted rate on Lek investments | 18.90 | 12.70 | 9.36 |

Amongst the factors affecting such decline are the investments' structure and the rate of return on domestic currency investments. Out of their analysis we will also highlight the factor having the most significant effect on this decline.

1. Banks' investment structure according to the risk, would be as follows:

Table 7 New investments in domestic currency (in millions of ALL)

| | Year 1999 | Year 2000 | Q I of Year 01 |
|---|---|---|---|
| Domestic currency credits | 410.30 | 263.21 | 219.27 |
| Treasury bills | 10,861.31 | 17,232.32 | 16,193.23 |
| Investments | 11,271.61 | 17,495.53 | 16,412.51 |

The data represent monthly averages.

Banks' investment structure assessed according to the risk has changed in favour of rising investments in Government securities, treasury bills and new credits. The newly extended credit in domestic currency as by monthly average occupies a small share compared to investments carried out in the primary market of treasury bills. January - March 2001 keeps the same tendency. Accordingly, even the effect of Lek credit portfolio on average weighted level of lek investments is noticeably small.

As in the previous periods of time, lek credit to economy continues to be carried out by the Fefad Bank, Tirana Bank, Malaysian Intercommercial Bank, and Alpha Credit Bank. The Fefad Bank and Tirana Bank occupy the main weight. The main tendency of credit delivery is mainly from 6-12 month credits and from 1-3 year credits.

The National Commercial Bank and the Savings Bank continue to invest only in the primary market of Government securities. Non-lending to economy by the largest bank of the country, which holds over 80 percent of the banking system liquidity in domestic currency has made investment in treasury bills be considered as potential means to cover the cost of interest expenditures and of interest-free assets.

This fact as well as other banks' increased participation in the primary treasury-bill market indicates that treasury bill investments in the primary market of securities continue to occupy the bulk of bank investments in domestic currency. Treasury bill investments in the primary market of securities occupy the average of 36.0-40.0 percent of the total accepted deposits. Banks value treasury bill investments as the easiest way to cover the cost of deposit returns.

## 2. CREDIT RATE EFFECT ON DOMESTIC CURRENCY AND TREASURY BILL YIELD

The average weighted interest on domestic currency credits during 2000 continued to stay at high levels. Their level remained almost unchanged over the first half of the year. They had a month-to-month declining tendency only in the second half of 2000.

The average level of credits reduced significantly in the first quarter of 2001. According to the structure, the largest decline was in interest payables for 6-12-month term and over 3-year term.

Table 8 Average interest of credits in domestic currency by maturity term (in percent)

| | December'00 | January'01 | February'01 | March'01 |
|---|---|---|---|---|
| Up to 6-month | 21.19 | 23.58 | 18.92 | 20.92 |
| 6-12 month | 23.70 | 15.11 | 19.61 | 16.10 |
| 1-3 year | 23.70 | 22.90 | 20.71 | 22.19 |
| Over 3-year | 27.00 | 15.09 | 16.30 | 15.58 |
| Average weighted for the system | 23.54 | 16.63 | 20.00 | 17.61 |

The constant and gradual decline of other market rates, such as treasury-bill yield; deposit rates were also accompanied by declining interest rates on credit to the economy. These interests were the last to record market decline, after almost remaining at the same levels for a long period of time.

This fact as well the rising level of newly accepted deposits in domestic currency at public banks comprised positive premises that in the future these banks will provide ongoing support to the economy through domestic currency loans at higher levels than at present.

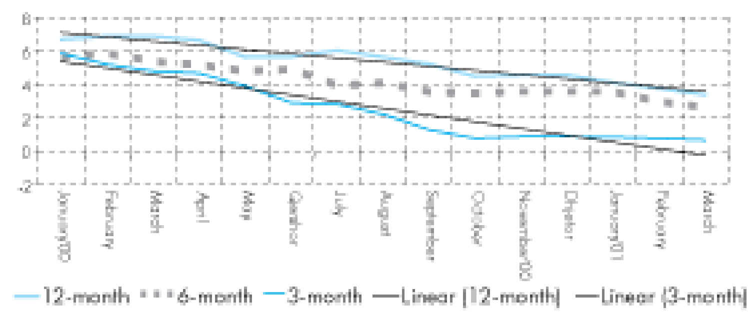
As the share of newly extended credits is small compared to T-bill investments in the primary market, the size of impact of the credit interest rate on the average weighted interest rate for investments is small. Therefore, the main tendency of average interest on investments is determined by T-bill investments.

Treasury bill yield has been falling. On average level, it has been reduced by figures presented in table 9 for the three maturity terms. During 2000, the reduction has been more significant for quarterly T-bills, while over the first quarter of 2001, the reduction has been more significant for 6- and 12-month T-bills.

Table 9 Treasury bill average yield and change (in percent)

| | June'00 (1) | Change (1-12.99) | Dec. 00 (2) | Change (2-1) | March (3) | Change (3-2) |
|---|---|---|---|---|---|---|
| 12-month T-bills | 14.00 | -1.65 | 12.33 | -1.67 | 11.14 | -1.19 |
| 6-month T-bills | 13.06 | -2.11 | 11.34 | -1.72 | 10.14 | -1.20 |
| 3-month T-bills | 10.73 | -4.15 | 7.83 | -2.90 | 7.57 | -0.26 |

Chart 3. Difference between T-bill yield and deposits' interest rates by maturity term




Reduction of treasury bill yield in the primary market of securities has given its main effect on the decreasing level of average weighted interest for Lek investments.

For the first time during the second half of 2000, there was rendered interest payment on required reserves held with the

Bank of Albania, beginning from August 2000 at one third of market rates and later in December at half of these rates. By means of the required reserve remuneration, the Bank of Albania intended reduction of investments price, by decreasing the intermediation cost of the banking system.

More precisely, for the period before the remuneration of required reserves, the cost of required reserves in domestic currency measured by the difference between domestic currency deposit and investment rates oscillated at 1.99-2.96 percent.

After the remuneration of required reserves at 1/3 of quarterly treasury bill yield according to the recent auction, the cost of the required reserve measured by the difference between domestic currency deposit and investment rates fell below 1.0 percent. More precisely, they were 0.44, 0.64 and 0.86 percent respectively for September, October and November 2000. The rising percentage of remuneration in December 2000, from 1/3 to 1/2 of the quarterly treasury-bill yield, despite the declining tendency of quarterly treasury bills, affected the reduction of the compulsory element of the required reserve. After this change, the cost of the required reserve measured by the difference between domestic currency deposits and investment rates continued narrowing, reaching minimum values for December 2000-March 2001 (0.86 percent).

The remuneration of the required reserve brought positive effects on releasing banks' cost by reducing the non-invested share. However, the rate of commercial banks' transmission of this effect to the market was different in invested prices in the market of treasury bills and credits. As to lending prices, they continue to remain at higher levels even after reductions. The spread between credit and deposit rates in domestic currency is about 2 times, not being very promoting for the lending market development.

Unlike credits, the treasury-bill yield had a gradual reduction, maintaining narrow differences with deposits. The fact that the Savings Bank is the main market bidder makes the price defined by demand-supply somewhat disfigured and dictated by its ruling position in the market.

For non-public banks, the intermediation cost estimated according to the difference for year 2000 and the first quarter of 2001 reduced significantly compared to 1999. Also for the period of January-March 2001, its level maintained the same tendency. The reduction has been more significant in new investment rates compared to the newly posted deposit rates. Despite that, this level remains higher than this difference for the system.

Table 10 The difference for non-public banks

| In percent | Average weighted for 1999 | Average weighted for 2000 | Change 2000-1999 | Q I of 2001 |
|---|---|---|---|---|
| Average deposit interest rates (1) | 7.20 | 6.06 | -1.14 | 4.39 |
| Average investment rate (2) | 20.41 | 14.18 | -6.23 | 11.49 |
| The difference (2-1) | 13.21 | 8.12 | -2.74 | 7.10 |

## ESTIMATING BANKS' FINANCIAL COST ACCORDING TO BANKS' AND THE SYSTEM'S FINANCIAL RESULT

According to this method, based on banks' financial result for year 2000, the banking system presents better indicators on the gross and net margin than in 1999.

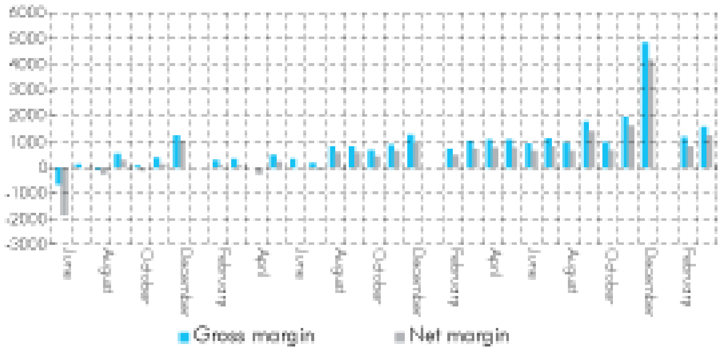
The changing figures of these indicators remain positive and at good levels even in the first quarter of 2001. From the chart it appears that gross and net margins are positive for all the months of the year 2000 and for the first quarter of 2001.

Table 11 The change in financial result indicators (in millions of Lek)

| | Year 1999 | Year 2000 | Q/1 Year 2001 |
|---|---|---|---|
| Interest margin | 432.85 | 735.90 | 738.6 |
| Gross | 517.80 | 1,455.78 | 1375.1 |
| Net | 263.25 | 1,123.71 | 1024.2 |

The fact that the monthly change of interest margin had a year on year growing trend indicates that the banking system had a rising tendency for interest collections compared to expenditures.

Chart 4 The change of the banking system's gross and net margin




On the other hand, even the incomes from other operations, with some exceptions, have increased, bringing about growth of the monthly (average) change of gross margin year on year. After discounting operating expenditures, the change in the banking system's net margin remains at positive monthly averages. The periodical increase in their monthly change is either dedicated to the increase of interests received or other incomes, while the operating expenditures of commercial banks did not reflect any significant changes during the year.

The observed trends of these indicators in 2000 continued to be maintained even in the first quarter of 2001.

The estimates of these indicators for separate banks in the system indicate improved indicators for year 2000 and on. Estimates made in the Savings Bank reflect a positive statement of the monthly change for gross and net margin indicators per each month.

For private and joint venture banks, monthly movements of gross margin are generally positive for year 2000 and ahead.

Tirana Bank, Alpha Credit Bank, Fefad Bank and American Bank of Albania have good indicators of financial result. Net margin movements are positive in the aforementioned banks.

Given the above, we may specify that during year 2001 and the first quarter of 2001:

- The banking system reached the lowest level of spread:
  - passing to one-digit figures,
  - maintaining the declining tendency,
  - having slight and very smooth oscillations against the line of the trend:
- The reduction of average interest for investments (treasury bills) is higher than the reduction of average weighted interest on the newly accepted deposits in domestic currency;
- For January-March 2000[1], the average weighted interest on investments shifted under one-digit figures, reaching for the first time the lowest level in the system, 8.33 percent;
- Domestic currency investments in the economy continue to occupy a small share compared to total investments;
- Although posing a very insignificant effect as above stressed, we can not neglect the fact that the level of average weighted interest for the newly extended credits reduced during the first quarter of 2001 at a higher level than the previous periods;
- Generally, all banks of the system aim at reducing the intermediation cost, endeavouring to maintain lower spreads compared to the previous periods;
- Indicators, according to the commercial banks' financial result, indicate improvements of every bank operation in particular, and of the entire system in general;
- Under the conditions when the treasury-bill yield is higher than time deposit interest in domestic currency, the type of domestic currency investments in treasury-bills relieves banks' job for covering the cost of domestic currency deposits. But, on the other hand, it does not promote banks to undertake long-term investments in the economy, taking over risk.

Year 2000 is considered as the initial phase of basing the monetary policy on indirect instruments, and in general, it is assessed that the Bank of Albania's monetary policy has been transmitted to the banking system.

During 2001, the Bank of Albania will expand money market operations at a broader scope, intending the rising efficiency of these instruments to guarantee the achievement of its principal target.

The market intervention through open market operations and the stimulation of interbank market will impact on increasing the flexibility of monetary policy instruments. Through these developments, the stabilization of short-term interests and liquidity levels will be ensured in the banking system and its competition will be further enhanced.

On the other hand, the economy has premises to be more credited by the banking system. An important factor would be the foreseen reduction of the budget deficit financing level by the banking system resources, providing broader spaces for increased financing to the economy. The Bank of Albania's monetary program for 2001 has forecasted a growth of the stock of credit to the economy by Lek 8.1 billion, comprising 29.6 percent of its current stock.

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[1] The data have been made available by Supervision Department, monthly statement of income and expenditures. The financial result includes both the activity in Lek and in foreign currency.