Bank of Albania

ANALYSIS OF FINANCIAL INTERMEDIATION

2012 Q1

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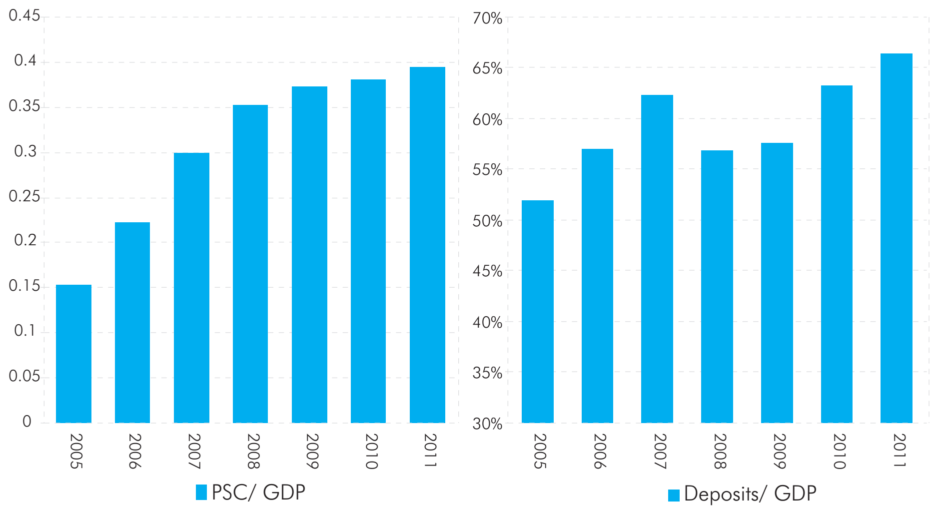
I. BANKS AND FINANCIAL INTERMEDIATION

In the first quarter of 2012, financial intermediation remained at similar levels to 2011. It performed in line with the year-start seasonal behaviour and the below-potential economic activity in Albania. The banking system was characterised by satisfactory liquidity levels, supported by households' ongoing propensity to save. Moreover, it was well-capitalised, reflecting the capital injection in the second half of 2011, in accordance with the regulatory requirements. On the asset side, loan portfolio was conditioned by economic agents' moderate demand for credit, driven by a low capacity utilization rate and low consumption. Also, against the background of heightened uncertainties surrounding the external and domestic economic outlook, as well as influenced by cross-border parent banks' conservatory policies, the banks tightened their lending conditions and were cautious in choosing sound projects. Credit activity survey for this period indicated that the demand for credit by businesses and households was weak because of the macroeconomic situation in the country, heightened uncertainties and concerns around certain sectors of the economy, as well as real-estate market performance.

Chart 1 Private sector credit and deposits as a share of GDP (in %)

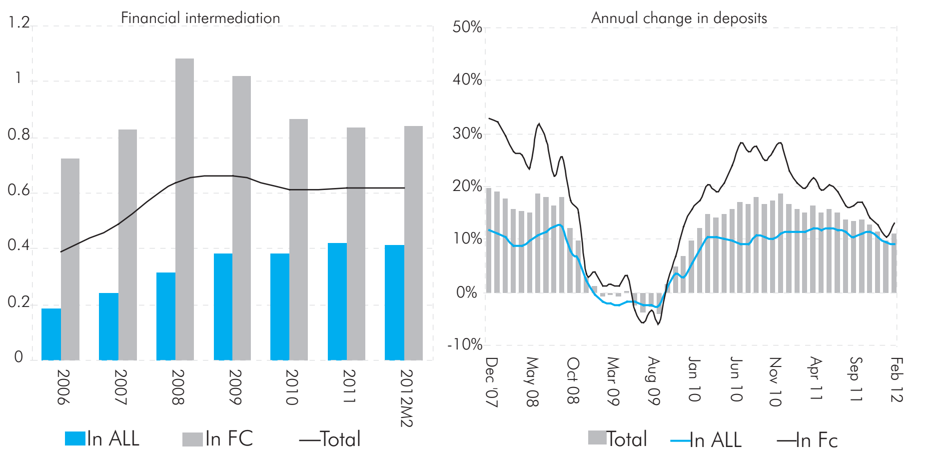


Source: Bank of Albania

Credit portfolio developments signal economic agents' weak demand for credit and banks' reluctance to take risks. As a ratio of GDP, the private sector credit portfolio, as at end-2011, reached 39.5%, or 1.4 percentage points higher than a year earlier. At the same time, deposits accounted for about 66.2% of GDP, up by 3 percentage points from end-2010. The phenomenon of poor lending performance against the background of slowing economic activity is being experienced by many South Eastern and Central European countries (SECE) and has also been explored by several working papers. A comparative analysis on loan portfolio performance by countries in the region and Central Europe depicts that Albania is one of the countries with the highest loan portfolio growth, at a time when some countries are experiencing portfolio contraction. Moreover, empirical assessments highlight non-performing loans, loan price and economic growth as determinants to this performance. They are assessed as statistically important factors for credit performance in the SECE countries.[1] Albania's higher credit growth is attributed to positive economic growth and good performance of banking system deposits over the past two or three years.

Monetary developments have been characterised by stable annual growth rates compared to end-2011. Notwithstanding the key interest rate cut, the transmission of easing monetary policy signals to the economy has remained slow and incomplete. The banks' loan portfolio quality impairment and their orientation by cross-border parent banks to restrict credit exposure have conditioned the increase in financial intermediation to the private sector. In 2011, the level of non-performing loans was 18.8%, or 4.8 percentage points higher than in 2010. The banking system intermediation has been stable over the past two years. In February, credit to deposit ratio remained similar to the previous year's level (61.7%). Unlike in the previous year, the increase in ALL intermediation has offset the decline in foreign-currency intermediation, compared to a year earlier.

Chart 2 Credit to deposit ratio



Source: Bank of Albania.

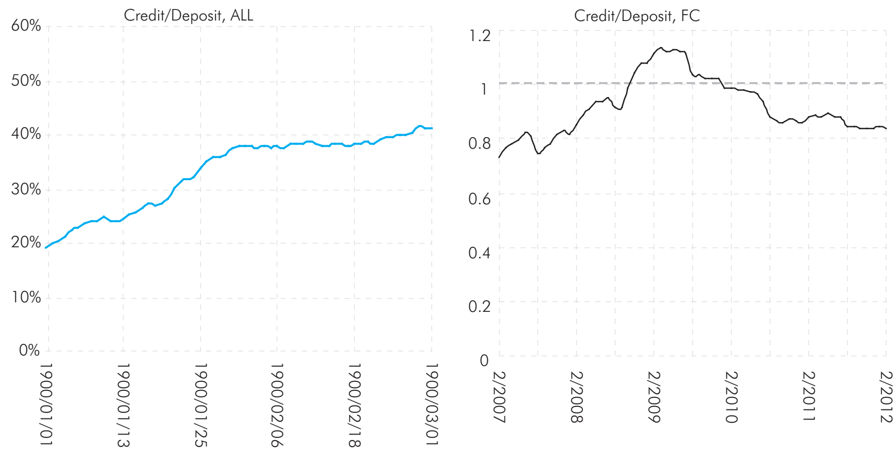
I.1. INTERMEDIATION BY CURRENCY

ALL intermediation in January-February was stable and slightly higher compared to the fourth quarter of 2011. Credit to deposit ratio settled at 41.2% over these two months, from 40.7% in the fourth quarter of 2011.

[1] *For more details, see the box on "Lending in the countries of the region", Annual Report 2011, Bank of Albania.*

Unlike in the previous year, when the increase in ALL intermediation was driven by high ALL-denominated credit growth rates and stable ALL-denominated deposit growth rates, in the first two months of the current year, the increase in intermediation was determined by their instantaneous slowdown.

Chart 3 Intermediation in ALL and in FC



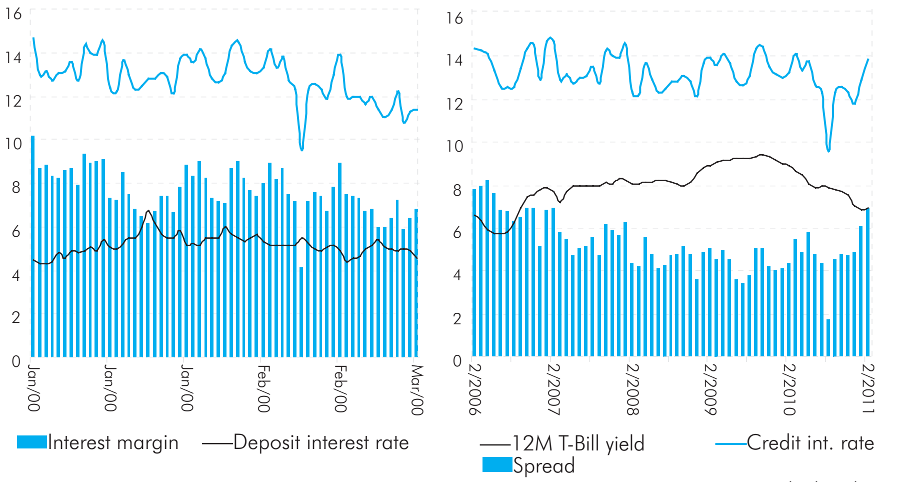
Source: Bank of Albania.

During January-February 2012, the performance of foreign-currency intermediation increased slightly, averaging 84.0%, from 83.6% in the fourth quarter of 2011. However, the size of foreign-currency intermediation remained lower than in the first half of 2011, with a spread of 4 percentage points. The decline in foreign-currency intermediation ratio since the second half of 2011 is attributed to decelerated deposit and credit growth rates; however, the impact of the latter has determined the downtrend of foreign-currency intermediation.

I.2 INTERMEDIATION COSTS

Following the growth recorded in the fourth quarter of 2011, the ALL intermediation cost increased slightly during January-February, averaging 6.6 percentage points for both months. While the average interest rate on ALL-denominated credit remained almost unchanged, deposit interest rate lowering, in response to easing monetary policy signals, has determined the performance of the ALL intermediation margin over the last months. Also, stable ALL-denominated credit interest rate and increased T-bill yields over the first months of the current year have been reflected in a narrowing spread between them.

Chart 4 ALL intermediation cost*.

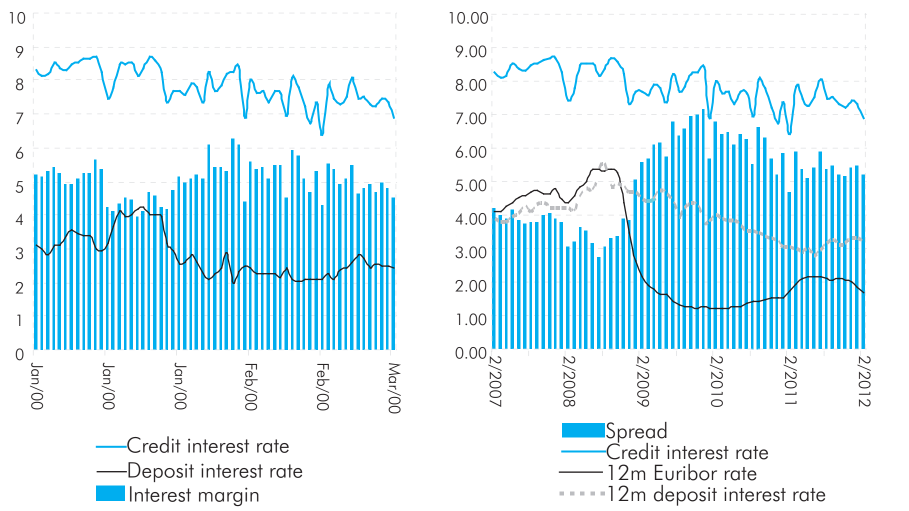


*Interest margin is calculated as a spread between credit and deposit interest rates. The spread is calculated as a difference between credit interest rate and reference rate (12-month T-bill yield for the ALL, and 12-month Euribor for the EUR)

Source: Bank of Albania.

The euro intermediation cost[2] was 4.65 percentage points over the first two months of 2012, continuing the downtrend having started since the second half of 2011. Its performance over the last two quarters has reflected the instantaneous lowering of interest rates on both loans and deposits denominated in euro, though the effect of the latter has been stronger. Despite the lowering of deposit interest rates, they remain significantly higher than the euro-denominated deposit interest rates internationally, reflecting Albanian banks' tendency to ensure ample liquidity in foreign currency.

Chart 5 EURO intermediation cost



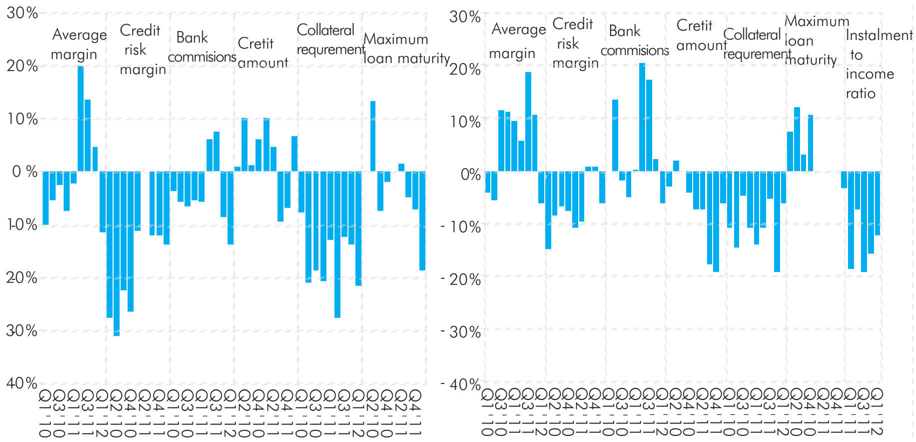
Source: Bank of Albania.

2 *The banks' activity in foreign currency is dominated by their transactions in euro, which account for more than 80% of foreign-currency activity.*

I.3 NON-PRICE ELEMENTS

Analysis on bank lending activity for the first quarter of 2012 reveals tightening in credit conditions of the banking system, both to businesses and households. Likewise in the previous quarter, the major part of non-price elements continued to impact on the tightening direction.

Chart 6 Credit conditions to businesses (left) and to households (right)*



*Net balance of survey answers.
Source: Bank of Albania.

Business credit conditions tightened further in the first quarter of 2012, albeit less than in the fourth quarter of 2011. Excluding the credit size criterion that eased during this quarter, all other non-price elements tightened. This tightening was associated with further rise in commissions and average credit risk margin. Also, following the easing taking place over some quarters, normal credit margin also increased in the first quarter of 2012, thus contributing to tightening business credit conditions.

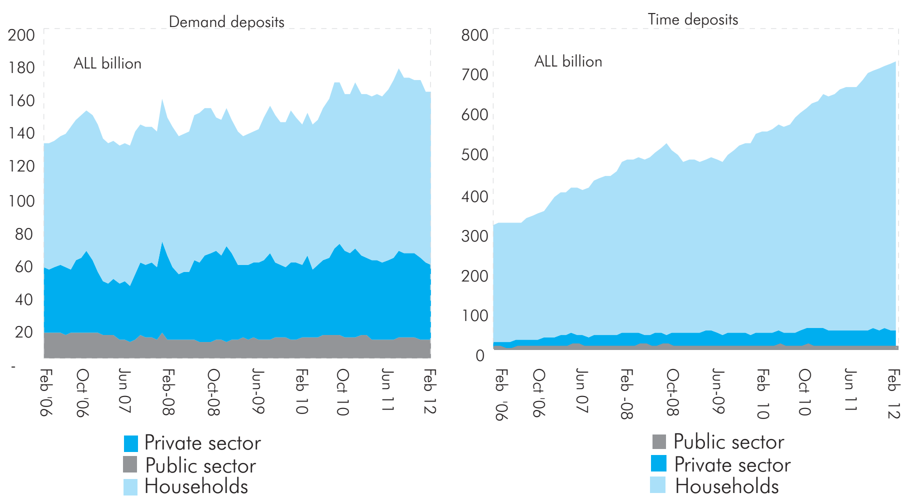
After remaining unchanged in the fourth quarter of 2011, credit conditions tightened at a larger extent for households than for businesses, in the first quarter of 2012. This tightening was mainly due to credit price elements (average credit risk margin, high credit risk margin, and commissions). Credit maturity criterion continued to provide a neutral effect on household credit conditions. Also, the tightening impact from other non-price criteria was smaller in this quarter than in the previous one.

II. DEPOSIT ACTIVITY

Funds deposited at the banking system in February were 11.1% higher than a year earlier. The slowing pace of their growth in 2011 reached the lowest level in January, by 9.8%, to subsequently increase in February. Improvement in the annual growth rate of total deposits has reflected not only their monthly increase by ALL 6.8 billion, but also the base effect of comparison with the previous year. During the first two months of 2012, deposits increased less than in the fourth quarter of 2011, in response to their seasonal behaviour. Also, their net flow during January-February was about 35% lower than in the same period of the previous year. This reduction has reflected the slower money creation in the first quarter of 2012 and the developments in business deposits, mainly in foreign currency.

Changes in deposit time structure over the first two months of 2012, confirmed the shift of household savings from demand deposits to time ones. This shift was even more obvious in ALL-denominated deposits. At the same time, business deposits were in line with their trading activity in the first months of the year. Likewise a year earlier, business deposits, mainly time and foreign-currency ones, have been used for loan repayment. The level of business deposits as at end of February is close to the several-year average. Shifting deposits to over-two-year time deposits has made their ratio to total deposits reach historically high levels, to 81.7%.

Chart 7 Deposits by maturity

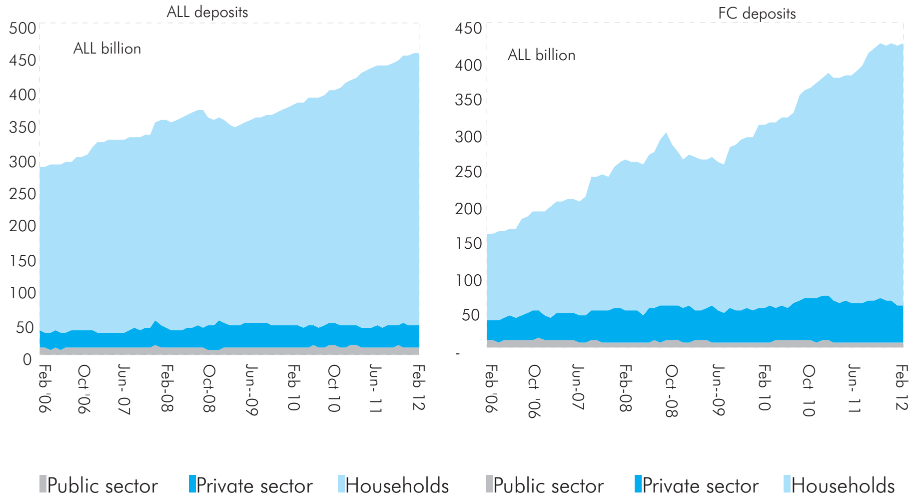


Source: Bank of Albania.

Deposit structure by currency shows that it remained almost unchanged relative to end-2011. ALL-denominated deposits account for 52% of total deposits. On a year earlier, they have slightly increased. This performance has reflected households' low preference for holding cash, as well as the larger money creation due to banks' intermediation in the national currency. The time structure of ALL-denominated deposits is dominated by time deposits (82.7%). Household deposits account for about 90% of total ALL-denominated deposits, remaining unchanged over the past two years. Net deposit flows in the first two months of the year were lower than in the same period a year earlier, averaging ALL 2.4 billion per month, compared to ALL 4.6 billion a year earlier.

Foreign-currency deposits account for about 48% of total deposits. The time structure of foreign-currency deposits is dominated by time deposits (81%). Household deposits account for about 86.4% of foreign-currency deposits and this ratio has been rising over the past two years. Foreign-currency deposits increased by 11.8% y-o-y, in the first two months of the year, continuing the decelerated growth rates relative to early 2011.

Chart 8 Deposits by currency

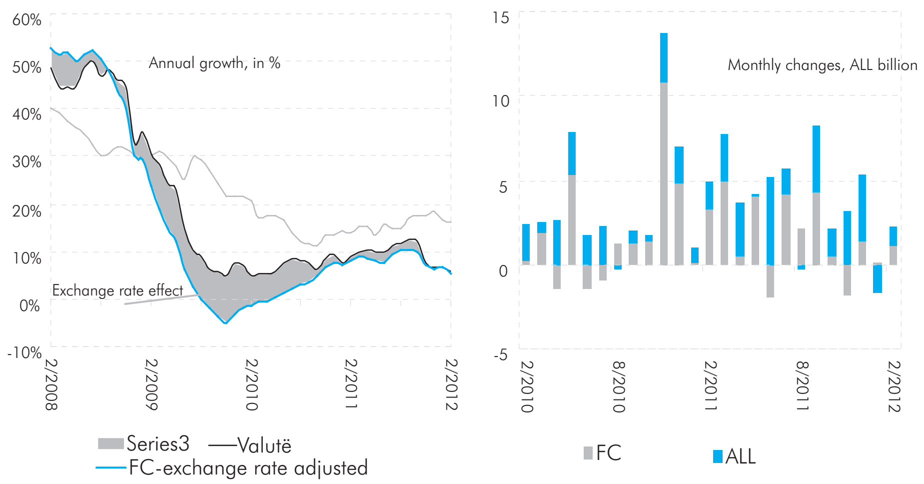


Source: Bank of Albania.

III. CREDIT ACTIVITY

Private sector credit[3] performed slowly during the first two months of 2012, mainly due to private sector's low demand for credit, reflecting its reluctance to spend and invest. On the other hand, the banks have displayed low tolerance to risk, by further tightening credit conditions over the first quarter of the year. The poor performance of the private sector credit in early 2012 has been reflected in further decline in its annual growth. As at end-February, the annual private sector credit growth was 9.2%, from 10.4% as at end-2011.

Chart 9 Credit by currency



Source: Bank of Albania.

In January and February, unlike in 2011, the ALL-denominated private sector credit performed sluggishly. Its annual growth fell to 16.6% and 16.0% in January and February, respectively, from 18.5% as at end-December 2011. The lower growth rate of ALL-denominated credit is apparent to business credit due to higher settlements of working capital loans over this period. ALL-denominated household credit maintained stable annual growth rates. Over the first two months of the year, its extension to households, albeit small, has taken the form of real-estate investment financing.

The annual growth of foreign-currency private sector credit, after remaining unchanged in January (at 6.6%), slowed down to 5.9% in February. Its performance was driven by overall low demand for credit in early 2012 and a lower preference for foreign-currency loans, in particular by households. The main source of its growth remains the business demand, which, during this year-start, albeit low, was mainly oriented towards investment loans.

3 *Private sector credit accounts for about 97% of total credit.*

Households continued to reduce their foreign currency liabilities to banks, reflected in annual contraction of foreign-currency loans to households over the last four months of the year.

During the last three years, a broader use of the national currency in bank lending has been also reflected in a significant increase of its share to private sector credit, particularly to businesses. As at end-February, the ALL portfolio accounted for about 30% of total business credit, up by 3 percentage points from end-2010 and up by 10 percentage points from end-2008. In relative terms, ALL-denominated credit to households was higher than ALL-denominated credit to businesses. The ALL-denominated credit accounted for about 46% of household credit as at end-February, up by 2 percentage points from 2010 and up by 3 percentage points from 2008.