Bank of Albania

ANALYSIS OF FINANCIAL INTERMEDIATION

2012 QII

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SOFIKA NOTE

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* *The views expressed in this paper are those of the authors and do not necessarily represent those of the Bank of Albania.*

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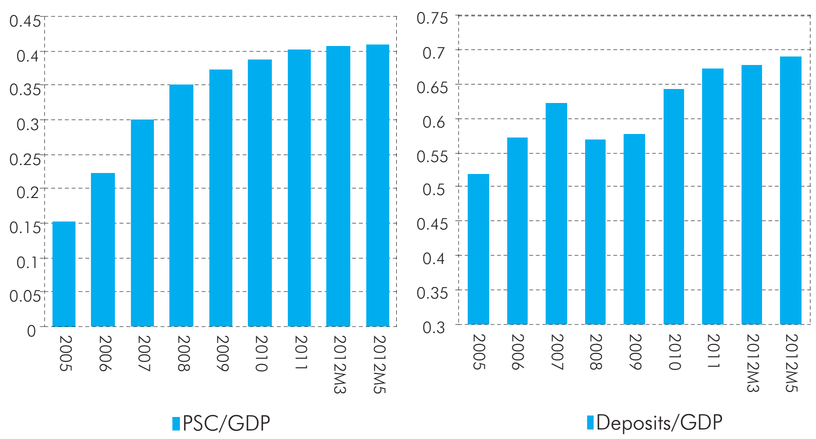
C O N T E N T S

1. BANKS AND FINANCIAL INTERMEDIATION

In recent years, the economy's upward monetisation has created appropriate conditions for the banking system to play an active role in financial intermediation. However, in the second quarter of 2012, the financial intermediation was determined by the private sector's sluggish demand for money. Albania's below-potential economic growth reduced the private-sector demand for financing. Commercial banks continued to be selective with regard to financing the private sector, preferring financing businesses. Business loan portfolio to total loan portfolio reached 74% in May, while household loan portfolio continued to shrink. Money market developments and uncertainty around the future, coupled with households' propensity to save led to a low demand for money. The perception[1] of the overall macroeconomic situation and developments of the real estate market have impaired the demand for mortgage loans and have determined the performance of household financing. Moreover, lack of investments or their postponement have led to a downward business demand for this category of financing. The business demand appears moderate and oriented towards working capital purpose.

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



Source: Bank of Albania.

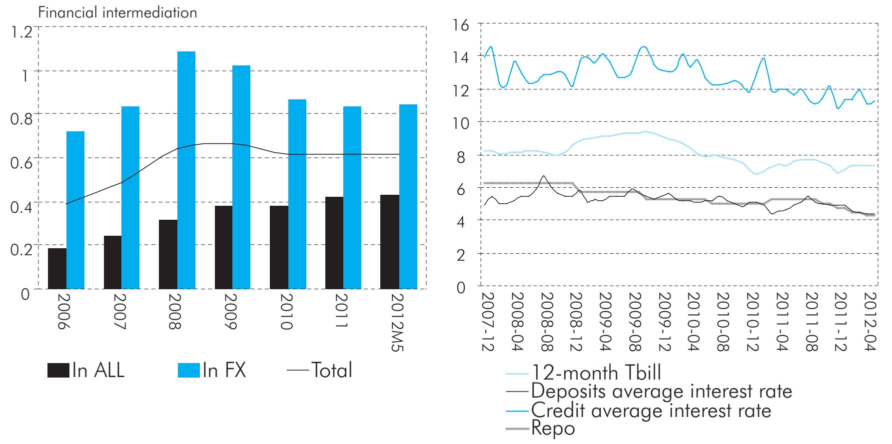
The overall banking system is assessed as liquid and well-capitalised. The slow economic performance, uneven development across sectors, and impaired loan portfolio quality to 20.1% as at end-March (from 18% a year earlier) made banks be prudent with regard to easing of lending terms and selective in their financing projects. Financial intermediation, measured as a ratio of private-sector credit to GDP, remained unchanged from the 2011's level, at 40.8%.[2] Deposit-to-GDP ratio continued the uptrend, accounting for 68.9%, being about 1.7 percentage points higher than in 2011.

[1] *As assessed by lending activity survey on the first and second quarters of 2012.*

[2] *Besides the performance of financial indicators, this radio has also reflected the revision of GDP series. Latest GDP revision published in July 2012 by INSTAT.*

Slow bank lending versus households' propensity to save contributed to a downward credit-deposit ratio in May, resulting 61.6%, or down by 0.8 percentage points from May 2011. Intermediation by currency highlights a better performance of the ALL intermediation.

Chart 2 Credit-deposit ratio and interest rates in ALL

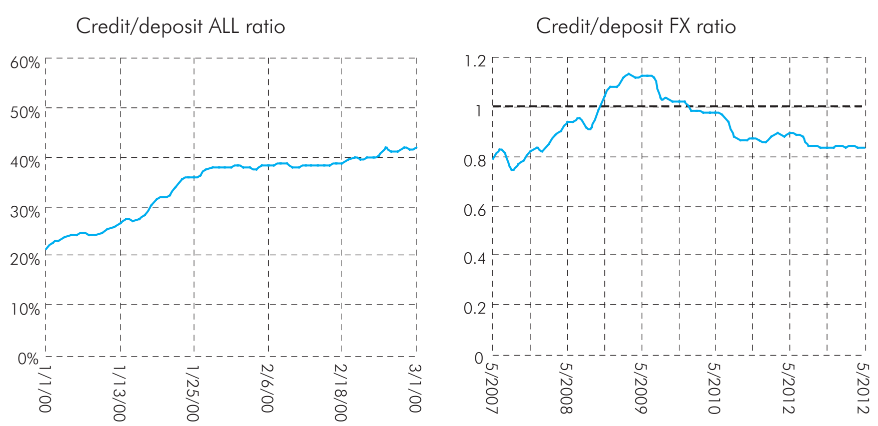


Source: Bank of Albania.

1.1. INTERMEDIATION PERFORMANCE

In the second quarter of 2012, the ALL intermediation was stable and the credit-deposit ratio remained at similar levels. As at the end of May, it reached 41.8%. Comparing over longer time spans, in the past 12 months, the ALL intermediation trended up. As at the end of May, credit-deposit ratio increased by 3.3 percentage points on a year earlier due to good performance of ALL-denominated credit, whose annual growth rate exceeded twice that of ALL-denominated deposits.

Chart 3 ALL and FX intermediation



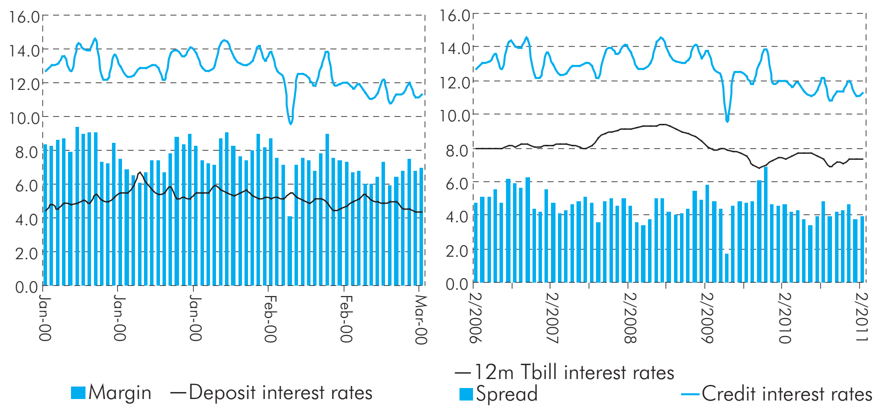
Source: Bank of Albania.

Foreign-currency intermediation slowed down marginally in the second quarter. As at the end of May, foreign currency credit-deposit ratio reached 83.2%, down by 1.0 percentage point from the end of the first quarter. Such a performance is determined by slight contraction of the foreign-currency loan portfolio over these two months, while foreign currency deposits have increased over this period, albeit at a more moderate size than in the previous periods. During the past 12 months, the size of foreign currency intermediation continued to drop, similar to the two preceding years. The credit-deposit ratio as at end-May 2012 was 6.3 percentage points lower than as at end-May 2011.

1.2. INTERMEDIATION COST

After the increase in the fourth quarter of 2011 and the first quarter of 2012, the average ALL intermediation cost remained almost unchanged in the second quarter of 2012, at 6.85 percentage points. The ALL intermediation cost sustainability is a result of instantaneous and similar-size lowering of ALL-denominated deposit and loan interest rates over this period. The latter seems to have pursued the monetary policy signals from the previous months, transmitted through the key rate cut. This is also noted from a longer time span comparison. Hence, within one year time span, the ALL intermediation cost fell by 0.3 percentage points due to interest rate cut on deposits by 0.4 percentage points and on loans by 0.7 percentage points. Also, the loan interest rate cut and T-bill yield rise in recent months contributed to reducing their spread in the second quarter of the year. For the second quarter of 2012, this spread averaged 3.8 percentage points, about 0.7 percentage points lower than a year earlier, fully influenced by ALL-denominated loan interest rate cut.

Chart 4 ALL intermediation cost*



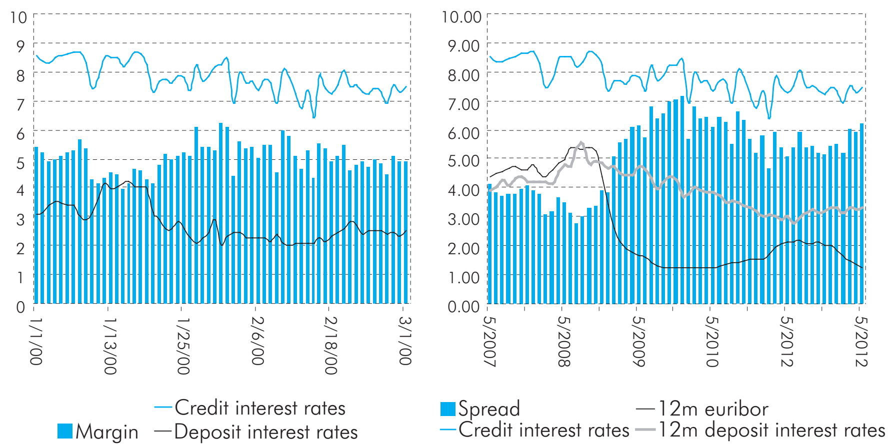
* Interest margin is calculated as a spread between credit and deposit interest rates. The spread is calculated as a difference between credit/deposit interest rate and reference rate (12-month T-bill yield on the ALL, and 12-month Euribor on the Euro).

Source: Bank of Albania.

Average Euro intermediation cost[3] was 4.93 percentage points in the second quarter of 2012, slightly up by 0.13 percentage points from the first quarter of 2012. While the average deposit interest rate remained unchanged, the slight increase in Euro intermediation costs was due to ALL loan interest rate increase. Despite these short-term developments, in the second quarter of the year, the Euro intermediation cost resulted close to the last 12 months' average, which is 0.3 percentage points lower than in the past 12 months.

Euro deposit interest rates in the country remained substantially higher than the euro interest rates in international markets, which dropped sharply over the last six months. The main factor behind this phenomenon is the banks' need for foreign currency liquidity in the country. Therefore, the lowering of the euro interest rates in international markets and the relative stability of the euro interest rates in the country have been materialised into an increasing spread between them, in the recent months.

Chart 5 Euro intermediation cost



Source: Bank of Albania.

1.3. NON-PRICE ELEMENTS[4]

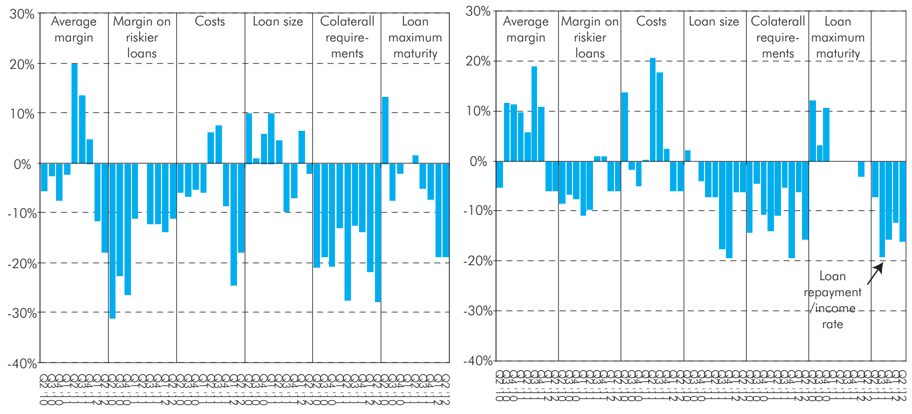
Based on the analysis on bank lending activity over the second quarter of 2012, credit conditions to businesses tightened further, whereas those to households remained unchanged. Almost all non-price elements of these conditions continued impacting on the tightening direction.

Of non-price elements, collateral requirements and maximum loan maturity remain key elements with a stronger impact on the tightening direction. Also, cost-elements of credit conditions continue to impact on their further tightening, with an added effect in the last two quarters.

[3] *Foreign-currency activity of banks is dominated by their transactions in euro, which account for more than 80% of the foreign-currency activity.*

[4] *This analysis is based on Lending Activity Survey results, conducted by the Bank of Albania quarterly. For more information, see www.bankofalbania.org, publications.*

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



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

Terms of household financing, after having been tightened in the first quarter of the year, remained unchanged in the second one. Collateral requirements and instalment/income ratio remained the non-price elements with the greatest impact on the tightening direction. Also, for the second consecutive quarter, the price elements of household credit conditions continued to impact on further tightening.

2. DEPOSIT ACTIVITY

In the second quarter of 2012, the banking system deposits maintained the same growth rates as in the first quarter. This performance was supported by upward monetisation of the economy and by households' propensity to save. The ratio of deposits to M3 rose to 82.8%, or 1.6 percentage points higher than in May 2011.

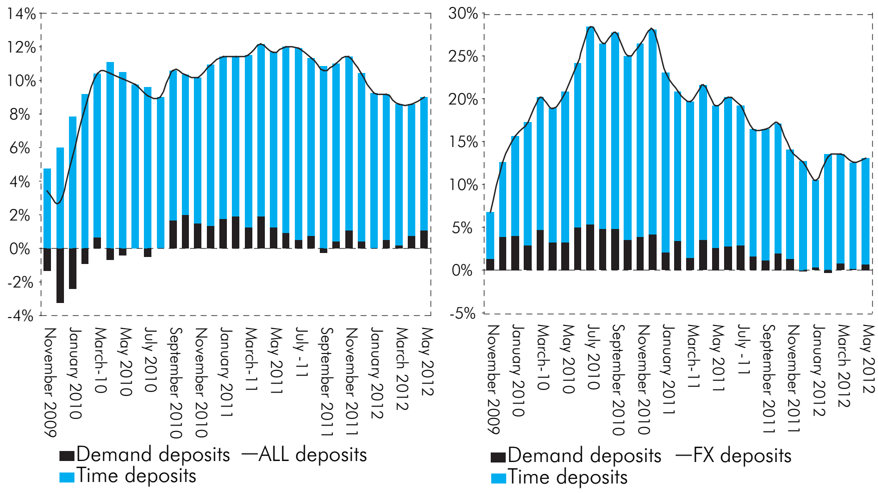
Deposits increased by ALL 23.4 billion in the first half of the year, supported by the ALL 18 billion increase in ALL-denominated deposits. In annual terms, ALL-denominated deposits have slightly slowed their growth rate, taking it down to 9% and reflecting the reduction of ALL-denominated deposit growth rates. Hence, in May, the annual growth rate of ALL-denominated time deposits marked 9.6%, from 12.8% a year earlier. This slowdown was influenced by the preference of households to invest their savings in primary-market treasury bills. Households' investments in non-bank financial institutions[5] increased, as well. These developments confirm households' low preference to hold liquid money and their propensity to save.

ALL-denominated demand deposits increased by ALL 1.5 billion per month, in contrast to their contraction in the first quarter, impacted mainly by the performance of financial institutions' deposits at the banking system. The

[5] *These institutions are not included in monetary indicators.*

annual demand deposit growth was 6.2% and pursued the upward trajectory of the year-start. This performance was also influenced by the contraction of demand deposits a year earlier. ALL-denominated demand deposits by private businesses ranged around the average of the past 2-3 years.

Chart 7 Deposits by currency



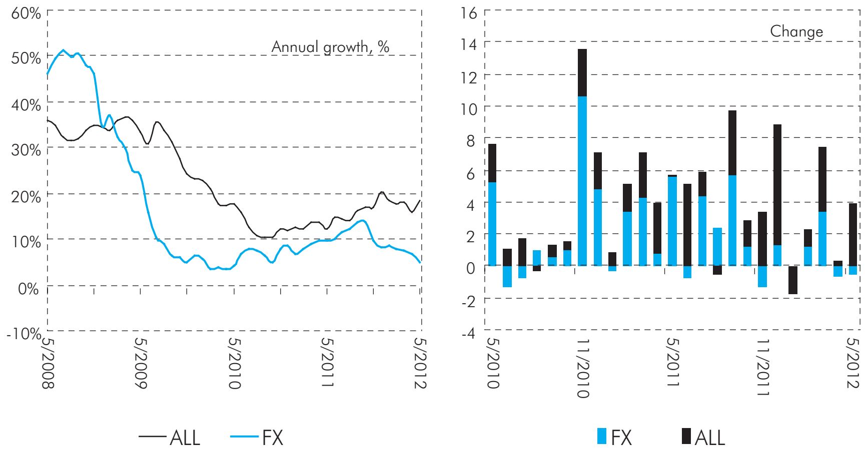
Source: Bank of Albania.

The ratio of foreign-currency deposits to total deposits in May 2012 decreased slightly, down to 47.7%, from 48.3% in December 2011. The reduced share of foreign-currency deposits in total deposits was determined by both slowdown in foreign-currency deposit growth rate and good performance of ALL-denominated deposits. In the second quarter of the year, foreign-currency deposits increased by ALL 2 billion on average, showing improvement compared to the first quarter. In annual terms, foreign-currency deposits increased by 13%, similarly to end-2011. However, compared to the same period a year earlier, the annual foreign-currency deposit growth rate continued its downtrend having started in mid-2011. This performance reflected lower foreign-currency flows than a year earlier and lower foreign-currency creation. Foreign-currency deposit growth is supported by households' time deposits. In the second quarter, demand deposits improved their annual growth rates moderately, at 3.2%.

3. CREDIT ACTIVITY

Credit to economy continued its annual slowdown even in the second quarter of 2012. Its annual growth recorded 9.4%, from 10.9% and 12.2%, respectively, as at the end of the first quarter of 2012 and end-2011. This slowdown reflected substantially the private sector's low demand for financing, in response to the sluggish domestic demand. Also, credit supply, regardless of good situation of banking system capitalisation and liquidity, appears tightened, likewise indicated by credit conditions. The prudent and selective behaviour of banks in terms of lending is a consequence of the increased credit risk in the country and added uncertainties around the future.

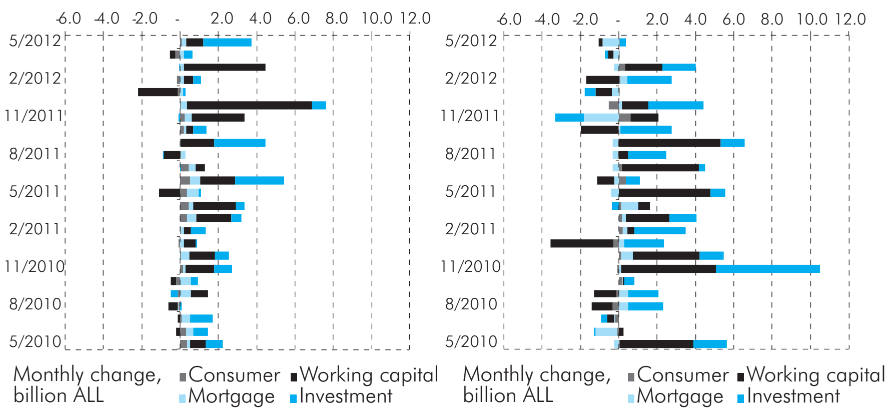
Chart 8 Credit by currency



Source: Bank of Albania.

All-denominated credit remains the main driver to credit to economy. Its annual growth, after falling to 16.0% in April, improved again in May, recording 18.3%. Its expansion in May derived mainly from increased financing for investment purposes to public enterprises. Excluding this financing, ALL credit expansion remained lower than a year earlier.

Chart 9 ALL-denominated credit (left) and FX-denominated credit (right), by purpose of use



Source: Bank of Albania.

Foreign currency-denominated credit continued to decelerate in the second quarter of the year. Its annual growth recorded 5.0% in May, from 7.3% and 8.3%, respectively, as at the end of the first quarter of 2012 and end-2011. Regardless of the generally low demand for financing, the poor performance of foreign currency-denominated loans was also affected by the shift of households' and businesses' preference to Albanian lek financing. Foreign currencies, mainly the euro, remained primary in lending for investment purposes. Credit for working capital highlights a larger use of the national currency over the last two years, particularly for lending to households. While foreign-currency household credit has continuously contracted over more than two years, the ALL-denominated credit has performed better, offsetting the foreign-currency credit contraction.