BANKA QENDRORE E REPUBLIKËS SË KOSOVËS
CENTRALNA BANKA REPUBLIKE KOSOVA
CENTRAL BANK OF THE REPUBLIC OF KOSOVO

Bank Lending Survey

Number 3

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Bank Lending Survey and Inflation Expectations

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Bank Lending Survey

Introduction[1]

In order to increase the analytical capabilities on a good assessment of lending dynamic activities in Kosovo and expectations on the price level, the Central Bank of the Republic of Kosovo (CBK) has designed and conducted a survey with commercial banks which operate in the banking sector of Kosovo. The report which will analyze the results of this survey will be published on quarterly basis at the website of the CBK, aiming at providing a more comprehensive survey about the risk perception of the banks and the willingness of the banks to lend, and the behavior of the households and enterprises in relation to credit activities dynamics. This report records the credit behavior for the first quarter of 2020, and banks expectations for credit dynamics in the second quarter of 2020.

Besides standard questions, in this survey were added some other questions related to the potential preventing measures undertaken by the Government of Kosovo against the spread of Covid-19 and its affection on the credit supply and demand, and their impact on the liquidity position and credit portfolio quality of the banks.

Results Summary

The results of the last survey on commercial banks in the country suggest that increased uncertainties after the announcement of pandemic and preventing measures undertaken in the country and in other economies abroad, have resulted in a tightened credit supply and a decline of the demand for loans in the first quarter of the year. Despite the high uncertainties that accompany the pandemic situation at this stage (the evolution of the virus and/or the second wave of potential spread in the fall), banks have stated they expect tighter loans supply and lower loans demand in the second quarter against the first quarter of 2020.

The slowdown dynamic of the increase of credit activity for enterprises during the first quarter of 2020, according to the bank lending survey, results to have been negatively affected by the loans supply conditions and loans demand as well. The expectations of banks for the coming quarter result to be more pessimistic. In line with this development, the stock of loans to non-financial corporations (NFC) increased by EUR 31.9 million during Q1 2020, while during Q4 2019 it increased by EUR 52.0 million, a similar difference if we compare it with Q1 2019 where the loan stock of NPL increased by EUR 52.7 million.

Within the credit supply, banks have reported to have tightened to some extent the standards applied in assessing enterprise applications for loans, disregarding the expectations stated in the previous survey. Credit standards for both categories of enterprises tightened to some extent.[2] The most conservative approach of banks towards lending to enterprises was attributed mainly to the measures taken by the Government of Kosovo to prevent the spread of Covid-19 virus, a factor that has increased the perceived risk of banks (complete interruptions in some business activities, namely a contraction of the activity of most of the registered businesses in the country). The increased uncertainty due to Covid-19 pandemic has been negatively affected also by other factors such as the deteriorating market outlook in general and the local banking market in particular, then potentially declining credit portfolio quality, increasing the negative impact of international factors such as the perspective of the

[1] For more detailed information about the back ground of the CBK bank lending survey, please refer to the publication "Bank Lending Survey and Inflation Expectations" No. 1

[2] Tightening of applied credit standards were stated by three out of nine participating banks in the survey.

global market and the quality of the credit portfolio, as well as the increased uncertainties about the stability of financing by deposits in the domestic market.

For the second quarter of 2020, banks' expectations consist of further tightening of credit standards, expectations that are primarily attributed to the expected decline in economic activity with isolation as a precautionary measure against the spread of COVID-19, as well as uncertainties about the dynamics that the pandemic situation will follow in the coming months. During Q2, the number of banks that declared to expect further tightening of credit standards increased to six from three as they were, out of a total of nine banks participating in the survey. By banks, this tightening is expected to be more concentrated on long-term loans.

Terms and conditions applied by banks in granting loans to enterprises were eased, albeit at a lower extent. The support by KCGF and the competition pressure by other banks had an impact on easing the credit terms and conditions to some extent. Meanwhile, for the second quarter of 2020, banks have stated that they expect tightening to some extent of the terms and conditions for new loans, mainly through reducing the size of loans and reducing maturity for new loans. At the same time, three banks stated a decline of collateral requirements. For the second quarter of 2020, credit terms and conditions are expected to be negatively affected by increased uncertainties about the health and economic crisis and potential effects to economic agents.

During the first quarter, the demand for loans from enterprises submitted to banks is resulted to have declined, resulting in a reverse direction with the expectations stated by banks in the previous survey. The negative index that resulted after the indexation of the banks' responses regarding the demand for loans is highly attributable to both SMEs and large enterprises. Within loans demand from enterprises, banks have stated that the demand was characterized with a decline for financing the fixed investments and for debt restructuring. Moreover, the use of alternative financing sources, such as the internal financing by the deposits of enterprises held at banks, marked to some extent a negative effect on the demand for loans. In Q2 2020, banks expect further decline of demand for loans from enterprises, a decline which is expected to be attributed to the decline of demand for financing fixed investments. This reflects the immediate need for liquidity from enterprises and their uncertainties relating to potential impact of the pandemic on the decline of the activity and as a consequence of the demand for financing fixed investments. At the same time, banks expect a significant decline on the quality of the enterprise applications for loans.

The dynamic of the credit activity for household loans during the reporting period, based on the survey, were negatively affected by the demand for loans, while the credit supply side remained unchanged for this segment. Credit standards applied for households, based on the survey, result to have remained not impacted by the situation created by the pandemic in the first quarter of 2020. However, the banks' expectations for Q2 2020 provide indications of a significant tightening of credit standards for the household sector, in particular for housing loans, as a result of increased uncertainties about future prospects and the long maturity of these loans. Banks expect tightening of credit standards also for consumer credit, albeit at lower level compared to housing loans. These expectations were based on the increase of banks' sensitivity to risk as a result of pandemics.

Terms and conditions for new loans to households were eased to some extent, mainly through offering more favorable interest rates, the increase of the amount of the approved loans and a more favorable demand for collateral. The increase of the competition pressure by the banking sector, and the favorable perspective of the banking market in the country and the good perspective of the real estate, result to have been key factors in easing the terms and conditions of lending to households in the first quarter of 2020. For the second quarter of 2020, banks expect a tightening to some extent of terms and condition for loans, especially for housing loans. Terms and conditions for new loans to households are expected to be adversely affected by the increased risk perceived by banks (unsatisfactory market prospects in the country and abroad, poor real estate prospects, uncertainty in clients solvency and higher collateral risk), deterioration of credit portfolio quality in the country and abroad, and to a lesser extent, unsatisfactory liquidity position. All the aforementioned factors were prompted by the impact of the pandemic on the economic activity of Kosovo and abroad. .

Although measures to prevent the spread of the Covid-19 virus have been taken only in the last two weeks of this quarter, the demand for loans from households results to have been affected to some extent. In this quarter, banks reported a decline in demand for loans from households, a more significant decline in housing loans against the demand for consumer loans. Banks reported that the decline in demand for loans from households has been attributed to declining demand for consumer financing, the decline of demand for debt restructuring and to a lesser extent, from the unsatisfactory perspective of the real estate market. In the second quarter of 2020, banks expect a sharp decline in credit demand from households, with a more pronounced decline in demand for housing loans, while consumer credit demand is expected to decline to a lower level. The results of the survey suggest that banks' expectations for credit demand dynamics are largely based on unfavorable prospects in the real estate market, declining customer confidence in their solvency, and declining demand for consumer financing.

High uncertainties about economic prospects as a result of the health crisis and the closure of business activities resulted in increased credit risk. Banks reported an increase of nonperforming loans to some extent compared to total loans in the first quarter of 2020, an indicator that is expected to worsen further in the second quarter of 2020.

Banks reported a slight decline in total financing in the reporting period, influenced by the withdrawal of corporate deposits, implying a covering of liquidity shortages through deposits held at banks, taking into account uncertainties in the realization of revenues. Meanwhile, household deposits continued to support the financing of banking activities. Over the next quarter, banks expect further decline in access to financing. Financing through household deposits is expected to decrease compared to Q1 2020, and financing from enterprise deposits is expected to continue to decline. Unlike the first quarter of 2020, in the next quarter two of the surveyed banks expect a support in financing the activity from international financial institutions, while as a result of the global nature of Covid-19 pandemics, banks generally do not expect changes in financing from parent banks.

Box 1. Methodology

The questionnaire of the Bank Lending Survey

The BLS questionnaire is based on the standardized questionnaires used by the Central Banks in the euro area and beyond. However, the BLS questionnaire of the CBK has been modified and adopted to its best and comprehensive way to represent lending developments in Kosovo's banking sector.

The BLS questionnaire contains 19 questions, which cover the changes of credit supply, changes in the demand for loans, factors which contribute in these changes and the access in banking sector's funding. Questions on banks lending are focused on two main categories: (i) loans to enterprises, and (ii) loans to households. Moreover, loans to enterprises are sub-categorized in loans to SMEs and loans to large enterprises, while loans to households are sub-categorized in loans for house purchase and consumer credit. For all the above mentioned categories, changes in loan supply conditions are defined by credit standards applied in the process of loans approval, terms and conditions applied for new loans, loans approval rate, and the factors which affect their changes. Meanwhile, the changes in the demand for loans are defined by the demand for loans (the number of applications for loans), the quality of the applications received, and the factors which affect the demand for loans. The questions of the survey primarily are designed to obtain a feedback for changes over the past three months and changes expected in the following three months. Also, questions cover loans in the aspect of their maturity and currency in which they were granted.

Besides the standard questions, the BLS questionnaire may contain also additional questions on specific issues in order to explain the developments in the banking sector. While standard questions cover a three-months period, additional questions may refer changes occurred during a longer period of time. The survey conveys nine out of ten banks operating in Kosovo. Consequently, the participating banks represent the general banking market and ensure a proper statistical representation, taking into account that they represent 98% of total assets of the banking sector, and 99.8% of total lending of the banking sector.

Survey participants are asked to indicate in a qualitative way the strength of any tightening or easing or the strength of any decrease or increase, reporting changes using the following five-point scale: (i) tightened/decreased considerably, (ii) tightened/decreased somewhat , (iii) basically no change, (iv) eased/increased somewhat or (v) eased/increased considerably.

Generation of the bank lending survey results

Quantifying of the answers received from individual banks and their aggregation to present the changes on the level of the sector is achieved through a generation of an index. This index is generated for each category and sub-category of each of the questions, thus giving in a quantifying unit for the answers received on the level of the sector.

Initially, the answers are determined by a value based on the strength of the changes, namely answers where banks stated a considerable tightening/lowering are determined with a value - 1 a double value in size than the one determined for answers when banks declare tightening/lowering to some extent (a value of -0.5). Similarly, answers have a value of 1 when there is a considerable ease/increase, while those with ease/increase to some extent are determined with a value of 0.5. Results are also weighed based on the weight that each of the banks has in total lending of the banking sector. Finally, the weight of each bank based on its share on the credit market is multiplied with the value determined based on the intensity of the given answer, thus obtaining the index in question.

Further more, the aggregation of the index on the sector's level is performed through the sum of the indexes obtained for each of the bank. The value of indexes are ranged from -1 to 1, where the positive values of the index represent ease, increase or positive contribution, whereas negative values represent tightening, decline or negative contribution.

The BLS questionnaire, and time series of the bank lending survey results, are available on the CBK website, on the link of the Bank Lending Survey.

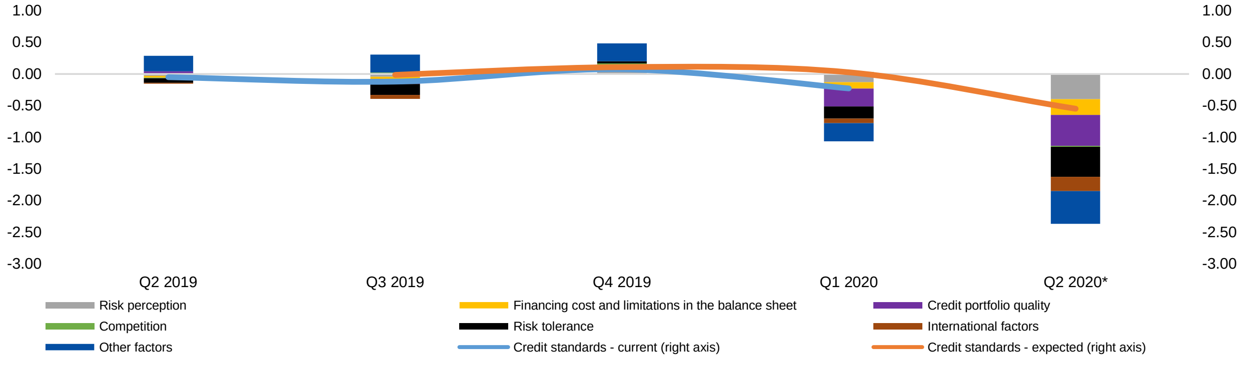
Developments in credit standards, credit terms and conditions, and in loans demand

Loans to enterprises

Credit standards

Credit standards (internal guides of banks or the criteria for loans approval) applied for enterprises tightened to some extent during the first quarter of 2020, being translated into a low negative level of 0.15 (positive index of 0.14 in Q4 2019). In the previous survey (Q4 2019), banks had stated their expectations for unchanged credit standards in Q1 2020 (chart 1).

Chart 1. Changes of credit standards applied for enterprises and factors which contributed



Source: CBK

Within loans to enterprises, credit standards were tightened for both categories of large enterprises and SMEs. Three of the banks surveyed reported tightening to some extent for both categories of enterprises, resulting in a negative index of 0.21 for SMEs and a negative index of 0.24 for large enterprises.

The main role in tightening the standards applied by banks in Q1 2020, turns out to have taken the measures to prevent the spread of the Covid-19, where the most banks reported negative contribution even though these measures affected banks only in the last two weeks of the quarter in question. The implemented measures, after indexing the responses of the banks, were attributed to a negative index of 0.56. Moreover, these measures also escalated the contribution of other factors in tightening credit standards. Consequently, banks perceived increased risk as a result of uncertainties in the internal market perspective in general, as well as in the domestic banking market perspective. Banks also reported an increase in credit risk, an increase in risk from international factors (as a result of increased uncertainty in international markets), and to a lesser extent banks declared a risk of declining funding from domestic sources. The only factor with a positive impact on credit standards was given by KCGF. The rate of loans approval for enterprises decreased during this period, albeit the declining rate was significantly lower than in the credit standards.

Banks are expected to further tighten credit standards in Q2 2020, based on expectations of multiple difficulties for enterprises operating in certain sectors affected by measures to prevent the spread of Covid-19 virus (freezing the economic activity, the decline of the demand, disruption of supply routes, etc.), as well as the possibility of reflecting these difficulties even during the second half of 2020. Banks expect that measures taken to prevent the spread of Covid-19 to be reflected in increased risk perception, deteriorating credit portfolio quality, difficulty in financing the bank's activities, significantly lower risk tolerance and negative impact from international factors. The only factor that banks expect to help with a favorable offer, which is very necessary in this situation, is the support given to SMEs from the KCGF.

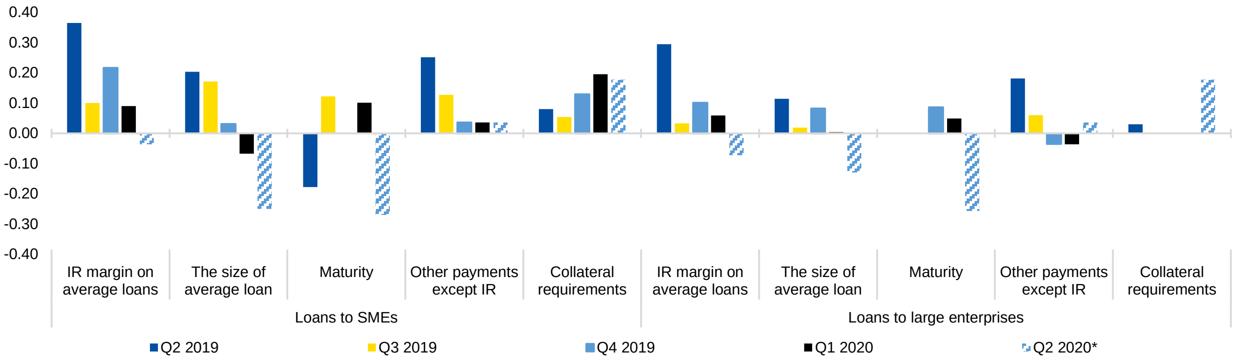
Specifically, six of the banks surveyed stated they expect to tighten credit standards with a negative index of 0.52, representing a figure many times higher than in the first quarter. Tightened credit standards are expected to apply for both SMEs (negative index of 0.59) and large enterprises (negative index of 0.51). At the same time, banks are expected to have a very tight supply for long-term loans (negative index of 0.52), as a result of uncertainty about the impact of pandemics.

In line with expectations for credit standards, the credit approval rate for enterprises is expected to decrease significantly, specifically for SMEs with a negative index of 0.61, for large enterprises with a negative index of 0.56, as well as in terms of maturity the approval rate for long-term loans is expected to decrease with a negative index of 0.63.

Terms and conditions

In Q1 2020, the overall terms and conditions applied by banks in issuing loans to enterprises (terms and conditions of a contract specified for a loans) marked a marginal ease (chart 2). Specifically, there was marked an ease to some extent in collateral requirements (positive index of 0.20) and marginal ease for the maturity of new loans (positive index of 0.10). These changes are mainly attributed to the conditions and rules for SMEs, because regarding large enterprises there was marked no change.

Chart 2. Changes of terms and conditions applied to enterprises



Source: CBK

Factors which affected to the ease of terms and conditions were primarily the support offered by KCGF with an index of 0.24 and the pressure from competition from other banks in the country with a lower index of 0.19. Although not reflected in the terms and conditions applied, banks have listed as a factor with negative contribution the measures taken to prevent the spread of Covid-19, which were consequently reflected in the unfavorable perspective of the banking market both in the country and on the international level, as well as the deterioration of the quality of the credit portfolio in the country and abroad.

As a result of the uncertainties perceived by banks for Q2 2020, banks are expected to have credit offer to a more conservative extent for enterprises based on the terms and conditions offered. In this context, banks stated that they would limit the size and maturity of loans approved for both categories of enterprises. Also, three of the banks are expected to have more favorable collateral requirements for both categories of enterprises.

Concentration of the measures to prevent the spread of Covid-19 mainly during the second quarter are expected to affect the deterioration of the banking market perspective in the country and abroad, increasing credit risk, difficulties in securing deposit financing and reducing the tolerance of banks towards the risk. These expectations present factors which are expected to contribute in tightening terms and conditions for enterprises.

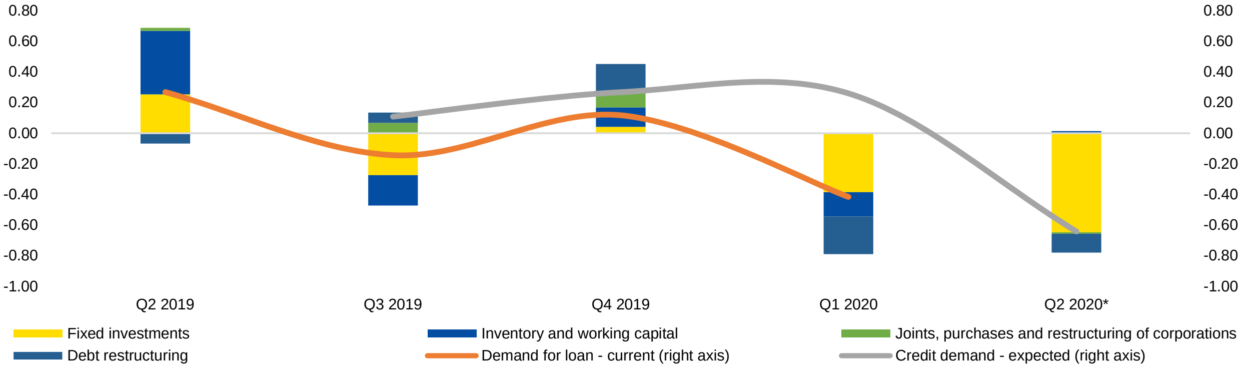
Demand for loans

During the first quarter, the demand for loans from enterprises marked a significant decline although this decline was concentrated only in the last two weeks of the quarter in question. Exactly, the demand for loans from SMEs shrank to a higher level with a negative index of 0.51, while that from large enterprises contracted with a negative index of 0.33. The freezing of economic activities of many sectors of enterprises, and consequently, the uncertainty about their solvency and meeting the criteria for being granted with loans, had an impact on the decline in demand for loans from enterprises.

According to the survey, the decline in credit demand from enterprises was largely affected by reduced demand for financing fixed investments (negative index of 0.39) and to some extent by reduced demand for financing the inventory and the capital (negative index of 0.16). At the same time banks stated for a decline of demand for debt restructuring by enterprises with a negative index of 0.25.

According to the banks, the quality of the application remained almost unchanged. However, for the first time since the survey conducted in September 2015, banks reported an increase in the ratio of nonperforming loans with a positive index of 0.11 in the first quarter of 2020, against the decline marked by this indicator in Q4 2019 with a negative index of 0.36.

Chart 3. Changes of demand for loans from enterprises and factors which contributed



Source: CBK

Over the next quarter, it is expected a frozen activity or limited activity for a considerable number of enterprises as a result of measures taken to prevent the spread of Covid-19 virus. These expectations were reflected in the forecasts of banks for changes in the demand for loans in Q2 2020. Consequently, the demand is expected to decrease significantly from both SMEs (negative index of 0.65) and large enterprises (negative index of 0.63). The decline of the demand for loans is expected to be affected by the decline of the demand from enterprises for financing fixed investments. Despite the difficulties in the activity of enterprises in Q2 2020, the demand for debt restructuring was not reflected as a factor with an impact in the decline of the demand for loans, due to the decision taken by the CBK to temporarily suspend the payment of loan installments for the clients who have been affected by the measures in force. The participation of enterprises in applying for the suspension of payment of loan installments until March, was 71.5 percent of the total applications, or 30.3 percent of the total loans stock.

In line with the difficulties encountered by enterprises, banks expect significant deterioration in the quality of loan applications from enterprises with a negative index of 0.40 for SMEs and a negative index of 0.30 for large enterprises.

Banks expect the nonperforming loans ratio to worsen further in Q2 2020 with a positive index of 0.36, representing an increase of nonperforming loans.

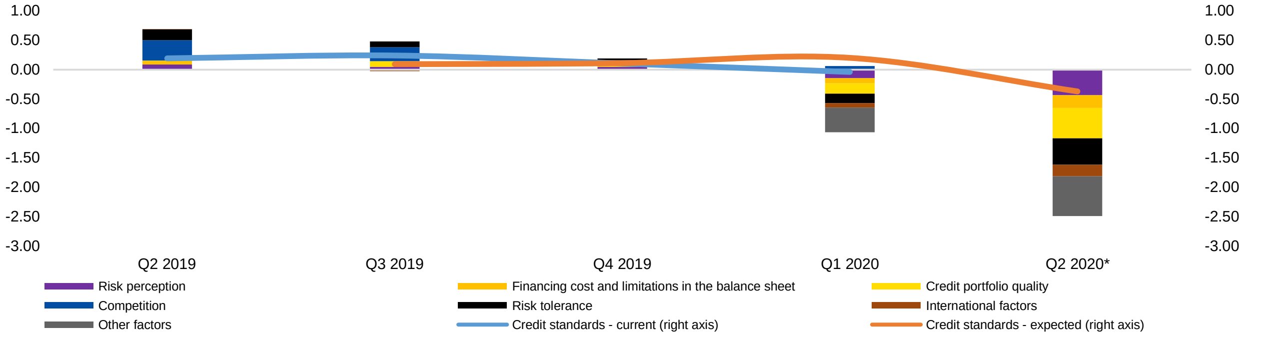
Loans to households

Credit standards

Credit standards applied to households during the first quarter of 2020 remained largely unchanged compared to the previous quarter. Although the expectations of the banks surveyed in the last quarter of 2019 suggested for easing the standards applied to a higher extent for the first quarter of this year, especially for consumer credit, the results of the survey in Q1 2020 suggest the opposite (chart 4). At the same time, banks stated to have decreased the approval rate of housing loans, while the approval rate of consumer credit remained almost unchanged.

Measures taken by the Government of Kosovo to close/suspend or reduce activities in certain economic sectors in order to prevent the spread of pandemics affected only the last two weeks of the first quarter, which was not reflected in the change of credit standards applied to households. Consequently, credit standards for households during this quarter in general remained unchanged. However, the measures taken by the Government to prevent the spread of pandemic were translated into increasing perceived market risk in general, clients solvency and potential decline in the quality of credit portfolio. The increase of the competition pressure was the only factor which had a positive impact on credit standards.

Chart 4. Changes of credit standards applied for Households and factors which contributed



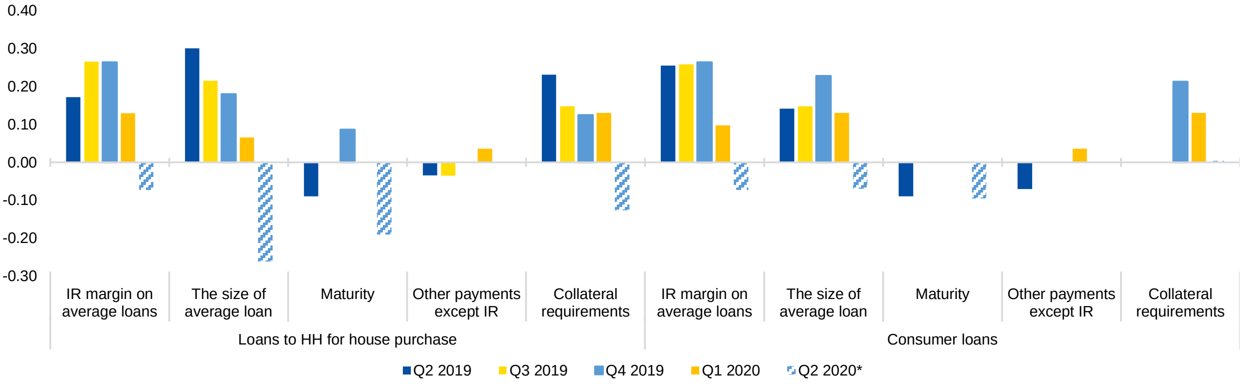
Source: CBK

In the second quarter of 2020, mainly as a result of the economic downturn by measures taken to prevent the spread of pandemics, banks expect significantly tighter credit standards for households with an index of 0.46. Credit standards are expected to be tightened to a higher level for housing loans than for consumer credit, a negative index of 0.43 and 0.31, respectively, as a result of the higher uncertainty that these investments may carry. In line with this, banks stated that they expect tight credit standards for long-term loans with a negative index of 0.46. Expectations for tight credit standards during Q2 2020 are based on the impact of measures taken against the spread of Covid-19 virus, which are expected to be reflected, among other things, in increased risk perception through unfavorable market outlook in general, not favorable perspective of real estate market and the uncertainty of the clients' solvency. Banks also expect that the increase of the credit risk and the significant decline of the banks' tolerance towards the risk may have negative contribution on the credit standards during the coming quarter (Q2 2020). At the same time, banks expect a sharp decline in the level of loans approval for both the housing loans and consumer credit, with a negative index of 0.53 and 0.34, respectively.

Terms and conditions

Terms and conditions for new loans to households marked an overall ease in the first quarter of 2020, albeit at low level. The ease was at the same level for both categories of consumer credit and housing loans, as well. Mostly, terms and conditions were eased by lowering interest rates (positive index of 0.13 for housing loans and 0.10 for consumer credit), increasing the approved amount (mainly for consumer credit with positive index 0.13) and reducing collateral requirements (positive index of 0.13 for both categories of loans) (chart 5).

Chart 5. Changes of terms and conditions applied to Households



Source: CBK

Factors that contributed to the easing of terms and conditions applied were mainly reflected through increased competitive pressure from the banking sector, the favorable outlook of the banking market in the country, and to a lesser extent, the good outlook for the real estate market.

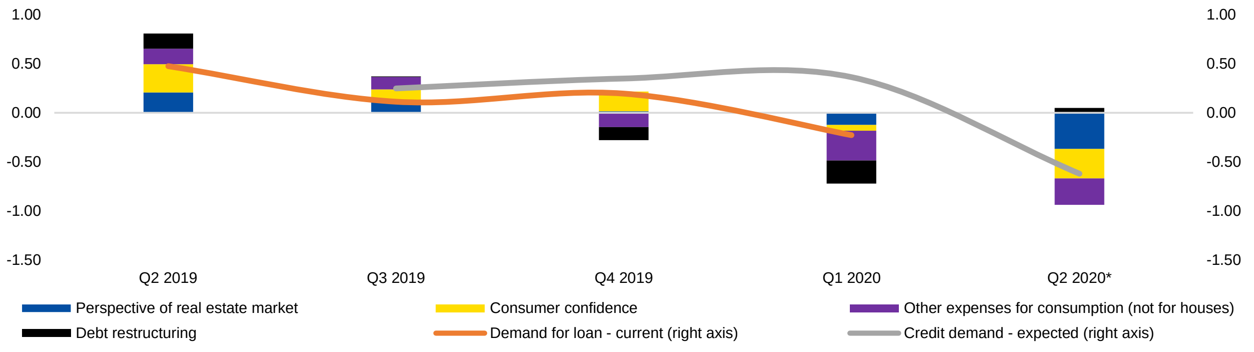
For the second quarter of 2020, banks stated that they would tighten to some extent lending terms and conditions for households. Banks are expected to tighten terms and conditions mainly for housing loans, influenced by the uncertainty they carry as long-term maturity exposures. More specifically, banks are expected to reduce the size of approved loans, to shorten the maturity, and to a lower extent, to increase collateral requirements. Terms and conditions for new loans to households are expected to be negatively affected by the increase in risk perceived by banks as a result of unsatisfactory market prospects in the country and abroad, poor prospects in the real estate market, uncertainty in clients solvency and higher collateral risk. Furthermore, banks stated that they expect this situation to affect the increase of credit risk, and five of the surveyed banks expect to face an unfavorable liquidity position.

Demand for loans

In the first quarter of 2020, banks reported a decline in the demand for loans from the households. Although measures taken against the spread of Covid-19 virus only affected the last two weeks of this quarter, the increased uncertainties were reflected in the lower demand for bank loans in four of the surveyed banks. Mainly, a more significant decrease in demand was for housing loans with a negative index of 0.38, while the decrease for consumer credit was marginal with a negative index of 0.08. The current situation turns out to be significantly different from what banks expected for the same period, reported in the previous survey (chart 6).

This decline was attributed to some extent to lower demand for financing the consumption, lower demand for debt restructuring, and to a lesser extent, from the unsatisfactory perspective of the real estate market. The decline of the demand for debt restructuring reflects the decisions in force for the temporary suspension of loan installment payments, to enable more efficient management of the potential shock on the banking sector from the economic crisis. The share of households in applying for the suspension of payment of loan installments until March, was 28.5 percent of the total applications, or 12.1 percent of the total loans stock. The quality of applications received remained unchanged for both categories of loans to households. Meanwhile, banks stated for the first time since the survey conducted in September 2015, an increase of nonperforming loans to total loans ratio regarding loans to households with a positive index of 0.17.

Chart 6. Changes of demand for loans from Households and factors which contributed



Source: CBK

In the second quarter of 2020, banks expect a significant decline in demand as a result of difficulties in realizing the income that a large part of households are facing, especially during the second quarter of 2020. Banks stated that they expect a significant decrease, especially in the demand for housing loans (negative index of 0.72), reported by six banks participating in the survey, while the decline in demand for consumer credit was expressed with a negative index of 0.53. The results of the survey suggest that banks attributed these expectations to the unfavorable outlook for the real estate market, declining of the confidence of the clients' solvency and declining demand for financing the consumption.

At the same time, banks stated that they expect a deterioration of the quality of loans applications from households. More specifically, the expectations for the quality of applications for consumer credit had a negative index of 0.22, while for housing loans the negative index reached 0.19.

Banks expect a significant increase of nonperforming loans to total loans ratio fro loans to households, in the second quarter of 2020, with a positive index of 0.36.

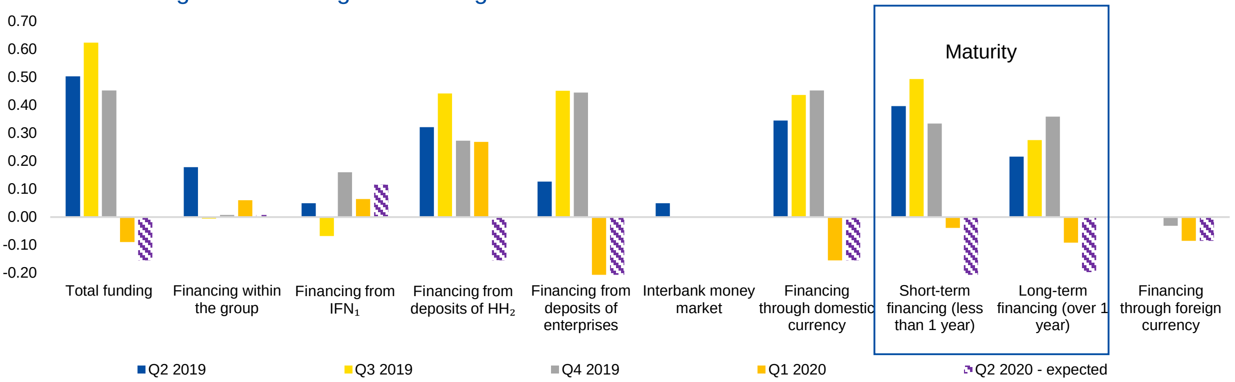
Financing

Banks reported a slight decline in access to financing in Kosovo during the first quarter of 2020. Considering the traditional model of the banking sector in Kosovo where financing is dominated by household and enterprise deposits, the risk of potential reduction of bank revenues as a result of potential decline in deposits level has increased.

Survey results show that bank financing during the first quarter of 2020 was negatively affected by corporate deposits, with a negative index of 0.24, while household deposits continued to support financing of the banking sector with a positive index of 0.27 (chart 7). One of the surveyed banks reported an increase in funding, to some extent, from international financial institutions, and another bank declared support for financing from the parent bank. According to maturity, the index was low for both short-term and long-term deposits in this quarter, namely the negative index reached 0.04 and 0.09, respectively.

In the coming quarter, banks expect a further decline of access to financing. Financing through household deposits is expected to decrease in contrast to Q1 2020 (negative index of 0.15), while financing from enterprise deposits is expected to continue to decline (negative index of 0.26). In the second quarter, two banks expect support in financing banking activity from international financial institutions, one of which is of systemic importance. Meanwhile, as a consequence of the global character of the Covid-19 pandemic, banks stated that they do not expect changes in financing from parent banks. By maturity, in the coming quarter the index results to be negative for short-term deposits and long-term ones as well, namely with a negative index of 0.26 and 0.20, respectively (chart 7).

Chart 7. Changes in financing the banking sector



Source: CBK

Results of focused questions: The impact of Covid-19 in the banking sector

The questionnaire sent to the banks for the first quarter of 2020 was supplemented with three additional questions, in order to assess the reaction of banks to the situation created by the Covid-19 pandemic through credit offer and their perception in terms of customer behavior regarding the credit demand. Moreover, questions address the impact of the measures taken against the spread of Covid-19 virus in the banks' liquidity and the quality of the credit portfolio.

Banks stated that during the first quarter, they did not take significant measures in terms of credit supply, but a considerable number of the banks emphasized that in the last two weeks of March the review of the demand for loans, which means analyzing the financial position of customers, was performed with additional caution. Furthermore, banks temporarily reduced or suspended lending to the most exposed sectors to measures against the spread of Covid-19 (such as gastronomy and construction), while selective approaches to lending to economic sectors are expected to apply in the second quarter of the year, as well. Regarding lending to households, one of the banks stated that they have stopped lending to private sector employees, while for public sector employees the financing requirements are being considered with additional caution. Most banks stated that the first quarter was mainly characterized by the review and implementation of the temporary suspension of the payment of current loan installments. At the same time, the difference in bank responses highlights the high uncertainty about the impact of Covid-19 pandemics and the different views of banks regarding the impact it has on the credit offer.

Regarding the second question, on the behavior of clients reflected in the demand for loans, banks stated that the effect of measures to prevent the spread of pandemic Covid-19 was observed since the beginning of their implementation resulting in a low demand. Banks expect a significant decrease in the demand of enterprises for financing capital investments, while the current demand of companies for maintaining liquidity, in the future may fall based on the decrease in the level of activity they will have due to preventive measures in power. Similar behavior is expected from households due to employment insecurity, ensuring income flow and the length of pandemics. For the second quarter of 2020, a considerable number of banks predicts an escalation of the demand for loans, and even one of the banks stated that the expected decline in lending is considered higher than the decline marked during the 2008 financial crisis. Meanwhile, two banks expect a recovery of the demand for loans foreseeing the end of the pandemic crises during the second quarter of 2020.

About the third question, on the impact of the pandemic crisis on liquidity, banks stated that in addition to withdrawals as a result of panic at the beginning of the implementation of measures, the level of liquidity in the banking sector remained stable and banks have taken measures to ensure liquidity during this period. However, most of the banks emphasized that the duration of pandemics plays a key role in successful liquidity management, as prolonging pandemics will negatively affect the GDP, economic activity, unemployment, prices, trade sector and others elements, and consequently this impact will translate into deposit withdrawals. Moreover, a longer pandemics will have an impact on the low banks income as a consequence of the postponement of loans installment payment, while on the other hand the withdrawals of deposits would be higher due to expenses that clients might have and consequently banks would have an outflow of assets.

Regarding the impact of pandemic on the quality of credit portfolio, banks stated that the measure taken to temporarily suspend the payment of loan installments has helped to some extent to keep under control the quality of credit portfolio, but for the next quarter of 2020, the prolongation of the pandemic crisis is expected to be followed by deteriorating credit quality due to low economic activity.

Expectations of Inflation

In order to advance the analytical capacities and based on the best regional practices and beyond, CBK has continued with the survey of financial institutions in the country, based on the hypothesis that financial institutions convey the best practices from parent banks and have proper expertise to design inflation dynamics. As a result, since the third quarter of 2019, BLS has been enriched with supplementary questions, which address commercial banks expectations on price developments in the country, thus supporting and supplementing our analysis, in modeling and forecasting.

In the last questionnaire conducted in April 2020, besides the statements of the banks relating their estimates on the level of inflation for the first quarter of 2020, the questionnaire addresses also the overall expectations of the banks for 2020. The survey serves also as a tool to identify specific factors which potentially may affect bank expectations for the specified level of inflation.

Taking into account that the survey on banks expectations on inflation is in its initial stage of implementation, the time series available is limited and does not enable comparative analysis at this stage.

Methodology

Inflation expectations have at least two important roles. First, they offer summarized quantitative series for inflation rate in the future, and secondly, may be used to assess the confidence of the objective of inflation set by the central banks.

The importance of inflation expectations is higher for the countries which have adopted the strategy of targeting the inflation. For these countries, inflation expectations, among others, serve also as an indicator of the public confidence towards central banks. If it is believed that the central bank will act in order to achieve the objective, than the expectations of the economic agents on the inflation rate would be closer to the objective. Inflation expectations are important also for banks which do not have monetary objectives, given that they serve as an important input in defining the prices and salaries, and in the process of modeling and forecasting. Moreover, inflation expectations have an impact on the aggregate demand, which later affect the inflation trend.

Unlike the present inflation which is measured in a direct way, inflation expectations are assessed with indirect methods. Among the mostly used is the survey of economic agents: consumers, businesses, commercial banks, etc. The Central Bank of the Republic of Kosovo, for the first time began with the assessment of inflation expectations as of the third quarter of 2019, initially with commercial banks and in the future it is expected to cover a wider range including also other economic agents.

Assessments which deal with commercial banks belong to quantitative forms associated also with the spread of the profitability. Expectations of inflation are assessed for different time horizons, initially expectations of inflations for the whole current year, accompanied also with the assessments for the previous quarter and the expectations for the coming quarter. The summarizing of inflation through the surveys is followed by a systemic process, elaboration and aggregation in order to find the average of inflation expectations from the commercial banks. The analysis for inflation expectations is expected to be part of regular reports of the CBK.

Results Summary

Based on the survey conducted on April 2020, most of the banks expect that inflation will be lower in 2020 compared to the previous year. Also for the first quarter of 2020, banks stated a lower level of inflation compared to the previous quarter. Banks expect an average inflation rate of 1.4 percent in

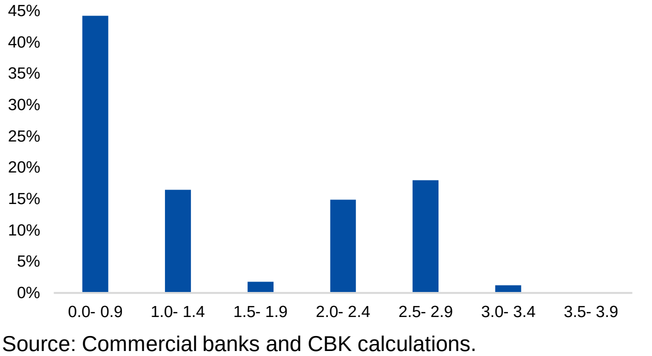
2020, compared to 2.7 percent as it was in 2019 (table 1). The survey conducted in April includes also banks expectations on potential effects of the economic crisis as a consequence of the pandemics on prices dynamics.

Table 1. Inflation expectations of banks, annual change in percent

Banks	2020	Q1 20209	Q2 2020
1	0.7%	0.3%	1.0%
2	2.2%	0.9%	1.2%
3	2.5%	2.6%	2.4%
4	-0.6%	-0.2%	1.1%
5	1.8%	0.5%	0.7%
6	0.9%	1.0%	1.1%
7	2.0%	2.1%	2.1%
8	1.3%	2.4%	1.7%
9	1.4%	0.5%	0.7%
Average	***1.4%***	***1.1%***	***1.3%***

Source: Commercial banks and CBK calculations.

Chart 8. Probability of inflation for Q2 2020 (axis-x: inflation expectations, annual change in percent; axis-y: probability)



Source: Commercial banks and CBK calculations.

The data published by the Kosovo Agency of Statistics (KAS) for 2019, suggest that inflation was around 2.7 percent, which is an approximate level as the expectations of the banks. In the survey conducted with the commercial banks for the previous quarter, estimates of the banks were that the level of inflation will be around 1.1 percent in the first quarter of 2020. Current data for this quarter suggest that the inflation level for this quarter was 1.1 percent, which is in line with the banks expectations. Regarding the second quarter of 2020, banks expect the level of inflation to reach around 1.3 percent. Five out of surveyed banks expect that the inflation level will range between 1 and 2 percent, two of the participating banks in the survey expect that inflation will be higher than 2 percent and two of the remaining banks expect that the inflation rate will be lower than 1 percent. As depicted in chart 8, the reported spreads of probability show that there is a relatively low uncertainty relating the following result of inflation, hence the spread of probability of the banks is concentrated in the expected inflation. In their qualitative comments, banks have stated that their expectations about the dynamics of the inflation rate are supported by certain factors:

- ✓ COVID-19 - Some of the banks have stated that since the measures taken by the Kosovo's Government in order to prevent the spread of the corona virus it is expected to affect the economic decline and consequently to have an impact on the decrease of the inflation level, hence the disruption on the supply chain may surge the price level.
- ✓ Low level of domestic manufacturing and the dependence on imports;
- ✓ Price dynamics in international markets;
- ✓ Trade relations between the U.S.A. and China.

Expectations of banks for 2020 are in line with the CBK forecasts, which suggest a lower level of inflation in 2020 compared to the previous year.

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