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

Bank Lending Survey

Number 4

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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, 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 second quarter of 2020, and banks expectations on lending dynamics in the third quarter of 2020.

In addition to the standard questions, in this survey were added certain other questions about the potential impact of containment measures taken by the Kosovo's Government against the spread of Covid-19 virus, on the credit supply and their impact on certain economic sectors, the main risk perception of banks, and the impact of weighting schemes on managing the pandemic crisis.

Results Summary

Credit supply tightened and the credit demand has marked a significant decline during the second quarter of the year, according to the survey results of the commercial banks. These developments are attributable to uncertainties due to the announcement of the pandemic and containment measures on COVOD-19, taken in the country and abroad. Despite the high uncertainties which continue to be associated with the pandemic statement, the ease of restrictive measures reflected on bank expectations on credit supply conditions to remain unchanged and an increase of credit demand in the third quarter of 2020.

The slowdown dynamics of the increasing pace of loans stock of enterprises during the first half of 2020, and halving down the new loans during the second quarter compared to the same period of the previous year, was negatively impacted on the credit supply and credit demand as well. Whereas**, bank expectations for the following quarter result to be more optimistic.** Within the credit supply, banks have reported to have tightened considerably standards applied in assessing enterprise loans applications during the second quarter of 2020, which is in line with expectations stated in the previous survey. Credit standards for both categories of enterprises tightened considerably and at the same extent. This result came from seven banks out of total nine banks which participated in the survey. The most conservative approach of banks towards lending to enterprises was attributed mainly to the measures taken by the Government of Kosovo on Covid-19 containment measures, 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). Among others, the increased uncertainty with Covid-19 pandemic was affected also by other factors as the deterioration of the perspective of domestic and global market, the decline of the credit portfolio quality, and the decline of the risk tolerance of banks.

For the third quarter of 2020, expectations of banks account mainly of credit standards which remained unchanged. Despite the uncertainties about the dynamics which will follow the upcoming months of the pandemic, banks have based their unchanged credit standards expectations on the decisions of easing the restrictive measures and consequently the expectations on economic recovery

[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

of enterprises in the country. However, credit standards of long-term loans are expected to be tightened to some extent also in the following quarter.

Terms and conditions applied by banks in issuing loans to enterprises tightened to some extent during this period. Terms and conditions applied, were tightened for both categories of enterprises, primarily by reducing the size of loans and shortage of maturity, while the interest rate on loans to SMEs marked an increase as well. Factors which had an impact on tightening terms and conditions of lending were influenced by containment measures on Covid-19, which consequently were reflected also in the unfavorable perspective of the domestic and foreign markets, a decline of the sector's tolerance to risk, and the increase of the risk from the required collateral. Meanwhile, for the third quarter of 2020, banks are expected to apply mainly unchanged credit supply conditions to enterprises, as a consequence of easing the restrictive measures against the spread of Covid-19.

During the second quarter, the demand of enterprises for bank loans resulted to have declined significantly, albeit at lower levels than the expectations for Q2 2020, 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 to some extent. During Q3 2020, it is expected an increase of the activity for a considerable number of enterprises as a result of measures taken to halt the spread of Covid-19 virus. These expectations were reflected on the projections of banks for an increase of credit demand to some extent from SMEs, while it is expected mainly an unchanged demand from large enterprises. The increase of the demand from SMEs is expected to be attributed to the increase of financing the inventory and working capital, which reflects the immediate liquidity needs of enterprises. In addition, banks expect an increase to some extent of the demand for debt restructuring being based on the "Guidelines on debt restructuring due to Covid-19", approved by the CBK in June 2020, which enables an ease to overcome financial difficulties caused by pandemic crisis.

Activity dynamics on lending to households during the reporting period were negatively affected by credit supply conditions and credit demand as well, where new loans were halved down compared to the same period of the previous year. Credit standards applied to households, based on the survey, have tightened taking into account that Covid-19 containment measures were more concentrated during this quarter. Lifting the restrictive measures during the following quarter, banks expectations give indications of easing credit standards for the household segment, namely on consumer credit. This would stimulate an increase of consumption, as an incentive for the economic activity in the country.

Terms and conditions for new loans to households were tightened to some extent, mainly through the decrease of the approved loans amount, shorter maturities, and to a lesser extent by increasing the collateral requirements. Similar to enterprises sector, key factors which had an impact on tightening terms and conditions of lending to households during the second quarter of 2020 were associated with containment measures on Covid-19, which contributed to the deterioration of the domestic and international market outlook, low risk tolerance, and to a lesser extent due to not so good real estate market outlook. For the third quarter of 2020, banks stated that they expect credit terms and conditions for households to remain mainly unchanged, with the exception of lower interest rates on housing loans and increasing the amount of approved consumer credit. These expectations were relied on a slightly higher risk tolerance and an increased competitive pressure although with a marginal positive index.

Since containment measures on Covid-19 convey a considerable time of the second quarter, the demand for loans from households results to have been affected considerably. In this quarter, banks reported a considerable decline in demand for loans from households, a more significant decline in consumer credit against the demand for housing loans. Banks reported that the decline of the demand for loans from households was primarily attributable to the decrease of consumer confidence in clients' solvency and the not so satisfactory market outlook in the real estate. In the third quarter of 2020, banks expect an increase of demand for loans, to some extent, for consumer credit, while the demand for housing loans is expected to remain unchanged. However, the survey results suggest that banks attributed these expectations to the increase of the demand for debt restructuring and not the increase of the demand for financing the consumption which would have given positive contribution to the increase of the economic activity in the country.

High uncertainties about economic prospects as a result of the health crisis and the closure of business activities resulted in increased credit risk. Despite the easing measures taken by the CBK to suspend loan installment payments, banks reported an increase of nonperforming loans to total loans ratio in the second quarter of 2020. Based on the expectations stated by banks, this indicator is expected to worsen further in the following quarter despite of lifting the restrictive measures and supportive programs on economic recovery in the country.

Survey results show that banks financing, during the second quarter of 2020, was positively affected only by household deposits, while all other financing sources have not undergone significant changes. This suggests for the need of enterprises to use cash in order to cover liquidity deficiencies, instead of collecting deposits in the banking sector. Over the next quarter, banks expect further growth in access to financing. Financing through deposits of enterprises is expected to increase at an approximate level as the one of household deposits. At the same time, two banks with systemic importance expect also a support in financing the banking activity from international financial institutions.

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.

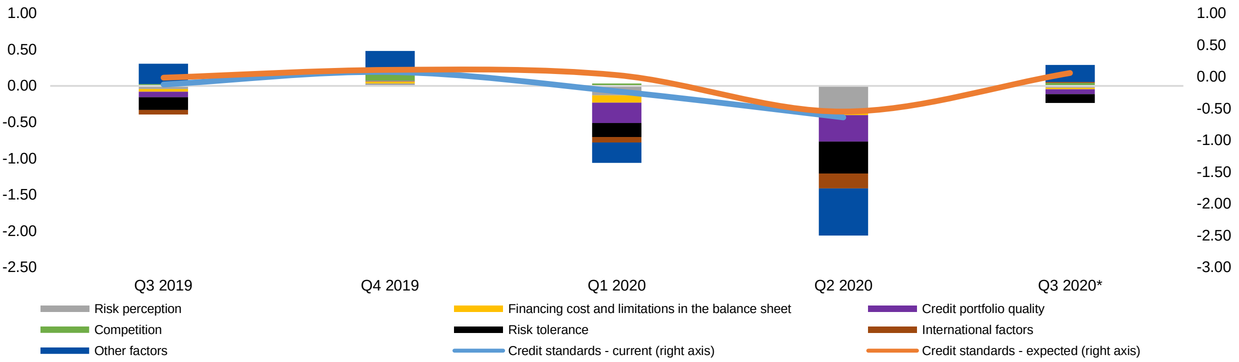
Developments in credit standards, credit terms and conditions, and in loans demand

Loans to enterprises

Credit standards

Credit standards (internal guides of banks or the criteria for loans approval) applied for enterprises, tightened considerably during the second quarter of 2020, being translated into a negative index of 0.64 (positive index of 0.15, in Q1 2020). In the previous survey (Q1 2020), banks had stated their expectations for considerable tightened credit standards, in Q2 2020 (chart 1).

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



Source: CBK. *Expected value

Within loans to enterprises, banks stated negative index of 0.64 on changes of credit standards for large enterprises and SMEs as well. This result came from seven banks out of total nine banks which participated in the survey.

The main role in tightening the standards applied by banks in Q2 2020, turns out to have been affected by the Covid-19 containment measures, where the most banks reported negative contribution even though these measures started to ease as of the second half of the quarter in question. The implemented measures, after indexing the responses of the banks, were attributed to a negative index of 0.61. 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 outlook in general (the factor with the highest negative index of 0.72), as well as in the global market outlook. Also, banks stated a decline of the risk tolerance, an increase of credit risk and a rise of international factors risk (as a consequence of additional uncertainties in the international markets). The only factor with positive impact on credit standards was the financing of one bank from parent bank. In line with the tightened supply condition, the approval rate of loans to enterprises marked a significant decline in this period, albeit the declining rate was lower than the tightening marked in credit standards

Banks are expected to not further tighten credit standards and to keep them mainly unchanged in Q3 2020, being based on expectations on economic recovery in the country and abroad, by easing or lifting restrictive measures to contain Covid-19 virus during the quarter in question. Banks also expect that the support of KCGF for SMEs will have an impact on easing standards to some extent. One of the banks with systemic importance also stated that it expects a positive contribution of credit standards from the risk decline of the collateral required and the improvement in the international area.

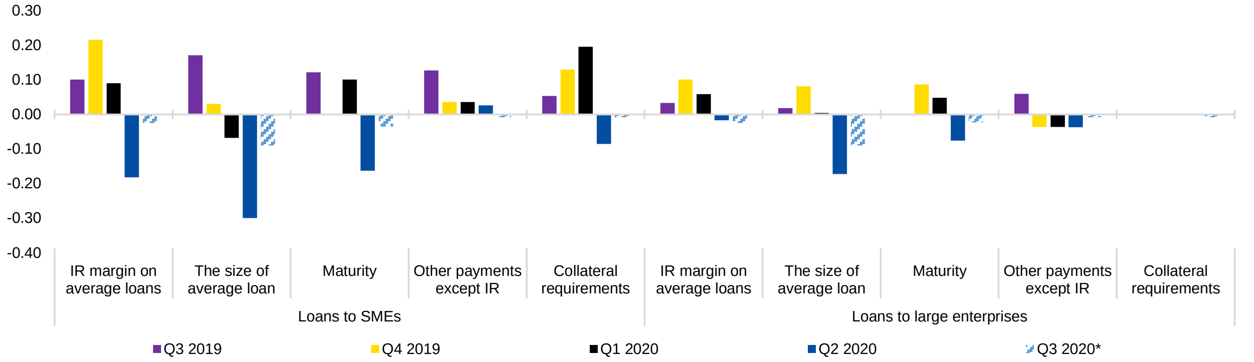
More specifically, banks with higher share to total lending of the sector stated that they expect credit standards to remain unchanged, while other banks expect tightening or ease of credit standards to some extent, and consequently after indexing the answers the index resulted to be positive despite of its low level of 0.06. The same credit standards are expected to be applied for SMEs and large enterprises as well. At the same time, banks are expected to continue with tightened supply conditions, to some extent, for long-term loans (negative index of 0.11).

In line with expectations for credit standards, the approval rate of loans to enterprises is also expected to remain mainly unchanged with low indices, namely for SMEs with a positive index of 0.04, for large enterprises with a negative index of 0.05.

Terms and conditions

In Q2 2020, the overall terms and conditions applied by banks in issuing loans to enterprises (the specific terms and conditions of a contract for loans) tightened to some extent (chart 2). Credit standards applied for SMEs were characterized with a tightening, to some extent, of interest rates (negative index of 0.18), the size of loans approved (negative index of 0.30), and of the maturity of new loans (negative index of 0.16). Terms and conditions for loans to enterprises tightened as well, but at a quite lower level, by tightening to some extent of the size of loans (negative index of 0.17), and lower maturity (negative index of 0.08).

Chart 2. Changes of terms and conditions applied to enterprises



Source: CBK.

*Expected value

Factors which had an impact on tightening terms and conditions of lending were influenced by containment measures on Covid-19, which consequently were reflected also in an unfavorable perspective of the domestic and foreign markets, a decline of the sector's tolerance to risk, and the increase of the risk from the required collateral.

As a consequence of the ease of of Covid-19 containment measures, banks do not expect an extension of tightening of terms and conditions in Q3 2020. Banks are expected to have a relatively similar credit supply-side for enterprises, based on terms and conditions offered. In this context, banks stated that they expect a limitation of the loans size for both categories of enterprises which will stand at low level. The factor with a positive contribution to credit terms and conditions for new loans and with a quite high index of 0.35 during Q3 2020, is expected to be the support of KCGF to SMEs. Whereas, the increase of credit risk in the country and abroad was assessed as a factor that is expected to contribute negatively.

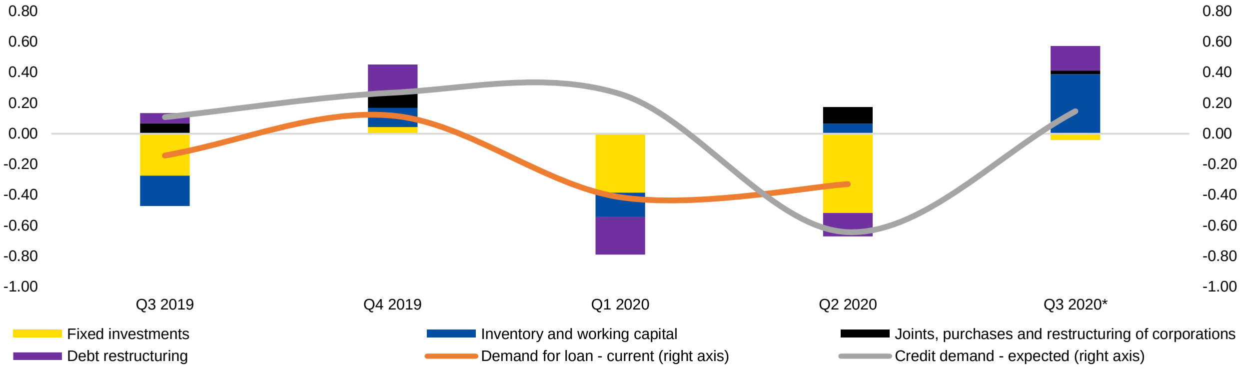
Demand for loans

During the second quarter, the demand for loans from enterprises marked a significant decline, which resulted to be at a lower level than banks' expectations stated in the previous survey (Q1 2020) (chart 3). More specifically, the demand for loans from SMEs shrank to a higher level with a negative index of 0.41, and the demand from large enterprises contracted with a negative index of 0.25. 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 of credit demand from enterprises was largely affected by reduced demand for financing fixed investments (negative index of 0.52) and to some extent by reduced demand for debt restructuring (negative index of 0.15). At the same time, the quality of the received applications worsened, especially for SMEs.

According to the survey, the ratio of nonperforming loans of enterprises continued to be characterized with a positive index of 0.10 (a same level as in the previous survey with a positive index of 0.11), implying an increase to some extent of nonperforming loans of enterprises.

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



Source: CBK. *Expected value

During the following quarter, it is expected an increase of the activity for a considerable number of enterprises as a result of easing the Covid-19 virus containment measures. These expectations were reflected in the projections of banks for changes in the demand for loans in Q3 2020. Consequently, the demand is expected to increase to some extent mainly from SMEs (positive index of 0.24), while it is expected mainly an unchanged demand from large enterprises (positive index of 0.06). The increase of the demand for loans is expected to be affected by the increase of the demand from enterprises for financing the inventory and working capital. In addition, banks expect an increase to some extent of the demand for debt restructuring being based on the "Guidelines on debt restructuring due to Covid-19"[2], approved by the CBK in June 2020, which enables an ease to overcome financial difficulties caused by pandemic crisis. The share of enterprises to applying for the suspension of payment of loan installments until June 2020, was 74.2 percent of the total applications, or 46.9 percent of the total loans stock. The high percentage of demands reflects the high rate of enterprises which were affected by Covid-19 containment measures. Consequently, banks expect the nonperforming loans ratio to worsen further in Q3 2020 with a positive index of 0.39.

Despite expectations for the resumption of activities for a large part of the economic sectors, banks do not expect improvements in the quality of loan applications from enterprises. Therefore, expectations for Q3 are similar, with a marginal negative index of 0.02 for SMEs and a negative index of 0.11 for large enterprises.

[2] https://bqk-kos.org/repository/docs/korniza_ligjore/english/ENG%20- 20Udhezues%20per%20ristrukturim%20te%20kredive%20Covid-19.pdf

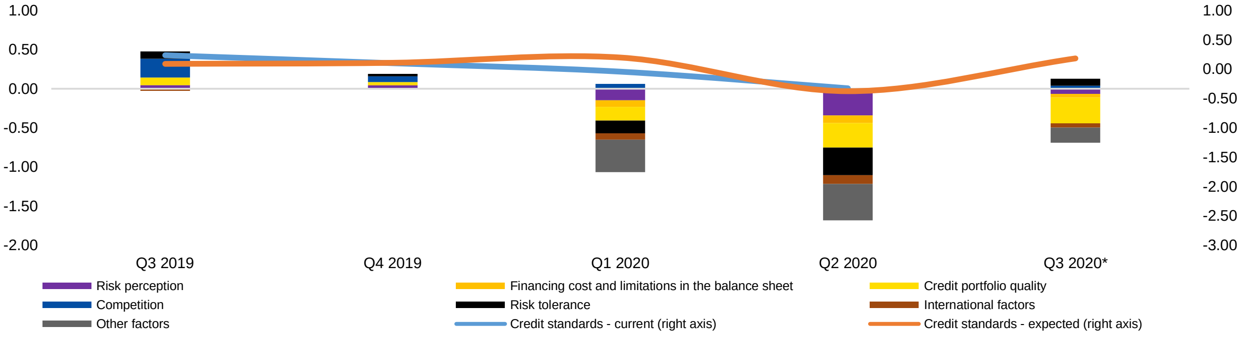
Loans to households

Credit standards

Credit standards applied to households during the second quarter of 2020 generally tightened compared to the previous quarter with a negative index of 0.37 for housing loans and a negative index of 0.28 for consumer credit. Also, the expectations for the second quarter stated by banks in the previous survey suggested an approximate tightening of credit standards applied (chart 4). At the same time, banks stated that they had reduced the loan approval rate for households to a greater extent for consumer credit (negative index of 0.44) than for housing loans (negative index of 0.30).

Measures taken by the Government of Kosovo to suspend or reduce activities in certain economic sectors in order to prevent the spread of pandemic affected the largest part of the second quarter, which contributed negatively in the change of credit standards applied to households. These measures were translated into an increase of perceived risk of the domestic and international market outlook, of the clients' solvency, lowering of the risk tolerance and the potential decline of credit portfolio quality.

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



Source: CBK.

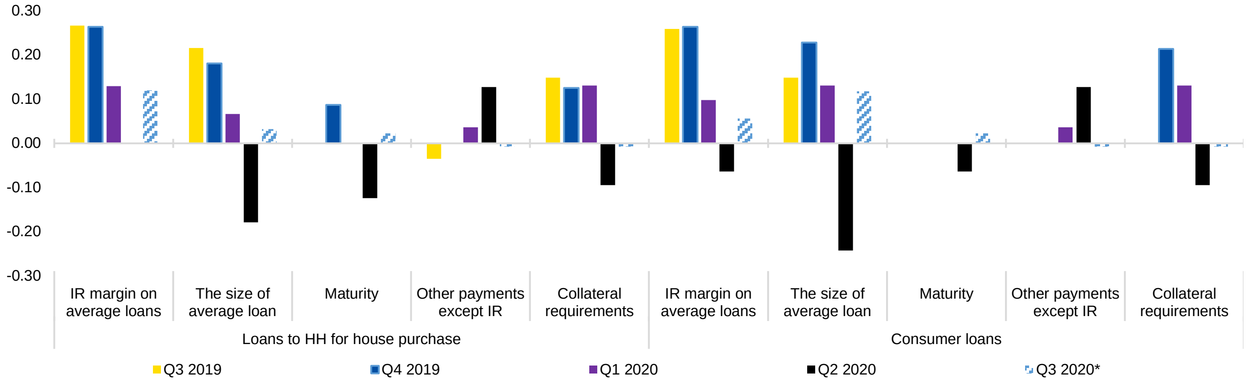
*Expected value

In the third quarter of 2020, mainly based on the easing of Covid-19 containment measures and the supportive measures taken by the local institutions, banks expect eased credit standards for households with a positive index of 0.26. Credit standards are expected to ease to a higher level for consumer credit than for housing loans, with a positive index of 0.26 and 0.11, respectively. Despite not being reflected in the overall expectations for credit standards, banks have stated that the deterioration of the quality of the loan portfolio, the Covid-19 containment measures and the reduction to some extent of banks' risk tolerance are expected to contribute negatively to credit standards during Q3 2020. At the same time, banks expect significant increase of the approved loans, to a higher extent for consumer credit than for the housing loans, with a positive index of 0.38 and 0.11, respectively.

Terms and conditions

Terms and conditions for new loans to households marked an overall ease in the second quarter of 2020, albeit at low level. The tightening of terms and conditions was at the same level for both categories of consumer credit and housing loans, as well. Mainly, terms and conditions were tightened by reducing the approved amount (negative index of 0.18 for housing loans and 0.24 for consumer credit) and increasing collateral requirements (low negative index of 0.10 for both types of loans) . In addition to these terms and conditions for housing loans banks also reduced the maturity by a negative index of 0.12. The reduction of charges other than the interest rate accounts for the only ease in the terms and conditions applied for new loans during this quarter with a positive index of 0.13 for both types of loans to households (chart 5).

Chart 5. Changes of terms and conditions applied to Households



Source: CBK. *Expected value

Factors which had an impact on tightening terms and conditions of lending were influenced by containment measures on Covid-19, which consequently were reflected also in an unfavorable perspective of the domestic and foreign markets, low sector's tolerance to the risk, and a not so good real estate market outlook.

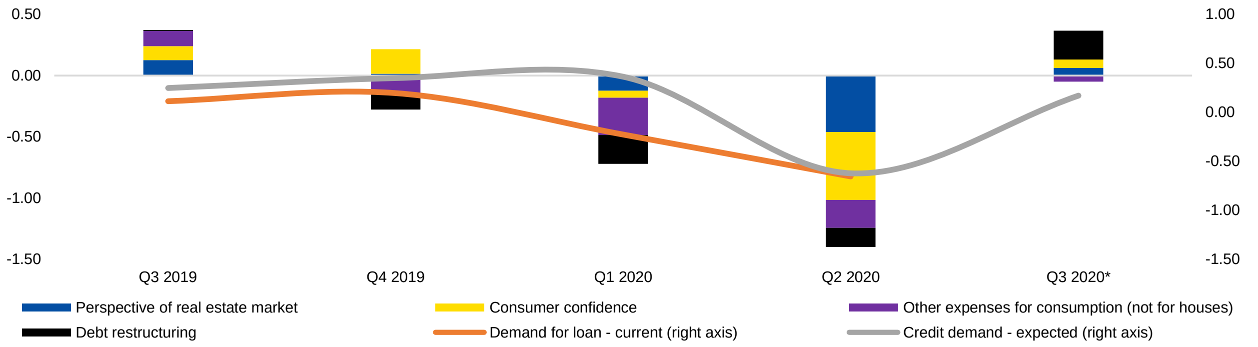
For the third quarter of 2020, banks stated that they expect credit terms and conditions for households to remain mainly unchanged, with the exception of lowering interest rates on housing loans and increasing to some extent the amount of approved consumer credit. These expectations were relied on a slightly higher risk tolerance and an increased competitive pressure, albeit the latter marking a marginal positive index.

Demand for loans

Uncertainty of the households in earning income, and consequently their solvency conditions, was reflected on the considerable decline of the demand for loans from households in the second quarter of 2020. Banks reported for a decline of the demand for loans for both categories of loans to households, and especially consumer credit. Seven out of a total of nine banks participating in the survey stated a decrease in the demand for consumer credit, which after indexing the answers resulted in a negative index of 0.74. While, the demand for housing loans had a negative index of 0.57. If we compare the current results of loans demand with the expectations of banks stated in the previous survey for the same period, the level of decline in demand is almost the same, but the difference lies in the fact that expectations were for a higher decline in housing loans compared to consumer credit (chart 6).

This decline was largely attributed to the decrease of customer confidence in their solvency with a negative index of 0.56, and to a lesser extent the unsatisfactory real estate market outlook with a negative index of 0.46. Banks have also stated that on a lower level, the decline of the demand was affected also by the decline of financing the consumption and debt restructuring. 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 June 2020, was 25.8 percent of the total applications, or 16.3 percent of the total loans stock. The quality of applications received was characterized with a significant decline for both categories of loans to households. Banks reported a further deterioration of the credit portfolio quality based on the responses to the increase in the ratio of nonperforming loans to total loans to households with a positive index of 0.34 against a negative index of 0.17 as stated by banks in the previous survey (Q1 2020).

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



Source: CBK. *Expected value

In the third quarter of 2020, banks expect an increase of demand for loans to some extent for consumer credit, while the demand for housing loans is expected to remain unchanged. Banks stated that they expect an increase in demand for consumer credit with a positive index of 0.31, reported by six banks participating in the survey. The survey results suggest that banks attributed these expectations to increased demand for debt restructuring in the third quarter of 2020. The increase in demand for debt restructuring implies an increase of households affected by Covid-19 containment measures and their difficulties in meeting loans obligations. In line with this statement, banks expect a significant increase in credit risk in the third quarter of 2020, based on expectations for an increase in the ratio of nonperforming loans to total loans to households with a positive index of 0.45

At the same time, banks stated that they expect an improvement to a low extent of loans quality applications from households, especially for consumer credit with a positive index of 0.10.

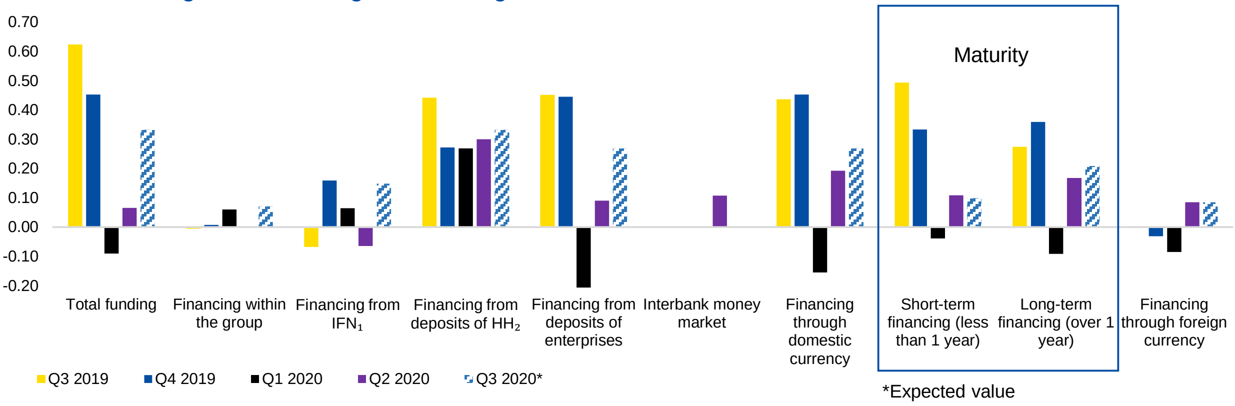
Financing

Banks did not report significant change in access to financing during the second 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 income realized through these two segments, if there will be no reaction with easing measures, it may reflect on the level of deposits in the banking sector.

Survey results show that banks financing during the second quarter 2020 was positively affected only by household deposits with an index of 0.30, while all other financing sources have not undergone significant changes (chart 7). One of the surveyed banks stated an increase in financing to some extent from the parent bank, while another bank with the highest share in lending to the sector stated that there was a decrease in financing from the parent bank, which had an impact on the index to be close to zero for this component. According to maturity, the index was lower for short-term deposits compared to long-term deposits in this quarter, namely the positive index reached 0.11 and 0.17, respectively.

Over the next quarter, banks expect further growth in access to financing. Financing through household deposits is expected to increase to a level close to corporate deposits, with a positive index of 0.33 and 0.27, respectively. In the third quarter, two banks with systemic importance expect a support in financing the banking activity from international financial institutions. While, two banks stated that they expect a financing support from the parent bank, albeit at a low level. By maturity, in the next quarter is expected to continue the highest growth of long-term financing along with the short-term, namely positive index of 0.21 and 0.10, respectively (chart 7).

Chart 7. Changes in financing the banking sector



Source: CBK.

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

The survey questionnaire for the second quarter of 2020 was completed with four additional questions, in order to assess the impact of the crisis caused by the Covid-19 pandemic on the overall credit supply, as well as against certain sectors of the economy. The questions also address the banks' perception of the risks posed by the crisis caused by the Covid-19 pandemic, as well as the effectiveness of measures taken by the country's institutions in addressing the increased risks in this period.

Most of the banks stated that during the second quarter, the main focus was the review and implementation of the temporary suspension of the payment of current loan installments. However, measures taken by the banks had an impact on tightening of the credit supply conditions especially for enterprises. Additional measures were set on the reviewing process of new approved loans, which were of a low number especially during the first half of the quarter in question. Additional measures include more detailed monitoring of clients' performance by categorizing them according to the risk they carry as clients, requests for additional documents, as well as new criteria depending on clients' requests based on the maturity and size of funding required. While the most of the banks, in general, tightened their credit supply conditions, one of the banks stated that it offered loans with more favorable conditions in order for enterprises to manage better financial difficulties during this period. For the remainder of the year, banks are optimistic in the recovery of the economic activity in the country as a result of lifting the restrictive measures. Therefore, banks expect to continue with lending to the economic sector in the country but with additional caution and closer monitoring of customers' financial performance. During the second quarter, banks have already added internal analysis and classifications of economic sectors. The sectors with increased observation and in some cases even with reduction and suspension of funding are mainly the sectors of hotels, gastronomy, transport and construction sector. Following the development of the pandemic, banks are expected to apply the above measures for the rest of the year for the sectors in question.

Regarding the increasing risks for the banking sector during this period, banks stated that credit risk remains the key risk of the sector during this year, while the implementation of the measures applied by the CBK to manage the quality of the sector loan portfolio by postponing installment payments without affecting the credit rating of customers and without additional provisions for customers affected by the Covid-19 containment measures, managed to mitigate its impact during the second quarter. Some banks reported an increase in liquidity risk at the beginning of the Covid-19 pandemic, however the rest of the sector did not perceive an increase in liquidity and solvency risk during the first half of 2020. Increased risks for the banking sector according to responses from banks were driven by the decline in economic activity, the possible decline in funds in the form of remittances due to the global nature of the pandemic and restrictions on mobility, which is expected to be reflected in declining consumption and investments.

In the additional question on the impact of KCGF and Emergency Fiscal Package on credit supply and demand, banks stated partial support, due to the extension of the implementation of the package as a consequence of the postponement of the approval process and amendment of the Law on budget appropriations for the Budget of the Republic of Kosovo for 2020. As a result of the political dynamics in the country, the approval of agreements with international financial institutions for financial assistance for the recovery of the economy failed to be concluded, and the implementation of the Emergency Fiscal Package was deficient, consequently their impact on credit demand during the second quarter was significantly limited. Nevertheless, most of the banks stated that there was a good support offered by KCGF, despite of the agreements to increase the fund were not approved by the Government during the quarter in question. The remainder of the year, banks expect a stronger support from these initiatives, and the approval of the Economic Recovery Package in order for the economic entities to face easier the Covid-19 consequences.

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 July 2020, besides the statements of the banks relating their estimates on the level of inflation for the second quarter of 2020, the questionnaire addresses also the overall expectations of the banks for the third quarter and for the whole year 2020. The survey serves also as a tool to identify specific factors which potentially may affect bank expectations for the specified level of inflation.

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 policy, 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 in 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 of the inflation expectations is expected to be part of the regular reports of the CBK.

Results Summary

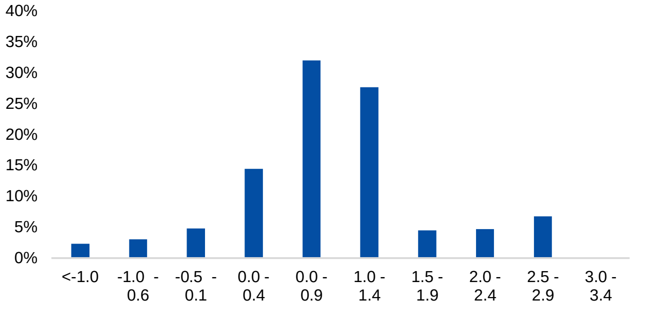
Based on the survey conducted in July 2020, most of the banks expect that inflation will be lower in 2020 compared to the previous year, and also for the second quarter of 2020 banks have estimated a lower level of inflation compared to the previous quarter. Banks expect an average inflation rate of 1.0 percent in 2020, compared to 2.7 percent as it was in 2019 (table 1). The survey realized in July conveys also the potential effects that banks expect after they have faced with the unprecedented situation caused by Covid-19 pandemic.

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

Banks	2020	Q2 2020	Q3 2020
1	0.7%	1.0%	0.3%
2	0.9%	0.1%	0.5%
3	0.5%	0.1%	0.4%
4	-0.6%	0.1%	-0.4%
5	0.9%	0.2%	0.7%
6	1.4%	0.8%	1.1%
7	2.7%	2.5%	2.6%
8	1.3%	0.5%	1.0%
9	1.4%	0.5%	0.5%
Average	***1.0%***	***0.6%***	***0.7%***

Source: Commercial banks and CBK calculations.

Grafik 8. Probability on inflation for Q3 2020 (axis-x: inflation expectations, annual change in per cent; 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 commercial banks for the previous quarter, estimates of the banks were that the level of inflation was around 0.6 percent in Q2 2020. The current data for this quarter suggest that the level of inflation was 0.2 percent, representing a lower inflation than the expectations of the banks. Regarding the third quarter of 2020, banks expect the level of inflation to reach 0.7 percent. Most of the banks (six of them) expect that inflation will range from 0 to 1 per cent, two other banks expect that inflation will be above 1 per cent, while another bank expects a deflation in the third quarter of 2020. 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 cited some of the possible factors which had an impact on the level of inflation:

- ✓ COVID-19. Some of the banks have stated that due to the disconnection of the supply chain, prices may increase while most have stated that measures to prevent the spread of the corona virus are expected to affect the decline in economic activity, thus reducing the level of inflation;
- ✓ Low manufacturing in Kosovo and the dependence on imports;
- ✓ Price developments in international markets;
- ✓ Trade relations between the U.S.A. and China.

Banks' expectations regarding inflation dynamics have been quite accurate for 2019 and for the first quarter of 2020, while for the second and third quarters of 2020 and for the whole year of 2020, banks' expectations for the level of inflation are considered to be slightly higher. Nevertheless, expectations of banks for 2020 are in line with the CBK forecasts regarding the trend, which suggest a lower level of inflation compared to the previous year.

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