

Financial Economics**Interest Rates on Deposits and Loans
(Kosovo Banking System 2012-2015)****Sokol Berisha¹, Fatos Haziri²**

Abstract: Kosovo's sluggish economic growth and financial market developments are two main reasons for conducting the analysis of banking system interest rates in Kosovo. It has been always considered that increase in the number of banks will in turn result in higher competitiveness; however this did not happen and the interest rates have only seen increase. As a result of this situation, poor access to loans continues to severely hamper the household and business economic activities in Kosovo. Despite rapid development of banking sector in Kosovo that was built since 2000 and which is considered as one of the most successful ones in Kosovo's economy, the impact of micro policies and governmental policies, including the high interest rates, have reflected in sluggishness of entrepreneurial initiatives. Irrespective of a considerable number of banks operating today in Kosovo (10 banks), this sector remains quite concentrated, since around 90% of total assets, more than 88% of deposits and around 80% of loans are concentrated in three largest banks with foreign capital.

Keywords: Interest rates; deposits; loans; investments; banking system in Kosovo

JEL classification: E4; E43; E44; E58

1. Introduction

The development trend of financial market has its repercussions in other socio-economic developments. The operation of financial market segments affects the country's global economic system and the reduction of interest rates in general. Increased quality management of deposits improves the confidence of customers towards banks and increases the credit potential, which in turn directly impacts the improvement of investments and reduction of unemployment rate. Increased investment initiatives also affect the growth of budget revenues and improve the tax system efficiency of the country. In this sense, consequences that may arise from the informality reduction must be accepted. These indicators are related to

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each other and have multiplying effect on numerous financial and economic outcomes.

2. Interest Rate Policies in Kosovo during 2012-2015

The Government, through its macro-policies, which are usually drafted and approved as short, medium and long term strategies, decides on directions, priorities and dynamics of economic development in general and the financial sector in particular. These frameworks of developmental dynamics reflect the entire economy and the lives of citizens of the country. Opportunities for the government authorities in Kosovo to influence macro-policies and development guidelines and banking business activities prior to 17 February 2008 have been limited due to specific and undefined status of Kosovo, and the lack of securities market. After 17 February 2008, upon Kosovo's declaration of independence and adoption of the Constitution when the status of CBAK (Central Banking Authority of Kosovo) got advanced to CBK (Central Bank of Kosovo) the preconditions were set for Kosovo to exercise its influence in guiding the development of banking guidelines through its government and CBK. To mitigate the effects of the economic crisis, developed countries undertook measures aimed at boosting demand, mainly by lowering the interest rates of central banks and expansionary fiscal policies. Reduction of the interest rates would have direct impacts in increasing the level of private investment, i.e. new jobs, increased consumption by consumers, which would in turn result in GDP growth and economic development of the country. If one might think that further increase of competition in the banking sector would help in reducing the high interest rates, which usually happens in countries with developed economies, where supply and demand are key determinants of overall prices and capital, it seems that this does not work for Kosovo because we have 8 commercial banks in total and the highest interest rates in the region.

In comparison with countries in the region, in Kosovo we still have poor loans offer and low intensity of loans; while on the other hand, banks' net earnings are among the highest in the region. These high profits of the banking sector are mainly based on interest rates on loans. Opening of new lending options/ funding will result in increased competition in the financial system of Kosovo, as a result of the lowering of interest rates. Low efficiency of the judiciary, cadastral registry and property rights are also problems that banks management have repeatedly highlighted as system shortcomings hampering banks to operate on lower interest rates.

3. The Impact of the High Interest Rates on Businesses and Economy of Kosovo

The running of the Kosovo's banking system mainly relies on financial resources of the country's economy, namely deposits collected from citizens within the country. In 2015 the overall deposits in Kosovo banking sector amounted to EUR 2.7 billion, marking the annual growth by 6.5 percent (3.6 percent during 2014). The main source of deposits in Kosovo banking system remains the household deposits, which in 2015 amounted to EUR 1.9 billion (72.7 percent of total deposits).

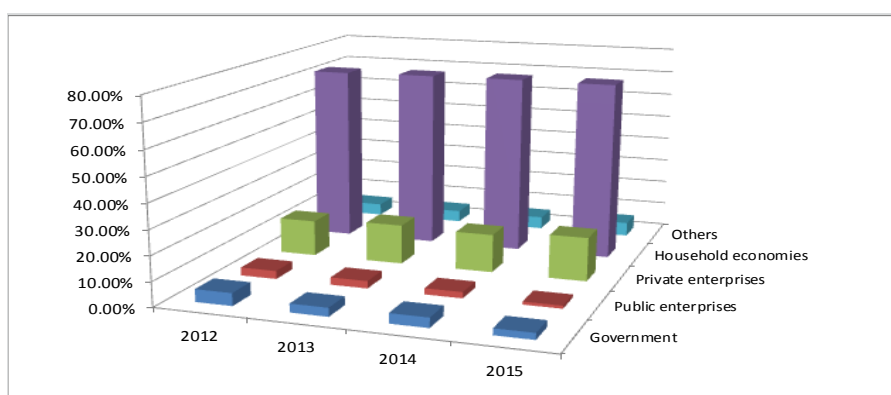


Figure 1. Structure of deposits by sector in percentage

Source: CBK Annual report 2015

From this graphic presentation we see that in the timeline 2012-2015 the structure of deposits is mainly dominated by household deposits (with 72.7%). This indicator does not show a good level in development of micro, small and medium enterprises, as well as the Kosovo business in general.

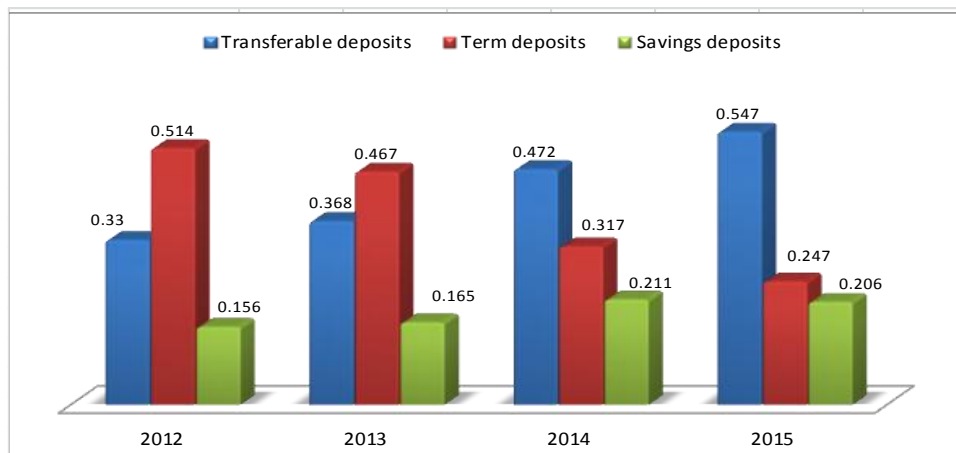


Figure 2. Structure of time deposits by maturity, in percentage

Source: CBK Annual report 2015

Another indicator is presented in this figure, such as the level of maturity of deposit structure, which clearly shows that the majority of deposits are in the category of maturity transferable deposits 54.70 percent.

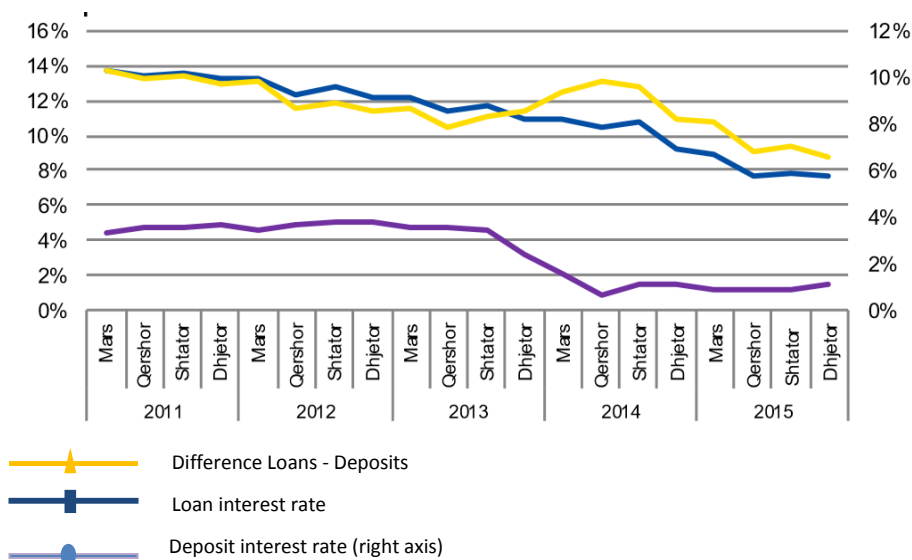


Figure 3. Average of interest rates, in percentage 2011 - 2015

Source: CBK Annual report (2015)

However, interest rates for loans in the banking system in Kosovo remain very high or amongst the highest in the region, thus imposing a discouraging and slow pace of development of medium, small and households business in Kosovo. The rate for

loans granted by commercial banks had an average of 14.3 percent in the first half of 2011, whereas the average interest rate on deposits was 3.4 percent. The difference between the interest rates for deposits and loans in the first half of 2011 had an average of 10.9 percentage points, which represents an annual increase of 0.2 percentage points.

Considering the fact that 72.7% of deposits are made by households, and the same citizens of Kosovo pay such high rates for their loans, up to 14.3%, then we are not dealing with the market economy rules or the self-regulating mechanism of supply and demand, but rather with a silent mechanism of monopoly.

The net profit of the banking system in Kosovo continues to remain positive, and during the first half of 2011, the net profit of the banking system in Kosovo was EUR 14.9 million in June 2011, which represents a decrease of 13 percent compared to June 2010. In June 2011, the indicator of capital adequacy ratio stood at 17.2 percent, which represents a higher level than the minimum required by the CBK¹.

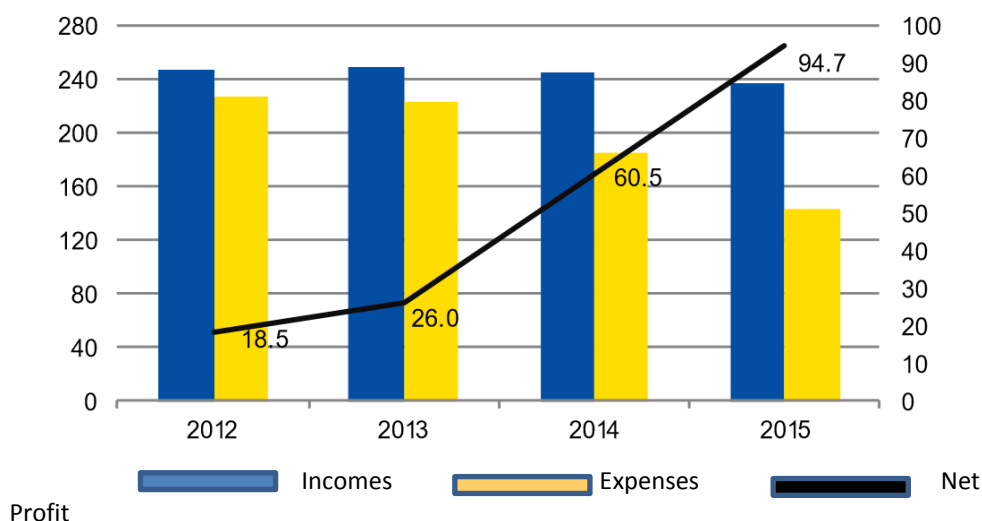


Figure 4. Financial performance of banking sector 2012-2015 (mil. EUR)

Source: CBK Annual report 2015

The net profit of the banking system in Kosovo year by year continues to be very higher compare to other sectors in Kosovo was EUR 94.7 million 31.12.2015 (60.5 million on 31.12.2014).

¹ Financial Stability Report No. II, December 2011 - CBK, Prishtinë.

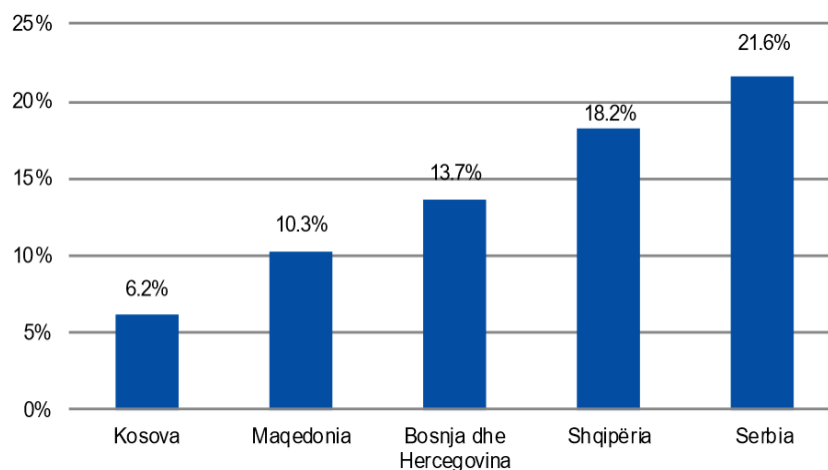


Figure 5. Rate of nonperformance Loans in Kosovo compare to region countries 2015

Source: Annual Report 2015 CBK (IMF -Central Bank of respective countries) 2015

The quote of non-performing loans still is too low in Kosovo compared to other countries on the region. However there still remains a high degree of coverage through banking fees.

The renowned world economist Irving in his book “The Theory of Interest”¹ states that interest is determined by impatience to spend income and the opportunity to invest it”. According to Fisher, the real interest rate is the price that equates supply and demand of capital. Offer depends on the willingness of people to save, i.e. to postpone consumption. Demand depends on productive investment opportunities.

The interest rate is the instrument for balancing the volume of savings and capital supply with demand of financial resources. Balanced Interest or “natural” rate of interest is the one formed at the level of balance between supply and demand of capital. In the financial market interest is formed on the basis of the ratio between the supply and demand for loan². Lack of securities developed market in Kosovo, has prevented the intervention in commercial banks through discount loans, thus increasing the credit potential and reducing interest rates.

The banking competition provides financial deregulation and liberalization. Deregulation in the financial sector and banking system affects the deregulation of interest system, as in every other sphere of trade that affects the definition of the price of goods and services³.

¹ Prof. Dr. Gazmend Luboteni *Financat e korporatave Prishtinë* 2005. p. 183.

² Srdoljub Jovic: *Bankarstvo, Naucna knjiga*, Beograd, 1990, p. 461.

³ Dr. Slobodan Komazec, Dr. Aleksander Zivkovic, Dr. Zarko Ristic, *Bankarstvo – Teorija, institucije, politika*. Cigoja stampa 1995, Beograd, p. 391.

In March 2009 the Kosovo Competition Commission was established pursuant to Law No. 2004/36 on Competition. One of the investigated segments was the banking system. This investigation was related to allegations of collusion between banks in order to maintain this level of interest rates, and there were public statements made about it by the Competition Authority.

4. Interest Rates in Some Countries of the Region and the EU

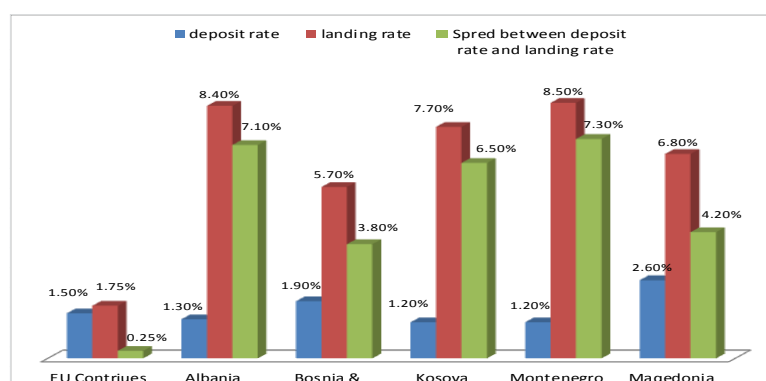


Figure 6. Interest rates on deposits and loans in some countries of the region and the EU

Source: Annual Report 2015 CBK

Having analyzed separately all countries in the region, we can see that the distribution between interest rates on loans and deposits in all countries compare to EU Countries is too higher.

5. Interest Rates on Deposits and Loans under Positive Laws in the Republic of Kosovo

Central Bank shall be a public legal subject having administrative, financial and managerial autonomy.¹ The primary objective of the Central Bank shall be to foster and to maintain a stable financial system, including a safe, sound and efficient payment system.

Additional Objective of the Central Bank, which shall be subordinated to the primary objective of the Central Bank, shall be to contribute to achieving and maintaining domestic price stability.² The Central Bank may provide facilities,

¹ Article 2, Law No. 03/L-209 , on Central Bank of the Republic of Kosovo.

² Article 7, Law No. 03/L-209 , on Central Bank of the Republic of Kosovo.

including intra-day credit collateralized by negotiable Government securities, to payment, clearing and securities settlement systems, and their participants, to ensure the safety, soundness and efficiency of such systems.¹

The Central Bank shall not grant any direct or indirect credits to the Government or to any other public agency or State-owned entity, with the exception of intra-day credits to secure the smooth functioning of the payment system. Such intra-day credits shall be collateralized by negotiable Government securities and shall be fully repaid before the end of the same day.

The restrictions of paragraph 1 of this Article regarding the provision of direct or indirect credits to Government, shall not apply to publicly-owned banks, which shall be given the same treatment as privately-owned banks. The Central Bank may purchase negotiable Government securities provided that such purchases are only made in the secondary market.²

The Central Bank shall be exclusively responsible for the regulation, licensing, registration and supervision of banks and other financial institutions as further specified in the relevant laws. Such responsibility shall include the imposition of administrative penalties. The staff of the Central Bank, and other qualified persons appointed by the Executive Board, shall visit the offices of financial institutions to examine such accounts, books, documents and other records, to obtain such information and records from them, and to take such other action as the Central Bank shall deem necessary or advisable.

Financial institutions shall furnish the Central Bank with such information and records concerning their operations and financial condition as the Central Bank may require.

The Central Bank may disclose information and data obtained under paragraph 3 of this Article in whole or in part in aggregate form for classes of financial institutions determined in accordance with the nature of their business.³

Regarding depositors and cashiers, Central Bank shall accept deposits in any currency from the Government, or on behalf of it, or from any other public agency. As depository, the Central Bank shall receive and disburse funds and keep account thereof and provide other financial services related thereto.

The Central Bank shall pay to the limits of the deposited amounts against payment orders concerning such accounts. The Central Bank may pay interest on such deposits at up to market rates.⁴

¹ Article 21, Law No. 03/L-209, on Central Bank of the Republic of Kosovo.

² Article 33, Law No. 03/L-209, on Central Bank of the Republic of Kosovo.

³ Article 23, Law No. 03/L-209, on Central Bank of the Republic of Kosovo.

⁴ Article 31, Law No. 03/L-209, on Central Bank of the Republic of Kosovo.

While banking officials and the Central Bank, under the Law, shall not grant any credit or make any significant monetary or financial gift; engage in commerce, purchase the shares of any corporation, including the shares of any financial institution, or otherwise have an ownership interest in any financial, commercial, agricultural, industrial, or other undertaking; or acquire by purchase, lease, or otherwise any rights in or to real property, except as it shall consider necessary or expedient for the provision of premises for the conduct of its administration and operations or similar requirements incidental to the performance of its tasks.

Notwithstanding the previous provisions of this Article, the Central Bank may make adequately secured loans to, or have an ownership share or otherwise participate in, any organization that is engaged in activities that are required or useful for the proper discharge of the Central Bank's own tasks and responsibilities; acquire, in the course of satisfaction of debts due to it, any interests or rights referred to in this Article; provided, however, that all such interests or rights so acquired shall be disposed of at the earliest suitable opportunity; and establish staff retirement funds or similar arrangements for the benefit or protection of the staff, and manage such funds and arrangements.¹

6. Conclusion and Implication of Findings

Reducing interest rates is a good precondition for the different development dynamics that Kosovo as a new state needs today, considering the highest unemployment and poverty rate in the region and the lowest income per capita:

- Due diligence of commercial banks management is needed for granting loans, because of the increasing trend of non-performing loans. However there still remains a high degree of coverage through banking fees;
- Reducing interest rates will not damage the business of commercial banks operating in the long run, because the banking system in Kosovo is consolidated and in the financial market it would further increase competition;
- The special challenge for Kosovo authorities and financial institutions remains to convey this message in various forms, and it shall affect banking business since Kosovo regarding the safety aspect does not differ from the countries in the region, and lower loan rates can be applied;
- The value of assets in the Pension Fund sector amounts to 1.535 million Euros invested in international markets at 99%, which means that even if these assets will be partially or completely returned to the financial market in Kosovo, the positive impact the development trend in the country will be very impressive and also

¹ Article 71, Law No. 03/L-209, on Central Bank of the Republic of Kosovo.

through this effect will have much faster economic development and overall prosperity;

- The amount of funds collected by the Privatization Agency of Kosovo from the sale of assets reached 486 million Euros in 2015 and about 600 million Euros in 2016, for which the law on PAK needs to be amended in order to withdraw these assets and to invest them in the country's financial market in order to create another very important impact on economic development either through the development fund or through any development bank that will manage these means in order to stimulate the economic development of the country;
- Improvement of efficiency of the judicial system, cadastral registry and clarities on property rights are also problems to which a quick solution need to be found, which in turn would enable banks to provide loans at lower interest rates.

All these recommendations are aimed to establish preconditions for a "sound" financial environment and, consequently, the good management with deposits and loans will directly affect the establishment of the basis for expedient economic development which is Kosovo's main objective. From this situation, with Kosovo's financial system having high level of profits generated by banks and the relatively low level of bad loans below the regional average, it can be concluded that there is sufficient room for interest rate cuts, at least up to the regional level, which will have a positive effect in investment level and business development.

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