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Interest Rates in Kosovo's Banking System

Introduction

Throughout the Western Balkans the transition from state owned enterprises to privately owned enterprises was harsh. In Kosovo, there are major issues regarding interest rates because they have been consistently higher than the regional average during the 15 years since the creation of the banking system. Thus the aim of this paper is to analyze the reasons as to why there is such discrepancy and whether or not this discrepancy is based on sustainable risk analysis. Through this paper we want to analyze the effects of interest rates in poverty reduction and thus the impact they may have in the economical security of individuals.

Kosovo like most of South-Eastern European countries faced major problems in creating its financial system. Coming from a communist regime where the state controlled the banks, to an open market economy left some bruises that are visible even today. However since Kosovo's banking system was created after the 1999 conflict, which in many ways was year zero for most of Kosovo's institutions with the banking system being no exception in terms of a starting point, Kosovo lagged behind the region in terms of policy making.

The banking sector in the Western Balkans is at different stages in different countries, since the reforms started at different times. In the Eastern European countries the transition from communism to liberalism was peaceful given that it was done without bloodshed As David Lipton, First Deputy Managing Director of IMF, explains the violent brake up of Yugoslavia and the closed economy of Albania until the 90s meant that "for the Western Balkan countries, the transition from socialism to capitalism and democracy was less smooth than in other parts"[1], he states that: while the fall of communism 25 years ago was the start of transition for the emerging Europe, in the Balkans this transition started after the conflict of the 90s.

In Kosovo commercial banks started opening in the year 2000, after the 1999 conflict and they do their activities under the Kosovo law for banking system and the Central Bank of Kosovo who works as a regulatory instrument.[2] Currently there are 9 commercial banks in the market out of them 7 are with foreign capital where 89.2 percent of the total assets managed by foreign banks. The presence of foreign financial institutions in Kosovo has contributed in the

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[1] https://www.imf.org/external/pubs/ft/reo/2015/eur/eng/pdf/erei_sr_030915.pdf p.5
[2] http://aab-edu.net/downloads/01_2012_sq_11____VD1x1.pdf p. 115

modernization of the financial system by bringing more advanced practices in management and financing operations.[3] However there are problems that Kosovo faces that are unique in the region and one of them is the higher interest rates.

The World Bank lists Kosovo as a lower-middle income economy, with the unemployment rate above 30 percent and 29.7 percent the population living under the poverty line of 1.72 cent per day[4]. Today the banking sector with its high interest rates and low deposit interest rates presents a serious obstacle to the economic growth of Kosovo.

Background

The banking sector in Kosovo was built from scratch in the aftermath of the armed conflict. The main priority in the process was ensuring the stability of the sector, therefore for a new bank to enter in to the Kosovo market significant reserves had to be held by the banks. However, this standard made it possible for only a small number of banks to enter the Kosovo's financial market. Therefore, even fifteen years after the armed conflict there are only nine banks in the market, with the two largest being ProCredit Bank and Raiffeisen Bank currently holding 41.2% and 36.4% of the market share, respectively. [5] When two banks hold 77% of the market the state should be wary of deals that occur behind closed doors thus not leave the interest rate to the market but to the leading banks whose priority is to maximize profits.[6]

The priority of the Central Bank of Kosovo (CBK) should be the wellbeing of the citizens, and since the current interest rates are not in the benefit of the Kosovo economy, CBK has legitimate reasons to interfere and lower the interest rates.

Interest Rate impact on SMEs

"Small and Medium Sized Enterprises (SMEs) are the backbone of Western Balkan economies, however their development is hindered by a lack of access to finance assistance and a limited capacity to innovate."[7] Within the current economic climate of Kosovo's banking system it is impossible for the SMEs to grow into sustainable businesses. According to a survey made by Riinvest 95 percent of SMEs did not apply for a loan, due to the fact that 70 percent of the firms consider the financing conditions as unfavorable or very unfavorable.[8]

To exemplify the importance of small interest loans and their impact on SME's, there is currently genuine concern in the UK that an increase in the interest rates from 0.5% to 1.5% can plunge 200.000 small firms into serious financial trouble[9].

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[3] http://www.riinvestinstitute.org/publikimet/pdf/53.pdf p. 4
[4] http://www.worldbank.org/content/dam/Worldbank/document/eca/Kosovo-Snapshot.pdf p.7
[5] http://www.oecd.org/globalrelations/43469966.pdf p.219

[6] http://zeri.info/ekonomia/4646/oligarkia-bankare-e-kosoves-iluzioni-per-konkurrencen/
[7] http://www.oecd.org/investmentcompact/enterprise-development-innovation-western-balkans.htm
[8] http://www.riinvestinstitute.org/publikimet/pdf/53.pdf
[9] http://www.thisismoney.co.uk/money/smallbusiness/article-2697498/Interest-rate-rise-1-plunge-200-000-SMEs-financial-trouble-survey-claims.html

According to the Organization for Economic Co-operation and Development (OECD) "Micro enterprises dominate the Small and medium-sized enterprises (SME) sector with 98.3%. Of the total registered enterprises in 2006, only 1.4% were small and only 0.2% were medium-sized businesses."[10] Looking at these statistics, low interest rates become even more important for the growth of Kosovo's economy since there is a need for these companies to grow so they can facilitate the job growth that is desperately needed.

Currently the inability of the banking sector to promote growth is one the major economical issues facing Kosovo. When you analyze the statistics above you cannot help but feel that the priorities of the commercial banks is not to facilitate economical growth and at the same time the Central Bank of Kosovo has not the economical development of Kosovo as priority.

Assessing the Interest Rate

When assessing the high interest rates in Kosovo the main reasons for the disparity within the region are usually attributed to: non-performing loans, risks related to business stability, economic growth, public debt and contract enforcement. Another important factor that should play a major role in reducing the risk in Kosovo is that the country does not have its own currency thus it is not affected by the exchange rates. Countries like Macedonia, Albania and Serbia do have their deposits and credits in different currencies so unlike Kosovo they are affected by the exchange rates[11]. According to Petrit Balija the executive director of Kosovo Banking Association (KBA), the interest rates during 2015 have fallen for the first time to single digits[12] and it has been a declining trend in recent years. However when compared to countries in the region like Macedonia where the interest rate is 3.32%[13] or in Bosnia where it stands at 5.64%[14] we can notice an discrepancy of more than 5% which in a country like Kosovo plays a major role in the well being of the citizens. With the current rates it is hard to open new businesses and the financial sector is the main problem with regards to the stagnation of Kosovo's economy.

Non-performing Loans

Non-Performing Loans (NPL) are defined as loans for which regular payments have not been made in 90 days or are close to default. Through NPLs we can assess the risk factors that banks take while lending money. By analyzing risk factors it is possible to predict the criteria that banks use to issue loans and to determine their level of sustainability.

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[10] http://www.oecd.org/globalrelations/43469966.pdf p.216

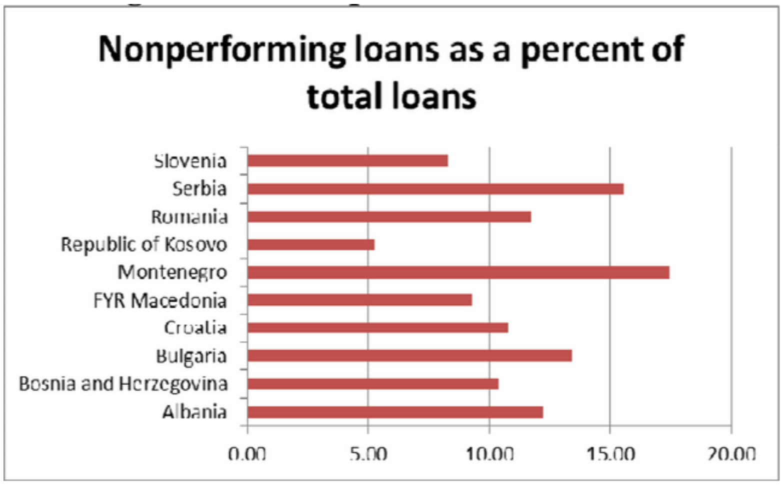
[11] http://zeri.info/ekonomia/4646/oligarkia-bankare-e-kosoves-iluzioni-per-konkurrencen/

[12] http://www.telegrafi.com/ekonomi/financa/viti-2015-norma-nje-shifrore-te-interesit.html

[13] http://www.tradingeconomics.com/macedonia/interest-rate

[14] http://www.tradingeconomics.com/bosnia-and-herzegovina/interest-rate

Throughout the period 2008 – 2012 the non-performing loans in Kosovo are the smallest in the region with an average of 5.27 percent compared to the next two countries; Macedonia with 9.3 percent and Bosnia and Herzegovina with 10.4 percent.



NPLs in Kosovo for the year 2015 have been 7.9 percent, which is considerably lower than Montenegro which stands at 17.6% or Serbia 18.6%.[15]

Business Stability

Kosovo has been one of the most stable countries in the region in the wake of the global financial crises. During the turbulent years of the world recession (2008 – 2009) Kosovo experienced growth every year with an average growth rate of 4.8% (period 207-2012).

Looking at the table below we can notice that Kosovo is one of the most stable countries in the region. Together with Albania, they are the only countries that throughout the global financial crises maintained a positive GDP balance thus had a relatively stable economy. Comparing the GDP growth in Kosovo to neighboring countries it is evident that Kosovo has been one of the most stable countries in the region. Therefore the assumed instability of Kosovo's economy falls short in explaining the high interest rates.

[15] http://koha.net/?id=27&l=64009

Table 1.3: Western Balkans: Real GDP growth and projections, percentage change, 2001-2012

	2001-2003	2004-2006	2007	2008	2009	2010	2011	2012 proj
Albania	6.0	5.6	6.0	7.7	3.6	3.3	3.0	0.5
BiH	4.3	5.6	6.8	6.0	-2.8	0.7	1.3	0.0
Macedonia	-0.3	4.1	5.9	4.8	-1.0	1.9	3.1	1.0
Montenegro	1.8	5.7	10.7	7.5	-5.7	2.5	2.4	0.2
Serbia	4.0	7.0	6.9	5.5	-3.5	1.0	1.6	-0.5
Kosovo*	n.a.	3.3	6.3	6.9	2.9	3.9	5.0	3.8
Western Balkans	3.2	5.6	7.3	6.4	-1.1	2.2	2.7	0.8
EU-10	3.4	5.8	6.3	4.2	-3.6	2.2	3.4	2.4

Source: IMF, World Economic Outlook, October 2010, April 2012, July 2012, and October 2012, and EBRD database

Public Debt

Since Kosovo until recently was not part of IMF and the World Bank the state's ability to get loans was limited. In 2014 the public debt was 11.21 percent of the GDP[16] which is significantly lower when we compare it with countries in the region like Serbia where it is around 70[17] percent and Albania where it is 69.11[18] percent of the GDP.

Contract Enforcement

When we look at contract enforcement according to the World Bank's report on conducting business the average for a contract issue to be resolved in Kosovo takes 330 days which is shorter than Albania (525), Serbia (635), Macedonia (604)[19] so it is clear that Kosovo is the leading country in the region for how long it takes to settle this sort of dispute.

Recommendations

- The government should create funds easily accessible for lending to SMEs and thus creating other outlet for money lending and generate growth.[20]
- The government should take actions to improve credit supply to the private sector, by issuing government bonds and therefore lower the interest rates.
- The government should encourage healthy competition in the financial sector and try to raise the number of banks in Kosovo.
- CBK should reduce non-licensing barriers and increase competitiveness between banks in Kosovo.[21]

[16] http://www.tradingeconomics.com/kosovo/government-debt-to-gdp
[17] http://www.tradingeconomics.com/serbia/government-debt-to-gdp
[18] http://www.tradingeconomics.com/albania/government-debt-to-gdp
[19] http://www.doingbusiness.org/data/exploretopics/enforcing-contracts
[20] http://www.riinvestinstitute.org/publikimet/pdf/53.pdf p. 10
[21] http://www.riinvestinstitute.org/publikimet/pdf/53.pdf p.10

- CBK and commercial banks must decrees the level of collateral to loan requirement to the average level of the region.[22]

Conclusion

It is apparent that the interest rates in Kosovo do not reflect the risk taken by the banks to issue those loans. In a country where the majority of the population lives in poverty it is unacceptable for the Central Bank of Kosovo to not take a stand and impact the market to lower the interest rates. Since the 77 percent of the market is controlled by two banks there is genuine concern of behind closed doors agreement that the government should address and create mechanisms to combat it.

Kosovo desperately need economic growth and the fact that the banking system, a synonym for development in the world, is one of the main challenges in Kosovo is simply not acceptable

[22] http://www.riinvestinstitute.org/publikimet/pdf/53.pdf p. 10

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