5. Special section

5.1. TEN YEARS AFTER THE GLOBAL FINANCIAL CRISIS: THE STATE OF THE FINANCIAL SECTOR OF THE CESEE REGION

by Olga Pindyuk

Quantitative easing undertaken by the ECB was supposed to provide liquidity to the banking sector, in order to make it easier and cheaper for banks to extend loans to companies and households. It has had limited effect on the CESEE countries, as foreign banks have not restored their pre-crisis positions in the region. Non-financial corporations have increasingly come to prefer direct lending and private equity to bank loans as sources of funding. Both companies and financial corporations tend to pile up cash on their balance sheets. As a result, the efficiency of resource allocation has decreased in the economies of the region, while the risk of asset price bubbles has grown.

5.1.1. Introduction

In this section we will analyse developments in the lending activities of European banks and deleveraging across companies and households in the CESEE region, to see whether there has been a reversal of the early post-crisis trends. The ECB's programme of quantitative easing (QE) was supposed, among other things, to restore the role of banks as financial intermediaries. Getting access to cheap liquidity was supposed to make it easier for the banking sector to extend loans to companies and households. The programme focused on the countries in the eurozone; however, it was expected to have a positive effect on non-euro EU members, as well as other CESEE countries that had benefited from cross-border credit from the EU prior to the global financial crisis. In our analysis, we use data from the Bank for International Settlements (BIS), and specifically its consolidated banking statistics on an ultimate risk basis,[26] its global liquidity dataset and its real property prices time series. Sectoral balance-sheet analysis is done using the national sector accounts statistics published by Eurostat.

Overall, the CESEE region is still experiencing difficulties in gaining access to international financing. Figure 5.1 shows that while the international liquidity situation remains worse than prior to the crisis for both the US and the eurozone, it is the countries of Central Europe[27] that have suffered the biggest decrease in access to cross-border credit in relative terms. The share of banks' international claims in Central Europe's GDP dropped from about 18% in Q1 2009 to a little less than 8% in Q3 2018. The eurozone has also experienced a decline in international banks' claims post-2009, with the steepest downward trend in 2015-2017. The US appears to have stabilised the inflow of cross-border bank credit at the Q1 2005 level.

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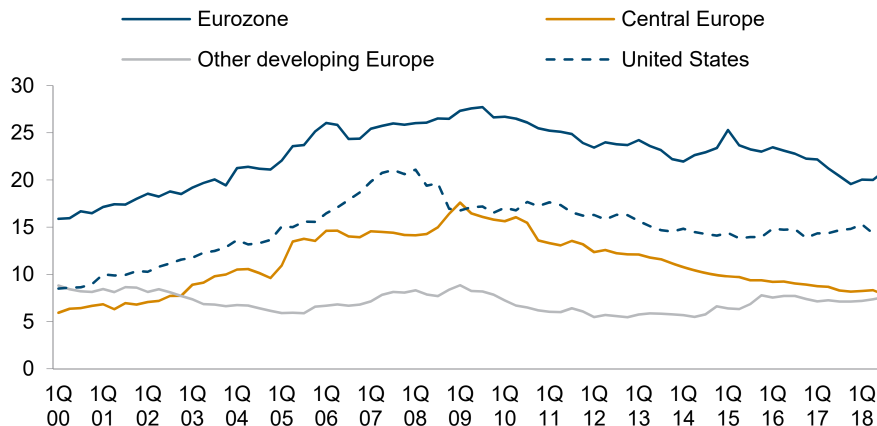
[26] The country of ultimate risk is defined as the country in which the guarantor of a financial claim resides or the country in which the head office of a legally dependent branch is located.

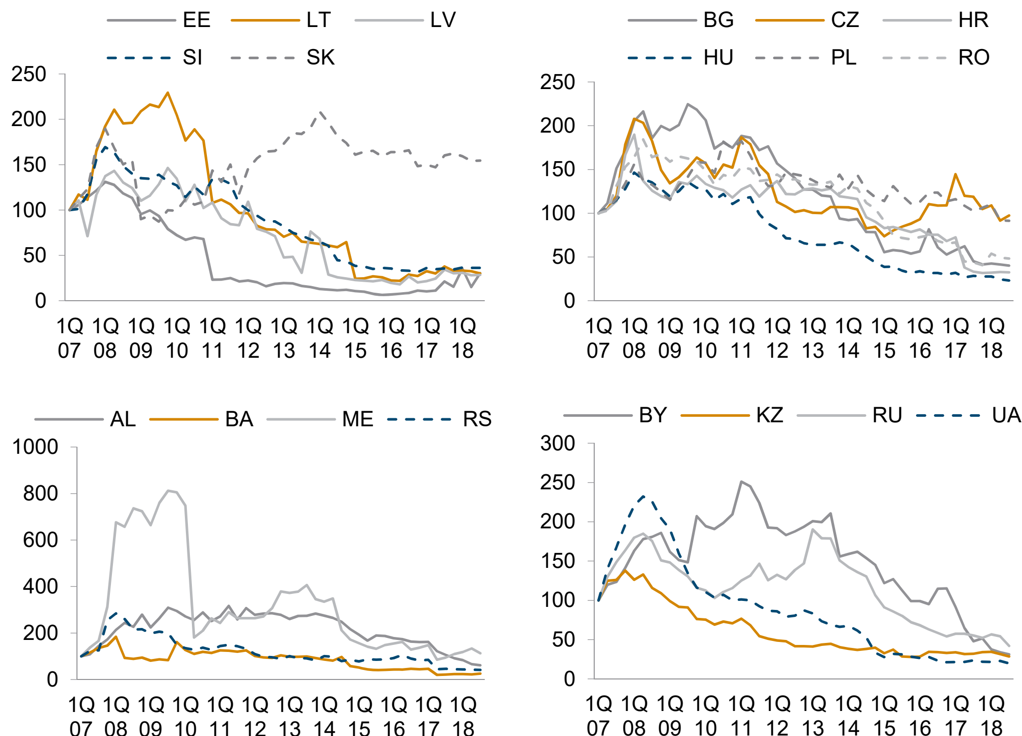
[27] Central Europe here comprises the Czech Republic, Hungary, Poland, Slovakia and Slovenia.

Figure 5.1 / Banks' international claims by residence of borrower, in % of GDP



Source: BIS global liquidity indicators.

Figure 5.2 / Cross border consolidated bank claims on an ultimate risk basis by counterparty, nominal EUR terms, 1Q 2007=100



Source: BIS.

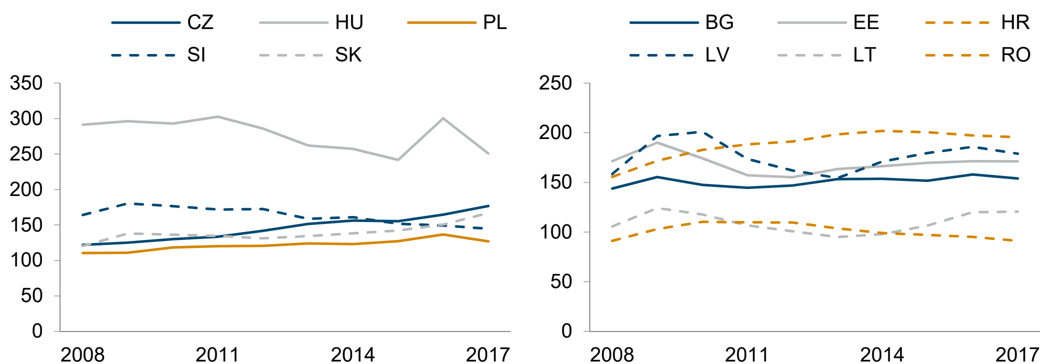
Foreign banks have not yet restored their positions in the majority of the CESEE countries. Figure 5.2 shows the indices of cross-border bank claims in different countries of the region. Generally, those countries that had been very active in accumulating European banks' foreign claims prior to the crisis have had the most difficulty in reversing the trend of decline in foreign banks' claims since the crisis. Among members of the eurozone, only Slovakia has reached the pre-crisis level of foreign banks'

claims. Another four eurozone countries witnessed a sharp decrease in cross-border bank inflows and have not yet bounced back. Poland and the Czech Republic, which experienced the slowest growth in cross-border banks' claims prior to 2008, have performed better than most of their peers in CESEE – during 2008-2017 they lost only 33% and 55% of the foreign banks' claims, respectively. In the Western Balkans and CIS + Ukraine, the situation with cross-border bank claims remains rather gloomy. In Belarus and Russia, a rise in foreign banks' activity around 2010-2012 turned out to be a temporary phenomenon, and cross-border banks' claims plunged thereafter.

5.1.2. Financial corporations

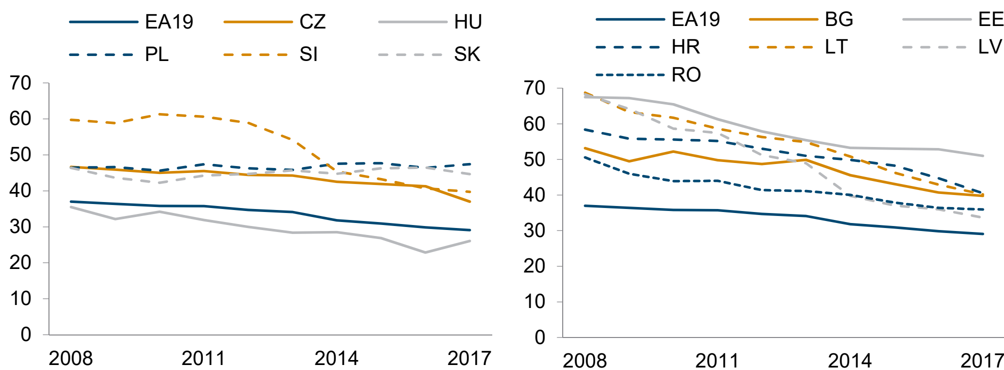
Financial corporations were directly hit by the declining exposure of European banks to the region. As Figure 5.3 shows, in only a few countries of EU-CEE[28] did financial corporations increase their assets relative to GDP during 2009-2017: namely, the Czech Republic, Croatia, Poland and Slovakia. In other countries, assets accumulation was negative.

Figure 5.3 / Assets of financial corporations, in % of GDP



Source: Eurostat.

Figure 5.4 / Loans, in % of total assets of financial corporations

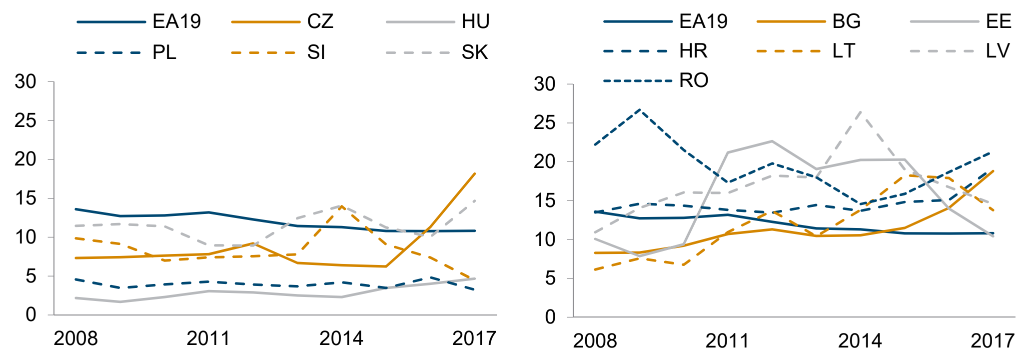


Source: Eurostat.

28 Eurostat covers only 11 countries of the CESEE region in the national sector accounts statistics; we refer to these 11 countries as EU-CEE.

Though the situation concerning access to finance has recently improved somewhat, bank lending has not been restored. Banks are increasingly reluctant to provide loans, regardless of the improvement in the quality of existing portfolios with reduction of the shares of non-performing loans (NPLs) in most of the countries (see 4.3 Credit monitor). As can be seen from Figure 5.4, in all the countries (apart from Poland) the share of loans in financial corporations' total assets decreased during 2008-2017, with the biggest reductions in Latvia (34.6 p.p.), Lithuania (28.6 p.p.) and Slovenia (20.0 p.p.). According to the CESEE Bank Lending Survey, demand for loans and credit lines continued to increase robustly in net balances in recent years; therefore the causes of such behaviour by the banks most likely lie on the supply side, and have to do with insufficient profitability of loans in a low-interest-rate environment.

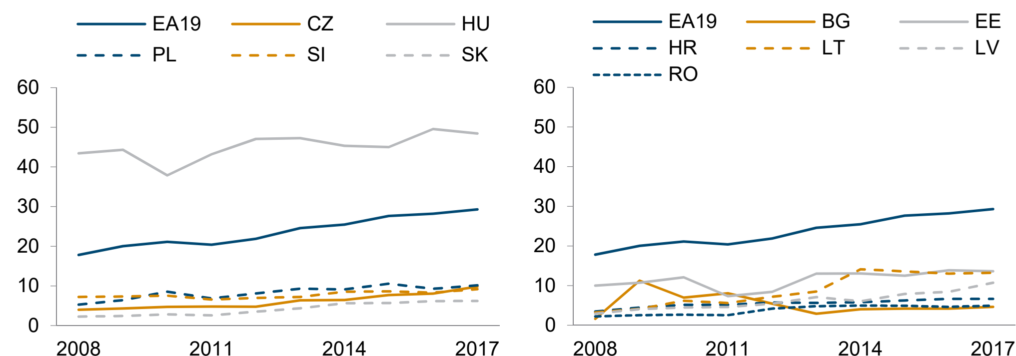
Figure 5.5 / Currency and deposits, in % of total assets of financial corporations



Source: Eurostat.

Currency and deposits and equity and bonds have been replacing loans in banks' portfolios. By 2017, financial corporations in all EU-CEE countries, apart from Poland and Slovenia, were still keeping a higher share of currency and deposits than in 2008 (see Figure 5.5). Moreover, in the majority of the countries, the shares of currency and deposits were higher in 2017 than in 2013 as well, indicating a possible continuation of the liquidity hoarding tendency. The proportions of equity and investment fund shares have also been on the rise in all the countries of the region analysed (see Figure 5.6). Hungarian banks have an especially high share of this type of assets in their portfolios – almost twice as high as the average EU level.

Figure 5.6 / Equity and investment fund shares, in % of total assets of financial corporations

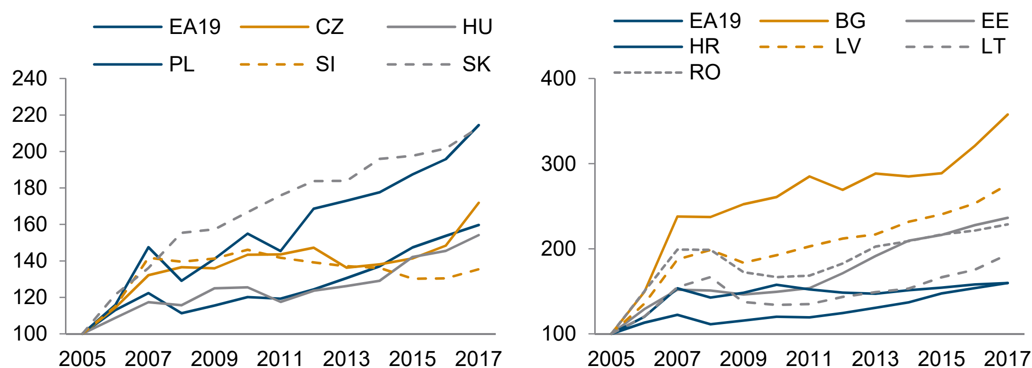


Source: Eurostat.

5.1.3. Non-financial corporations

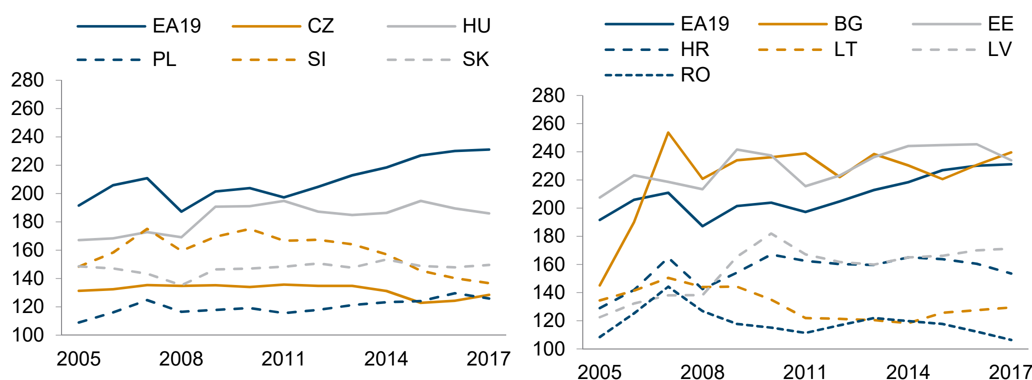
Prior to the crisis, all the EU-CEE countries experienced a much faster accumulation of corporate debt than the eurozone; but the situation changed post-crisis, when the eurozone outpaced most countries of the region in terms of growth rates of corporate debt. Still, overall during 2005-2017, firms' financial liabilities in most countries of the region expanded much faster than in the eurozone; Hungary, Slovenia and Croatia are the only exceptions (see Figure 5.7). Slovenia is the only country that has not recovered its pre-crisis level of corporate debt – due to the prolonged effects of the bursting of the property bubble. Poland stands out as a country with the most dynamic corporate debt expansion (measured as an average growth rate) in the post-crisis period, followed by Estonia and Bulgaria. During 2015-2017, financial liabilities growth accelerated in most countries (apart from Estonia and Slovakia) – probably reflecting injections of extra liquidity by the ECB.

Figure 5.7 / Total financial liabilities of non-financial corporations, 2005=100



Source: Eurostat.

Figure 5.8 / Total financial liabilities of non-financial corporations, in % of GDP



Source: Eurostat.

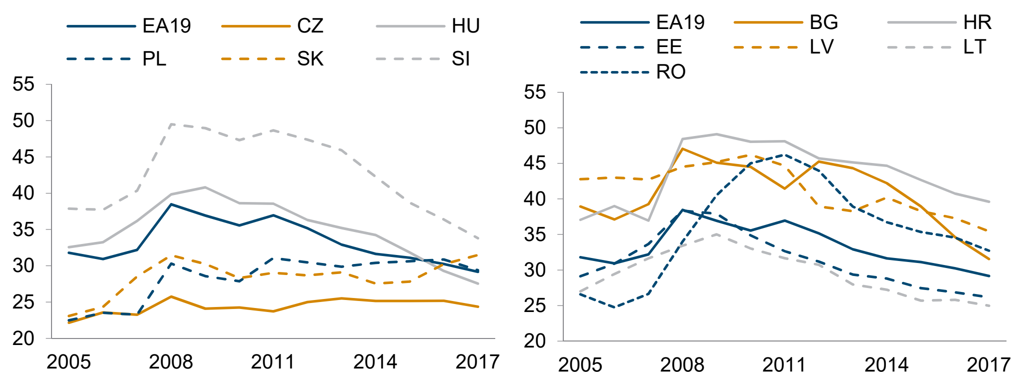
In contrast to the eurozone, where the share of the financial liabilities of non-financial corporations in GDP increased during 2011-2017 by almost 34 p.p., to 231%, in the EU-CEE countries there has been no significant upswing in the value of this indicator (see Figure 5.8). At the same time, the depth of the corporate debt market has not decreased either, even in those countries where there were signs of corporate debt overhang prior to the crisis. By 2018, non-financial

corporations in Bulgaria and Estonia (which had been the most heavily indebted) were keeping their financial liabilities at above 230% of GDP. Slovenia and Lithuania are the only countries of those analysed that have continued in recent years to reduce corporate debt relative to GDP.

The importance of loans as a source of funding has been declining in most of the countries (see Figure 5.9). Poland and Slovakia are the only countries in the region where loans to non-financial corporations as a share of GDP expanded slightly during 2008-2017. In all the other countries, they were lower in 2017 than in 2008. The most dramatic decline took place in Slovenia and Bulgaria, which initially had among the highest levels of NPLs among the peer countries, as well as among the highest shares of loans to non-financial corporations in their GDP; they had to go through significant deleveraging to cleanse banks' balance sheets. Though the situation with NPLs has improved recently, companies in all EU-CEE countries, apart from Poland and Slovakia, continued deleveraging during 2013-2017.

Instead, companies have been opting for direct lending and private equity as sources of financing, as these forms tend to have less stringent requirements for borrowers. The past few years have seen a significant rise in direct lenders and alternative funding structures, which are much less strictly regulated than banks. In particular, a rapidly growing market of leveraged loans (which are extended to already indebted or poorly rated companies) gives cause for concern. The lion's share of the leveraged loans issued are 'covenant-lite', which means fewer restrictions on the borrower and less protection for the lender. Though Europe has lagged behind the US in terms of the size of the leveraged loans market, it has started to catch up: according to S&P European Leveraged Loan Index (ELLI), the market grew by almost 80% during 2016-2018, to 181 billion euros.

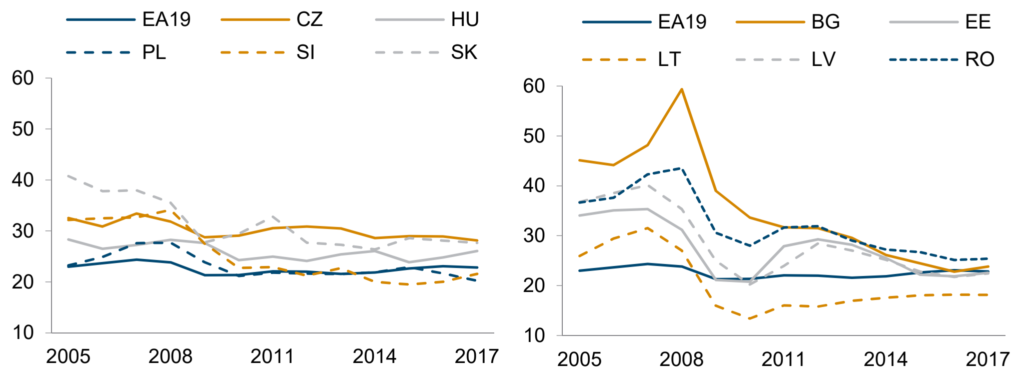
Figure 5.9 / Loans to non-financial corporations in % of the sector's total financial liabilities



Source: Eurostat.

There is some debate about whether the increase in corporate debt in the past decade has funded much investment. Figure 5.10 shows that firms in all the EU-CEE countries have massively reduced their share of gross fixed capital formation (GFCF) in gross value added (GVA) – by an average of as much as 11.8 p.p. during 2009-2017. This is much higher than the average of 1.2 p.p. in the eurozone. The most striking decreases during this period were recorded in Bulgaria (35.5 p.p.) and Romania (18.2 p.p.). These countries had unsustainably high volumes of investments prior to the crisis: in 2008, the share of GFCF in GVA reached 59% in Bulgaria and 44% in Romania.

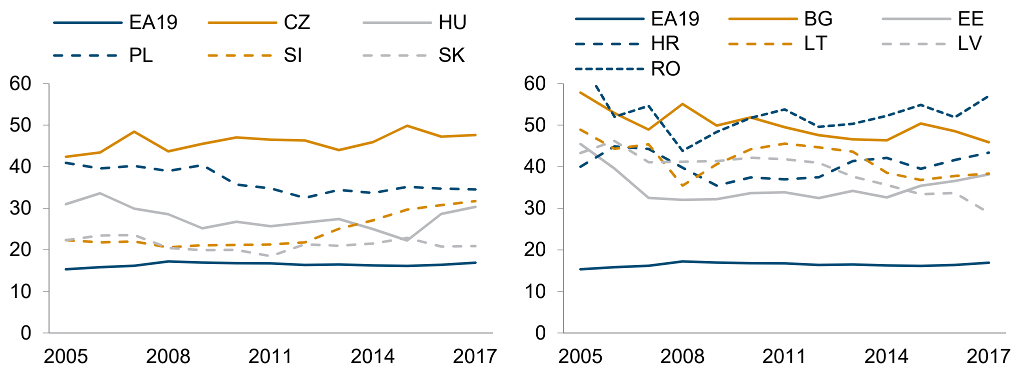
Figure 5.10 / Gross fixed capital formation of non-financial corporations, in % of GVA



Source: Eurostat.

Companies in many EU-CEE countries still had a lot of cash piled up on their balance sheets in 2017. In all the EU-CEE countries, the share of currency and deposits in the total assets of non-financial corporations has been significantly higher than on average in the eurozone (see Figure 5.11). Only in Bulgaria, Latvia and Poland was the share of currency and deposits in the total assets of non-financial corporations lower in 2017 than in 2008.

Figure 5.11 / Currency and deposits, in % of total assets of non-financial corporations

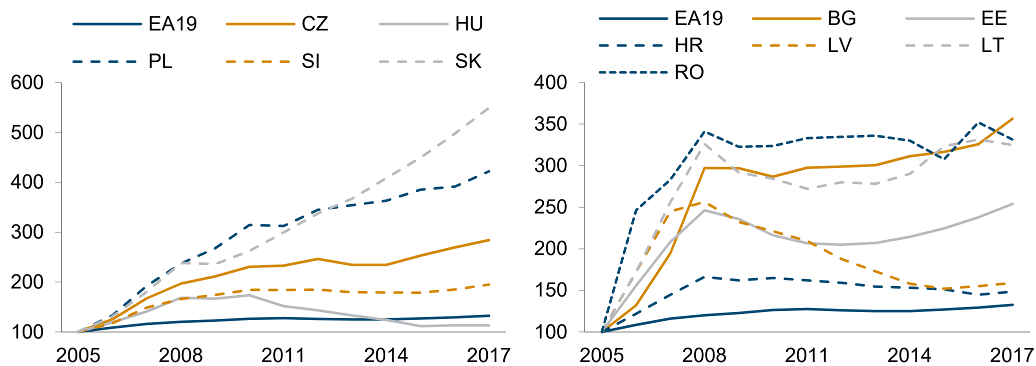


Source: Eurostat.

5.1.4. Households

As was the case with firms, prior to 2009 households in all the EU-CEE countries accumulated debt much faster than in the eurozone; but the situation changed post-crisis, when households in many countries either went through deleveraging or expanded household debt more slowly than in the eurozone. Latvia experienced the most dramatic decline in household debt value in relative terms – in 2017 it was still 38% lower than in 2008. Slovakia stands out as a country with the most dynamic debt expansion in the post-crisis period, with an average annual growth rate of about 10%. During 2015-2017, many countries recorded a speeding up in the growth of households' financial liabilities.

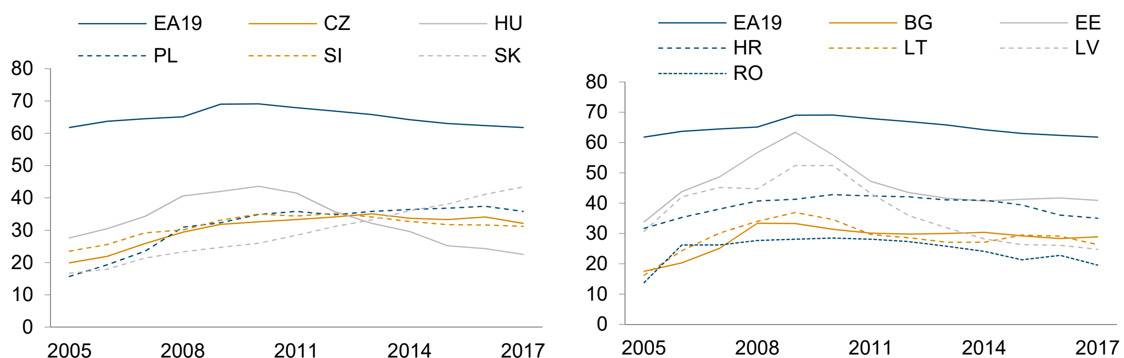
Figure 5.12 / Total financial liabilities of households, 2005=100



Source: Eurostat.

The EU-CEE countries have experienced various developments in household debt as a share of GDP. Notwithstanding the decline in NPLs and low interest rates on loans, households in the Baltic states, Bulgaria, Croatia, Romania and Hungary have reduced their leverage relative to GDP – as is the case in the eurozone (see Figure 5.13). In the Czech Republic, Poland, Slovakia and Slovenia, by contrast, the opposite trend has occurred. In 2017, Slovakia had the highest share of household debt to GDP in the region – 43.4%, which is 20.1 p.p. higher than the value in 2008. However, it is still significantly lower than the average in the eurozone.

Figure 5.13 / Total financial liabilities of households, in % of GDP



Source: Eurostat.

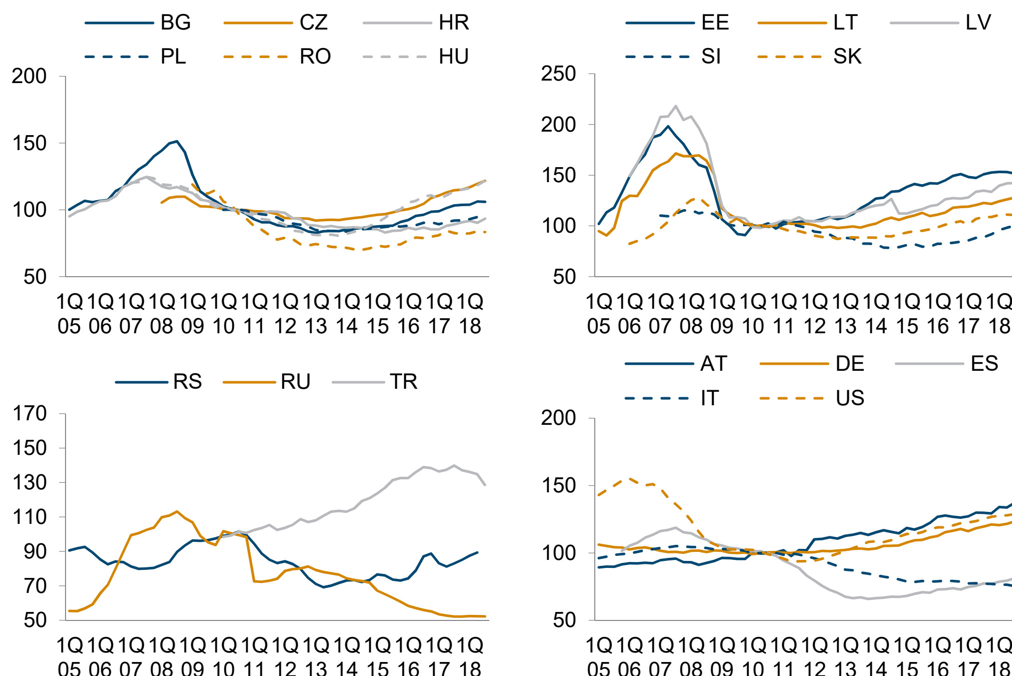
The relatively slow accumulation of households' indebtedness in many EU-CEE countries might have to do with rapid wage growth in the context of a shortage of labour. Consumers are likely to finance their expenditure more out of wage income. Additionally, gross household savings rates have been growing recently in many countries (see Overview). This behaviour on the part of households could well be explained by dwindling confidence in the economy, which makes them less willing to increase spending – as well as less willing to finance that spending through loans.

5.1.5. Where has all the liquidity gone?

All in all, it may be concluded that the legacy of the financial crisis of 2008-2009 is still largely being felt in the financial sector of many CESEE countries. It appears that the ample liquidity provided to the banking sector in the eurozone as part of quantitative easing (as well as loose monetary policy in many non-euro countries) has not had any significant positive effect on the economies of the EU-CEE countries. Foreign banks have not restored their exposure to the region, and financial corporations in the region have continued to take a cautious approach to loans expansion, still favouring liquidity hoarding. Non-financial corporations in many countries appear to have benefited from access to low-cost liquidity – though to a lesser extent than in the eurozone. This has allowed even countries with significant corporate debt overhang to keep its share in GDP unchanged. However, instead of increasing investment in fixed capital, many companies are tending to pile up cash on their balance sheets.

Another worrisome development in the aftermath of the global financial crisis is the increasing reliance of firms on direct lending and private equity as sources of financing. Lenders in these markets have less strict requirements of borrowers and are much less regulated, which could enable reckless lending by firms. This reduces the efficiency of resource allocation in the economy, as companies that might otherwise have gone bankrupt continue to function due to low borrowing costs.

Figure 5.14 / Real residential property prices, 2010=100



Source: BIS.

Moreover, there is increasing evidence that the bulk of the extra liquidity went into asset bubbles that might pose the risk of another financial crisis. Real residential property prices have been on the rise throughout the EU, with the fastest growth taking place in the Western European countries such as Austria and Germany (see Figure 5.14). CESEE countries appear to have followed suit over recent years. In pushing up the price of assets, QE exacerbates social divides, since those who do not own financial assets are unable to earn interest on their savings. This particularly affects future pensioners' income.