

Monthly Report

What Can be Expected from the Strategy for the Adoption of the Euro in Croatia?

European Financial Markets Ten Years after the Global Crisis

The Process of Financialisation in Central, East and Southeast Europe

Deleveraging in CESEE Continues



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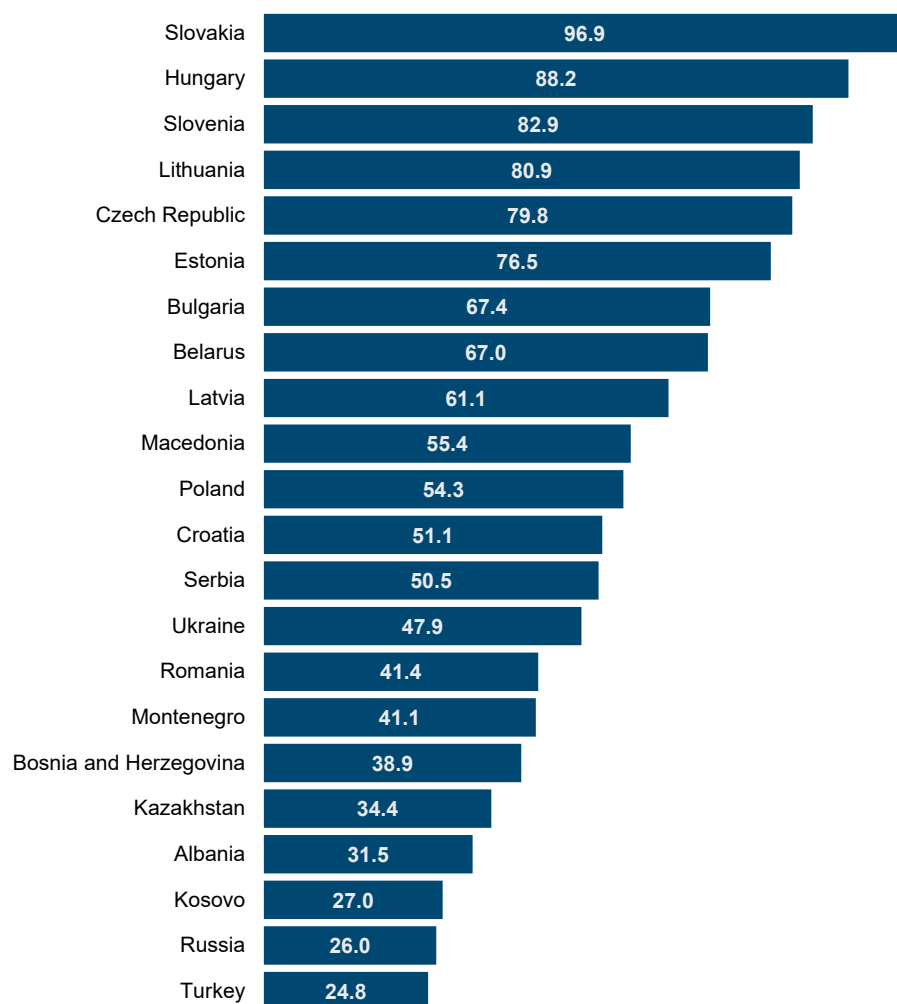
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Openness of CESEE economies, 2017

Share of exports of goods and services, as % of GDP



Source: wiiw Handbook of Statistics 2018.

Opinion Corner^{*} : What can be expected from the Strategy for the adoption of the euro in Croatia?

BY GORAN VUKŠIĆ

In October 2017, the government of the Republic of Croatia and the Croatian National Bank (CNB) announced the *Strategy for the adoption of the euro in Croatia* (Eurostrategy). The document evaluates the costs and benefits of euro adoption, but does not set a target date, as the latter depends not only on Croatia. The overall assessment is that the benefits outweigh the costs.¹ The largest benefits are expected from currency risk elimination that should reduce the likelihood of banking and balance of payments crises. Medium-sized positive effects should come about through a reduction in interest rates and via investment and trade boosts. On the cost side, the loss of monetary independence is considered a small cost, given the already limited room to manoeuvre for the monetary and exchange rate policy, resulting from high exposure to currency risk and strong financial links to the euro area. It is further estimated that euro adoption will lead to a very mild increase in consumer prices amounting to 0.2 percentage points, while the risk of excessive capital inflows and accumulation of imbalances is expected to be mitigated by the mechanisms of EU economic policy coordination.

According to the latest ECB Convergence Report (May 2018), consumer price inflation, long-term interest rates, and general government balance in Croatia are currently within the limits defined by the convergence criteria. The kuna exchange rate against the euro has been quite stable over the last two years, although it did not participate in the exchange rate mechanism (ERM II). The share of general government debt in GDP still exceeds 60%, but has been declining towards the reference value in accordance with the Stability and Growth Pact's debt reduction benchmark.²

Thus, at first glance, the prospects of Croatia successfully completing the euro adoption process in the medium term do not look that bad. There are, however, some serious risks. The Croatian economy has been experiencing excessive macroeconomic imbalances, such as high unemployment or a strongly negative international investment position. Despite some recent improvements, the impression is that, similarly to fiscal developments, those have largely been driven by the comparatively favourable external economic conditions over the recent years. It is likely that, barring a considerable deterioration of these conditions, Croatia's macroeconomic imbalances, as well as the public debt to GDP ratio, will further diminish.³ However, in order to achieve better resilience to potential shocks and medium- and long-term

* Disclaimer: The views expressed in the Opinion Corner section of the Monthly Report are exclusively those of the authors and do not necessarily represent the official view of wiiw.

¹ The Eurostrategy and the related studies on the economic effects of euro introduction are available at <http://euro.hnb.hr/>.

² Croatia exited the Excessive Deficit Procedure in June 2017. The ratio of general government debt to GDP amounted to 77.5% at the end of 2017, down from the peak of 84% in 2014.

³ Regarding the expected development of public debt, one should bear in mind also the potential risks stemming from contingent liabilities, as noted in the aforementioned ECB Convergence Report.

convergence sustainability, wide-ranging structural reforms are needed to address the issues of low productivity and potential growth, as well as the demographic challenges.

The reform performance of Croatian governments since the country's EU accession in 2013 has been rather disappointing, with very slow progress in the implementation of EU policy recommendations. For example, the assessment of the 2018 National Reform and Convergence Programmes in the 2018 Country-Specific Recommendations by the European Commission reminded that: *'The planned adoption of key legislation to improve Croatia's fiscal framework is long overdue'*; or that: *'The introduction of a property tax already legislated was postponed with no indication of whether and when it would be implemented'*. Similarly, the report also emphasised the long-standing problems such as lengthy court proceedings and inefficiency of the justice system, or administrative burden and parafiscal⁴ charges, which *'... continue to weigh on the business environment'*. Moreover, the Commission's recommendations regarding some of the above issues, as well as on e.g. the reform of the pension and health care systems, wage-setting mechanisms, or the liberalisation of regulated professions and professional and business services, have been repeated year after year.

This is not to say that no reform progress is being made – the proposals of the Fiscal Responsibility Act and of the Amendments to the Pension Insurance Act are currently in the parliamentary procedure – but the advances have been very slow, so that the recently achieved macroeconomic improvements, stability and growth may turn out to be quite fragile. This is, of course, well known to the euro area Member States (and the EU institutions) that need to decide on the entry of Croatia into the ERM II mechanism, which is a required step in the euro adoption procedure. It seems reasonable to assume that the existing euro area members would expect that the newcomers implement the reforms needed to ensure long-term convergence prior to euro adoption (in addition to fulfilling the nominal convergence criteria), as the incentive to reform may weaken once the euro is introduced, and the budget constraints are loosened.⁵

Given that Croatia has committed to euro introduction at the time of joining the EU, the explicit announcement and public presentation of the Eurostrategy (with extensive media coverage) may be seen as an attempt to mobilise public support for the reforms. However, following the announcement of the Strategy, which itself emphasised the need for comprehensive reforms, the percentage of those in favour of euro adoption⁶ fell by 5 percentage points to 47% between 2017 and 2018.⁷ For the first time (surveys have been conducted since 2014), the proportion⁸ of those against the introduction of the euro⁸ reached 50%. Despite this decline in public support, it might still be (politically) worthwhile to relate the reforming efforts to the goal of euro adoption.

⁴ Parafiscal charges in Croatia are defined as all compulsory non-tax levies paid by firms to the central, regional or local government administration or other entities with public authority, whereby the payer is not provided a service, a good or a right in return, or these are of lower value than the amount paid. The definition and a list of activities to reduce these charges undertaken are available at www.mfin.hr/adminmax/docs/Registar_Neporeznih_Davanja.pdf. The register of parafiscal charges is available at <https://nameti.mingo.hr/registar>.

⁵ See J. Fernández-Villaverde, L. Garicano and T. Santos (2013), 'Political Credit Cycles: The Case of the Eurozone', *Journal of Economic Perspectives*, 27(3): 145-166.

⁶ The sum of those 'very much in favour' and 'rather in favour' of euro adoption.

⁷ Eurobarometer.

⁸ The sum of those 'very much against' and 'rather against' euro adoption.

Thus, it seems that the speed and success in the implementation of the wide-ranging structural reforms will determine the success and the timing of the euro adoption process. Those reforms can ensure that the preconditions for long-term convergence and stronger resilience to shocks are existent at the time of euro adoption. Croatia would also demonstrate its readiness to undertake further reforms if required by the circumstances, so that also the aforementioned expectation can be fulfilled – namely, that the mechanisms of EU economic policy coordination will mitigate the risk of excessive capital inflows and accumulation of imbalances. This seems crucial in the context of convincing the other euro area Member States that they are not threatened by spillovers if (or when) risks of negative shocks materialise, and ensuring their political support for the entry of Croatia into the ERM II mechanism. In this respect, it will be difficult to be optimistic, in the short and medium term, if the slow progress with economic reforms in Croatia that we have witnessed since its EU accession were to continue.

European financial markets ten years after the global crisis

BY AMAT ADAROV

As of end-2018, while Europe is generally enjoying robust economic growth, the outlook is clouded with downside risks emanating from macroeconomic and political challenges. In some countries high non-performing loans remain an issue, while in others ample liquidity on account of years of ultra-easy monetary policy reinforced potentially unsustainable dynamics in certain asset markets. This highlights the need to accelerate reforms focusing on the resilience and sustainability of European financial market architecture – still largely dominated by banks – in line with the Banking Union and the Capital Markets Union initiatives.

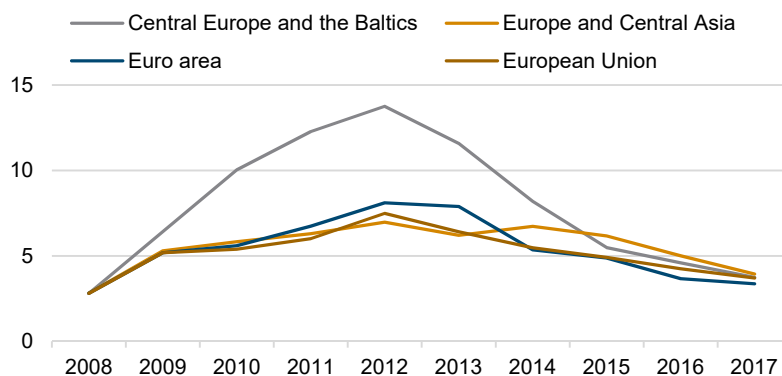
MACROECONOMIC BACKGROUND CONDITIONS AND BANKING SECTOR PERFORMANCE

As of end-2018, while Europe is generally enjoying robust economic growth, the outlook is clouded with downside risks emanating from both external and internal macroeconomic and political challenges, including uncertainty around the impact of Brexit, US foreign policy, crisis in the EU Neighbourhood, and other factors. In light of these risks it is not surprising that the ECB's monetary policy remains highly accommodative, although the amount of purchases via the Asset Purchase Programme has been reduced with European Central Bank President Mario Draghi suggesting a likely phasing out by the end of 2019. Outside the euro area, monetary policy has also remained largely accommodative with gradual moves towards normalisation by some monetary authorities (for instance, the UK, Czech Republic).

Besides these challenges, of particular concern for economic growth and its sustainability in Europe are the remaining vulnerabilities in financial markets. Ten years after the global crisis financial markets across Europe still do not look healthy and could potentially trigger a new financial and economic meltdown. One of the key characteristics of the state of the financial sector in Europe, largely relying on the banking sector, is the dynamics of non-performing loans (NPLs). NPLs are typically defined as loans that are overdue by more than 90 days and/or not likely to be repaid in full. A high share of NPLs (in total gross loans) adversely affects bank profitability, increases funding costs and inhibits new lending via higher risk-adjusted capital requirements.

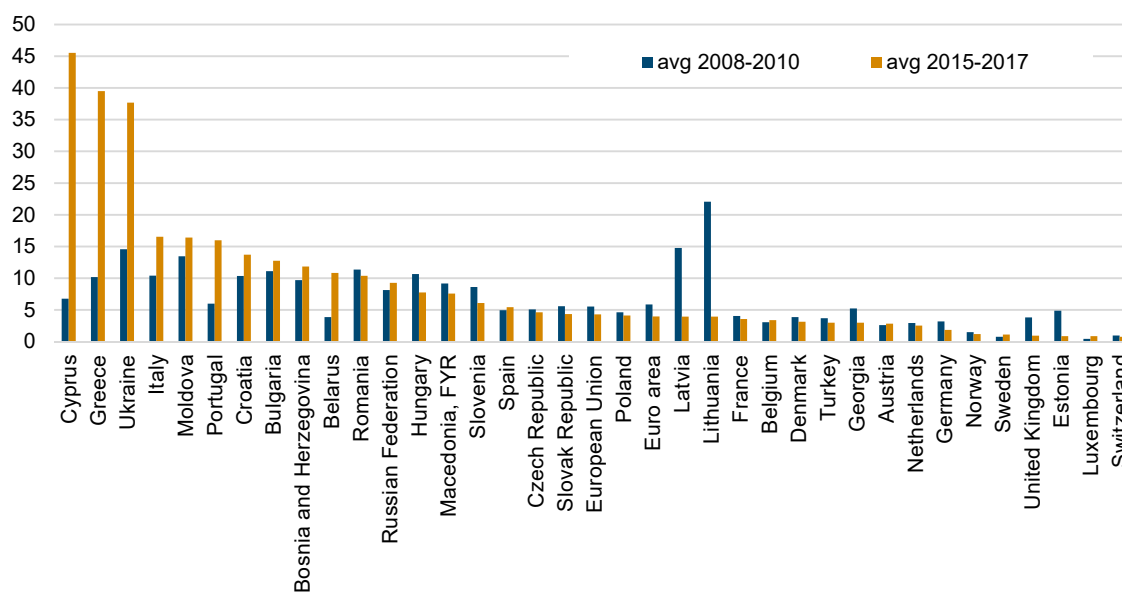
NPL ratios increased dramatically throughout Europe after the start of the financial crisis in 2008. In the EU, after reaching the decade-high level of 7.5% in 2012, the average NPL ratio declined to 3.7% in 2017 (see Figure 1). The dispersion among countries, however, has been considerable (Figure 2). With NPL ratios exceeding 40%, Greece, Cyprus and Ukraine remain especially problematic.

Figure 1 / The dynamics of non-performing loans in Europe (% of total gross loans), 2008-2017



Source: World Bank World Development Indicators (WDI).

Figure 2 / Distribution of banks' non-performing loans in Europe (% of total gross loans)



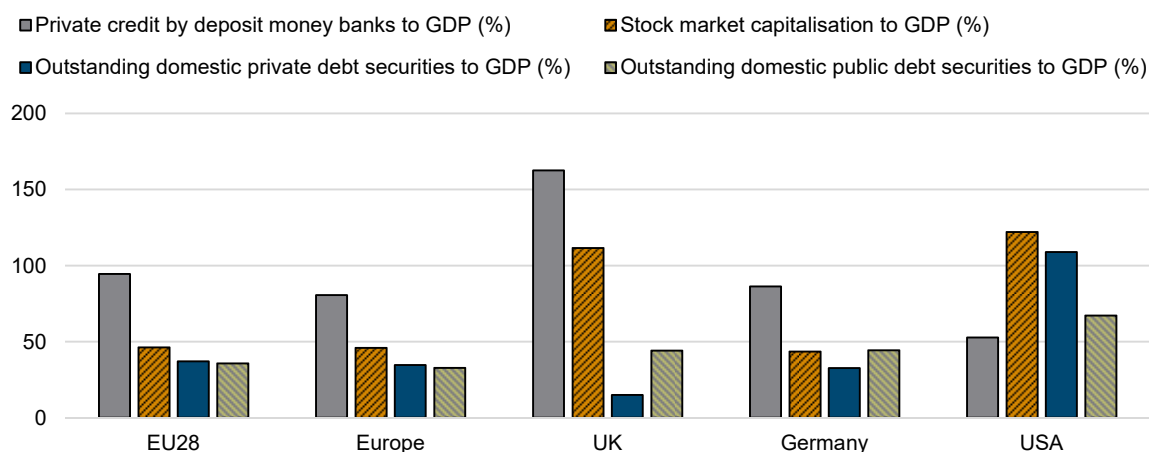
Source: World Bank WDI.

In part the problem of such persistently high NPLs is associated with the protracted weak recovery (in fact, Europe experienced a double-dip recession), while macro-financial problems in some countries, including the 'PIIGS' (Portugal, Ireland, Italy, Greece, Spain) as well as Cyprus, still have not been fully resolved. Besides this, the profitability of the banking sector is adversely affected by low interest rates on account of ultra-easy monetary policy. Years of monetary policy stimulus resulted in ample liquidity and search for yield, which contributed to potentially unsustainable dynamics in certain asset markets, particularly, the housing sector in Hungary, Germany, Lithuania, the Netherlands, Spain and the UK; and equity markets in France, Italy, the Netherlands, Spain and Switzerland (see also Adarov, 2018).

IMPLICATIONS OF THE EUROPEAN FINANCIAL MARKET STRUCTURE

In addition to cyclical factors, pertaining both to business cycles and financial cycles, challenges of the European financial system stem from deeper structural characteristics pertaining to the composition of financial markets and regulatory bottlenecks revealed during the crisis. In particular, as can be seen in Figure 3, financial markets in Europe are largely dominated by the banking sector, while capital markets are much smaller in relative terms, compared, for instance, to the United States. In particular, the size of the equity market is much smaller (less than 50% of GDP), while for the US it exceeds 100% of GDP. In the case of the bond markets, the difference is even larger. Purely bank-based financial systems are prone to greater risks as opposed to economies with diversified financial systems, i.e. developed capital markets, which are typically accompanied by well-functioning banking sectors (market-based systems). In the event of pressures on the banking sector such as persistently high NPLs, the absence of alternative channels of financing (both for banks and non-financial corporations) constrains economic growth.

Figure 3 / Structure of financial markets, 2007-2016 average



Source: Own calculations based on the World Bank's Global Financial Development Database.

Another important feature of the European financial system is its core-periphery structure in terms of the high reliance of the CESEE countries on foreign banks (predominantly from Western Europe). While access to foreign funding is generally welcome for addressing funding constraints of transition economies and thus financing their economic growth, the prevalence of foreign-owned banks and related excessive cross-border credit flows being highly pro-cyclical, also contributed to unsustainable credit booms, further stimulating economic overheating and deepening the recession triggered by the global financial crisis, particularly, in the Baltic countries.

POLICY RESPONSES AND CHALLENGES

At the moment, the European financial markets are still vulnerable, although safer relative to their state at the start of the global financial crisis. The lessons learned from the crisis gave an impetus to a range of improvements in financial stability policies, both micro- and macroprudential. Capital ratios of European banks have increased as a result of stricter regulations improving their resilience to shocks. At

the same time, Europe is not ready to cope with another crisis as macroeconomic policy responses have largely been exhausted. The key new policy responses concerning European financial architecture were formulated along two major initiatives: the Banking Union project launched by the European Commission in 2012 and the Capital Markets Union project launched in 2015. The challenges outlined above call for further decisive steps to facilitate the Banking Union and Capital Markets Union initiatives.

The Banking Union (see also European Commission, 2017) involves three pillars: (i) the Single Supervisory Mechanism, focusing on the effectiveness of supervision and coordination, particularly related to monitoring of systemic banks; (ii) the Single Resolution Mechanism, focusing on effective resolution procedures for failing banks; (iii) the European Deposit Insurance Scheme, focusing on the harmonisation of deposit protection. The action plan for the Capital Markets Union, adopted in 2015 (European Commission, 2015), covers six areas: (1) financing for innovation, start-ups and non-listed companies; (2) entering and raising capital on public markets; (3) facilitating long-term investment; (4) fostering retail and institutional investment; (5) facilitating securitisation; and (6) facilitating cross-border investment. In comparison with the Banking Union, this initiative, however, is more difficult to implement, as an effectively functioning Capital Markets Union needs harmonisation of national regulations across the participating countries, which includes adoption of common accounting practices, corporate laws, and regulations pertaining to insolvency and bankruptcy. This is challenging in light of the fragmented capital markets and significant heterogeneity across Europe in terms of existing institutions and capacity to finance and administer speedy adoption of new regulations.

In part, the progress has also been hampered by rising anti-integration sentiment throughout Europe and preference for national interests coming at the cost of bridging remaining gaps in the quality of the EU institutional architecture. Related to the latter, Brexit also complicates the situation as London has long been a major European hub for financial transactions. At the same time, it could be seen as an opportunity to revisit the existing structure of financial markets in Europe underscoring once again the need for an effective Capital Markets Union.

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The process of financialisation in Central, East and Southeast Europe¹

BY MARIO HOLZNER

Financialisation has been particularly strong in the three small Baltic states, followed by countries from CEE and, at a certain distance, by economies of SEE and the CIS. This pattern can be observed in the deregulation indicator as well as in different indicators of foreign financial inflows. However, an important distinction can be made with regard to the structure of inward FDI stocks in the CESEE region.

INTRODUCTION

Financialisation reached the eastern periphery of Europe relatively late, but all the more fundamentally. From the very beginning of the transition from central planning to a market economy at the beginning of the 1990s, the IMF and national central banks were the prime advocates of a comprehensive financialisation of the economy, widely disregarding the productive sector (Gabor, 2012). For a number of countries, the Europe Agreements with the EU as well as cooperation with and accession to the Organisation for Economic Co-operation and Development (OECD) also played a role. Compared to other emerging markets, financial deregulation has been more pronounced in the countries of Central, East and Southeast Europe (CESEE), with lower levels of, but strong increases in household debt (Karwowski and Stockhammer, 2017), as they literally started from scratch. However, countries in the western semi-periphery of CESEE also received large foreign direct investment (FDI) in the manufacturing sector, while the more peripheral countries farther to the northeast, east, and southeast were predominantly attracting FDI in other sectors such as the financial and retail services.

In this article we discuss the development of financialisation in CESEE across country groups and over time according to six dimensions as recently defined by Karwowski and Stockhammer (2017), which follow the pattern of the relevant financialisation literature that deals mostly with emerging markets: (1) financial deregulation, (2) foreign financial inflows, (3) asset price volatility, (4) the shift from bank-based to market-based finance, (5) business debt, and (6) household debt. The different developments before and after the outbreak of the global financial crisis are of particular interest. Moreover, special emphasis is placed on different types of foreign financial inflows – inflows creating external debt vs. FDI – and on different types of FDI (export-oriented manufacturing vs. domestic market-oriented services).

This article follows the above-cited six dimensions of financialisation but uses partly different variables and data sources, as our goal was to compare as many CESEE countries with one another as possible. The term *financialisation* in its broadest sense characterises the increasing role of finance in the economy, thus allowing for many different interpretations and angles of analysis.

¹ This article is based on an adapted excerpt from M. Holzner (2017), 'The Financial Effects of the Crisis in European Emerging Markets', in: P. Havlik and I. Iwasaki (eds), *Economics of European Crises and Emerging Markets*, Palgrave, pp. 39-62.

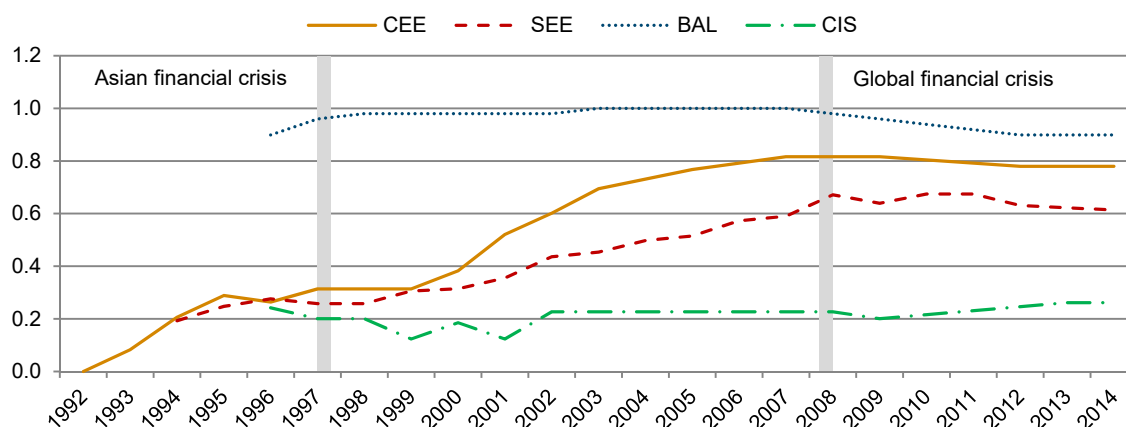
Our country groups consist of Europe's semi-periphery in Central and Eastern Europe (CEE), comprising Poland, the Czech Republic, Slovakia, Hungary, and Slovenia; the northwestern peripheral Baltic states (BAL), Estonia, Latvia, and Lithuania; the southeastern periphery on the Balkan peninsula – i.e., Southeast Europe (SEE) – Croatia, Bosnia and Herzegovina, Serbia, Montenegro, Kosovo, Albania, Macedonia, Turkey, Bulgaria, and Romania; and the eastern periphery of Europe associated with the so-called Commonwealth of Independent States (CIS), including Russia, Belarus, Moldova, Ukraine (a former associate member of the CIS), and Kazakhstan. Indicators for the country groups are simple averages across countries and time periods, according to data availability.

FINANCIAL DEREGULATION AND OPENNESS

Our first indicator of financialisation is related to financial deregulation or liberalisation. Specifically, we look at Chinn and Ito's (2006) Index of Financial Openness that contains information on regulatory restrictions on cross-border financial transactions. Capital account liberalisation was an important first step towards the financialisation of the former communist economies and was actively supported by the International Financial Organisations, such as the International Monetary Fund or the World Bank. It was expected that deregulation would improve the efficiency of local financial markets, thereby improving the allocation of resources and generating economic growth. The potential risks of increased financial openness to macroeconomic stability were widely ignored.

Figure 1 / Financial deregulation at different speed

Financial deregulation in CESEE according to the Chinn-Ito Financial Openness Index, 1992-2014



Note: The index is normalised with the highest degree of financial openness captured by the value of one and the lowest by the value of zero.

Source: Chinn and Ito (2006), 2014 update, own calculations.

As can be seen from Figure 1, financial deregulation was, from the very beginning, strongest in the Baltics, where it was mostly driven by the ideological agenda of the countries' authorities (Árvai, 2005). By 1997, the year of the outbreak of the Asian financial crisis, these countries had almost completely liberalised their capital accounts. Other CESEE countries were more cautious, having achieved by that time only a low level of financial openness. Nevertheless, this was a period characterised by a series of banking crises throughout the region, interrelated with the collapse of the corporate sector. As a result of the Asian financial crisis, *inter alia*, the price of oil also plummeted, triggering the 1998 Russian financial

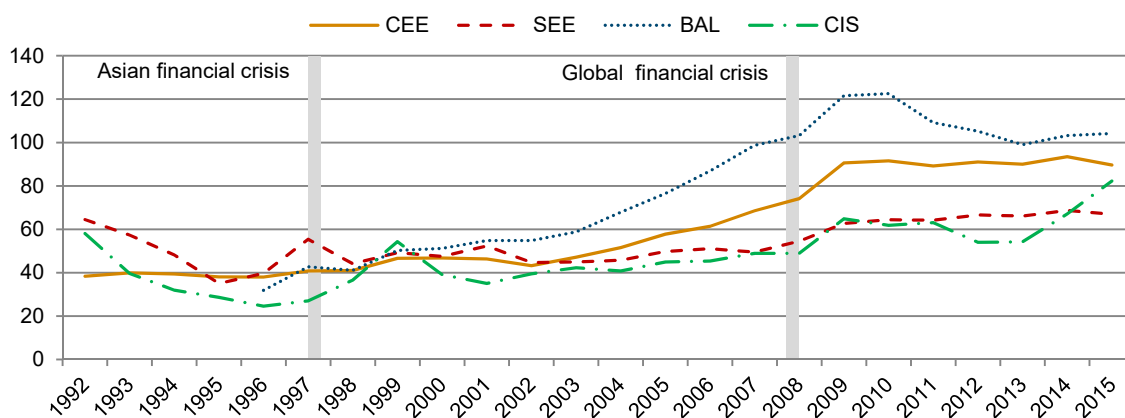
crisis and causing strong global repercussions. It is interesting to note that from that point onward, the CIS economies did not further open their capital accounts. After a certain pause, the SEE and, especially, the CEE economies again resumed deregulation efforts, mainly due to the EU accession process. They reached levels of capital account liberalisation closer to the one of the Baltics just before the outbreak of the global financial crisis in 2008. Since then, liberalisation has again stalled.

FOREIGN FINANCIAL INFLOWS: EXTERNAL DEBT VERSUS FDI

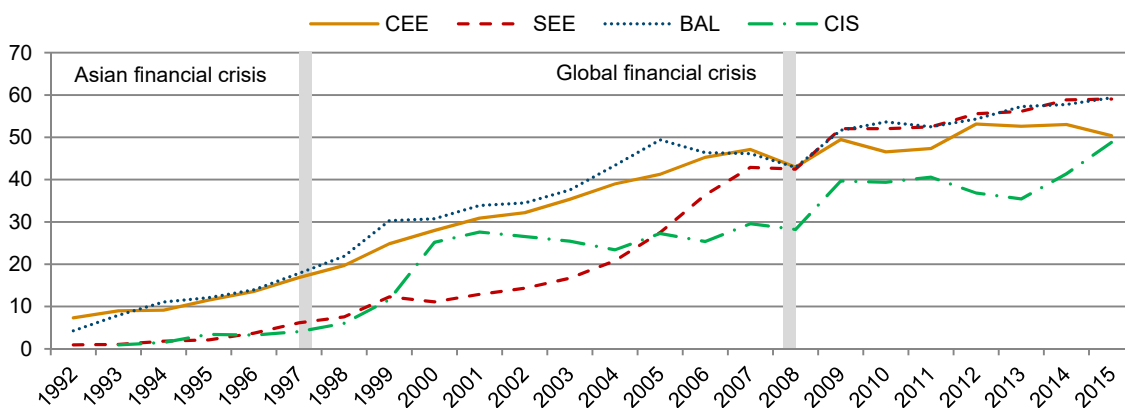
Nevertheless, deregulation has laid the groundwork for strong foreign capital influx into CESEE. This is reflected in the buildup of both gross external debt and inward FDI stocks as a share of GDP (see Figure 2). External debt began to surge, especially in the boom years starting from about 2003, particularly in the Baltics and, to a lesser extent, also in CEE. In SEE and the CIS, the development was fairly flat. In the aftermath of the global financial crisis, the dynamics in the Baltics and CEE dampened or even reversed slightly. Meanwhile, countries from SEE and, especially, the CIS have increased their share of foreign debt for a number of reasons. Most recently, gross external debt of CESEE economies has ranged between 70% and 100% of GDP (Figure 2, upper panel).

Figure 2 / Foreign financial inflows of different qualities

Gross external debt in % of GDP, 1992-2015



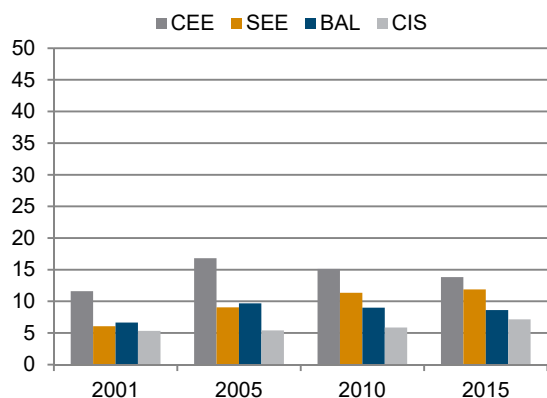
FDI inward stock in % of GDP, 1992-2015



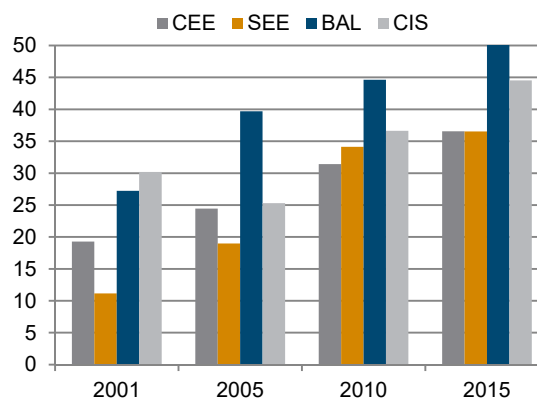
Source: wiiw Annual and FDI Database, own calculations.

Figure 3 / Foreign financial inflows of different structure

FDI inward stock in % of GDP in the manufacturing sector



FDI inward stock in % of GDP in the other sectors of the economy



Note: The data is a combination of NACE Rev. 1 and Rev. 2 statistics, with a break around 2008/2009 in most of the countries.

Source: wiiw FDI Database, own calculations.

FDI inflows have developed in a more linear way throughout the region, with a smaller slowdown after both the Asian financial crisis and the global financial crisis (Figure 2, lower panel). Although the Baltics and the CEE countries had for a long time been front-runners in this respect, SEE and CIS economies have gradually caught up, and the range of the inward FDI stock in the economies of CESEE is now somewhere around 50% to 60% of GDP.

More importantly, there has been a substantial differentiation in the type of FDI between the countries of the region. The left panel of Figure 3 presents the FDI stock in the manufacturing sector. Clearly, the CEE countries were prime targets for manufacturing FDI early in the process, with approximately twice the share, as compared to other, more peripheral country groups. However, more recently, CEE's share has declined slightly and, in particular, the Balkan economies have become increasingly the targets of more sophisticated and export-oriented FDI in the manufacturing sector. By 2015, the average CEE country attracted manufacturing FDI stock on the order of about 14% of GDP, the average SEE economy received some 12%, and shares in the Baltics and the CIS are around 9% and 7%, respectively. Conversely, countries from the latter two groups were leading the FDI stock statistics in the sectors other than manufacturing (see the right panel of Figure 3), with 45% to 50% of GDP in 2015. In CEE and SEE, they were about 35% of GDP. Most of the FDI in other sectors is concentrated in banking, insurance, and retail trade services oriented towards the local market, contributing to more imports than exports.

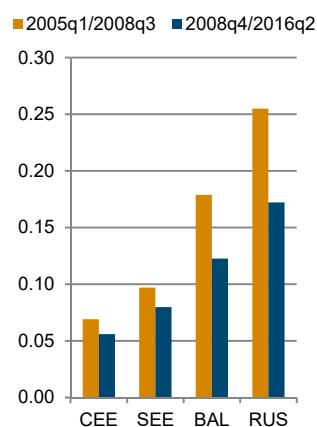
ASSET PRICE VOLATILITY AND STRUCTURE OF FINANCIAL MARKETS

Especially foreign capital inflows targeting the financial sector in CESEE might have triggered, among others, Minsky-type asset price inflation and volatility, whereby, according to Minsky (1992) the buildup of speculative asset price bubbles typically leads to system instability. Indeed, as can be seen from the left panel of Figure 4, house price volatility was stronger in the run-up to the global financial crisis as

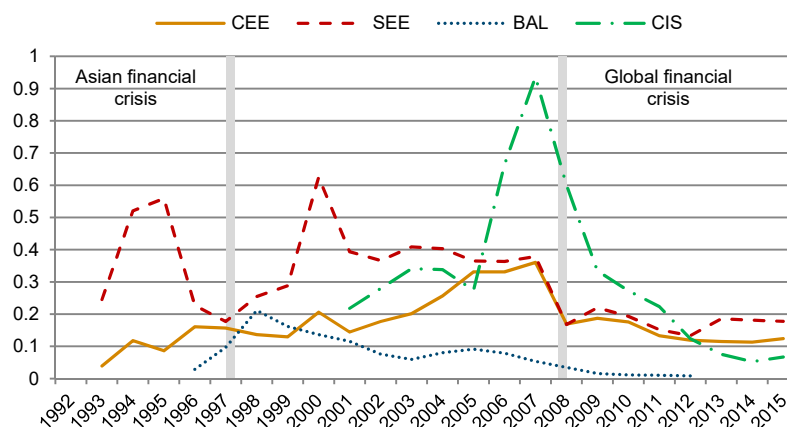
compared to the later period, and it was also stronger in Russia (comparable data for other CIS economies was not available) and the Baltics as compared to the SEE and CEE economies. There was also a boom in the stock markets, especially in Russia, Turkey, the Czech Republic, and Hungary, in the years before the outbreak of the global financial crisis. Until 2007, this pushed up the ratio of stocks traded to domestic credit to the private sector by banks (see Figure 4, right panel). However, after 2008, this ratio degenerated to insignificance almost everywhere in the region. For the moment, it appears that the shift from bank-based to market-based finance has failed in CESEE.

Figure 4 / Asset price volatility and the (missing) shift from bank-based to market-based finance

Quarterly real house price index coefficient of variation



Ratio of stocks traded in relation to domestic credit to private sector by banks (1992-2015)



Source: Eurostat, BIS, WDI, FRED, own calculations.

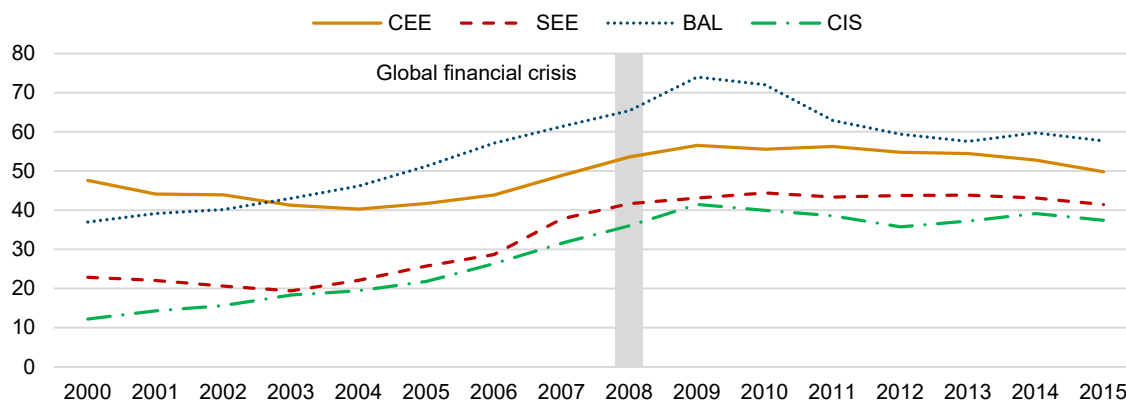
BUSINESS AND HOUSEHOLD DEBT LEVELS

Typically, rising levels of non-financial corporation (NFC) indebtedness have been seen as a sign of financialisation, which can imply growing financial vulnerability, as ever-larger volumes of cash flow are required to meet future debt servicing commitments. The upper panel of Figure 5 shows that it was especially the Baltics and, to a lesser extent, CEE, SEE, and CIS that increased their NFC indebtedness (as per cent of GDP) to unsustainable levels during the boom years. In the years after the outbreak of the global financial crisis, debt ratios had to be reduced quite significantly in the Baltics and also in the countries of CEE. Elsewhere, debt levels stagnated.

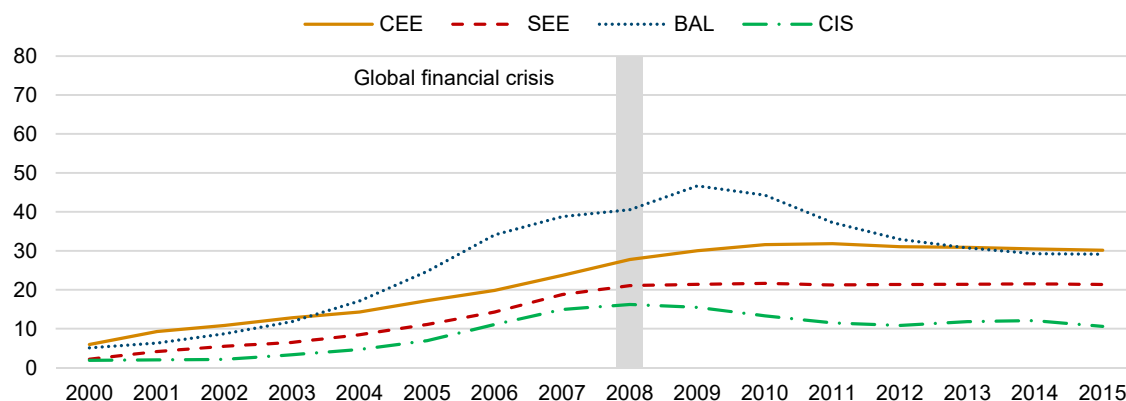
Rising household indebtedness is a particularly worrisome indicator of financialisation, as household debt is not typically invested in productive activities that have the potential to generate cash flow for debt servicing. As can be seen from the lower panel of Figure 5, household debt to GDP has developed in a similar pattern as that of NFC indebtedness, but at a less dramatic pace. The Baltics also led in this statistic, followed by CEE, SEE, and the CIS. The boom stopped around 2009; since then, e.g., Baltic households had to reduce their debt levels by almost 20 percentage points of GDP.

Figure 5 / Business and household debt have lost dynamism since the outbreak of the global financial crisis

Debt of non-financial corporations (loans and debt securities) in % of GDP (2000-2015)



Debt of households and NPISHs (loans and debt securities) in % of GDP (2000-2015)



Note: For EU countries and Ukraine based on consolidated balance sheets for financial accounts, for other countries based on various banking statistics reports. For Albania, Belarus, Kazakhstan and Russia based on claims. For Belarus: wiiw estimates until 2005. For Kosovo, Montenegro, Serbia, Turkey corporate loans only. NPISHs are non-profit institutions serving households.

Source: Eurostat and National Banks, own calculations.

CONCLUSIONS

Overall, it can be concluded that financialisation has been particularly strong in the three small Baltic states, followed by countries from CEE and, at a certain distance, by economies of SEE and the CIS. This pattern can be observed in the deregulation indicator as well as in different indicators of foreign financial inflows. However, an important distinction can be made with regard to the structure of inward FDI stocks in the CESEE region. Economies from CEE and, to a certain extent and with a lag, also those from SEE were able to attract highly productive and export-oriented manufacturing FDI, while the Baltics and the CIS had a much stronger focus on attracting FDI into domestically oriented banking, insurance, and retail trade service that supported import activities more than exports.

The strong influx of foreign funds into the financial sector has triggered, particularly in Russia and the Baltics, asset price volatility in the housing market – a bubble that partly burst after the outbreak of the global financial crisis. Similarly, the start of a shift from bank-based to market-based finance in a few countries of the region has been reversed in recent years. The repeating pattern of strong financialisation up to the outbreak of the global financial crisis, especially in the Baltics and, to a certain extent, also in CEE, can again be observed with regard to the indebtedness dynamics of NFCs and households. The less dynamic development of indebtedness in SEE and the CIS and the partial reversal in the Baltics and CEE after the outbreak of the global financial crisis have led to a certain alignment in financialisation trends in CESEE.

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Deleveraging in CESEE continues

BY OLGA PINDYUK

The quantitative easing launched 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. By now it has mostly failed to achieve this goal as foreign banks in CESEE have not restored their pre-crisis positions. Financial institutions in many countries of the region have carried on liquidity hoarding and restrained credit expansion, while both non-financial corporations and households have continued deleveraging despite low interest rates on loans.

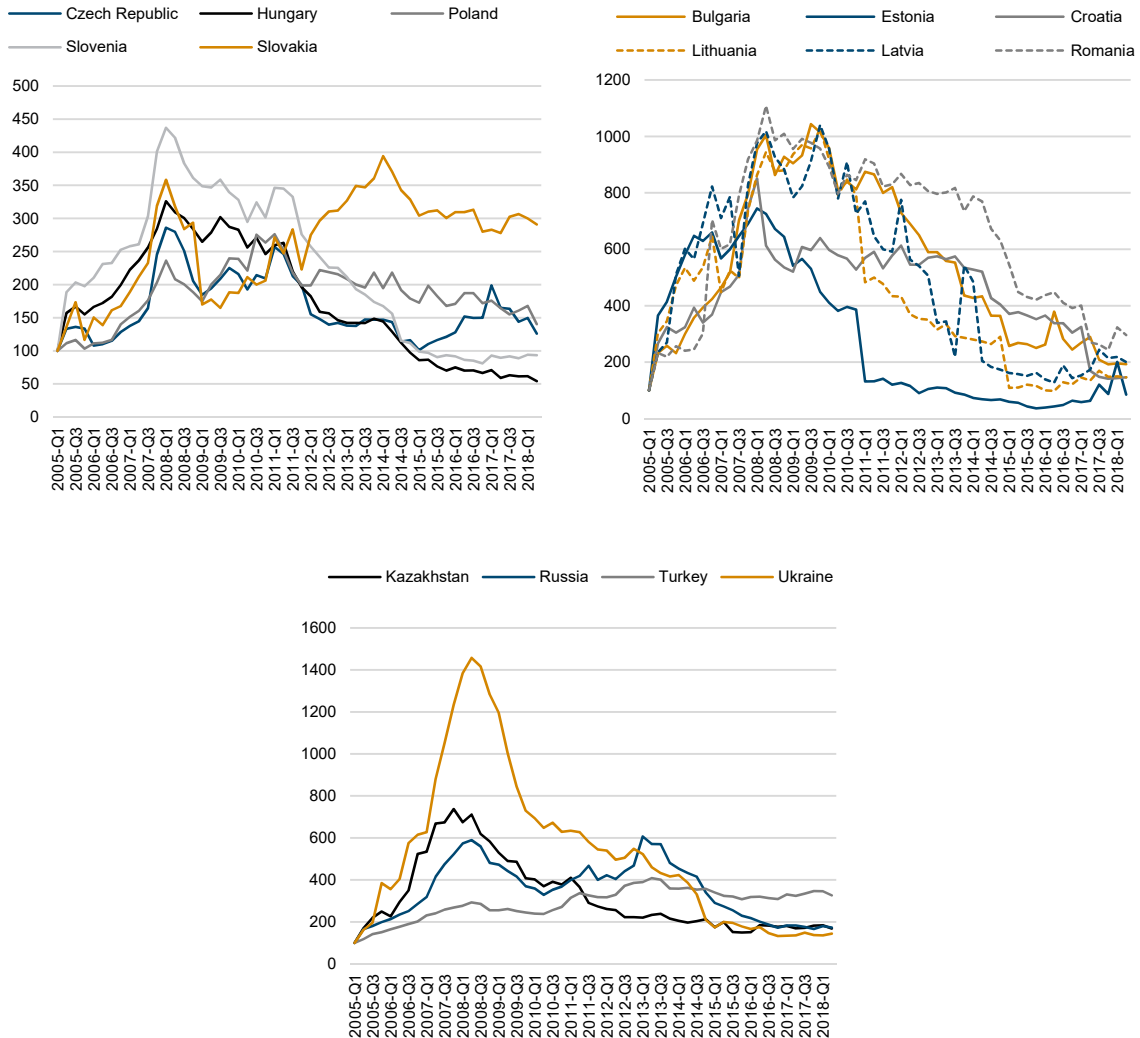
INTRODUCTION

In the aftermath of the global financial crisis Western European banks substantially decreased their exposure in CESEE countries in their flight to safe assets. This caused a deterioration of liquidity in the region's financial sector. Only in the core EU 15 countries did financial corporations avoid assets decrease during the crisis years. In response to the situation the ECB launched its quantitative easing (QE) programme that was aimed at, inter alia, providing liquidity to the banking sector in order to make it easier and cheaper for banks to extend loans to companies and households, thus stimulating credit growth. This article analyses the developments in lending activities of European banks and the deleveraging across companies and households in the CESEE region to see whether there has been a reversal of the early post-crisis trends.

This analysis uses data from the Bank of International Settlements (BIS) that come from the consolidated banking statistics on an ultimate risk basis (the country of ultimate risk is defined as the country in which the guarantor of a financial claim resides and/or the country in which the head office of a legally dependent branch is located). Sectoral balance sheets analysis is done using sectoral national accounts statistics published by Eurostat.

The first observation to be made is that in the majority of the CESEE countries foreign banks have not restored their positions. Figure 1 shows indices of cross-border bank claims in different countries of the region. Only Slovakia and Turkey reached pre-crisis levels of foreign banks' claims in 2017. Countries which had been accumulating European banks' foreign claims at a very high speed prior to the crisis have had the most difficult time reversing the trend of decline in foreign banks' claims after the crisis. Poland and the Czech Republic, which had experienced the slowest growth in cross-border banks' claims prior to 2008, performed better than most of their peers – during 2008-2017 they lost only 33% and 55% of the foreign banks' claims respectively.

Figure 1 / Indices of cross-border consolidated bank claims on an ultimate risk basis by counterparty, nominal EUR terms, Q1 2005=100

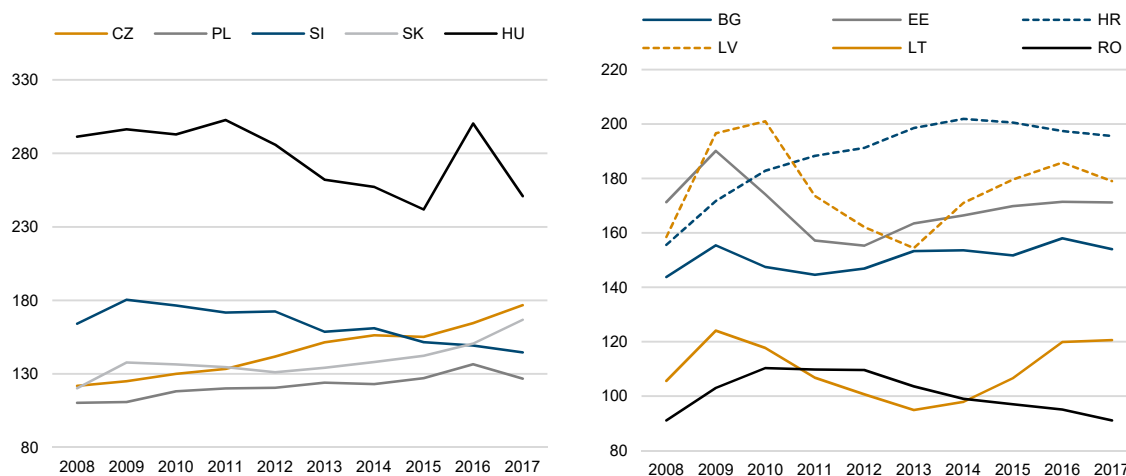


Source: BIS.

FINANCIAL CORPORATIONS

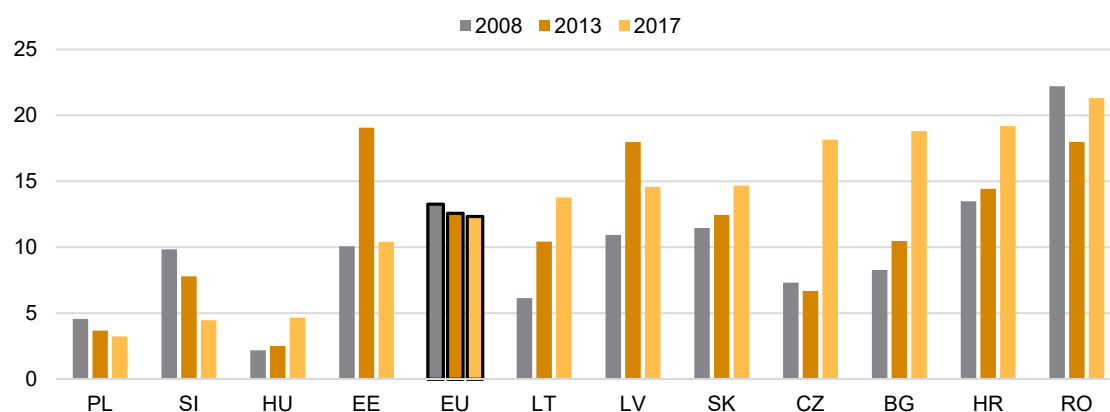
Financial corporations were directly hit by the declining exposure of European banks to the region. As Figure 2 shows, only in some countries of EU-CEE¹ did financial corporations increase their assets relative to GDP during 2009-2017, namely in the Czech Republic, Croatia, Poland, and Slovakia. In other countries assets accumulation was negative.

¹ Eurostat covers only 11 countries of the CESEE region in the national sectoral accounts statistics, to which we refer as EU-CEE.

Figure 2 / Assets of financial corporations, in % of GDP

Source: Eurostat.

The dynamics of total assets does not show the whole picture though, as changes in the assets structure are also important for understanding the impact of the crisis, in particular, in detecting liquidity hoarding. In times of economic downturns banks tend to increase liquidity of their assets (i.e., the share of currency and deposits in their assets grows) to make their balance sheets safer. Aggregated sectoral accounts data show that in 2017, financial corporations still kept the share of currency and deposits higher than in 2008 in all EU-CEE countries apart from Poland and Slovenia (see Figure 3). Moreover, in the majority of the countries the shares of currency and deposits in 2017 were higher relative to 2013 as well, indicating a possible continuation of the liquidity hoarding tendency.

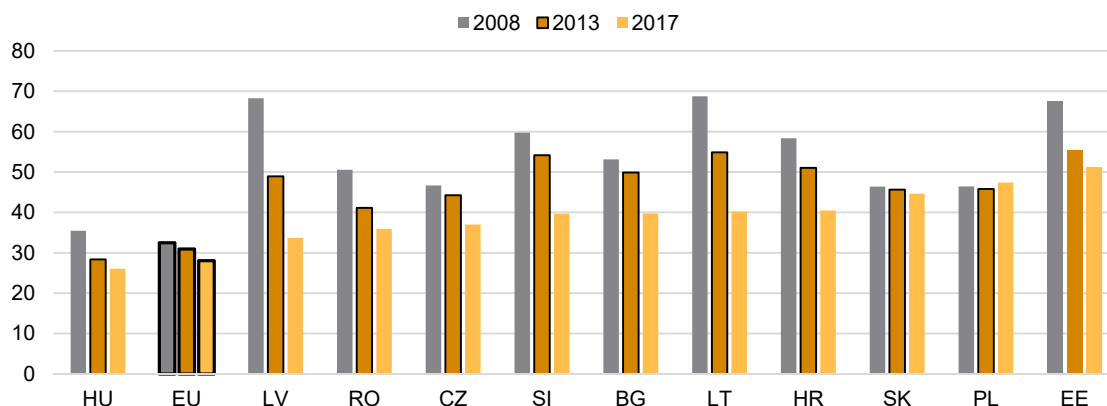
Figure 3 / Currency and deposits, in % of total assets of financial corporations

Source: Eurostat.

With increasing shares of currency and deposits, and also of equity and bonds, shares of loans in assets continued to shrink. As can be seen in Figure 4, in all the countries apart from Poland shares of loans in financial corporations' total assets decreased during 2008-2017; the biggest reduction took place in Latvia (35pp), Lithuania (29pp), and Slovenia (20pp). Banks appear to be increasingly reluctant to provide loans regardless of the improvement in the quality of existing portfolios with a reduction of the

shares of non-performing loans (NPLs) in most of the countries.² One of the reasons behind such behaviour of the banks may be insufficient profitability of loans in the low interest rates environment.

Figure 4 / Loans, in % of total assets of financial corporations

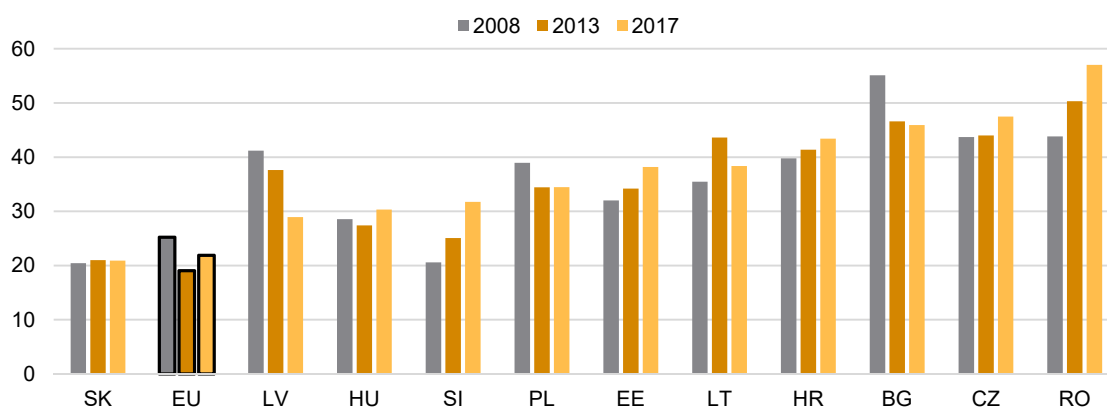


Source: Eurostat.

NON-FINANCIAL CORPORATIONS

After the onset of the global financial crisis companies in most of the EU-CEE countries started to pile up cash (see Figure 5). Over time, as economies returned to growth and risks of investment diminished, the shares of cash and deposits in total assets of non-financial corporations started to decline in some countries: in Croatia, the Czech Republic, Estonia, Hungary, Romania, and Slovenia they were lower in 2017 as compared with 2013. Still, only in Bulgaria, Latvia, and Poland were the shares of currency and deposits in total assets in 2017 lower as compared to 2008 levels, suggesting that companies in other countries continue to have ample liquidity. In 2017, Romania had the highest share of currency and deposits in assets of non-financial corporations among its peers with 57%. This exceeded the average EU level of the indicator by about 160%.

Figure 5 / Currency and deposits of non-financial corporations, in % of total assets

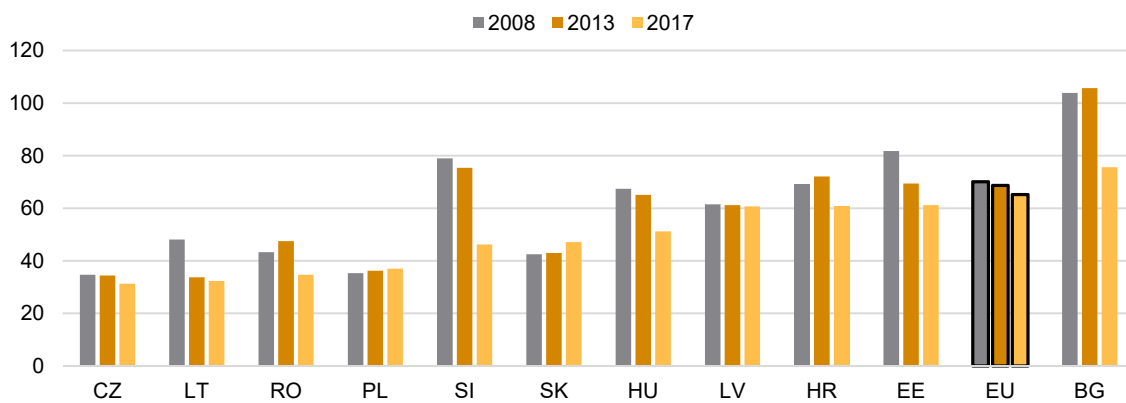


Source: Eurostat.

² See 'Credit monitor' in *wiiw Forecast Report Autumn 2018*, November 2018.

In the situation of abundant liquidity companies are likely to have subdued demand for external funding and this can be an additional factor behind the decrease in banks' lending to the corporate sector. Poland and Slovakia are the only countries in the region where loans to non-financial corporations as a share of GDP expanded during 2008-2017 (see Figure 6). In all the other countries they were lower in 2017 than in 2008. The most dramatic decline took place in Slovenia and Bulgaria, where NPL levels as well as the share of loans to non-financial corporations in GDP were initially among the highest compared to the peers and which 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.

Figure 6 / Loans to non-financial corporations, % GDP

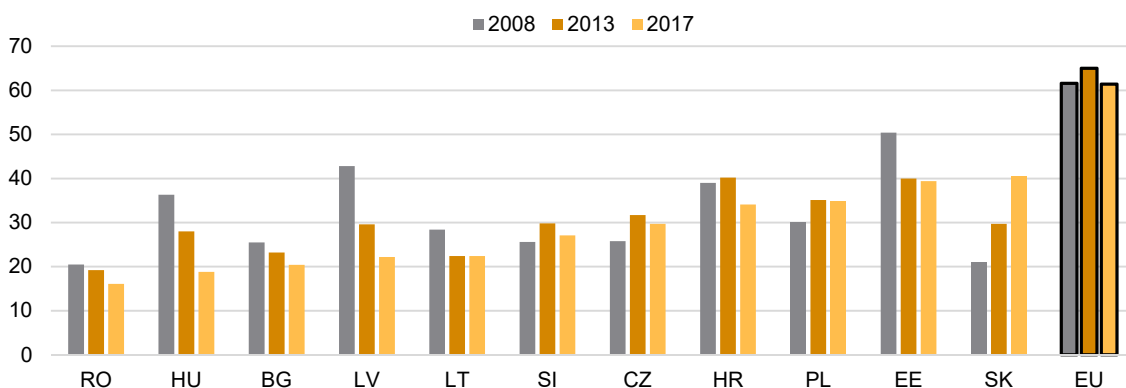


Source: Eurostat.

HOUSEHOLDS

In all EU-CEE countries apart from the Czech Republic, Poland, and Slovenia households started deleveraging around 2011. Deleveraging continued further until 2017 in all the countries except Slovakia – even in countries with low levels of household indebtedness (see Figure 7). Cleansing balance sheets from NPLs and low interest rates on loans have not been able to change the situation so far.

Figure 7 / Loans to households, % of GDP

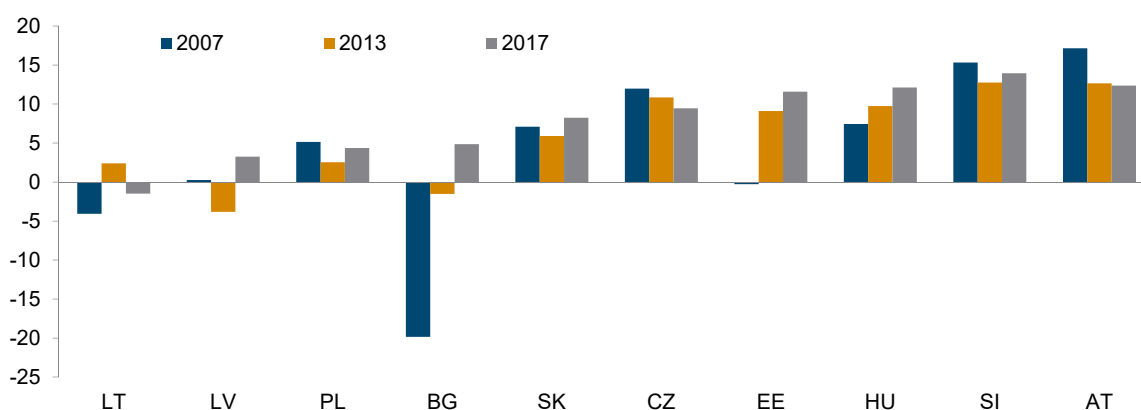


Source: Eurostat.

The relatively slow accumulation of households' indebtedness might have to do with the fast wage growth in many EU-CEE countries in the situation of labour shortages.³ Consumers are likely to finance now their expenditures more out of wage incomes. Additionally, the household saving patterns have been changing recently (see Figure 8). In 2017, gross household saving rates declined relative to 2013 only in the Czech Republic and Lithuania. In the rest of the region they increased, with Slovenia, Hungary, and Estonia having the thriftiest households. The household saving rate in Slovenia even exceeded the level of Austria (which tends to have quite a high saving rate). This behaviour of households could likely be explained by dwindling confidence in the economy, which makes them less willing to increase spending as well as finance it with loans.

Figure 8 / Gross household saving rate, %

Households and non-profit institutions serving households



Source: Eurostat.

SUMMARY AND CONCLUSIONS

All in all, it can be concluded that the legacy of the financial crisis of 2008-2009 is still largely felt in the financial sector of many CESEE countries. Stronger economic growth over the past few years has not stopped liquidity hoarding of financial corporations, which have typically remained cautious about expanding their exposure in the CESEE region in the recent years. Non-financial corporations in many EU-CEE countries have been also piling up cash and continued deleveraging despite a significant decline in NPL levels and low interest rates on loans. Households exhibited similar deleveraging trends. Thus, it appears that the transmission of ample liquidity from the banking sector (which to a large extent resulted from quantitative easing in the eurozone and loose monetary policy in many non-euro countries) into the real sector of the economy of many CESEE countries has had rather limited success so far. Moreover, there is increasing evidence that the bulk of the extra liquidity went into asset bubbles⁴ that might pose the risk of another financial crisis.

³ See 'CESEE economic outlook' in *wiiw Forecast Report Autumn 2018*, November 2018.

⁴ See the article by A. Adarov on 'European financial markets ten years after the global crisis' in this Report.

Monthly and quarterly statistics for Central, East and Southeast Europe

The monthly and quarterly statistics cover **20 countries** of the CESEE region. The graphical form of presenting statistical data is intended to facilitate the **analysis of short-term macroeconomic developments**. The set of indicators captures trends in the real and monetary sectors of the economy, in the labour market, as well as in the financial and external sectors.

Baseline data and a variety of other monthly and quarterly statistics, **country-specific** definitions of indicators and **methodological information** on particular time series are **available in the wiiw Monthly Database** under: <https://data.wiiw.ac.at/monthly-database.html>. Users regularly interested in a certain set of indicators may create a personalised query which can then be quickly downloaded for updates each month.

Conventional signs and abbreviations used

%	per cent
ER	exchange rate
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices (for new EU Member States)
LFS	Labour Force Survey
NPISHs	Non-profit institutions serving households
p.a.	per annum
PPI	Producer Price Index
reg.	registered

The following national currencies are used:

ALL	Albanian lek	HUF	Hungarian forint	RSD	Serbian dinar
BAM	Bosnian convertible mark	KZT	Kazakh tenge	RUB	Russian rouble
BGN	Bulgarian lev	MKD	Macedonian denar	TRY	Turkish lira
CZK	Czech koruna	PLN	Polish zloty	UAH	Ukrainian hryvnia
HRK	Croatian kuna	RON	Romanian leu		
EUR	euro – national currency for Montenegro and for the euro-area countries Estonia (from January 2011, euro-fixed before), Latvia (from January 2014, euro-fixed before), Lithuania (from January 2015, euro-fixed before), Slovakia (from January 2009, euro-fixed before) and Slovenia (from January 2007, euro-fixed before).				

Sources of statistical data: Eurostat, National Statistical Offices, Central Banks and Public Employment Services; wiiw estimates.

Online database access



wiiw Annual Database



wiiw Monthly Database



wiiw FDI Database

The wiiw databases are accessible via a simple web interface, with only one password needed to access all databases (and all wiiw publications).

You may access the databases here: <https://data.wiiw.ac.at>.

If you have not yet registered, you can do so here: <https://wiiw.ac.at/register.html>.

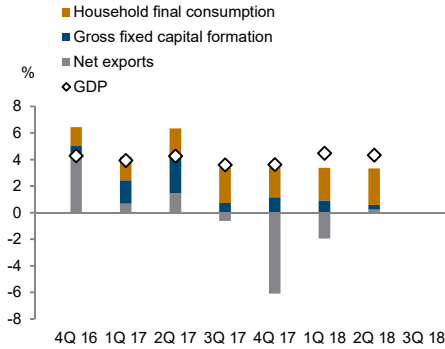
Service package available

We offer an additional service package that allows you to access all databases – a Premium Membership, at a price of € 2,300 (instead of € 2,000 as for the Basic Membership). Your usual package will, of course, remain available as well.

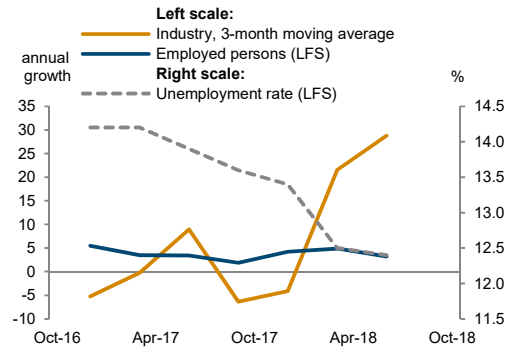
For more information on database access for Members and on Membership conditions, please contact Ms. Gabriele Stanek (stanek@wiiw.ac.at), phone: (+43-1) 533 66 10-10.

Albania

Real GDP growth and contributions
year-on-year



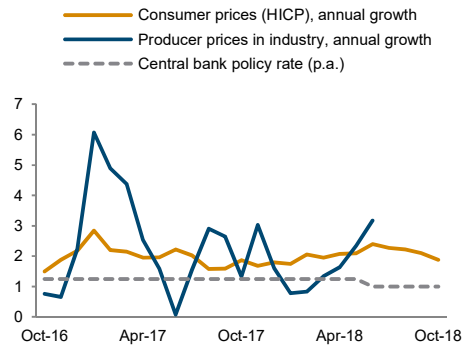
Real sector development
in %



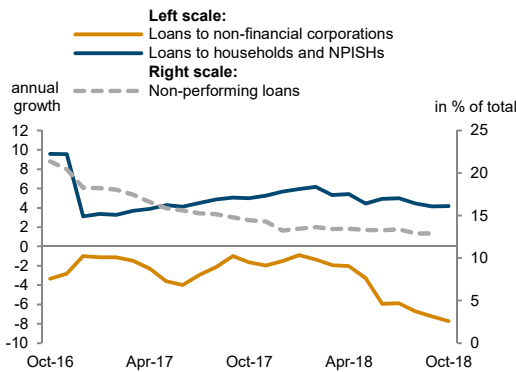
Unit labour costs in industry
annual growth rate in %



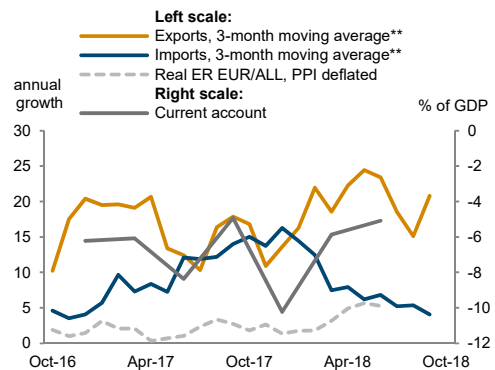
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



*Positive values of the productivity component on the graph reflect decline in productivity and vice versa.

**EUR based.

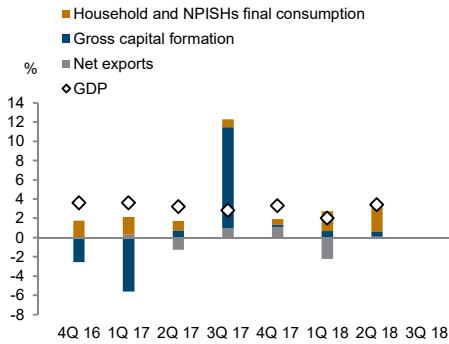
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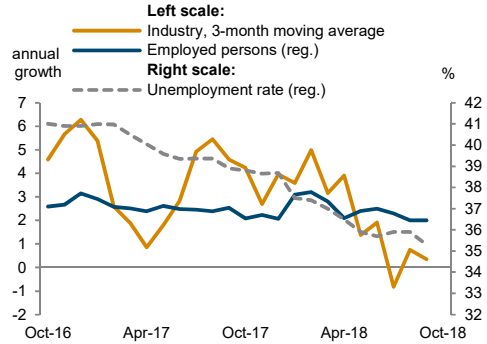
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Bosnia and Herzegovina

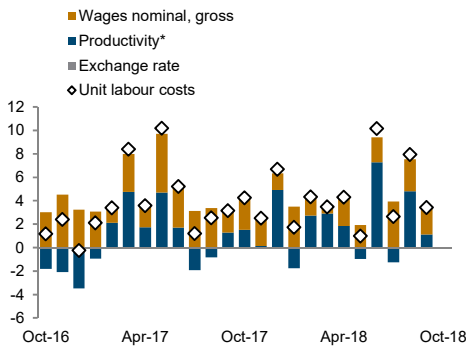
Real GDP growth and contributions
year-on-year



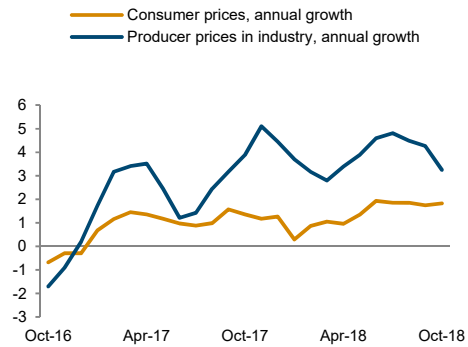
Real sector development
in %



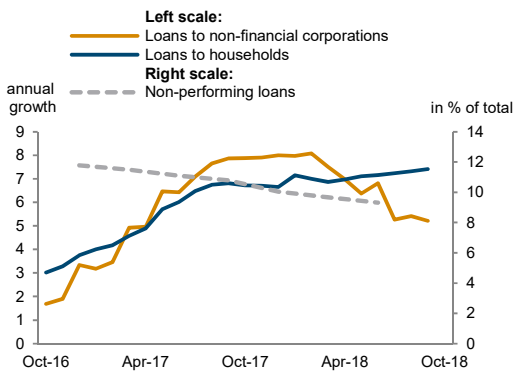
Unit labour costs in industry
annual growth rate in %



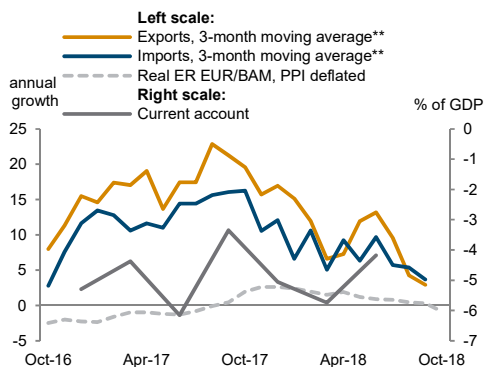
Inflation
in %



Financial indicators
in %



External sector development
in %



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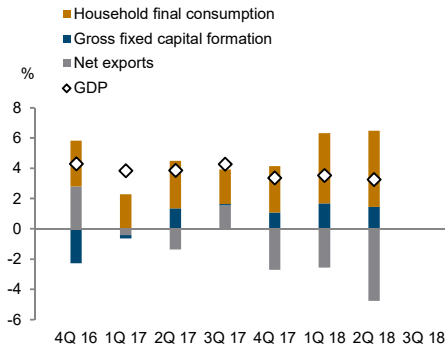
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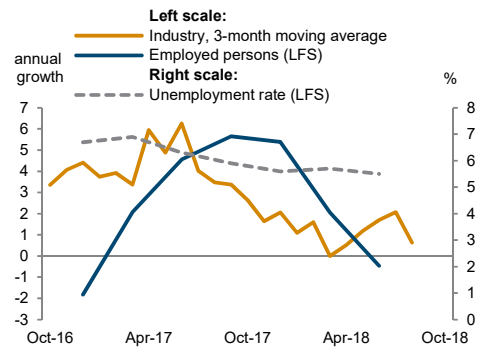
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Bulgaria

Real GDP growth and contributions
year-on-year



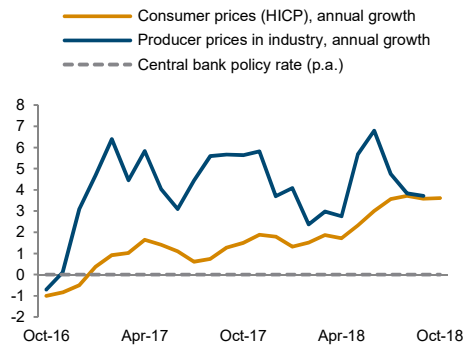
Real sector development
in %



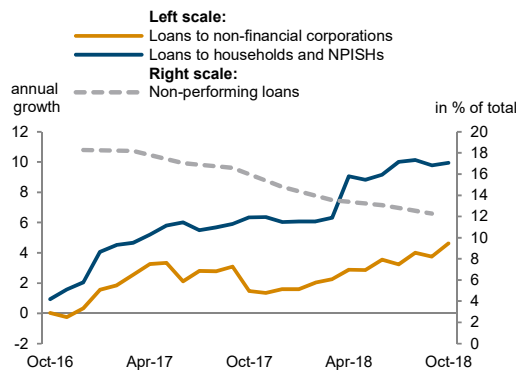
Unit labour costs in industry
annual growth rate in %



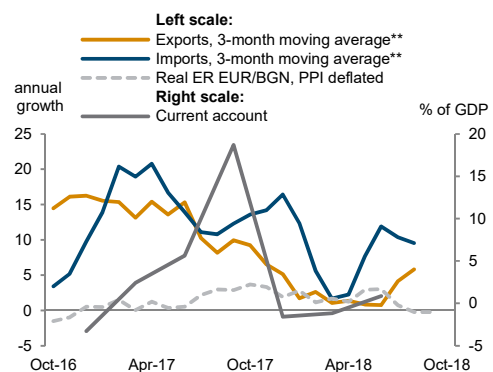
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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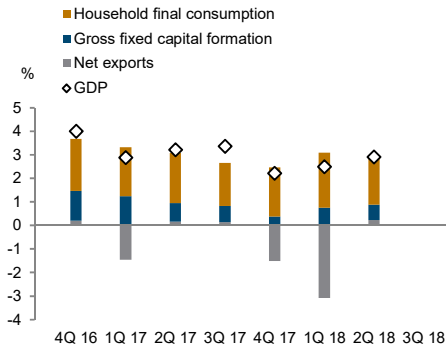
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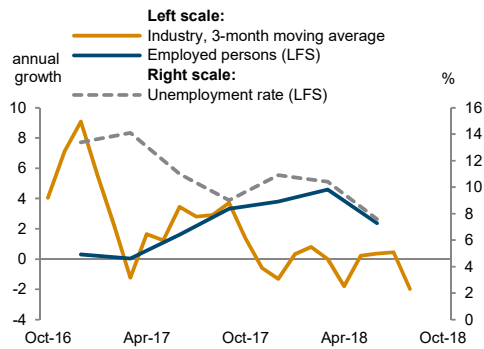
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Croatia

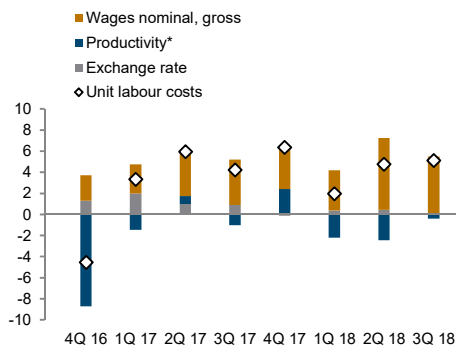
Real GDP growth and contributions
year-on-year



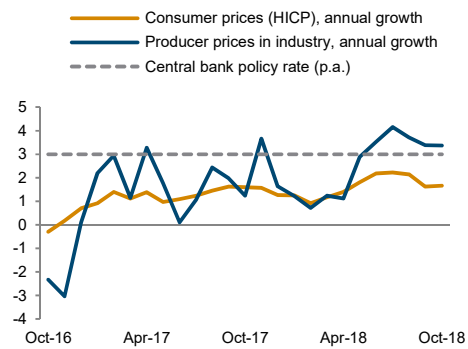
Real sector development
in %



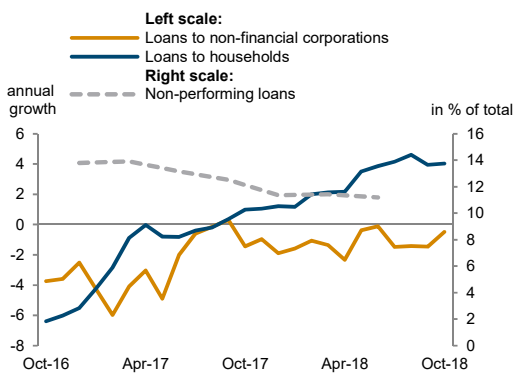
Unit labour costs in industry
annual growth rate in %



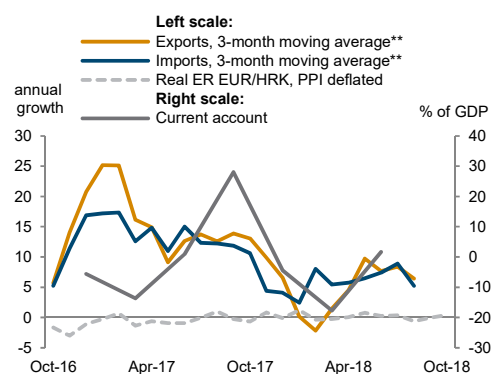
Inflation and policy rate
in %



Financial indicators
in %



External sector development
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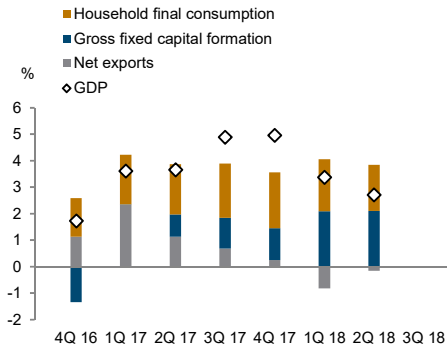
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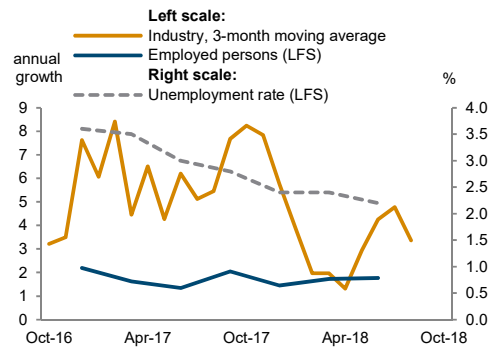
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Czech Republic

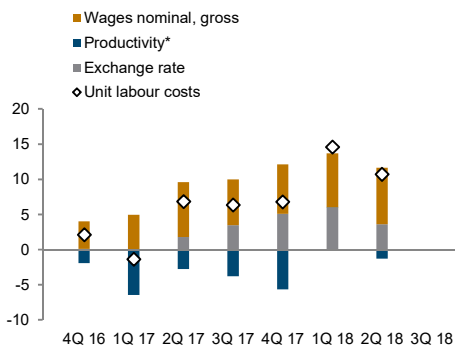
Real GDP growth and contributions
year-on-year



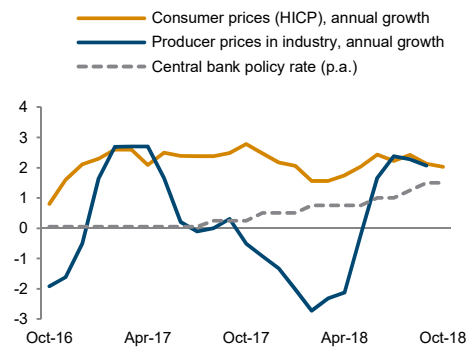
Real sector development
in %



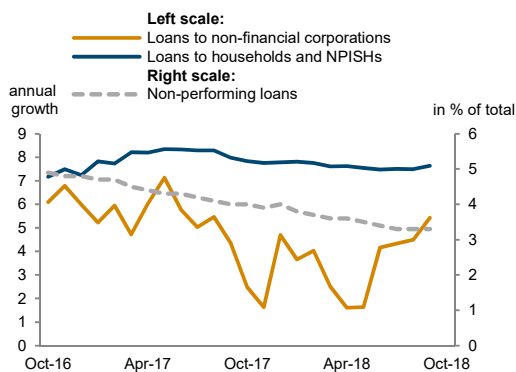
Unit labour costs in industry
annual growth rate in %



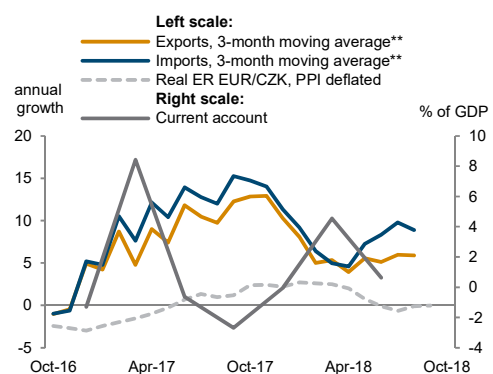
Inflation and policy rate
in %



Financial indicators
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External sector development
in %



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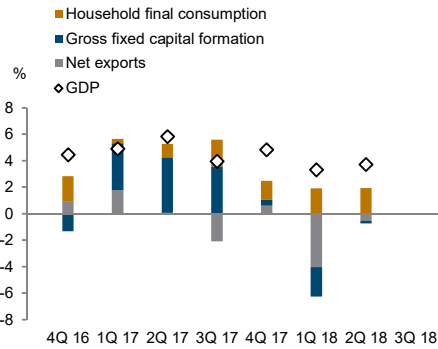
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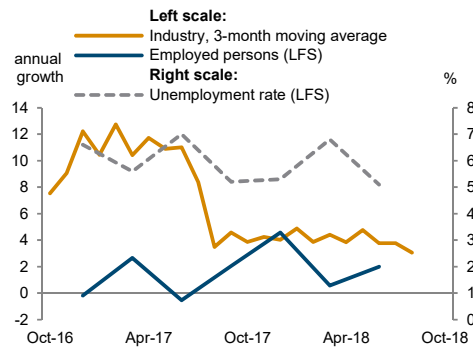
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Estonia

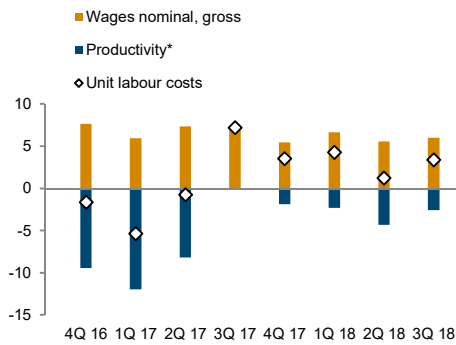
Real GDP growth and contributions
year-on-year



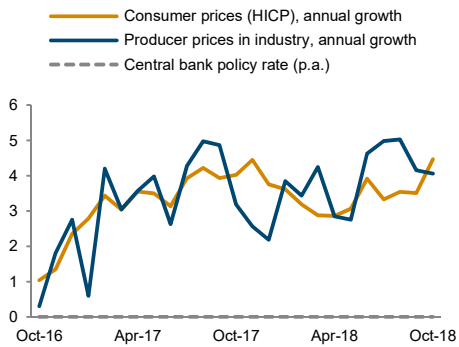
Real sector development
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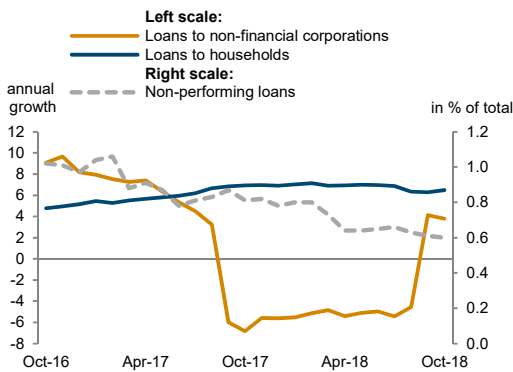
Unit labour costs in industry
annual growth rate in %



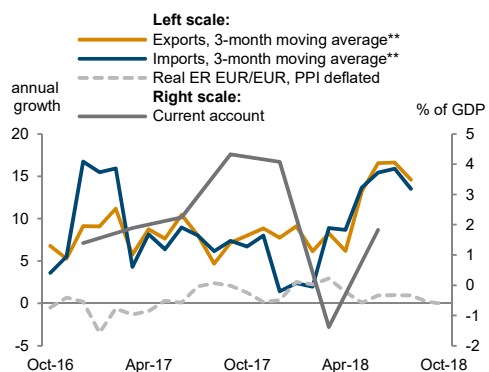
Inflation and policy rate
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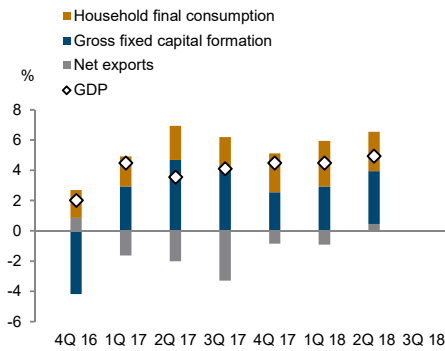
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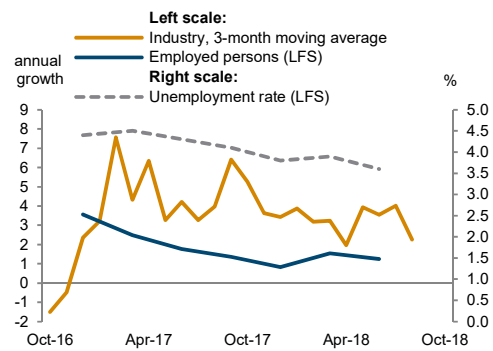
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Hungary

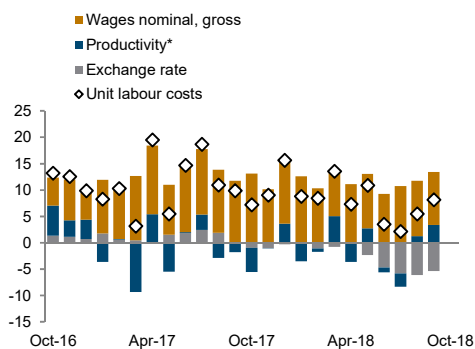
Real GDP growth and contributions
year-on-year



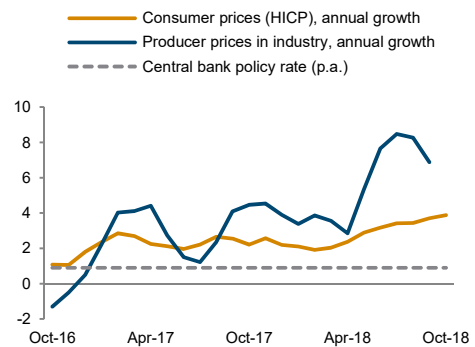
Real sector development
in %



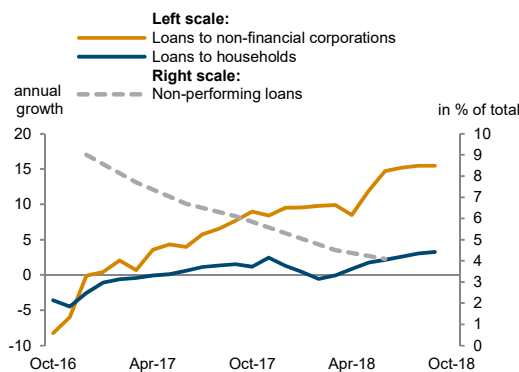
Unit labour costs in industry
annual growth rate in %



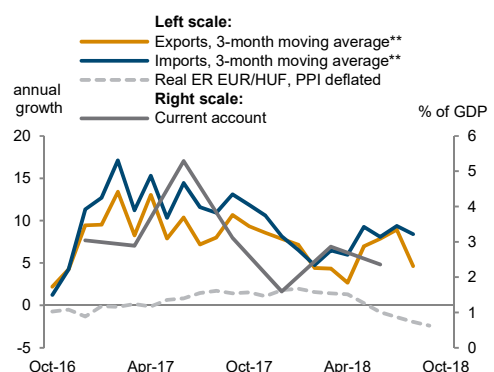
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

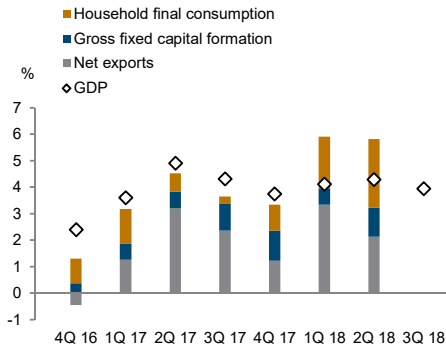
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

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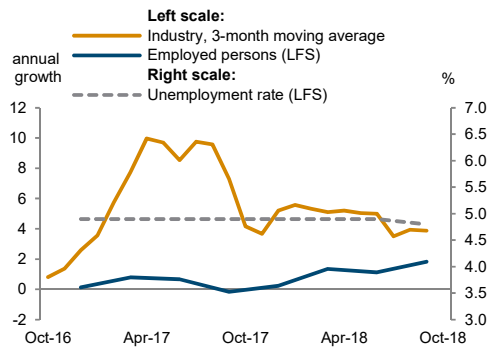
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Kazakhstan

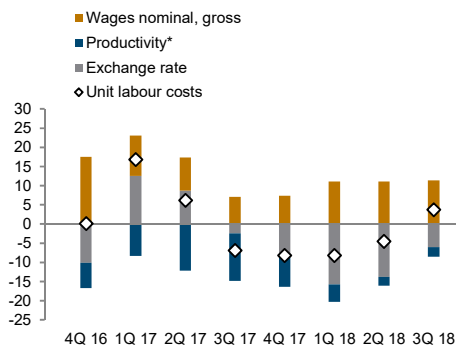
Real GDP growth and contributions
year-on-year



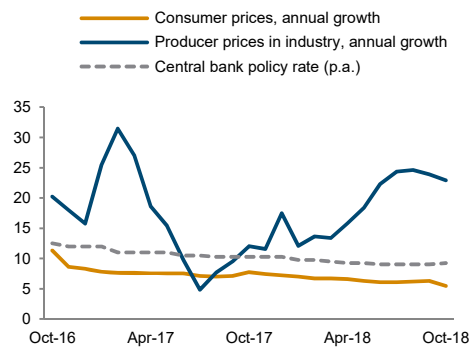
Real sector development
in %



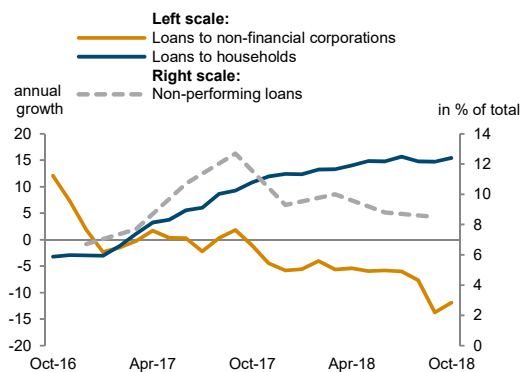
Unit labour costs in industry
annual growth rate in %



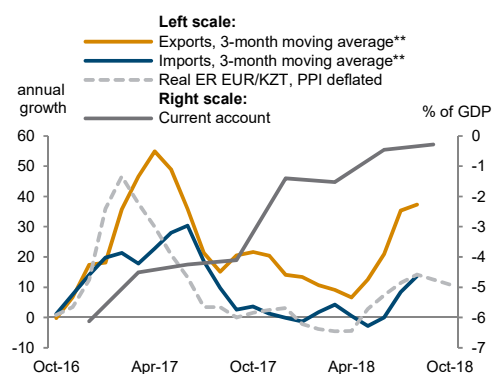
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



*Positive values of the productivity component on the graph reflect decline in productivity and vice versa.
**EUR based.

Source: wiiw Monthly Database incorporating Eurostat and national statistics.

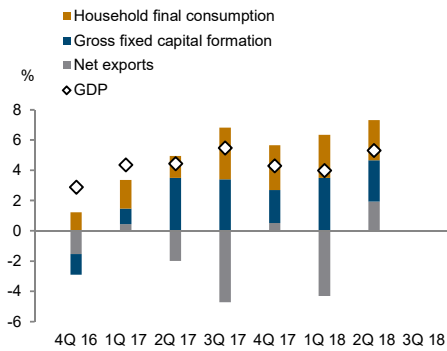
Baseline data, country-specific definitions and methodological breaks in time series are available under:

<https://data.wiiw.ac.at/monthly-database.html>

Latvia

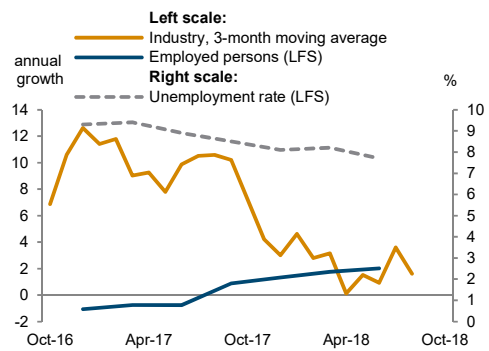
Real GDP growth and contributions

year-on-year



Real sector development

in %



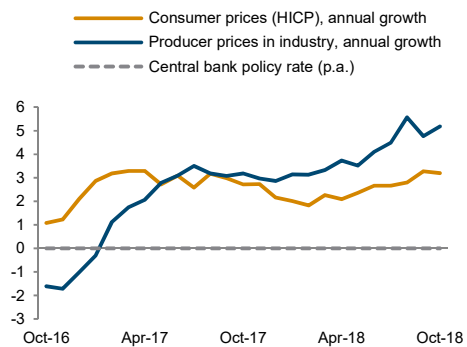
Unit labour costs in industry

annual growth rate in %



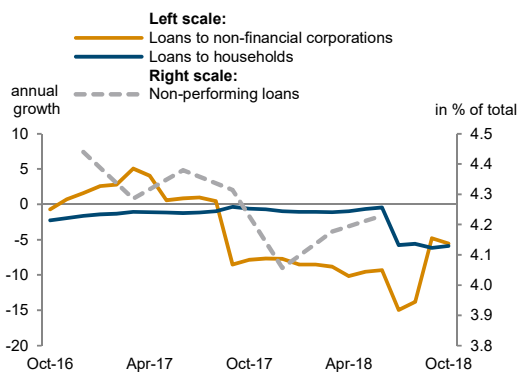
Inflation and policy rate

in %



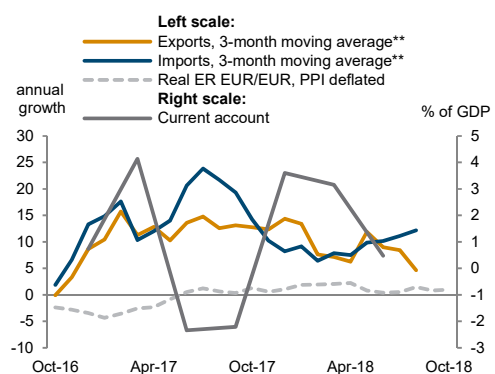
Financial indicators

in %



External sector development

in %



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**EUR based.

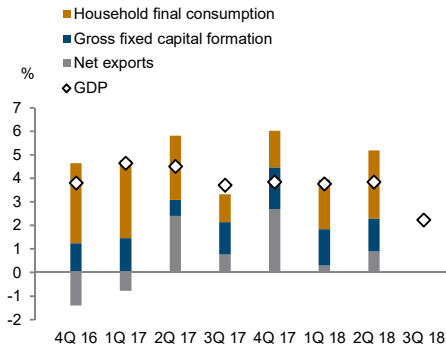
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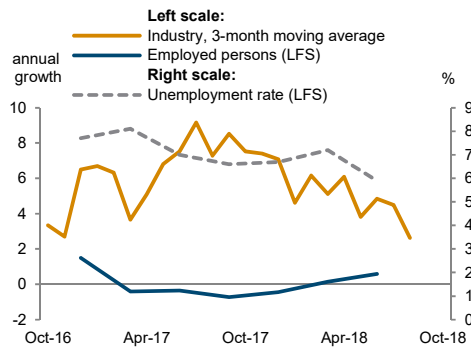
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Lithuania

Real GDP growth and contributions
year-on-year



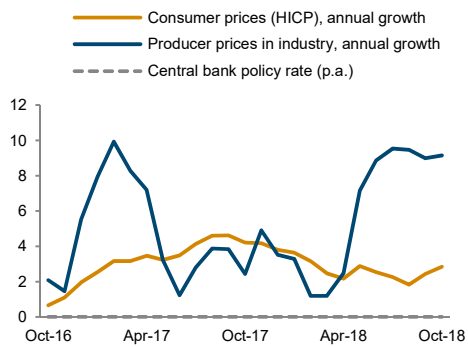
Real sector development
in %



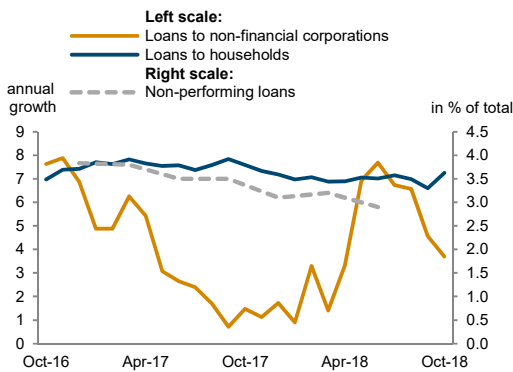
Unit labour costs in industry
annual growth rate in %



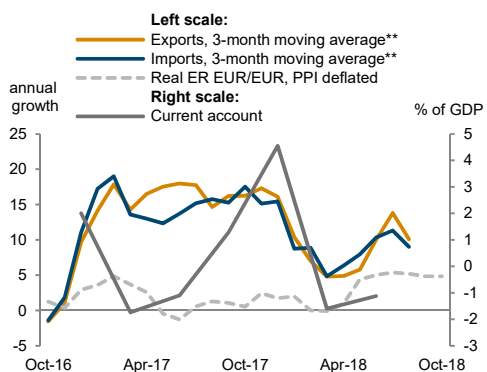
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

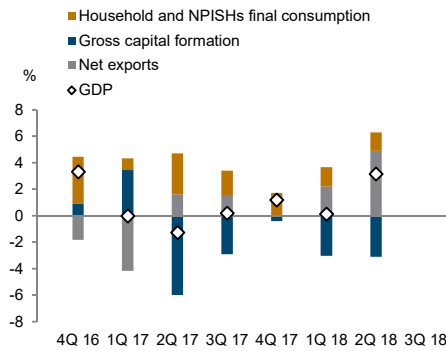
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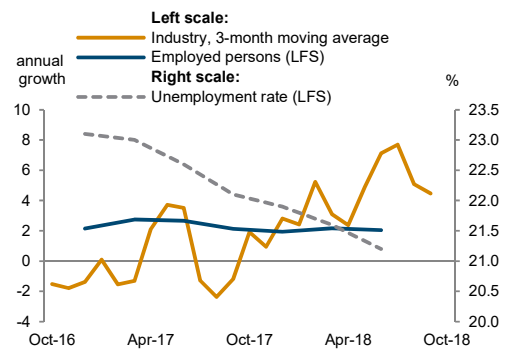
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Macedonia

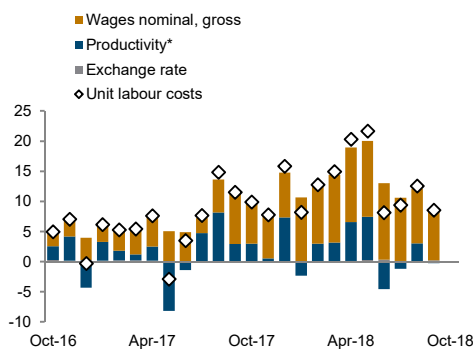
Real GDP growth and contributions
year-on-year



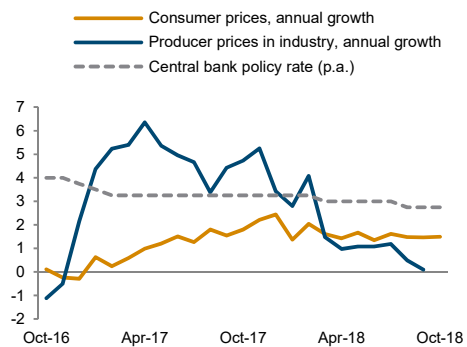
Real sector development
in %



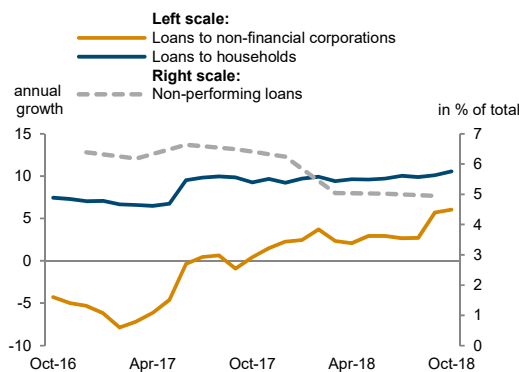
Unit labour costs in industry
annual growth rate in %



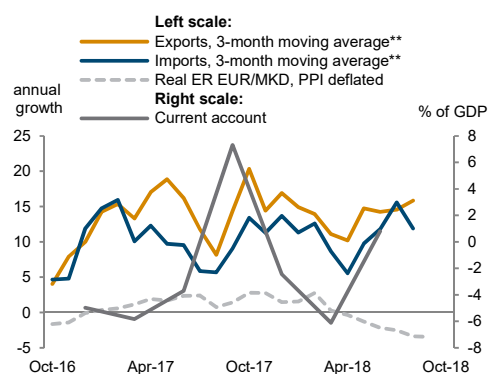
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

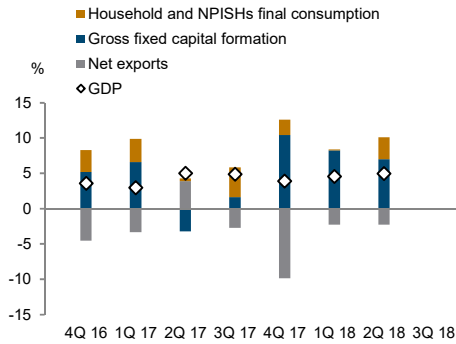
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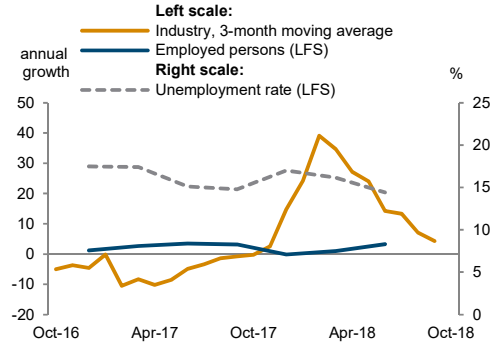
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Montenegro

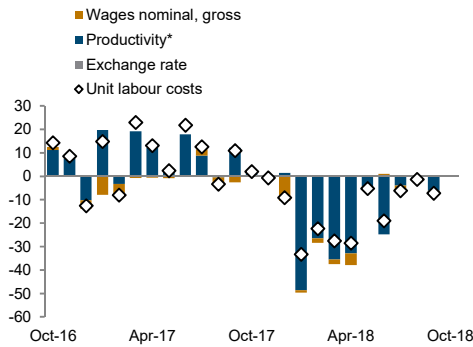
Real GDP growth and contributions
year-on-year



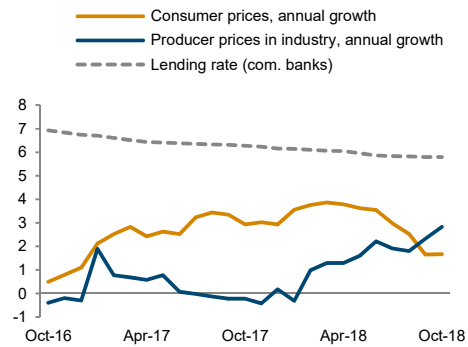
Real sector development
in %



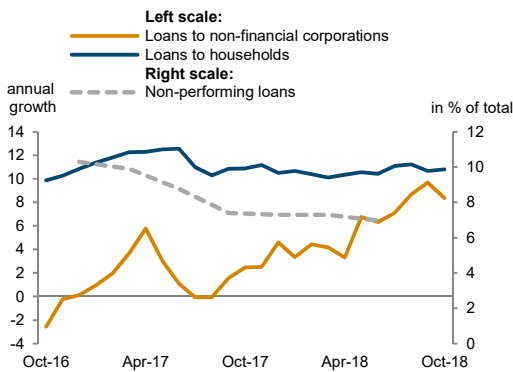
Unit labour costs in industry
annual growth rate in %



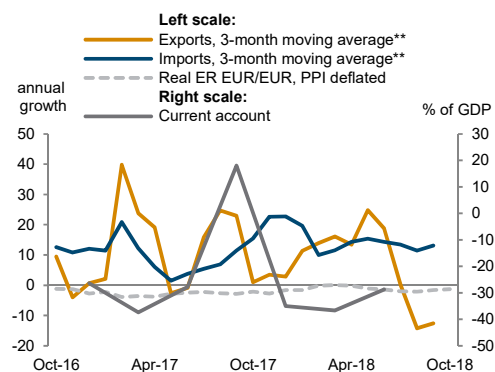
Inflation and lending rate
in %



Financial indicators
in %



External sector development
in %



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 **EUR based.

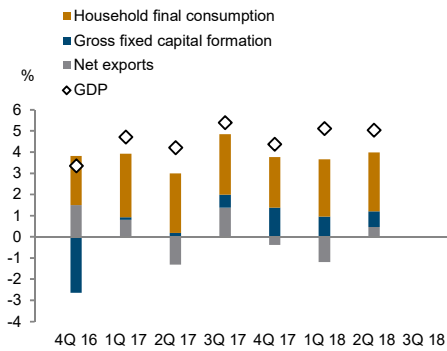
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

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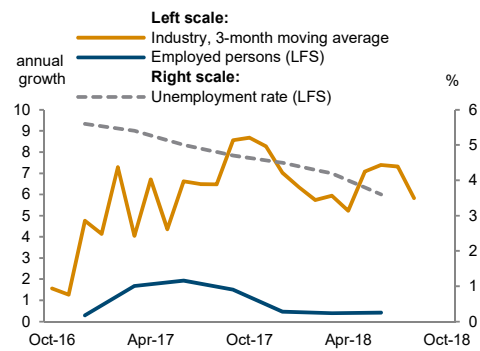
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Poland

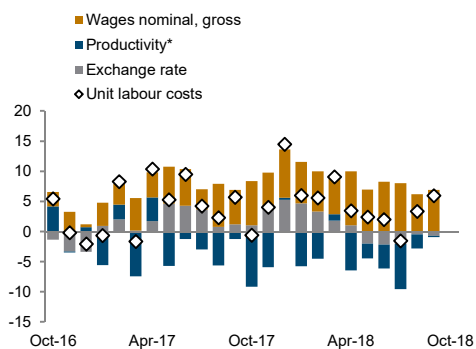
Real GDP growth and contributions
year-on-year



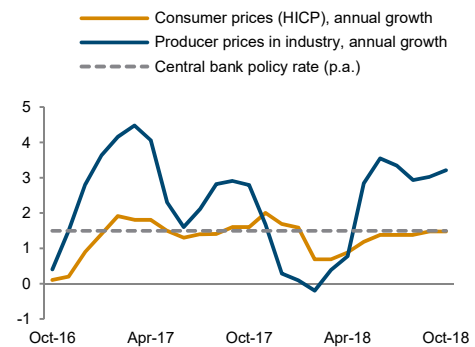
Real sector development
in %



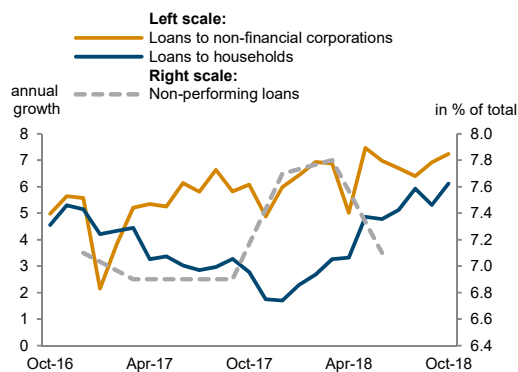
Unit labour costs in industry
annual growth rate in %



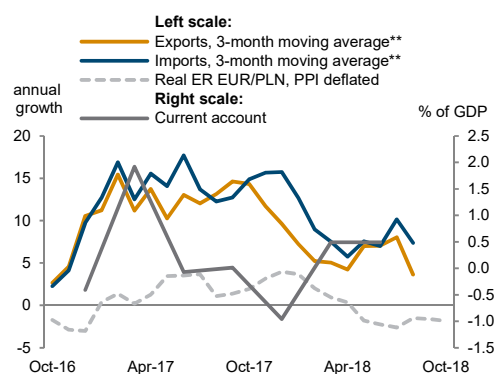
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

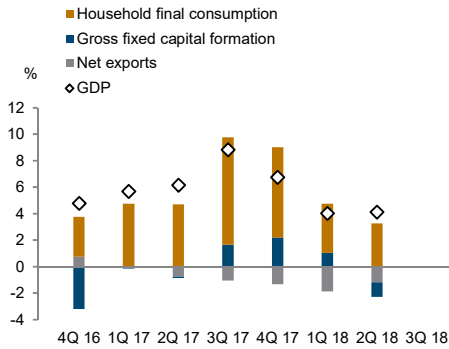
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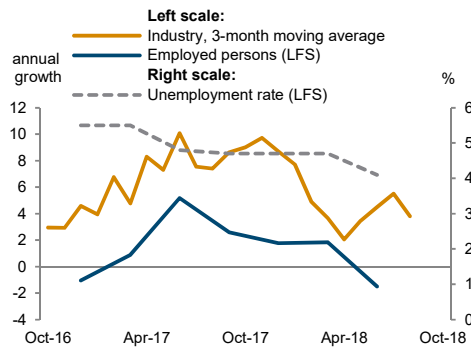
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Romania

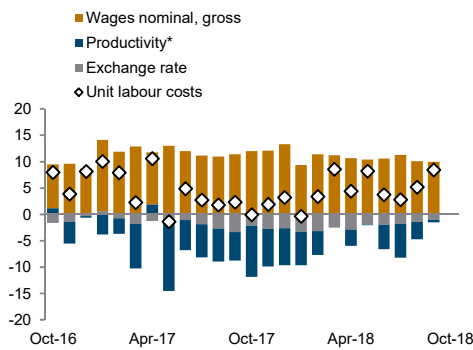
Real GDP growth and contributions
year-on-year



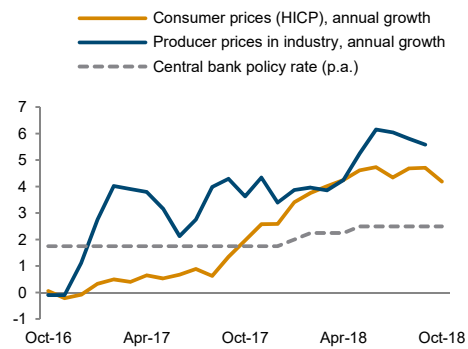
Real sector development
in %



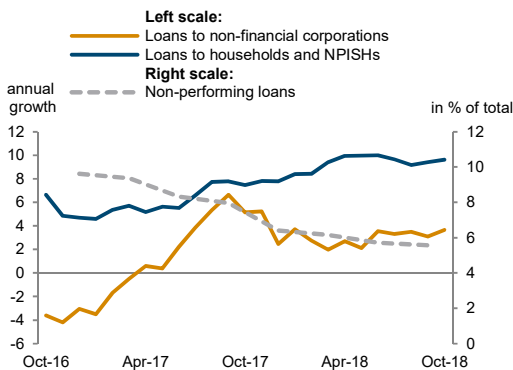
Unit labour costs in industry
annual growth rate in %



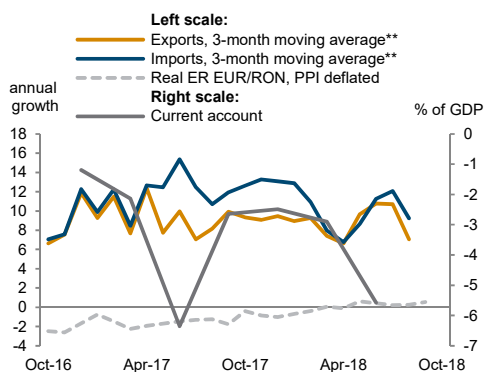
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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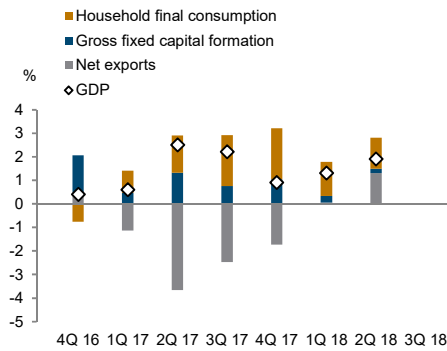
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Baseline data, country-specific definitions and methodological breaks in time series are available under:

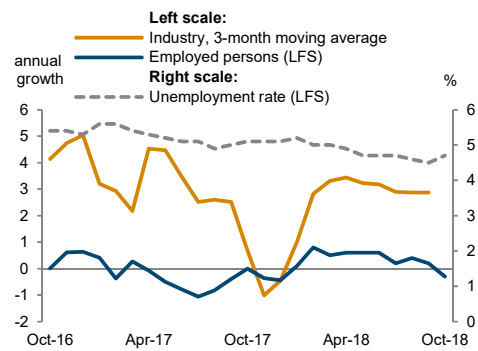
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Russia

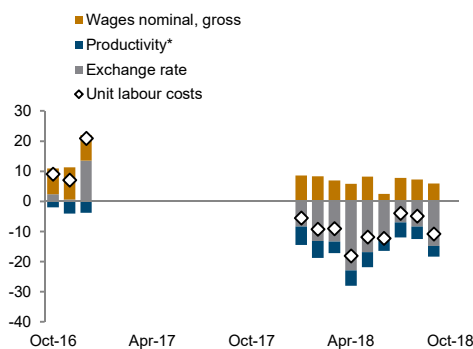
Real GDP growth and contributions
year-on-year



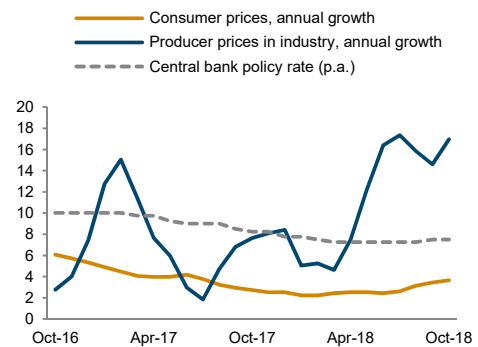
Real sector development
in %



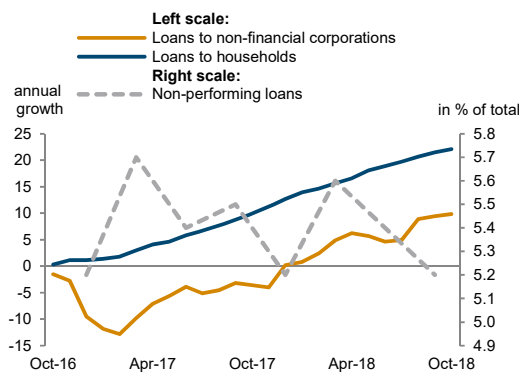
Unit labour costs in industry
annual growth rate in %



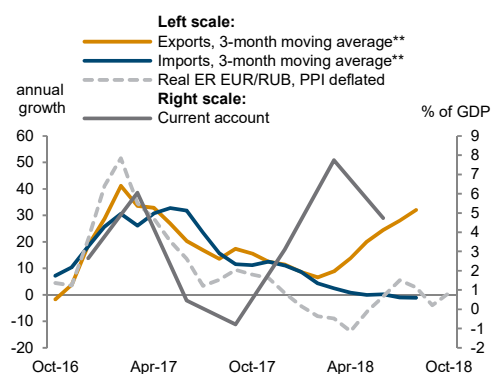
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

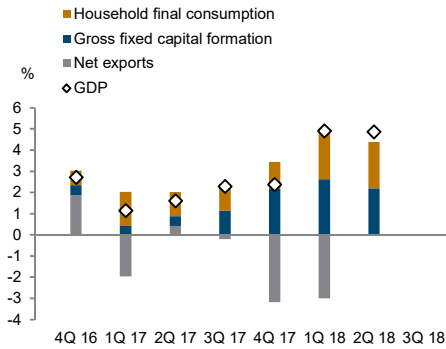
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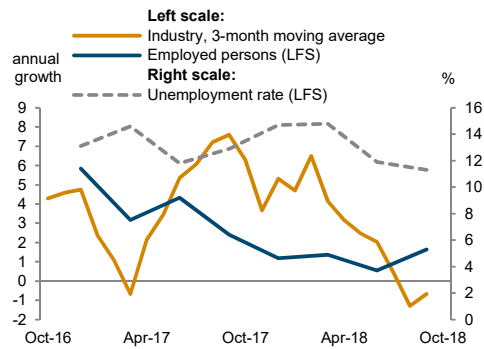
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Serbia

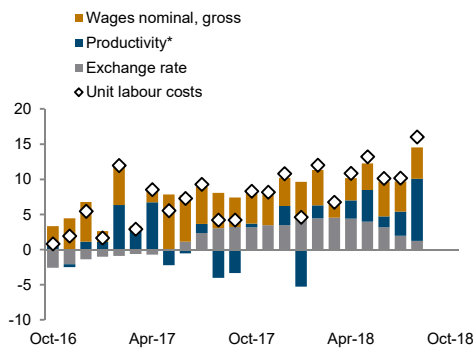
Real GDP growth and contributions
year-on-year



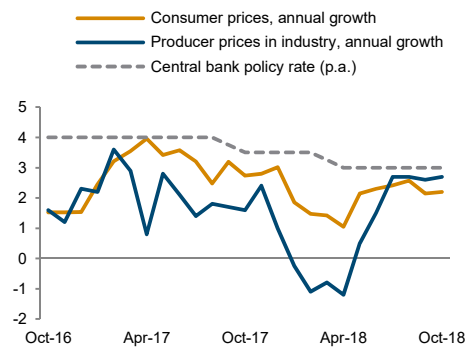
Real sector development
in %



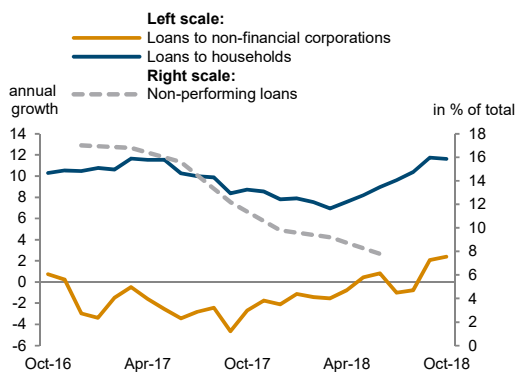
Unit labour costs in industry
annual growth rate in %



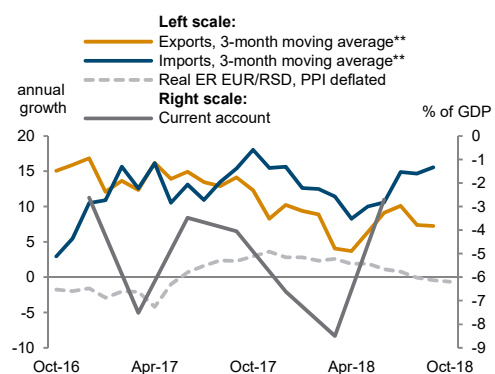
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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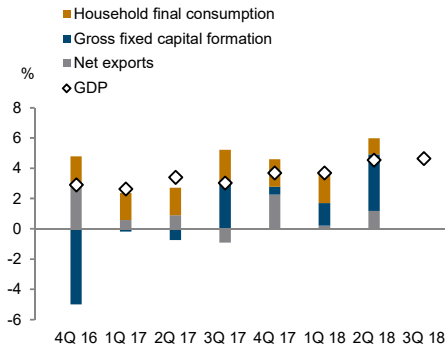
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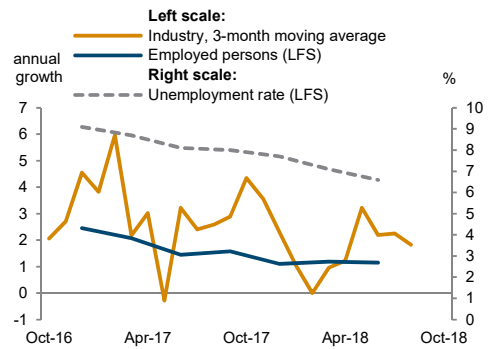
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Slovakia

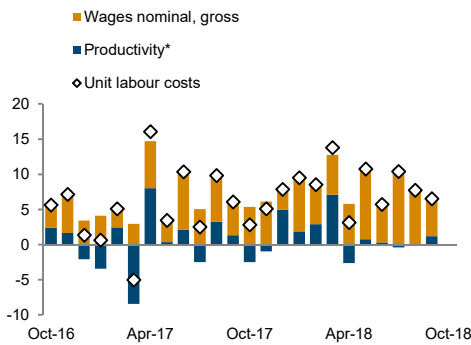
Real GDP growth and contributions
year-on-year



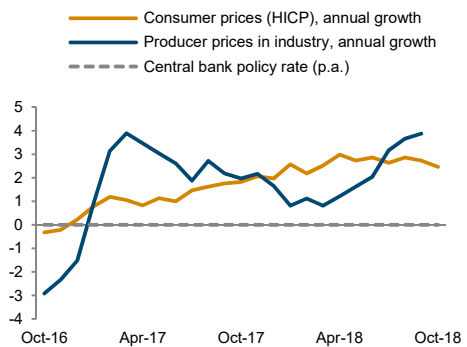
Real sector development
in %



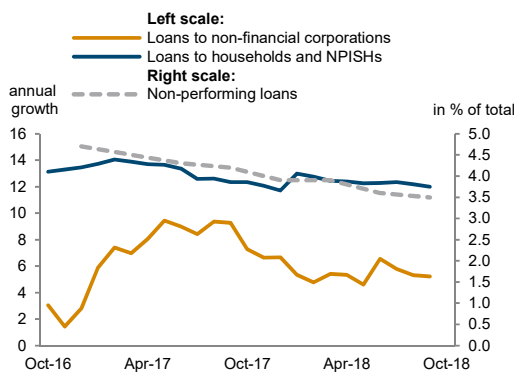
Unit labour costs in industry
annual growth rate in %



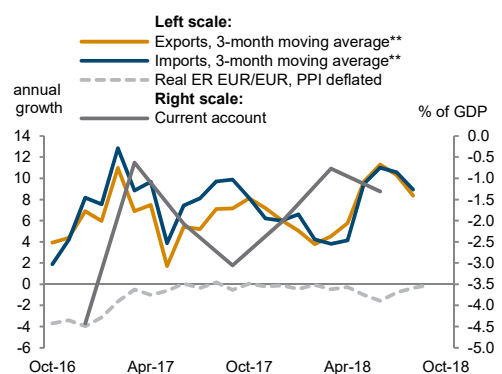
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

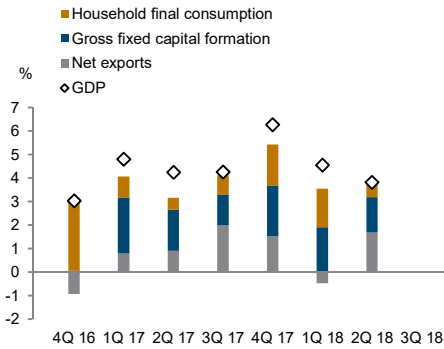
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Baseline data, country-specific definitions and methodological breaks in time series are available under:

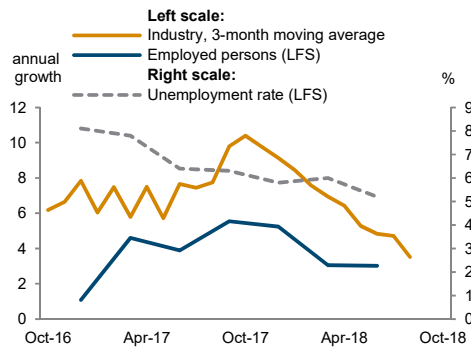
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Slovenia

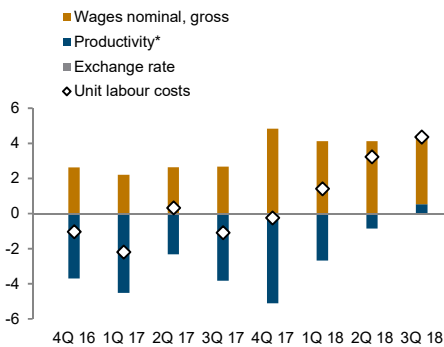
Real GDP growth and contributions
year-on-year



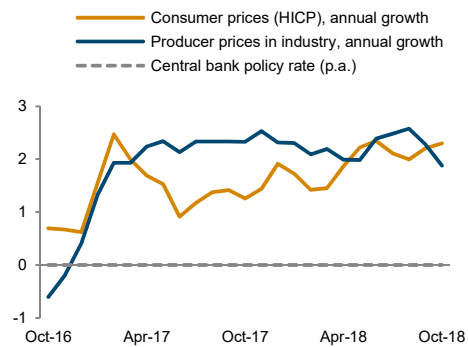
Real sector development
in %



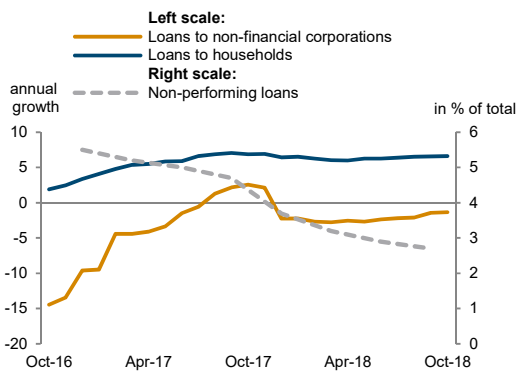
Unit labour costs in industry
annual growth rate in %



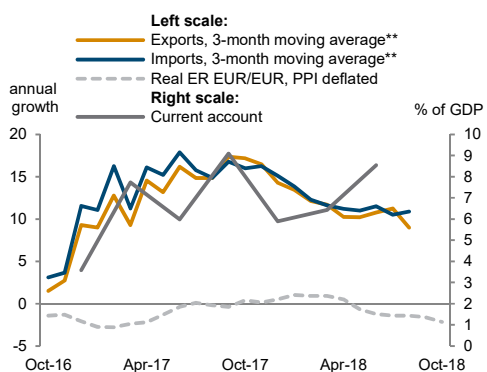
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

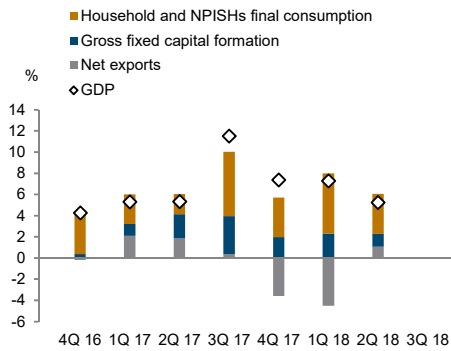
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Baseline data, country-specific definitions and methodological breaks in time series are available under:

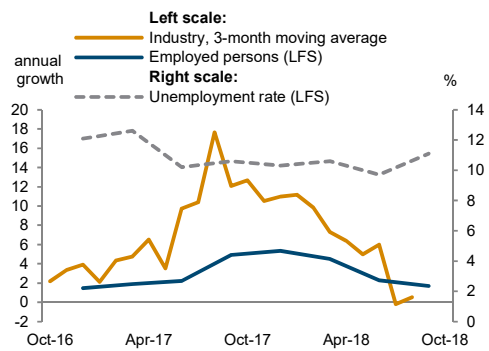
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Turkey

Real GDP growth and contributions
year-on-year



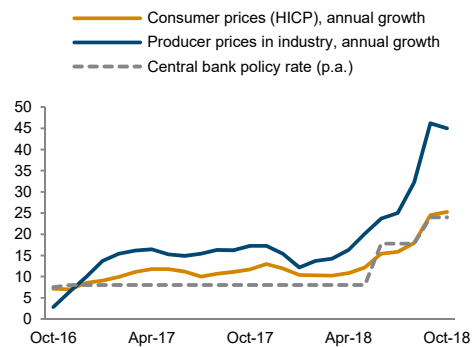
Real sector development
in %



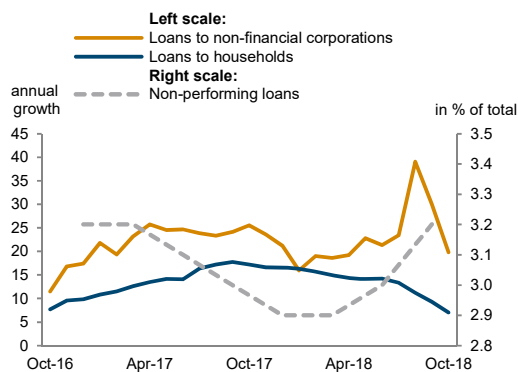
Unit labour costs in industry
annual growth rate in %



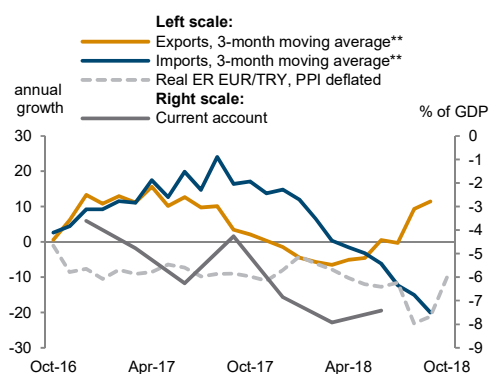
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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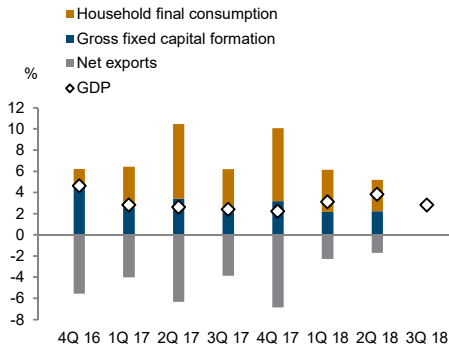
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

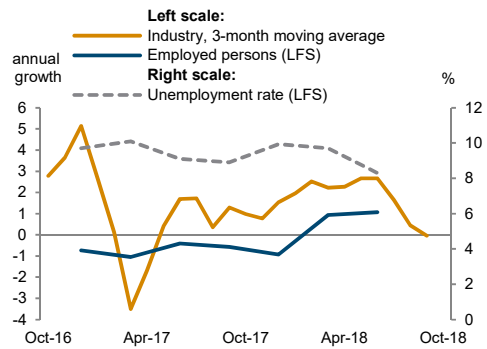
<https://data.wiiw.ac.at/monthly-database.html>

Ukraine

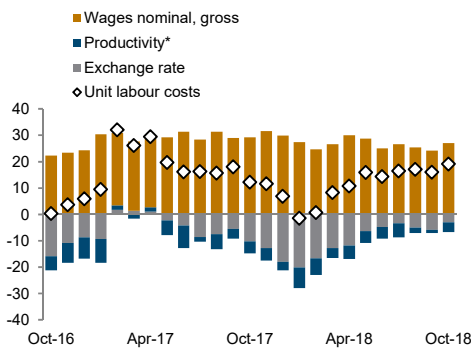
Real GDP growth and contributions
year-on-year



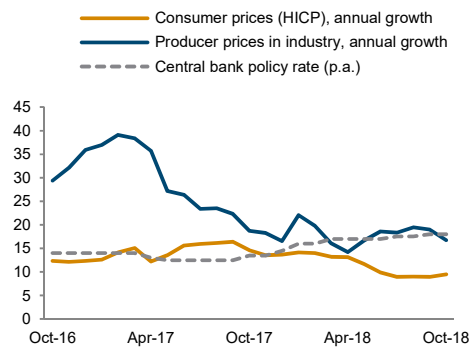
Real sector development
in %



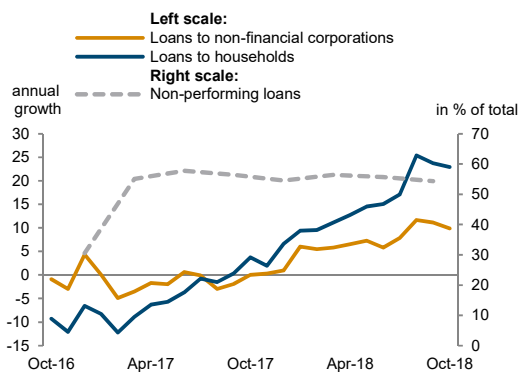
Unit labour costs in industry
annual growth rate in %



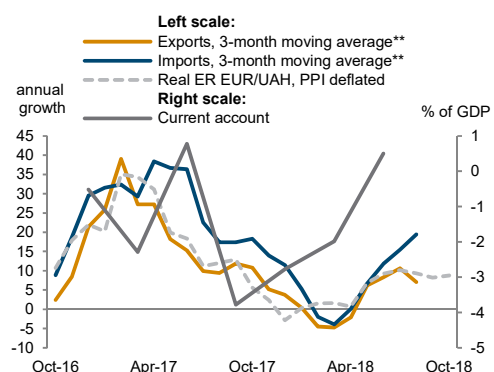
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



*Positive values of the productivity component on the graph reflect decline in productivity and vice versa.

**EUR based.

Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

<https://data.wiiw.ac.at/monthly-database.html>

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