IMF-BoS High-Level Seminar on Reinvigorating Credit Growth in Central, Eastern, and Southern European Economies
25−26 September, 2014

Opening Remarks

Boštjan Jazbec
Governor, Banka Slovenije

It is a great pleasure to welcome you all to the high-level seminar on reinvigorating credit growth in Central, Eastern, and South European Economies organized jointly by the Bank of Slovenia and International Monetary Fund. It is indeed a great honour to have a very distinguished gathering of central bank governors and vice governors, senior officials of other international financial institutions, former public officials and leading academics to discuss a very critical issue that occupies the minds of policymakers in the region and elsewhere.

The objectives of the seminar are to learn about the diverse experiences of different countries in the region and to exchange views on the policy challenges and possible responses. The appropriate policy responses necessarily are country-specific and must take into account the heterogeneity within the various sectors of the economy and the role of idiosyncratic and institutional factors. Still, important lessons can be drawn from cross-country comparisons.

The presentations and discussion in the seminar will focus on four main themes: (1) repairing balance sheets in the financial system and the corporate and household sectors; (2) the role of foreign banks in fostering credit growth; (3) best practices for reviving credit markets and the pitfalls; and (4) risks of a new financial crisis. I will now briefly touch on these themes in general terms.

How the situation has changed! Not that long ago, policymakers in Central and Eastern Europe were concerned about the issue of rapid credit growth. A key question then was whether rapid credit growth should be seen as an endless boom or as an early warning.

As we all know very well, the boom turned to bust abruptly in 2008. The turmoil in international financial markets and the consequent collapse in output in major developed economies also adversely impacted the countries in central, eastern and southern Europe in varying degrees through a combination of the trade, financial and domestic demand channels.

A fallout of the global financial crisis was balance sheet recession in the region. The rapid credit growth during the pre-crisis boom period was grounded in excessive borrowing and risk taking by banks and enterprises. Banks relied heavily on external wholesale funding and the rapid credit expansion took place against very limited equity capital in the corporate sector. The global financial crisis exposed these balance sheet vulnerabilities. The onset of the crisis caused a sudden stop in external financing, and countries in the region were caught in a vicious cycle of reduced credit availability, deleveraging, rising non-performing loans, and a cutback in corporate investment and output.

Much of the region is still suffering from the fallout of the global crisis. In a large number of countries, economic recovery remains feeble and bank credit is still contracting. For these set of countries, reviving credit growth is considered essential to achieving a strong and durable output expansion. However, the task is complex.

Boosting credit growth without addressing the large sectoral and aggregate imbalances in the economy that had built up during the credit boom years can be risky. Matters may become worse if additional credit availability enables enterprises to postpone balance sheet adjustment. In the wake of a balance sheet recession, the allocation of credit matters more than its aggregate amount. It is important that good borrowers rather than the bad ones are the main beneficiaries of credit growth.

It is not surprising that much of the CESEE region is experiencing a slow so-called credit-less recovery. Balance sheet recessions are typically not very responsive to traditional demand management measures. This is because the monetary policy transmission channel is impaired by the weak balance sheets of banks and the corporate sector. As long as asset quality is poor and capital is inadequate, banks will tend to restrict overall credit supply. Liquidity may not be a binding constraint in such a situation. As has been argued by some analysts in the context of an unexpectedly low take up in the recent first auction of liquidity under the ECB's TLTRO programme, the profitability of borrowing very cheaply for the central bank to lend to the private sector (especially SMEs) is not guaranteed if non-performing loans are high and banks would need to discount high expected default rates and if lending to SMEs implies high risk weights and, consequently, capital charge.

Credit demand also is weak in a balance sheet recession. Bank lending surveys in the region indicate that credit demand has decreased since the onset of the global crisis. An important factor weighing down credit demand is the corporate debt overhang. The easing of monetary conditions will not necessarily induce higher borrowing while highly indebted companies are focused on deleveraging.

Thus, repairing the balance sheets of both the banking sector and corporate sector is a priority for unlocking credit growth. A complicating factor here is that the maximum possible speed for completing bank restructuring is typically faster than that for corporate restructuring, even if all the enabling legislative and institutional frameworks for the latter are in place. So, the resumption of credit growth may take a while. There also is a worrisome aspect of the different restructuring speeds of the two sectors. Experience shows that, when enterprise restructuring is lagging, non-performing loans continue to accumulate and erode the capital buffer of banks created by their recapitalization, creating a likely need for another round of capital injection.

Revival of credit growth is also difficult because of the tensions between monetary policy considerations and financial stability considerations. The global crisis has demonstrated very clearly the importance of having adequate safeguards in place to prevent unhealthy risk taking and creation of credit bubbles. All central banks in the region are now in the process of putting in place frameworks to strengthen bank supervision, enhance risk management and governance standards, and increase transparency and statistical disclosure. National authorities also are establishing the institutional framework for macroprudential oversight of the financial system. These prudential aspects of the financial policy framework are meant to reduce the amplitude of financial cycles. However, they also are likely to dampen the pace of credit growth.

It also should be recognized that it will not be possible to achieve durable economic growth underpinned by abundant credit in the same manner as that pursued during the pre-crisis boom period. It will be necessary to limit the reliance on debt-financing and shift towards more equity financing. Given the need to ensure fiscal sustainability, recourse to more state funding for restructuring the economy and increasing investment is not a feasible option. An appropriate business environment has to be created for attracting new non-debt capital flows. This will require addressing the institutional and regulatory bottlenecks that currently inhibit investment. In this context, increasing the efficiency of the legislative and judiciary systems would be extremely important.

Not all CESEE countries have been equally hit by the crisis. Indeed, a few countries in the region managed to escape the worst effects of the financial crisis, highlighting the role of country-specific factors. Economic growth and strong credit expansion in these countries have resumed after a brief pause. For them, an important question is whether the momentum can be sustained. Based on the lessons from the crisis, a key priority for these countries should be to prevent a build-up of imbalances that could threaten financial and macroeconomic stability. The main tasks are to identify and implement on a timely basis measures to curb the boom and to build the capacity to cope with a possible bust. An advantage here is that, because of the differences in cyclical position, policy conflict between monetary policy and prudential policy is absent, unlike in the case of countries suffering from balance sheet recession.

Given the integration of CESEE countries in the world financial markets, credit growth in these countries has acquired an international dimension. There is significant presence of foreign-owned banks and external funding is an important source of bank liquidity. While external bank funding for the region has been on a declining trend since the onset of the global crisis and sizeable deleveraging has already occurred, parent bank funding still represents a large share of bank funding in several CESEE countries. Thus, countries in the region are highly vulnerable to changes in the external environment. If parent banks come under pressure to deleverage and build up capital in the period ahead on account of the results of the just concluded euro area asset quality review and stress tests or because of tighter global financial conditions, the liquidity support for credit growth in the daughter banks may not be forthcoming.

I would like to conclude by pointing out that central banks alone cannot succeed in reviving credit growth and economic growth. Putting the economies in the region back on track will require an integrated national policy strategy to restore the health of the financial sector, restructure the corporate sector, reinforce the sustainability of the public finances, improve the flexibility of product and labor markets, and reform the business environment. Because of the complementarity of the measures, coordination between government agencies and other stake holders is essential in policy implementation. Successful and timely policy implementation will require political resolve and social consensus. If there is no determined follow through on policies, the fragile recovery that is underway will come to an end and economic problems will intensify.

*****