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# *Credit Growth and Instability in Balkan Countries: The Role of Foreign Banks*

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***Credit Growth and Instability in Balkan Countries: The Role of Foreign Banks***[1]

**Abstract -** *The present paper seeks to examine the role played by foreign banks in the credit growth in Bosnia and Herzegovina, Croatia and Serbia. Fast credit expansion was the main contributor to economic growth in these countries prior to the financial and economic crisis of 2007-2010. This development is associated with the entry of foreign banks, particularly banks from EU-15 countries. In addition, the Balkan countries faced large capital inflows from parent banks located in old EU member states. It is argued that the rising profit orientation and the increase in the risk proclivity of European banks, which have been the result of the financialisation of the European Union banking sector, was the main driver behind the fast credit growth rates in the Balkan countries. With the outbreak of the recent financial and economic crisis, concerns about the quality of outstanding loans have materialized. The global economic crisis and the increase in bad loans then led to a breakdown of the debt-led growth model in the region.*

[1] The author is grateful to Engelbert Stockhammer for comments.

# 1 Introduction

Countries of Central, Eastern and Southeastern Europe (CESEE) experienced fast credit growth rates in the private sector prior to the financial and economic crisis of 2007-2010. This lending boom was associated with the expansion of foreign banks into the region. Moreover, credit growth was boosted further by capital inflows from parent banks located in old European Union member states. The main driver behind the credit expansion by foreign banks is the rising profit orientation of these banks, accompanied by an increase in their risk proclivity. Structural changes in the EU banking sector build the background for this rising profit orientation of EU banks. These structural changes have occurred since the 1990s and can be summarized under the term *financialisation*.

This article examines the role played by foreign banks in the credit growth in Balkan countries. The three Balkan countries considered here are Bosnia and Herzegovina, Croatia and Serbia. After the entry of foreign banks, these countries have experienced lending booms, particularly in the household sector. A great portion of loans have been denominated in foreign currencies, mainly in euros, and have been partly used for purchases of consumption goods. This in turn led to a growth model, which was based on a rising indebtedness of the private sector.

Banks have been engaged in an expansion of riskier loans during the lending boom. After the crash of the US subprime market, rising concerns about the quality of outstanding loans in the Balkan countries have occurred. As the financial crisis spread to Europe, these concerns have materialized. An increase in the share of bad loans led to a slowdown in bank lending. As a consequence, the debt-led growth model was hit by the financial crisis, leading to a sharp drop in GDP growth rates in Bosnia and Herzegovina, Croatia and Serbia.

The paper is structured as follows. The next section explains the main hypotheses regarding the financialisation of the European Union banking sector and is followed by some theoretical considerations about credit growth in banking systems, which are dominated by foreign-owned banks. The next part of the paper presents some stylized facts about the expansion of EU banks into Bosnia and Herzegovina, Croatia and Serbia, the development of domestic credits and cross-border banking inflows and financial and macroeconomic stability. Finally, the main results are summarized in a concluding section.

## 2 The background: Financialisation of the EU banking sector

The term *financialisation* lacks a unique definition and is usually used to describe a lot of phenomena. It is, for example, associated with the deregulation of financial markets and the liberalization of international capital flows. It has also been used to explain the shareholder value orientation of non-financial business or the rise in investment in financial assets by non-financial firms. The shift from bank-based to market-based financial systems is a further example, which has been mentioned in the financialisation literature.[2]

In this paper financialisation will be narrowly defined, as it refers only to the structural changes in the European Union banking sector. There has been recent literature discussing the financialisation of the banking sector of advanced capitalist countries (Erturk & Solari 2007; dos Santos 2009; Lapavitsas 2009b). Mainly two points have been mentioned. First, as large enterprises have relied increasingly on direct borrowing in open markets, the banking sector has been looking out for new profit sources. As a consequence, commercial banks shifted their lending to private households. Second, commercial banks in advanced capitalist countries adopted investment banking practices and now generate a remarkable part of their profits by non-interest income. While the spread between lending and borrowing rates has been the main source of profits for these banks in the past, they now offer their customers, particularly private households, a lot of other financial services products, like insurance, savings or pension plans.

The present article aims at highlighting two other aspects of financialisation, which are important for the banking sectors in European Union member states. One of these aspects has been the rise of Mergers and Acquisitions (M&A) in the European Union banking sector since the 1990s, which led to an increase in balance sheets of major European banks. A further consequence of the wave of M&As has been a weakening of competition, as the number of credit institutions in the EU-15 decreased from 9,077 in 1997 (ECB 2010: 23) to 7,102 in 2008 (ECB 2003: 3). Proponents of such M&As in the banking sector highlight economies of scale as a major factor behind this development. However, such economies of scale may disappear when a bank gets too big, measured in terms of its assets (Dymski 1999: 16). Nevertheless, financialisation in the Euro Area banking sector is also evident, as total banking assets have been rising in relation to GDP during the period 1997-2008 (RMF 2010: 38).

[2] Erturk et al. (2008) offer a summary of some key texts to financialisation; Erturk and Solari (2007), dos Santos (2009) and Lapavitsas (2009b) discuss changes in the banking sector; Schaberg (1999) examines the shift from bank-based to market-based financial systems.

A further point, which is also the most important one for this paper, is the aggressive expansion of banks from the EU-15 to the new EU member and candidate countries. Privatisation and liberalisation policies in the transition countries of Central, Eastern and Southeastern Europe enabled the entry of foreign banks, which have been looking out for new profitable markets. The expansion of foreign banks into the region have been mainly promoted by the World Bank and the International Monetary Fund, which see the presence of foreign banks as a source of stability for the financial sector in these countries (Stein 2010: 260-261).

# 3 Foreign-owned banks and credit expansion

The banking system in some European Union member countries, like Germany or Austria, was characterized by a large number of regional banks, savings institutions or state-owned development banks in the past, where banks were not exclusively profit-oriented. In these countries, banks were also engaged in achieving common goals, like regional development or industrial promotion. However, the banking system in Austria, for example, has undergone significant structural changes since the 1990s. Prior to the integration in the European Union, state-owned banks in Austria have been privatized and savings institutions changed their legal form and act now as stock companies (Stockhammer 2010b). In addition, there has been an increase in M&A activity in the Austrian banking sector. These structural changes led to a rising profit orientation of Austrian banks. As the countries of Central, Eastern and Southeastern Europe offered banks the opportunity of high profits, Austrian banks expanded into the region. The high profitability in the banking sectors in CESEE countries attracted also banks from Germany, Italy or France to enter the region. As a result, banks from the EU-15 countries are now major players in the CESEE region, holding up to 90% of total banking assets in many countries.

With the presence of foreign banks, credits to the private sector in CESEE countries began to increase significantly. The main driver behind the fast credit growth has probably been the higher profitability in the region than in the EU-15. A high gap between interest on loans and interest on deposits, which significantly exceeds that in the old EU member countries, may have fuelled credit growth in Central, Eastern and Southeastern Europe. Fast credit growth rates could also be pushed by profit-based payment schemes for bank managers. Top managers of foreign owned banks are in many cases expatriate professionals from the parent bank's home country, who work on a limited term and receive parts of their remuneration from bonus payments. Due to the high profitability, a high volume of lending boosts profits, which in turn determine the size of the bonus payments. Thus, the managers of foreign-owned banks could be interested in fast credit expansion in order to boost their own income (Mihaljek 2008: 26). Moreover, the balance sheet structure of an individual bank is not only the result of its own management's decision, it is also dependent on the balance sheet structure of other banks in the banking system (Alves et al. 2008). Therefore, if one bank increases its assets by expanding loans, other banks may follow, and the result may be an overall acceleration of credit growth in a country.

Furthermore, a high interest gap between the CESEE countries and the EU member countries, may lead to capital flows from parent banks located in the EU-15 to their subsidiaries in CESEE countries in order to gain profits by expanding credits. Such capital inflows could also be the result of direct borrowing from abroad by non financial companies. As a consequence, the credit expansion in Central, Eastern and Southeastern Europe will be further boosted by these capital inflows.

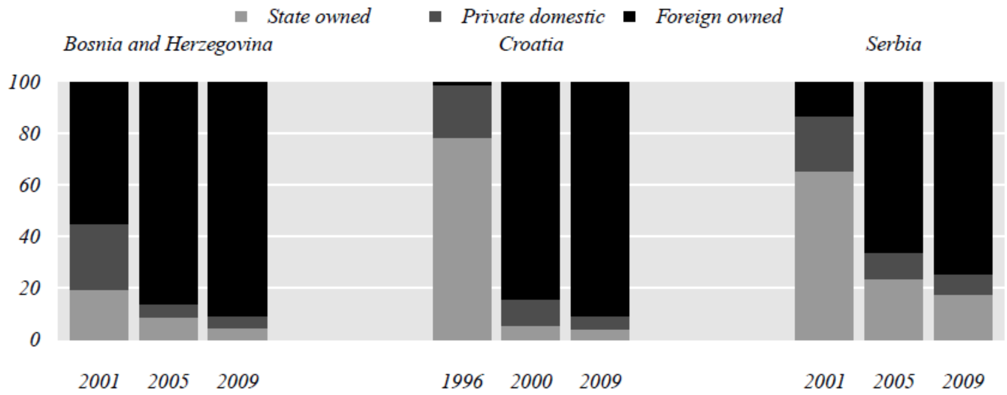
The profit-based credit expansion may be accompanied by an increase in the risk proclivity of the considered banks. Foreign banks, which expanded into the CESEE region, are generally part of major European banking companies, which present an important part in financial intermediation in their home countries. Therefore, the incentive to expand risky loans could rise due to the anticipation that governments would support these banks if they get in trouble (Eichengreen 2003: 42). Moreover, the fast credit expansion may lead to an inability of banks to appropriately asses the build-up in credit risk. Due to a lack of regular contact and personal relations with their borrowers, foreign banks rely heavily on statistical methods to evaluate the credit risk of their costumers. Credits are therefore based on numerical information and are granted if an individual exceeds a threshold (Lapavitsas 2009b: 138-139). As these statistical methods have been designed for risk evaluation in major capitalist markets, they may be inappropriate for emerging and transition countries (Mihaljek 2008: 25). As a result, fast credit expansion may lead to an increase in risky loans and eventually threaten financial and economic stability.

# 4 Stylized Facts

## Expansion of EU banks into the Balkans

Like in other countries of Central, Eastern and Southeastern Europe, the transition process in the successor countries of the former SFR Yugoslavia has been characterized by liberalisation and privatisation policies, which attracted foreign banks to expand into the region. Figure 1 shows the development of the ownership of the banking system in Bosnia and Herzegovina, Croatia and Serbia.

***Figure 1: Ownership structure of the banking sector in percent***




*Source: CBBH (2009, 2010a), BARS (2003), BAFBH (2003), CNB (Banking sector, Standard presentation format), NBS (2002, 2006, 2010).*
*Notes: For Bosnia and Herzegovina the ownership structure in 2001 is related to shareholders' capital. For the calculation of the ownership structure the relevant sectors in the Federation of Bosnia and Herzegovina and the Republika Srpska were summarized and divided by the sum of total shareholders' capital in the two entities.*

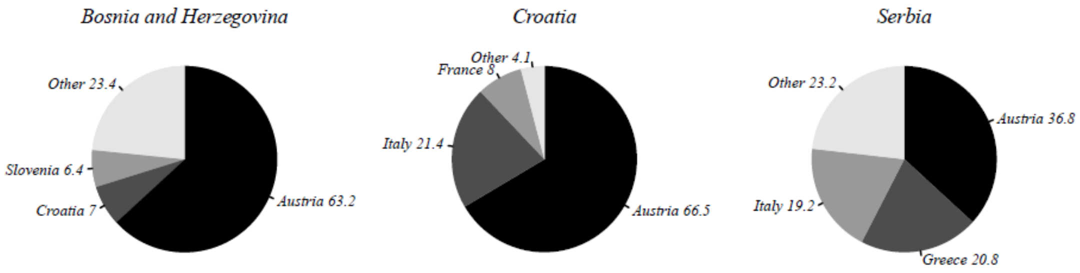
The privatisation policies in the banking sector in Bosnia and Herzegovina set in at the end of the 1990s. The share of state-owned banks in shareholders' capital declined to 20% until 2001. On the other side, the share of foreign banks rose to 55%. In contrast to 2001, the ownership structure for Bosnia and Herzegovina in figure 1 for the years 2005 and 2009 is related to the assets of the banking sector. Until 2005 foreign banks have purchased the major part of the banking system in Bosnia and Herzegovina and at the end of 2009 they held 90.8% of total assets, while state-owned banks accounted for only 4.7%.

The transition process in Croatia started earlier than in Bosnia and Herzegovina. In 1996 the Croatian state owned nearly 80% of total assets of the banking sector, while foreign banks accounted for only 1%. In the period 1998-1999, Croatia suffered from a banking crisis, and as the economy was on the road to recovery, major privatisations to foreigners have been executed (Kraft 2004: 156). As a result, 84% of the assets of the banking sector in Croatia were already foreign-owned in 2000. Foreign banks expanded their ownership further to almost 91% until the end of 2009. On the other side, the state held a modest share of 4.2% at the end of 2009.

The entry of foreign banks in Serbia set in later than in Bosnia and Herzegovina and Croatia. While more than 65% of the banking sector was owned by the state in 2001, foreign banks accounted for some 13%. However, the latter expanded their share to 66% until the end of 2005. Further purchases of Serbian banks by foreigners led to a 74% foreign-owned share of the banking sector in Serbia at the end of 2009. In the same year the state held a 17% share in the banking sector, which was much higher than the state-owned shares in the banking sectors of Bosnia and Herzegovina and Croatia. On the other side, the dominance of foreign banks in Serbia is lower than in the other two countries.

Figure 2 shows the ownership of foreign-owned banks by countries. While the shares in the ownership for Bosnia and Herzegovina are based on shareholders' capital of foreign-owned banks, for Croatia and Serbia they are related to total assets of foreign-owned banks. As can be seen, Austrian[3] banks account for the highest share in foreign-owned banks, with a figure of 63.2% and 66.5% in Bosnia and Herzegovina and Croatia, respectively. In Serbia, Austrian banks account for almost 37%, and are followed by Greek and Italian banks, with a share of 20.8% and 19.2%, respectively. Italian banks hold also a remarkable share of 21.4% of foreign-owned banks' assets in Croatia.

***Figure 2: Ownership of foreign-owned banks by country in percent, end of 2009***




*Source: CBBH (2010a), CNB (2010), NBS (Ownership structure and financial reports).*
*Notes: The ownership structure for Bosnia and Herzegovina is based on shareholders' capital, for Croatia and Serbia on assets of the banking sector. The ownership structure for Serbia relates to 30th June 2010, and was calculated on the basis of individual bank data, which were obtained from the homepage of the NBS.*

[3] The former Austrian *Bank Austria Creditanstalt* is a member of the Italian *Unicredit Group* since 2005. As the Bank Austria still control their subsidiaries in the CESEE region, they are reported here as Austrian banks.

As can be seen from figure 2, foreign-owned banks in the Balkan countries are highly concentrated by countries, with Austria having the leadership, followed by Italy. In addition, the ownership of banking assets is also very high by the number of banks. For example, the five largest banks owned more than 59% of the banking sector's assets in Bosnia and Herzegovina in 2009, while the largest 10 accounted for almost 80% (CBBH 2010a: 79). The ownership concentration in Croatia is even higher than in Bosnia and Herzegovina. In 2009 the largest 6 banks accounted for 82.7% of total assets of the Croatian banking sector (CNB 2010: 64). In comparison to Bosnia and Herzegovina and Croatia, the concentration in Serbia is lower, where the largest 5 banks own some 46% of the banking sector's assets (NBS 2010: 74).

The high profitability potential in the Balkan countries may have been a driving force behind the expansion of banks from old EU member countries into the region. Kraft (2004), for example, examines the reasons for foreign bank entry in Croatia, and concludes that high interest margins have been an important factor. However, he argues that other pull factors, like the search for new clients or the potential of lending to households, has been more important than high interest margins for keeping foreign banks in Croatia. Table 1 shows some measures of profitability in the banking sector for the three Balkan countries compared to some European Union member countries.

As can be seen, for most of the years Return on Assets (ROA) has been significantly higher in Croatia and Serbia than in those EU member countries, whose banks are most engaged in the Balkans. ROA in Bosnia and Herzegovina was also on a high level prior to 2008, but experienced a sharp drop after the outbreak of the recent financial and economic crisis. However, regarding Return on Equity (ROE) as another profitability measure, no clear differences are obvious between the Balkan and the EU member countries. Only Croatia shows Levels of ROE, which in some years were higher than in the reference countries of the European Union. It is also worth to mention that due to differences in national accounting, taxation, and supervisory regimes, ROA and ROE are not strictly comparable across countries.

***Table 1: Return on Assets (ROA) and Return on Equity (ROE) in the banking sector in percent, 2000-2009***

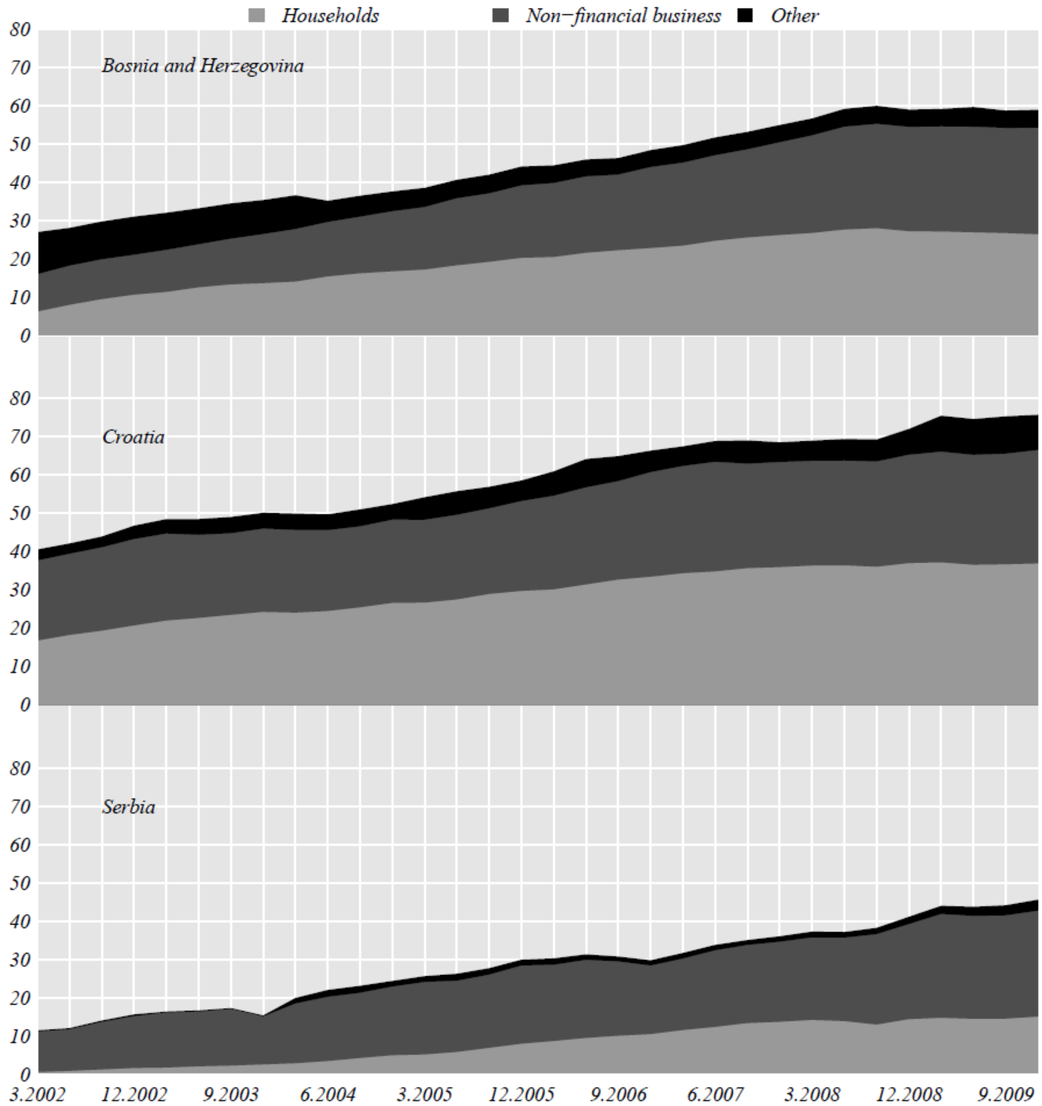
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|---|---|
| *Bosnia and Herzegovina* | | | | | | | | | | |
| *ROA* | -1.8 | -1.1 | -0.3 | 0.4 | 0.7 | 0.7 | 0.9 | 0.9 | 0.4 | 0.1 |
| *ROE* | -7.0 | -4.8 | -2.0 | 3.4 | 5.8 | 6.2 | 8.4 | 8.9 | 4.3 | 0.8 |
| *Croatia* | | | | | | | | | | |
| *ROA* | 1.3 | 0.9 | 1.6 | 1.6 | 1.7 | 1.6 | 1.5 | 1.6 | 1.6 | 1.1 |
| *ROE* | 10.4 | 6.6 | 13.7 | 14.5 | 16.1 | 15.1 | 12.4 | 10.9 | 9.9 | 6.4 |
| *Serbia* | | | | | | | | | | |
| *ROA* | - | - | -8.4 | -0.3 | -1.1 | 1.1 | 1.7 | 1.7 | 2.1 | 1.0 |
| *ROE* | - | - | -60.6 | -1.2 | -5.4 | 6.6 | 9.7 | 8.5 | 9.3 | 4.6 |
| *Austria* | | | | | | | | | | |
| *ROA* | 0.8 | 0.5 | 0.2 | 0.3 | 0.6 | 0.6 | 0.7 | 0.8 | 0.1 | 0.1 |
| *ROE* | 9.4 | 9.8 | 5.2 | 7.0 | 14.8 | 16.8 | 14.9 | 17.0 | 2.6 | 1.5 |
| *Italy* | | | | | | | | | | |
| *ROA* | 0.8 | 0.6 | 0.5 | 0.5 | 0.6 | 0.7 | 0.8 | 0.7 | 0.3 | 0.2 |
| *ROE* | 11.2 | 8.6 | 7.1 | 7.4 | 9.3 | 9.7 | 14.3 | 12.8 | 4.5 | 3.6 |
| *Germany* | | | | | | | | | | |
| *ROA* | 0.2 | 0.2 | 0.1 | 0.0 | 0.1 | 0.4 | 0.4 | 0.3 | -0.3 | - |
| *ROE* | 6.1 | 4.6 | 2.9 | 0.7 | 4.2 | 13.0 | 9.4 | 6.6 | -7.7 | - |
| *France* | | | | | | | | | | |
| *ROA* | 0.5 | 0.5 | 0.5 | 0.4 | 0.5 | 0.6 | 0.6 | 0.4 | 0.0 | 0.4 |
| *ROE* | 9.7 | 9.6 | 9.1 | 8.5 | 10.6 | 11.8 | 14.0 | 9.8 | -1.0 | 8.2 |
| *Greece* | | | | | | | | | | |
| *ROA* | 1.4 | 1.0 | 0.5 | 0.6 | 0.4 | 0.9 | 0.8 | 1.0 | 0.2 | -0.1 |
| *ROE* | 15.4 | 12.4 | 6.8 | 8.9 | 6.4 | 15.9 | 12.7 | 14.8 | 3.2 | -1.5 |

*Source: CBBH (Selected FSIs for banking sector), CNB (Banking sector, Standard presentation format), NBS (2010, 2009), IMF (Financial Soundness Indicators - FSIs, Global Financial Stability Report, various editions).*
*Notes: Data for Austria are on a consolidated basis from 2004, comparability across years is therefore limited. Due to differences in national accounting, taxation, and supervisory regimes, profitability data are not strictly comparable across countries.*

## Development of domestic loans

Compared to other countries, the credit stocks in Bosnia and Herzegovina, Croatia and Serbia were on relative low levels in 2002. However, with the entry of foreign banks, the Balkan countries have experienced a significant increase in private sector credits. Figure 3 shows the development of credits in the three countries on a quarterly basis. Starting from a level of about 27% of GDP, total credits in Bosnia and Herzegovina increased steadily and reached almost 60% in September 2008.[4] The rise was due to an increase in loans to private households and private non-financial business. Loans to other sectors, which include the governmental sector or public enterprises, experienced a drop in March 2004 and then remained constant. However, the outbreak of the global financial crisis in September 2008 stopped the rise in lending in Bosnia and Herzegovina.

***Figure 3: Domestic loans in percent of GDP, 2002-2009***




*Source: CBBH, CNB, CROSTAT, NBS, RZS.*
*Notes: GDP for Bosnia and Herzegovina has been calculated by linear interpolation of annual GDP. GDP for Croatia and Serbia relates to a 4-quarter rolling sum.*

Croatia had a higher credit to GDP ratio than Bosnia and Herzegovina at the beginning of 2002. Starting from 40%, total credits in Croatia have been on the rise too, which has been

[4] For Bosnia and Herzegovina, no quarterly GDP data are available. Therefore, quarterly GDP has been calculated by linear interpolation of annual GDP data.

mainly due to an increase in lending to private households. In contrast to Bosnia and Herzegovina, the increase in credits in Croatia was already slowed at the end of 2007, when the first signs of a financial crisis in the USA occurred.

With a level of nearly 12% of GDP, Serbia had the lowest credit stock of the three countries in 2002. Similar to the other two countries, lending to private sector in Serbia experienced a steady increase, and at the end of 2009, the credit to GDP ratio was more than 40%. In Serbia the financial crisis had its effects only on lending to private households, which has been decreasing after the outbreak of the crisis in September 2008.

As was shown in figure 3, loans to the private sector in the three countries experienced fast growth rates prior to the recent financial and economic crisis. Two questions arise in the context with this credit expansion. First, how fast should credits be rising in the process of economic development and the catch-up with developed countries? Second, when does the speed of lending growth endanger financial and economic stability? According to Caprio and Klingebiel (1996), real credit growth of one to two times real GDP growth may occur in normal times as a result of financial deepening. By contrast, a real growth rate of credits that exceeds two times real GDP growth indicates a lending boom and may lead to a banking crisis, as was the case in Latin American countries in the past.[5] Table 2 shows the real credit growth rates and real GDP growth rates for the three Balkan countries.

In Bosnia and Herzegovina, real growth rates of total credit always exceeded real GDP growth by more than two times between 2002 and 2008. Credit expansion was then stopped in 2009, when due to the global financial and economic crisis negative real credit growth rates occurred. According to the above definition, Croatia faced a lending boom too from 2002 to 2006. The boom has been stopped in 2007 and in 2009 total credits in Croatia show a negative growth rate. For Serbia, a lending boom can be identified in the period 2003-2008, with a slight break in 2006. Although the real growth of total credits decreased significantly in 2009 in Serbia, it has not been negative like in the other two countries.

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[5] Another definition of a lending boom has been presented by Gourinchas et al. (2001). A lending boom there is identified by deviations of the credit to GDP ratio from its long-term trend. We do not utilize this method here, because the period of our sample is relatively short and the identification of a long-term trend would be hardly possible. However, Cottarelli et al. (2005) apply this method to countries of Central and Eastern Europe and the Balkans. They do not find any lending boom regarding total credits. In the case of credits to the household sector they detect significant deviations for Hungary or a borderline case in Romania. They also present further calculations in order to examine, if the credit development in these countries is consistent with the process of convergence to developed countries. They estimate equilibrium levels for bank credit to the private sector, based on a panel of non-transition developing and industrialized countries, and compare this equilibrium levels with the actual levels. They conclude that in 2002 bank credit to private sector was above its equilibrium level only in Bosnia and Herzegovina, and close to equilibrium in Croatia and Serbia and Montenegro. For all other countries, credit to the private sector was below its equilibrium level in 2002.

***Table 2: Real growth rates of loans and GDP, 2002-2009***

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|
| *Bosnia and Herzegovina* | | | | | | | | |
| *Total* | 27.76 | 18.92 | 15.25 | 22.68 | 16.26 | 26.48 | 13.42 | -2.74 |
| *Non-financial business* | 25.76 | 28.17 | 32.72 | 26.16 | 18.39 | 27.49 | 18.93 | -0.69 |
| *Households* | 112.81 | 34.22 | 33.07 | 26.68 | 19.35 | 28.08 | 9.65 | -5.47 |
| *GDP* | 4.87 | 3.79 | 6.27 | 3.92 | 6.10 | 6.20 | 5.70 | -3.20 |
| *Croatia* | | | | | | | | |
| *Total* | 31.37 | 14.76 | 10.78 | 16.47 | 18.91 | 10.15 | 7.85 | -0.08 |
| *Non-financial business* | 20.58 | 3.27 | 5.76 | 12.60 | 22.16 | 7.12 | 5.81 | -0.44 |
| *Households* | 40.60 | 25.44 | 16.24 | 16.50 | 18.03 | 14.69 | 5.62 | -5.17 |
| *GDP* | 5.40 | 5.00 | 4.20 | 4.20 | 4.70 | 5.50 | 2.40 | -5.80 |
| *Serbia* | | | | | | | | |
| *Total* | -39.51 | 23.36 | 30.43 | 28.91 | 9.40 | 25.32 | 25.03 | 8.78 |
| *Non-financial business* | -35.19 | 19.07 | 18.88 | 19.58 | -3.60 | 20.98 | 30.05 | 9.34 |
| *Households* | 168.35 | 69.52 | 99.34 | 68.65 | 44.64 | 35.21 | 15.09 | 2.64 |
| *GDP* | 3.90 | 2.40 | 8.30 | 5.60 | 5.20 | 6.90 | 5.50 | -3.00 |

*Source: CBBH, CNB, NBS.*

It can also be seen from table 2, that prior to the financial crisis the fastest growth rates occurred in the private household sector, particularly in Bosnia and Herzegovina and Serbia. The credit growth to the household sector in Croatia has been slower than in the other two countries, but Croatia had the highest credit to GDP ratio in this sector at the beginning of 2002. Furthermore, the household credit to GDP ratio in Croatia is comparable to that of developed countries, like Italy or Greece (Kraft 2007: 353). The rise in indebtedness of the household sector is mainly the result of an increase in mortgages and credit card lending by foreign banks. In addition, domestic banks may have also been attracted by high profitability and therefore entered the field of lending to private households (Lapavitsas 2009a: 18). As the financial crisis broke out, the private household sector have experienced the sharpest drop in credit growth in 2009, with real credit declining by -5.47 and -5.17 in Bosnia and Herzegovina and Croatia, respectively.

Credit growth was initially financed by rising deposits, which were the result of the changeover process of pre-Euro currencies to Euros (Kraft & Jankov 2005: 110). While a further increase in deposits was an important factor for the lending boom during the 2000s, the contribution of capital inflows to the funding of credit growth played an increasing role. In the case of Croatia, the high interest gap between Croatia and the Eurozone has been an important factor for these capital flows, which were used for credit expansion, particularly in the household sector (Kraft 2007: 349). A detailed explanation of the capital flows to the Balkan countries is subject to the next section.

### Development of cross-border lending

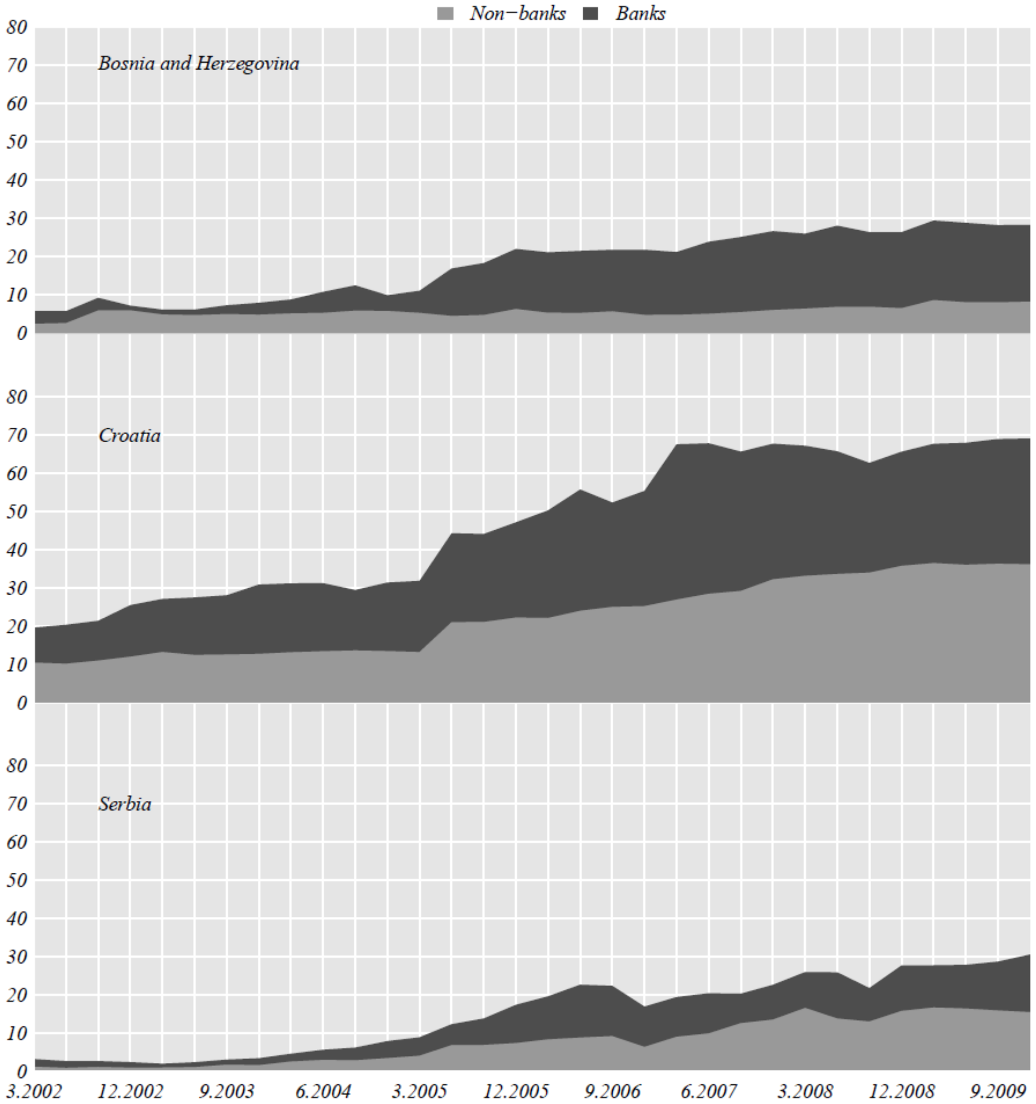
Capital movements have experienced a sharp increase due to capital market liberalization since the 1970s. But such capital movements are also subject to high capital flow reversals in times of crisis and are therefore characterized by a high volatility. For example, net short-term capital inflows to developing countries showed a sharp increase between 2003 and 2007, but turned negative in the recent economic crisis (Cordero & Montecino 2010: 12-14). Particularly developing countries have been faced with huge capital inflows during good times, which led to an appreciation of the domestic currency and a loss of competitiveness of the tradable sector. However, when economic conditions become less favourable, capital flow reversals occur and difficulties in the balance of payments may result.

An important part of these capital flows is constituted by cross-border bank lending. The cross-border claims of banks, particularly of European banks, achieved high levels prior to the economic crisis of 2007-2010. Regarding the Euro Area this is true for both, lending from core Eurozone states (Germany, France, Belgium, the Netherlands) to the periphery (Greece, Ireland, Italy, Portugal, Spain) and from the periphery to the core (RMF 2010: 39). Cross-border lending to transition and developing countries showed also an increase until 2008 (Cordero & Montecino 2010: 14). These capital flows contributed to the debt-based growth in some Central, Eastern and Southeastern European countries, which came to an end after the outbreak of the financial crisis in 2008.

To examine the cross-border bank lending to Bosnia and Herzegovina, Croatia and Serbia, data from the Bank for International Settlements (BIS) were used. The BIS publishes a set of banking data on a quarterly basis. To trace cross-border lending it is useful to turn to the *locational banking statistics*, which are consistent with the principles of balance of payments data.[6] Figure 4 shows the claims of BIS-reporting banks vis-à-vis the three Balkan countries.

[6] The BIS locational banking statistics provide quarterly data on gross on-balance sheet asset and liability positions of banks in major banking centres vis-à-vis banks and non-banks located in other countries. The locational statistics are not consolidated and are based on the residence principle. Therefore, consistence with balance of payments data is given. The implication for our purpose is that these data also include cross-border flows from parent banks to their subsidiaries and vice versa.

***Figure 4: Outstanding claims of BIS-reporting banks vis-à-vis the Balkans in percent of GDP, 2002-2009***

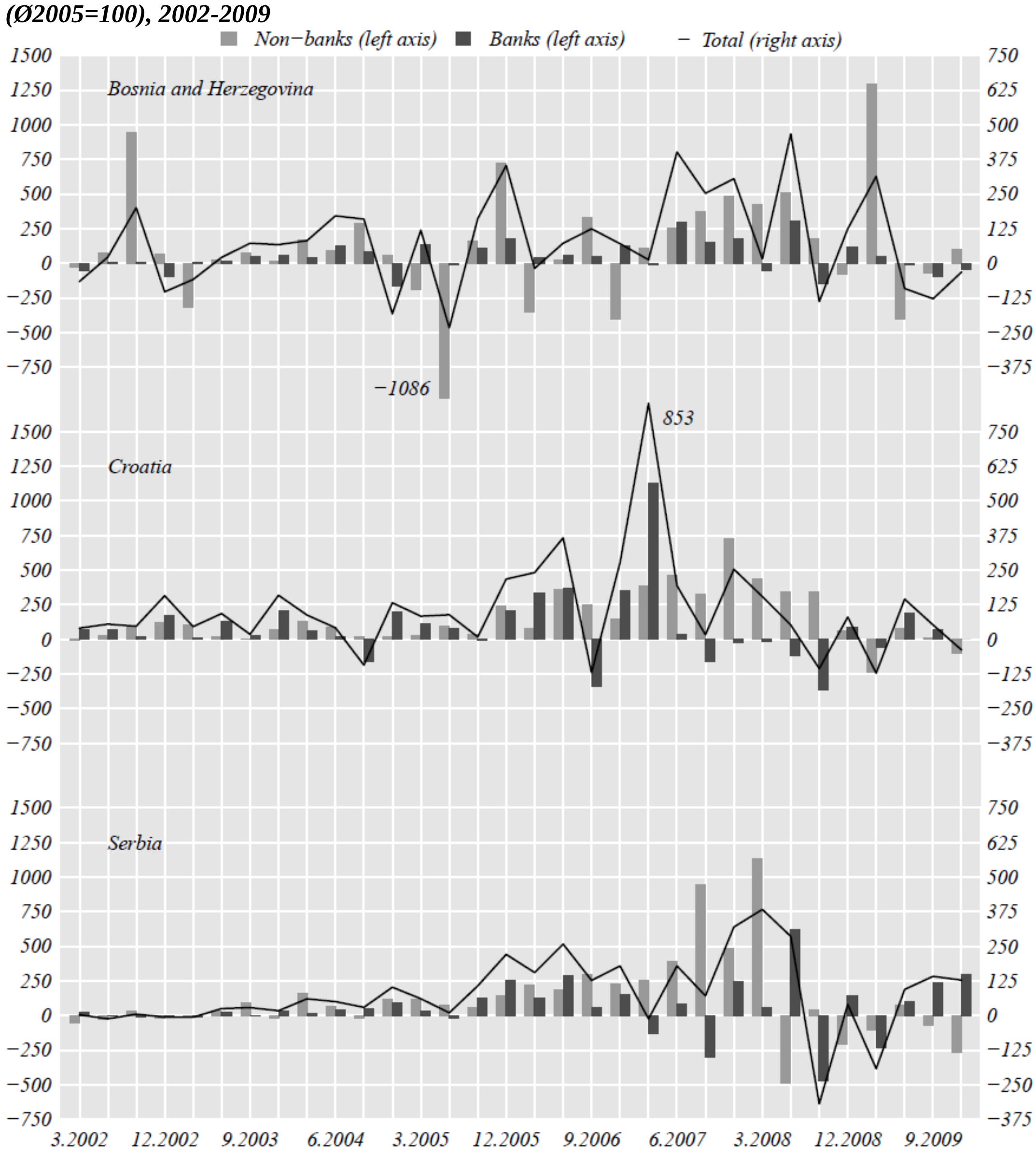



*Source: BIS (Locational banking statistics 6A & 6B), CBBH, CROSTAT, RZS.*
*Notes: The data for Serbia refer to Serbia and Montenegro until September 2006. GDP for Bosnia and Herzegovina has been calculated by linear interpolation of annual GDP. GDP for Croatia and Serbia relates to a 4-quarter rolling sum.*

Cross-border lending has been increasing in all countries from the first quarter of 2002 to the end of 2009, with Croatia having by far the highest ratio of capital inflows to GDP during the whole period. In Bosnia and Herzegovina the development has been driven by capital flows to the banking sector. These capital flows were partly the result of lending of foreign-owned banks from their parent banks, in order to finance credit expansion. This was also the case in Croatia and Serbia, but these two countries additionally have experienced a large increase in capital flows to the non-bank sector. However, the flows to the non-bank sector stagnated (Croatia) or even decreased (Serbia) after the outbreak of the financial crisis in September 2008.

Because the BIS-statistics are presented in US Dollar terms, the changes in the stocks of cross-border banking flows may be partly the result of exchange rate movements. In order to eliminate these shortcomings, the BIS also provides data for exchange rate value-adjusted changes in the stocks of cross-border claims. These adjusted capital flows to the Balkan countries are shown in figure 5 on an index basis.[7] As can be seen, capital flows to the region accelerated at the end of 2005, particularly in Croatia and Serbia. The financial crisis then led to a significant drop in all three countries.

***Figure 5: Index of exchange rate value-adjusted changes in the stocks of cross-border claims (Ø2005=100), 2002-2009***



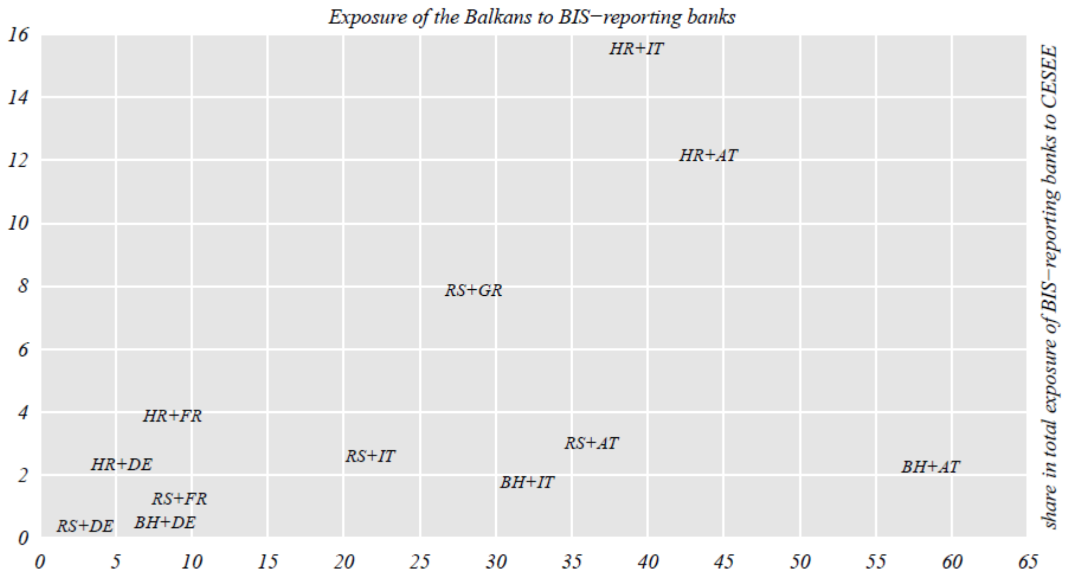

*Source: BIS (Locational banking statistics 6A & 6B).*
*Notes: The data for Serbia refer to Serbia and Montenegro until December 2006.*

[7] An index has been calculated in order to make the results for the three countries comparable. Alternatively, the ratio of capital flows to GDP could have been calculated to compare the results. However, this method was not possible here, as there are no quarterly data for GDP in Bosnia and Herzegovina available.

Prior to the financial crisis, there was a rising trend in the exchange rate value adjusted changes in the stocks of cross-border claims to the banking sector in all three countries. Regarding the non-bank sector, no such clear trend can be observed for Bosnia and Herzegovina. By contrast, in Croatia and Serbia, the flows to the non-banking sector show a considerable increase. The outbreak of the financial crisis then led to a drop in the capital flows to both, the bank and the non-bank sector in all three countries. In contrast to the banking sector, the flows to non-banks did not really recover during 2009.

Finally, the nationality of BIS-reporting banks, which are most involved in the credit expansion in the Balkans, should be mentioned. The BIS provides also data, tracing the nationality of BIS-reporting banks, which have claims vis-à-vis other countries (*consolidated banking statistics*).[8] Figure 6 shows the exposure of the three Balkan countries to BIS-reporting banks from specific EU member countries, and the share of Bosnia and Herzegovina, Croatia and Serbia in the total exposure of banks from individual EU member countries to the CESEE region.[9]

***Figure 6: Exposure of the Balkans to BIS-reporting banks and share of the Balkans in the total exposure of BIS-reporting banks to the CESEE region in percent, December 2009***




*Source: BIS (Consolidated banking statistics 9D, ultimate risk basis).*
*Notes: BH stands for Bosnia and Herzegovina, HR for Croatia, RS for Serbia, AT for Austria, IT for Italy, DE for Germany, FR for France and GR for Greece.*

[8] The consolidated banking statistics provide information of the exposure of BIS-reporting banks on a worldwide consolidated basis. The data include the exposure of these banks to other countries and the exposure of their foreign offices. In contrast to the locational banking statistics, inter-office positions are excluded here, due to the consolidation of the data.
[9] The CESEE region here includes the following countries: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey and Ukraine.

As can be seen, while the Balkan countries are most exposed to Austrian[10] banks, the exposure of banks from EU member countries is the highest for Croatia. Furthermore, there is a strong asymmetry between the exposure of the Balkan countries to banks from EU member countries and the exposure of banks from the EU member countries to individual Balkan countries. For example, the exposure of Bosnia and Herzegovina to Austrian banks amounts for nearly 59%, while the exposure of Austrian banks to Bosnia and Herzegovina accounts for only 2% of their total exposure to the CESEE countries. This leaves the Balkan countries highly dependent on credit supply from BIS-reporting banks, and modest changes in the credit policy by parent banks may have considerable negative macroeconomic and financial stability effects in the Balkan countries (Mihaljek 2008: 29).

**Financial and macroeconomic stability**

As was shown, the three Balkan countries have been faced with a fast increase in domestic credit, particularly in the household sector. In addition, there has also been an increase in cross-border lending. As loans to private sectors are rising at a fast pace, concerns about the quality of outstanding loans may arise. These concerns have gained importance, since the outbreak of the recent financial crisis has questioned the quality of banking assets. Table 3 shows the development of non-performing loans as a percentage of total loans for Bosnia and Herzegovina, Croatia and Serbia.

***Table 3: Non-performing loans in percent of total loans, 9.2008-9.2010***

| | 9.2008 | 12.2008 | 3.2009 | 6.2009 | 9.2009 | 12.2009 | 3.2010 | 6.2010 | 9.2010 |
|---|---|---|---|---|---|---|---|---|---|
| *Bosnia and H.* | 3.0 | 3.1 | 3.3 | 4.0 | 4.8 | 5.9 | 7.1 | 8.7 | 9.2 |
| *Croatia* | 4.8 | 4.9 | 5.2 | 6.0 | 6.4 | 7.8 | 9.0 | - | - |
| *Serbia* | - | 11.3 | 14.2 | 16.5 | 17.7 | 15.7 | 16.5 | 17.5 | 17.8 |

*Source: CBBH, CNB, NBS, IMF (Financial Soundness Indicators - FSIs, Global Financial Stability Report, various editions).*

In comparison to other CESEE countries, like Romania or Ukraine, the share of bad loans in total loans is relatively low in the three Balkan countries. However, the share of bad loans has been rising steadily since the third quarter of 2008. Non-performing loans in Bosnia and

[10] The *Bank Austria Creditanstalt* as part of the *Unicredit Group* is treated as an Italian bank in figure 6. This stands in contrast to figure 2, where it is mentioned as Austrian bank.

Herzegovina have tripled from September 2008 to September 2010. In Croatia there was a high growth of bad loans too, reaching a share of 9% in March 2010. With a level of 17.8% in the third quarter of 2010, Serbia had a significantly higher share of non-performing loans in total loans than the other two countries.

Such increasing credit risk may lead to a slowdown in credit growth, because banks have to increase the provisioning rates, which in turn would lead to lower profitability for the banks in the region (Mihaljek 2008: 27). While in good times the capital flows from parent banks to their subsidiaries show an increase, they may be subject to sudden stops or even reversals when economic conditions get worse. Capital flow reversals may be the case, if, for example, parent banks withdraw profits from their subsidiaries due to liquidity problems in their home market (Mihaljek 2008: 28). Although the major active banks have agreed in the *Vienna Initiative* in June 2009 not to stop their activities in the region, it is not predictable how these banks will act in the future. For example, the Austrian *Hypo Group Alpe Adria*, which has been rescued by the Austrian government, has announced that it will reduce its assets. In general, banks may shrink their balance sheet in order to maintain capital adequacy requirements. This may result in a reduction of credit supply in Central, Eastern and Southeastern Europe or even a withdrawal of foreign banks from the region.

A further threat for financial stability may be presented by foreign currency loans. In Bosnia and Herzegovina credits in foreign currency or indexed to foreign currency accounted for 73.9% of total credits at the end of 2009 (CBBH 2010b: 68). In the same year, in Croatia some 70% of loans to the household sector were either in foreign currency or indexed to foreign currency (CNB 2010: 23). In Serbia, such loans accounted for 80% of total loans to the household sector in 2009 (NBS 2010: 14). In addition, the lending of non-financial business from abroad has been on the rise over the last years, particularly in Croatia and Serbia. Thus, financial stability is highly exposed to foreign currency risk. However, as the Central Bank of Bosnia and Herzegovina operates under a currency board, and the Croatian *Kuna* is pegged to the Euro, the exposure of credits to changes in exchange rates has been limited. By contrast, the National Bank of Serbia operates under a managed float combined with some sort of inflation targeting. Here the exposure of loans in foreign currency to exchange rate movements is higher, particularly because the Serbian *Dinar* has experienced a reasonable devaluation since the outbreak of the recent financial and economic crisis.

The fixed exchange rates in Bosnia and Herzegovina and Croatia have been established in order to achieve low inflation rates. The primary goal of the National Bank of Serbia has also been to maintain price stability. As the three countries have a large share in trade with the

European Union, their strong commitment to low inflation makes them less competitive, because the higher inflation rates relative to the EU member countries have negative effects on real exchange rates and commodity trade. Particularly Croatia and Serbia show an overvaluation of real exchange rates (Holzner 2006). As a result, the high trade and current account deficits make these countries highly dependent on capital flows and leaves them highly vulnerable to external factors (Becker 2008).

Such capital flows, in addition to an increase in domestic credits, has been the main contributor for economic growth in these countries. The growth model, mainly based on rising indebtedness of the household sector, came to and end as the recent financial crisis broke out. The region was therefore part of the global imbalances between debt-led and export-led growth models.[11] Although, the consequences of the financial and economic crisis of 2007-2010 were not as high as in other debt-led economies, like for example Latvia, the Balkan countries will have to reconsider their development strategies for the future.

# 5 Conclusion

The countries of Central, Eastern and Southeastern Europe have been seriously hit by the recent financial and economic crisis. This has been mainly the consequence of the breakdown of a growth model, which has been based on the rising indebtedness of the private sector. The purpose of this paper, therefore, was to explain the role foreign banks played in the credit expansion in Bosnia and Herzegovina, Croatia and Serbia. Particularly Austrian banks have expanded aggressively into the Balkans, holding an ownership share of more than 60% of foreign-owned banks in Bosnia and Herzegovina and Croatia. In Serbia, the dominance of Austrian banks is lower, but accounts also for considerable 37%.

With the entry of foreign banks, the Balkans have been faced with a fast increase in loans to the private sector. The high profitability in the banking sector in the Balkans and the increasing profit-orientation of EU banks has been the major cause of this credit growth, which was mainly driven by the rising indebtedness of the household sector. Furthermore, the rise in domestic loans has been accompanied by an increase in cross-border lending by the Balkan countries. Particularly Croatia shows a high level of cross-border indebtedness to BIS-reporting banks.

[11] For further details on debt-led and export-led growth models and the structural causes of the financial and economic crisis of 2007-2010, see Stockhammer (2008, 2009, 2010a) or IMK (2009a, 2009b, 2009c).

During the lending boom, banks were engaged in risky lending practices. Additionally, the fast credit growth rates led to an inability to appropriately asses the risk of borrowers' default. As the financial and economic crisis spilled over to the Balkans, these risky loans turned into bad loans. The share of non-performing loans in Bosnia and Herzegovina has tripled from the end of 2008 to the end of 2010. In Croatia bad loans have doubled, and Serbia shows a serious share of non-performing loans in total loans of nearly 18%. Bad loans are even expected to increase further in 2011, and therefore present a threat for financial stability in the region.

With the outbreak of the recent financial and economic crisis and the increase in bad loans, banks reduced their lending, particularly lending to private households, which led to a slowdown in credit growth rates. The reduction of domestic credits was accompanied by capital flow reversals, particularly in Croatia and Serbia, as economic conditions turned negative. The slowdown of credits led to a drop in economic growth, as the three countries relied heavily on private indebtedness in the past. As a consequence, the Balkan countries are still facing a tough road to economic recovery.

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