2015

Reinvigorating Credit Growth in Central, Eastern, and Southern European Economies

Bostjan Jazbec

Cristopher Towe

Marco Pinon

Biswajit Banerjee
Haverford College

REINVIGORATING CREDIT GROWTH

In Central, Eastern, and Southern European Economies

Edited by
Boštjan Jazbec, Christopher M. Towe,
Marco Piñón, and Biswajit Banerjee

BANKA SLOVENIJE
BANK OF SLOVENIA
EUROSYSTEM

Reinvigorating Credit Growth
In Central, Eastern, and Southern European Economies

Edited by Boštjan Jazbec, Christopher M. Towe,
Marco Piñón, and Biswajit Banerjee

Reinvigorating Credit Growth
In Central, Eastern, and Southern European Economies

RCGMCMEA

Proceedings of a conference jointly organized
by the Bank of Slovenia and the International Monetary Fund

Reinvigorating Credit Growth

In Central, Eastern, and Southern European Economies

Edited by
Boštjan Jazbec, Christopher M. Towe, Marco Piñón, and Biswajit Banerjee

Proceedings of a conference jointly organized by the Bank of Slovenia and the International Monetary Fund

Cover design: Catherine Cho, IMF Multimedia Creative Services

Disclaimer: The views expressed in this book are those of the authors and do not necessarily represent the views of either the Bank of Slovenia or the International Monetary Fund (IMF), its Executive Board, or IMF management.

Cataloging-in-Publication (CIP) Data

National and University Library in Ljubljana

336.77(4)(082)

REINVIGORATING credit growth: in Central, Eastern, and Southern European economies: proceedings of a conference jointly organized by the Bank of Slovenia and the International Monetary Fund / edited by Boštjan Jazbec, Christopher Towe, Marco Piñón, and Biswajit Banerjee. – Washington, D.C.: International Monetary Fund, Publication Services; Ljubljana: Bank of Slovenia, 2015.

Available on: http://www.imfbookstore.org/

ISBN 978-961-6960-04-5 (Banka Slovenije)
1. Jazbec, Boštjan .
278986496

1. Credit growth —. 2. CESEE economies —. 3. Boštjan Jazbec —.
3. Christopher Towe —. 4. Marco Piñón —. 5. Biswajit Banerjee —.

ACKNOWLEDGEMENTS

We would like to thank the following people for their role in organizing the conference and helping in the preparation of the book: Ksenija Berdnik, Polona Flerin, Vanja Kobe, Eva Ribič, and Vida Šeme-Hočevar (all Bank of Slovenia); as well as Pavel Lukyantsau, Jessica Allison, Christie Chea, Sabine Tuzik, and Melissa Wills-Dudich (all IMF staff). We also thank Charles Enoch (IMF), who was involved in the early stages of the organization of the conference.

TABLE OF CONTENTS

GLOSSARY

ABS	Asset-backed securities
AQR	Asset quality review
BAMC	Bank asset management company
BIS	Bank for International Settlements
BRRD	Bank Recovery and Resolution Directive
CEE	Central and Eastern European
CEPR	Centre for Economic Policy Research
CESEE	Central, Eastern, and Southern European Economies
CME	Comprehensive monetary easing
CNB	Croatian National Bank
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBITDA	Earnings Before Interest, Taxes, and Depreciation Allowance
EBIT	Earnings Before Interested and Taxes
EBRD	European Bank for Reconstruction and Development
EBA	External Balance Assessment
EBT	Earnings Before Taxes
ECB	European Central Bank
EIB	European Investment Bank
EIF	European Investment Fund
EMEs	Emerging Market Economies
EMBI	Emerging market bond index
EMU	European Monetary Union
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
FDI	Foreign direct investment
Fed	U.S. Federal Reserve
FSAP	Financial Sector Assessment Program
FSI	Financial soundness indicators
FX	Foreign exchange
FYROM	Former Yugoslavian Republic of Macedonia
GFSR	Global Financial Stability Report
HR	Human resource
HUF	Hungarian florint
IFC	International Finance Corporation
IIF	Institute for International Finance
IMF	International Monetary Fund
IT	Information technology
JFSB	Joint Financial Stability Board
KNF	Polish Financial Stability Authority
LIBOR	London Interbank Office Rate
LLP	Loan loss provision
LTRO	Longer-term refinancing operation
LTV	Loan-to-value ratio
MFSA	Malta Financial Services Authority

MiFID II	Markets in Financial Instruments Director II
NACE	National Advocacy Coalition on Extractives
NAFTA	North American Free Trade Agreement
NBFIs	Nonbank financial institutions
NBP	National Bank of Poland
NPLs	Nonperforming loans
NSFR	Net stable funding ratio
OECD	Organization for Economic Co-operation and Development
OeNB	Oesterreichische Nationalbank
PBS	Pre-bankruptcy settlement
QE2	Quantitative Easing 2
ROA	Return on assets
ROE	Return on equity
RWA	Risk-weighted asset
SEE	South-eastern Europe
SMEs	Small- and medium-sized enterprises
TFP	Total factor productivity
TLTRO	Targeted longer-term refinancing operation
U.K.	United Kingdom
U.S.	United States
WEO	World Economic Outlook

FOREWORD

We are pleased to introduce this volume, which summarizes the proceedings of an important and timely conference on the key policy challenge of reinvigorating credit growth in Central, Eastern, and Southern European Economies (CESEE).[1] The need to act decisively and remove structural barriers to a high and sustainable credit expansion has been a core preoccupation of policymakers in the region and the IMF since the onset of the Global Financial Crisis, and is widely recognized as a critical prerequisite to establishing a new growth momentum.

Indeed, even seven years after the onset of the crisis, and after experiencing a sharp contraction in both credit and economic activity, much of the CESEE region still suffers from low credit and economic growth. And the worry is that, without a reinvigoration of the reform momentum, this "low growth" performance could become the "new normal."

The fact that this conference was able to attract such an impressive group of senior European policymakers—including 15 governors and vice-governors of central banks—provides both a testament to the commitment of policymakers to engaging on these issues and recognition of the importance of continued efforts. The two-day event provided an encouraging degree of consensus on where these efforts need to be concentrated.

It is our sincere hope that this event, and the summary of the discussions that have been compiled here, will provide a useful springboard for moving forward with bolder actions and reforms that will help put the region on a solid growth path.

José Viñals
Financial Counsellor
Director of the Monetary and Capital Markets Department
International Monetary Fund

Boštjan Jazbec
Governor
Bank of Slovenia

[1] The conference was held in Portorož, Slovenia on September 25–26, 2014.

I. Executive Summary

Marco Piñón, Advisor, Monetary and Capital Markets Department, IMF

The IMF-Bank of Slovenia high-level conference[2] on "Reinvigorating Credit Growth in Central, Eastern, and Southern European Economies (CESEE)" attracted prominent policymakers in the CESEE region, as well as from the rest of Europe and elsewhere. This participation testified to the importance that was attached to the opportunity to come together and discuss the issues weighing on the region's recovery.

Indeed, reactivating credit in the CESEE represents one of the most important challenges to improving the economic prospects of the region in the years ahead. Recoveries without the support of healthy levels of credit, so called "*creditless recoveries,*" tend to be subpar and less sustainable. In the case of the CESEE, seven years after the onset of the global financial crisis, and the ensuing collapse in credit, lending and broader economic growth remain anemic in most countries.

Although policymakers have placed an appropriate emphasis on the need to jump-start credit, the design of effective policy responses has been elusive. What is often required are difficult institutional changes and deep reforms that can threaten deeply rooted practices or vested interests, or have costs that are difficult to bear given the difficult fiscal situation in most CESEE countries. Instead, the focus has often been on easier measures to boost credit that may have only a temporary or

[2] Held in Portorož, Slovenia on September 25–26, 2014.

palliative effect, or unintended and undesirable macroeconomic consequences.

Background

The 2008 global financial crisis was markedly different from several previous crises. In contrast with other episodes, when weak credit growth was associated with emerging and developing economies, this time the epicenter of the crisis was the advanced countries of the world. And, while many of these countries still suffer from the after-effects of the crisis, emerging market economies have been generally resilient.

However, the experience of the CESEE region differs markedly from that of other emerging markets. Not only did the CESEE region experience a more abrupt and severe drop in credit levels during 2008–09 (albeit following an equally striking rally in the preceding years) but, with very few exceptions, CESEE countries continue to face depressed credit levels and uncertain credit growth prospects.

Recent studies and surveys point to a range of factors as likely drivers of credit developments in the CESEE region. Econometric estimates indicate that global factors, domestic macroeconomic conditions, and domestic and parent bank fundamentals all played a role. Interestingly, the results suggest that while macroeconomic factors were important, particularly in the early phases of the crisis, bank fundamentals gained relevance over time. In particular, depressed credit levels appear to be related to an important extent to domestic banks' asset quality, liquidity constraints, and capital reserves, as well as to parent banks' funding costs and capitalization.

A survey conducted by the European Investment Bank (EIB) in the context of the Vienna Initiative 2 confirms the key econometric findings. The survey, which was completed by a large sample of bankers operating in the CESEE area, points to local nonperforming loans (NPLs) as well as group NPL figures as the most important factors explaining weak credit performance in the CESEE region. It also finds that the local and global market outlook and the local and global funding outlook have become less binding constraints and, in some instances, are already helping to reactivate credit growth. Beyond the factors identified by the econometric studies, the survey indicates that, to a lesser but still important extent, changes in local and global regulations have also affected credit growth negatively.

A survey conducted by the IMF on measures to promote credit growth adopted around the world, including in the CESEE region, offers further insights. The survey was applied to 42 countries, covering 50 policy categories. The results were then used to identify policy gaps with significant potential impact for the CESEE region, by comparing the measures adopted (or not) with the factors identified as driving credit conditions in the same countries.

A key finding is that the CESEE region lags behind considerably in terms of bank restructuring efforts with respect to other parts of the world, including the advanced economies. This is a meaningful finding considering that NPLs and, more generally, bank fundamentals, both domestic and foreign, appear to be the key drivers of slow credit growth. It also finds that there is significant room for further corporate and household debt restructuring efforts, although in this case lagging efforts appear to be widespread also outside the CESEE region. The survey also finds that virtually no capital market measures have been adopted in the region, suggesting that this could also be a fertile ground to activate nonbank credit.

Against this background, the conference's discussions were centered on four high-level panels covering a wide range of relevant issues.

Panel 1—Repairing balance sheets and other challenges

During the discussions, there was broad consensus that strengthening banks' weak balance sheets should be at the core of any efforts to reactivate credit growth on a sustainable basis, and that more decisive efforts in this regard are needed in most CESEE countries. Capital injections had often not been sufficient or timely, and efforts to address high NPLs had not gone far enough in most cases. At the same time, the general view was that improvements are not only needed for banks' balance sheets, but also for corporations and households, where efforts are lagging even further.

Panelists generally expressed the view that efforts on multiple fronts were needed, involving a coordinated approach that calls for actions that go well beyond the purview of the central bank and supervisory authorities. Going forward, the primary focus should be on forceful measures to improve the quality of institutions, legislation, and regulations. The priority should be on removing barriers that hinder NPL resolution, such as inappropriate and inefficient insolvency and tax legislation. But efforts are also needed on other fronts, including to improve and reinforce risk management strategies and corporate governance. Some panelists called for more coordinated macroeconomic policies, where fiscal policies are more supportive of monetary and structural policies. Others, however, emphasized the limited fiscal space in many CESEE countries, and that an unintended consequence of monetary easing could be further delays in identifying and correcting the underlying imbalances.

Panel 2—Prospects for credit growth and for foreign bank engagement in the region

The discussions focused on the role played by foreign banks in explaining credit developments in CESEE countries, particularly in the context of the global crisis and the subsequent regulatory reforms. Several panelists pointed out that a more appropriate distinction between banks would be in terms of management practices instead of ownership. In their view, many foreign banks had displayed lower levels of NPLs and managed to maintain higher levels of credit. Furthermore, foreign banks had brought considerable benefits to the CESEE before the crisis, including more efficient intermediation and improved access to credit by the corporate sector. Nevertheless, participants agreed that foreign banks have an ongoing role to play and that it will be important to ensure their long-term commitment to their host country.

Regarding the causes of foreign banks' weak credit growth, the diversity of experiences within the CESEE region illustrated that, while deleveraging was an important driver of credit developments, this was a needed correction to earlier credit excesses; and that macroeconomic fundamentals were an important determinant of credit developments in specific countries. With respect to regulatory reforms, at both the European Union (EU) and international levels, there was agreement that stricter capital and liquidity requirements may have dampened credit, but also that in the long run this would be offset by the benefits of a more stable financial system, improved confidence, and lower costs of bank financing.

Panel 3—Measures to revive credit markets: best practices and pitfalls

The panel acknowledged that the continued weakness in credit is partly a correction that still needs to run its course. Several panelists mentioned that confidence needs to be restored before credit growth can be expected and saw the recent asset quality review and stress tests as helping to restore confidence and credit growth in the medium run. Still, credit growth may continue to be weak in the short run, especially in banks that are short of capital. Moreover, panelists stressed that structural reforms have stalled and need to be reinvigorated if sustained credit and economic growth are to return anytime soon.

The panel discussed alternatives to bank funding, especially for small- and medium-sized enterprises (SMEs). The consensus view was that alternatives to bank financing should be developed, and that financial markets should play a greater role. Securitization and further development of ABS markets were seen as plausible alternatives to bank lending. Other alternatives included venture capital funds, joint venture funds, and development of mini-bond markets.

Regarding central bank schemes, panelists observed that these have a role to play in creating the necessary conditions for liquidity to be channeled to the real economy, but cautioned that in the past they have not always been successful. In particular, they stressed that central banks' direct credit or subsidies to SMEs pose risks, such as political interference. To minimize political interference, some panelists suggested that multilateral institutions could play a greater role as intermediaries.

Panel 4—Risks of a new financial crisis affecting the CESEE region

The panel discussed the vulnerability of the CESEE region to a new financial crisis. Encouragingly, most felt that the near-term risks were relatively modest, especially since many countries had reduced their reliance on parent or wholesale funding, and dollarization/euroization had diminished. However, they also warned that medium-term risks remained, which called for sustained reform efforts.

Panelists discussed vulnerabilities resulting from market rigidities in Europe, debt overhangs, and weak balance sheets in the CESEE region and more broadly in Europe. While these factors were not seen as posing near-term risks, they tended to depress demand and growth, and therefore prevented institutions from rebuilding their capital and other buffers, leaving them exposed to future shocks.

The panel also discussed risks resulting from geopolitical developments outside the CESEE region, protracted low growth in Europe, and the normalization of global monetary conditions. It was acknowledged that the region was already feeling the impact of economic developments in Russia, and panelists warned that a slowdown in emerging markets could have a significant impact on Europe and, in particular, on the CESEE area, given that its exports have been one of the most dynamic sectors. The prospective tightening of U.S. (and U.K.) monetary policy could potentially lead to a large re-pricing of assets and a return to higher risk premiums, which could also put strains on the region given the aforementioned lack of buffers and the lack of progress in balance sheet repair.

Panelists agreed that the current period of relative calm represents a window of opportunity to reduce the risk of a renewed crisis by tackling the underlying vulnerabilities. With high and rising NPLs, action is needed to address the issue of debt overhang, including at the level of corporates and sovereigns. Buffers need to be rebuilt, and this will require steps to promote orderly balance sheet restructuring and the restoration of sustained bank profitability. But addressing underlying weaknesses—especially the low long-term trend growth rate—will require structural measures that go beyond the financial system and encompass labor markets, education systems, and new and innovative European financing vehicles.

Conclusions

While weak credit reflects a natural response to the overleveraging that occurred prior to the crisis, and will need to run its course, in much of the CESEE region this process still needs to be supported by decisive structural and other reforms to avoid more permanent damage to the credit channel and output growth. What appears to be weighing on the region is a legacy of inadequate or incomplete efforts to address the weak balance sheets not only of banks, but also of corporations and households.

The role of foreign banks in this recovery process also needs careful thought. Deleveraging by foreign banks has dampened credit in the region, but at the same time foreign banks have contributed to significant efficiency gains in most countries and have had a positive impact on credit growth in countries with stronger macroeconomic policies and market outlook. While regulatory reforms at both national and global levels have weighed on credit, such measures offer the eventual promise of a more stable financial system.

A further lesson for the region from the crisis is the importance of developing more diversified sources of investment financing, especially for SMEs, including through securitization and further development of ABS markets, venture capital funds, and the development of mini-bond markets. While direct credit by central banks or credit subsidies to SMEs can help jump-start the credit channel, such schemes are not always effective, can distort credit allocation in ways that are not growth friendly, and are prone to political interference. But, more generally, the panels agreed that there could be a role for multilateral institutions in assisting in the development of credit diversification.

The core conclusion of the event was the importance of injecting a new momentum to the implementation of structural reforms. These measures need to go beyond merely reactivating credit, and should be geared toward addressing the weak balance sheets of financial institutions, the corporate sector, and households. They also need to extend beyond financial issues and address the more fundamental impediments to strong and sustained growth, especially those in the labor markets and education systems.

II. OPENING REMARKS

A. Boštjan Jazbec, Governor, Bank of Slovenia

It is a great pleasure to welcome you all to the high-level seminar on reinvigorating credit growth in Central, Eastern, and Southern European Economies (CESEE), organized jointly by the Bank of Slovenia and International Monetary Fund (IMF). It is indeed a great honor 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 (CEE) 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 NPLs, 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 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 creditless 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 European Central Bank's (ECB) targeted longer-term refinancing operation (TLTRO) program, the profitability of borrowing very cheaply from the central bank to lend to the private sector (especially (SMEs)) is not guaranteed if NPLs are high and banks need to allow for high expected default rates, and if lending to SMEs implies high risk weights and, consequently, capital charges.

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, NPLs 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 the 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 will 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 a 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 stakeholders 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.

B. Christopher Towe, Deputy Director, Monetary and Capital Markets Department, IMF

Thank you very much Governor Jazbec for these very helpful opening remarks. Let me just add a few additional thoughts before we begin with the first session.

At the outset, I would like to underscore the importance of the topics that we will be debating today and tomorrow.

Like the Governor, I too find it ironic that we are meeting here today to discuss how to reinvigorate credit when only 10 years ago the worry was excess credit growth. Indeed, almost exactly 10 years ago, the IMF co-hosted a conference in this region whose proceedings were published in a book entitled—*Rapid Credit Growth in Central and Eastern Europe: Endless Boom or Early Warning?*

Unfortunately, for all of us, the answer to that question was that rapid credit growth, especially cross-border credit, was an early warning for crisis.

With the benefit of hindsight, it is clear that lending in foreign currency was excessive, there was inadequate risk management by foreign banks, macroprudential oversight was too weak, and home-host relations were not robust enough.

And while it is encouraging that considerable progress has been made in addressing these shortcomings, the region is still struggling with twin hangovers from the global financial crisis and home-grown credit busts. These have undermined the credit channel, left balance sheets still fragile, and dampened growth.

And, as the IMF has recently reported to the G20, the economic environment is likely to become more challenging in the period ahead.

Yes, we expect the global recovery to regain strength in the coming year, on the back of exceptionally supportive financial conditions and moderating fiscal consolidation. And strengthening balance sheets also should support the recovery in the remainder of 2014 and into 2015.

However, downside risks have increased, including those related to geopolitical tensions, continued signs of deflation pressures in some regions, and the possibility of a disorderly renormalization of the United States' (U.S.) monetary policy. A more fundamental concern is that the new normal post-crisis will be much lower potential growth. Moreover, there is growing concern that easy monetary policies globally are leading to financial excesses and asset price overvaluations in some markets, which could increase the chances of a disorderly unwinding when monetary accommodation is unwound.

So I would leave you with three thoughts as we begin our discussions today and tomorrow.

First, the issues we are to address are vitally important for the economic well-being and financial stability of the region.

Second, with increasing risks globally, there is an even greater urgency now to tackle the impediments to sound and growth-enhancing credit.

Third, the fact that we have been fortunate enough to assemble here such an impressive number of key policymakers from the region provides a unique opportunity to engage in a frank and candid dialogue on these issues. I am confident that this opportunity will be seized by all of you and look forward to lively, policy relevant, and fruitful discussions.

With these remarks, let me close by thanking Governor Jazbec and his team for having organized this event, especially in such a lovely venue.

III. What is Driving Credit Developments? Can Something be Done?

A. Lead: Marco Piñón, Advisor, Monetary and Capital Markets Department, IMF[3]

It is a pleasure to be here before such a distinguished audience. The topic that brings us here is an important one for the CESEE economies. Indeed, reinvigorating credit growth on a sustainable basis will be important because it relates directly to the well-being of the people of the region. The idea of this seminar is to benefit from the collective experience of high-level policy practitioners, from within and outside the region. Key questions that we will try to answer together in this event include: what works or at least has better prospects of working, and what are the costs and benefits of different alternatives?

In this session, the idea is to offer background information for each of the key questions that have been posed to the four panel discussions that follow. It is organized in four parts. First, it gives a quick assessment of credit growth performance in the region; second, it aims to shed light on the factors that are likely to be driving credit growth; third, it discusses the measures that have been taken to revitalize credit, both in the region and in other parts of the world; and fourth, it suggests possible ways forward by comparing part two (what drives credit) and part three (what has and has not been done).

[3] Mr. Piñón's presentation was co-authored by Johannes Ehrentraud and Benjamin Huston, Economist and Research Assistant, respectively; from the Monetary and Capital Markets Department, IMF.

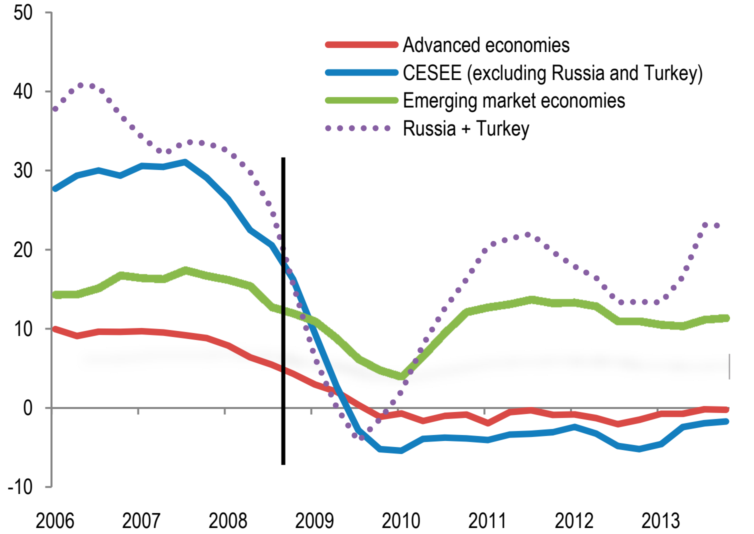
CESEE credit growth performance

Starting with the first part: how is credit performing in the CESEE region? The red line in Figure 1 depicts credit growth in annual terms for (a selection of) advanced economies. It shows that after the drop resulting from the global crisis in 2008–09, credit has remained fairly stagnant in real terms, even further contracting throughout the crisis. In the case of (selected) emerging market economies (green line), the drop in credit following the global crisis was less severe, and it has since recovered. In some sense, this crisis is different from what we have seen in the past, and the old saying "when developed countries catch a cold, emerging economies get pneumonia" did not generally apply. Except in Europe! In the case of the CEESE region (blue line), excluding Russia and Turkey, having experienced a substantial boom before the crisis, credit collapsed and thereafter credit growth has remained, on average, negative. While these are arithmetic averages of growth rates and there is a lot of heterogeneity across countries, credit for the region as a whole is not performing well.

Before turning to the next part, let us look at Russia and Turkey, which were excluded from the previous analysis, where the story is different.

In these cases (dotted line), credit collapsed initially but, much like the emerging economies in other parts of the world, it bounced right back soon after. This raises a different question: is this sustainable, or is it a repeat of what we saw before the crisis? And if it's a repeat, what can be done to prevent another large correction?

Figure 1. Real Bank Credit Growth, by Region
(In percent, year over year)



Source: EBRD, BIS, IMF staff estimates
Note: vertical black line denotes onset of global financial crisis.

To take another look at the same issue, Figure 2 classifies countries by their rate of credit growth (quarterly average over a one-year period). The first column shows that credit in most advanced economies is still contracting in real terms or expanding only moderately. In contrast, the second column shows that (a selection of) non-European emerging economies are already exhibiting clear signs of credit expansion, sometimes vigorously. In the case of the CESEE region as a whole (third column), credit is still generally contracting, six years after the onset of the global crisis. As previously presented, this chart confirms that for a few cases, notably Russia and Turkey, credit growth is vigorous, behaving similarly to that observed in non-European emerging economies.

To summarize, while credit growth has already resumed for most of the emerging markets outside Europe, the majority of CESEE countries continue to experience negative credit growth, much

Figure 2. Average Credit Growth, by Region

	Advanced Economies	Other Emerging Market Economics	Central, Eastern, and Southeastern Europe
Contracting	Austria Denmark France Germany Greece Ireland Italy Portugal Spain United Kingdom		Albania Croatia Czech Republic Hungary Latvia Lithuania Romania Slovenia
Moderate	Belgium Finland Korea Norway Sweden United States		Bosnia and Herzegovina Bulgaria Estonia FYR Macedonia Poland Slovak Republic
Expanding	Japan Luxembourg Netherlands Singapore Switzerland	Brazil India Malaysia Mexico South Africa	Montenegro
Rapidly Expanding		Argentina China Indonesia Thailand	Moldova Russia Turkey

Source: EBRD, BIS, IMF staff estimates
Note: bank credit is measured as the average of real FX-adjusted quarterly bank credit growth over the period of 2013Q-2013Q4.
Average credit growth levels are: "Contracting" is between -10 percent and 0 percent, "Moderate" is between 0 percent and 3 percent, "Expanding" is greater than 3 percent and less than 10 percent, "Rapidly Expanding" is greater than 10 percent.

like many of the developed economies, including in Europe. Moreover, with some exceptions, recent developments do not point to a clear trend toward an improvement.

Factors explaining credit growth

Let me move to the second part of this section. To shed light on what may be behind credit developments in CESEE countries, we have used a number of complementary approaches (Figure 3). Borrowing from recent econometric research at the

Figure 3. Approaches to Identify Credit Constraints

Bank-level Panel Analysis

- Regression model with bank fixed effects

Structural Model on Bank Lending

- Disequilibrium model using data from Latvia, Lithuania, Montenegro, Poland, Romania

Bank Lending Surveys

- CESEE bank lending survey
- IIF emerging market bank lending survey

Figure 4. Bank-Level Panel Analysis

Main Results

- Bank fundamentals more constraining post crisis, but macroeconomic constraints remain

Bank fundamentals

- Banks in CESEE tend to lend more when (i) their asset quality is better; (ii) they are less subject to liquidity constraints; (iii) they have higher capital reserves

Parent bank characteristics

- Lower funding costs and higher capitalization of the parent increase credit growth in CESEE

*Analysis done by Gregorio Impavido, Jerome Vandenbussche, and Li Zeng (IMF-EUR).

IMF's European Department, one approach that we have used is panel regressions, that is, the estimation of pooled time series cross-country regressions (with fixed effects), with generally encouraging results. Another one is disequilibrium (between supply and demand) models, which are time series models for individual countries. Although typically less robust than panel models, the results of disequilibrium models tend to offer similar intuition. To complement this, we have also taken advantage of two leading bank lending surveys for the region: the first one is the CESEE Bank Lending Survey and the other is the Institute for International Finance (IIF) Emerging Market Bank Lending Survey.

So, we are trying to use different or alternative approaches that, as a group, will give us a broad view of the likely "suspects," that is, factors that we should focus on as possible drivers of credit growth (or lack thereof) in the CESEE region. For the purposes of this presentation, we would like to concentrate now on the first econometric approach, which is the panel analysis, and the CESEE Bank Lending Survey.

The results of the bank-panel model estimated by staff of the European Department of the IMF were initially published last year, but were updated for this conference last June. So they are fairly recent and are available online. This model uses individual bank-level data for 2005–12 and it covers 75 banks, both domestic and external, in nine countries. It uses three sets of explanatory variables to ascertain which ones may be driving credit growth: macroeconomic factors, domestic bank fundamentals, and parent bank conditions.

The results are not surprising and show that both bank fundamentals (domestic and foreign) and macroeconomic conditions matter. What we have found interesting is that the relative importance of these two factors appears to be shifting. In the early part of the global crisis, their importance was more or less evenly distributed but, as the crisis evolved, bank fundamentals appear to have gained importance.

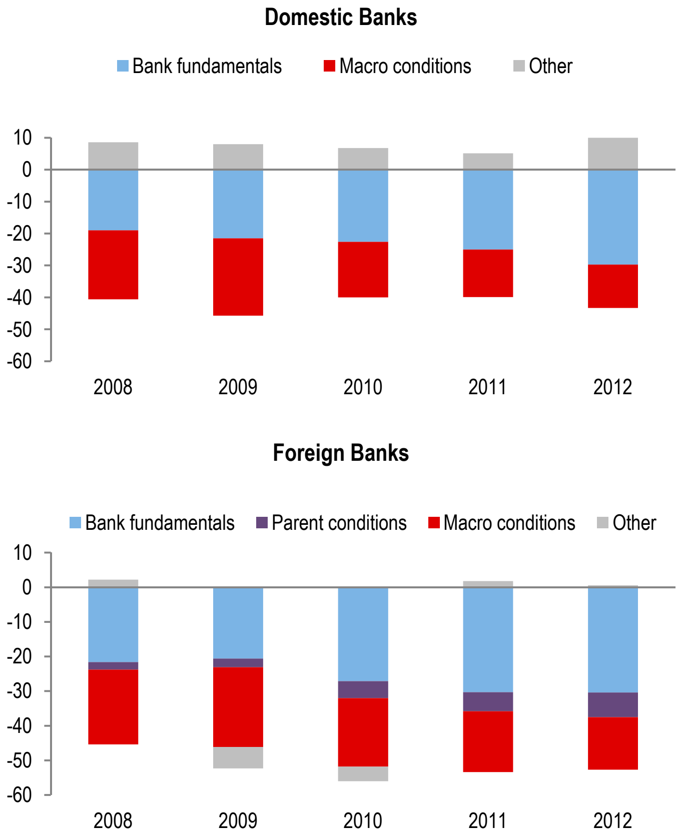
Let's look at some details of the estimated panel analysis equation. In the equation, higher asset quality, liquidity, and capital reserves, and are found to be associated with higher credit growth. For parent bank characteristics, we find that lower funding cost and capitalization of the parent increases credit growth. Again, the results are not surprising.

Another way to look at this, using the same equation, is in the two charts below (Figure 5). The top chart shows the variance decomposition of credit growth for domestic banks. The drop in credit growth now and the average rate observed during 2002–08 can be explained by two bars: the one in blue shows how much of the drop is explained by bank fundamentals; and the one in red shows how much of it is explained by macroeconomic conditions. As you can see, in the early years of the crisis, the model tells you that, roughly half was explained by bank fundamentals and half by macroeconomic conditions. But as the crisis evolved, the breakdown seems to have changed, with bank fundamentals becoming more important. A similar story is told by the lower chart for foreign banks. The only difference is that we have included one more variable, which is parent conditions, i.e., bank fundamentals for foreign banks. We found generally the same conclusion, that is, that bank fundamentals and parent bank conditions appear to be driving the poor performance of credit growth in the region.

Before moving to the results of the surveys, let me digress slightly and briefly discuss the issue of how external or domestic factors are driving credit. The original version of the panel regression estimated by the IMF's European Department included global factors as one of the retained explanatory variables. The conclusion at that time was that global factors were important drivers of the drop in credit at the beginning of the crisis, but also that they were becoming less important as domestic conditions became more relevant. This was an intuitive result consistent with our priors. Thus, it comes as no surprise that, in the re-estimated model with more recent data, this variable dropped out (i.e., was not statistically significant).

Figure 5. Credit Growth Decomposition, 2001–2007

(In percent of total credit growth)



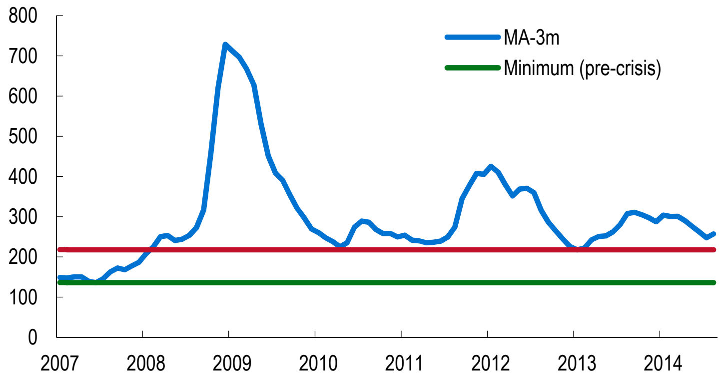
Source: IMF staff calculations; analysis done by Gregorio Impavido, Jerome Vandenbussche and Li Zeng.
Note: credit growth decomposition was estimated relative to average credit growth over 2001-2007 pre-crisis period.

To shed more light on this, the charts below show the emerging markets bond index (EMBI) spread for Europe (Figure 6) and a comparison of the evolution of NPLs in the CESEE region, advanced economies, and (selected) emerging markets (Figure 7). The EMBI jumped to very high levels at the beginning of the global crisis, and while there have been subsequent spikes, these have been smaller. At present, while still above pre-crisis levels, the EMBI is substantially below the levels observed during the crisis. I think we can say, with some confidence that this suggests that global factors, while important, are unlikely to be a critical determinant factor for credit growth.

In contrast, if we look at the comparison of NPLs between the developed, developing economies and then Europe, we can see that the economies where credit recovered quickly in emerging markets have lower and declining NPLs, after a little spike at the time of the crisis. Yes, there is an identification issue here, although it is partially addressed in the previous econometric work presented above. However, it is interesting to note that in the developed economies, which are also facing a credit growth problem, NPLs have continued to increase. Now, what is happening in the CESEE countries? They also see an increase, but at a much more rapid pace. While these are only arithmetic averages, they not only show a dramatic increase, but also just as worrisome, no clear downward trend.

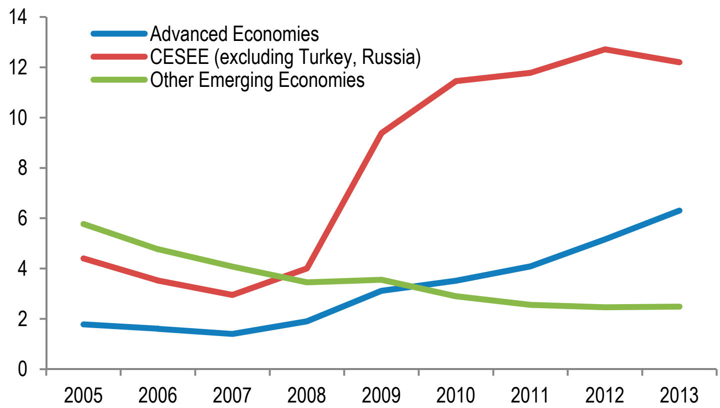
Now, let us move away from the econometric results and turn to what the industry's surveys tell us, i.e., what the banks' views are regarding the factors that are driving credit growth. In this case, we will concentrate on the CESEE Bank Lending Survey prepared by the EIB. The survey is conducted twice a year, covering over 100 groups, both domestic and international. It includes a number of questions aimed at assessing demand and supply factors that may be driving credit growth. The results are interesting and generally support what the econometric work says. It finds that, while numerous factors affect credit growth, NPLs are the single most important factor. Second to NPLs, bankers believe that regulatory changes are also an important constraint.

Figure 6. EMBI Spread Europe
(In basis points)



Source: Bloomberg, IMF staff estimates.

Figure 7. Nonperforming Loan Ratio, by Region
(In percent)



Source: IMF Financial Soundness Indicators.
Nonperforming loan ratio is defined as the ratio of nonperforming loans to total loans.

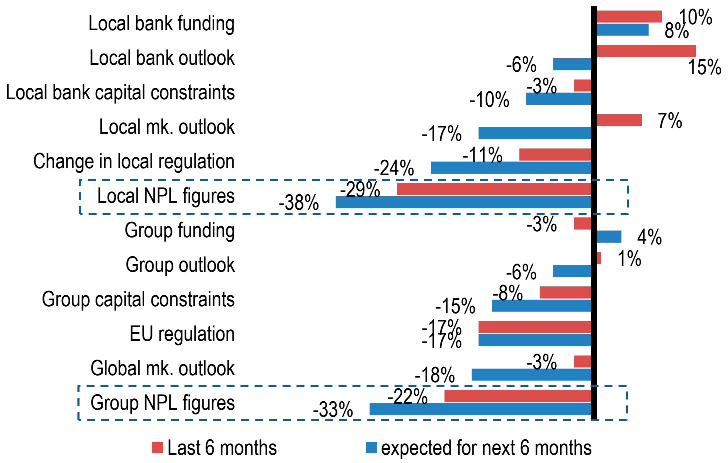
In Figure 8 below, negative values means that credit conditions are getting worse, while positive values means that they are improving. As previously mentioned, the single most important factor according to banks is NPLs. And this was true for both domestic and external factors. Moreover, it is true for the previous six months and even more important in terms of expectations for the following six months (red versus blue bars). The survey also shows that bankers find changes in regulation, both local and at the EU level, also important. Somewhat surprisingly, they do not see funding, especially local, as a particularly important constraint.

Before I turn to the next topic, let us explore further the results of the survey. Figure 9 shows the evolution over time of demand and supply factors constraining credit growth. Again, if the numbers are negative it means that things are getting worse. Conversely, when the numbers are positive, it means that things are getting better. According to this, conditions on the demand side have stabilized and have even moved from very negative to slightly positive. On the supply side, while becoming less negative, the results indicate conditions are still deteriorating, albeit at a slower pace. The next question here is what bankers expected for the future. Will this get better or worse? Interestingly, bankers expected both supply and demand to improve markedly over the following six months. Before we become overly optimistic, however, it is important to note that, according to the survey last year, there was also the expectation of a recovery, which did not fully materialize.

Policies put in place to support credit

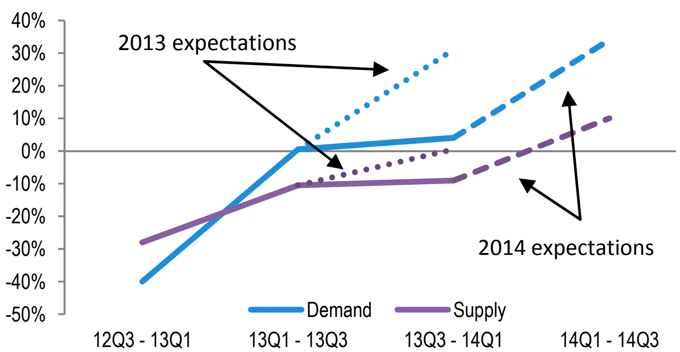
Let me now move to the third part of the presentation. We have so far looked at how bad the problem seems to be, and

Figure 8. Factors Constraining Credit Supply
(As a net percentage of positive and negative responses)



Source: CESEE Lending Survey (H1-2014)
Note: Negative values indicate tightening credit conditions.

Figure 9. Outlook of Credit Supply and Demand Conditions
(As a net percentage of positive and negative responses)



Source: CESEE Lending Survey (H1-2014)
Note: Negative values indicate tightening credit conditions.

now we want to look at what policies have been put in place in the region so far. For that, I want to use the results of an IMF survey conducted late last year for 42 countries and questions covering over 50 policy categories. The results of this survey were published last year in the Global Financial Stability Report

(GFSR), although for the case of the CESEE countries, the survey was updated just two months ago.

Figure 10. Taking Stock of Credit Policies Implemented

Scope

42 countries, including CESEE

About 50 policy categories

- Measures enhancing credit supply
- Measures supporting credit demand

Note: detailed table available online at http://www.imf.org/External/Pubs/FT/GFSR/2013/02/pdf/appendix2_1.pdf

Questions that were asked covered a wide array of measures to enhance credit adopted in the region and elsewhere. This is not to say that these measures are advisable. Clearly, some may not be effective or, under certain conditions, may entail higher costs than benefits. The purpose is to do a comprehensive survey of measures adopted. On the supply side, there were 50 policies in 5 sub-categories: monetary policy, fiscal programs on credit, supportive financial sector regulation, capital market measures, and bank restructuring (Figure 11). On the demand side, it covered measures related to corporate and household debt restructuring, including government-led schemes, legal approaches, and workout plans (Figure 12).

In Figures 13 and 14 below, "Y" denotes measures that have been implemented. It does not describe the specific measures taken or how deep or successful they have been. So it is a broad look into the general areas where countries are moving, a bird's eye perspective of what has been done.

Let's take a look at credit supply policies. The left side of the table presents the responses for developed economies (both European and non-European), while the right side presents the results for CESEE economies. One of the first things that stands out is that the column on bank restructuring is sparsely populated in the case of CESEE, compared to developed economies. This is

Figure 11. Policies Enhancing Credit Supply

Monetary policies

- Monetary policy operations
- Purchases of private sector assets
- Lending facilities to firms and households via banks

Fiscal programs

- Direct extension of loans to firms and households
- Subsidies and tax incentives
- Credit guarantees

Financial sector regulations

- Reduction of RWs for SMEs
- Forbearance on recognizing NPLs

Capital market measures

- Promotion of corporate bond markets and securitization

Bank restructuring

- Recapitalization programs
- Asset purchases, and guarantees for bank assets

Figure 12. Policies Supporting Credit Demand

Corporate/ Household debt restructuring

- Government-led scheme with contingent fiscal liabilities
  - Debt restructuring using state-owned banks or asset management companies
  - Subsidy and tax incentives
- Legal approach (without direct fiscal involvement)
  - Moratorium on debt services
  - Amendments to bankruptcy-related rules
- Coordination to reach orderly workout plan

an interesting result given our finding from previous sections that the problem of high NPLs is more acute in these countries. As a first take, it appears to be an area in which much can still be done.

Similarly, perhaps less significant, but still important, is the result for capital market measures. In the responses received, not a single CESEE country reported that they have adopted capital market measures. While some countries may not be large enough, it is an interesting result to keep in mind. For example, the possibility of a regional approach comes to mind as a possibility worth exploring.

Figure 13. Credit Demand Policies Implemented Since 2007

	Monetary Policy	Fiscal Programs on Credit	Supportive Financial Regulation	Capital Market Measures	Bank Restructuring
Central, Eastern, and Southeastern Europe Non-Euro-Area					
Albania			Y		
Bosnia and Herzegovina					Y
Bulgaria			Y		
Croatia	Y	Y	Y		
Czech Republic					
Hungary	Y	Y			
Latvia					Y
Lithuania		Y			
FYR Macedonia	Y	Y	Y		
Moldova	Y				
Montenegro		Y			
Poland		Y			
Romania		Y	Y		
Russia	Y	Y	Y		Y
Serbia	Y	Y	Y		Y
Turkey					
Ukraine	Y	Y			Y
Central, Eastern, and Southeastern Europe Euro-Area					
Estonia	Y				
Slovak Republic	Y				
Slovenia	Y	Y	Y		Y
Other Euro Area					
Austria	Y				Y
Belgium	Y	Y			Y
Finland	Y				
France	Y			Y	Y
Germany	Y	Y			Y
Netherlands	Y	Y		Y	Y
Euro Area (periphery)					
Greece	Y	Y			Y
Ireland	Y	Y			Y
Italy	Y	Y	Y	Y	Y
Portugal	Y	Y			Y
Spain	Y	Y		Y	Y
Other Advanced Europe					
Denmark	Y	Y			Y
Iceland		Y			Y
Norway	Y	Y			
Sweden	Y				
United Kingdom	Y	Y		Y	Y
Non-European Countries					
Australia					
India	Y	Y	Y	Y	Y
Japan	Y	Y	Y	Y	Y
Korea	Y	Y	Y	Y	Y
South Africa					
United States	Y	Y		Y	Y

Source: IMF staff.

Figure 14. Credit Supply Policies Implemented Since 2007

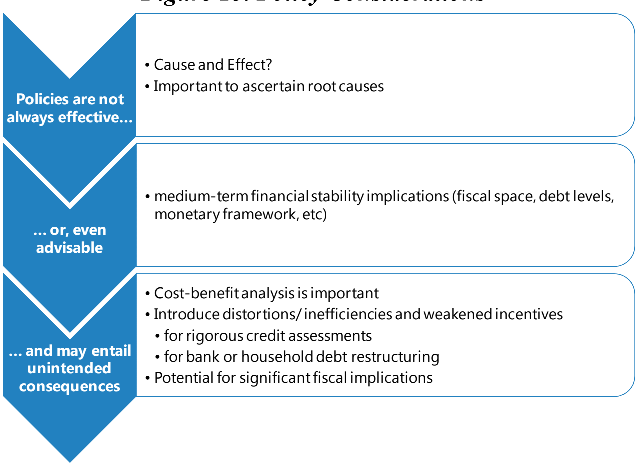
	Corporate Debt Restructuring	Household Debt Resolution
Central, Eastern, and Southeastern Europe Non-Euro-Area		
Albania	Y	Y
Bosnia and Herzegovina	Y	Y
Bulgaria		
Croatia	Y	
Czech Republic		
Hungary		Y
Latvia	Y	Y
Lithuania	Y	Y
FYR Macedonia		
Moldova	Y	Y
Montenegro		Y
Poland		
Romania	Y	Y
Russia		
Serbia	Y	
Turkey		
Ukraine	Y	
Central, Eastern, and Southeastern Europe Euro-Area		
Estonia	Y	Y
Slovak Republic		
Slovenia	Y	Y
Other Euro Area		
Austria		
Belgium		
Finland		
France		
Germany		
Netherlands		
Euro Area (periphery)		
Greece	Y	Y
Ireland	Y	Y
Italy	Y	Y
Portugal	Y	Y
Spain	Y	Y
Other Advanced Europe		
Denmark		
Iceland	Y	Y
Norway		
Sweden		
United Kingdom		Y
Non-European Countries		
Australia		
India	Y	
Japan	Y	
Korea	Y	Y
South Africa		
United States	Y	Y

Source: IMF staff.

Let's move to the other side of the equation, that is, the demand side. Compared to the supply side, here the picture is more mixed. Let's look at the implementation of corporate and household debt restructuring across groups of countries. Starting with the first column covering developed economies, while implementation is rather mixed, it is interesting to note that all the countries that faced the strongest impact of the crisis, the so-called periphery (Greece, Ireland, Portugal, and Spain), have implemented both corporate and household debt restructuring schemes. In the case of the CESEE area, the picture is more varied. In these countries, while some have implemented debt-restructuring programs, particularly for corporations, many have not. While this is by no means definitive, the latter provides some evidence that more could be done in this area. Of course, a deeper analysis on a case-by-case basis, and taking into account other factors would still be needed.

Before I conclude, let me qualify the analysis that we have so far presented. First, ascertaining causes and effects is difficult. But it is also essential to understand the root causes of low credit and hence, the potential effectiveness of alternative measures to revitalize it. While the econometric work presented above incorporated to some extent the latter, there is further work that could be carried out in this area. Also importantly, the analysis presented above did not elaborate on the costs and benefits of the alternatives measures, or on the medium-term financial implications, including whether there is fiscal space. Nor did it enter into the issue of the monetary framework, which clearly has implications for the viability of some measures. Nevertheless, despite these important qualifications, it should provide a broad but useful framework to see where further analysis and policy efforts could concentrate.

Figure 15. Policy Considerations



The way forward

One key conclusion we derive is that the risk of a creditless recovery appears significant for several countries in the CESEE region and that spurring sustained credit growth requires actions in both home and host countries, particularly the former (Figure 16). A central issue here is the need to repair banks' balance sheets, and also corporate and household balance sheets. An area that appears particularly promising, despite serious challenges in its implementation, is that of decisive actions to deal with the problem of high NPLs. Other areas that also appear to offer promise include corporate and household debt restructuring efforts.

This presentation has focused primarily on the countries that are facing low credit growth problems. A few countries, however, are already experiencing vigorous growth, and raising different policy questions, such as whether credit growth is sustainable/excessive, and if so, the appropriate macroeconomic policy mix (Figure 17).

With this let me conclude. This presentation provides a justification and background for the four panels of this seminar: repairing balance sheets; prospects for credit growth and foreign bank engagement; measures to revive credit markets (best practices and pitfalls); and risks of a new financial crisis.

Figure 16. Findings

Risks of a creditless recovery appear significant for several countries

- Spurring "sustained" credit growth requires actions in both home and host countries
- More proactive actions on debt restructuring and NPL resolution, appear particularly important
- Measures to repair corporate and household balance sheets also appear promising
- Other actions could also be considered, such as diversification of financing options, provided that benefits are carefully weighted against costs

Figure 17. Further Findings

Rapid credit expansion in a few countries raises the question of sustainability

- Is credit growth excessive?
- Appropriate macroeconomic policy mix?
- A possible role for appropriate macroprudential policies?

IV. PANEL 1: REPAIRING BALANCE SHEETS AND OTHER CHALLENGES

A. Summary

Panelists discussed the extent to which balance sheets in the financial system and the corporate and household sectors constrain credit growth in the CESEE region; the key impediments to the repair of balance sheets; and how best to address high levels of NPLs and high private and household indebtedness. The discussion focused on practical considerations to make meaningful progress both in the banking system, as well as in the private and household sectors, given the experience in the CESEE region as well as in the rest of Europe.

There was acknowledgement that credit is procyclical. On the one hand, weak credit growth is to an extent a symptom of stabilization from the imbalances that had built up before the crisis. On the other hand, the financial crisis is likely to have depressed credit levels beyond this correction. In this context, several alternative explanations for weak credit growth, both on the supply and demand side, were discussed.

Firstly, banks may not have sufficient funds to lend because of weak balance sheets as a direct result of the crisis and the effects of a high level of NPLs, toxic assets, and hidden off-balance sheet activities. Secondly, credit may be suppressed due to perceived underperformance of potential borrowers. The vicious circle that emerges out of the banks' risk-aversion during the downswing of the business cycle prevents growth, which results in underperformance of potential borrowers and may potentially further increase NPLs.

The discussion stressed that, while some advocate natural processes for the resolution of weak balance sheets and low credit, the process is usually too slow and proactive actions may be necessary. Moreover, it pointed out that capital increases have not been sufficient or timely for much of the region. In this connection, improvements are needed not only for banks' balance sheets, but also for those of corporations and households; this calls for actions that go beyond central bank policies.

Going forward, panelists argued that the primary focus of the policymakers in the CESEE region should be on improving the quality of institutions and regulation. The argument was that unnecessary barriers hindering NPL resolution, such as inappropriate and inefficient insolvency and tax legislation that causes delays in restructuring and raises confidence issues in potential investors, should be removed. There were calls to improve and reinforce risk management strategies and corporate governance, and also to improve coordination of macroeconomic policies. Monetary policy cannot alone provide a further demand stimulus, so the fiscal stance and structural reforms should be reconsidered, and institutional and legal frameworks should be strengthened.

B. Presentations by Members of the Panel

Lead: Jan Švejnar, Columbia University and Vilem Semerak (CERGE EI)

Quite a few issues have already been raised. I will go quickly over those that have been covered and deal a little bit more with some other ones.

The first thing to remind ourselves of is that credits are procyclical. The literature indicates that credit supply is very much procyclical, and that there are three key factors that hinder the provision of credit: (i) banks may not have funds to lend; (ii) companies may not be fit enough to borrow (collateral constraints); and (iii) banks may have funds but cannot lend because of regulatory constraints (poor health of banks versus capital adequacy rules). In addition, customers may change their evaluations of what will be happening in the future and may be less willing to indebt themselves than before.

Note that cases (ii) and (iii) above are directly related to the balance sheets of borrowers (business sector) and banks (and possibly other intermediaries), respectively.

Problems related to the financial crisis and subsequent recessions (or slow recoveries):

- Assets that turned "toxic"
  - Assets related to subprime market-linked derivatives (Iceland, Cyprus, and Greek bonds)
- Domestic NPLs
- Additional issues
  - Hidden risks ("off-balance sheet" risks, repo agreements)
  - Additional pressure: Basel Leverage Rule
- New threats
  - Threats related to complicated relations with Russia

When we consider banks' balance sheets, there are problems related to the financial crisis and the subsequent recession(s) and/or slow recoveries. There are assets that turn "toxic," such as the bonds of Iceland, Cyprus, and Greece (subprime market linked derivatives), and there are domestic NPLs. Additional issues are related to hidden risks (off-balance sheet activities, repo agreements) and the Basel Leverage Rule. There are also new threats related to complicated relations with Russia that have emerged recently.

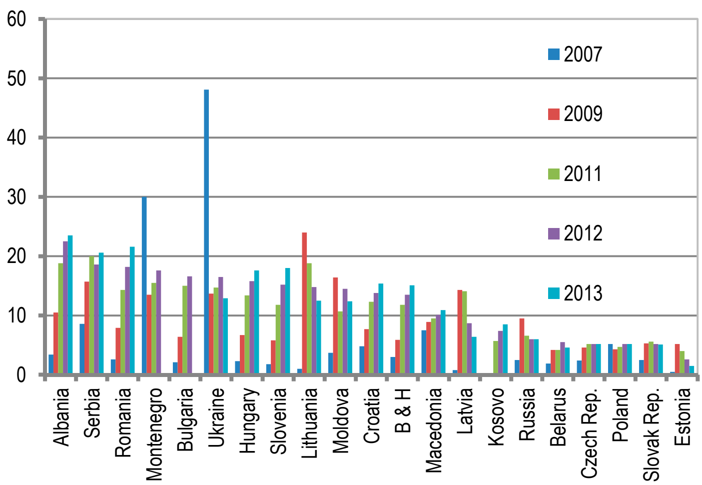
Let me say a few words about the CESEE region. NPLs in the region are a legacy of fast credit growth before the crisis and one observes a variety of performances. There are, for example, countries with low shares of NPLs—Estonia, Slovakia, Poland, and Czech Republic—and there are countries with high shares of NPLs—Albania, Serbia, and Romania (see Figure 1). Moreover, two issues can be observed in these situations: (i) data deficiencies and possible underreporting (highlighted in the

Vienna initiative report), and (ii) macroeconomic disequilibria in countries with a high share of NPLs. The disequilibria act as constraints on policymakers and increase the risk of further shocks that may escalate the NPL problems.

So if you look at Figure 1, you see that on the left there are countries that have relatively high shares of NPLs, which are growing over time. These are the Baltic countries that have reduced the share of NPLs to a low level, and countries such as Poland, the Czech Republic, and Slovakia where the share is steady at a relatively low level.

Figure 1. Bank Nonperforming Loans

(In percent of total gross loans)



Source: World Development Indicators, online database (as of September 2014).

Figure 2 shows current account balances and balances of goods and services as a share of GDP in the CESEE countries. It is noteworthy that some of the same countries are at the extremes as in Figure 1.

A somewhat similar picture emerges when we look at the government budget surplus/deficit figures (Figure 3). It is

Figure 2. External Disequilibria of CESEE Countries, Current Account Balances, and Balances of Goods and Services
(In percent of GDP)

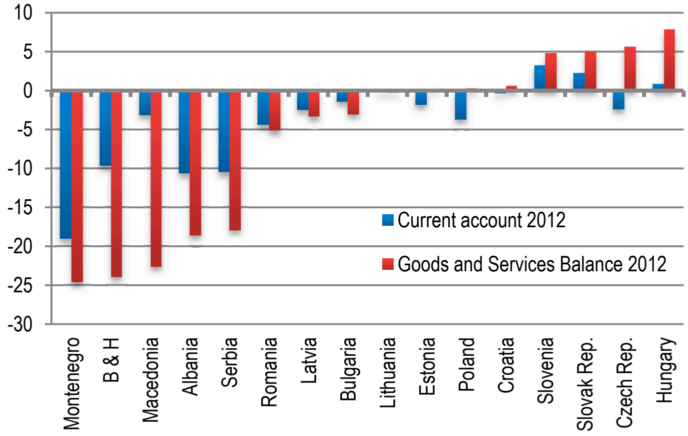
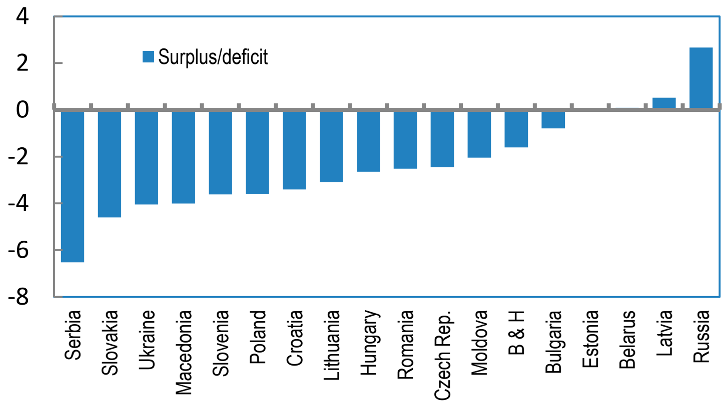


Figure 3. Fiscal Disequilibrium, Cash Surplus/Deficit in 2012
(In percent of GDP)



Source: World Development Indicators, online database (as of September 2014).

interesting that, even with a simple set of indicators, one can start getting a sense of what is going on. The in-depth analysis done by the IMF is naturally complementary.

The process of cleaning up the banks' balance sheets is affected by economic growth and the time span under consideration. With enough growth and time, many problems go away. Bankruptcies of banks with the biggest problems and mergers and acquisitions are also parts of the process. There are obvious problems with natural processes. There are losses brought about by the lack of trust, asymmetric information, and slow pace of the process. There is also the chicken-and-egg problem—economic growth will be achieved when the balance sheets are better, but balance sheets improve when the economy starts to grow.

So what assistance can governments and regulators give? First, a timely identification of risks is essential. Yet, this is not an easy task because of international linkages and hidden risks. Second, the government could provide support that would accelerate takeovers of these "ill" banks by healthier partners. The question that arises here is whether the government ought to provide guarantees. Third, one could have swaps of NPLs and toxic assets for higher quality bonds or other assets. This is usually done by state-controlled asset management corporations. The question is how often you can do this—just once when you, for instance, establish the market system, or more frequently? Fourth, there could be direct recapitalization—the state provides additional capital and (temporarily) becomes a shareholder.

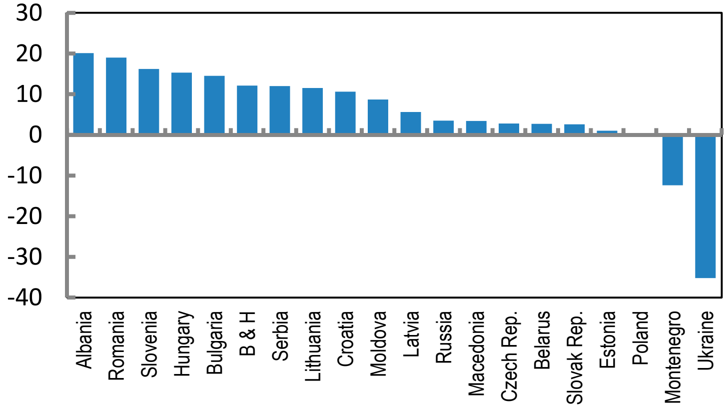
- Efforts to reduce NPLs exist, but the results are weak
    - Share of NPLs has continued to increase in many countries
- Reduction of NPLs is an uphill struggle
    - Weak economic recoveries
    - Negative effects of lower quality institutions on the quality of credit allocation and subsequent enforcement
        - Too slow enforcement of collateral
        - Company restructurings underutilized
        - Tax systems that hinder loan write-downs
    - Complications related to developments in Russia

When examining NPL resolutions in the CESEE region, one observes that there have been major efforts, but the results so far have not been particularly impressive, as the share of NPLs has continued to rise in many countries. Among the factors contributing to this outcome, one notes weak economic recoveries and the negative effects of underdeveloped institutions on the quality of credit allocation and subsequent enforcement. Institutional weakness often results in low reliance on company restructuring and excessive reliance on a tax system that hinders the write-down of loans. And of course, there are complications related to the developments in Russia.

Examining the five-year (2007–12) change in NPLs in Figure 4, one observes that Albania, Romania, Slovenia, Hungary, and Bulgaria significantly increased their share of NPLs. The 2012–13 data in Figure 5 indicate that this growth in NPLs continued in spite of the awareness of the problem and the efforts to deal with it.

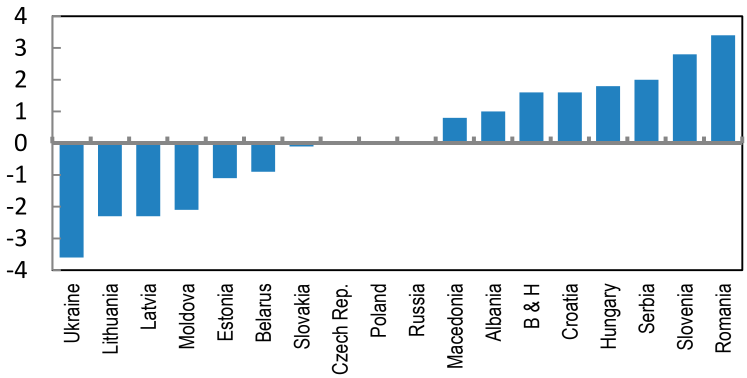
Let me end with some implications for the CESEE region. The primary focus should be on improving the quality of institutions and the regulation and coordination of macroeconomic policies. An emphasis also ought to be placed on removing unnecessary barriers that hinder the resolution of the NPL problems (e.g., burdensome insolvency legislation and tax barriers). Finally, it is useful to adopt best practices observed in other contexts (see e.g., the Vienna initiative report).

Figure 4. Change in the Share of NPLs, 2007–12
(In percentage points)



Source: World Development Indicators, online database (as of September 2014).

Figure 5. Change in the Share of NPLs, 2012–13
(In percentage points)



Source: World Development Indicators, online database (as of September 2014).

Panelist 1: Josef Bonnici, Governor, Central Bank of Malta

Thank you. It is a pleasure for me to be here, and thank you, Boštjan, for inviting me. I come from a country, which is not part of the region we are focusing on, so I have been thinking about what I can say that would add some input to this debate.

First of all, Malta has a relatively large financial sector, probably the second largest in Europe after Luxembourg. The second place used to be occupied by Cyprus, but things have changed since then.

The banking crisis in Cyprus has focused attention on other European countries with developed financial sectors. Malta came under the spotlight as being similar to Cyprus as another small country with a large banking sector.

However, the structure of the Maltese banking sector is very different from the Cypriot one. In Malta, there is a clear separation between international banks and core domestic banks. The core domestic banking sector in Malta follows a traditional banking model, relying mainly on resident deposits for its funding and lending exclusively to the domestic economy. This contrasts with the situation in Cyprus, where systemically significant banks have taken on a large international role that included large holdings of Greek paper and a large volume of funds from outside the EU. In addition, unlike Cyprus, Malta's core domestic banks have very low reliance on non-resident deposits. Cypriot banks made significant efforts to expand overseas, especially in Greece, where banks' exposure was concentrated and which formed the starting point of the Cypriot banking crisis.

Some 12 to 13 years ago, Malta followed the United Kingdom's example of separating supervision from the central bank and setting up an independent authority in charge of national financial supervisory tasks. According to the legislation in place, the central bank was responsible for ensuring financial stability, while the supervision was managed by another institution, the Malta Financial Services Authority (MFSA). At the time, the credit market was booming and the Central Bank of Malta had limited ability to supervise and control the situation in an active manner.

More recently, the European Systemic Risk Board, the newly established institution to oversee risk in the financial system as a whole, came up with a recommendation for a financial stability board or authority. I agreed with this proposal since this could provide us the opportunity to influence the relationship between the banking sector and the economy. In the local context, the establishment by the Central Bank of Malta and the MFSA, of the Joint Financial Stability Board (JFSB) was an important step in the preparation for the Single Supervisory Mechanism.

Amongst the issues that have been discussed by the JFSB was the proposed revision of the Banking Rule BR/09/2008. The rule deals with provisioning for NPLs, taking into account their duration. It also calls for a specific buffer linked to the gap between provisions and NPLs, and takes into account the International Financial Reporting Standards' accounting definition of NPLs. There was a lot of resistance concerning the NPLs from an accounting point of view. We introduced a requirement of extra buffers that banks would be required to hold over a period of three years. The reason we did this was also because we felt that the banks, since they were profitable, should allocate a higher portion of their profits to provisions for NPLs rather than distributing them. This was a bone of contention because the banks were very keen on distributing profits so that their share prices keep going up. I kept on arguing, as my predecessor did, that banks should make more provisions instead of distributing profits. Still, the banks ignored my recommendations. Accordingly, we reviewed the banking rule dealing with the provisioning for NPLs, which had the result of reducing distributable profits, but not to an alarming degree. This initiative was undertaken at a time when banks were repairing their balance sheets in view of the Asset Quality Review (AQR).

Recently, I came across a newly elected member of the European Parliament who wanted to see me and know what I thought of all these bank changes and bank regulations. He said, "…introducing all these regulations, doesn't this mean that banks will be less able to lend? Doesn't this go against what is now required for a high rate of economic growth?" And of course, I explained that having a sound and healthy domestic banking sector is an important necessity for economic growth, and one should not rely on implicit government guarantees. Today, economies can no longer be dependent on implicit government aid, mainly due to the introduction of the bail-in element. I have the impression that some mistakenly argue that the pendulum has swung too far towards regulation at a time when the economy is weak. In addition, people believe economies have gone through harsh budgetary restrictions, so that a relaxing of regulations is needed. This presents a challenge, and although some gains have been made, some more gains are yet to come, such as some type of common deposit compensation scheme, which is in the background. At least some improvements need to be made in this direction.

In the case of the Maltese economy, the banking sector has been showing signs of weak credit growth, and at the same time, NPLs have increased. Nevertheless, the economy keeps growing; in fact, it is growing by about 3 percent. Unemployment is falling, and employment growth is very strong due to the increased participation rate and the inflow of people from countries where low wages and high unemployment are causing a human-capital flight.

When credit growth is negative, one has to examine also the substance of the causes behind it. Again, because I come from a very small country, I have the advantage that I can speak to all presidents of the banks and their chief executives, and the story differs from one institution to another. Sometimes the averaging process hides the substance of the argument, because there are cases in which a bank is restructuring and is still issuing new credit while the old credit is being reduced because of balance sheet repairs.

Overall, it is possible to observe a negative credit growth within an economy that is growing, so the overall situation may be not that negative. This is one of the aspects that I have learned, that is, one also needs to disentangle the information within the aggregates.

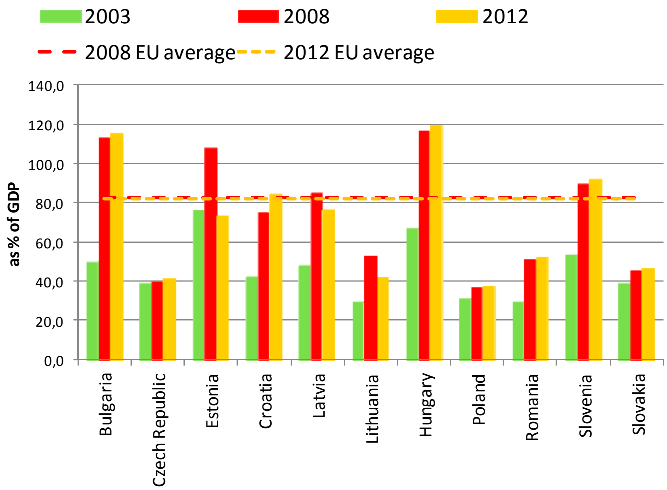
Panelist 2: Boris Vujčić, Governor, Croatian National Bank

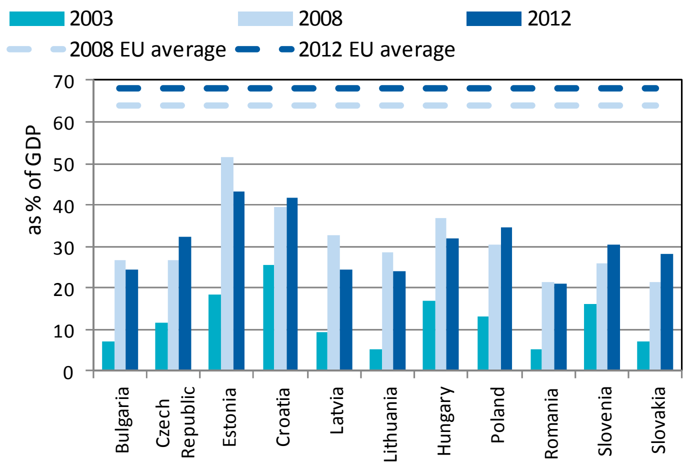
High credit growth rates and the significant rise in private sector debt in the CEE countries prior to the onset of the global financial crisis have generally not been perceived as a problem or potential danger. The rationale behind this way of thinking was based on the belief that these countries had been on their natural way of catching up with more developed countries through the process of real convergence. These "natural" developments have been additionally stimulated by the high level of global liquidity, low risk aversion, low interest rates in developed markets, as well as the high share of foreign banks in the banking sectors of most CEE countries, serving as an efficient transferring channel for foreign capital in search of higher returns. Despite the intensive catching-up process in the pre-crisis period, CEE countries' debt levels are still relatively low compared to the advanced European economies, and neither corporate nor household indebtedness seems to be excessive.

The level of corporate sector indebtedness in the majority of the CEE countries is lower than both the commonly used threshold of 80 percent of GDP and the EU average (Figure 1, top). A similar analysis shows that, for the household sector, this picture looks even better (Figure 1, bottom).

The world financial crisis and the accompanying recession resulted in a substantial decline in the real income of households and the corporate sector in the majority of the CEE countries. Declining income and the worsening economic outlook reduced sustainable debt levels, which in some countries prompted the adjustment of the private sector's balance sheet and resulted in deleveraging.

Figure 1. Corporate and Household Indebtedness





Source: Eurostat.

The adjustment of unsustainable levels of private sector debt, particularly in households, to the sources available for the servicing of this debt (current income and financial and real assets) may lead to significant economic costs in view of the importance of private consumption as one of the key generators of economic growth. It is therefore vital to achieve a better understanding of the process of household deleveraging, particularly its required intensity and duration, which is a prerequisite for creating adequate expectations of short-term and medium-term economic growth and for developing macroeconomic and macroprudential measures in line with the fundamentals.

Household sector—is there a need for further adjustment?

The most common questions associated with household indebtedness are related to the estimation of the necessary short-term balance-sheet adjustment of the household sector, the potential need for additional adjustments, and the driving forces behind the adjustment. When analyzing levels of indebtedness, the question is which benchmark to use—other CEE countries, EU or euro area countries, or something else.

But even when the benchmark is chosen, there is still a question of how to know whether a country is over-indebted or not. Stable levels of debt in literature were until recently based on a static threshold value determined on the basis of historical data such as a specific pre-crisis level, positional value in the distribution of debt of a group of countries[4] or a trend level.[5] According to the

---

[4] The indicators of macroeconomic imbalances of the European Commission (MIP Scoreboard Indicators) take (consolidated) private-sector debt-to-GDP ratio of 133 percent as the threshold value.

[5] Methodology of countercyclical capital buffers.

new approach,[6] the level of debt that is economically reasonable, given the current level of income, should be determined based on models taking into account key macroeconomic determinants. The selection of the econometric method (and the estimator) enables an individual approach and better identification of the specific country features.

According to the usual indicators, it does not seem that the household sector in the CEE countries is excessively indebted. If the model for the non-risky level of indebtedness is estimated for other countries, it is expected that most of them would not “flash red.” Therefore, it could be concluded that the non-risky level of indebtedness depends on the prospects for GDP growth and household income growth, which are very difficult to predict. This additionally complicates the estimation of the optimum level of household indebtedness, making it almost impossible.

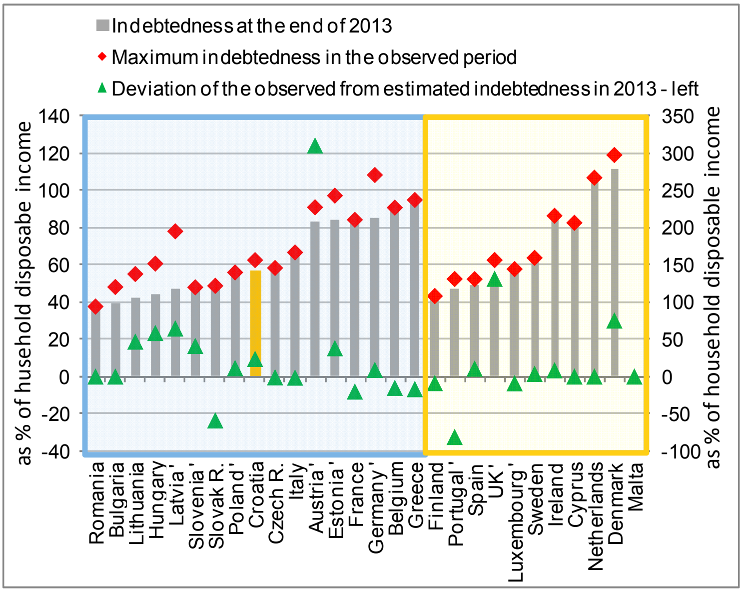
In order to assess the level of household sector indebtedness—which is determined by key current macroeconomic factors and is thus country- and period-specific—as well as to determine which part of the necessary short-term balance-sheet adjustment of the household sector in the EU countries has already been made, the Croatian National Bank (CNB) has estimated a model on the basis of quarterly data for 28 EU countries in the period from the beginning of 1999 to the end of 2013.

In 2013, in almost one-half of the observed countries, households were on average capable, given the disposable income, of taking on additional debt. Croatia belongs to a group of countries with a relatively low need for further adjustment of debt to the disposable amount of income (below 10 percent). If

[6] Empirical research of a thus-specified optimum level of debt has only appeared recently, mainly for the United States; please see Albuquerque B. et al. (2014): *Has U.S. Household Deleveraging Ended? A Model-based Estimate of Equilibrium Debt*, ECB Working Paper Series 1643.

the countries for which the estimated model did not prove to be statistically significant are excluded from the analysis, in the process of adjustment, under existing conditions, 5 percent of deviations should be eliminated within a period of one to three years (Figure 2).

Figure 2. Household Indebtedness in the EU

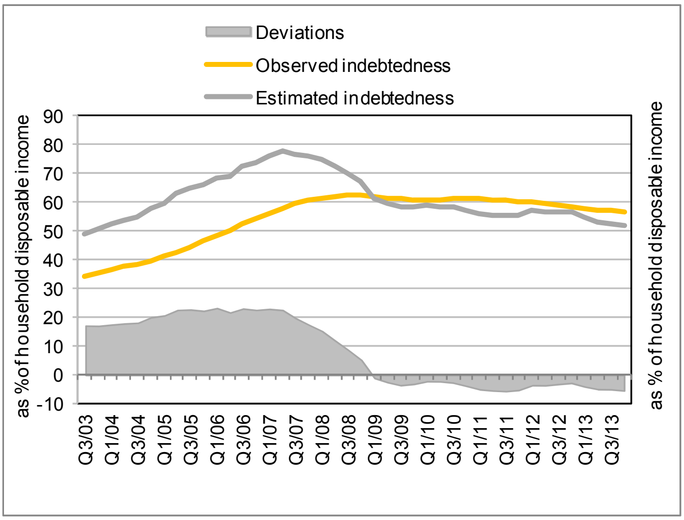


Sources: Eurostat and CNB calculations.

Note: Household indebtedness is measured as the ratio of loans granted to households adjusted for exchange rate changes to their disposable income and is modeled by a set of macroeconomic factors: household interest rate, homeownership rate, the consumer confidence index, unemployment rate, real GDP growth rate, and the ratio of residential property prices to disposable household income. The mark shows the insignificance of the error correction component, i.e., its positive value.

In the period of strong credit expansion and economic growth in Croatia, the aggregate creditworthiness of households, measured by the economically justified level of indebtedness, rose steadily, so the underestimation of the realized levels of household debt compared to those implied by the fundamentals left room for further borrowing. However, with the slowdown in economic growth in early 2007, the potential for further borrowing first started to decline, and then vanished completely with the outbreak of the global financial crisis and its spillover to the domestic real sector. The last six years of recorded recession in Croatia prompted households to adjust their credit liabilities to some degree to their disposable income (by approximately 10 percent since end-2008). However, this debt reduction was on average slower than the fall in income, with the result that in the entire recession period the need for further short-term household deleveraging fluctuated around a relatively low four percent (Figure 3).

Figure 3. Observed and Modeled Level of Indebtedness for Croatia



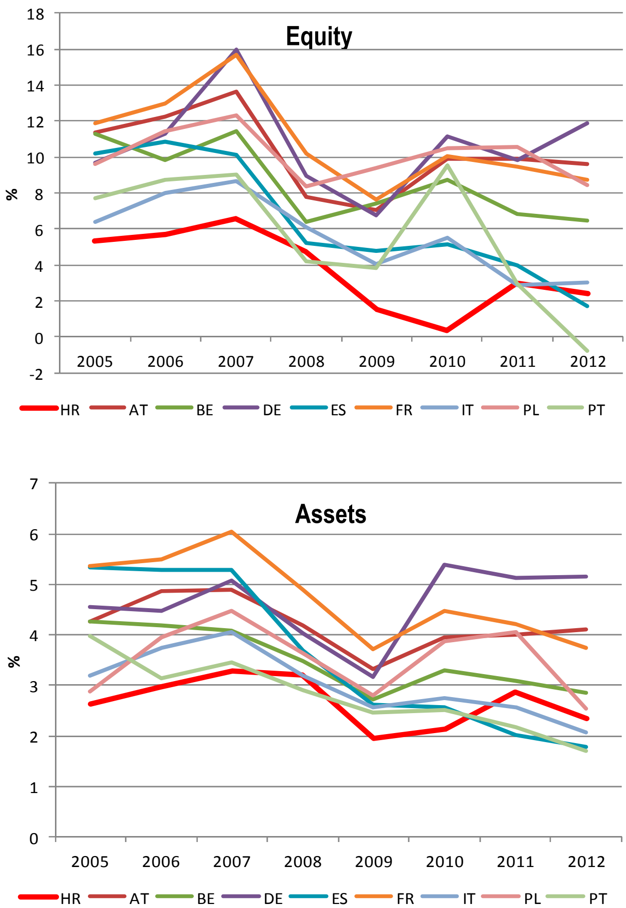
Sources: Eurostat and CNB calculations.

Note: The modeled level of household indebtedness is shown as a four-quarter moving average.

Corporate balance sheet—in need of repair

The average profitability of Croatian companies is lower than in the majority of EU countries, resulting in a relatively high debt burden compared to profits. Croatian corporate sector profitability has been relatively poor even during the pre-crisis period, while the ongoing recession has just worsened the already negative trends (Figures 4 and 5). There are many loss-making enterprises, among which companies from the construction sector dominate.

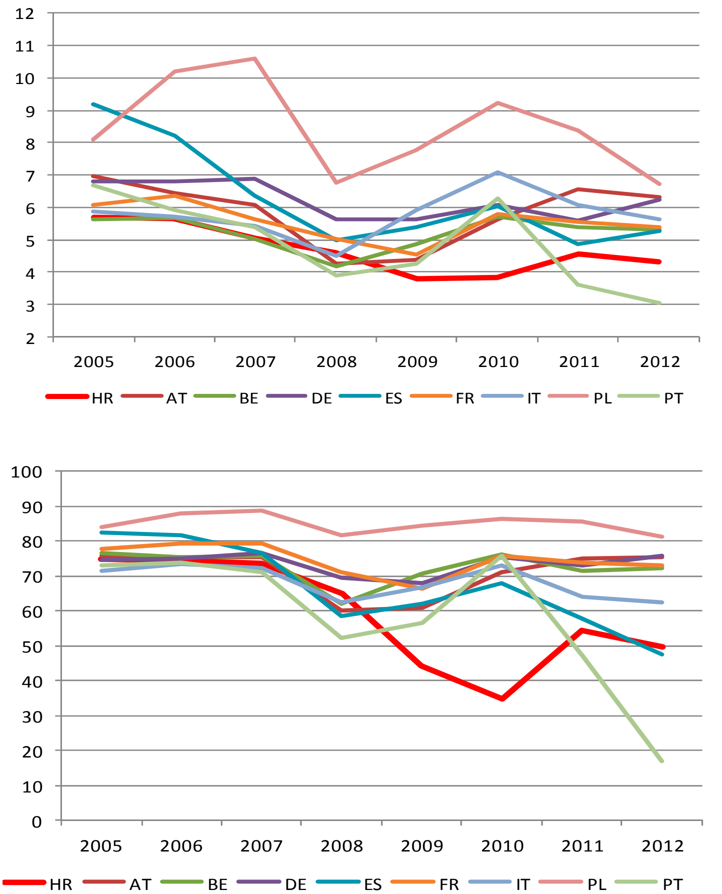
Figure 4. Return on Equity (ROE) and Return on Assets (ROA) for the Corporate Sector



Sources: BACH (Banque de France) and Financial Agency.

Indicators presented in Figures 4 and 5 lead to the conclusion that the need to repair corporate balance sheets stems from poor profitability rather than from elevated debt. In practice, this means that efforts to restructure the corporate sector and improve its profitability should be stepped up, while debt reduction might not resolve the underlying issue of inefficient capital allocation.

Figure 5. EBITDA over Interest on Financial Debt and EBT over EBIT

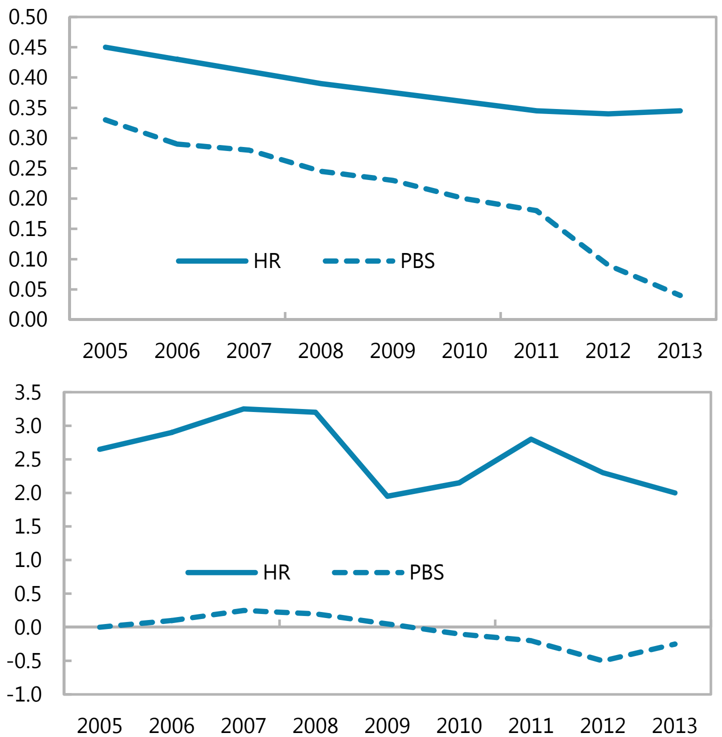


Sources: BACH (Banque de France) and Financial Agency.

Note: EBT/EBIT; higher values on the chart represent lower interest share in expenses and therefore lower interest burden; includes only companies with interest on financial debt.

Croatia has taken the first step in that direction by introducing pre-bankruptcy settlement (PBS) in order to foster corporate restructuring and resolution of NPLs. PBS started in late 2012 and represents a temporary (one-off) "Chapter 11" type of procedure aimed at fostering corporate restructuring. About 6,600 companies entered into this procedure, which is 7 percent of the total number of companies, and they employ about 55,000 people, against 850,000 in the corporate sector. An analysis of the capital-to-asset ratio and return-on-assets ratio of companies in the PBS procedure and the rest of the nonfinancial sector shows that companies in the PBS are loss-making with high leverage, which is a result of little or no capital (Figure 6).

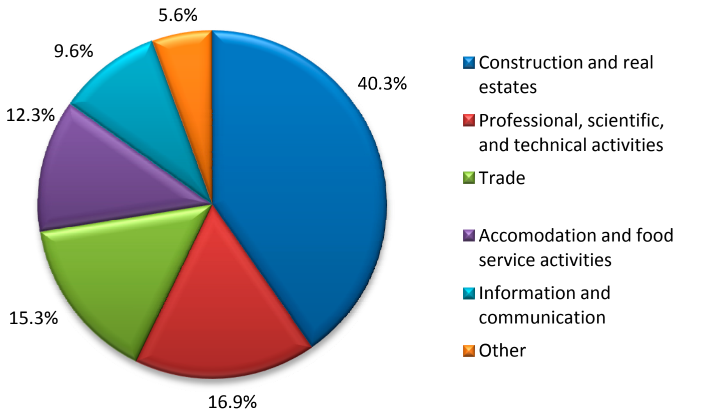
Figure 6. Capital-to-Asset Ratio/Return on Assets



Source: Financial Agency.
Methodology notes: Includes total NACE for the nonfinancial sector without K642 (Activities of holding companies) and M701 (Activities of head offices), includes companies of all sizes; for HR: companies>1 employee. Measures represent by country/by year-weighted mean ratios in percent.

Banks' exposure to these companies amounts to HRK 0.5 billion, which is approximately 10 percent of all banks' corporate exposures. About 50 percent of bank clients in PBS are from construction activities, but it should be noted that a significant part of professional, scientific, and technical activities are also closely linked to construction (Figure 7).

Figure 7. Structure of Banks' Clients in Pre-Bankruptcy Settlements



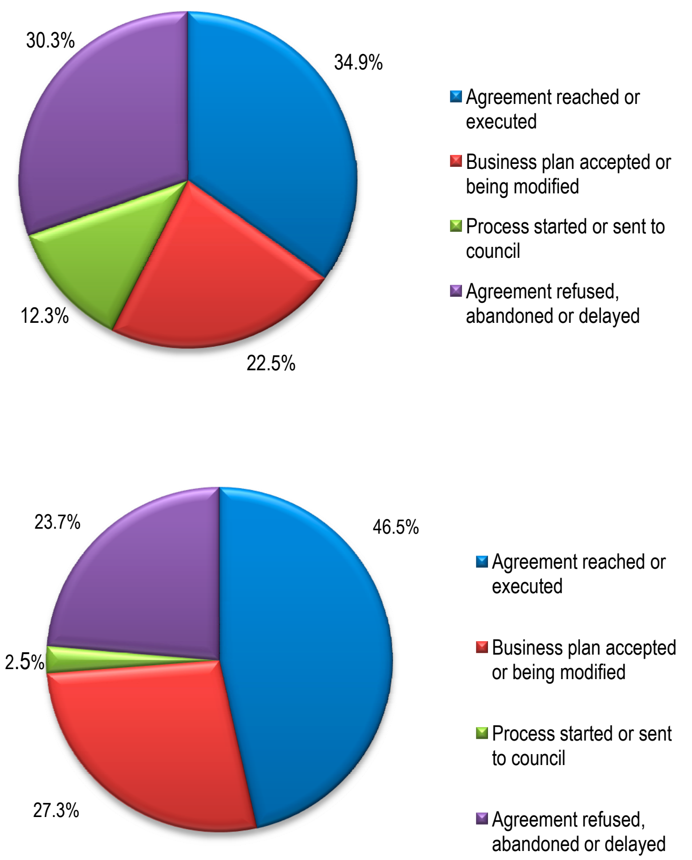
Source: Financial Agency.

The first preliminary analysis conducted after a year and a half from its introduction shows that PBS still has a long way to go, but according to the percentage of reached or executed agreements, PBS for bank clients seems to be progressing slightly better than for the others (Figure 8). Ensuring profitable business models still remains one of the biggest challenges, together with the fact that most of these companies need fresh capital.

When to react?

One of the main conclusions based on the analysis of private sector indebtedness is that it is almost impossible to know if

Figure 8. Progress in Pre-Bankruptcy Settlements—All Companies vs. Bank Clients



Source: Financial Agency.

there is too much credit or not. From the central bank's point of view, this presents a major challenge; yet it also encourages the view that policymakers should react not necessarily only to the level, but also to the rate/pace of credit growth. This means that if credit is growing rapidly, the central bank should act, even if models do not show explicitly that the growth pace is excessive.

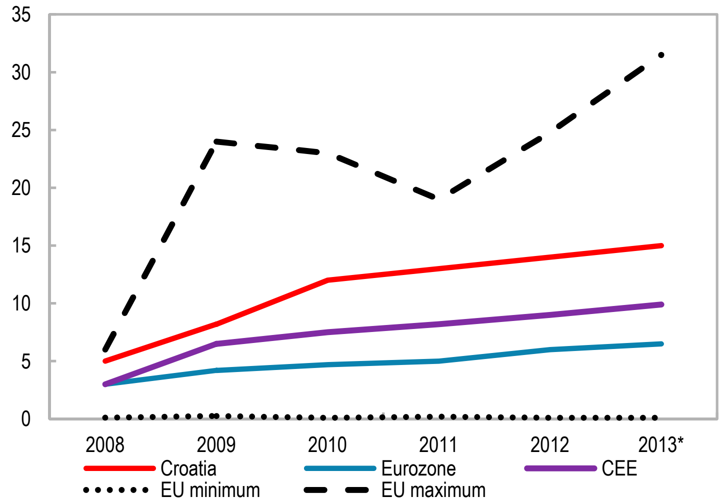
Therefore, if the credit growth rate is high, and the analysis shows that there are signs of overheating in the economy—even without analytical confirmation of an excessively high indebtedness level—it would be reasonable to conduct a policy aimed at slowing down credit activity. The Croatian case confirms this conclusion. In the pre-crisis period, the CNB had introduced a set of monetary and macroprudential measures aimed at restraining both credit growth and the buildup of external vulnerabilities. Although these measures were criticized at the time, the crisis has proven that the rationale for introducing such a set of measures was right. Therefore, despite the fact that analytical tools and models often present the main tool for making decisions, which is good and necessary, central bankers and all other market participants should always be aware of the potential limitations of these models.

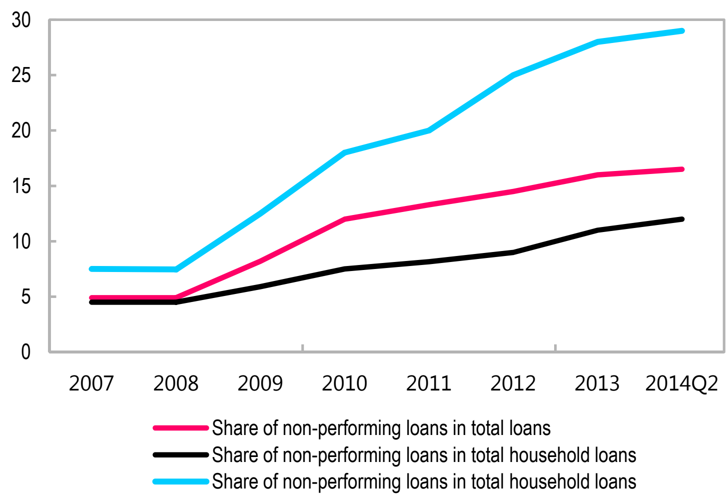
Low credit activity—what could be done?

When trying to find an answer for stagnating credit activity in banks' balance sheets, the high level of NPLs in the CEE countries is usually seen as one of the main credit growth constraints. But this is true only if NPLs are not adequately provisioned. If a bank has an adequate provisioning policy, it is possible to dispose of NPLs or put them into the asset booth and manage them separately, leaving enough room for granting new loans. Conversely, if NPLs are not adequately provisioned, banks may lose a lot of energy in trying to evergreen and restructure them in order to hide the real situation in the balance sheet, which they should actually show to their shareholders, owners, and depositors.

This implies that regulators in that area have a very important role. Considering the fact that Croatia has a higher NPL ratio than the EU average, the above reasons motivated the CNB to tighten provisioning standards in order to deal with the seizure of collateral and related procedures which create obstacles to an efficient unwinding of NPLs (Figure 9).

Figure 9. Nonperforming Loans Ratio
(In percent)





Source: IMF, FSI, (bank assets) weighted averages.

Note: CEE countries include Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia

If a bank does not adequately tackle the loan-resolution process, regardless of collateral, it has to increase the provisioning level progressively over time. This means that if banks have NPLs, they should make the necessary provisions, even if the loan is fully collateralized, amounting to at least 30 percent of the loan value two years after delinquency, and then 5 percent subsequently every six months. At some point it will become very unreasonable for banks to wait, and the measure will serve as an incentive to clean up the balance sheet in order to dispose of NPLs.

The other very important factor for repairing and cleaning banks' balance sheets is the surroundings in which banks operate. In that sense, the CEE countries do not represent a stimulating environment, primarily due to the fact that creditor protection rights are relatively weak as seizure of collateral is often very difficult, sometimes even impossible. This represents a serious obstacle in disposing of NPLs. This problem is very difficult to solve even if distressed debt managers are engaged; they also face the same (usually) legal problems as it gets very complicated to seize collateral or to dispose of collateral without entering into uncharted legal waters. Thus, one of the key issues for increasing the efficiency of NPL resolution is improving the legal environment in which banks—as well as potential buyers of distressed debt—operate. Unfortunately, it is impossible to make these changes in a short period of time, meaning that banks still have to rely on their prudent policies, as well as on forward-looking regulators.

The high share of NPLs is also related to the elevated probability of default, which may induce banks to grant less credit. If the quality of loans is analyzed according to their vintage, it can be observed that more recent loans have a lower probability of default, while the most problematic loans are those which originated in the period from 2003 to 2008. During the crisis, banks have tightened their lending standards and extended less credit, and the quality of these loans has been better than that of the loans granted during the boom period. Banks' behavior is determined not only by models, but also by people who are running the banks, meaning that the quality of granted loans does not only depend on models and risk analysis, but also on the quality of bank management—a factor that is often neglected in the debates on how to ensure good loan quality.

Concluding remarks

It is not clear that credit growth is crucial for growth as such. A detailed analysis reveals that the main problem lies in corporate balance sheets that need to be repaired primarily because of low profitability. The ROE of companies is an important indicator in this regard and points to the heart of the problem. Efforts to restructure the corporate sector and its profitability are needed, and for that purpose Croatia has introduced PBS.

In practice, too much emphasis is generally put on credit growth as a way of problem solving. There is no clear evidence that more credit is necessarily related to stronger economic growth. This broken link has been confirmed by the Croatian data as well, as Croatia had the highest rate of credit growth in the EU over the last five years and one of the lowest rates of GDP growth. I would say that we should look again at the familiar evidence from international finance and open macroeconomics, which has taught us that there is usually enough capital, but the issue is how good and how efficient is the process of financial intermediation. If the intermediary directs capital into the wrong sector or company, this will certainly reflect on the future level of NPLs and reduce the countercyclical potential of the banking sector in the downturn.

In that context, the main challenge is to find a long-term viable growth model based on an improved allocation of capital and underlying corporate profitability, which will simultaneously improve the debt sustainability arithmetic. The first task, in that sense, is to repair corporate sector balance sheets, rather than focus on banks' balance sheets and credit.

Panelist 3: José Ramalho, Vice Governor, Banco de Portugal

In Portugal, we have a long experience of dealing with unsound balance sheets that can be useful for other countries. There are three main ideas. First, we made a lot of mistakes, so if you can avoid them, good for you; second, we had some success in correcting balance sheets and so if the measures that we have taken are useful for you, that's also good; and third, we still have a lot of work to do.

As you can see, over-indebtedness is a serious situation in Portugal, not only in the public sector but also in the private sector. The figures we have are much higher than those presented by my neighbor Boris Vujčić, on Eastern Europe debt. The household debt ratio was above 100 percent and the corporate debt ratio was above 140 percent of GDP in 2010. The private sector debt accumulation was reflected in a strong expansion of banks' balance sheets that showed signs of unhealthy developments. Then, in 2010, we lost market access and, in the context of the sovereign debt crisis, we had to ask for an adjustment program, which started in 2011.

The program had three pillars. One of them was financial stability, which involved several work streams and several instruments. There is one instrument that I would like to highlight because it has proven to be very useful for us. This instrument is the Funding and Capital Plans. These are quarterly forward-looking reports that banks had to prepare and that have proven instrumental in enabling the central bank to gear the adjustment of banks' balance sheets towards the capital and funding targets.

The main results overall have been very positive; by 2013, we had a much healthier financial situation. The borrowing needs or the lending capacity of every domestic sector has improved. The country achieved a net lending capacity, i.e., an external surplus, after several years with an external deficit close to 10 percent of GDP. And we are now seeing debt repayment flows from corporations to banks and from banks to the central bank and to the external sector. Debt ratios started to improve very clearly in the household sector. In the corporate sector, this improvement is more recent and more limited. The public sector debt ratio is expected to start declining this year, but I will leave the public sector out of this presentation.

Now, concerning the banks, results were broadly positive. Solvency strengthened significantly, liquidity and funding structure became much more stable. We have been able to manage a more or less orderly process of balancing deleveraging needs with the financing of the economy. This was particularly challenging, because we needed to deleverage but at the same time we could not leave the economy without finance. Here I would like to make two points. Firstly, a large part of deleveraging was done by reducing external assets. This was the case in Portugal; maybe it is not possible in other countries. Secondly, credit has declined, but we have evidence that some degree of discrimination has been achieved in favor of the most dynamic sectors. This is very positive, because, as the Governor of the Bank of Slovenia said, the allocation of credit is crucial when you are deleveraging. And then the inevitable weak point is the NPLs. NPLs have increased a lot because of two factors—economic recession and stricter supervisory action by the Bank of Portugal. Because of that, banks have recorded losses for three years in a row and only in 2014 are they returning to profitability, if we exclude Banco Espírito Santo, which is an idiosyncratic case.

Let's turn to households. The developments have also been very positive. Households have improved the capacity to service their debts and the incentives to engage in new borrowing have been reduced. What I would like to highlight is that these positive developments were the result of a combination of different policies and changes in behavior. There was a change in the savings behavior of households that adjusted consumption downwards and consequently increased their savings rate and net lending capacity. Monetary policy also made a contribution in this particular sector, namely because there was a pass-through of lower interest rates to existing mortgages that benefited existing mortgage borrowers. There was also a contribution from structural reforms, particularly through the development of the housing rental market that decreased the demand for housing credit. And there was also a contribution from fiscal policy—the tax deduction of mortgage interest payments was sharply reduced for old loans and actually eliminated for new loans; this also reduced the demand for housing credit. Debt ratios benefited from these measures and started to decline consistently, and there were no major problems of debt restructuring or household over-indebtedness.

In regard to corporations, the story is more complex. There we had more mixed results because there were many more blocking factors that prevented a holistic approach from being fully pursued. And so this led us to launch a corporate debt restructuring program with the following key points: discriminate between the viable and nonviable firms; restructure viable firms; and resolve or liquidate the nonviable firms. The major problems that we are trying to overcome are the risk of evergreening temptations by banks, the lack of coordination among creditors and with debtors, and the blocking power of debtors. There are multiple measures that were implemented or are in preparation under the program, including microprudential supervision actions, changes in insolvency regimes and other legal changes, the reinforcement of the role of the credit mediator, and different measures to promote the capitalization of firms.

Lessons learned. The first set of lessons has to do with monitoring and prevention; this is crucial. Monitoring market development is not enough; it may lead to complacency and delayed action, and we have been misled by that in a way. We also need to carefully monitor information on the behavior of economic agents, namely the savings evolutions and patterns, balance sheet structures, and all that; particular attention needs to be given to credit growth. Another lesson is that the financial sector is instrumental in the process of debt accumulation. So it is very important to have sound policies for banks. Now we have macroprudential policy instruments that we did not have at the time, and we hope that they will be very useful in the future.

A second set of lessons has to do with correction, once we are in a situation of excessive debt. One lesson is that the correction of over-indebtedness is very likely to have recessionary impacts, as economic agents' attempts to restore or improve their debt-servicing capacity in a stressful situation are likely to negatively affect consumption and investment. A second lesson is that bank deleveraging is important, but it is not enough. The central bank has a strong influence on the balance sheets of banks and can—to some extent—gear the correction of these balance sheets. But this is not enough to correct balance sheets of households and corporates. And for those other balance sheets, we need what we call a holistic policy response—the combination of different policies, addressing both stock issues and flow issues. This response involves contributions from conventional monetary policy, non-conventional monetary policy, prudential measures, fiscal policy, and—last but not least—structural reforms. The latter vary from country to country; but in our case, they have proven to be very, very important—namely the change in the legal framework.

Panelist 4: Stanislava Zadravec Caprirolo, Vice Governor, Bank of Slovenia

The issues to address are the lessons from recent developments, the challenges ahead, and the policy response to the challenges. To begin with, we could ask: what happened; why it happened; what was the policy response; where are we now; and what further challenges do we face?

The broad picture as to where we currently stand—as has already been discussed by previous presenters—is that we are facing very weak and constrained credit activity, not only in Europe but also globally. The observed credit dynamics are the result of country-specific factors and a mix of drivers that are common across countries, and are propagated by globalization and financial integration. We have to take into account such interactions when defining either common or country-specific policies at the European level or globally. We also need to take into account that we are limited and constrained by not having had some of the tools available, let's say, 20 years ago (before the single monetary system). Also, the effectiveness of available tools is different and policy framework conditions and circumstances have changed. In such a context, some policy responses might not have the appropriate feedback or desired impact.

The common drivers of the crisis affecting us include: financial losses; the freezing of the interbank market and the sudden stop of capital flows; financial disintegration; and weak aggregate demand. While countries are commonly affected by these factors, they also exhibit specific conditions prior to the crises that magnify the effects—such as financial bubbles, highly leveraged corporate and household sectors, and so forth.

Policy responses have been similar at the global and country-specific level, and they have consisted mainly of balance sheet repair. The questions for today, particularly regarding banks, are: (i) Are the banks' balance-sheet repairs sufficient to move countries to a sustained growth path? (ii) Are the banks' balance sheets still subject to risk pressures? The response to both questions is clearly "No." But then, what are the additional policies that we have to follow and push forward? Country-specific policies have to tackle the specific weaknesses of nonfinancial private-sector balance sheets and address specific structural issues. In Marco Piñón's presentation, the policy responses of different countries taken so far were reviewed. The presentation focused on the financial market response and the well-coordinated fiscal policy response during the first phase of the crisis. But now there is clearly need to refocus the policy responses beyond the financial sector, on both the global and country-specific levels.

In the list of priorities, it is not only the problem of credit supply that needs to be tackled, but also the problems of weak overall aggregate demand and weak confidence, which are holding back credit dynamics and recovery. Credit supply constraints, as we are aware, have been mainly addressed over the past five years. But the supply still remains constrained, and the question is why. Is it because there is not enough liquidity and/or capital, or is it because certain channels are not yet functioning; or are there other drivers affecting confidence?

Without doubt, on the aggregate demand side, there are also constraints to be addressed. Let me focus briefly on the Slovenian case, to just underline the broad versus specific dimensions that influence not only the policies that need to be agreed and measures to be taken, but also their effectiveness.

Slovenia already experienced a banking crisis 20 years ago. The policy responses at that time in terms of the banking system were pretty much the same as those being taken currently. Policy measures included state recapitalization of banks and the sett-up of an entity to deal with NPLs removed from banks. However, a few elements of the policy set-up were very different and had a bearing on the policy outcome. One is whether or not to have an independent monetary policy. Clearly, within the monetary union, we have a common coordinated monetary policy; but its effect differs across countries. Thus, to ensure the desired effects, country-specific policy measures have to be focused on additional policies to achieve a given outcome. Another consideration is the global dimension of the crisis and the weakness of aggregate demand. Is this weakness country-specific, limited to the euro area or global? It seems that weak aggregate demand that affects country-specific recovery is a more common problem, particularly at the euro area level, and is linked also to a lack of confidence that—of course—overlaps with country-specific conditions. The third important issue that is different in the current crisis is the institutional framework with global implications (i.e., regulation), particularly state aid rules and regulation affecting EU countries.

Now let me turn to supply and demand shocks affecting credit activity, and those affecting Slovenia in particular.

Supply shocks were broadly similar across the globe, affecting most large economies with few exceptions. An initial shock was the shutdown of interbank markets and the consequent liquidity crunch. The second was a fundamental shock to banks' capital; equity losses in the banking system were followed by the reversal of wholesale funding. There were not only sudden stops of capital flows but also their reversal, which still continues in some countries today. In some cases, like Slovenia, the capital flows were also affected by insufficient and untimely capital increases. Banking fundamentals, liquidity, and capital are those that really matter with regard to the credit supply. Insufficient and untimely capital increases triggered a confidence shock and deposit outflows in 2012 and 2013, in addition to those of bank deposits. The available supply of funds was strongly affected by the sizable private outflows (nonfinancial corporations and households) in 2013 (4.7 percent of GDP), which was similar to that of banks. But credit recovery does not depend only on supply but also on shocks affecting demand, which in Slovenia were very similar to the experiences of other countries. In particular, the collapse of domestic demand, weak external demand, and leveraged nonfinancial companies increased credit risk on the back of a collapse in asset prices, and consequently also resulted in the tightening of credit standards.

The policy response evolved over time and was underlined by the global, broad policy responses of the U.S. Federal Reserve (Fed) and the ECB, and then by specific-country responses. Some affected credit supply, which is the first step to be taken but definitely not the only one. Now policies should address primarily the demand side, hopefully, with a faster speed than those addressing supply constraints.

What is the current state of affairs?

The banking sector is in general stable, liquidity is ample, capital is robust enough, and confidence has returned to some extent in terms of deposit behavior. But there are some extremely important elements to be addressed. These are the interbank market channel and interest rate differentials. The question of confidence is of utmost importance in this respect.

What should be done to restore credit growth, confidence, and cross-border flows—especially within the weak economic environment where other alternative sources of financing are also limited?

The new supervisory infrastructure is now set up. The AQR exercise and the stress testing of banks' balance sheets before entering into the Single Supervisory Mechanism is designed with the objective of restoring confidence by increasing transparency. It remains to be seen whether the expectations of this policy decision and measure are going to bring further positive effects in terms of restoring confidence in the banking sector and renewing cross-border flows. Aggregate demand is the key challenge to be tackled by policy responses now, which definitely goes beyond monetary policy. Balance-sheet repair of the nonfinancial sector is also a key policy priority. But on the other hand, there is also a need for policies to find the very delicate balance between structural reforms, in terms of their impact on aggregate demand, and fiscal stance in the medium term. There is a need for an overall EU fiscal stance to address the issue of aggregate demand and structural supply policies that should encompass the deleveraging of corporate and household sectors. This is particularly important because the fiscal space of many countries is quite constrained, while on the other hand, the monetary policy cannot do the job alone to further push the demand side.

With this I conclude and look forward to your remarks.

C. Discussions

Following the presentations, participants from the floor—several of them members of other panels—posed questions and raised important issues for discussion by the members of the panel.

- Participants acknowledged the critical importance of addressing weak balance sheets—whether for banks, corporations, or households.

- However, they questioned whether the discussion was over-emphasizing the need for credit growth. Several examples were given in which lower levels of credit, or credit growth, have been associated with higher GDP growth, and vice versa. In particular, when much of the credit goes to the wrong sector, as happened in many CESEE countries before the crisis, countries end up with problems later on—such as high NPLs, or even a sovereign debt crisis.

- Participants also asked whether enough emphasis has been placed on the appropriateness or viability of the business models followed by banks and corporations. In this sense, high NPLs in the bank's balance sheets may not be so much a result of the level of indebtedness in corporations but rather a reflection of their fundamentals. In this connection, it was posited whether the problem is the banking model and whether the issue is how to create the right incentives for banks to start lending to highly dynamic, productive, and innovative firms.

- Several participants questioned whether there had been an overreliance on monetary easing, which may have delayed needed reforms—including NPL resolution—and, hence, the recovery. Prolonged easing can delay the recognition of losses, while low interest rates can lead banks to overestimate payment capacity and to keep nonviable and nonproductive businesses. Failing to resolve the NPL issue and allowing nonviable corporations to continue to operate increases the cost of funding for the viable economy and slows down economic growth.

Panelists' responses to questions and comments

Credit level and funding. One panelist emphasized that the credit level is indeed important and that the funding channel is a part of what has to be restored. Some countries still lag behind in the recovery process because they have little diversification of funding sources. Other funding instruments have to be developed, particularly those that would benefit SMEs; for example, there is no equity channel. A policy is needed, and it is interesting that in the IMF survey presented in this seminar, none of the CESEE countries had implemented any capital market measures.

Allocation of credit. A panelist warned about the risks of having central banks—and authorities, in general—conducting a kind of industrial policy and channeling credits to certain sectors of the economy to the detriment of other sectors. This must be left to banks, because it requires micro information at the firm level. Central banks cannot be a substitute for adequate risk management by banks.

Restructuring the financial system. Another panelist noted that this crisis has provided an opportunity to restructure the financial system, and it should be taken. To start a recovery, nonviable firms should be simply resolved and new ones should emerge. In this connection, having adequate provision for NPLs helps because then banks can more easily dispose of bad assets. Moreover, the companies can get rid of the debt and start from scratch, with some even getting some equity in.

For example, in the United States, compared to Europe, recognition of losses and repair of balance sheets was easier because there is no recourse credit. If people cannot pay, they return their keys to the bank. Also, on the asset side of bank balance sheets, you had mostly mark-to-market assets, which entailed an immediate haircut, realized losses, and the need to recapitalize the banks.

Monetary accommodation. In response to the concern that monetary accommodation could delay the restructuring reform, one panelist warned that this has to be put into the context of where we stand in terms of expected inflation. If there is a possibility that one can get stuck in a prolonged deflation situation, monetary accommodation is necessary. On how to stimulate new investments in SMEs, risk-sharing schemes have been implemented in some countries, which have been successful.

Studies and experiments. A panelist emphasized that econometric analysis confirms that firms that go bankrupt actually look pretty bad several years beforehand. If the banks paid attention and were willing to cut off lending at an earlier stage, they could probably avoid some of the NPLs. Moreover, there have been a number of experiments in the region on noncollateral-type lending, based on well-prepared business plans and cash flows. Econometric studies confirm that these seem to perform as well as the traditional collateral based loans. It may be good to know in future discussions why they have not been utilized more.

V. PANEL 2: PROSPECTS FOR CREDIT GROWTH AND FOR FOREIGN BANK ENGAGEMENT IN THE REGION

A. Summary

The panel reviewed prospects for credit growth and foreign bank engagement in the region, against the background of concerns that the global financial crisis and global regulatory reform were causing foreign banks to rein in their exposures to the region, thereby impairing credit and growth.

The panel considered a range of issues. First, has credit growth been unduly impaired and, if so, what factors have been at work? The panel generally acknowledged that credit growth has slowed in recent years, and that in many cases this has been a cause for concern. As for the reasons for weak credit growth, three main factors have been identified: the high level of NPLs; pressures to boost capital, both domestically and internationally; and tighter regulation and supervision, both at home and abroad. However, some emphasized that weak credit growth was not being universally felt within the CESEE, and this diversity of experience illustrated that macroeconomic fundamentals were also an important driver.

Others argued that deleveraging was the natural consequence of earlier credit excess, and therefore could not be avoided. And, by the same token, they cautioned that it was more important to address the structural constraints to credit than to take measures to subsidize or otherwise boost lending. These latter steps risk distorting the allocation of loanable funds, imposing fiscal costs, and could retard the more fundamental adjustments needed. Moreover, some warned that it would be important to take these steps quickly, since the current global environment is relatively favorable and the process of repairing balance sheets could be even more difficult once monetary conditions became less accommodative.

The panel also touched on the effect of regulatory reforms, at both the EU and international levels. It was recognized, as shown in bank surveys, that stricter capital and liquidity requirements has dampened credit provision, but the consensus view was that this was a necessary step to promote a more stable financial system in the long run. Moreover, it was recognized that the effects of regulation would be offset, at least in part, by improving confidence and lowering the cost of bank financing.

Regarding reforms at the EU level, these too were viewed as favorable; but concern was expressed about the rules governing "state aid," whose complexity could impair the ability of jurisdictions to respond quickly and effectively to systemic threats.

The panel debated the merits of domestic versus foreign ownership of banks, as well as the role this has played in dampening credit. Some argued strongly that foreign banks—especially those that were larger, diversified, and well established—has brought considerable benefit to the CESEE before the crisis, improving the efficiency of intermediation and improving access to credit—especially for the corporate sector. During the crisis they had shown better financial performance, experiencing lower levels of NPLs and managing to maintain higher levels of credit.

Others suggested that the distinction between foreign and domestic banks was overstated. These panelists emphasized more the role of management in explaining divergences in performance, the level of competition among banks, and the importance of both home and host supervisors in ensuring the soundness of risk management. It was suggested that it was important to ensure that foreign banks showed a long-term commitment to their host country, including by listing their equity on the local stock market.

Structural issues were also identified as a potential factor explaining differences in credit growth. Notably, uncertainties about the legal structures in some CESEE countries—including those governing collateral collection, or the application of sanctions as a result of the Russia-Ukraine conflict—were seen as driving the willingness to extend credit across borders. Moreover, while several panelists welcomed efforts to reduce the reliance of banks on short-term wholesale funding, they recognized that this was likely to adversely affect the willingness and ability of parent banks to fund their foreign subsidiaries. This argued for steps to improve access by banks to alternative sources of long-term funding.

Several panelists also stressed the importance of steps to address the high level of NPLs in the CESEE. However, it was acknowledged that this was complicated because these NPLs largely reflected loans to the corporate sector, and were concomitantly harder to resolve given weaknesses in existing legal frameworks and the fact that NPLs were in many cases held by state-owned banks—and thus political hurdles would need to be addressed in the event of foreclosure.

The panel expressed a range of views on the role of state banks in the recovery process. Some argued that state banks had in many countries performed poorly in the crisis and that these banks had grown in importance as a result of bail-outs. They worried that state involvement in credit allocation could lead to inefficiencies and (ultimately) fiscal costs, and they suggested that countries would be well served to act decisively and quickly to divest their ownership stakes. Others took a more sanguine view, arguing that divestment was less important than ensuring that state banks were subject to proper governance structures that ensure they operated under sound commercial principles.

B. Presentations by Members of the Panel

Lead: Christopher Towe, Deputy Director, Monetary and Capital Markets Department, IMF[7]

Introduction

Let me begin by saying how honored I am to be able to chair this session, which allows us to try and tackle a set of issues that are hugely relevant for the region—which has been struggling for the last several years to reinvigorate credit, especially by foreign banks.

Fortunately, my panelists are both distinguished and deeply knowledgeable of the underlying problem and policy challenges.

My role principally is to try and lay out a framework for the discussion and trust my panelists to follow up with a more substantive discussion.

The issues before us, I think, can be distilled into the following three questions:

1) Do we think economic activity will be supported by credit, and what conditions need to be in place for this to happen?

2) To what extent should we fear that regulatory reforms, including Basel III and the Banking Union, will have an inappropriate impact on foreign bank engagement in the region?

[7] Mr. Towe's remarks were co-authored by Jeanne Gobat, Senior Economist, Monetary and Capital Markets Department, IMF.

3) What will be the implications for credit growth as foreign banks rely increasingly on local funding?

Will credit support the incipient recovery?

The good news is that most data suggest that economic growth is picking up in the region. In our April 2014 World Economic Outlook (WEO) projections, the CESEE—excluding Russia and Turkey—was projected to grow by 2.3 percent in 2014 compared to 1.2 percent in 2013. Our more recent projections are still being finalized, and it's possible that global and regional growth forecasts may be revised down slightly—partly owing to the intensification of geopolitical tensions. But we still see the region as continuing on the recovery path.

The less good news is that credit growth for the region, including cross-border lending, has remained sluggish compared to other emerging market regions. Indeed, while the Bank for International Settlements' (BIS) quarterly report that was released last week showed that cross-border lending has rebounded generally, an important exception that of was emerging Europe, where cross-border credit fell for the fourth consecutive quarter.

This suggests that, while the aftershocks of the global financial crisis may have receded for many regions, the hangover is still being felt here.

And as my colleague, Marco Piñón, has already pointed out, the EIB's most recent survey of bank lending suggests that credit conditions are likely to remain tight over the next six months.

This survey is very informative about the factors that are likely to act as a drag on bank lending, and quite clearly suggests that there are both home-grown and international factors at play.

At home, the survey suggests that three factors are most important: (i) the high level of NPLs; (ii) domestic regulatory reform; and (iii) looking forward to the next six months, concern that local market conditions may weigh on credit.

On the international front, the survey suggests that credit is being dampened by: (i) EU-level regulatory reforms; (ii) group-wide NPLs; (iii) levels of bank capital at the group level; and (iv) growing unease about market conditions.

Should we be concerned about the weak prospects for credit growth in the region? I think the answer is an unequivocal "yes."

This issue has been studied extensively by my colleagues in the IMF's Research Department, who conclude that—when recessions are associated with a credit crunch and asset price bust—output recoveries tend to be creditless, and that these creditless recoveries are usually suboptimal since the downturns are deeper and the recoveries slower than otherwise.

This reflects not just the overhang of debt from the credit boom but also the dampening effects of balance sheet impairments, weak local capital markets, and limited access to foreign funding.

What are the policy messages of these findings? I would not suggest that the answer is to drive up credit at all costs, since credit is neither necessary nor sufficient to drive an economic recovery—especially when the recession reflects the hangover from a credit boom.

And policies to promote credit that are distortionary, impose undue fiscal burdens, or diminish incentives for balance-sheet clean-up should be avoided.

Instead, I would argue for steps to fix the plumbing that is clogging up the credit channel; policymakers need to:

- promote the recognition and resolution of NPLs;

- adopt clear and credible plans for addressing capital shortfalls where they may exist;

- take strong supervisory action when these plans cannot be met; and

- support these steps with legal and other reforms to facilitate corporate bankruptcy and debt workouts.

Taking these steps would help relieve banks from legacy assets and improve their capacity to finance new, viable projects at reasonable interest rates.

None of these steps is easy, and I don't pretend that there is a one-size-fits-all approach; but early and decisive action is essential.

How will the global regulatory reform agenda and the prospective banking union impact credit prospects in the region?

Let me now shift to the next important question on how the global and European regulatory reform agenda could impact the credit outlook in CESEE as well as foreign banks' engagement in the region. In regard to the European move to banking union, we see this as an important opportunity to address the shortcomings that were brought to light in the recent crisis.[8]

The reforms are expected to establish a level playing field for bank regulation and supervision, consistency in bank resolution and deposit insurance frameworks, and (eventually) clarity on the financial backstops to break the adverse feedback loop between sovereigns, banks and the economy. And a crucial first step will be the AQR and stress testing exercises that are just concluding.

These steps will have important implications for the CESEE countries, both because many are members of the euro area and

---

[8] The EU measures include the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) in 2013, the Bank Recovery and Resolution Directive (BRRD), and the adoption of harmonized standards for deposit guarantees.

because many are host jurisdictions for the European institutions that will be subject to the Banking Union.

We see a number of positive implications of the establishment of the Banking Union for countries in this region:

- It should help reduce the fragmentation of euro area banking and money markets that have emerged in recent years. But, this does not mean necessarily more cross-border lending, but greater confidence and lending rates that are more clearly linked to underlying risk.

- It will enhance consolidated supervision of euro area headquartered banks, including of their subsidiaries in the CESEE region, which should help improve host and home regulatory and supervisory coordination and consistency.

- It will introduce common and harmonized standards and their implementation, reducing the likelihood of regulatory arbitrage or supervisory home bias.

- The AQR should also help identify any remaining weaknesses in banks in the system and improve confidence.

Overall, the reforms should help establish a healthier and better supervised banking system in the euro area and, given their systemic role in the region, should enhance the financial stability of CESSE banking systems.

However, we also see a number of challenges, many of which were flagged in our recent Financial Stability Assessment Program (FSAP) and Article IV Consultation assessments of the EU. These include:

- There will be operational risks that are associated with any major institutional change, and it will be critical that the transition does not result in a diminution of oversight as responsibilities shift from national authorities to the ECB.

- Even once banking supervision at the ECB is up and running, there will be the challenge of coordinating its work with the work of national authorities, which will continue to have sole responsibility for a very large number of banks.

- Moreover, it remains to be seen how EU authorities can and will respond when there are divergences between national and region-wide priorities and conditions.

- Notwithstanding the establishment of the European Stability Mechanism (ESM), there remains a lack of full clarity about how the burden of large bank resolution will be shared among members of the Union.

- The question of burden sharing is especially relevant for countries that are hosts to foreign bank subsidiaries.

- And finally, the uncertainty surrounding the results of the AQR and stress tests has cast a pall over cross-border lending by euro area banks; while we may hope that the results will be confidence enhancing, this still remains to be seen.

These issues are nicely laid out in the recent note by the Vienna Initiative Working Group.[9] There, the point is made—which we endorse—that these uncertainties increase the premium on ex ante discussions with all parties on information sharing and crisis management arrangements.

---

[9] Vienna Initiative Working Group on the European Banking Union and Emerging Europe," April 30, 2014.

And what about the implications of the global regulatory reform agenda?

Regarding Basel III, I think the big unknown is how large an impact the new capital and liquidity requirements will have on the cost of funding and equity capital.

Encouragingly, recent IMF research suggests that the effects should be manageable.[10]

This study suggests that among the major financial markets, the effect would be to raise lending rates by only around 20 basis points. The relatively small size of the increase reflects the fact that much of the adjustment has already taken place, the assumption that the incidence of the measures will fall at least partly on the banks themselves through cost cutting, and partly investors will reward banks with lower costs of funding as they become safer.

As for the impacts in the CESEE, we can take comfort from the fact that, in many cases, banks in this region are well placed to accommodate these new requirements because their capital is generally of high quality and—in some cases—loan loss provisioning has been raised.

Indeed, our more recent analysis of bank activity suggests that the effects of regulation are also being mitigated by several factors including: the fact that these regulations are being phased in gradually; the extraordinarily easy monetary policy conditions throughout the world; the fact that many banks are adjusting to tighter regulations by scaling back their trading books; and

[10] André Oliveira Santos and Douglas Elliott, "Estimating the Costs of Financial Regulation," IMF Staff Discussion Note 12/11, September 11, 2012.

efforts by banks headquartered elsewhere (e.g., Australia, Canada, and Asia) to build market share.

But we should not fool ourselves into thinking that these measures will not have a material effect, since the intention was to raise costs and curb lending, to reduce unwarranted risk taking and enhance buffers.

And these costs are likely to be greater in jurisdictions where the under-appreciation of risk has been greatest and where the scope for accessing nonbank financing is the least.

Moreover, it also remains to be seen whether credit spreads, which have fallen to unusual lows in recent years, are more vulnerable to the effects of the eventual unwinding of monetary accommodation in the United States and elsewhere than the effects of the tighter regulatory environment. To paraphrase George Soros' famous commentary on the global financial crisis "It's only when the tide goes out, that one sees who's swimming naked."

What will be the implications for credit growth as foreign banks rely more on local funding?

This leads me to the final question on what will be the implications for credit growth as banks rely more on a local funding model.

At the global level, we have seen significant adjustments in funding structures, with banks moving away from reliance on short-term wholesale funding—including the interbank market and money market funds—and moving towards deposit and/or bond funding.

This has been a relatively universal phenomenon but has been especially apparent among European banks. Indeed, work by my IMF colleagues suggests that the application of the net stable funding ratio (NFSR) would have a disproportionate effect on European banks. This reflects the fact that banks in Europe have tended to rely more heavily on short-term wholesale funding—

including the interbank market, the dollar swap market, and money market funds—to support their lending.

This suggests that the introduction of the NFSR, which will be fully phased in by 2018, could weigh on the funding provided by European banks to their CESEE subsidiaries.

While this could seem to be an ominous development, there are a number of reasons why this should not be viewed with alarm.

First, a lower reliance on wholesale funding is appropriate, since the crisis showed this can be dangerous and procyclical in times of stress.

Second, we are seeing welcome signs that banks in the region are shifting their business models toward greater reliance on local deposits and other sources of funding.

This should provide a more stable platform for credit intermediation in the region, and it will reduce incentives for foreign currency lending and reduce maturity and currency mismatches.

Greater reliance on local funding will help insulate local markets from regional shocks. This is not to say that cross-border and intragroup funding will disappear; but hopefully, and thanks at least in part to regulatory reform, the risks associated with this type of funding will be properly priced.

Concluding remarks

So let me now offer a few concluding remarks, which are intended to help stimulate the discussion among the panel.

I tend to agree with those that feel that financial regulatory reform at the global, EU, and national levels will dampen credit.

However, I also tend to view this credit compression, at least in large part, as entirely appropriate. The leverage that was built up ahead of the global financial crisis was—with the benefit of hindsight—unsustainable and too often directed to low-quality borrowers. And so the deleveraging we are seeing is, in many cases, the unfortunate and painful after-effects of this earlier excess, and the shift in business models that is underway will deliver more sustainable and sounder financial systems.

However, I believe that there are policy measures that can and should be taken to help this adjustment, especially where credit is unduly constrained and having potentially long-lasting effects on growth potential.

Although these will be discussed in more detail in our other sessions, my suggestion would be to focus on the constraints to credit growth rather than seek to circumvent them with stimulus measures. By this I mean:

- Tackling the high NPLs, which act as drag on bank earnings and balance sheet position.

- Strengthening capital markets, including markets for securitized lending and covered bonds. This would not only improve bank access to stable funding, but also provide instruments to meet the Basel III liquidity and funding requirements.

- Addressing legal and administrative constraints on financial market services and infrastructures, and on corporate debt restructuring.

- Supporting the development of a healthy pension and insurance sector, since these can be an important source of long-term funding, including the direct funding of corporates and projects through investment in bonds and equity.

- Improving the quality and effectiveness of bank supervision, regulation, financial reporting, transparency, and governance, since these will help encourage the participation of outside investors.

Addressing these factors, as well as maintaining strong macro fundamentals, will keep banks committed to the region and provide the foundation for sustainable credit growth.

Panelist 1: Boštjan Jazbec, Governor, Bank of Slovenia

I would like to follow up on the puzzle between foreign and domestic banks. In my view, what really matters is effective management, and this ultimately depends on the exercise of proper ownership. Let me give four reasons why ownership really matters.

The first reason is the governance issue. The roles of principal agents should be clearly defined by the proper owners and then made use of. It does not really matter if you have domestic or foreign banks, though it does matter if you have state-owned banks.

The second issue is the ability to raise capital. In the European context, it is very difficult for any state-owned or public-owned bank to raise capital because of the punitive state aid rules that are currently in place. In Austria and Slovenia, we have already felt the consequence of this. It is also difficult to perceive how domestic investors will be able to raise the enormous amount of capital needed to make banks financially stable and meet the ever increasing capital adequacy requirements. This is the point where I would slightly disagree with Christopher Towe when he said that the new rules might impede credit growth. I am always puzzled with that because I understand that the capital is on the liability side of the balance sheets of the bank. If you increase capital then something has to match up on the asset side. So, it means that more capital might not necessarily reduce credit activity. In addition, more capital also reduces the cost of funding. This is something that has already been mentioned a few times today.

The third reason why ownership matters is attitude towards risk. In my view, banks that have proper owners are more risk averse and have better risk management.

The fourth reason is approach to NPLs. This is also something that we are trying to resolve at this seminar. If you look at the Slovenian case, the approach to NPLs is different because it is also related to the attitude towards risk. And the way in which NPLs have been managed by foreign banks in Slovenia is different compared with domestic banks. Data show that, until 2008, there was no difference in the level of NPLs between domestic banks and foreign banks. However, following the onset of the financial crisis, foreign banks were better in the management of NPLs. In my view, this also demonstrates that ownership really matters. In the case of Slovenia, most of the NPLs are related to problems in the corporate sector, unlike in some other countries such as Ireland and Spain, where NPLs were mainly related to the mortgage market. Since most of the NPLs in Slovenia are related to the corporate sector, transforming the NPLs also means ownership restructuring.

There also may be a political dimension when you have ownership restructuring, as is the case in Slovenia. Since a majority of the banks in the country are state-owned banks, it means that, when the stakes of the banks (i.e., NPLs) are taken over through a debt-equity swap, we have a vicious circle that never ends. How can we solve this puzzle? We again come to the principal agent problem: Who is in the lead and who should make the final decision? All I know is that playing with other people's money is really expensive in the long run.

I will stop here and hope for more discussion of these issues.

Panelist 2: Ewald Nowotny, Governor, OeNB

The economic recovery in the region remains fragile in the light of increasing downside risks. Several factors are significantly contributing to the slowdown of the growth momentum in the euro area as well as the CESEE region, including the mounting geopolitical tensions across the globe, the still ongoing process of balance sheet repair in the financial and nonfinancial private sectors, and the continued need for further fiscal consolidation in some countries.

As the most recent growth forecasts have been revised downwards for the world economy, the euro area, as well as for the CESEE region, the challenges are clear. The recovery is lagging and uneven, mostly due to crisis legacies resulting in lower growth potential. Investment has been subdued and demand remains weak. Hence, reinvigorating (credit) growth in Europe appears high on the agenda of policymakers. Beyond the support of accommodative monetary policies, targeted reform measures are needed in order to avoid recoveries which go hand in hand with prolonged periods of weak output and employment growth. In general, structural reforms to strengthen growth potential or make growth more sustainable are needed.

Due to its geographical and cultural proximity to CESEE, Austria has always had a special interest in the region. Austrian banks were among the first to enter the region, realizing the possibilities and potential of the region and thereby acting as a driver for banking sector development. Their long-term commitment to CESEE is also reflected in their broadly maintained total exposure to the region in the past years, which amounted to EUR 97.5 billion by mid-2014.[11] With a total number of 62 subsidiaries as of June 2014, Austrian banks are still the major players in the region and contribute to a stable flow of credit to the local economies. Thanks to their traditional business model and higher than EU growth rates in CESEE, their activities in the region also continue to be an important contributor to the profitability of Austrian banks on a consolidated basis.

However, CESEE operations also come with higher risks. Higher NPL ratios, goodwill write-downs, and political uncertainty in some countries pose challenges to Austrian banks operating in the region. These risks have translated into higher risk costs over

[11] CESEE exposure of majority Austrian-owned banks (BIS definition).

the past few years. What is more, in the past, the profit sources of Austrian subsidiaries had been evenly distributed across CESEE, which also yielded risk diversification benefits; in recent years, by contrast, profits have increasingly come from just a few countries, namely the Czech Republic, Slovakia, Russia, and Turkey. This highlights a concentration risk and the need for a sustainable growth strategy in the region. Recent turmoil in some of these markets has also underlined the fragility of the current earnings situation. The reduction of exposure in some countries with a difficult economic environment or unorthodox economic and financial policy was more than compensated for by an increase in other CESEE countries, where Austrian banks' subsidiaries have generated profits and registered a relatively stable credit quality in recent years.

As far as foreign currency lending of Austrian banks' subsidiaries to CESEE is concerned, these loans, which have declined by 7.1 percent year on year, amounted to EUR 4.2 billion at end-2013, taking into account exchange rate effects. Yet, the outstanding volume of foreign currency loans continues to pose a material risk both to households and to Austrian banks.

The decreasing trend in foreign currency lending of Austrian banks reflects the success of the macroprudential tools already implemented by the Austrian authorities before 2014, most recently the revised minimum standards on risk management and new lending in foreign currency from early 2013. Furthermore, in March 2012, the Oesterreichische Nationalbank (OeNB) and the Financial Market Authority provided supervisory guidance[12] with a view to strengthening the sustainability of the business models of large and internationally active Austrian banks, in

---

[12] For further information see http://www.oenb.at/en/Financial-Stability/Systemic-Risk-Analysis/Sustainability-of-Large-Austrian-Banks-Business-Models.html.

order to ensure that they increase their capital buffers, rebalance the funding position of subsidiaries, and prepare recovery and resolution plans for potential crisis situations. Monitoring results from the end of the first quarter of 2014 indicate that a large majority of Austrian banks' subsidiaries in CESEE have sustainable business models (on a year-on-year basis). Strengthening of the long-term stable funding of foreign subsidiaries goes hand in hand with developing domestic capital markets, which can be more difficult in small economies that have not (yet) adopted the single currency. These measures also reflect the spirit of the Vienna Initiative[13] to promote a sustainable growth model underpinned by strengthened capitalization, while at the same time proactively preventing pronounced boom-bust cycles.

Coming back to the conditions for reinvigorating credit growth, it is important to note that potential output growth is still higher in the CESEE region compared to the euro area. Many CESEE countries have followed a remarkable economic catching-up process over the past two decades, but have not yet reached the levels seen in most of the euro area countries. These differentials imply a great potential for above-average growth, not only for the CESEE region, but also for the countries with which the region maintains close relations. Owing to the slump in growth in the CESEE region caused by the global financial crisis, the previously substantial growth differential between the CESEE EU member states and the euro area has declined in recent years.

---

[13] The European Bank Coordination "Vienna Initiative" is a platform for cooperation and discussion of all the relevant public and private sector stakeholders of EU-based cross-border banks active in emerging Europe, such as home and host country supervisors, the European Commission, international financial institutions like the IMF, and banks. The Vienna Initiative was launched at the height of the global financial crisis in January 2009 and played a key role in stabilizing the situation in the CESEE region. It helped to prevent a systemic banking crisis in the region and ensured that credit kept flowing to the real economies during the crisis.

Nevertheless, this growth differential is projected to persist until 2019 according to the most recent WEO by the IMF.[14]

Countries with a geographical proximity and traditionally strong ties with the region, like Austria, are in an excellent position to support this process. Austrian banks stay committed to a retail-oriented business model and continue to focus on CESEE. In this regard, with a more sustainable business model, banks play a key role in providing finance to the real economy. This is particularly important as higher investment can boost demand, which—in the end—supports economic recovery. In order to tackle the policy challenges and possible responses in connection with reinvigorating credit growth in CESEE, it is critical to learn about the various experiences of different countries in the region and to exchange opinions. Moreover, as CESEE and the euro area are economically and financially integrated, close coordination between home and host authorities is vital.

Panelist 3: Jan Tóth, Deputy Governor, National Bank of Slovakia

The presentation consists of two parts. The first part deals with our experiences with foreign ownership of banks. The second part gives more detail about the Slovak banking sector.

Today's banking sector in Central Europe (V5 countries) could be arguably divided into three groups in terms of its healthiness and performance. The best group consists of Slovakia and the Czech Republic. Poland and Hungary are in the middle group, with the issue of foreign exchange loans. Slovenia seems to fare the worst, having the universal state banks as major players.

[14] WEO (October 2014).

Slovakia's policy lesson is simple: sell the state banks; attract foreign bank capital from the developed world; and have reasonably low and stable domestic interest rates (i.e., monetary policy of inflation targeting). The advantages of having foreign banks have vastly exceeded the disadvantages. Having state banks in post-communist Slovakia turned out to be extremely costly for the tax payer.

Part 1: Slovak experience with foreign ownership of banks

The Slovak banking system has emerged from the formerly common Czechoslovak communist banking system. In the early 1990s, the Slovak banking system still had many characteristic features inherited from the previous regime and commercial bank activities were concentrated in a few specialized banks.

Beyond the procedural difficulties faced at the very beginning in the newly stabilizing banking sector, the transformation process was impeded by the fact that most of the main financial market institutions had to be newly created, because the majority of the processes were originally managed from Prague—former capital of the Czech-Slovak Republic. The role of the newly formed National Bank of Slovakia was not only to supervise the development of a new banking system, but above all it was responsible for introducing a new currency and maintaining an independent monetary policy.

A consequent period of hectic changes in Slovak society involved also the financial sector. The market has witnessed a dramatic increase in the number of financial institutions with a banking license (that peaked in 1996, when reaching 34). Within a few years, the share of foreign ownership in the sector increased to 50 percent. Simultaneously, employment in the banking system increased and so did the banks' assets, liabilities, and loans.

However, buoyant evolution in the unclear environment brought a significant increase in NPLs. The share of classified loans rose to almost 30 percent of total loans. This unpleasant development was fuelled by inefficient banking institutions, inexperienced banks with an underdeveloped methodology for assessment of creditors, weak risk management, relatively widespread partisan rating of clients, and financially illiterate customers. Accumulation of NPLs was prevalent in the corporate sector. In the unhealthy political environment, coupled with an unstable economic environment, unfair practices of business managers were relatively common, coupled with political pressures to provide unprofitable loans to friendly businessmen.

In the nonstandard economic environment, interest rates were very high. Interest rates on deposits were around 15 percent and the interest rates on loans were at the level of 20 percent per annum. The need for tightened monetary policy and a massive defense of the exchange rate was to a large extent a consequence of very loose fiscal policy and a lack of structural reforms.

A natural component of transformation was privatization of state banking institutions. The inevitable intermediate step in this process was cleaning the banks of the accumulated NPLs. This happened in 2000 and 2001. Based on available estimates, NPLs represented one of the biggest costs of the overall transformation process, exceeding 11 percent of GDP in Slovakia. The value of the NPLs in state banks reached EUR 3 billion (more than 9 percent of GDP). NPLs of well-connected local private equity accounted for another EUR 660 million (i.e., 2 percent of GDP). This is a huge cost that is fully comparable to what many observers would consider to be the biggest cost—a broad-based privatization process involving local friends during the 1994–98 Meciar era. The price difference between the revenue and the accounting value of those companies was comparable at 10.7 percent of GDP (EUR 3.2 billion). Hence, the state ownership of universal big banks turned out to be extremely expensive in a post-communist country.

The early negative experience (the stigma of the banking crisis) and its high public costs helped shape the more conservative behavior of clients, bank regulators, and supervisors in Slovakia in the following years.

Next, the development of the Slovak banking system took place in an environment of low inflation supported by inflation targeting monetary policy. Interest rates declined substantially. At the same time, cleaning of the banking sector asset side and low inflation, which helped protect deposits, resulted in a small loan to deposit ratio in Slovakia. Loans and deposits in foreign exchange have been very limited.

Based on theory, foreign ownership of banks brings several benefits and costs. Undisputed benefits include transfer of know-how, higher competition, and better or "more independent" allocation of resources in the host country. Besides benefits, we may identify some costs related to weaker longer-term commitments. We may expect fewer financial resources to be available for corporates, because lending to corporates is more complex and requires stronger effort and more analysis. In general, the volume of available finances depends on the value of collateral and costs or complexity of monitoring. These factors may lead to higher lending to households and fuel real estate booms.

However, the existence of these relationships in practice is not so straightforward. The experience of the Slovak Republic is based on the gradual creation of three different groups of commercial banks. The first group present in the market can be called "pure" foreign banks. These banks usually relied on capital from their home countries and concentrated on corporate private-sector clients. Therefore, they usually strongly supported policies that strengthened corporate balance sheets and investments, mainly structural reforms and low taxation. The second group represents "mixed" foreign banks. These are former state banks acquired by large Austrian or Italian banks, and they retained their positions of biggest players in the Slovak market. In these banks, we could observe gradual corporate culture changes, and in general their services are more expensive. The third group comprises small local banks that are often owned by local equity firms. These banks have tended to finance their owners and sometimes engage in more risky activities (e.g., Greek bonds).

As already indicated, the three groups differ not only in terms of their ownership, but also in terms of their behavior and historical development (Figure 1).

1) **"Pure" foreign banks** could not rely on a wide branch network and they did not perceive Slovakia as their key market due to its small size. They focused on medium and large enterprises, and thanks to their connections with mother banks, they were able to dramatically improve their price competitiveness and introduce new investment banking products (structural finance).

2) **"Mixed" (foreign) banks** took over mortgage and consumer finance as the theory would predict. These segments have remained the most dynamically growing until now. But the banks did not stop there and continued to service a corporate clientele as well, including SMEs. In fact, at present, there are some signs that the "mixed" banks are trying to price out "pure" foreign banks in the large and mid-corporate sector.

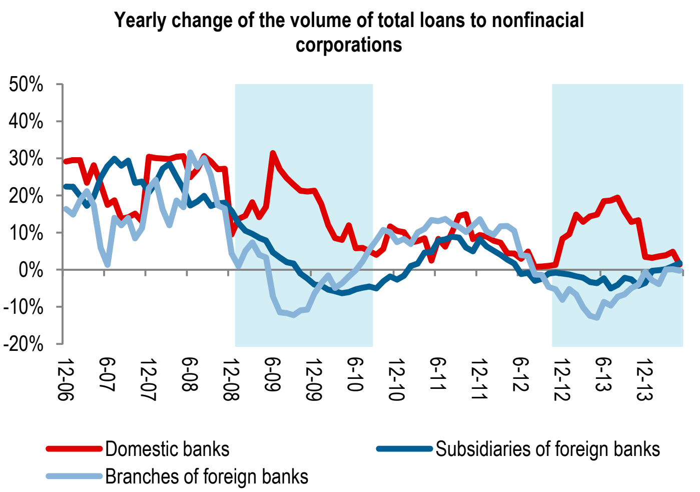
3) **The group of small local banks** relied on central bank financing due to limited access to money market activities. Also, their capital adequacy ratios are usually not as strong as those of the other groups.

Euro adoption and the economic, financial, and debt crises influenced the three groups differently. Despite the ability to adapt to euro area prices and increase their price competitiveness (among the top seven lowest prices in the eurozone at present), we can observe a decrease in profit and market shares of "pure" foreign banks. The main reason seems to be the fact that foreign-owned companies tend to finance themselves via corporate headquarters on a larger scale than before. In contrast, our "mixed" banks continue to benefit from a growing retail sector. Retail loans are growing at double-digit rates and the banks maintain very favorable returns on equity or assets. The prices of mortgages have been the highest in the eurozone. The last relatively small group of local banks keeps on maintaining lower capital adequacy ratios and, due to worse access to the money market, they continue to prefer central bank financing.

Based on our experience, the presence of foreign banks brings a lot of advantages for the stability of the banking sector. These include the transfer of know-how, liquidity, and capital support. The existence of large universal state banks turned out to be extremely costly.

As a small disadvantage, unlike domestic banks, foreign banks tend to be more prone to limit their lending activities in the event of an economic downturn or uncertainty. As shown in the Figure 1, domestic banks continued lending while foreign banks slowed down their lending activities in recent bad times.

Figure 1. Differences in Behavior of Domestic and Foreign Banks

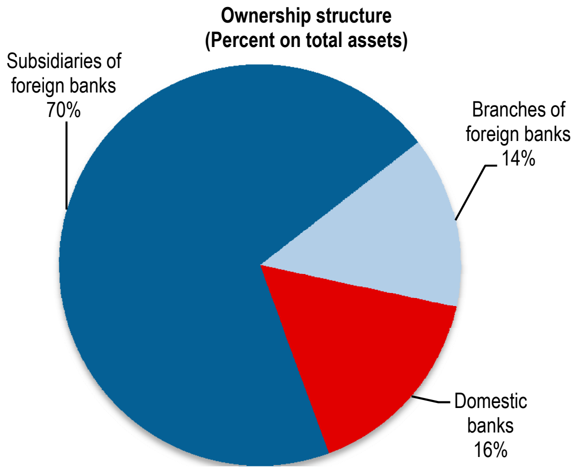


Source: NBS.

Part 2: Slovak banking-sector today

Moving to a broader picture of the present Slovak banking sector, we cannot omit several important features that distinguish it from the majority of the euro area banking sectors. As was already indicated, foreign ownership of the banks has been gradually growing. Today, foreign capital is highly engaged in the Slovak banking sector. Subsidiaries of foreign banks and branches of foreign banks represent almost 85 percent of total assets (Figure 2).

Figure 2. Prevailing Foreign Ownership

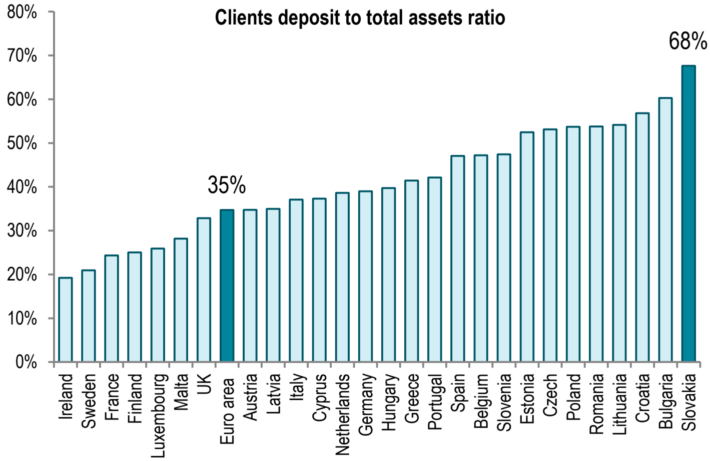


Source: NBS.

At the same time, the Slovak banking sector is much less sensitive to financial markets due to high domestic deposits. Clients' deposits to total assets ratio is the highest in the EU (Figure 3). This aspect forms a very good funding position for the Slovak banking sector, because it eliminates reliance on funds from parent banks and lowers liquidity funding risk.

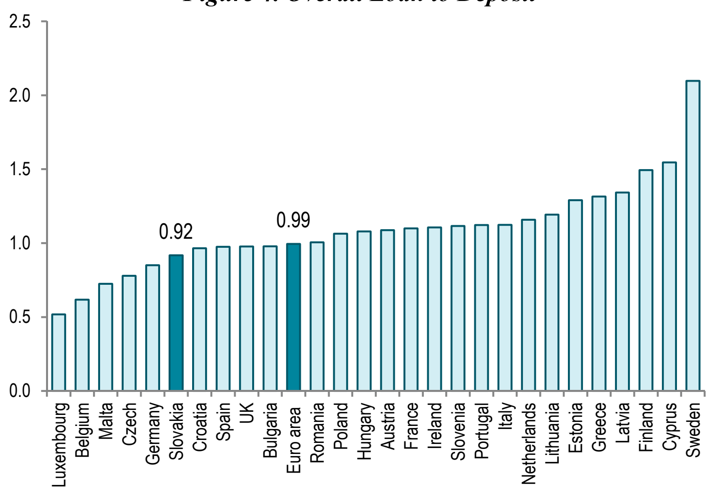
Loans are fully funded by clients' deposits. The loan-to-deposit ratio is lower than the euro area average (Figure 4). And both total and corporate loan-to-deposit ratios belong to the lower half of the EU countries (Figure 5).

Figure 3. Dominant Role of Clients' Deposits



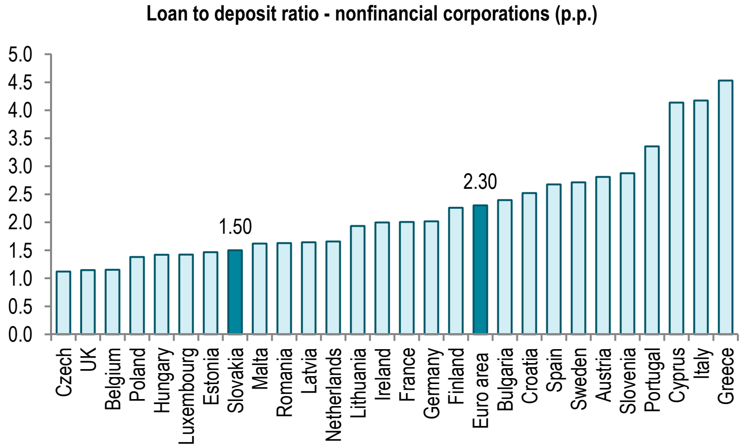
Source: ECB.

Figure 4. Overall Loan to Deposit



Source: ECB.

Figure 5. International Comparisons of Returns
(In percent)

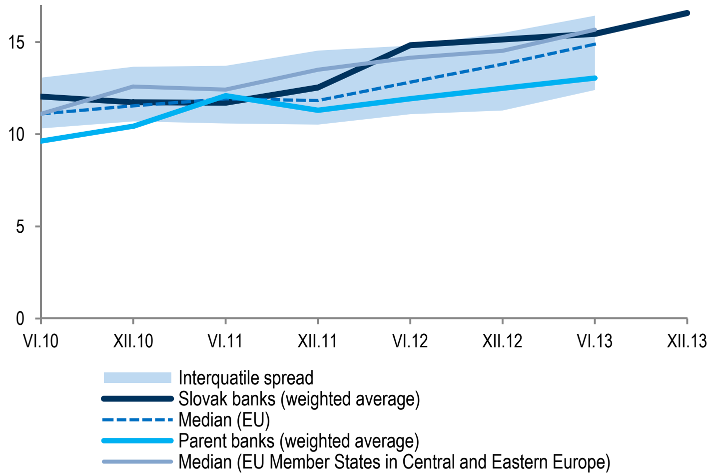


Source: ECB.

Capital adequacy remains one of the pillars of the banking sector's resilience to external risks. The capital adequacy ratio has continued to rise, and in 2013 it reached 17 percent. Simultaneously, we could observe an increase in Tier 1 capital. The value of this ratio for the Slovak banking sector was higher than the median value for EU countries (Figure 6).Capital adequacy remains one of the pillars of the banking sector's resilience to external risks. The capital adequacy ratio has continued to rise, and in 2013 it reached 17 percent. Simultaneously, we could observe an increase in Tier 1 capital. The value of this ratio for the Slovak banking sector was higher than the median value for EU countries (Figure 6).

Besides a good level of capital adequacy, Slovak banks have an adequate leverage ratio. The average value for the Slovak banking sector fluctuated between 7.6 percent and 7.8 percent in 2013. In June 2013, large international European banks recorded a value of 3.0 percent. At the same time, banks operating in Slovakia follow conservative bank business models and maintain sound profitability.

Figure 6. International Comparisons of the Tier 1 Capital Ratios
(In percent)

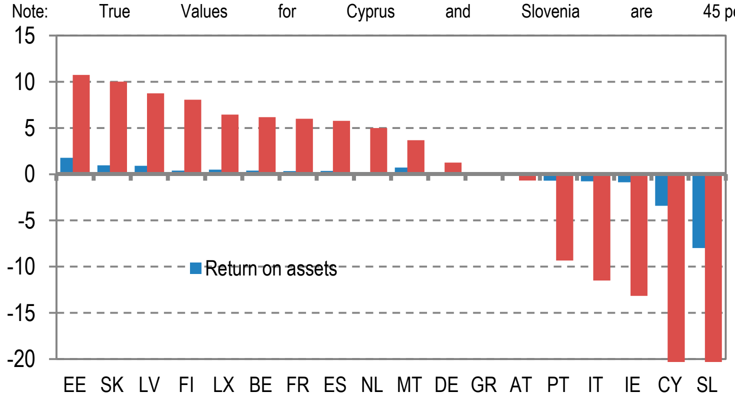


Source: NBS (Analysis of the Slovak Financial Sector).

Figure 7. International Comparisons of Returns
(In percent)

Source: ECB (Consolidated Banking Data).

Note: True Values for Cyprus and Slovenia are 45 pe



rcent, and90 percent for Slovenia.

Besides a good level of capital adequacy, Slovak banks have an adequate leverage ratio. The average value for the Slovak banking sector fluctuated between 7.6 percent and 7.8 percent in 2013. In June 2013, large international European banks recorded a value of 3.0 percent. At the same time, banks operating in Slovakia follow conservative bank business models and maintain sound profitability.

However, sound overall performance indicators do not mean that there is no scope for improvement. At a time when the corporate sector is curbed by a weak economic outlook and development is driven by the retail sector, we may identify several risks stemming from the low interest rate environment and limited demand. Low interest rates, in combination with high debt-to-income ratios for selected clients, may indicate risks in case interest rates significantly increase in the future. In the retail sector, we also may observe rising loan-to-value (LTV) ratios and a relatively high share of intermediaries taking over lending activities. Taking these risks seriously, measures formulated in the new European directives are already being implemented well in advance of deadlines and will be soon extended with our own country specific recommendations. They range from specific loan to value recommendations to individual clients' stress tests and the introduction of third-party regulation.

Panelist 4: Andrzej Raczko, Member of the Management Board, National Bank of Poland

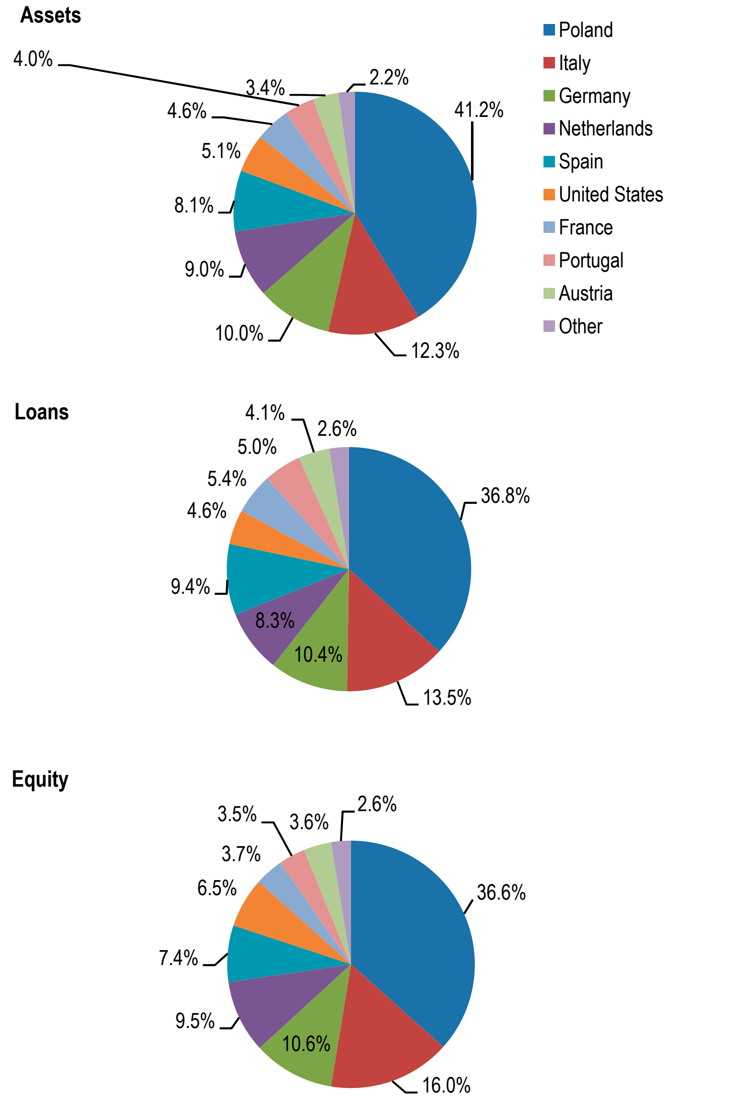
The main subject of our panel discussion is the prospects for credit growth and foreign bank engagement in the CESEE region. The example of Poland in this respect is interesting from the point of view of credit policy during and after the last financial crisis.

Before proceeding to this issue, I would like to briefly characterize the significance and size of the foreign bank sector in Poland. In the Polish banking sector, 63.4 percent of equity belongs to foreign banks. Regarding the value of assets, their share is almost 58.8 percent of the assets of the whole of the banking sector. What differentiates Poland from the other countries of the CESEE region is the significant diversification of the ownership structure of foreign banks, taking as a criterion the country of origin. Naturally, banks from the euro area prevail, but there are also banks from other regions and continents operating here, e.g., the United States (Figure 1).

The significant diversification of the foreign bank sector diminished the risk of deleveraging. The risk of negative effects of deleveraging for the Polish financial sector resulting from the problems of some foreign parent banks is significantly reduced, as no banks from a single country dominate the sector. This is why neither the Greek crisis, nor the Irish crisis, nor the Spanish banking-sector crisis caused tensions in the Polish banking sector. The problems of parent banks led mainly to a change of owner and, to a small extent, an outflow of subsidiary bank financing. In other words, the parent banks in financial need sold profitable Polish subsidiaries to a new foreign company, which immediately offered liquidity support. For these reasons, the deleveraging process—unlike the cases of some other countries in the region—did not have a perceptible impact on credit growth in the economy. The outflow of foreign funding, which was noticeable in the first quarter of 2014, was related to banks' originating mortgage loans in foreign currencies before the financial crisis. During the crisis, these banks stopped lending to households in foreign currency. As a result, the principal repayment of the existing portfolio of foreign-currency loans led to a gradual reduction in the need for foreign funding by the banking sector from abroad (Figure 2).

The stable position of foreign banks in Poland results, to a large extent, from the convergence process that the Polish banking sector has undergone. On the one hand, Polish banks received the know-how of foreign banks; while on the other hand, the foreign banks learned how to adapt their services to the needs of the local market. If we compare the performance of both sectors, we see that they differ only slightly. ROE and net interest margin are practically at the same level; foreign banks have a slightly higher capital adequacy ratio.

Figure 1. Ownership Structure in Terms of: Assets, Loans, and Equity



Source: NBP

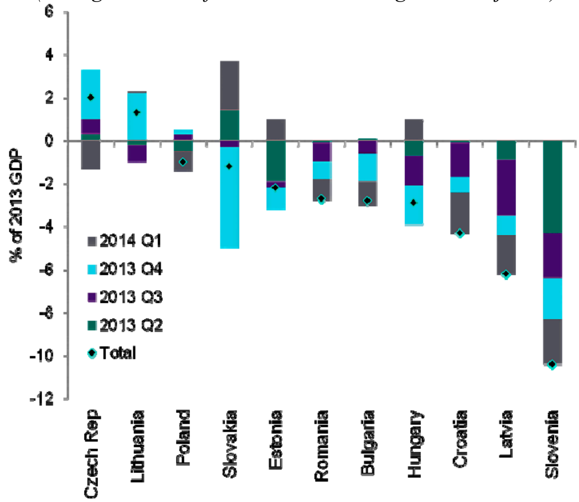
The considerable difference between the cost-to-income ratios is caused by the significant share in the domestic bank sector of one state bank (Bank Gospodarstwa Krajowego), which finances large infrastructure projects and manages foreign credit lines obtained from international financial institutions, e.g., the EIB and European Bank for Reconstruction and Development (EBRD). Due to the profile of its operations, this bank—unlike other universal banks—does not pay the high costs of maintaining a network of branches (Figure 3).

Similarly, there are no major differences in the structure of the balance sheets of domestic and foreign banks. An important difference is the higher share of foreign funding and a correspondingly higher share of mortgage and corporate loans in the structure of foreign banks compared to domestic banks. These differences are entirely understandable. Foreign banks benefited from easy access to foreign funding from their parent banks. Through foreign subsidiaries, these funds were used to grant mortgage loans denominated in foreign currency to Polish households and large enterprises, mainly Polish exporters (Figure 4).

Domestic and foreign banks have stopped granting foreign currency denominated loans to households that are not hedged against exchange-rate risk. The problem of foreign-currency-denominated mortgage loans was not such a painful experience in Poland as in other CEE countries, since at the beginning of the credit boom the Polish Financial Stability Authority (KNF) introduced quite restrictive conditions for borrowers of foreign currency loans (the so-called Recommendation “S”). As a result, foreign-currency loans were granted only to households with the highest incomes. During the crisis, these households were able to service their debt despite a significant depreciation of the zloty.

Figure 2. External Positions of BIS-Reporting Banks vis-à-vis All Sectors, 2013:Q1–2014:Q1

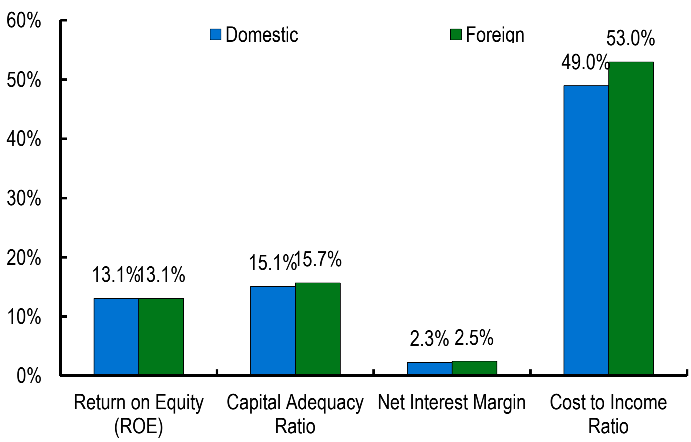
(Change Percent of 2013 GDP, Exchange-Rate Adjusted)



Source: Vienna Initiative CESEE Deleveraging and Credit Monitor, August 4, 2014.

External Positions of BIS-reporting Banks vis-à-vis all sectors, 2013:Q1–2014:Q1 (Change, Percent of 2013 GDP, exchange-rate adjusted.

Figure 3. Selected Profitability and Capital Ratios, as of H1 2014



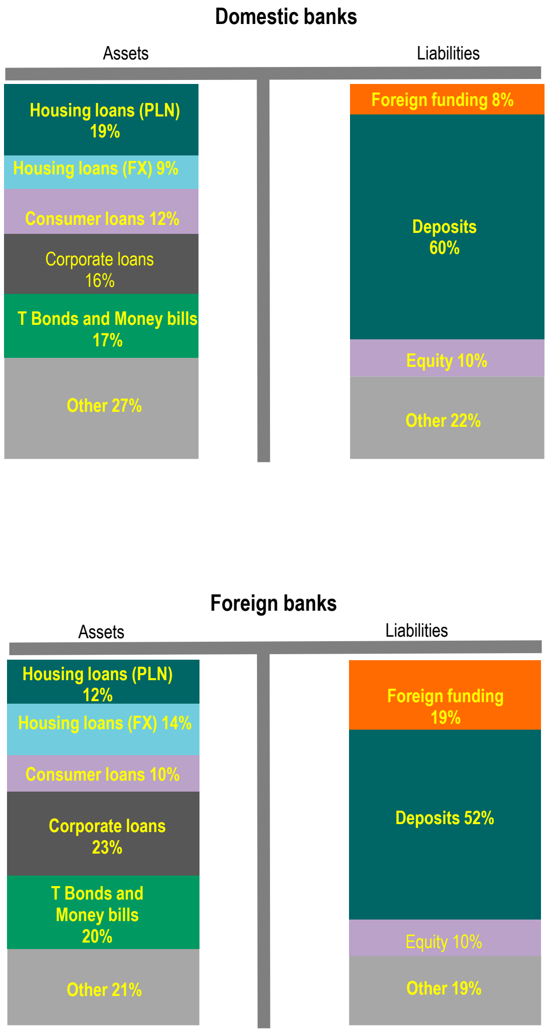
Source: NRB.

Domestic and foreign banks have stopped granting foreign currency denominated loans to households that are not hedged against exchange-rate risk. The problem of foreign-currency-denominated mortgage loans was not such a painful experience in Poland as in other CEE countries, since at the beginning of the credit boom the Polish Financial Stability Authority (KNF) introduced quite restrictive conditions for borrowers of foreign currency loans (the so-called Recommendation "S"). As a result, foreign-currency loans were granted only to households with the highest incomes. During the crisis, these households were able to service their debt despite a significant depreciation of the zloty.

Let us now focus on the credit policy conducted by banks of both sectors. Are foreign banks more risk averse than domestic banks? The level of NPLs is a significant indicator of the scale of credit risk undertaken by banks. Although the NPL indexes are approximately at the same level, it is easy to explain some small differences. The level of NPLs for corporate loans is higher in domestic banks than in foreign banks. This difference is explained by the larger share of large enterprises in the credit portfolio of foreign banks (often these are subsidiaries of foreign firms or domestic exporters). In turn, domestic banks have a larger share of SMEs in their credit portfolio, which have a higher level of credit risk. The NPLs of consumer loans are at a similar level; however, the higher share of NPLs for mortgage loans is related to the structure of these loans. As previously mentioned, mortgage loans denominated in foreign currency were granted to the wealthiest clients, which is why they have the lowest NPL level. These, however, dominate in the mortgage loan portfolio of foreign banks. It seems that foreign banks are more effective in assessing credit risk, although they undertake it on a larger scale than domestic banks, which is shown by the higher risk-weighted assets (Figure 5).

It would be beneficial to get a more comprehensive picture of credit policy before, during, and after the financial crisis. The National Bank of Poland (NBP) examines changes in credit policy by using opinion polls of senior loan officers.

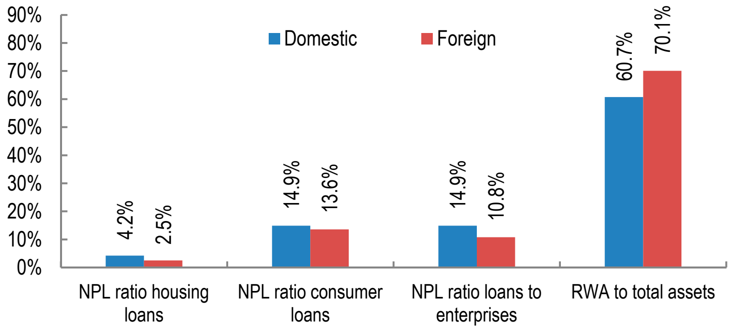
Figure 4. Balance Sheet Structure of Domestic- and Foreign-Owned Banks



Source: NBP.
Note Data as of 2014H1.

An indicator based on the survey shows easing or tightening of credit standards. A comparison of the credit policies between the foreign bank sector and the domestic bank sector in the years 2005–14 is presented in Figure 6.

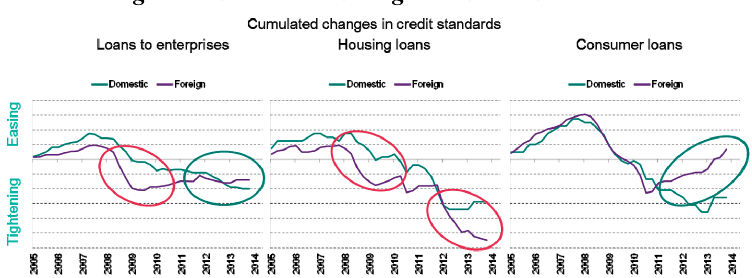
Figure 5. NPL Ratios of Domestic- and Foreign-Owned Banks for Different Client Groups



Source: NBP.
Note: Data as of 2014H1; NPL ratio = impaired loans to toal loans; RWA = risk weighted assets.

Domestic banks accepted a level of risk for corporate loans close to that of foreign banks in the period 2005–08. Beginning from 2008, foreign banks abruptly tightened their criteria for granting loans to enterprises, while domestic banks introduced such a tightening more gradually. Ultimately, together with the economic recovery, the monetary policy stance was at a similar level.

Figure 6. Cumulated Changes in Credit Standards



Source: NBP.

In the case of mortgage loans, the lending conditions were tighter in the foreign bank sector. Foreign banks granted mainly foreign currency loans, which—in accordance with the requirements imposed by the Polish FSA—required tighter criteria for granting credit than in the case of loans in zlotys. After 2012, foreign banks further tightened credit conditions due to the imposition of stricter prudential requirements on the way in which the portfolio of foreign loans should be managed.

Consumer loans were granted on similar lending conditions in both sectors. Significant easing of lending standards in the segment of consumer loans observed since the beginning of 2013 can be to a large extent attributed to amendments to the Polish FSA's Recommendation "T" on granting these loans. The amendments were particularly vital for the granting of low-value loans, for which the requirements on creditworthiness assessment were significantly eased. The segment of low-value consumer loans is dominated by foreign-owned banks. As a result, it was this group of banks that took the biggest advantage of the amendments in Recommendation "T" (and improving macroeconomic conditions) and expanded their activities in the consumer loans market.

Although there were some differences in the credit policy of the domestic and foreign banks in Poland, the dynamic of credit supply has not varied significantly between the sectors in recent years. This is explained by the convergence process of the domestic and foreign banking sectors, which has accelerated since 2004.

The fundamentals of the banking convergence process were established in the middle of the 1990s. Initially, green-field investments dominated in the foreign bank sector. At this time, foreign subsidiaries differed significantly from the domestic banks in terms of the acceptable risk profile, financial instruments applied, management principles, and client base—which were made up mainly of foreign companies operating in Poland. In the second half of the 1990s, a period of intensive privatization of the banking sector began. A significant number of state banks were purchased by foreign investors. The method of privatization was important; it consisted in finding a strategic investor, who in the privatization agreement pledged to ensure conditions for the long-term development of the acquired bank, mainly in terms of constant capital accumulation. An important role was played by the Polish banking supervisory authority. Its rigorous approach meant that decisions regarding the management of subsidiary banks had to be taken at the boardroom level of these banks and not at the level of the headquarters of parent banks. Headquarters only controlled strategic decisions, which gave quite a significant amount of autonomy to the local staff. As a result, the value added brought by the foreign investor in the form of capital, a management model (particularly of risk management), and new financial instruments were adapted to local conditions. The privatized bank maintained the client base, the local staff, and—in general––the universal business model of the bank. Banks created as green-field investments soon lost significance in the foreign-bank sector; they either remained as niche banks servicing only a certain segment of the market (for example, banks financing the purchase of cars) or became absorbed by large foreign banks that were created as a result of privatization.

Competition from large universal foreign banks also forced important changes in the domestic bank sector. Domestic banks were compelled to introduce modern technology (information technology (IT) systems), banking services,. and risk models similar to those of foreign banks. The need to constantly accumulate capital forced domestic banks to look for capital on the Warsaw Stock Exchange. This process also affected banks controlled by the state, leading to their gradual privatization. The requirements for a listed company curtailed the negative impact of state ownership on credit policy.

Let us summarize: The diversification of the Polish banking sector—both in terms of the significant share of domestic banks and the broad representation of foreign investors from various countries—helped ensure a sufficient level of competition, particularly in relation to credit operations. Polish banking supervision and an appropriate mechanism of privatization resulted in a constant accumulation of capital in the foreign bank sector; consequently, capital has not been a barrier to constantly increasing credit activity. Sound domestic supervision regulations and the adaptation of foreign credit risk models to the Polish situation compelled the banks of both sectors to pursue a prudential credit policy. The significant role of local staff in the management of subsidiary banks prevented a credit crunch, even though their parent banks were hit by a sudden stop of credit activity during the last crisis.

Panelist 5: László Baranyay, Vice President, EIB

Thank you very much. Let me start my remarks in a light way and perhaps a somewhat unusual approach, as Hungarians sometimes do, even in economics. On my way to Ljubljana, I stopped to buy a book—The Alchemists—which was named business book of the year. The book is about three famous central bankers, calling themselves alchemists without adding a question mark. I think the difference between an alchemist and a central banker is that alchemists never managed to produce gold, which was their main target. However, central bankers today try to use several new tools and facilities with the objective of supporting economic recovery, which is why I think it is an interesting book to read, even though the title may not be very adequate.

I thought about my role in this important meeting of highly respected representatives, politicians, and academics. It is perhaps a bit of a special one because I represent an international financial institution that directly invests in the real economy, while here we are talking a lot about the national banks' role, the central banks' role, the banking sector in general, and the special case of foreign-owned banks, etc. The role of EIB in the European economy is therefore somewhat different.

But first let me ask a question. I always begin with a question. I follow J.F. Kennedy's way of thinking, who once suggested not seeking the Republican or Democratic answer, but simply the right answer. But I think that before doing that we first have to think about the right questions!

What are the prospects for credit growth?

I think discussing the prospects for credit growth is indeed important, but the more fundamental issue concerns the revitalization of economic growth in Europe and all around world, as was mentioned earlier by the Croatian Governor. So what is the macroeconomic situation in the world, and what is the macroeconomic situation in the countries that we have mentioned? Let me highlight only one figure about these countries—GDP growth. Several countries have not reached the level of economic growth and economic performance that they had before the crisis, e.g., Hungary and some other countries. At the same time, we cannot generalize. Poland is absolutely different because the Polish economy is in a sustainable economic situation and faces comparably few problems in the banking sector, which supports its economic growth and sustainable public finances.

Where are we then? Are we in the middle of the crisis, after the crisis, or before the next crisis? Well, I know that—in regard to the economy—we are always before a crisis, and we never know when the new crisis will begin.

I think the last crisis was not a normal cyclical crisis, and that's why I propose quite different tools to be used for the management of the consequences of the crisis.

The situation is quite controversial, and I think it is important to make clear this distinction when we discuss the problems in and outside the eurozone. There are some very important economies outside the eurozone as well (e.g., Great Britain) and some of them are actually not candidates to join the eurozone. So it is important to see the whole banking sector, not only the part of it that is in the eurozone. The banking regulation and the ECB must observe it as a single sector.

In the CEE region, the foreign-owned banks have a special role. The parent companies of these foreign-owned banks settled mainly, but not exclusively, in the eurozone. That's why many of them can be regarded as banks of the eurozone, but others not. Furthermore, there is a very significant, active, and consequently very important financial institution in this region, which comes from outside the EU.

In summary, I think there are new challenges and we have to find new answers for new challenges.

I mention the phrase "global metamorphosis'" because—as you may know—Zeus had several metamorphoses, but always with the same aim, yet it was not a politically correct one. We have a politically correct aim because we want to increase the investment capacity of governments, economies, and by extension the competitiveness of the EU. The current global economic situation is a big challenge for the European countries and EU member states. The investment bank's tools and opportunities are different from those of the central banks. EIB has several special activities, and the most important ones are its lending, blending, and advising activities, which are well known.

Advising capacity and advising activity are quite important for the creation of new investment projects that are bankable for the commercial banking sector. The impact of such projects on the economy is good, not only for economic growth, but also for the employment situation. Furthermore, I think one of the key challenges for the future of Europe is the issue of youth unemployment, because the level of youth unemployment is very high in several countries and we will have to do everything we can to reduce it. Besides project finance and investment advice, we operate our advisory services for these dedicated goals as well.

The EIB is not only a single bank, but also a banking group. This is important because of the opportunities for investing offered by the European Investment Fund (EIF), the EIB Group's equity subsidiary, which also provides guarantees for SMEs. It is quite important when, in this region and also in other regions of Europe, companies are partially undercapitalized.

By way of conclusion, I would like to mention that when we are working together with the commercial banking sector, we also cooperate with the other international financial institutions.

Our cooperation with other international financial institutions, the national promotional banks, and the commercial banks is excellent. I would point out that the cooperation with the national promotional banks (even though some countries don't have such an institution, e.g., Slovenia and Poland), but where they exist, the cooperation is highly appreciated and fruitful.

There is enough liquidity available in the markets and the funding is cheaper than previously. The question should be posed differently; because the real question is not who should provide the financing, but rather what can be financed in a responsible manner to increase growth? That is the question for the future.

C. Discussions

Following the presentations, participants from the floor raised a number of issues, mainly centered on the relative importance of foreign- and state-owned banks in explaining the credit boom and its eventual bust.

- One participant noted that banks had had differing experiences with the growth of NPLs after the credit boom, with some being more successful than others in maintaining credit quality. He suggested that western banks, in particular, had benefited from better risk management during the boom years, which—in turn—had helped insulate them when the bubble burst. He also wondered whether state-controlled banks had been subject to insufficiently rigorous governance and risk management.

- Another participant acknowledged these differences, but suggested that it was the banks' business models rather than their ownership that was the more important factor. In his experience, more important factors were the fact that banks that had entered the region as green-field investors, versus having partnered with an established entity, and the quality of management ownership. And private ownership was also no guarantee of proper risk management. Moreover, he questioned whether European rules for state aid could be applied easily in the region, given the already heavy involvement of the public sector in the financial sector.

- Another comment was that public ownership of banks could be helpful in times of crisis, since it facilitated the crisis response. While there were legitimate concerns about the inefficiency of public banks, state control of banks was less of an issue in determining the efficiency and stability of the financial sector than the quality of public institutions and their policies.

- A contrasting view was that public sectors were tempted to direct credit in ways that delayed corporate restructuring and the recognition of losses, which created inefficiencies in the allocation of credit and the economy more generally. These problems were compounded by shortcomings in bankruptcy law, tax law, and the efficiency of credit allocation.

- Another participant argued that the improvement in corporate governance brought by foreign-owned banks was immense, especially given that they were less subject to vested interests. However, he cautioned that foreign banks tended to share common risk methodologies, often based on historical data and relationships that were not attuned to the specificities of the CESEE region. This created the risk of an overly procyclical reaction to a crisis.

Panelists' responses to questions

Resource mobilization. One panelist suggested that a key issue in the region was the dearth of funding for investment, and for this reason he viewed as significant the Juncker Plan and a similar proposal by the Polish Finance Minister, which promised to mobilize resources from the public and private sectors, as well as from international institutions. He viewed prospects for a European consensus on these proposals as encouraging.

Bank ownership. Several panelists expressed their views on this issue:

- One panelist stressed the critical importance of high-quality corporate governance and management, which needed a proper balance between foreign headquarters and local staff. At the same time, the domestic supervisory framework could play an important role in ensuring that (i) foreign investors in the banking sector took an appropriately long-term view of their participation, and (ii) there was healthy competition between domestic and foreign-owned banks. This emphasis helped explain the relatively favorable experience of the foreign banks in Poland. For example, to help encourage this longer-term perspective, the Polish supervisor had insisted that foreign-owned banks be quoted on the Warsaw stock exchange, which helped improve local capital markets and the transparency of bank operations. Another key to success was an effective deposit guarantee scheme, which in Poland was solely bank funded, helping to avoid the transfer of risk to the public sector. The Polish authorities' conservative response to bank stress—the central bank was not asked to provide liquidity to insolvent banks—had also encouraged strong risk management and corporate governance.

- Another panelist strongly disagreed with the notion that state ownership was irrelevant for the quality and health of the banking sector. In his view, it was not sufficient to simply appoint strong managers, because the experience of the crisis illustrated clearly that state-owned banks had performed the worst. Indeed, the relatively high costs of state-ownership of banks could be seen not just in the region but globally.

- A third panelist agreed, but also noted that strong competition was needed to ensure efficiency, either on the funding side or the lending side. The experience in Austria illustrated that public ownership was particularly problematic when the bank operated in a niche market and was not subject to healthy market forces. He also cautioned that the recently agreed rules on bank resolution could impair the ability of authorities to respond quickly to banking sector stress, since the consultation processes appeared to be cumbersome. He suggested that these rules still needed to be fine-tuned to enable a quick and effective response to crises.

- The final panelist agreed that the response of the state-owned banks in the crisis had tended at times to be unhelpful, especially given their reluctance to write off loans. He also viewed the deleveraging process as a natural response to the excessive inflow of capital that had occurred during the boom years, and was not something that could be resisted.

VI. PANEL 3: MEASURES TO REVIVE CREDIT MARKETS: BEST PRACTICES AND PITFALLS

A. Summary

The panel discussed various possible measures to revive credit markets and a range of best practices and associated pitfalls in the environment following the financial crisis, with the prospect of slow and potentially creditless recovery.

In the introduction, it was stressed that central banks face two main challenges during financial crises. The first challenge is to provide sufficient liquidity to the financial system, while the second is how to ensure that this liquidity is transmitted into credit growth. All the panelists agreed that there were important bottlenecks in channelling credit to the real economy and that innovative approaches are needed to successfully resolve this issue.

Several schemes aimed at channelling liquidity provided by central banks to the real economy were discussed. While panelists largely agreed that the funding-for-lending scheme in the United Kingdom had had limited success, some argued that in other jurisdictions, and depending on the design of the scheme, they can have even stronger positive effects. Some touched upon the ECB's purchases of asset-backed securities (ABS), and while they viewed it as a positive measure, nobody saw it as a sufficient one. One panelist stressed that the funding-for-lending scheme in the United Kingdom was successful only in sectors where there was sufficient collateral. A consensus view was that these programs only provided resources, but did not provide proper incentives for banks to lend, especially to SMEs. Because it is incentives that matter most, additional measures were needed to increase banks' incentives to lend.

The panel discussion touched upon direct intervention by central banks as a potential option. While one panelist suggested that central banks should directly target SMEs, most panelists emphasized that such an intervention poses risks. Several panelists mentioned that such measures are especially prone to political interference, as they entail directed lending towards a particular sector. One panelist pointed out that the provision of targeted subsidized loans to SMEs by government-owned banks worked well when such banks were not given orders regarding to whom to lend, but were left to their own decisions within the allocated budget. Some panelists suggested that multilateral institutions could stand in as intermediaries and that this could help to avoid central banks having to channel credit directly to the real economy.

A few panelists stressed that it is necessary to first identify the friction that is preventing credit growth and then apply appropriate policies to address this friction. One panelist suggested that credit demand and supply factors should be disentangled and that a decrease in credit is not problematic when this is due to falling demand related to over-indebtedness. It was emphasized that new credit should be channelled to viable companies and that the quality of new credit is more important than quantity. Another panelist argued that negative aggregate credit growth may be a result of the situation where viable companies are able to obtain new loans, but over-indebted or unviable companies are not. In such cases, negative credit growth implies a correction of imbalances and an improvement in the credit quality, which is a desirable outcome from a policy perspective.

The panel debated the issues of confidence in the banking sector. Several panelists mentioned that confidence needs to be restored before credit growth can be expected. One panelist argued that, while AQR and stress tests help in restoring confidence and credit growth in the medium run, they may nevertheless result in credit contraction in the short run—especially in banks that are short of capital. Another panelist argued that confidence issues resulted in a fragmented financial market in which banks in different jurisdictions face different nominal interest rates.

Panelists agreed that cross-country differentials in real interest rates can be exacerbated due to inflation differentials.

The panel discussed alternatives to bank funding, especially for the SMEs. The consensus view was that alternatives to bank financing should be developed, and that financial markets should have a greater role. Several panelists saw securitization and further development of ABS markets as a plausible alternative to bank lending. Venture capital funds, joint venture funds, and development of mini-bond markets were also mentioned as alternatives. Some panelists viewed ABS markets as a way of easing credit risk management for originating banks. One panelist emphasized that credit risk models used by banks should be tailored to the country where the bank is active and should be less reliant on history-based risk models in countries that are undergoing a structural change by reorientation to different drivers of growth.

Several views were expressed regarding the costs and benefits of a creditless recovery. Some panelists argued that a creditless recovery is typical following a financial crisis. New investment had been slow and therefore new credit is not required because of substantial spare capacity. However, others argued that credit growth would speed up the recovery. One panelist stressed that economic growth in the region would have stalled even without falling credit, because structural reforms have stalled. When these reforms are revived, both economic growth and credit growth will return.

B. Presentations by Members of the Panel

Lead: Fabrizio Coricelli, Paris School of Economics and CEPR[15]

Creditless recoveries and deleveraging

Creditless recoveries have been a typical feature of recoveries from financial crises and sudden stops in emerging economies, as documented by Calvo et al. (2006). Calvo et al. define a creditless recovery as an episode in which the GDP recovery point has been reached—when GDP has gone back to its pre-recession peak—but the real stock of credit has not recovered its pre-crisis level. Coricelli and Roland (2011) take a broader perspective and analyze a sample of 143 countries over the period 1963–2003, thus excluding the Great Recession. They identify 421 recession episodes for both advanced and emerging economies. Table 1 summarizes the frequency of creditless recoveries and the depth of the recession in creditless recoveries (defined as the drop in GDP from the pre-recession peak to the trough).

Table 1: Creditless Recoveries
(In percent)

	Creditless Recoveries		Recoveries with Credit		Proportion of Creditless Recoveries
	Output Decline	Stock	Output Decline	Stock	
Developed Countries	2.6	-10.5	2.0	18.5	35.8
Emerging Markets	5.0	-18.6	2.5	24.9	40.6

Source: Coricelli and Roland (2011).

Note: Output Decline = Average decline in GDP per capita during the recession period; Stock = Change in credit per capita between the pre-crisis peak and the full-recovery year.

[15] Centre for Economic Policy Research.

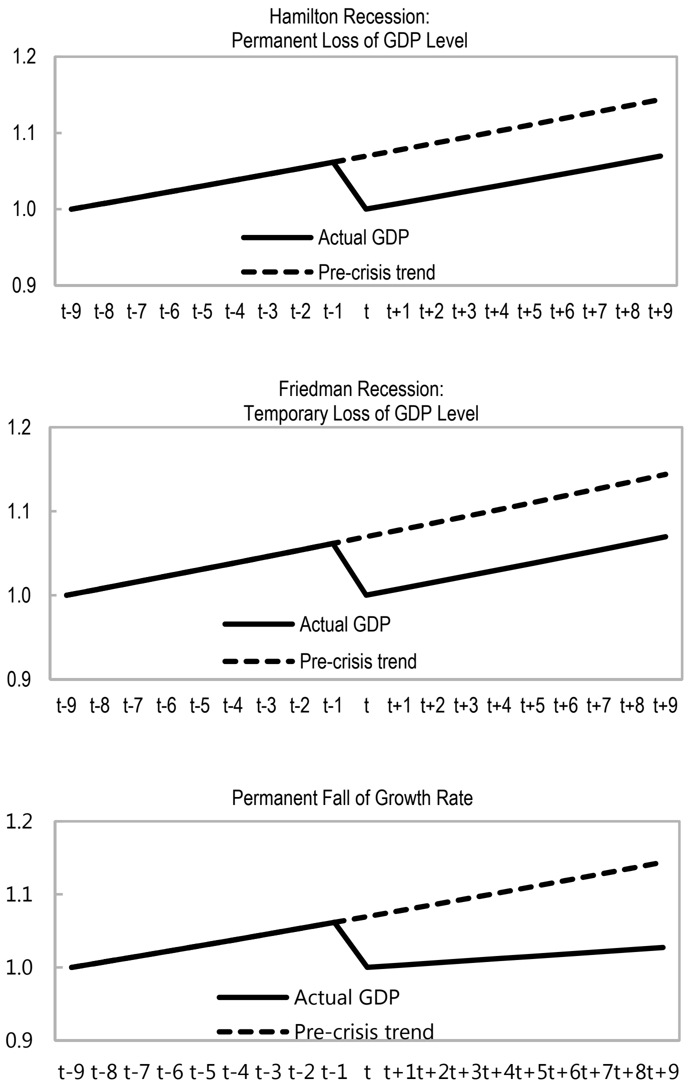
Interestingly, creditless recoveries are not uncommon. Furthermore, they are associated to a deeper recession and to a longer duration of the period from peak to recovery (3.2 years compared with 2.7 years in the "with-credit recoveries"). Creditless recoveries may be a cause for concern not only because of the more persistent recession phase, but also because of the likelihood that either the post-recovery level of GDP remains permanently below its pre-recession trend or that the post-recovery growth rate remains below its pre-recession trend growth. These two possibilities are presented in Figure 1 and contrasted with the pattern common to the with-credit recoveries, defined as a "Friedman recession" (Cerra and Saxena (2008)).

In emerging Europe, following the Great Recession, there is a highly heterogeneous set of experiences. Some countries, such as the Baltic States, experienced a creditless recovery. Several Southern-Eastern European countries experienced a creditless "nonrecovery," as GDP has yet to recover its pre-crisis peak—a phenomenon shared by most European and euro area countries. Finally, there are countries such as Turkey, which did not experience any fall in credit and still faces the problem of containing credit growth. With the exception of Turkey, most emerging Europe is either in the state described by the first panel of Figure 1 ("Hamilton recession") or in the third panel (with a fall in the growth rate).

Furthermore, with a few exceptions most emerging European countries face tight credit conditions as a result of their dependence on the supply of credit originating in the euro area, which is struggling to reactivate credit supply in a bank-dominated financial sector.

The nature of the recovery has crucial implications for the assessment of the deleveraging process. Indeed, a permanent loss in output—or, even worse, a permanent loss in the growth rate of output—implies a growing debt burden in terms of output. Moreover, lack of inflation, or deflationary pressures present in the eurozone, further increase the burden of debt.

Figure 1. Patterns of Post-Recession GDP Dynamics



Source: Author's calculations.

Deleveraging

The eurozone fits into the worst scenario in terms of Figure 1. Indeed, while the United States seems to replicate a Hamilton recession, the eurozone is travelling along a dismal growth path, with no recovery of a pre-crisis growth rate. In fact, six years since the start of the Great Recession, the eurozone experience can be defined as stagnation (Figure 2).

As a result, eurozone countries have not yet begun the process of deleveraging, as the adverse dynamics of output have increased rather than decreased the total debt to GDP ratios. Looking forward, this is extremely dangerous. Although the real economy suffers from a lack of credit, the need to reduce the burden of debt is a clear obstacle to the revival of credit in the economy.

As households and firms are faced with either the burden of their own, private debt or with the uncertainty of the future burden on their income of the government debt, European countries are confronted with a difficult prospect in revitalizing private credit.

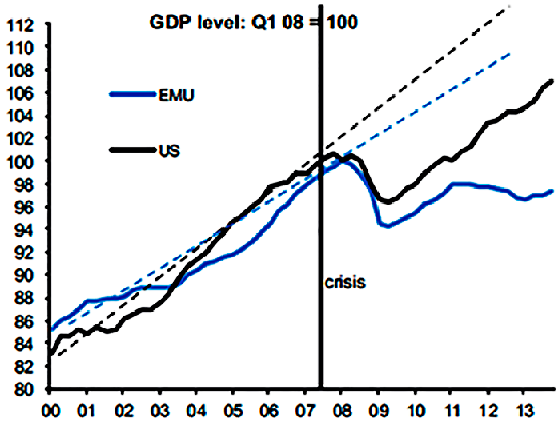
However, the deleveraging process is only one dimension of the problem.

The other dimension, perhaps even more important, is associated with the inability of the banking sector to channel credit to the system, even when central bank policies have induced an increase in liquidity in the system.

How to revive credit to the economy in Europe

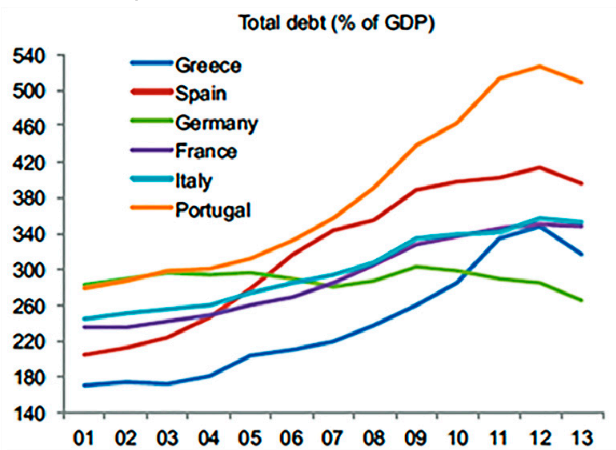
The financial sector of emerging Europe is dominated by the presence of banks from the eurozone. Therefore, credit supply in emerging Europe depends on the health and lending policies of banks of the eurozone. The EIB CESEE Bank Lending Survey (2013) identifies in the large stock of NPLs and regulation the two main obstacles to reviving bank credit in Europe.

Figure 2. GDP Dynamics Post Crisis—United States vs. Eurozone



Source: Geneva Report on the World Economy 16, (2014).

Figure 3. Debt Levels in the Eurozone



Source: Geneva Report on the World Economy 16, (2014)

Against this background, two types of policies have been tried in Europe. One is the so-called funding-for-lending scheme, implemented in the United Kingdom during the recent recession, as well as in Hungary (funding-for-growth scheme) and in some ways also by the ECB in its targeted longer-term refinancing operations (TLTROs). The second is the policy recently introduced by the ECB to purchase ABS in the market, with a special focus on SME loans and mortgage loans. We will briefly discuss these two policies.

Funding-for-lending

The scheme was implemented in the United Kingdom in 2012, and mainly consisted in reducing the funding costs for banks and building societies by providing them with relatively cheap liquidity. Banks received as loans treasury bills for up to four years in exchange for the widest possible range of collateral, including existing portfolios of loans. Those treasury bills could be used as liquid assets to increase lending or turned into cash if necessary. Banks faced favorable conditions on the funding as long as a bank's stock of lending did not contract over the period to end-2013.

It has been widely recognized that the effects of the scheme were very disappointing. Mortgage loans showed some signs of recovery, but loans to SMEs failed to recover; in fact, they continued declining.

From this experience, one can conclude that reducing the cost of funding is not sufficient to increase bank loans. Furthermore, in terms of allocation across types of borrowers, it emerged that the scheme suffered in consequence of the collateral requirements that characterized bank loans, collateral requirements that tend to be tightened in a period of financial distress. Indeed, mortgage lending may respond, as it is based on ''real collateral,'' whereas SME lending is harder to revive, as SME projects possess much less collateral.

ECB purchases of ABS

The ECB has launched in August–September 2014 a plan to purchase ABS. The rationale of the program is to free resources for banks that have in their books ABS that are not traded, and in this way revitalize the ABS market. The final objective of the program is to increase credit to the economy, especially for SMEs and possibly for households.

The scheme has drawbacks: The most serious is likely to be due to the fact that, if new flows of loans to SMEs are not guaranteed, banks will be reluctant to lend to SMEs—even if the ECB buys the existing stock of ABS. Therefore, why may the program fail in reviving credit flows to the economy? The reasons are similar to those that have led banks to invest the funds obtained through the LTRO in treasury bills rather than bank loans. Indeed, left to make their own decisions, banks may have incentives to reduce loans where they are most needed. Market failure is a salient feature of financial crises, during which banks become dysfunctional.

Reallocation of resources

In addition to the negative effects of a large stock of NPLs and procyclical regulatory measures, there is a fundamental problem impairing the efficient functioning of credit markets during the recovery from a financial crisis.

The problem is that loan contracts tend to be associated to collateral requirements. During a financial crisis, collateral values collapse and, thus, the firms' borrowing capacity falls. Banks are more risk averse in the aftermath of crises, and thus collateral requirements are likely to be tightened. Most important, the availability of collateral is not correlated with the production efficiency of the borrower. The amount of collateral available for the firm is largely a technological parameter, as it is linked to the tangibility of its assets. For instance, real estate tends to be associated to real collateral. Even though the fall in real estate prices experienced during the crisis has sharply reduced the value of housing as collateral, it is remarkable that after the crisis real estate experiences a more rapid recovery than many manufacturing SMEs (see above example on the United Kingdom). The hoped-for reallocation of resources away from real estate and construction—spurred before the crisis by excessive lending—to dynamic manufacturing or service firms is impeded by imperfections in financial markets.

Therefore, even accepting the view that rather than an overall increase in credit to the economy, an efficient recovery, consistent with gradual deleveraging, should rely on a better allocation of credit, it remains true that the market is unlikely to achieve such efficient reallocation of resources.

Dilemma and solutions

In summary, it is hard to revive credit without more direct and targeted interventions by central banks. How can we reconcile this with the objective of avoiding political capture and a large distortion of the private banking sector? It is hard to find solutions. Nevertheless, it is hard to escape innovative measures that are able to reach directly the real economy and the firms and sectors more in need of credit. Adam Posen has suggested that the United Kingdom create a state-backed and dedicated small-business lending bank with funding support from the Bank of England. Similarly, for the euro area, proposals have been advanced to complement purchases of SME-related ABS with guarantees from the ECB for new loans to SMEs, which will be later on be securitized (Bénassy-Quéré et al. (2014)).

In general, a more pragmatic approach is needed, perhaps learning from the Brazilian experience after the Argentinean crisis at the beginning of the 2000s, whereby the central bank lent directly to exporters with large immediate benefits for the real economy (Calvo et al. (2013).

Panelist 1: Erdem Başçi Governor, Central Bank of the Republic of Turkey

Thank you very much Fabrizio, and thank you for the invitation. It is always a pleasure to be in Slovenia.

It is an interesting feeling to be the first speaker on this panel and to talk not about how to revive credit markets, but about how to contain credit booms. Fortunately, our problem is a rather nice one, as we are still trying to contain and direct the credit expansion in Turkey. There are many reasons why we still have a relatively rapid credit growth in this global environment.

One of the reasons is the low household sector leverage that we had initially. Macroeconomic stability has been achieved after four decades of extremely high and volatile inflation and extremely heavy fiscal dominance. Turkey solved the fiscal dominance problem by bringing down the budget deficit-to-GDP ratio from double-digit levels to below 2 percent as of now. With the inflation targeting regime, we have also addressed the inflation problem and decreased it to single digit levels. Since then, access to long maturities and the low cost of credit have led to a significant demand coming from households and firms for all sorts of credit.

Now, the question is, what do you do with your external account? If the private-sector debt is booming instead of public-sector debt, then you have a low domestic savings rate and, inevitably therefore, a high external deficit. Having an external deficit at levels like 10 percent of GDP in 2011, may sound a good idea if you had ample liquidity thanks to quantitative easing in major central banks. But when people start talking about normalization, then the spotlight turns on the countries with external deficits. It is, therefore, a good idea to contain the extremely rapid credit growth in the private sector through macroprudential policies. Turkey has used those effectively, together with monetary policy.

I would like to express two points that are essential to revive credit—first, to provide liquidity from the central bank, and second, to ensure that central bank liquidity is allocated to useful ends by the banking sector.

In our case, the situation is somehow similar, but the opposite. We basically should reduce liquidity, including the creation of “inside money.” Regarding the second point, we should ensure that liquidity continues to support productive forms of credit at a sustainable pace, which I call a “targeted credit policy.” How do you run a targeted credit policy? One very nice example, which works well in Turkey, is a state-owned bank that is directly targeting SMEs. This is basically a bank, which is eligible to get some subsidy from the government’s budget. Therefore, in the budget there is an amount which will be transferred to specific types of SMEs through subsidized loans. This has been there for a long while, since the bank was established many decades ago. It is working well.

Previously, before Turkey's 2001 crisis, the problem was that this subsidy was not budgeted; the bank was directly ordered to lend to SMEs at a low cost and thereby made losses. That was a very bad idea, and then after a reform in 2002, this process became very transparent—there is a budgeted amount, everybody knows the fiscal costs, and the bank makes money off these loans. The purpose is served by this budgetary subsidy mechanism. The second example is coming from history. The central bank has been using funding for an exports program. Turkey has an export deficit problem; therefore, it is a good idea to fund exporters directly. The second use of this program is lending to exporters in domestic currency, but with FX indexed to LIBOR, through the Turkish Eximbank (state-owned investment bank for financing exports) and any other bank willing to use this facility. They then put a very minor spread on these funds and lend them to the exporters. This is, in essence, like buying FX from our exporters, so we are building our reserves through this channel. This facility has been used from time to time in history, and after the global financial crisis in 2008, we have reactivated it by increasing the line. Today, the stock of receivables we have from this channel is US$9 billion, and we are going to add this amount to our reserves within the coming eight months.

These are just some examples. But then, what do we do about consumer loans? The pace of consumer credit growth reached 35 percent, 40 percent nominal, when QE2 started at the end of 2010. That was simply unsustainable and not very good for the current account deficit as well. Our research has also shown that consumer loans are the main drivers of the current account deficit, in sharp contrast to business loans. We have really taken a lot of macroprudential measures such as higher risk weights on nonmortgage consumer loans—100 percent and 150 percent, depending on the maturity, well above the Basel II minimum;

and also 50 percent instead of 35 percent on mortgages. We have introduced a LTV restriction of 75 percent on housing loans; also recently, loan-to-income restrictions initially for credit cards, and we will then extend these restrictions to broader types of consumer loans. All in all, it works. Now, the pace of consumer credit growth has come below 10 percent, which is compatible with our macro objectives, including the external deficit. But commercial loans still keep growing at about 20 percent, nominal. So basically, the composition is shifting from consumer loans to commercial loans. But as a central bank, we have not been able to do it alone; the bank regulator and the Government had to take action to achieve this by using macroprudential policy instruments.

Thank you very much for your attention.

Panelist 2: Adam Balog, Deputy Governor, Central Bank of Hungary

Thank you for the invitation. I am really sorry that the Governor could not come; it was a last minute issue. I will try to convey what he wanted to explain.

The first thing about Hungary—it is a very small and open economy. It is among the top ten most-open economies in the world, which means a lot of things strategically in the credit and capital markets. First, half of our GDP is produced by multinational companies, who are financed by their parent companies. We do not have much to do with that.

Second, we have the SME market, which is responsible for the second half. This is highly fragmented, and very hard to finance through the capital market; only bank credit is an option for them. However, our banking sector is to a large extent foreign-owned; but this would not be a problem, except that they are foreign-directed banks and it is really hard for them to understand how the Hungarian SME market works. That is the reason why there are constant problems in solving credit issues with the SME sector.

Third, we have the household sector, which is about 40 percent employed by either multinationals or the state, and it is a relatively lucrative segment for the banks.

All in all, this situation resulted in some issues for SME financing even before the crisis, but especially after it. In practice, it meant that competition among the banks took place in the household sector, in the form of FX lending, or in the multinational sector, where, as I just said, we do not have much to do, or in commercial real estate lending, where a small Hungarian real estate bubble evolved. Thus, poor SMEs with a normal business have always had a problem in accessing credit in Hungary.

Then the crisis came, and—in a country like Hungary with an open economy, a huge budget deficit, and growth problems—unfortunately it not only resulted in contraction in lending where the problems occurred; I mean here particularly the household sector, but also in SME lending, where excessive lending had not taken place. SME loans outstanding amounted to 14–15 percent of GDP, which, when compared to other countries, is less than a quarter, less than a half. Still, after 2009, a steady contraction in SME lending started, reaching minus 5–6 percent annual growth rate.

Hungary needed a targeted solution. First we had to understand where the problem was, because there was not a liquidity problem in Hungary. We have seen the decrease in other sectors more as normalization and not a problem; only in the SME sector did we see it as an issue. We reviewed the situation regarding debt and found both supply and demand problems. For SMEs, the cost was actually too high; interest rates of 8, 10, and 12 percent were not affordable to the SMEs, while banks—due to issues with the government, the legislation, and the general problem of the banking groups in Europe—decided to change their credit conditions negatively. For SMEs, they increased considerably the role of collateral, making it almost impossible for SMEs to fulfill these conditions. Hence, all other steps were very negative to SMEs.

The Hungarian National Bank decided on a funding for lending scheme, a targeted scheme with two phases. First, the goal was to revive SME lending. Here we allowed the refinancing of outstanding loans, including the refinancing of FX loans to Hungarian florint loans, and only to a small extent were banks asked to finance, for example, investments. The interest rate charged to banks by the national bank was zero percent, and they were allowed to lend to SMEs at a maximum of 2.5 percent. It was not a general easing, but a targeted one. Nevertheless, the administration was managed by the banks, the selection of SMEs was made by the banks, and risks were assumed by banks as well. Even if we accepted the SME loans as collateral, we did so with a 50-percent haircut, while the other 50 percent of the collateral had to be standard eligible securities.

The first phase was, in our view, very successful because in three months EUR2.3 billion was lent, which stopped the decrease in SME lending. Even the annual growth rate went to slightly positive territory, so we saw a small but steady increase in SME lending. It is largely attributable to the scheme, but we also saw signs that normal lending had started to improve as well.

The second phase was different; it was even more targeted. Here we allowed basically only new loans, as 90 percent of the scheme has to be used for new lending and only 10 percent is allowed for refinancing. Investment loans are preferred within new loans.

This scheme stopped the decrease in SME lending and the second phase has already boosted the economy in Hungary, which all in all, according to our calculations, may lead to a 0.5–1 percent GDP increase this year and next year. We are also writing a paper about that, which is already underway and will be ready in few weeks. Thank you very much.

Panelist 3: Yannis Stournaras, Governor, Bank of Greece

The global financial crisis has impaired the ability of the financial system in the euro area to channel funds to the real economy, in particular, for the financing of long-term investment and SMEs. Banks in the euro area have been particularly affected as the financial crisis was followed by a sovereign debt crisis, which has set in motion a negative feedback loop between banks and sovereigns. As a result, over the past six years, bank credit to the real economy and, in particular to SMEs, has fallen dramatically in the EU. Credit, which had been growing at double-digit growth rates before the global financial crisis, has contracted during the past few years.

The crisis also hit banks in the CESEE region, as foreign bank engagement in the region declined and the over-indebtedness of households and businesses, a legacy of the earlier credit expansion, led to a large and rising volume of NPLs. In some cases, those have reached, or exceeded, 20 percent of total loans. As a result, bank credit in the region declined from average growth rates above 30 percent in the period 2003–08 to close to zero or even negative rates of growth in recent years.

Bank credit is particularly important for economic growth in the EU. This situation is attributable to the fact that European economies are heavily dependent on bank financing. This dependence on banks is in contrast to the United States, where capital markets play a bigger role in financing the economy. CESEE economies are also bank-based financial systems in which capital markets remain relatively underdeveloped. Consequently, bank deleveraging, combined with increased risk aversion on the part of investors, has affected the ability to finance sustainable growth throughout the region.

A key characteristic of the economic recovery in the euro area at the present stage is the weakness of bank lending to the private sector in general and to companies in particular. This situation applies at both the aggregate level and for many individual countries.

The situation appears to be better in the CESEE region (perhaps with the exception of Turkey), as credit growth remains on average positive, but is nevertheless too weak to support satisfactory rates of sustainable growth. In particular, there are countries—like Bulgaria, Bosnia and Herzegovina, and

FYROM—where credit to the private sector is experiencing a moderate recovery;, but in other countries—such as Slovenia, Serbia, and to a lesser extent Croatia and Romania—bank credit growth to the private sector, and in particular to enterprises, is still negative.

As Fabrizio Coricelli has discussed in his presentation, creditless recoveries are not uncommon in the aftermath of financial crises, in particular, when the financial crisis has been preceded by a credit boom to the private sector. Calvo et al. (2006), in a seminal paper published in the American Economic Review, describe creditless recoveries as "Phoenix Miracles." The phenomenon of creditless recoveries has been documented mainly in emerging market and low-income economies, but seems to also play a role in industrial countries. Empirical evidence suggests that creditless recoveries are more likely when the preceding recession was deep and when the recession coincided with a banking crisis. Several other factors also play a role: the openness of the economy to financial flows; the degree of export dependence; the degree of external adjustment during the recession; and the stance and mix of fiscal and monetary policies.

Several explanations of this phenomenon have been proposed in the literature. One explanation is that economies can rebound without bank credit because capacity utilization is low during a recession, allowing GDP to recover mainly through the absorption of unused capacity rather than through investment. A second explanation is that, in the absence of bank credit, firms increasingly use internal finance and trade credit. Furthermore, even if bank credit is declining, it may be reallocated toward more dynamic sectors, thus allowing an economic rebound.

Empirical research at the Bank of Greece suggests that the probability of a creditless recovery depends on two additional features of the economy: first, the saving investment gap—in other words, the net financing needs of the private sector; and second, the degree of a country's fiscal and external adjustment during the recession. In particular, the lower the net financing needs of the private sector at the bottom of the recession, the more likely it is that the economy can recover without bank credit. Since the gap between investment and savings can be financed through either capital inflows from abroad (in other words via current account deficits) or through lower budget deficits (in other words by freeing private savings to finance investment), saving-investment imbalances naturally correspond to fiscal and external imbalances.

A second important implication of this research is that the degree of a country's fiscal and external adjustment during the recession plays a significant role during the recovery. In particular, the probability that a country may experience a creditless recovery is higher in countries that have followed economic adjustment policies during the recession to reduce their external and fiscal deficits. This result has important implications for both countries of the euro area periphery and countries of the CESEE region.

Nevertheless, creditless recoveries are suboptimal outcomes from an economic policy perspective since, as has been observed by several researchers, creditless recoveries are on average weaker than recoveries with credit. As Fabrizio Coricelli also points out, creditless recoveries may have negative effects on long-run potential growth by affecting investment and the stock of productive capital, but also by increasing long-term unemployment.

A number of actions may be undertaken in order to address the problem. I will confine my remarks to three areas: monetary policy; confidence in the banking sector; and initiatives that target the mobilization of funds from capital markets, thus broadening the sources of financing the economy. I will focus on our recent experience in the euro area, in general, and Greece, in particular—where the banking system has undergone a significant transformation over the past few years. Overall, my emphasis will be on measures that aim to revive bank credit and to mobilize funds from capital markets.

Monetary policy

On monetary policy, the ECB has taken important actions to improve confidence and to restore the smooth operation of the monetary transmission mechanism. Credit growth would have been significantly more negative had it not been for these actions.

The policy rate is now at a historical low of five basis points. Nonstandard measures, including the TLTROs, the ABS Purchase Program and the third Covered Bond Purchase Program, will inject liquidity into both banks and markets.

Confidence in the banking sector

The establishment of the Banking Union is restoring confidence in the banking sector. The supervisory authorities are assessing the resilience of banks and requesting injections of capital, so that confidence in the quality of bank balance sheets will be restored. In this respect, the Comprehensive Assessment and the EU-wide stress tests, which are currently underway, will be key to improving confidence in the banking sector. The Banking Union will also help reduce financial fragmentation.

The faster that banks clean up their balance sheets, the easier it will be for them to regain confidence, to attract fresh capital from private investors, and to provide credit to the economy.

At this point, allow me to say a few words about Greek banks. Following the first recapitalization of our banks in 2012, we began to reform and consolidate the banking system. Banks sharply reduced reliance on central bank funding, while forming provisions for bad loans. As a result, they have been able to attract private investors.

Early this year, we concluded follow-up stress tests that were exceptionally well received by the markets. Following the release of the results of the stress tests in March, core banks completed much larger than requested capital increases to the tune of EUR 8.3 billion, with issues being significantly oversubscribed. Two systemic banks have repaid state aid that has been in the form of preference shares. All four systemic banks are now under private management.

These are the signs needed to restore confidence and lay the foundation for the healthy financing of the economy at a later stage.

Mobilizing funds from capital markets

Returning to the broader picture, it appears that bank credit will remain constrained at least until the European stress tests are completed and banks adjust to the results of the exercise. The burden of NPLs in economies that have gone through a deep recession—and Greece is a good example here—will be a major factor constraining the supply of bank credit in the medium term. Given the limited quantity of resources, it is important that banks use these limited resources in a way that improves allocative efficiency. In other words, they have to be channeled to the most productive uses.

Nevertheless, despite the important role that banks will continue to play in the EU, particularly for SMEs, it has been clearly communicated by market participants that there is a pressing need to broaden the sources of long-term financing in Europe.

Broadening the sources of financing of the economy toward capital markets should be viewed as one of the key priorities of economic policy.

In this respect, the development of a deep, transparent, and robust European securitization market for corporate loans would improve risk sharing and increase banks' lending capacity to corporates and, in particular, SMEs.

And this solution will probably serve its purpose better this time than previously, since the lessons of the inadequate regulation of some securitization models in the past can be taken into account.

The ABS and the Covered Bond Purchase Programs will provide an initial boost, especially for the European ABS market, which has lain largely dormant since 2008.

However, in my view, if we are to move farther towards the development of a market for corporate loans, a concerted effort is needed in several directions. A list of key priorities in order to revive credit markets should include the following:

1) ***Further measures to revive the market for securitizations, in particular for SME bank loans.*** Securitization is an important instrument to promote bank credit. Allowing banks to securitize and redistribute SME loans to a broader investor base can provide banks with capital relief and allow them to lend to the real economy. This is not an easy task given the stigma attached to securitization following the global financial crisis, when the "originate-to-distribute" model led to excessive leverage and financial fragility. Of course, lessons have been learned since then, and the regulatory framework has been adapted in a way that makes a repeat of past mistakes unlikely. For this securitization to work in a way that does not endanger the resilience of the financial system, we must ensure that only high-quality assets that are simple and transparent are used in securitizations. In this respect, it is important to develop a set of rules that allow the definition of a pool of "high-quality securitizations" at the EU level.

2) ***Changes to the prudential treatment of securitizations.*** It is essential, in my view, to adjust the regulatory framework for securitizations in a way that provides banks with incentives to engage in the market. Capital relief for banks' holdings of ABS which are simple, transparent, and robust could provide an answer. The second aspect of regulation relates to potential investors, such as insurers,

pension funds, etc. The regulatory framework should allow for a fair treatment of high-quality ABS relative to ABS products with higher risk profiles, in order to provide long-term institutional investors with incentives to trade in the market.

3) ***Policies to promote better access of SMEs to capital markets.*** As is well known, corporate bond markets work well for large corporations while they are not attractive to SMEs, which remain largely dependent on bank loans for financing. Efforts should be undertaken to reverse this trend and promote the access of SMEs to capital markets. The development of “mini bond” markets for SMEs in Italy and Germany could serve as examples to gain insights into best practices for the establishment of SME markets. The development of bond and equity markets for SMEs and mid-sized companies would also encourage more cross-border investment within the EU and from foreign investors.

4) ***Measures to develop alternative financial intermediaries for young companies and SMEs***. In this context, efforts should be intensified toward the creation of a risk capital market for non-listed companies such as a market for venture capital funds and markets for infrastructure financing. MiFID II is an important step towards improving the functioning of EU trading venues and setting the stage for the development of SME capital markets. However, further steps are necessary, in particular, to correct differences throughout the EU in the tax treatment of these products both at the issuer and investor level.

5) ***Measures to improve investors’ access to business, credit, and financial information on SMEs.*** It is well-known that most SMEs are not rated by rating agencies. The lack of adequate and readily available information on the credit quality of SMEs is a

> structural problem in the EU as a whole and in the CESEE region, in particular. This is one of the major reasons that SMEs in the EU have historically faced significant difficulties in accessing funding from capital markets.
>
> There is, thus, the need for a harmonized EU approach to credit scoring comparability of SME data. Improving the availability of financial information is paramount in allowing investors to gauge the riskiness of securitized products. In this respect, it is important to develop national credit registers for SMEs, allowing for higher transparency, standardization, and comparability of underlying assets.

A final word of caution is in order: Most of the measures I have discussed above will likely have only medium- to long-term effects in reviving credit markets in the EU, because most of these measures constitute fundamental changes in the structure of the financial system. Such structures naturally change only gradually over time. In the short term, monetary policy will continue to play the major role in determining liquidity provision to banks and the cost of funding for the private sector. Nonstandard monetary policy measures and progress towards a Banking Union are, thus, of prime importance, in order to reduce market fragmentation and allow the normal transmission of monetary policy to the most vulnerable areas of the monetary union.

Panelist 4: Fernando Restoy, Deputy Governor, Banco de España

Introduction

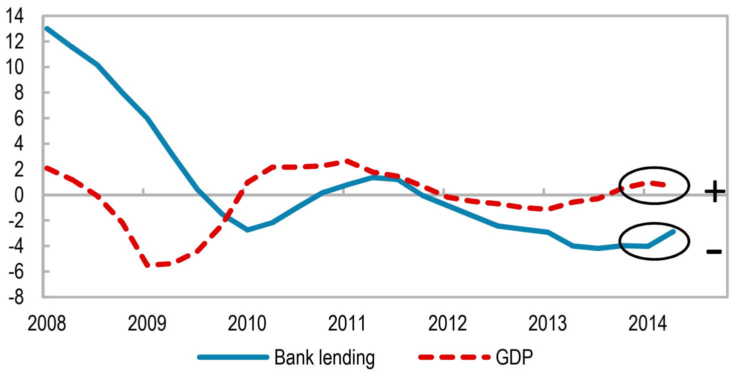
Thank you very much and good morning to everyone. It is a pleasure to be at this important conference, on this important matter.

Recent developments in the euro area show a diverging path between the evolution of the real economy and lending dynamics. While GDP is recovering, credit to nonfinancial corporations continues contracting, as Figure 1 shows. In this context, if credit does not recover, logical concerns about economic prospects arise.

However, in my opinion, the analysis of credit developments and the implications for growth is not straightforward and before taking or recommending any policy action, a thorough examination of the factors explaining credit developments is required.

With this in mind, my contribution to this debate lies in providing an overview of the factors explaining credit behavior (Section 1), and discussing possible policy actions based on the diagnosis that those factors suggest (Section 2). The analysis focuses on developments in the euro area, but this analysis is complemented in some particular aspects with evidence corresponding to the Spanish economy.

Figure 1. GDP and Bank Lending to Nonfinancial Corporations: Euro Area Year-on-Year Growth in Real Terms



Sources: Eurostat; and ECB.

What factors explain credit behavior?

As mentioned before, in order to define the policy agenda, we need to first analyze the factors explaining credit behavior. This implies analyzing first the extent to which supply restrictions predominate or not over poor credit demand. If demand factors are relevant, then it has to be considered whether weak credit demand is associated to the necessary corrections of imbalances. It is subsequently important to pay attention to whether we can expect recovery of credit demand before recovery of output, and finally whether we can identify specific supply frictions that need to be addressed.

Can we disentangle credit demand from credit supply changes?

Starting then with the first question on whether supply restrictions predominate or not over poor credit demand, we have to acknowledge that disentangling credit demand from credit supply changes is far from easy.

Having said that, and not wishing to go into a detailed description of supply and demand factors and its recent evolution,[16] some insight can be provided by turning to the Bank Lending Survey[17] that asks participating banks to provide their

---

[16] A detailed description of the credit evolution in Spain can be found in Ayuso, J. (2013), "An Analysis of the Situation of Lending in Spain," Economic Bulletin, October 2013, Banco de España.

[17] The Bank Lending Survey is an official quarterly survey that has been conducted in coordination with all the euro area national central banks and the ECB since January 2003. The survey asks a representative group of credit institutions about the changes in their lending policies and perceived demand, distinguishing between three market segments: nonfinancial corporations, households for house purchase, and households for consumption and other purposes. They are likewise asked about their forecasts for the following three months.

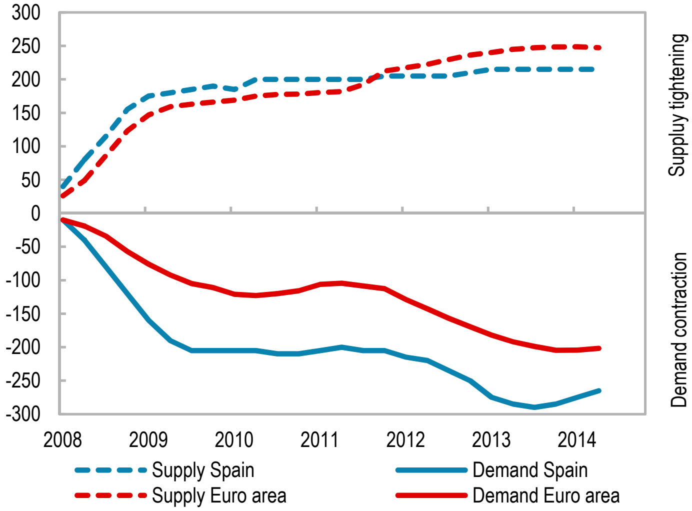
Aggregate results for the euro area are regularly published on the ECB website: https://www.ecb.europa.eu/stats/money/surveys/lend/html/index.en.html. The results for the participating Spanish institutions are published on the Banco de España's website: http://www.bde.es/webbde/en/estadis/infoest/epb.html.

(continued)

views on developments in credit demand and supply. Figure 2 shows cumulative changes in demand and supply in the segment of lending to nonfinancial corporations in the euro area and Spain, extracted from the Survey, i.e., it shows the results over time of the cumulative changes in demand and supply that the survey provides for each quarter.

Figure 2. Bank Lending Survey, Cumulative Changes in Demand and Supply, and Bank Lending to Nonfinancial Corporations

(In percentage points)



Sources: ECB; and Banco de España.

These cumulative changes reveal that during the crisis the weak bank lending to nonfinancial corporations has been driven by

---

Additionally, quarterly articles in the Economic Bulletin of the Banco de España summarize the results of the Survey corresponding to the participating Spanish institutions and compare them to the results corresponding to the euro area.

both demand and supply factors, in Spain as well as in the euro area. More recently, there have been some signs of a mild recovery in both demand and supply. But current levels are still significantly below the pre-crisis levels.

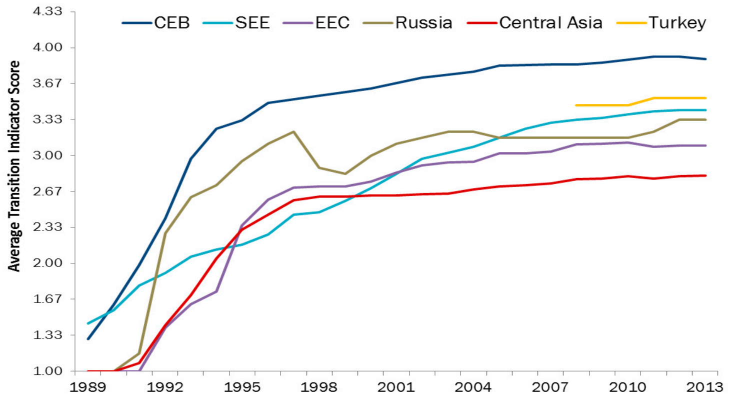
Panelist 5: Bojan Marković, Lead Economist, EBRD

Let me please lay down several points relevant for the revival of bank credit growth in the CESEE region.

First, one should hardly expect a revival of economic and thus credit growth in the CESEE region to the pre-crisis level if structural reforms are not reinvigorated. The EBRD regularly produces the so-called transition indicators, measuring structural gaps between market practices in CESEE countries and best practices in developed countries. These indicators kept improving until the mid-2000s, but across all the transition regions, including CESEE, they stalled from 2005 onwards (Figure 1). This suggests that structural reforms stalled in the mid-2000s, i.e., before the crisis struck, and some of the CESEE countries have even witnessed reform reversals during the prolonged crisis period. The CESEE region seems to have become "stuck in transition," implying that economic growth would have probably stalled even without the fall in bank credit. In its 2013 Transition Report, the EBRD found that—without structural reform—revival growth convergence between some of the CESEE countries and Western European countries may not continue, while in some countries it may continue but at much slower rates than otherwise (Figure 2). This has clear implications for the pace of bank credit growth, but also indicates that the revival of credit growth will not be sufficient to sustainably revive economic growth.

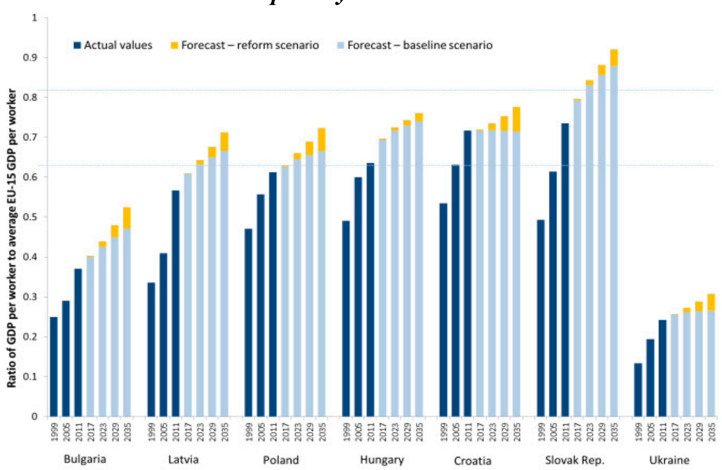
The second point I'd like to make is that the credit growth revival may optimally be slower in CESEE countries where the credit-to-GDP ratio was a way too high before the crisis (Figure 3). In the decade before the crisis, many of the CESEE countries recorded consumption-driven growth financed by large

Figure 1. Structural Reforms Across Transition Regions Have Stalled Since Mid-2000s



Source: EBRD Tranistion Report 2013

Figure 2. Without Structural Reform Revival Growth Convergence in Europe May Not Continue



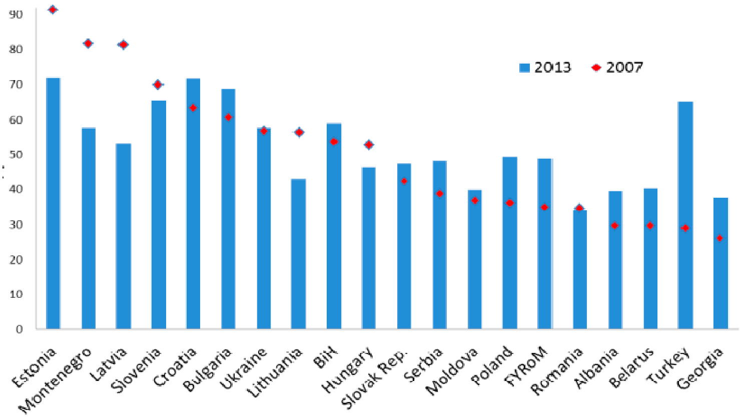
Source: EBRD Transition Report, 2013.

capital inflows, often through banks, which resulted in large external imbalances, as reflected in unsustainable double-digit current account deficits. In such circumstances, some sectors—e.g., nontradable services—overdeveloped, while some potentially prosperous sectors remained underdeveloped. Ensuing deleveraging and lower bank credit growth in some CESEE countries, therefore, may have been an optimal and necessary adjustment (Figure 4).

The second point I'd like to make is that the credit growth revival may optimally be slower in CESEE countries where the credit-to-GDP ratio was a way too high before the crisis (Figure 3). In the decade before the crisis, many of the CESEE countries recorded consumption-driven growth financed by large capital inflows, often through banks, which resulted in large external imbalances, as reflected in unsustainable double-digit current account deficits. In such circumstances, some sectors—e.g., nontradable services—overdeveloped, while some potentially prosperous sectors remained underdeveloped. Ensuing deleveraging and lower bank credit growth in some CESEE countries, therefore, may have been an optimal and necessary adjustment (Figure 4).

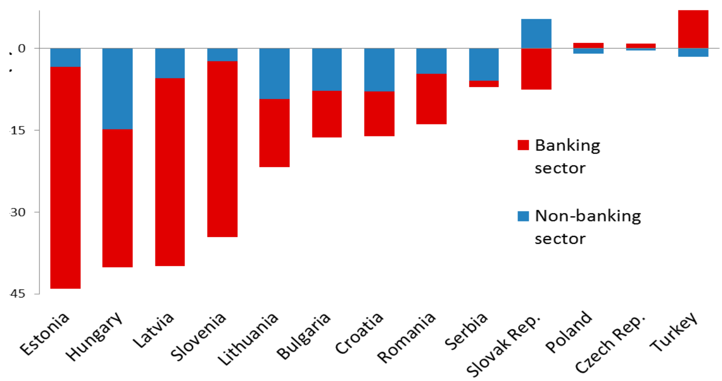
That leads me to the third point to make. The ability of banks to revive credit growth in the CESEE region sustainably over the longer term will likely depend on who gets the new credit—viable restructured corporates or nonviable corporates. In other words, it is the quality rather than quantity of credit growth that may matter, especially in countries that need to change sectoral drivers of growth in the future—such as those with previously large current account deficits. As mentioned, in those CESEE countries, corporates that flourished in a decade of consumption-driven growth were usually those in the nontradable services sector. Business models of some of these corporates will not necessarily remain viable in the future and they may have to wind down. Some of them have already accumulated delayed debt, contributing to increasing NPLs across the CESEE region. Continued support to these weak nonviable corporates holds back loans to viable corporates, preventing the economic restructuring and sustainable economic and credit growth revival.

Figure 3. CESEE Credit-to-GDP Ratio Before the Crisis—Private Credit
(In percent of GDP)



Source: IMF WEO, CEIC.

Figure 4. Deleveraging During the Crisis—BIS Reporting Bankers' Claims (FX-adjusted) as Share of 2012 Nominal GDP
(In percent)



Source: BIS.

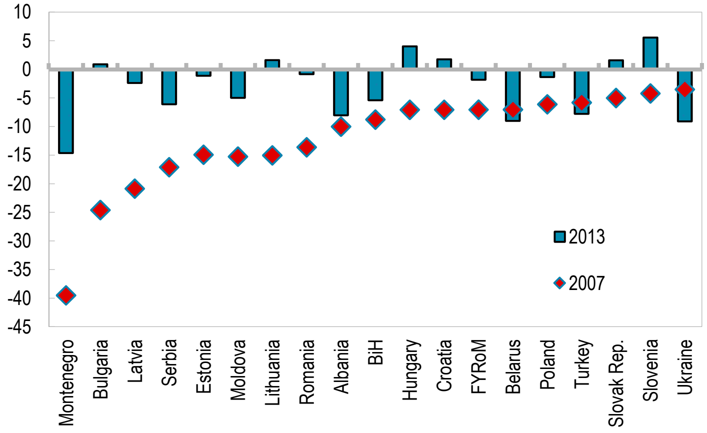
Policy focus thus should be less on "more bank credit" and more on making the corporate sector stronger to be able to take on more long-term debt and redevelop securitization and capital market funding in general, not only bank-lending funding.

Indiscriminate lending support was partly the reason why some of the policy measures implemented over the past few years in some of the CESEE countries didn't eventually yield sustainable credit growth. In Serbia, for example, the policy of subsidized loans, which was in place from 2009 to 2014, arguably kept alive many nonviable corporates, interfered with the monetary policy transmission mechanism, and often just substituted credit—which would anyways be extended through market mechanisms. Even more discriminate subsidies should be taken with caution, as governments throughout history were often less efficient than markets in picking up national champions amongst corporates.

The fourth point I'd like to make is that the ability of central banks to revive credit growth—e.g., through TLTRO—will likely be particularly limited in countries with large NPLs, especially when these reflect underlying problems in the corporate sector, and these need to be resolved. Large NPLs, even when fully provisioned, discourage new lending, as they: (i) absorb managerial time, both in banks and corporates, thus suffocating managers' focus on new lending and core business; (ii) lower the average return on the total stock of loans, thus pushing up on interest rates on performing loans; and (iii) lower expectations of future economic growth, thus further building-up interest margins and cost of funding for performing loans.

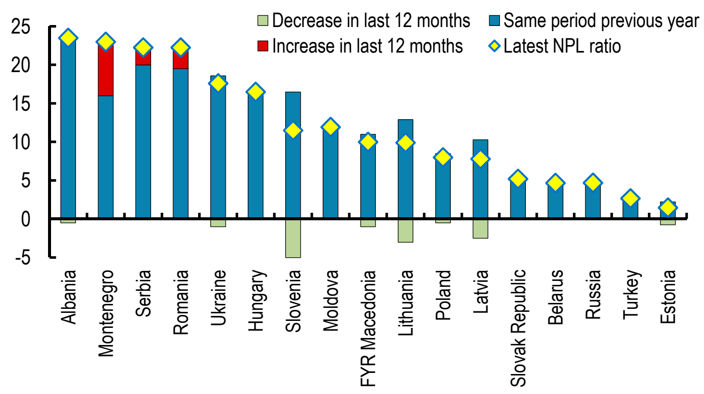
But large NPLs in CESEE countries are mostly a reflection of problems in the corporate sector, and thus clearing-up bank balance sheets may not be sufficient to kick-start new lending. It should be accompanied by a comprehensive corporate-restructuring action, which would: delineate upfront between viable and nonviable corporates; restructure the prior ones; and, in an orderly manner, wind down the latter ones. In CESEE countries, the restructuring will be particularly challenging due to the heterogeneous nature of NPLs in terms of sectors and in terms of the same corporate debt consisting of a series of bilateral lending contracts with multiple (sometimes dozens of) lenders.

Figure 5. Current Accounts Have Largely Rebalanced During the Crisis
(In percent)



Source: CEIC.

Figure 6. NPLs Remain Persistently High Across the Region
(In percent)



Source: CEIC.

In such circumstances, coordination between various stakeholders within and between countries may prove very important. The best-suited available framework to ensure such coordination may be the so-called Vienna Initiative framework, which includes home and host-country banks, regulators, international financial institutions, and investors. The good news is that this framework has been recently intensifying efforts on coordinating its various stakeholders in CESEE countries with large NPLs in order to enable them to draw on each other's ideas and experiences on their resolution, and yet formulate a tailor-made solution, which would stimulate the orderly resolution of NPLs.

The final point to make is that the ability of banks to extend credits in times of changing sectoral drivers of growth may be impeded due to the use of historically based credit-assessment models. When drivers of growth change, corporates that did well in the past may not do well in the future and vice versa. So historical data is worth less than otherwise, and credit assessment methodologies commonly used in banks may: (i) lead to continued forbearance of nonviable corporate clients; and, perhaps more importantly, (ii) prevent credit flowing towards corporates with good future prospects. The issue is particularly pertinent in the CESEE region with a large share of foreign-owned banks and credit-assessment procedures unified and often centralized in so-called home countries. Many of these home countries have not experienced changing drivers of growth and historically based credit-assessment models work well there, so regional banks have little incentive to change the existing methodology. While it makes sense for the regional banking groups to have a unique risk-assessment methodology for the whole group, the unified methodologies may sometimes disadvantage subsidiaries in CESEE countries with changing drivers of growth. Developing alternative assessment methodologies, more aligned to the needs of particular CESEE markets, may thus be desirable to prevent piling-up liquidity in CESEE banks, and to help channel bank credit to prospectively viable corporates. Furthermore, this may prove particularly useful when these viable corporates are start-ups, or innovative firms with an often uncertain and volatile cash flow. In such cases, developing nonbank funding—such as venture capital, factoring, or securitization—may additionally help towards the sustainable revival of economic growth.

C. Discussions

A number of issues were raised by participants from the floor following the presentations by the panelists. The issues were mainly related to the role of macroprudential instruments, nonstandard monetary policy measures, asymmetries of policy effects between stressed and nonstressed countries, and the size of the banking sector.

- While agreeing about the importance of the securitization, one participant cautioned that small countries have a small volume problem, which could potentially translate into a price problem. He proposed supranational ABS as a potential solution that would provide sufficient volumes to be attractive for investors.

- He also asked whether there is scope for macroprudential measures to boost credit growth, and he expressed scepticism that such instruments could work symmetrically. He related this issue to the optimal size of the banking sector and wondered whether it is sensible to promote credit growth to the extent that would return the economies to pre-crisis volumes.

- Another participant raised the issue of whether the promise of the introduction of the ABS-purchase program by the euro system is having adverse effects on the incentives of banks to use other long-term refinancing operations provided by central banks. He noted that this could cause a delay in accessing existing schemes for liquidity provision while banks waited for the introduction of the new program.

- A final question concerned the extent to which unconventional monetary policies introduced within the euro area are having asymmetric effects on countries under stress and on those that are not stressed.

Panelists' responses to questions

Securitization, macroprudential policies, and the ABS and TLTRO programs. Several panelists agreed with the problem of small volume with securitization. One pointed out that, in addition to increasing volume, cross-border securitization would exploit the opportunity for diversification of risks. The inclusion of other asset classes—mortgages, for example—was viewed as a potential solution to the small volume problem. While technically difficult, such securitization is feasible provided there is political will and potential involvement of supranational entities, such as the EIB, in the process of securitization. The panelist further argued that the ABS-purchase program would bring the benefits of lower long-term interest rates for SMEs and thus would foster economic activity.

Regarding the asymmetric effects of macroprudential policies, one panelist noted that such policies may work both ways, provided that they are sufficiently tight during booms to form buffers that can be released during downturns. Another panelist agreed that asymmetries were induced by macroprudential measures and proposed greater financial integration as a solution. An integrated financial union would be able to redistribute liquidity from the areas where liquidity was plentiful to the areas that may need this liquidity.

Most panelists agreed that the ABS-purchase program and TLTRO programs are complements, rather than substitutes. One panelist observed that some banks may be waiting for the details of both programs to become fully known before deciding on which instrument to use to obtain liquidity.

Another panelist linked the issue of securitization and ABS purchases to the issue of asymmetric effects of unconventional monetary policy. He argued that stressed economies have problems with collateral for monetary policy operations due to low credit ratings. While it would be illogical to exclude some countries' government bonds from refinancing operations on this account, the benefit of ABS is that they can function as collateral that is supplementary to government bonds.

Banking-sector size. One panelist noted that there is little consensus on the issue of the optimal size of the banking sector. However, it is important for the various ratios to be balanced, such as the ratio between debt and equity, and the relationship between financing and GDP.

VII. PANEL 4: RISKS OF A NEW FINANCIAL CRISIS

A. Summary

The panel discussed the risks of a new financial crisis affecting the CESEE region. The hoped-for revival of credit growth may be disrupted by renewed financial market turmoil and macroeconomic strains. Also, misdirected or mistimed efforts to stimulate the economy generally and in particular credit growth may themselves be procyclical and destabilizing. The panel therefore considered both the probability attached to various shocks, and the evolution of financial system resilience in the light of macroeconomic conditions and the policies pursued. There was acknowledgement of the difficulties attached to predicting the timing of renewed tensions and how they may play out. Over a long enough time horizon, a major (exogenous) negative shock is inevitable, but certain policies may be available to enhance resilience and reduce the chance of endogenous shocks.

There was consensus that various market rigidities in Europe and inherited weaknesses are increasing the risk of prolonged low growth and intensified vulnerabilities. The market rigidities need not in themselves provoke a crisis; but may prevent financial and nonfinancial institutions from building-up resilience to an eventual exogenous shock, most obviously by condemning them to low profitability and low growth.

Debt overhangs—whether in the corporate, household, bank, or government sectors—may persistently depress investment and consumption, and therefore growth. In these conditions, the debt overhang is difficult to work off, as are the substantial stocks of NPLs. Moreover, many financial institutions are not currently profitable enough to restore their buffers from internal resources. This uncertainty surrounding the European banking system may hamper recovery.

Labor markets in much of Europe display hysteresis, affecting especially young workers, with all the attendant economic and social costs. Youth unemployment is a social problem, a political problem, and a generational problem. There is a need for more investment, especially private investment but also public investment. That investment will support both demand and also, if well chosen, potential growth; but it requires a reduction in uncertainty and a rekindling of optimism about economic prospects.

Turning to possible exogenous shocks to the region, at present obvious geopolitical risks prevail. Certain sectors have already been affected significantly by the sanctions on Russia and that country's economic difficulties. Also, the European recovery has been largely export-led; so a slowdown, especially in emerging-market economies (for example, because of strains affecting highly leveraged multinationals), would have strong repercussions. Credit risk would then intensify further, most notably in export sectors—which have, so far, been rather insulated from recession. Even without a major global slowdown, Europe—including the CESEE region—cannot expect to see a further large strengthening of its current account balance.

The current environment of very low interest rates and loose monetary policy has certainly eased tensions; but the eventual exit from this situation will require a delicate policy balance, especially if some countries exit earlier and faster than others. In this context, the prospective tightening of U.S. (and U.K.) monetary policy could be a catalyst for a change in sentiment. Certain financial markets, including those for European sovereign debt, now price in very little risk; a very dramatic repricing of assets and a return to higher risk premiums could be disruptive and reveal underlying weaknesses. Here, political risk in Europe, where reform fatigue and disenchantment with established parties is widespread, may spark a "blow out" in sovereign risk premia. Further down the road, certain trends suggest that nonbank intermediated financial markets may be becoming more susceptible to large, systemically driven portfolio shifts. Funding connections in nonbank financial institutions (NBFIs) and between NBFIs and banks may be becoming more nontransparent and fragile.

The short-term risk of a crisis endogenous to the CESEE was viewed as modest. In many ways, and in many CESEE countries, financial systems have been strengthened—for example, in terms of reduced reliance on parent or wholesale funding, and reduced dollarization. As a result, loan conditions are softening, albeit in the face of weak demand for new loans. There are few signs of excessive asset valuations or very rapid credit growth in most CESEE countries, albeit with some exceptions. Generalized deflation in CESEE was seen as unlikely.

Regarding the debt overhang, the picture is mixed: government debt is high in some countries, and corporate debt is pronounced and rising in others; but aggregate household debt is mostly modest by European standards. Also, the distribution of debt matters: some countries have pockets of heavy indebtedness. Of more concern is the rising level of NPLs, especially in the enterprise sector, which weigh on that sector and the banks. Thus, incomplete fiscal consolidation and private-sector deleveraging may be key ingredients of new vulnerability in some countries of the region.

Especially if the recovery takes firmer hold, then the policy challenge of how to sustain growth on a financially sound basis will become more urgent. During the current relatively calm time, the authorities can help reduce the risk of a renewed crisis by tackling the overhang of (impaired) debt. Action is needed at the level of banks but more importantly at the level of corporates and sovereigns. Buffers need to be built up, and that will require the promotion of the orderly elimination of excess capacity in the financial sector and the restoration of sustained bank profitability. Another element of the policy response is the development of macroprudential instruments, and the means to implement them in a timely fashion. But addressing underlying weaknesses—especially long-term youth unemployment and the low trend growth rate—will require structural measures; for example: in labor markets; in better education for all sections of society; and in creating innovative European financing vehicles.

B. Presentations by Members of the Panel

Lead: Erik Jones, The Johns Hopkins University

There are signs of recovery in parts of the EU. The question is whether they are durable. Performance across EU member states is becoming more differentiated. Some countries are growing more quickly and experiencing lower levels of unemployment. Others remain mired in what can best be described as (very) slow growth equilibrium. Moreover, the European economy is being buffeted by shocks from the conflicts in the Ukraine, the Middle East, and in North Africa even as it experiences the usual volatility induced by political events such as the referendum in Scotland, the unofficial plebiscite in Catalonia, and the mid-term elections in the United States Also worrying is the prospect that any recovery will only result in the accumulation of imbalances that will lead to another round of financial fragility and instability. For every voice that warns of secular stagnation, there is another that cautions against the dangers of moral hazard; calls for quantitative easing or fiscal stimulus are met with concern for pent-up inflation and excessive indebtedness.

The purpose of this contribution is to assess the risks that Europe will experience a new financial crisis—including the possibility that it never completely emerged from the last one. The implicit focus is on the countries of CESEE; given the nature of interdependence in the EU, however, Western European countries both inside and outside the euro area also garner consideration.

The analysis is divided into four sections: The first examines the evidence that the CESEE countries have actually emerged from the crisis as part of a more general European recovery. The second looks at the negative impact of exogenous factors. The third explores the reemergence of endogenous risks through the accumulation of imbalances as a result of current performance trends. The fourth concludes with the prospects for policy action both at the Europe and national levels.

Rigidity and recovery

Any recovery in European economic performance should be measured against those factors that best reflect the impact of the crisis. These factors are less causal than symptomatic. They matter more as obstacles to adjustment than as explanations for the deterioration in European performance during the period that ran from 2007 to 2013. This analysis focuses on five possible sources of rigidity that would prevent CESEE countries (and the rest of Europe) from recovering robustly. They are:

- hysteresis in unemployment;
- deflationary expectations;
- a loss of confidence and an increase in risk aversion among banks and firms;
- balance sheet dependence upon cheap and plentiful liquidity; and
- excessive public indebtedness.

The problems associated with these different sources of rigidity are well-known. Hysteresis in the labor market occurs when cyclical unemployment becomes structural as long-term unemployment accumulates and workers locked out of employment lose their ability to find work. Deflationary expectations emerge when the usual expectations about price inflation become unanchored, and economic actors begin to build in falling prices as part of their wage bargaining and investment planning. A loss of confidence in the banking sector results in fewer loans (offered at higher standards) to nonfinancial firms and households; a loss of confidence outside the banking sector results in a fall in demand for borrowing to finance new investment or large purchases. Excessive dependence on cheap and plentiful liquidity requires a balance-sheet adjustment to change the gearing of debt to equity.

Meanwhile excessive public indebtedness leaves little margin for maneuver for fiscal stimulus.

The evidence for these rigidities across the CESEE region is mixed. Looking at unemployment as a percentage of the labor force, for example, what is striking is not so much the high level of unemployment as the very slow and uneven pace of its alleviation—particularly when compared to the fast changes that took place during the period from 2002 to 2008. Meanwhile, evidence for deflationary expectations in the euro area continues to accumulate. Actual headline increases in consumer prices remain mired below 0.5 percent on an annualized basis. The average of forecasts for expected future price increases shows this figure rising to “below but close to 2 percent” only over a 10-year time horizon. This estimate corresponds with the five-year breakeven rate in the bond markets, which have fallen to 1.7 percent in October 2014.

The news is not entirely disappointing. Confidence within the financial sector has been improving and credit standards applied to new loans to nonfinancial firms and households have been loosening progressively. Moreover, these factors should continue to strengthen as European banks emerge from the ECB’s comprehensive assessment that was completed this October. The result will not be a flood of fresh liquidity, but it will be an improvement over the tight conditions that resulted from bank de-leveraging after the ECB’s AQR and in anticipation of its stress testing of bank balance sheets.

Unfortunately, there is little evidence that the softening conditions on the supply side of the banking industry will be met by aggressive demand for credit among nonfinancial firms and households. Moreover, consumer and business confidence indicators show continued signs of concern. At least part of this pessimism is due to their own balance sheet considerations. Nonfinancial firms also need equity and households worry about paying down their debts. Data from credit reform shows that the difficulties associated with repairing nonfinancial balance sheets are taking their toll in terms of corporate insolvencies. SMEs, in particular, are struggling to meet their obligations and often coming up short. The burden of these insolvencies is not everywhere the same and yet the absolute volumes across Europe are high relative to recent history and so continue to weigh on any European recovery.

Meanwhile, progressively higher public debt-to-GDP ratios limit the possibilities for fiscal stimulus. This is most evident in the euro area where there is a heated debate between the German government and governments in those countries most affected by the crisis about the need to strictly observe the terms of the EU's fiscal compact. There is pressure on the governments of the CESEE countries as well. Even where these countries have relatively low public debt-to-GDP ratios, the European Commission has been quick to raise concerns about debt sustainability and reluctant to grant flexibility in providing fiscal stimulus.

At the nexus of such constraints, it is small wonder that politicians express concern about the dangers of secular stagnation even as economists recommend ever more sweeping structural reforms. The challenge for policymakers is to identify which are the priorities in any given situation. The data show considerable variation from one country to the next, both in terms of the strength of the different sources of rigidity and in terms of their relative impact on economic performance. This dilemma is nothing new in European politics and policymaking. Indeed, it is much the same as that confronted by European policymakers during the period from 1997–2000 when the EU developed its Lisbon strategy for open cooperation in market structural reform; it is also much the same as that confronted by policymakers in 2004–05 when a mid-term review of the Lisbon strategy highlighted the many failures in making progress. The fact that the challenge is familiar does not make it less intractable. Overcoming market rigidities is a major obstacle to ensuring a durable recovery.

Exogenous shocks

The challenge of engaging in market structural reform is complicated by the many powerful exogenous factors that are impacting upon European economic performance. The list of such factors is lengthy; the focus here is on just four categories. The big geostrategic worries associated with conflict and instability around Europe are at the top of the list. More mundane political events add to market volatility. The performance of key markets in Asia, North America, and elsewhere are a concern as well. So, too, is the movement in global currencies such as the euro, dollar, yen, and pound.

The conflicts in the Ukraine, Syria, and Libya are important because they restrict access to key markets, jeopardize energy security, and add to immigration pressures. These are first-order concerns for the countries of the CESEE region, particularly in relation to Russia. The tightening of U.S. and European sanctions on Russia that has taken place in stages during the 2014 spring, summer, and early autumn—coupled with Russian retaliation against European exporters—has slowed the pace of business between Russia and the CESEE region with the promise of even greater deceleration to come. At the same time, the Russian economy has suffered from the heightened sense of market uncertainty and resulting decline in business and consumer confidence above and beyond the threat of sanctions. This has depressed Russian economic performance and so further dented prospects for countries that export to Russian markets.

The potential impact of Russian sanctions on energy supplies is important as well. Western sanctions target major energy producers and the banks that support them. So far this has not resulted in declines in Russian output. Moreover, the Russian government has shown little willingness to use energy resources as leverage—at least apart from the Ukraine, and from trying to prevent the re-export of Russian energy resources from other European countries back into the Ukraine. Nevertheless, it is unclear whether this attitude will change as the impact of sanctions on Russian energy firms strengthens and should Russia succeed in negotiating access to alternative markets. The two recent agreements between Russia and China are cases in point. Europe will remain Russia's primary energy export market and yet the margin for exercising leverage against smaller European countries that are excessively dependent upon Russian energy supplies will increase as alternative markets become more important.

The conflicts in Syria and Libya are contributing factors in adding downward pressure on the CESEE region because they complicate the search for alternative energy supplies. These conflicts also add to immigration pressures through Turkey and across the Mediterranean; they subtract from business confidence across the European economy, more generally; and they distract European and American attention away from dealing with Russia.

Meanwhile, an unusual congruence of political events has added to market volatility. The Scottish referendum is important as an illustration of this dynamic more than as a permanent influence. The surprising closeness of pre-referendum polling in late August 2014 fostered a spate of media speculation that the actual referendum put to rest. Firms and financial actors made contingency plans and, in some cases, deferred investments in response—but the whole episode was quickly forgotten once the results of the referendum became known. A similar pattern can be seen around the plebiscite in Catalonia and the mid-term elections in the United States, although uncertainties in both cases have lingered. This pattern will persist as the United Kingdom and Poland head to the polls in 2015, and as Italians wonder when Giorgio Napolitano will resign as President of the Republic and whether the Italian Prime Minister Matteo Renzi will opt for early elections. The political situation in Greece is also problematic. There is nothing surprising about these influences; the point is only that they create a drag on economic performance. Should one or more of these events result in a full-blown political crisis, the impact will be even greater.

The performance of key export markets is a further source of concern. The U.S. market is a major consumer of exports from Europe and has been moving more soundly into recovery. By contrast, the Chinese market is growing in importance and yet not performing as well. Exports to Russia are declining as a result of the geopolitical tensions mentioned earlier. Exports to Switzerland—which is a more important destination than Russia and only slightly less important than China—have also been falling off. The impact of these contractions in European exports shows up first in those countries like Germany that rely heavily on an export-led growth model and only subsequently in those countries—like much of the CESEE region—that supply goods and services for incorporation into German exports. That said, the lag between changes in German and CESEE performance is short. The impact of declining European export performance is also felt in countries like Italy and France, which are less export dependent (and are arguably suffering more for reasons related to the rigidities mentioned at the outset). As these larger European economies struggle, they bring down the prospects for economic performance in the CESEE countries as well.

Exchange rates are a fourth exogenous factor. The relative movements in the euro, dollar, yen, and pound have had a powerful influence on European economic performance; both because of the impact of exchange rate levels on relative cost competitiveness, and because of the impact of exchange rate volatility on trade and investment patterns. This influence is likely to strengthen now that monetary policy is diverging across the Atlantic and as intra-European conflict increases over the limits on the use of unconventional monetary instruments like quantitative easing and over the relative usefulness of fiscal stimulus.

Endogenous imbalances

Turbulence in the world economy is a risk that the CESEE region will have to learn to accept. That makes the structural reform agenda to reduce the influence of market rigidities all the more important. However, there is an attendant possibility that the fruits of any recovery in the present will emerge as future unsustainable imbalances. This prospect is hardly unique to the CESEE region and could be applied to the world as a whole. Nevertheless, it is a major source of concern in Europe because of the financial interdependence that influenced the crisis as it unfolded. Here it is important to distinguish between symptoms and causes in a way that is different from the discussion of market rigidities in the first section of this analysis. Market rigidities are in many ways a symptom (or expression) of the crisis and an obstacle to recovery. By contrast, financial imbalances are a symptom (or expression) of recovery and a potential source of the next crisis.

Four imbalances warrant particular attention. The first of these is closely tied to the political economy of extraordinarily loose monetary conditions and finds expression in the accumulation of indebtedness, even when there is little growth in credit. The second emerges in the form of price bubbles that affect both real and tradable assets. The third develops in the form of the progressively uncompetitive expansion of labor costs. The fourth takes the form of cross-border liabilities.

The evidence for accumulation of household indebtedness during the crisis is mixed. Some CESEE countries like Slovakia and the Czech Republic have seen an increase in household indebtedness as a ratio of disposable income; others like Hungary and Poland have seen household indebtedness decrease by the same measure. The build-up of outstanding loans from commercial banks is more consistent, particularly when measured as a share of GDP. The farther east you travel in the CESEE region, the greater the burden of outstanding loans becomes and the more significant the increase as the crisis has moved into recovery. This accumulation of indebtedness corresponds with a growing burden of NPLs that will impinge on bank performance both in the present and looking ahead. The accumulation of indebtedness also constitutes a significant vulnerability. Should interest rates rise suddenly due to a change in market conditions or a policy shock coming from elsewhere (like the United States), the consequence would be a sudden build-up of debt servicing requirements coupled with a greater risk of insolvency and nonperformance.

An interest rate shock could also affect the prices of real and tradable assets. The evidence for a real estate bubble emerging during the recovery is not strong in the CESEE region, although there is some concern in countries like Ireland and the United Kingdom. A more prominent concern for CESEE countries (and for much of the southern European periphery) is the very low yield on (and therefore correspondingly high prices attached to) government debt securities. An interest rate shock that punctured a price bubble on sovereign debt instruments would quickly reassert the symbiotic relationship between bank balance sheets and sovereign finances by imposing losses on a significant volume of banking assets while at the same time redirecting an increasing share of government expenditures onto debt servicing requirements. This is probably the most significant threat to Europe's recovery from accumulated imbalances.

By contrast, the impact of the recovery on relative real unit labor costs is more varied across countries. Within the CESEE region, countries like Bulgaria, the Czech Republic, Slovakia, and Slovenia have experienced a relatively modest appreciation; others like Croatia, Hungary, Poland, and Romania have seen their relative competitiveness increase. What is unclear in these movements is how much the effect will show up in terms of relative export volumes or manufacturing performance. What is clear is that none of the countries is currently running a significant currency-account deficit.

Indeed, that uniformity in current-account performance may be symptomatic of a different kind of imbalance—not within Europe but between Europe and the outside world. Here it is useful to look beyond the CESEE region. Whereas before, the euro area was roughly in balance with the outside world—meaning that any current account surpluses run by countries like Germany were offset by countries like Spain; snow, the euro area is running a consistent current account surplus as an entity. The CESEE countries are running surpluses as well. Hence, it is worth considering which part of the world is running the offsetting deficits and how long those deficit positions will be sustainable. This is a more generalized expression of the concern for major export market performance insofar as it focuses not only on how Europe's major markets are doing at the moment, but also on how they can be expected to perform in the foreseeable future.

Policy response

The analysis presented here suggests the need for an effective policy response both at the national and European levels. National policymakers will be the primary architects of any major market structural reforms. They will also be responsible for any fiscal stimulus. European policymakers will have a hand in overseeing market structural-reform efforts and in coordinating the use of fiscal policy. Policymakers at the ECB will work alongside these efforts by maintaining an accommodative monetary stance. And the whole of the policymaking community will be engaged in slowing or reversing any accumulated imbalances.

The problem with this division of labor is well understood. National policymakers struggle to make market structural reforms in the face of significant domestic opposition to change. There is progress, but it is hard won—and all too often unrewarded either in terms of significant changes in economic performance (within a politically relevant time frame) or at the ballot box. The pace of reform can be accelerated under conditions of strict conditionality, as in exchange for emergency lending or conditional credit facilities. But such acceleration only defers the political consequences of any major market structural reform and risks building-up resentment toward the impingement on national sovereignty. Portugal's early exit from its bailout program is a good illustration; Greece's current efforts to emerge from Troika supervision are also relevant; and Viktor Orban's campaign against the IMF in Hungary is a further case in point.

The challenge on the fiscal side is to take advantage of economic interdependence within the context of the EU's "fiscal compact." The countries that have sufficient flexibility should engage in stimulus measures so that the countries that are excessively indebted can maintain the pace of consolidation. However, such efforts are challenging to coordinate across diverse national electorates; they create conditions of moral hazard, and they depend upon market structural reforms to achieve lasting success. Hence, the trust required to organize something like this across diverse national governments is probably greater than what exists in Europe at the moment.

As a result, monetary policy authorities both in the ECB and elsewhere are carrying an excessive share of the policy burden. They have exhausted most of their conventional instruments, and so have had to resort to unconventional measures that are openly distributive and so subject to controversy. It is a simple matter to calculate how much German savers "lose" from near-zero interest rates (and negative deposit rates at the ECB) and how much Italian tax payers ”gain" from relatively low sovereign debt yields. As the ECB moves into the purchase of covered bonds and ABS, its actions will give rise to a different kind of distributive calculus. Those instruments are more likely to circulate in some countries than in others and so the benefits of this light form of quantitative easing will provoke a new round of distributive controversies. A full-blown quantitative easing using corporate paper or sovereign debt instruments will only fuel the controversy further.

Finally, it is worth considering whether the intellectual framework for regarding accumulated imbalances is appropriate. The whole of the European policy apparatus treats current-account surpluses and deficits asymmetrically, regarding surpluses as an indicator of competitiveness and deficits as the reverse. This normative framing makes it difficult to bring European economic performance into balance with the outside world. That is a vulnerability insofar as the rest of the world cannot operate as Europe's consumers of last resort, particularly when the rest of the world includes export powerhouses like

China and the other countries of East and Southeast Asia. Hence, there is a significant risk that Europe's policy response will be inadequate. If that risk is borne out, then Europe will face another crisis—albeit perhaps only in the distant future.

Panelist 1: Cristian Popa, Deputy Governor, National Bank of Romania

Like other speakers, let me add my thanks to Banka Slovenia and Boštjan for having invited me.

That said, I need to qualify the agreeable character of the invitation by recalling the early literature on proxies for central bank independence (notably Rogoff (1986)), which spoke about the best choice of governor being a person whose aversion to inflation is higher than the social average. I would say that my risk awareness regarding the financial system, if taken by similar metrics, has seen an increase in the relatively recent period. So, with that comment as a background to my subsequent messages, what I want to do here in the brief time span allocated is to ask questions more than provide answers.

My first point is that we should be rather humble about how much we actually know and are able to quantify regarding financial sector risks. Rather than imagining clear and detailed scenarios about how things could go wrong, what I think is much more productive is an investigation of the vulnerabilities currently affecting the financial system, with some assessment of their attached probabilities of realization. This would provide us with an image about the way the window will crack, which points are the weakest and what can be done about them, rather than exactly what the broken window will end up looking like.

The second point is, given my qualification, what do we know? The idea from previous crises is that these tend to be localized in time and quite cathartic in the way we shape the economy and in the way that the real sector and possibly even the financial one undergo a restructuring that transforms them. But this idea may no longer be valid in the same manner as in past episodes. Depending on whether you believe that the secular stagnation concept is valid, or just think that this is a temporary phenomenon, we are living through the hangover of the previous crisis. And, again conditional upon the time horizon we have in mind, this may influence things going wrong the next time around.

The first risk I see is the fact that, again from the perspective of how you look into financial system risks, at the present juncture it is very difficult to distinguish between two things: (i) what has been valid in the short run that we think is sustainable (or persistent) in the longer run; and (ii) what really are positive, factual developments compared to the normative aspects we tend to associate with the current state or we would like to think should undergo a correction.

One example is Daniel saying that we would like to have more new lending taking place without more indebtedness; in the current state, even with some considerable mileage being registered from deleveraging in regard to both corporates and households, debt burdens (and relative undercapitalization, especially for the former) are still important. So are NPLs, which are frequently invoked by banks as one of the principal reasons for lending remaining sluggish so far. Therefore, an additional jump in the stock of NPLs is not a scenario that helps at the present juncture. We are barely able to deal with the existing stock across many economies, and the attendant workout has proven to be more difficult and time-consuming than initially thought.

But let me say that central banks have had to take on a more prominent role by acting like fire fighters. In the initial stages of the crisis, they fought the risk of a really disorderly repricing of assets because the alternative was really off the charts in terms of welfare costs. This got us into history. How do we get out of history is a more important question, even if tinged with irony. Is financial repression, even if we have the backdrop of difficulties (barely sustainable debt levels across many developed economies) really a feasible long-term solution? That is the first question, and one to which I believe the answer is negative.

Secondly, the fact that we seem to be seeing increasingly divergent business and financial cycles in different economies and regions, is that something that is going to last or is it a temporary phenomenon? Because in the former case, the persistent aspects of lax monetary policy may be further complicated. But we need to be aware of what impairments to transmission from monetary policy may be generated in terms of distortions in the financial sector over time. We also need to look at how accurately markets are pricing in risks right now with this kind of low rate backdrop being taken as more persistent than it may actually be, with divergence looming ahead in terms of G-4 central-bank stances.

Other risks relate to the financial sector reform agenda and macroprudential policy.

Financial sector reform agenda

Compared to its initially hoped-for configuration, the implementation of the financial sector regulation reform agenda has been rather inconsistently delivered. And I speak here not only of the European perspective but more of G20. This needs to be broader than just the EU in order to avoid delocalization and regulatory arbitrage, both of which would impair the ability of regulators and supervisors to obtain accurate information and act to prevent risks from accumulating and/or being manifested. It would also affect the cost of new capital in a manner that would be more significant in the presence of over-indebtedness and continued deleveraging.

At the same time, we are rightly concerned about shadow banking, which partly is a result of things moving from the formal sector into the informal sector and of the concentration we have; I believe we do not even have good data on that besides the superficial stuff. Yet we are being sanguine in the wrong way about how liquidity dependence, common funding sources and the complexity that evolves over time between the formal and informal sectors in finance are shaping things. I think that co-movements may be stronger than they were in the past. Indeed, I think roll-over risk, not just rising yields that may translate into higher cost of capital, is a problem. And these may be significant in a second round way for emerging markets, given the close integration between developed and emerging market financial sectors.

Let me now concentrate on things that have something of a political economy nature. We are in a very difficult world here because I do not think central banks were prepared for the kind of actions they have had to take. But at the same time, trying to fight a fight that ultimately concerns structural reforms and productivity enhancing policies by macroeconomic demand management and giving a growth mandate more or less explicitly to central banks may not be the best way to go forward. I am still a very orthodox believer in price and financial stability being the best things that central banks are active in, and that should stay with us and not be mixed with the economy-wide real sector mandates that I just mentioned. Also, some countries have run into a different problem: the central bank is seen as institutionally and reputationally so powerful, but may actually be lacking the necessary tools when it is supposed to compensate for or remedy actions that are time-inconsistent in other components of the macro policy. Or the remedy to reform that was there as a program item but was not completely delivered upon. I think we should be concerned about that.

Macroprudential policy

The second thing is the new field offered by macroprudential policy. Whenever we discover a new tool and its name has been there for a while, we tend to overuse it or overpromise regarding what it can actually deliver in isolation. I think here there are a lot of things that need to be done, but macroprudential policy needs to work in tandem with monetary policy as part of the macroeconomic policy mix. We also need to look at the financial sector inter-linkages between countries, because typically we are talking about partial equilibrium and country specific notions, because that brings more clarity and is an impetus for action. But really things are much more cross-border in nature. And we need to be prudent about how effective these measures are, if they have side effects—some of them do—how porous can they become, whether cross-border cooperation by macroprudential authorities and others blend into the mix, are they as good as they can be or can they be enhanced. We actually need to collectively deliver on these measures very well and avoid overpromising. Because then, when crunch time comes, we need to show what was on paper has actually taken place in reality and the best safeguards have not only been thought of but are operational, without believing that these can ever be a panacea by themselves. Thank you.

Panelist 2: Dubravko Mihaljek, Head of Macroeconomics Analysis, BIS

Introduction

Erik Jones' introduction provided a stimulating framework for an analysis of the risks of a new financial crisis in CESEE. I shall discuss the three scenarios he outlined—recovery never really gains momentum, Europe gets pushed back into crisis, the recovery leads to a new crisis—and examine how likely these scenarios are in South-Eastern Europe (SEE). For the purpose of this note, I shall include in this region Bulgaria, Croatia, Hungary, Romania, Slovenia, and Turkey. This is a heterogeneous group of countries, whose economic performance and policies elude easy generalizations. But they display a similar pattern of macroeconomic developments before and—with the exception of Turkey—after the global financial crisis.

In particular, after a strong expansion accompanied by high inflation, low unemployment, low savings, high investment rates, and very high external deficits in 2003–08, the period since 2010 has been one of very low or negative growth, much lower inflation, much higher unemployment, and the disappearance of external deficits (Figure 1). The impact of the crisis was smallest in the case of Turkey, where the economy has evolved since 2010 similarly to Asian and Latin American emerging markets. But looking ahead, Turkey faces some of the same challenges as other economies in this region, and can therefore be analyzed within the same group framework.

My main argument will be that incomplete fiscal consolidation and private sector deleveraging, as well as the stalling of structural reforms are key ingredients of a potential new crisis in this region. These vulnerabilities could threaten financial stability and lead to a standstill or reversal of the convergence process. In other words, without fiscal consolidation, deleveraging, and structural reforms, SEE not only puts financial stability at risk but could also remain stuck on the periphery of developed Europe.

The remainder of this note is divided into four sections. Section 2 provides a brief overview of the global economy at the current juncture. Section 3 evaluates domestic risks for the recovery. Section 4 evaluates some exogenous shocks that might push SEE back into crisis. Section 5 concludes by examining whether the recovery could lead to a new crisis through repetition of past mistakes made in the private and public sectors.

Global economy is approaching a turning point

The past year has seen macroeconomic conditions diverging across major advanced economies: growth has taken hold in the United States and the United Kingdom; remained weak in the euro area; and become very volatile in Japan. In the emerging market economies (EMEs), the slowdown in growth that started in late 2012 has stabilized and output is expected to pick up over the next few years, though at a slower pace than in 2010–12.

Despite a somewhat better global growth outlook, there has been a broad-based decline in inflation, reflecting remaining slack in labor markets (e.g., in the United States), weak domestic demand (e.g., in the euro area), and falling commodity prices. One concern for inflation targeting central banks has been that several forward-looking measures suggest that inflation might remain low or fall further over the medium term.

Figure 1. Macroeconomic Developments in SEE Countries: Pre-and Post-Crisis[1]

Sources: IMF, WEO, October 2014; author's calculations.

[1] Period averages

Diverging macroeconomic conditions have been reflected in diverging monetary policies. The U.S. Federal Reserve ended large-scale asset purchases in 2014 and started preparing for the lift-off of policy rates. The Bank of England has maintained a very accommodative monetary policy stance through late 2014, while the ECB and in particular the Bank of Japan have further eased their stance.

The shifts in the macroeconomic outlook and monetary policy have been associated with significant movements in exchange rates. The dollar has appreciated sharply against major currencies over the past year. Conversely, the yen has fallen sharply against both major advanced and EME currencies.

In global financial markets, periods of unusual calm have been interspersed with episodes of heightened volatility over the past year. Different market segments were affected each time: emerging market assets in January; high-yield corporate bonds in August; and advanced economy government bonds and equities in October.

Observers, rightly or wrongly, related these bouts of volatility mainly to changes in market expectations about major central banks' monetary policies. One issue is that monetary policy guidance may have increased market sensitivity to macroeconomic surprises. More fundamentally, there are concerns that after a long period of monetary accommodation, central bank policies have become a key determinant of global financial market conditions, possibly overshadowing underlying macroeconomic conditions.

Given the expectations about U.S. monetary policy and the dominant role of the dollar as the funding currency for international investors, this implies that global financing conditions will likely tighten over the next year or so. This would affect not only the EMEs in Latin America and Asia, but also those in Europe. Despite its close economic and financial ties to the euro area, where monetary conditions will remain easy, governments and firms in south-eastern Europe that rely on external funding will thus face higher borrowing costs in the period ahead.

Domestic risks for the recovery

Against the backdrop of global macroeconomic and financial market conditions in late-2014, one key risk for the recovery in SEE stems in my view from high public and private-sector debt and doubts about their sustainability as global financial conditions start normalizing.

Several governments in the region—notably Croatia, Hungary, and Slovenia—have debt levels close to or exceeding 80 percent of GDP (Table 1). They depend heavily on cheap and plentiful external funding to sustain such levels of debt. As global interest rates start to rise, some of these governments could run into funding problems. In its 2014 Autumn Economic Forecast, European Commission estimates interest expenditure of the general government in Croatia, Hungary, and Slovenia in the range from 3.3 percent to 4.1 percent of GDP. This is fairly high compared with the euro area average of 2.7 percent of GDP on average debt of 108 percent of GDP in 2014.

Several countries also have very high levels of private debt. In Bulgaria, Croatia, Hungary, and Slovenia, for instance, nonfinancial corporate-sector debt ranges from 80 percent to over 120 percent of GDP in 2014; the average for other SEE countries shown in Table 1 was well over 50 percent of GDP.

Household debt is generally about 30 percent of GDP, which is significantly below most advanced economies (except Italy), but higher than in most EMEs. Moreover, several SEE countries have seen a large increase in private sector debt—for instance, Croatia by 14 percent of GDP and Turkey by 28 percent since end-2008. Since much of this debt is external or, if domestic, held by foreign investors (e.g., in Turkey), countries in question are vulnerable not only to higher global interest rates, but also to domestic currency depreciation against the dollar.

Table 1. Debt of the Nonfinancial Sector
(As a percentage of GDP)

	Level in 2014 /1				Change since end-2008 /2			
	House-hold	**Corpo-rate**	**Govern-ment /3**	**Total**	**House-hold**	**Corpo-rate**	**Govern-ment /3**	**Total**
Advanced economies /4, /5	75	87	118	280	–6	–4	35	24
United States	77	68	106	252	–17	–5	34	12
Euro area	64	103	108	274	0	–2	30	28
France	57	124	115	296	7	12	36	54
Germany	56	56	84	196	–5	–5	14	4
Italy	44	80	147	272	4	–1	28	31
Spain	75	111	108	295	–9	–21	60	31
United Kingdom	93	79	102	274	–8	–23	44	13
Japan	65	103	230	398	0	–3	58	55
Major EMEs /4,/6	27	79	44	150	8	21	3	32
South-Eastern Europe								
Bulgaria	24	126	25	175	–2	–5	10	3
Croatia	41	90	82	213	2	12	53	67
Hungary	28	92	79	200	–9	7	6	4
Romania	19	48	40	107	–2	–45	26	–22
Slovenia	29	82	82	188	3	–7	61	57
Turkey	21	50	34	104	8	20	–6	21

Sources: ECB; European Commission; IMF; OECD; national data; author's calculations.

/1 Refers to Q1, Q2, or Q3 2014; for Bulgaria, 2013.

/2 In percentage points of GDP.

/3 OECD and IMF estimates of gross financial liabilities.

/4 Weighted averages of the economies listed based on 2005 GDP and PPP exchange rates.

/5 Economies shown.

/6 Argentina, Brazil, China, the Czech Republic, Hungary, India, Indonesia, Korea, Mexico, Poland, Russia, South Africa, and Turkey.

But there are also countries in the region in which private-sector debt has been significantly reduced: Bulgaria and Romania have seen deleveraging in both household and nonfinancial corporate sectors; Hungary in the household; and Slovenia in the corporate sector—though some of this reduction is offset by the rise in public debt related to bank restructuring.

Private-sector lending conditions in the region are relatively tight at present, and many households and nonfinancial firms are still deleveraging, notably in Bulgaria, Hungary, Romania, and Slovenia. As a result, credit demand currently is very weak.

Higher global interest rates should thus initially affect mainly debt-servicing costs. But for borrowers who are not indebted, tighter global financing conditions will make a difference. As a result, it will be harder for the recovery to gain traction.

How important are other "market rigidities" that Erik identified as weighing on the recovery: labor market hysteresis, de-anchoring of inflation expectations, and insufficient credit supply due to ongoing repair of banks' balance sheets, but also weak confidence of lenders in the general economic outlook?

Unemployment is already mostly structural, so the relevance of any labor market hysteresis effects arising from the latest crisis is probably marginal. But extremely high youth unemployment is a major concern. However, it is not clear how far current proposals for reducing labor-market rigidities could help reduce youth unemployment. The real impediments to job creation are, in my view, a poor business climate and inadequate education systems, rather than existing labor legislation.

Similarly, it is hard to think that expectations of deflation could form in SEE and trigger a further drop in aggregate demand. Perceived inflation is rather high, not low. Many households in this region spend their entire budget on food and utilities, displaying a rising medium-term price trend due to structural changes in food and energy production and distribution, and, in the case of utilities, a gradual removal of remaining price controls.

With the exception of Turkey, credit growth in SEE is very weak, as both banks and their customers are in the process of repairing their balance sheets. This kind of adjustment after the bursting of credit and asset price bubbles is normal and in my view does not reflect rigidities in financial intermediation. Households and firms have to reduce their debt to more sustainable levels before they get in a position in which they can start borrowing again. And banks have to strengthen their capital and start cleaning up their balance sheets from nonperforming assets before they can resume lending. The faster this adjustment takes place, the sooner banks will begin to lend again.

Long delays in payments to suppliers—for instance, government institutions' payments to SMEs for goods and services delivered—are arguably a bigger corporate liquidity issue in some SEE countries than firms' access to bank credit. Rather than devising schemes to encourage banks to lend, governments could issue debt to repay promptly what they owe to the private sector. This would leave the public-debt level largely unchanged but would prevent many SMEs in SEE from going under, thus stimulating private sector activity and growth of the tax base—all this without increasing private sector debt.

External risks

The risk that SEE gets pushed back into crisis as a result of exogenous shocks is in my view relatively small. Political conflict and instability, notably in relations between Russia and the Ukraine, is clearly weighing on the outlook. But we lack empirical benchmarks to assess the potential economic impact of such idiosyncratic shocks, whose effects depend crucially on the nature and duration of the conflict.

Regarding political risks, the impact of any particular national election on market volatility is likely to be temporary. More generally, the impact of political developments in individual countries on trend investment is likely to be small, as investment rates have already been on a declining trend for some time for reasons not well understood. And political gridlock in some SEE countries reflects perhaps more the inability of institutions to adapt to changing circumstances than any particular election outcome.

Weaker economic performance in Europe clearly does not help the already slow recovery in SEE. But a number of European markets are expanding: the United Kingdom is currently the fastest growing advanced economy; Nordic economies and Switzerland are also performing well; and Germany's growth foundations remain sound despite some slowdown in mid-2014. Unless the slowdown in Europe is widespread and prolonged—which doesn't seem to be the case based on current consensus forecasts and vulnerability assessments—it is not likely to lead to another crisis in SEE.

Weaker economic performance outside Europe is a significant external risk. But based on the current outlook, the U.S. and Chinese economies are unlikely to be hit by macroeconomic or financial market shocks large enough to tip Europe into a new recession or a financial crisis.

SEE countries could be more affected by contagion from a possible wider emerging-market turmoil. One source of contagion could be loss of confidence in EME local currency debt, which has become an important segment of global financial markets over the past few years. In particular, many multinational corporations from EMEs have reportedly become quasi-financial institutions: their overseas operations issue bonds in international markets, typically in U.S. dollars, and buy financial products in their own countries' market instead of expanding their business. Low volatility, cheap funding costs, and strong demand for emerging market corporate bonds by global investors have supported such carry-trade type strategies.

However, once U.S. interest rates start to rise, some EMEs could experience large capital outflows. Investor sentiment towards SEE assets could also deteriorate by association with emerging market debt. This effect is likely to be temporary; however, global investors have demonstrated on several occasions over the past few years that they quickly start to discriminate among emerging market debtors in periods of turmoil. For instance, SEE assets were generally not affected by the financial market "taper tantrum" of May–August 2013, unlike assets from Asian and Latin American EMEs.

Another potential external shock in the period ahead relates to greater exchange-rate volatility. As monetary policies in the United States and the United Kingdom get normalized while the ECB and the Bank of Japan maintain their highly accommodative policies, exchange-rate volatility among major currencies is likely to increase. But with current monetary policy settings—and other things equal—the euro would tend to weaken against the dollar in the near term, which would help euro area and SEE countries with exports and low inflation. But, depending on the composition of external assets and liabilities, it could also lead to valuation losses on SEE countries' external balance sheets.

Risk of repeating past mistakes

In addition to domestic and external risks discussed above, there is also a risk of repeating past mistakes once growth in the region finally gains traction. In the private sector, this risk would arise if households, firms, and financial institutions resumed the borrowing, lending, investment, employment, and consumption decisions that resulted in misallocation of resources before the crisis. In the public sector, the main policy mistakes that could lead to a new crisis would be to abandon fiscal consolidation and structural reforms.

With firms and households in most SEE countries still deleveraging and banks continuing to restructure their balance sheets, we are probably several years away from the start of a new credit cycle. The possibility that the economic recovery in SEE could lead to a new crisis via another credit and asset price boom, a surge in cross-border lending, and loss of competitiveness through wage inflation and real exchange-rate appreciation seems remote at the moment. The strengthening of global bank regulation and the experience that the authorities in SEE have gained with the use of macroprudential policies also provide reassurance that the most egregious consequences of a new credit boom could be avoided.

The main concern would rather seem to be the public sector. One issue is that governments of highly indebted economies in the euro area and SEE are generally not doing enough to reduce public debt. Availability of cheap funding, since the sovereign debt crisis in the euro area was contained in August 2013, has reduced incentives for fiscal adjustment. Once global financing conditions start to tighten with the rise in dollar funding costs, concerns about debt sustainability will likely reemerge and make access to market funding much more difficult and expensive.

This could easily threaten the incipient recovery in the private sector.

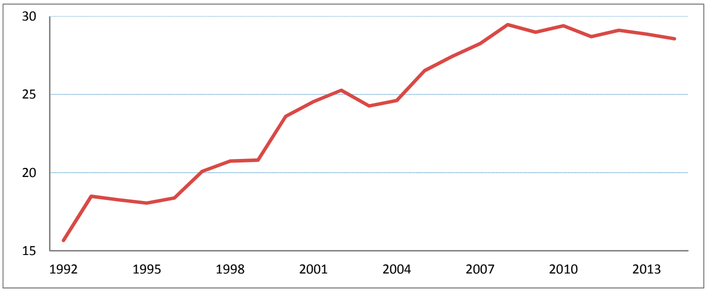
Another concern is that structural reforms remain incomplete and get postponed for some "better times." This is particularly the case with health care and education reforms. These areas account for a significant share of public expenditure and are complicated to reform because they involve a large number of stakeholders with different interests, operating in environments often characterized by market failure. Most SEE countries also need to strengthen significantly their legal systems and judiciary, which are essential for improving the business climate.

From the perspective of long-term economic growth, reforms of education—from primary and secondary school systems through universities—are crucial. Former socialist countries started their transition to a market economy with relatively solid human capital stock in industries such as energy, mining, manufacturing and construction, or in services such as health care. But after becoming successful low-cost manufacturing and outsourcing destinations for western European firms, these economies have so far largely failed to develop successful domestic industries based on homegrown entrepreneurship and innovation. To make this transition, it is essential to reform the often antiquated school and university curricula, especially in public administration, finance, economics, and business management. Due to bottlenecks in these areas, new EU member countries consistently fail even to spend all the EU funds that are allocated to them—unlike, in the past, the southern European countries such as Greece, Portugal, and Spain, which otherwise face similar structural challenges. At the same time, widespread corruption and lack of competition are raising the costs of projects that are being undertaken, for instance, in transportation infrastructure. Not least because of these deficiencies, the convergence process in SEE has stalled since 2008 (Figure 2).

To respond to these challenges, it would be important for governments in SEE not to repeat the mistakes of their counterparts in southern Europe, who avoided the hard reforms

Figure 2. GDP per Capita at Current Prices, in U.S. Dollars

(South-Eastern Europe as a percent of EU-10)



Sources: IMF, WEO, October 2014; author's calculations.

Note:

SEE: simple average of Bulgaria, Croatia, Hungary, Romania, Slovenia, and Turkey.

EU-10: simple average of Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Sweden, and the United Kingdom.

of public administration and legal and educational systems after joining the EU. Otherwise, SEE countries risk remaining on the periphery of European economic development, where they have been for much of their recent history—except for the brief catch-up phase from the mid-1990s to 2008.

It is interesting to note in this context that central banks in SEE have generally managed the transition to best practices far better than their counterparts in government. But monetary policy is clearly not the answer to structural problems. Only prudent macroeconomic and financial stability policies and consistent implementation of structural reforms on the part of both government institutions and the private sector will make a difference.

Panelist 3: Daniel Hardy, Advisor, Monetary and Capital Markets Department, IMF

Especially the central bankers in this room appreciate the importance of choosing your words carefully: we would all like to revive growth and credit, but we do not want to revive growth in indebtedness. Adopting one expression rather than the other and using synonyms can convey very different impressions.

Indeed, growth in indebtedness is the single most reliable indicator of susceptibility to a financial crisis. Hence, it is quite meet and proper to discuss not only how to revive credit growth, but also whether to be concerned that these efforts may, in fact, increase vulnerabilities over time.

In addition, right from the start, it is useful to be clear on time frame that we are talking about, and on the nature of a (financial) crisis. First, the probability of a crisis occurring in 2015 may differ greatly from the probabilities of crisis in 2016, 2017, etc. Second, the occurrence of a crisis requires both a trigger and a relevant vulnerability; one system may suffer a particular shock but survive it much better than another system with different characteristics. Here we are going to discuss both aspects, but policy can and should work more on increasing resilience than on reducing the probability of exogenous shocks that, inevitably, come as surprises. Eventually, some shock will occur, so we should be prepared. As the footballers say, after the game is before the game. Once we have gotten past one crisis, we need to start training and revise our tactics for the next crisis, and hopefully we can score 7:1 next time.

Turning to near-term vulnerabilities, in some ways the situation of the financial system in Europe—and the CESEE countries, in particular—is less crisis-prone than it was in the mid-part of the past decade before the global crisis. There is a greater reliance on local financing, dollarization or euroization is less pronounced, many asset markets including real-estate markets are rather subdued, and many banks have built up substantial liquidity cushions. Part of this improvement reflects policy actions including the implementation of prudential measures in the financial sector and also central bank action. It is also noteworthy that the macro imbalances are less, and especially that current-account deficits are smaller; vulnerability to a combined external and financial crisis is reduced. There is also a greater confidence that the policymakers are willing to do whatever it takes to prevent an out-and-out collapse. That has been demonstrated quite forcefully.

As to the risk factors, some have already been mentioned. Obviously, political risk affects the CESEE region. This risk might be realized through a hike in energy prices and even a curtailment of supply. Another factor is the possibility of a slowdown in emerging markets. One of the more successful areas of the European economy in recent years has been the export sector, particularly towards the emerging markets. Even if countries like Slovenia, Slovakia, and the Czech Republic do not export much directly to these markets, they are integrated into the export sector of, say, Germany, and thus are linked indirectly to demand conditions in emerging markets.

While concern about high valuations in asset markets is absent in most of Europe, there are some exceptions. Policy actions have been taken and may have been successful in taking the edge off asset prices, such as in certain real estate markets. But what is more exceptional now is the extraordinary low spreads on some sovereign bonds, including those for Spain and Slovenia, which are perhaps a reflection of the great abundance of liquidity in the market and the lack of alternative investments, rather than an assessment of medium-term credit risks. This situation is unlikely to persist and could adjust back sharply; a reversal at least over the medium term is highly likely and could revive pressures on sovereigns and corporate borrowers.

Mention has already been made of the danger that a prolonged period of low growth and even deflation, combined perhaps with future attempts to stimulate the economy with ever greater amount of liquidity, could in fact increase vulnerability to exogenous shocks. First, some signs can be detected of "search for yield" on a global scale, whereby assets move towards investments outside Europe that may look fine during times of ample liquidity and low interest rates but which could be revealed as much more risky when conditions revert to normal. Second, very low interest rates make high indebtedness sustainable even in a slow growth environment, but it is difficult to reduce those stocks. When, in due course, rates and risk premia revert back to normal levels, credit risk will re-intensify. Finally, and perhaps most importantly, as mentioned yesterday, profitability is so low for many European financial institutions—not just in banking but also in some other sectors, such as life insurance—that it is very hard to build up the stocks of capital that are needed to achieve true, sustained resilience. Adequate profitability is a prerequisite to being able to recover from a series shocks, and not just from a one-off hit. This low profitability is partly a matter of the inherited stock of poorly performing loans, that is, of having to make hefty provisions, but reflects also low spreads, a very flat term structure, and low fee income.

Let us consider now some relevant developments and potential risk factors outside Europe. Several significant trends can be identified. One is that, although markets individually do not look far out of balance, the synchronicity of unusual phenomenon is unsettling. Thus, we see exceptionally low volatility in many financial markets at the moment (and it is worth bearing in mind that emerging market debt is particularly susceptible to fluctuations in volatility); at the same time we see very high equity valuations in the United States compared to projected covered earnings; and also corporate bond yields are very low, such that the spreads do not currently compensate for typical through the cycle loss rates. Again, no one phenomenon represents a massive anomaly, but many parts are coming together.

More structurally, the years since the crisis have witnessed strong growth in the assets managed by mutual funds, and the increasing concentration of mutual funds, often with rather similar portfolios. The top 10 largest family asset managers control, it is estimated, about US$19 trillion of assets, which is a fair amount of money even by world standards. Many of these funds are very "benchmark sensitive," as in the case of exchange-rated funds. Many may also incur more liquidity risk than is commonly appreciated; especially should overall market conditions tighten. The exposure arises because it is easy for an investor to withdraw savings, but if many of these funds have to redeem a lot in a hurry, markets would be affected and prices would start falling. The markets for the securities held by these funds may be liquid on the margin, but may be disrupted by large coincident portfolio shifts.

Asset holdings by the public sector, namely central banks and sovereign wealth funds, show comparable similarities. Concentrated holdings in a few asset classes and homogenous behavior are often warning signs in financial markets. When people start behaving in the same way, they may also change behavior in the same way and provoke a sudden shift. And if you are anticipating that the others will change their behavior, you may want to front-run that change and accelerate the shift.

In these circumstances, policymakers face a policy balancing act: if they undertake too little stimulus, the result may be low growth, heavy indebtedness, low profitability, and no (real sector) risk-taking by financial institutions. Vulnerability is increased because of what might be termed market rigidities. However, if the authorities undertake too much stimulus, then one may see imprudent search for yield, too much leveraging of balance sheets, and too much financial risk-taking. Vulnerability to an eventual sudden rebalance is increased.

To sum up, exogenous shocks may well occur, though there is not much that policymakers in this region can do about them. In the short term, it seems that endogenous risks in this region are low. However, resilience is now not as good as we would like, and resilience may not be being built up as quickly as we would like.

So we come back to some rather familiar themes in policy advice aimed at reducing vulnerability to a new crisis. Number one is the urgent necessity of tackling the inherited stock of poor-quality corporate debt. The second is the development of macroprudential instruments for both boom and bust conditions that are truly usable. Many efforts are going into that but the usability of some instruments is still an open question. And the third theme relates to the need to eliminate excess capacities in the banking system in an orderly manner, so that banks can restore their profitability and therefore contribute to both sustained financial sector resilience and reliable intermediation. Thank you.

C. Discussions

Following the presentations, participants from the floor raised important issues for discussion by the members of the panel.

- There was broad consensus among participants that the CESEE financial sector remains vulnerable because of (i) generally weak macroeconomic conditions in the region and in Europe more widely, and (ii) incomplete recovery from the global crisis. The persistence of sluggish growth was seen to be at the heart of this vulnerability.

- A major endogenous shock arising within the region was viewed as unlikely to occur in the near term, with only a slight risk of a boom-and-bust cycle. Rather, participants believed that shocks were more likely to come from outside, in the form of: (i) geopolitical developments leading to a disruption in trade; (ii) a revival in concerns over sovereign risk; or (iii) a rapid increase in (U.S.) interest rates.

- One participant wondered whether EMEs have now reached a size where they can play a major stabilizing role in the world economy.

- Returning to Europe, views were exchanged on the connection between structural reforms, investment, and fiscal policy. There was agreement on the need for structural reforms in Europe in order to raise the trend growth rate and address structural unemployment. It was noted that the United States still has a big advantage in the availability of venture capital, flexibility in labor markets, and the dynamism of the high-tech sector.

- Several participants remarked that sovereign bond spreads, and bond spreads generally, were very low, with markets seeming to attach almost zero probability to the chance of a euro area break-up or sovereign credit event. They were concerned that this attitude was excessively sanguine and could be reversed abruptly.

Panelists' responses to questions and comments

Vulnerabilities. One panelist observed that the major vulnerability was the overhang of government debt in many countries and, in some cases, the corporate or household debt overhang. The overhangs also put a drag on growth and limit the scope for fiscal policy activism. A negative feedback loop exists: high indebtedness discourages investment and growth; but. In their absence, it is difficult to reduce indebtedness. The situation is currently sustainable in an environment of very low interest rates, ample central bank liquidity, and limited demand for new credit. The absolute level of rates is low by historical standards, and recently spreads have been compressed. For now, borrowers can roll over debt cheaply, and the pressure for adjustment is lessened. Hence, the situation could deteriorate rapidly if all rates and, in particular, risk spreads rise rapidly.

A factor contributing to vulnerabilities is that low interest rates increase the attractiveness of debt financing, rather than the use of equity. Certain sectors are clearly overleveraged, although it is difficult to establish empirically what would be an optimal level of leverage for households, corporates, and the public sector in the various CESEE countries. The lower prospects for growth and inflation in much of the region, and, arguably, greater long-term uncertainties suggest that the optimum has shifted towards greater reliance on equity.

Role of EMEs. Panelists responded to the question on the role EMEs can play in stabilizing the world economy. In the past, the EMEs were very prone to contagion from adverse developments in advanced economies and especially U.S. monetary policy. Massive capital inflows would overheat their economies, which would then be plunged back into crisis when U.S. policy tightened and the capital flows stopped or even reversed. The biggest EMEs now have large domestic economies, and many are less dependent on capital inflows and have built up large buffers. Thus, as seen to some extent already in 2008, a truly global recession is less likely than in the past because the EMEs are more robust to the developments in advanced economies.

Structural reforms, investment, and fiscal policy. One panelist suggested that structural reforms, which impose extra costs on certain sections of the population at least in the short term, should be accompanied by a fiscal stimulus and, at a minimum, a strengthened social safety net. Another argued that there was currently no "fiscal room" for such measures in most CESEE countries. Indeed, current account spending in the small open economies of the region has a multiplier close to zero, and past experience suggests that structural deficits were consistently underestimated because they were masked by unsustainable cyclical effects. Hence, what could help is an expansion in public sector investment, and possibly the promotion of private sector investment, even while overall fiscal consolidation is pursued.

The situation in Europe. The discussion ended on a positive note, based on the view that the EBA/ECB-led stress testing exercise and AQR were being conducted to high standards. The publication of results (at the time forthcoming) would reassure markets and the public at large that the European banks are generally robust and that the authorities have in place measures to deal with remaining weaknesses. The Single Supervisory Mechanism should, over time, enhance the resilience and efficiency of the banking system in the euro area and Europe more generally.

VIII. KEYNOTE SPEAKERS

A. European Perspective

Benoit Coeuré, Member of the Executive Board, ECB

What is needed is to revive the euro area economy recapitalization and also to repair private-sector balance sheets. The banking sector is undergoing a necessary process of structural reforms. With the conclusion of the comprehensive assessment, there is potential to ensure that credit supply constraints diminish and the cycle turns.

For a stronger rebound in investment, the private nonfinancial sector needs to raise equity. One instrument especially for SMEs is to allow EU investment funds to be distributed in the form of equity and not only in the form of debt, as the EBRD and the International Finance Corporation (IFC) already do in many countries. Also, the fragmentation in venture capital markets should be reduced.

For smaller firms with the need to deleverage, debt-for-equity swaps—possibly fostered by tax incentives—could facilitate private-debt workouts.

What is also needed is to raise productivity. An "upward shock" to total factor productivity is needed but only possible in highly competitive markets.

Introduction

Across Europe credit growth is weak. In most central and eastern European countries, credit is either stagnant or growing at low rates. In many countries of the euro area, credit to the private sector is even in negative territory. The reasons for this are several; but at the heart is a vicious circle of low growth, low investment and low credit. And the challenge facing policymakers today is how to break it.

The current policy debate is largely focused on the credit dimension. And indeed, there is evidence that creditless recoveries, while not as rare as sometimes contemplated, are much less common in high income, financially developed economies than in low income countries. As European economies heavily depend on bank loans, it stands to reason that the recent weak credit performance of Europe is contributing low economic growth rates.

It is, nevertheless, important that reinvigorating credit growth is not seen as an end in itself. Research based on international evidence suggests that a fast-growing banking sector can be detrimental to aggregate productivity growth. And we have seen in the euro area that credit growth that leads to the wrong type of investment creates financial imbalances eventually leading to crises, while doing little to support long-term economic performance.

Indeed, the 1999–2007 period saw a positive correlation between the initial level of GDP per capita and average total factor productivity (TFP) growth rates. The highest TFP growth rates were found in Germany, Austria, the Netherlands, and Finland, while in the "catching-up" economies (Spain, Greece, Portugal, and Ireland) TFP actually declined. An important explanation for this is that capital in the latter economies flowed disproportionately into the nontradable/services sector, which in general has lower productivity growth. Investment was highest in the construction and real-estate sectors, closely followed by retail, transport, and leisure.

This experience shows us that the quality of credit matters as much as the quantity and it implies that policymakers should focus on a broader question than just reviving credit—namely, "how can we channel savings towards productive investment?" This focus on investment is warranted because, in the short run, it is key to boosting demand and creating a self-sustaining recovery. And over the longer run, ensuring that investment is efficiently allocated helps create a virtuous circle between productivity and credit, thus avoiding mistakes of the past.

Achieving this requires a policy agenda that encompasses both credit supply and demand factors. It requires that we unclog and diversify the channels of financial intermediation in the euro area; that we recapitalize the economy through both reducing debt and raising equity; and that we have a policy mix that makes borrowing to invest worthwhile.

In other words, it requires a comprehensive approach. And what I would like to do this afternoon is to sketch out for you what such a comprehensive approach could look like, drawing on the lessons learned from the crisis and the post-crisis adjustment.

Fixing the credit channel

The starting point is logically the financial sector, and here we are confronting a changing landscape: the European banking sector is undergoing a necessary and largely unavoidable process of structural change. Banks are adopting less-risky business models, moving to more deposit-based funding strategies, and strengthening their equity capital. As a result, there is a clear trend towards an overall smaller and less-leveraged banking industry.

While there are several benefits to this process, it also presents an important question, which is how we can have more credit for productive firms, but less leveraged banks.

The medium-term solution is for both banks and capital markets to adapt to the new environment. For banks, this means refocusing their business models and taking advantage of IT developments to improve risk management and lower operating costs. We will always need strong banks in the euro area, as they play an essential role in situations where information cannot be standardized or where state verification is costly, for example, in lending to SMEs.

The main challenge in capital markets is to expand market access for firms across the euro area. This is to some extent already happening organically, as firms that can issue diversify their funding sources, but it is uneven: bond issuance is strongly concentrated in countries and among firms where bank lending constraints are lowest. As the ECB has argued on several occasions, this is one reason why we need to urgently focus on creating the legal and regulatory framework for a genuine single market in capital in Europe.

Essentially, what we are aiming for is a more balanced financing mix in which firms have a greater ability to substitute bank and market finance, and hence intermediation becomes more contestable and resilient. I would, however, emphasize that balance is key; we should not view market finance as a cure-all. Indeed, there is some research to suggest that too much substitution towards market finance may lead to less total borrowing, as firms that replace bank loans with bond issuance internalize the fact that this type of borrowing will be harder to restructure in bad times. Besides, Europe does not have a set of institutions consistent with a fully market-based allocation of savings, such as funded pension schemes.

In any event, a more diversified financing mix is realistically a project for tomorrow. We are now seeing signs that credit demand is picking up, making it imperative that nascent demand is not choked off by credit supply constraints. Our focus today therefore has to be on bank finance, namely ensuring that it can continue to fund the real economy even as banks downsize and restructure. And this is where two current policy initiatives come in.

The first is the comprehensive assessment of bank balance sheets, which has the potential to ensure that supply constraints diminish as the cycle turns this year. One purpose of the assessment is to steer the deleveraging process towards a “good” form—i.e., banks quickly carving out nonperforming assets and raising equity—which international experience suggests leads to a faster rebound in credit to viable firms. Indeed, empirical research suggests that the oft-heard view that higher bank capital leads to lower loan supply is not accurate. Long-run evidence for Germany, for example, finds that higher bank capital tends to be associated with higher business loan volume, with no evidence of a negative effect.

While the exercise will only conclude next month, we can already see signs that it has affected both the speed and quality of deleveraging. Whereas from 2011 to 2012 asset deleveraging accounted for only 0.1 percentage point of a 1.3 percent increase in banks' Core Tier 1 ratios, from 2012 to 2013 (i.e., after the assessment was launched) it accounted for 1.0 percentage point of the overall increase of 1.2 percent. Capital increases accounted for about half the increase over the two years. This acceleration of the process suggests that, once the final results are known and residual uncertainty is removed, banks will be in a stronger position to resume new lending.

The second ongoing initiative is the full roll-out of the ECB's credit easing package, which aims to encourage banks to use their new balance sheet space for lending to the real economy.

The TLTROs have a built-in incentive mechanism to encourage loans to firms and households, and we expect a stronger take-up from banks in the December 2014 operation and in the six subsequent installments until June 2016. And our programs to purchase outright high-quality ABS and covered bonds complement this by providing market incentives for banks to originate more saleable securities, and thus more loans to collateralize them.

In short, the combination of these two initiatives results in a confluence of factors—improved incentives and higher capital—that should allow loan supply to expand elastically to meet loan demand. And to the extent that credit supply and demand are endogenous—for instance, through the effect of supply constraints on macroeconomic risk—we could see the beginnings of a self-sustaining credit recovery.

I would, nonetheless, question whether a credit recovery is enough to achieve an investment recovery, and hence a sustained recovery for the economy. If we look at the breakdown of credit demand components in the survey data, fixed investment is only having a mildly positive effect on demand after 11 quarters of negative effects. And this demand may well be "backward-looking"—that is, delayed projects coming back online. From a "forward-looking" perspective, there are reasons to be cautious about the degree of pent-up investment demand.

Principal among these is that, while banks might have deleveraged, not all of their customers have. In several euro area countries firms still face a debt overhang that affects the economics of taking on new credit.

Real interest rates in the euro area are expected to decrease, as nominal interest rates will remain low for a long period while inflation is expected to gradually rise back towards 2 percent. But the issue for over-indebted firms is that long-term real interest rates probably cannot go low enough to make new investment attractive: any profits generated will be absorbed by servicing existing debt. Indeed, we see a clear negative correlation—with a coefficient of 0.48 between corporate debt-to-GDP levels in different countries at the beginning of the crisis and the evolution of nonresidential investment since.

Repairing private-sector balance sheets

If we want to see a stronger rebound in investment across the euro area, the next step therefore has to be repairing nonfinancial private-sector balance sheets. And as this process will take place against the backdrop of low inflation and, in the most affected countries, limited fiscal space, it will have to involve reductions in nominal debt.

The rebooting of the financial sector that has already taken place puts us in a better position to achieve this. When the comprehensive assessment concludes, banks will acknowledge losses and raise provisions and capital. After the disclosure of the results, capital shortfalls are expected to be covered within six months for the AQR or the baseline stress test scenario, and within nine months for the adverse stress test scenario. Thus, from the bank side, restructuring loans to distressed borrowers should become more feasible.

What we need going forward is more efficient debt restructuring and insolvency regimes for firms, which at present vary widely between euro area countries. The effectiveness of the restructuring regimes is often hampered by sluggish creditor coordination, a lack of new financing for viable companies undergoing restructuring and an overburdened judicial system. For example, according to the World Bank, to resolve insolvency in Italy takes 1.8 years compared with just 0.4 years in Ireland.

A number of stressed countries have already begun to take initiatives to improve restructuring and insolvency proceedings. In Greece, for example, facilitating debt workouts for viable companies is being made simpler by two new out-of-court debt restructuring tools: one for larger enterprises that includes a multi-creditor coordination mechanism inspired by international standards; and one for SMEs that employs standardized templates.

In Spain, the substantial amendment to the Insolvency Law earlier this year, among other things, makes facilitating out-of-court settlements easier while also making in-court settlements more effective. Court approved refinancing agreements now have lower majority requirements and permit the extension of maturities on bank loans, negotiating haircuts and arranging debt-for-equity swaps. Ireland and Portugal have also introduced various measures targeted at enterprises, SMEs, and households.

In most cases, however, restructuring and insolvency regimes could be made more efficient still by adopting best practice more broadly. This would include, inter alia, strengthening measures to facilitate out-of-court settlements for viable firms; introducing centralized guidelines for voluntary debt workouts coupled with independent intermediation for larger companies; and establishing standardized voluntary workouts for SMEs.

The deleveraging of European firms is, however, not only about reducing debt; it is first and foremost about raising equity. We have in fact already seen a significant decline in debt-to-equity ratios for larger euro area corporates since end-2009 due to valuation gains in equity markets, supported by low interest rates. To the extent that our new monetary policy measures affect the relative supply of financial assets and initiate further portfolio rebalancing, we may see further spillovers to equity markets that continue this trend.

For smaller firms, however, these channels are less powerful, as equity markets are largely underdeveloped. Raising equity therefore has to be a more proactive process.

One way to achieve this is to use debt-for-equity swaps (fostered possibly through tax incentives) to facilitate private debt workouts. Another is for EU investment funds to be distributed in the form of equity as well as debt, as the EBRD and IFC already do in many countries, and as I called for in a recent article. A third, more medium-term aim is reducing fragmentation in European venture capital markets to increase the depth of private equity markets.

This last point is another example of where advancing towards a single market in capital would be beneficial for the euro area; it would not only help strengthen capital markets relative to banks, but also help strengthen equity funding relative to debt. This would also have positive structural effects for the euro area: cross-country integration through equity improves risk-sharing and, as it is harder for investors to "cut and run," would most likely provide more resilience in a crisis than integration through interbank lending and fixed income investment. New research shows that the vulnerability of the euro area to a "sudden stop" worsened the crisis by further constraining the fiscal reaction of governments during the downturn.

While such options to increase equity funding are being developed, a strategy that can improve debt dynamics for all firms is to raise "implied equity"—the outlook for future income. If firms expect higher income, it improves their debt-to-income ratios and debt service capacity, which in turn creates space for new investment. In this sense, raising both the level and trend of potential growth is an integral part of recapitalizing European firms, and indeed of the economy as whole.

We face, however, a circular problem in the euro area. We need higher potential growth to work through the debt overhang so that firms can begin investing again; but that investment is itself necessary to raise potential growth. And this circle is potentially vicious; if low potential growth leads to lower investment, then it further lowers potential growth.

A policy mix to lift investment demand

This is where the next part of a comprehensive approach comes in—getting the policy mix right on the supply side of the economy to lift investment demand.

In a basic Solow growth model, investment grows at the growth rate of productivity plus the growth rate of hours worked along the steady state path of the economy. As we can only expect limited labor participation gains in an ageing society, to raise investment demand, we therefore have to raise productivity. Indeed, achieving an upward shock to TFP seems to me essential to trigger, in a sustainable way, a positive accelerator effect between productivity, investment and credit.

But it requires an environment characterized by two things—competition and certainty.

Competitive markets are necessary to ensure that investment and productivity are indeed mutually enhancing, which as I said earlier is not a given: high investment in several euro area countries in the pre-crisis period did not lead to a convergence in TFP. Certainly, an important reason for this was that too much capital flowed into real estate. But misallocation also resulted from low levels of competition in the non-tradable/services sector more generally, which distorted price signals. As some firms could capture excess rents, a falling marginal product of capital was counterbalanced by rising profit margins, meaning that total compensation from investing in these sectors remained high.

So the flipside of productive investment is more competitive markets that produce more accurate price signals, thus drawing resources to where they are most efficiently employed. Achieving this requires not only product and labor market reforms that accelerate the “churn” process within and across sectors, but also reducing unnecessary regulations that hinder the allocation and reallocation of resources.

The World Bank’s “Doing Business” report gives examples such obstacles.[18] If an entrepreneur wants to start a new business in Spain, she has to go through 10 separate procedures, while doing so in Slovenia requires only 2. If a firm wants to launch a green-field investment, it would have to wait 200 calendar days in Ireland before a new warehouse gets electricity; in Germany, it would have to wait only 17 days.

There are reasons to be optimistic about the effects of a reform process in the euro area. Recent micro-level research from the euro system’s Competitiveness Network, for instance, shows that there is a large and skewed distribution between the most and least productive firms in individual euro area countries. Far from being normally distributed, there are a few highly productive firms and many which have low productivity. This implies that a faster and more efficient reallocation across firms and sectors could be quite powerful.

Where certainty complements this process is by fixing expectations: the more that firms trust that structural reforms will be followed through vigorously, the more they will be inclined to

[18] World Bank (2013), Doing Business 2014: Understanding Regulations for Small- and Medium-Sized Enterprises.

invest on that basis. Put differently, certainty allows the positive medium-term effects of structural reforms to be brought forward into the present. The fact that euro area corporates are currently holding record amounts of cash, rather than investing, suggests that plans for structural reforms are not yet credible enough to reap this "certainty dividend."

Certainty also extends to tax policy. Remember that what matters for firms when deciding whether to invest is the after-tax return on investment. Thus, if firms expect the burden of future taxation to rise, the internal rate of return on a given project is lowered, effectively canceling out the stimulating effect of lower interest rates on investment. And by contrast, a lower expected tax burden increases the effectiveness of any monetary policy measures.

But certainty means also that we stick to our commitments. Indeed, sticking to our own commitments has to become the hallmark of the euro area. The ECB will continue to provide a nominal anchor to the euro area recovery by delivering its primary mandate to bring inflation back to a growth rate of below but close to 2 percent. It is essential that, in parallel, all countries follow the rules outlined in the Stability and Growth Pact and in the Macroeconomic Imbalances Procedure and that these rules are not stretched to the point where they would lose credibility.

Conclusion

My main message today is simple: we need to focus on the quality of credit, not only the quantity.

To create an environment where credit flows to productive investment requires a coherent and comprehensive approach. It requires managing the bank deleveraging process while the euro area transitions to a more-balanced financing mix. It requires finding workable solutions to reduce the debt overhang involving both reducing debt and raising equity. And it requires acting on the basic determinants of investment demand, namely productivity.

Fortunately, all the pieces of the jigsaw are now in place to achieve such an approach. Banks are approaching the end of their deleveraging. This is creating a better-capitalized sector that can facilitate restructuring. And we have an emerging consensus on the importance of supply-side policies to boost growth potential. We now simply need to put those pieces together.

B. Outside Perspective/Lessons from Other Parts of the World

Guillermo Ortiz, Former Central Bank Governor and Minister of Finance of Mexico

Introduction

Good evening. I would like to thank the Bank of Slovenia, in particular Governor Jazbec, as well as the International Monetary Fund for the invitation to participate in this seminar on Reinvigorating Credit Growth in Central, Eastern, and Southern European Economies. It is a pleasure for me to share with you the challenges we had to face in Mexico, during and after the financial crisis known as the Tequila Crisis. I hope the lessons we learned in Mexico can be useful for your own reflections. Although the structures of our real economies are indeed very different, I think our financial systems share to some extent, for good and for bad, the costs and benefits of being directly integrated with much larger neighboring ones: the United States in our case, and the core EU in yours. And those similarities may induce common challenges for policy making.

The Tequila Crisis: the Short-Run Response

In my view, the "Mexican Tequila Crisis" of 1994 to 1995, which as you know had nothing to do with Tequila, began with Mexico's "Original Sin." Of course, "Original Sin" is not meant here in a biblical sense, but in the way Eichengreen and Haussman defined it 15 years ago, as the inability of emerging economies to fund themselves in their own currency.[19] That sin eventually led to high external-debt ratios, engendered currency mismatches and eventually ended up in a financial crisis.

A financial crisis involves macroeconomic stock disequilibria and national balance-sheet imbalances. This is essentially different from standard balance-of-payment crises, which involve just flow disequilibria and normally require only exchange-rate adjustments and supportive macro policies. As a consequence, a financial crisis typically involves: strong movements in credit volumes and asset prices; severe disruptions in financial intermediation leading to liquidity deterioration; forced asset sales at fire-sale discounts; large-scale balance sheet problems of firms, households, intermediaries and/or the sovereign; and large-scale public liquidity support and recapitalization.[20]

Unfortunately, as Reinhart and Rogoff[21] as well as others have argued, it takes a long time for output to return to pre-crisis levels in the wake of a financial crisis. Therefore, the economy is expected to have a slow-paced recovery. This was the case in Mexico in the mid-1990s and in Europe in the post-Lehman crisis.

The Tequila crisis was a classic case of a sudden stop. In Mexico at the beginning of the 1990s, a fixed exchange rate and a very positive economic outlook fostered by NAFTA, together with a set of market-friendly reforms, led to an abundance of capital flows, allowing Mexican banks to tap international markets in large amounts. The combination of abundant liquidity, macroeconomic stability, financial deregulation, lack of proper

---

[19] See Eichengreen and Hausmann (2002).

[20] See Ortiz (2014).

[21] See Reinhart and Rogoff (2009).

supervision, and eager-but-inexperienced private-sector bankers proved to be fatal. Banks extended large numbers of loans without sufficient credit analysis and with both currency and maturity mismatches.

In 1994, the financial framework was weakening and the country suffered two major shocks: (i) on the domestic front, the leading candidate in the presidential election was assassinated; and (ii) on the foreign front, the Federal Funds rate increased from 3 to 6 percent. Both events triggered large capital outflows.

As a result, the fixed exchange rate regime prevailing at that time did not provide the government with much room to maneuver. The peso-dollar exchange rate depreciated 92 percent by mid-March 1995. Borrowers stopped servicing their debts and depositors withdrew resources from the financial system on a large scale, although annual interest rates spiked at 80 percent. The result was the collapse of the banking system and a very deep recession.

The severity of the crisis forced the authorities to act quickly to stabilize the exchange rate and to reduce the risk of bank runs. In this context, I want to highlight six actions:

1) The Mexican government sought international support, and achieved an unprecedented US$50 billion rescue package, consisting of US$20 billion from the U.S. government, US$17.5 billion from the IMF, and the rest from other international organizations.

2) As the central bank had run out of reserves, we had to adopt a flexible exchange rate regime—80 percent of government liabilities were foreign.

3) A very restrictive fiscal austerity package was put in place to close the balance-of-payment deficit and regain investors’ confidence.

4) A U.S. dollar liquidity window was created to help banks service their obligations.

5) A temporary capitalization program was introduced to allow several banks to improve their capital-asset ratio, as well as capitalization and loan purchase mechanisms; several banks were intervened.

6) Finally, support programs for debtors were put in place to help borrowers reschedule their debts, and to avoid the costly consequences of the proliferation of a so-called "nonpayment culture."

The last three actions were explicitly directed to support the banking system.

In sum, the short-run program adopted by Mexico during the Tequila Crisis was characterized by an overshooting both in adjustment and finance. The main features of the program eventually became a model by the IMF for dealing with subsequent financial crisis.

The aftermath of the Tequila Crisis: strengthening the institutional framework

Once the worst part of the crisis was over, the government embarked on a series of deep modifications to achieve the recovery on the basis of three basic pillars: (i) a sustainable fiscal policy; (ii) credible monetary and exchange rate policies; and (iii) a stronger financial sector.

Pillar One: a sustainable fiscal policy

On the fiscal side, the Mexican government achieved quite low fiscal deficits, going from more than 5 percent of GDP in the late 1990s to a balanced budget by the mid-2000s. In addition, in recent years fiscal responsibility laws have been passed aimed at achieving fiscal balance over the economic cycle.

Pillar Two: credible monetary and exchange rate policies

At the beginning, some controversy took place within the Mexican government as to whether a truly free-floating exchange rate regime was feasible at all, since no other EM country had adopted such a regime at the time, and there were widespread fears that the deep financial integration with the United States could be a special source of instability. Once the 'yes' side came through, we were able to develop a monetary policy and exchange-rate framework that included: (i) an independent central bank whose main objective was to reduce inflation and gain credibility; (ii) the establishment of an inflation-target framework; and (iii) a mostly hands-off approach to achieve a fully flexible exchange rate regime. This allowed the country to experience single-digit inflation in the year 2000, and it then became a stationary process in 2001.[22]

Moreover, the Foreign Exchange Commission—formed by the central bank and the Ministry of Finance—in charge of FX policy, adopted an almost hands-free approach towards the exchange rate. I say "almost" because, in stormy times of higher global volatility, the authority implemented preannounced and predictable interventions to restore U.S. dollar/Mexican peso market liquidity, but not to set a level for the exchange rate. On top of that, the central bank accumulated foreign reserves, which surged from less than US$10 billion by year-end 1995, to nearly US$200 billion in August 2014.[23]

Probably, the most unexpected consequence of the free-floating regime was the extraordinary depth and liquidity that the FX market acquired in the course of just a few years. For instance, the daily global turnover in the Mexican peso market increased from below US$5 billion in 1994 to US$135 billion in 2013, making the Mexican peso the eighth most-traded currency according to BIS statistics.[24]

---

[22] See Chiquiar, Noriega, and Ramos Francia (2007).

[23] Source: Banco de México.

[24] See BIS (2014).

Pillar three: a stronger financial sector

Healthy public finances and responsible monetary policy allowed for the development of a liquid local-currency-denominated bond market—ending up with the Original Sin. The government strategy to develop this market started with the issuance of a three-year fixed-rate, peso-denominated bond back in year 2000—the birth of "Mbonos." At the same time, "Formadores de Mercado" or primary dealers were created in order to provide liquidity in the secondary market. With a very well-defined coupon payment and issuance calendar structure, and a gradual approach towards increasing the maturities according to market conditions, the government was able to increase the average maturity of local debt from 200 days in 1994, to almost 8 years currently. This is above the U.S. debt maturity profile.

In this context, the ratio of external debt to Mexican GDP went from the aforementioned 80 percent, to its current ratio of 30 percent. Mexico experienced a "baptism of fire" and redemption from the "Original Sin" in October 2006, when a 30-year Mbono was successfully issued. There is now a well-defined yield curve that spans up to 30-year maturities. The span of the curve and the total convertibility of the peso are almost unique features among large EMEs and a strong source of demand from global asset managers. Their long position on Mbonos has induced a vibrant market for peso-denominated interest rate swaps; for instance, although trades in peso instruments are not yet required by Dodd-Frank legislation to be centrally cleared, the CME opened such a clearing facility at the end of last year and the open interest in peso IRS has already reached US$14 billion. Another interesting feature that attracted more foreign investors in their global search for yield was that Mbonos are now euro-clearable.

The government reformed the pension fund system, from a pay-as-you-go, to an individual account fully-funded system in 1993. Later on, the investment regime of these funds, called Afores, has been changed several times to allow the managers to diversify the pensioners' portfolios, from only investing in government bonds to a more diversified financial instruments portfolio. Today the Afores have 12.5 percent of GDP of assets under management and are the most important institutional component of the local buy side of the financial markets.

Financial regulation and supervision also played a very important role in maintaining a complete macrostability framework. In this context, having restrictive but effective regulation and supervision schemes, it was relatively easy to implement Basel II and, later on, Basel III capital requirements.

Another important feature was foreign bank participation. Financial restrictions to acquire large Mexican financial institutions were lifted in 1998. In this context, the foreign bank participation rate in Mexico increased from 2 percent in 1995, to 82 percent by 2002. For some policymakers, it made sense to leave the Mexican financial system in the hands of foreigners, particularly because of what had happened during the 1994–95 painful episode. In addition, they also considered other potential benefits in terms of innovation, better risk management and access to capital. Nevertheless, several formal studies have found evidence that—even though some benefits have been achieved—it has been at the expense of leaving several population groups out of the banking sector reach.[25]

In summary, achieving a healthy fiscal stance, with responsible monetary policy in a full-fledged flexible exchange rate regime, with a strong financial regulation scheme, along the same lines as the creation of a liquid peso-denominated debt market, are in my view responsible for the rock-solid macroeconomic framework Mexico currently enjoys.

[25] See Stiglitz (2005), and Beck and Martínez Peria (2008).

In fact, the aforementioned new institutional framework was recently put to the test by the 2008–09 global financial crisis. Even though Mexico's GDP fell 4.7 percent in 2009, no banks filed for bankruptcy. In addition, the peso depreciated around 50 percent at some point, and inflation did not surpass 6.3 percent; because, for the first time in our economic history, inflation expectations remained well anchored in the face of a sharp devaluation. Consequently, the economy recovered quite quickly. This was probably the most effective test of the resilience of our new exchange rate regime and financial institutions.

The negative legacy of the Tequila Crisis: creditless low growth

In the aftermath of the Tequila Crisis, Mexico experienced a creditless recovery, which has proved to be a lasting legacy and has contributed to a growth rate below potential. Commercial bank credit to the (nonfinancial) private sector, as a percentage of GDP, fell from nearly 30 percent in 1994 on the brink of the crisis to a level below 7 percent by 2002. Later on, Mexico has observed a slow process of gradual credit penetration increase. Today, Mexico's commercial bank credit to the nonfinancial private sector is currently about 15 percent of GDP.[26] This is not only considerably below developed economies' standards; but it is also well below emerging markets' credit ratios, even in Latin America (for instance, 72 percent in Chile, 46 percent in Brazil, or 41 percent in Colombia.)[27]

I believe low credit penetration levels stem from two features of the Mexican economy: (i) the large number of individuals and firms working in the informal sector; and (ii) the difficulties faced by banks to recover collateral. As a result, commercial

---

[26] Source: Banco de México.

[27] Source: World Bank.

banks are not able to lend to a plethora of sectors, particularly SMEs and low-income families that either operate in the informal sector, or that are high-risk potential clients, whose assets (if any), are not easy to repossess. Therefore, alternative sources of financing arise.

Low credit penetration is clearly related to a low productivity vicious cycle. Consumers usually borrow money from "loan sharks" and resort to small-appliance-related credits, in a small weekly-payment program with astronomical annual interest rates of 150 percent or more. Firms, SMEs, and even large companies mainly use supplier credit. According to the latest Banco de México survey, nearly 83 percent of the surveyed firms said that they use supplier credit as their main source of financing, while only 40 percent responded that they used some sort of commercial bank credit.[28]

The high interest rates that SMEs and individuals—usually working in the informal sector—have to face and the hassle to obtain loans from informal sources subtract from productivity. SMEs' and individuals' low productivity keeps them from going formal, so their access to commercial bank credit continues to be limited, leading them to continue using alternative sources of funding, forming an unfortunate vicious cycle.

Fortunately, the government has recently achieved approval for a bank-lending reform. This reform is based upon a two-axis structure: (i) a full improvement of the collateral-recovery processes, creating specialized courts and fostering the development of specialized judges, as well as easing the guarantee-execution procedures; and (ii) the allowance for government-owned development banks to significantly increase

[28] See Banxico (2014).

the amount and number of guarantees for commercial banks to lend to SMEs.

In this context, using quite conservative assumptions for Mexico—such as GDP annual growth rates of 2.5 percent to 3 percent—credit-to-GDP ratios could easily reach 20 percent in five years and are projected to increase up to 40 percent by 2025.[29]

CESEE parallelisms with the Mexican experience

The CESEE countries face important challenges in their banking system. After having a buoyant period before the global crisis, with the entry of foreign banks and foreign investment, the situation has changed dramatically. After the crisis, European authorities decided to implement a stricter regulatory framework that forced European banks to increase their capitalization ratios. This created a process of strong deleveraging that has left CESEE countries with high levels of NPLs and, in some cases, has constrained private-sector balance sheets.

These factors are holding back domestic demand and credit. According to IMF data, credit growth to nonfinancial firms (in nominal exchange-rate-adjusted terms), has been negative in the Baltic States, CEE, and SEE through end-2013, though there are some signs of a relaxation in credit standards. Furthermore, in SEE countries, private-sector balance-sheet weakness, high NPLs, and fiscal and structural challenges continue to constrain the recovery in domestic demand.

The recent situation has become riskier for the region as it reflects a possible protracted period of weak growth in the eurozone, surges in financial market volatility along the path

[29] Source: Banorte-Ixe.

towards higher interest rates globally, an escalation of geopolitical tensions in the region, as well as delayed resolution of crisis legacies.

At first glance, the current situation of the CESEE region looks familiar to me. The possibility of a sudden stop in capital flows, the financial fragility experienced in the last few years, and a tighter regulation for capitalization in Europe create certain parallelisms with the Mexican experience. That is why I would like to share with you the most important policy components, which in my view have helped Mexico to achieve a more stable and resilient financial system, as well as the challenges we are still facing.

1) **Act quickly.** In the case of a financial crisis, it is necessary for the authorities to respond expeditiously with short-term measures intended to contain liquidity and capitalization problems.

2) **Achieve monetary and fiscal stability.** Rebuilding fiscal policy space not only restores investors' confidence, but allows any country to respond in case of external shocks.

3) **Develop a domestic securities market.** To reduce reliance on foreign funding, which I understand is an important concern for many of the CESEE countries, it is necessary to adopt several measures to increase the liquidity and depth of domestic markets. In the case of Mexico, the development of institutional investors and the secondary market's liquidity enhancements have been key to achieving it. On the fiscal side, by reducing the vulnerability of public finances to adverse interest and exchange rate movements, the government has been able to actively manage its debt and improve its amortization schedule. On the other hand, deeper and more-developed financial markets have allowed agents to pool and diversify risk in a more efficient fashion, and have facilitated the allocation of savings

to more productive uses, thereby making the economy less vulnerable to adverse shocks.

4) **Create a more resilient banking system.** A stricter regulation can help to align the incentives of debtors, bank creditors, and shareholders. For instance, in the case of foreign banks, it is essential to encourage cooperation among supervisors, central banks, and finance ministries from the countries involved in extensive cross-border banking. For example, the subsidiaries of foreign financial institutions in Mexico have rigorous limits on credit to related parties, which restrict the possibility of domestic banks being asked to provide liquidity support to their parent banks. Also, the Mexican banking system is well-capitalized, with adequate leverage ratios.

5) **Adopt a free-floating exchange rate and accumulate reserves to serve as a shock absorber**. This was very important for Mexico. I understand several CESEE economies are either part of the EMU or thinking seriously about joining. A monetary union has a number of political, monetary, and banking advantages. However, we have seen the difficulties experienced by the eurozone countries in the absence of a political, fiscal, and Banking Union. In Mexico's case, the free-floating exchange rate has served a very useful purpose as a shock absorber and also as a key element to achieve a complete and strong macro structure.

Finally, it is fundamental for Mexico and other EMEs to implement the necessary structural reforms for creating a more inclusive and efficient financial system. Those reforms will be able to create a more competitive and productive economy, and increase economic growth.

Thank you very much for your time.

IX. Case Studies

A. The Case of Slovenia

Daria Zakharova, European Department, IMF

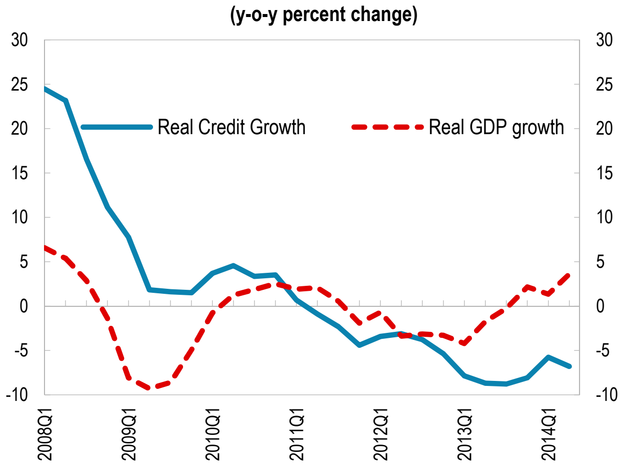
Slovenia experienced a deep and protracted recession following the crisis. Output dropped by 11¼ percent from its peak in 2008:Q2 to its trough in 2012:Q4. This was the largest output loss among euro area members after Greece. Real GDP still remains some 10 percent below its pre-crisis peak.

The economy is now recovering, but credit continues to contract. Quarterly GDP growth turned positive in 2013:Q2, helped by recovering euro area demand. Meanwhile, credit is still contracting.

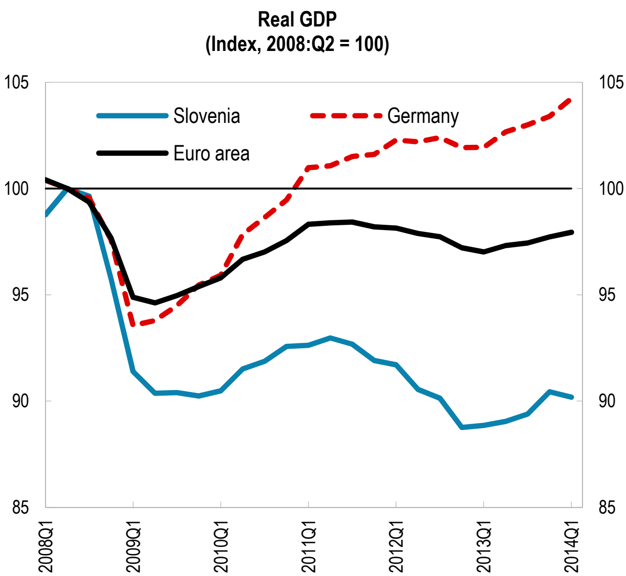
Should we be worried about a creditless recovery? Recent studies find that creditless recoveries tend to be weaker than those supported by stronger lending. And many such recoveries are more likely to be followed by mediocre growth, reflecting the long-term adverse effects of lower investment and weaker productivity. The figures below show the evolution of output and credit in creditless and normal recoveries in advanced economies. Following Everaert and Tereanu (2014), a creditless recovery is defined as one where the average year-on-year growth rate of real credit—defined as the stock of nominal credit in national currency deflated by the GDP deflator—is negative. Economic growth is about 20 percent lower in a creditless recovery compared with a normal recovery—arguably a poor prospect for Slovenia.

What holds credit back? In this presentation, I will argue that in Slovenia both supply and demand factors are important in explaining the contraction in credit. Reforms would therefore need to tackle both supply- and demand-side constraints in order to revive credit.

Figure 1. Slovenia: Real Output and Real Credit Developments



Source: Haver Analytics.



Source: Eurostat/Haver Analytics.

Supply-side issues

On the supply side, banks are burdened with NPLs. Following the crisis, NPLs increased rapidly from under 3 percent of total assets at the end of 2007, to over 18 percent in November 2013. Even after the transfer of a portion of NPLs to the bank asset management company in December 2013, NPLs have remained high, standing at over 15 percent of total assets in June. NPLs are particularly high in domestic banks. And the worst affected sectors are construction, food and accommodation services, and financial holding companies.

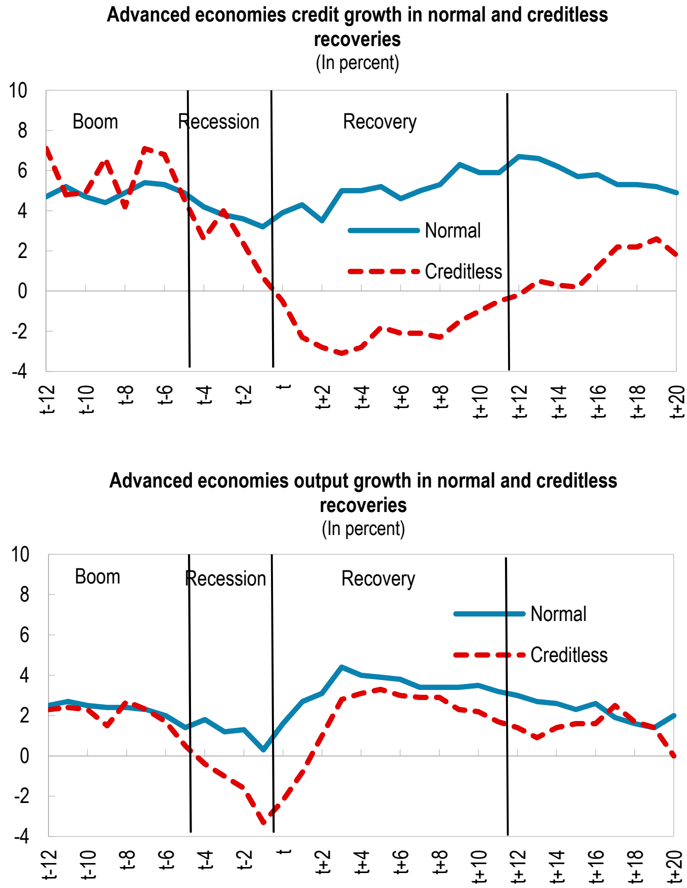
High NPLs are a problem, because they keep lending rates high. The text figure shows a strong correlation between the level of NPLs and lending rates across different types of banks. This should not come as a surprise. High NPLs divert bank resources from core activities to NPL workouts, weigh on banks' profitability, hinder extension of credit, and push up interest rates on new loans.

Demand-side issues

On the demand side, corporates are overextended with leverage. Slovenia has one of the highest debt-to-equity ratios in the EU. This is largely a result of scarce equity, rather than high debt. In part, the relative scarcity of equity reflects low foreign direct investment (FDI), which is a key source of potential equity in a small open economy. FDI into Slovenia has averaged 1½ percent of GDP per year since euro adoption, compared to an average for the euro area of 29½ percent of GDP.

Corporate leverage weighs on credit growth, investment, and economic recovery. The next figure illustrates the positive correlation between corporate leverage and the decline in the investment-to-GDP ratio in the post-crisis period. Companies use any available resources to repay debt, rather than invest. As a result, investment continues to decline, undermining economic recovery. This is evident in Slovenia's own experience. Slovenia's investment-to-GDP ratio declined to 18 percent in 2013—the lowest recorded in the country's history.

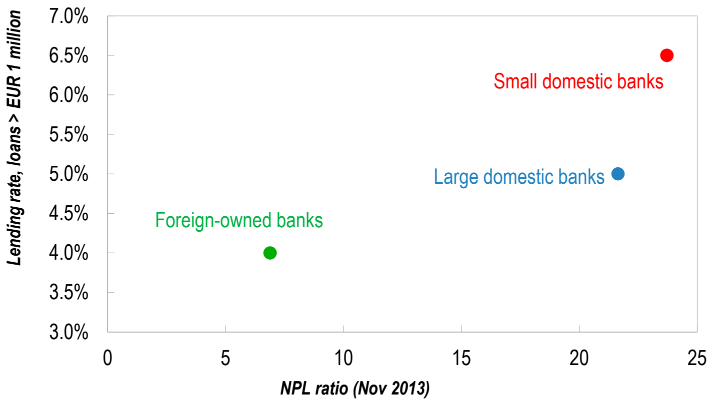
Figure 2. Output and Credit Growth in Normal and Creditless Recoveries



Sources: 2014 IMF Baltic Cluster Report.

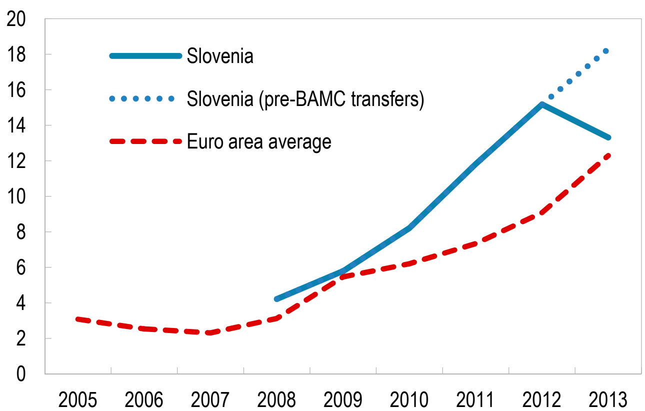
High corporate leverage in the context of a prolonged recession also translated into high corporate NPLs. The share of NPLs in loans to nonfinancial companies peaked at 28 percent in November 2013. Corporate NPLs are also highly concentrated. The 50 corporates with the largest exposure in arrears accounted for some 43 percent of all banking sector arrears in November 2013. This share shrank only moderately to 36 percent post-bank asset management company (BAMC) transfer.

Figure 3. Slovenia: NPLs and Arrears in Banks



Source: Bank of Slovenia.

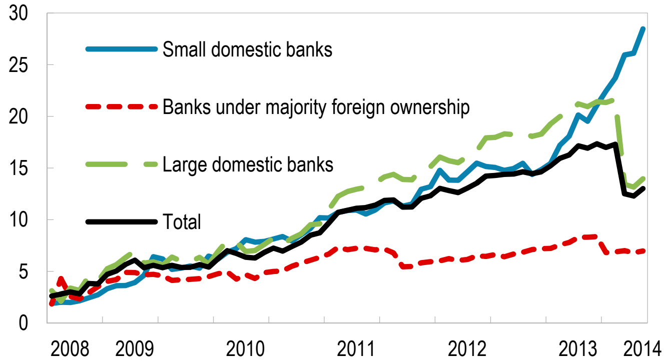
NPLs to Total Gross Loans
(In percent)



Source: IMF FSI.

Figure 3 (Concluded). Slovenia: NPLs and Arrears in Banks

Arrears of more than 90 days as a proportion of banks' classified claims by bank group
(In percent)



Source: Figure 6.13, 2014 Financial Stability Report, Bank of Slovenia.

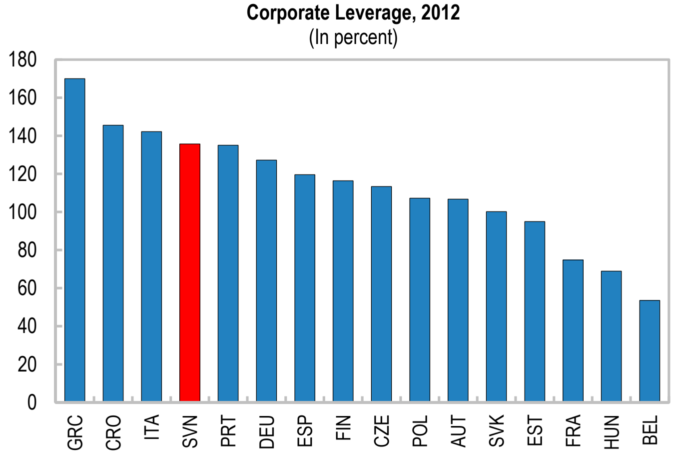
Financial stress is widespread. Firms that cannot cover their interest bill through their earnings account for 16 percent of total employment in Slovenia. In addition to large companies, the ratio of financial debt to earnings is particularly high in micro companies—those with fewer than 10 employees. This sort of bi-modal distribution of debt distress could hold some clues as to what restructuring frameworks are best suited for Slovenia.

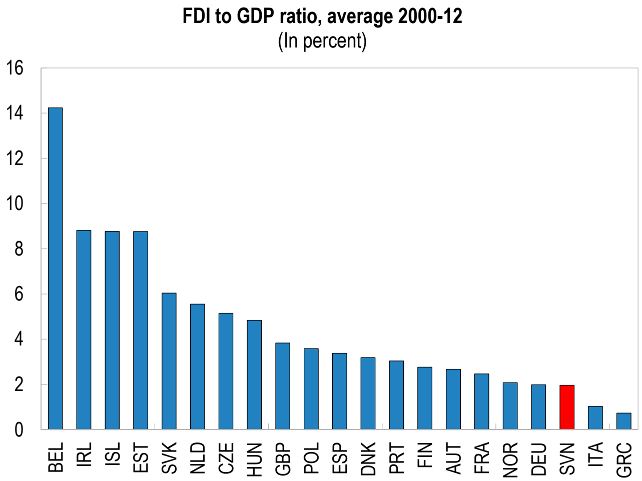
Slovenia's recent actions

A lot has been done in Slovenia to address the problems in the banking and corporate sectors.

In 2013, the Bank of Slovenia carried out a comprehensive AQR and stress tests in banks to determine capital needs and establish the price for the transfer of NPLs to a newly established BAMC. In December 2013, NPLs with a face value of EUR 4.6 billion were transferred to the BAMC, reducing the average NPL ratio

Figure 4. Corporate Leverage and FDI in a Cross-Country Perspective





Sources: ECB, Eurostat, and OECD.

in the system from 18 to 13 percent. The government also injected some EUR 3.7 billion in fresh capital into the three largest domestic banks.

To facilitate corporate restructuring, the bankruptcy law was amended in line with international best standards to introduce a simplified pre-insolvency regime and an enhanced compulsory settlement procedure.

But more is needed to complete the restructuring of banks and corporates and unlock credit flows.

Strengthening the demand side

On the demand side, the focus should be on accelerating corporate restructuring.

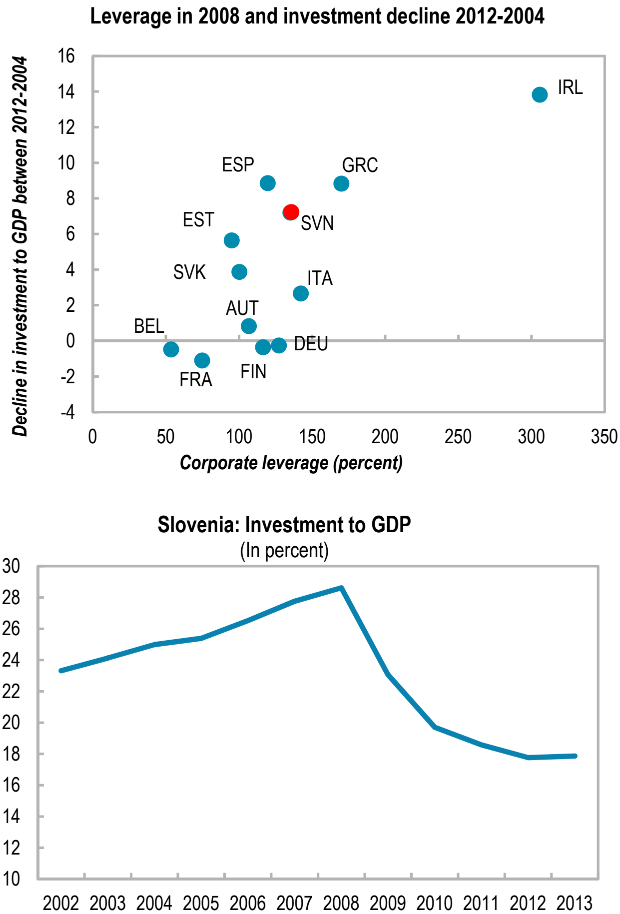
Let's look at the supply side first. As I mentioned earlier, NPLs remain high, even post-BAMC transfer. This is not conducive to a revival of credit supply. Thus, additional transfers of problem loans to BAMC are in order. This is necessary both to further cleanse banks' balance sheets from legacy problem loans and to strengthen BAMC's capacity to act as a catalyst for the much-needed corporate restructuring. The ongoing comprehensive risk assessment by the ECB offers an opportunity to determine the value of the assets for the transfer and to quantify the size of the existing capital buffers in the two largest domestic banks.

Going forward, there is a need to strengthen bank governance and supervision to prevent the reemergence of the same vulnerabilities that led to the crisis. Governance can be improved through privatization. The government currently owns 62 percent of the banking system capital. Privatizing the intervened banks would ensure that their management responds solely to commercial motives. It would also weaken the link between the creditworthiness of the government and the banks—a key source of vulnerability.

Finally, further bank consolidation may be needed to exploit economies of scale, reduce administrative costs, and shore up banks' profitability.

First, the apparent concentration of problems in large Slovenian corporates implies that a large reduction of leverage can be

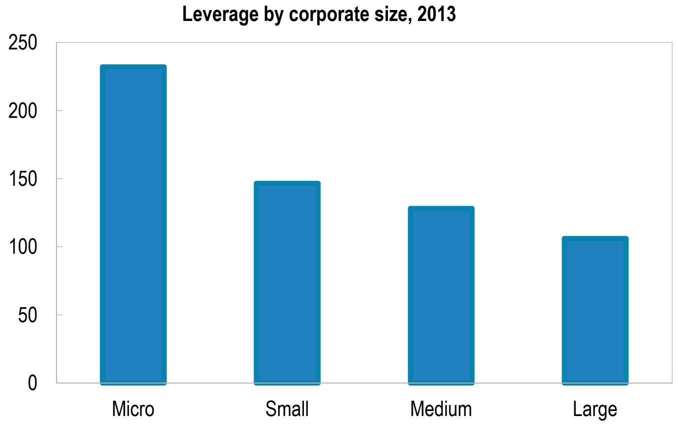
Figure 5. Corporate Leverage and Investment

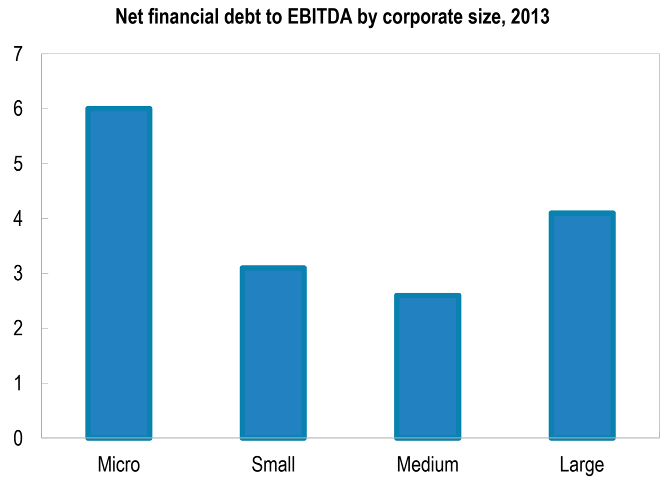


Sources: ECB and Eurostat.

achieved by involving only a few parties in restructuring negotiations. The BAMC can be instrumental in this regard since, by collecting claims from the three largest banks, it can potentially drastically reduce creditor coordination problems.

Figure 6. Leverage and Debt Repayment Capacity by Corporate Size





Source: Figures 4.14 and 4.15, 2014 Financial Stability Report, Bank of Slovenia.

Second, equity injections are key to revitalizing the corporate sector in Slovenia. Foreign capital can play an important role here and FDI should be encouraged.

Third, given the bi-modal distribution of financial stress in Slovenia, care should be taken to address the specific needs of microenterprises. Here, standardized approaches for restructurings (used in Iceland (2011) and Turkey (2001)) can help simplify negotiations by providing simple tests for viability and a set of harmonized restructuring terms.

And finally, to the extent that banks are the factor that constrains credit to domestic firms, it could be useful to explore the scope for nonbank financing. For larger corporates, direct access to capital markets may be a good alternative. Smaller companies could take advantage of minibonds (as was done in Italy) or debt securitization.

B. Austrian Banks in CESEE

Thomas Reininger and Doris Ritzberger-Grünwald, OeNB[30]

Travelers to CESEE countries, but also investors and entrepreneurs doing business in the CESEE region, quickly notice the strong presence of Austrian banks in the CESEE region. How did this come about? The comparatively low interest margin in Austria pushed Austrian banks to expand their business abroad. Looking for alternatives—preferably nearby—they seized the historic opportunities to focus on the CESEE region, given the geographical proximity and cultural ties.

Interestingly, the difference between the Austrian and the euro area interest rate margin has remained broadly constant between 2004 and 2014 (Figure 1). This is mainly ascribable to the competitive pressure resulting from the high number of Austrian banks (end-2013: 790 registered banks), given the prominent role of decentralized bank groups (in particular, the Raiffeisen sector). To adjust the cost structure, banks have responded to the

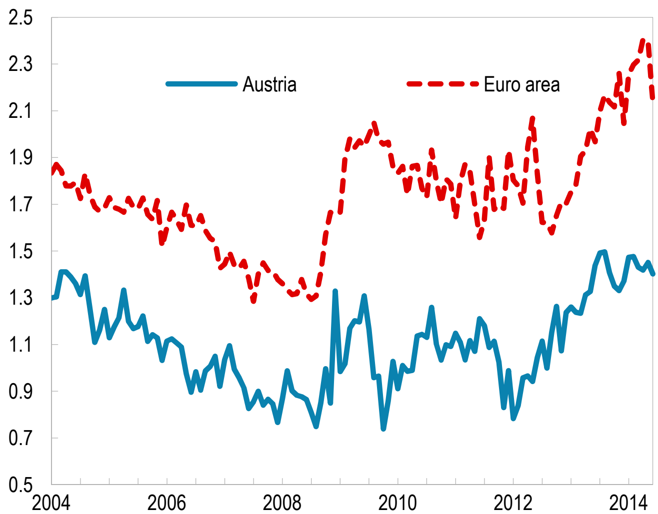
---

[30] Thomas Reininger is Senior Expert in the OeNB's Foreign Research Division and Doris Ritzberger-Grünwald is Chief Economist and Director of the OeNB's Economics Department. The presenters want to thank Andreas Greiner and Alexandra Schober-Rhomberg, Head of Unit in the OeNB's Financial Stability Department, for valuable support.

relatively low domestic net interest income with ongoing restructuring and redimensioning, and the number of banks has been on a continuous decline. Over the past two years, the interest margin on new lending has risen, but on the basis of relatively small volumes, so that the margin on the outstanding stock did not increase substantially. Moreover, this hardly changed the relative position of Austrian banks, given the parallel rise in the euro area.

Domestic Interest Margin and Consolidated Profitability of the Austrian Banking Sector

Figure 1. Interest Margin, New Lending to Nonbanks
(In percentage points)

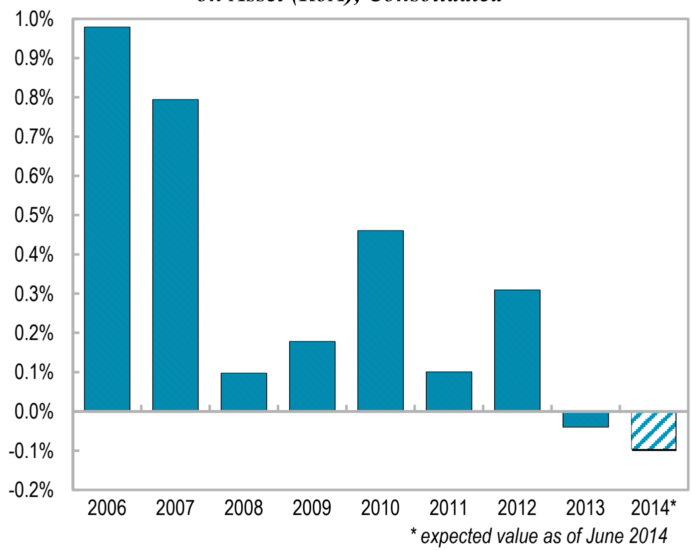


Source OeNB.

Overall, Austrian banks' eastward orientation, i.e., their so-called CESEE strategy, may be considered a win-win story. On the one hand, it provided financing for transition processes as well as catch-up growth, and it supported export-oriented FDI inflows. On the other hand, it markedly increased the profitability of the Austrian banking sector. The return on assets (ROA) of the consolidated banking sector was close to 1.0 percent in 2006; in

2007, the year before the crisis, it still came to 0.8 percent (Figure 2). Clearly, these results were driven by the net profits of Austrian bank subsidiaries in CESEE, which posted ROA ratios between 1.2 percent and 1.7 percent from 2003 to 2008 (Figure 5). However, it would be too rosy a picture if we did not mention that, during this period, banks to some extent also pursued ill-considered business strategies—such as lending based on insufficiently strict lending standards coupled with overreliance on funding from parent banks abroad, even though the supervisory authorities of several host countries issued some explicit warnings.

Figure 2. Earning Power of the Austrian Banking System—Return on Asset (RoA), Consolidated



Source: OeNB.

In 2008, the ROA of the consolidated Austrian banking sector dropped significantly and then remained at a lower level, which may be explained by the legacy problems of past excesses and the weak growth in the euro area and its impact on the CESEE region. In 2013, the ROA became negative (-0.04 percent) for the first time (Figure 2). This was attributable—apart from a moderate decline in the net interest income resulting from weak growth and the low interest rate environment—to two major one-off effects, namely the losses of Hypo Alpe-Adria Bank International AG and the write-downs of goodwill linked to the CESEE subsidiaries of one major bank. In absolute terms, the net loss amounted to EUR 1 billion. Without these one-off effects, the RoA would have amounted to about 0.2 percent.

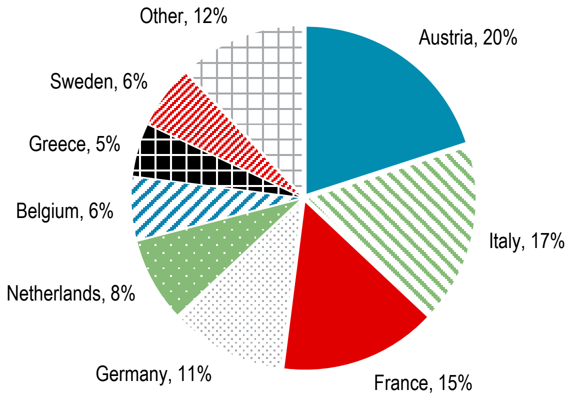
Exposure to CESEE

Against the background of relatively low interest margins at home, Austrian banks were among the first to take advantage of the opportunities in CESEE and to become major players in the region. Banks expanded their activities in parallel with nonfinancial companies entering the CESEE markets after the Iron Curtain had come down, partly following them and partly paving the way for them. In 2014, majority domestically owned Austrian banks held a share of 20 percent in the total exposure of EU-15banks to CESEE (Figure 3). If we also included Bank Austria, which is majority owned by the Italian UniCredit Banking Group, in this category, this share would increase to about 30 percent (and the share of Italy would decline correspondingly).

Since the crisis of 2008/09, Austrian banks' exposure to the aggregate CESEE region and their share in total EU-15 banks' CESEE exposure has remained remarkably stable. Still, the crisis has impacted—not immediately, but definitely step by step—the structure of Austrian banks' CESEE exposure. At the peak of the crisis, banks avoided falling into the trap of the rush to the exit and prevented the loan supply from collapsing not only on aggregate in the region, but also in almost all individual host countries. In this context, the private-public Vienna Initiative played a rather important role. Later on, the exposure developed in a more heterogeneous way, with country-specific differences emerging, depending on factors like real growth, credit demand, the size of legacy problems, and the economic policy approach. A country-by-country analysis shows that the exposure remained quite stable, for instance, in the Czech Republic (after some further increase) and in Romania. By contrast, the exposure shrank significantly in particular in Hungary and the Ukraine, mostly due to unfavorable political conditions. In Turkey and Russia, the exposure grew strongly until the fourth quarter of 2013. However, during 2014, the exposure to Russia contracted markedly (Figure 4). Indeed, the increases in some countries, e.g., the Czech Republic, Turkey, Russia and—via acquisition—in Poland, helped maintain the exposure to the total CESEE region stable after the crisis of 2008/09. Interestingly, there is also evidence that Austrian banks do not stay under all circumstances, as Bank Austria left Kazakhstan.

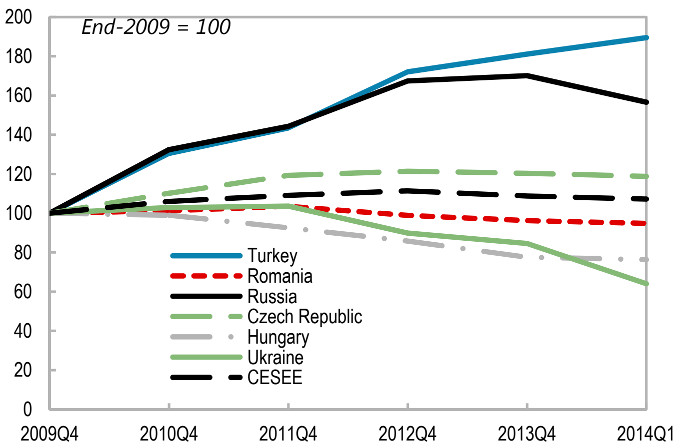
Since the crisis of 2008/09, Austrian banks' exposure to the aggregate CESEE region and their share in total EU-15 banks' CESEE exposure has remained remarkably stable. Still, the crisis has impacted—not immediately, but definitely step by step—the structure of Austrian banks' CESEE exposure. At the peak of the crisis, banks avoided falling into the trap of the rush to the exit and prevented the loan supply from collapsing not only on aggregate in the region, but also in almost all individual host countries. In this context, the private-public Vienna Initiative played a rather important role. Later on, the exposure developed in a more heterogeneous way, with country-specific differences emerging, depending on factors like real growth, credit demand, the size of legacy problems, and the economic policy approach. A country-by-country analysis shows that the exposure remained quite stable, for instance, in the Czech Republic (after some further increase) and in Romania. By contrast, the exposure shrank significantly in particular in Hungary and the Ukraine, mostly due to unfavorable political conditions. In Turkey and Russia, the exposure grew strongly until the fourth quarter of 2013. However, during 2014, the exposure to Russia contracted markedly (Figure 4). Indeed, the increases in some countries, e.g., the Czech Republic, Turkey, Russia and—via acquisition—in Poland, helped maintain the exposure to the total CESEE region stable after the crisis of 2008/09. Interestingly, there is also evidence that Austrian banks do not stay under all circumstances, as Bank Austria left Kazakhstan.

Figure 3. Home Countries' Shares in Total EU-15 Banks' Exposure to CESEE



Source: BIS.

Figure 4. Development of Austrian Banks' Exposure to CESEE



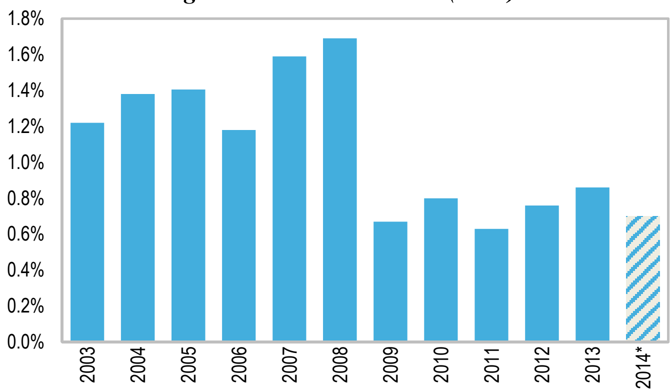
Source: OeNB.

Profitability of Austrian bank subsidiaries

A closer look at the profitability of Austrian bank subsidiaries in the CESEE region reveals why Austrian banks stayed in the region, although economic conditions were less favorable than before the crisis of 2008–09. In the post-crisis period, the ROA of CESEE subsidiaries was only half the pre-crisis level, coming in at 0.8 percent in 2013 (Figure 5). This ROA ratio, however, still exceeds the ROA recorded by Austrian banks in their domestic market. Moreover, this profitability level has remained remarkably stable throughout the post-crisis period.

Earning Power of Austrian Subsidiaries in CESEE

Figure 5. Return on Assets (ROA)

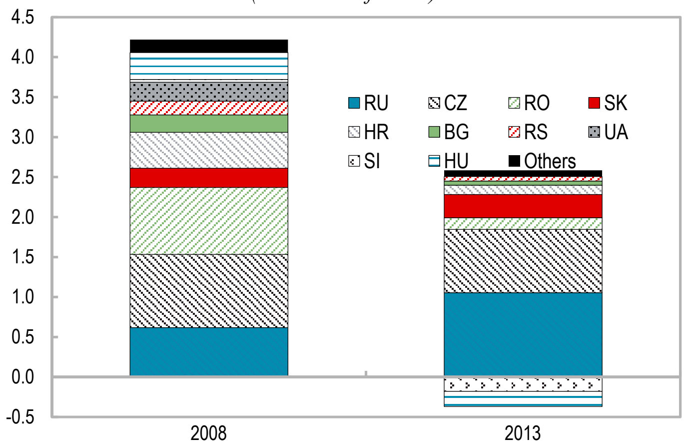


* expected value as of June 2014

Source: OeNB.

Similar to the changing structure of the (otherwise stable aggregate) CESEE exposure, the CESEE subsidiaries' stable profitability level of recent years masks a change in the structure of Austrian banks' net profits in CESEE (after credit risk provisioning and taxes). In fact, the changing profit structure reflects a growing concentration of profits on a few countries. In 2008, the total profit of CESEE subsidiaries was characterized by a more equal allocation over a larger number of CESEE countries. In 2013, this profit was concentrated on Russia, the Czech Republic, and—to a lesser extent—Slovakia; while the activities in Hungary and Slovenia even resulted in small losses (Figure 6).[31] As a matter of fact, the increased concentration of profit sources implies a higher risk for the Austrian banking sector.

Figure 6. Profit/Loss After Taxes
(In billions of euros)



Source: OeNB.

A key factor for lower CESEE profitability in the post-crisis period was the rise of NPLs and the resulting substantial credit risk provisioning—basically a legacy problem of boom-related exuberance. In the domestic market, the NPL ratio of Austrian banks (i.e., the unconsolidated NPL ratio) increased from a low level to about 4 percent in the first quarter of 2009, but has since then remained stable. By contrast, the loan quality in CESEE continued to weigh down group figures. For CESEE subsidiaries,

[31] Note that the positive results for Turkey are not included in Figure 6, as a significant joint venture in Turkey had not been covered separately by the Austrian supervisory reporting framework up to 2013.

the NPL ratio climbed from 7 percent (early in the crisis) up to 15 percent in mid-2014. As a result, the NPL ratio of the consolidated Austrian banking sector increased to 8.6 percent. Whereas the unconsolidated loan loss provision (LLP) ratio was 3.6 percent in mid-2014, the consolidated ratio (taking CESEE subsidiaries into account) stood at 4.8 percent. Overall, the LLP ratio kept pace with the NPL ratio, preventing the coverage ratio from deteriorating. Moreover, the good news is, that after the steep rise of the NPL ratio in CESEE from 2009 to 2012, it leveled off and even declined slightly (Figures 7 and 8).

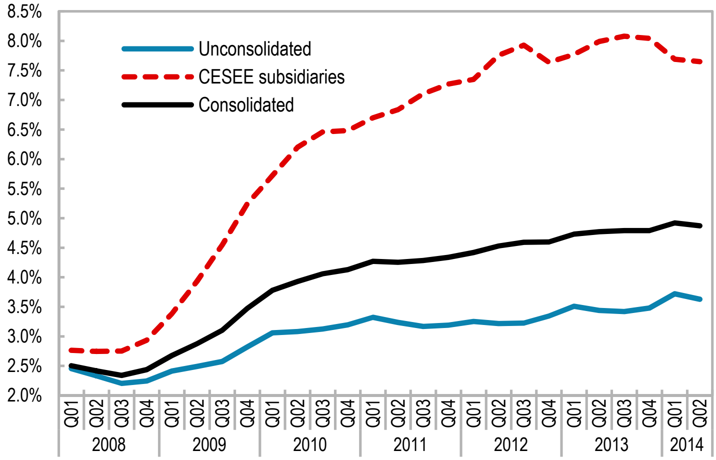
To what extent has credit growth recovered?

CESEE aggregate credit growth recovered from the crisis, with a smaller role for foreign currency lending. Indeed, net new foreign currency lending to households virtually disappeared. Figure 9 shows this development in detail in terms of credit growth by economic sector and currency relative to annual GDP. Before the crisis, the CESEE economies on aggregate recorded very high credit growth of more than 14 percentage points of annual GDP. In this situation, foreign currency loans played a significant role for both households and nonfinancial companies. Cross-border credit to the corporate sector, denominated almost entirely in foreign currency, was used intensively to meet the demand for credit, as investment activities were high and their financing was not always fully met by (foreign-owned) domestic banks. Instead, parent banks stepped in and financed, in particular, bigger projects.

In 2009, domestic and cross-border credit growth came to a standstill, with very small increases in national currency loans canceled out by decreases in foreign currency loans to nonfinancial companies. Thereafter, domestic credit growth revived to a moderate level. However, within domestic credit, foreign currency lending to households did not reemerge on an aggregate level, as it was restricted in various ways by banks'

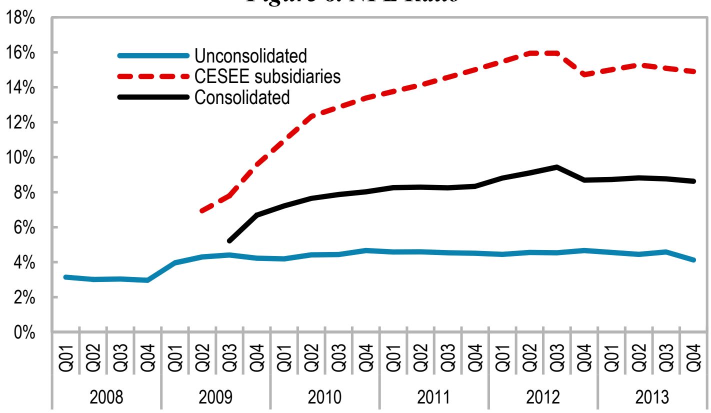
Credit Quality of the Austrian Banking System

Figure 7. LLP Ratio



Source: OeNB.

Figure 8. NPL Ratio

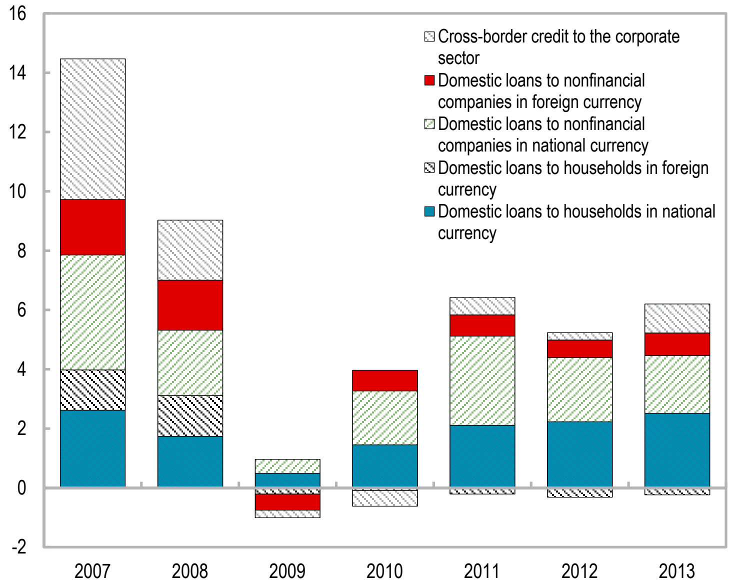


Source: OeNB.

internal rules or supervisory authorities' new requirements in most countries. As a case in point, nowadays a customer will quite frequently have to provide proof of foreign currency earnings as a hedge against the inherent exchange rate risk in order to get a foreign currency loan. In some countries, e.g., the

Figure 9. CESEE: Changes in Outstanding Stocks of Domestic Credit and Cross-Border Credit to Private Nonbanks by Sector and Currency

*Annual **change** (after adjustment for exchange rate changes), in percent of CESEE annual GDP (all banks, not only Austrian banks).*



Sources: ECB, Eurostat, national central banks, national statistical offices, OeNB.

Note: Domestic credit comprises loans to households and to nonfinancial companies (NFCs), except for Russia where it includes also loans to other financial institutions (OFIs). Domestic foreign currency loans include also exchange rate-linked loans denominated in national currency. Cross-border credit to the corporate sector comprises cross-border credit to 'other sectors' (including OFIs), including portfolio debt securities held abroad by nonbanks, but excluding trade credit and intra-company loans. CESEE: EU-MS in CESEE, plus Serbia, Albania, Ukraine, Russia and Turkey.

Ukraine, the supervisory authorities have prohibited new foreign currency lending. In other words, both banks and supervisory bodies have learned their lesson and started to limit this risky business.

In the pre-crisis period, CESEE aggregate credit growth was fueled by most countries across the region. However, it is important to highlight that foreign currency lending to households was not a phenomenon shared by all CESEE countries. In the post-crisis period, the moderate positive growth of CESEE aggregate credit stemmed mainly from a few, but relatively large countries—notably Slovakia, the Czech Republic, Poland, Russia and Turkey—while several other countries suffered from negative credit growth.

Strategy of diversification

Traditionally, Austrian banks in CESEE pursued a risk-reducing strategy by diversifying their business across many countries of the region. At the same time, this strategy allowed them to realize economies of scope by providing added value for customers operating throughout the region. Up to now, this strategy has helped Austrian banks weather adverse economic developments in the region. To some extent, this seems to apply also to the years 2014 and 2015: GDP growth forecasts for the CESEE EU member states have been rather stable for these two years; no major downward revisions have been made so far (Figure 10).

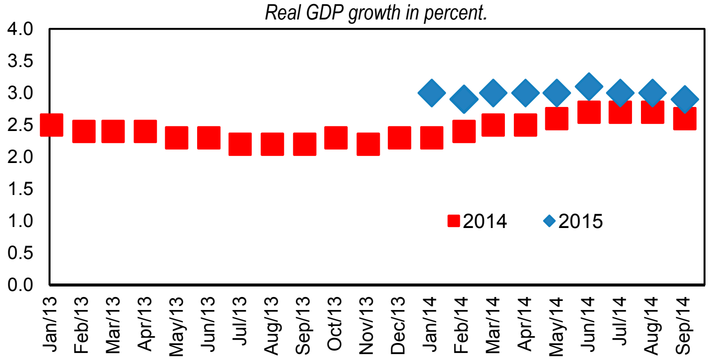
However, if one adds Ukraine, Russia and Turkey to the sample, the picture changes completely and a constant downward revision of growth prospects becomes obvious (Figure 11). While in recent years, growth in Russia (and Turkey) compensated for recent years, growth in Russia (and Turkey) compensated for weak economic growth in the CESEE EU member states, the latter provide more stability now, dampening the effect of adverse developments in the former.

Capitalization

Despite lower profitability resulting mainly from higher credit risk provisioning, Austrian banks responded to increased capital requirements by both market participants and regulatory bodies by improving their capitalization. As a result, major Austrian banks operating in CESEE now have above-average leverage ratios (defined as Tier 1 capital to total assets). However, given their business model and the risks inherent in their assets, these

Figure 10. CESEE EU Member States: Growth Projections for 2014 and 2015

Real GDP growth in percent.

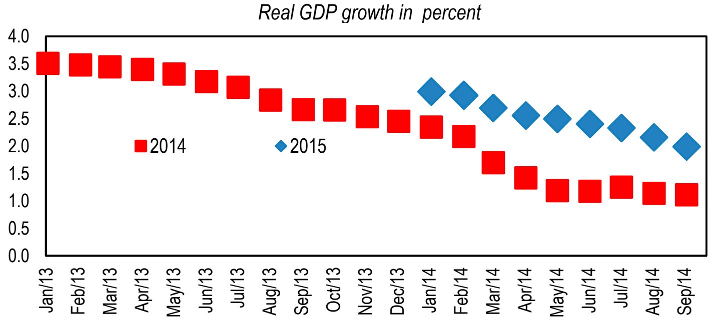


Source: Consensus Economics.

Note: With the beginning of July 2013, Croatia is included in the CESEE EU member states aggregate.

Figure 11. CESEE (CESEE EU-MS plus UA, RU, TR): Growth Projections for 2014 and 2015

Real GDP growth in percent



Source: Consensus Economics, WEO for PPP weights.

Notes: The CESEE aggregate comprises, Bulgaria, Croatia, Czech Rep., Estonia, Hungary, latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia, Turkey and Ukraine. Average of GDP at PPP over the period from 2007 to 2013 to aggregate the single countries.

large Austrian banks record below-average capital ratios (relative to risk-weighted assets) compared to their peers, with the total Austrian banking sector having posted a Tier 1 ratio of 11.9 percent at the end of 2013. This may be regarded as a signal for the need to further buildup high-quality capital. Moreover, banks have to face several challenges in the coming years: a low interest margin, further restructuring, weak economic growth, and higher political uncertainties. Therefore, additional risk buffers are required. From another perspective, it is important to highlight that the capitalization of Austrian subsidiaries in CESEE is generally well above the respective country minimum requirements, but in some countries “ring fencing” complicates reallocation and thus an optimal use of bank group capital.

Recommendations

Against this background, the recommendations by the OeNB to the Austrian banking sector are:

- Banks should continue strengthening their capital levels.

- Banks should strive to address structural issues and improve their cost efficiency.

- Banks should strive for sustainable loan-to-local stable funding ratios at the subsidiary level and for the risk-adequate pricing of liquidity transfers.

- Banks should further pursue risk-adequate provisioning and coverage policies to deal with loan-quality issues.

- Banks should ensure high standards of risk management so that risks are properly addressed and effectively controlled.

X. Contributors

Boštjan Jazbec, *Governor, Bank of Slovenia*

He graduated from the Faculty of Economics, University of Ljubljana, and continued his studies at the Central European University in Budapest and Prague. After completing his Ph.D. studies in Economics at the Institute for Advanced Studies in Vienna he defended his doctoral thesis on real exchange rate determination in transition economies at the Faculty of Economics, University of Ljubljana. His research interests focused on the macroeconomic topics including the impact of structural reforms on the exchange rate determination and the convergence of the transition countries to the European Union (EU). He has worked as a short-term consultant for the European Bank for Reconstruction and Development (EBRD) and the World Bank in Washington, DC. In July 2003, he was appointed to the Board of the Bank of Slovenia and continued his post until 2008. After 2008, he worked as a consultant to the International Monetary Fund (IMF) at the Central Bank of Kosovo and the Central Bank of Suriname. In July 2013, he was appointed Governor of the Bank of Slovenia.

Christopher Towe, *Monetary and Capital Markets Department, IMF*

Christopher Towe is presently Deputy Director in IMF's Monetary and Capital Markets Department. His responsibilities include coordinating the IMF's FSAP program and financial sector technical assistance work across the Fund's membership. In recent years he has taken a leadership role in FSAP assessments of the United States, Turkey, and Japan. Prior to his assignment to the Monetary and Capital Markets Department, he was mission chief to a wide range of countries, including the U.S., Canada, Japan, India, and Hong Kong. His research has covered areas including fiscal sustainability, monetary policy implementation, tax policy, and exchange rate bubbles, and before joining the IMF, he worked for three years at the Bank of Canada, covering money markets. He holds a Ph.D. in Economics from the University of Western Ontario and earned his B.A. from Queen's University.

<table>
<tr>
<td></td>
<td>

Benoît Cœuré, *Member of the Executive* Board, ECB

Benoît Cœuré is a member of the Executive Board of the European Central Bank and the Chairman of the Bank for International Settlements' Committee on Payments and Market Infrastructures. Prior to joining the ECB, he served in various policy positions at the French Treasury. He was the CEO of the French debt management office, Agence France Trésor, then France's Assistant Secretary for Multilateral Affairs, Trade and Development, co-president of the Paris Club and G8 and G20 finance sous-sherpa for France, and finally Deputy-Director General and Chief Economist of the French Treasury. Mr. Cœuré is a graduate of École polytechnique in Paris. He holds an advanced degree in statistics and economic policy and a B.A. in Japanese. He has taught international economics and economic policy at École polytechnique and at Sciences Po in Paris, and authored articles and books on economic policy, the international monetary system and the economics of European integration, including most recently: "Economic Policy: Theory and Practice" (Oxford University Press, 2010).

</td>
</tr>
<tr>
<td></td>
<td>

Marco Piñón, *Monetary and Capital Markets Department, IMF*

Marco Piñón is currently an Advisor at the Monetary and Capital Markets Department (MCM) of the International Monetary Fund (IMF), concentrating on European issues and Financial Sector Assessment programs (FSAP). He is currently leading the FSAP for Norway. Since 1990, he has also served the IMF in several capacities in the Western Hemisphere and Strategy and Policy Review departments, including as division and mission chief for several program countries. Prior to joining the IMF, he was an econometrician and international consultant at Wharton Econometrics Forecasting Associates in Philadelphia. He completed his education in economics at the Monterrey Institute of Technology (Mexico) and the George Washington University. His recent research interests focus on macro-financial linkages and macroprudential policies. Recent Publications include books (main author) such as "Central America, Panamá and the Dominican Republic: Challenges following the 2008–09 Global Crisis;" and "Macroeconomic Implications of Financial Dollarization: The Case of Uruguay."

</td>
</tr>
</table>

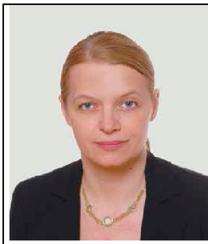
	**Jan Švejnar,** *Professor, Columbia University* Jan Svejnar is the James T. Shotwell Professor of Global Political Economy and Founding Director of the Center on Global Economic Governance at Columbia University's School of International and Public Affairs. His research focuses on the effects of foreign investment and government policies on firms and workers; corporate, national and global governance and performance; and entrepreneurship. He has published widely in academic, policy and practitioner-oriented journals in advanced and emerging economies. Prior to joining Columbia, Svejnar taught at the University of Michigan, University of Pittsburgh, and Cornell. He received his BS from Cornell University's School of Industrial and Labor Relations and his MA and PhD in Economics from Princeton University. In 2012, Professor Svejnar was honored with a Neuron Prize for lifelong achievement from the Karel Janeček Endowment for Research and Science. In 2008, Professor Svejnar was one of two candidates for the Presidency of the Czech Republic.
	**Josef Bonnici,** *Governor, Central Bank of Malta* Josef Bonnici was appointed as Governor of the Central Bank of Malta for five years with effect from 1 July 2011 after serving as Director on the Board of the Bank. He graduated B.A. (Hons) in Economics from the University of Malta, and read for his Masters and PhD from Simon Fraser University, Canada specialising in the areas of Monetary Economics, Macroeconomics and Econometrics. He was awarded a Doctor of Humanities, Honoris Causa from Rikkyo University in Japan. Josef Bonnici has published books and many articles in professional Economics journals, and lectured at Deakin University in Australia, and Simon Fraser University in Canada. He was advisor to the Prime Minister of Malta, Parliamentary Secretary in Finance and Minister for Economic Services in two legislatures, with a wide portfolio, including that of economic development policy. He was Observer member of the European Parliament, and Member of the European Court of Auditors, with responsibility for the institution's Statement of Assurance (DAS). Prior to his appointment as Governor Josef Bonnici held the post of Professor of Economics at the University of Malta, focusing primarily on Monetary Economics, Macroeconomics and Econometrics.

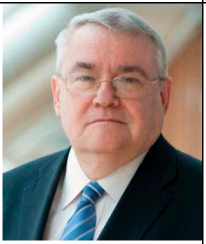
Boris Vujčić, *Governor, Croatian National Bank*

Boris Vujčić (born 1964) holds a BA, an MA and a PhD in Economics from the University of Zagreb. He joined the Croatian National Bank in 1997, and was Director of the Research Department for three years before becoming Deputy Governor in 2000, a position to which he was re-appointed in 2006. In July 2012, Mr Vujcic became Governor of the Croatian National Bank for a six-year term of office. Mr Vujčić became an associate professor in 2003 at the Faculty of Economics, University of Zagreb. He also teaches at the Diplomatic Academy of the Croatian Ministry of Foreign Affairs and the University of Zagreb, Department of Mathematics. Mr Vujčić's fields of expertise are macroeconomics, international finance and labor economics.

José Joaquim Berberan e Santos Ramalho, *Vice Governor, Banco de Portugal*

He graduated in Economics from Institute Superior de Economia (School of Economics of the Technical University of Lisbon) in 1981. He performed functions as economist in the Central Planning Department of the Ministry of Finance (1981–83), Banco de Portugal (1983–88) and BIS (1989–90). At Banco de Portugal, he was Deputy Head of the Statistics and Economic Research Department (1990–93), Head of the Foreign Department (1993–99) and of the Markets and Reserve Management Department (1999–2000). He was a member of the Board of Directors of Caixa Geral de Depósitos (CGD) (2000–07) and, in that capacity, a member of management boards across the group's companies, namely Chairman of the Board of Directors of Caixa Gestão de Activos. As a member of the Board of Directors of CGD, he was the Deputy Chairman of the Board of Directors of Bolsa de Valores de Lisboa e Porto (the Portuguese stock exchange) (2000-2002). Within the CGD group, he was also a member of the Board of Directors of the insurance companies Fidelidade-Mundial and lmpério-Bonança (2008–10), Deputy Chairman of the Board of Directors of Caixa Banco de lnvestimento (2008–11) and General Manager of CGD branches in France and Luxembourg (2010–11). He was appointed Vice-Governor of Banco de Portugal in September 2011.

	**Stanislava Zadravec Caprirolo,** *Vice Governor, Bank of Slovenia* Stanislava Zadravec Caprirolo is holding current position since April 2010. She is also a Member of ECB Supervisory Board, Member of Board of Supervisors of EBA and non-voting national representative for banking supervision to the ESRB. She was Director General of Treasury of the Ministry of Finance (2005–2009), responsible for the field of central government debt management, general government liquidity management, payment systems and state consolidated balance sheet and State Undersecretary at the Ministry of Finance (1998–2005). From 2003 to 2009 she was a member of EFC T-Bills and Bonds Working Group. Working experience includes also international financial organizations, bilateral relationships and financial succession issues after disintegration of former Yugoslavia. She started her career in 1989 in the Central Bank of the Republic of Slovenia. She also worked as public finance expert in the region (including for Regional Center for Excellence in Finance and IMF). She was a member (and President) of the Supervisory Board of SID bank and of NLB. She holds a master degree in International Affairs (Economic Policy Management), Columbia University, New York and bachelor degree in Law, University of Ljubljana.
	**Ewald Nowotny,** *Governor, Oesterreichische Nationalbank* Before taking on his current position in September 2008, Ewald Nowotny held a number of high-level positions in financial institutions. He was CEO of the Austrian BAWAG P.S.K. banking group from 2006–07, served as Vice-President and Member of the Management Committee of the European Investment Bank (EIB) in Luxembourg from 1999–2003, and, between 1971 and 1979, was first a Member and then President of the Governing Board of Österreichische Postsparkasse (P.S.K.). Moreover, from 1992–2008, Mr. Nowotny served on the supervisory boards of several banks and corporations and was a member of the OeNB's General Council from 2007–08. Mr. Nowotny was born in Vienna, Austria, in 1944. He studied law and political science at the University of Vienna and economics at the Institute for Advanced Studies (IHS) in Vienna. In 1967, he received his doctorate in law from the University of Vienna. He served as a professor at the University of Linz and at the Vienna University of Economics and Business, where he was also Vice-Rector for Financial Affairs. Mr. Nowotny was Vice President of the Austrian

	Economic Association and is a Member of the University Board of the Vienna University of Economics and Business.
	**Ján Tóth,** *Deputy Governor, Národná banka Slovenska* Mr Jan Toth received his master's degree from the Faculty of Management at Comenius University in Bratislava. He completed an extensive part of his studies in the United States, where he was awarded first a BBA, magna cum laude, from the W. Barton School of Business at Wichita State University and then MA in economics from The Ohio State University passing field exams in monetary economics, macroeconomics and international economics. In 1998 Mr Toth returned to Slovakia to join Tatra banka (a member of Austrian Raiffeisen group) as a research economist and strategist, shortly becoming the bank's Chief Economist and Strategist. In 1999 he was hired by ING Bank (former ING Barings), where he spent ten years as Chief Economist for Slovakia. For another two years, he took up the same post at Slovak UniCredit Bank before being recruited to the Ministry of Finance to head its research arm as the Ministry's Chief Economist in late 2010. In late 2012, the President of the Slovak Republic appointed Mr Toth as Deputy Governor of the Slovak central bank, NBS.
	**László Baranyay,** *Vice President, European Investment Bank* In September 2013, László Baranyay became Vice President of the EIB, responsible for financing operations in Hungary, Poland, Slovakia, Slovenia, Belarus and Ukraine, Ex post evaluation of operations, Information technologies and data governance, Strategy for the Danube region. He is Alternate Governor of the EBRD. He most recently (2010-August 2013) held the positions of CEO and Chairman of Board of Directors of MFB (Hungarian Development Bank). From 2002 to 2010, Mr. Baranyay was both Member of the Supervisory Board of the Hungarian National Bank and Advisor to the Chairman of OTP Garancia Insurance Company (from 2007 Groupama Insurance). During the 1980s and early 90s, he worked as a civil servant first by teaching Macroeconomics in Budapest; then at the Central Office of the Hungarian Academy of Sciences, where he managed research and the finances of several socioeconomic research institutes of Academy. László Baranyay graduated in economics from the Budapest University.

Andrzej Raczko, *Member of the Management Board, National Bank of Poland*

Andrzej Raczko is a member of the Management Board of Narodowy Bank Polski. He started his political career as Undersecretary of State in the Ministry of Finance. His responsibilities covered public debt management, financial negotiations with the European Union and co-operation with international financial institutions. In 2003-2004, during the final stage of the Polish accession to the European Union, he was Minister of Finance. Before he began his public responsibilities, he had worked as CEO in the Polish banking sector for over 10 years. He served as Alternate Executive Director in the International Monetary Fund for four years. Mr. Raczko graduated from the University of Lodz (M.A. in economics). In 1985, he obtained his Ph.D. from the same university and then worked as an assistant professor.

Biswajit Banerjee, *Chief Economist, Bank of Slovenia*

Biswajit Banerjee is Chief Economist of the Bank of Slovenia. He is a former senior staff member of the International Monetary Fund, where he led surveillance and program missions to several countries in central and southeastern Europe. He also previously taught at Haverford College, the Wharton School of the University of Pennsylvania, and University of Oxford. He has served as an external advisor to the Minister of Finance of the Slovak Republic, and has conducted training courses in financial programming for senior government officials of Bangladesh. Dr. Banerjee received his doctorate in economics from the University of Oxford, which he attended as a Rhodes Scholar. He has numerous publications in leading academic journals.

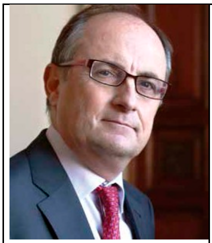
Daria Zakharova, *Advisor, European Department, IMF*

Ms. Zakharova heads the Poland-Baltics Unit in the European Department at the International Monetary Fund and is a mission chief for Poland. She previously led missions to Slovenia, Iceland, and Slovakia. Her research interests span a broad range of issues, including economic growth, fiscal and monetary policy and institutions, and capital flow management. Ms. Zakharova holds a Ph.D. in Economics from the University of Minnesota and a B.A. in Economics from the University of Michigan. Prior to joining the IMF in 2000, she worked as an associate analyst at the Federal Reserve Bank of Minneapolis and a teaching associate at the University of Minnesota.

	**Doris Ritzberger-Grünwald,** *Director, Oesterreichische Nationalbank* Doris Ritzberger-Grünwald (Director of the OeNB's Economic Analysis and Research Department) studied social and economic sciences at the University of Vienna and completed a postgraduate program in economics at the Vienna Institute for Advanced Studies (IAS). She started her career as a research assistant at the IAS before joining the Oesterreichische Nationalbank (OeNB) in 1988 as an economist. In 2000 she moved into a management position as Deputy Head of the OeNB's Foreign Research Division, which she managed as Head of Division from 2002 to 2013. In 2013 she was promoted to the position of chief economist. Her fields of policy- oriented research include monetary policy, economic growth, convergence issues, inflation as well as EU and euro area enlargement, with a special focus on Central, Eastern and South-Eastern European Countries. She is a member of the Monetary Policy Committee of the European Central Bank and an Executive Board Member of the Joint Vienna Institute.
	**Vedran Šošić,** *Vice Governor, Croatian National Bank* Vedran Šošić (born 1974) is Vice Governor at the Croatian National Bank. He has responsibility for the Research and Statistics Area, which besides the Research and Statistics Departments also includes the Financial Stability Department and the Econometric Modeling Department. He started his career in the Research Department of the Croatian National Bank in 1997 and worked in the Real Sector and Budget Analysis Division until 2006, when he moved to the Mission of the Republic of Croatia to the European Union in Brussels, to work as a second secretary responsible for economic and monetary issues, free movement of capital and financial services. From 2008 to his appointment as Vice Governor, he was heading the CNB Financial Stability Department where he worked on the development of stress-testing framework, early-warning systems and preparation of the Financial Stability Report. Mr Šošić received his BA and MA in Economics from the Faculty of Economics in Zagreb.

	**Guillermo Ortiz,** *Former Central Bank Governor and Minister of Finance, Mexico* Guillermo Ortiz is currently Chairman of the Board of Grupo Financiero Banorte-Ixe. Dr. Ortiz is also a member of the Group of Thirty, of the Advisory Board of the Center for Financial Stability, of the Advisory Council of the SWIFT Institute and of the Advisory Board of the Globalization and Monetary Policy Institute at the Federal Reserve Bank of Dallas. He is Chairman of the Per Jacobsson Foundation. Additionally, he currently serves as member of the International Advisory Council of Zurich Insurance Group Ltd., on the advisory Board of Bombardier Inc., and he is a board member of Weatherford International Ltd. He also serves on the board of several Mexican companies. He was Governor of the Bank of Mexico from 1998 to 2009. From 1994 to 1997, Dr. Ortiz served as Secretary of Finance and Public Credit in the Mexican Federal Government. In 2006 he was appointed to the Board of the Bank for International Settlements (BIS) and was elected Chairman of the Board in 2009. Dr. Ortiz earned a B.A. degree in Economics from the Universidad Nacional Autónoma de México and an M.A. and Ph.D. in Economics from Stanford University.
	**Erdem Başçı,** *Governor, Central Bank of the Republic of Turkey* Born in Ankara in 1966, Dr. Erdem Başçı graduated from the Electrical and Electronics Engineering Department of Middle East Technical University in 1987 with high honors. He completed the M.B.A. program at Bilkent University in 1989, ranking first in his class. Having obtained his M.A. in Economics from Bilkent University in 1990, Dr. Başçı received his second M.A. degree in Economics from Johns Hopkins University in 1993. He obtained his Ph.D. in Economics from Bilkent University in 1995. Between 1995 and 2003, he worked as an Assistant Professor at Bilkent University's Economics Department. In 1999, Dr. Başçı was promoted to the rank of Associate Professor and lectured at the University of York, U.K. as an honorary visiting fellow. Erdem Başçı's research field includes monetary economics, financial economics, macroeconomic theory and mathematical economics and has many articles published in national and international journals. Having served as Deputy Governor of the Central Bank of the Republic of Turkey since 9 October 2003, Dr. Başçı was appointed Governor on 19 April 2011.

	**György Matolcsy,** *Governor, Central Bank of Hungary* György Matolcsy obtained his degree in economics at the University of Economics in 1977. Between 1978 and 1985, he worked as a chief rapporteur and was a contributor to economic reform at the Department of Industry of the Ministry of Finance. After spending a few years at the Financial Research Plc, Matolcsy was appointed to the position of Political State Secretary and Personal Economic Adviser to Prime Minister József Antall in 1990. In this capacity, he was also head of the Economic Policy Secretariat of the Economic Cabinet. Between 1991 and 1994, he served on the Board of Governors of the EBRD. He was founder of the Hungarian Economic Development Institute in 2007, which he headed until 2010. Matolcsy served two terms as Minister for National Economy (2000–2002; 2010–2013). He took office as Governor of the Magyar Nemzeti Bank in March 2013. He is the author of several books, articles, studies and other publications.
	**Yannis Stournaras,** *Governor, Bank of Greece* Graduated from the Department of Economics, University of Athens and obtained his post-graduate degrees (M.Phil., D.Phil.) from Oxford University, where he also worked as a Research Fellow and Lecturer at St. Catherine's College and as Research Fellow at the Oxford Institute for Energy Studies. He worked as a Special Advisor to the Ministry of Economy and Finance (1986-1989) on Public Enterprises and Incomes Policy issues, and to the Bank of Greece (1989-1994) on Monetary Policy issues. As Chairman of the Council of Economic Advisors at the Ministry of Finance (1994-July 2000), he participated in the negotiations for the entry of Greece in the Economic and Monetary Union. He was Vice Chairman of the Public Gas Corporation (1994-1997), member of the Board of Directors of the Public Debt Management Office (1998-July 2000), Chairman and Chief Executive Officer of Emporiki Bank and Vice Chairman of the Association of Greek Banks (2000-2004), and managing director of Kappa Securities (2005-August 2008). He served as Director General of the Foundation for Economic and Industrial Research (September 2009-June 2012), as Minister of Development of the Interim Government (May–June 2012) and as Minister of Finance (July 2012–June 2014). Since June 2014, he is Governor of the Bank of Greece.



Fernando Restoy, *Deputy Governor, Banco de España*

He is a graduate in Economics and Business Studies from the Madrid Complutense University, a M.Sc. in Econometrics and Mathematical Economics from the LSE, and an M.A. and Ph.D. in Economics from Harvard University. He was appointed Deputy-Governor of the Banco de España in 2012. He is also a member of the Supervisory Board of the ECB, Chairman of the FROB (the Spanish Fund for the Orderly Restructuring of the Banking Sector) and a member of the CNMV (Spanish National Securities Market Commission) Board. His entire career has been pursued in the realm of public institutions. He was Vice-Chairman of the CNMV Board. He was also a member of the Board of Directors of ESMA, Deputy-Chairman of the IOSCO Technical Committee and member of the Supervisory Board of the IFRS Foundation. He joined the Banco de España in 1991, where he held several positions at the Monetary and Financial Studies Department.

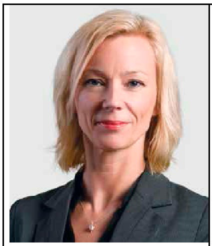
Bojan Markovic, *Lead Economist, EBRD*

Bojan Markovic is Lead Economist at the European Bank for Reconstruction and Development. He holds Ph.D. and M.Sc. in Economics from the University of Birmingham (UK), and B.Sc. from the Belgrade Faculty of Economics. Mr Markovic began his central banking career in 2000 at the Bank of England (London), working on monetary analysis and financial stability. He was in charge of the official model for forecasting U.K. inflation. In 2008, he moved to Goldman Sachs, where he was an executive director in private wealth management, focusing on investment strategies for exchange rates, short- and long-run interest rates, and equities, mainly in G10 countries. From 2009 to September 2012 he was the Vice Governor of the National Bank of Serbia in charge of monetary policy, financial markets and payment systems. Until November 2013, he was visiting scholar in the IMF, and external expert on several IMF missions. He is also an Honorary Senior Visiting Fellow at the Cass Business School (London) and the University of Birmingham.

<table>
<tr>
<td></td>
<td>Erik Jones, Professor, The Johns Hopkins University

Erik Jones is Director of European and Eurasian Studies and Director of the Bologna Institute for Policy Research at the Johns Hopkins University School of Advanced International Studies (SAIS). He is also Senior Research Fellow at Nuffield College, Oxford. Professor Jones writes on topics in international and comparative political economy with a focus on Europe and the transatlantic relationship. His commentary has been published in newspapers and magazines across Europe and North America; he has written four books, edited more than twenty collections, and contributed to numerous journals. His most recent volumes are Weary Policeman: American Power in the Age of Austerity (2012), The Oxford Handbook on the European Union (2012), The Year the European Crisis Ended (2014), and, forthcoming The Oxford Handbook on Italian Politics. Professor Jones has won prizes for excellence in teaching at both the University of Nottingham and the Central European University.</td>
</tr>
<tr>
<td></td>
<td>Gaston Reinesch, Governor, Banque centrale du Luxembourg

Gaston Reinesch is Governor of the Banque centrale du Luxembourg and a member of the European Central Bank’s Governing Council since January 1, 2013. Prior to taking up these responsibilities, he was Director General at Luxembourg’s Ministry of Finance. In this capacity, he was involved with economic, financial and tax policy. He was also Chairman of the Luxembourg Credit and Investment Bank, Vice-President of the Board of the Luxembourg State and Savingsbank until 2008, and from 2009 to 2012 Chairman of BGL BNP Paribas in which the government had to take a participation in the context of the financial crisis. He was Member of the Board of the European Investment Bank and also represented the Luxembourg Government on the boards of various public and private companies in fields such as telecommunications and satellite services. Mr. Reinesch also is a Visiting Professor at the University of Luxembourg.</td>
</tr>
</table>



Karolina Ekholm, *Deputy Governor, Sveriges Riksbank*

Karolina Ekholm is Deputy Governor of Sveriges Riksbank. She is on leave from a professor position that she took up in 2006 at the Department of Economics at Stockholm University. Her research has dealt primarily with international trade and investment. In 1995 she obtained a PhD in economics from the Department of Economics at Lund University. Between 1996 and 2000, she was a researcher at the Research Institute of Industrial Economics. From 2000 to 2006, she was first assistant then associate professor at the Department of Economics at Stockholm School of Economics. She has been a member of the Swedish Economic Council between 2001 and 2007, and a member of the Swedish Fiscal Policy Council between 2007 and 2009. In 2004-2009, she was external research director at the Center for Business and Policy Studies in Stockholm. She is an affiliate of the Center for Economic Policy Research in London and of CESifo in Munich.

Cristian Popa*, Deputy Governor, National Bank of Romania*

Cristian Popa (b. 1964) is Deputy Governor and Board member of the National Bank of Romania (NBR). He coordinates monetary policy, research, econometric modeling/forecasting, EU affairs and international relations, and financial stability. He additionally heads the inflation targeting taskforce and coordinates NBR participation in Romania's sovereign dialogue with ratings agencies and investment banks. Dr. Popa serves as World Bank Alternate Governor for Romania, as member of the ECB International Relations Committee and of the Economic and Financial Committee, as well as alternate member of the ECB General Council. Dr. Popa joined the NBR in 1998, as Senior Advisor to the Governor/Chief Economist. He previously worked in research (between 1991–98, he was Senior Research Fellow with the Institute of National Economy in Bucharest) and government (in 1993–94, Governmental Advisor to the Deputy Prime Minister in charge of Economic Reform; also, Director of Macroeconomic Policy Coordination within the Department of Economic Reform). Dr. Popa has been Fulbright fellow with Harvard University (1994–95), ACE-PHARE visiting fellow with the NIESR (London, 1997), and visiting scholar with the University of Michigan (Ann Arbor, MI, 1997). He completed two previous mandates as NBR Deputy Governor (1998–2004, 2004–09).

Dubravko Mihaljek, *Head of Macroeconomic Analysis, BIS*

Dubravko Mihaljek is Head of Macroeconomic Analysis in the Monetaryand Economic Department of the Bankfor International Settlements (BIS) in Basel. In this capacity he analyses global macroeconomic and financial market developments and international monetary policy issues; drafts background notes for the Global Economy Meetings of central bank Governors; and serves as the Secretary to the Group of Governors from Small Open Economies. Before joining the BIS in 1999, Dubravko was Economist and Senior Economist in Fiscal Affairs, European and Asian Departments of the IMF in Washington DC (1990–99). He started his professional career as Assistant Researcher in the Economics Institute, Zagreb (1982–89). Studied economics at the University of Pittsburgh (PhD, 1990); University of Minnesota (MA, 1986); and University of Zagreb (Dipl oec, 1981). Published empirical and policy-oriented papers on capital flows, international banking, housing markets, the Balassa-Samuelson effect, fiscal policy, transition economies and health care financing.

Daniel Hardy, *Monetary and Capital Markets Department, IMF*

Daniel C. Hardy is currently an Advisor in the Monetary and Capital Market Department of the International Monetary Fund. During his career he has worked on macroeconomic and financial sector surveillance; Fund-supported programs; and technical assistance in a wide range of industrialized, emerging-market, and developing countries— including many in Central Europe. Recently, he spent two years on leave from the IMF working at the Austrian Financial Market Authority. He has undertaken research on such topics as cross-border policy coordination, credit market behavior, and stress testing. He studied at the universities of Oxford and Princeton.

XI. References

Albuquerque B. et al., 2014, "Has U.S. Household Deleveraging Ended? A Model-Based Estimate of Equilibrium Debt," ECB Working Paper Series 1643.

Ayuso, J., 2013, "An Analysis of the Situation of Lending in Spain," Economic Bulletin, October 2013, Banco de España.

Banco de México (Banxico), 2014, "Evolución del Financiamiento a las Empresas Durante el Trimestre Abril-Junio 2014," Mexico City, August 2014.

Beck, T., Martínez Peria, M., 2008, "Foreign Bank Participation and Outreach: Evidence from Mexico," Journal of Financial Intermediation, El Sevier.

Bénassy-Quéré A, P.O. Gourinchas, P. Martin and G. Plantin, 2014, "L'euro dans la 'guerre des monnaies,'" Note du CAE no. 11.

Bank for International Settlement, 2014, "Global Foreign Exchange Market Turnover in 2013," Triennial Central Bank Survey, Monetary and Economic Department, Basel, February 2014.

Buttiglione, Luigi, Philip R. Lane, Lucrezia Reichlin, and Vincent Reinhart, 2014, "Deleveraging? What Deleveraging?" Geneva Reports on the World Economy, 16 (London: CEPR and Geneva: ICMB).

Calvo, G., F. Coricelli and P. Ottonello, 2013, "Jobless Recoveries During Financial Crises: Is Inflation the Way Out?" in Bauducco, S., L. Christiano and C. Raddatz (eds.). Macroeconomic and Financial Stability: Challenges for Monetary Policy, Central Bank of Chile.

Calvo, G.A., A. Izquierdo and E. Talvi, 2006, "Sudden Stops and Phoenix Miracles in Emerging Markets," American Economic Review, Vol. 96(2), p. 405–10, May.

Cerra, V. and S. C. Saxena, 2008, "Growth Dynamics: The Myth of Economic Recovery," American Economic Review, Vol. 98(1), p. 439–57, March.

Chiquiar, D.; A. Noriega and M. Ramos Francia, 2007, "A Time Series Approach to Test a Change in Inflation Persistence: The Mexican Experience," Banco de México Working Paper Series 2007–01, Mexico City.

Coricelli, F. and I. Roland, 2011, "How do Credit Conditions Shape Economic Recoveries?" CEPR Discussion Papers 8325.

Eichengreen, B.; R. Hausmann, U., Panizza, 2002, “Original Sin: The Pain, the Mystery, and the Road to Redemption,” paper presented at a conference on Currency and Maturity Matchmaking: Redeeming Debt from Original Sin, Inter-American Development Bank, Washington, D.C.

International Monetary Fund, 2014, Baltic Cluster Report, IMF Country Report No. 14/117 (Washington D.C.: International Monetary Fund).

IMF, 2014, World Economic Outlook, April (Washington: International Monetary Fund).

Oliveira Santos, André and Douglas Elliott, “Estimating the Costs of Financial Regulation,” IMF Staff Discussion Note SDN/12/11, September 11, 2012.

Ortiz, G., 2014, “Managing Financial Crisis,” Per Jacobsson Lecture, Basel, Switzerland.

Reinhart, R., Rogoff, K, 2009, “The Aftermath of Financial Crises,” NBER Working Paper No. 14656, National Bureau of Economic Research.

Stiglitz, J., 2005, “Finance for Development,” In: Ayogu, M., Ross, D. (Eds.), “Development Dilemmas: The Methods and Political Ethics of Growth Policy,” Routledge, Taylor & Francis Inc.

Vienna Initiative, “Working Group on the European Banking Union and Emerging Europe April 30, 2014.