

82nd East Jour Fixe: Debt in Central, Eastern and Southeastern Europe: vulnerabilities and opportunities¹

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The 82nd East Jour Fixe organized by the Oesterreichische Nationalbank (OeNB) focused on recent developments, opportunities and challenges related to both public and private sector debt in Central, Eastern and Southeastern Europe (CESEE). The event took place on June 11, 2018, at the OeNB's premises. The speakers, who came from diverse academic, political and professional backgrounds, presented insights from their expertise to a selected audience. Notably, for the first time since the establishment of the East Jour Fixe in 1991, female presenters outnumbered male ones.

In her introductory statement, *Doris Ritzberger-Grünwald*, Director of the OeNB's Economic Analysis and Research Department, highlighted that external and internal vulnerabilities had increased in most CESEE countries during the economic boom preceding the global financial crisis. This was in particular due to high credit growth and foreign currency lending. However, on a more positive note, she also pointed out that as a distinctive component of the region's growth model, credit growth had, implicitly, also been furthering convergence. After a rather controlled deleveraging process right after the onset of the global financial crisis, total debt has recently been on the increase again (with the upsurge in private debt stronger than that in public debt). Public debt has been on the rise since 2008 already, with some countries posting an increase of nearly 30 percentage points of GDP at year-end 2017. Therefore, a potential contraction of fiscal space could weaken the scope for public investments and would provide less of a cushioning effect in case of vulnerabilities due to private sector debt, among others. Moreover, although debt levels in CESEE are still below those seen in the euro area countries, the fact that, to a varying extent, private sector credit growth in the CESEE countries has rebounded in recent years raises questions regarding the drivers of private debt, its sustainability (also with regard to potential spillovers arising from the "normalization" of monetary policy in major advanced economies) and its "wise" (i.e. productivity-enhancing) use in the corporate sector.

The keynote speech was given by *Laura Papi*, Assistant Director of the IMF's European Department. After providing an overview of debt developments in CESEE in the wake of the crisis and putting them into regional perspective, Papi noted that the timing of the East Jour Fixe was very opportune as policy makers are now able to tackle issues concerning debt in a more sustainable manner in contrast to implementing crisis-related ad-hoc measures. She pointed out that there is no consensus among academics and policy makers on how high debt levels have to be for them to be considered detrimental but stressed that a granular approach, i.e. paying attention to the underlying dynamics and composition, is of utmost importance. Using data from the newly released IMF Global Debt Database, Papi showed that external debt in CESEE is elevated compared to peer countries. At the same time, private sector debt is rising faster than public sector debt in CESEE. In particular, household sectors are leading a new spike; in contrast, a robust

¹ The presentations and the workshop program are available at www.oenb.at/en/Monetary-Policy/Research/workshops.html.

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recovery of corporate lending is mainly prevented by institutional and structural gaps in the majority of CESEE countries.

The event then focused on individual sectors in turn, with session 1, chaired by *Doris Ritzberger-Grünwald*, zoning in on the structure and sustainability of public debt in CESEE as well as on the role of fiscal rules. *Stéphanie Pamies Sumner*, Head of Sector in the European Commission's Directorate-General for Economic and Financial Affairs, introduced the Commission's framework for assessing public debt sustainability. She emphasized that, on average, public debt burdens appear to be more contained in the 11 CESEE EU Member States (CESEE-11) than in the EU as a whole, but also pointed to considerable cross-country heterogeneity. Government debt-to-GDP ratios in the CESEE-11 are still lower and the overall increase since 2007 has been smaller compared to the EU aggregate. However, a few CESEE-11 countries, i.e. Croatia, Latvia and Slovenia, have experienced particularly large increases in their government debt-to-GDP ratios. To ensure fiscal sustainability, Pamies Sumner recommended rebuilding fiscal buffers in high-debt countries, improving fiscal frameworks, reforming the pension and health care system, making taxation and expenditure more efficient, improving tax rules and administration, strengthening the supervision of the financial sector, and pursuing efforts to reduce nonperforming loans (NPLs). The second speaker in this session, *Markus Eller*, Principal Economist in the OeNB's Foreign Research Division, examined the composition of government debt in a broad set of CESEE countries. He showed that the increase in government debt levels in CESEE following the financial crisis, together with foreign portfolio investors (usually with a short-term orientation) playing a more prominent role, has accentuated refinancing risks. However, at the same time, refinancing risk has also been alleviated as governments have been increasingly able to issue longer-term debt instruments. In a few countries, a still large share of foreign currency-denominated public debt, in combination with increased debt stocks, reveals serious exposure to exchange rate risks. With respect to policy implications, Eller stressed that special emphasis should be placed on fostering CESEE capital markets to strengthen government borrowing at home and in local currencies as well as to further develop derivative products in order to hedge against interest and exchange rate risks.

Session 2, chaired by *Julia Wörz*, Head of the CESEE Analysis Unit of the OeNB's Foreign Research Division, put a spotlight on the composition and drivers of private debt in CESEE. In his presentation, *Miquel Dijkman*, Coordinator at the World Bank Financial Sector Advisory Center, took a closer look at the debt of nonfinancial corporations. He underscored paying attention to company size and institutional gaps, in particular (the lack of) bankruptcy legislation, as a means of gaining a better understanding of current debt developments. Dijkman outlined that large corporations account for the lion's share of nonfinancial corporate credit and NPLs, while small and medium-sized enterprises (SMEs) often have difficulty fulfilling collateral requirements and as a result struggle to obtain loans. At the same time, entrepreneurs are facing real finance constraints, particularly in less established sectors of the economy. Dijkman highlighted the importance of strengthening insolvency frameworks, reinforcing the functioning of the judiciary as well as creating alternatives to formal court-based insolvency proceedings (e.g. out-of-court restructuring) for unlocking the growth potential of the economy. In her presentation, *Mariya Hake*, Senior Economist in the OeNB's Foreign

Research Division, linked the analysis of income inequality and household credit in a sample of ten CESEE countries. Based on data from the OeNB's Euro Survey, Hake presented a paper showing new estimates of income inequality at the regional level, which she related to the likelihood of household debt for the period 2009–2015. The results indicate that after 2009, it was predominantly households with above median incomes that had taken out a loan, with this likelihood increasing with more pronounced regional income inequality (i.e. consumption smoothing). Consequently, banks use income inequality as an additional factor when evaluating borrowers' creditworthiness (i.e. signaling effect).

The third session, chaired by *Helene Schuberth*, Head of the OeNB's Foreign Research Division, dealt with the role of institutional arrangements, and especially the "normalization" of monetary policy. *Marek Ličák*, Director of Macropprudential Supervision, Národná banka Slovenska (NBS), gave an overview of the developments in the housing loan segment in Slovakia and the response of the NBS. The current high credit growth rates and increased household debt in Slovakia – already above levels suggested by fundamentals – are being addressed exclusively with macropprudential tools. In particular, the NBS aims to reduce the speed of credit growth by encouraging responsible lending requirements, and to increase the resilience of the banking sector by instituting higher capital buffers. Ličák reported that there is tentative evidence that the measures implemented since 2014 are showing some positive effects, and the NBS expects that a new package of measures, adopted recently, will reduce the annual growth in loans to households to 8%–9%. The implications of monetary policy normalization for debt developments in CESEE were discussed by *Birgit Niessner*, Head of Analysis Financial Institutions & Countries at Raiffeisen Bank International AG. She stressed that corporate debt levels should receive more attention as they are the likeliest source of the next debt crisis. In addition, several countries (e.g. Croatia, Russia, Turkey) are already showing large corporate balance sheet mismatches between foreign assets and liabilities. She outlined that several factors mitigate the vulnerability of CESEE resulting from the normalization of monetary policy. These include the high share of euro-denominated debt, strong and resilient foreign direct investment (FDI) flows and intercompany loans, and good reserves coverage of external debt refinancing. Niessner added that CESEE was more resilient than some other emerging market regions, given the fact that it has not been the main destination for "hot money." The third presentation was given by *Belma Čolaković*, Chief Economist, Central Bank of Bosnia and Herzegovina, on the impact of EU institutional arrangements on debt developments in the Western Balkans. Čolaković specifically referred to Article 114 of the CRR/CRD IV, according to which subsidiaries of EU banks must apply a 100% risk weight to exposures to non-EU sovereigns and central banks. She pointed out that, in particular, Western Balkan countries with a high share of government debt held by subsidiaries of EU banks could be affected by this regulation. Čolaković also illustrated that the average household in the region is not in a position to save, with the recent increases in deposit levels largely driven by the wealthiest individuals.

Wrapping up the event, *Tina Zumer*, Senior Economist in the Euro Area External Sector & Euro Adoption Division of the European Central Bank, concluded that private sector debt in CESEE should be seen as an opportunity for long-term growth despite a likely negative impact in the medium term. She stressed that

higher public debt, in contrast, would be rather detrimental to economic growth. Zumer emphasized that despite the still low debt levels (in comparison to the EU average), the resulting vulnerabilities are likely to increase risks. On the one hand, this would be due to monetary policy normalization and the resulting likely deterioration of debt-servicing capacities. On the other hand, heightened global uncertainty would lead to higher costs as well as liquidity and refinancing risks. Summing up, Zumer underlined the need for country-specific assessments as well as (structural) policy measures to ensure fiscal sustainability, a resilient and supportive institutional framework and a targeted implementation of the preventive arm through macro- and microprudential measures.