Bank Intermediation in Southeastern Europe: Depth and Structure

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This short study examines similarities and differences in the depth and structure of bank intermediation in Southeastern European (SEE) countries. In the process, we also analyze to what extent the patterns of bank intermediation in SEE countries are already similar to those observed in the new EU Member States of Central and Eastern Europe. Overall, it turns out that the depth, structure and quality of bank intermediation has advanced considerably in all SEE countries. At the same time, the development in the individual SEE countries is far from uniform. In some countries, bank intermediation is already similar to, or approaching the levels observed in, the new Member States, while in others, it is at an earlier stage, notwithstanding major progress in recent years.

1 Introduction

In recent years, financial intermediation by banks has changed rapidly and substantially in Central and Eastern Europe (CEE), in terms of both depth and structure. This study examines to what extent this transformation of bank intermediation has already spread beyond these new EU Member States to the acceding, candidate and potential candidate countries of Southeastern Europe (SEE). The study focuses on Bulgaria and Romania (EU acceding countries), Croatia and the Republic of Macedonia (EU candidate countries) as well as Albania, Bosnia and Herzegovina, and Serbia (potential EU candidate countries).[2] The present analysis focuses on developments in the first half of the current decade (2000–2001 to 2005). As for the general lines of banking sector transformation, we chose a somewhat longer time frame, starting from the 1990s, so as to put developments into perspective.[3]

This article is structured as follows. Section 2 sketches the stylized features of bank intermediation in the new EU Member States of Central and Eastern Europe (CEE-8). This group of countries thus serves as a benchmark against which developments in SEE countries are assessed. Section 3 examines banking sector transformation and changes in the depth and structure of bank intermediation in Southeastern Europe. Our analysis is based on a set of key structural and prudential indicators as well as on banking sector asset and liability data. The quality of supervision and regulation is indirectly covered by our presentation of transition indicators created by the European Bank for Reconstruction and Development (EBRD). We also make selective references to stress testing, depending on the accessibility of up-to-date information. However, we do not examine market-based data, such as stock prices or credit

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[2] *The authors take note of the recent separation of Serbia and Montenegro into two independent states. This study draws on statistical data published by Narodna banka Srbije which refer to banks operating in Serbia. Montenegro is not covered separately, as it was not yet independent during the period under review. Turkey is not covered, as this study focuses on countries that have undergone a transition process from a planned to a market economy (for a recent study on banking sectors that includes Turkey, see Backé, Reininger and Walko, 2006).*

[3] *There are only very few studies on bank intermediation which cover the whole SEE region and include, in particular, also the potential candidate countries. A notable exception is Bruckbauer, Perrin and Gardo (2005).*

ratings, as this would go beyond the scope of our analysis. The main findings are summarized in section 4.

One of our main aims is to keep the analysis short and concise. To achieve this aim, we mostly follow a cross-country (horizontal) approach that is synthesized, intentionally selective and, at times, generic. For example, when sketching the macroeconomic setting in which SEE banks operate, we restrict ourselves to a few pointers and stylized facts. However, there is no rule without an exception: The analysis of banking sector balance sheets is at the very core of our topic, and thus we explore it in greater detail than the other aspects. This focus is underlined by our presentation of both country-by-country and cross-country data for that particular part of the analysis.

2 General Stylized Features of Bank Intermediation in the CEE-8

The literature on bank intermediation in Central and Eastern Europe has grown fast in recent years.[4] As for the new EU Member States, this literature conveys the following stylized facts: Financial sectors in the CEE-8 countries have remained predominantly bank-based, despite the development of nonbank financial intermediaries (mainly insurance companies, investment funds and leasing companies) in recent years. Banking sectors in the new Member States have undergone a comprehensive transformation process that included wide-ranging reforms of regulatory frameworks and supervisory arrangements, bank consolidation schemes and – in almost all countries – sweeping privatization, mainly to foreign strategic owners (mostly financial institutions based in "old" EU Member States). In the new CEE Member States, this process took place mostly in the second half of the 1990s, while in a few countries it stretched into the early 2000s. Bank governance has improved substantially, and banking sector performance and soundness have advanced considerably, too.[5]

A standard summary indicator for the transformation of the banking sector is the EBRD transition indicator on "banking reform and interest rate liberalization," which captures mostly the quality of regulation and supervision as well as ownership structures, but also private sector access to finance. This indicator can take values between 1 and 4+, with the value 1 representing little progress in transition, and a value of 4+ meaning full convergence with the standards and performance typical of advanced industrial economies (the indicated scores refer to the state of affairs in fall 2005).[6] Reflecting the thorough overhaul of banking sectors, the new Member States score high on this indicator (4– to 4, close to the top value of 4+). Only Slovenia is an exception, scoring 3+, which is presumably attributable mainly to the slow progress on privatization of the Slovenian banking system.

[4] *See e.g. ECB (2005a and 2005b); Coricelli, Mucci and Revoltella (2006); Hilbers, Otker-Robe and Pazarbaşıoğlu (2006); Backé and Zumer (2005); Barisitz (2005a); Bruckbauer et al. (2004); IMF (2005, 2006a).*

[5] *Some standard prudential indicators for the CEE-8 countries are reported in section 3.*

[6] *The EBRD transition indicators reflect the judgment of the EBRD's Office of the Chief Economist about country-specific transition progress and capture progress in key transition areas; "banking reforms and interest rate liberalization" is one of these areas. For a more detailed account, see EBRD (2005).*

Banking sector transformation has been an important element in the overall transition process, which encompasses macroeconomic stabilization, institution-building, structural reforms and the creation of new regulatory frameworks in all major policy areas. EU membership (and, before that, the prospect thereof) has been a key anchor for implementing this far-reaching agenda of systemic change. Successful transition has led to robust output growth, improved growth expectations, low or moderate inflation and – more recently – improved labor market conditions.

In the Central European Member States, in particular in the Czech Republic, Hungary, Poland and Slovenia, GDP growth has been broadly balanced in recent years, with sizeable contributions from both domestic and external demand, while in the Baltic countries, GDP growth has been mainly driven by domestic demand (both private consumption and fixed capital formation). In most CEE-8 countries, residential investment has been booming; aggregate domestic demand growth has been supported by a fast expansion of domestic lending by banks and most recently also by nonbank financial institutions. Credit growth to the private sector has been quite pronounced, with particularly high growth rates registered for credit to households (most notably mortgage loans). By contrast, credit to the public sector has remained steady or has even fallen. This fast credit growth in the new Member States set in at different points in time: While it started in the late 1990s in Estonia, Hungary, Latvia and Slovenia, it began in late 2001 in Lithuania and in 2004–2005 in the Czech Republic and Slovakia. Only in Poland have developments taken a somewhat different course: After experiencing a credit boom in the late 1990s that continued until 2000–2001, aggregate private sector credit growth has been rather anemic, as credit to the corporate sector has declined, while credit to households has (increasingly) picked up.

In the early stages of credit expansion, credit growth was typically financed domestically, i.e. by private sector (especially household) deposits, which increased dynamically as confidence in the banking sector reforms strengthened and real incomes grew. In the later stages, credit expansion was increasingly financed from abroad. As a consequence, banking sectors in most countries shifted from a net foreign asset to a net foreign liability position, which has become fairly large in some cases. Concomitantly, non-FDI capital inflows (often provided by foreign parent banks) have increased, complementing typically sizeable FDI inflows. In addition, the lending booms have often been associated with widening external imbalances, in particular in the Baltic countries and in Hungary. At the same time, the lending boom has bolstered banking sector profitability despite falling interest rates and narrowing interest rate margins, while banking sector stability indicators have so far remained broadly satisfactory or good.

3 Banking Sectors and Bank Intermediation in Southeastern Europe

3.1 Banking Sector Transformation

Where do the banking sectors in Southeastern Europe stand compared with the CEE-8? As the EBRD transition indicator on "banking reform and interest rate liberalization" shows, SEE countries have also advanced substantially in terms of overall banking system transformation. However, in some countries there is certainly still some scope for further improvements of regulation, supervision, ownership transformation and access to finance. More specifically, Croatia and Bulgaria (with a 2006 score of 4 and 4–, respectively) are essentially at par with the CEE-8 countries in terms of overall banking sector reforms, while Romania (with a score of 3) lags behind somewhat. Given the ongoing progress of bank privatization in Romania, however, the country's 2007 score is presumably in for an upgrade.

Table 1

EBRD Transition Indicator on Banking Reform and Interest Rate Liberalization (1989–2006)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	1	1	1	2–	2	2	2	2	3–	3–	3–	3	3	3+	3+	4–	4–	4–
Romania	1	1	1	1	1	2	3	3	3–	2+	3–	3–	3–	3–	3–	3	3	3
Croatia	1	1	1	1	2	3–	3–	3–	3–	3–	3	3+	3+	4–	4–	4	4	4
Republic of Macedonia	1	1	1	1	1+	2	3–	3–	3–	3–	3–	3–	3–	3–	3–	3–	3–	3–
Albania	1	1	1	1	1+	2	2	2	2	2	2	2+	2+	2+	2+	3–	3–	3–
Bosnia and Herzegovina	1	1	1	1	1	1	1	1	1	2+	2+	2+	2+	2+	2+	3–	3–	3–
Serbia and Montenegro	1	1	1	1	1	1	1	1	1	1	1	1	1	2+	2+	2+	3–	3–
CEE-8 (range)	1	1 to 2	1 to 2	1 to 3	2 to 3	2 to 3	3– to 3	3– to 3	3– to 4	3– to 4	3– to 4	3 to 4	3 to 4	3 to 4	3+ to 4	3+ to 4	3+ to 4	3+ to 4

Source: EBRD.
Note: For more details on this indicator and the values it can take see section 2.

The other SEE countries covered in this study – the Republic of Macedonia, Albania, Bosnia and Herzegovina, and Serbia – recorded a score of 3– in 2006. Interestingly, though, the Republic of Macedonia had reached this score already by 1995, while the other countries did so only in 2004 and 2005, respectively. To put the current state into perspective, it is instructive to adopt an intertemporal perspective: Back in the mid-1990s, the CEE-8 countries recorded EBRD transition scores of 3 (Slovakia: 3–) on "banking reform and interest rate liberalization." Thus, it took them between four and twelve years to move up to scores of 4– and 4. For Bulgaria and Croatia, in turn, it took seven to eight years to move from 3– (the current score for the Republic of Macedonia, Albania, Bosnia and Herzegovina, and Serbia) to 4–.[7]

A closer look at ownership transformation in SEE banking sectors on the basis of EBRD data suggests that the basic pattern observed in almost all new Member States, namely privatization of large parts of the sectors to financial institutions, is also very characteristic of the SEE countries. In terms of time lines, we find that Croatia had privatized its banks by 2000, while privatization in Bulgaria took place mostly in the early 2000s and in Romania toward the middle of the current decade. In Albania, banking sectors had been privatized by 2004 and in Bosnia and Herzegovina by 2002, while privatization is advanced but still not fully completed in Serbia (which posted a state ownership share of 24% in 2005). The ownership figures for the Republic of Macedonia have shown a very low share of state ownership since the 1990s, which seems to be

[7] *The indicated time spans relate to the number of years between the first year in which a country recorded the lower score and the first year in which the country recorded the higher score.*

attributable to the fact that socially owned banks were counted as nonstate banks.

As in the new Member States, banking sector transformation is a key element in the overall transition process of the SEE economies. This process has yielded fairly strong output growth in recent years that was mainly driven by domestic demand (both private consumption and fixed capital formation) and accompanied by external imbalances in most countries. Moreover, significant success has been achieved in disinflation across the region and in most countries also with respect to fiscal consolidation. The prospect of EU membership has strongly anchored the transition process in the acceding countries (Bulgaria and Romania). While the perspective of EU accession is still an incentive for the candidate countries (Croatia, Republic of Macedonia) and in the longer run also for the potential candidate countries (Albania, Bosnia and Herzegovina, Serbia, and now also Montenegro), the strength of this anchor certainly hinges on the degree of commitment to further enlargement by the EU.

3.2 Prudential Indicators and the Role of Foreign Currencies

A quick review of standard prudential indicators on capitalization, asset quality and profitability underscores that banking sector transformation in Southeastern Europe has promoted the sectors' soundness.

Chart 1 shows that capital adequacy ratios (CARs) have, in general, fallen somewhat in the first half of this decade, as bank capital rose less quickly than banks' risk-weighted assets. Nevertheless, CARs in the countries under observation remain at double-digit levels; they are higher than the CARs in the CEE-8 and certainly much higher than the Basel minimum threshold of 8%. When putting these figures into perspective, a note of caution is in order. First, if capital is overstated or risk-weighted assets are understated, published CARs may be more favorable than they are in reality.[8] Second, regular stress testing (or at least the publication of stress test results) is not yet fully established in all SEE countries. Up-to-date information on stress tests by the IMF and/or national central banks is available for four SEE countries, namely Albania, Bulgaria, Romania and Serbia; relatively recent but partial information (released in mid-2005) is accessible for Bosnia and Herzegovina.[9] For Bulgaria, the stress tests suggest that the banking system is well placed to absorb adverse shocks in the areas of credit as well as market risk. In the case of Romania, central bank stress tests suggest that the banking system is resilient to the direct impact of interest rate and exchange rate movements, while indirect exposures through loan portfolios are more difficult to assess.[10] The stress tests performed in Albania indicate that the domestic banking sector is resilient to standard credit quality, exchange rate and interest rate shocks. For Serbia,

[8] *Risk-weighted assets may be understated due to inaccurate asset classification or insufficient risk provisioning by individual banks. This risk was explicitly pointed out in the Financial System Stability Assessments (FSSAs) for Serbia (IMF, 2006b) but may also be present to some extent in a few other SEE countries.*

[9] *This paragraph draws from recent Article IV consultations and, in the cases of Albania and Serbia, from recent FSSAs. See IMF (2005, 2006a and 2006b). Another FSSA is currently being completed for Bosnia and Herzegovina, but it has not yet been published.*

[10] *This indirect exposure of banks results from unhedged foreign exchange borrowing by nonbanks, which may become a source of debt servicing difficulties in the case of adverse exchange rate movements.*

the available stress tests suggest that credit risk is the most significant risk for the country's banking system and a credit shock could lead to a material loss of bank capital. Banks also face indirect exposure to credit risk resulting from unhedged foreign exchange borrowing. Interest rate risk, in turn, is found to be rather low. However, the large state banks are vulnerable to a narrowing of interest rate margins. For Bosnia and Herzegovina, the stress tests undertaken in 2005 showed that the resilience of some banks to shocks to credit quality was not high.[11]

Chart 1

Capital Adequacy Ratio

Source: NCBs, ECB.

Note: BG: Bulgaria, HR: Croatia, RO: Romania, CS: Serbia, BA: Bosnia and Herzegovina, AL: Albania, MK: FYR Macedonia; CEE-8 represents the arithmetic average of data for Estonia, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Slovakia and Slovenia.

In most countries of the region, the share of nonperforming loans (NPLs) has fallen in the first half of this decade (see chart 2). Romania and Serbia are exceptions in this respect, with the share in Serbia being much higher than elsewhere in the region.[12] In both countries, the rise in the share of NPLs is attributable to the tightening of classification rules. Albania, Bosnia and Herzegovina, and the Republic of Macedonia have recorded substantial improvements in asset quality, with the latter country still recording a somewhat high NPL share. In the case of Albania and of Bosnia and Herzegovina, the main factor for the improvement of the NPL ratio was the cleaning of banks' balance sheets, while in the Republic of Macedonia changes in the methodology of asset classification also played an important role. In Bulgaria, Croatia, Albania, and Bosnia and Herzegovina, the NPL ratio was comparable with or lower than the average ratio in the CEE-8. At the same time, it should be borne in mind that NPL ratios are a lagging indicator that may be significantly biased downward in periods of credit booms (which cause the denominator of the ratio to rise rapidly, while the numerator increases only with a time lag as

[11] *Public information on stress tests to assess market risk is not yet available for Bosnia and Herzegovina.*
[12] *Note that differences in classification rules across countries render exact comparisons difficult.*

the credit portfolio matures). Similarly, a slowdown in lending activity and/or a deterioration in general macroeconomic conditions may lead to an increase in NPL ratios in the future.

Chart 2

Share of Nonperforming Loans in Total Loans

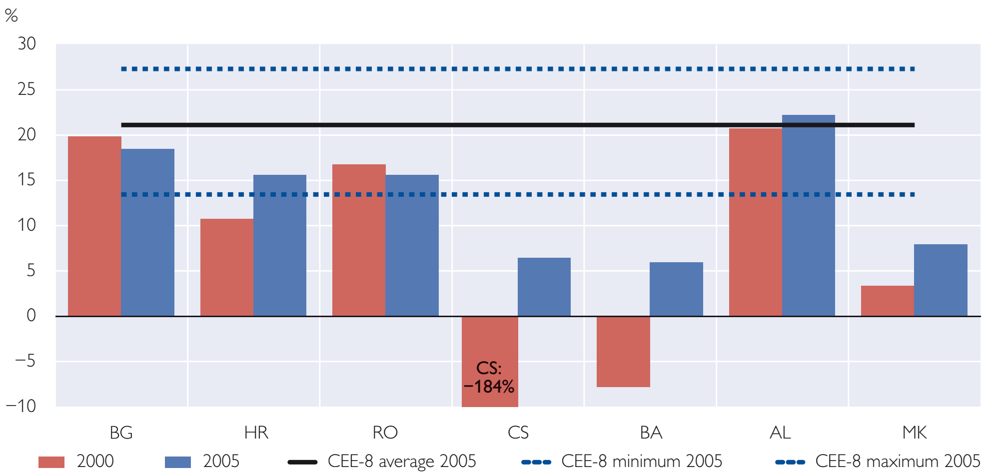
Source: NCBs, IMF, ECB.

Note: Bosnia and Herzegovina: 2001 data instead of 2000 data.

In most SEE countries, bank profitability has improved substantially during the first half of the current decade – see the return on equity (ROE) figures in chart 3. Notwithstanding this improvement, the 2005 ROE levels in all SEE countries except Albania were below the CEE-8 average. While in Bulgaria, Croatia and Romania, ROE was above the minimum level of the CEE-8, profitability in the other three countries (Bosnia and Herzegovina, Serbia and

Chart 3

Return on Equity



Source: NCBs, ECB.

Note: Serbia: Data based on pretax profits.

the Republic of Macedonia) was clearly lower but positive. This variation seems to be in part attributable to differences in asset quality, which means that the cost of risk provisioning weighed heavily on bank profits. Profitability in the SEE countries continues to be supported by relatively large interest rate margins, as suggested by the higher ratio of net interest income to average assets in the SEE region than in the CEE-8 countries. However, this advantage is eroded by higher operating costs (as a percentage of average assets) in the SEE countries, highlighting the need for further efforts to increase efficiency.

An important feature of bank intermediation in Southeastern Europe is the large role of foreign currencies both on banks' asset and liability sides. It goes without saying that this currency substitution involves risks. This is particularly true for foreign currency lending to unhedged borrowers, especially households. As pointed out above, the resulting foreign currency exposure of households and other borrowers increases banks' indirect foreign exchange risk and thus their credit risk. This clearly pertains to countries with flexible exchange rate regimes, while countries with fixed exchange rate arrangements are less exposed as long as such regimes remain credible.

Charts 4 and 5 illustrate the share of foreign currency loans in total loans to the private sector[13] and the share of foreign currency deposits in total deposits to the private sector, respectively. The charts convey that currency substitution in Southeastern Europe has been persistent and in some cases has increased noticeably in recent years (foreign currency loans in Bulgaria, Albania and the Republic of Macedonia; foreign currency deposits in Albania, Serbia and in the Republic of Macedonia). Moreover, currency substitution has on the whole been higher in the SEE countries than in the CEE-8 countries. It is important to know that foreign currency-indexed instruments are in use in some, but not all, of the countries under observation. Such instruments exist in Croatia, Serbia, and Bosnia and Herzegovina, but not in Albania, Bulgaria, the Republic of Macedonia and Romania. In Croatia, Serbia, and Bosnia and Herzegovina, central banks do not publish time series that distinguish between local currency loans and foreign currency-indexed loans (the latter are registered as local currency loans). Thus, the loan data in chart 4 – including the indicated differences across countries and time – need to be interpreted with some caution.[14] On the deposit side, indexation to foreign currencies is generally much less common.[15]

Overall, it turns out that the banking sectors in SEE are (1) well capitalized, but display different degrees of resilience to standard shocks (with results of stress tests being available for most, but not all, SEE countries), (2) profitable, though to different degrees, (3) fairly diverse in terms of asset quality, and (4) characterized by a rather high degree of currency substitution.

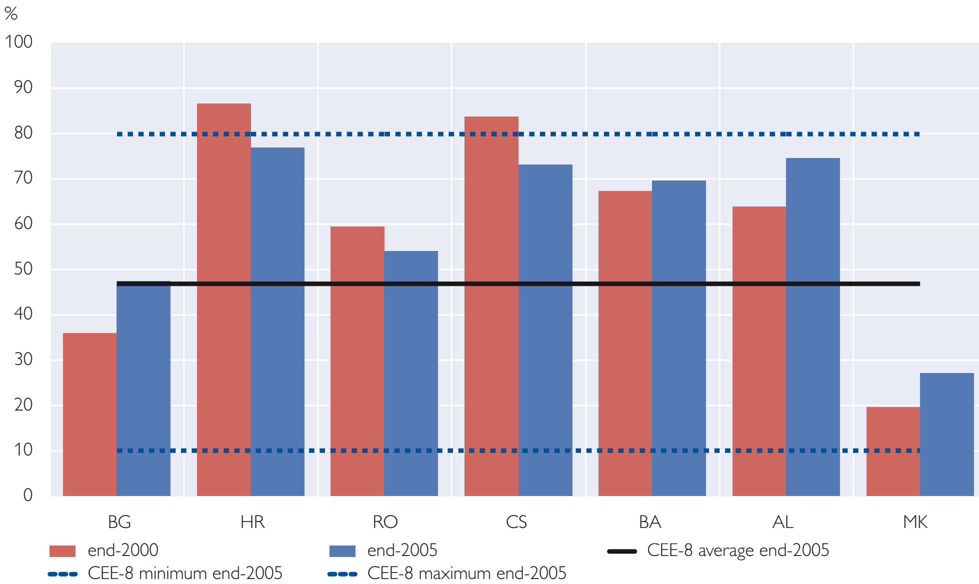
[13] *The private sector is defined here as the nongovernment nonbank sector, i.e. households, nonfinancial corporations and nonbank financial institutions.*

[14] *This caveat is somewhat mitigated, but not fully resolved, when taking into account (as chart 4 does) data on indexed loans which the central banks of Croatia and of Bosnia and Herzegovina have kindly provided and which, for Serbia, were taken from IMF (2006b).*

[15] *For the factors that drive currency substitution and for its implications, see ECB (2006a).*

Chart 4

Share of Foreign Currency Loans in Total Loans to Households and Enterprises

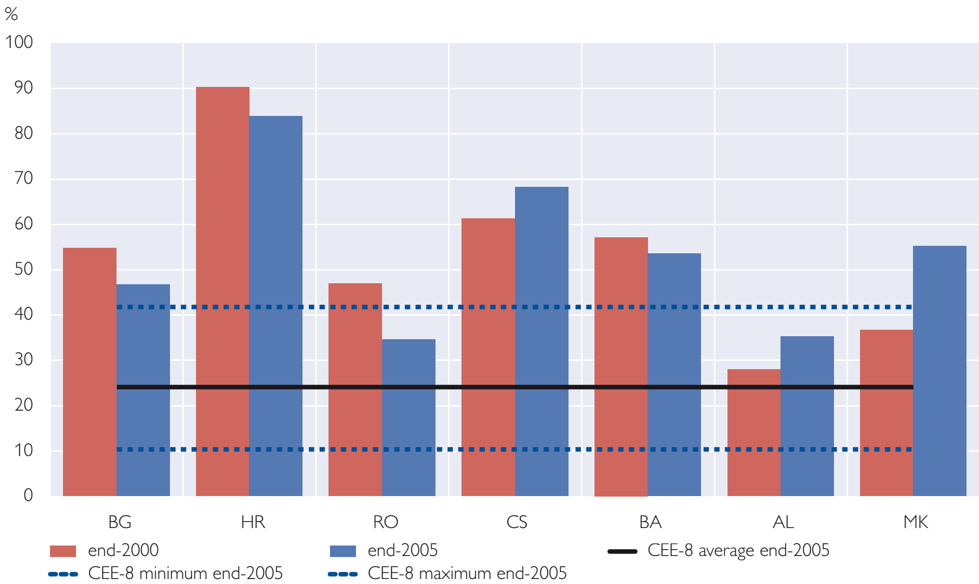


Source: NCBs, IMF, OeNB.

Note: Data including loans indexed to foreign currencies in Croatia. 2005 data for Serbia as at end-September 2005 and including loans indexed to foreign currencies. 2005 data for Bosnia and Herzegovina including loans indexed to foreign currencies to all sectors (as a disaggregation by sectors is not available for indexed loans).

Chart 5

Share of Foreign Currency Deposits in Total Deposits of Households and Enterprises



Source: NCBs.

Note: Data for Croatia including deposits indexed to foreign currencies. 2000 data excluding Hungary and Slovakia.

3.3 Bank Intermediation: Developments in Individual Countries

Over the past few years, bank intermediation, expressed as bank assets in percent of GDP, has advanced in the SEE countries (see chart 6). Still, with the exception of Croatia (which posted around 110% of GDP at end-2005), the degree of intermediation ranges between 40% and 80% of GDP and is thus below the average level observed in the CEE-8 countries (around 93% of GDP). This is not surprising, given that the GDP-per-capita levels (in PPP) in the SEE countries (excluding Croatia) are roughly half of those of the new Member States: There is an empirical regularity that financial depth, e.g. measured by credit-to-GDP levels, increase with rising GDP-per-capita levels.[16]

During the first half of the decade, banking assets in Southeastern Europe have increased steadily and dynamically relative to GDP, in particular in Bulgaria, Croatia, and Bosnia and Herzegovina. In Albania, Serbia and the Republic of Macedonia, this process has been less even, and bank assets started to expand somewhat later (in Macedonia in 2003, in the other two countries in 2004), i.e. after bad loan write-offs had taken effect. A broadly similar picture emerges, if we consider the development of commercial bank credit to households and enterprises (i.e. to households, nonfinancial corporations and nonbank financial institutions) in percent of GDP, as documented in chart 7. It is noteworthy that in this segment already two countries – Croatia and Bosnia and Herzegovina – passed the respective CEE-8 average ratio in 2005.

Chart 6

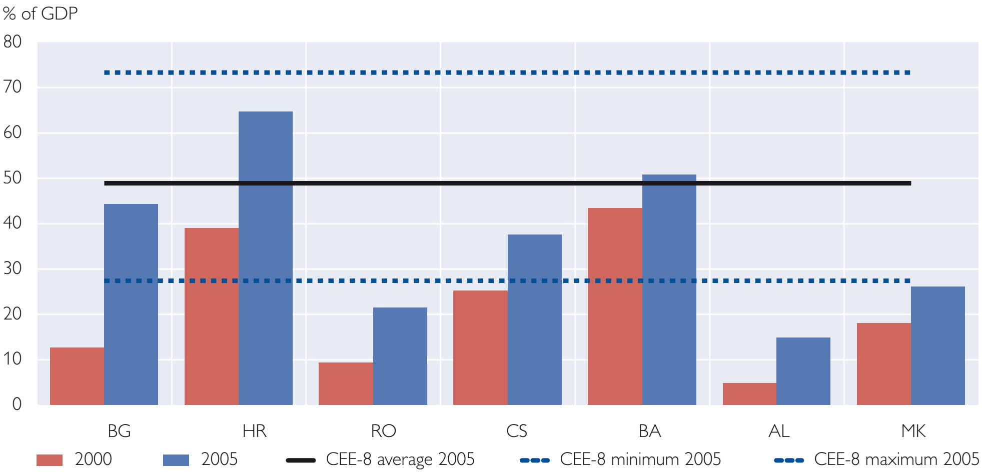
Commercial Bank Assets

Source: NCBs.

[16] *This was first noted by Goldsmith (1969). For recent references, see Backé and Zumer (2005) or Arpa, Reininger and Walko (2005).*

Chart 7

Commercial Bank Credit to Households and Enterprises



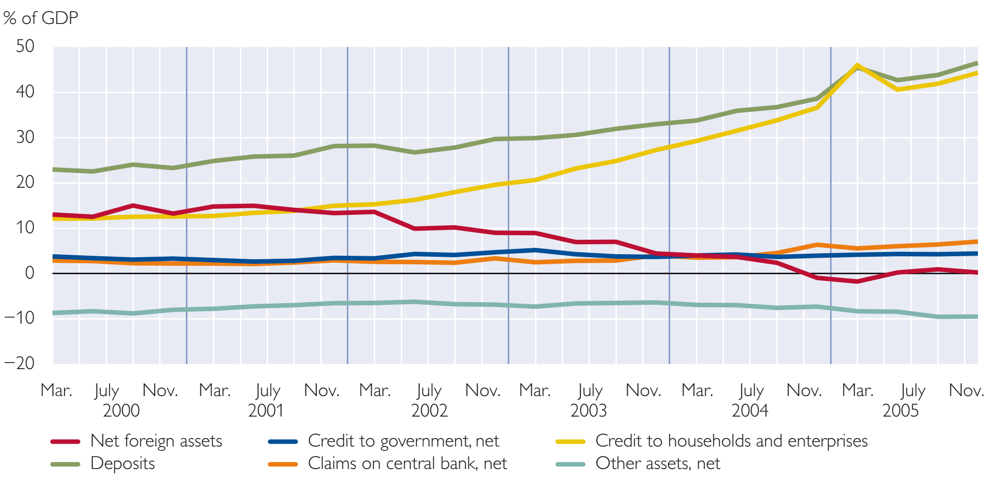
Source: IMF, OeNB.

A more detailed examinatia of the development of the structure of bank assets on a country-by-country basis provides further interesting insights.

The analysis shows that developments in Bulgaria (see chart 8) and Croatia (see chart 9) conform to the stylized pattern drawn in section 2: Following an initial period in which deposit accumulation preceded and then kept pace with credit expansion, private sector credit started to grow increasingly faster than deposits. This phenomenon has been associated with a gradual decrease of net foreign assets in Bulgaria and a gradual increase of net foreign liabilities in Croatia. As regards Bulgaria, the spike in lending and, to a lesser extent, in deposits in March 2005 is noteworthy. It has to be seen in the context of a (preannounced) move by the central bank to introduce quarterly credit growth ceilings and additional mandatory reserves for commercial banks.

Chart 8

Bulgaria: Selected Asset and Liability Positions of Banks

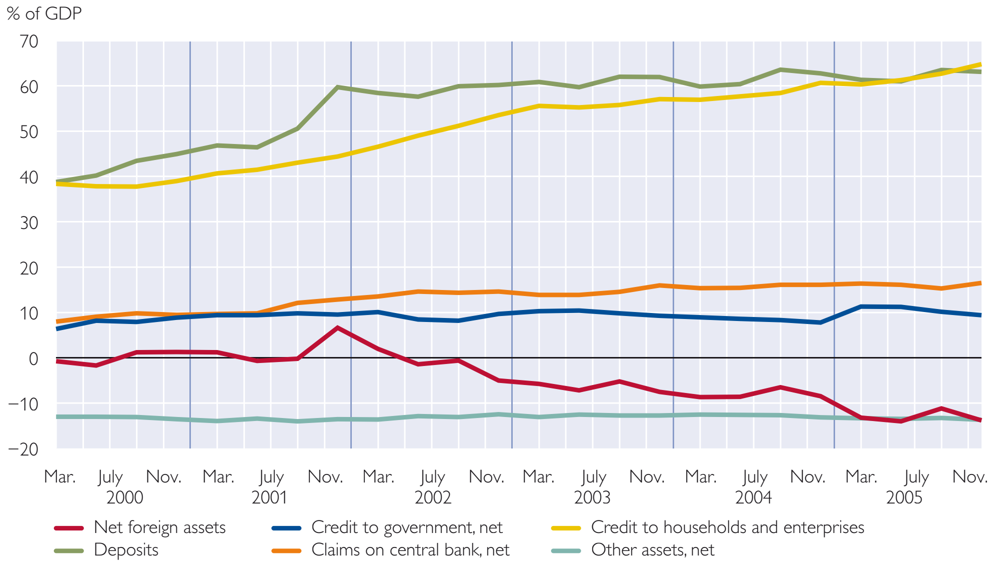


Source: IMF, OeNB.

The new ceilings were to be calculated on the basis of the credit volume outstanding at end-March 2005, which prompted banks to frontload their lending activities so as to achieve a high base. In the case of Croatia, two other interesting aspects can be highlighted: First, deposits soared at the turn of 2001 to 2002 due to the euro cash changeover – a feature that is also observable in most other SEE countries. Second, net claims on the central bank have risen, which apparently reflects central bank measures to contain domestic lending and foreign borrowing by banks (via interest-free deposits that commercial banks have to hold at the central bank when they increase their foreign liabilities).

Chart 9

Croatia: Selected Asset and Liability Positions of Banks



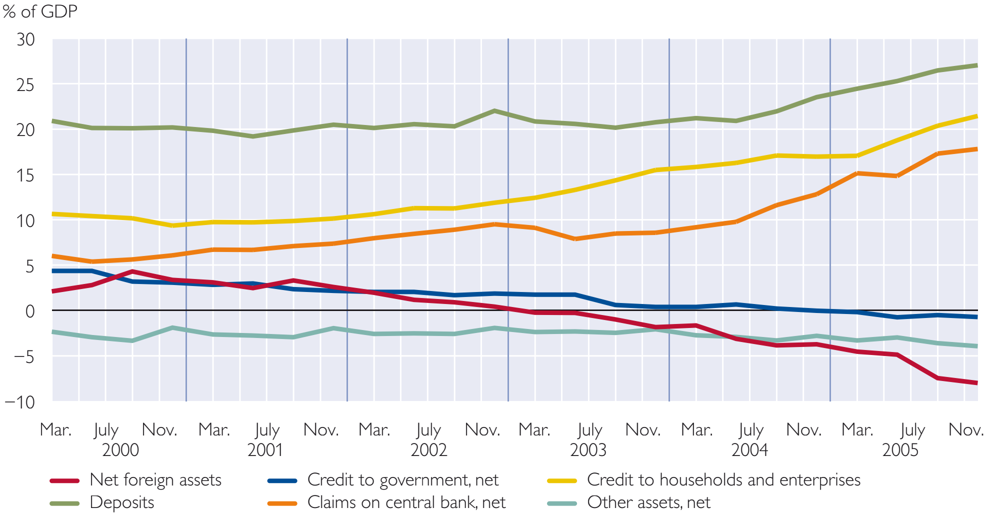
Source: IMF, OeNB.

Developments in Romania (see chart 10) differ to some extent from those in Bulgaria and Croatia. While credit has expanded dynamically, so have deposits. Still, net foreign assets have fallen noticeably, as in many CEE-8 countries. These developments seem to be associated with higher foreign capital inflows, attracted by sizeable interest rate differentials to the euro area. Net claims on the central bank increased considerably owing to substantial interventions by Banca Naţională a României (NBR) to contain exchange rate appreciation (especially before the move to allow more exchange rate flexibility from November 2004 onward) and accompanying sterilization measures, alongside the tightening of reserve requirements by the central bank.[17] To a lesser extent, a reduction in net credit to the government made room for the expansion of credit to the private sector.

[17] *See various recent NBR press releases (www.nbr.ro) as well as Neagu et al. (2006).*

Chart 10

Romania: Selected Asset and Liability Positions of Banks

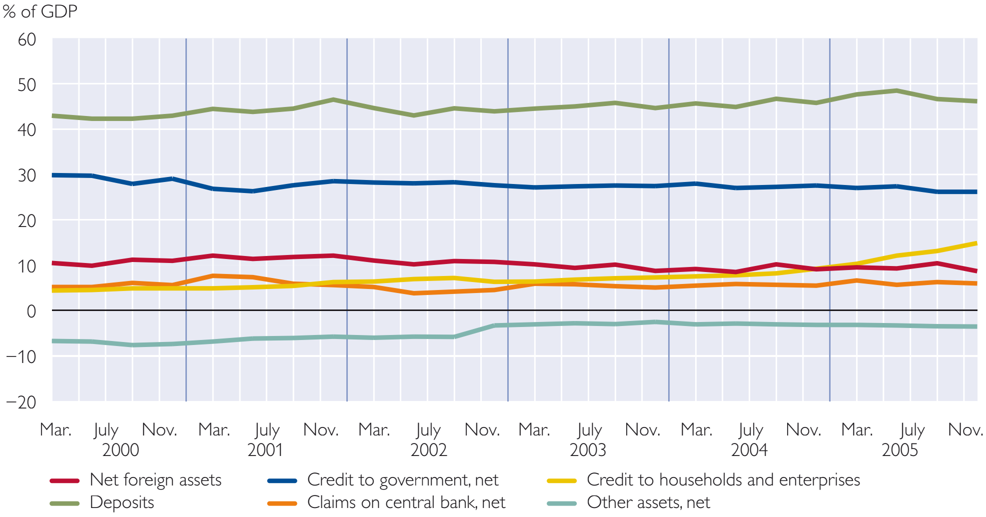


Source: IMF, OeNB.

Albania (see chart 11) is set apart from the other countries, as a large part of bank assets in this country consists of public sector credit. However, the growth of credit to the private sector started to pick up rapidly in 2005 (albeit from very low levels). This development has been financed almost completely by an increase in deposits and some decline in the public sector credit-to-GDP ratio, leading only to a very modest decline in net foreign assets. Thus, Albania does not (yet) seem to display the previously described stylized pattern of private sector credit growth that is financed to a considerable degree from abroad (for example by parent banks of foreign-owned subsidiaries). It remains to be seen to what extent banks will finance the further expansion of credit to the private sector by reducing their exposure to the government and to what extent they will, alternatively, revert to foreign sources of funding – a move that would not be surprising, given the very high (92% in 2005) share of foreign-owned banks in total banking sector assets.

Chart 11

Albania: Selected Asset and Liability Positions of Banks



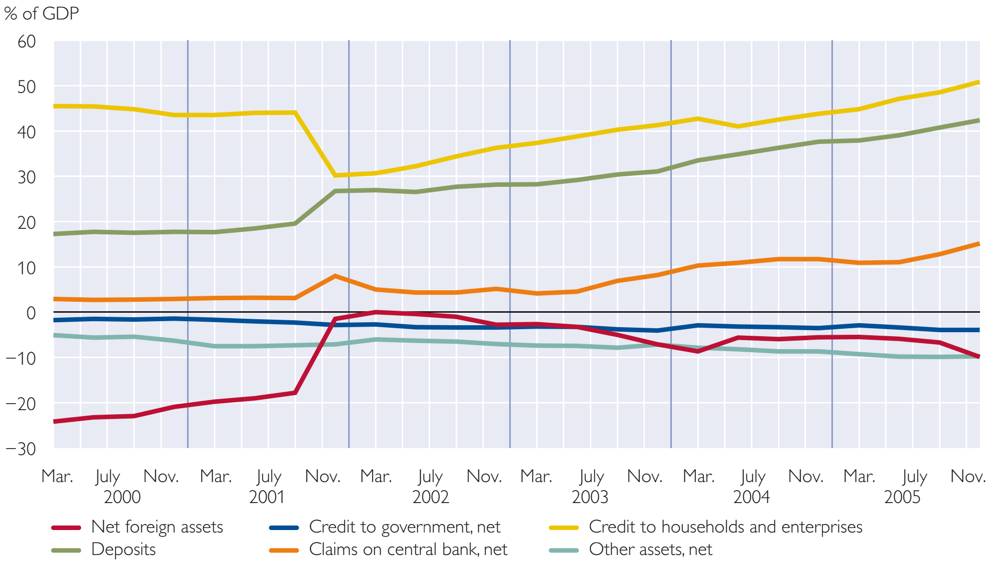
Source: IMF, OeNB.

Until late 2001, the private sector credit-to-GDP ratio in Bosnia and Herzegovina (see chart 12) was substantially higher than the deposits-to-GDP ratio. This fact was mainly offset by sizeable but gradually declining net foreign liabilities. At the end of 2001, substantial volumes of nonperforming loans were written off, thus reducing overall credit outstanding – a development which coincided with a surge in deposits due to the euro cash changeover.[18] These two factors, in turn, basically equilibrated credit and deposit levels and reduced net foreign liabilities to very low levels. Since then, credit has grown only somewhat faster than deposits, which is, however, partly attributable to a temporary halt in aggregate credit growth in 2004, when further measures to clean banks' balance sheets took effect. Net claims on the central bank have also risen noticeably since mid-2003 – a development that should be seen in the context of the repeated tightening of mandatory reserve regulations during this period, which the central bank undertook to dampen domestic lending activity. Net foreign liabilities have increased only more recently (fourth quarter of 2005).

[18] *It should be noted that the Central Bank of Bosnia and Herzegovina (CBBH) uses a data set that deviates, in some respects, from the IMF data used in this study. The differences mainly relate to the timing at which the write-offs entered the statistics. While the IMF recorded them as of end-2001, the CBBH did so at the actual time of the write-off. The break observed at end-2001 in the data displayed in chart 11 is thus attributable to the fact that the IMF recorded the write-offs at that point. While there are good reasons to use the CBBH data, in particular for economic analysis, we opted for the IMF data, mainly with a view to cross-country comparability.*

Chart 12

Bosnia and Herzegovina: Selected Asset and Liability Positions of Banks

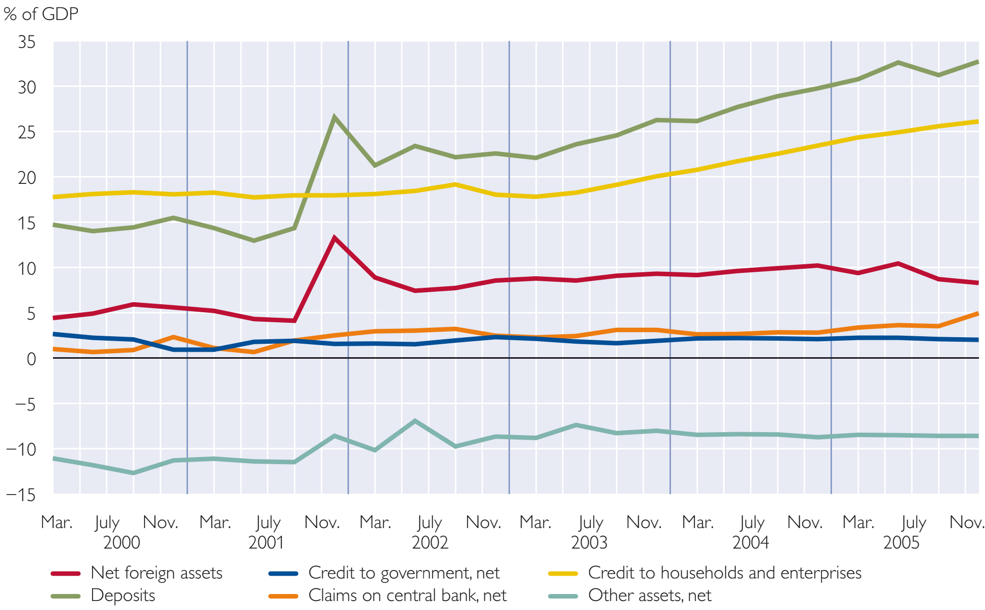


Source: IMF, OeNB.

In the Republic of Macedonia (see chart 13), the picture is again somewhat different. As in Bosnia and Herzegovina, the euro cash changeover caused deposits and net foreign assets to soar in late 2001. Since mid-2003, credit to the private sector – which had been at slightly below 20% of GDP for several years – has gradually risen (unlike credit to the government, which continues to stagnate). Deposits have also grown, starting in the second quarter of 2003,

Chart 13

Republic of Macedonia: Selected Asset and Liability Positions of Banks



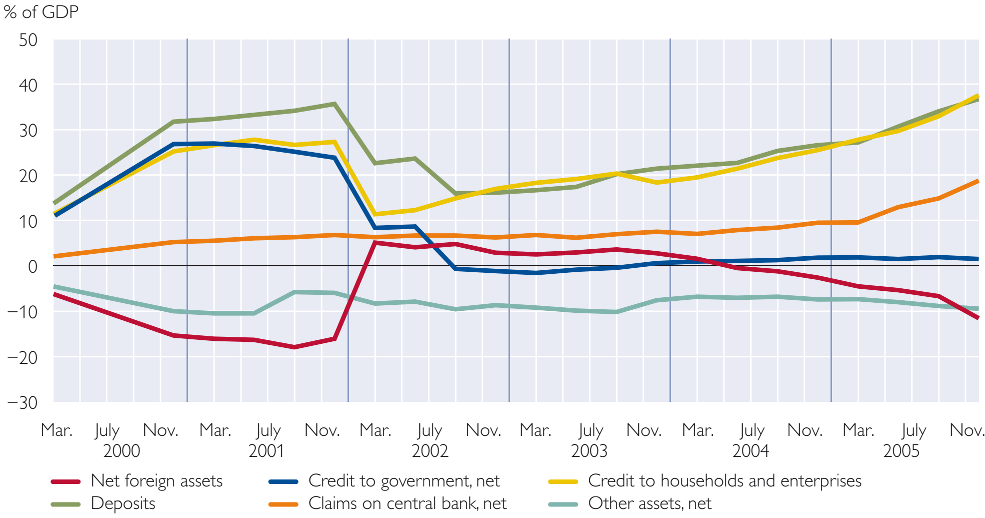
Source: IMF, OeNB.

broadly at similar rates as credit, thus leaving net foreign assets steady. Net claims on the central bank, which were also relatively stable between early 2002 and late 2005, rose noticeably only in the last quarter of 2005, reflecting a pick-up of sterilization activities in a setting of increased foreign exchange purchases by the central bank.

In Serbia (see chart 14), credit developments in the early 2000s have been dominated by sizeable bad loan write-offs, reducing the private sector credit-to-GDP ratio from nearly 30% at end-2001 to slightly more than 10% in March 2002. Net credit to the government fell from 24% to around 8% of GDP in the same period and had been practically eliminated by September 2002. The simultaneous decrease in the deposit-to-GDP ratio was attributable to the transfer of frozen foreign currency deposits from the balance sheet to off-balance sheet positions in the course of 2002. In the same period, banks' net foreign asset position improved considerably owing to the conversion of obligations toward the London and the Paris Clubs into bank shares. Since early 2002, credit to the private sector has risen again to almost 40% of GDP, whereas credit- and deposit-to-GDP levels have moved in tandem since late 2002. Net credit to the government has risen only very modestly since 2002. Net foreign assets started to decline in late 2003 and turned negative in mid-2004. Since then, net foreign liabilities have climbed to more than 10% of GDP, almost doubling in the last quarter of 2005. The development of net claims on the central bank roughly mirrors these changes: after rising very gradually until early 2005, net claims on the central bank surged in the last three quarters of 2005. Again, sterilization and increases in reserve requirements seem to explain this increase.

Chart 14

Serbia: Selected Asset and Liability Positions of Banks



Source: IMF, OeNB.

3.4 Bank Intermediation: The Cross-Country Perspective

Overall, a relatively diverse picture emerges. Credit growth has been dynamic in all SEE countries, which compares to the trends observed in the new Member States. Lending dynamics have been particularly strong in Bulgaria and in Albania, where private sector credit-to-GDP ratios tripled in the first half of the decade, albeit starting from low, and in Albania very low, levels. On the other end of the spectrum, more moderate credit expansion was recorded in the Republic of Macedonia as well as in Bosnia and Herzegovina. Private sector credit growth in the SEE region began at different points in time, but generally later than in those new Member States where lending booms started back in the late 1990s.

The timing of the write-offs of bad loans has also had an impact on credit developments in some SEE countries; this impact was also observable in the CEE-8, but already mostly in the 1990s (only in the Czech Republic and in Slovakia did write-offs extend into the beginning of the current decade). In the SEE countries, sizeable write-offs were undertaken in Bosnia and Herzegovina and in Serbia in the early 2000s. In the other SEE countries (Croatia, Bulgaria, Romania, Albania and the Republic of Macedonia), the credit ratio declined on similar grounds already in the second half of the 1990s.

As in the new Member States, credit growth to the private sector, in particular to households (with a substantial share of mortgage loans), has been fairly strong, while credit to the public sector has remained steady or has even declined. In fact, in some SEE countries, the crowding-in of private sector credit by reducing public sector credit-to-GDP ratios seems to have been more pronounced than in the CEE-8 countries.

Net claims on the central bank have risen substantially in a number of SEE countries, while climbing less in the CEE-8 (with the exception of Latvia and Slovakia). Increases in reserve requirements to contain bank lending and, in some cases, sterilization activities explain this development.

Net foreign asset positions have worsened in most SEE countries, as they have in many CEE-8 countries. However, while in the CEE-8 this was attributable to the fact that credit expansion has been increasingly financed by borrowing from abroad, the same can be said only of Bulgaria Croatia among the SEE countries. In the other countries of the region, credit growth has essentially been financed by deposit growth, and changes in the net foreign asset positions appear to be mainly associated with rising net claims on central banks. There are several explanations for the different development in the SEE countries and the CEE-8: First, in some cases, lending booms are yet at a relatively early stage in the SEE region (and at this stage, domestic financing was also the typical pattern in the new Member States). Second, the euro cash changeover has had a much more pronounced level effect in most SEE countries than in the CEE-8, given that currency substitution in the cash segment has been much more important in the former group of countries than in the latter. Third, remittances play a key role in the balance of payments in a number of SEE countries (in some cases surpassing 10% of GDP). This steady and strong stream of remittances has certainly contributed to bolstering deposits in SEE banking sectors (as part of these transfers was certainly saved), thus providing an extra layer of funding for credit growth without incurring foreign liabilities. In this respect, bank intermediation in SEE will probably remain different from that witnessed in CEE-8 countries.

Progress in bank intermediation has entailed substantial economic benefits for SEE countries. At the same time, one of the key features of this development – fast credit growth – has posed substantial challenges to policymakers. If we compare the authorities' response to these challenges, we find that the authorities in SEE countries have, on the whole, taken a more activist stance toward containing credit growth in recent years than those in CEE-8 countries. The measures taken included implementing higher minimum reserve requirements and administrative measures (like introducing credit limits and limits to foreign borrowing), but also selective prudential measures.[19] Given that monetary policy is constrained by explicit or implicit exchange rate commitments in a number of SEE countries,[20] interest rate policy did not play an important role (or no role at all) in most cases.[21]

Official statements suggest that it was mainly macroeconomic considerations that made the authorities take measures to contain credit growth.[22] In recent years, the SEE countries have actually recorded fairly strong output growth, and income expectations have risen, which has encouraged consumption smoothing. GDP growth has been mainly driven by domestic demand (both private consumption and fixed capital formation). In most countries, residential investment has been booming. Credit expansion has given an extra impetus to brisk domestic demand growth. In the process, lending booms have also contributed to widening current account deficits to high or very high levels in most SEE countries, clustering around 6% to 12% of GDP in 2005, and reaching 22% in Bosnia and Herzegovina. The only exception in this respect is the Republic of Macedonia, which displayed a deficit of slightly above 1% of GDP last year.[23] Rapid credit growth may also have added to inflation pressures, but this link is less certain (except for prices in the construction sector), as much of the extra demand (aside from housing) has been satisfied by additional imports.

Financial stability considerations, in turn, have been a less prevalent motive for policy measures to restrain lending booms. Notable exceptions are prudential and administrative measures taken by some SEE central banks to keep foreign currency lending to households in check.

Initially, these measures have, to some extent, been effective e.g. in slowing bank credit growth in Bulgaria and foreign currency lending in Romania. What remains to be seen, however, is the scope of the substitution effects (causing a shift from domestic to external borrowing and from bank intermediation to nonbank financial intermediation), if these measures remain in

[19] *For a more detailed account of the measures taken, see ECB (2006a), Hilbers, Otker-Robe and Pazarbaşıoğlu (2006), as well as recent reports on IMF Article IV Consultations with SEE countries on www.imf.org.*

[20] *See Barisitz (2005) for an account of exchange rate arrangements and monetary policy in SEE countries.*

[21] *It should be noted that in a setting of high capital mobility, the room for monetary policy to contain aggregate demand and credit growth is limited even for those SEE countries that operate flexible exchange rate regimes; compare Lipschitz, Lane and Mourmouras (2002) for a more detailed discussion.*

[22] *For a more detailed presentation of macroeconomic developments and data of SEE countries, see Gligorov (2006) or EBRD (2006).*

[23] *See Duenwald, Gueorguiev and Schaechter (2005) for empirical evidence on the latter aspect.*

place for a longer period of time. The most recent rapid expansion of nonbank financial intermediation in some SEE countries is obviously connected to the implementation of various regulations on bank lending. Furthermore, credit developments in Croatia – which has several years of experience with controls over lending and borrowing – already clearly point to the diminishing effectiveness of such measures over time.

4 Conclusions

This study examined similarities and differences in the depth and structure of bank intermediation in Southeastern European countries. In doing so, we also analyzed to what extent the patterns of bank intermediation in SEE countries are already similar to those observed in the new EU Member States of Central and Eastern Europe. Overall, it turns out that the depth, structure and quality of bank intermediation has advanced considerably in all SEE countries.

As in the new Member States, the process was driven by banking sector consolidation and privatization, in the course of which many banks were sold to foreign financial institutions. These banks then started to tap previously underserved market segments. At the same time, the level of banking sector development is far from uniform in the region: In some SEE countries, the structure and depth of bank intermediation are already similar to, or approaching the levels observed in, the new Member States, whereas they are at an earlier stage in others, notwithstanding major progress in recent years.

As regards the structure of intermediation, the following aspect is particularly noteworthy: While in a number of new Member States the credit expansion has been increasingly financed by foreign sources, it is still mainly financed by domestic sources (deposits, in some cases falling public credit-to-GDP levels) in most SEE countries, even though foreign funding has recently gained in importance. Only in Croatia and Bulgaria is the significance of foreign funding as high as in the new Member States. Risks in connection with the increased reliance on foreign capital inflows are partially mitigated by the fact that a considerable portion of these inflows is provided by foreign parent banks.

Foreign currency lending to unhedged borrowers, in particular households, is high and rising in a number of SEE countries. The resulting exposure of nonbanks to fluctuations in the exchange rate and in foreign interest rates eventually increases banks' credit risk. While being fairly diverse in terms of asset quality, banking sectors in SEE appear to be well capitalized overall and profitable (albeit to different degrees). Furthermore, stress tests conducted by the IMF and/or national central banks attested banking sectors different degrees of resilience to standard shocks, with Bulgaria, Romania and Albania standing out positively in this respect.

Overall, the rapid changes in bank intermediation observed in the CEE region have also reached Southeastern Europe. As elsewhere, this brings with it a wide range of benefits, but the sheer speed of these changes and, in some cases, structural weaknesses inherited from the past involve risks that need to be monitored and tackled appropriately.

Cutoff date for data: November 13, 2006.

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