

CREDIT GROWTH IN POST-CRISIS RECOVERY: EMPIRICAL EVIDENCE FROM THE WESTERN BALKAN COUNTRIES

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Abstract: Numerous empirical tests have been confirmed the importance of the financial sector in generating real economic growth. The reasoning for existence of financial sector development influence on economic growth is simplistic – financial sector uses real assets and therefore affects real economy. Global financial crisis (2007-2008) has led transition countries into recession. The bank credit crunch following the financial crisis may constitute the main constraining factor for real economic activity. Determining the direction of the relationship between the two sectors of the economy is important for the foundation of necessary economic policy. There is a rich body of literature on the theoretical and empirical relationship between financial development and economic growth. The presence of this relationship, as well as its direction, has long been a debated topic among economists. According to the literature, financial development supports economic growth particularly in low and middle income countries. Western Balkan countries have been characterized mostly as low income countries, developing economies with relatively low level of openness to world markets, with a stable banking system. In this paper we attempt to identify the effects of credit activity on economic recovery, with a special reference on domestic banking system. In this regard, we investigate the role of bank credit activity in financing the economic growth of the Western Balkan region including Albania, Bosnia and Herzegovina, FYR of Macedonia, Montenegro, and Serbia in the years 2007-2017. More specifically, the paper analyzes the level of lending activity in relation to GDP growth in observed economies, during and after the economic crisis. The main aim of the research is to identify the importance of credit growth in the conditions of the post-crisis period. The paper deepens literature about the financial intermediation influence on economic growth, pointing out significant degree of causative consequential connection between financial sector and economic results. According to that, our hypothesis starts from the view that economic growth is in strong correlation with the level of credit activity, and vice versa. More precisely, the paper starts from the view that the credit activity follows the level of economic growth, but it is also an important incentive factor for economic development. In this sense, the main goal in this work is to point out the specific connection between the financial and economic aspects in the post-crisis recovery, in particular in the conditions of the countries of the Western Balkans.

Keywords: Western Balkans, Economic Crisis, Credit Growth, Banking System

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INTRODUCTION

Global financial crisis (2007-2008) has led transition countries into recession. The economic model of the recovery process in the Western Balkans is highly challenged. One of the leading roles of the development process should be entrusted to the financial sector. Finance is a vital ingredient for economic growth. It became more evident that the consequences of excessively risky credit supply can not only contribute to the possible collapse of some banking and other financial institutions, but also affect the process of financing the other economic sectors that contribute to economic growth. Both economic practice and economic theory are interested in analyzing the role of financial sector in promoting the economic development and economic growth. Commercial banks are the most important financial institutions in bank-based economies such as the Western Balkan countries.

In earliest economic theories of economic cycles the emphasis was given to the positive effect of credit expansion on economic growth. The activity of banking industry has procyclical character in lending function and supporting the economic growth and development. Usual financial crisis implicate the changes of assets prices, volume of bank credit activities, high rate of non-performed banking loans, government intervention in financial sector and increase of level of systematic risk (Ercegovic, 2017). Impairment of credit quality of debtors, decrease of interest rates, deflation and reduction of investment activities caused banking industry to reduce the loan supply which enhanced the negative indicators of national economy (Rusek, 2014).

The crisis originated in the developed markets spilled over in the last quarter of 2008 to the countries of Western Balkan region. The Western Balkan countries are significantly exposed to the effects of global crisis because most of them are highly indebted abroad, possess insufficient hard currency reserves and experience high balance of payments deficits. Global financial crisis implication on Western Balkan countries banking sector resulted with sudden deposits outflow, investor's confidence decrease, cost of capital increase and credit quality deterioration. Global economic crisis also caused a decline in potential GDP due to a strong contraction in demand which is difficult problem in demand-driven small open economies, such as the Western Balkan countries.

Referring to the historic background and the transformations suffered, the Western Balkan countries have developed bank based financial structure so the soundness of the banking sector is significantly important for the stability and progress of their economies on the long run. Banking sector occupies the major part of total assets of their financial sector which is directly or indirectly affected by the financial shocks of the last years. Any disturbance, interference or irregularities in the banking sector is mainly reflected to the real economy if considering the bank based financial structure of Western Balkan countries and the strong relationship between the banking sector and the financial system. The improvements on the banking sector efficiency and performance will accelerate their economic recovery.

Banking sector transformation was an important element in the overall transition process. Process of transformation of banking sectors in Western Balkan countries went through similar phases during 2000s. Characteristics of the first phase is that the biggest part of credits issued by the banks was used for financing public companies, which would be dismissed, scrapped out or country would take care of returning it. The second phase is characterized by privatizing and selling banks, mostly to foreign investors. In the third phase banks started standard operations of buying and selling securities and issuing loans for the private sector. Speed of the process of transforming and reforming banking sectors is different from individual country to country, but major number of countries went through these phases.

Despite the fact that credit growth can encourage economic growth, rapid credit growth in some cases precedes the occurrence of a banking crisis. A financial accelerator amplifies the initial

effects of any shock (financial or real) on economic activity. The three main channels through which shocks affect the business cycle are: 1) bank credit, 2) the balance sheet and 3) a liquidity. The third one has become increasingly important since the financial crisis and emphasis the importance of bank's liquidity, which is necessary to extend credit and consequently accelerate economic activity (Basel Committee on Banking Supervision, 2011).

LITERATURE REVIEW

The main function of banks in economic sense is to facilitate operation of fund lending as much as possible in order to increase investments in economy. Development of a country depends on increasing investments. Banks assume an important intermediary role in providing increase of investments. When banks contract credits that they let use, they can cause economic stagnation and for some sectors to go through a difficult period.

Banks can also ensure effective distribution of resources in economy by transferring resources that they have collected to certain regions and sectors in need. Some authors evaluate whether the level of development in the banking sector exerts a causal impact on economic growth and its sources. Their paper's results support the view that „Better functioning banks improve resource allocation and accelerate total factor productivity growth with positive repercussions for long-run economic growth” (Beck, Levine, & Loayza, 2000). Beck and Levine (2002) investigate the impact of stock markets and banks on economic growth and they find positive impact of stock market development and bank development on economic growth.

Empirical evidence suggests that real activity, the volume of bank lending activity, and the volume of trading in equity markets are strongly positively correlated. Durusu-Ciftci, Ispir and Yetkiner (2017) showed that debt from credit markets and equity from stock markets are two long run determinants of GDP per capita and they showed that by fostering the development of a country's financial sector, economic growth will be accelerated. Some papers archive significant impact of bank stability on the economic growth and inflation (Monnin & Jokipii, 2010). Empirical evidence also suggests that inflation and financial market activity are strongly negative correlated as are inflation and the real rate of return on equity in the long run. Inflation and real activity are also negatively correlated in the long run, particularly for economies with relatively high rates of inflation. Huybens and Smith (1999) presented a monetary growth model in which banks and secondary capital markets play a crucial allocative function. They showed that the predictions of the model are consistent with these observations about inflation, finance and long-run real activity.

Financial crises of last years have led to the need of scientific researches of the factors causing them in modern economy, and investigation of main economic indicators, the institutional environment and financial sector interrelation. Effective activity of banking system catalyzes general development of national economy. Being an integral part of market infrastructure, the banking system is in bilateral connection with real sector. And all changes in real sector anyway affect whole banking system (Larionova & Varlamova, 2014).

The recent global economic recession (2007-2008) highlights the need for economists and policy makers to question the optimal size of financial systems for sustainable economic growth. Study conducted by Law and Singh (2014) provided a new evidence on the relationship between finance and economic growth using an innovative dynamic panel threshold technique. They showed that the level of financial development is beneficial to growth only up to a certain threshold; beyond the threshold level further development of finance tends to adversely affect growth. “In terms of policy implications, policy makers could focus less on increasing the size of the financial sector and more on improving its intermediating function” (Law & Singh, 2014). Also, there is certain assume that financial market starts to influence on economic growth only

after achieving certain level of institutional development (Siong Hook Law, Azman-Saini, & Ibrahim, 2013).

Credit to the private sector has been grown very significantly in a number of transition countries in past two decades. Undoubtedly, rapid credit expansion has become a key topic for policy discussion in the Western Balkans. On the one hand, rapid credit growth can be justified by the very low initial level of intermediation in these countries and the convergence towards levels observed in developed EU countries. On the other hand, both empirical and theoretical arguments imply that too rapid credit growth, also known as credit boom, can have serious macroeconomic consequences, especially if it is connected with sizable external imbalances and high level of dependence on global impacts which can also be observed in many of transition systems (Kiss, Nagy, & Vonnák, 2006). It is clear that the rapid credit growth has been one of the main drivers of growth in the region in recent years as it has boosted both domestic consumption and investment.

Consequently, many of the transition countries faced with serious economic and credit contractions caused by the global economic crises. In this paper, we investigate macroeconomic conditions and banking sector indicators of the selected economies in the past fifteen years. More specifically, the main consideration of our analyses is to identify the equilibrium credit/GDP levels of the Western Balkans countries during and after economic crises.

METHODOLOGY

The article considers economic stagnation and bank channels possibilities for recovery perspectives of the Western Balkan countries during the last decade using statistical macroeconomic analysis. In order to accomplish the aim of this survey a set of data was collected and interpreted. For the purpose of comparative analysis of the credit activity in the observed countries, we used the data obtained by the supranational methodology of the World Bank and IMF. The main research period for the data collected covers the years 2007-2017. We monitor the credit indicators as percentage of GDP in selected countries and by the method of descriptive statistics point to the significance of the banking sector in financing economic growth. We also represent the annual growth of net domestic credit in Western Balkans.

RESULTS AND DISCUSSION

Completion of economic and institutional transition through structural reforms, adoption of the EU acquis, catching up process to higher per capita income levels, reduction of unemployment, poverty and inequalities, infrastructure modernization and future successful integration into the European Union are going to be a real test for the region given current circumstances and global instabilities (Berthomieu, Cingolani, & Ri, 2016).

Additional impacts of the global financial and economic crisis on the Western Balkans are reported through two main channels – a drop in export demand in foreign (mainly EU) markets and the abrupt reduction in foreign capital inflows. Deficit in revenues, as well as in the inflows of foreign capital, on the top of that had a negative consequences on economic recovery in these countries. The key macroeconomic circumstances of the Western Balkans, as well as their sensitivity to global tendencies, are best seen through the economic growth trajectory. Figure 1 shows the real GDP growth of the observed countries over the last decade.

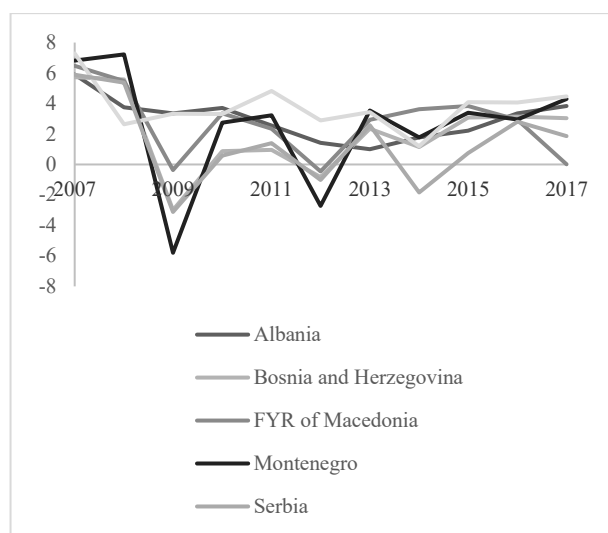
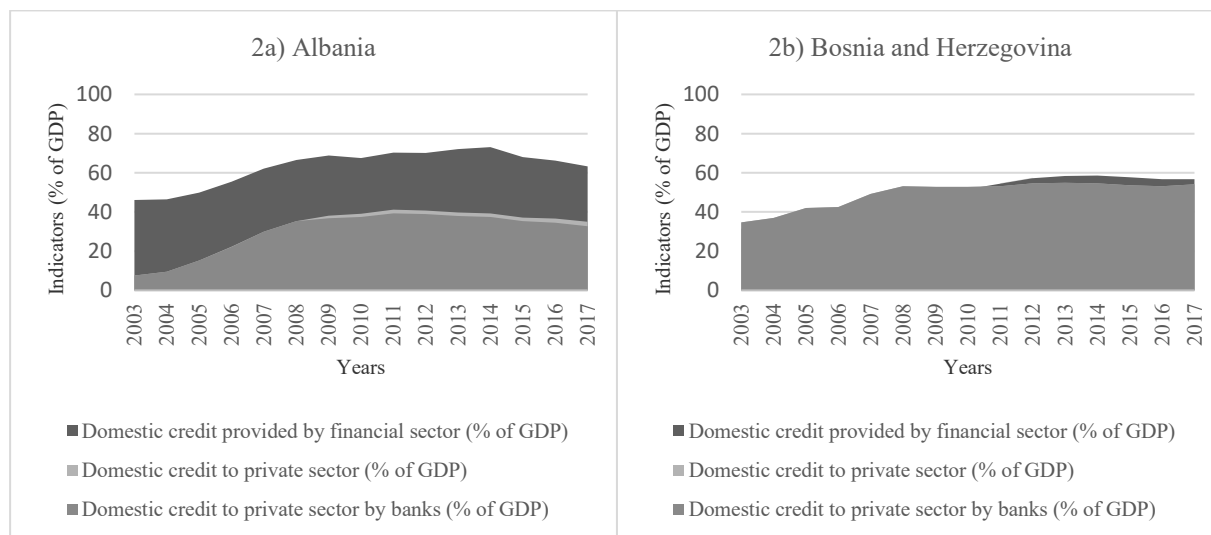


Figure 1: Real GDP growth (%)

Source: Authors, according to data from World Bank dataset (Data Bank, 2018)

Figure 1 shows the percentage increase of GDP in the countries of the Western Balkans. It is indicative that the trajectory of economic growth is very variable in the observed ten-year period. After accelerating in 2007 to an average pace of 6.3% of GDP, growth in the Western Balkans declined in the second half of 2008. Economic activity was driven by strong domestic demand and fuelled by credit and wage growth. In contrast, the contribution of net export to GDP growth remained negative in all countries of the region. Represented data indicate that growth continued after 2009, but at more moderate levels.

The next point of research deals with the significance of financial sector in the analyzed economies. Figure 2 shows a very high level of convergence between total domestic credit to private sector as percentage of GDP and domestic credit to private sector provided by banks, also presented as percentage of GDP.



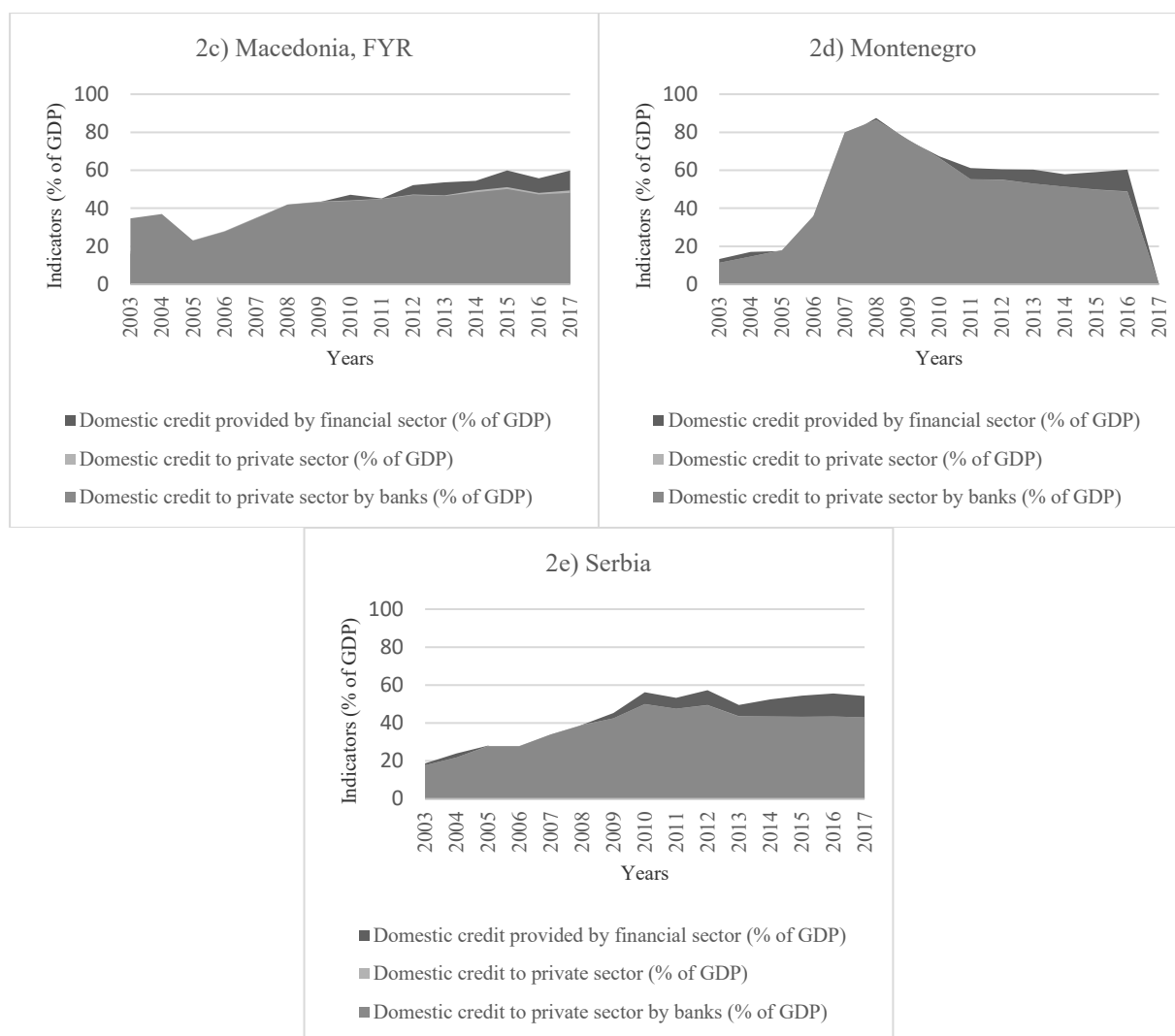


Figure 2: Domestic credit provided by financial sector, Domestic credit to private sector and Domestic credit to private sector by banks, all presented as percentage of GDP, 2003-2017.

Source: Authors, according to data from World Bank database (Data Bank, 2018)

The financial systems in transitional Western Balkan countries are based on banks – approximately 85% of total assets of financial sector are accounted to bank assets, whereby the capital markets are generally underdeveloped (Égert, , Backé, & Zumer, T., 2006). Banking sector, as the Figure 2 shows, is the most important channel of financial intermediation in the case of Bosnia and Herzegovina, FYR of Macedonia, Montenegro, and Serbia. In Albania after the financial crisis the economy started to slowdown and the banks, while facing a rise in Non-Performing Loans, started to cut out lending. This lead to a situation today when banks are holding excessive quantities of deposits and in the same time the lending is low (Musta, 2016).

Credit policy, as well as monetary policy, represents a very important instrument of economic policy to achieve macroeconomic objectives. Figure 3 shows annual growth of net domestic credit represented in current LCU, between 2007 and 2017. This figure also indicates the level of demand for bank's loans by the private sector, the level of credit activity as the cause of the demand and the final real growth of gross domestic product in the period from 2007 to 2017.

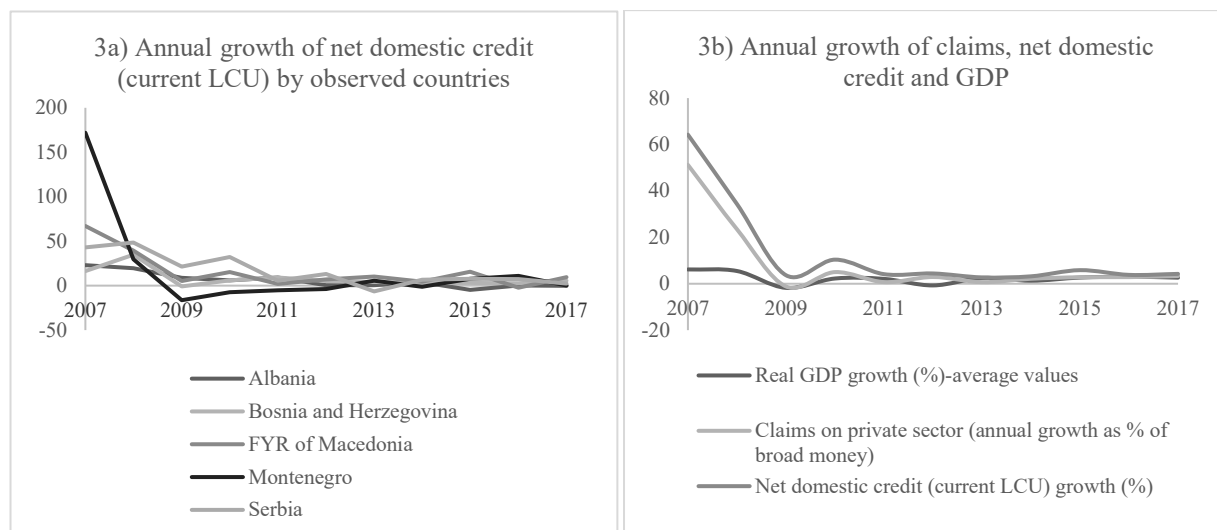


Figure 3: Annual growth of net domestic credit (current LCU) by observed countries and Annual growth of claims, net domestic credit and GDP, 2007-2017.

Source: Authors, according to data from IMF database (International Financial Statistics, 2018) and World Bank database (Data Bank, 2018)

The previous figure indicates the decline in net credit activity in the post-crisis period in 2008, while the observed indicator in the next ten-year period marks a modest growth in all countries of the Western Balkans (Figure 3a). The largest decline in credit activity is recorded by Montenegro while other countries record relatively moderate recessionary stages of credit activity in the crisis. The right side of Figure 3 indicates a fair convergence in the movement of net domestic lending and private sector credit to financial institutions in the observed countries. The high level of credit activity and private sector credit demand decline is noticeable in the period of the 2008-2009 crisis, but the level of lending activity does not change significantly in the next ten year (Figure 3b). It is important to note that the lines of the movement of net credit growth, private sector credit and GDP growth are almost overlapping, which can indicate an important correlation of the observed variables. With respect to the economic impact of the crisis on the Balkan countries, it must be said that the crisis here follows the general European and global trends, but with a certain time lag (of about a year) behind the development of the crisis in the EU.

CONCLUSIONS

Observed through growth rates, there is a strong match between the trajectory of credit and economic growth in the countries of the region of the Western Balkans, without concrete investigation of the cause-effect relationship between these variables.

It is also noticeable that during the entire period after the crisis, a much lower level of economic growth was recorded compared to pre-crisis rates in 2008. Following the discussion of banking sector and macroeconomic causes, the descriptive statistics can confirm that there are still a huge possibilities for economic growth with financial and more specifically banking sector origins. It is clear that the banking system will play an important role in the future in providing incentives for economic growth and development.

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