

The emerging financial landscape in South-East Europe

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Weathering the pandemic: the emerging financial landscape in South-East Europe

With summaries of interventions by Fokion Karavias (CEO, Eurobank), Francis Malige (MD for Financial Institutions, EBRD), Dr Debora Revoltella (Chief Economist, EIB), and Professor Boris Vujcic (Governor, Croatian National Bank).

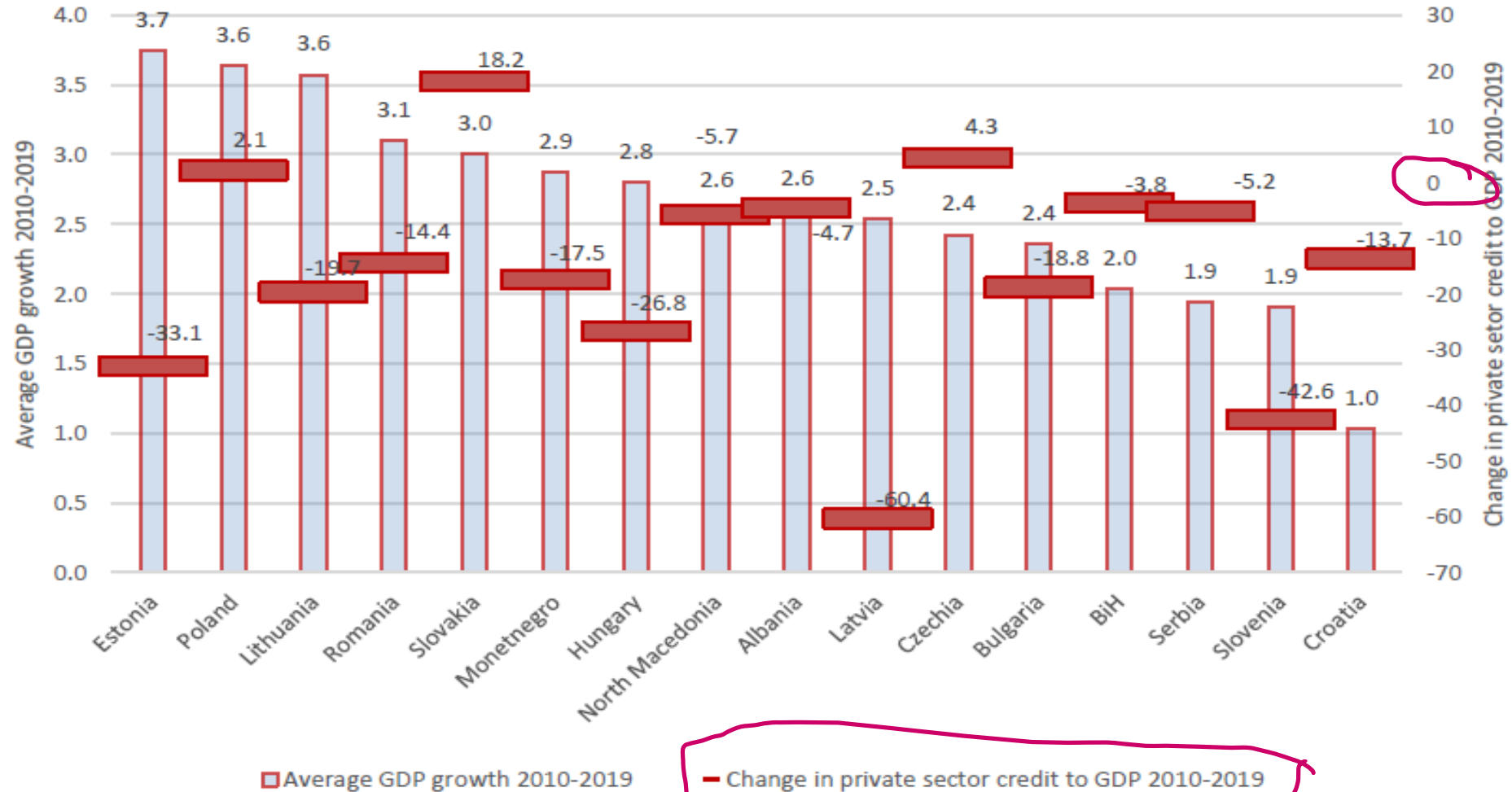
Overview

- **Transition phases:** Although countries in SE Europe are different in terms of history, their banking sectors went through similar transition processes in four phases: restructuring, expansion, **rebalancing and adaptation**.
- **Financial integration:** Due to privatizations, higher interest rate and anticipated economic growth, the fresh capital of large foreign regional banking groups (from Austria, Italy, France, Greece and Hungary) appeared in this region. This growth pattern was domestic demand driven and externally financed, hence was hampered significantly by the global financial crisis and subsequent euro area debt crisis. Policy coordination in the framework of the Vienna initiative mitigated crisis spillovers and facilitated rebalancing.
- **Credit imbalances:** During the boom years preceding the global crisis, credit markets in SEE had experienced several years of overperforming credit growth. Rapid credit growth in this period was well above its fundamental level in most of the countries, considerably overshooting the equilibrium level. NPLs became a long standing structural problem that took several years to bring under control.
- **Assessment of reforms:** A significant cost efficiency gap has been confirmed between EU and non-EU banking systems in the region, where on average EU banking systems tend to be more cost efficient than their non-EU counterparts. The detected cost efficiency gap is closing predominantly because of adjustments on the side of the less efficient banks.
- **Capital markets** in the region continue to be substantially less developed, judging from the balances of debt securities, listed shares and investment fund shares outstanding. Development gaps are also substantial with respect to the role of nonbank financial institutions, such as mutual funds, insurance companies and pension funds in financial intermediation, while the market size of alternative financing sources (e.g. private equity, business angels, online alternative financing) is negligible.

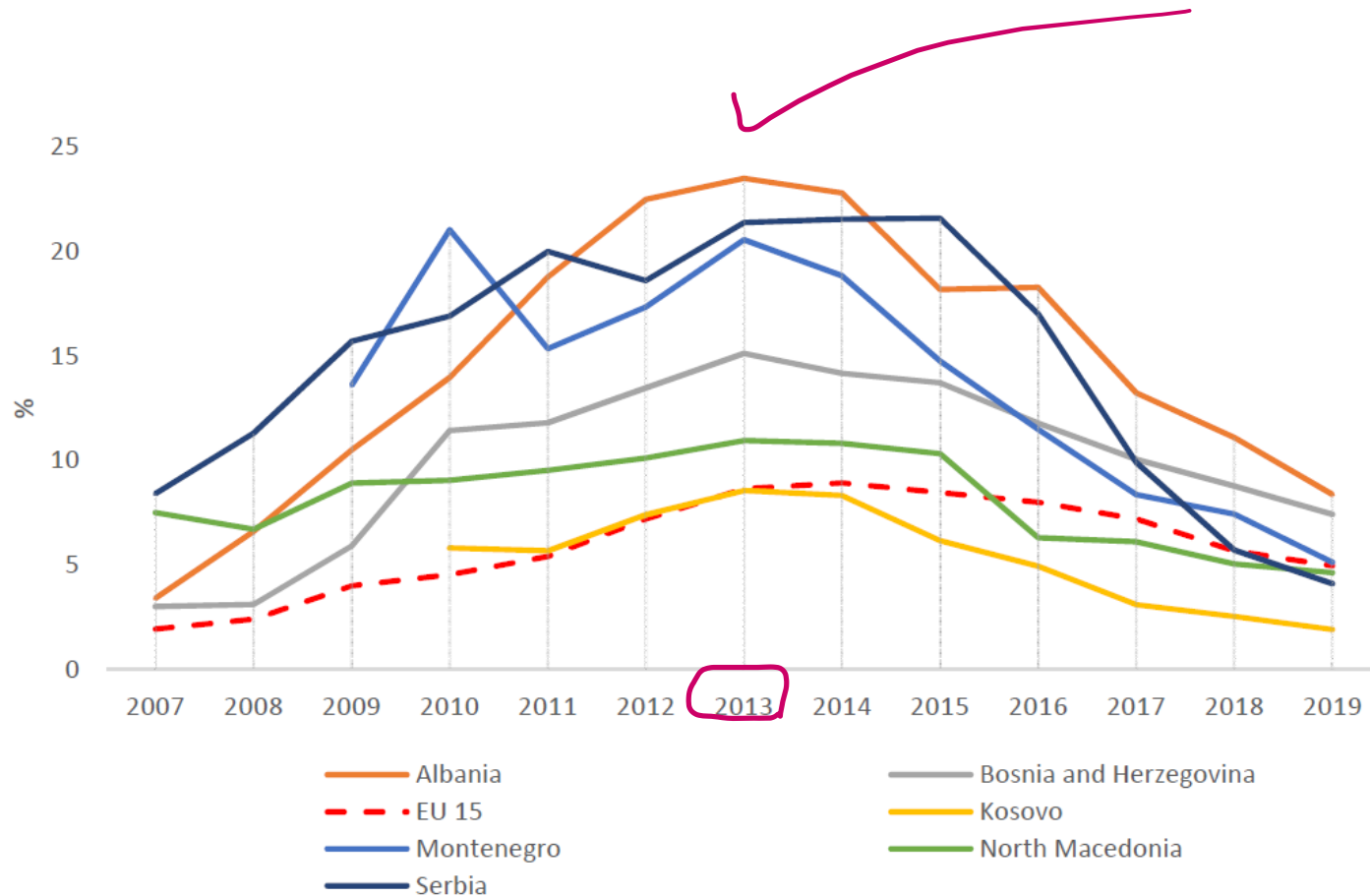
The current context: From «weathering the pandemic» to «weathering twin crises»

- **Pandemic impact:** The disruptive effects of the COVID-19 crisis on the SE European economies led to a considerable drop in the region's GDP by 4,2% in 2020. However, the impact on employment was negligible due to Governments' actions. In 2021 the economic rebound was quite robust as GDP expanded by 6,4%. Besides the strong base effects, annual output growth continued to benefit from robust domestic and external demand. Economic growth for 2022 before the war was predicted 4%— a slowdown from 2021, but still a healthy rate of recovery.
- **Risks:** There are material downside risks to this trends in the In the backdrop of the current economic and geopolitical climate. Financing the current-account deficits will be challenging, especially given the expected decline in foreign direct investment and increasing levels of public debt, especially in Western Balkans. High inflation may well have a much bigger dampening impact on economic growth than we currently expect. And COVID-19 waves are hitting an often unvaccinated and elderly population. Finally, the war in Ukraine constitutes another major downside risk.
- **Foreign subsidiaries:** Around 60% of foreign banking groups intend to maintain operations in the region, while 40% intend to somewhat expand operations. The current stance remains an improvement from a couple of years ago, when an average of 20–30% of banking groups signalled intentions to either reduce or selectively reduce operations. However, profitability of markets in terms of return on assets and return on equity differs substantially across countries.
- **Investment prospects:** Private sector capex in the region could rebound at a slow pace for several reasons. First, supply-chain blockages in manufacturing have postponed many investment projects, especially in the automotive sector. Investment recovery is not expected before 2H22, with a stronger pickup in 2023. Second, most CEE companies have not hedged against higher energy costs and their margins are likely to suffer in 2022, affecting capex. Third, rate hikes and market sentiment could slow credit growth and turn the credit impulse negative in 2022. On a brighter note, investment co-financed with EU money is expected to accelerate in 2H22 and further in 2023.
- **Green transition:** The green transition is an important policy objective and with that policy makers are confronted with additional social and economic challenges and the need to combine with accountability mechanisms. The situation is complex; all the Western Balkan countries are faced with significant development financing needs while EU Member States are entering private markets with green and de-carbonization development plans.

Average rate of growth and change in private sector credit to GDP ratio 2010-2019

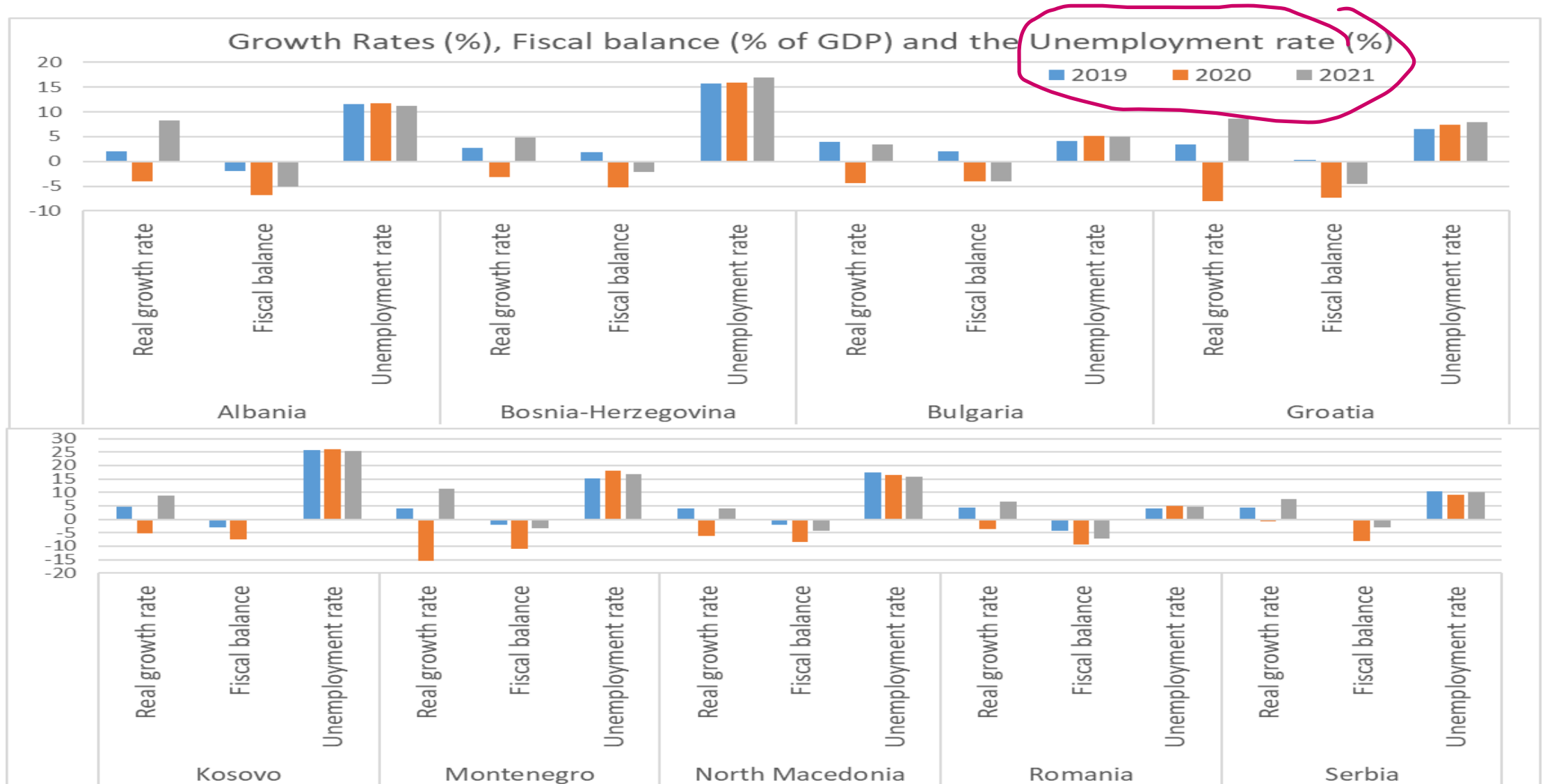


Banks non-performing loans (in % of all loans)



Source: World Bank Global financial development indicators; National bank of Serbia for Serbia series.

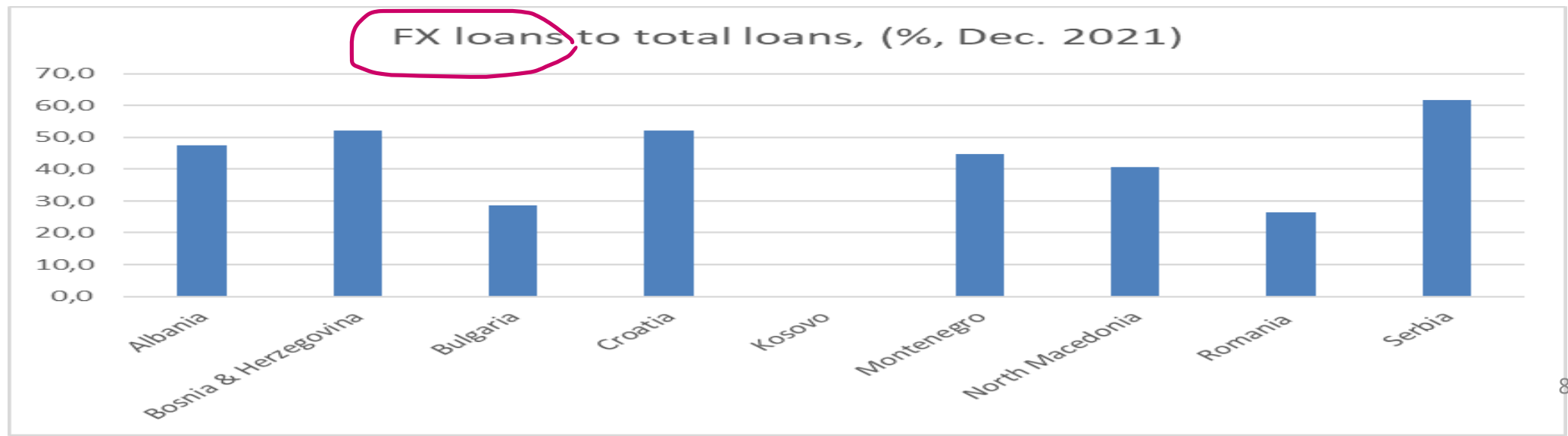
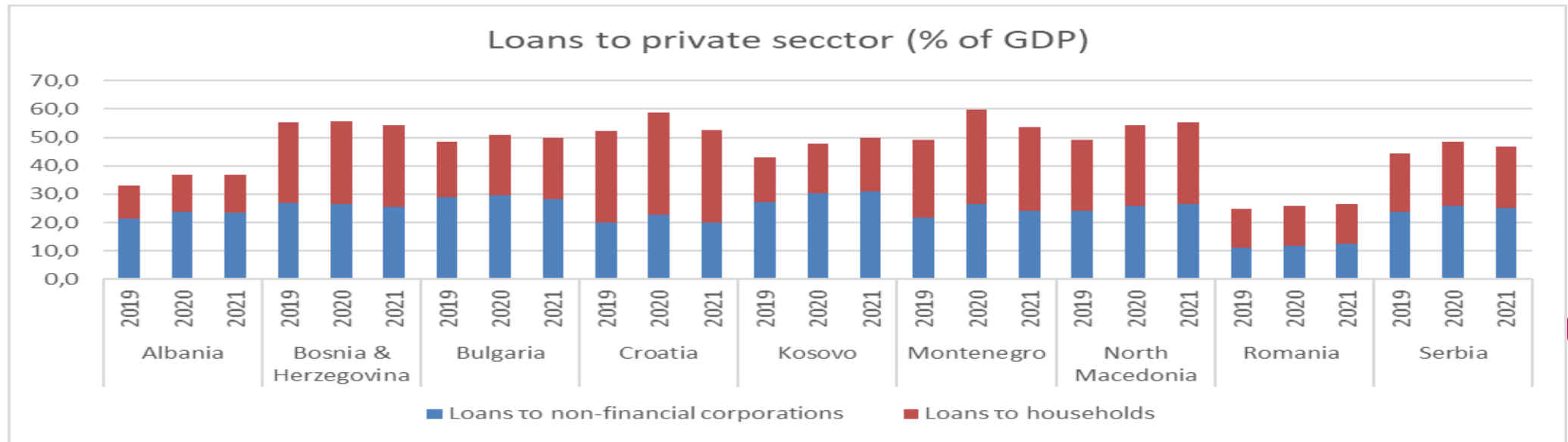
COVID-19 and economic activity



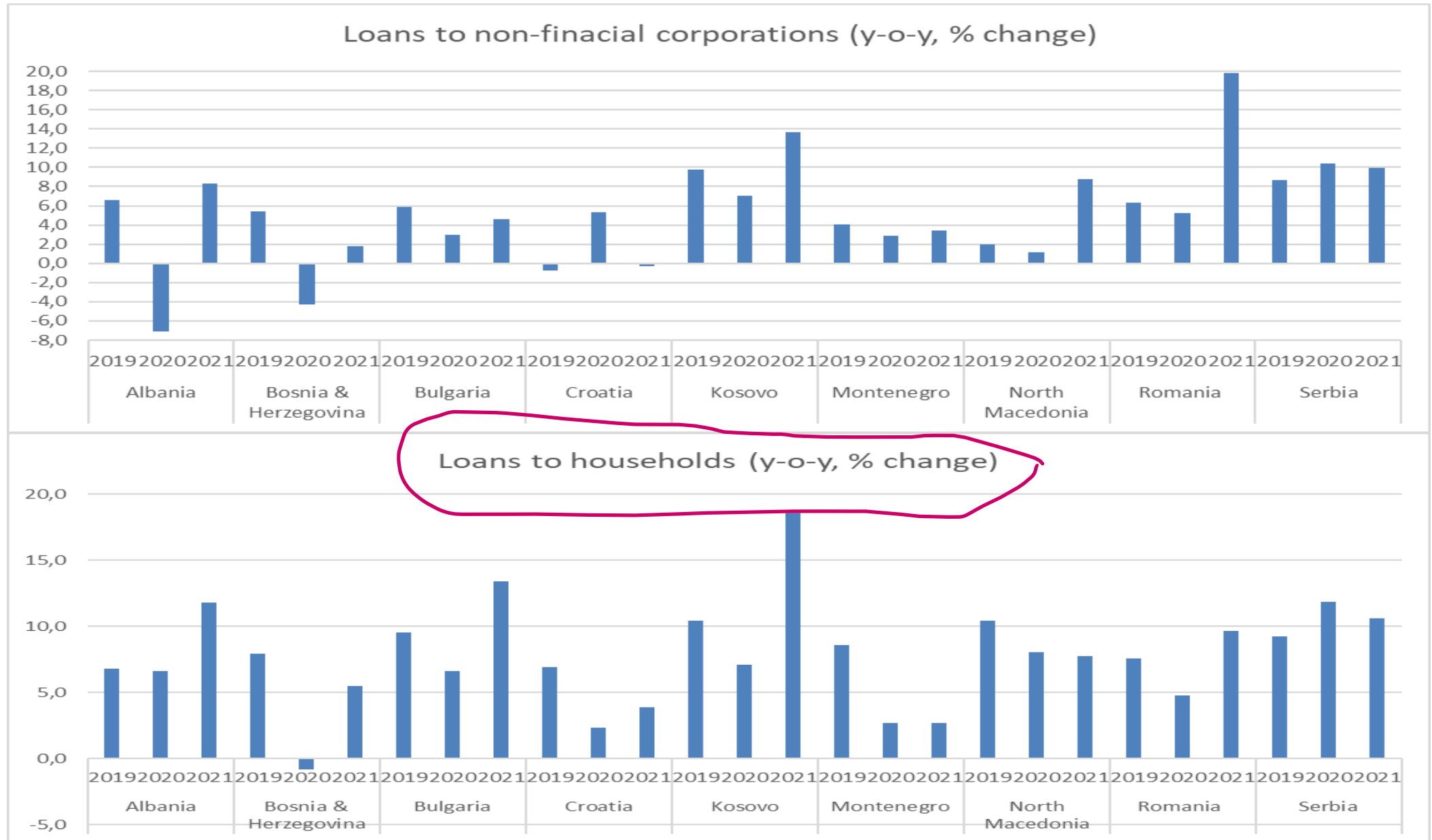
Public debt portfolio of the Western Balkan 6 countries

	Montenegro			North Macedonia			Serbia			B&H			Kosovo			Albania		
	2010	2015	2020	2010	2015	2020	2010	2015	2020	2010	2015	2020	2010	2015	2020	2010	2015	2020
GDP (mil EUR)	2104	3625	4245	7109	9072	10,766	31,546	35,740	47,156	12,969	14,618	17,322	4402	5807	6831	8933	10,448	12,710
Public debt % GDP	42	61.6	102.4	44.6	38	60.2	42.9	76	56.8	33.8	40	35	6.2	13.0	24.6	57.7	72.8	77.9
Public debt portfolio (% of total public debt)																		
Multilateral and bilateral creditor loans	46.4	27.7	13.7	49.2	25	na	46.6	35	37.8	66.6	70.4	68.5	na	49.25	33	18.9	25.7	25.6
Eurobond	15.7	39.6	44.9	19	22.3	na	0	19	19	0	0	5.4	na	0	0	3.36	4.31	9.05
Private sector loans	9.8	18.1	32.5		13.6	na	0	5	0.9	0	4.13	1.85	na	0.45	1.4	3.03	6.38	3.07
Government securities	3.9	4.37	4.2	31.3	38.9	na	47.5	30.5	39.5	11	10.4	15.8	na	50.5	64.7	32.41	36.32	40.12

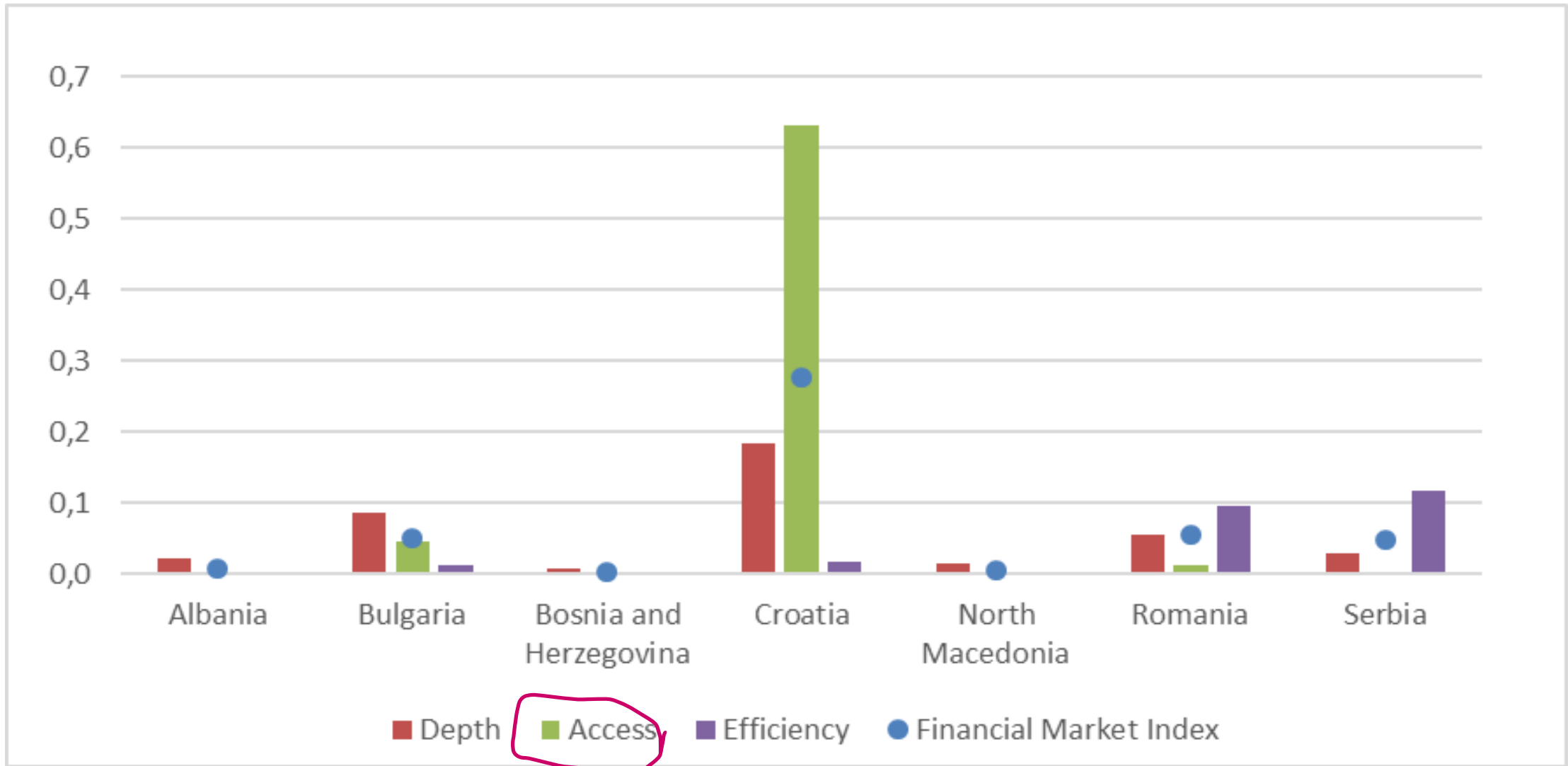
Credit to the private sector during the pandemic



Credit to the private sector during the pandemic (corporates and households)

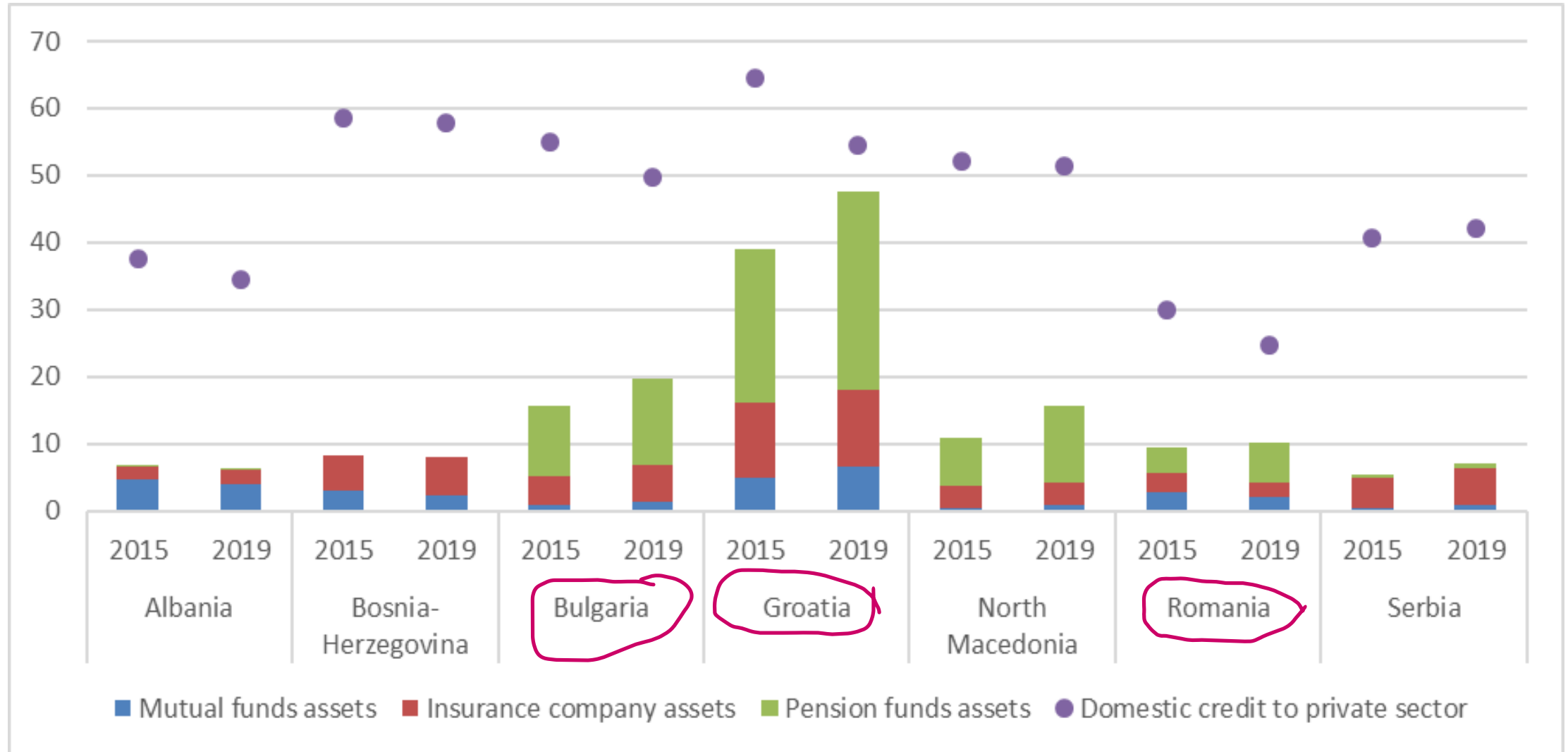


Benchmarking the financial sector: IMF financial index, 2019

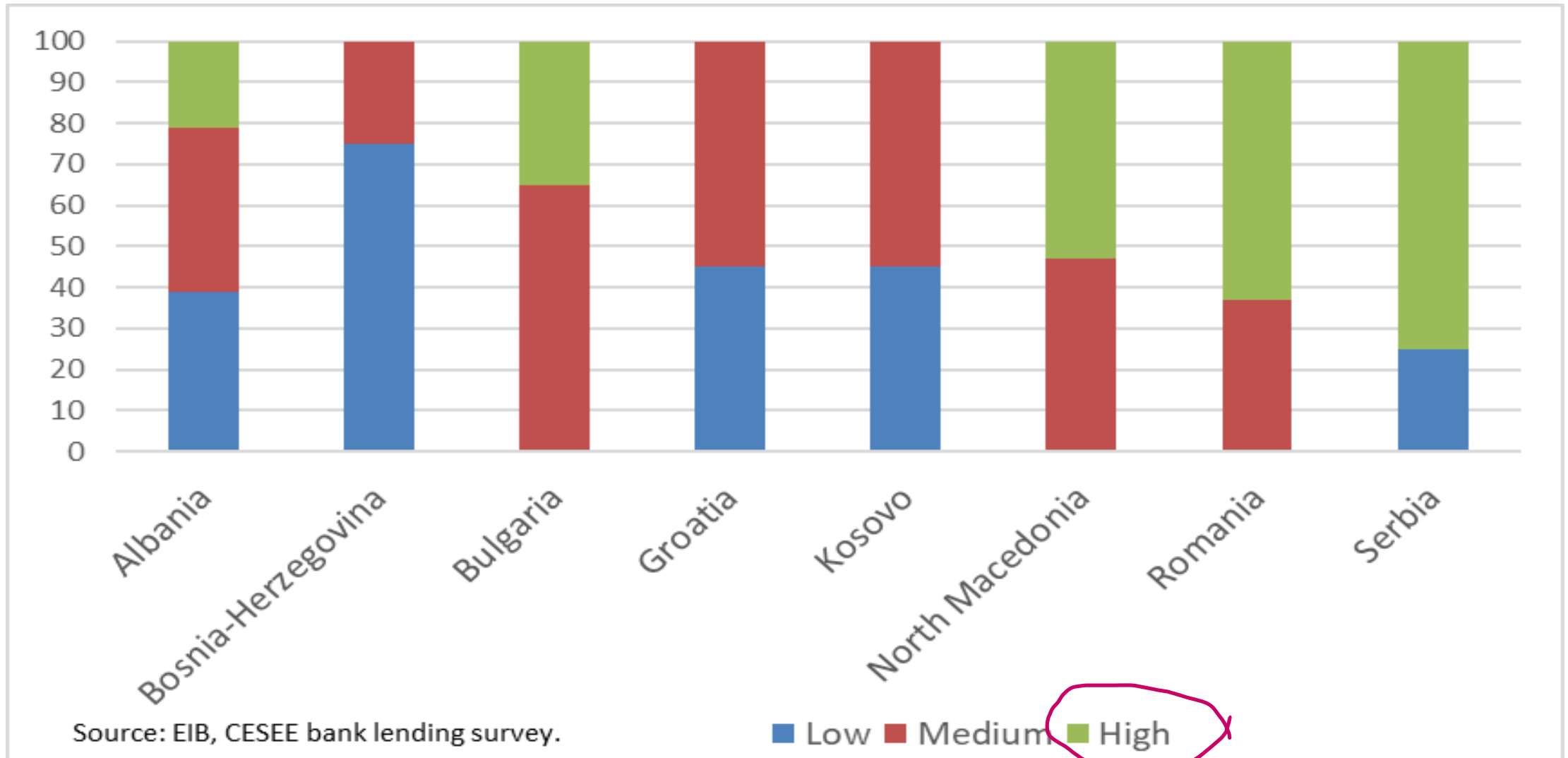


Depth: size and liquidity of markets, **Access:** ability of individuals and companies to access financial services, **Efficiency:** ability of institutions to provide financial services at low cost and with sustainable revenues, and the level of activity of capital markets

The role of nonbank financial institutions in SE Europe, % GDP



Banking sector potential from the perspective of foreign banks



Foreign subsidiaries of Greek banks, 2009 and 2021

	Total Adroad		Albania		Bulgaria	
	2009	2021 (H1)	2009	2021 (H1)	2009	2021 (H1)
Total Assets (euros, bn)	87,6	32,3	1,6	0,67	10,5	7,41
Total Loans (euros, bn)	61,9	19	1,2	0,31	8,4	4,52
Total Deposits (euros, bn)	37,8	22,8	1	0,55	5,56	6,3
Number of Employees	50.728	9.152	1.358	410	8.505	2.970
Number of Subsidiaries	37	11	4	1	5	1
	North Macedonia		Romania		Serbia	
	2009	2021 (H1)	2009	2021 (H1)	2009	2021 (H1)
Total Assets (euros, bn)	1,2	1,9	13,8	3,8	3,7	2,47
Total Loans (euros, bn)	0,86	1,35	8,95	2,75	2,2	1,61
Total Deposits (euros, bn)	0,89	1,46	6,2	2,8	1,88	1,49
Number of Employees	1.407	983	10.525	1.978	6.163	1.724
Number of Subsidiaries	2	1	7	1	4	1

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Issues for further consideration by the Panel – Banking perspectives

Mr Fokion Karavias (CEO, Eurobank)

- The banking sector is confronted with several post COVID challenges: higher interest rates, digitalization, green economy transition and recently geopolitical risk. What is your assessment of these challenges and how they might affect the business model of banks?
- Governments and IFIs in the region have introduced several crisis response financial instruments in the last two years. Do you think that they are sufficient for investment recovery? Are there any other market segments that need specific attention?
- Eurobank decided to remain active in South East Europe after the global financial crisis. Could you please elaborate on the background assessment for this decision and on your strategy for future presence in the region?

Mr Francis Malige (MD for Financial Institutions, EBRD)

- Could you please provide an overview of banking sector trajectories in the region at the country level? Suggested areas for consideration: NPLs, risk profile, credit supply and profitability.
- To what extent divergence of financial systems in EU and non-EU countries in the region is taking place? Are there any specific structural problems in Western Balkans? Please elaborate on the role of the EIB as co-financier in EU countries in the region and in the Western Balkans.
- What are the prospects for capital market development and non-bank financial institutions in the region?
- Could you please comment on potential spillovers from the elevated geopolitical risk?

Issues for further consideration by the panel – Macro perspectives

Dr. Debora Revoltella (Chief Economist, EIB)

Please provide an overview of the impact of Covid-19 on the financial sector in South east Europe. Suggested areas for consideration: Market positioning of foreign banks, macroeconomic conditions affecting the banking sector, medium term prospects.

What are the risks the crisis is bringing, in terms of access to finance and growth trajectories of firms?

Please elaborate on the role of the EIB as co-financier in EU countries in the region and in the Western Balkans. Are there any bottlenecks and/or best practise business models for the recovery of corporate investment and infrastructure projects?

Prof. Boris Vujcic (Governor, Croatian National Bank)

- Drawing on your personal experience please provide your assessment on lessons learned from the recent crisis.
- Croatia has done exemplary progress with successful financial deepening and efficiency improvement of its financial system. What are the milestones of this achievement and what has been the sequence of reforms?
- Do you see any opportunities from financial innovations in the banking and non-banking sector in the region?
- What are the prospects for capital market development and non-bank financial institutions in the region?

Comments by Mr. Karavias

- Mr Karavias started by saying that the world faced an unprecedented global disruption due to the Covid-19 pandemic, only to then find itself in the middle of an unthinkable military aggression in Europe. The latter will have significant implications not only for geopolitical balances, but also for world economy trends.
- The first important trend is the acceleration of de-globalisation. The world started becoming smaller from the beginning of the pandemic and recent geopolitics are speeding up this process. The second important theme is energy and the complex transition to renewables. Geopolitics have made clear that the latter process needs to accelerate. However, higher energy costs are set to persist globally for the next few years, making stagflation the main threat of post crisis normalization. The third global trend is very relevant for the financial sector and includes the use of data analytics through artificial intelligence and machine learning.
- Mr Karavias expressed his optimism about the banking sector, even though the anticipated positive outlook for EU banks, which were set for a growth trajectory after the pandemic, may now look less certain after the war on Ukraine. The persistent high inflation rates may cause a moderate – but equally persistent – increase in the operating costs of banks.
- He underlined that in these challenging times, we should monitor the asset quality dynamics closely and assess the effect of inflation and higher interest rates for households and businesses.
- Turning to the Greek economy, he suggested that Greece was on track to achieve high growth rates for several years ahead and the positive fundamentals are still in place.
- Mr Karavias highlighted Eurobank's regional role in the Balkans, with expanding trade networks and opportunities in interregional exchanges.

Comments by Mr. Malige

- Mr Malige stated that the economies in SEE have proved resilient during the Covid-19 pandemic, thanks to the efforts made by regulators in the previous ten years. With respect to NPLs, as of the first half of 2021, only Bosnia and Herzegovina, Albania and Montenegro had NPLs slightly above the level of 5%, defined by the European Banking Authority as a threshold for high level ratio.
- The EBRD evaluates how advanced market economies are through six qualities: competitive, well-governed, green, inclusive, resilient, and integrated. Out of these six, most SEE countries and the Western Balkans score lower on the well-governed and green. The poor performance on green can be attributed to dependency on coal, large energy losses, and low share of renewables.
- The weaknesses in governance are mainly due to a large share of state firms, but also gaps in digitalisation. Digital innovation is an important area, where there has been divergence between smaller and larger markets. Large players are less willing to invest in smaller markets because market scale is lacking. Nevertheless, the pandemic has worked as a catalyst for the advancement of the digital agenda in the whole region and further efforts to spread digital innovation are required in the post-pandemic period.
- Having served as EBRD's Managing Director of Eastern Europe and the Caucasus from 2014 to 2018, Mr Malige shared useful insights on Ukraine and the war's impact on the region and neighbouring countries in Central East Europe (CEE). He stressed that apart from the sanctions on Russia, the wider popular support in the West to reduce reliance on Moscow as a supplier is crucial. In many cases, it is not the agreed sanctions that force companies or banks to stop doing business in Russia (or Belarus), but a general tendency of financial institutions to enforce their own broader and informal limitations on Russian economic actors. Exposure to Russia varies across the SEE region – for instance, Romania has limited exposure while, Serbia is more exposed to potential spillovers.

Comments by Dr. Revoltella

- Dr Revoltella shared a balanced macroeconomic view, considering the region's positive response to the pandemic and the series of multiple shocks that may destabilise its recovery. Regarding the financial sector, Dr Revoltella said that the SEE region performed better than expected during the pandemic, while in 2021 both supply and demand conditions were starting to relax again. The new challenge for SEE economies has been the Russian invasion of Ukraine. The economic shock generated by the war is far from being localised and represents a major geopolitical transformation, with long lasting consequences.
- The region is very much concentrated in terms of banks operating, with a few banks playing a central role in the financial system. Five of these banks are present in the Russian market and face associated risks. Even if the size of the exposure is not a systemic issue, the new geopolitical context is likely to affect these banks profitability and possibly their overall strategy in CEE and SEE. The big concern, according to Dr Revoltella, is whether there will be additional further spillovers and what their effect will be on the banks' strategies after the war and sanctions.
- On the corporate side, Dr Revoltella noted the strong policy support to firms affected by the Covid-19 crisis. This allowed firms to start their transformation process and respond to challenges. What will be important is the firms' resilience in the recovery stage when policy support is removed. Combined with the new energy shock, aggravated by current geopolitics, the removal of policy support may lead to an increase of NPLs and defaults.
- When asked about Green Transition, Dr Revoltella said that the process is both a challenge and an opportunity at the same time. The challenge is the protracted and expected energy shock, which is having an immediate impact on households and firms. The temptation to compensate for this price shock may demotivate households and companies from investing in green energy, although partial compensation remains a correct tool.
- It is important that the EU moves to the next step of energy security and sends the right signal in terms of national policies that should be adopted. This transition is going to be a multi-year process but now is the right time and opportunity to create the necessary infrastructure and incentives.

Comments by Prof. Vujcic

- Prof. Vujcic gave an overview of the CEE and SEE banking systems starting from the transition period in the 90s, the emergence of private banking, and the lessons learnt from the financial crisis. Before the crisis, the region's banking system was characterised by large capital inflows, as banks used imported capital to finance both the retail and the public sector. After the financial crisis – and before the pandemic – the banking system was based more on domestic sources of funding rather than imported capital. This made the growth of the banking system and financial deepening more modest and resilient.
- According to Prof. Vujcic, three important lessons have been learnt in the past decade. Firstly, too much sophistication and innovation can lead to a crisis more easily than the less sophisticated and more traditional ways of lending. Secondly, macroeconomic stability is crucial for the banking sector, as the Greek case showed during the eurozone crisis. Similarly, banking sector stability is important for macroeconomic stability, as the Irish example demonstrated in the same period.
- The third important lesson from the period after the financial crisis is that banks may become more stable, productive, and resilient with a lower number of branches and employees. This is the case in Croatia where there are only around 20 banks compared to 60 over a decade ago, making the banking system more competitive and efficient than in the past. Prof. Vujcic stressed that these lessons have been valuable during the Covid-19 crisis and will remain so for the future.
- When asked why Central Bank Governors perform better than governments in SEE, Prof. Vujcic, who is also Chair of the Vienna Initiative, said that Central Banks in the region have managed to preserve their independence and through efficient and informal coordination in the context of the Vienna Initiative, they have been able to coordinate consistent policies across the region. This efficient coordination has proved a useful tool during all recent crises, including the ongoing one in Ukraine.

Conclusions

- The resilience of the banking system, which is currently serving as a pillar of stability in the region, was highlighted by all participants who shared their optimism about the banks' future.
- The lessons learnt during the global financial crisis helped the financial systems of SEE countries to overcome the first shock of the pandemic. However, the recent war on Ukraine has posed serious challenges for the region, with the supply shock and increased cost of commodities threatening post-pandemic recovery.
- The Green Transition and the advancement of the digital agenda (core pillars of the EU's Recovery and Resilience Facility) must remain priorities for these countries in the years ahead, despite the expected protracted crisis especially in the energy sector.
- EU membership for the Western Balkan countries and broader political and economic cooperation will be important steps for an optimistic scenario in the wider SEE region.
- Both EIB and EBRD representatives confirmed their commitment to the region.