Capital Flows, Credit Crunch and Deleveraging Dynamics: The Case of Slovenia, Croatia and Hungary in Comparison

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Presentation

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• We are going to connect following elements into one coherent story:

  – Changes in the stock market
  – Capital flows in a small open economy
  – Credit growth
  – Credit policies
  – Sources of economic growth
  – Monetary policy
Three countries

• We are going to look at three countries:
  – Croatia: joined EU in 2013
  – Hungary: joined EU in 2004

• Although the three countries are economically different and their economic trajectory was different, the end result was the same in all three countries: prolonged recession without sources of long term growth.
• In 1990 all of the aforementioned countries have entered into a process which has been termed “economic transition”.
• The main objective of this process was to transform economies from socialism into capitalism.
• The process should have been achieved through economic transformation and both political and economical inclusion into capitalist world (EU, EMU, NATO, WTO)
Up to 2008

- All three countries have had:
  - Strong economic growth
  - Strong investments in fixed capital
  - Negative current account
  - Positive capital account
  - Strong credit growth, especially the growth of personal (household) debt
• When the economic crisis started in 2008 the selected three countries were also in different positions in terms of economy.
• In terms of the EU average GDP PPP:
  – Slovenia had 91%
  – Croatia had 65%
  – Hungary had 64%.
What happens after 2008

Real GDP growth rates

Investments in fixed capital as % of GDP

Domestic demand

Foreign debt as % of GDP
• There is a strong realignment. What was up (above the EU average) is now down (below the EU average).

• The main source of economic growth should be investments in fixed capital. Basic economic theory states that increase in investments will lead to the increase in fixed capital. In order to keep the capital to labor ratio constant; increase in fixed capital should lead to increase in labor demand. However, our three countries did not have a significant investment boom before the crisis. The investments in fixed capital, as percentage of GDP are only several percentage points higher than the rates in EU28. So we do not see in the data that the economies were led by investment boom.

• After the recession the investment rates fell and in the time period from 2009 are almost exactly the same in the three countries as they are in the EU28. This is the true implication of the crisis: what is the new source of economic growth?
• So the first three graphs are giving us the following set up before the crisis: there is economic growth, but it is not driven by investments and there is a strong domestic demand.
• Graph four gives us the explanation of how this was achieved: foreign debt.
Dig in

• What have we seen so far in the data in all three economic stories?
• We have a similar path and same the same end.
• But to conclude that what has happened in all three countries is the same, would be wrong.
• Although the end result is the same, we are in fact dealing with three completely different stories.
Arguably before the 2008 Slovenia was one of the most successful transition countries.

The process of economic transition in Slovenia is generally split into three separate periods, as described in Simoneti (2010). The first period is from 1991 to 2004, so from start of independence to joining the EU. The second period is from 2004 to 2008 when the crisis started and the third period is the period of crisis from 2009 onwards.

Slovenian approach to transition was gradual. The state ownership was not quickly privatized and Slovenia decided to keep control over several key industries like banking, as described in Ribnikar (2004).

In general, Slovenia was regarded as a closed country and foreign investments and foreign purchases of Slovenian companies were not very welcomed, as mentioned in Masten (2010).
• The second period is the period of joining the EU and period of economic benefits from the EU membership.
• As we have seen from the data overview Slovenia had considerable rates of economic growth, but at the same time there was a significant increase in foreign debt.
• In case of Slovenia, foreign debt was not used for investments in real economy since there were very little investments in Slovenian capital, but it was used for portfolio investments.
Slovenian stock market

• Slovenian stock market in the time period from end of 2003 to end of 2007 had significant growth rates. In this time period growth of main Slovenian stock index increased 151% while DAX index increased 113% and Dow Jones increased only 23%.

• At the end of 2008 Slovenian stock index has lost 67% of its value and it has never recovered since. As a matter of fact, the Slovenian stock index SBI 20 was discontinued in 2009 and replaced by a new index SBI TOP.
What has happened in Slovenia?

The era of cheap money combined with no capital restrictions and stable economy was used for stock market speculation. What was considered development of stock market and capitalist economy was, in fact, nothing more but speculation and stock market bubble.

The inflow of money into stock market was simply much more than the economy could absorb, the demand for stocks overcame the supply of the financial instruments.
Croatia did not have a large capital flows before 2000.
From 1995 to 2000 foreign debt increased by 6 billion dollars and foreign investments were 3.1 billion dollars.
The capital inflow boom was in the period from 2000 to 2008 when the foreign debt increased by 30.4 billion euros and foreign investments totaled another 18.1 billion euros.
Foreign debt structure

- General government
- Credit institutions
- Firms
- Rest

Year:
- 2009: 12.99
- 2010: 12.00
- 2011: 12.01
- 2012: 12.02
- 2013: 12.03
- 2014: 12.04
- 2015: 12.05
- 2016: 12.06
- 2017: 12.07
- 2018: 12.08
- 2019: 12.09
- 2020: 12.10
- 2021: 12.11
- 2022: 12.12
- 2023: 12.13

Percentage:
- 100.00%
- 80.00%
- 60.00%
- 40.00%
- 20.00%
- 0.00%
Why did the foreign debt of firms increase so much?

• Starting with 01.01. 2007 Croatian central bank introduced a new regulation whose main objective was to decrease credit growth in Croatia.

• The measure was simple: banks were allowed to have 1% of credit growth per month, if the credit growth was more than 1% per month the banks would have to buy bills issued by central bank.

• The central bank bills yielded 0%. This simple measure affected the cost of funds for the banks because when the credit growth was more than 1% the cost of loans issued by the banks increased.
Since the households cannot directly borrow from foreign entities because of complicated procedures, the banks used the 1% limit to lend to households and firms were instructed to borrow from abroad.

This had two major important effects. First, this increased firm’s borrowing from abroad and second, increased foreign debt. This explains why there was a restructuring of foreign debt in Croatia.
- In 2003 government started a new program: subsidized housing loans in Hungarian forint. This new banking product was acceptable for the households because of the monetary policy.
- From 1990 to 2000 Hungary had a variable exchange rate regime, but in 2000 the exchange rate was stabilized versus the EUR. So a long term loan in HUF did not have any currency risk.
- In 2000 Hungary has changed its monetary policy and has switched from variable to stable exchange rate regime. The removal of the currency risk opened a new possibility for the banks.
• However, because of the budget restrictions in 2004 the subsidized program was finished.

• The banks were able to carry on with a lucrative product of housing loans, but under the new exchange rate regime the housing loans were in Swiss francs.

• The banking strategy of cheap loans and monetary policy of stable exchange rate regime led to an explosion of household debt. When this new debt was larger than the deposits in the bank, the banks simply moved outside of Hungary to get funds and this lead to an increase in the foreign debt.
The best way to describe the crisis of 2008 is to say that economic illusions have been shattered.

- Credit without investments is not a positive thing
- Unchecked capital flows can cause significant long term imbalances
- Economic expenditures have to be based on real economic activity
- The foreign money is not cheap or unlimited
- Monetary problems can easily transfer into real economic problems, especially into fiscal (budget problems)
Lessons, if any?

- It is clear the central bank cannot any longer focus only on the stability of the prices, but has to focus on other elements of the economy. Most importantly, the central bank has to focus on the structure of credit and the effects credit growth has on the economy in the long run.
- Most standard economic models do not allow households to borrow above their economic constraint, however we have seen this behaviour in the data.
- The importance of sources of fiscal revenue has also come into spotlight with the 2008 crisis. Countries which do not have a clear source of revenue based on real economic activity cannot sustain their spending in the long run. As we have seen from the data, all three countries have problems with volatility in domestic demand. This problem did not arise because of problems in the real economy, but because of the lack of controls of cash flows in and out of a small open economy.
- Credit has to follow real economy and real economy cannot be fuelled by credit growth expenditures. Real economy has to be fuelled by real economic activity and investments. This is the perception we should also take regarding the process called deleveraging. From our perspective deleveraging is nothing more than decrease and implosion of monetary economy.
• In all three countries monetary policy has done little or nothing to address the severe changes in monetary variables.

• There is a significant portion of research which perceives the growing imbalances as a normal and positive thing.

• Central banks were focused on the low inflation completely ignoring instabilities and bubbles which were being created around them.

• The stock market bubble, credit bubble, foreign debt bubble, housing prices bubble were all caused by monetary factor: capital inflows.
Conclusion

- Central banks have allowed the built up of the economic imbalances.
- Stock market was unfortunately not a mechanism of free market and capital allocation, but in fact an indicator of those imbalances.


Hosszú, Zsuzsanna, Gyöngyi Körmendi, Bálint Tamási and Balázs Világi (2013). Impact of the credit supply on the Hungarian economy. MNB Bulletin Special Issue, October 2013, pages 81 – 90


