Ivan Iskrov: Growth and the financial system – lessons from emerging Europe with a focus on Bulgaria

Speech by Mr Ivan Iskrov, Governor of the Bulgarian National Bank, at the conference on "Achieving sustainable growth in South East Europe: macroeconomic policies, structural reforms, socio-political support, and a sound financial system", organised by the Bank of Greece and St Antony's College (Oxford), Athens, 11 February 2011.

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Ladies and Gentlemen,

It is a pleasure to be here at this conference, organised by the Bank of Greece together with St. Antony's College, Oxford. Above all, let me thank Governor Provopoulos for the invitation and the opportunity to come here and, together with my distinguished colleagues from South East Europe, to be able to talk before such a reputable audience.

As a central banker, certainly the financial industry is of direct interest to me. But although the topic of this panel is "growth and the financial system", I would also like to go beyond it and touch upon other issues discussed so far today.

Politics and politicians do matter

The topics of the panels overlap and the four main sessions are arranged in a very logical sequence. I am saying this, because the financial sector does not function in isolation from the rest of the economy and the political stance. A strong financial system cannot co-exist with a fragile economy and political instability (at least not for long). The opposite is also true: weak financial markets and weak institutions hamper the sustainable growth.

For example, the recent crisis drew the attention to the banking industry, many times blamed to have caused the global turmoil. There is no use repeating now how guilty the banks are, that is, the well-known sequence of events: the "sub-prime" lending, the "toxic" assets, the need to bail out banks and the subsequent economic and fiscal dimensions of the crisis. However, we should not turn a blind eye to the root cause: the role of politics and politicians. What about the call for "affordable housing" which was dominating the political ideology in the last two decades in the US (and not only there)? What about the related environment of low policy rates, coupled with the failure of regulators to identify and control systemic risks? Was that not really at the root of the asset bubbles and risky behaviour of the banks? We all know the answers. The "greedy" bankers are not the only ones to blame.

Learning from emerging Europe

At least, that is the story in the "advanced" countries. We should bear in mind that no shocks came from the so-called "periphery" of the euro area and emerging Europe. Rather, the crisis set in with the failure of financial markets and institutions in countries where they had supposedly been best regulated, most experienced and of highest liquidity. Being part of the global markets, the countries of emerging Europe became also part of the crisis. From today's perspective, they could serve as a good example of mitigating and weathering the crisis.

So how can the experience of this region contribute to a better understanding of the interplay between finance and growth and the various policy choices?

The countries of emerging Europe gained experience from their own deep crises over a decade ago. In most of them, output collapsed at the start of transition. Then almost everywhere there was a banking crisis, leading to heavy private and public losses. But valuable lessons were learned during the economic transformation. Some of the pressing issues were bank insolvencies, debt restructuring and privatisation. The key lesson was that everyone, including not only the general public but also the elected politicians themselves, pays a higher price when reforms are delayed. This is true even if such reforms seem painful and unpopular in the short run.

Ten of the former transition economies are today members of the European Union (three of them – Slovenia, Slovakia and Estonia – already joined the euro area). But EU accession was not granted automatically. Membership was not a gift. Many criteria had to be complied with, including the assessment of whether the country had a “functioning market economy” and its “capacity to cope with competitive pressure and market forces within the Union”. That necessitated radical legal and institutional reforms in the candidate countries. Transition Europe had no choice but to learn by experience, well before the recent global crisis, what policies were ultimately beneficial for sustainable economic growth and for the stability of the banking system. These policies included: privatisation and limiting the role of the state in the economy; increasing the flexibility of labour markets; opening-up to foreign investments; liberalisation and eliminating barriers to competition; combatting corruption and other forms of public sector inefficiency, etc.

The lessons from the previous crises and the EU accession experience are the major factor why emerging Europe is showing such resilience and flexibility now. These are the main reasons why the region has been weathering the current crisis relatively better than the rest of the continent.

The case of Bulgaria: using growth to save for a rainy day

By way of illustration, let me focus on the experience of Bulgaria. My country went through a severe banking and financial crisis in 1996–1997, when one third of the banks went bankrupt. There was hyperinflation and the confidence in the national currency vanished. That prompted the introduction of a very conservative monetary regime, the currency board, in July 1997. After that, inflation and interest rates went down swiftly and sustainably. Since then the Bulgarian economy has been growing in an environment of practically non-existent exchange rate risk, with highly flexible labour markets, hard budget constraints and fiscal discipline. The ratio of public debt to GDP fell from 105% in 1997 to 16% in 2010. The currency board arrangements are and will be our main anchor of stability and predictability till the euro adoption. Irrespective of all electoral cycles, the support for the currency board by the business community, the general public and all political parties has stayed intact.

The current crisis started to affect Bulgaria towards the end of 2008, with the decline in external demand and the lower capital inflows. However, the banks in Bulgaria did not have any exposure to foreign “toxic” assets and did not suffer directly from the “domino effect” of collapsing financial institutions abroad. The Bulgarian case was different from the Anglo-Saxon scenario because we had learned our lessons from 1996–1997 and we had accumulated enough reserves to serve as a cushion. To talk in numbers, the government entered the crisis with a fiscal reserve of 12% of GDP at the end of 2008. The gross international reserves of the Bulgarian National Bank were 36% of GDP then. The banking system average capital adequacy was 14.9% in December 2008.

Our banking system has never been a source of problems. Engaged in traditional commercial banking, our banks were affected by the crisis only when the general economic activities declined and as a result some of their clients found it harder to service their loans. The banking system itself withstood the crisis, displaying outstanding soundness and stability. But this did not happen on its own, neither was it simply due to the presence of reputable names on our market.

We, the BNB, as supervisors have always believed that the good times with strong growth must be used to “save for a rainy day”. The consistent countercyclical policies of the

Bulgarian National Bank played a key role for the good performance of the banking sector, both before and during the crisis.

In the booming years before the crisis, the BNB insisted on a build-up of capital and liquidity buffers, discouraging banks from excessive asset growth and risk-taking. Some of the measures then included:

- broadening the deposit base for the calculation of MRRs; gradually excluding the recognition of cash balances as reserve assets;
- raising the MRR rate to 12%;
- imposing additional tough MRRs on banks with excessive lending growth;
- keeping the capital adequacy ratio at 12% even after our EU accession (that rate is 50% higher than the existing minimum Basel 2 rule);
- keeping risk-weightings higher than what was required under the EU's Capital Requirements Directive;
- excluding the interim profits when calculating banks' capital;
- discouraging foreign currency lending (except in euro for obvious reasons);
- imposing a conservative LTV threshold for mortgage loans, etc.

However, when the business cycle turned down, our focus shifted towards providing capital relief, supporting liquidity, and easing lending for temporarily constrained, but solvent clients. Some of the steps then involved:

- gradually lowering the MRR rate to 7% on average (from 0% to 10% depending on the source of funding);
- making it easier for credit institutions to renegotiate credit conditions;
- expanding the range of acceptable collateral;
- adjusting risk weights down to the requirements of the Capital Requirements Directive (e.g. retail exposures previously risk-weighted at 100% and exposures backed by eligible residential mortgages and risk-weighted at 50%, started to be weighted at 75% and 35%, respectively);
- prohibiting the distribution of dividends during the crisis period (for 2008 and 2009, for 2010 selectively);
- getting commitments by the foreign banks to keep their exposures to their subsidiaries, etc.

Our bank supervision was not influenced by short-term political considerations. The BNB's measures were then often seen by some politicians and entrepreneurs as being too strict and unnecessarily conservative, even "hampering the economic growth". Especially during 2005–2007, optimism was dominating. But we never gave in to pressure.

If regulators do not stay countercyclical in both "good" and "bad" times, the effects of future negative shocks are amplified. That lesson, which is only now being learned in many West European countries because of the current crisis, has been a milestone of supervision for many years in Bulgaria. With respect to bank regulations and the supervisory tools and practices, today Bulgaria is rather advanced, and not a "catching-up" economy. This is also true for most of the other countries in the region as well.

As the crisis unfolded, the quality of assets deteriorated with NPLs reaching 11.9% by December 2010 (up from 2.4% at the end of 2008) but sufficient capital buffers were preserved. The banking system continued to make profits despite the rise in non-performing loans and the subsequent increased provisioning. Today the average capital adequacy ratio exceeds 17%, with Tier 1 capital adequacy above 15% and overall liquidity ratio of around 24%. That is not the case in the most developed markets.

Beware of superficial announcements

It is equally important to stay aware of the consequences of speculative public speaking and bad communication. Despite even the most prudent policies and sound financial fundamentals, stability may be put at risk by repeated negative superficial public comments. Let me tell you now that an important share of our work during the crisis was devoted to monitoring and promptly reacting against the numerous ridiculous statements that were coming from abroad, even from international financial institutions of good reputation. That is why two months ago the Bulgarian National Bank organised a seminar for the local media where we presented a "Top 30" list of failed doomsday scenarios and forecasts made by foreign and Bulgarian observers since 2008.

The Greeks are well aware how the accumulation of adverse market sentiments may lead to "self-fulfilling prophecies".

And a few words on the so-called "Greek" banks in Bulgaria. This may serve as another example in this respect. After one year of much talking about them, these subsidiaries have kept doing well. There has been no withdrawing of liquidity from Bulgaria to support the parent institutions in Greece, nor have local residents moved their deposits to other banks. The banks' shareholders confirmed their long-term commitments to stay and even expand activities in Bulgaria to exploit the opportunities on our market. Generally, the indicators of Greek subsidiaries in Bulgaria are equal or higher than the average of the system as a whole.

We as supervisors and guardians of financial stability had to spend much time to dispel all the rumours and fears. These efforts were not in vain.

Continuing reforms, letting banks work

Governments need to stay firm in their efforts to conduct fiscal consolidation complemented by the necessary structural reforms. Politicians must not be afraid of reforms the needs for which are well understood. Even in the short run, reform-minded politicians get social and political rewards, as long as their message is clear. That has been demonstrated recently in both emerging Europe (with the re-election of a reformist government in Latvia) and also here in Greece (during the local and regional government elections last autumn).

Policymakers should not yield under populist pressures. Better financial consumer protection and prudential regulations are certainly needed. But the banking industry should not be overburdened and prevented from fulfilling its traditional functions. Measures such as bank levies or the taxes on bank transactions, etc., may be very close to crossing that "red line". The global crisis has not changed the fact that financial development is a powerful driver for economic growth. Let us not make the banks a scapegoat!

Thank you for your attention!