Boštjan Jazbec: Financial crises and the current situation in Slovenia

Address by Mr Boštjan Jazbec, Governor of Bank of Slovenia, at the Annual Conference of the Bank Association of Slovenia, Ljubljana, 18 November 2014.

*   *   *

My congratulations to the Bank Association of Slovenia for choosing a most appropriate theme for this year's annual conference, and for putting together in the November edition of Bančni vestnik some high-quality papers on critical issues that occupy the minds of policymakers in Slovenia.

This year is the tenth anniversary of Slovenia's accession to the European Union. Who would have dared to predict ten years ago that Slovenia would find itself in the midst of a most severe and protracted economic and financial crisis?

Can we take comfort by claiming, like in the famous hit song by Billy Joel, "We didn't start the fire"? In my opinion, much of the problem that we face today is of our own making. We have to figure out ourselves the best strategies to put the economy back on track and make sure that we get there.

***

Let me start with what we all know about financial crises and the current situation in Slovenia.

A common cause of the vast number of financial crises experienced in various countries at different times is excessive debt accumulation without enough awareness of the consequent risks. Most debt-fuelled booms end badly. Financial crises generally tend to be protracted affairs.Sometimes, inertia and denial on the part of the policy makers add to the duration of the crisis period.

The situation in Slovenia conforms to this pattern.

The rapid economic growth that followed European Union accession in 2004 was fed by excessive borrowing and risk taking by banks and enterprises. Banks relied heavily on external wholesale funding and the rapid credit expansion took place against very limited equity capital in the corporate sector.

These balance sheet vulnerabilities got exposed when the external financing began to drain away with the onset of the global financial crisis in 2008. Slovenia was caught in a vicious cycle of reduced credit availability, deleveraging, a cutback in corporate investment and output, and rising non-performing loans. The deterioration in the balance sheet of banks became a problem for the state, given that the state owns the majority of the banking sector.

The recession put the public finances under severe strain and, as early as in 2009, Slovenia was placed under the Excessive Deficit Procedure of the European Commission requiring substantial fiscal consolidation efforts in the near and medium term. The burden of restructuring the state-owned banks further added to the strain on the public finances.

Concerns about the health of the banking sector and sustainability of public debt fuelled speculation for a while around mid-2013 that Slovenia would need a bailout and submit itself to a program with the Troika. But, we managed to avoid this by taking some resolute measures and announcing a policy agenda aimed at fixing the fundamental problems with the economy. However, since then, we have lost valuable time in policy formulation and implementation because of not having an effective government for a significant part of this year. Much remains to be done. We have miles to go before we can declare "mission accomplished".

***

What are the challenges that we currently face?

There are visible signs that an economic recovery is underway, but in an environment where net bank credit to the non-financial sector is still contracting. The structure of output growth reveals an underlying fragility. Growth has been primarily export led. The dynamics of private business investment and private consumption remains weak.

What holds back the revival of credit growth and the empowerment of domestic demand?

One reason is that the monetary policy transmission channel is impaired by the weak balance sheets of banks and the corporate sector. As long as asset quality is poor and capital is inadequate, banks will tend to restrict overall credit supply and apply a large risk premium to lending rates. Liquidity may not be a binding constraint in such a situation. Indeed, there is considerable liquidity currently in the Slovene banking system, and this accounts for the unexpectedly low take up in the recent first auction of liquidity under the ECB's TLTRO programme.

A second reason is weak credit demand. Credit demand has decreased since the onset of the global crisis. This is because highly indebted companies are focused on deleveraging. The process still has some way to unwind. Slovene enterprises remain overleveraged, both relative to their euro area peers and historical trends. As long as the deleveraging process continues, the easing of monetary conditions will not necessarily induce higher borrowing.

A note of caution is in order regarding boosting credit growth. The financial crisis has demonstrated and recent empirical research shows that credit growth should not compromise financial stability. If we boost credit demand willy nilly without addressing the large sectoral and aggregate imbalances in the economy that had built up during the credit boom years, we may end up sowing the seeds of another financial crisis. Matters are likely to become worse if additional credit availability enables enterprises to postpone balance sheet adjustment. So, the focus should be on the proper allocation of credit instead of its aggregate amount. It is important that good borrowers rather than the bad ones are the main beneficiaries of credit growth.

I am not downplaying the importance of credit in fostering economic activity. Far from it. Bank credit and other debt instruments are crucial to all economies, but balancing the risk and opportunities is always a challenge, a challenge that we must never forget. The crisis has demonstrated very clearly the importance of limiting the reliance on debt-financing and having adequate safeguards in place to prevent credit bubbles. A shift toward more equity financing is urgently necessary, for which, an appropriate environment has to be in place for attracting new non-debt capital flows.

***

So, what should be the way ahead?

Putting the economy back on track requires a coherent, integrated national policy strategy to restore the health of the financial sector, restructure the corporate sector, and reinforce the sustainability of the public finances. The economic recovery must be based on equity-financed investment and not on debt-financed investment. Given the need to ensure fiscal sustainability, recourse to more state funding for restructuring the economy and increasing investment is not a feasible option.

Some of the required policy measures, notably in the financial sector, have been and are being implemented. Without a determined follow through with supporting measures on other fronts, the fragile economic recovery will stall and problems will intensify.

***

Priority has been given to repairing the balance sheet of banks. Based on the findings of a comprehensive asset quality review and stress tests in late 2013, balance sheets of four banks have been repaired through recapitalization and transferring non-performing loans to the Bank Asset Management Company. The findings of the recently concluded Comprehensive Assessment indicate that, notwithstanding these efforts, the health of the banking sector remains fragile.

This is not surprising. The banking system is the nerve center of the entire economy. Non-performing loans remain high even after the transfers to the Bank Asset Management Company and their volume has increased in the course of 2014. This is a result of the still weak economic growth, slow deleveraging in the corporate sector and too slow enterprise restructuring.

The rehabilitation strategy also involves bank resolution through liquidation, consolidation and privatization. Two small domestic banks are currently in the process of being wound down, and the privatization of one state-owned bank (NKBM) has already been initiated. The new European resolution mechanism is scheduled to take effect in 2016. Banka Slovenije is seeking to speed up the process. It intends to create in 2015 a deposit insurance fund and a resolution fund to facilitate the consolidation of weak banks.

The banking sector is undergoing a necessary process of structural reforms, and the world of banks is changing. Regulation and supervision is being strengthened to make the future of the banking system more stable and less crisis-prone. On 4 November, the European Central Bank assumed responsibility under the Single Supervisory Mechanism for supervising 8 banks in Slovenia accounting for more than two-thirds of the market share. The supervisory culture will change under the new regime. Supervision will become more quantitative and the ECB will also inspect the business models of banks. For the 10 credit institutions not covered under the SSM, Banka Slovenia will align its supervisory approach with that of the SSM. The Central Credit Registry is being upgraded to support banking supervision.

Banka Slovenije has established, like other European central banks, an institutional framework for macroprudential oversight of the financial system that is in line with the recommendations of the European Systemic Risk Board. The basic aim is to safeguard the stability of the financial system by identifying the emergence of systemic risks at an early stage and taking preventive measures to mitigate these risks.

****

Bank rehabilitation is only a necessary condition for unlocking credit growth to the Slovene economy. Successful corporate restructuring, which entails both financial and business restructuring, is also essential to lay the foundation for productive investment and strong employment creation. Unless enterprise restructuring is undertaken decisively in a timely fashion, the capital buffer of banks created by their recent recapitalization will erode and further injections will be needed once again.

The enabling legislative framework for enterprise restructuring is in place, but systematic restructuring is yet to begin. This should be given priority by the government. A decision must be made with regard to the most urgent restructuring cases

A critical constraint that Slovenia faces is the availability of funding for corporate restructuring and increasing investment activities. Given that the feasibility of using state resources for these purposes is limited, privatization and entry of private investors should be the key vehicles for the required non-debt capital infusion foreign direct investment is a key source of potential equity. The business and political culture will need to adapt and embrace the realities of globalization and Slovenia’s integration in the world economy. A communication strategy must be developed and implemented to promote and market Slovenia as an attractive FDI destination. In parallel, steps should be taken to ease regulatory and other barriers that currently inhibit investment.

****

Small and medium-size enterprises (SMEs) play a very important role in the Slovene economy and their financing must not be ignored. It would be necessary to increase the absorption of foreign resources for supporting SMEs. The Slovene financial institutions responsible for final credit delivery should develop new financial instruments for start-ups and young fast-growing enterprises, and explore methods for attracting higher volume of venture capital investments from foreign sources.

****

I would like to conclude by asking “What have we learnt from the financial crisis”? Maybe you know the famous quote:“There is nothing new except what is forgotten.” The cover of the Special Issue of Bančni vestnik has reminded us the lesson from history: “No more credit excesses”. Let us not forget this any time soon.