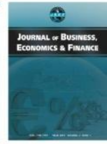
Journal of Business, Economics & Finance ISSN: 2146-7943

Journal of Business, Economics & Finance

Year: 2013 Volume: 2 Issue: 1



THE EU DEBT CRISIS: A REFLECTION ON FINANCIAL SECTOR OF THE WESTERN BALKANS

Mehmed Ganić[1]

[1]Faculty of Economic and Business Administration, International University of Sarajevo, Bosnia and Herzegovina.mganic@ius.edu.ba.

KEYWORDS

EU debt crises, foreign banks, Western Balkan, banking indicators , European bank subsidiaries.

ABSTRACT

The main objective of this article is to analyze the certain financial variables in order to have asses transmission effects of the EU debt crises on stability and efficiency of financial sector of Western Balkan (WB). Also, this study uses a cross-country comparison methodology and examines the following aspects: Capital adequacy, liquidity position and efficiency of the banking sector of the WB in pre crisis and crisis period as well as financial sector size, structure, and trends in financial developments for the WB region in pre crisis and crisis period. The paper is divided into six sections. Section 2 deals with the literature review. Section 3 contains an explanation of the data and methodology. Section 4 analyze trends in financial developments for the WB region. Section 5 gives an overview of the implications ofEU debt crises for WB financial system while the focus of the section 6 is on an analysis of changes in perceptions by European bank subsidiaries in WB countries in context of the European debt crisis.

The findings and discussion presented in previous sections of this article ends with conclusions that impact of EU debt crises has been transmitted on the position banking sector of WB through several sources, especially through: decline in profitability, credit growth has dropped significantly and asset quality has deteriorated markedly.

1. INTRODUCTION

Four years ago the whole world was concerned about the global crisis since global economy was affected by adverse developments in the United States. At a time when the global economy began to show positive signs of recovery European Union-27 (EU-27) has remained on the sidelines. The crisis apparently has deeper roots than those seen on the surface. In other words, European debt crises has had a far wider range and complexity of the problem than it has been discussed for years. The general atmosphere of inherited and created disputes and wrong economic decisions only made the EU -27 more divided. Year 2008 marked as beginning of the debt crisis in EU-27 caused collapse of the banking system in Iceland. As opposed to defuse the situation and improve the atmosphere in the rest of the world the EU has remained rough area with a lot of chronic problems and acute debt crisis. The transmission of the crisis to other EU-27 countries, including Greece, Ireland and Portugal in 2009 further multiplied the negative impact of the crisis for EU

market, but also in countries that are more integrated with the region. The crisis has reached its first peak in early 2010 as a result of major structural problems with the deficit in Greece increasing cost of financing government debt. By its nature the current debt crisis in EU-27 is structural. The causes of European debt crises are complex but related to series of obvious abuses in fiscal and economic policies. It turned out the previous history of European integration that the membership of a number of countries in the euro area and EU with different levels of economic development constitutes an obstacle to the harmonization of economic policies. There is a significant gap between the EU-27 countries in terms of GDP per capita expressed in purchasing power parity (PPP). Data released by the Eurostat show that the indicator of PPP for the 16 euro area countries amounted to 108 percent of average EU-27 by the end of 2010. It was noted that this indicator was only 72 percent in Slovakia, 78 percent in Portugal and Malta, 86 percent in Slovenia, 95 percent in Greece and 98 percent in Cyprus. In this context it must be mentioned that not all members of the euro area successfully adopted an innovative model of development, which would provide a guarantee that European countries continue to maintain a competitive advantage. The causes can be found in the fact that in some countries on the periphery of the EU-27 that have not been able to transform its uncompetitive economy and adapting them to conditions of globalization. Some countries used membership in the EU-27 and the euro area to take advantage of improving the living standards of their citizens, for example, in the framework of a supranational regional policies, and not to exploit any synergistic effects (such as national companies access to new markets, selling or developing cooperation in the field of production) .

The following serious objection is that the international statistics formally even put several troubled EU countries in group of developed countries, simply because they are EU members. However, in terms of productivity, they are lagging far behind the leading European countries. Poor quality of education, which is common of southern Europe, also indicates a low level of human capital, and the slow process of assimilation and integration of population in modern information technology developments. A number of countries on the periphery of the EU-27 has lived for years beyond their means, because wages are generally growing faster than output per person employed. The adverse consequences of sustained large budget deficits, troubling social security system and inefficient administration worsened the social situation (A. Dynkin, 2010, pp. 7-9). Furthermore, in order to understand seriousness of the situation it's important to point out that in 2009 the level of EU-27 budget deficit stood at -6.8 percent, and at the level of the euro area (EU 16) -6.3 percent (Eurostat, 2011, p.66).

The spillovers from EU debt crisis fully hit the economies of WB and led in 2009 to the deepest recession since early transition. The countries of the WB have faced significant challenges since the latest financial crises began in 2008. However, 2009 has proved to be a difficult year for all economies of the WB countries. The credit expansion of Western banks caused instability in many transition economies where these banks had operations. Equally important is that in the pre crisis period (2003-2007) the economies of the WB had enjoyed solid economic growth mainly fuelled by large inflows of bank credits, enabling increased domestic borrowing. In some cases, notably Montenegro, average annual rates of credit growth exceeded 90 percent. Over this period, in Bosnia and Herzegovina, Macedonia, Serbia, and Albania, average annual rates of credit growth were between 20 percent and 30 percent. On the other hand, Croatia managed to keep the rate of credit growth within reasonable bounds, averaging 15 percent over the period.

2. LITERATURE REVIEW

In the most recent systemic banking crises around the world it can be concluded that they have typically been caused by an adverse macroeconomic shocks that have weakened the whole financial system, rather than the impact of the transmission of panic that followed the failure of a

single bank. (Claudio, B., 2003). In some countries, it took several years to clean up the balance sheets of the banking sector because of the concealment nonperforming loans from regulatory authorities. Such delays in action of the restructuring the banking sector can cotter financial intermediation and credit crunch as well as to lead to non-banking private sector. In some developing countries, dealing with a banking crisis often results in large fiscal expenditure since that the rescue of the banking sector was a serious threat of sound and sustainable government budget positions.

The banking system is particularly important for small and open economies because of their size as a rule, while other segments of the financial markets are small and underdeveloped. In other words, for these countries banking system is the most important source of liquidity for the real sector of the economy. Therefore, the banking crisis in these countries may have a much greater negative implications and much greater potential to spread crises from the financial to the real sector. Also, it may be particularly at risk for those small economies that have a disproportionately high value of financial assets to GDP. Banking business is very sensitive in every country because it could cause market instability. Even the bankruptcy of small banks can generate financial instability, because depositors may be concerned about their deposits in other banks, and begin withdrawing their deposits – sparking a real bank run. Due to concentrated nature of the banking system, even bankruptcy of individual bank generally can have a negative impact on the whole banking industry. Therefore, the banking crises are more dangerous in small economies due to high concentration of individual depositors and thus widespread panic that potentially can cause a collapse of the financial system. Also, by definition, small economies have to be very open, and therefore are more susceptible to external shocks transfer from abroad, or "imports" of banking crises.

As pointed out by Mendis (2002) in small opened economies (SOEs) worsening terms of trade, reduced inflow of foreign capital, large fluctuations in exchange rates or limited access to international financial markets have great potential for developing into a crisis. Also, his study found strong association between the frequency of occurrence of external shocks and banking crises in SOEs. Key macroeconomic factors such as negative income shocks, level of debt and the real exchange rate represented the main determinants of the crisis while negative trade shocks, were responsible for a large number of banking crises in the sample.

This means that the financial crisis more easily spread in SOEs than in the case of large countries with less share of external sector. This made mono-cultural country to be particularly vulnerable as well as a country of exporting primary products.

One of the significant analyses to take such a perspective was probably De Haas and and Van Lelyveld's article on multinational bank subsidiaries in Central and Eastern Europe (CEE) countries (2006) and (2010). They find that a lower solvency, liquidity and profitability of parent banks can lead to lower credit growth of multinational banks' subsidiaries that are located in CEE. Analyzing different components of the multinational banks' subsidiaries that are located in CEE they provided evidence that if only a limited number of local banks are part of a multinational bank holding, or if many banks are part of a multinational bank but these banks are headquartered in quite different home countries, aggregate bank lending in the host country will become less dependent on local economic development and thus be less procyclical. This contrasts with a situation in which a substantial share of the banking sector is taken over by parent holding companies from one single home country.

Kaminsky and Reinhart (2001) examined the potential for contagion through exposure to a common lender. They found evidence that common bank lenders have played a significant role in

the spread of currency crises—indeed, the bank-lending channel outperforms trade channels in explaining the vulnerability of a country to contagion.

3. DATA AND METHOD

The implications of the EU debt crisis have demonstrated specific effects on the economy of the WB. Due to the reduction of external capital inflows and low accumulative capacity of the domestic economy, there was a shortage of resources for lending by commercial banks. In the foreground are banks because they occupy the largest share of the financial system. Commercial banks' share of total financial assets is at over 80%, measured by total assets. This indicates the huge importance that banks maintain a prevailing position in the financial sector's structure in compared to other financial intermediaries that have on the overall economy of the region. The remaining market share was divided among the other financial intermediaries (investment fund, leasing companies, insurance companies, and pension funds) which market share is almost neglected. In other words, it confirms a fact that financial systems of the WB countries are bank-centric while the other financial markets in the WB are still shallow, narrow and thin. This means that beside of banks there are only a few institutions that are able to adequately fulfill the role of financial intermediaries. The main objective of this article is to analyze the certain banking variables in order to have asses effects of the European debt crises on stability and efficiency of banking sector of Western Balkan in pre crisis and crisis period. To achieve the goals, we used the method comparison of the performance of the banking system in the region of WB over the past decade. The analysis covered six national banking system of the WB: Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia. In our analysis we use annually data series which are sourced from the following IMF databases: International Financial Statistics (IFS), and Global Financial Stability Report (GFSR), from the national central banks, their annual reports. The data covers the period between 2003 – 2011.

The main hypotheses used in this article are based on the following assumptions: First, banks are the dominant channel of trade finance and the economy of WB countries; second, the main effects of the first wave of the crisis on banks' balance sheets are the increase in credit risk (NPL) and reduce their profitability; third, over crises period in countries of WB recorded trend changes in the maturity structure of European banks towards deleveraging over the share of short- term and middle –term claims and leveraging of the share of long-term claims.

4. TRENDS IN FINANCIAL DEVELOPMENTS FOR THE WB REGION

There is substantial evidence that is credit expansion definitely improvement in the living standards of the countries of the region. However, credit expansion has increasingly resulted in borrowing on the unrealistic assumptions. The problems of high levels of concentration of risk by banks to private companies impacted on banks to be focused on the retail segment.

In some WB countries foreign banks had acquired substantial holdings in the domestic banking sectors and were easily able to expand their operations due to the growing demand for credit. The high penetration of foreign banks in the region is evident if one takes into account that the market share of foreign-owned bank in Croatia, Albania, Bosnia and Herzegovine and FYR Macedonia is higher from 90 percent. By the end of 2011, in Serbia share of foreign-owned bank was 72.7 percent.

Table 1 shows the trends in financial sector development, proxied by five indicators of financial deepening, in both pre- crises and during the crises period. These indicators are banking deposit liabilities to GDP ratio, ratio of domestic credit to private sector to GDP, ratio of total credit to GDP as well as Stock Market Capitalization to GDP and Insurance Premiums to GDP. The most

important feature of the financial sector WB countries is that its size in relation to the size of GDP is smaller.

Table 1: Financial sector size, structure and trends in financial developments for the WB (weighted average over GDP)

	Pre-crises Period			Crises Period		
	Avg	Min	Max	Avg	Min	Max
Domestic credit to private sector (% of GDP)	43.91	20 (B&H)	80.26 (Montenegro)	48.52	23.45 (B&H)	71.4 (Montenegro)
Deposits (as % of GDP)	54.31	35.45 (Serbia)	72.4 (Croatia)	53.34	38.26 (Serbia)	77.48 (Croatia)
Credit (as % of GDP)	58.05	35.42 (Serbia)	83.97 (Montenegro)	61.99	44.05 (FYR Macedonia)	82.14 (Croatia)
Stock Market Capitalization (as % of GDP)	85.72	34.1 (Macedonia)	119.1 (Croatia)	40.78	18.08 Macedonia)	82.83 (Montenegro)
Insurance Premiums (as % of GDP)	1.89	0.62 (Albania)	3.29 (Croatia)	1.79	0.67 (Albania)	2.85 (Croatia)

Source: Author's elaborations on data: International Financial Statistics (IFS), Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

The banking trends documented over the recent crisis and pre crisis period reveal a relatively low depth of the financial sector (table 1). In terms of GDP share of credit to the private sector on average was below 50 percent. The initial level of bank credit to the private sector in terms of gross domestic product in countries in transition was generally much lower than in the EU, which is caused by underdevelopment of domestic financial (banking) system at the beginning of the transition process. The expansion of bank credit began with a low level of financial intermediation in these countries attempt to "catch up" the level of financial deepening with the developed countries of the EU. Therefore, it was expected that total loans-to-gross domestic product ratio grew consistently faster in transition countries as compared to developed countries. Rapid growth in bank credit to the private sector is primarily financed by the high level of domestic savings. The strong growth of bank deposits was the result of growing confidence in the banking sector, the inflow of money from abroad, and the relatively high level of interest rates on deposits. Over the last two years private sector lending by domestic banks has been stabilized at 49.12 percent of GDP, and generally in re-expanding, but at a much more modest (and more sustainable) rates than before the crisis.

Although growth of banks' total gross loans is mainly driven by an increase in deposits of residents, inflows of funds from abroad - either from parent banks or borrowing on international financial markets - are getting more important. Main driving force of capital inflows from abroad represented an opportunity to achieve significant profits on credit markets in transition countries.

Low levels of bank lending during the crisis period can be explained by the negative consequences of the EU economic debt crisis, resulting in a recession and a drop in GDP in most selected economies except Albania.

Another a popular measure that reflects the position of the banking sector in the financial system of transitional economies and the subject of this analysis is the ratio of total deposits to GDP. The global financial crisis has led to protracted difficulties in funding via financial markets. Although in an environment of slower deposit growth versus loan growth in some countries of WB there has been recorded an increase in the ratio of deposits to GDP in relation to the crisis period. The average ratio of deposits to GDP in the crisis period (53.34 percent of GDP) is slightly lower than the pre-crisis period (54.31 percent of GDP). The most developed market of deposits in the region has Croatia, with the average ratio of deposits to GDP of 77.48 percent, as well as Serbia with a ratio of deposits to GDP of 38.26 percent. After the sudden withdrawal of deposits from the banking sector in 2008, when the average GDP share of deposits in the countries of the region fell below 50 percent of GDP, the recovery process was recorded in 2010. The total amount of deposits in the region in 2011 was higher to the pre-crisis level with exception in Montenegro.

Taken as an indicator of the level of financial intermediation ratio credits-to-GDP increased in pre crises (58.05 percent) to 61.99 percent in crises period. It is interesting that this indicator as the primary indicator of financial deepening, increased significantly in most of the countries, as a result of rapid credit growth relative to economic growth. In crises period the level of financial intermediation remains relatively low in the WB region, with the exception of Croatia (82.14 percent).

Most of the countries analyzed first felt the impact of the crisis on their most sensitive part of the financial markets - the stock market. Given the characteristics of the under-developed capital markets of WB countries, it was considered that the impact of the EU debt crisis on this sector will be limited. However, the unstable political environment in early 2008 (Serbia, Bosnia and Herzegovina, FYR Macedonia) reduced investment and the speed of further withdrawal of foreign capital that adversed effects on future developments in stock markets. EU debt crisis is initially expressed in the economies of the WB over liquidity in the global financial markets resulted in growth of interest rate. This caused a slowdown of external funding and the reduction in domestic demand, as well as an increase in domestic interest rates and a slowdown in economic activity. The stock market decline in 2009 by more than 70 percent annually exerted influences on withdrawal of foreign institutional investors from the financial market. If we neglect Albania where there is no trade and therefore can not be expressed any capitalization, ratio of Stock Market Capitalization (as % of GDP) is halved compared to the pre-crisis period.

In contrast to the trends and results in the banking sector, the situation in other financial market segments in the countries of former Yugoslavia is unsatisfactory. A decline in global investor confidence contributed to a reduction in capital inflows and investment in the financial markets of the region. As a result, weak activity had been observed only in capital markets, in which debt market liquidity may be reduced. New issue of securities applies only to the bond market, where the bond market is dominated by state as a major issuer of securities. The greater part of the funds raised by issuing securities government are generally used to cover government budget deficits rather than boosting the investment cycle. Due to the deteriorating credit ratings of most of these countries have abandoned the international bond issues. It can be concluded according to the previus trends of key indicators of financial markets the following:

- ✓ WB stock exchanges are small as gauged by the ratio of market capitalization to GDP and they are dominated by few stocks. In addition, liquidity, as measured by the yearly turnover ratio per stock market capitalization in all countries of former Yugoslavia is too modest.
- ✓ a depth of financial markets is insufficient because the trading activity in the stock market is in general much lower than those for banking development; and

- ✓ Low liquidity of capital markets and an increased sensitivity of the financial markets to the movements of speculative capital.

The insurance sector is in its infancy with the exception of Croatian.

5. IMPLICATIONS FOR WB FINANCIAL SYSTEM - LOANS RAPIDLY BECAME NON PERFORMING

In spite all the turmoil in the EU the banking system of WB countries can be characterized as well healthy also well capitalized with the average capital-adequacy ratio (CAR) higher than set by capital requirements. The CAR has been slightly decreasing from 18.9 percent in pre crises period to 17.1 percent in crises period. Among group of analyzed countries Croatia is the only country showing progress in increase of CAR in the crisis period than it was in late 2007. In the second group can be included Serbia with the highest CAR in pre crises (26.3 percent) as well as in crises period (20.7 percent). Finally, CAR of the third group - all the other Western Balkan countries experienced relatively sharp declines in crises period relate to pre crisis period. Table 2 shows the levels of activity in the crisis period compared to the pre-crisis period.

Table 2: Evidence of change in the size selected banking indicators in the region

	Pre-crises Period			Crises Period		
	Avg. 2006-2007	Min	Max	Avg. 2008-2011	Min	Max
Bank Regulatory Capital to Risk-Weighted Assets	18.9	15.2 (Croatia)	26.3 (Serbia)	17.1	16.1 (Albania)	20.7 (Serbia)
Bank Capital to Assets	11.5	7.2 (Albania)	19.8 (Serbia)	12.4	9.1 (Albania)	20.1 (Serbia)
Bank Nonperforming Loans to Total Loans	5.4	3.3 (Albania)	8.4 (Serbia)	11.3	8.1 (B&H)	15.6 (Serbia)
Bank Return on Assets	1.4	0.9 (B&H)	1.8 (Macedonia)	0.5	-1 (Montenegro)	1.5 (Serbia)
Bank Return on Equity	13	8.8 (B&H)	20.4 (Albania)	3.5	-10.3 (Montenegro)	9.7 (Croatia)

Source: Author's elaborations on data: International Financial Statistics (IFS), Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

It is worth noting that, banks in the WB countries held at the end of 2011 average ratio of capital to risk weighted assets (CAR) at almost 17.9 percent (table 2), that is significantly higher than set by capital requirements.[1] This capital adequacy indicator provided adequate protection against shocks originating in the domestic economy and the banking system.

[1]Minimum capital requirements: Albania (12%), Bosnia and Herzegovina (12%), Croatia (10%), Macedonia (8%), Montenegro (10%), Serbia (8%).

The main effects of the first wave of the crisis on banks' balance sheets are the increase in credit risk (NPL) and decline of their profitability. The latest financial global crisis has left an indelible mark on the banking of WB. As shown in Table 2, the average ratio of NPL to total loans for the 6 countries of WB increased from 5.4 percent in pre crises to 11.3 percent in crises period. This is the first significant increase in NPL ratio after more than ten years and period of banking reform began in the 1990s. These very high levels of NPLs have shown significant deterioration of loan quality. When we compare the results from table 2 it can be concluded that in the years preceding the EU debt crises were characterized by strong credit growth. In pre crisis period, NPLs ratios kept on falling substantially in all countries of Western Balkan. Recorded data on the movement of NPLs show that the banking system in the crisis period is facing major challenges in the process of preserving the stability of their banking system as a whole and the stability of the entire economic system. Available data indicate that in Albania, Bosnia and Herzegovina, and Montenegro ratio Banks' Non-Performing Loans to Total Loans is already an issue. The share of NPLs in total loans jumped in Albania, Bosnia and Herzegovina and Montenegro to 13.9 percent, 11.4 percent and 21 percent respectively in 2011 from 3.4 percent, 3 percent and 3.20 percent respectively in 2007. In Serbia the share of NPLs in total loans in 2011 recorded at 16.90 percent.

Since provisions are a deduction from profits, increases in loan-loss provisions appeared to have a substantial impact on banks' profitability indicators (ROA and ROE). The increasing level of provisions reflects also the declining asset quality. Thanks to the increasing participation of NPLs and there was a significant increase in allocation of reserves to cover potential loan losses that had significant effect on earnings and regulatory capital.

In the pre-crisis period, the rate of return on assets (ROA) and return on equity (ROE) in the WB countries recorded positive growth. As a confirmation it can be concluded in the pre-crisis period, the average rate of ROA was 1.4 percent and the rate of ROE of 13 percent. Table 2 show that in WB countries earning indicators continue to weaken, as ROA and ROE have worsened since the start of crises. Thus, in the crisis period the average rate of ROA in the banking sector of the WB was 0.5 percent and the average rate of ROE of 3.5 percent.

6. CHANGES IN PERCEPTIONS BY EUROPEAN BANK SUBSIDIARIES IN WB COUNTRIES

Austria was among the first countries that recognized the market potential of the region of Central and Eastern Europe and the WB. It also was naturally taking into account the historical ties, cultural and economic relations with this region. It is therefore not surprising that commercial banking from Austria were among the first that were more willing to take risks in the markets of the region. The major Austrian banks (Raiffeisen, Erste Bank, Volksbank, BAWAG P.S.K., Bank Austria Creditanstalt) have been among the main players that went beyond national borders in searching of a leading position in most countries WB markets. Spheres of interest by foreign banking groups divided by the WB countries in a way that banks in Austria and Italy, played a dominant role in B&H, Croatia, Montenegro and Serbia, while the banking sector FYR Macedonia and Albania is heavily influenced by banks in Greece. In the last decade foreign banks established subsidiaries and daughter companies in the region, due to the relatively high returns available in emerging markets with underdeveloped financial systems. In a very short period foreign banks are proved to have access to cheap capital that can be quickly placed in countries where demand for corporate and retail loans is very high. The region has unusually strong banking-sector linkages with high-income Europe, both in terms of ownership links and day-to-day financing. Share in the total assets held by foreign banks in these countries is significant (about 89% of the total), where the foreign presence in some cases involves significant financing of local business affiliates. With that in mind, it is clear why the presence of local subsidiaries of foreign banks creates another

channel of potential transmission of EU debt crises to the WB region. Several large banking groups from Austria, Germany and Italy controlling a high percentage of banking assets in the region and thereby generate significant vulnerability in the event of any repatriation of funds. The nature of European banks' holdings in the region underscores its vulnerability to deleveraging.

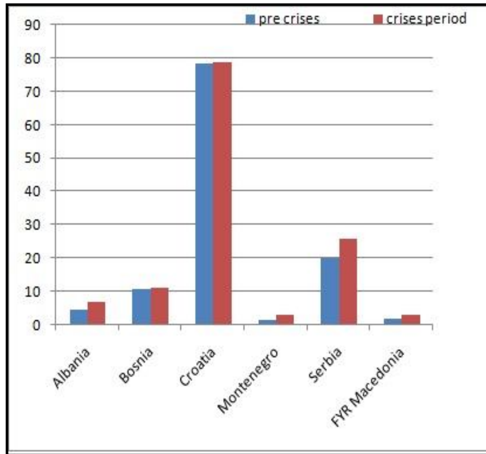
The financial sector of WB countries is significantly exposed to a financial crisis in Europe compared to other regions. One of the primary reasons is that European banks (by Austrian, Italian and German banks) have a significant presence in the region. The most significant risk to the region of WB associated with EU debt crisis is that an escalation of the crisis could result in financial risks created within the domestic financial sector. The growth of credit markets in the WB has grown at a faster pace before the global crisis. However, after a temporary slowdown in late 2010, credit growth in almost all countries on a higher level than in relation to the beginning of the EU debt crisis. Foreign banks in the region of WB use cross-border lending from their parents to finance their loan portfolios. According to loan-to-deposit ratios most exposed is Montenegro (152 percent), followed by Bosnia and Herzegovina (128 percent), Serbia (118 percent), FYR Macedonia (92.06 percent) and Albania 60.06 percent.

Since the banking sector of WB countries is highly concentrated and largely foreign owned, the behavior of the parent banks in Austria, Italy, Germany and Greece is extremely important for the liquidity and solvency of banks in the region. Also, the WB region is characterized by a comparatively high share of Greek- and Italian-owned banks. Austrian banks also have a significant presence in the region although these banks face less risk in their own sovereign debt market. Macedonia is vulnerable to economic developments in Europe - due to strong banking and trade ties - and dependent on regional integration and progress toward EU membership for continued economic growth. As a result, banks are extremely vulnerable to a cut-off of lending, let alone to an active effort by parent banks to recover funds either by selling assets or calling loans where possible. Funding pressures will add to the stress in the domestic banking sectors that are already at risk to a sharp increase of Banks' Non-Performing Loans to Total Loans. Due to the effects of the EU debt crises, these developments could occur much sooner than currently expected, considering all of the limited liquidity of foreign markets and the increasing reluctance of banks to accept the risk.

Subsidiaries of international banks (by Austrian, Italian and German banks) in the region of WB is financed a significant part of the of their investments in retail markets at local level, and partly through their European parent banks. Out of total foreign claims European banks accounts for more than 98% of total foreign bank borrowing by countries of WB. (Figure 1 and figure 2). Available data suggest further growth foreign banks involvement (in crises period) as measured by Total foreign claims by major EU banks on WB countries. In compare with pre crises period during crises period WB countries experienced a rise in the foreign bank claims: on average by 9.9 percent. The most marked rise in foreign bank claims was occurred in Albania 45.79 percent and Serbia (28.04 percent).[2]

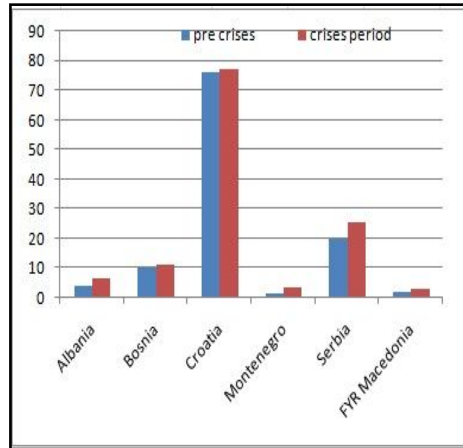
[2]Foreign claims are defined as the sum of cross-border claims and local claims of foreign affiliates.

Figure 1: Total foreign claims in pre crises and crises period



Source: BIS, author's calculation.

Figure 2:Claims by EU banks in pre crises and crises period(% of all claims)



Source: BIS, author's calculation.

Furthemore, in according to BIS-reporting banks, it can be concluded that Austria is far the most important creditor countries of WB accounting for 39.25 percent of foreign bank funding to the region, followed by Italy 35.17 percent, Greece 8.13 percent as well as France 7.99 percent (Figure 3). Also Greece is the most important foreign creditor for Macedonia FYR, Albania and Serbia. The shares of Greece banks claims range from 48.95 percent of total foreign claims on Macedonia FYR, to 27.9 percent on Albania while it accounts for 22.8 percent of total foreign claims on Serbia.It is suggesting that the sensitivity financial sector of these three countries to economic conditions in Greece might be significant.

Out of total foreign claims on WB it accounts 43.30% on banks from Greece and Italy (figure 3).

Another important fact, which will in the medium and long term impact on the performance of banking, is the high external dependence of national banking systems of on *external*borrowings as well as *dependent* on their foreign "parent companies". Also, dominant foreign banks were holders of rapid growth in credit in the pre-crisis period. The number of *foreign banks* is used a large difference in interest rates between the market of WB and the EU and consumed large stocks of capital. Raising domestic savings, on which they were primarily oriented local banks, were not sufficient to finance the expansion of credit or by volume, not by maturity structure because it was dominated by demand deposits.

Therefore, the inflow of foreign savings was the primary source of credit restoration activities for all countries included in this analysis. A common feature of all the national banking system of WB is that the expansion of credit supply mainly relies on locally funded, mostly through deposits but partly in the form of Western European parent banking groups financing. Local companies often through the mediation of local affiliates from the composition of the pan-European parent banking groups supplement their financing by cross-border borrowing directly from foreign banks (Austrian, Greek and Italian) to fund their expansion.

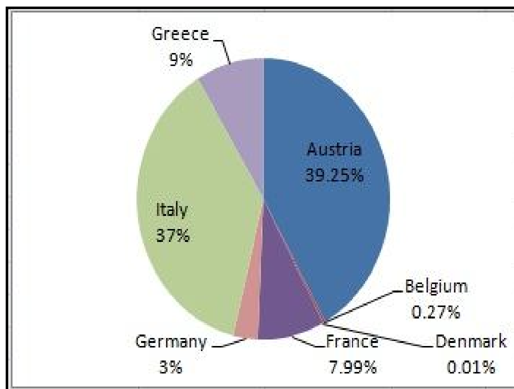
International Claims by Maturity (foreign bank claims) have changed in crises period across WB countries. Figure 4, figure 5 and figure 6 show the maturity breakdown of international claims on

WB countries. Based on Figure 4, it can be concluded that in countries of WB recorded trend changes in the maturity structure of European banks towards deleveraging over the share of short- term claims (Up to and including one year) in the range of 5.97 percent (Serbia) - 44.19 percent (FYR Macedonia) over the period 2009-2011. When compared to other WB countries, Croatia and Serbia has a relatively large share of International Claims from foreign banks up to and including one year (together with 83.65 percent of total amount all WB countries).

Also, it is recorded average decline of the share of midle-term claims (One year up to two years) in the range of 0.87 percent (Albania) - 31.29 percent (Bosnia and Herzegovina) over the period 2009-2011 (figure 5). By contrast, rise of the share of long-term claims (International Claims by Maturity Over two years) is recorded over the same period for 16.11 percent indicating a greater dependence on sources of funding that come from outside the local banks (figure 6).

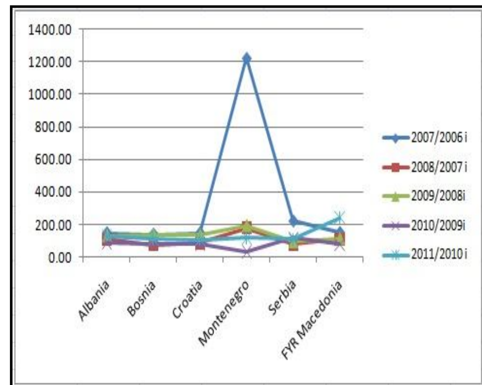
The banking system of WB countries is much less exposed to the risk of refinancing short-term credit lines, while is recorded a growing share of long-term credit lines to finance the banking sector. Out of total amount of international claims from foreign banks at the end of 2011 the share of claims by maturity over two years was 51.46 percent. This share of claims by maturity over two years in markets of WB can be seen as positive because it reduced the dependence of the so-called average short-term funding from 56.5 percent (2008) to 48.53 percent (2011) .

Figure 3: Geographic structures of consolidated foreign bank claims in WB countries



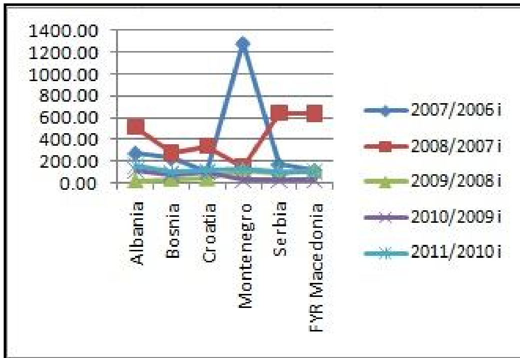
Source: BIS, author's calculation.

Figure 4: International Claims by Maturity Up to and includingone year



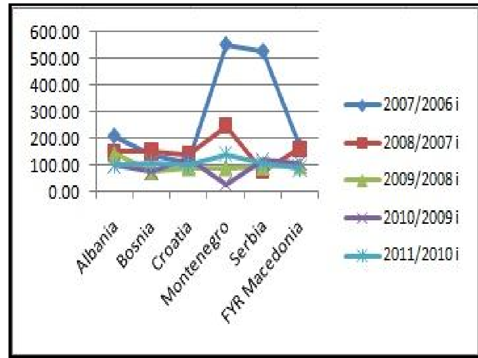
Source: BIS Consolidated International Banking Statistics, author's calculation.

Figure 5: International Claims by Maturity Over one year up to two years



Source: BIS Consolidated International Banking Statistics, author's calculation.

Figure 6: International Claims by Maturity Over two years



Source: BIS Consolidated International Banking Statistics, author's calculation.

7. CONCLUSION

The financial sector of countries WB has not yet emerged from the most recent recession. Confidence in the banking sector, but also the entire financial system is not fully restored, because certain banks are concerned about facing a high risk of litigation outside WB countries. Commercial banks are in mitigating of negative effects of the EU debt crisis adopted a restrictive credit policy by setting high interest rates, which constricts credit growth as well as increasing levels of capital and maintenance of liquidity planning.

One of the most significant risks to the economy of WB is high level of NPL that are still growing and exposure to sectors that has been particularly affected by the crisis, such as through decline in trade volumes , manufacturing export activities, and construction. Because of the need of recapitalization of European banks as 'collateral victims' can fall their subsidiaries, including those that operate in the WB. According to the current conjuncture and expectations in the banking sector in the near future, we should not expect significant growth in bank loans, as well as serious a positive boost economic growth. In the case of excessive levels of indebtedness European periphery countries and bankruptcy (Greece) investors may be motivated by fears so that they may lack immediate access to their deposits (eg. FYR Macedonia, Albania, Serbia). Another problem for WB countries is the lack depth of domestic financial markets. European banks are significant to finance local borrowers in the region much higher than in other advanced countries in transition.

We should also bear in mind the significant reduction of bank profitability in those countries. Technically, reducing the profitability is the consequence of the decline in net interest margins and rising impairment losses and provisions for losses. Reducing the interest rate margin is the result of increasing competition and reducing demand for loans due to the strong recessionary pressures. It should also be noted that those factors will affect the future performance of banks in the WB. As we mentioned, almost all the banks in the region of WB are coming from EU countries. However, the WB region is characterized by relatively large share of banks in the Greek and Italian ownership. Along with calls from across the EU to increase the capital of the leading banks, any additional stress on the financing of parent banks can be a strain on local banks owned by foreign banks to provide liquidity or dividends to their parent banks. This could potentially cause another credit crunch in the region. Strong expansion of European banks in the region of WB increased

consolidated balance sheet of the banking systems in home countries such as Austria, Italy, Greece and Germany - far above the historical value of the loan and the ratio of the sum of the GDP of their national financial systems.

The growth of risk during the last decade has dramatically raised the question of stability of this structure. The real question to be asked is whether these banking systems can maintain solvency in the long run?

REFERENCES

Bank of Albania, (2006-2011). Financial Stability Report,Annual Report.

BIS, (2003). Guide to the international banking statistics. Bank for International Settlements, BIS Paper, (16)-April.

Backe, P., Egert B. and Zumer, T. (2006). Credit Growth in Central and Eastern Europe: New (Over) Shooting Stars? Oesterreichische Nationalbank, Focus on European Economic Integration, (1):112–139.

Brown, M., S. Ongena and P. Yesin. (2009). Foreign currency borrowing by small firms. Center Discussion Paper No. 2008-16.

Brana, S. and Lahet, D. (2011). Foreign banks and the stability of foreign and domestic credit in CEECs, LAREFI Working Paper CR11-EFI/07, Université Montesquieu-Bordeaux, 2011.

Central Bank of Bosnia and Herzegovina, (2006-2011). Financial Stability Report,Annual Report.

Central Bank of Montenegro, (2006-2011). Financial Stability Report,Annual Report.

Cetorelli N. and Goldberg L. S. (2009). Global Banks and International Shock Transmission: Evidence from The Crisis, Federal Reserve Bank of New York.

Claudio, B. (2003). Towards a macroprudential framework for financial supervision and regulation? BIS Working Papers No 128.

Cocozza, E. , Colabella, A. and Spadafora, F. (2011) The Impact of the Global Crisis on South-Eastern Europe, IMF Working Paper, WP/11/300.

Croatian National Bank, (2006-2011). Financial Stability Report,Annual Report.

Dynkin, A. (2010). Euro area crises: Causes and consequences for the Euro – Atlantic region, Report for the Commission of the Euro-Atlantic Security Initiative (EASI), Institute of World economy and International relations –Russion academy of sciences, Moscow.

De Haas R. and Van Lelyveld I. (2006). Foreign banks and credit stability in central and Eastern Europe. A panel data analysis", Journal of Banking and Finance, 30, 1927-1952.

De Haas, R. and Van Lelyveld, (2010). Internal capital market and lending by multinational bank subsidiaries", Journal of Financial Intermediation, Vol.19, pp. 1-25.

Derviz A. and Podpiera J. (2007). Cross-border lending contagion in multinational banks, ECB Working Paper Series, no 0 807.

ECB, (2010). Financial stability challenges in EU candidate countries-Financial systems in the aftermath of the global crisis, Occasional paper series, No 115.

Eurostat Yearbook 2011.

Farbis, N. (2011). Bankarske krize s posebnim osvrtom na male otvorene ekonomije, Ekonomske ideje i praksa : kvartalni časopis iz oblasti ekonomije, poslovne ekonomije i menadžmenta, statistike i poslovne informatike, str.25-44.

Feyen, E., Kibuuka, K. and Ötker-Robe, İ. (2012). Bank Deleveraging- Causes, Channels, and Consequences for Emerging Market and Developing Countries, The World Bank Financial and Private Sector Development Network Financial Systems Global Practice.

Ganić, M. (2012). The Impact the Global financial crisis on the banking sector of Western Balkans: Cross-country Comparison Analysis", Journal of Economic and Social Studies, ISSN 1986- 8499 (print), 1986-8502 (online Vol. 2, No. 2.

Geršl, A. (2007). Foreign Banks, Foreign Lending and Cross-Border Contagion: Evidence from the BIS Data, Czech Journal of Economics and Finance, 2007, 57(1-2)

Haselmann R. (2006). Strategies of foreign banks in transition economies, Emerging Markets Review, vol. 7, pp. 283-299.

Kaminsky, G. L. and Reinhart, C. M. (2001) Bank Lending and Contagion: Evidence from the Asian Crisis. Published in: in Takatoshi Ito and Anne Krueger, eds. Regional and Global Capital Flows: Macroeconomic Causes and Consequences, (Chicago: University of Chicago Press for the NBER, 2001). pp. 73-99.

Maechler, A.M. and Ong, L.L. (2009). Foreign Banks in the CESE Countries: In for a Penny, in for a Pound? IMF Working Paper, WP/09/54.

Mendis, C. (2002). External Shocks And Banking Crises In Developing Countries: Does the Exchange Rate Regime Matter?, Cesifo Working Paper No. 759.

National Bank of the Republic of Macedonia, (2006-2011). Financial Stability Report,Annual Report.

National Bank of Serbia, (2006-2011). Financial Stability Report,Annual Report.

Pindyuk, O. and Holzner M. (2012). The European banking crisis and spillover effects in the CESEE countries, The Vienna Institute for International Economic Studies.

Puhr, C., Schwaiger, M. S. and Sigmund, M. (2009). Direct Cross-Border Lending by Austrian Banks to Eastern Europe, Financial Stability, 17–June.

Reinhart, C. and Kaminsky,G. (2001). Bank Lending and Contagion: Evidence from the Asian Crisis, in Regional and Global Capital Flows:

Rosenberg, C. and Tirpák,M. (2008). Determinants of foreign currency borrowing in the New Member States of the EU. IMF Working Paper WP/08/173.

World Bank (2012). Global Economic Prospects- Europe & Central Asia Annex, Washington D.C.

World Bank, (2012). African Financial Sectors and the European Debt Crisis: Will Trouble Blow across the Sahara? CRISIS MONITORING POLICY BRIEFING.

World Bank, (2011). Jugoistočna Evropa Redovni ekonomski izveštaj, Jedinica za smanjenje siromaštva i ekonomsko upravljanje Region Evrope i Centralne Azije.