Understanding credit markets for Europe

Foreign currency indebtedness: A potential systemic risk in emerging Europe

Angelo Fiorante

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Foreign currency indebtedness in new EU member states has had serious post-crisis consequences, where a substantial currency mismatch has contributed to an alteration in the macroeconomic and financial risk profile of individual countries. Although a first set of recommendations has been proposed by the European Systemic Risk Board (ESRB), a pivotal challenge ahead for emerging Europe will be to strengthen institutional and monetary credibility, and reinforce stable and efficient capital markets that are less dependent on foreign capital inflows. This would ultimately reduce countries' vulnerability to future shocks to the economy, and facilitate their full-blown recovery.

Levels of foreign currency (FX) indebtedness are endangering financial stability and increasing the risk of systemic crisis in new EU member states. Although recovery from the global crisis in emerging Europe has been surprisingly sound up to now, the lack of a resolution of the eurozone's debt problems is dragging the region into a negative spiral and stalling its full-blown recovery. The EBRD has recently downgraded Central and East European growth forecasts amid worries over eurozone exposure (EBRD, 2011). Capital flows are reversing as investors seek safer assets, and the region's financial sector, which is characterised by a high number of eurozone banks that operate with subsidiaries, fears a possible credit crunch if the liquidity from parent banks dries up.

Initiatives to curb FX lending have been taken in the past throughout the region, however, with varying outcomes. The debate recently escalated when Hungary passed a new law in September 2011 without properly consulting the European Central Bank (CON/2011/87). The new law allows households with foreign currency loans to pre-pay them at a discounted exchange rate (180 HUF/CHF for Swiss francs, 250 HUF/EUR for euro and 200 HUF/100 JPY

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for yen). The debt restructuring programme is said to provide significant temporary relief for distressed households, but the temporary losses will have to be borne by the banking sector, which consists mostly of subsidiaries of eurozone banks that are already under pressure. Policy-makers and experts are asking themselves how the de-dollarisation[1] strategies in emerging Europe should be shaped to avoid severe drawbacks, which might in themselves prove counterproductive in the near future.

As calls for policy action intensify, the first coordinated effort for curbing FX lending in Europe has been put forward recently by the European Systemic Risk Board (ESRB/2011/1). The policy recommendations are said to increase the resilience of the financial system by addressing manifold risks stemming from excessive foreign currency lending. Both Austria's central bank and Sweden's *Riksbanken* welcomed the ESRB's initiatives in an open statement, acknowledging further how their banking sectors have been, and still are to some degree, affected by cross-border spillovers from badly originated FX loans in emerging EU member states.

FX lending sky-rockets...

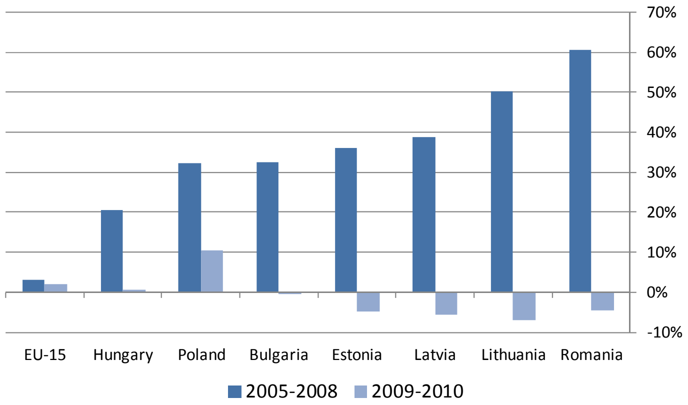
The global crisis is clearly shedding light on several risk aspects that our financial systems created and incubated during the boom period. A risk that has become highly visible in the aftermath is the currency risk exposure that the private sector (households in particular) in emerging Europe is facing as a consequence of the lavish unhedged foreign currency borrowing trend, which gained momentum when Eastern Europe undertook the convergence process of Western Europe.

Household credit growth in EMU aspirant countries was in full swing prior to the crisis (see Figure 1). EU-related reforms, combined with market liberalisation measures jump-started a convergence process, making countries such as Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland and Romania experience economic growth at a fast pace, and the adoption of the euro appeared to be just around the corner. At the same time, when credit demand was high, foreign currency borrowing became popular and much of the credit was actually funded by financial institutions from a Western Europe that spotted lucrative business opportunities. What appeared to be a win-win situation for financial institutions facing a rather mature market in the West, and the emerging private sector that could suddenly access to cheaper credit, turned into a currency mismatch problem.

The credit boom in the Baltic countries (Estonia, Latvia and Lithuania) took off in 2004, and was above all driven by foreign currency lending from Nordic banks. A significant portion of FX loans relative to the size of their economies is observed, and the ratio has increased distinctly in

[1] The terminology "dollarisation" denotes the usage of foreign currency loans in general, and does not explicitly mean the usage of dollar denominated loans. Liabilities of the household sector in emerging Europe have predominantly been denominated in euro or in Swiss Francs, but other currencies have also been used, such as the dollar or the yen.

Figure 1. Real average credit growth of households



Source: Lending to Households in Europe (1995-2010): ECRI Statistical Package 2011, CEPS, Brussels, August 2011. Henceforth this citation is referred to as the "'ECRI Statistical Package 2011".[2]

past years (see Figure 2). Ever since their independence there has been a clear commitment to adopting the euro. However, Estonia is the only country that reduced its currency risk exposure when it officially adopted the euro in January 2011. For Latvia and Lithuania, fiscal adjustments have been put in place that might enable them to adopt the euro in 2014; however, in the meantime they will have to monitor their currency risk exposure closely, which could ultimately threaten financial stability.

As with the Baltic countries, the rapid credit expansion in Central and Eastern Europe (Bulgaria, Hungary, Poland and Romania) gained momentum in 2004, underpinned by foreign currency borrowing. It is particularly interesting to note that loans denominated in foreign currency account for a substantial part of total loans (see Figure 3). The composition of the loan portfolios shows that a clear shift towards FX loans took place between 2005 and 2010. Some countries have had a high percentage of FX loans to start with, others, such as Hungary, Romania and

Figure 2. FX loans, % of GDP

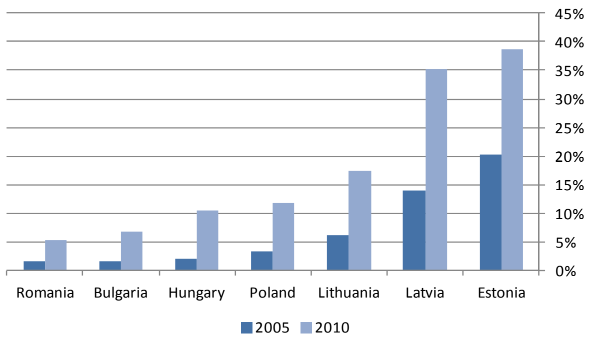
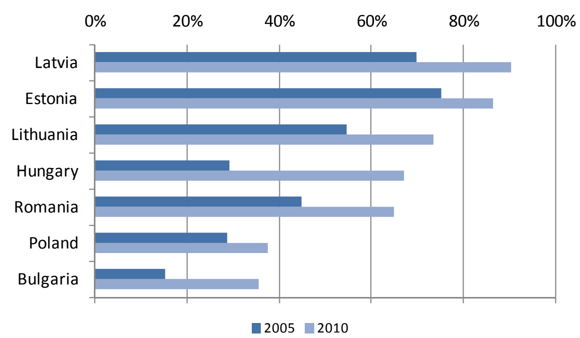


Figure 3. Foreign currency loans, % of total



Source: ECRI Statistical Package 2011.

[2] For further information, visit the website: www.ecri.eu or contact Angelo.Fiorante@ceps.eu.

Bulgaria, have increased their shares quite dramatically in recent years. In fact, the currency breakdown of outstanding household loans, where the stock of local currency loans grew with less momentum than the stock of FX loans, denotes a clear shift of preference. The sectoral composition of household credit shows that in the Baltic countries FX loans were mainly designated to house purchases, whereas in Bulgaria, Hungary and Romania a considerable share was granted for consumption purposes (see annex). This further highlights how currency risk is clearly underestimated and draws attention to the core of the problem.

...and the crisis has not slowed the upward trend

Surprisingly, the impact of the financial crisis has not discouraged the FX lending trend. The aggregated amount of foreign currency loans extended to households represented roughly €100 billion in 2010 for the selected countries (see Figure 4). Although a slowdown is apparent, it is more likely to reflect the general lending downturn. Foreign banks operating in the region might have started to acknowledge their risk exposure and tightened the lending standards for FX loans and credit in general, slowing down lending, but still there is no sign that households are shifting their preferences towards local currency loans (Beckmann et al., 2011). In fact, year-on-year credit growth of FX loans has in most cases consistently exceeded the growth rate of local currency loans (see annex). This indicates that the problem persists and will not go away by itself.

Figure 4. FX loan growth by country

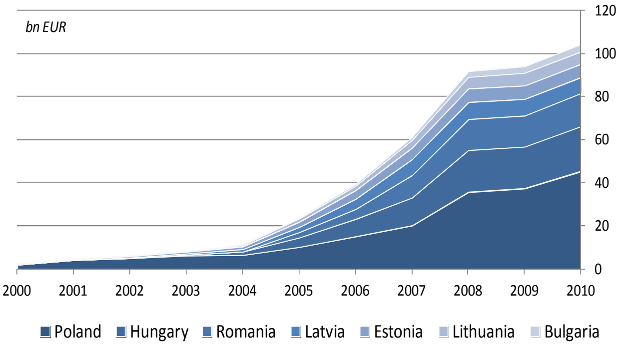
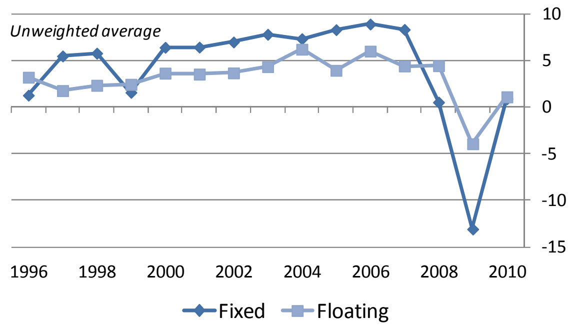


Figure 5. Real GDP growth



Source (Figure 4): ECRI Statistical Package 2011.
Source (Figure 5): Eurostat. *Note:* Fixed exchange rate: Bulgaria, Estonia, Latvia, Lithuania. Floating exchange rate: Hungary, Poland, Romania (EBRD).

The currency mismatch has added a new risk dimension that concerns financial stability in emerging Europe, and the risk is in fact materialising and compounding the crisis by holding back its recovery. Countries with a floating exchange rate (e.g. Hungary, Romania and Poland) suffered a depreciation that made FX loans unaffordable to households with small margins, and countries with a fixed exchange rate (e.g. Latvia, Estonia, Lithuania and Bulgaria) needed to restructure their economies while maintaining their currency pegs, which complicated the policy actions needed to respond to the crisis. The countries with a currency board arrangement (i.e. the exchange rate between the domestic and a selected foreign currency is fixed) witnessed the sharpest fall in real GDP growth (see Figure 5).

Although the first act of the crisis (2008-10) has been managed and controlled with the help of fiscal reforms and in some cases with external support, the second act, the eurozone crisis (2011-), is playing out right now in emerging Europe's 'backyard' and might be a tougher challenge to muddle through. Apart from Poland, which is by far the largest economy of the new EU members, worries are growing about how the euro crisis could severely affect the smaller economies.

Motives for taking out FX loans and the risk involved

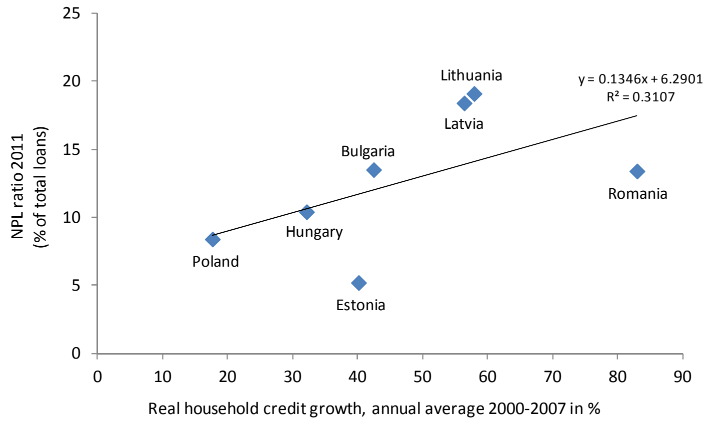
The current literature offers numerous explanations to the soaring growth in foreign currency loans, where both supply-side and demand-side drivers have been highlighted. Some plausible factors that are said to have encouraged an excessive debt accumulation in foreign currency are, for example, different types of market liberalisation measures, the presence of foreign-owned banks, the accessibility of cheap and abundant credit in the pre-crisis period due to large capital inflows, the stability and credibility of macroeconomic policy, and the effect of exchange rate regimes (e.g. Paulhart et al., 2008; Brown et al., 2009; Arteta, 2005; Coudert & Pouvelle, 2008).

However, a more simplistic and perhaps the most straightforward explanation has been attributed to the interest rate spread between loans in local currency and loans in foreign currency (e.g. Steiner, 2011; Csajbók et al., 2010; Rosenberg & Tirpák, 2008; Basso et al., 2007). Borrowing in a low-yielding currency to fund investment in a high-yielding currency is a financial transaction known as "carry trade". The risk involved in such a contract is straightforward, since households usually lack a natural currency hedge (i.e. cash or other assets used to pay loan instalments are not in foreign currency) and the means to purchase derivatives to manage FX risk are small, making them subject to exchange rate volatility. However, considering the popularity of these types of contracts one might think that households neglect, are not sufficiently informed or even accept the risks involved in foreign currency borrowing. Moreover, having made extensive use of FX loans for house purchases (see annex) means that households are doubly exposed when accounting for unfavourable house price developments, which is of relevance as asset bubbles are usually the bi-product of exponential credit growth.

EU officials and national regulators reckon that the 'dollarisation' – or rather the 'euro-isation' – process has serious inherent threats for the financial stability of many emerging European countries. The fast-paced credit growth recorded in the pre-crisis period is said to contain short-term borrowing trends that led to the build-up of a systematic currency mismatch in household budgets. While it did not appear problematic back then, today many households in countries with floating exchange rates have been subject to substantial exchange rate volatility, and those countries with a fixed currency regime experienced severe austerity measures. In both cases, the debt servicing costs of loans have been aggravated and this has in turn exacerbated borrowers' default risk.

The peril of borrowing in foreign currency affects not only borrowers but also lenders. In fact, a high percentage of non-performing loans (NPLs) seems to go hand in hand with the pronounced pre-crisis credit growth in the region (see Figure 6). The banking sector has now a major challenge ahead: that of absorbing or restructuring 'bad loans'. Parent banks, many of them from the eurozone, are urged to recapitalise their subsidiaries and branches to reignite growth and avoid a credit crunch in the region. However, the political will to do so may have been diminished by the current ambiguity over the eurozone's own debt problems and weak financial situation, especially if losses from a potential 'hair-cut' of Greek bonds materialise.

Figure 6. NPLs & credit boom



Source: Author's own calculations based on credit growth data from ECRI Statistical Package 2011 and non-performing loans data from IMF International Financial Statistics.

Paving the way for EU-wide FX lending supervision

The first recommendations coming from Europe's new top watchdog, the European Systemic Risk Board (ESRB), whose mission is to flag systemic risks affecting the EU's financial stability, offer a range of risk-mitigating solutions to abate foreign currency mismatches. Considering that it tackles the problem in a more coordinated fashion than previous policy measures adopted at national level, which in fact had a rather limited impact on discouraging foreign currency lending (ECB, 2010), the recommendations can be seen as a step in the right direction.

According to the ESRB, the recommendations include i) that adequate information on the risks associated with foreign currency loans is efficiently conveyed to borrowers; ii) the creditworthiness of new borrowers is improved by setting more stringent underwriting standards, such as applying higher debt service-to-income and loan-to-value ratios; iii) foreign currency lending is monitored and curtailed when it becomes a significant contributing factor to excessive overall credit growth. It further suggests that iv) financial institutions incorporate FX risk into their internal risk management system, and v) consequently hold adequate capital that is in line with their exposure. Lastly, vi) it urges national supervisory authorities to monitor and control funding and liquidity risk taken by financial institutions, especially where currency and maturity mismatches between assets and liabilities are being built up; when reliance on foreign markets for currency swaps is great; and when there is a concentration of funding sources.

The high level of foreign currency indebtedness in emerging Europe has EU-wide ramifications. Hopefully, the action taken by the ESRB will put foreign currency lending practices on a sounder footing. However, policy-makers need to realise that over-regulating the market for FX loans might be dangerous, and indeed counterproductive, when financial stability is still a problem and local currency funding is undeveloped. This might apply to member states that are less integrated into 'core Europe' (Zettelmeyer et al., 2010). Since there appears to be no quick-fix or one-size-fit-all solution to the problem, a selective implementation of the recommendations based on a county-by-country basis is crucial if we are to avoid knocking back overall credit growth to a perilous level and derail emerging Europe's road to recovery. The effect of these recommendations is still to be seen. National supervisory authorities have until December 2013 to follow through and implement the various recommendations where the ESRB is set to monitor the progress by applying the 'comply or explain' principle. Stay tuned.

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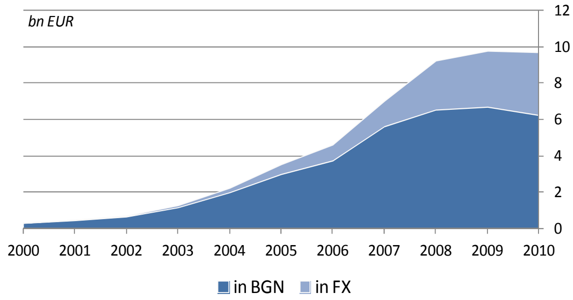
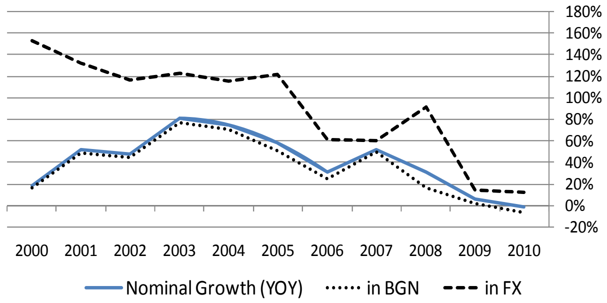
Annex - Stylised facts[3]

Bulgaria

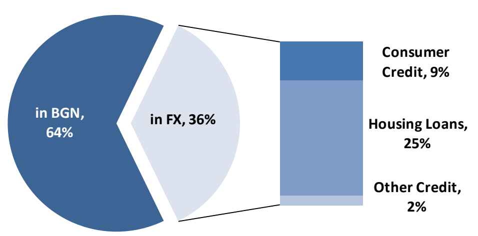
Total credit to households (stock)



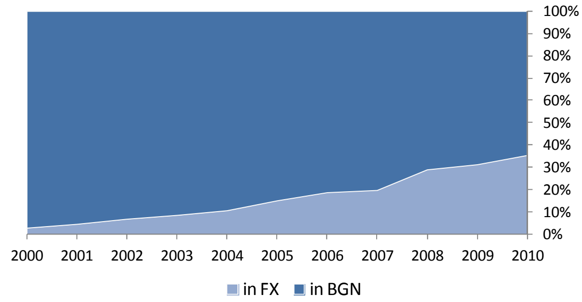
Year-on-year credit growth (in %)



Household credit by type and currency (end 2010)

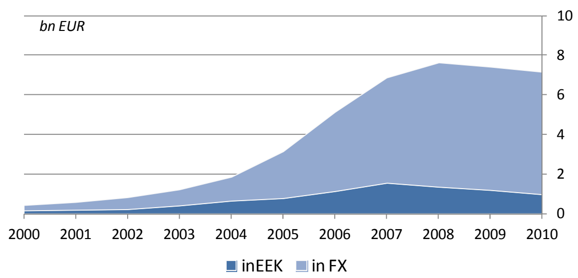


FX lending development, % of total

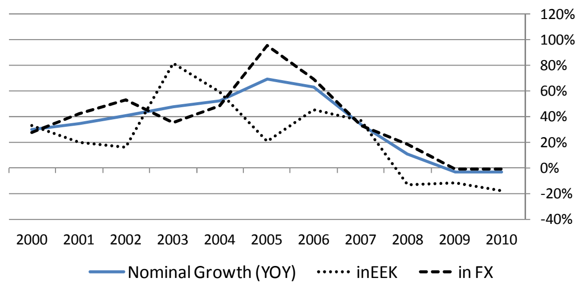


Estonia

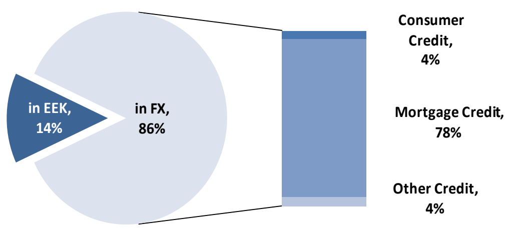
Total credit to households (stock)



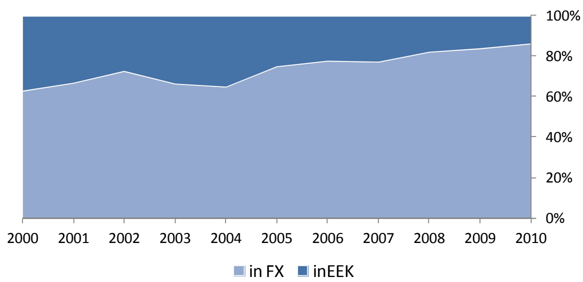
Year-on-year credit growth (in %)



Household credit by type and currency (end 2010)



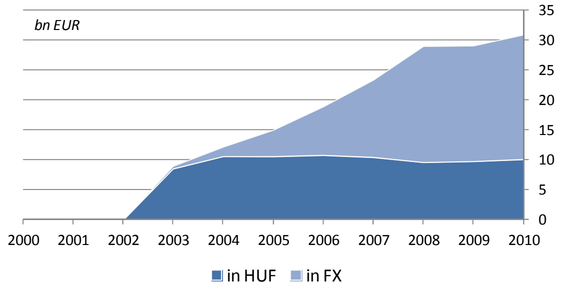
FX lending development, % of total



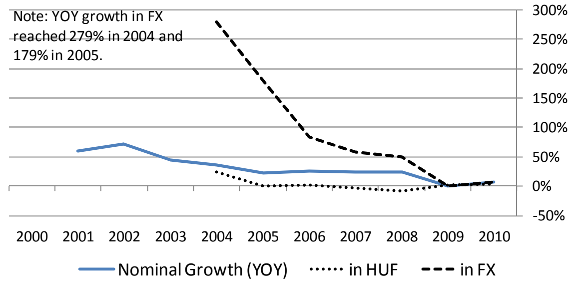
[3] *Source:* ECRI Statistical Package 2011.

Hungary

Total credit to households (stock)



Year-on-year credit growth (in %)



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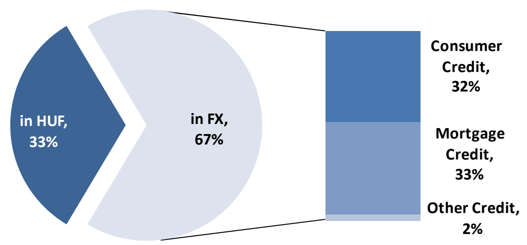

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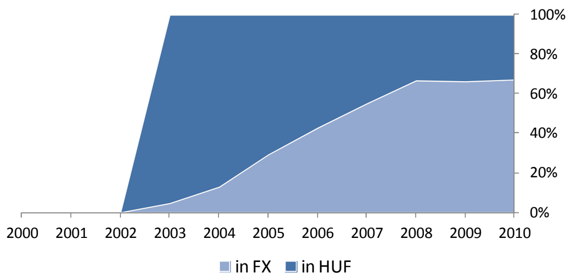
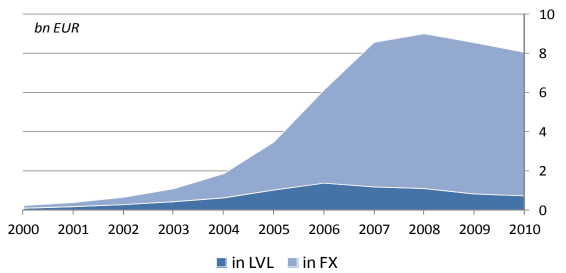


Latvia

Total credit to households (stock)



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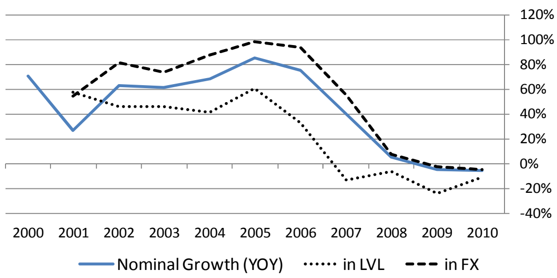
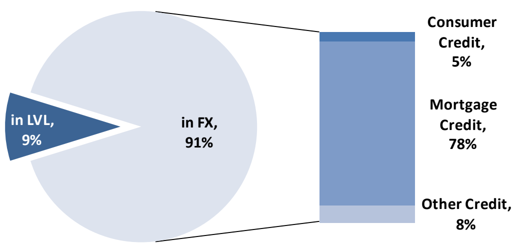
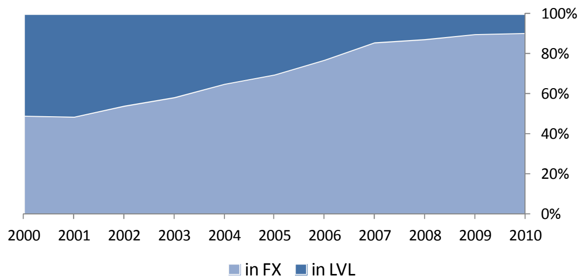


Household credit by type and currency (end 2010)

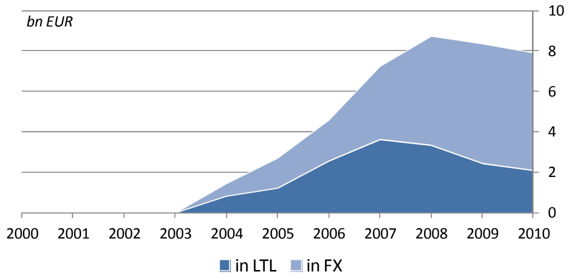


FX lending development, % of total



Lithuania

Total credit to households (stock)



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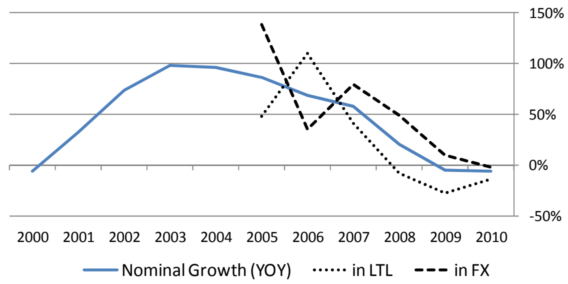

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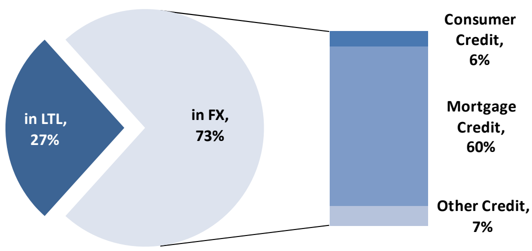

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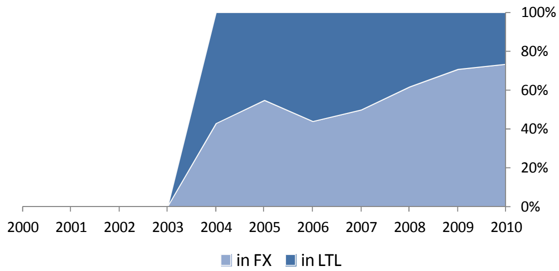
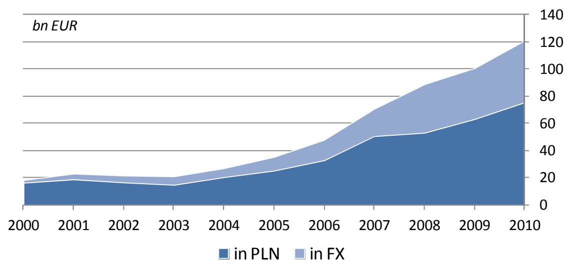


Poland

Total credit to households (stock)



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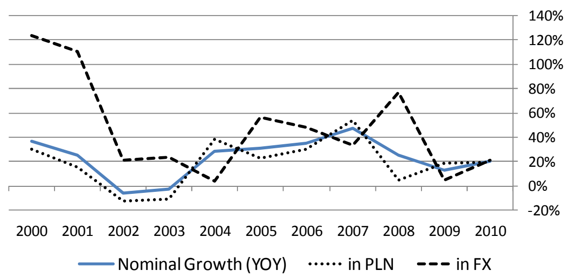

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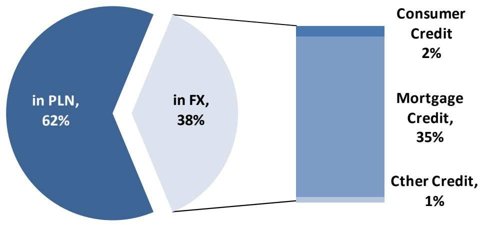
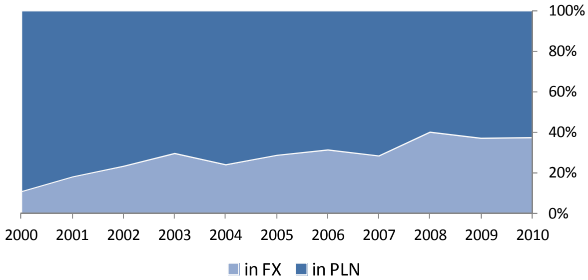
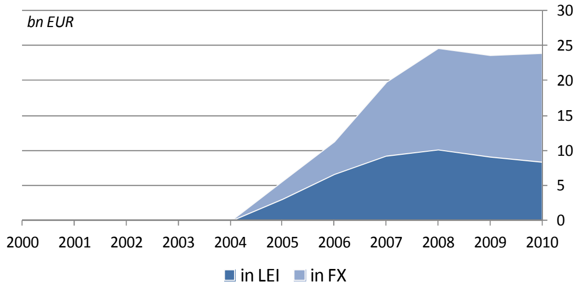


FX lending development, % of total

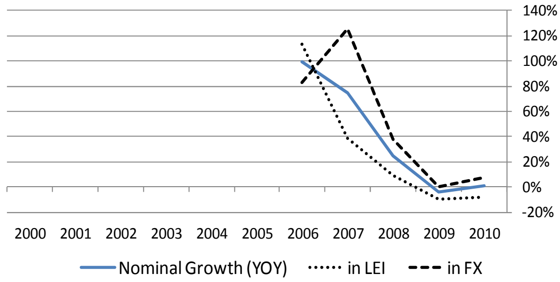


Romania

Total credit to households (stock)



Year-on-year credit growth (in %)



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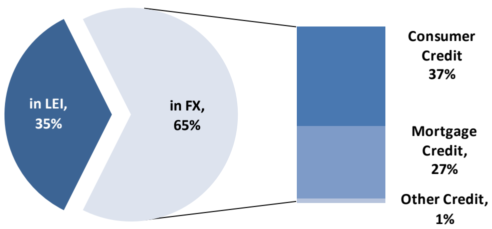
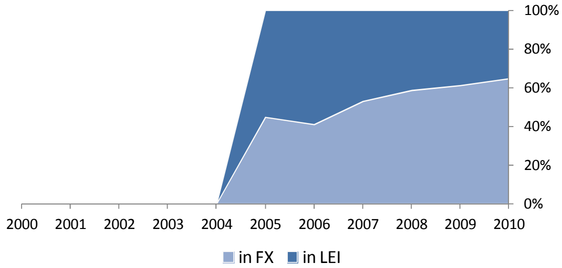


FX lending development, % of total



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