

# Multinational banks and the formation of debt-type economy in the countries of Central and Eastern Europe

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## Abstract

**Research background:** Given the fact that multinational banks' credit activity leads to the accumulation of external debt in the borrowing countries, which potentially contributes to the formation of a debt-type economy, more in-depth research of the scope and consequences of such impact on the example of specific recipients is required.

**Purpose of the article:** The purpose of the article is to develop theoretical and methodological bases of the study of multinational banks' lending activity in terms of debt-type economy on the example of the countries of Central and Eastern Europe.

**Methods:** A system of general scientific and special research methods, namely, statistical (correlation analysis, in particular), structural-functional and comparative analysis, has been applied to achieve the above-mentioned purpose.

**Findings & Value added:** The results of the study indicate that multinational banks' direct cross-border lending remains an important source of external debt accumulation and the formation of a debt-type economy in the countries of Central and Eastern Europe. Based on the assessment of the external debt indicators of the countries under the study, it has been determined that they all can be classified as debt-type economies. At the same time, the countries of the group still remain significantly differentiated in terms of relative indicators of direct cross-border lending and external debt. It has been concluded that multinational banks' aggressive lending strategy during the growth phase in the countries of Central and Eastern Europe has exacerbated the problem of external indebtedness during the recession phase.

**Keywords:** *cross-border lending; external debt; multinational banks; Central and Eastern Europe*

**JEL Classification:** *E32; F34; F44*

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## **1 Introduction**

The global expansion of multinational banks (MNBs), which are the main intermediaries in the global debt capital market, their aggressive credit strategies cause the accumulation of external debt in the borrowing countries, thus potentially contributing to the formation of a debt-type economy. The debt nature of national economies has become commonplace in the world, and the existence of significant public and private debt may not have significant negative effects as long as the country's economies grow and interest rates remain low. Thus, the most important feature of the debt economy is not so much the actual presence of external debt, as its scale and impact on economic growth.

The debt-type economy is characterized by increased risks of the external debt crisis in borrowing countries, which in the context of the global spread of debt accumulation problems may trigger a systemic financial crisis worldwide. In this regard, conducting the research aimed at developing the theoretical and methodological foundations of the study of credit activities of MNBs amidst a debt-type economy and substantiation of scientific and practical recommendations for improving the credit regulation of MNBs to minimize its negative impact on external debt and formation of debt-type economy in the borrowing countries, is relevant and appropriate. The ambiguous impact of MNBs' lending activity on the economy of borrowing countries requires a more in-depth study of the scope and consequences of such impact on the example of specific recipients. Thus, the purpose of our research is to develop theoretical and methodological bases of study of MNBs' lending activity in terms of debt-type economy on the example of the countries of Central and Eastern Europe (CEE).

## **2 Literature Review**

The theoretical basis of the study form two groups of scientific researches. The first one is represented by studies of economists who developed theoretical approaches to the study of the emergence of external debt, its impact on the economic growth of a borrowing country and the formation of a debt-type economy. Thus, Hayati et al. (2019) conducted a systematic review on related articles from SCOPUS database in order to examine whether there exists positive, negative or non-linear relationship between external debt and the economic growth of a country or group of countries. The authors concluded that there is no mutual consensus on the relationship between external debt and economic growth. Ehikiyoa et al. (2020) used the Johansen cointegration test and system Generalised Method of Moments to examine the dynamic relations between external debt and economic growth in 43 African countries over the period 2001-2018. The result of the research revealed evidence to support a long-run equilibrium relationship between external debt and economic growth in Africa. Kharusi and Ada (2018) employed the Autoregressive Distributed Lag cointegration approach to investigate the relationship between government external borrowing and economic growth, prompted by continuous increases in Oman's external debt to finance its annual budget. Their findings revealed a negative and significant influence of external debt on economic growth in Oman. The second group of scientific researches is represented by conceptual studies of the role of MNBs in global financial markets, the impact of their lending activities on the economy of the borrowing countries. Natsir et al. (2019) investigated whether the impact of MNBs penetration on bank credit risk is conditional on the measurement of foreign bank penetration, whether it is based on the share of foreign bank total assets or the share of foreign bank branches. The results of their study reveal that foreign penetration in terms of assets and branches exhibits different impacts on credit risk in banking. Claessens (2017) analyzed changes in global banking since the 2008-2009 economic crisis, benefits and risks of MNBs for the borrowing country economy, considering countries' characteristics and circumstances. He concluded that banks from emerging and developing countries continue

to expand abroad, and banking has become more regional. According to Claessens, benefits and risks of MNBs' lending can vary by bank, home, and borrowing countries characteristics. His research highlighted that long-term debt flows are becoming less volatile. Exploiting unique, time-varying, bilateral data on foreign bank ownership for many countries, Claessens et al. (2017) studied the role of MNBs in trade. Overall, their results show that MNBs facilitate trade in emerging markets by increasing the availability of external finance and helping overcome information asymmetries. Kutasi (2017), Brana and Lahet (2010) in their researches studied the impact of the flow of credits from provided by Western European banks on the financial stability of the CEE countries. They concluded that multinational ownership softened the impact of the 2008-2009 economic crisis in commercial banks, as the parent banks capitalized those affiliates which suffered from lack of financial resources.

Despite the numerous scientific publications on the impact of MNBs' lending activity on the economy of borrowing countries and the emergence of external debt, there is a deficit of scientific researches that analyze the role of this activity in the formation of the debt-type economy in the borrowing countries. All of the abovementioned led to the choice of the topic of our research, its aim, object and subject.

### **3 Materials and Methods**

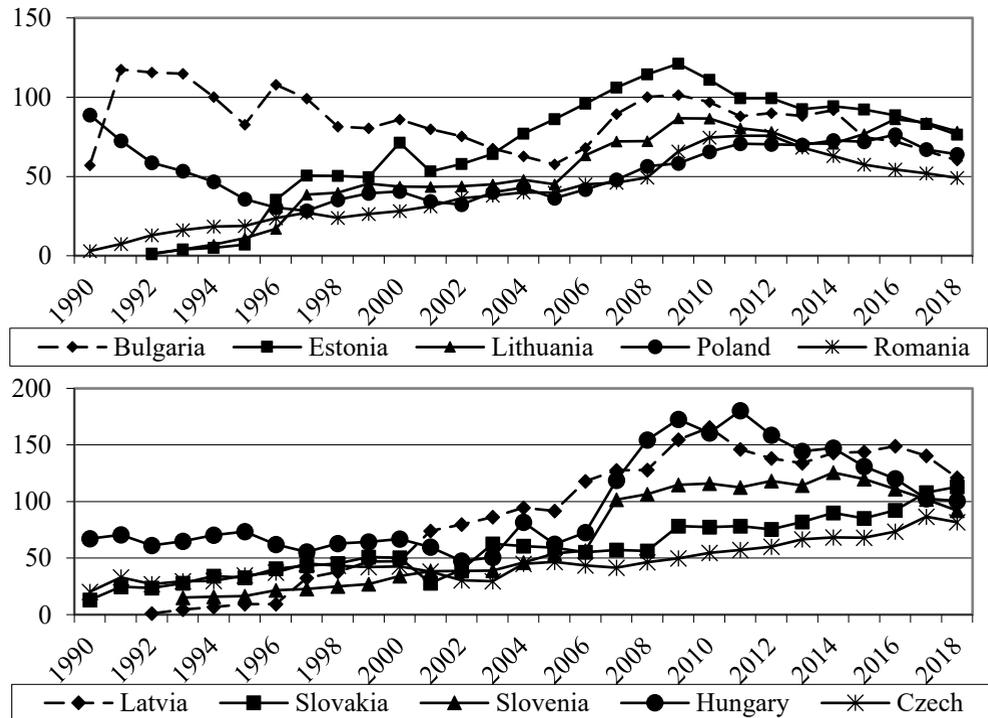
In order to assess the impact of MNBs' lending activities on the external debt of the CEE countries a system of general scientific and special research methods was used, namely: statistical (correlation in particular), structural-functional and comparative analysis. The statistical analysis was performed in order to examine relative indicators of direct cross-border loans provided by MNBs and external debt in the CEE countries. We used correlation analysis to evaluate the strength of relationship between MNBs' direct cross-border loans and the external debt of the CEE countries. The comparative analysis was conducted in order to investigate to what extent the countries of the group are differentiated in terms of relative indicators of direct cross-border lending and external debt.

Our sample consists of ten CEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia, Estonia, Latvia and Lithuania) during the 1990-2018 period. Two other CEE countries, namely, Albania, which is not a member of the European Union (EU), and Croatia, which joined the EU only in 2013, were excluded from the list of countries under analysis to form more homogeneous sample of countries. The CEE countries were purposefully chosen for the analysis due to a number of reasons. Firstly, the results of our previous research show that in 2018 developed countries were the main recipients of MNBs' direct cross-border loans (Zapotichna, 2020). According to the methodology approached by a number of international organizations (in particular, the United Nations Conference on Trade and Development – UNCTAD), the economies of most CEE countries are classified as developed ones. Secondly, this choice was made due to the availability and accessibility of comparable data on multinational banks' lending activity in these countries. Thirdly, this group of countries was chosen because of its heterogeneity, as it includes countries with fixed and floating currency regimes ; countries with different levels of financial openness and external debt, and different level of MNBs' penetration. Fourthly, the exceptional importance of MNBs for CEE countries is the main characteristic which distinguishes the banking systems of this region from other regions of the world. Fifthly, for these countries, the banking system is the most important source of liquidity for the real sector of the economy.

## 4 Results and Discussion

Based on the researches mentioned in section 3, we developed the conceptual and categorical apparatus of the research of MNBs' lending activity in terms of the debt economy by providing own approach to interpretation of the categories «debt-type economy». We define it as a national economy that demonstrates a significant stable dependence on external borrowing, which occurs when the amount of external debt is at least 30% of GDP and/or external borrowings, and promotes at least 30% of economic growth.

The analysis of the current level of external debt of the CEE countries shows that they all can be classified as debt-type economies, with the ratio of external debt to GDP in 2018 ranged from 49% to 79% in Bulgaria, Poland, Romania, Estonia and Lithuania, and from 82% to 121% in Latvia, Slovakia, Slovenia, Hungary and Czech Republic, as illustrated in Figure 1.



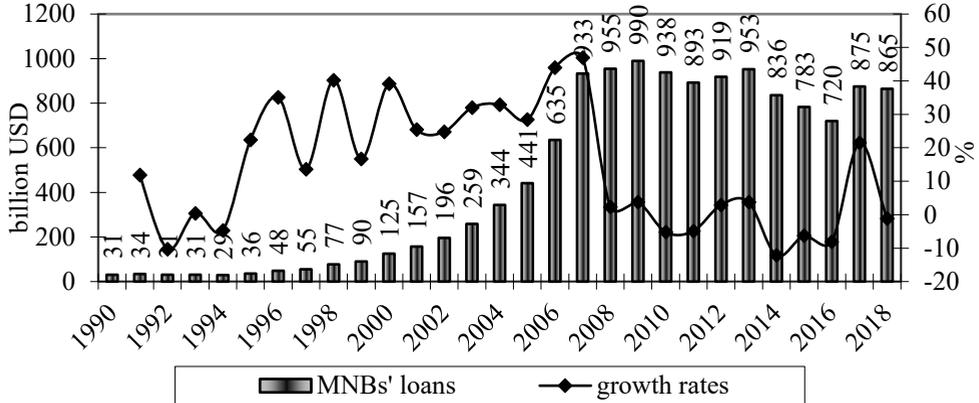
**Figure 1.** Ratio of external debt to GDP in the CEE countries in 1990-2018.

Source: calculated and constructed by the author based on the World Bank statistics.

Official sources of external financing were dominant for the CEE countries at the beginning of the transition period (Ban and Bohle, 2020), reflecting the sharp deterioration in tax revenues in the early 1990s and the low creditworthiness of these countries. An insignificant amount of private credit inflows was caused by a number of factors, including the incompleteness and partialness of reforms in most countries, political and social risks of the transition process itself, and high levels of corruption and political instability. In 1992 the CEE countries regained access to international credit markets. The volume of private loans, including loans provided by MNBs, began to grow and by 1996 accounted for 73% of total external loans (BIS). This trend can be explained by the acceleration of reforms and, therefore, improving economic prospects amidst the EU near-future integration (Głodowska and Pera, 2019), prospects of a better institutional framework (Nahtigal, 2018), accession to the World Trade Organization and liberalization of the internal financial market. In addition, the opening of the CEE banking systems coincided with the withdrawal of MNBs' capital from the Asian region and the search for new directions of capital

dislocation (Gani, 2016), profits limitation in Western markets caused by their oversaturation, and the possibility of high returns in the CEE transition economies (Badulescu et al., 2018).

Since then and until 2009, there has been a steady increase in the total volume of loans received by the CEE countries from MNBs, although in the last two years the dynamics of loans declined significantly: if in 2007 growth rates of loans amounted to about 47%, then in 2008- 2009 they fell to 2,3% and 3,7%, respectively (Figure 2).



**Figure 2.** Volumes of loans received by the CEE countries from MNBs (billion USD) and their growth rates (%), 1990-2018.

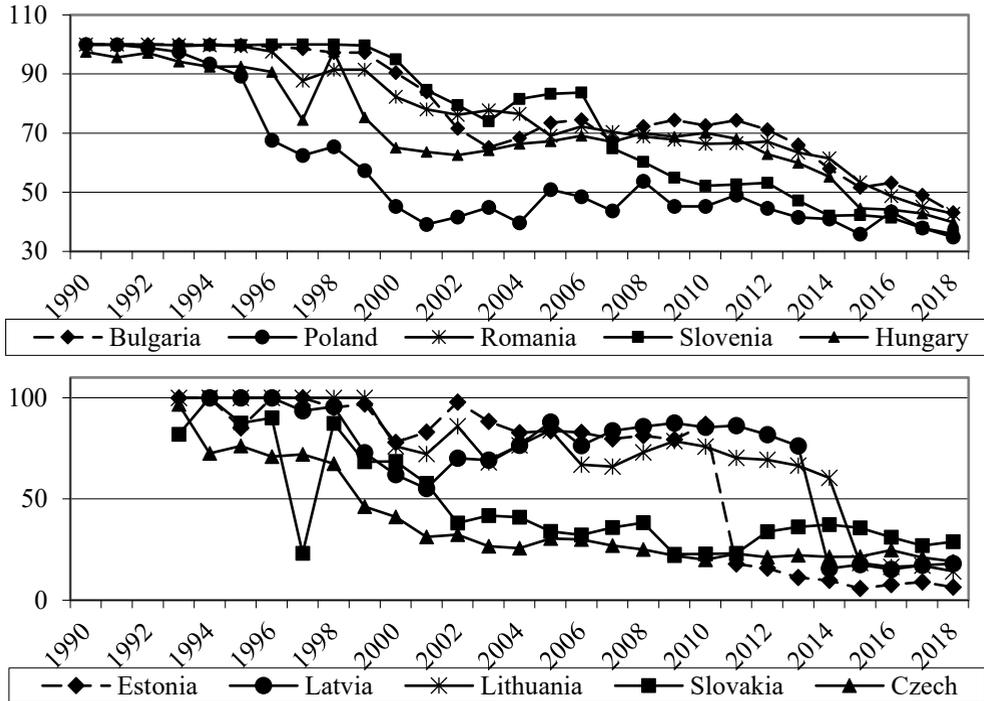
Source: calculated and constructed by the author based on the BIS statistics.

The 2008-2018 period witnessed both ups (2012, 2013, 2017) and downs (2008, 2014, 2018) in MNBs' lending. The growth in MNBs' lending to the CEE countries in 2017-2018 was stimulated by gradual post-crisis recovery of the global banking system and increasing role of bank loans in financing economic development.

Today, the main private creditors of the CEE countries are banks from the EU: as of 2018 they accounted for an average of about 89% of total loans (BIS).

The importance of MNBs from the EU for the CEE countries can be explained by their geographical and cultural proximity (most of the CEE countries were united as part of the Austro-Hungarian Empire until 1918, thus these countries became a natural region for expanding MNBs' external operations through close cultural ties between Bavaria, Austria and the eastern countries of the former empire), economic integration, joint membership in the EU. Austria is the most important foreign lender to the region: banks headquartered in this country are responsible for about 25% of all loans provided by the EU banks to the CEE countries and more than 22% of total loans from MNBs. The share of loans provided by Austrian banks in the total volume of MNBs' loans is the highest in Slovakia, Romania, the Czech Republic, Hungary and Slovenia. France, Italy, Belgium and Germany are also important creditors for the most CEE countries. Loans from Swedish banks are concentrated in the Baltic States (their share in total external borrowing exceeds 58% in Estonia, 75% in Latvia and 80% in Lithuania). Greek MNBs are important creditors for Bulgaria and Romania. The largest recipients of MNBs' loans are the Czech Republic and Poland. The Czech Republic is the most important market for Austria, Belgium and France, while banks from Germany, Spain, France and the Netherlands are the largest creditors for Poland (BIS). Thus, in the CEE countries there is a significant concentration of MNBs' loans from the EU.

During the 1990s, in all of the CEE countries direct cross-border lending was the dominant, and in some cases the only form of lending provided by MNBs. This form of lending led to the accumulation of external debt. In the following years, there was a global trend to reorientation to indirect lending by MNBs, which intensified during 1997-1998. This was reflected in the decrease in the share of direct cross-border loans in their total volume, as shown in figure 3.



**Figure 3.** Share of direct cross-border loans in the total amount of loans received by the CEE countries from MNBs in 1990-2018

Source: calculated and constructed by the author based on the BIS statistics.

Analysis of the data presented in figure 3, shows that until 2016, the CEE countries were significantly differentiated in terms of the share of direct cross-border loans (for example, in the early 2000s, the share in different countries fluctuated from 25% to 97%). However, in the last three years there has been a gradual convergence of the countries of the group on this indicator: the limits of the variation in the share of direct cross-border loans of MNBs have narrowed to the range from 6% to 43%. At the same time, as of 2018, their significance for different countries was still differentiated. Based to the share of direct cross-border loans in their total volume received by the CEE countries from MNBs, two groups are distinguished: 1) countries with a relatively small share of direct cross-border loans which doesn't exceed 30% (Bulgaria, Poland, Romania, Slovenia, Hungary); 2) countries with relatively higher dependence on direct cross-border loans, the share of which exceeds 30% (Estonia, Latvia, Lithuania, Slovakia, the Czech Republic).

During 2003-2007 «credit boom» in most of the CEE countries led to an increase in domestic demand for external financing and accelerated GDP growth. On average, the region's GDP grew by 5,5% annually. According to the IMF estimates, during 2003-2008 MNBs' lending contributed to the region's GDP growth by 1,5% (IMF).

We can conclude that the growth rate of direct cross-border loans during the «boom» period in those CEE countries which joined the EU in 2004 grew at an average 37,4%, while direct lending to EU countries in 2007 grew even faster: in Bulgaria – 67,6%, in Romania – 89% (table 1). The results of the analysis of the data in this table show that MNBs have implemented various types of credit strategies in the markets of CEE countries. Thus, in Bulgaria, Latvia, Romania and Estonia, the average annual credit growth rate exceeded 50%, which indicates the implementation of an aggressive lending strategy by the then dominant Swedish and Greek MNEs in these countries. In other CEE countries (Lithuania, Slovakia,

Poland, Slovenia, Hungary and the Czech Republic) the average growth rate of direct cross-border loans did not exceed 46%, i.e. in these countries MNBs implemented a relatively conservative credit strategy.

**Table 1.** Average indicators of MNBs' lending and external debt of the CEE countries

Country	Average growth rates of direct cross-border loans during the «boom» period	Average reduction rates of direct cross-border loans during the «bust» period	Ratio of direct cross-border loans to indirect loans during the «boom» period	Ratio of external debt to GDP during the crisis «bust» period
Bulgaria	67,6	-1,8	85,3	118,1
Estonia	52,9	-8,4	79,7	121,8
Latvia	71,7	-5,1	83,7	209,2
Lithuania	46,1	-8,1	65,9	87,6
Poland	27,9	8,5	43,7	65,7
Romania	89	-6,4	68,9	76,5
Slovakia	35,2	-8,2	47,5	78,8
Slovenia	37,2	-10,9	83,7	110
Hungary	32,5	-1,5	70,1	198,1
Czechia	26,4	-5,9	26,9	57,7

Source: calculated and constructed by the author based on the BIS and World Bank statistics.

Countries with fixed exchange rate regime (currency board), namely Bulgaria, Estonia, Latvia, Lithuania and Slovenia, as well as countries with the highest share of direct cross-border loans in the total amount of loans provided by MNBs experienced the most intensive flow of loans during the «boom» period, and during the «recession» the ratio of external debt to GDP reached its maximum. During the «boom» period, MNBs' loans grew faster than GDP, as a result of which the debt-to-GDP ratio increased significantly.

The «credit boom» was characterized by an inflow of direct cross-border loans in most countries. This trend can be explained by both demand-side and supply-side factors:

- demand-side: growing balance of payments deficit as a result of deteriorating trade conditions, among other factors. In addition, direct cross-border loans were stimulated by the difference in interest rates (they were cheaper) (Borio and Gambacorta, 2017). It should be noted that such loans were not limited to loans in euros. In some countries, loans were denominated in currencies with lower interest rates, such as the Japanese yen and the Swiss franc;

- supply-side: the funding structure provided incentives for foreign currency lending. MNBs' subsidiaries received funding from parent banks in euros, so it was more profitable for them to lend in euros than in local currency. Another possible explanation for MNBs' expansion during this period is based on the hypothesis of «disaster myopia», which reflects banks' perception that the global macroeconomic environment has become more stable and the level of uncertainty has decreased (Hills and Hoggarth, 2013). The growth of direct cross-border lending was also facilitated by the accession of the CEE countries to the EU, after which the main obstacles to cross-border banking operations were removed.

Growth in lending accelerated GDP growth, while the «credit boom» led to serious imbalances and volatility. The economies of the CEE countries began to overheat, there were significant current account deficits as a result of rapid growth in external financing. The debt of the CEE countries to MNBs during the «credit boom» increased sharply (table 1): the average share of direct cross-border loans in the total external debt of the countries increased from 50% in 2002 to 85% in 2006.

The first wave of MNBs' lending reduction began after the collapse of Lehman Brothers in September 2008 and ended in the mid-2010s. In the second quarter of 2008, loans began to decline and the region's overheated economy entered a «bust» phase. At the same time, the region's economy has become more dependent on fluctuations in MNBs' lending. During 2008-2010, the volume of loans decreased by 19% compared to the pre-crisis «boom» period (BIS), which can be explained by the growing load on MNBs, as well as declining demand for loans during economic downturn. The rise and fall in bank lending led to high macroeconomic volatility and an exacerbation of the external debt problem.

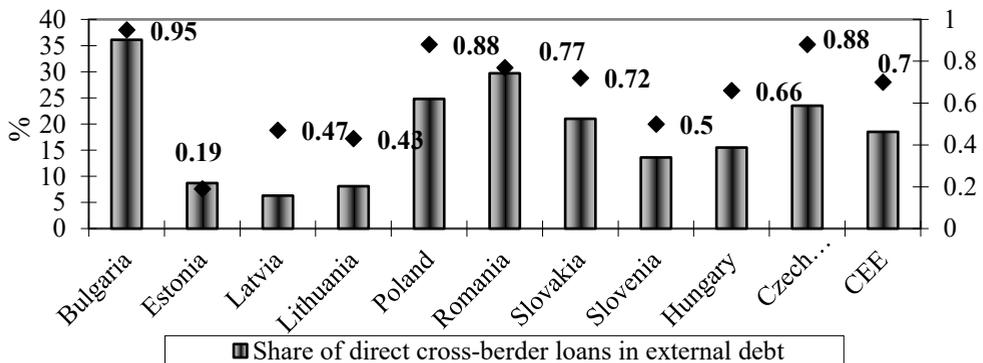
The highest ratios of external debt to GDP during the «bust» period are observed in countries with higher growth rates of loans during the «boom» and in those countries that were most dependent on MNBs' lending (where the ratio of direct cross-border loans to GDP were the highest) (see table 1).

As can be seen from table 1, during the global financial crisis in all of the CEE countries except Poland, there was a reduction in direct cross-border lending provided by MNBs.

From mid-2010 to mid-2011, lending provided by Western MNBs to the CEE countries slowly moved upwards as the region emerged from the crisis that remained limited to three small peripheral countries. With the exception of several lending cuts at the end of 2011, countries of the region were generally unaffected by the Eurozone crisis, mainly because at this stage, financing for their economic growth was less dependent on direct cross-border loans from European MNBs.

After the crisis, the share of direct loans in relation to indirect loans decreased in all the countries of the group. As of 2018, indirect loans are the dominant form of MNBs' lending to most CEE countries (only in Bulgaria and Romania the share of direct cross-border loans remains at a fairly high level - about 43%). Thus, today the CEE countries are less dependent on MNBs' direct cross-border loans, which makes them less vulnerable to credit outflows and reduces the likelihood of financial shocks and exacerbation of external debt. If in 2007-2008 the countries of the region were prone to sudden capital cuts because they borrowed large amounts from MNBs to finance a significant current account deficit, today these economies are not overheated and economic growth is more dependent on exports rather than domestic demand, fueled by the inflow of foreign loans.

The calculated correlation coefficients between the volumes of direct cross-border lending and the external debt of the CEE countries show that, in general, there is a strong relationship between these indicators (figure 4).



**Figure 4.** The share of direct cross-border loans in the external debt of the CEE countries (2018) and the correlation coefficients between direct cross-border loans and the external debt

Source: calculated by the author based on the BIS and World Bank statistics.

Assessment of the degree of correlation between MNBs' direct cross-border loans and external debt of the CEE countries, on the one hand, revealed that this type of loans

significantly affects the external debt of Bulgaria (very strong relationship), Poland, Romania, Slovakia, Czech Republic (strong relationship), Slovenia, Hungary (significant relationship). On the other hand, the external debt of Latvia, Lithuania (moderate relationship) and Estonia (weak relationship) is insignificantly dependent on direct cross-border lending provided by MNBs. Moreover, the following pattern was revealed: the greater is the share of external debt formed by direct cross-border loans, the stronger is the relationship between direct cross-border loans and external debt.

## 5 Conclusions

Based on the assessment of the external debt indicators of the CEE countries, it has been determined that they all can be classified as debt-type economies. Overall, the region repeats global trend to reorientation from direct cross-border lending to indirect lending, which has resulted in reducing the level of external debt, which is formed by MNBs' direct cross-border loans.

The results of our research indicate that direct cross-border lending provided by the MNB remains an influential source of external debt accumulation and leads to the formation of a debt economy in the CEE countries. At the same time, the scale of attracting direct cross-border loans and their corresponding impact on external debt vary significantly by countries of the group. Taking into account the share of direct cross-border loans in the total amount of loans received by the CEE countries from MNBs, these countries were divided into two groups: countries with a relatively small share of direct cross-border loans (up to 30%: Bulgaria, Poland, Romania, Slovakia, Slovenia, Hungary); countries with relatively higher dependence on direct cross-border loans (over 30%: Estonia, Latvia, Lithuania, Slovakia, the Czech Republic). This group of countries is also differentiated in terms of the importance of direct cross-border MNB loans in the formation of external debt: in half of the countries, the share of these loans is more than 20%, and in other countries – only within 6-16%.

It is determined that in general, MNBs can really exacerbate the problem of external debt in borrowing countries. However, the extent of this impact and the associated risks depend to a large extent on the nature of the presence of MNBs, which can vary considerably between countries. There is a strong relationship between direct cross-border lending and external debt in Bulgaria, Poland, Romania, Slovakia, the Czech Republic, Slovenia and Hungary. In the Baltic countries, where direct cross-border loans do not exceed 8% of GDP, direct lending by the MNBs does not significantly affect the level of external debt. Today, the CEE countries are less dependent on MNBs' direct cross-border loans, which makes them less vulnerable to credit outflows and reduces the likelihood of financial shocks and exacerbation of external debt problem.

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