Summary

The process of Slovenia's accession to the EU, liberalisation of capital movements and joining the EMU increased Slovenia's integration in international financial and monetary flows. This contributed to the faster growth of financial flows in Slovenia in recent years and gradual reduction of the development gap between the Slovenian financial sector and the average of the EU and EMU.[1] Despite this, the gap in this area is still wide and exceeds the difference Slovenia records in terms of economic development (gross domestic product per capita by purchasing power), which in 2007 reached 89% of the EU average and 81% of the EMU average.

The most important segment of the Slovenian financial sector is banking, where somewhat faster progress has been made. Nevertheless, Slovenia records only a third of the EMU average in terms of banks' total assets in comparison with GDP. In the two other segments (insurance, capital market) the relative difference in development is smaller.

The volume of bank loans to non-banking sectors in comparison to GDP in Slovenia is the lowest among the EMU countries, and in 2007 reached two thirds of the EMU average. Within that, the difference in the share of loans to companies and non-monetary financial institutions is relatively lower than the share of credits to households. Borrowing by companies and non-monetary financial institutions has been more intensive in recent years than household borrowing, and contributed up to 80% of the overall net borrowing of domestic non-banking sectors. This is also due to the redirection of companies and non-monetary financial institutions from borrowing on foreign markets to borrowing from domestic banks, in accordance with the process of convergence of interest rates and improvement of borrowing conditions in Slovenia after 2004. Household borrowing is also an important part of banks' lending activity in developed financial systems. However, in this regard Slovenia has the lowest share relative to GDP among all EMU member countries despite households' intensive taking of bank loans in recent years. The lag is relatively higher for housing loans than for consumer loans to households, although the former have been growing more rapidly in recent years.

The significant growth in loans in recent years is not only characteristic of Slovenia, as the lending activity of banks has also increased in developed financial systems in the environment of high economic growth and low interest rates. However, in Slovenia, this growth was relatively higher than the average of the Eurozone countries.

In Slovenia, banks lowered deposit interest rates in the process of convergence of interest rates to the EU level somewhat faster, and for a year and a half they have remained below the EU average, while lending interest rates are above the EMU average. Among lending interest rates, the biggest differences between Slovenia and the EMU occur in interest rates for housing loans, while the differences between interest rates for consumer loans and loans to companies are somewhat smaller.

[1] After Slovenia's entry into the EMU, the Slovenian financial sector can be compared to the average of the Eurozone, where the difference is somewhat greater than in comparison with the EU average. On the other hand, in terms of development of the financial sector Slovenia is achieving relatively better results than the majority of new EU Member States.

The population adjusts the structure of their savings to changes in interest rates and better savings options on the market. In recent years, the decrease of deposit interest rates has resulted in lower growth of households' savings in banks. With favourable trends on capital markets at home and abroad (up to last August), increased domestic and foreign investing options, and intensive marketing, savings in mutual funds has strengthened significantly in recent years. The volume of assets in mutual funds at the end of last year reached almost a quarter of savings in banks. The importance of pension funds has also increased.

Low rates of growth in bank deposits and high demand for loans have led to increasing external financing of banks, mainly through long-term foreign loans. This also influenced changes in the structure of liabilities of domestic banks, where the share of foreign sources is increasing. After the outbreak of the international financial crisis in August 2007, banks increased the volume of short-term borrowing abroad in aggravated conditions on the inter-bank market. Considering that these sources are still loaned mostly on a long-term basis, this worsens maturity matching of the balance sheet, and consequently increases liquidity risk. Increased borrowing abroad led to the growth of overall gross external debt, which stood at 102.4% of GDP at the end of 2007. Although gross external debt is growing relatively rapidly in comparison with other EMU members, Slovenia is still among the least indebted countries in the Eurozone.

Besides the increased borrowing of primarily domestic banks abroad, Slovenia's accession to the EU and EMU also strengthened Slovenia's integration into other international financial and capital flows. International assets increased, primarily in portfolio and direct investment, commercial loans and bank loans. Liabilities also increased strongly; besides loans, growth was recorded in foreign banks' deposits, foreign commercial loans and portfolio investment and to a lesser extent also in foreign direct investment. Total liabilities grew faster than total assets, and thus the net financial position turned into a deficit. The majority of the deficit is represented by net external debt, which stood at 18.9% of GDP in 2007. The deficit of the net financial position stood at 21.9% of GDP at the end of the year.

The impact of the financial crisis which started in August 2007, considering integration and exposure of financial sectors to external shocks, is reflected to varying degrees in different countries. The overall loss for banks and other financial institutions at the global level stands at over USD 300 bn, while the IMF estimates that the overall loss could exceed USD 900 bn. Considering the scope of the crisis, the consequences will be felt not only in the financial sector, but also in the real sector, although these effects differ from country to country. The direct impact of the financial crisis, which is felt in all countries, is an increase in interest rates on inter-bank markets because of aggravated conditions in these markets and less confidence among banking subjects. Countries, including Slovenia, in which modern financial instruments are relatively less developed than in the US and some EU Member States, are relatively less exposed to other direct effects of the financial crisis. Increased risk related to the consequences of the financial crisis is shown in these countries primarily in the case of closer ties with exposed banks abroad. Here, dependence on foreign financing does not necessarily imply negative effects of the financial crisis, but it does increase the related risks. In Slovenia, the worsening situation on inter-bank markets primarily influenced the low accessibility of long-term foreign loans, which is reflected in the increase in short-term borrowing abroad.

Introduction

The Slovenian financial sector, in comparison to other EU Member States, is relatively underdeveloped, while noticeable shifts in development have only been made in recent years, primarily in the banking sector, where lending activity has been strengthened and integration in international monetary and capital flows is increasing. Considering the importance of the level of development of the financial sector for the functioning of the entire economy, such shifts increase the possibilities for faster economic growth (Jazbec and Masten, 2004, pg. 95), whereas it is of key importance that this development is sound and that faster development does not increase the risk related to higher exposure to external shocks.

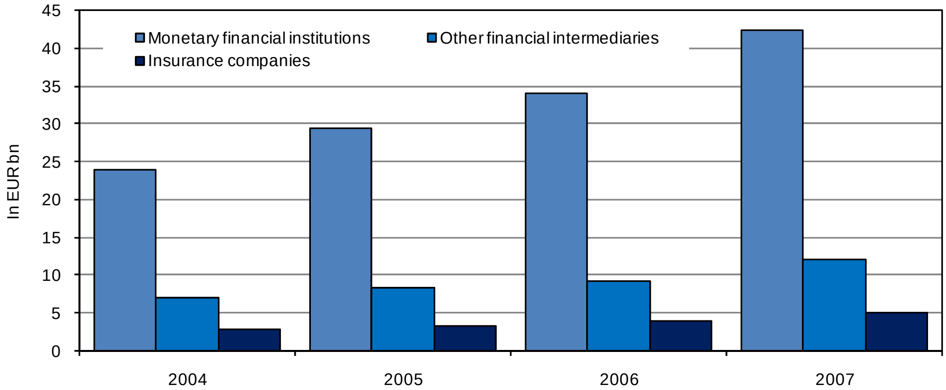
This analysis focuses primarily on the development of the Slovenian banking sector and the movement of financial flows at home and abroad in recent years. Analysis of the lending activity of banks, household savings, borrowing abroad and other capital flows with foreign countries in recent years determines the main trends and their importance for the development of the banking sector. In the final section we present the impact of the international financial crisis, which started in August 2007, on the financial sector in developed economies and assess the possible consequences for the Slovenian banking sector and economy.

1. Development of the financial sector

1.1. The financial sector in Slovenia and its development in comparison to the EMU

In the Slovenian financial sector, the largest share is held by banks (about 60% of total assets), followed by other financial intermediaries, while the lowest share is held by insurance companies. The structure of the financial sector has not changed considerably in recent years, as all sectors are growing at similar rates.

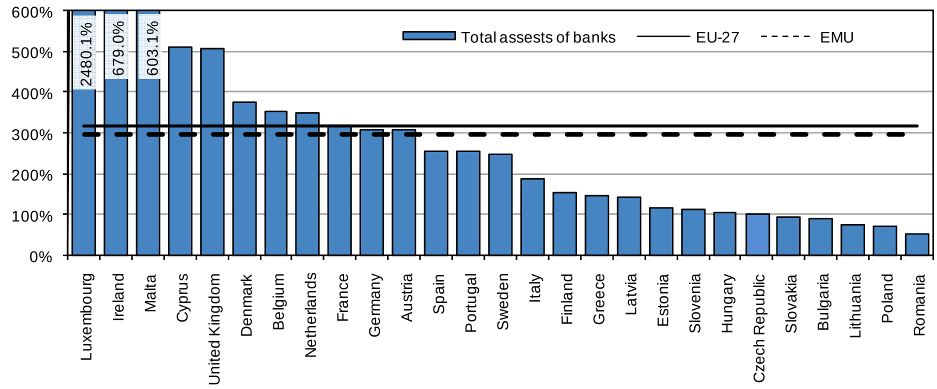
Figure 1: **Scope and growth of total assets in individual sectors in the Slovenian financial sector in the 2004−2007 period**



Sources: Bank of Slovenia, Agency of the Republic of Slovenia for Public Legal Records and Related Services (AJPES)

Indicators of development in the Slovenian banking sector show that the lag behind the EMU average is still significant but slowly decreasing. The most important segment of the Slovenian financial sector is banking, where relatively faster progress has been recorded only in recent years, when interest rates decreased noticeably because of membership in the EMU, while exchange rate risk was considerably limited after 2004, and especially from 2007, which boosted the lending activity of banks and, consequently, the growth of their total assets. Despite this, Slovenia records only a third of the EMU average according to the indicator of total assets of banks in comparison with GDP.

Figure 2: **Comparison of total assets in GDP in 2006**

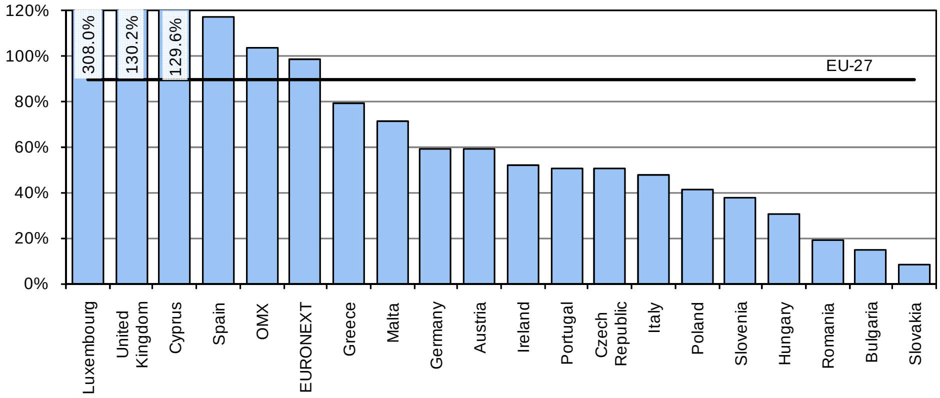


Sources: Statistical Office of the Republic of Slovenia (SORS), Eurostat, Bank of Slovenia, ECB, LBo, Slovenian Insurance Association, Sigma: World Insurance in 2006

In terms of the development of financial services, Slovenia is the closest to the EU average in the area of the capital market and lags behind somewhat more in insurance.[2] The market capitalisation of shares on the Ljubljana Stock Exchange almost tripled over the last two years. A large part of the growth is the consequence of the growing value of shares, and an important contribution was made by the listing of certain state-owned companies on the stock exchange. At the end of 2007, the indicator of the market capitalisation of shares compared to GDP reached about two thirds of the EU average. Because of a greater decline in the market capitalisation of shares in the first quarter of 2008, the difference could increase again. A somewhat larger development gap than on the capital market is recorded in the area of insurance (about 60% of the EU average), where the gap was not reduced in 2006 for the second consecutive year. Only the structure of insurance premiums is improving gradually, to the benefit of more developed financial services (life insurance), while life insurance still represents less than a third of all premiums, or about half the EU average.

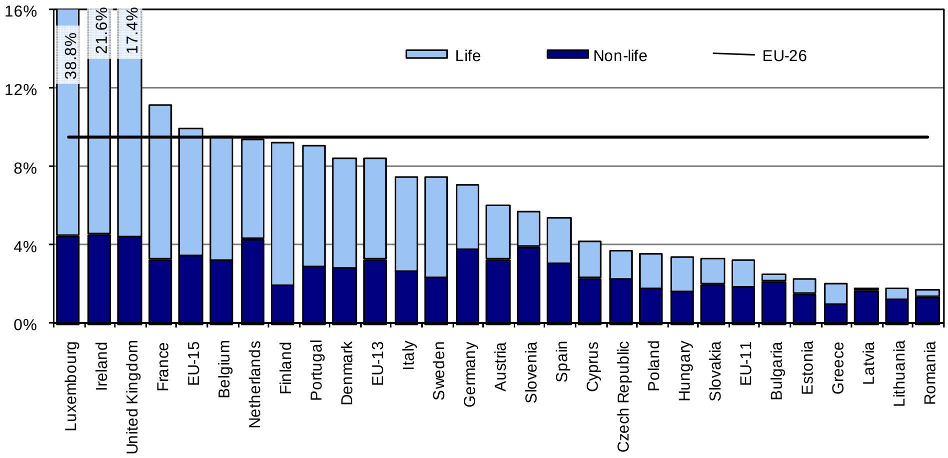
[2] Measured only by market capitalisation of shares in GDP. We are aware that this is a synthetic indicator which by no means can represent the entire situation in the financial sector, but it is frequently used in international comparisons for measuring development of the capital market.

Figure 3: **Market capitalisation of shares relative to GDP in 2007**



Sources: SORS, Eurostat, LBo
Note: EURONEXT: since 01/2001: Amsterdam-Brussels-Paris; since 02/2002: + Lisbon, OMX: Nordic and Baltic market

Figure 4: **Insurance premiums relative to GDP in 2006**



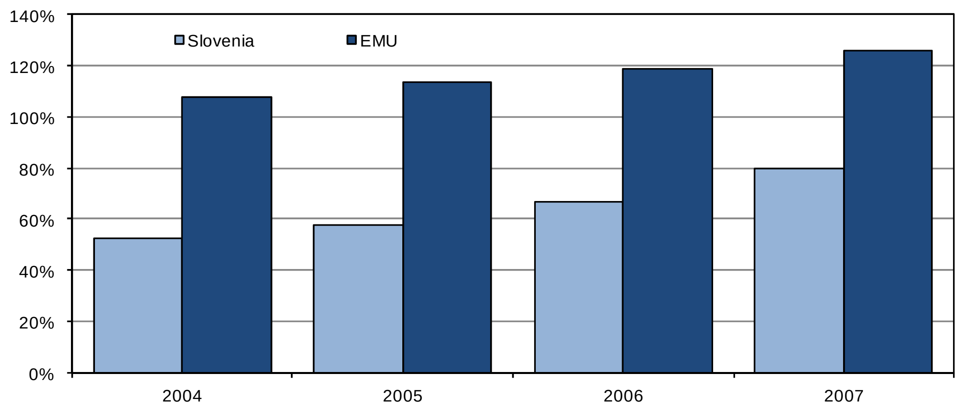
Sources: SORS, Eurostat, LBo, Slovenian Insurance Association, Sigma: World Insurance in 2006

1.2. Comparison of the Slovenian banking sector with banking sectors in the EMU

Comparison of the Slovenian banking sector with the EMU shows that it is relatively underdeveloped. The share of total assets of the banking sector relative to GDP in Slovenia reaches only a third of the EMU average (see 1.1.).The volume of bank loans to non-banking sectors compared to GDP in Slovenia is the lowest among EMU countries, and in 2007 reached two thirds of the EMU average, which is almost half more than in the year of accession to the EU (see Figure 5). The difference in the share of loans to companies and non-monetary financial institutions is relatively lower than the share of credits to households

The lag behind the EMU average in the share of loans to companies and non-monetary financial institutions is relatively small. In terms of the share of loans to companies and non-monetary financial institutions compared to GDP, Slovenia is only slightly behind (just over 2 percentage points) the EMU average, which stood at 60% in 2007. The share of loans to companies compared to GDP (without non-monetary financial institutions) already exceeds the EMU average. Reasons for the relatively great importance of bank loans in the financing of the entrepreneurial sector can be found in the structure of the Slovenian financial system, which is bank-oriented, and in insufficient development of the financial sector and the shallowness of the domestic financial market. Other possibilities for financing companies are rather limited.[3] Also, in some comparably developed EU Member States (Portugal and Spain) similar reasons influence the high dependence of companies on the banking system, and the share of loans to companies compared to GDP in these countries considerably exceeds the Slovenian level.

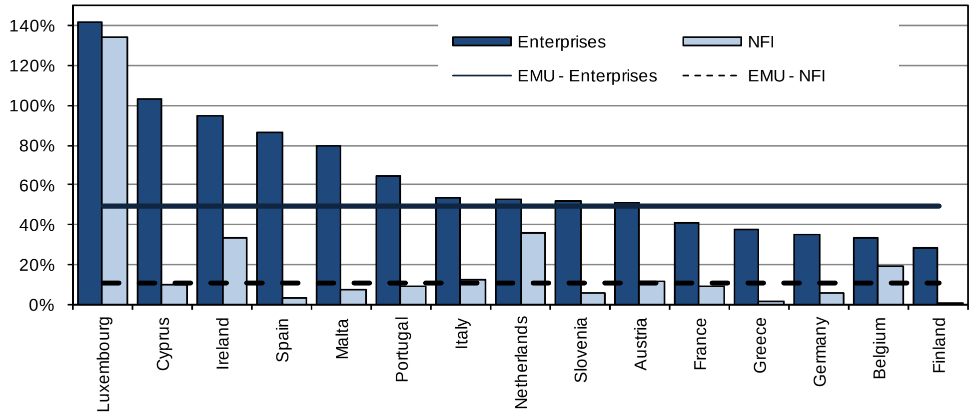
Figure 5: **Comparison of shares of loans to the non-banking sector relative to GDP in the 2004−2007 period**



Sources: Bank of Slovenia, ECB, SORS, Eurostat, calculations by IMAD

[3] The first phase of privatisation of the second largest bank, which took place through an initial public offering, could also contribute to a larger role of other segments of the financial market. Considering the great interest from investors, other potential issuers also opted for such a way of acquiring financial assets, but in the first half of the year the situation on the capital market was rather unfavourable to this way of financing. One of the possible sources of financing is also venture capital funds, but this activity is still underdeveloped despite the adoption of the legal framework.

Figure 6: **Comparison of shares of loans to companies and non-monetary financial institutions in GDP in 2007**



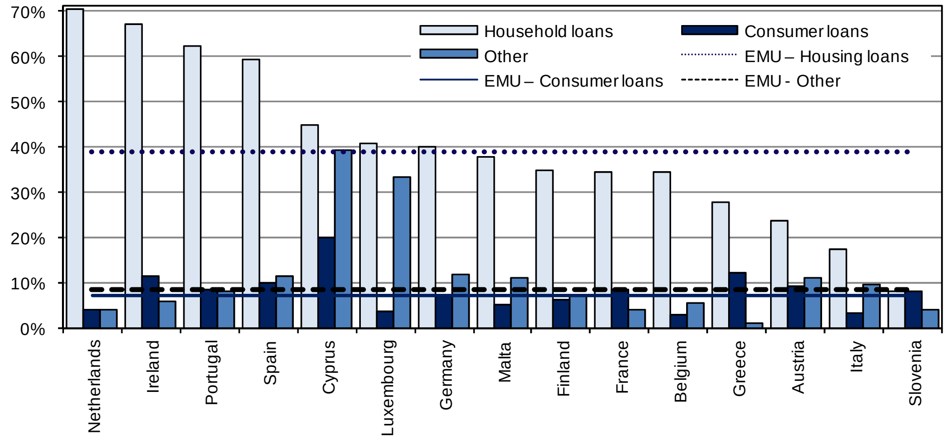
Sources: Bank of Slovenia, ECB, SORS, Eurostat, calculations by IMAD

Household borrowing in Slovenia is still relatively low, primarily because of the low share of housing loans in GDP in comparison to the EMU average. In developed financial systems, an important part of lending activity is represented by household borrowing, and despite relatively extensive borrowing in recent years, Slovenia is still the least indebted among all EMU members (in relation to GDP). The average indebtedness of households, measured in the share of loans in GDP, in 2006 stood at 54.3% in the EMU, and at 44.8% in the EU. The share of loans to households in GDP in Slovenia stood at 20.3% of GDP in 2007. The lag is still largest in the area of housing loans, as their share of GDP accounts for only a fifth of the EMU average (see Figure 7). The total share of consumer loans and loans for other purposes in GDP in 2007 in Slovenia was lower by a fifth than in the EMU, where it stood at around 15.7% in recent years. A more detailed comparison shows that Slovenia exceeds the EMU average in the area of consumer loans, which, however, grow considerably more slowly than housing loans. The share of household credits for other purposes amounts to only half of the EMU level.

The volume of housing loans in Slovenia is relatively low, but these have recorded the highest growth rates among household credits in recent years. Reasons for the relatively small volume of housing loans include the modest development of their supply in the past, relatively favourable conditions for the purchasing of apartments in the privatisation process in the first half of 1990s – as a consequence there was no increased demand for such loans at that time – and also in the relatively underdeveloped institutional framework,[4] where only in recent years have there been gradual improvements, which also contributed to faster growth in such financing. Besides increased competition and, consequently, improved offers from banks in this area, the larger volume of housing loans in recent years has also been strongly boosted by lower interest rates.

[4] Difficulties were experienced with land register, unregulated conditions in the area of enforcement (long court proceedings) and mortgage banking.

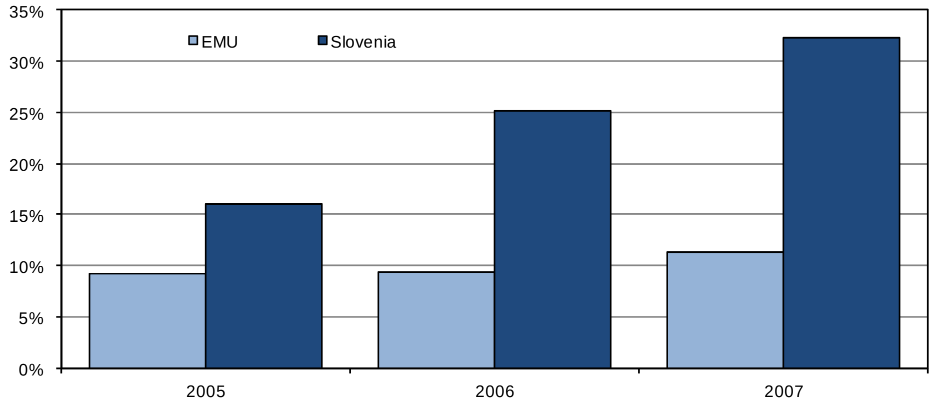
Figure 7: **Comparison of shares of loans to households in GDP for 2007**



Sources: Bank of Slovenia, ECB, SORS, Eurostat, calculations by IMAD

Similar to Slovenia, the lending activity of banks in developed financial systems also improved considerably in the period of high economic growth and low interest rates. The total volume of loans in the EMU in the last three years increased on average by 10% a year, while in Slovenia growth stood at almost 25%, which resulted in catching up more quickly to the EMU average. The highest share is represented by borrowing in the entrepreneurial sector, which in this period recorded a higher rate of credit growth than households.

Figure 8: **Comparison of year-on-year rates of growth of loans to non-banking sectors**



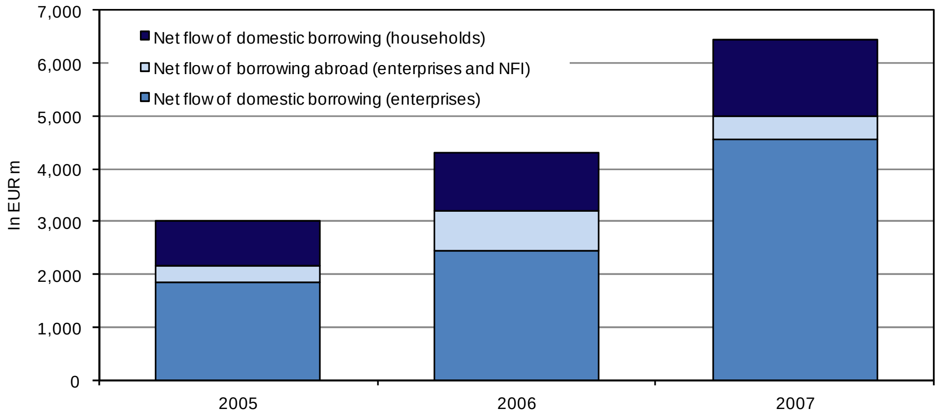
Sources: Bank of Slovenia, ECB, SORS, Eurostat, calculations by IMAD

2. Analysis of financial trends and flows in banks and mutual funds

2.1. Lending activity of domestic banks

Since Slovenia's accession to the EU, the lending activity of domestic banks has constantly increased. In the first year and a half after accession, the decrease in interest rates, which started with the process of their convergence towards the EU average in 2003, continued. Household borrowing increased, and borrowing by companies and non-monetary financial institutions increased even more. Foreign currency borrowing recorded the highest growth rates, as interest rates for such credits were more favourable than interest rates for loans in the domestic currency. Furthermore, Slovenia entered the ERM II system at the end of the first half of 2004, which considerably decreased exchange rate risk, as the majority of foreign currency loans were taken in euros. At the beginning of 2004, foreign currency loans represented about a quarter of total bank loans to non-banking sectors, and before Slovenia's entry into the EMU their share increased to almost two thirds. Since a large portion of foreign currency loans were denominated in EUR, their share dropped to less than 5% after Slovenia's entry into the EMU (the majority being represented by loans in CHF, and to a lesser extent in GBP and USD).

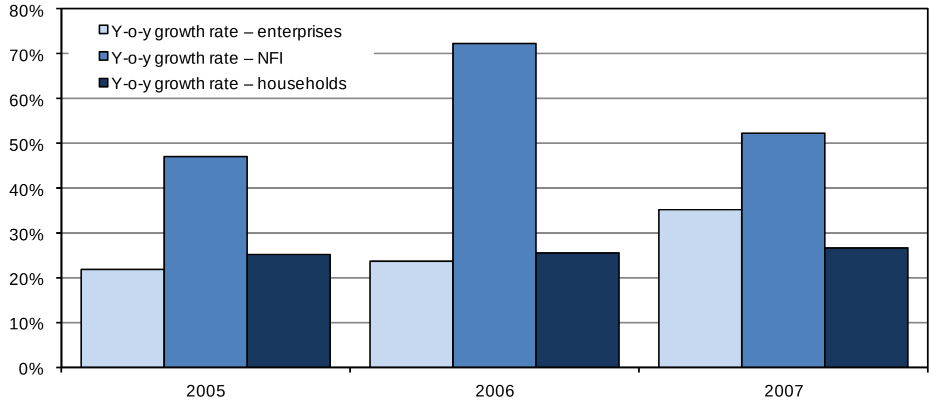
Figure 9: **Net flows of borrowing of households, companies and non-monetary financial institutions from domestic banks and abroad**



Source: Bank of Slovenia, calculations by IMAD

Increasing growth in borrowing was largely contributed by companies and non-monetary financial institutions, which represented 80% of the total net borrowing of domestic non-banking sectors. Companies and non-monetary financial institutions gradually shifted after 2004 from borrowing on foreign markets to domestic borrowing, because of the convergence of interest rates and the improved loan conditions resulting from increased competition among banks in Slovenia. Decreasing interest rates thus additionally stimulated demand from companies and non-monetary financial institutions for loans, which in those years also increased due to favourable economic conditions in the international environment, which positively influenced domestic economic activity. Moreover, demand for loans was additionally strengthened by relatively high takeover activity in recent years. According to the Bank of Slovenia, non-monetary financial institutions, which especially in previous years strongly increased their borrowing, were particularly active in takeovers; growth in bank loans to these institutions exceeded 50% (the share of non-monetary financial institutions within loans to companies and non-monetary institutions at the end of 2007 represented 10.1%). In 2007, low real interest rates, which were mainly a consequence of relatively higher inflation in Slovenia compared to the EMU average, also contributed to the growth in borrowing.

Figure 10: **Year-on-year rates of growth in loans to non-banking sectors in domestic banks**

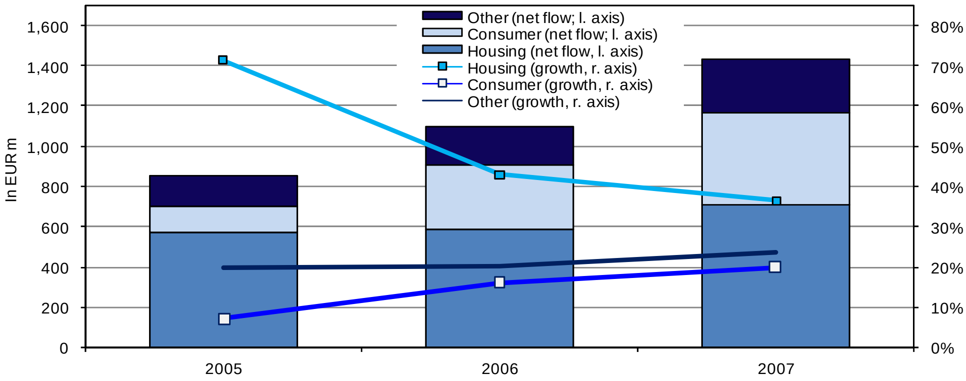


Source: Bank of Slovenia, calculations by IMAD

Similar to companies, households also considerably increased their volume of borrowing in this period. Household borrowing for purchasing apartments increased the most, and, as such, loans in the period between 2005 and 2007 increased by 50% a year on average, and their net flows represented about a half of overall net household borrowing (see Figure 11). The maturity of housing loans was also extended; as before, the share of loans with maturity over 15 years reached less than a third of all loans, while in 2007 it already exceeded 60%. Before the introduction of the euro, households primarily took foreign currency loans, while their importance decreased after the introduction of the euro, which became the domestic currency, but this decrease was lower than for companies.[5] The Bank of Slovenia notes that a large portion of foreign currency loans are denominated in Swiss francs, as borrowing in this currency was more favourable in terms of interest rates than in euros. The rapid growth in foreign currency loans was additionally stimulated by favourable movements of the value of the Swiss franc in comparison to the euro in the period between 2006 and 2007. The share of net flows of foreign exchange loans considerably increased at the beginning of this year, while the value of the Swiss franc in comparison to the euro was changing more than in previous years, which means that households were more exposed to foreign currency risk in this area of borrowing.

[5] Before the adoption of the euro, the share of foreign currency borrowing stood at about 80% and then dropped to about 30%, while companies and non-monetary financial institutions previously borrowed only in the form of foreign exchange loans, and then their share dropped to a tenth.

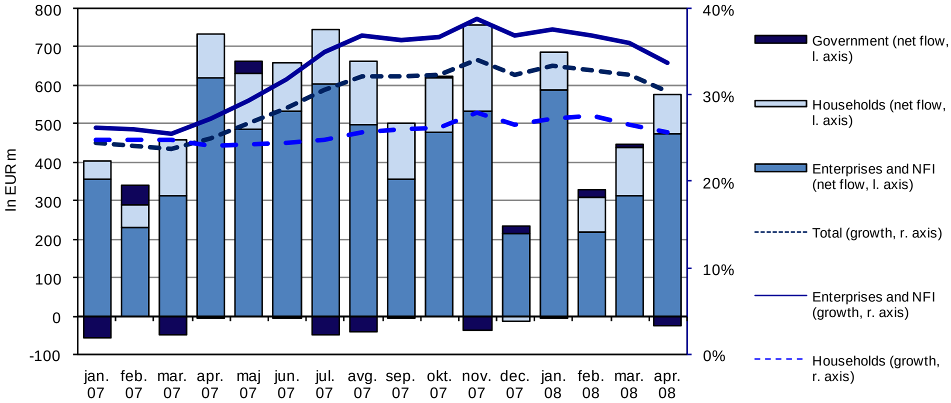
Figure 11: **Net flows of household borrowing and year-on-year nominal growth rates for loans**



Source: Bank of Slovenia, calculations by IMAD

After relatively high growth in January 2008, the lending activity of domestic banks slowed considerably in the following three months. Net flows in the first four months of this year were, at EUR 2,010.9m, only a tenth higher than in the comparable period last year, which is considerably lower growth than in previous years. There are several reasons for the slowing down of growth, on both demand and supply sides. The lower demand is primarily influenced by higher interest rates, which are a consequence of the international financial crisis.[6] On the other hand, because of the consequences of the international financial crisis, banks are facing more difficulties acquiring financing from abroad (especially those which are not owned by foreign banks), which influences their supply of loans. The year-on-year rate of credit growth in the first four months still remained at a relatively high level, but it decreased in April for the third consecutive month and stood at 30.4%, which is the lowest rate in the last ten months.

Figure 12: **Net flows of domestic bank loans to non-banking sectors and year-on-year growth rates for loans**



Source: Bank of Slovenia, calculations by IMAD

[6] The onset of the crisis also resulted in an increase of referenced interest rates on monetary financial markets (the 3-month EURIBOR in May was 0.6 percentage points higher than before the outbreak of the financial crisis; see Section 6).

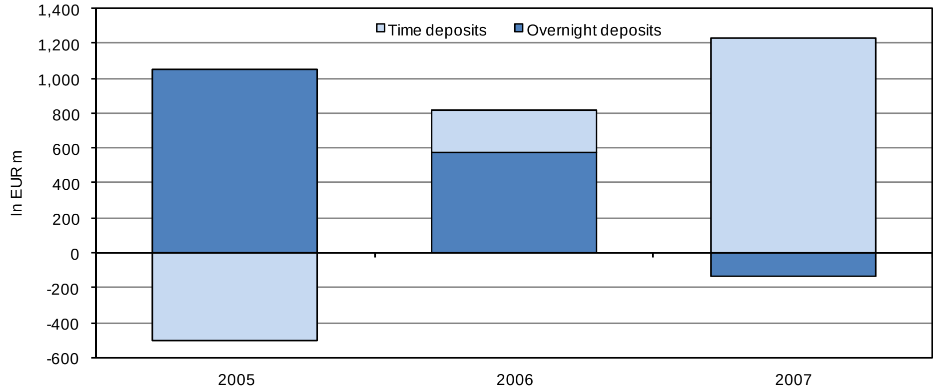
Borrowing of companies and non-monetary financial institutions also dominated in the first four months of the year. More than three quarters of the net borrowing of the non-banking sector in this period went to companies and non-monetary financial institutions, which amounted to a net borrowing of EUR 1,590.7m, which is only about 5% more than in the same period the year before. Over half were loans for working capital, which lagged behind the same period the year before by over a fifth – this can also be linked to a gradual deceleration in the growth of production activity. On the other hand, net flows of loans for investment and other purposes increased by over a third. The high growth of net flows of loans for other purposes (80%) was most probably linked chiefly to the financing of takeover activities of companies. The importance of borrowing abroad as a source of financing companies continues to decrease, as companies took loans in the first three months of the year in the net amount of EUR 89.8m, which is only a third of the amount from the same period the year before. Besides slight differences between foreign and domestic interest rates, this decrease was also influenced by the limited availability of loans on foreign markets.

The growth of household borrowing in the first four months of the year decreased more slowly than the borrowing of companies and non-monetary financial institutions, which is primarily a consequence of further extensive borrowing in the form of housing loans. In the first four months of the year, households borrowed a net EUR 417.0m, which is 13.7% more than in the same period last year. The biggest share was in net flows of housing loans, which in the first four months of the year reached EUR 285.2m, which is 50% more than in the same period last year. On the other hand, net flows of consumer and other loans in the first quarter of the year decreased by a quarter over the same period last year. This lower amount of such net borrowing is most probably a consequence of negative trends on capital markets and, consequently, the smaller volume of household borrowing for the purchase of securities.

2.2. Household savings in banks and mutual funds

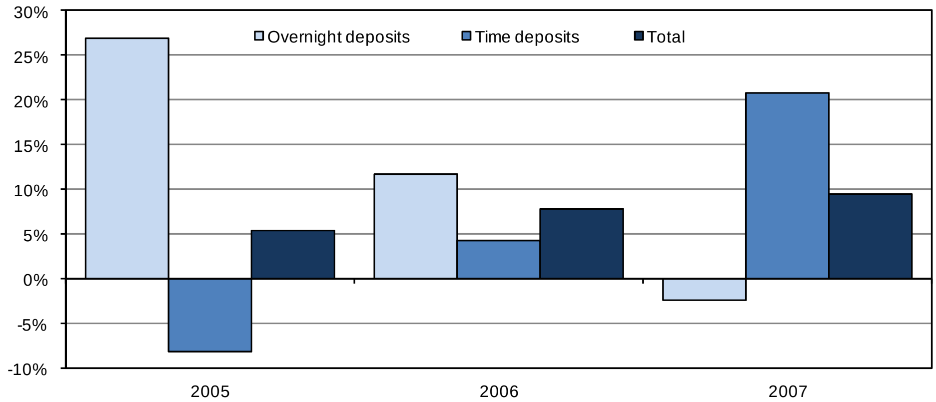
The reduction of interest rates has influenced lower growth rates of household savings in banks. The net inflow of term deposits slowed down considerably in 2005, while net inflows of more liquid deposits (overnight deposits) took on a more important role among household deposits in banks (see Figure 13). These trends changed in 2006 and 2007, as term deposits started gaining ground. This is especially the case with deposits redeemable at notice, which have higher interest rates. One reason for higher growth rates could also be the higher growth of net wages and the gradual increase in deposit interest rates. The growth of net wages was higher in income groups with a higher propensity to savings and is a consequence of lower progression in the new income tax legislation, which entered into force in 2007. Increasing interest rates in the first half of 2007 were a consequence of the increase in the key interest rate of the ECB, while deposit interest rates later also increased because of worsening conditions on inter-bank markets as a consequence of the financial crisis, as this greatly restricted banks' access to foreign financial assets.

Figure 13: **Net flows of household savings in banks**



Source: Bank of Slovenia, calculations by IMAD

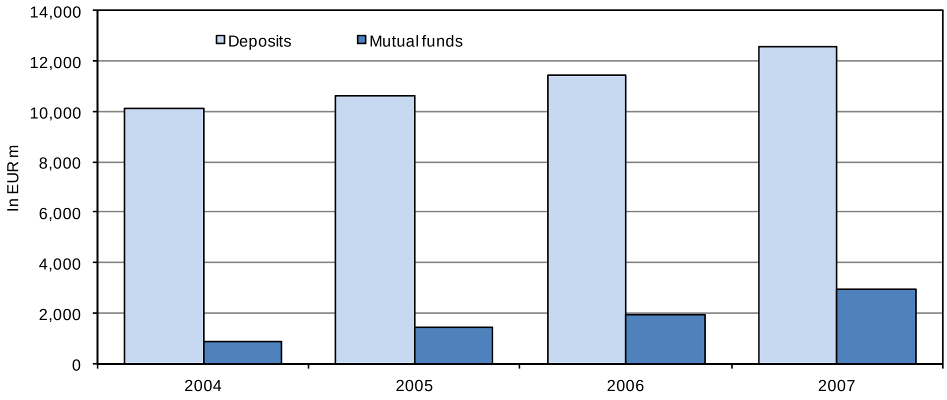
Figure 14: **Year-on-year growth rates of household savings in banks**



Source: Bank of Slovenia, calculations by IMAD

The reduction in interest rates, favourable trends on capital markets at home and abroad (up to last August), increased domestic and foreign investing options and intensive marketing have contributed to the strong increase of household savings in mutual funds in recent years. In the 2004–2007 period, the volume of assets in domestic mutual funds increased on average by two thirds per year (see Figure 15). Year-on-year yield in individual mutual funds meanwhile exceeded the 50% level. High yields encouraged investors to make more bold investments in equity funds, as their shares more than doubled in this period and at the end of 2007 represented almost two thirds of assets in domestic mutual funds.

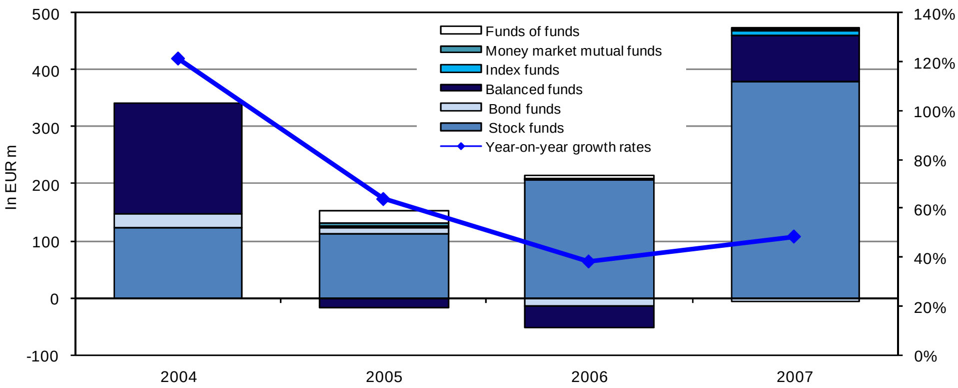
Figure 15: **Volume of household savings in banks and mutual funds**



Source: Securities Market Agency, calculations by IMAD

The volume of assets in mutual funds at the end of last year accounted for almost a quarter of household savings in banks. Net flows in mutual funds accounted on average for just under 30% of net flows of household deposits in banks. Despite high growth in recent years, an international comparison shows that mutual funds in Slovenia continue to be a relatively less important form of saving than on average in the EMU, where assets per citizen exceed EUR 15,200,[7] while this amount in Slovenia stands at a mere EUR 1,200. A comparison with GDP also shows that the difference is considerable, as the share of assets in mutual funds in Slovenia in 2006 stood at 6.5% of GDP, and in the EMU at 57.2% of GDP.[8] Pension funds are also gradually gaining importance, as their volume of assets increased by a factor of 7.5 in the 2004−2007 period, but at EUR 439.1m at the end of 2007 reached only 15% of the assets in domestic mutual funds.

Figure 16: **Net deposits in mutual funds and year-on-year growth rates for assests in domestic mutual funds**

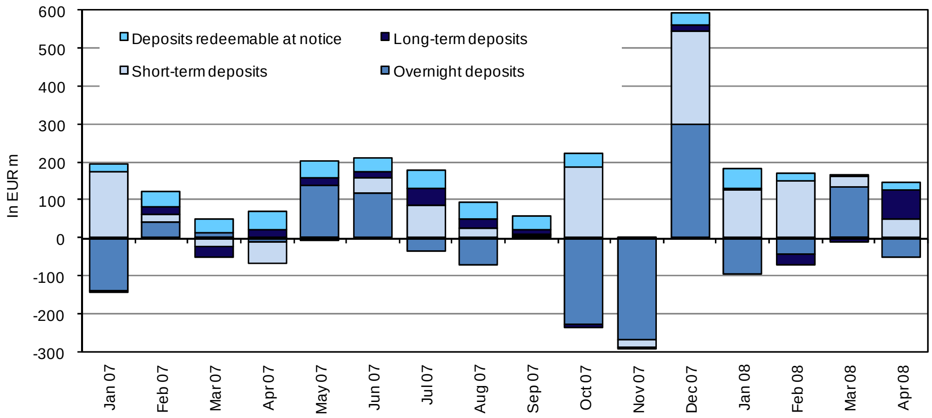


Source: Securities Market Agency, calculations by IMAD
Note: MMMF: Money Market Mutual Funds

[7] Data for 2006. There is no data for Malta and Cyprus, while data for Ireland and Luxembourg, which considerably stand out from the average, were also included. The average without these two countries would only exceed EUR 8,300.
[8] See note 7.

In 2008, household savings, with worsening conditions on international financial markets, are again gaining more importance as a source of financing the lending activities of banks. Growth in household savings in banks continued to increase with the gradual rise in interest rates and most probably also because of lower household investments in capital markets. The net flow of household deposits in banks in the first four months of the year stood at EUR 437.6m, and exceeded the amount from the same period last month by a factor of nearly 2.5. Term deposits (primarily short-term and redeemable at notice) recorded higher growth rates, while overnight deposits at the end of April were 1% lower than at the end of last year.

Figure 17: **Net flows of household savings in banks**

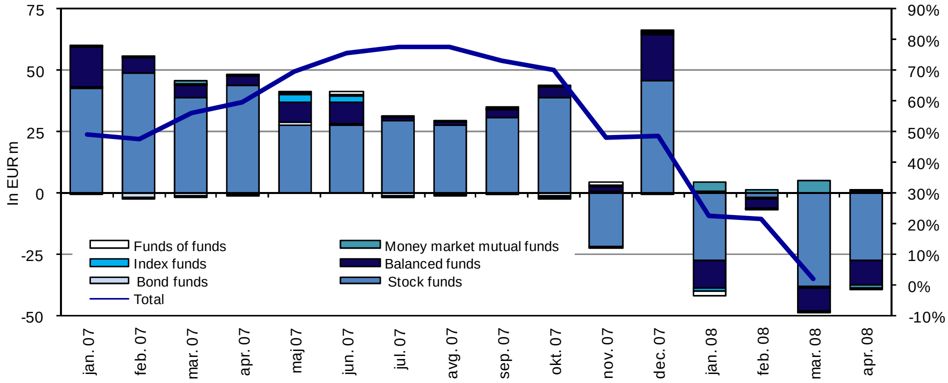


Source: Bank of Slovenia, calculations by IMAD

After a strong boost in the last year, the volume of assets in domestic mutual funds dropped in the first four months of the year by almost a fifth.[9] This drop was largely the result of a decrease in the value of securities on the majority of capital markets, and a quarter of the decrease was a consequence of net outflows of assets from mutual funds, which stood at EUR 123.3m, while in the same period last year net inflow was recorded at EUR 204.6m. The major part of assets of mutual funds is still in equity funds (64.5% of all assets), but their share decreased this year by 1.6 structural points.

[9] A decrease also at the annual level was recorded in April for the first time in the last ten years.

Figure 18: **Net flows in individual types of domestic mutual funds and year-on-year rates of the overall volume of assets**



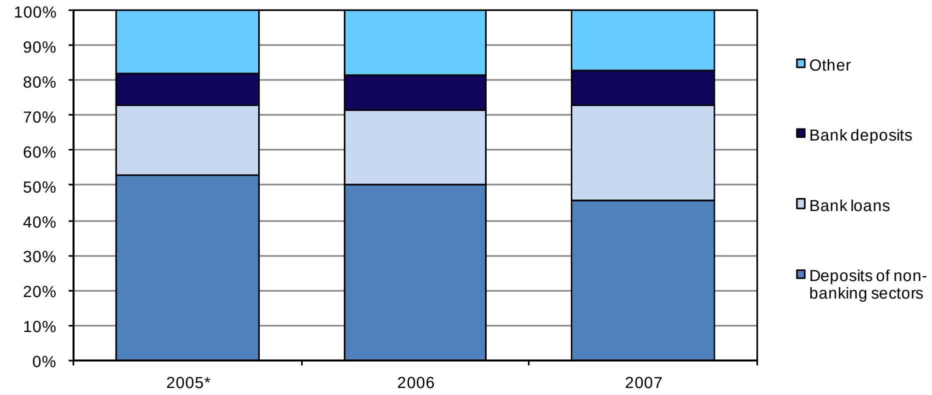
Source: Securities Market Agency, calculations by IMAD

2.3. Changes in the structure of liabilities in the total assets of domestic banks

Low growth rates for bank deposits and high demand for loans in recent years have led to boosted external bank funding. Banks financed a large part of their lending activities by borrowing abroad, which has been increasing year by year and in 2007 exceeded EUR 3.3bn (see Figure 20). The international financial crisis that began in August 2007 considerably changed the structure of this kind of borrowing. Before the crisis, banks borrowed mostly in the form of long-term loans, but worsening conditions on the inter-bank market forced them to settle for short-term borrowing. Considering that these assets are still loaned long-term,[10] this worsens maturity matching of the balance sheet and consequently increases liquidity risk. An important source of financing was also deposits of foreign banks, which fluctuated in the last three years at around EUR 1bn. Considering less accessible external sources of financing this year, banks are also resorting to capital injections in order to acquire additional assets, which is a consequence of the fact that the capital adequacy of the majority of banks did not follow the high lending activity, while additional capital requirements are also imposed by the implementation of the Basel II Framework.

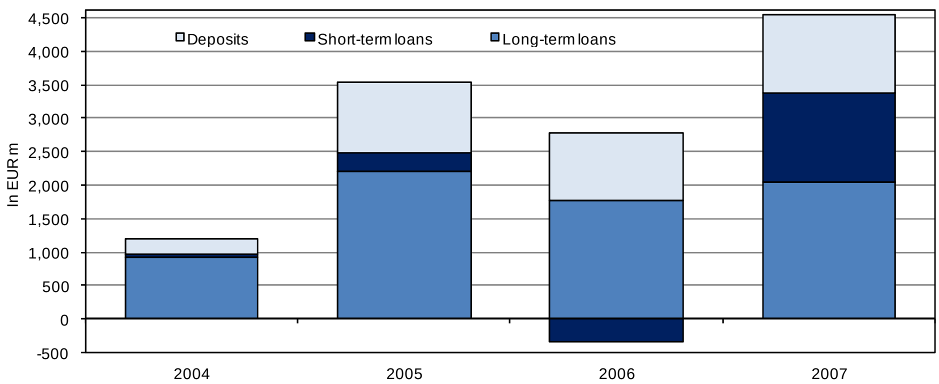
[10] On the basis of data from financial accounts we estimate that banks granted about two thirds of overall net flows in long-term loans.

Figure 19: **Changing liability structure in banks**



Source: Bank of Slovenia, calculations by IMAD
Note: *Data for January 2006.

Figure 20: **Structure of net borrowing of banks abroad**

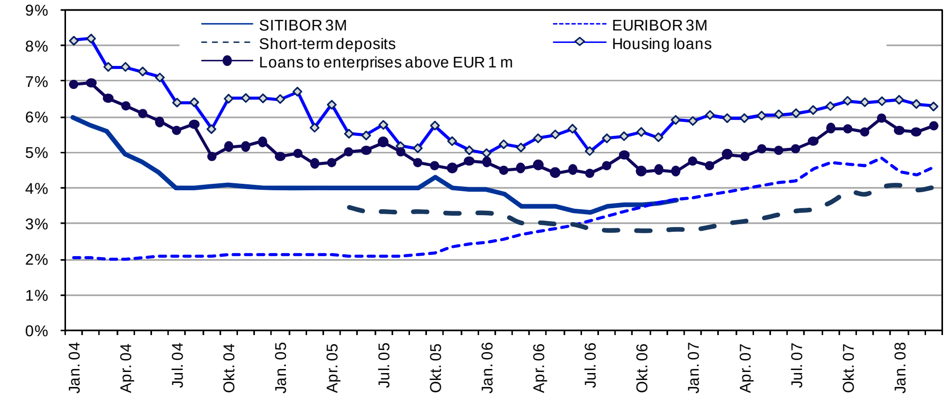


Source: Bank of Slovenia, calculations by IMAD

2.4. Interest rates

Lower inflation and the elimination of indexation of interest rates have in recent years considerably reduced the level of interest rates, which by the end of 2006 converged towards the EMU level. As a year before Slovenia's entry into the EMU the ECB started to gradually raise the main interest rate, the convergence was faster. After entry into the EMU, interest rates in Slovenia again started to rise, which was initially a consequence of the restrictive monetary policy measures of the ECB, which at the end of 2005 started gradually raising interest rates, while increases in the second half of 2007 were related to the worsening conditions on financial markets because of the international financial crisis.

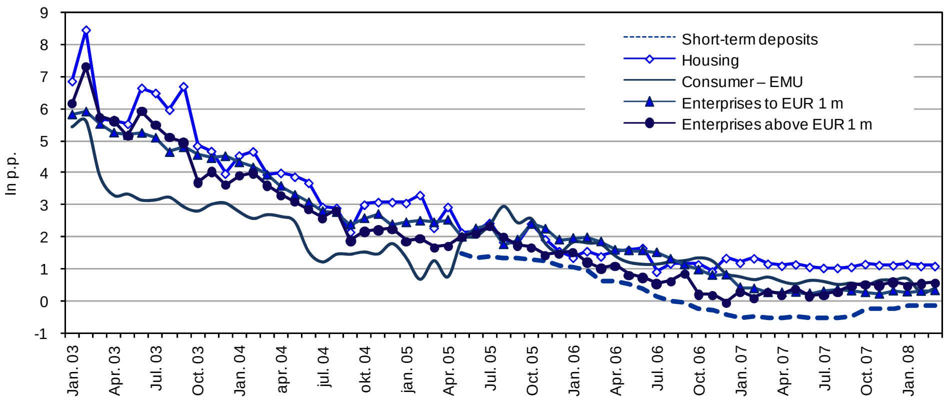
Figure 21: **Movements of certain interest rates**



Sources: Bank of Slovenia, www.euribor.org, calculations by IMAD

In Slovenia, banks lowered deposit interest rates more rapidly, and they have remained below the EU average for more than a year and a half. On the other hand, lending interest rates are above the EMU average. The most significant differences between Slovenia and the EMU are recorded in interest rates for household credits as individuals have limited access to foreign borrowing.[11] For housing loans, interest rates are 1.2 percentage points above the EMU average, while the differences between interest rates for consumer loans and loans to companies are somewhat lower. A greater difference between lending and deposit interest rates points to still insufficient competition on the Slovenian banking market.

Figure 22: **Movement of differences between comparable interest rates in Slovenia and the EMU**



Sources: Bank of Slovenia, calculations by IMAD

[11] The volume of borrowing is too small in the majority of cases to justify the hiring of financial advisers, while foreign banks are more careful in loaning because of a relatively small amount of available information.

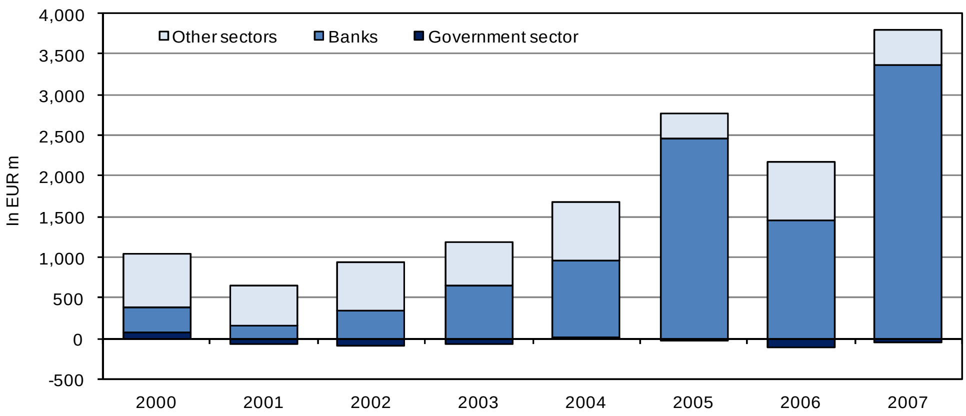
Net borrowing by domestic banks abroad increased slightly at the end of the year, but still remained below the average rate from the previous year. After net repayment of short-term loans in January, such credits in the remaining months of the first quarter regained importance within bank borrowing abroad. The overall net flows of foreign loans (short-term and long-term) in this period stood at EUR 561.6m, and in the same period last year banks even repaid foreign loans in the amount of EUR 208.3m. The needs for such financing were smaller then because banks obtained additional financial assets when the bills of the Slovenian central bank matured.

3. External Financial and Capital Flows

3.1. Borrowing Abroad

Upon entering the EU and EMU, Slovenia's integration in international financial and capital outflows strengthened. The following factors in particular influenced the increased volume of international financial and capital flows, assets as well as liabilities: firstly, the full liberalisation of the capital and financial account of the balance of payments during accession to the EU; and secondly, the adoption of the euro in 2007.

Figure 23: Banks, companies, other financial institutions and government sector borrowing abroad



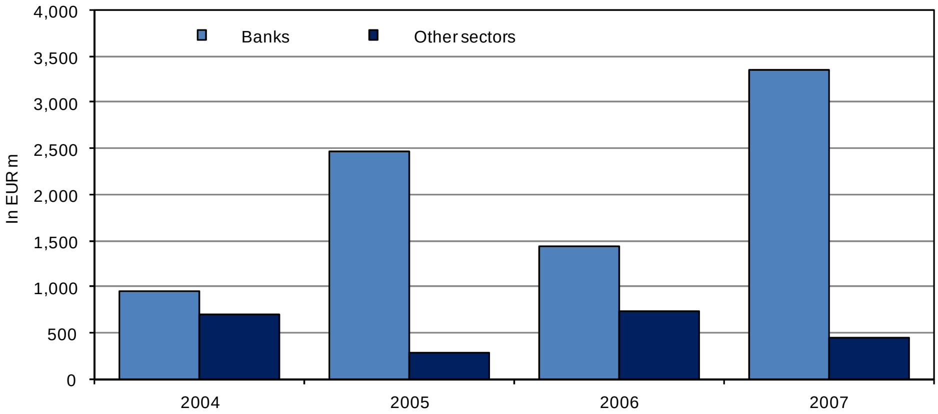
Source: Bank of Slovenia

Borrowing abroad has strengthened since 2003; in the past four years especially domestic bank borrowings abroad have grown rapidly. In the period after 2003, more borrowing by the banking sector was encouraged by the slower depreciation of the tolar (SIT) against the euro, together with domestic and foreign interest rate convergence prior to and following Slovenia's accession to the EU, which on the one hand influenced the slower growth in deposits in domestic banks, and on the other influenced the increase in demand for credit among companies and households. With lower growth in domestic sources of financing, domestic commercial banks started to increase the volume of borrowing abroad, in particular after 2004. In this way they provided the means for increased demand for credit[12] in other sectors (in particular from companies). In addition, after entering the EMU in 2007, the elimination of exchange rate risk in borrowing in euros (borrowing in euros represents around 90% of total external debt) and lower risk premiums, which increased the availability of foreign loans, also impacted the increased volume of foreign borrowing. Direct company borrowing abroad gradually decreased after 2004 and was redirected to borrowing from domestic commercial banks. Growth in borrowing abroad by the banking sector, the majority of which is represented by long-term loans, was

[12] Moreover, the raising of loans abroad was joined by received payments in cash and foreign bank deposits as important sources of financing on domestic banks balance sheets (see Section 2.1.3.).

somewhat slower in 2006 and the beginning of 2007, since banks partially covered the increased domestic demand for credits from matured bills of the Bank of Slovenia. In 2006, the greater volume of loans raised abroad by other financial institutions considerably influenced the growth in borrowing abroad.

Figure 24: **Banks and other sectors borrowing abroad**



Source: Bank of Slovenia

Increased borrowing abroad influenced the growth of gross external debt, which at the end of 2007 stood at 102.4% of GDP. Gross external debt amounted to EUR 34,358m at the end of 2007, and was EUR 10,324m higher compared to December 2006. Borrowing by domestic commercial banks, whose growth strengthened last year, contributed EUR 5,197m, or 50.3%. The share of the debt of commercial banks has constantly increased since 2001, and at the end of 2007 represented 47.2% of gross external debt and 48.3% of GDP (as compared to 36.2% of GDP at the end of 2006). Besides the direct raising of foreign loans by banks and companies, as well as other financial institutions, the increase in external debt in 2007 was also the result of the debt of the Bank of Slovenia, incurred by its entry into the Eurosystem. By entering the EMU, claims on the bills and long-term deposits of commercial banks against the Bank of Slovenia decreased. The liabilities of the Bank of Slovenia were replaced by short-term liabilities to the Eurosystem, which greatly increased in particular in the first five months of 2007 (by EUR 3,522.5m), when tolar (SIT) bills matured. The liabilities of the Bank of Slovenia to the Eurosystem thus contributed 34.6% of the increase in gross external debt. Furthermore, long-term Eurobonds issued by the government, which in the case of foreign investments is shown as the gross external debt of the government sector,[13] also contributed to the growth in gross external debt.

The government sector has in recent years repaid net loans raised abroad and contracted debts mainly by issuing long-term national securities (Eurobonds). Strong interest on the part of foreign investors influenced the growth in gross external debt of the government sector in 2007 in particular. Government sector

[13] Resources from the sales of reference bonds of the Republic of Slovenia were partially used to finance the execution of the state budget and partially to finance existing (more costly) debt redemption.

indebtedness increased due to the EUR 1bn in Slobond bonds, equalling EUR 3,026m at the end of 2007, just under one-tenth of the total gross external debt.

Affiliated companies[14] borrowed abroad relatively less compared to other sectors. Affiliated companies borrowed abroad relatively less compared to other sectors until 2007, when their debt increased, which was mainly the consequence of the methodologically broader coverage of direct investment[15] liabilities previously covered as company liabilities in other sectors. As a result, the share of affiliated companies in total external debt decreased from the time of accession of Slovenia until 2007. However, in 2007, it increased by EUR 2,859m to EUR 3,997m, or 11.9% of gross external debt (of this, by EUR 2,035m resulting from methodological changes), as compared with December 2006. Hence, the gross external debt of other sectors largely decreased (to EUR 7,551m) because of the above-mentioned restructuring of part of the loans from other sectors (where companies prevail) among the loans of affiliated companies. Here, debt liabilities to direct investors increased faster than debt liabilities to affiliated companies abroad.

Most of the gross external debt in 2007 was composed of long-term and non-guaranteed private debt. Not considering the liabilities to affiliated companies, for which classification by maturity was not issued, long-term debt accounted for 64.7% and short-term for 35.3% of gross external debt at the end of 2007. This structure, from the point of view of debt maturity, shows that Slovenia has hitherto not experienced problems with liquidity or solvency. This ratio was even more in favour of long-term debt at the end of 2006 (77.3% in relation to 22.7%), but in 2007 an increase in short-term debt occurred, mainly as a consequence of changes in monetary policy instruments, as well as growing short-term indebtedness abroad. The incurred liabilities of the Bank of Slovenia to the Eurosystem last year were the main factor in the increase in public and publicly guaranteed debt, which at the end of 2007 amounted to EUR 8,087m or 23.5% of gross external debt. Guarantees assumed by the Republic of Slovenia for external debt, which are part of the publicly guaranteed debt, at the end of December 2007 amounted to EUR 2,555.7m, which is EUR 597m more than at the end of 2006.

Slovenia has the lowest share of foreign debt in GDP among the Eurozone countries. At the end of 2007, the share of gross external debt was 102.4% of GDP, which is significantly lower than the Eurozone average in 2007 (191.8% of GDP). In the period between 2003–2007 for which there are data available for the Eurozone, the nominal growth of external debt in Slovenia was higher than the Eurozone average (Slovenia 24.9%, Eurozone 14.2%; only in Ireland has external debt increased more than in Slovenia, by 28.7%). Despite almost double the growth of foreign debt in Slovenia compared to the EMU, its share in relation to GDP increased less than in the EMU (from 52.2% of GDP to 102.4%, as compared to 191.8% from 129.0% of GDP in the EMU).

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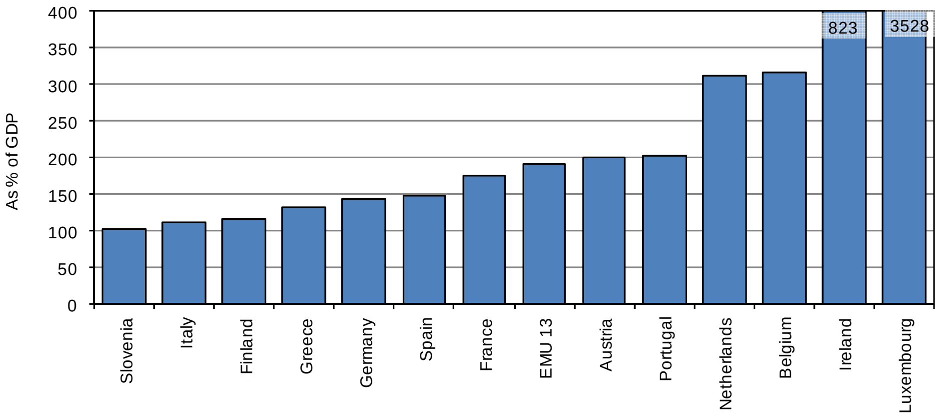
[14] Legal entities affiliated with non-residents who are owners of at least 10% of the capital.
[15] Besides company liabilities to the direct foreign owner, liabilities to all non-resident companies belonging to this group are included among direct investments using the new reporting scheme.

Figure 25: Gross external debt across Eurozone countries, as % GDP



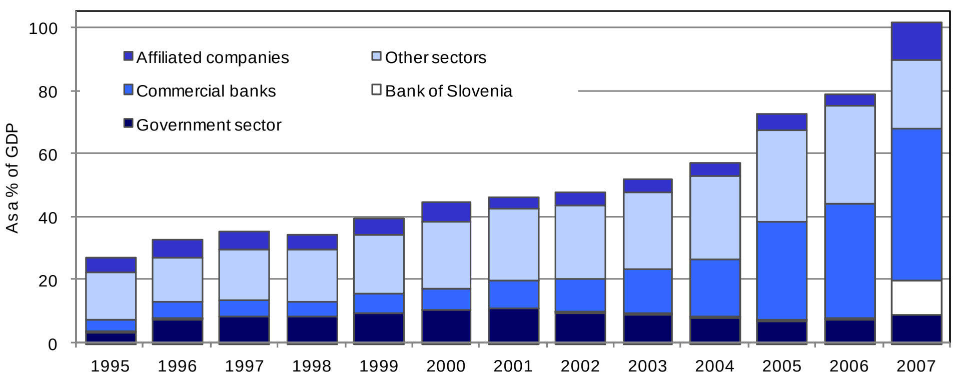
Source: Statistical Office of the Republic of Slovenia (SORS), Bank of Slovenia, World Bank, National Central Banks, recalculations made by the Institute of Macroeconomic Analysis and Development (IMAD)

Table 1: **Slovenia's gross external debt, in EUR m**

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total gross external debt	9,490	10,386	11,524	13,225	15,343	20,508	24,034	34,358
Short-term debt	2,283	2,213	2,327	2,475	2,659	4,543	5,206	10,673
Public and publicly guaranteed debt	0	15	99	70	57	40	48	3,588
Private non-guaranteed debt	2,283	2,198	2,227	2,405	2,603	4,503	5,158	7,086
Long-term debt	5,895	7,369	8,229	9,590	11,552	14,551	17,709	19,708
Public and publicly guaranteed debt	2,883	3,095	3,142	3,461	3,689	3,771	4,275	4,499
Private non-guaranteed debt	3,012	4,274	5,087	6,129	7,863	10,780	13,435	15,209
Liabilities to affiliated companies	1,312	804	969	1,160	1,132	1,415	1,118	3,977
Public and publicly guaranteed debt	0	0	0	0	0	0	0	0
Private non-guaranteed debt	1,312	804	969	1,160	1,132	1,415	1,118	3,977

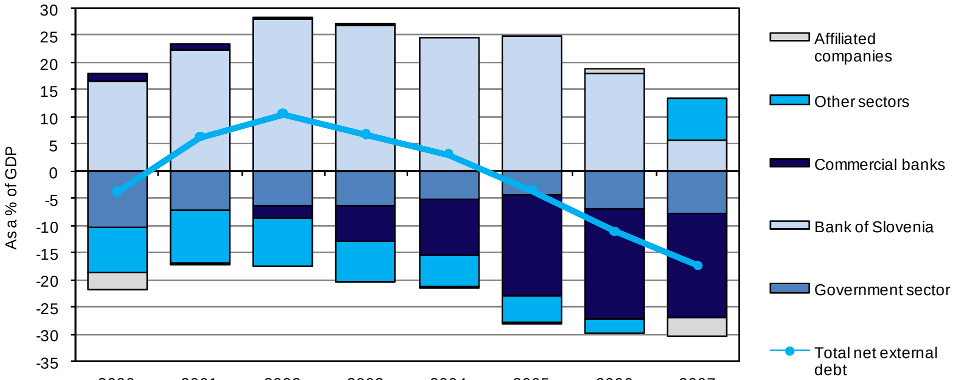
Source: Bulletin of the Bank of Slovenia, April 2008.

Figure 26: Gross external debt by sector, as % GDP



Source: Bulletin of the Bank of Slovenia, April 2008, calculations by IMAD

Figure 27: **Net external debt and net claims, as % of GDP**



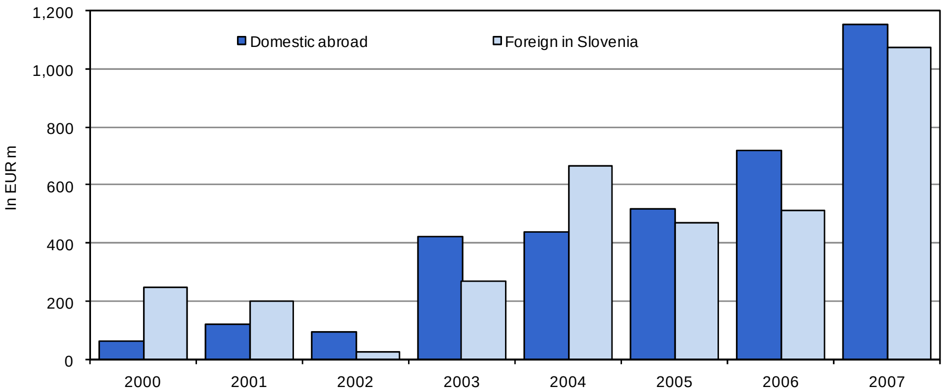
Source: Bulletin of the Bank of Slovenia, April 2008, calculations by IMAD
Note: the plus sign (+) represents foreign net debt liabilities and the minus sign (-) net external debt.

Although the outflow of loans increased significantly over the past two years, its volume lagged behind that of inflow of raised loans abroad, hence net external debt increased. Domestic banks mainly granted loans for financing countries in the area of the former Yugoslavia, while domestic companies were directing loans to borrowers in EU Member States. Regardless of the faster increase in debt claims towards the rest of the world in recent years, the net debt-based position deteriorated and net external debt at the end of 2007 was 18.9% of GDP (compared to 11% of GDP at the end of 2006).

3.2. Other capital flows

Among other capital flows in recent years, direct and portfolio investments of Slovenian investors abroad, which exceeded the investments of foreign investors in Slovenia, increased in particular.

Figure 28: **Direct investment flows, in EUR m**

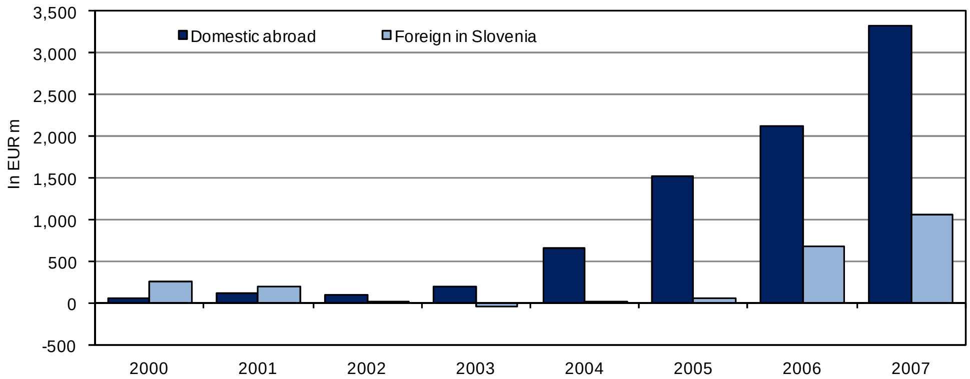


Source: Bank of Slovenia, calculations by IMAD

In the past three years, direct investment outflows exceeded inflows of foreign investors in Slovenia *(see Figure 29*: **Flows of portfolio investments**
). Slovenian enterprises made the majority of direct investments in countries of the former Yugoslavia. The decreasing share of Slovenian goods exports to this area shows that Slovenia is replacing some of the previous exports with local production in these markets. According to the data available for 2003–2006, Slovenia had the most direct investments in Croatia, namely as much as 42.5%, followed by Serbia and Montenegro, Germany, BiH, Poland and Macedonia. The value of Slovenia's direct investments abroad consisted, on average, of two thirds of equity capital, while one third comprised net claims to foreign entities affiliated through capital (the difference between the claims and liabilities between affiliated companies). The ratio between equity capital and other capital is increasing and indicates the long-term interest among owners in financing their investments abroad.

EU countries invested most in Slovenia in the form of direct foreign investments. According to data on direct investments in Slovenia by country in the 2003–2006 period, our most important trade partners contributed around two thirds of all direct foreign investments on average. Among the latter, the most important foreign investors were Austria, Germany, France and Italy. Of the EU Member States, with which Slovenian trade flows are modest, the share of The Netherlands represented 5.1% of the value of all investments on average. Of non-EU countries, Switzerland was the largest investor in Slovenia. Equity capital was the most dominant in the value structure of direct foreign investments in Slovenia. At the end of 2006, the total value of equity capital was EUR 5,601.1m. Even though foreign investors, in addition to capital investments also support the current financing of Slovenian enterprises with loans and commercial credits, the share of net liabilities to foreign investors of all foreign direct investments in the past two years declined considerably (to 10.4%, and 8.6% in 2006; it was 12.1% in 2003). Therefore, most direct foreign investment inflows in the past two years occurred in the form of equity capital.

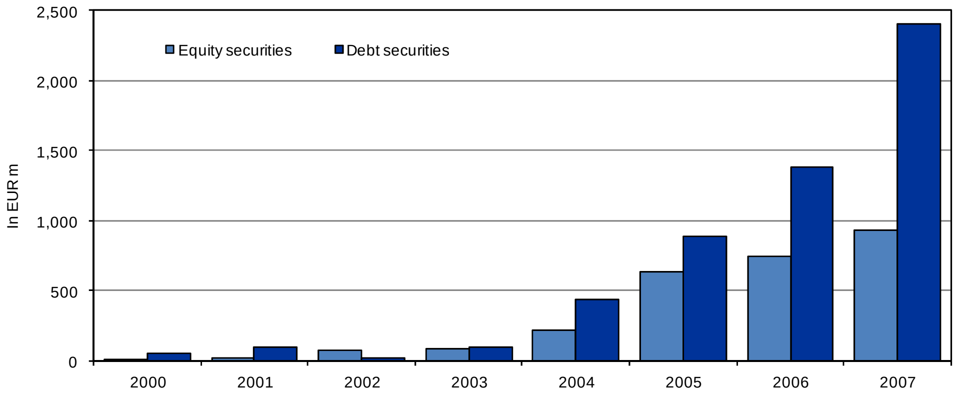
Figure 29: **Flows of portfolio investments**



Source: Bank of Slovenia

Within portfolio investments, the investments of Slovenian investors abroad also exceeded those of foreign investors in Slovenia. Among claims, investments of the private sector in foreign equity shares increased in particular. The increase was especially noticeable in 2005 after the restrictions on investments in foreign securities were abolished, when mutual fund investments increased, and the investments of citizens and insurance companies were higher as well. Investments in foreign securities also increased in 2006 and 2007, but growth rates calmed down somewhat (base effect). The release of liquidity after bills of the Bank of Slovenia matured, most in the first quarter of 2007, heavily increased the investments of Slovenian commercial banks in foreign securities, especially government bonds in the European area. Thus, the portfolio investments of Slovenian commercial banks in foreign bonds, debt obligations and money market instruments increased considerably. Among portfolio liabilities, foreign investment in Slovenian government securities increased in particular in the past two years.

Figure 30: **Flows of portfolio investment abroad by type of security**

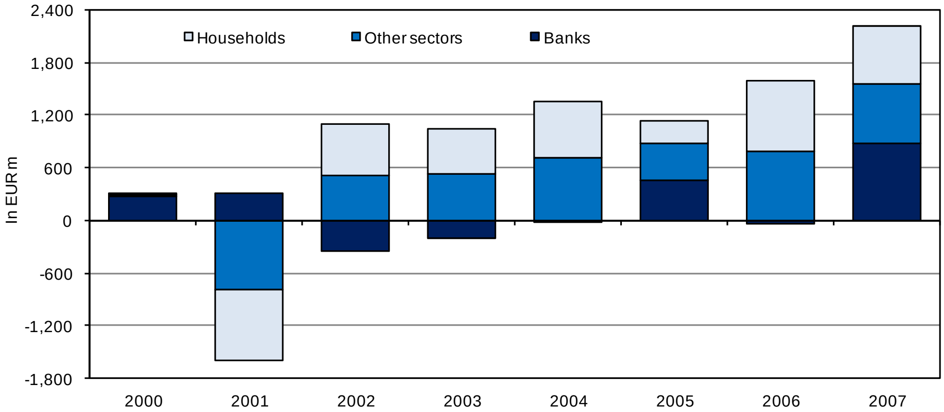


Source: Bank of Slovenia, calculations by IMAD

The major part of other investments consists of currency and deposits. The household sector holds the majority of currency and deposits, consisting of cash outside the domestic banking system: 1) foreign currency kept at home, and 2) foreign currency in foreign bank accounts. Before the introduction of the euro, residents brought quite a large amount of foreign currency kept at home to banks to be later converted into euros. Since 2001, outflows under household currency and deposits have remained at a relatively high level. Transfers by non-residents to their families have also been increasing, as well as purchases of residents abroad. Last year's increase was due to changes in methodology.[16]

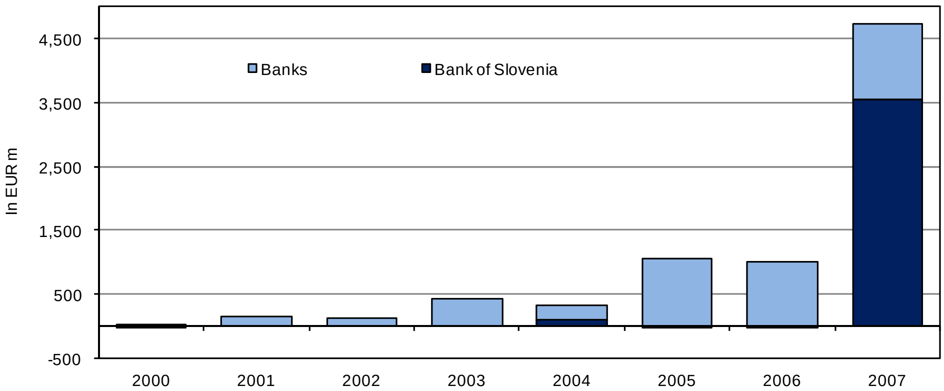
[16] In 2007, the Bank of Slovenia also adopted a new methodology to estimate cash transactions with non-residents, which considerably decreased the statistical error. According to the double-entry bookkeeping principle, cash and deposits of residents represent the counter-entry to travel and labour income. Cash of residents is evaluated as the sum of differences between cash inflows and outflows under tourism and labour income.

Figure 31: **Claims on non-residents under cash and deposits**



Source: Bank of Slovenia

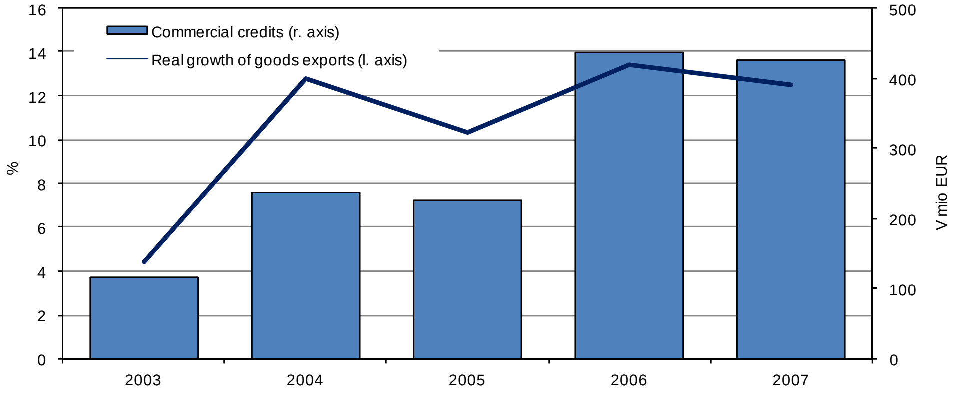
Figure 32: **Claims on non-residents under deposits**



Source: Bank of Slovenia

After Slovenia's accession to the EU, flows of short-term commercial credits increased as well, whereby outflows from Slovenia exceed inflows from abroad. Short-term commercial credits are very much connected to the dynamics and structure of goods exports. Slovenia has more than half of claims under short-term commercial credits with EU countries, with which it conducts around two thirds of all flows of goods, and one third to other European countries.

Figure 33: **Short-term commercial credits, in EUR m, and real growth in goods exports in %**



Source: Bank of Slovenia, calculations by IMAD

4. BS bills and BS liabilities to the Eurosystem in 2007

Before entering the EMU, the Bank of Slovenia (BS) gradually adapted monetary policy instruments to existing regulations in the Eurozone. The operation of BS monetary policy from entering the ERM II exchange rate mechanism to the adoption of the euro focused on stabilising the SIT-EUR nominal exchange rate. Because the fluctuations of market exchange rates around central parity were small, the central bank did not intervene (except in the first month after joining ERM II). Since commercial banks did not require additional liquidity, the instruments for issuing primary money were rarely used (collateralised loan and the temporary purchase of securities). The BS withdrew the larger part of surplus liquidity by selling tolar bills. Due to the planned entry of Slovenia into the Eurozone, the BS gradually adapted monetary policy instruments to the ECB instruments. Tolar bills were being replaced by long-term deposits. It progressively released the minimum prescribed foreign currency liquidity which banks and savings banks had invested in long-term tolar deposits. Finally, the BS purchased foreign currency from the banks under a seven-day swap. Because of the change of monetary and exchange-rate policy instruments, the total amount of tolar bills at the end of 2006 was considerably higher than the total amount of bills in foreign currency.

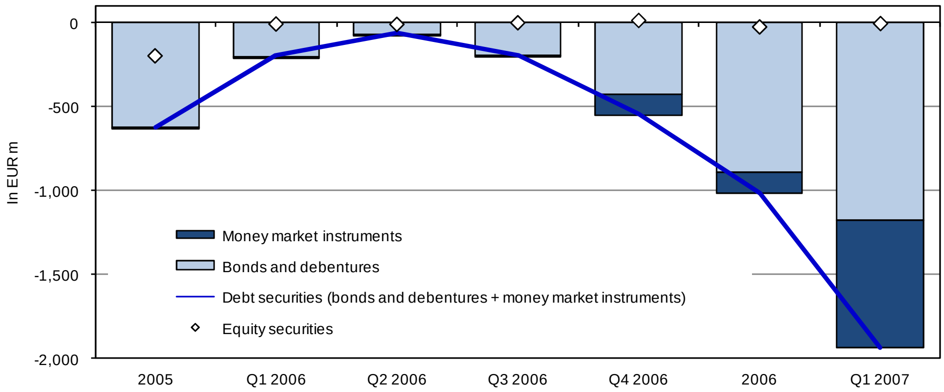
The process of ensuring a stable currency exchange rate through swap transactions before entering the EMU demanded the strong embeddedness of commercial banks in the transactions of the central bank, which caused the commercial banks to devote relatively less attention to the development of other forms of transactions, resulting in a negative impact on the development of the financial sector as well as on economic growth (Jazbec and Masten, 2004: 95). In the second half of 2004, the amount of swap transactions began to decrease. But the Bank of Slovenia, in order to put off the increase in liquidity due to the maturity of tolar bills in the period after euro adoption, started to offer banks long-term deposits with an interest rate 0.2 p.p. higher than the interest rate for 60-day tolar bills, thus compensating approximately two thirds of the reduction in swap transactions. This was, however, a continuation of forcing out the banks' other investment activities and an obstruction to deepening the financial sector.

By adopting the euro, Slovenia has also become a member of the Eurosystem,[17] ***and monetary policy has thus become a matter of common interest.*** By entering the Eurozone, the conditions of borrowing and investment of Slovenian banks at the European Central Bank have equalised with the conditions of other banks in the Eurozone. The instruments used are those of the ECB, which has no bills in the liabilities of its balance sheet. The position of the Bank of Slovenia’s bills and long-term deposits was therefore gradually decreasing, so that domestic commercial banks transferred a portion of their capital into foreign securities, particularly into government bonds of the Eurozone. The first quarter of 2007

[17] Since 1 January 1999, the Eurosystem has been responsible for determining and executing common monetary policy of the Eurozone. It consists of the ECB and the central banks of the countries using the euro as the common currency (there are 13 at the moment). The ECB's main objective is to preserve price stability. Beside the main objective, other important objectives exist, such as: foreign currency exchange rate, interest rate, nominal growth of GDP, monetary aggregate M3, etc.

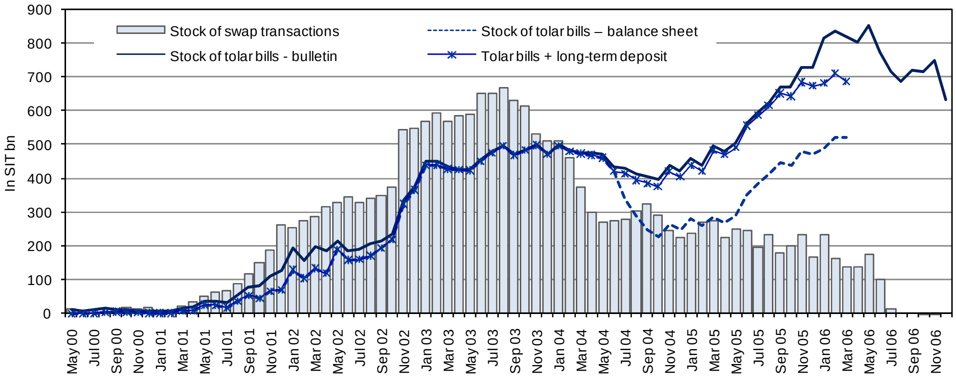
thus witnessed a distinctive increase in the portfolio investments of Slovenian commercial banks in foreign bonds and debt obligations (EUR 1,173.6m) and in monetary market instruments (EUR 761.4m).

Figure 34: **Portfolio investments of Slovenian business banks prior to entering the Eurozone and after, flows in EUR m**



Source: Bank of Slovenia

Figure 35: **Stock of swap transactions and tolar bills of the Bank of Slovenia**



Source: Bank of Slovenia

A less strong bank dependence on transactions with the central bank after entering the EMU will enable faster development in the banking sector. Despite a gradual deepening, the banking market in Slovenia is still shallow; the volume of banking assets compared to GDP is still below the level that would be in equilibrium with our economic development according to assessments (Jazbec and Masten, 2004: 93). Such a situation indicates that banks probably still do not provide all the necessary services to support faster economic growth; the deepening of the banking and financial sector in general is therefore an important developmental challenge that will also contribute to higher economic growth.

5. The international investment position of Slovenia or net financial position

Upon the liberalisation of the capital-financial account and Slovenia joining the EU, the net financial position[18] changed from surplus to deficit. After showing a slight surplus (0.1% of GDP) in 2002, the deficit in 2007 was 21.9% of GDP. In claims in the period 2004‒2007 (until entering the EMU), there was a noticeable increase in the reserve assets of direct investments abroad and portfoilo investments, while the proportion of other investments was decreasing. In liabilities, the proportion of gross external debt or non-equity liabilities in the period 2004–2007 represented nearly 80% of total liabilities, and the remaining 20% was in equity liabilities (equity capital and reinvested profits from direct investments of foreign entities in Slovenia and investments in equity securities). The total international investment position of Slovenia on average showed a net debt position that was EUR 2bn higher than net external debt.

Table 2: **International investment position of Slovenia, in % GDP**

	2003	2004	2005	2006	2007
1 Debt claims	59.0	60.6	69.3	67.9	83.7
2 Equity claims	3.7	6.2	9.9	14.6	16.8
3 Total claims (1+2)	**62.6**	**66.8**	**79.2**	**82.5**	**100.4**
4 Gross external debt	52.2	57.3	72.6	78.9	102.4
5 Equity liabilities	16.3	17.4	17.8	20.7	19.9
6 Total liabilities (4+5)	**68.5**	**74.7**	**90.4**	**99.7**	**122.4**
7 Net external debt/claims (1–4)	6.8	3.3	–3.3	–11.0	-18.8
8 Net equity debt/claims (2–5)	–12.6	–11.2	–7.9	–6.1	-3.2
9 Net financial position (7+8)*	**-5.8**	**-7.9**	**-11.2**	**-17.1**	**-21.9**

Source: Bank of Slovenia Bulletin (2008)
Note: *a negative (positive) sign in the balance represents the net debt (credit) financial position.

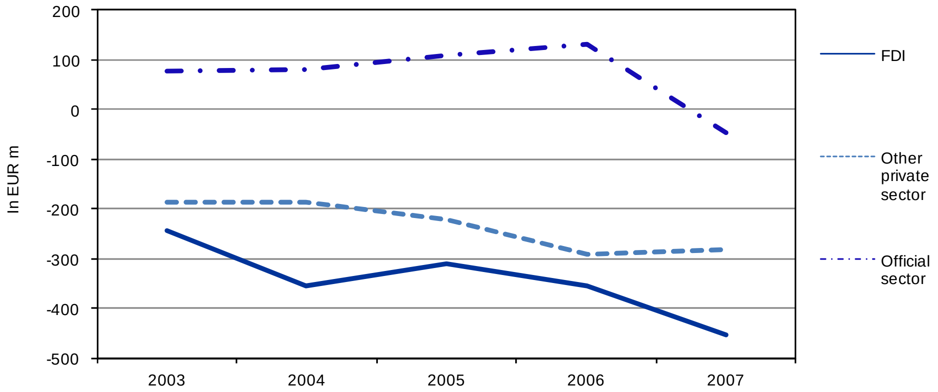
The faster growth of liabilities rather than claims has, with a relatively lower return on liabilities, influenced the growth of the deficit in the balance of factor income in the current account of the balance of payments. We estimate that in the period 2003–2007, the implicit nominal rate of return[19] on the total claims of Slovenia (2.6%) was on average lower than the implicit rate of return on total liabilities to foreign countries (4.7%), which has, with a faster increase of liabilities from claims, influenced the growth of net investment expenditure in the current account of the balance of payments. That is, in liabilities, the loans raised in foreign banks prevailed, while in assets as at the end of 2006, the foreign reserve assets of the Bank of Slovenia are composed predominantly of deposits and first-class interest bills that basically bring a lower return. Last year, upon

[18] The international investment position or net financial position indicates the position of total international claims and liabilities of Slovenia at the end of each year, with a structure equal to the structure of the financial account of the balance sheet. Besides debt instruments that are included in gross external claims and gross external debt, it also includes claims and liabilities from equity relations. Changes in the net financial position between two consecutive years reflect transactions in the balance of payments (balance of current and capital account as well as net errors and omissions) and capital gains/losses due to price, exchange rate and other changes.

[19] Implicit rate of return is calculated by comparing the flow of received and paid return on capital (interests from equity and debt capital) in the current year to the position of total claims and position of total liabilities of the preceding year.

adoption of the euro, the foreign reserve assets of the Bank of Slovenia were reallocated to other positions of financial claims, but the Bank of Slovenia property value remained unchanged. Due to the maturity of bills, the liabilities of the Bank of Slovenia to the Eurosystem also increased considerably in the last year.

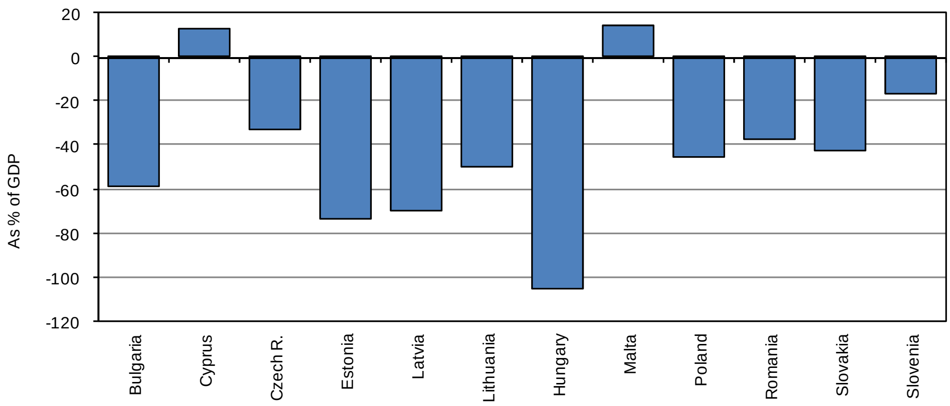
Figure 36: **Investment incomes, in EUR m**



Source: Bank of Slovenia, calculations by IMAD

Besides higher net interest payments, net paid return from equity capital within direct investments has also increased in the current account over recent years. In foreign direct investments in Slovenia after 2005, equity capital expenditure exceeds equity capital income. Capital gains were more volatile than paid return on liabilities and received return on international claims. Particulary outstanding was 2003, when the net loss of capital equity on foreign direct investments increased considerably.

Figure 37: **International investment position of new Member States (at the end of 2006), in % GDP**



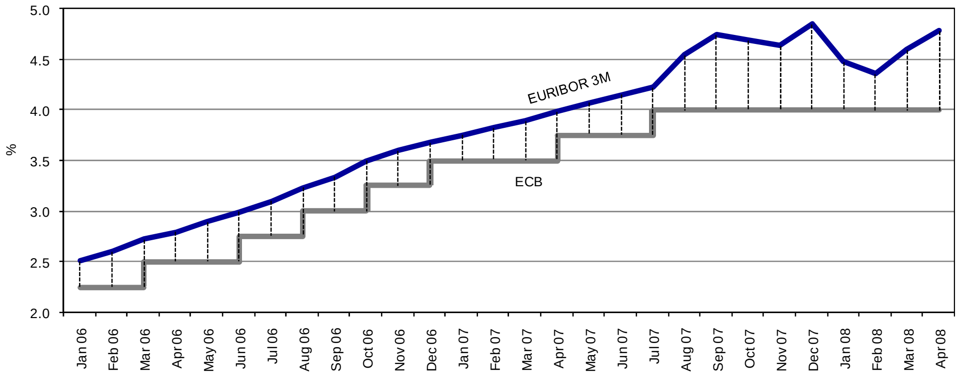
Source: SORS, Bank of Slovenia, Eurostat, calculations by IMAD

6. The financial crisis on international monetary markets in 2007 and assessment of its impact on the Slovenian economy

The impact of the financial crisis, considering its magnitude, is also transferred to other segments of the economy, while the differences between countries are immense. The crisis started in August 2007 with the breakdown of the subprime mortgage market in the US. Because of the nature of risk diffusion through the process of securitisation that has taken place in recent years, it quickly spread to the other parts of the world. The existing overall loss for banks and other financial institutions stands at somewhat over USD 300bn, while IMF estimates that the overall loss will exceed USD 900bn. Considering the magnitude of the crisis, consequences will be felt not only in the financial but also in the real estate sector, but the impact is considerably different among countries, as countries, including Slovenia, where modern financial instruments are less developed than in the US and older EU Member States are less directly exposed. Increased risk in these countries related to the consequences of the financial crisis has been assessed to be shown primarily in the case of closer ties with exposed banks abroad.

The most obvious direct influence of the financial crisis was the aggravated situation on inter-bank markets, where interest rates, as a sign of less trust among banking subjects, have risen considerably. The average margin between the 3-month EURIBOR and the key interest rate of the ECB from the beginning of the crisis until May 2008 stands at 0.64 percentage points, while it was at 0.26 in the first seven months of 2007. The ECB has not changed interest rates, which stand at 4.0%, since June 2007, while the 3-month EURIBOR increased from 4.2% in July 2007 to 4.9% this May.

Figure 38: **ECB interest rates and 3-month EURIBOR**

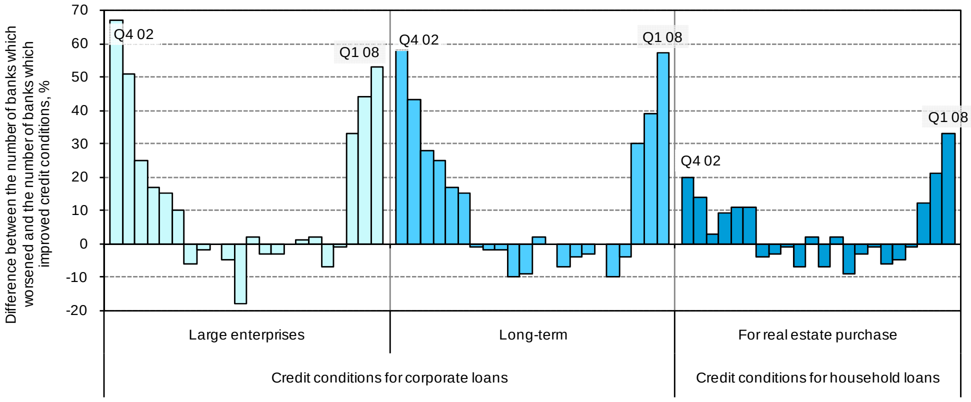


Source: ECB

Aggravation is also shown by the indicator of monetary conditions in the Eurozone. The ECFIN indicator of monetary conditions in the Eurozone, which is a combination of changes of real foreign exchange rates and short-term interest rates, has been growing rapidly since last August, which indicates more restrictive monetary conditions. The value of the indicator dropped in the first two months of this year, but again increased considerably in March and April.

The key channel of transfer of the financial crisis to the real economy is through worsening of loan conditions and reduced loan availability. According to the results of the ECB Bank Lending Survey,[20] loan conditions in the Eurozone started worsening in the third quarter last year, and this trend has been growing ever since. The ECB assesses that loan conditions worsened more in terms of loans to companies than to households, and more for large companies than for small and medium-sized companies, and more for long-term than for short-term loans.

Figure 39: **Changes in loan conditions between the last quarter of 2002 and the first quarter of 2008**



Source: ECB

The worsening of loan conditions has been increasing since the beginning of the financial crisis last August and is expected to continue in the following quarters. The main reasons for banks in the Eurozone making their conditions for loans to companies stricter are more pessimistic expectations in terms of the general economic situation and banks' ability to access market financing. The tightening of loan conditions, judging by the response from banks, is already being reflected in decreased demand, primarily from large companies for long-term loans. In the April survey,[21] banks still estimated that the tightening of loan conditions, primarily for large companies and for long-term loans, will continue in the next three months, while the demand for loans will continue to decrease.

The high growth in loans to companies continues despite the deterioration in loan conditions. The growth in loans to companies and non-monetary financial institutions was higher last year than in 2006, which is the case for the Eurozone as well as the new EU Member States, including Slovenia; it increased slightly this year in all countries. Last year's growth at the Eurozone level stood at 13.9%, and at 32.2% in Slovenia (3 percentage points more than the average growth in

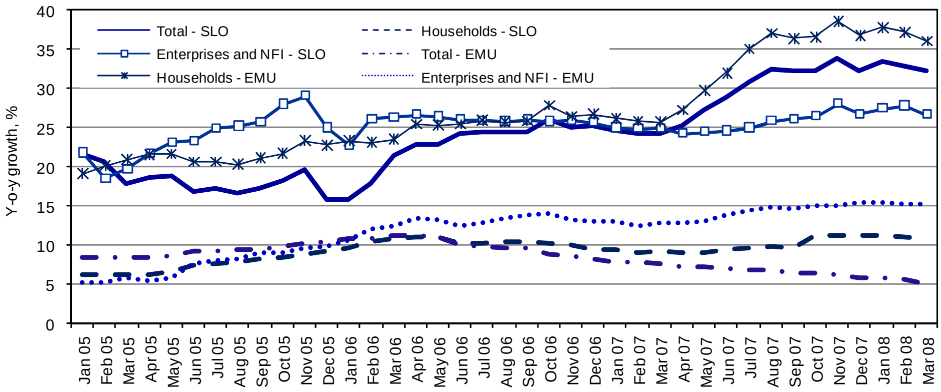
[20] ECB Bank Lending Survey (October 2007, January 2008, April 2008).
[21] ECB Bank Lending Survey (April 2008).

the new Member States). The continued high growth in loans to companies indicates on the one hand that companies are planning their investments despite the fact that global economic growth is slowing down. On the other hand, this may show that alternative financing sources (structured financial instruments) are less available because of the financial crisis, so that companies have no other choice than to take loans from banks[22]

Similar to the situation with companies, loan conditions in the Eurozone countries also worsened in terms of loans to households, although to a lesser extent. In terms of loans to households, loan conditions are becoming stricter for housing loans than for consumer loans. The main factors influencing the deterioration of loan conditions for the first type of loans are pessimism regarding the general economic situation and housing market prospects. When it comes to consumer loans, these are pessimistic expectations regarding the general economic situation and decreased creditworthiness of consumers. Similar to the situation with companies, banks are expecting further deterioration in loan conditions and less demand for loans, also in terms of loans to households, and both more intensively for housing loans than for consumer loans.

The growth of loans to households in the Eurozone has been slowing since 2005 because of the higher interest rates of the ECB. In the Eurozone, the growth of loans to households for the purchase of real estate started slowing down before the beginning of the financial crisis, primarily because of a gradual increase in the key interest rate of the ECB from December 2005 onwards, and also because of a cooling-off of real estate markets in certain countries. The growth in housing loans in the Eurozone in 2006 stood at 12.3%, and last year at 8.3%, while in the first three month of this year it was 6.4%. However, the growth in housing loans in Slovenia remains high, almost five times higher than in the Eurozone. In terms of consumer loans, the picture is rather similar to the situation with housing loans.

Figure 40: **Year-on-year growth in loans in Slovenia and the Eurozone**

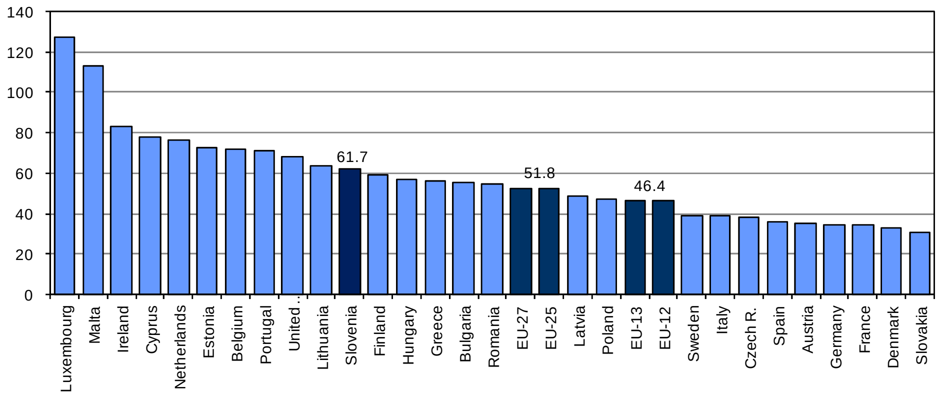


Source: ECB

[22] Citigroup mentions as one of the possible reasons for further high growth of loans despite deteriorating lending conditions also the fact that banks concluded lending agreements before the beginning of the financial crisis (estimated amount of USD 6,000bn), which companies did not start drawing until a few months ago.

When identifying the possible consequences of the financial crisis for old and new EU Member States, exposure of their financial systems to foreign countries should be taken into account. When the exposure to financial systems in foreign countries (a high share of foreign assets and liabilities in total assets of banks) is high, the effects of the financial crisis can be transferred faster and more intensively. An estimate of the exposure of financial systems to foreign countries on the basis of locational banking statistics of the *Bank of International Settlements*[23] indicates that Slovenia and its financial system, according to this indicator, were more exposed to foreign countries in 2006 than the EMU and EU averages. Only Malta, Cyprus, Estonia and Lithuania among the new EU Member States were more exposed to foreign countries.

Figure 41: **Exposure to foreign countries as the share of overall total assets in country, 2006**

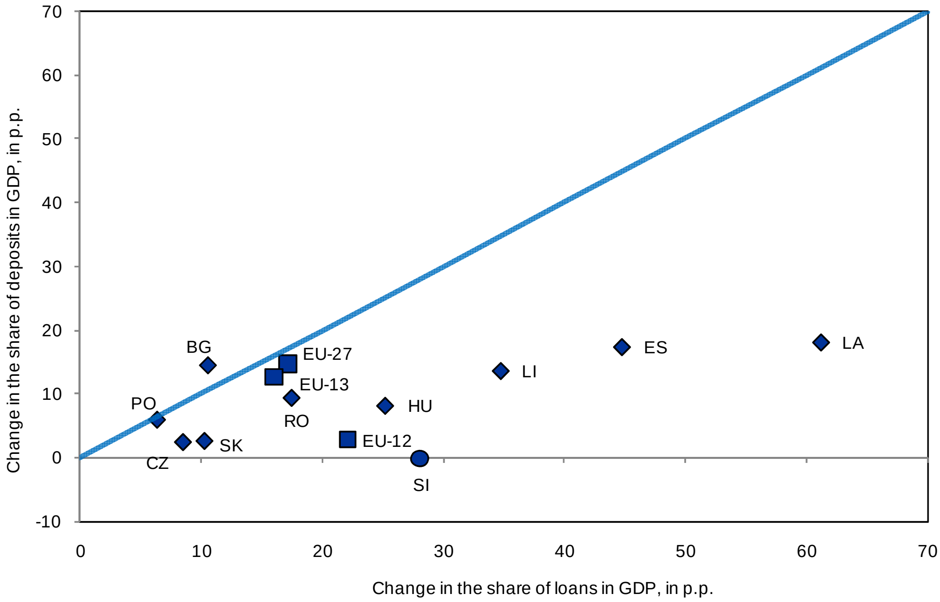


Source: ECB, BIS

Banks in the majority of the new EU Member States satisfy needs for financing through taking loans abroad. Dependence on foreign financing, which still does not necessarily mean greater effects of the financial crisis but increases related risks, can also be estimated on the basis of a comparison in the growth of the share of loans and deposits in GDP. Faster growth of the former signals increasing needs for financing, which banks cannot satisfy completely with deposits. This is a process characteristic of countries in the process of catching up with developed countries. As shown in Figure 42, the share of loans in GDP between 2002 and 2006 grew much faster in the majority of the new EU Member States, including Slovenia, than the share of deposits in GDP, while the growth of both shares at the Eurozone level as well as at the level of the entire EU is much more balanced.

[23] Banks which report to the Bank of International Settlements come from 40 countries, including EU members Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and United Kingdom.

Figure 42: **Change in the share of deposits and loans in GDP, 2002−2006**



Source: ECB, Eurostat

7. Conclusion

Slovenia is decreasing the lag of its financial sector behind the average of the EU. Although the Slovenian financial system is mainly based on banks, the lag is most significant in the banking sector. In the area of bank loans to companies and non-monetary financial institutions, and consumer loans to households, Slovenia is relatively closer to the Eurozone average than in the area of housing loans, despite high growth in housing loans in recent years. The reasons can be found primarily in the insufficient development of the financial sector and shallowness of the domestic financial market, as other possibilities for financing are rather limited. The bigger gap in housing loans is primarily the consequence of less developed banking products in this area in the past, the privatisation of housing and its financing in the past, and an underdeveloped institutional framework, where gradual improvement has been seen only in recent years.

Decreasing interest rates in recent years have stimulated demand from companies and non-monetary financial institutions for loans, which in these years also increased due to favourable conditions in the international economic environment and certain structural changes in the economy which positively influenced domestic economic activity. High demand for bank loans in recent years is thus linked to the needs of the domestic non-banking sector (companies, non-monetary financial institutions, population) for financial assets for financing domestic investment in equipment and machinery, infrastructure and the construction of housing and other buildings, and also for other investment activities at home and abroad. From this aspect, high growth in bank loans is necessary for financing faster economic growth and is a constitutive part of the process of catching up with developed economies.

The process of Slovenia's integration in the European financial market resulted not only in accelerated growth in domestic bank loans to the non-banking sector, but also in structural changes in banks’ financial sources. This significantly increased the importance of foreign sources, primarily of long-term loans from foreign banks. This is a consequence, on the one hand, of better availability of these sources because of lower interest rates and reduced exchange rate risk after Slovenia's accession to the EU and the EMU, and on the other hand, insufficient growth in household savings for financing fast-growing loans. Deposits of foreign banks are also an important source of financing. At the same time, lower interest rates and better integration of the Slovenian financial sector in international financial and capital flows also stimulated the growth of assets in mutual funds, which are becoming an increasingly important form of household savings outside the banking system. With worsening conditions on international monetary markets, household savings in banks this year are again becoming increasingly important for financing the lending activity of banks, and their growth is primarily stimulated by higher interest rates and more risk in investments in mutual funds.

Although competition in the Slovenian banking sector is increasing, certain trends indicate that it is still insufficient. In the area of interest rates, the gap between lending and deposit interest rates is relatively wider than the average in the Eurozone, primarily in transactions with households. We estimate that relatively low competition was also partially affected by conditions on the domestic monetary market before the entry to the EMU, when domestic banks were not encouraged enough to develop new banking products because of the favourable possibilities for investing in monetary policy instruments.

The increased borrowing of domestic banks abroad led to the growth of gross external debt, which at the current level, from the aspect of solvency at the macroeconomic level, still does not present a serious macroeconomic problem, as this is mainly long-term external debt in euros in which there is no danger of a fluctuating exchange rate. The relatively high growth in gross external debt, the share of which in GDP in comparison to developed countries of the Eurozone is still relatively low, is primarily a consequence of better integration in international financial movements, and reflects the process of convergence to more developed financial and economic systems. Risks for the banking sector, because of more borrowing abroad, increased somewhat in the last year, when the share of short-term foreign debt increased in their total liabilities, while there were no similar changes in the maturity structure among claims because newly granted loans are still mainly long-term loans. From the macroeconomic point of view, the net debt or net financial position, which besides loans also includes other financial inflows and outflows, is primarily important for a stable international financial position. Although the situation has worsened in recent years, the net external debt and deficit of the net financial position in Slovenia are still relatively low.

The Slovenian banking sector is exposed to the influence of movements in international monetary markets through fluctuations of interest rates, and to a lesser extent through derivative financial instruments, which are still relatively underdeveloped in Slovenia. The consequences of the last year's financial crisis are shown in the Slovenian financial system primarily in increased interest rates and the reduced availability of foreign loans, which will also influence the availability of loans in domestic banks and the financing of domestic economic activity. Given less accessible external sources of financing, banks also resort to capital injections in order to acquire additional assets, which is a consequence of the fact that the capital adequacy of the majority of banks did not follow the high lending activity, while additional capital requirements are also imposed by the implementation of the Basel II Framework.

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