

THE REAL ESTATE BUBBLE, BANKING SYSTEM AND THE ECONOMIC GROWTH

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During the last decade Baltic countries (Lithuania, Latvia and Estonia) experienced a full economic cycle – slow recovery, fast growth and sharp deterioration (downfall) of the whole economy. On the growth period the portfolio of mortgage loans and the real estate market developed extremely rapidly, thus, since 2007 - 2008 there were discussions about the overheating of economies and bubbles of the real estate prices in the Baltic countries. Unfortunately the doubts about the overheating of the separate parts of the economies were reasonable and the economies of Baltic countries contracted most among all EU members. This alteration is extremely devastating due to several reasons: first of all, from the entry into EU onwards, the economy of the country was growing very rapidly, at even 7 to 10% annually [1].

Identification of the main factors that are determining the growth of the portfolio of mortgage loans is important for developing a strategy to avoid possible economic crises in the future or to ease the negative effects of the economic downturn.

The aim of the paper – to analyze dynamic of mortgage portfolio in Lithuania, Latvia and Estonia in the years 2004 to 2009, and to assess the impact of the activity of commercial banks on the development of the economy in Lithuania, Latvia and Estonia.

During the last 10 years commercial banks of Baltic states increased amounts of loans 13 times: from 4 billion. EUR 1999 to 52 billion. EUR 2009. Despite the fact that population of Baltic states is different we still can compare absolute proportions because loans portfolio dynamics is irrespective of the number of households.

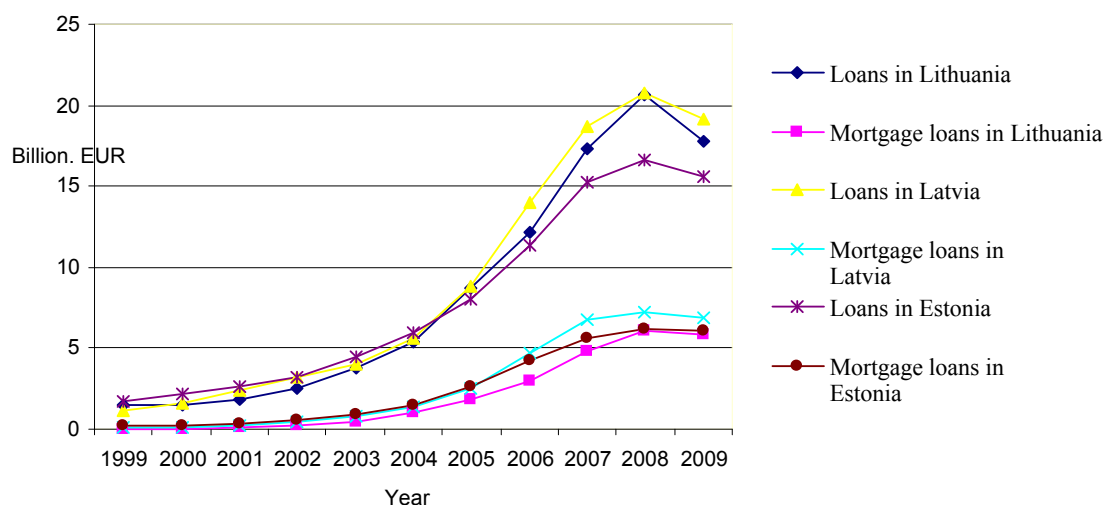


Figure 1. Dynamics of loans portfolio of Lithuania, Latvia and Estonia in 1999-2009 m.

Latvia is in the first place between Baltic states by the amount of borrowing. Latvias` total portfolio of loans increased 16 times: from 1.2billion EUR in 1999 to 19.2billion EUR in 2009. During the same time loans portfolio in Lithuania increased 12 times: from 1.5billion. EUR to 17.8billion EUR. With those amounts Lithuania took second place between three Baltic states. Loans portfolio of Estonia was the fastest to react to financial disequilibrium and increased just 9 times and in 2009 its loans portfolio was 15.6billion EUR.

As we can see in figure 1, in 2008 amount of loans continued to increase despite the start of financial crisis which was provoked by too huge amounts of loans in 2007. This could be blamed on inertia. In 2009 the amount of loans to businesses decreased more than the amount of mortgage loans to because of increased borrowers credit risk and stricter rules of lending money, which took the loan portfolio back to the level of 2007. This has 2 main reasons. Firstly, partly repayments of those loans are relatively small. Secondly, the quality of this portfolio comparing 2009 and 2008 worsen just slightly.

Mortgage loans increased mostly during those 10 years. The loans from Sweden banks constitute the biggest amount of loans portfolio in Baltic States – 41 billion. Two Sweden banks „SEB bankas“ and „Swedbank“ are major market leaders in Baltic states. Those two banks and their subsidiary companies comprise 80% of Estonia market, 55% of Lithuania market and 60% of Latvia market.

As long as macro economical situation is getting worse and the portfolio of loans is getting smaller the risk of insolvent clients is increasing which creates the requirement of loan impairment (social provisions).

As we can see in figure 2, the formation of loan impairments (social provisions) in Lithuania was not significant between 1999 and 2007. However, in 2008 we can see that quality of loan portfolio worsen which forced the amount of loan impairments to double, compared to 2007. Scandinavian capital banks analysed market conservatively and formed bad loan impairments which increased 5.5 times which means 1100 mln. EUR more than in 2008.

Oligopoly market structure developed in the banking sector, which is dominated by several major banks whose behaviour in the market was conditioned by interrelationship in establishing prices and the seized share of the market. The dominance of several major banks in the market limited the scope of expense regulation and the possibility of employing scale economy. The peculiarities of competition in the banking sector not only promoted the development of the banking sector but also raised threats regarding its stability. The limited possibilities of gaining from the advantages of competition forced banks to take riskier solutions and limited the possibilities of adequate reaction to external changes and the behaviour of the competitors [2]. The dynamics of net profit in the banking sector in the years 2004 to 2009 showed that commercial banks being involved into competition fights in 2004 to 2007, mostly paid attention to the increase of profit rather than the quality of the issued loans.

ПРОБЛЕМЫ И ПЕРСПЕКТИВЫ РАЗВИТИЯ СОТРУДНИЧЕСТВА МЕЖДУ СТРАНАМИ ЮГО-ВОСТОЧНОЙ ЕВРОПЫ В РАМКАХ ЧЕРНОМОРСКОГО ЭКОНОМИЧЕСКОГО СОТРУДНИЧЕСТВА И ГУАМ

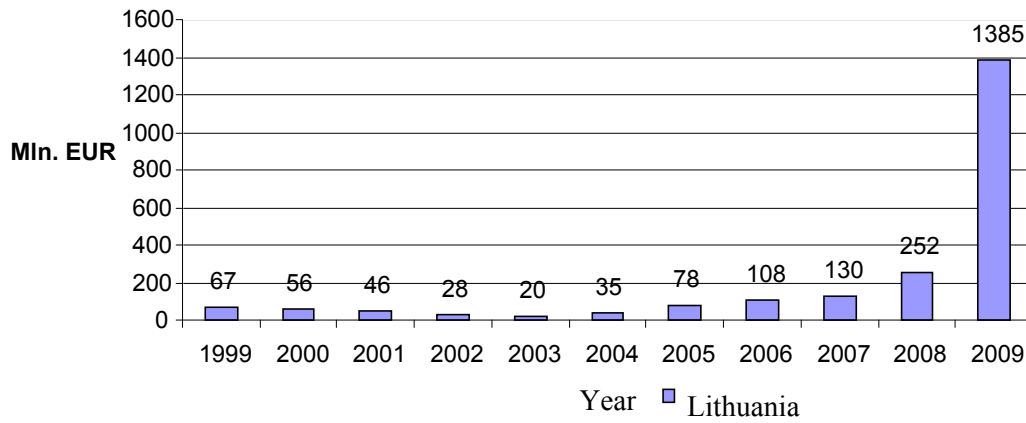
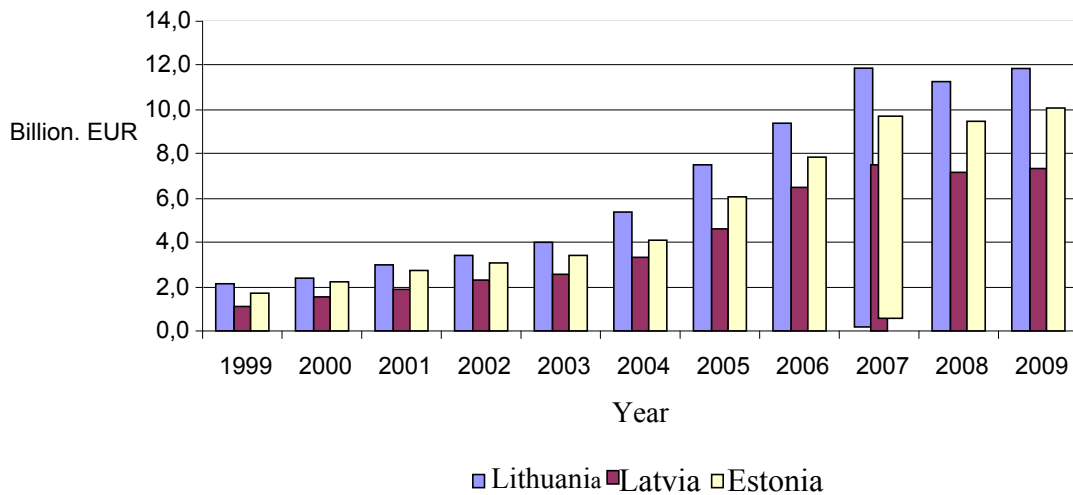


Figure 2. The loan impairment (special provisions) in Lithuania

The risk of liquidity is ability to fund the increase of assets in bank at the present and required times, as well as ability to meet financial commitments at maturity.

Banks can sponsor their credit expansion in few main ways: by borrowing from abroad; decreasing reserve (by using monetary policy); decreasing lending to government; increasing borrowing from other sources or attracting more deposits [3].

Figure 3, dynamics of deposits portfolio of Lithuania, Latvia and Estonia 1999 – 2009.



The portfolios of deposits were constantly increasing during all those years in all three countries. Just in 2008 we can see insignificant decrease in Latvia and Lithuania which was a result of public distrust in banks and worries about economical situation. Between 1999 -2005 the balance was kept between loans and deposits. However, in 2005 the amount of loans increased more than amount of deposits. At the start of the crisis in 2007, in Lithuania banks gave 17 billion EUR worth loans and got 12 billion EUR worth deposits, respectively in Latvia 19 billion EUR and 705 billion EUR and in Estonia 15 billion EUR and 9 billion EUR. This means that banks became and able to fund the credit expansion which created huge risk of liquidity.

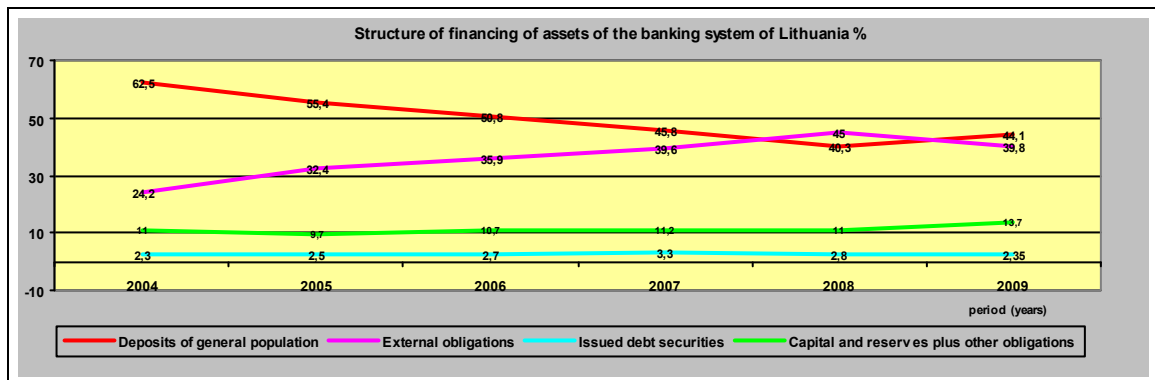


Figure 4. Structure of financing of assets of the banking system of Lithuania (in %, years 2004 to 2009; mln. LTL)

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With the growth of the dependence of the banking system on external sources of financing, the dependence of the banking system on unfavourable alterations of the external environment increased. Due to the rising tension in international financial markets and the increasing preoccupation of investors with the macroeconomic situation in the Baltic countries, the willingness of patronizing foreign banks to go on financing the economy of the Baltic states substantially decreased. If we take into consideration that one of the principal sources of the financing of banks is the assets of patronizing banks, banks faced the issue of the capital sufficiency. Even though in the banking system the share of external obligations during the year 2009 decreased, nevertheless, a major part of the capital is financed by the account of foreign investors.

In figure 5 we can see that from 2004 the biggest increase of borrowing was in Latvia 7% GDP. The process of borrowing was most significant in Latvia and Estonia (from 2% to 50% GDP) during 1999-2007. Lithuanians were more conservative about borrowing from banks than other Baltic countries, however, the borrowing increased 30 times between 1999 -2007 and in 2007 it formed 31% GDP. Households borrowing in Latvia and Estonia decreased in 2008, in Lithuania it stayed the same – 31% GDP. In 2009 we can see more significant change in the market. Household borrowing decreased in Latvia by 16% GDP, Lithuania by 7% GDP, Estonia 6% GDP.

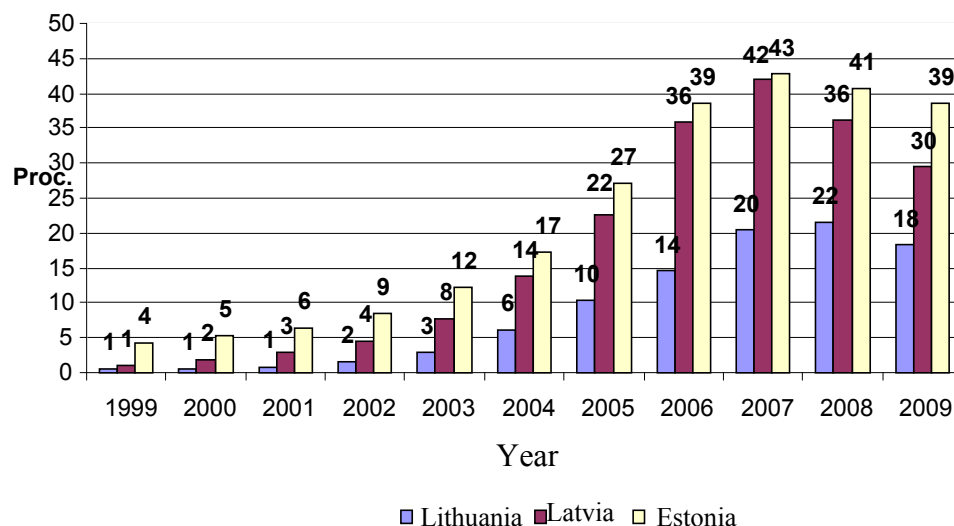


Figure 5. Mortgage loans in proportion to GDP (%)

Statistical correlation analysis shows significant relationship between mortgage loans and GDP. GDP is the main factor affecting mortgage loans. The increase in real GDP had significant statistical and correlation relationship with mortgage loans portfolio in all Baltic countries. Fluctuations in households' income did not affect or affected mortgage loans portfolio insignificantly in Baltic States. This could be the main reason of increase in unbalanced loan portfolio.

Conclusions:

- In Lithuania, Latvia and Estonia, internal and external causes of crisis "interwove", which led to the extremely heavy decline of the economy revealing the weakness of the economy growth model that had been selected upon integration into the EU based on the promotion of internal consumption with the investment of borrowed private capital and state expenses.
- The impact of the worldwide financial crisis on the economy was increased by the activity of the sector of commercial banks. The developed oligopoly of the market structure in the sector, the increasing dependence of commercial banks and the whole economy on external sources of financing developed a credit cycle in the country which significantly worsened the impact of the worldwide financial crisis on the national economy.
- The growth of economy has to take place first of all on the grounds of internal financial sources, while external sources of financing should be used primarily in the sectors of economy creating exported products and services.

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РЕЗЮМЕ:

У статті досліджується динаміка обсягів кредитування й кредитів на придбання нерухомості в Литві, Латвії й Естонію Розглядається вплив комерційних банків на економічний розвиток трьох країн.

Ключові слова: комерційні банки, нерухомість, кредитування, національна економіка

РЕЗЮМЕ

В статье исследуется динамика объемов кредитования и кредитов на приобретение недвижимости в Литве, Латвии и Эстонии Рассматривается влияние коммерческих банков на экономическое развитие трех стран.

Ключевые слова: коммерческие банки, недвижимость, кредитование, национальная экономика

SUMMARY

The article presents an overview portfolio of loans and portfolio of mortgage loans in Lithuania, Latvia and Estonia. Impact of commercial banks on economic growth of three countries.

Keywords: commercial banks, real estate, crediting, loans, mortgage loans, national economy