

Review

## Significance of credit risk in economies in transition

Aleksandar Vasiljevic, Miodrag Koprivica\* and Vasilj Koprivica

School of Law and Business Studies, Novi Sad, Serbia.

Received 12 April, 2010; Accepted 13 June, 2014

Uncontrolled wish for even larger profits led to neglecting the significance of credit risk, and later on to bankruptcy of American mortgage banks that significantly initiated the world economy crises. If credit risk manifested itself in a relatively stable economy such as American, it is not hard to draw a conclusion how important is quality credit risk managing in economies in transition, which are fragile and unpredictable. Economies in transition are characterized by powerful economic, debtor-creditor, and credit expansion. Serbian economy as an example shows that even traditionally rigid banks did not manage to resist the negative impact of great credit risk while the economy felt drastically this negativity through system illiquidity, blocked accounts and ceasing of business systems. All that in transiting economies manifested as positive, with generation of economic crises demonstrated as a serious negativity. Economy sponsors in transitions who “manad” economic prosperity (foreign investors), in conditions of crises turned to their own problems while the sponsored economies were left weak to preserve themselves from recession. The oncoming period will be, obviously, a period of general rigidity of economic system since it is hardly believable that anybody will afford the luxury of un-inspecting debtor – creditor relations without quality obligations; this referrers to both micro and macro economic levels where state economies should maintain a highly restrictive monetary policy.

**Key words:** Credit, risk, crises.

### INTRODUCTION

Credit risk is a “phenomenon” that is known to all business systems that materialize their goods or services in the market with postponed payments. Credit risks come down to a simple question of weather we have made a quality estimation of buyer’s payment capability, that is, weather the buyer will pay the goods or services sold in the way as stipulated by the sales-purchase contract. Credit risk is most often thought of in the context of banking and the risk of credit (*loan*) granting (Vasiljević and Koprivica 2009). Such interpretations are wrong because credit is not only a banking product, but is (although it is not named so) any situation in which one

entity gives to another something expecting that the given value will be paid back in the future (Bjelica, 2000; Kovačević, 2004).

How serious consequences of uncontrolled exposing to credit risks is shown by the fact that the present global economic crises was predominantly initiated by high credit risks of American mortgaging banks. Striving for even larger profits these banks were crediting purchasing of apartments and houses of clients with dubious credibility. This is the lower middle class of the American society that ended up with their credit debts on existential seesaw, that is, they have become very vulnerable

\*Corresponding author. E-mail: [miodragkoprivica@hotmail.com](mailto:miodragkoprivica@hotmail.com).

against the least negative economic and social disturbances in the society. For a significant period, the mentioned “seesaw” worked in favor of mortgaging banks, which encouraged by the conditions, kept even more intensifying mortgage crediting involving numerous investment funds, creating thus a chain of interlocked and interdependent business systems. When the “seesaw” swung against the banks because of the decrease of population’s standard of living, loss of jobs, inflation, increase of living costs, negative exchange rates for the borrowers, the process became unstoppable on a short run and drew into bankruptcy a chain of all business systems that were connected with the mortgaging crediting. The result of mass incapability to pay back the borrowed money is obvious and manifests in economic crises globally spread, in crash of construction industry, real-estate market crash, deep recession, social unrests. The situation may be interpreted as a set of circumstances, cyclicity in growth of economies, and so on; however, the facts are much simpler. The crises initiator is no superior force but extreme wish for profit that ignored the significance of credit risk and gravity of consequences originating from uncontrolled crediting. All this happened in the USA as a developed and stable economy. When we say the economy is stable and developed, we first think it is controlled, predictable, which makes predictions and deciding much easier, and, also, that it is sufficiently independent, that is, the economic motions do not produce the predominant impact. All of the characteristics that we understood in developed and stable economy are opposite to characteristics of economies in transition which, undoubtedly, belongs Serbian economy, too; so it is not hard to conclude how significant is credit risk managing in such an economic environment.

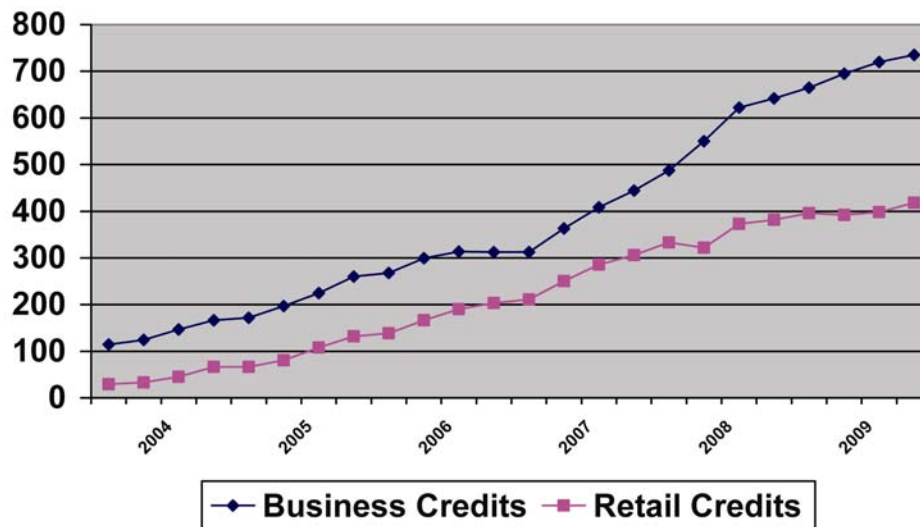
### **SIGNIFICANCE OF CREDIT RISK IN ECONOMIES IN TRANSITION**

Transition is a very much-used term, frequently without any grounds, or out of ignorance. Economy in transition may be considered as an economy exiting from one social order – socialistic, in which protectionism and State interfering with economic flows were characteristic, to “capitalistic” social order where economy is freed of protectionism and opened to foreign competition that intends to become, some day, a part of the milieu, the values of which it accepts without any reservation. This transitional road will end, if there is an end, with new protectionism and State control of economy that are characteristic for EU countries, as well as for other developed economies. Economies in transition share a similarity that is the wish for quick economic growth, “primal accumulation of capital”, uncontrolled infiltration of foreign capital, inclination towards neo-liberal concept of dealing, change of capital ownership structure, a lot

higher cost of capital than the one in developed economies, population’s outstanding wish to make up for the previously poor living standard in a time as short as possible, uncontrolled infiltration of “dirty technologies”, significant influences of IMF and WB regarding fiscal and monetary policy, developing foreign investments’ addiction. Bearing in mind the listed characteristics of economies in transition, we believe, that by analyzing credit risk managing in Serbian economy, we will present the prevailing conditions in all economies in transition.

Until 2000 Serbian banking resembled credit funds more than institutions that are supposed to provide a scope of financial services to their clients. Small and medium companies and especially the population were deprived, practically, of serious crediting, while this privilege was reserved for larger business systems, only. After 2000 foreign banks made a powerful entrance onto Serbian financial market, while the next significant moment was January 1, 2003, when the payments circulation got transferred from the State institution into banks. At that moment all the banks gained prerequisites for un-obstructed rendering of all banking services. The population that lived for a very long time in conditions of economic isolation and in poor living standards without serious possibilities to provide for themselves a living space, automobiles, furniture, utensils, and so on by way of credits, all at ones find themselves in a situation to be offered all of that, and very aggressively, at that. Foreign banks that entered the Serbian market were aware of the population’s great “hunger” for consumption, and were also aware that in such a surrounding of, practically, unlimited demand, they can make incomparably higher profits than by crediting in their domicile countries. Vast demand for credits by the population and outstandingly high profit rates (interests) that banks made by such crediting placed in the second plane the concern of excessive exposure to credit risk. That was done perfectly consciously since the banks were calculating that a number of credit consumers will not be able to settle their obligations (5-6%), but the profit rate was high enough to absorb the losses caused by unpaid credits and provide a satisfactory profit for the bank. In Figure 1, we present the bank portfolios’ trend expressed in billions of RSD.

Based on the presented graph we can see that in the period of 5 years banks’ portfolios towards population grew more than four times. The reason of such an expansion is mostly a low starting position, that is, the fact that in the previous period the population was not in the position to use bank credits. The remarkable credit expansion could not have been achieved without a drop in qualifying criteria for credit consumption and increased exposing to credit risk. The credit risk was somewhat absorbed by the fact that Serbian economy entered, from the state of isolation into the state of uncontrolled capital infiltration that made the issues of employment losses and drop of living standards non actual; instead the



**Figure 1.** Banks' lending to business and physical entities in the period 2004-2009.

current issues were new jobs, employment increase, and living standards increase. Just like all transiting economies, also, the Serbian economy was, and is still depending on foreign capital input, which, to the difference of all the previously mentioned characteristics of the stable economies, makes it very dependent on economic trends in the surrounding. This kind of dependence makes the economy in transition very fragile, and regardless of the semblance of growth and prosperity, the economies are not stable because neither the growth nor prosperity are the results of their proper efforts and capacities, therefore they are not subject to control of the national economy policy.

How dependent transiting economies are on the foreign factor shows the present world economic crises that caused foreign capital to turn to solving its proper illiquidity problem instead of creating economic ambient and market in transiting countries. The result of this is that countries in transition, including Serbian economy, in these critical conditions get short of financial resources, being too weak to produce by themselves the additional value that would maintain growth and economic development, waiting for new investors and lessening the criteria (protective mechanisms against foreign competition) to the lowest possible level. In such conditions, the puffing Serbian economy started slowing down, which unavoidable produced surplus of employees who were necessary in the period of economic expansion, while the labor power that was not surplus was degraded and the ambient of general social insecurity was created. All this is visible in Figure 1 through stagnant banks' portfolio towards population (retail) in the critical 2009, for banks are maybe the best indicator of the economic and social conditions (money always runs away from risk). In economic crises conditions foreign banks have directed

their financing towards their domicile countries (Figure 2) safeguarding the stability of the Head Bank, whereas on the other hand they have become very concerned about credit risks in conditions of social and economical instability (Kovačević, 2004; Vasiljević 2001a, b)

The above mentioned concern is not typical for foreign banks only, but also, of other investors, which may be noticed in Figure 1. Increased rigidity of business banks is manifested not only compared to new lending but also towards the old credit arrangements that are slowly getting problematic, which is visible in Figure 3. The banks are desperately trying to save previously approved, and now dubious credits, partly through reprograms, selling collaterals by free negotiations, and partly through selling claims with discounts.

We can easily notice in Figure 3 that percentage of dubious loans in total banks' lending doubled in only one year, the period that Serbian economy was exposed to the world crises. The presented data acquired from the National Bank of Serbia show loans repayment delayed by more than 90 days. However, the situation is far worse because the banks have reprogrammed a great number of loans trying to find solutions, together with the consumers, for timely settling of obligations. The said reprograms of loans are dubious, but they are not in the category of non-performing loans since the banks have postponed maturity dates by administrative procedure. Only in the second half of 2010 may we expect to see the effects of reprogramming and further negative shifts expressed through increase of non-performing loans in total bank lending since it is hardly probable that all reprograms will realize banks' expectations.

Earlier in the text, we have mentioned that credit risk is not only a banking category but also the one appertaining to all of those who sell their goods or services in the

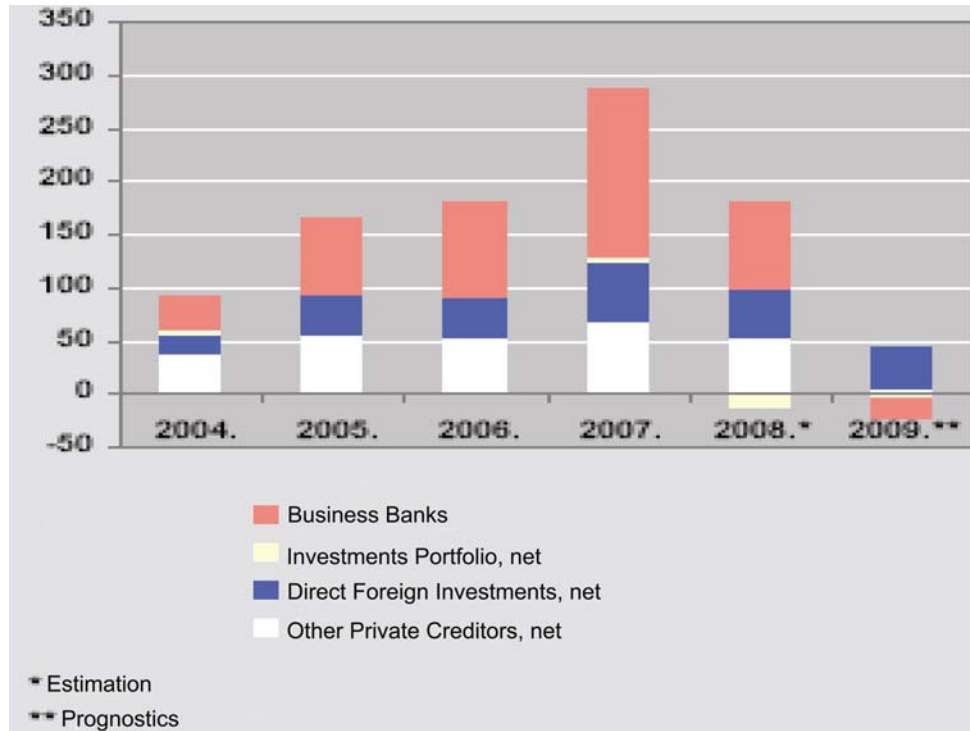


Figure 2. Capital inflow to markets to European developing countries.

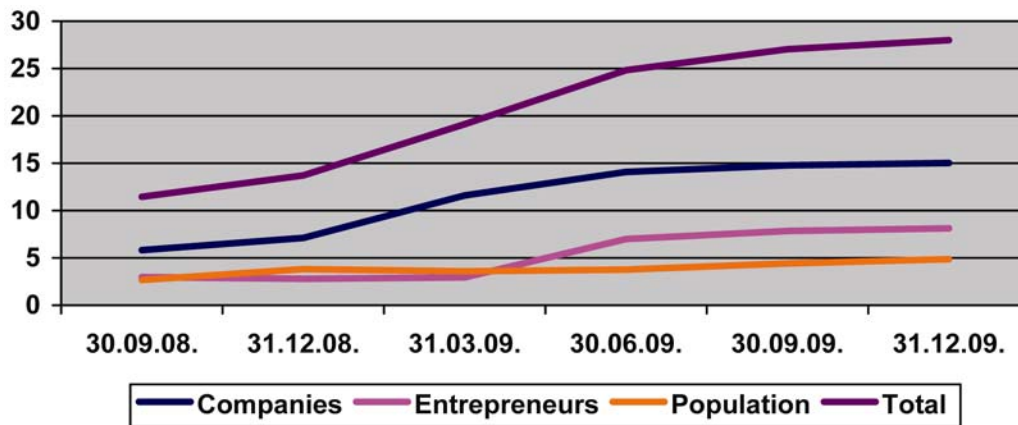


Figure 3. NPL (non-performing loans) trend in total bank lending (%).

market with postponed payment. As we also have said in the text, before the world crises, Serbian economy was showing, just like all economies in transition, a trend of expansion and development of small and medium entrepreneurship. In such circumstances small and medium companies raced to conquer the market not taking care to whom and under what conditions are they selling their goods or services. The seeming expansion of small entrepreneurship, statistically supported by enviable growth of local gross product (Figure 4) was highly un-

sound since a long chain of non-regulated debtor–creditor relations was made that had no quality obligations arrangements backing. After the world crises got more significantly integrated into economy flows, debtor–creditor chains started “breaking” producing the illiquidity spiral. And, like all economies in transition, Serbian economy got and still is overburdened by State’s impositions (taxes, duties...) for which the State demands to be paid regularly settled because due to the lack of significant investment from abroad there are no other

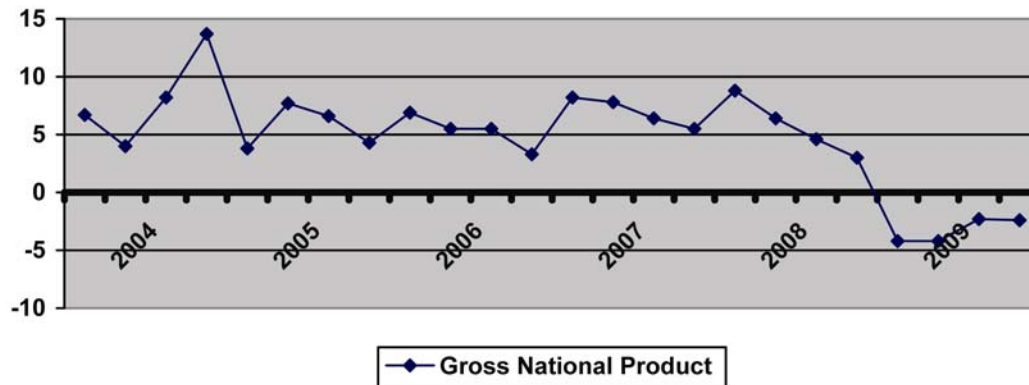


Figure 4. GNP of the Republic of Serbia's trend in the period 2004-2009.

ways to fill up the budget deficit. At that moment the entire destructiveness of uncontrolled exposition to credit risk surfaced out because the economy got into the position of having to pay their debts to the State regularly, but was not able to collect their own claims. The result of this situation was that in 2009 about 70.000 companies had blocked accounts, which meant employees were not paid so the banks which could not collect their claims from the companies had a problem, and they still have the same problem. They could not have collected their claims from the employees of those companies who are the credit beneficiaries. Then it turned out that financial statements in the past period were not realistic, because they contained a significant revenue that actually was not really collectable, and that fact manifested in 2009. If it is possible at all to speak of a positive side of the world economic crises than it is that the economy came to its senses which was noticeable in 2009, since hardly any one sells their goods or services for a postponed payment without previously having checked the customer or without a quality obligation relationship with the customer. Credit risk in earlier period was neglected in economy and that was an attribute of rigidity has become a dominant factor of business operations that will in time clear the economy of business entities that survived in the market by tricks and continuous compensating of old obligations with the new ones. In previous part, we have mentioned that inadequacy of credit risk in a stable and predictable economy (USA) triggered the global economic crises, which leads to a conclusion in what ratio it is existentially important to be concerned about credit risk in transiting economies that are not stable but rather predominantly dependent on foreign factors, which makes them most unpredictable. In Figure 4 we present GNP of the Republic of Serbia's trend in the period, 2004-2009.

The next period in Serbian economy requires maximum tightening of criteria towards the customers, which is something that banks are doing; however, banks are facing problems of existent loans, especially with the population. By the Republic of Serbia Government's Plan,

according to the IMF's suggestions, pays in public sector that are presently the largest employer and the pensions will be frozen during 2010. Situation like this is not typical only for Serbian economy, but of all economies in transition, as well as of developed economies hit by the crises, such as Greek, Portuguese, Spanish. Many citizens whose pays will be frozen next month are credit beneficiaries and the issue is if they will, with the rising exchange rate (the credits are mostly with foreign currency clause), rising costs of living and decreasing standard, manage to pay their credit debts, or, will in banks start to grow numbers of dubious loans. Figure 5 presents growth trend of costs of living in period 1997 - 2009. Based on these facts we have presented hypothetical, but quiet realistic example of a situation in which an average credit beneficiary may find himself, in not only Serbia, but anywhere where economic circumstances are similar (Vunjak, 1994).

If we take as an example that an average citizen, in February of 2007, got a credit from the bank, for a term of four years, the situation will be as follows: we can take that the credit beneficiary's pay in February 2007 was €500, that is, according to the exchange rate at the time (79.9900) about RSD 40.000. The NBS allows pays to be encumbered only up to 30%, which at that moment was €166.5, that is RSD13.318. According to the parameters the customer could have borrowed € 6.000 for a repay period of four years. In February 2010 the exchange rate € against RSD is 99.5236, which means that an installment is RSD 16.471, that is, it is RSD 3.153 higher compared to the beginning.

At the beginning of the period, the amount of income less the credit installment (the amount available to the customer for regular daily needs) was RSD 26.682, while in February 2010 this amount is RSD 23.529. Further, we can assume that the growth of costs of living in the period 2007-2009 was of about 20% that additionally decreases afore mentioned available amount for about RSD 8.000. Finally, we conclude that the credit beneficiary has come from the available RSD 26.682 in 2007, when the loan



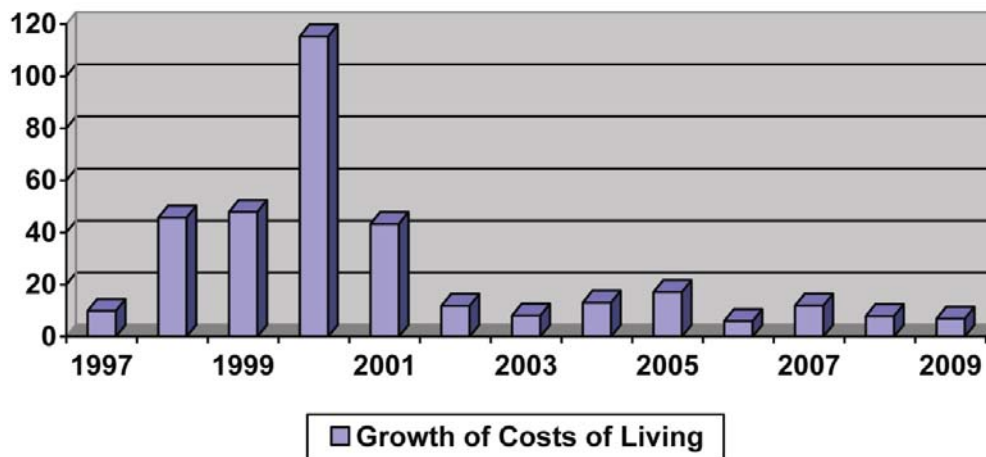


Figure 5. Trend of growth of costs of living in the period 1997-2009.

was taken, to the available RSD 15.519 (23.529-8.000). That means a decrease of family budget of about 42%. Of course, in the said period, there have been increases of pays, which most certainly never were 42%, so that we can state with high level of certainty, even without official data, that the family budget in our hypothetical example suffered a decrease of 25-30%. Bearing in mind the above-mentioned freezing of pays in public sector and pensions, further pressure onto family budgets of credit beneficiaries is due, and it is only the question of limits of depriving (of food, clothes...) in favor of credit installments, because when that limit is transgressed, cessation of due credit installments settles in.

## Conclusion

Even though banks are thought to be very rigid and conservative institutions, that rigidity could no save them from significant percentage of dubious loans in total of their proper placements. As causes of the world crises, a number of different factors are listed. They have one common quality; somebody else is culpable, always. Heading the list are economies in transition that have, in conditions of economic prosperity, completely "leaned" onto investors from developed countries and have let themselves create ambient based on neo-liberal economic principles. Hardly anywhere will be mentioned personal liability for incautiousness in sales of goods and services to dubious buyers. Most often, the argument is the alleged pressure of the State for timely payment of taxes and contributions, inadequacy of the judiciary system and impossibility to collect claims.

Nevertheless, if matters are analyzed in their core, every State always requires that dues be paid regularly and on time, judiciary system was inadequate in the time of economic progress, as well, so the only thing that may be controlled, which is marginalized, is personal

responsibility for poor estimation of paying capacity of proper customers. Regardless of the negativities caused by the crises in economy and social system, at the end it will clear the business and economy of dubious business systems that have continued through years by going from one into another obligation and it is most likely that economic system will prevail consisting of really sustainable business entities where we can only hope that continuous "hunger" for yet additional profit will not influence oblivion of the crises or the existential significance of credit risk quality managing.

## Conflict of Interests

The authors have not declared any conflict of interests.

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