

# Lending activity and credit supply in Croatia during the crisis

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## Abstract

Banks sometimes respond to deterioration in the quality of their placements by extending loan repayment periods to borrowers in default and hiding the actual quality of placements, hoping that difficulties of borrowers are only temporary. This practice is termed evergreening or zombie lending. Due to a prolonged recession and stagnation coupled with relatively high share of non-performing loans, such practice may be occurring in Europe nowadays. We use data for Croatia, a country that fought recession for several years, to study the existence of zombie lending practice. We analyse credit supply to individual enterprises in Croatia at the beginning and in the midst of the recent crisis and determine to what extent zombie lending is present and how lending behaviour changed during the crisis period. Results of the estimated regressions indicate that there is evidence that some of the loans being prolonged are the result of zombie lending practices. This implies that policymakers should be aware of the possibility of such a relationship between banks and firms, as well as of its impact, and should try to minimise it.

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## 1. Introduction

Stagnation in aggregate loans to the economy during a recession often hides tumultuous lending activity that unfolds at a micro level and is crucial for successful restructuring of the economy.

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During recessions, banks usually try to reduce their exposure to enterprises in distress, often by writing off loans, and turning to new and promising projects, thus laying the foundation for economic growth. For example, as documented in [Contessi and Francis \(2010\)](#), US banks, as in previous recessions, strongly reduced the level of existing corporate loans during the 2008 recession. Still, banks sometimes respond to a sharp deterioration in the quality of their placements by extending loan repayment periods to borrowers in default and hiding the actual quality of placements, hoping that difficulties of borrowers are only temporary or because of fear that a bank's position in the market or the management's position vis-à-vis the owners may be threatened. [Peek and Rosenren \(2005\)](#) give evidence of this practice (termed evergreening and later on zombie lending) in Japan. Such responses of banks to unfavourable developments in credit quality can slow down the flow of production resources to propulsive activities, hinder the entry of new entrepreneurs to the market and negatively affect potential growth. It is very difficult to draw the line between a bank's patience with clients in temporary distress and its intention to hide non-performing placements. Examples from practice, such as the case of Japan, clearly show that a several-years long prolongation of bank loans may keep resources in inefficient enterprises and contribute to a long-lasting economic stagnation. This in turn adds pressure on bank stability. Due to a prolonged recession and stagnation coupled with relatively high share of non-performing loans, such practice may as well be occurring in Europe nowadays. Subsequently, we use data for Croatia, a country that experienced prolonged recession, to study the existence of zombie lending practice.

This paper focuses on the link between credit supply and zombie companies using data on bank lending to individual enterprises in Croatia in 2008 and 2012. It aims to establish whether there was any credit misallocation and what bank and company characteristics contribute to such behaviour. There is anecdotal evidence that banks rolled over some potentially problematic loans to firms after the crisis started. By using firm-level data this research will shed more light on the issue of detecting credit misallocation.

The research is organised in seven sections. The section after the introductory section presents survey of the related literature. Stylised facts are presented in the third section. Data and methodology are described in the fourth section. Results of the analysis are discussed in the fifth section, while implication of results and policy discussion is presented in Section 6. Finally, the last section concludes the paper.

## 2. Related literature

In the literature on credit misallocation two terms are widely used: evergreening and zombie lending. Both names refer to the same phenomenon where good money is thrown after bad: loans are rolled over in order to keep borrowers solvent, because otherwise they would most probably default. Banks engage in such a practice because they reap short-term gains, they do not have to declare a loan as non-performing (which is costly) or they do it in order to preserve their relationship with borrowers and/or business partners. In the literature there are three common ways to detect zombies:

- 1) by way of interest rate subsidies, when a borrower pays less than the prime rate ([Caballero, Hoshi, & Kashyap, 2008](#));
- 2) using company financial indicators (such as profitability, liquidity and leverage) and interacting them with various bank characteristics ([Peek & Rosenren, 2005](#)); and

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