



# Financing and the financial situation in Slovakia's corporate sector during 2006

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Operational and investment needs in the corporate sector<sup>1</sup> may be financed with own or external funds. For investment projects, business entities usually use the possibility to acquire external funds. In countries with a developed capital market, capital may be raised through an initial public offering (IPO), or by the issuing of more shares. Another possibility is to issue debt securities (especially corporate bonds). In Slovakia, as in Europe, the most frequently used form of external financing is, however, the bank loan. Given that Slovakia's capital market is hardly used at all by the corporate sector, this article will focus on the financial cost of borrowing, the development of lending and lending conditions, as well as the indebtedness of business entities in the course of 2006. On the basis of the available statistical data, the corporate sector has been divided into 3 types of entities. Under non-financial corporations, there are small and medium-sized enterprises and large enterprises,<sup>2</sup> while the third category consists of own-account workers.<sup>3</sup> Such a breakdown cannot, however, be applied to all types of loans. Interest rates are evaluated separately for the category of current account overdrafts and credit card borrowing and for other loans.<sup>4</sup>

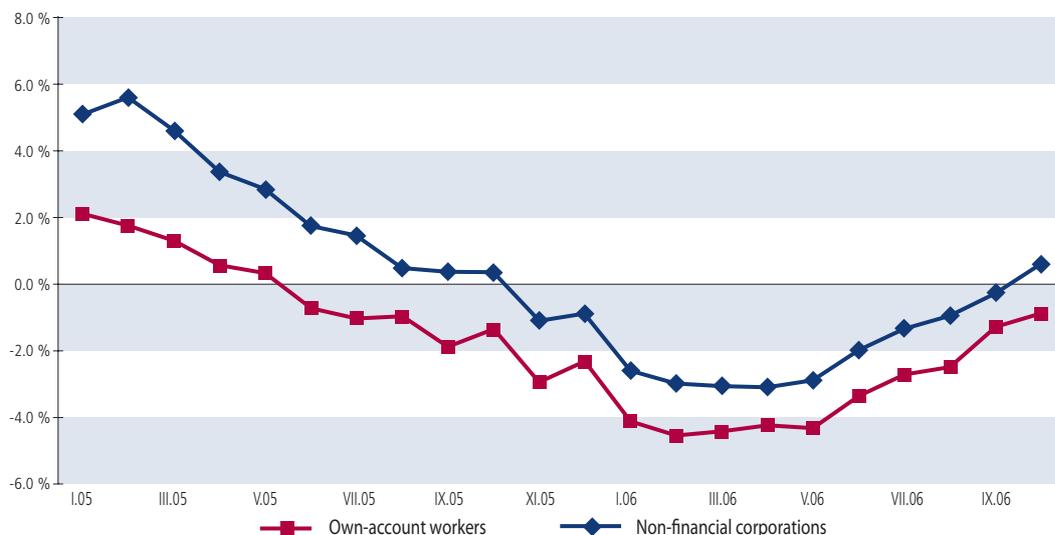
## FINANCIAL COSTS

Real financial costs<sup>5</sup> (also, for our purposes, the

simplified real interest rate) calculated as the nominal interest rate deflated by the index of industrial producer prices (ex post approach) increased slightly during the first half of the year, but are, nevertheless, relatively favourable and not at the level recorded in the first months of 2005. The long-term decline in real financing costs continued at the beginning of 2006, accompanied mainly by low nominal interest rates, before coming to an end as the year progressed. From May, amid higher nominal interest rates, there prevailed an increase in the real costs of external financing. The same development was seen in the real lending rate for non-financial corporations as well as in lending to own-account workers.

When evaluating nominal interest rates according to the type of business unit, it should be taken into account that the main factor in the setting of the lending rate is the creditworthiness of customers and how lending is secured. Given the low financial strength of own-account workers and their more limited scope for providing a guarantee, lending rates are set higher for them than for non-financial companies. In 2006, however, the difference between the lending rate for own-account workers and that for non-financial corporations was relatively stable. For another view, we can examine how changes in NBS key rates were passed on to customer rates for different types of entrepreneur-borrowers. In this context,

## Real lending rates (excluding current account overdrafts and credit card borrowing)



Source: NBS, Statistical Office of the Slovak Republic (ŠÚ SR).

1 The corporate sector, meaning business entities, is understood throughout the text to include non-financial corporations (the sector S.11 according to ESA 95) and own-account workers (part of the sector S.14).

2 Loans of up to EUR 1 million are provided usually to small and medium-sized enterprises, and loans of more than EUR 1 million to large enterprises.

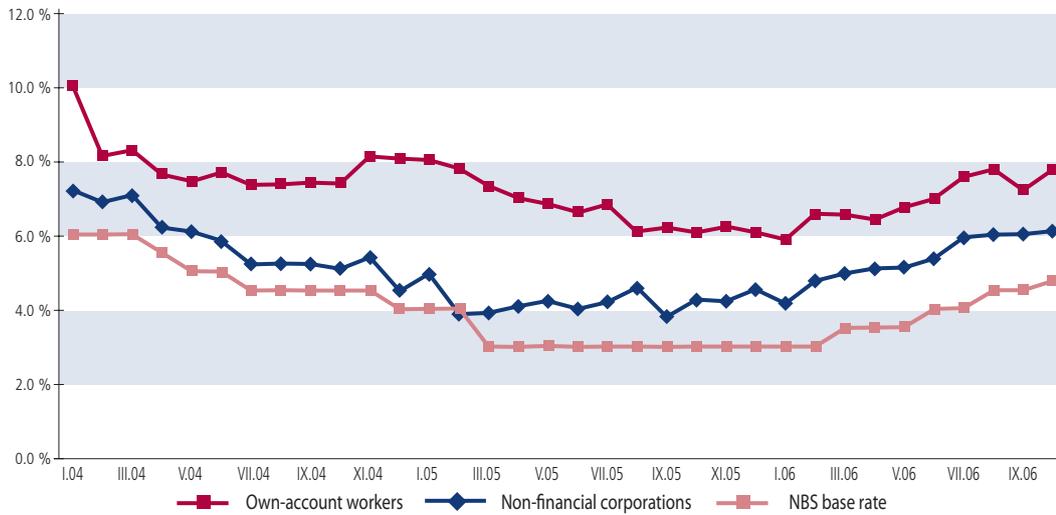
3 When evaluating lending to own-account workers and related interest rates, it should be noted that banks are in some cases unable to determine or separate lending for consumption, housing or business purposes, or a combination thereof.

4 This is because of the different reporting of the said category within the flow statistic (month-end balances are reported also for new transactions), as well as the specific use of such types of loans.

5 Real financial costs are calculated as a weighted average of the real costs of various forms of external financing (bank loans, share issues, and issues of debt securities – corporate bonds). For our purposes, only bank loans are taken into account, since other forms of external financing are either not being used or take the form of share issues in other countries.



Lending rates (excluding current account overdrafts and credit card borrowing) for non-financial corporations and own-account workers, and the NBS base rate



Source: NBS.

the banking sector in 2006 reflected the increase in NBS key rates (amounting to 1.75 percentage points over the year) with about the same intensity in lending rates for non-financial corporations and for own-account workers – comparing the lending rates in October 2006 with those in December 2005, the increases represented 1.64 and 1.69 percentage points, respectively.

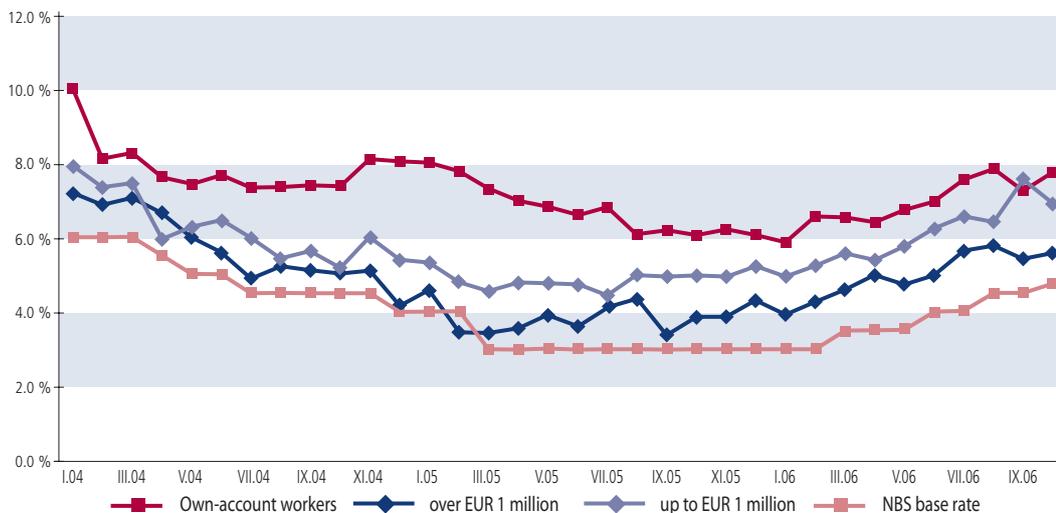
Among non-financial corporations, the lending rate for small and medium-sized enterprises recorded a slightly sharper rise. A comparison of lending rates for different types of business entities (see Chart 3) shows that lending rates for own-account workers are around 1 percentage point higher than those for small and medium-sized enterprises (the difference in October stood at 0.9 of a percentage point). This difference narrowed mainly at the end of 2005 and the beginning of 2006, after which it remained almost constant (with the exception of September). The most

likely explanation for this is that loans are to a large extent being provided to creditworthy own-account workers,<sup>6</sup> since the corresponding interest rate is relatively low. The risk premium that banks impose on non-financial corporations and own-account workers as an addition to the market rate remained relatively stable in 2006, an indication that borrowing conditions are fairly favourable.

**SHORT-TERM AND LONG-TERM INTEREST RATES**

A difference in the development of lending rates has been recorded in regard to maturities – between short-term and long-term loans. In the course of 2006, short-term lending rates for non-financial corporations and own-account workers (i.e. customer floating interest rates with an initial rate fixation of up to 1 year, excluding cur-

Lending rates for non-financial corporations and own-account workers



Source: NBS.

<sup>6</sup> The evaluation of interest rates applies to all lending with the exception of current account overdrafts and credit card borrowing.



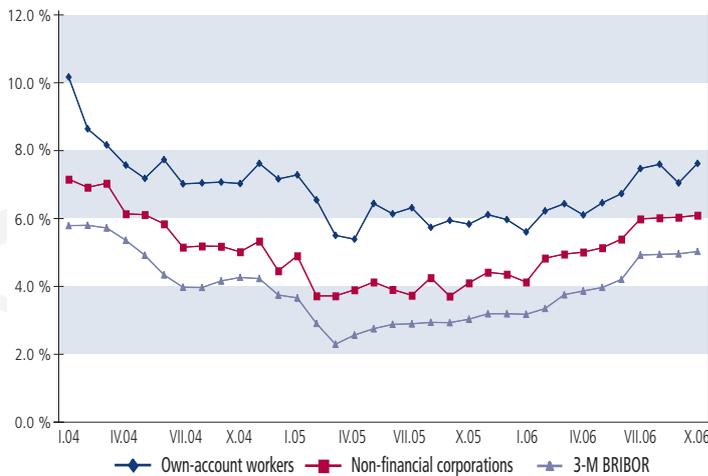
- 7 The statistic of interest rates does not disclose interest rates on new euro loans, only interest on the outstanding amount of euro loans.
- 8 When evaluating internal financing (and even external financing), no account is taken of intra-company loans since these cannot be captured statistically. They include loans provided by a foreign parent company to a subsidiary in Slovakia, where such transactions are accounted abroad. Likewise, the lending statistic does not cover borrowing from non-residents.
- 9 The approximation of the profit generated by own-account workers used the indicator of gross mixed income, which includes net mixed income and amortization; net mixed income includes, apart from business profit, remuneration for work performed by the owner (or a member of his family), which cannot be separated from his profit as an entrepreneur. This item should also include the self-supply of households with agricultural products as well as imputed rent.

rent account overdrafts and credit card borrowing) fully reflected the development of comparable market rates and also NBS key rates. An evaluation of long-term rates (i.e. customer lending rates with an initial rate fixation of over 5 years) shows, by contrast, that lending rates for own-account workers rose far more sharply in 2006 in comparison with those for non-financial corporations. Despite the greater volatility caused by the low volume of loans with long-term interest rates, it may be said that these rates to a large extent mirrored the development of the market benchmark (yield on 5-year government bonds) with the exception of the last three months. Regarding lending rates for own-account workers, those with an initial rate fixation period of over 5 years increased more sharply in 2006 in comparison with lending rates for non-financial corporations. At the beginning of the year, however, the lending rate for own-account workers was lower than that for non-financial corporations. This was probably influenced by two factors. Firstly, large and more cre-

ditworthy entities are seeking to acquire cheaper long-term funds in foreign currencies or from abroad. The long-term lending rate for non-financial corporations is around 1.5 percentage points lower in euro than in Slovak koruna, where the interest rate on new loans is approximated with the interest rate on the outstanding amount of loans.<sup>7</sup> A roughly similar difference also arises where the interest rate on loans to non-financial corporations with an initial rate fixation of over five years is compared between Slovakia and the euro area. The second factor could be that lending rates for own-account workers, which have a longer fixed rate period are offered to a relatively small group of highly credit-worthy customers.

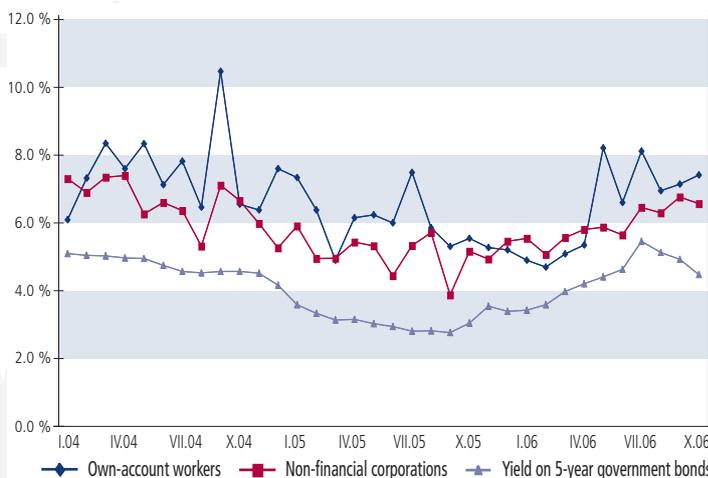
Current account overdrafts and credit card borrowing are evaluated separately, based on their specific reporting and purpose of use. The purpose of a current account overdraft is usually to cover operational needs or a temporary shortage of funds in business relations. This type of lending is therefore used to an increasing extent. The interest rate is typically pegged to interbank market rates with certain risk premium. That is why the development of interest rates has been relatively stable for both non-financial corporations and own-account workers – the risk premium stayed at around the same level for almost the entire period from the beginning of 2005 to October 2006. It may therefore be concluded that the conditions under which current account overdrafts are provided have remained equally favourable also during the recent period. As regards the use of credit cards in the corporate sector, they are largely provided to employees for company purposes, though in some cases also for private purposes. This form of lending is not used primarily for business activities, but to improve payments and to have better oversight of expenses or costs.

Short-term interest rates



Source: NBS.

Long-term interest rates



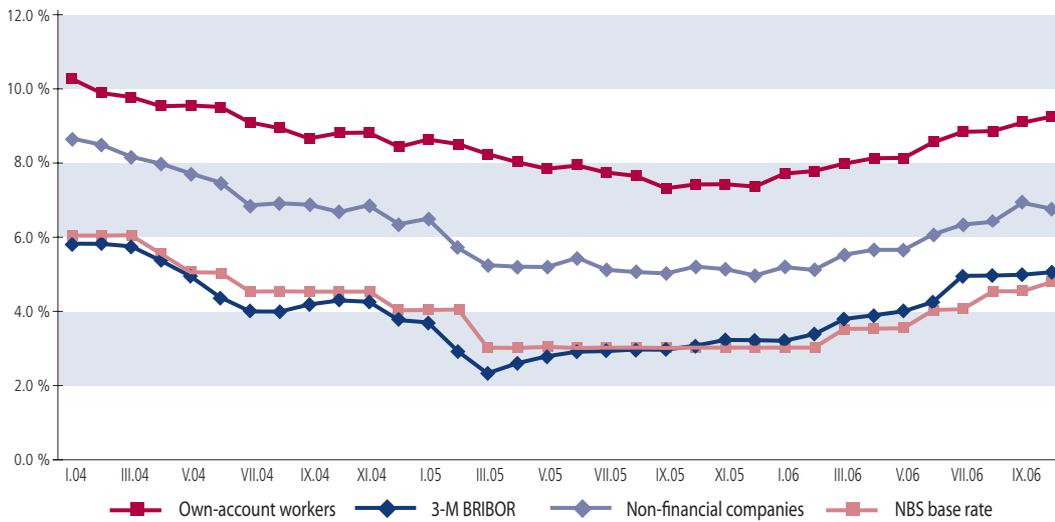
Source: NBS.

INTERNAL SOURCES OF FINANCING<sup>8</sup>

In 2005 and also in the first three quarters of 2006, the corporate sector created good conditions for the internal financing of its activities. The year-on-year increase in the profit of non-financial corporations for the first three quarters of 2006 represented 29% (10.4% in the first quarter, 23.5% in the second, and 50.8% in the third) and the pace of growth rose year-on-year. Double-digit figures were also reported for own-account workers during the same period, with the year-on-year rise in profit (i.e. gross mixed income)<sup>9</sup> representing 16.2% (17.2%, 15.6% and 15.9% in the respective quarters). The profitability of the corporate sector also increased in 2005, when the year-on-year growth in profit of non-financial corporations represented 14.4% and that of own-account workers 12.7%. This good performance also created favourable conditions for business entities to meet their needs with internal financing.



**Interest rate on current account overdrafts and credit card borrowing for non-financial companies and own-account workers, the NBS base rate, and the 3-M BRIBOR**



Source: NBS.

**EXTERNAL SOURCES OF FINANCING**

Although the corporate sector showed an improvement in profitability, it still required external financing in the form of bank loans. In conditions of strong economic growth (real GDP growth for the first half of 2006 stood at 6.7%, and for the third quarter it was an even faster 9.8%) and high investment creation (especially in 2005, followed by a slight slowdown in the first half of 2006), external financing is a necessity. The connection between real growth in lending and the investment activity of business entities is seen particularly in the development during 2005 and 2006. Gross fixed capital formation<sup>10</sup> increased substantially throughout 2005, accompanied by a steep rise in lending. During the course of 2006, amid a slowdown in the formation of fixed assets, the pace of lending growth declined. It should be noted, however, that 2006 also saw an increase in key interest rates and this probably contributed to the slower lending growth. Nevertheless, the pace of real growth in lending<sup>11</sup> to non-financial corporations and own-account workers continues to be relatively high.

The increase in lending to business entities was also supported by positive expectations for the future; these were represented by the economic sentiment indicator, with relatively high figures recorded for the confidence indicator in industry (industry orders recorded substantial year-on-year growth during the course of the year) as well as the confidence indicator in retail trade.

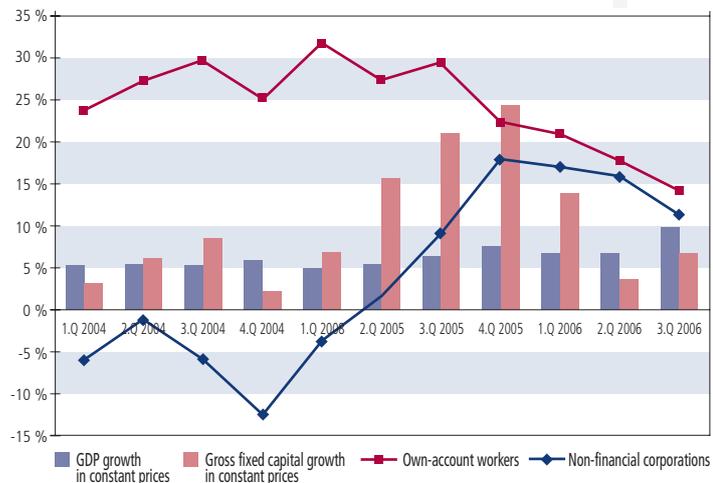
**LENDING GROWTH WAS ACCOUNTED FOR MAINLY BY CURRENT ACCOUNT OVERDRAFTS**

The positive development of the economy and the expectations for its further progress was reflected in the volume of lending to business entities. The year-on-year growth in 2006 was strong,

10 The strong growth in gross fixed capital formation in 2005 was largely related also to the construction of car factories and the positive stimuli for other business entities, which followed from that.

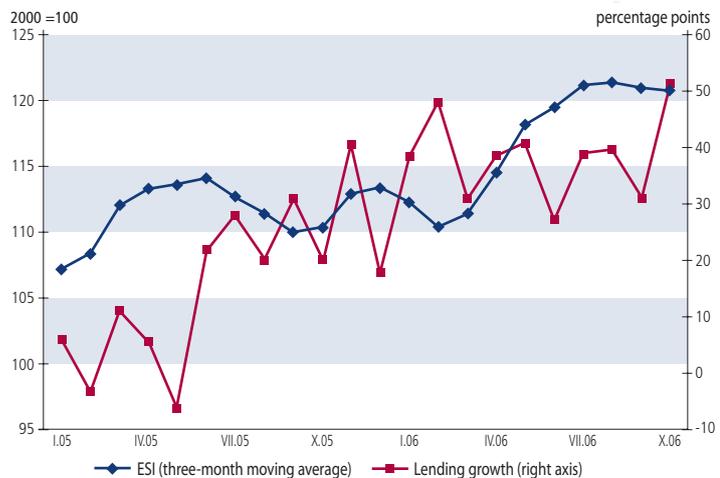
11 Real lending growth is calculated as the quotient of nominal lending growth divided by the GDP deflator.

**Real lending growth, GDP growth, and investment growth (in %)**



Source: NBS, ŠÚ SR.

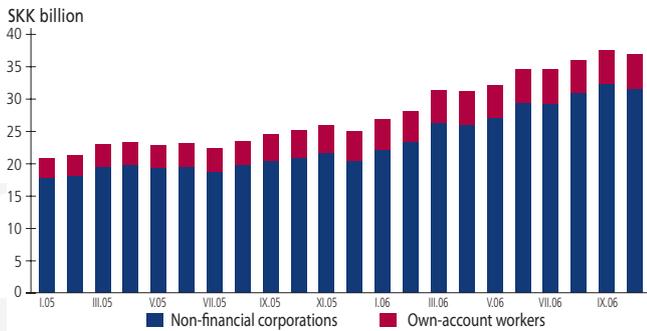
**Year-on-year growth in lending to the corporate sector and the economic sentiment indicator**



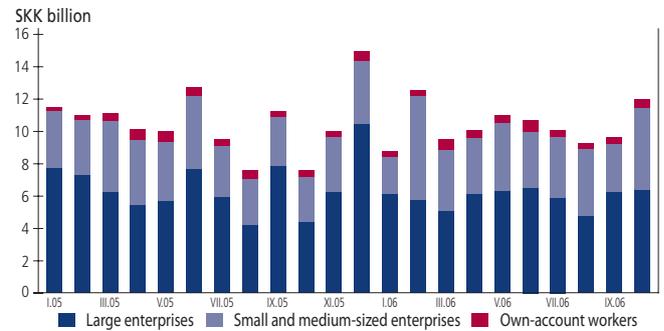
Source: NBS, ŠÚ SR.



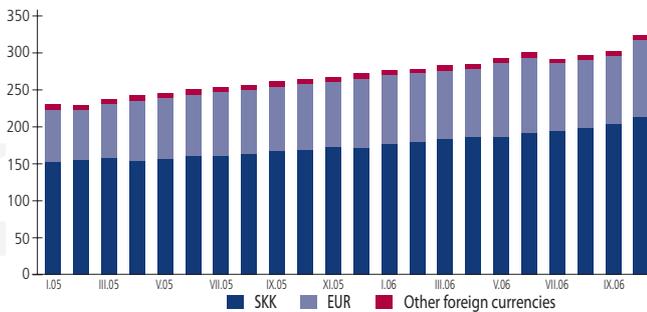
Volume of current account overdrafts and credit card borrowing



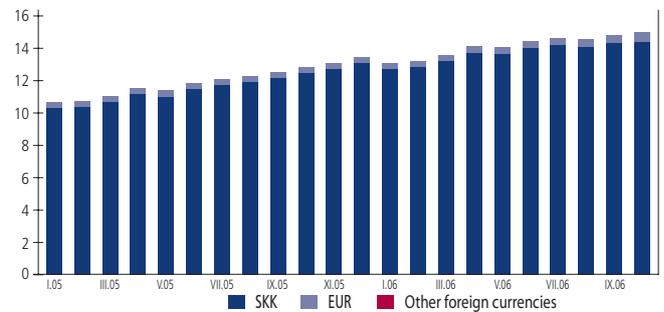
Volume of lending excluding current account overdrafts and credit card borrowing



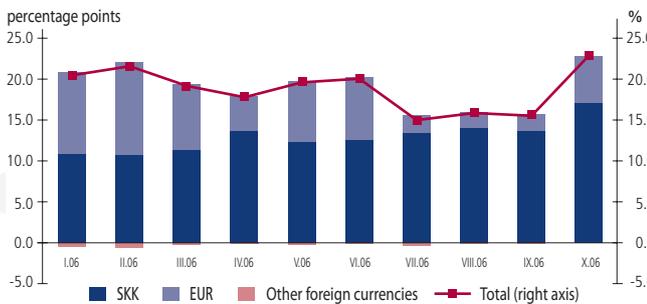
Lending to non-financial corporations (in SKK billion)



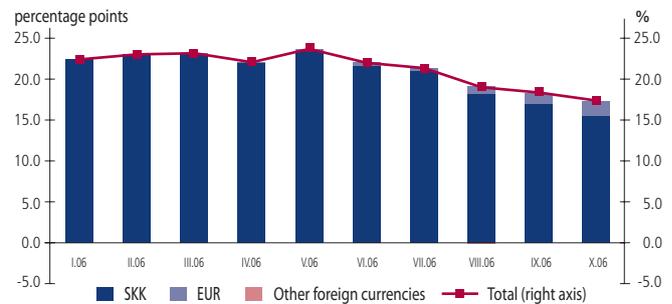
Lending to own-account workers (in SKK billion)



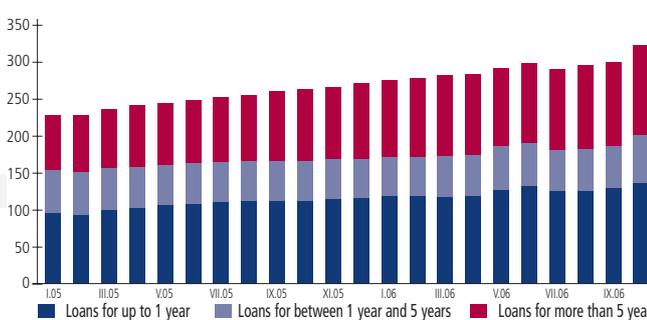
Year-on-year growth in lending to non-financial corporations and the contributions in difference currencies



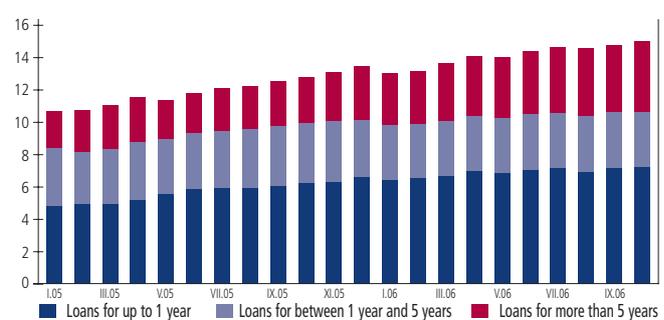
Year-on-year growth in lending to own-account workers and the contributions in difference currencies



Lending to non-financial corporations by maturity (in SKK billion)



Loans to own-account workers by maturity (in SKK billion)



Source: NBS.

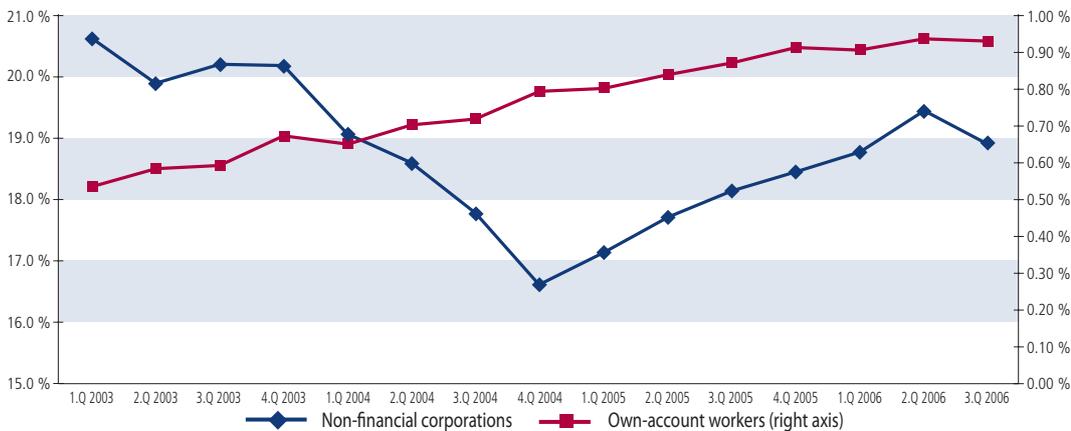
especially because of the steep increase in the volume of current account overdrafts, both for non-financial corporations and for own-account workers. This lending category accounts for a substantial proportion of overall lending. Aside from current account overdrafts and credit card borrowing, the volume of lending (i.e. investment loans, operational loans, real estate loans, and other loans) is slightly volatile. The main reason for this is that investment projects are launched,

or operational needs are higher, in certain months, and that when the loan agreement is signed, the whole volume of the loan is entered into the flow statistic.

The increase in lending has also been reflected in the balance of loans. In October 2006, the outstanding amount of loans to non-financial corporations was higher by SKK 52 billion in comparison with the end of 2005; the largest proportion was accounted for by koruna loans (up



**Outstanding amount of loans relative to GDP**



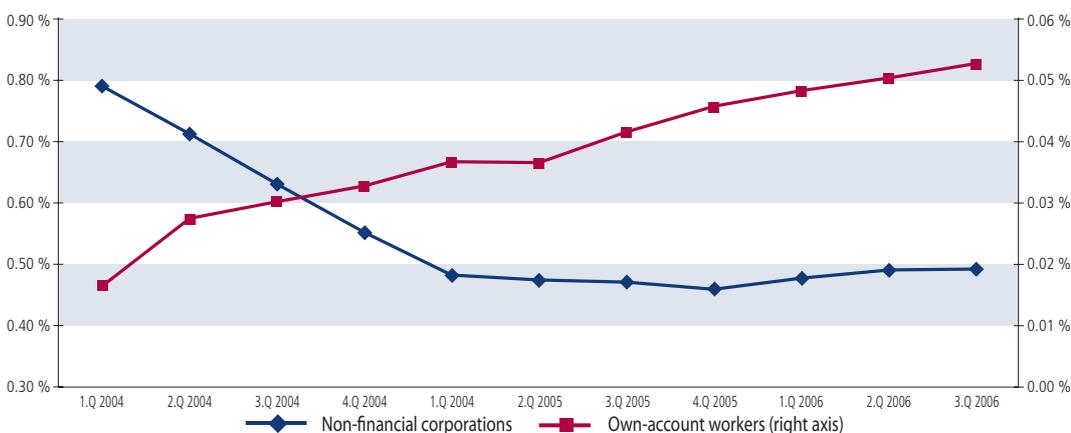
Source: NBS, ŠÚ SR.

by SKK 41 billion) and euro loans (up by almost SKK 11.5 billion). Lending to own-account workers rose in the same period by SKK 1.6 billion, with koruna loans constituting the major part (up by SKK 1.3 billion).

During 2006, the pace of growth in lending to non-financial corporations approached 20%. Although koruna loans accounted for most of the total lending growth, euro loans also made a strong contribution to lending growth in the first half of the year. In the third quarter, euro loans to non-financial corporations accounted for a reduced share of overall lending growth, which may have been linked with the increase in exchange rate volatility that followed the parliamentary elections. The outstanding amount of loans to

October, the outstanding amount of short-term loans and long-term loans with a maturity of over five years was higher by around SKK 20 billion in comparison with December 2005. Long-term loans with a maturity of between 1 and 5 years recorded an increase of SKK 12 billion. As for loans to own-account workers, those with a maturity of over 5 years reported the largest increase (SKK 1.5 billion) while short-term loans rose slightly (by around SKK 1 billion). This development may point to an improvement in the financial situation of own-account workers, since the banking sector is showing greater confidence in them and their projects; this is seen in the rising share of long-term loans in the balance of loans (albeit the volumes are small).

**Net interest payments (share in GDP)**



Source: NBS, ŠÚ SR.

own-account workers was probably affected more by the increase in interest rates, given that the growth in lending slowed down after May (by 6 percentage points, to around 17% in October). In the last three months, the growth in euro loans to own-account workers increased, possibly in connection with positive expectations for future development of the exchange rate.

As regards the maturities of loans to non-financial companies, the share of each maturity remained more or less unchanged during 2006. In

**INDEBTEDNESS OF BUSINESS ENTITIES AND INTEREST PAYMENTS**

The trend of increase in lending and the consequent rise in the outstanding amount of loans in 2005 and 2006 was reflected also in a moderate rise in the indebtedness of business entities, expressed as the ratio of the outstanding amount of loans to GDP. When evaluating the development in 2003 and 2004, it should be noted that the trend decline in the debt of non-



12 Net interest payments of non-financial corporations and own-account workers were calculated as the difference between their interest costs and interest income. Both the net interest payment figures were given as a share in GDP and were annualized.

13 The ECB calculates this ratio only for non-financial corporations sector; it does not have data for own-account workers at its disposal. According to September's monthly bulletin, net interest payments of non-financial corporations stood at almost 1.65% for the second quarter.

financial corporations was caused by a reduction in the outstanding amount of loans, owing to specific factors such as loan restructuring in certain companies and the consequent issuance of debt securities and the sale of loans. A change took place in 2005 in that lending growth began to accelerate. This trend continued into the second quarter of 2006. In the third quarter of 2006, the indebtedness of non-financial companies gradually declined to 18.9%, representing an increase of 0.5 of a percentage point in comparison with the end of 2005. A comparison with the previous period shows that the debt of non-financial corporations has still not reached the 2003 level. The loan indebtedness of own-account workers has been rising ever since 2003. In the third quarter of 2006, the ratio of loan indebtedness of own-account workers to GDP amounted to 0.93% (a rise of 0.03 of a percentage point on December 2005), and in comparison with the beginning of 2003, it was higher by 0.4 of a percentage point.

The relatively sharp increase in the outstanding amount of loans (higher indebtedness) and, in 2006, the rise in customer interest rates on loans

and deposits were reflected also in a slight increase in the net interest payments<sup>12</sup> of non-financial corporations and own-account workers. Relative to GDP, net interest payments of non-financial corporation for the third quarter of 2006 amounted to 0.49%, which is 1.15 percentage points lower than the figure for the euro area.<sup>13</sup> Net interest payments of own-account workers as a share in GDP represented 0.05%.

## CONCLUSION

The real external financing costs of business entities increased in the last two quarters, reflecting the rise in NBS key rates. Through money market rates, this change was passed on quite swiftly to customer lending rates. Lending growth, however, continues to maintain a relatively fast pace, supported above all by robust economic growth (the effect of foreign direct investment and related production, and the sharp increase in exports), higher confidence in the economy, and favourable expectations for its future development.