EUROPEAN CENTRAL BANK

Private sector credit growth in new Member States

Key facts, underlying forces and implications

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Outline of presentation

- Introduction
- Key facts and figures
- Underlying forces
- Effects and implications
- Conclusions

Introduction

- Financial development is an important driving force of economic growth
- At the same time, credit growth – one of its key features – is a main leading indicator for financial crises, if taking place at a rapid pace
- Such crises often have sizeable output costs

⇨ Need to understand and suitably address the financial-stability <u>and</u> the macroeconomic implications of credit growth

Introduction

- This presentation deals with private sector credit growth in the eight new EU Member States (MS) from Central and Eastern Europe
- It focuses on the *macroeconomic* effects of credit growth and its implications
- General caveat: Data availability and comparability across countries are limited

Key facts and figures

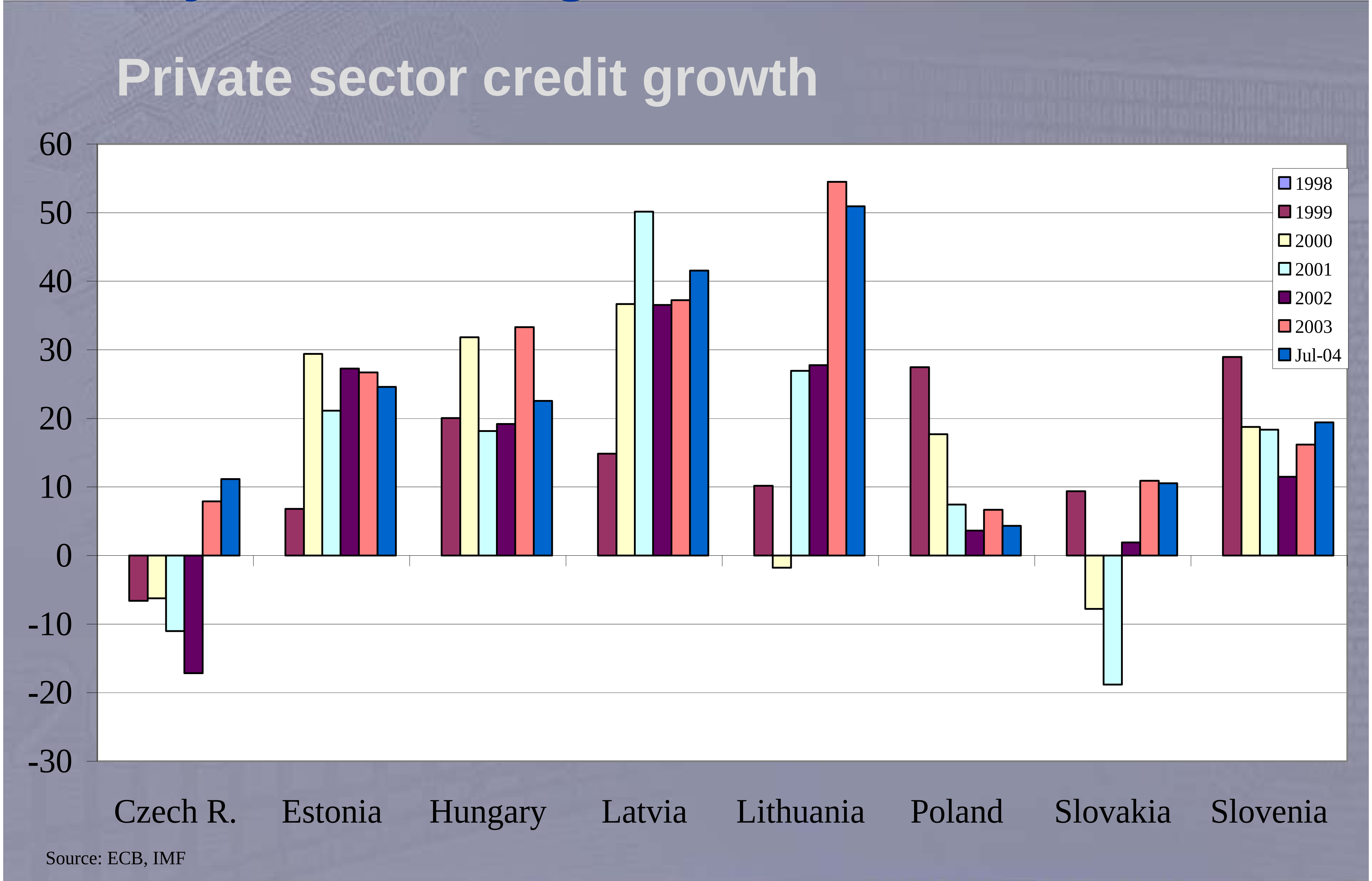
- Dynamic private-sector credit growth in many (but not all) new MS from Central and Eastern Europe
- Private-sector credit/GDP ratios are rising but still remain below levels of comparable countries

Key facts and figures

Private-sector credit growth

- Credit growth in recent years particularly fast in the Baltic countries, considerable cross-country variation in the Central European new MS
- Especially fast rise of credits to households, in particular in the area of housing loans
- Foreign-currency denominated credit tends to grow faster than credit in local currency

Key facts and figures



Key facts and figures

- Private sector credit/GDP levels in most cases rising

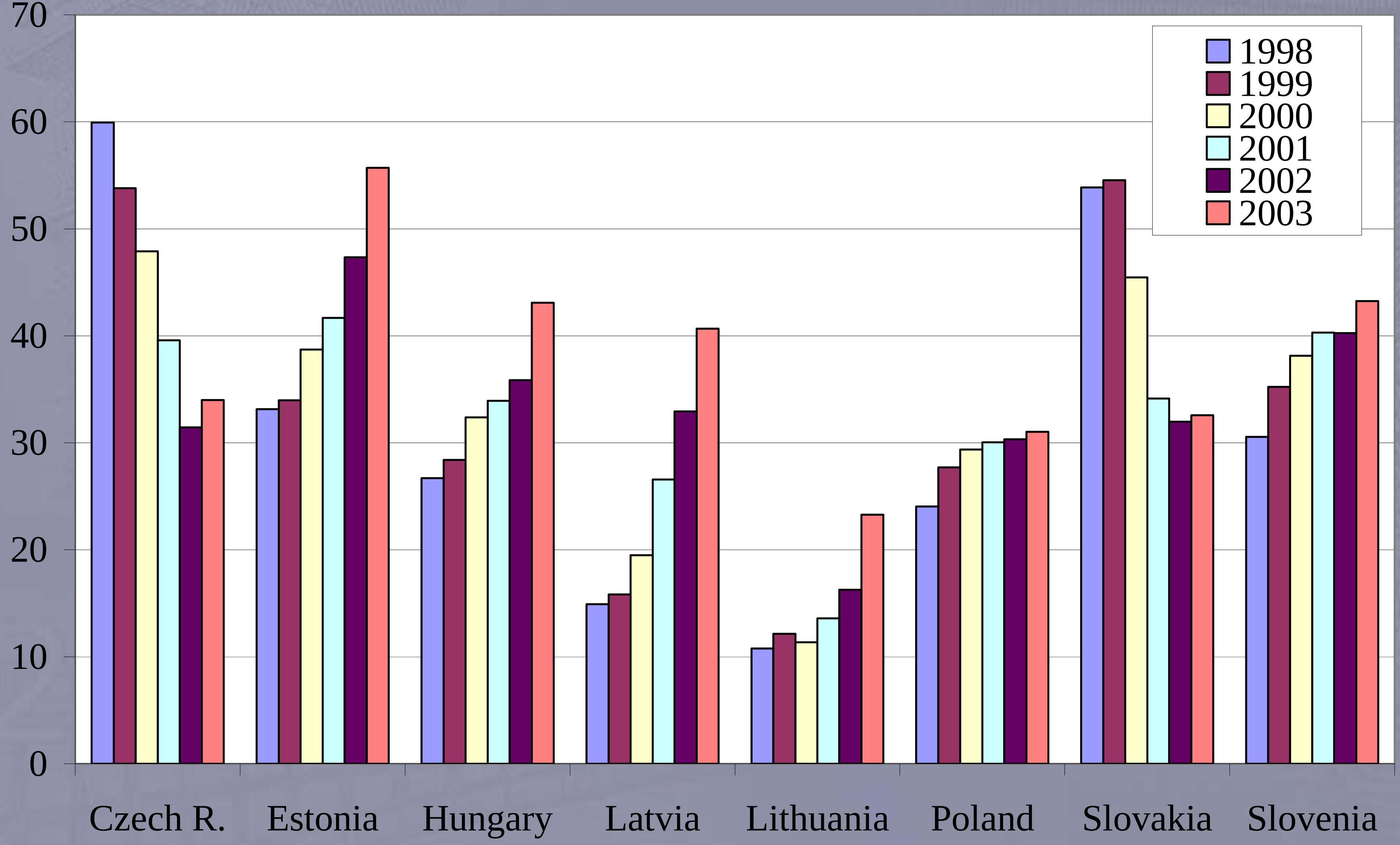
  … but still significantly undersized

  – relative to PPP per-capita income for most new MS from Central and Eastern Europe, on average by 30% in 2003

  – relative to a broader set of fundamentals for all eight countries: Cottarelli et al. (2003) find that actual levels were between one fifth to two thirds of expected levels in 2002

Key facts and figures

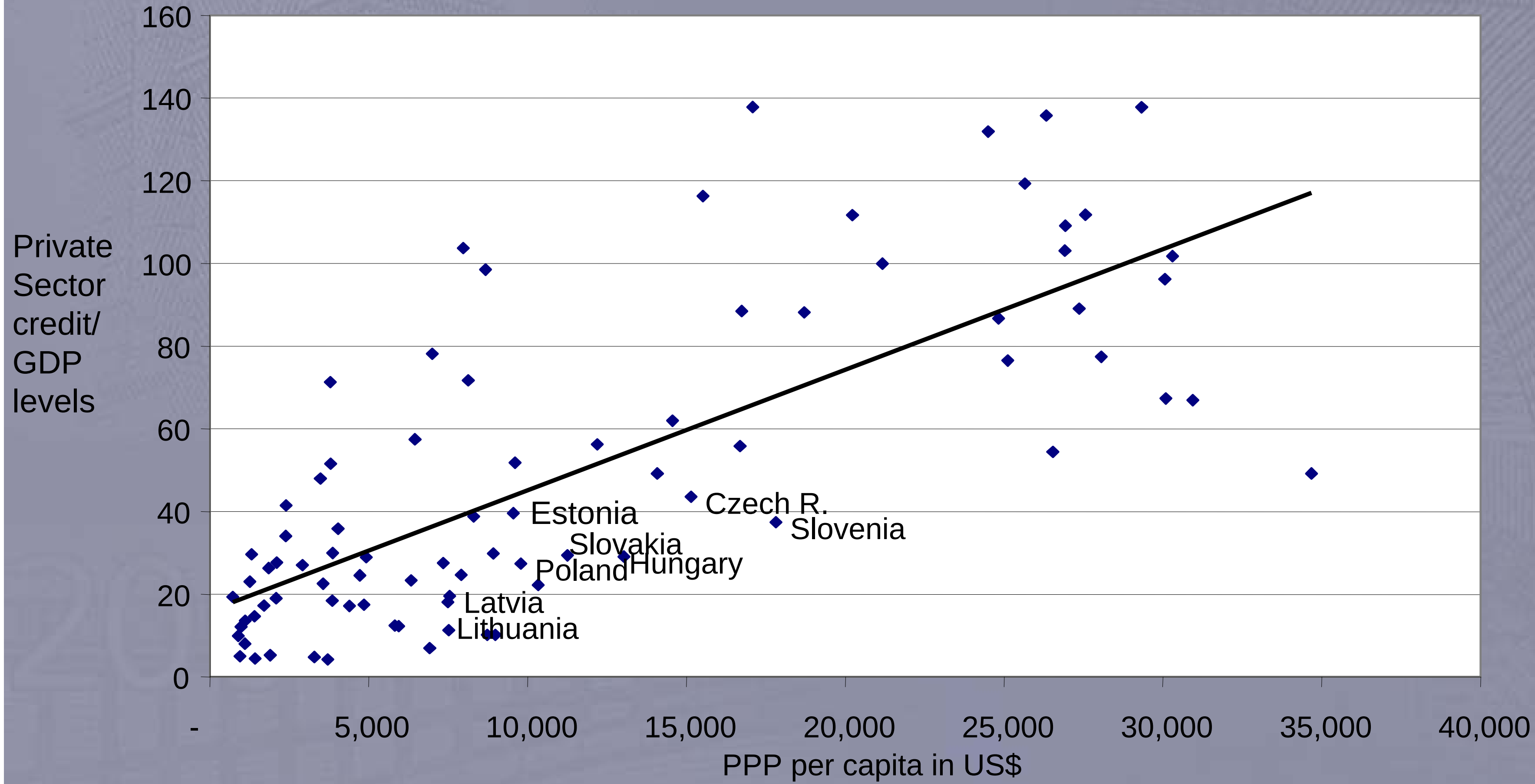
Private sector credit/GDP levels



Source: ECB, IMF

Key facts and figures

Private sector credit/GDP levels and per-capita income levels at PPP terms (2001)



Source: World Economic Outlook, International Financial Statistics, and IMF staff estimates.

Underlying forces

- **Credit growth can have different underlying reasons:**
  - **Financial deepening due to**
    - **increasing per-capita GDP levels (*trend movements*)**
    - **removal of macro- and/or microeconomic impediments (*movements towards a new equilibrium path*)**
  - **Cyclical movements**
    - **Regular movements in line with the business cycle**
    - **Excessive movements (unsustainable credit booms with subsequent reversals)**

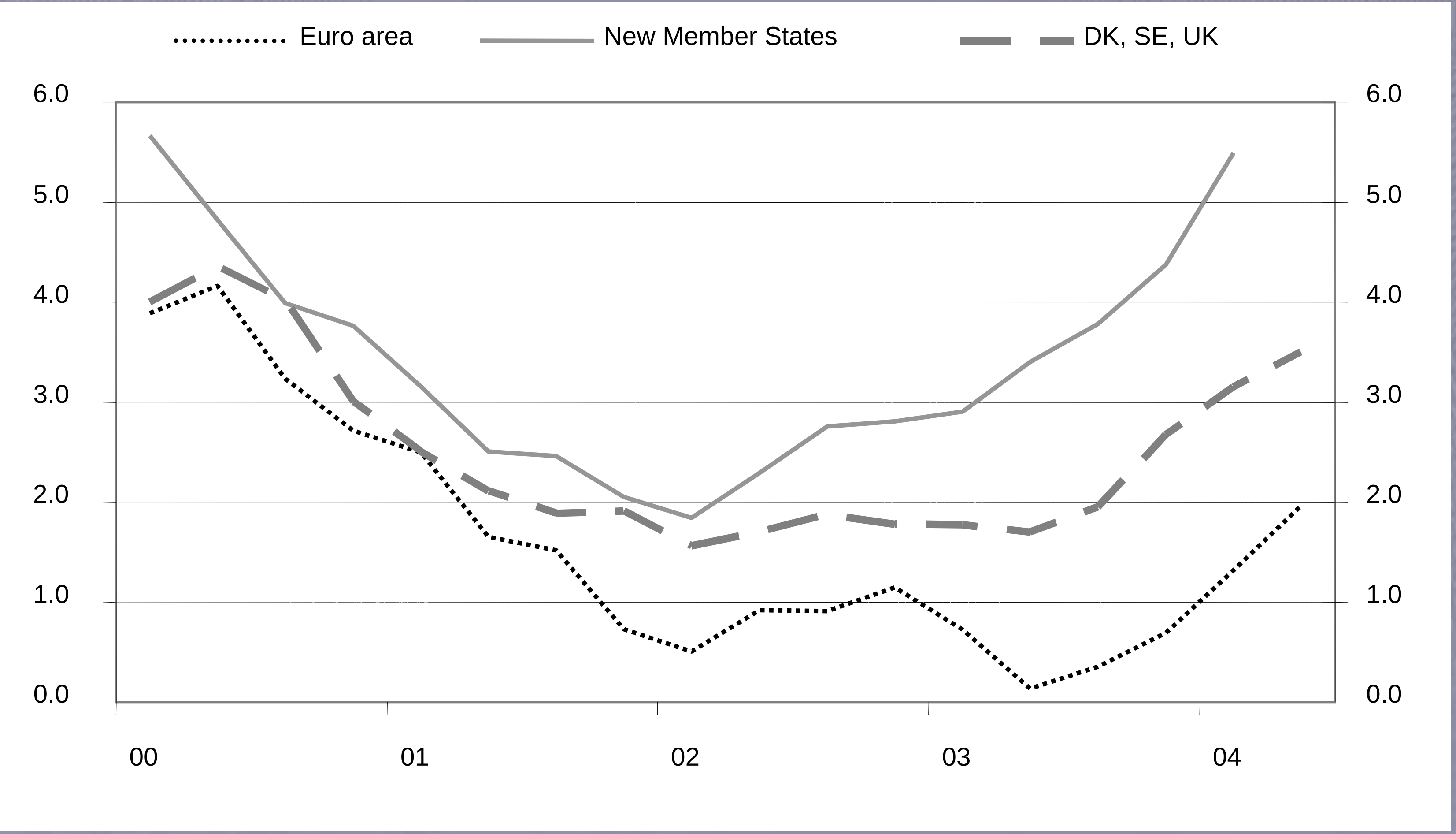
Underlying forces

- General factors underpinning recent private-sector credit growth in new MS
  - Catching-up implies rising credit/GDP levels
  - Structural reforms and macroeconomic stabilization promote move towards higher equilibrium credit/GDP levels
  - Current cyclical conditions in new MS further quicken the shift to higher credit/GDP levels

Underlying forces

Real GDP growth in the euro area and in new MS

(year-on-year changes in %)



Source: Eurostat.

Underlying forces

- **Recent private-sector credit growth in new MS: A closer look at specific driving forces**
  - Easing of liquidity constraints and broadening range of financial products as a consequence of structural and institutional change
  - Loan portfolio expansion strategies of (mostly foreign-owned) banks
  - Improved profit and income expectations spur investment and promote life-cycle consumption smoothing
  - Particular institutional factors (affecting mortgage loans) also impact on the pace of the adjustment of credit/GDP ratios

Effects and implications

- Benefits of increased financial intermediation
  – positive effect on the potential growth rate
  – improving efficiency of the financial sector and, more generally, in the economy as a whole
- Risks of fast credit growth
  – strains on risk management of banks ⇨ easing of lending practices ⇨ worsening asset quality
  – macroeconomic imbalances, higher output and inflation volatility

Effects and implications

- **The financial stability picture in new MS**
  (in a nutshell)
  - **Financial soundness indicators in new MS appear to be generally satisfactory and improving**
    (see e.g. IMF, Global Financial Stability Report, Fall 2004)
  - **Caveats:**
    - **Prudential indicators are lagging indicators**
    - **Little information on net foreign exchange exposure of the balance sheets of households and the corporate sector**
    - **Rising asset prices, often associated with unsustainable credit booms, can be observed in a number of new MS – but seem to be essentially driven by fundamental factors**

Effects and implications

- Financial stability implications appear to be straightforward
  - further enhancing regulatory and supervisory framework, in particular in implementation and enforcement terms
  - focusing on soundness of credit-risk assessment of commercial banks to safeguard banking sector asset quality

Effects and implications

- **Macroeconomic effects of credit growth**
  - **Fast credit growth boosts aggregate demand** which can lead to
    - a pick-up of inflation (including rising asset prices)
    - a widening of current account imbalances
  - **A strong credit-driven demand impulse may cause overheating and call for a corrective policy response**
    - uncertainty about potential output (particularly marked in post-transition economies) complicates the assessment of the size (and at times even the sign) of the output gap

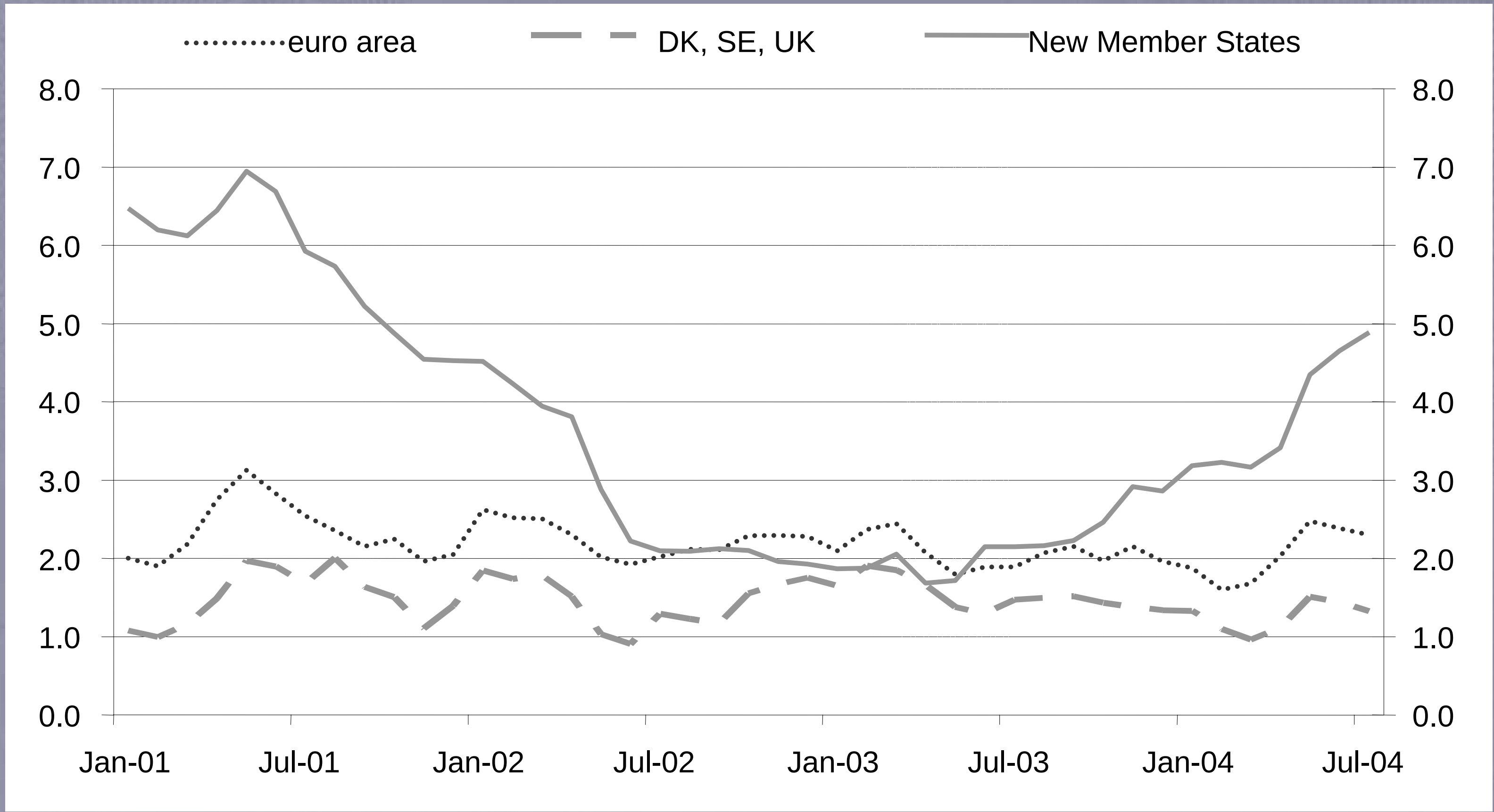
Effects and implications

- Apart from positive effects on GDP growth, financial deepening has further medium- to long-run effects:
    - Changes in monetary transmission mechanism: strengthening of interest rate and credit channels ⇨ more effective conduct of monetary policy
    - Higher exposure of private agents to changes in (actual and expected) profits / incomes, asset valuations ⇨ may imply higher volatility of macroeconomic variables

Effects and implications

HICP in the euro area and in new MS

(year-on-year changes in %)

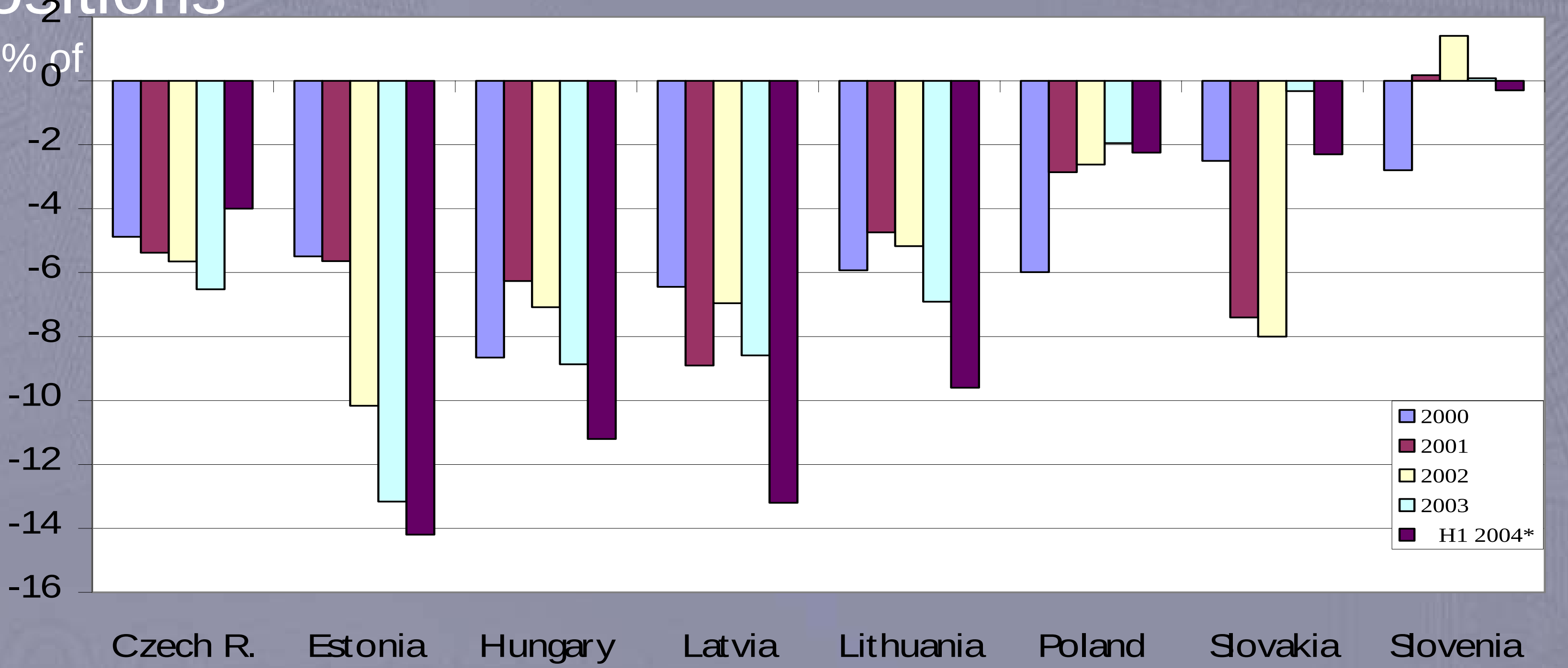


Source: Eurostat

Effects and implications

Current account positions of new MS: Recent performance and estimates of sustainable long-term positions

(in % of



Source: ECB. * Preliminary figures.

	Czech R.	Estonia	Hungary	Latvia	Lithuania	Poland	Slovakia	Slovenia
Mean	-4.8	-8.0	-4.2	-6.7	-7.8	-3.3	-6.5	-0.5
Min	-7.1	-12.1	-6.2	-9.8	-11.9	-7.1	-10.2	-3.3
Max	-2.1	-4.4	-1.4	-0.4	-4.8	2.0	1.9	1.7

Estimates

Source: Bussière et al. (2004)

Effects and implications

- Macroeconomic policy implications:
  - No hard and fast rules on how preventive (pro-active) macroeconomic policy should be to reign in rapid credit growth
  - However, there is a clear case for caution given
    - the possibly sizeable effects of unsound credit expansion and
    - the importance of sustainable convergence

Effects and implications

- Macroeconomic policy implications (cont'd):
  - Close monitoring of aggregate demand implications of credit growth is of key importance, particularly
    - if there are signs of capacity constraints and other potential evidence of overheating
    - especially if associated with current account imbalances exceeding levels which are not sustainable in the medium to longer run
  - Policy response also depends on the persistence of underlying driving forces of credit growth
    - In new MS, ample liquidity of banks and still comparatively moderate private sector credit/GDP levels seem to point at a continuation of strong credit growth dynamics

Effects and implications

- Policy tools for moderating credit growth
  - Monetary policy, fiscal policy, prudential instruments, moral suasion
    - Should prudential regulations be used to achieve macro-economic objectives?
    - Further instruments would be credit ceilings and temporary capital controls – but would involve obvious downsides and face institutional constraints
  - Longer run: structural reforms that boost the growth potential of the economy
  - Adequate mix of policies case- and time-dependent

Effects and implications

- ERM II context
  - Smooth participation in the mechanism is of key interest to all parties involved in ERM II

    ⇨ explicit focus on policy consistency, to be achieved through
    - prior action (if needed),
    - policy commitments in the context of ERM II entry and
    - monitoring during ERM II participation
  - ERM II entry by three new MS in June 2004:
    - Containing credit growth features in the policy commitments of the new entrants

Conclusions

- **New MS experience a permanent and sizeable shift in credit/GDP levels rather than a transitory cycle**
- **Robust GDP growth is accelerating this level adjustment**
- **Financial stability risks appear to be contained at the current juncture**

  …while fast credit growth continues to put high demands on risk management and financial supervision

Conclusions

- Credit growth has contributed to buoyant aggregate demand conditions and macroeconomic imbalances (especially current account deficits) in some new MS
- With a view to preserving macroeconomic stability, it is key to contain such imbalances to sustainable levels over the medium term
- Policy action to this end may need to involve measures bringing about a moderation of credit growth