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Part One

Assessing and Managing Rapid Credit Growth—General Framework

1

Credit Growth in Central and Eastern Europe

*Charles Enoch*¹

Rapid credit growth is one of the most pervasive developments in recent years in the countries of Central, Eastern, and South-eastern Europe (CEE). The benefits of this growth are unquestioned; but so are the potential risks.

The following chapters derive largely from presentations prepared for a conference in Sinaia, Romania in October 2005, organized jointly by the National Bank of Romania (NBR) and the IMF.² Additional contributions are drawn from ongoing work on rapid credit growth in a number of the participating institutions. The objectives of the conference, and of this book, are to provide a channel to share experiences and counteractive measures, and to consider how best to take policy work forward.

I. The IMF and rapid credit growth in the region

The IMF has been focusing on rapid growth in CEE in a number of different fora. The chapters in this volume add to the realm of statistics showing that credit growth across the region has been running for several years at extremely rapid rates. Table 1.1 shows rates of credit growth for ten of the countries in the region. Ukraine showed the most rapid rate of growth of credit over the 2001–04 period, with an annual average of almost 37 percent per year, followed closely by Latvia with over 35 percent per year. Although the stock of credit relative to GDP started from a low base in all these countries, over this period there was a substantial increase, as shown in Table 1.2, with the credit to GDP ratio for Ukraine for instance rising from 11 percent of GDP in 2000 to almost 25 percent in 2004, and that in Latvia rising from 17 percent to over 45 percent of GDP over the same period. Recent evidence is that rapid growth rates continue in many of the countries in the region.

IMF involvement with this issue has a number of interrelated forms. First, as the central part of surveillance, the IMF Article IV consultations focus on monetary and

4 General Framework

Table 1.1 Rates of Growth of Credit in Central and Eastern Europe

	2000	2001	2002	2003	2004	Average (2000–04)
Growth of Credit						
Ukraine	32.9	25.5	48.8	55.7	21.6	36.9
Latvia	28.1	33.5	34.3	41.2	41.1	35.6
Albania	33.9	38.9	25.6	23.0	28.5	30.0
Bulgaria	6.0	23.0	34.6	45.4	40.5	29.9
Lithuania	-7.0	4.9	30.1	60.8	38.1	25.4
Russia	27.2	25.1	12.3	27.4	34.0	25.2
Belarus	6.8	8.3	16.2	43.8	36.1	22.2
Estonia	7.4	12.1	15.6	30.9	39.5	21.1
Moldova	6.1	26.2	31.0	29.8	7.9	20.2
Hungary	30.3	8.0	13.6	27.4	11.2	18.1

Source: Hilbers et al (2005).

Table 1.2 Credit to GDP Ratio

	2000	2001	2002	2003	2004	Average (2000–04)	Cumulative Change (1999–2004)
Credit to GDP Ratio							
Ukraine	11.1	12.9	17.5	24.3	24.9	18.1	16.4
Latvia	17.2	21.3	26.5	34.6	45.4	29.0	30.9
Albania	4.6	5.9	7.3	8.4	9.9	7.2	6.0
Bulgaria	12.6	14.9	19.6	27.4	36.7	22.2	24.6
Lithuania	11.4	11.4	14.0	20.4	25.6	16.6	12.8
Russia	13.3	16.5	17.7	21.0	24.5	18.6	11.5
Belarus	8.8	8.2	8.9	11.9	13.9	10.3	4.7
Estonia	23.9	25.2	26.9	33.1	43.3	30.5	19.0
Moldova	12.6	14.7	17.1	20.5	21.3	17.3	9.5
Hungary	32.4	33.7	35.8	43.0	46.0	38.2	19.9

Source: Hilbers et al (2005).

financial developments, in particular those that may indicate vulnerabilities for the country or more widely. With the IMF's ongoing medium-term strategy³ containing a pledge to integrate more fully the macroeconomic and financial sector work, focus on areas such as rapid credit growth is likely to become more intense. Second, the IMF has conducted a number of studies on this topic to aid understanding, and give insights as to appropriate policy responses.⁴ These studies also contain references to earlier IMF and other work in this area.⁵ Third, a number of countries have approached the IMF, in particular its Monetary and Capital Markets Department, to discuss how to handle problems of rapid credit growth. The IMF has thus provided bilateral technical assistance on this subject for a number of countries. Fourth, beyond such assistance, there are a range of issues concerning rapid credit growth which are useful to discuss amongst the IMF and member countries, to reach a better understanding of rapid credit growth and how country authorities might design remedial action. Such discussions can often be most productive when handled on a

regional basis, both because this can involve a relatively large group of people, and because sharing country experiences can serve to provide additional insights. It is with these last considerations in mind that the Sinaia conference was organized, and the papers prepared for wider dissemination.

II. Measuring credit growth

Rapid credit growth is a particularly difficult topic to address, for a number of reasons. First, it is hard to measure. Probably most observers would agree that the figures quoted are the lower bound of what is actually happening. These may be just flows through the banking system—which may well be the dominant flows, but are certainly not the whole story. In many countries nonbank financial institutions are now conducting a significant part of the overall intermediation. Also, close substitutes for lending are appearing—leasing is one example, and the IMF has in recent months received a number of requests from country authorities for assistance with assessing developments regarding leasing companies and designing regulations and supervisory practices to manage them. This may well be an example of what is known as Goodhart's law—as the authorities move to control one activity, there will be a shift away from institutions or mechanisms conducting the activity that is being controlled to those conducting activities that are not. Indeed, I will return to this phenomenon later.

III. Rapid credit growth may be very popular

Second, rapid credit growth is particularly hard to assess and determine how to handle because credit growth is inherently beneficial, and indeed is a basic underpinning for economic growth and development. In many countries of the CEE region there are recent memories of credit crunches, and then stagnation in credit while economic needs were clear and urgent. Banks seemed to be too restrictive in providing credits to the real sector and thus not contributing to economic growth. Revivals in credit growth may be seen as signs of a healthy banking system and returning confidence in the economy. There is likely to be irritation and disbelief then, just when it seems that things are turning out right, central bankers and regulators start issuing warnings of problems ahead, and urging that remedial action is needed. The message is bound to be a hard sell to a politician, for the politicians of course are dependent on a public that is, at least in the short term, the beneficiary of the credit growth. Credit is being used for home ownership or improvement, and purchases of cars and consumer durables, and anyone who suggests limiting such activity, or making it more expensive, is not likely to be very popular.

IV. Is it too much?

In this connection, it would be very helpful if there were a well-accepted threshold number beyond which credit growth would be consistently deemed as excessive. The third difficulty with handling rapid growth is that a definitive number beyond

which credit growth can be deemed excessive is not known, and indeed if it exists would be unlikely to be constant across space or time. In those cases where credit growth starts from a lower base, one can broadly expect that a high growth rate may be sustainable for a longer period than in a situation where there are high levels of credit to begin with. Also, where the monetary and financial systems are well managed, a higher rate of growth can be sustained longer than where monetary and prudential management capacity is yet to be developed. And where the economy is simultaneously undertaking substantial structural reforms, as in many of the countries at the Sinaia conference, rapid credit growth may be seen as evidence of the success of the reform program. Indeed, this is not just an issue for transition or emerging market economies. Both the United Kingdom in the late 1980s and the United States in the late 1990s downplayed the risks of rapid credit growth in the exuberance of their ongoing structural reforms. In both cases the credit growth proved not to be sustainable, and the countries experienced a period of reversal. For many other countries the reversals after unsustainable credit growth were even more significant.

On the side of quantification, much has been achieved in recent years. One of the problems of rapid credit growth is that it may undermine financial system soundness. Until recently there have been no commonly-accepted measures of financial system soundness. The Asian financial crisis, however, showed the perils of leaving policymakers and regulators without a good quantitative basis for identifying weakening soundness in their financial systems. As a result, considerable efforts have been put into developing financial soundness indicators (FSIs). A core set, and an encouraged set, of FSIs were endorsed by the IMF Board, after extensive interaction with member countries, amongst which are indicators related to credit growth.⁶ Many member countries have now put considerable efforts into compiling such indicators; some, including many from CEE, are participating in the coordinated exercise being run by the IMF's Statistics Department. Nevertheless, there is still some way to go. These indicators are compiled on a national basis, and there are ongoing struggles with harmonization. FSIs certainly do not provide a black box from which one can effortlessly determine if credit growth is too fast or if a system has become unsound.

Thus the demonstration that credit growth is excessive will generally need to be made through detailed analytical demonstration, and remedial action justified on the basis of demonstration of the desirability and efficacy of the proposed remedial action. The chapters presented in this volume provide additional insights to make these demonstrations.

V. The monetary/prudential interface

Fourth, credit growth is hard to handle because the concerns it raises are both monetary and prudential. Indeed, it was probably because the issues are at the interface between monetary and prudential management that it took so long to develop FSIs. The interface between monetary and prudential concerns and actions is an issue which all policymakers need to be fully aware of. It has both analytical

and organizational implications. From an organizational point of view, the two sets of issues may involve very different sets of people, even from different institutions, perhaps with not much experience of communication with each other, and little experience of interfacing and understanding the concerns of the other. One of the purposes of the Sinaia conference was to bring these two sets of people together, and for all to be exposed to the range of issues. Hopefully one of the results will be a more comprehensive understanding of the issues, and so a better grasp of appropriate policy responses, even those outside one's own field of responsibility.

VI. The international dimension: the banks

Fifth, credit growth is hard to handle because of its international and institutional dimensions. Many of the causes of credit growth are nationally determined, and the case studies presented tell us much about these. But to an important extent the causes are externally driven. There is amongst many of the countries here the prospect of early accession into the European Union (EU), so EU policies and developments will have an important influence on credit growth across the region. Not unrelated, in many countries a large part of the credit growth derives from the activities of international banks, often from outside the region, that are likely to have a regional strategy on how they will grow their business in the countries of the region. Table 1.3 shows the share of foreign banks in total assets in a number of the countries in the region. In Estonia, Lithuania, and the Czech and Slovak Republics foreign-owned banks account for over 90 percent of total banking sector assets. In both Hungary and Poland more than two thirds of banking sector assets are held by foreign-owned banks.

Table 1.3 Rate of Foreign Bank Ownership in Selected Countries of Central and Eastern Europe

Country	Number of Banks	Number of Foreign-owned Banks (%)	Asset Share of Foreign-owned Banks (%)	Private Sector Credit Growth end-2004 (%)
Estonia	6	50.0	97.3	43.8
Slovak Republic	21	90.5	96.3	7.0
Czech Republic	35	77.1	96.0	13.3
Lithuania	13	76.9 ^b	95.6	39.8
Hungary ^a	36	80.6	83.3	18.8
Poland ^a	60	76.7	67.8	3.6
Malta	16	62.5	67.6	–
Latvia	22	40.0	47.2	50.0
Slovenia	22	27.3	36.0	20.1
Cyprus ^a	14	42.0	12.3	6.7

Source: European Central Bank (2005).

^a Excludes cooperative banks and international banking units, but includes the Cooperative Central Bank (in Czech Republic).

^b Includes foreign bank branches.

In this connection, it should be noted that only a relatively small number of foreign banks account for the major share of this foreign penetration, and also that it tends to be the same banks that are active across the various countries in the region. Banking behavior in the region is thus not only subject to regulators in Bucharest, Sofia, and Zagreb, but also to those in Amsterdam, Brussels, and Vienna. It also means that regulatory action in one country in the region, or monetary action in a single country to curb excessive credit growth, may lead much of that growth to reappear elsewhere in the region. And while the actions of a particular bank may be of systemic importance to a country in this region, if that country accounts for only a small part of the overall activities of that bank, they may not register heavily with the regulators in the bank's parent country. This all adds to the case for discussing the subject on a regional basis, and to include participation also from outside the region.

VII. The international dimension: the currency

The sixth issue is a further aspect of the international dimension: the role of foreign currencies. In many countries a large part of the credit growth has been in foreign currencies. This carries additional risks, even if the authorities design and enforce appropriate limits on banks' net open positions. It seems to be the case in many countries that lending in foreign currency is made available to even those borrowers without an assured foreign currency income. The appearance of lower nominal interest rates on foreign currency borrowing has encouraged such borrowing, notwithstanding that the associated exchange rate risk may not be appropriately hedged, or indeed even recognized.

An additional wrinkle in this region is that a number of countries have aspirations to join the European Economic and Monetary Union (EMU) within a few years. At that time much of what is now foreign currency lending would become domestic currency lending. Before one gets there, however, vulnerabilities associated with rapid foreign currency borrowing may add to the strains on the convergence process.

VIII. What part of credit growth is the problem?

A seventh issue, looking particularly at the prudential side, why it is hard to handle the issue of credit growth, is because it is not clear whether one needs primarily to focus on aggregate growth, or some components of it.

To some extent, it is aggregate credit growth that is the problem, even as regards prudential concerns, and—notwithstanding the point above that rapid growth may be sustainable for longer when it begins from a low base—one can argue that rapid growth may even be a larger problem when it starts from a low base. When there is little history of granting commercial credit, or of enforcing regulations governing banks' prudential behavior, there is likely to be little capacity to manage it, whether in the commercial banks or amongst the regulators. Evidence of overall lack of capacity, particularly during the early stages of the economic transition in the region, was the repeated poaching that occurred of newly-trained regulators by the

emerging commercial banks, thereby compelling regulators in many of the countries in the region to retrain their supervisory teams from scratch more than once. Rapid credit growth in such an environment might be considered particularly risky.

In the early days of the transition, observers were concerned primarily at continuing rapid growth of public sector credit, on the grounds that such credit might be politically driven and not subject to proper prudential oversight, and might be directed into sectors of the economy that were not likely to be sustainable on a commercial basis. Indeed, banks in many transition economies suffered serious difficulties from nonperformance of loans to government entities. More recently, the focus of concern has shifted to private sector credit growth, in part because that is now the dominant component of credit growth, and because its rates of growth have generally been the most spectacular. Such concern also results because of questions regarding governance of the corporate sector, and the relationships of the corporates with the banks. In environments where many local banks started essentially as treasury functions for corporate partners, rapid private sector credit growth leads to questions as to whether the banks are sufficiently separate from their customers to make—and enforce—sound judgments as to whether they should be lending to them.

While concern is frequently voiced at overall levels of credit growth to the private sector, specific concern also focuses on its components. At the present time, credit is in many countries expanding rapidly both to the corporate and to the household sectors. The issues affecting the respective sectors may be somewhat different. As regards corporate lending, again one has issues of corporate governance, including that the corporation should have a viable business plan that involves its making productive use of its borrowings, and that it should be sufficiently separate from its lender that the latter is able to decide whether or not to lend purely on prudential criteria. As regards consumer lending, on the other hand, a key issue may be that of consumer protection. Are lenders misleading their customers as they advertise their services? Do they make clear the borrowers' repayment obligations and how these might change, for instance if interest rates rise? Do borrowers understand the implications of pledging collateral? And, overall, have lenders an adequate system of risk analysis on which to base their lending decisions, or are they focusing purely on the current values of their collateral? Such issues are not only of relevance to transition economies. Consumer protection has come very much to the fore also in industrial countries in recent years, with several scandals that have undermined both the regulators and the authorities that drew up the regulations. And concerns over possible excessive consumer indebtedness have emerged also in advanced countries, including perhaps most significantly in the United States.

There are also issues of sectoral concentration that frequently raise concern. In many countries the most rapid source of credit growth is into property, and property prices have risen substantially in many countries. To some extent this is a healthy development. It is a widespread aspiration to own one's own house, and house purchase is likely to involve the single largest credit transactions that most of us ever undertake. Nevertheless, credit crises in many countries have in the past frequently been attributable to over-exuberance in the property sector. Borrowings

are inherently frequently long term, which creates additional vulnerabilities both for the borrower and lender: risks of changes in the borrower's earning capacity, or of payment obligations in the case of floating rate loans. Also, banks may seek to sweeten such lending by low initial interest or principal payment requirements, without making clear that payment obligations are likely to rise subsequently. On the banks' side, while deposits continue to be very much short term, there is a serious risk of liquidity pressures if loans do not continue to perform. Moreover, lending may be on the basis of collateral, although the collateral may be difficult to seize, and its value will be closely linked to that of other properties, so that if economic conditions change and the banks have to seize a number of properties, their value could fall substantially, leaving the banks unprotected and vulnerable.

IX. Credit growth and inflation

Much of the above discussion has related to the financial stability aspects of rapid credit growth. Rapid credit growth also of course can have important monetary implications, which indeed are arguably more urgent. Unless counteracted, credit growth increases liquidity in the economy, raising the risk of a resurgence of inflation. For many transition economies, where the hyperinflations of the early transition periods are not-very-distant memories, this risk would be especially worrisome. As inflation has been brought down, it has in some cases taken many years for the public to regain confidence in the currency, and to behave with the expectation that monetary savings will retain their value rather than be rapidly eroded away. The substantial reduction in inflation over the past few years has no doubt made a significant contribution to the economic recovery in many economies of CEE. If rapid credit growth leads to a resurgence of inflation, these hard-won gains may be quickly jeopardized. And if liquidity also leads to problems on the external accounts and to exchange rate pressures, these macroeconomic policy difficulties will be compounded further.

In this connection the recent slight pickup in inflation in a number of countries may be a cause for concern. There are, as always, arguments that the pick up has little or nothing to do with credit growth, so that addressing credit growth would not address the problem of inflation. It would however be reckless, at a minimum, not to watch credit, liquidity and inflation developments very closely, and to be prepared to take prompt action. Many countries in this region have only limited powers to dampen liquidity expansions, whether because of institutional constraints such as those imposed in a currency board system, or because of lack of market development. The country presentations in Part Two of this volume give further details of both these types of constraints. In general, however, these constraints increase the case for the response to be firm and timely, since it is that much harder to take effective remedial action once the situation has seriously deteriorated.⁷

X. Targets and instruments

Much of the discussion of rapid credit growth concerns the choice of measures to address the problems of rapid credit growth. This introduction will not go far into

this fascinating area, but I would like to raise two broad issues, that are among the major themes in the chapters that follow: assigning instruments to targets, and ensuring that remedial measures are, to the extent possible, market friendly.

There are two broad targets when one acts to contain rapid credit growth: achieving financial stability and achieving monetary stability. It is a well known maxim that instruments should be matched to the targets that they most directly affect. Thus, financial stability should in principle be achieved through prudential measures, while monetary objectives require the use of monetary instruments. There is a considerable variety of instruments of both types at least potentially available. Monetary instruments include, for instance, interest rate tightening, and sterilization measures, and correction of any exchange rate misalignment. Prudential measures include promulgation and enforcement of best practice prudential regulations, including on classification and provisioning, and liquidity, concentration and net open position limits.

In practice, however, targets and instruments have in some countries become mixed. First, the monetary and financial effects may be difficult to distinguish: developments that cause monetary distress are likely also to cause financial distress. Second, some types of measures may be regarded as politically difficult—it may be thought easier, for instance, to put extra regulations on to the banks than to raise interest rates. While a number of the chapters focus on dilemmas in this area, it would be worth observing here that regulators and policymakers should be very leery about easily accepting political difficulties as an excuse to move toward second or third best solutions—such acceptance could quickly lead to recommendations that are no solution at all.

In this connection, it is worth stressing the desirability of finding solutions that are market friendly. Sterilizing liquidity by issuing paper, for instance, can help to develop markets, while adding regulations—such as imposing high reserve requirements—might harm market development and financial intermediation. Although one might appear to be addressing the credit growth problem one may largely be diverting resources into other sectors or countries—an example of the Goodhart's law to which I referred at the outset. Given constraints on more market-friendly interventions, there may be cases where the less preferred forms of approach are the only ones available—perhaps especially where a country has a tight exchange rate peg, in its most extreme form a currency board arrangement. But in such cases, if one seeks directly to impose controls, their impact is in the present environment of multiple types of institutions and sources of financing, likely to be at best only partial and temporary, and—while having a helpful impact in the short term—could serve in the longer term to undermine and threaten the financial development that the countries in the region have achieved over the past few years.

XI. Conclusion

To summarize, the rapid credit growth that has been experienced for several years across much of the CEE region is in many ways welcome, and one should not forget the importance of nurturing credit growth. It is indeed with the objective

of safeguarding credit growth, and ensuring its sustainability that one is looking at measures that may serve to contain it. A variety of measures may be brought into play, and these are examined in the contributions in this volume. While there have been periods of rapid credit growth in the past, the present experience of the region seems new in a number of regards. One important regard is the international dimension, with the dominant role of foreign banks and foreign currencies, and the international constraints on, and interrelationships between, national policy responses. It is this dimension that certainly will add to the value of the exchanges of information and analyses of policy options contained in the remaining papers.

Notes

1. International Monetary Fund (IMF).
2. I would like to thank the NBR, and in particular Governor Isarescu and Deputy Governor Popa, for providing the facilities for these discussions.
3. Please see the Managing Director's Report on the Fund's Medium-Term Strategy.
4. See Cottarelli, Dell'Aricca' and Vladkova-Hollar (2003); Hilbers, Ötker-Robe, Pazarbasioğlu, and Johnsen (2005); and Maechler and Swinburne (2005).
5. Please note that these papers are at this stage the responsibility only of the authors, and do not necessarily reflect an official IMF view.
6. See Sundararajan, Enoch, San José, Hilbers, Krueger, Moretti, and Slack (2002).
7. Also, while the pickup may be slight, it could well be significant in determining whether a Euro aspirant meets or breaches the Maastricht criteria.

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