Box 3

CREDIT DEVELOPMENTS IN THE NEW NON-EURO AREA EU MEMBER STATES

Macroeconomic stabilisation and banking sector restructuring are two of the factors that have fostered financial sector development in several of the new EU Member States. Regulatory reforms, leading to increased competition and supply of new products have, together with improvements in domestic legal systems, also supported dynamic credit activity in these countries. In addition, favourable financing conditions, supported by low-inflation policies and higher incomes and income expectations, have encouraged strong credit demand, up from relatively low levels. This Box discusses some of the financial stability implications that could arise from the strength of credit growth in these countries.

Over recent years, credit growth to the private sector has been very robust in most new EU Member States (see Table B3.1). This growth seems to have been driven primarily by

Table B3.1 Credit to the private sector

(% per annum; period average)

	2002	2003	2004	Q4 2004	Q1 2005	Q2 2005	July 05	Aug. 05
Czech Republic	..	2.0	11.3	13.0	13.8	15.1	17.0	18.0
Estonia	23.3	26.0	27.5	30.8	31.2	32.2	34.3	35.4
Cyprus	7.7	6.3	5.0	5.8	5.2	4.0	4.2	4.4
Latvia	43.6	39.3	43.1	46.8	48.7	50.3	54.9	55.5
Lithuania	27.4	43.1	51.1	42.4	37.1	37.6	42.7	44.4
Hungary	21.5	24.2	24.7	18.5	18.2	16.8	15.1	14.5
Malta	1.7	4.9	12.6	9.2	7.8	6.1	4.2	4.2
Poland	4.6	5.4	5.2	5.0	3.5	6.0	6.5	6.1
Slovenia	13.4	13.3	18.8	19.3	22.9	24.3	22.9	23.7
Slovakia	-1.6	8.3	9.7	8.4	10.6	14.9	19.0	19.5
EU-10[1)]	..	11.2	13.8	12.7	12.4	13.8	14.6	14.7
euro area	4.9	4.9	5.9	7.0	7.8	9.0	8.6	8.9

Sources: ECB and national central banks.
1) The EU-10 aggregate comprises the ten new EU Member States, 2003 GDP weights. EU-10 aggregate data are not included for 2002 due to a structural break in the data series of the Czech Republic.

household lending, largely in the form of mortgage lending. Annual growth in housing loans in September 2005 exceeded 30% in six new EU Member States. Mortgage lending was particularly buoyant in the Baltic countries, where growth rates above 70% were recorded. In comparison, the growth of loans to non-financial corporations has been more moderate in most countries, albeit faster than in the euro area. In many countries, the share of foreign currency-denominated loans in lending has been high and continues to grow. These loans are mostly euro-denominated, although other currencies have also been gaining in importance recently. They have been typically granted to the non-financial corporate sector, although in the Baltic countries and Poland, to households as well. Borrowing in foreign currency is mostly associated with lower borrowing costs. In addition, the bulk of borrowing in foreign currency is generally undertaken by larger multinational firms, which generate the greater part of their revenues in foreign currency, and can therefore be seen as a natural hedge. In general, borrowing in foreign currency has been more typical in those countries with fixed exchange rate regimes or exchange rate targets (particularly the Baltic countries), where borrowing had already picked up as early as the mid-1990s.

From a financial stability viewpoint, rapid credit growth deserves careful monitoring. This is because many banking crises have been preceded by episodes of rapid or excessive credit growth, although the opposite has not always held.[1] Several theoretical explanations exist for why credit booms tend to be associated with a higher probability of banking distress. According to one main strand of the literature, this relationship may be attributed to the pro-cyclicality of bank lending behaviour. Risks may be underestimated during expansionary phases of the business cycle, thereby resulting in loosening credit standards and a lower average quality of borrowers. This may lead to higher credit losses when the next economic downturn occurs. Another often cited theory related to the over-expansion of credit is the "financial accelerator" mechanism. Over-optimism about future returns could boost asset valuations and thus firms' net worth, which then feeds back into higher investment and credit demand and a further increase in asset prices. Consequently, this self-reinforcing mechanism

1 On the first point, see, for instance, D. Ottens and E. Lambregts (2005), "Credit Booms in Emerging Market Economies: A Recipe for Banking Crises?", *DNB Working Paper* No 46, De Nederlandsche Bank, June. On the latter point, see, for instance, A. Tornell and F. Westermann (2002), "Boom-bust Cycles: Facts and Explanation", *IMF Staff Papers*, 49 (Special Issue).

may lead to excesses in the growth of credit and asset prices. A change in expectations could then precipitate a reverse process with falling asset prices and a credit crunch, which may significantly increase repayment difficulties for borrowers and may ultimately lead to higher loan losses for banks.

When assessing the nature of credit growth in the specific case of the new EU Member States, it is important to recall that the initial depth of financial intermediation was low in these countries compared to their level of economic development. Some studies concluded that credit-to-GDP ratios in the central and eastern European and Baltic countries were significantly lower than what could be justified by their fundamentals.[2] Thus, rapid credit growth can, to a considerable extent, be attributed to a catching-up effect. There is as yet only limited empirical evidence on whether credit growth in the region has been excessive or not. According to recent empirical findings, there may be, at best, only a small sub-group of new EU Member States in which rapid credit expansion might have reached the proportions of a lending boom.[3] However, even in those countries, the pace of credit growth is not out of line with that experienced in former "converging" countries, such as Ireland or Portugal.

It is also important to bear in mind that the pace of credit growth alone may not be a sufficient guide to assess its riskiness. Considering other important aspects of credit growth in the new Member States, there are concerns that rapid credit growth expansion may have been accompanied by the build-up of some vulnerabilities, of which four main concerns can be identified. First, this may put a strain on banks' ability to monitor and assess risks, especially because risk assessment by banks in these countries is burdened by measurement difficulties in forecasting future credit losses owing to the lack of sufficiently long credit histories. This problem may be even more pronounced in the case of previously under-serviced customers of banks such as households and SMEs. Second, foreign currency lending to the domestic private sector has been strong in some countries. This may have also contributed to increasing the vulnerability of households or unhedged non-financial corporations to unexpectedly large adverse exchange rate movements. Third, due to relatively moderate growth in domestic deposits, banks in some countries increasingly rely on foreign interbank borrowing to finance credit growth. This may have left these countries more vulnerable to potential changes in the current favourable external financing conditions. Fourth, since in several new Member States mortgage loan contracts typically have floating interest rates, this implies that rising interest rates would weigh mostly on households' debt servicing ability in those countries.[4]

There are, however, some mitigating factors. Credit risk is contained by the fact that the ratio of debt servicing burdens of firms and households relative to income remains considerably lower in these countries than in the euro area. Moreover, a favourable growth outlook and improving income prospects owing to continuing real convergence as well as a low interest rate environment are likely to support the debt servicing ability of private sector borrowers. Some comfort can also be drawn from the fact that a strengthening of banks' profitability in most new Member States has helped to maintain a solid capital base, thereby helping to increase banks' shock absorbing capacity. With regard to asset quality, the ratio of non-performing loans

2 See, for instance, C. Cottarelli, G. Dell'Ariccia and I. Vladkova-Hollar (2003), "Early Birds, Late Risers, and Sleeping Beauties: Bank Credit Growth to the Private Sector in Central and Eastern Europe and in the Balkans", *IMF Working Paper* No 03/213.

3 P. Hilbers, C. Pazarbasioglu, G. Johnsen and I. Ötker (2005), "Assessing and Managing Rapid Credit Growth and the Role of Supervisory and Prudential Policies", *IMF Working Paper* No 05/151.

4 See ECB (2004), "Aggregated EU Household Indebtedness: Financial Stability Implications", *Financial Stability Review,* December, pp. 147-153.

decreased or remained at a low level in most countries. It should be stressed, however, that banks' asset quality indicators are typically backward-looking. Since risks may build up during boom phases, a deterioration in credit quality might only become visible with a significant time-lag if general economic conditions were to worsen. As most new Member States have been enjoying relatively high rates of economic growth in recent years, the resilience of loan portfolios to negative output shocks remains untested up to now.