Credit Expansion in Emerging Europe

Some countries have witnessed a true credit boom that has contributed to overheating of their economies

Eastern and Central European countries entered the EU with reformed and relatively modern banking systems. Despite the impressive progress, all of the NMS face the challenge of financial system deepening and remain far behind the eurozone in respect of financial depth of bank and non-bank financial institutions, and capital market development. In some countries, such as Latvia and Romania, the total assets of financial institutions still constitute less than 50% of GDP. In most NMS, foreign-owned banks dominate the banking system.

Rapid Credit Expansion

Over the last decade, bank credit to the private sector has expanded impressively in almost all countries, at an average annual compounded rate of 24%. The growth of bank lending was particularly strong and sustained in Southeastern Europe (SEE) — Romania and Bulgaria — and the Baltic countries. The credit expansion of the last two years is largely a result of increased loans to households, while growth in the corporate sector has remained modest. The latter has been due to an improvement in companies' earnings, accumulation of liquid funds and access to external lending. This raises questions about the productive impact of the observed credit growth.

Among loans to households, housing loans have been growing particularly fast. Between 2004 and 2005 alone, such loans increased 95% in Bulgaria and around 90% in Latvia and Lithuania. However, compared to the EU-15, the level of residential mortgage debt remains rather low, below 30% in the Baltic countries and Hungary and below 10% in other countries (compared to e.g. over 70% in UK).

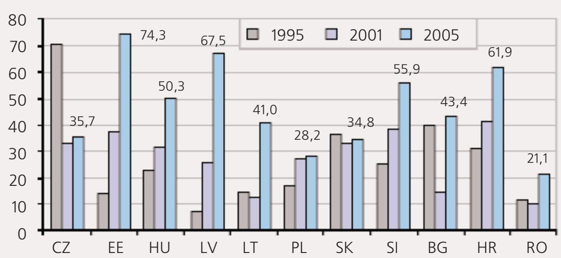
The demand for credit has grown because of increases in disposable income and higher confidence related to EU accession, falling inflation and interest rates, stable or appreciating local currencies, and better investment opportunities. The increased supply of bank loans has been driven primarily by financial sector deregulation and deepening (due to large privatizations in the sector and increased competition from foreign banks).

Large Macroeconomic Imbalances in Some Countries

An analysis of the current financial health of banks suggests that generally they are well-capitalized and profitable. They have also visibly improved the quality of credit portfolios. For example, in the Czech Republic the ratio of non-performing loans (NLP) to total loans decreased from around 13% in 2001 to 4.3% in 2005, and in Slovakia from almost 25% to 5.5%. Banking supervision has also improved significantly. Yet, the low ratios of NLP today are no guarantee of low levels in the future, and credit quality may be deteriorating. Besides, less sound banks are equally engaged in lending and may be taking even higher risks. Moreover, there is no guarantee that parent banks of foreign owned banks would come to the rescue in case of trouble.

The sharp increase in domestic demand, especially household consumption, has spurred real GDP growth in the region since 2000, but also contributed to the emergence of large macroeconomic imbalances in some countries. Output growth has been particularly rapid in the Baltic countries at around 10% in 2000-2005. In these countries, strong inflationary pressures have raised concern about overheating. The domestic demand boom has led to a surge in imports and large current account deficits, especially in the Baltic and SEE countries. External debt levels have increased sharply in some countries, with the external debt-to-GDP ratio in Estonia and Latvia reaching about 80% of GDP in 2005. Most countries have not taken adequate advantage of the strong growth to consolidate public finances and have been running pro-cyclical fiscal policies.

Bank Credit to the Private Sector
(% of GDR, 1995/2001/2005)



Source: national Central Banks; World Development Indicators for 1995.

Thus, while credit expansion to a significant extent reflects a normal catching-up process by previously underdeveloped financial systems and credit to the private sector as a share of GDP remains in line with per capita incomes in the region, some countries, in particular the Baltic and the SEE countries, have witnessed a true credit boom that has contributed to surging consumption and the overheating of their economies. Slovenia, which joined the eurozone in January 2007, probably enjoys the best protection against any potential financial distress.

International experience suggests that prolonged, rapid credit growth coupled with macroeconomic imbalances can easily deteriorate into financial distress. Many countries have been concerned about excessive credit growth and have taken measures to control this. However, their effectiveness is unclear as credit continued growing rapidly and macroeconomic imbalances remained large.

Policy Advice

A proactive policy response is needed ranging from enhanced supervision and possibly regulation to more hard-hitting measures, including tightening of monetary policy (where possible) and fiscal policies aimed at discouraging household borrowing and stimulating private savings. Authorities should also prepare themselves for the unlikely, but not impossible scenario of a financial distress, and put in place adequate contingency plans. Given the lessons learned from previous experience, it is clear that prudence should dominate the "growth versus imbalance" policy dilemma that many of the NMS face today.

Source: World Bank EU8+2 Regular Economic Report, January 2007, www.worldbank.org/eu8-report. The report covers the NMS in Central and Eastern Europe. **BT**