69th East Jour Fixe[1]
Credit to the Private Sector: Threat to or Opportunity for Growth in CESEE?

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The 69th East Jour Fixe hosted by the OeNB on June 20, 2011, dealt with the development of credit to the private sector in CESEE countries from a macroeconomic perspective. While credit dynamics in the CESEE region have been explored in depth from a financial stability perspective, the interlinkages between credit and macroeconomic variables like GDP growth or private consumption have received comparatively little attention as yet. To fill this void, the 69th East Jour Fixe provided a platform for stocktaking and for assessing the implications of future credit growth in the CESEE region.

The keynote session was chaired by *Peter Mooslechner,* Director of the OeNB's Economic Analysis and Research Department. In his opening statement he underlined the importance of the credit-growth nexus in the CESEE countries yet questioned whether credit levels had indeed been in line with fundamentals before the recent financial and economic crisis. He pointed out the need to consider the implications that the private sector's elevated debt levels might have for economic recovery in general, and for private consumption and investment in the region in particular. Accordingly, the aim of the OeNB's 69th East Jour Fixe was to draw lessons from the latest credit boom episode, with a view to getting a better handle on credit dynamics in boom periods and on the real-time assessment of sustainable credit growth.

In the first keynote address, *Martin Brown,* Professor at the University of St. Gallen, contrasted the microeconomic and the macroeconomic perspectives of private-sector credit growth in the countries of Central and Eastern Europe. He shared insights into the debt overhang existing in the corporate sector as derived from the Business Environment and Enterprise Performance Survey (BEEPS). While according to BEEPS data, the credit-to-GDP ratio of the private sector increased by 29 percentage points prior to the crisis (2003 to 2008) and foreign currency-denominated credit accounted for as much as 48% of outstanding credit in 2007, the share of firms, large ones in particular, that relied above all on bank credit to finance their investment projects was fairly small. Moreover, the results revealed that the crisis-related contraction of GDP and export growth, especially in certain CESEE countries (e.g. Baltic countries), was highly correlated with excess corporate leverage. Hence, the debt overhang in the corporate sector might be of increasing relevance for financial stability especially in the tradable sector. Moving on to the debt overhang threat in the household sector, Brown presented recent results based on the EBRD's latest Life in Transition Survey. According to this survey, the debt overhang appears to be less of a threat in the household sector than in the corporate sector, as only a small share of CESEE households have mortgages and only a small share thereof is denominated in foreign currency. Furthermore, financial constraints appear to have had a negligible impact in the crisis on the household sector relative to income shocks.

[1] *The presentations and the workshop program are available at http://ceec.oenb.at (Events).*

In the second keynote lecture, *Märten Ross,* Deputy Governor of Eesti Pank, voiced concerns about the ability of policymakers to detect credit booms in real time and about the effectiveness of policy measures in mitigating the boom. Real-time data for Estonia before the crisis, for instance, provided little guidance as to whether double-digit quarterly credit growth rates were contributing to an overheating of the economy rather than being a natural phenomenon of financial deepening. Accordingly, Ross advocates a policy of keeping actual figures in good times consistently below the levels that would be considered optimal. Most importantly, credit should grow in line with the strength of the financial sector. Ross also stressed that policy measures to contain credit growth are likely to have limited effectiveness, especially when the banking system consists almost exclusively of foreign-owned banks, as is the case in Estonia. For instance, following the launch of several administrative measures by Eesti Pank in 2006 to rein in credit growth, the credit and asset price cycle did indeed turn in early 2007, but it is difficult to disentangle the combination of underlying reasons. At any rate, these measures contributed to financial stability in the course of the crisis. At the same time, the crisis also revealed the importance of having prudent policies and safeguards in place both in home and in host countries. Finally, Ross sees the broadening of the EU supervisory framework as a positive development in this respect, subject to the caveat that more players are involved in the decision-making process and that some important issues are still left to the host countries (e.g. burden sharing).

In the ensuing discussion it was argued that Brown's micro-based findings (especially for households) imply less severe an impact than expected from a macro perspective, which in turn raised the question whether the macro models had overestimated the threat for the financial sector. Brown countered that the financial stability threat had to be seen separately from the debt overhang, explaining that what the models had overestimated was the real impact of the debt overhang. Regarding the debt overhang in the corporate tradable sector, Ross elaborated that this was not really an issue as long as foreign parent banks continued to provide liquidity (as Swedish banks did in Estonia).

Credit Developments in CESEE: Where Do We Stand and What Do We Know?

The first session of the workshop, chaired by *Peter Backé,* Deputy Head of the Foreign Research Division at the OeNB, was devoted to stocktaking, exploring inter alia how current credit-to-GDP ratios relate to fundamentals and how deleveraging may affect macroeconomic dynamics. *Aleksandra Zdzienicka,* researcher at CEPII (Centre d'études prospectives et d'informations internationals), opened the session by elaborating on the issue whether credit growth has been excessive in the CESEE region and has increased the risk of a debt overhang. Zdzienicka used an unbalanced panel data set of 13 CESEE countries to assess the impact of a credit expansion on economic growth as well as to shed light on recent developments in banking credit in CESEE. Her main results underline that the causal relation runs from credit to economic growth and that excessive credit growth has a detrimental impact on growth. Her assessment yielded the result that Estonia, Bulgaria and Hungary might face debt overhang problems. With a view to mitigating the risks of a debt overhang, Zdzienicka underlined the need for prudential regulation and

supervisory measures during episodes of rapid credit growth and stressed the importance of an effective regulatory response to growing private-sector indebtedness (bankruptcy, debt reliefs, bailouts).

Mariya Hake, economist at the OeNB, reported on a meta-analysis testing the robustness of seven macroeconomic determinants of foreign currency borrowing in the private sector in CESEE countries, namely interest rate differentials, inflation and exchange rate levels and volatilities, deposits in foreign currency and the ratio of inflation volatility and real exchange rate volatility (minimum variance portfolio). Given the increasing number of studies with controversial results, the meta-analysis approach aims at estimating the study-independent unbiased impact of the seven determinants accounting for between-study differences related to data definition and structure, estimation method as well as control variables. The meta-analysis found the coefficients for all determinants of foreign currency borrowing to have been influenced by the features of the studies. In several estimations, Hake and her coauthors identified strong support for the robustness of the negative impact of exchange rate volatility and the positive impact of the minimum variance portfolio as well as of foreign currency deposits. Only weak evidence was found for common determinants such as the interest rate differential and inflation volatility. From a policy perspective these results stress the importance of macroeconomic stability for the future development of foreign currency lending in the CESEE region, although country-specific differences must of course be taken into consideration.

Naotaka Sugawara, economist at the World Bank, addressed the impact of adverse shocks on the capability of households with mortgage loans to fulfill their financial liabilities in a timely manner (i.e. household stress-testing). In particular, he referred to a World Bank project that had investigated the impact of macroeconomic risks on the vulnerability of the household sector in the CESEE and CIS regions given two distinct types of shocks: exchange rate depreciation and an increase in (foreign as well as domestic) interest rates. The size of the shock was defined as the largest depreciation of the local currency and the largest increase in interest rates observed during the period from January 2007 to December 2009, respectively. Households were considered to be "vulnerable" if their debt service-to-income ratios exceeded 30% or if they were servicing their debt with negative household income. The stress test results indicate that, on average, the share of vulnerable households more than doubled from 7% to 16% during the crisis – an increase that was, however, rather marginal from the perspective of the whole economy. In Estonia, for instance, where 30% of all households are indebted, the simulations showed the share of vulnerable households to increase from 4% to 8%. Proportionately, the social classes affected most by shocks (e.g. rising interest rates and falling currencies) are middle- to upper-income families, which weakens the social case for government intervention. Finally, though stress-testing is a useful tool for assessing the risks facing the private sectors of the CIS and CESEE regions, further analysis would benefit from the incorporation of more country-specific information and possible countermeasures (e.g. selling durables).

Questions raised addressed the weak significance of the interest rate differential for borrowing in foreign currency. Hake argued that a possible explanation could be that the macroeconomic fundamentals driving the increase of the interest rate differential appear to be more robust determinants of foreign currency lending than the interest rate differential itself.

The Way Forward: Creditless Recoveries, a Revival of Credit Growth or Subdued Economic Performance Due to Insufficient Credit Supply?

The second session, chaired by *Doris Ritzberger-Grünwald,* Head of the OeNB's Foreign Research Division, was devoted to the possible scenarios for CESEE countries after the crisis. The first presenter, *Fabrizio Coricelli,* Professor at the Université Paris 1 (Paris School of Economics) and CEPR, investigated the topic how credit conditions shape economic recoveries. The nature of the recovery is linked to the nature of the output decline. Severe crises are often associated with sudden stops of credit flows. In the short run, the availability of alternative sources of financing such as trade credit, the reallocation of production to less credit-dependent sectors, or the take-up of unutilized capacity may enable the economy to grow despite the creditless character of the recovery. In the long run, the restoration of credit flows is crucial, in particular when investment has fallen sharply during the recession. Among the EU Member States, the Baltic countries and Hungary experienced a sudden stop in net capital inflows, which has been slowing down the incipient economic recovery and hence reduced long-run growth perspectives. Which prompts the question: will credit flows return? The special feature of the unconditional income convergence miracle of EU integration was based on rapid trade and financial integration through dominant foreign ownership of banks and large cross-border capital flows. As long as the banking system in the core countries remains weak and endangered by the sovereign debt crisis, respectively, less capital will flow to the CESEE countries. Furthermore, even if capital flows do pick up again, sustainable long-term growth can only be achieved when the issue of vulnerability that comes by and large from the lack of restraint on risk-taking and moral hazard by euro area financial institutions will be addressed properly through efficient coordination in regulation and the presence of a supranational lender of last resort.

Abdul de Guia Abiad, International Monetary Fund, discussed the nature of creditless recoveries in general. On average one in five recoveries can be qualified as creditless either because credit is not available or because credit is not needed. The relative frequency of creditless recoveries increases significantly in the aftermath of banking crises and credit boom-busts for instance associated with real construction investment booms. Episodes of creditless recoveries are characterized by slower growth and more protracted recovery due to significantly lower investment activity and private consumption and a decline in total factor productivity. Finally, sectoral analysis suggests that creditless recoveries tend to be credit supply-driven rather than demand-driven, i.e. they reflect impaired financial intermediation.

The global financial and economic crisis had a relatively strong impact on CESEE countries, as their preceding economic expansion had been financed by relying heavily on cross-border capital flows. With the macroeconomic adjustment process coming to an end, *Martin Bijsterbosch,* European Central Bank, investigated how the post-crisis recovery phase could look like and what the role of credit could be in such a recovery. Results from estimated panel probit models suggest that creditless recoveries are typically preceded by large declines in economic activity and financial stress, in particular if private-sector indebtedness is high and the country relies on foreign capital inflows. The predicted probability of a creditless recovery during the coming years is relatively high in the Baltic

states, where credit growth has been subdued due to a combination of supply and demand factors. Loan-to-deposit ratios still signal some need for deleveraging for the banking sector, which probably supresses credit growth. Capacity utilization rates are still below precrisis peaks, although aggregate demand pressures may be higher than capacity utilization rates suggest. As a near-term challenge, Bijsterbosch identified the fact that subdued lending may not only dampen output growth but also endanger structural change, which needs to be financed as well. In the medium term, capital flows will return if the right policies are pursued – together with the risk of a renewed lending boom and the risk of a re-emergence of macroeconomic imbalances.

The ensuing discussion centered on the question whether creditless recoveries are a blessing or a curse. Coricelli and Abiad stressed that as long as core European banks are financially distressed, impaired intermediation will hinder the efficient reallocation of credit from less productive to more productive sectors, with potentially harmful consequences for CESEE economies. The introduction of new regulations and higher capital requirements for banks may put an additional drag on investment and consumption. Furthermore, in countries which have built up large current account deficits in the precrisis period, firms and households might find access to credit particularly difficult. Nevertheless, a return to the unsustainable precrisis episodes of double-digit current account deficits is equally undesirable.