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The collateral effects of political integration on credit growth in the new member states of the EU

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ABSTRACT

Since 2009, low interest rates have been associated with increases in credit growth and overheating pressure in many emerging markets. In the new member states (NMS) of the European Union (EU), however, domestic lending contracted along with a shrinkage in cross-border financial inflows. In this paper, I investigate whether political integration with the EU has strengthened the relation between domestic credit growth and international financial inflows in the NMS in comparison to other emerging markets. Taking into account the period 2008–2014 and the boom period in the run-up to the 2008 crisis, I provide empirical evidence that domestic lending in both periods is more responsive to changes in cross-border bank lending if a country is a member of the EU. The paper's finding lends support to studies suggesting that political integration has collateral effects on emerging markets via financial integration.

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1. Introduction

The collapse of Lehman Brothers in 2008 and the following global financial crisis depressed markets around the world. To stabilize the financial markets and fight the so-called Great Recession, the world's major central banks opted to cut interest rates toward zero and implement unconventional policies such as large-scale bond-buying programs. The central banks in most emerging markets followed the monetary policy of the advanced economies.

It is debatable to which extent the low interest rate policies helped stimulate lending in the advanced economies, as the link between monetary expansion and domestic credit creation via the portfolio re-balancing channel seems broken due to prevailing risks in the domestic and global economies (see, e.g., Orlowski, 2015). However, the fall in interest rates was accompanied by an increase in financial inflows and a pick-up in investments and growth in many emerging markets. The corresponding rise in credit growth and inflation has become a major concern for policymakers in a number of emerging and developing countries in Latin America and East Asia (e.g. Borio et al., 2011; Reinhart, 2013; Hoffmann and Loeffler, 2014). In the new member states of the European Union (NMS),[1] however, domestic credit to the private sector decreased widely from 2008 to 2014.

This paper suggests that *political integration* with the EU has strengthened the link between international financial inflows and domestic credit growth in the NMS relative to other emerging market countries. Building on Lane and McQuade's (2014) empirical model, I provide empirical evidence that domestic lending is more responsive to changes in cross-border

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[1] In this study, I refer to Bulgaria, Estonia, Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and the Slovak Republic as NMS.

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bank lending if a country is a member of the EU. Given the stark decline in cross-border financing in the NMS since 2009, political integration with the EU explains much of the recent contraction in domestic lending in these countries.

In the 2000s, EU accession provided hope for institutional reforms and macroeconomic convergence. Previous research therefore found that *political integration* with the EU created financial benefits for emerging Europe. For instance, Hauner et al. (2007) and Luengnaruemitchai and Schadler (2007) show that government bond yields dropped significantly when EU membership was decided in the NMS. In line with this, Ebner (2009) suggests that investors were willing to hold lower-yielding NMS bonds even when the current fundamentals would have justified a higher bond premium. Friedrich et al. (2013) provide evidence that current account deficits (which reflect international capital inflows) were not associated with substantial growth over a longer period (until 2008) in any region apart from emerging Europe.[2]

Taking into account the post-2008 period as well as the 2002–2008 boom period, I further show that the strong link between cross-border financial flows and domestic credit growth in the NMS of the EU is not just a side-effect of the ongoing European crisis. In fact, also in the run-up to the crisis, a rise in cross-border lending translated into more rapid domestic lending if the country was a member of the EU. Therefore, I argue that political integration with the EU strengthened, for good or ill, financial linkages between the EU and the NMS.

This paper is related to the growing literature on the link between international capital flows and domestic credit growth. For instance, Mendoza and Terrones (2012) show that large international capital inflows (current account deficits) can help explain episodes of rapid credit growth. Recent research has focused particularly on the type of capital inflows associated with domestic credit growth, suggesting that rises in cross-border bank flows rather than equity flows tend to increase domestic lending (e.g. Calderón and Kubota, 2012; Borio and Disyatat, 2011). For the EU, Lane and McQuade (2014) provide evidence that increases in cross-border bank inflows contributed to domestic credit growth until 2008.

However, the link between international debt inflows and credit growth is not obvious and may differ between countries. If domestic banks finance domestic credit to the private sector mainly domestically, e.g. via deposits, changes in international financial inflows may not result in credit growth. In contrast, if banks finance domestic credit mainly via loans or deposits from global banks, we would expect a closer dependence of domestic credit growth on cross-border financial inflows.[3] This paper finds that political integration can influence the dependence of domestic credit growth on external financing.

In particular, this paper suggests that in the 2000s, when European financial markets seemed sound, EU accession and the adoption of EU rules provided additional credibility to the convergence process[4] of the NMS, shrinking political and sovereign risks. This led to increased financial integration with the euro area, mounting cross-border financing of banks, and enhanced domestic lending in the NMS until the 2008 financial crisis. The dependence of domestic credit growth on foreign funding increased in the NMS of the EU relative to that in other emerging market countries. However, since 2009 the problems in the euro area and its shaky financial system pulled the NMS into the maelstrom of crisis. My findings therefore imply that for the NMS of the EU the collateral effects of political integration with the EU via financial integration very much depend on the time period under consideration and the expectations stemming from the EU's political and economic institutions.

2. EU membership and the link between cross-border financial flows and domestic credit growth: a graphical assessment

In order to analyze whether the strength of the link between cross-border bank flows and domestic credit growth differs if a country is a member of the EU, I evaluate data for 89 emerging and developing countries. The full country list is presented in Appendix A. The countries were selected based on the World Bank categories "emerging market" and "developing country", while domestic credit data were taken from the World Development Indicators (WDI).

I begin with a graphical assessment of the link between cross-border bank flows and credit growth. Fig. 1 plots the rise in domestic credit to the private sector as a percentage of GDP for each region of emerging markets since 2008. "NMS" means new member states of the EU.

Domestic credit to the private sector has declined by more than 15 percent since 2008. In contrast, in Eastern Europe and Central Asia (ECA), Eastern and Southeastern Asia (ASIA), South America (SA), Central America and the Caribbean (CAC) and Sub-Saharan Africa (SSA), domestic credit to the private sector as a percent of GDP grew by several percentage points in the same period. The South American and the Eastern and Southeastern Asian countries stick out with particularly high rates of credit growth. In the Middle East and North Africa (MENA), we see smaller changes in average credit growth.

[2] Collateral effects of political integration are not exclusive to the NMS and have also been analyzed for other regions and time periods. For instance, Ferguson and Schularick (2006) provide evidence that members of the British Empire were preferred by investors, as such membership signaled institutional quality. These countries attracted larger financial inflows, particularly from Britain, which allowed governments to borrow at lower cost. Mitchener and Weidenmier (2008) find an "Empire effect" on trade between Empire countries. Moreover, numerous studies on "currency union effects" suggest that bailout expectations, to take one example, increase inter-country linkages.

[3] Note that there is an extensive literature that analyzes the role of, e.g., foreign banks on cross-border banking as well as credit growth in general (e.g. Adams-Kane et al., 2013; Peek and Rosengren, 1997) as well as in the NMS of the EU (e.g. Vogel and Winkler, 2012; De Haas, 2014). However, none of these studies analyze whether there are differences in the link between international capital flows and domestic credit growth between different emerging market country groups and whether this difference may be attributed to political integration.

[4] Such institutions did not only include the EU financial regulatory and supervisory system (Čihák and Fonteyne, 2009) and market reforms, but also prescriptions for a rather cautious fiscal policy.

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