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Measures to tame credit growth: Are they effective?

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ABSTRACT

This paper focuses on policy measures taken to curb bank credit growth in the private sector in the pre-crisis period 2003–2007. Our analysis is based on an original survey conducted in 2010 on eleven central banks in Central and Eastern Europe (CEE). The findings reveal substantial policy intervention: a total of 82 measures were implemented in CEE during the period considered. The paper presents a panel data analysis of the effectiveness of the policy measures adopted in the region. The overall results indicate that certain measures – particularly asset classification and provisioning rules and loan eligibility criteria – might have been effective in taming bank credit growth, especially if applied in the context of more general policy measures featuring a combination of various instruments. However, in countries in which the authorities managed to somewhat decrease the flows of bank credit into the economy, the measures were often circumvented via direct, cross-border credit from foreign banks and credit provided by domestic, non-bank financial companies.

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1. Introduction

Credit growth is an inherently beneficial process. Its revival is often regarded as a sign of a healthy banking system and confidence in the economy. In the case of emerging markets, credit growth is also associated with financial deepening. For illustration, in 2003, none of the economies in Central and

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Eastern Europe (CEE)[1] exceeded a 50% private credit to GDP threshold (ranging from 13.7% in Romania to 49.2% in Croatia). Despite these initially low levels, credit development in the 2003–2007 period underwent turbulent changes that affected the borrowing of both households and firms. In CEE, credit growth was also associated with catching up to the Western economies. During the 2003–2007 period, private credit growth in CEE on average increased three times more rapidly than in the euro area, reaching its highest pace in mid-2006.

Despite the benefits of financial deepening, excessive credit growth increases imbalances and can amplify the vulnerabilities of a financial system. Credit development over the period 2003–2007 raised concerns among both policymakers and academics that it was excessive, unsustainable and potentially creating over-heating pressures on the economy (Backé et al., 2007; Duenwald et al., 2005; Enoch and Ötker-Robe, 2007; Kraft and Jankov, 2005; Popa, 2007; Zumer et al., 2009). As a result, a number of countries attempted to either inhibit these credit booms or limit specific aspects of the credit expansion that posed risks to the system, such as foreign currency denominated loans.

This paper tracks the experiences of eleven CEE economies in their transition from credit growth to a credit crunch (2003–2007). In particular, it closely examines the policy measures introduced by central banks to alleviate the adverse effects of credit growth.

The key contribution of our paper is twofold. First, we present a detailed dataset on all relevant policy measures applied across the CEE region over the period 2003–2007 to slow private sector credit growth. The dataset is not based on any aggregate database but was created in collaboration with all eleven Central and Eastern European central banks. Thus, using our direct survey, we exclusively consider the responses that the central banks categorized as "measures to cope with credit growth". In total, we record 82 policy interventions implemented over six years in eleven CEE countries, covering a wide range of instruments from monetary to administrative or macroprudential policies. We believe that the description of such a dataset is a valuable input for better understanding the development of both private credit and the ensuing policy response.

Second, given the global call to develop theoretical insights on the role of macroprudential policies, our aim is to contribute to the discussion by presenting an analysis of such policies' effectiveness in CEE economies prior to the credit crunch. We assess their effectiveness by combining our survey results and macroeconomic data (GDP growth, lending rate and exchange rate volatility). As the reactions of CEE countries to the credit crunch differed in scale and scope, we analyze the "treatment effect" of specific policy tools in comparison to other economies and periods as controls in the panel data framework. Our results demonstrate that certain instruments, primarily asset classification and provisioning rules and loan eligibility criteria, might have been effective in taming bank credit growth, especially if applied in the context of a more general policy that featured a combination of various instruments. However, none of the policy tools seem to perform well over longer periods. In countries in which the authorities managed to somewhat decrease the flows of bank credit into the economy, the measures were often circumvented via direct, cross-border credit from foreign banks and credit provided by domestic, non-bank financial companies.

This paper was originally influenced by an important contribution by Hilbers et al. (2005), which, in addition to analyzing the theoretical and practical advantages and disadvantages of each policy instrument, also presented a complete dataset of policy measures implemented by a broad group of Central and Eastern European countries prior to mid-2005. In this spirit, our paper collects data throughout the most vibrant period of policy intervention until end-2008.

Furthermore, the paper will also contribute to the emerging stream of literature on the effectiveness of macroprudential policies, most notably Dell'ariccia et al. (2012), Lim et al. (2011) and Vandenbussche et al. (2012), who provide econometric evidence of the effectiveness of various tools in CEE countries.

The paper is structured as follows: Section 2 introduces stylized facts regarding credit development in CEE and a literature review of credit booms and policy responses. Section 3 examines the menu of policy measures policymakers may implement to counter a credit boom in greater detail. Section 4 presents the results of a survey of central banks in the CEE region and discusses the most popular

[1] The group of CEE countries considered in this paper consists of Bulgaria, the Czech Republic, Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

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