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Journal of Banking & Finance 29 (2005) 83–104
Journal of BANKING & FINANCE
www.elsevier.com/locate/econbase

Early birds, late risers, and sleeping beauties: Bank credit growth to the private sector in Central and Eastern Europe and in the Balkans

Carlo Cottarelli *, Giovanni Dell'Ariccia, Ivanna Vladkova-Hollar

Department of Monetary and Financial Systems, IMF, 700 19th Street, NW, Washington, DC #20431, USA

Available online 12 September 2004

Abstract

Following a period of privatization and restructuring, commercial banks in Central and Eastern Europe and, more recently, in the Balkans have expanded rapidly their lending to the private sector. This paper studies whether these developments are consistent with a process of convergence and structural financial deepening by estimating an ''equilibrium'' level of the bank-credit-to-GDP ratio. It concluded that while there is no clear evidence that the recent increases in bank credit ratios is inconsistent with financial deepening, policy-makers will have to evaluate carefully its implications for macroeconomic developments and financial stability.

JEL classification: E44; G21
Keywords: Credit booms; Financial development; Transition economies

* Corresponding author.
E-mail addresses: ccottarelli@imf.org (C. Cottarelli), gdellariccia@imf.org (G. Dell'Ariccia), ivladkovahollar@imf.org (I. Vladkova-Hollar).

0378-4266/$ - see front matter © 2004 Published by Elsevier B.V.
doi:10.1016/j.jbankfin.2004.06.017

1. Introduction

Since the second half of the 1990s, several countries in Central–Eastern Europe and the Balkans (CEB countries) have experienced sizable increases in domestic bank credit. For example, the cumulative growth of bank credit to the private sector (BCPS) in real terms in Bulgaria, Estonia, and Latvia was, respectively, 315%, 121%, and 304% during 1998–2002. While these rates are inflated by the initially low levels of credit stocks, the BCPS-to-GDP ratio (BCPS ratio) also increased fast (by 11%, 22%, and 17% points for the same three countries and period). More recently, BCPS has accelerated also in some Balkan countries where the transition process is less advanced. In 2002 BCPS in real terms rose by over 50% in Bosnia and Herzegovina (BH), and by 23% in Serbia and Montenegro (SM). [1]

These developments have raised the question of whether the fast pace of credit growth reflects a structural financial deepening that will benefit the real economy, or if instead, it represents a bubble-like credit boom detrimental to loan quality and banking system stability. [2] Indeed, although in this region credit growth has not yet reached the pre-crisis excesses of some Asian countries, and in any case has not yet led to major macroeconomic imbalances, several observers have expressed concern for the effect that it may have for macroeconomic developments and financial stability. [3]

This question is important from a policy perspective and is essentially an empirical one. This paper tries to tackle it by estimating a model of the BCPS ratio based on a panel of non-transition developing and industrialized countries, and using its coefficients to evaluate the "equilibrium" level of the BCPS ratio for CEB countries. The idea is to compare the actual level of the BCPS ratio in the latter with what would be a "normal" level as assessed based on the experience of countries with similar fundamentals. In addition, the paper presents a few stylized facts to compare the growth rates of credit in CEB countries with those experienced by countries that eventually suffered from financial crises. In that context, the paper also examines the evolution of credit growth in each country by comparing the current rate with its structural component estimated by a non-linear trend.

[1] A more detailed description of banking system developments in CEB countries can be found in Cottarelli et al. (2003).

[2] The view that well-functioning financial markets can play a critical role in supporting growth has recently been revived by a number of studies (see, for example, Rajan and Zingales (1998), Beck et al. (2000), and Levine et al. (2000)). At the same time, a growing literature has also documented that fast credit growth is often associated with episodes of financial distress (see for example, Goldfajn and Valdés (1997), Drees and Pazarbaşioğlu (1998), Demirgüç-Kunt and Detragiache (1997), Kaminsky and Reinhart (1999), and Gourinchas et al. (1999)).

[3] For example, the Board of Directors of the IMF has cautioned CEB countries against the risks associated with a too rapid growth in private sector credit, and called for increased bank supervisory attention (see, for example, the Public Information Notices, available on the IMF website, relative to the 2001 Article IV Consultation with Latvia, the 2002 Article IV Consultations with Bulgaria and Croatia, and the 2003 Article IV Consultations with Estonia and Hungary).