Lucas Papademos: Financial structures, credit growth and house prices in the new EU Member States - policy challenges on the road to the euro

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the Conference held by Latvijas Banka, Riga, 19 September 2005.

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I. Introduction

It is a great pleasure for me to speak at this conference organised by Latvijas Banka, in a country that has played such an important role as a major trading centre in European history. Initially, that role partly reflected its geographic location on one of the oldest trading routes in Europe – the so-called "Route from the Vikings to the Greeks", which was used to trade, among other things, Latvian amber – a route dating back to the times of the Ancient Greeks and the Roman Empire. And then later, the city where we have gathered today, Riga, became one of the most significant members of the Hanseatic League, which controlled trade on the bustling Baltic Sea in the 14th and 15th centuries. Today, Latvia has a modern and dynamic economy, again occupying an important position in European trade, having achieved a remarkable transition towards a successful market economy after gaining independence in 1991.

Trade and finance have always gone hand in hand. Therefore, it is no surprise that just as the Latvian economy has undergone an impressive transformation, so too has the Latvian financial system. Latvia has made substantial progress in the development of its financial structure and has created the institutional and legal frameworks necessary to support a market-oriented financial system.[1] Today, its financial markets are developing rapidly in new directions and are providing valuable services to both households and the corporate sector, underpinning the functioning of a modern high-growth economy.

As I am addressing a distinguished audience with expert knowledge of the Latvian economy, I consider it appropriate to take a broader and more comprehensive view, and look at the development of the financial sector not only in Latvia, but in the new EU Member States as a whole. After an overview of certain salient features characterising the financial structures of these countries, I will concentrate on two issues that have recently received considerable attention from both policy-makers and the media: strong credit growth and rapidly rising house prices. This will bring me to the focal point of my remarks: the challenges arising from these developments and the appropriate policy responses.

II. Features of the financial structures in the new Member States

Many of you have witnessed at first hand the remarkable transformation of the economies and financial systems of the new Member States in Central and Eastern Europe over the past decade. The convergence of the financial structures of these economies with those of Western Europe has also been significant. The modernisation of a country's financial structure – that is, of the whole set of financial markets, instruments and institutions – is of crucial importance for actual and potential economic growth, and has received a lot of

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[1] See European Central Bank, "Financial Sectors in EU Accession Countries", July 2002.

attention from both academics and policy-makers.[2] Financial structures differ from country to country, reflecting the influence of various factors and of different traditions; but those structures also change over time as the processes of economic development and financial integration evolve. Looking at the financial structures of the new EU Member States today, five key characteristics are apparent.

First, the overall degree of financial depth in the Central and Eastern European countries is still lower than in the euro area. This applies in particular to financial intermediation by banks and to the household sector. For example, bank financing represents a much smaller share of GDP than in the euro area.[3] It may be argued that if the low degree of financial intermediation persists, this could impede the efficient channelling of savings to investment, and that further financial reforms would therefore be needed.

Second, the capital markets in these countries remain relatively underdeveloped. As a result, the issuance of quoted equity and debt securities by non-financial corporations in order to finance their investments and operations is not as important as in the euro area. This may come as a surprise, given that the stock markets in the new EU Member States have experienced very strong and, indeed, accelerating growth over the past few years. The average annual returns on equity in most of these countries have outperformed significantly those of the stock markets in the euro area. On the one hand, the substantial increases in equity prices in the new Member States may have reflected a rise in the fundamental values of the shares. On the other hand, this development may also reflect supply constraints: the limited issuance of new equity by firms and the relatively small number of companies listed. For example, the share of the five biggest listed companies in total market capitalisation and turnover is very high in most of the new EU Member States. Thus, since liquidity in these markets is relatively low, price movements in a small number of companies might influence to a relatively large extent the overall price level of the stock market.

Overall, financing through banks remains the dominant form of intermediation and a key feature of the financial structure in the majority of the new Member States. That said, equity financing has grown steadily over the past few years, even though the amount of corporate funds raised through capital markets remains rather limited. Furthermore, financial account data, which have been collected and compiled by the ECB in close collaboration with the new Member States, indicate that, in terms of amounts outstanding, shares and other equity are an important source of financing for non-financial corporations, mainly owing to the large contribution of non-quoted equity. This form of equity financing, for example family capital invested in small companies, also contributes to the large share of equity financing of euro area non-financial corporations.[4] For the six new Member States for which data on unquoted equity is available, its share in total equity financing is 80% or more.

Third, in the new EU Member States we observe a significant degree of foreign involvement in the financial sector in terms of ownership, financing and investment. This is particularly visible in the banking sector, which is predominantly under foreign ownership in practically all of those countries. But it also extends beyond that. For example, a substantial share of

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[2] See, for example, B. Amable and J.-B. Chatelain, "Can Financial Infrastructures Foster Economic Development?", Journal of Development Economics, 64(2), April 2001, pp. 481-498; J. Bonin and P. Wachtel, "Financial Sector Development in Transition Economies: Lessons from the First Decade", Financial Markets, Institutions & Instruments, 12(1), February 2003, pp. 1-66; and L. Ndikumana, "Financial Development, Financial Structure, and Domestic Investment", Journal of International Money and Finance, 24(2), June 2005, pp. 651-673.

[3] With the exception of Cyprus and Malta, which are in this respect somewhat more comparable with the euro area.

[4] ECB Monthly Bulletin, "Characteristics of corporate finance in the euro area", February 2001, pp. 37-50.

government and enterprise financing comes from abroad and many major firms are listed on stock exchanges outside these countries.

Fourth, most new EU Member States have experienced significant consolidation in the number of financial institutions, particularly banks. This process has contributed to the soundness and stability of these countries' banking sectors. Consolidation has also affected stock markets. For example, the three Baltic stock markets recently merged with the Scandinavian OMX markets and use a common trading platform.

Finally, it is clear that in several new Member States, further improvements in the legal frameworks and market infrastructures may be needed in order to establish more transparent and efficient financial markets. This also applies to the greater transparency of counterparties in financial transactions, which would undoubtedly promote the further integration of these countries' financial markets with those in the euro area.

From this overview, it is evident that, despite the significant progress made in previous years, the convergence process of the financial structures of the new EU Member States with those of the euro area is not yet complete. I will come back to this issue – and how we see the road ahead for the new Member States – later. At this stage, allow me to address two issues that are very topical for both the Latvian economy and several other new Member States: strong credit growth and rapidly rising house prices.

III. Credit growth

Let me start, on the question of credit markets, by pointing to three characteristic facts. First, dynamic credit growth to the private sector can be observed in a number of the new EU Member States, well above the average rate in the euro area. The growth of credit to the private sector has been especially strong in the Baltic countries and Hungary, where it has reached annual rates of between 30% and 50% in recent years. In other countries, such as the Czech Republic and Slovakia, the rate of credit growth to the private sector has been more moderate, but has picked up recently, while in Poland it has slowed down considerably, following peaks reached around the turn of the decade. Second, credit-to-GDP ratios in Central and Eastern European countries still remain well below the euro area level. Third, credit expansion has, in most of these countries, been financed by both domestic and external sources. In the early stages of credit expansion, a rise in domestic savings, partly reflecting increased confidence in banking systems and the overall financial deepening of these economies, was a particularly important source of banks' financing. Subsequently, as interest rates have declined and the propensity to consume has increased, banks have progressively relied more on external sources.

Looking at the sectoral breakdown of credit growth, it is fairly clear that the main driver of credit dynamics has been loans to households – largely in the form of mortgage lending. Intense competition in this market segment has encouraged banks to substantially expand their lending to households. By contrast, bank credit growth to the corporate sector has lagged behind. This can be partly explained by the fact that an important share of investment by the non-financial corporate sector has been financed by retained earnings and foreign capital, including credit from banks in other countries and foreign direct investment.

Another striking – and potentially worrying – feature of credit growth in some of the new Member States is the high share of foreign currency-denominated loans. These loans are mostly euro-denominated, although loans in other currencies have also been gaining in importance recently. They have typically been granted to non-financial corporations, though also to households in the Baltic countries and Poland. Borrowing in foreign currency has been driven by lower borrowing costs and stimulated by the financial liberalisation in some countries prior to EU entry. The majority of foreign currency loans are held by larger multinational firms, which generate the greater part of their revenues in foreign currency, and can therefore also be considered as a hedging instrument. In general, borrowing in foreign

currency has been more widespread in countries with fixed exchange rate regimes or exchange rate targets, particularly the Baltic countries. Nevertheless, the external net liability position of the banking sectors of most Central and Eastern European countries continues to be limited, with the exception of Estonia and Latvia, where the external net liability positions reached levels corresponding to 23% and 17% of GDP respectively at the end of 2004.

IV. House prices

As you are well aware from the Latvian experience, rapid credit growth has gone hand in hand with strong increases in house prices, especially in certain segments of the housing market, such as apartments in major cities. That said, the picture is quite diverse across countries, and it is difficult to discern general patterns. Some countries, including the Baltic countries, have experienced double-digit increases in house prices, whereas in others, for example the Czech Republic, house price developments have been more moderate. In general, however, house prices in many new Member States have risen more strongly in recent years than the average in the euro area, albeit admittedly from a much lower base. Moreover, housing construction is picking up throughout the region, reflecting buoyant housing demand. Of course, property prices have also increased at a fast pace over the past few years in several euro area countries, as well as in other countries around the world, notably the United States and the United Kingdom. So this phenomenon is not characteristic only of the new EU Member States.

When discussing trends in house prices, it is important to keep in mind a number of specific features of the housing markets of the new Member States. I am thinking in particular of the generally high – and still rising – degree of owner-occupancy or the fact that institutional arrangements associated with more developed housing markets, such as the legal framework, the easy transfer of property, the different types of available insurance, good valuation methods or alternative forms of mortgage finance, are still in a rather embryonic stage in some countries. This may explain why the volume of transactions relative to the total housing stock is still relatively limited in many new Member States. That said, it is a positive development that in several countries considerable efforts are being made to improve the institutional arrangements and the financial services on offer.

How can we explain the observed house price developments? Very favourable financing conditions and perceptions among households that house prices are likely to continue to rise in the future have contributed significantly to strong housing demand. The supply side of the housing market, as recently suggested by indicators such as building permits granted and the number of housing completions, has partly and gradually responded to the strong price signals. If the supply of new houses continues to increase, this will alleviate some pressure on the market and contribute to a moderation in house price increases.

V. Policy challenges

From this tour d'horizon of the salient features of financial structures and, in particular, of credit and housing markets, I see a number of pertinent policy questions arising: How should we assess the risks to financial stability that may be associated with these developments and market characteristics? What are the main challenges for policy-makers, that is, for governments, central banks and supervisory authorities? What are the issues to watch out for concerning the evolution of financial structures in the years to come? Let me provide some answers to these questions.

I shall start with the potential implications of rapid credit growth and strong increases in housing prices for financial stability in the new EU Member States. Strong credit expansion can be a cause for concern, not least because banking crises have often been preceded by episodes of excessive credit growth. This statement is supported by theoretical arguments and extensive empirical research. That said, I should stress that a banking crisis is not the

inevitable consequence of an episode of excessive credit expansion. However, a number of theoretical explanations have been put forward to elucidate why credit booms are associated with a higher probability of banking distress, notably the procyclicality of bank lending behaviour. Risks may be underestimated during the expansionary phase of the credit cycle, thereby resulting in a lowering of credit standards and of the average "quality" of borrowers. This may lead to higher credit losses when the next economic downturn occurs. Risks may also be underestimated as a consequence of the so-called "financial accelerator" mechanism, whereby over-optimism about future returns may boost asset valuations and thus firms' net worth, which then feeds back into higher investment and credit demand and a further increase in asset prices.

So much for the theory: what should be our concern in the specific circumstances of the new Member States? First, there is a danger that rapid credit expansion may strain banks' ability to monitor and assess risks properly. This is especially relevant for the new Member States, where banks' credit risk assessment is burdened by measurement difficulties in forecasting potential future credit losses, owing to the lack of sufficiently long credit histories. This problem may be even more pronounced in the case of market segments that were previously underserviced, such as households and small and medium-sized enterprises. Second, the relative importance of foreign currency lending for the domestic private sector in some countries may have increased the vulnerability of households and unhedged non-financial corporations to adverse exchange rate movements. Third, since mortgage loan contracts in several new Member States typically have floating interest rates, rising interest rates would have a negative impact on households' debt-servicing ability in those countries.

Furthermore, since mortgage lending has been the major growth area in most new Member States, the evolution of house prices – as mentioned before – is, of course, a relevant factor which requires careful monitoring. The upward trend in real estate prices can be expected to continue over the medium and longer term, partly as a result of the gradual convergence with price levels in the "old" EU Member States. However, it would be comforting to think that such a "natural" development would not result in excessive and unsustainable house price increases. In this respect, it would be useful to monitor the extent to which strong mortgage lending and house price increases may lead to mortgage equity withdrawals, which in turn may stimulate consumption even more and thus fuel further GDP and credit growth.

When assessing the balance of risks to financial stability, a number of mitigating factors should also be taken into account. To begin with, credit risk should be contained, because the ratio of the debt-servicing burden of firms and households relative to income is still considerably lower than in the euro area. Moreover, a favourable growth outlook and improving prospects for household disposable income which are associated with the catching-up process, and the current low interest rate environment, are likely to make it easier for private sector borrowers to service their debts. In addition, the improved profitability of banks in most new Member States has helped them to maintain a solid capital base, which should also improve their shock-absorbing capacity. Finally, the ratio of non-performing loans to total loans has, in most countries, decreased or remained at a low level over the past few years. Let me stress, however, that banks' asset-quality indicators are typically backward-looking. Since risks may build up during the boom phase, a deterioration in credit quality may become visible only with a significant time lag if general economic conditions worsen. As most new Member States have been enjoying relatively high rates of economic growth in recent years, the resilience of loan portfolios to negative output shocks remains untested until now.

Notwithstanding the overall positive near-term outlook for financial stability in the new Member States, potential risks implied by rapid credit growth call for continued vigilance by national authorities. Reflecting these concerns, central banks and supervisory authorities have taken several measures in response to rapid credit growth. The most commonly applied measures can be classified under the category of "moral suasion". These include enhanced central bank communication concerning the risks related to fast credit expansion, through

Financial Stability Reports or by other means, and recommendations made by prudential supervisors aiming to increase banks' risk awareness. In some countries, the tightening of monetary policy, for example in Latvia, and fiscal measures aiming to reduce the incentives for borrowing, such as those introduced in Estonia, have also been used to moderate credit growth. Nonetheless, these measures have not yet proved sufficient to moderate the pace of credit growth in the Baltic countries, which has remained very high through the middle of 2005. Financial regulation and prudential supervision should therefore ensure that sound asset quality is maintained. Furthermore, fiscal policy can also contribute to macroeconomic stability and thus help to moderate volatility in financial markets.

Finally, let me address one issue that is somewhat "closer to home". Since robust bank credit growth may continue in the period leading up to the accession of some new Member States to the euro area and even in the years following the adoption of the euro, it is pertinent to consider whether this could have a bearing on the euro area as a whole in the future. Given the strong ownership and other links between euro area banks and banks in the new Member States, it could be argued that there might be a risk transmission channel within the EU. However, bearing in mind that banking sectors in new Member States represent a relatively small fraction of the total assets of euro area banking groups, such a potential contagion risk seems rather limited.

VI. The outlook for financial structures and the risks to financial stability

What is the outlook for financial structures and what are the potential risks to financial stability in the coming years? Broadly speaking, the expected catching-up of the economies of the new Member States in financial and real terms is likely to have two main implications for their financial structures. First, it is expected to lead to a deepening of financial intermediation and a further development of capital markets to levels comparable to those of the euro area. Second, it is likely to promote an increased role for non-bank financial intermediaries, such as pension funds and life insurance companies, whose presence is very limited when compared with the euro area countries. As a result, financial sector balance sheets are expected to expand substantially in most of the new Member States over the next decade. Similarly, bond and stock markets are likely to develop significantly, along with life insurance companies and pension funds. Against this background, a key policy challenge in the new Member States is to safeguard the soundness of the banking system and the robust and stable development of financial markets.

In fact, there are several potential stresses that could arise as financial systems expand, especially in an environment of capital mobility and financial market integration. Experience in a number of emerging market economies has shown that financial market exuberance can drive risk premia on external debt and domestic financial instruments to levels lower than are warranted by fundamentals. Under such circumstances, strong capital inflows, rapid credit growth and buoyant asset prices may lead to episodes of sizeable real exchange rate appreciation – with potentially serious repercussions for the real economy if expectations are at some point not fulfilled. It is important to guard against such potential risks. After all – to paraphrase slightly what Larry Summers once said – "the new finance is like a highway. It gets you to where you are going better and faster, but the accidents may be worse."

VII. Concluding remarks

Let me conclude. Our review of the financial structures in the new Member States has showed that substantial progress towards convergence with the euro area has been achieved, but also that there is still a need to improve the financial infrastructure and to strengthen the legal framework. I highlighted two major issues which are currently attracting our attention in a number of Member States: robust credit growth and rapidly rising house prices. While these developments could pose, in certain circumstances, significant risks to

financial stability, we see such risks as being rather modest at this juncture, bearing in mind that the situation varies considerably from country to country. Nevertheless, it is important that authorities and market participants be vigilant and take measures that can help to reduce the likelihood of risks materialising and increase the resilience of the financial system. To this end, the implementation of sound macroeconomic policies is key – particularly the implementation of prudent fiscal policies that can contribute to moderating unsustainable aggregate demand increases and contain large current account deficits. Fiscal measures should also aim to eliminate tax distortions that can fuel property price dynamics. Moreover, the further strengthening of supervisory mechanisms and practices and the enhancement of the risk management methods employed by banks will help both to limit some potential risks and to improve the shock-absorbing capacity of the financial system. What should be clear, however, is that supervisory authorities cannot take financial stability for granted. The British statesman and political theorist Edmund Burke once remarked that you can never plan the future by the past. This is an observation that should not be forgotten, particularly in the fields of financial stability and prudential supervision, and especially given the fact that the modern financial history of the new Member States is still rather short.

Thank you very much for your attention.