Household Credit Growth In Emerging Market Countries

Ceyla Pazarbasioglu

Division Chief
Monetary and Capital Markets Department
Contents

• Motivation
• Composition and Factors Driving Household Credit Growth
• Potential Vulnerabilities
• Legal, Regulatory and Institutional Reforms
• Policy Implications and Conclusions
Rapid growth of household credit across EM

Annual Growth of Real Household Credit, 2004-05
(In percent)

Average for all countries: 24.8
Catching up?

Household Credit: Level in 2000 and Real Growth Rates, 2000

Average growth 2000-05 (In percent) vs. Household debt in 2000
Welfare gains

• Reduces consumption volatility

• Improves investment opportunities

• Eases constraints on small and family businesses

• Diversifies household and financial sector assets
...and pitfalls of rapid credit growth

Combination of rapid credit growth with:

- Weak macroeconomic environment
- Lax or insufficient prudential regulation
- Inadequate risk management
- Weak legal and institutional infrastructure

➤ Can create systemic vulnerabilities
Composition and Factors Driving Household Credit Growth
The level of Household Credit varies widely across EM countries...

Household Credit in Percent of GDP, End-2005

Average for all countries: 29.2

Sources: IMF staff estimates based on data from country authorities, CEIC, and WEO.
Positive Relationship between Household Credit and Income

Household Credit/GDP and GDP Per Capita in Selected Emerging and Mature Market Countries, End-2005

Sources: IMF staff calculations based on data from country authorities, CEIC, and WEO.
Other Drivers of Household Credit

• Financial liberalization
• Financial innovation
• Highly favorable global liquidity conditions
• Lower inflation, stable interest rates
• Corporate de-leveraging post Asian crisis
• Access to capital markets by corporates
• Increased retail lending by foreign banks
Housing loans dominate in Mature Markets but less so in EM countries

Share of Housing Loans in Total Household Credit, End-2005 (In percent)

Average for all countries: 52.9

Mature Markets 77.5

Emerging Europe 27.9

Latin America 37.5

Emerging Asia 54.2

Sources: IMF staff estimates based on data from country authorities and CEIC.
Assessing the nature of credit growth

- **type of borrower**
  - Households, individual businesses, corporates
- **purpose and use of the loans**
  - mortgage loans/loans for asset purchases/loans for consumer goods
- **sectoral composition and concentration of the loans**
  - for productive vs. non-productive activities
- **currency denomination of the loans**
  - FX-denominated (or indexed) vs. domestic currency denominated
- **maturity of loans**
  - short-term vs. long-term
- **funding sources of the loans**
  - Foreign/domestic banks, non-banks
- **other loan conditions**
  - collateral, interest rate conditions
Potential Vulnerabilities
Credit growth have fueled asset price inflation in some EM

**House Price Indices (2000=100)**

**Selected Mature Market Countries**
- Spain
- New Zealand
- France
- Ireland
- United States
- Netherlands

**Selected Emerging Countries**
- Thailand
- Korea
- Hungary
- South Africa
- Malaysia
- China

Sources: ESRI, Ireland; Ministerio de Vivienda, Spain; OFHEO, USA; RBNZ, New Zealand; NVM, Netherlands; ODBP, UK; ABS, Australia, Central Bank of Malaysia, CEIC and Bloomberg.
... contributed to current account deficits
...and to cross-border inflows and foreign currency lending

- Foreign currency borrowing in EE, mainly for housing
- Taking advantage of low euro interest rates
- FX risks for households but there are mitigating factors:
  - low share of such loans;
  - policy convergence with EU;
  - presence of well supervised foreign owned banks
- Authorities are taking action in several countries

Share of Foreign-Currency-Denominated Household Credit, End-2005
(In percent of Total Household Credit)

Sources: IMF staff estimates based on central banks and CEIC.
Note: Data for Bulgaria does not include overdraft.
EM Household Balance Sheets indicate positive net worth but this may mask vulnerabilities...

- EM countries with rapidly rising HH debt also have significant positive net financial assets

- HH also have non-financial assets i.e. housing

- Need for improved HH level data on the distribution of debt (e.g. Riksbank Sweden)

Sources: IMF staff calculations based on data from central banks and CEIC.
Note: Data for Colombia, India and Japan is as of end-2004.
1 Household leverage is defined as the ratio of household liabilities to household assets.
EM countries appear to have sufficient cushion to absorb credit losses

- Well capitalized banking system – reported CARs ranging from 11 to 20 percent;
- With low non-performing loans in most countries;
- But, these indicators are backward looking and often reflect market averages and mask pockets of weaknesses.
Legal, Regulatory and Institutional Reforms
Teething Problems in Securitization of EM household credit

- High liquidity and more than adequate regulatory capital
- Underdeveloped institutional investor base
- Regulatory constraints discouraging investment in securitized products
- Legal limitations
Legal and Institutional Reforms Needed

- Directed credit still existing in some countries
- Need to upgrade supervisory capacity
- Weak creditor protection and enforcement
- Inadequate origination standards
- Weak risk management of HH loan portfolios
- Weak disclosure standards and lack of proper credit information
- Lack of a framework to analyze linkages between HH credit and macro-prudential variables
Menu of Options

Policy Options

Macroeconomic Policy Measures
- Fiscal measures
  - Fiscal tightening
  - Avoiding fiscal/quasi fiscal incentives that may encourage certain lending.
- Monetary measures
  - Interest rate tightening
  - Reserve requirements
  - Liquid asset requirements
  - Sterilization operations.
- Exchange rate policy response
  - Increase exchange rate flexibility
  - In general maintain a consistent policy mix

Prudential Measures
- Higher/differentiated capital requirements
- Closer onsite/offsite inspection/surveillance of potentially problem banks or those with aggressive lending portfolios
- Closer eligibility criteria for certain loans
- Dynamic provisioning
- Tighter collateral rules
- Rules on credit concentration
- Tightening net open FX position limits
- Maturity mismatch regulations, and guidance to avoid excessive reliance on short-term borrowing

Supervisory/Monitoring Measures
- Increasing availability of hedging instruments to manage risks
- Increasing availability of asset management instruments to deal with distressed assets
- Developing securities markets to reduce dependence on bank credit and improve diversification of banks' credit risks
- Improving credit culture (establishment of credit bureaus, credit registry, stronger legal system, creditor rights, etc)
- Improving banks' and corporations' accounting standards

Market Development Measures
- Overall or bank-by-bank credit limits
- Marginal reserve requirements based on credit growth
- Controls on capital flows: e.g.,
  - control on foreign borrowing by banks and/or bank customers
  - different reserve requirements on domestic and foreign currency
  - Taxes on financial intermediation
  - Import restrictions

Administrative Measures
- Strengthening banks' ability to monitor, assess, manage risks
- Public risk awareness campaigns, press statements, etc
- Discussions/meetings with banks ("moral suasion" being an extreme version, to warn/persuade banks to slow down credit extension, etc).

Promotion of Better Understanding of Risks
- Strengthening banks' ability to monitor, assess, manage risks
- Public risk awareness campaigns, press statements, etc
- Discussions/meetings with banks ("moral suasion" being an extreme version, to warn/persuade banks to slow down credit extension, etc).
## Risks associated with rapid credit growth

<table>
<thead>
<tr>
<th>Aspects of Credit Growth</th>
<th>Type of Risk Associated</th>
</tr>
</thead>
</table>
| Speed of credit growth   | • Credit risk (from inappropriate loan assessments, strain on ability to monitor and assess risks)  
                           | • Macro risks           |
| Main providers of credit (foreign versus domestic banks, etc.) | • Credit risk (from aggressive lending strategies)  
                                                                           | • Macro risks |
| Main borrowers of credit (households, corporates, etc.)        | • Credit risk (greater sensitivity of repayment capacity of corporate loans to the economic situation, that of consumer loans to collateral values)  
                                                                           | • Macro risks (likely impact of loans on the current account)  
                                                                           | • Market risks (sensitivity to economic activity and price changes) |
| Sectoral loans concentration/composition of credit (mortgages, durable consumer goods, investments, etc.) | • Credit risk from concentration, collateral values for mortgages, etc.)  
                                                                           | • Macro risks (impact on the current account in the case of consumer/investment loans, etc.)  
                                                                           | • Market risks (e.g., sensitivity to real estate prices) |
| Currency composition of loans | • Direct (through banks’ net open positions) and indirect (via borrowers’) exposure to FX risks |
| Maturity of loans       | • Maturity/liquidity risks (longer term loans financed through shorter term borrowing by banks) |
| Sources of credit       | • Foreign exchange risk (loans funded by bank borrowing)  
                           | • Maturity risks (when liabilities short-term, assets longer term)  
                           | • Macro risks (from exposure to market sentiment) |
Measures taken by some EM countries

• Tightening prudential/supervisory policies
  ➢ loan eligibility and amounts (LTV, debt service/income)
  ➢ imposing differentiated risk weights based on credit type
  ➢ higher capital requirements for FX loans and/or NPLs
  ➢ tighter collateral requirements

• Use of dynamic (ex-ante) provisioning

• Targeted on-site inspections

• Elimination of tax deductibility of interest payments

• Limiting aggressive marketing campaigns

• Consumer protection laws and credit bureaus
Policy Implications and Conclusion
Policy Implications

• Macroeconomic and financial linkages complicate the conduct of monetary policy
  ➢ Need to build a framework
  ➢ Understanding of implications on transmission mechanism

• Relatively few episodes of systemic distress from HH credit in EM countries
  ➢ Low levels of household credit / “catching up process”
  ➢ Mostly untested risk from bank and regulators’ perspective

• Traditional crisis management may have limits
  ➢ Political implications of household bankruptcy
  ➢ Formulate contingency plans
Conclusion

• Healthy development in household credit can foster growth in EM countries

• In most EM countries, retail credit expansion from a low base does not seem to threaten financial stability

• To mitigate potential vulnerabilities:
  - Ensure sound macroeconomic policy environment;
  - Implement sound prudential regulations; comprehensive legal, regulatory and institutional infrastructure;
  - Enhance information disclosure
  - Develop contingency plans