Some challenges after the crisis: is there evidence of another credit boom in emerging markets?

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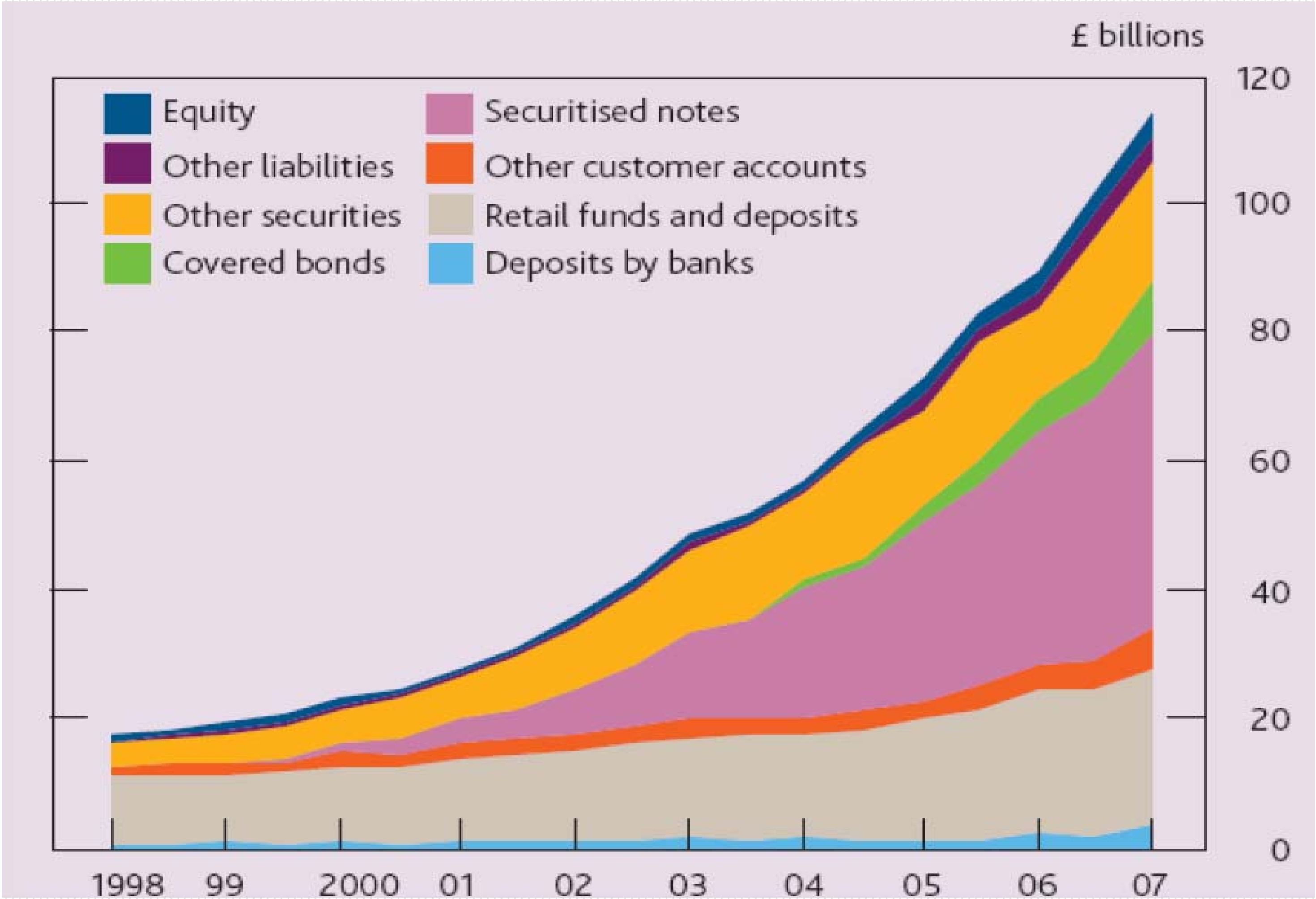
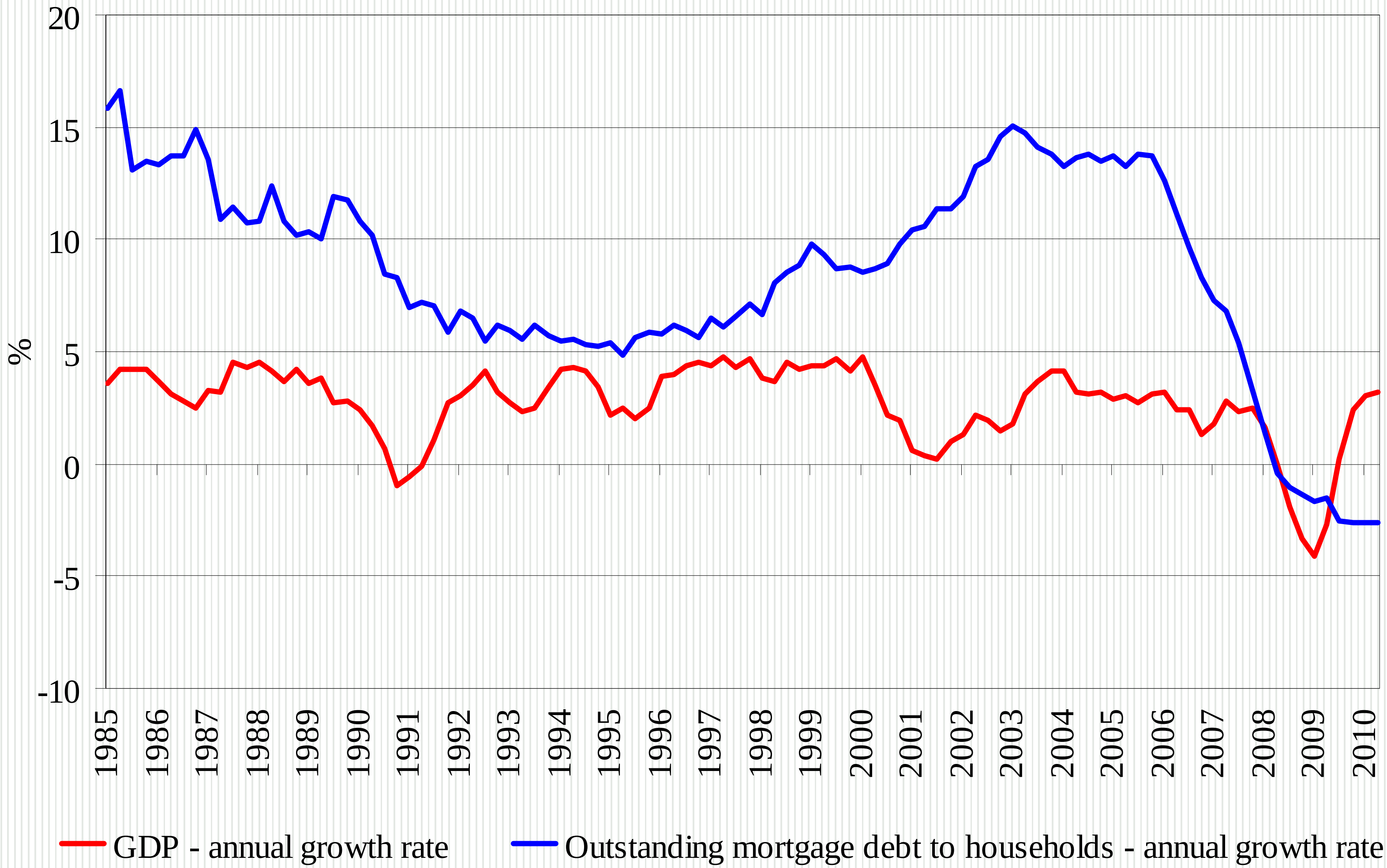
Northern Rock – customers outside the branch in Kingston Upon Thames

Northern Rock – balance sheet growth and liability structure



Source: C. Gondat-Larralde, „Crisis Management & Resolution. The Bank of England's Perspective", Seminar on Policies for Financial Sector Stability, 2009.

Dynamics of GDP and mortgage to households in the USA



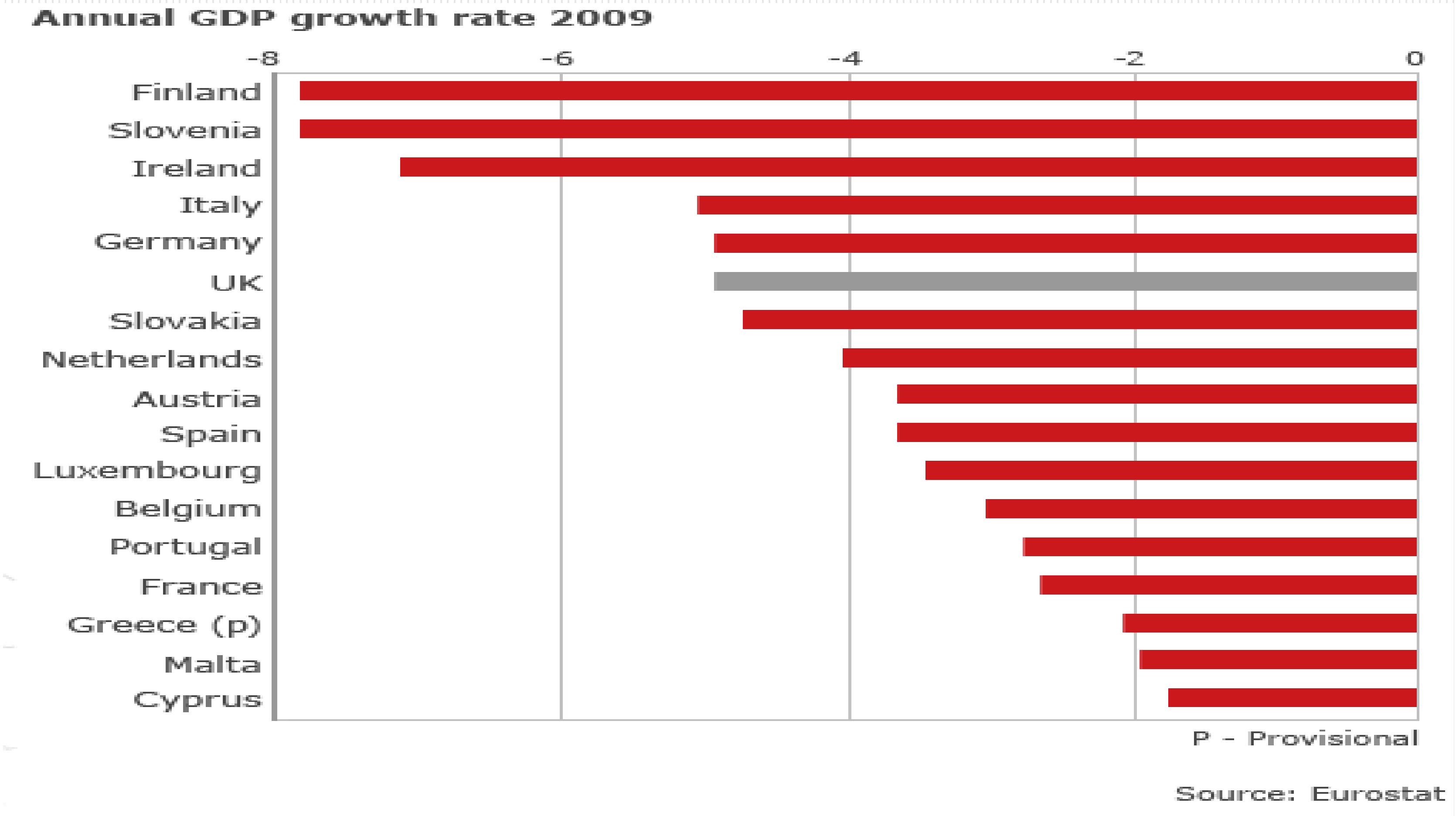
Financial sector in the USA was heavily exposed to real estate market

Collapse of the real estate market…

… was followed by a stock market crash

Number of foreclosures surged

Financial and real sector interlinkages led to global recession



Providing liquidity to banking sectors became the main issue

Measures undertaken by central banks (1)

- **Stage I – standard measures**
  - providing short-term liquidity
- **Stage II – evolution of measures**
  - providing long-term liquidity
  - extending the list of eligible collateral

Measures undertaken by central banks (2)

- **Stage III – unconventional measures**
  - quantitative easing / credit easing
    - purchase of corporate debt instruments in primary and secondary markets (BoE, Fed)
    - purchase of treasury bonds in the secondary market (BoE, Fed)
    - purchase of covered bonds in the primary and secondary market (ECB)
  - Emergency Liquidity Assistance to individual banks (Fed)

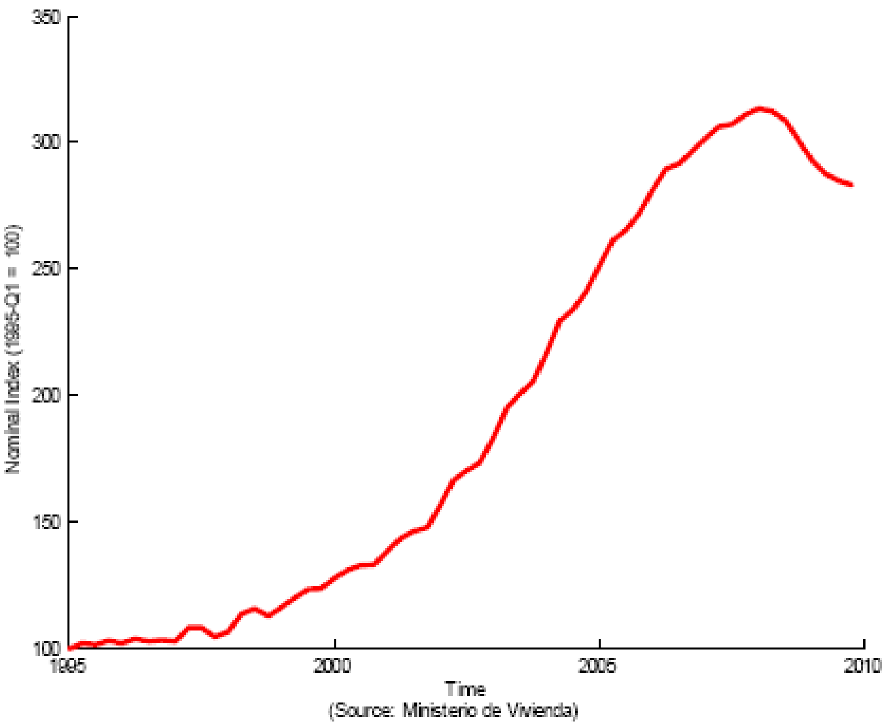
- I was aware that the loosening of mortgage credit terms for sub-prime borrowers increased financial risk.
- But I believed then, as now, that the benefits of broadened home ownership are worth the risk.

A. Greenspan, “The Age of Turbulence”, 2007, p. 233

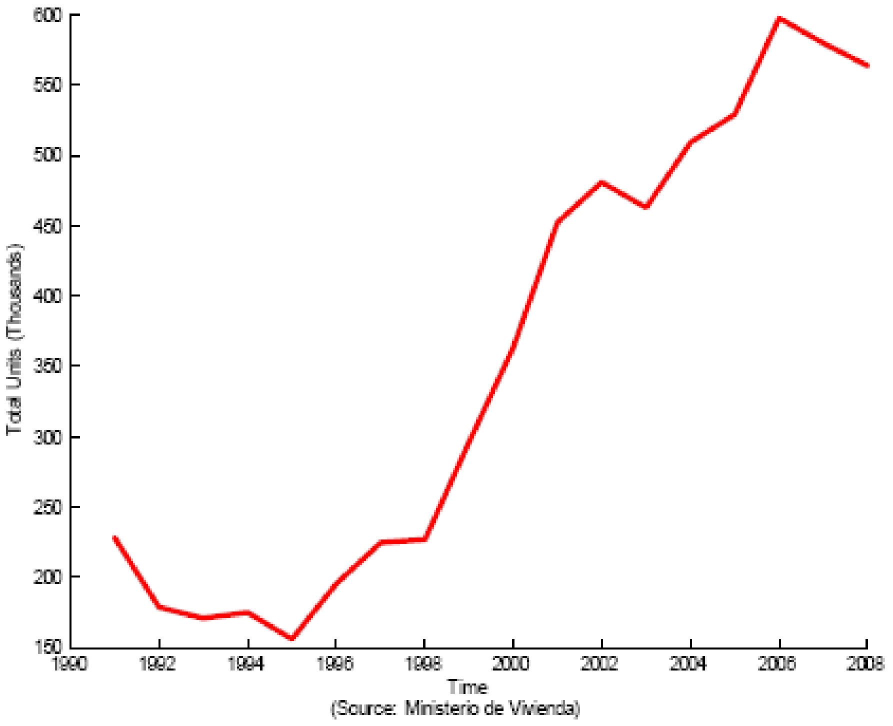
Anti-crisis measures required public funds

Credit expansion in Spain led to even larger housing boom between 1998 and 2008

Nominal house price index per square meter (1995Q1 = 100)



Residential investment - number of new units put in place (in 1,000)



Source: C. Garriga, *The Role of Construction in the Housing Boom and Bust in Spain, 2010.*

Could monetary policy prevent boom-bust cycle?

„(…) government actions and interventions caused, prolonged, and worsened the financial crisis. They caused it by deviating from historical precedents and principles for setting interest rates, which had worked well for 20 years."

John B. Taylor, *The financial crisis and policy responses: An empirical analysis of what went wrong*, January 2009.

„(…) as I see it, the crisis was mainly caused by factors that had very little to do with monetary policy and were mostly due to background macro conditions, distorted incentives in financial markets, regulatory and supervisory failures (…), information problems and some specific circumstances, including the U.S. housing policy to support home ownership for low-income households."

Lars Svensson, *Inflation targeting after the financial crisis*, February 2010.

It seems that monetary policy is not enough

„Good flexible inflation targeting by itself does not achieve financial stability, if anyone ever believed that. (…) Other instruments like supervision and regulation, including appropriate bank resolution regimes, should be the first choice for financial stability.”

Lars Svensson, *Inflation targeting after the financial crisis*, February 2010.

„The best approach is likely to involve a portfolio of instruments.”

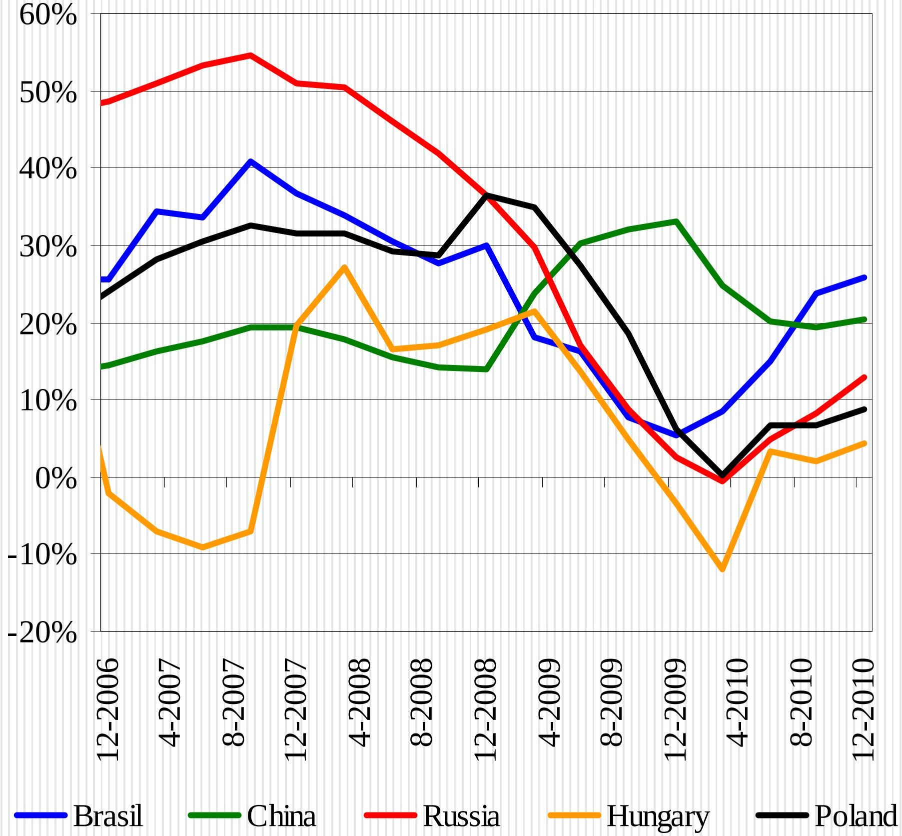
Charles Bean, *The Great Moderation, the Great Panic and the Great Contraction* , August 2009.

Macroprudential approach still remains a hot-button issue

The list of systemic risks is not shorter despite the crisis!

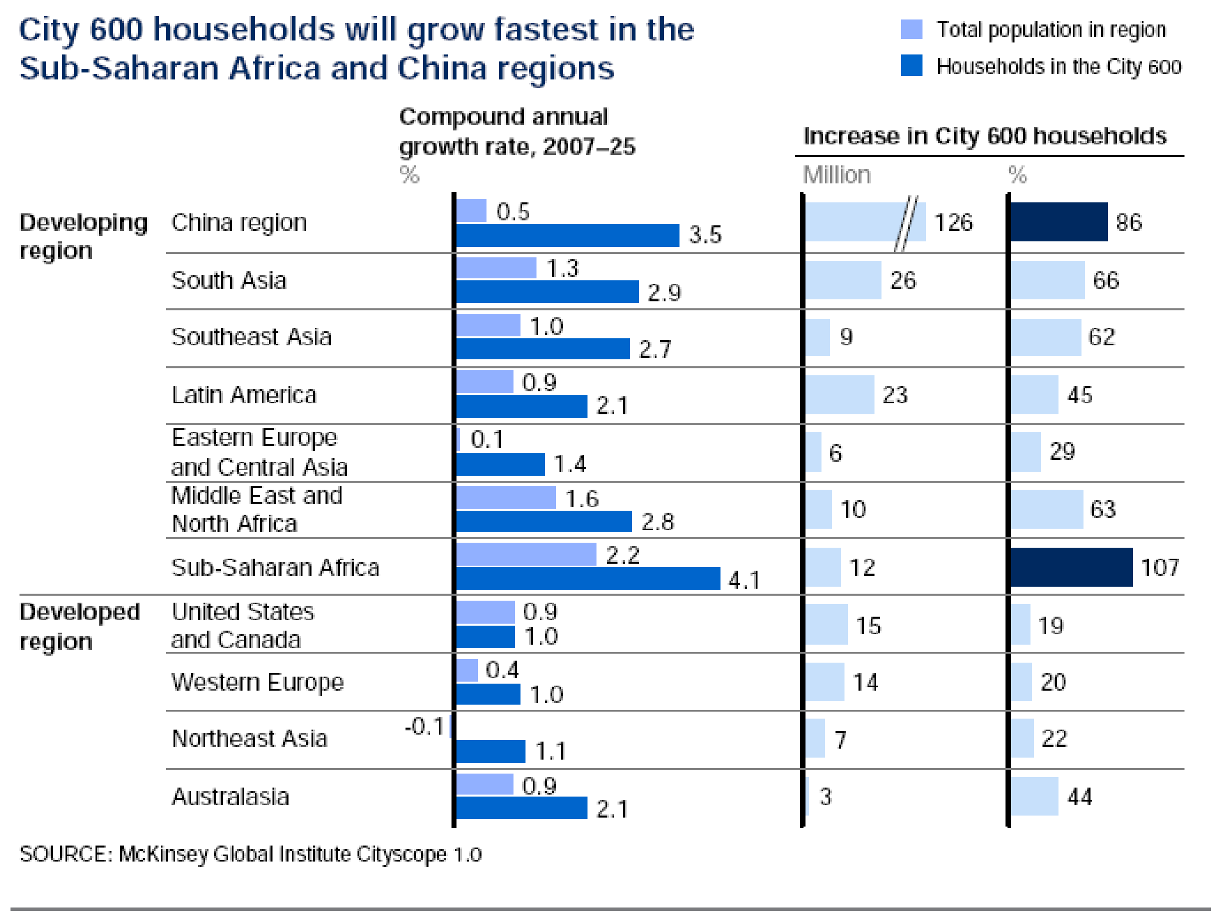
Banks did not change their corporate structures and business models significantly

Credit growth in emerging markets (y/y)



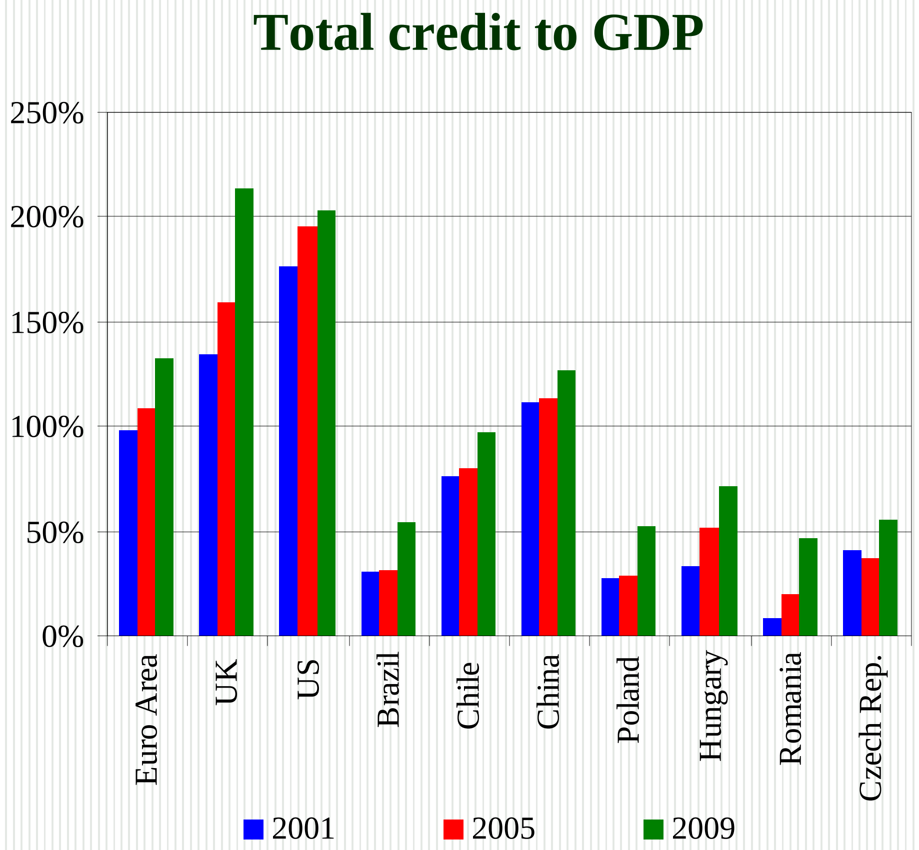
Source: IMF, International Financial Statistics.

Fundamental factors influencing credit supply and demand in emerging markets are still in force (1)



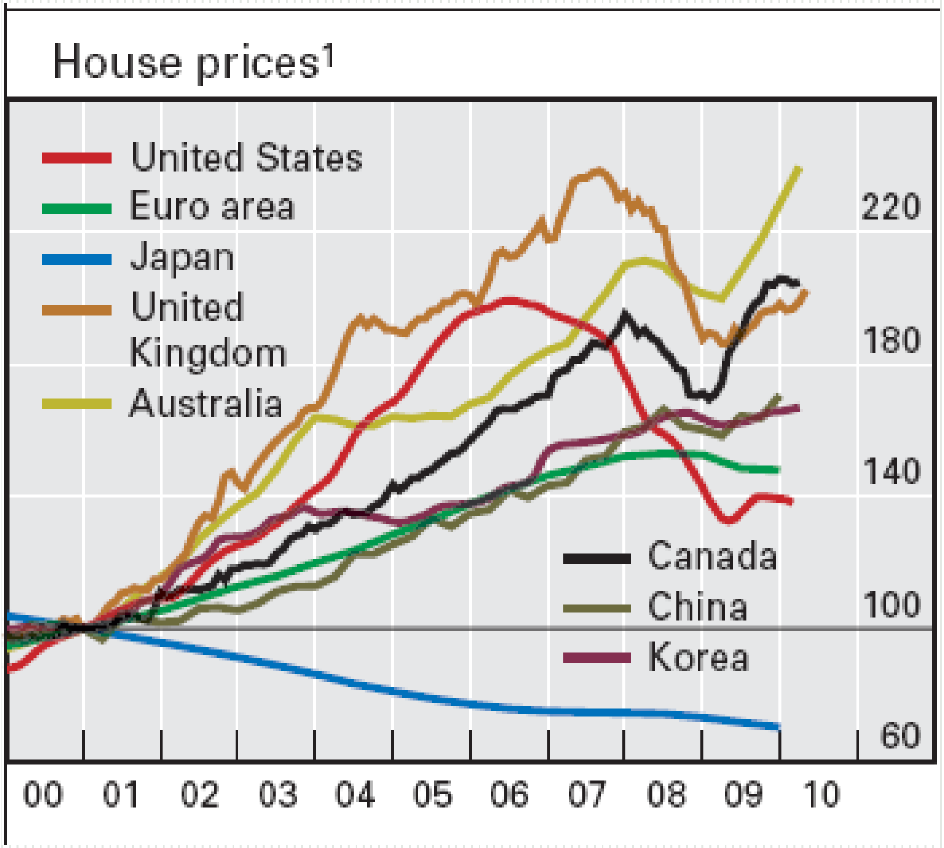
Note: „City 600" refers to 600 cities with the biggest forecasted contribution to the world GDP growth until 2025
Source: McKinsey Global Institute, *Urban world: Mapping the economic power of cities*, March 2011.

Fundamental factors influencing credit supply and demand in emerging markets are still in force (3)



Source: World Bank, Development Indicators

Fundamental factors influencing credit supply and demand in emerging markets are still in force (4)

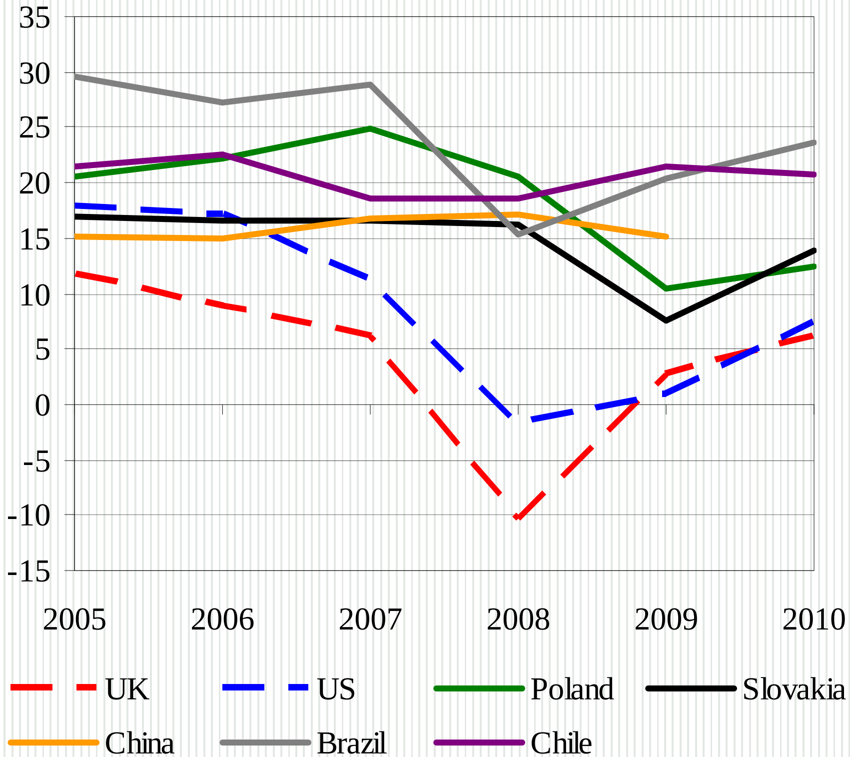


[1.] End-2000 = 100

Source: BIS, *80th Annual Report*, 28 June 2010.

Capital inflow to the emerging markets via banking sectors and portfolio investments (1)

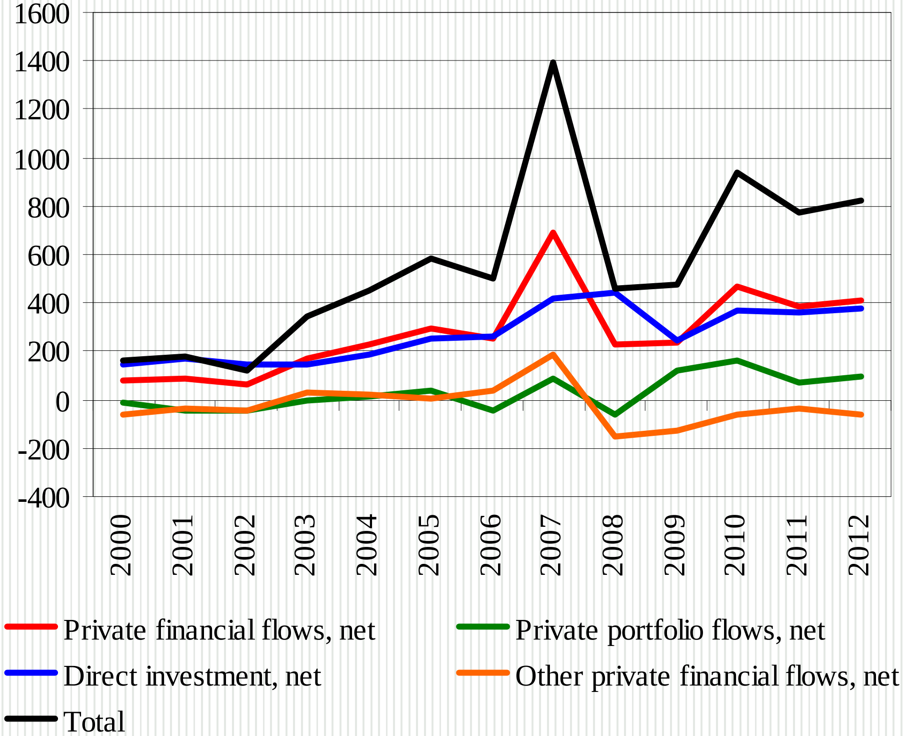
RoE in banking sectors (in %)



Note: In 2010 last data for September in case of US, PL, BR and for June in case of UK.

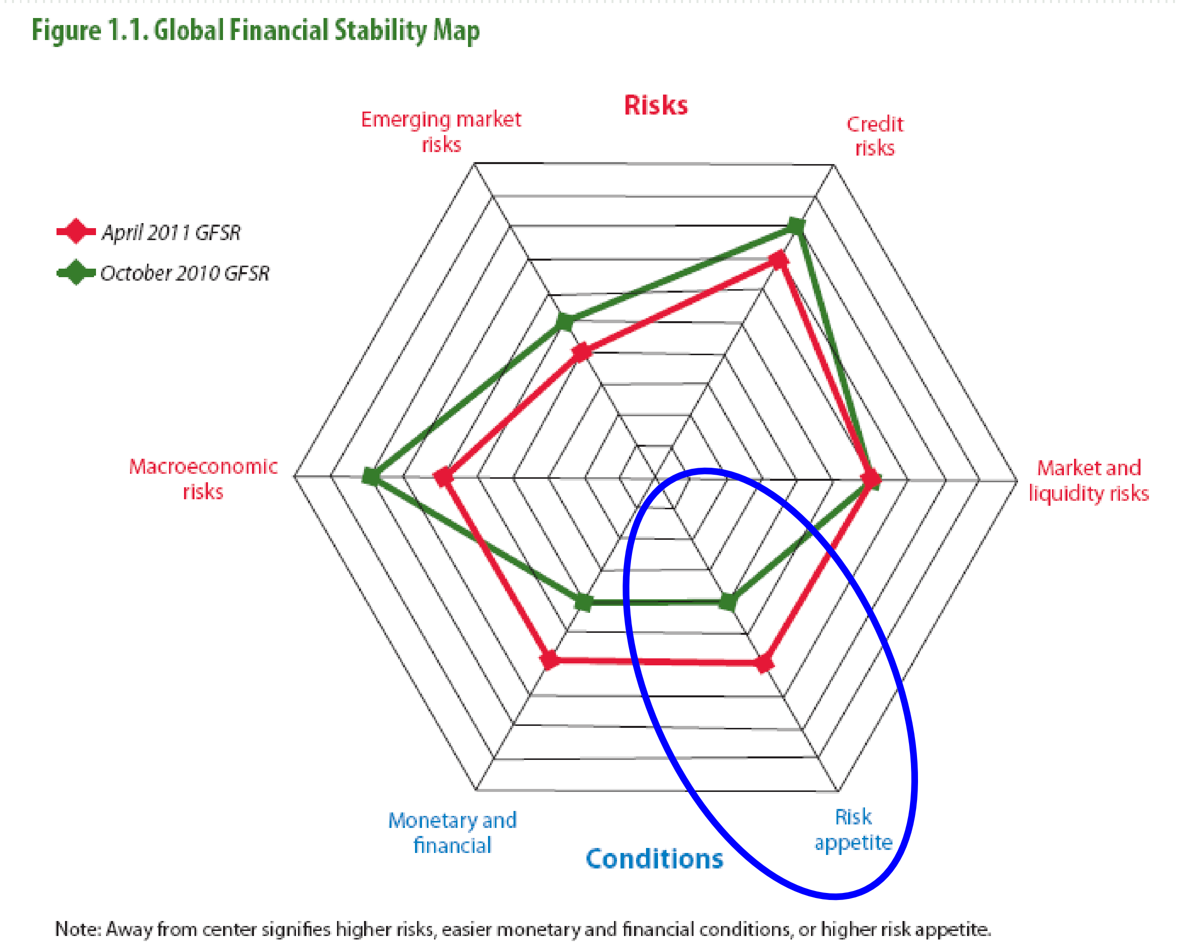
Source: IMF, *Global Financial Stability Report*, April 2011

Capital inflows to emerging markets (in USD billion)



Source: International Monetary Fund, World Economic Outlook Database, April 2011.

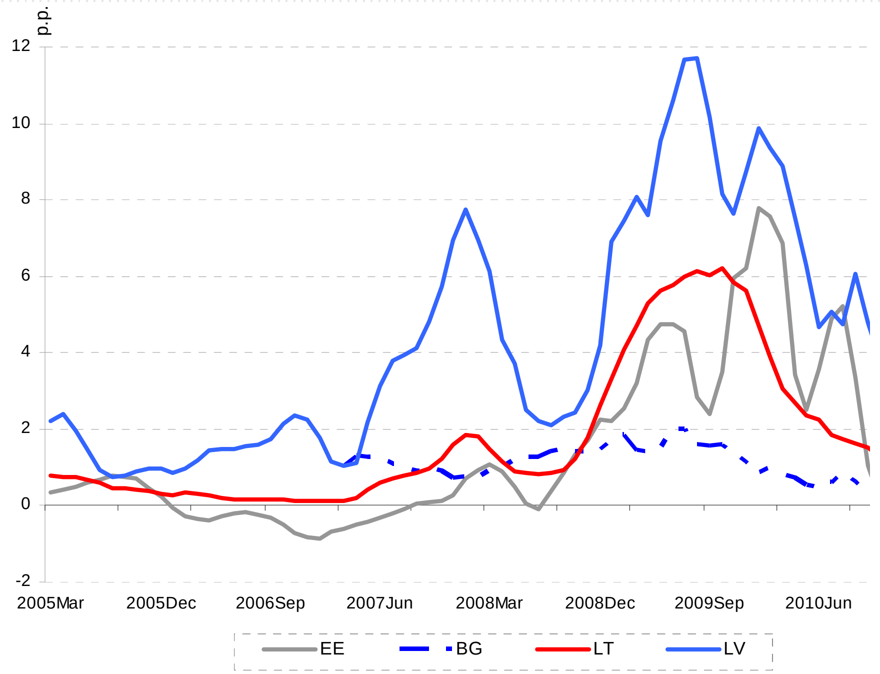
Capital inflow to the emerging markets via banking sectors and portfolio investments (2)

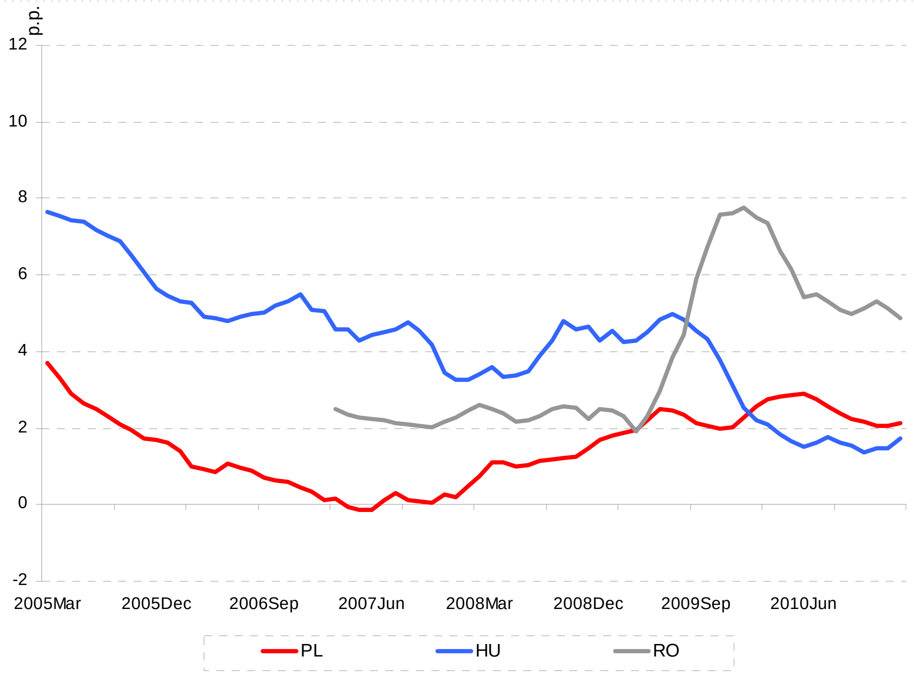


Source: IMF, *Global Financial Stability Report*, April 2011.

Low interest rates environment

Difference between interest rates on news loans to households for housing purposes in local currency and EUR (CEESE region)





Source: ECB, Statistical Data Warehouse.

Risk of credit boom (1)

- Elevated risk of credit boom can not be described as a global phenomenon
- However, described factors are gaining in importance in different jurisdictions
- National Bank of Poland already recognizes credit boom as one of the main financial stability risks:

  „If macroeconomic risk does not materialize and economic growth in Poland accelerates, loosening of banks' lending policy and excessive credit growth may become a long-term risk factor.”

  Financial Stability Report, December 2010, NBP.

Risk of credit boom (2)

Credit boom fuelled by FX lending has already taken its toll in Ukraine during the financial crisis

Chart 1 Credit to the non-financial sector versus the exchange rate

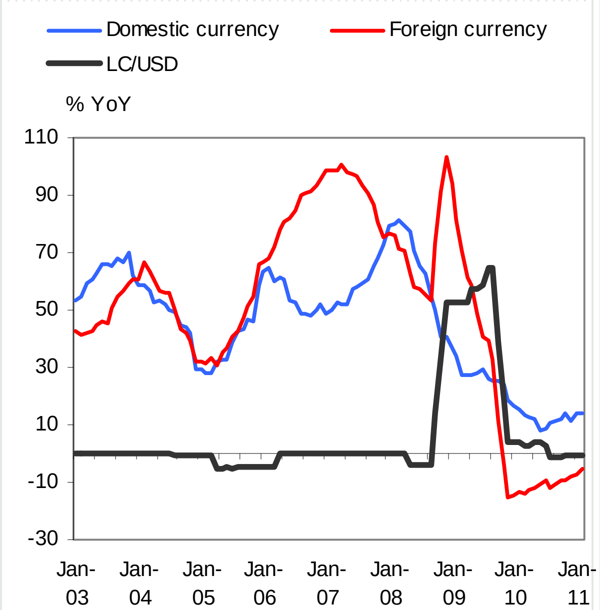
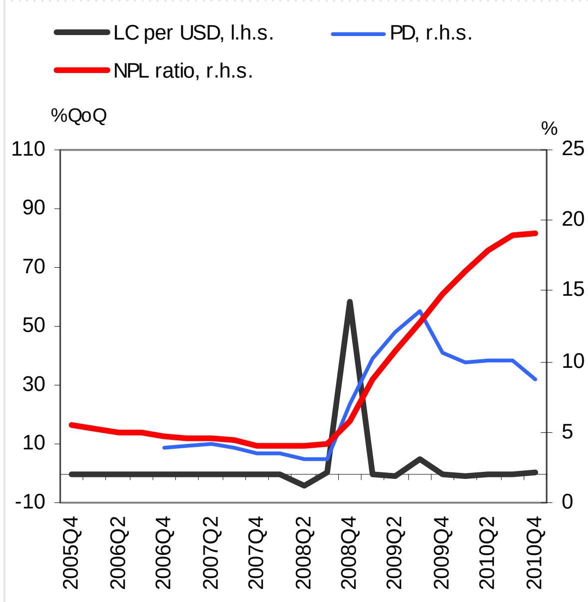


Chart 2 Loan quality versus the exchange rate



Source: Haver Analytics, National Bank of Ukraine and ECB calculations.
Notes: The NPL ratio is approximated by the share of loan loss reserves in total loans. The probability of default (PD) was computed using an assumption for a constant write-off rate of 20%.

Source: ECB/ESRB

Conclusions

- The risk of credit booms has not vanished during the crisis
- Resorting only to monetary policy is insufficient
- What is needed?
  - Regulatory actions
  - Macroprudential approach
  - Research on optimum pace of credit growth
- There are single countries which are already exposed to elevated risk of credit boom
- Still existent macroeconomic risk (e.g. global imbalances, debt restructuring) may lead to high credit losses in case of its materialization

Thank you for your attention!