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Credit Growth

Credit growth has been relatively rapid across most of Asia. This may raise some concerns because, historically, episodes of rapid credit growth in Asia have been characterized by a higher incidence of crises compared to other emerging economies. When does rapid credit growth become excessive and lead to financial imbalances? What are the drivers of credit growth? And what are the policy options? The latest IMF Regional Economic Outlook for Asia and the Pacific, which was launched in Manila on October 17, looks at these questions in detail (available at: http://www.imf.org/external/pubs/ft/reo/2011/apd/eng/areo1011.htm).

After the collapse of Lehman Brothers, credit growth to the private sector slowed sharply across most emerging markets, including in Asia with the exception of China. After economies started to recover, however, we have seen a striking turnaround in bank lending, which has been expanding at a brisk pace during the last 18 months, most recently growing at about 20 percent in ASEAN (which includes Indonesia, Malaysia, the Philippines, and Thailand) as well as India, while credit growth has slowed in China. It seems natural that at these rates, observers have been concerned about the creation of asset-price bubbles or higher consumer price inflation.

It is difficult to tell though at what point credit growth becomes excessive. Should we just look at bank lending or other forms of credit extension as well? In addition, it is not just the level that matters, but also where the credit is going with lending to the property sector in particular being watched carefully. It also depends where we are in the economic cycle (is credit going to increasingly more risky borrowers?), bank-level fundamentals, the sources of funding (deposits versus wholesale funding), and the terms of the lending (fixed or flexible rates, long or short term loans denominated in local or foreign currency etc.). Given these challenges, pundits therefore try to identify episodes of exceptionally strong credit growth, so-called credit booms, defined as episodes during which real credit to the private sector increases substantially faster than has been observed in previous expansions. Indeed, credit booms have tended to end in disruptive busts in various emerging market economies in the past, particularly so in Asia. Typically, credit booms last three years with a buildup, peak, and ending phase lasting one year each.

Credit booms are influenced by both domestic and external factors. In terms of external factors, credit booms seem tightly interconnected with episodes of large capital inflows. Other (bank) flows—which tend to be less stable sources of financing and to have short maturities—increase during the buildup phase, particularly for booms that are followed by credit busts. In terms of domestic factors, the evidence suggests that low policy rates have been associated with booms ending in disruptive credit busts. Low policy rates bring down the cost of borrowing, implying lower firm-level average interest rates, leading to increasing corporate leverage (debt-to-equity ratio). Indeed, corporate leverage has increased

substantially in Asia, in some cases almost doubling compared to the pre-crisis level in 2007. In addition, the uptick in leverage has so far been most prominent for firms that are already highly indebted and in sectors where there are more concerns that excess capacity may be building up, such as construction.

In addition, lower prepeak interest rates tend to artificially boost firm-level valuations, which are then reflected in buoyant stock prices. This dynamic incentivizes excessive risk taking, borrowing, and looser lending standards, which seem to be related to the distinct increase in bank credit-to-asset ratios. Booms that were followed by particularly sharp reversals in key macroeconomic variables, including for example, domestic demand, seem to have been especially vulnerable to these bank and corporate balance sheet-related imbalances.

Which of the two factors tends to be more important historically: external or domestic? For Emerging Asia during the last two decades, changes in domestic conditions appears more important that the external environment. Although domestic demand and supply conditions, deposit growth, and monetary policy matter relatively more, external shocks have become more important over time likely reflecting the increased integration of economies.

Interestingly, the results in the IMF study indicate that for economies with more flexible exchange rate regimes (for example, Indonesia, the Philippines, and Thailand) external factors are relatively less important for credit growth. This points to the importance of allowing the exchange rate to act as a shock absorber: when an economy is doing well, credit tends to expand, which is further fueled by capital inflows, but if the exchange rate is allowed to appreciate, this mitigates the risk of overheating and the buildup of financial imbalances.

In sum therefore, although external factors such as global liquidity conditions matter, and increasingly so over time, domestic factors (including monetary policy) remain a more important driver of real credit growth in emerging Asia. Although the rapid credit growth has not entered boom territory just yet in most Asian countries and while near-term macroeconomic policy should be geared towards managing exceptionally uncertain global growth prospects, policymakers should remain focused on potential risks to financial stability and the real economy from lingering financial imbalances, including rapid credit growth. In particular, while abating recently, overheating pressures (which are associated with rapid credit growth) are still a concern in several economies including China, Hong Kong SAR, and Indonesia. Therefore, depending on country circumstances, policymakers should be prepared to use monetary, macroprudential, and exchange rate policies to limit financial imbalances that could eventually jeopardize macroeconomic stability.

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