THE RELATIONSHIP BETWEEN CREDIT ACTIVITY AND ECONOMIC GROWTH IN CENTRAL AND EASTERN EUROPE

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Abstract: *The literature analyzes the countries of Central and Eastern Europe as interesting case studies of developing countries, whereas the transition from a centralized economy to a market economy has been largely supported by the deepening of financial intermediation and by the presence of Western European banks in the region. Another compelling feature of these countries is due to the rapid growth cycle that some of them experienced before the crisis and the immediate contraction that followed. Using a qualitative and quantitative analysis, the main objective of this paper is to establish the role of credit activity in determining and supporting economic growth in the developing countries of Central and Eastern Europe, the main channels through which credit influences GDP, how it should be intervened and what are the measures to influence credit policies adopted to mitigate the effects of the financial crisis. In the recent years, although liquidity has improved and economic growth has revived, the recovery of bank credit activity is not yet on track to develop. The balance of evidence seems to favor a positive relationship between private sector credit and economic growth for these countries. The lack of research focused in particular on the role of financial development in transition economies suggests the need for in-depth research focusing on Central and Eastern Europe.*

Key words: *Central and Eastern Europe; credit activity; economic growth.*

JEL Classification Codes: C10, G21.

1. INTRODUCTION

The influence of the financial sector on economic growth has been widely debated in the economic literature for over a hundred years. The banking system is the one that prevents the information asymmetry between creditors and borrowers, reduces transaction costs, monitors managers and provides financial resources in an inherently uncertain economic environment. Meanwhile, in the absence of an appropriate institutional framework and in a specific economic context, the banking system may develop opportunistic behavior manifested by moral hazard and adverse selection, which is reflected in non-performing loans and inefficient allocation of resources.

In the recent years, the link between credit and private sector economic growth has been a major problem in economic discourse around the world, and empirical literature has not concluded this. Economic development is usually significantly influenced by lending activity and the ability of firms to access finance. The countries of Central and Eastern Europe (CEE) are interesting case studies of developing countries, whereas the transition from a centralized economy to a market economy has been largely supported by the deepening of financial intermediation and by the presence of Western European banks in the region. Another compelling feature of these countries is due to the rapid growth cycle that some of them experienced before the crisis and the immediate contraction that followed.

Using a qualitative and quantitative analysis, the main objective of this paper is to establish the role of credit activity in determining and supporting economic growth in the developing countries of Central and Eastern Europe, the main channels through which credit influences GDP, how it should be intervened and what are the measures to influence credit policies adopted to mitigate the effects of the financial crisis. Over the last few years, although liquidity has improved and economic growth has revived, the recovery of bank credit activity is not yet on track to develop.

2. LITERATURE REVIEW

The research studies have reached mixed conclusions about the role of financial sector development in economic growth. The study by Demetriades and Hussein (1996), in which causality tests are performed for 16 developing countries, suggests that the causality between financial development and economic growth varies from state to state. In about half of the countries examined, the authors detect a feedback relationship, but in several countries, the relationship extends from growth to finance, which suggests that it is by no means universal that financial development can contribute to economic growth. Drakos' (2002) study of the relationship between the financial sector and economic development in 21 transition economies shows that imperfect competition in the banking sector tends to slow economic growth and deepen business cycles.

Empirical research has studied the role and impact of credit activity to economic growth in Central and Eastern European countries. One such study looks at the equilibrium level of private credit to GDP in 11 Central and Eastern European countries to see if the recent increase of credit growth in some of these countries has led to a level of equilibrium from private credit to GDP. Egert et.al. (2007) showed that there is a large amount of uncertainty to determine the equilibrium level of private credit. However, their results indicate that a number of countries are very close to or even above the estimated equilibrium level, while others are well below the equilibrium level.

Winkler (2009) analyzes the process of rapid financial deepening, vulnerability and associated risks for Southeast European countries. He argues that the strategy of pursuing financial development through the entry of foreign banks does not guarantee financial stability. Finally, there has been a strong consensus over the last decade that well-functioning financial intermediaries have a significant impact on economic growth (Bonin and Watchel, 2003).

In the pre-crisis period, the high financing of foreign banks increased credit growth, supporting the development of the financial sector and the process of European integration in the region. Bakker and Gulde (2010) argue that rapid credit growth has been one of the main factors driving aggregate demand, leading to economic growth imbalances and weaknesses in some sectors of the economy.

Immediately after the crisis, the tightening of the credit supply was the most important factor that contributed to the slowdown in credit growth rates. According to the report studied by Suljoti et. al. (2018) the slowdown in lending in the region was largely determined by credit performance in the Czech Republic, while Poland and Hungary continued to record stable growth rates. The Balkans also recorded the highest growth rates, especially in countries such as Bulgaria and Romania.

Cojocaru, Hoffman and Miller (2011) demonstrated in 25 CEE and CIS countries (including Romania) for the period 1990-2008, that there is a significant positive relationship between credit to the private sector (as a percentage of GDP) and GDP growth and a negative correlation between interest rate and GDP. The main conclusions of the work of Dudian and Popa (2013), which evaluated a model also for the countries of Central and Eastern Europe, are: (1) the increase of non-performing loans and interest rate differences negatively affect economic growth, (2) the increase of domestic credit to the private sector negatively affects GDP growth, but the increase of the growth rate positively affects GDP. Petkovski and Kjosevski (2014) studied 16 transition economies in Central and South-Eastern Europe to assess whether the banking sector influences economic growth. The research results show that private sector credit and interest margins are negatively correlated with economic growth. The results of Duican and Pop (2015) indicate that loans have a significant influence on the evolution of gross domestic product in Romania. For emerging market economies, is found a significant impact of credit growth on GDP growth, with the magnitude and channel of transmission of the credit impact on real activity, depending on the specific type of credit.

3. CREDIT ACTIVITY AND IT'S IMPACT ON THE ECONOMY OF CEE

Economic growth is one of the ultimate goals of any economic system. The lack of research focused in particular on the role of financial development in transition economies and the findings that this relationship may depend on the level of development and other factors specific to the economy suggest the need for in-depth research focusing on Central and Eastern Europe. These countries offer an excellent test, as their financial systems are relatively new and vary widely.

One of the most important preconditions for ensuring the proper functioning of each country's economy is undoubtedly the performance of its banking system, which must be able to fulfill its main role as a financial intermediary and support economic growth by providing unused capital for active activity and by facilitating capital movements within the economy. At the same time, the involvement of banks in such activities depends very much on the profitability that can be achieved by them, which in turn depends on several determinants, including the economic and social climate, specific to that country or globally valid, such as the manifestation of the financial crisis.

Credit is the most important part of the economy. Credit leads to an increase in spending and an increase in the level of income in the economy. In turn, this leads to a higher GDP and therefore faster productivity growth. If credit is used to purchase productive resources, it helps economic growth and is added to incomes. In addition, credit leads to the creation of debt cycles.

The financial crisis of 2008 severely affected the credit activity of CEE banks. The financial problems with the toxic assets that most western parent banks had, were passed on to their subsidiaries in the region, significantly affecting their banking activity. Especially after the Greek crisis and the strengthening of European supervisory standards, the CEE region experienced a second wave of tension, which was accompanied by economic decline and the further withdrawal of banks from their role as intermediaries. In this context, has been given a special interest in understanding the relationship between credit activity and economic growth in CEE, emphasizing the impact of credit growth on GDP.

After 2011, the main factor preventing credit growth was the low demand for loans due to poor economic performance, deteriorating confidence and lower financing needs. The restriction on bank liquidity was the main factor that initially determined the consolidation of credit conditions and the slowdown in credit growth in these countries. Subsequently, with the gradual replacement of domestically financed foreign debt and the strengthening of confidence in the banking sector, the liquidity situation has improved in most countries. In recent years, although liquidity has improved and economic growth has revived, the recovery of banks' lending activity is not yet developing. Another factor that influenced the tightening of lending conditions in the region was the increase in credit risk. The ratio of non-performing loans to total loans has increased significantly in most of these countries, mainly reflecting the poor performance of the economy. The banking system has experienced a rapid deterioration in credit quality, which has become a key factor in tightening credit conditions in certain sectors.

A distinctive feature of the countries in the region is the significant difference between them in terms of usage of the financial leverage. Countries such as Hungary, Bulgaria and Croatia are the countries with the highest use of financial leverage in the region, measured as a ratio between private sector credit and GDP. These countries have a level of about 65% of this ratio compared to the regional average of 50%. Meanwhile, Albania and Romania, even after the crisis, are ranked as the countries with the lowest use of financial leverage in the economy. Divergences in the level of financial leverage between countries in the region point out that, in some of them, there is still room for further growth in credit demand. This growth will require a more active role of banks in deepening financial intermediation and supporting economic growth. The low use of financial leverage in some countries emphasizes that deepening financial intermediation will be an important tool in supporting their long-term development and integration process with Western European countries.

Financial intermediation plays a key role in the savings-investment process because it facilitates the transfer of capital and risk between those who save. International theory and practice, also applicable to economies in transition, emphasize the important role of financial intermediation in the efficient allocation of resources in the economy. Financial intermediaries mobilize savings, transform maturities, exercise control over companies and direct funds according to efficiency criteria. At the macroeconomic level, the level of credit has a direct influence on economic growth (Levine (2000)). For developing countries, such as Romania, Albania, etc. credit is more important for economic growth, given that the self-financing capacity of firms is low, the small and medium enterprise sector is small, and the role played on the financial market by other intermediaries is still limited. In institutional terms, financial intermediation is, for these countries, an eminently banking process, as banks have owned and still hold the vast majority of financial assets.

Lending to the private sector has recently grown considerably in a number of transition economies. This can be attributed to a number of factors, including macroeconomic stabilization, comprehensive reforms and privatization in the financial sector, the introduction of market institutions and legal reforms.

Table 1. Domestic Credit Growth by Country

Country	Albania	Bulgaria	Croatia	Czech Rep.	Hungary	Poland	Romania	Serbia	Slovenia	Ukraine
Credit Growth (%)	3.4	4.9	12.3	7.4	13.1	10.0	10.0	23.5	-1.6	10.4
GDP Growth Rate (%)	-8.8	4.3	-14.9	6.2	11.3	7.7	5.6	-9.2	-9.6	-9.9

Source: Data from https://www.ceicdata.com and https://tradingeconomics.com/

In Table 1 are presented the latest data for domestic credit growth rate and GDP growth rate for some of the countries of the CEE region. In September 2020 all countries except Slovenia, have registered a positive credit growth rate, with the highest of 13.1% in Hungary and the lowest of 3.4% in Albania. However, credit growth rate in Bulgaria, Hungary and Romania is lower in the last quarter than the previous one, as shown in red. On the other hand, the majority of these countries, Albania, Croatia, Serbia, Slovenia and Ukraine, have registered in the last quarter a negative growth of the GDP, facing more the latest economic problems related to the pandemic.

Poland is the largest economy in Central and Eastern Europe. According to Eurostat and the European Commission, its economy has been one of the fastest growing among EU Member States. Favorable labor market developments and strong consumer confidence are key factors supporting private consumption. These trends, with a fairly strong credit demand, make Poland a potentially favorable destination for the development of the banking sector. The Polish banking system is characterized by high stability and strength. Prudent credit policy and the good results of the Polish economy have allowed banks to keep their non-performing loans at a relatively low level.

The favorable state of the Bulgarian economy, characterized by low unemployment, rising incomes, a stable fiscal position and the lack of excessive imbalances have had a positive impact on the Bulgarian banking sector. It was also marked by several trends, such as consolidation processes, rising deposit growth, continued credit growth, accompanied by higher incomes, declining the non-performing loans (NPLs) and growing digital challenges.

On the other hand, in Albania despite the smaller number of banks, the financial activity of the banking sector continued to grow with a moderate positive trend. The foreign exchange composition of deposits and loans held by Albanian banks and exchange rate changes mask these positive trends. In the last years commercial banks were forced to constrain credit standards, especially in the sector of small and medium enterprises, but also in the large enterprises sector. The main reason for that are is related to the increase of the non-performing loans in the Albanian banking system (Gabeshi 2019).

In recent years, the Romanian economy has become extremely dependent on financing from the banking sector. Increasingly integrated financial markets have facilitated the inflow of foreign capital and the expansion of the Romanian banking system, but have also facilitated the transfer of the effects of the crisis in the Romanian banking sector. Currently, the main objective of the authorities is to resume the credit activity of banks, which is believed to support economic growth.

The CEE region has entered the recessionary environment COVID-19 on a fairly strong basis, with easing supply conditions and strong loan demand over the last six months. The COVID-19 pandemic brought a sudden negative revision of expectations. Regional demand is expected to contract, supply conditions to tighten significantly and approval rates to shrink. Along with a decline in the quality of loan demand, non-performing loans are expected to increase for the first time since 2015.

As seen in Figure 1, demand for loans continued to increase until March 2020, and after that all the expectations reversed. Before COVID-19 affected the region, banks expected an increase in demand of credits in line with the recent past, while post-COVID-19 expectations changed abruptly and they are in a contractionary zone for the first time in the last six years. The expected demand seems to be more contractionary in the household than the corporate segment, including SMEs. This suggests a still sustained need for financing in the corporate segment to meet liquidity needs in the short term. The quality of loan applications is also expected to deteriorate sharply in the spectrum of the client.

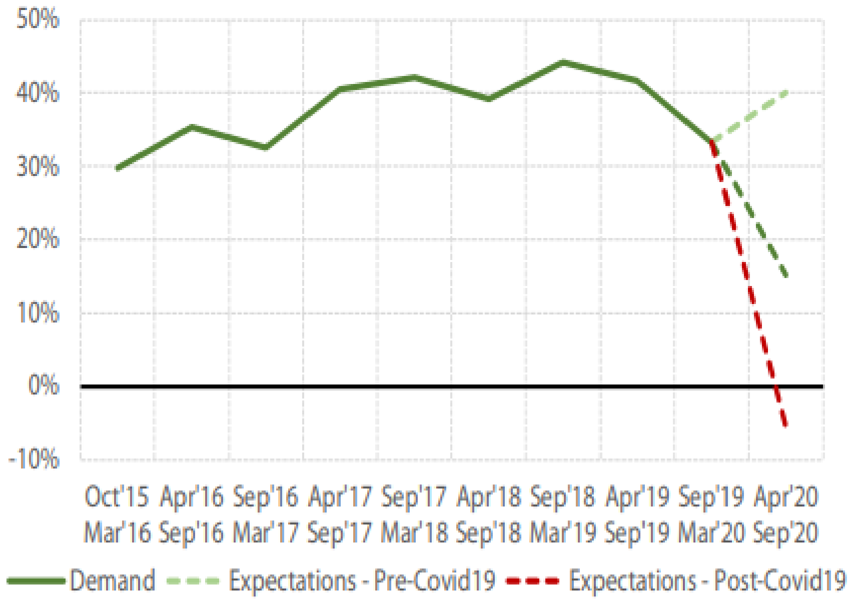

Figure 1. Demand for Loans, Source: EIB-CESEE Bank Lending Survey

The region entered the recessionary environment COVID-19 on a fairly solid macroeconomic and financial basis. The banks' reports, prior to the implementation of the COVID-19 measures of restriction and isolation, expected an increase in demand in line with past positive developments. In contrast, post-COVID-19 expectations are standing in a contractionary zone. On the other hand, the demand for debt restructuring is expected to increase for the first time in the last six years. Consumer and household expectations have been significantly reversed. In particular, consumer confidence and consumer spending should contribute negatively to credit demand.

4. CONCLUSIONS

Several empirical studies have shown that efficient lending has a positive and significant effect on output and employment opportunities, while a low level of financial development and its inefficient credit system accompanying the private sector distort economic growth. A strong and inclusive financial system and the availability of investment funds play a key role in financing economic projects and activities that would promote growth and development. This is due to the fact that access to credit improves the productive capacity of companies and enhances their growth potential.

In recent years, the link between credit and economic growth has been a major problem in economic discourse around the world, and empirical literature has not concluded this. However, the balance of evidence seems to favor a positive relationship between private sector credit and economic growth. Economic development is usually significantly influenced by lending activity and the ability of firms to access finance. The lack of research focused in particular on the role of financial development in transition economies suggests the need for in-depth research focusing on Central and Eastern Europe.

CEE subsidiaries and local banks have entered the COVID-19-induced crisis supported by an increase in credit demand. However, expectations for the coming months were reversed when COVID-19 began to affect regional economies, indicating the contracting of demand conditions and the poor quality of credit applications.

In a modern point of view, the primary role of banking institutions is to manage the risks they face, among the most important being: credit, operational, fraud, political, economic risks and bankruptcy. Banking and lending cannot be done randomly, just as the bank's success or failure does not entirely belong to it. I believe that banking must be supported by the other institutional and governmental components, both at national and European or global level.

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