Why Do Low Interest Rates Not Fuel Credit Growth in the “New” Member States of the European Union?

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Short Abstract

To stabilize financial markets and fight the evolving Great Recession the world’s major central banks opted to slash interest rates towards zero and implement unconventional policies such as large scale bond buying programs. Because low interest rates can fuel credit growth and asset market booms that often precede financial crises (e.g. Borio and Disyatat 2011, Bordo and Meissner 2012, Jorda et al. 2011, Taylor 2009), the resulting low world interest rate environment since 2009 bears some severe risks for financial stability in emerging markets. Not surprisingly, the recent rise in credit growth has become a major concern for policymakers in fast-growing emerging and developing countries.

There is, however, one notable exception. In the New Member States (NMS) of the European Union (EU) domestic credit to the private sector shrank from 2008 to 2012. I analyze why credit to the private sector declined rapidly during this period in spite of the sharp drop in interest rates.

I empirically show that in contrast to most emerging and developing countries the foreign exposure of banks in the NMS has declined since 2009 and depressed credit growth. Most interestingly, controlling for financial restrictions, credit demand and other potential influences, domestic lending in the NMS is more responsive to changes in cross-border lending than in other emerging markets. I explain this increased elasticity of credit growth to financial flows (1) by political integration with the EU and (2) with the dominant position of the European banking system.

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