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Mariyam Rashfa

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THE SLUGGISH GROWTH IN BANK CREDIT TO THE PRIVATE SECTOR

*by: Mariyam Rashfa**

Abstract

This paper examines the marked slowdown in bank credit to the private sector in Maldives since 2008. The paper documents the developments in bank credit during 2004-2014 and explores if a credit boom preceded the current slowdown as experienced by other regions of the world. It also explores how bank balance sheets have changed in the credit boom and the slowdown period and uncovered the role played by bank funding (external borrowing slowed considerably) and bank-level fundamentals (deteriorating loan quality) in explaining the differences in credit growth during the two periods. Although initially caused by a cut back in external funding, the prolonged slowdown in credit was largely contributed by increasing strains on banks' balance sheet which reduced the willingness to lend by banks.

1. Introduction

After a period of rapid growth, bank credit to the private sector in the Maldives registered a marked turnaround in mid-2008 and since then it has been undergoing a protracted period of sluggishness. A sustained decline in credit to the private sector is a concern for policy makers given its detrimental impact on private sector growth and thus long-term economic growth. However, as experienced by several regions across the globe such as in Latin America in the late 1990s and in the Middle East and North African region in 2008-2010, prolonged slowdowns in private credit has often come after periods of rapid credit growth which was accompanied by high levels of banking distress and increased macroeconomic imbalances, thus presenting a dilemma for policy makers — on the one hand lending growth must continue to support economic growth while on the other hand consideration has to be given to reduce financial risks.

* The author is an Economist at the Monetary Policy and Research Division of the MMA. She would like to thank Dr. Azeema Adam for her comments on the article and Dhaha Shuaib for her research assistance.

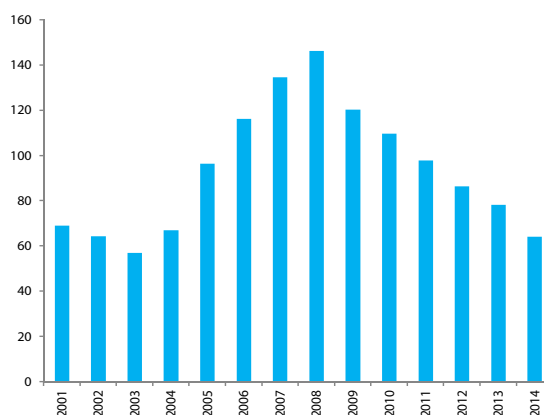
Several factors may have contributed to the stagnation in private credit in the Maldives. Literature on credit slowdowns in other parts of the world suggests it may either be due to a decline in demand for credit from the corporate sector (due to the economic downturn following the global crisis or high corporate debt) or due to supply-side constraints. On the supply side banks may have been subject to funding difficulties or balance sheet constraints such as deteriorating asset quality stemming from excessive risk taking or high corporate debt. Therefore, policy responses to revive credit growth should focus on the cause of the slowdown in credit. For example, if the cause of the slowdown is balance sheet strain, the main focus should be on balance sheet repair in order to maintain the stability of the overall financial system. On the other hand, if the slowdown is due to funding constraints, policies should be aimed at providing liquidity support to the banks through monetary and fiscal policy (quantitative measures). However, this would only be possible if there is enough fiscal space or if the macroeconomic environment is stable.

Against this background, this paper aims to deepen our understanding of the causes of the recent sluggishness in bank credit to the private sector in the Maldives in order to guide policy makers in the design of policies to revive credit growth. The paper is organised into four sections. Section two will provide an overview of the banking sector of the Maldives, focusing on its key characteristics. Section three will analyse the behaviour of bank credit to the private sector in the pre-crisis period in order to determine if credit growth was excessive. Section four will examine credit developments through a decomposition of credit growth. Section five will discuss factors affecting the post-crisis stagnation in credit, highlighting the role played by supply side factors. Finally section six will conclude and discuss some policy considerations.

2. Overview of the Banking Sector in the Maldives

The financial system of the Maldives is dominated by the banking sector with the banking sector assets accounting for 62% of the total assets of the financial sector at the end of December 2014. The banking sector witnessed a period of rapid expansion in 2004–2008, owing to fast accumulation of bank assets. As of end 2013, the total assets of the banking sector stood at 81% of GDP. Despite evidence of significant financial deepening—bank credit as a ratio to GDP has risen from 16% during 1995–2003 to 45% during 2004–2012—a considerable portion of the private sector’s investment needs continue to be financed by foreign direct investment inflows and borrowings from banks abroad.

Figure 1: Loans to Deposits Ratio, 2001–2014
(percent)



Source: Maldives Monetary Authority

At the end of 2004 there were seven commercial banks operating in the country. Two of these banks are locally incorporated of which the Bank of Maldives (established in 1982), is a public limited company¹ and has the largest financial network in the country. The second locally incorporated bank is the Maldives Islamic Bank, which was established in 2011. The remaining five banks are subsidiaries of foreign-owned banks, which together account for 53% of assets in the banking system. The three largest banks hold 83% of total banking sector assets and 81% of deposits of the banking sector in 2014.

The banking system of the Maldives is highly dollarized both on the assets and liabilities side of the commercial banks' balance sheet. This reflects several structural features of the economy such as the excessive reliance of the economy on the tourism sector and also imports. On the liabilities side, foreign currency liabilities account for close to half of total liabilities of commercial banks. Deposits which account for 48% of total liabilities had previously been the major source of funding for banks. However, since 2003 external borrowings became more significant and played a major role in funding the sharp increase in credit during 2004–2008 (Figure 1).

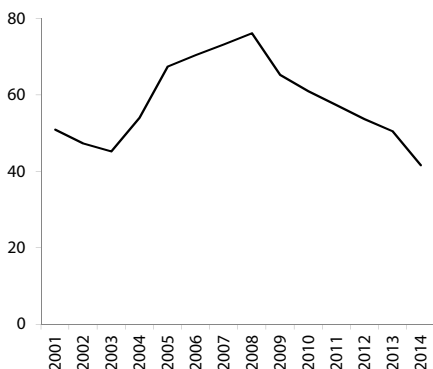
On the assets side, foreign currency assets represent more than half of total bank assets (53% of total assets in 2014). More than half of bank assets are in the form of loans and advances (Figure 2) due to the lack of alternative investment opportunities for banks.

¹ With direct and indirect government shareholdings of 75 percent.

Lending is mainly in foreign currency, which rose to as high as 70% of total loans in the rapid credit expansion period (Figure 3). Much of the foreign loans were lent to foreign exchange earning tourist enterprises, providing a hedge against foreign currency risk.

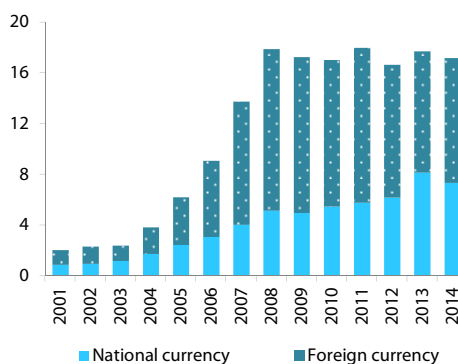
The banking industry of the Maldives is highly concentrated both by borrower and sector. Credit to individuals remains rather small, roughly accounting for 30% of total private sector credit while the remaining 70% are to corporations in 2014. The bulk of credit to corporations is lent to the tourism sector, with a heavy concentration of credit to few large borrowers. For example, about 55% of the total private sector credit was lent to the tourism sector of which 75% were in foreign currency, and these account for 25% of all foreign currency lending. Construction and commerce are the other two main sectors to which banks lend (8% and 15%, respectively) (Table 1). It should also be noted that the exposure of banks to tourism is much higher than the numbers indicate, since credit to sectors such as commerce and construction are very much dependent on the growth of the tourism sector. Due to the high exposure of banks to the tourism sector (both directly and indirectly), the Maldivian banking sector is particularly sensitive to developments in the tourism sector. At the same time, because tourism activity is very much affected by economic conditions in key markets and also other exogenous factors, such as natural disasters (for example the 2004 tsunami) or political tensions, the Maldivian banking sector is very vulnerable to external shocks.

Figure 2: Share of Commercial Bank Loans to Assets, 2001–2014 (percent)



Source: Maldives Monetary Authority

Figure 3: Commercial Bank Loans by Currency, 2001–2014 (billions of rufiyaa)



Source: Maldives Monetary Authority

Table 1: Private Sector Loans by Economic Activity, 2004–2014
(percent of total)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Fishing	6.3	6.5	7.8	9.5	6.8	6.2	5.9	4.8	3.8	3.8	2.7
Construction	6.8	5.4	6.4	8.4	8.5	8.2	7.4	7.4	8.4	9.1	11.6
Tourism	58.2	55.7	52.5	52.3	57.8	59.4	57.6	57.4	57.8	51.1	43.4
Commerce	20.7	18.4	20.2	10.4	11.4	10.3	11.8	13.3	14.9	17.6	16.9
Transport and communication	2.5	4.5	4.5	4.4	4.9	5.3	4.5	3.8	3.3	3.6	4.3

Source: Maldives Monetary Authority

3. Lending Booms and Credit Slowdowns - A Brief Review of Literature

Although the majority of credit booms around the world have not resulted in banking or financial crises, rapid credit growth has been one of the most robust leading indicators for banking distress. Rapid credit growth can trigger banking sector distress through macroeconomic imbalances and deterioration of loan quality (Duenwald, Gueorguiev and Schaechter, 2005). For example, rapid credit growth can often lead to a widening of macroeconomic imbalances (high current account deficit and high inflation) and increase the vulnerability of the economy to macroeconomic shocks. Additionally, a sudden reversal in capital flows or other external shocks could slowdown economic growth and cause distress for the banking sector, depending on the sector's exposure to these risks in relation to its strength (well capitalised, low NPLs and healthy profitability). Loan quality is not only prone to macroeconomic shocks but also to banks' excessive risk taking. For example, during a boom period bank officers' risk assessments may suffer due to the vast amount of new loans extended. Therefore, the perceived risk of loans may be underestimated during lending booms because the risk assessments are based on the current strong economy and rising values of underlying collateral.

Sharp credit slowdowns have also been followed by periods of protracted recovery in credit as shown by the historical pattern of credit surrounding booms in Middle East and North Africa (Barajas, Chami, Espinoza, and Hesse, 2011). Consistent with this finding and based on the experience of other regions of the world (which suggests that credit slumps are quite protracted), Barajas and Steiner (2001) concluded that credit stagnation in Latin America in the early 2000s could be the beginning of a long period of sluggish private sector credit. An analysis of national contributions to weak credit growth in the

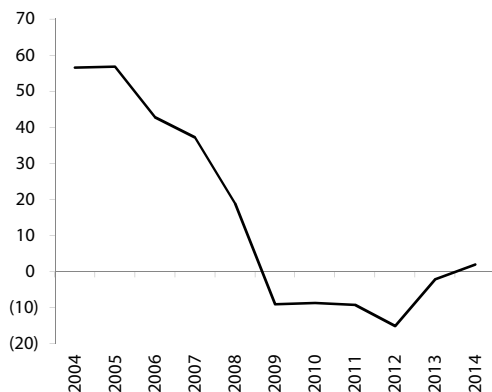
EU has also showed that credit growth was particularly weak in countries in which lending grew especially sharply in the years before the onset of the crisis (Deutsche Bundesbank, 2013). This negative credit growth reflected the need to reduce existing credit overhangs and was thus the consequence of a process of balance sheet adjustment on both borrower and creditor sides.

4. A Look Back– Was There a Credit Boom Prior To the Slowdown in Credit?

The current prolonged weakness in lending to the private sector in the Maldives has been preceded by very pronounced credit growth in the years prior to the crisis. As shown in figure 4, the annual growth in real credit which averaged 43% during 2004-2008 (referred hereafter as pre-crisis period) turned negative in 2009 and declined by an average of 8% during 2009-2014 (referred hereafter as post-crisis period). In order to assess the magnitude of the current slowdown in credit, this section will try to identify if credit growth was excessive in the years preceding the slowdown in the credit.

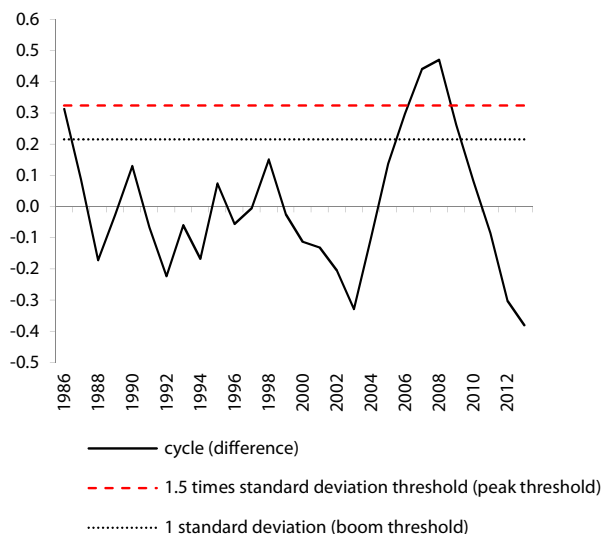
A credit boom is generally defined as an episode during which real credit to the private sector expands substantially faster than what has been observed in previous expansions. To identify credit booms this paper will follow the methodology proposed

Figure 4: Real Private Credit Growth, 2004–2014
(annual percentage change)



Source: Maldives Monetary Authority

Figure 5: Deviation of the Logarithm of Real Credit from Long Term Trend, 1986–2013 (units)



Source: Maldives Monetary Authority

by Mendoza and Torrene (2008) and used by others such as Elekdag and Wu (2011). The credit variable used in this paper is real credit instead of credit per capita as used by the original study². Using data spanning from 1986 to 2013, the long term trend in the log of real credit was calculated using Hodrick-Prescott filter with a smoothing factor of 100. In this analysis, a credit boom was defined as a period when the standard deviation of logarithm of real credit from its long term trend exceeds a certain threshold factor (in this case the standard deviation multiplied by 1.5).

Figure 5 shows the deviation of real credit from trend—the cyclical component. Since the cyclical component exceeds the cut-off peak threshold, shown by the horizontal line (which is equal to 1.5 times the standard deviation of the cyclical component of real credit), a boom is identified. In this case a credit boom occurred during 2007 and 2008 (cyclical component is higher than the threshold), with the peak of the boom occurring in 2008. A lower threshold, uses one standard deviation, and is used to identify the start and end dates.

² The original study uses the geometric average of credit per capita as a measure of credit. However, for simplicity purposes Elekdag and Wu (2011) have used end-year stock of private sector credit deflated by the CPI.

4.1 What Caused the Pre-Crisis Credit Boom?

Several factors have contributed to the strong growth in credit to the private sector witnessed during the pre-crisis period. On the demand side, this was driven largely by a strong increase in the demand for credit from the tourism sector, fuelled by the leasing of several new islands for resort development by the government during 2004–2006. Furthermore, improved prospects for the domestic economy, owing to robust GDP growth, averaging 9.9% during 2004–2008 (Table 2), and the buoyant performance of the tourism sector also contributed to the sharp growth in credit.

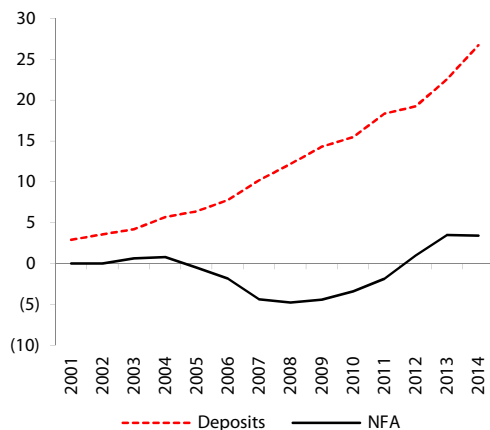
Table 2: Key Economic Indicators, 2004–2014
(annual percentage change, unless specified otherwise)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Real GDP growth	14.1	(8.6)	20.7	10.8	12.5	(5.5)	7.1	12.6	3.0	8.8	8.5
Tourism sector growth	14.2	(33.8)	44.3	9.7	3.5	(5.4)	15.8	9.2	(0.1)	9.0	6.8
Inflation (end of period)	1.0	1.8	4.0	8.9	8.9	5.4	6.9	16.7	5.4	3.1	1.2
Current account deficit (percent of GDP)	na	na	na	na	na	na	na	(16.0)	(7.4)	(4.4)	(6.3)
Fiscal deficit (percent of GDP)	1.0	7.3	4.3	3.2	10.0	18.8	14.3	6.6	7.6	4.2	3.4

Source: Maldives Monetary Authority, National Bureau of Statistics, Ministry of Finance and Treasury

On the funding side, the expansion in credit was supported by ample global liquidity and low interest rates that facilitated foreign borrowings by commercial banks. As shown in Figure 6 net foreign liabilities of commercial banks increased significantly through 2004 to mid-2008 as banks continued to borrow from abroad and on-lend these funds domestically. All these factors combined with rising collateral values increased the risk appetite of banks and thus increased the willingness to lend by banks.

Figure 6: Deposits and NFA of Commercial Banks, 2001–2014
(billions of rufiyaa)



Source: Maldives Monetary Authority

5. Decomposition of Credit Growth

In order to gain insight into the causes of the slowdown in credit, it is useful to view them in the context of the balance sheet of the banking sector, through an examination of the counterparts to credit growth. In this regard, by using the balance sheet of commercial banks, changes in credit as well as its growth, can be accounted for by changes in the remaining components of the banking sector's balance sheet in the following manner:

$$\Delta \text{ Private sector credit} \equiv \Delta \text{ Deposits} + \Delta \text{ Capital and other} + \Delta \text{ Net foreign liabilities}^3 - \Delta \text{ Net credit to public sector} - \Delta \text{ Net credit to central bank}$$

The above identity can be explained as follows. Deposits, capital and net foreign liabilities (or accumulation of foreign debt) are sources of funds for banks and thus have a positive effect on credit to the private sector. Meanwhile, net lending to the public sector and net credit to the central bank are alternative uses of funds for banks and therefore has an offsetting effect on private sector credit, and thus the negative sign. Table 3 below presents the specific series of the data used in the credit decomposition analysis.

This counterpart framework can be used to decompose the credit growth during both the pre-crisis expansion period and the post-crisis slowdown period as shown in figure 7. In a similar manner the change in credit growth between these two periods was also decomposed (figure 8).

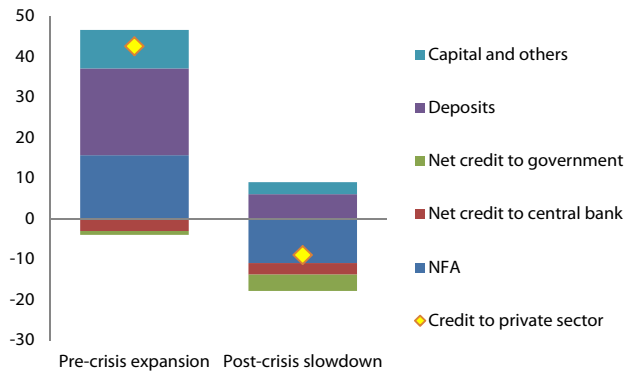
Table 3: Variables Used in the Credit Decomposition Analysis

Variable	Descriptor
Private sector credit	Claims on private/other sectors
Deposits	Transferable deposits included in broad money and other deposits included in broad money
Net foreign liabilities	Foreign assets minus foreign liabilities
Capital & other	Capital and other items, net
Net credit to the public sector	Claims on central and local government, public entities, public financial institutions, minus government deposits
Net credit to the central bank	Reserves minus liabilities with the monetary authorities

³ Throughout this paper net foreign liabilities and net foreign lending are used interchangeably.

Figure 7 shows the contribution of the counterparts of credit growth in the pre-crisis expansion period and the post-crisis slowdown period. In the expansion period, where credit growth was excessive, deposits and net foreign liabilities were the dominant counterparts to credit growth (contributing 21 and 16 percentage points, respectively). The other positive contribution came from capital and other. However, net credit to central bank and net credit to public sector both had a dampening effect on credit expansion (4 percentage points). In the slowdown period three major changes took place which contributed to the slowdown in credit. Among this, the main contributing factor was the turnaround in net foreign liabilities which dragged down credit growth by 11 percentage points. Meanwhile, net credit to central bank and net credit to government contributed to the slowdown period by 3 and 4 percentage points respectively. On the other hand, deposits and capital had offsetting effect and dampened the credit slowdown by 9 percentage points.

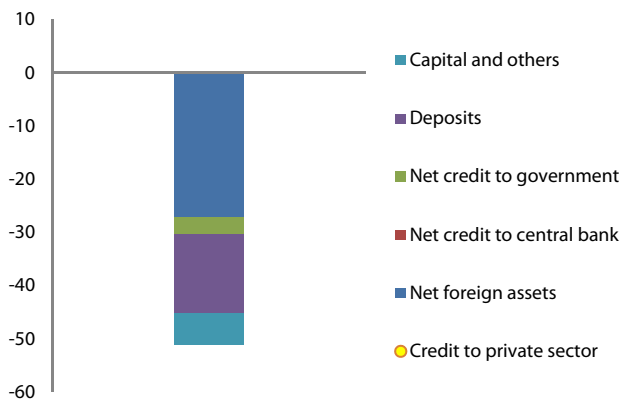
Figure 7: Decomposition of Credit Growth: Pre-Crisis Expansion and Post-Crisis Slowdown (percentage points)



Source: Maldives Monetary Authority

Figure 8 shows the change in real credit growth from the pre-crisis period to the post-crisis period. In the post-crisis period, real credit growth decelerated to a negative 8% from an average of 43% in the pre-crisis period, indicating a decline of 50 percentage points between both the periods. Between these two periods, except for net credit to central bank—which had an almost negligible effect on credit growth—all the remaining balance sheet items contributed to the credit slowdown. Among these, net foreign liabilities showed a marked turnaround, contributing 27 percentage points, followed

Figure 8: Decomposition of Credit Growth: Change in Credit Growth between Pre-Crisis Expansion and Post-Crisis Slowdown (percentage points)



Source: Maldives Monetary Authority

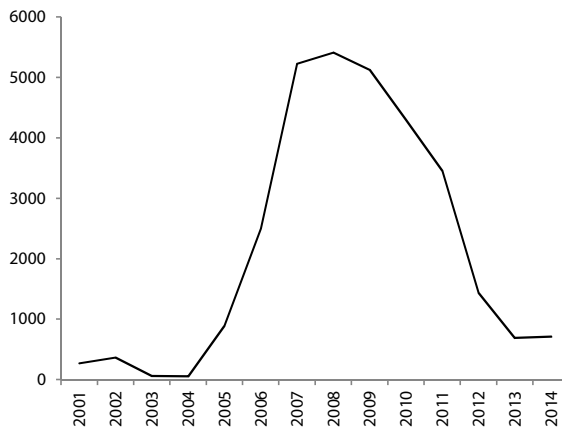
by a shift in deposits amounting to 15 percentage points. Meanwhile both capital and net credit to government (together amounting to 9 percentage points) also played a contributing role in the decline in credit growth between the two periods.

5.1 Factors Affecting the Changes in Credit Growth

The change in credit growth from the pre-crisis period to the post-crisis period identified in the credit growth decomposition analyses can be explained by linking them with economic developments. This section will analyse these developments by attributing them into four major factors.

Loss of external funding: Although foreign borrowing was one of the drivers of credit growth during the pre-crisis period, there was a sharp reversal of this in the years that followed (figure 9). The initial impact of the global financial crisis on the domestic financial sector came from a massive decline in funding, especially to local subsidiaries from their headquarters abroad. This was due to the sharp decline in global risk appetite following the collapse of Lehman Brothers in September 2008. In the meantime, part of the decline in foreign borrowings can be attributed to the prudential regulation on foreign currency exposure limits, which came into force in 2010. The regulation on net open position was introduced to address the vulnerabilities of severe imbalances between foreign currency-denominated assets and liabilities (long open positions in foreign currencies) of the domestic banking sector.

Figure 9: Gross External Borrowings of Commercial Banks, 2001–2014
(billions of rufiyaa)



Source: Maldives Monetary Authority

Increased credit risk: Although the initial decline in credit was caused by a drying up of external funding, the subsequent stagnation in credit resulted from an increase in problem loans. The increase in non-performing loans (NPLs) was partly related to the poor performance of over-leveraged borrowers, especially in the tourism sector after the financial crisis.

As mentioned in the analysis of the credit boom, the pre-crisis credit expansion was driven to a large extent by large resort construction projects that were undertaken with financing from local banks and from investors and banks abroad. In the run up to the global financial crisis, some of these projects incurred large cost over-runs as prices of materials escalated and also due to elaborate design changes which led to significant construction delays. Meanwhile, the domestic commercial banks had funded these projects by accumulating their foreign liabilities and lending was usually based on collateral value, rather than cash flow or ability to pay. Hence, when tourism revenues fell and credit availability and investor interest decreased, several large projects fell into arrears, as a number of highly leveraged borrowers found it difficult to repay their loans due. For example, the absolute value of NPLs which amounted to MVR1.6 billion in 2008 rose by 114% or MVR1.8 billion from 2008 to 2012 and reached MVR 3.4 billion by the end of 2012. At the same time, it should also be noted that part of this increase in NPLs also reflected the better recognition of poor quality assets (table 4).

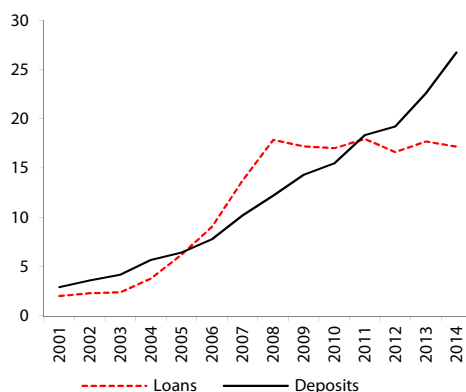
Table 4: Prudential Indicators of the Banking System, 2007–2014
(percent)

	2007	2008	2009	2010	2011	2012	2013	2014
Return on Assets (ROA)	4	3	2	2	3	3	5	5
Return on Equity (ROE)	31	19	14	12	15	14	24	20
Non-Performing Loans Ratio	2	9	13	17	19	21	18	17
Capital Adequacy Ratio	17	21	25	29	29	36	35	44
Liquid Assets in Percent of Total Assets	12	10	18	21	23	28	34	43

Source: Maldives Monetary Authority

As shown in figure 10, despite the recovery in bank deposits, loans as a ratio to deposits continued to fall after 2008 reflecting the risk averse behaviour of banks. Hence, in the face of shocks to tourism and increasing balance sheet strains—as shown by the high NPL ratio; and decline in profitability indicators such as return on assets (ROA) and return on equity (ROE) (Table 5)—banks became more cautious in their lending practices due to their increased perception of risk. As a result, banks focused more on balance sheet repair by repaying their debts and opted for investing in risk-free assets such as Treasury bills (T-bills) while concentrating on loan recovery.

Figure 10: Loans and Deposits of Commercial Banks, 2001–2014
(millions of rufiyaa)



Source: Maldives Monetary Authority

Table 5: T-bill Interest Rates, 2006-2014
(percent)

	2006	2007	2008	2009	2010	2011	2012	2013	2014
28 days (WAIR)	5.00	6.00	6.00	5.97	4.51	6.97	7.87	10.03	7.50
91 days (WAIR)	5.25	6.25	6.25	6.13	5.35	6.96	7.90	10.21	8.00
182 days (WAIR)	na	na	na	na	5.50	6.97	7.85	10.00	8.50
364 days (WAIR)	na	na	na	na	na	na	7.86	10.50	9.00
Memorandum items									
T-bills outstanding, banks (millions of rufiyaa)	323.0	463.0	639.0	2,531.0	3,247.0	3,492.0	3,539.2	3,952.1	5,908.5

Source: Maldives Monetary Authority

High and rising fiscal deficit: During the post-crisis period, the government relied heavily on domestic banks, mainly in the form of Treasury bills (T-bills), to finance its large and growing cash flow requirement, particularly during times when central bank lending to the government was halted. As shown in table 5, the growth in commercial bank lending to the government increased by around 69% during 2009 to 2013, pushing up the domestic T-bills rates close to the commercial banks' lending rate to the private sector.

As for T-bills investments by commercial banks, it should be noted that although the average annual growth in T-bills during 2009–2013 as a whole was 69%, the annual growth in T-bills in the latter three years of this period was only 7%. This indicates the banks' preference for keeping an increasing proportion of their assets in the form of short-term investment in banks or branches abroad. Therefore, while the increased commercial banks' investment in T-bills point to some crowding out of private investment, it is however difficult to separate voluntary lending to the government as a result of poor prospects in the private sector from a crowding out effect of increased reliance on the banking sector to fund fiscal deficit.

Tightening of prudential regulations: In the face of heightened risk to financial stability, the MMA tightened its prudential regulations by introducing a set of new prudential regulations which came into effect in May 2009. These new regulations focused on the following areas: capital adequacy; single borrower limits; limits on loans to related persons; transactions with related persons; asset classification and provisioning; interbank exposures; external audits; publication and disclosure; fit-and-proper requirements, and corporate governance. In addition to this, the regulation concerning

excessive open positions in foreign currency came into effect in January 2010. The MMA's tightening of regulations forced the banks to be more cautious in their lending practices by tightening their lending standards. For example, the prudential regulation on asset classification and provisioning requires banks to apply consistent loan review and grading standards, make adequate provisions, and write-off bad loans in a timely manner. As a result, banks improved their standards for new loans, strengthened credit underwriting and administration, and began pursuing more vigorous recovery efforts. However, banks' recovery efforts continued to be constrained by the lengthy court process which has further contributed to credit risk.

6. Conclusion

The link between credit and economic growth is well documented in several studies⁴. However, excessive credit growth can pose risks to macroeconomic and financial stability through strains on banks' balance sheets (high NPLs and reduced profitability) and also through increased macroeconomic vulnerabilities stemming from a widening of current account deficits, inflationary pressure and potentially higher external debt.

In the case of the recent credit stagnation in the Maldives, supply-side factors appear to be dominant. Although initially caused by a cut back in external funding, the prolonged slowdown in credit was largely contributed by increasing strains on banks' balance sheet which reduced the willingness to lend by banks. For example, even after bank funding improved, credit growth has been constrained by risk aversion and stricter lending standards owing to high NPLs. Moreover, the increased commercial banks' investments in T-bills during 2009 to 2013, which partly reflects banks' appetite for risk free assets, may also have a crowding out effect. Hence, the continued sluggishness in bank credit is a reflection of reduced willingness to lend rather than a lack of ability to lend.

As for policy responses, given that the main cause of the weakness in private sector credit growth is balance sheet strains, focus should be given to improve the balance sheet of banks, so as to get the banking system to function properly and support long term economic growth. In this regard, vigilant bank supervision and enforcement of prudential regulations will be important. Moreover, to the extent that lending is constrained by a reduced willingness to lend by banks, measures should be taken to

⁴ See Beck, Levine and Loayza (2000), King and Levine (1993) and Levine, Beck and Loayza (2000).

reduce risk aversion by banks. This could include the removal of some of the regulatory uncertainty, particularly after introducing extraordinary measures, and through the strengthening of the legal framework. For example, inefficiencies in the legal system with regard to loan recovery, such as the lengthy court process, have often been identified as a major factor contributing to credit risk. At the same time, efforts to increase the availability of reliable financial data on potential customers through the strengthening of the credit bureau could also help in alleviating the risk averse behaviour of banks and thus improve credit growth.

In the medium-to-long term, policies should also focus on developing alternative channels of financing for the corporate sector, through the development of domestic debt markets which can help in diversifying the economy's financing channels.

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