

German Advisory Group

Institute for Economic Research and Policy Consulting

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The influence of creditors' protection on credit markets

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About the German Advisory Group

The German Advisory Group on Economic Reforms, which is active in Ukraine since 1994, advises the Ukrainian Government and other state authorities such as the National Bank of Ukraine on a wide range of economic policy issues and on financial sector development. Our analytical work is presented and discussed during regular meetings with high-level decision makers. The group is financed by the German Federal Ministry of Economics and Technology under the TRANSFORM programme and its successor.

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The influence of creditors' protection on credit markets

In the relevant empirical literature there is a general finding that shows a close connection between creditors' rights and the development of credit markets. This connection can be expressed in two interdependent ways:

1) Creditors' protection and the size of the credit market

A key result of an analysis by Galindo and Micco (2005)[1] is that on average the size of the credit market (measured as the amount of private credit outstanding in relation to GDP) is three times as large in countries with a certain degree of creditors' protection in comparison to those countries where such protection is weak. In countries with weak creditors' protection the credit market has on average a size of only 22% of GDP, while the size is at 66% in countries with stronger protection.

The same study argues also that the volatility of the credit supply depends very much on the protection of creditors' rights. An environment of low creditors' protection contributes to high volatility, and vice versa. This may have to do also with the maturity structure of loans outstanding. It seems safe to assume that the average maturity is the longer the better the rights of creditors are protected.

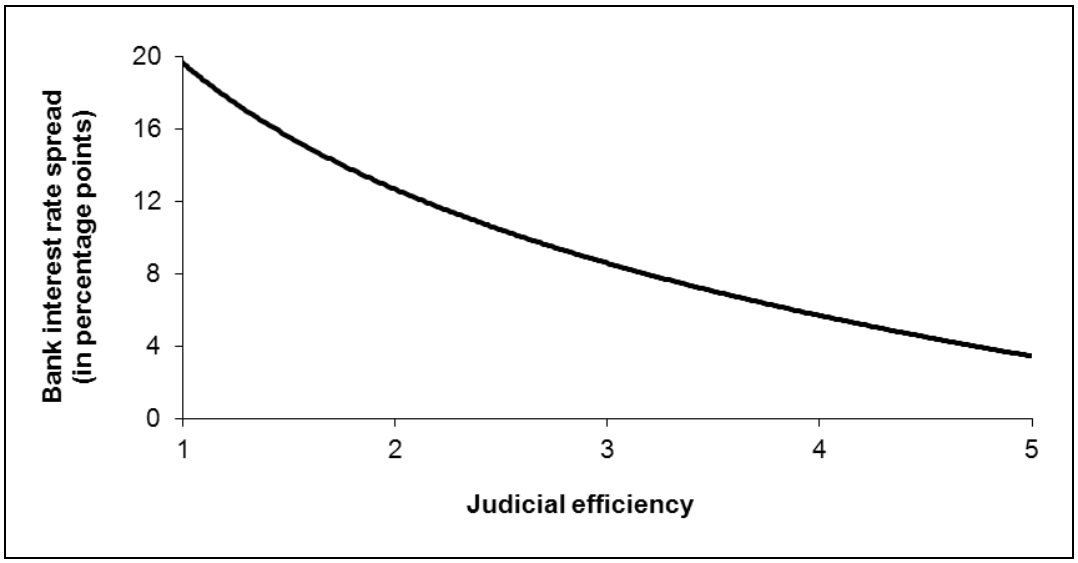
2) Creditors' protection and interest rates

The cross-country study of Laeven and Majnoni (2004)[2], in which 106 countries are analysed, comes to the conclusions that in addition to inflation, judicial efficiency appears to be the main driver of bank interest rate spreads. According to their study the impact of an improvement of the judicial efficiency proves to be substantial:

[1] Galindo, A. and Micco, A. (2005): Creditor Protection and Credit Volatility.

[2] Laeven, L. and Majnoni, G. (2004): Does Judicial Efficiency Lower the Cost of Credit?

Relationship between bank interest rate spread and judicial efficiency



Notes: *The bank interest spread is the difference between the average lending rate and deposit rate. "Judicial efficiency" is an index ranging from 1 to 5, with a higher score indicating more judicial efficiency.*

Source: *Own estimations based on the data collected by Laeven and Majnoni (2004), which are for the year 2000. The relationship shown is based on a non-linear regression.*

Further empirical work seems to support the results obtained by Laeven and Majnoni (2004). A study about the Brazilian credit market (Pinheiro and Cabral (1999)) finds that the existence of good collateral (e.g. in mortgage loans) and of "protection" to creditors from judicial slowness contribute to reduce interest rates charged by banks.[3]

The paper of Japelli et al. (2002)[4] finds out that the depth of mortgage markets is inversely related to the costs of mortgage foreclosure and other proxies for judicial inefficiency.

The fact that a numerous reforms of the bankruptcy law have taken place over the last few years all over the world supports the hypothesis that the enforceability of contracts plays a key role for the development of the financial sector.

To sum up, the protection of creditors' rights influence the bank interest rates through various channels:

1. The higher the protection of the creditor, the less is his risk to loose on his loan exposure. Thus he will be prepared to extend loans at lower rates than in the case of expecting no protection of his rights.

[3] Pinheiro, A. C. and Cabral, C. (1999): Credit Markets in Brazil: The Role of Judicial Enforcement and Other Institutions.

[4] Japelli, T., Pagano, M., Bianco, M. (2002): Courts and Banks: Effects of Judicial Enforcement on Credit Markets.

2. The lower the credit availability (e.g. the lower the market's size) the higher the loan interest rates. This is the result of credit being extraordinary scarce and thus expensive.
3. High volatility of credit availability means higher risk for the banks involved, as it means that even if one lender does continue to provide credit to one client it could be that the same lender is cut from credit by another financial institution. This could jeopardize the payments due.

Implications for Ukraine:

- The high level of bank lending interest rates in Ukraine is currently seen as a major impediment for economic recovery and development
- Thus: A reduction of the level of bank lending interest rates should be a long-term goal of the government and the National Bank
- A crucial way to achieve this goal consists in the improvement of creditors' rights, since as shown by international experience (see above) better rights lead to lower bank interest rate spreads
- The main beneficiaries of such a decrease in spreads are the decent borrowers, since they will have to pay lower interest rates (all other things being equal)
- Thus, such measures should find support by the population (and Parliament), if properly communicated

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