

# Credit Expansion & Credit Limits

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## Abstract

This article discusses the problem of credit expansion and credit limits. A distinction of the concepts of credit expansion and credit limits. The author proposes a classification of credit limits. The article discusses the features of credit booms. An importance of managing credit limits as necessary condition for the sustainable development of the credit sphere is highlighted.

**Keywords:** bank, currency risk, control, risk management

## 1. Introduction

In today's economy, credit is again at the centre of events. The financial and economic crisis that began in the West in the credit sector, showed the need for more in-depth studies of credit and its impact on the economic environment. The companies are even more interested not only in overcoming the economic downturn, but also in finding a way to avoid previous mistakes and errors in the monetary regulation. The question of the new economic structures, measures to ensure stable and sustainable development, including credit instruments, have become the most popular in both academic and practical terms.

In theoretical terms credit expansion, known to the world for decades, is not ordinary, long explainable phenomenon, but a process, showing new sides of its development. Many things that seemed quite clear and understandable, has caused serious doubts, require new explanations.

For modern domestic financial and banking science fields this problem was particularly acute. It so happened that credit expansion was largely associated with monopolistic tendencies readily perceived as a phenomenon peculiar to developed economies, with a lot of inherent capital, seeking a more profitable use. It turned out, however, that credit expansion happens in both developed and developing countries, the consequences can be very diverse. This credit expansion brings not only troubles, causes crises of production and circulation, but also able to provide society with opportunities for economic development.

The question, therefore, is not how to deal with credit expansion, but how to guide the development of the monetary sector, creating imbalances and sharpen the contradictions.

Unfortunately, conventional economic theory can't answer these questions. It is possible that this is due to the fact that in general credit, as economic relations, has not been given due attention, explanations of cyclical development of the economy were more likely to be associated with money without credit as a special phenomenon, providing both the production and exchange with monetary circulation in specific effect. It seems that the actual content of the credit expansion due to the incompleteness of the research on credit was not disclosed in full.

## 2. Credit Expansion: Essence, Nature, Form and Types

In modern science and practice, the concept of expansion is widespread. According to its terminological interpretation, expansion comes from the Latin *expansio* means extension, distribution. From an economic point of view expansion is the expansion of economic impact, economic activities of a country, group, organization, political associations, groups, states, through displacement of other countries, firms, capital markets, acquisition of resources (for example, the export of capital).

In the literature on monetary relations credit expansion is treated as a kind of economic expansion, its content is also associated with the extension. The origins of this approach can be found even in works of the most eminent

representative of the Austrian school of Economics, Ludwig von Mises, who believed that credit expansion and the extension of credit are synonymous. (von Mises, 1967) The following definition of credit expansion as the intensive expansion of credit transactions and operations of banks was adopted in modern literature.

Credit expansion as an economic process is not random, it acts as an expression of patterns of economic development, reflect the growth of material wealth and real savings. Spawn the interests of lenders and borrowers, credit expansion characterizes the development of the monetary system.

As part of the credit cycle, credit expansion occurs, exists and develops in the phase of economic recovery, manifests itself as an extension of credit to different subjects, the emergence of new fields of application of credit, as intensive and long-term expansion of credit supply. On the development horizon, credit expansion acts as a strategic process.

Of course credit expansion is not only a quantitative process of scaling up lending, but also, according to the characteristics of the International Monetary Fund, but also changes in money supply in circulation (Fjodorov, New English-Russian Dictionary of Economics & Banking, SPB, 2006, p. 221), which are the result of an increase in the credit supply through opening credit accounts in the chain of banks.

Credit expansion from an institutional point of view is not only a phenomenon affecting macro-economic relations, but also a process involving the activities of individual banks. We believe that credit expansion is reflected not only in the activities of the creditor, but the borrower who needs more capital, and in this case expresses the patterns of circulation and turnover at the macro and micro level of economic relations.

In modern Russian practice credit expansion visibly manifests itself in the expansion of the subjects and objects of lending terms and provision of credit resources and the payment for a loan, the benefits of lending, export of capital, export credit, geography of credit products.

With the development of banking practice, credit gets new inventory and production costs. Gradually, banks in both international and national practices were transferred from credit to the private objects to total objects, from lending for inventories to borrowers' costs, where one could guarantee repayment of the loan only in the future. It is known that in developed countries, some banks and specialized companies issue venture loans.

It is known that in the modern practice of collateralizing loans not only guarantees of wealth and property are used, but also a variety of types of securities and financial instruments (stocks, bonds, bills, certificates, insurance policies and others). In some cases, the collateral of a loan repayment are not only material object and various financial obligations, but also the personal assets of the borrower.

Unfortunately, in modern practice of collateral usage a range of credit derivatives takes a very special place, by volume substantially exceeding the volume of gross domestic product. Bubble of collateral and associated bubbles, as it is known, became a source of speculation, overheating and as a consequence the reason of the modern financial-economic crisis.

Credit expansion may be fueled by the expansion of the banks' resource base. It is known that internal sources of expanding the resource base of Russian commercial banks before the financial and economic crisis turned out to be significantly less than those of borrowing needs, which demonstrated enterprises and organizations. Using external sources (loans from foreign banks and companies), banks-residents were able to significantly increase their credit investments; credit expansion through external borrowing has received additional breathing.

The expansion of lending to economic entities can be done through interest rate policy of banks, stimulating demand for credit (declining payments for the loan) and the inflow of deposits for subsequent redistribution on a credit basis. It is known that the low interest rate on loans to purchase real estate in the United States led to the widespread development of mortgage loans, however, as it turned out, without proper assessment of the creditworthiness of borrowers, and later to significant losses of credit institutions.

Credit expansion especially during its boom, the critical point, may be accompanied by the liberalization of lending. Low line of borrowers cut-off, a more liberal approach to assessing the creditworthiness of the borrower causes an increase in lending, and in case of adverse shocks lead to a collapse of both the lender and the borrower. According to the testimony of A. Swiston (Swiston, 2008) adherence to lending standards has an impact on the business cycle. The tightening of lending by 20% reduces business activity by 0.75% in one year and 1.25% after two years. To similar findings come and other authors, marking the fall of GDP along with total contraction in credit. (Bayouni & Melander, 2008)

In external economic relations credit expansion is manifested in the form of export of capital and the expansion of export credits. Fueled by an excess of capital within the country credit expansion overcomes national boundaries,

allows lenders to conquer new frontiers and markets, increases the supply of credit in the new geographical boundaries.

For developing countries, credit expansion can occur within national borders, be distributed on the territory to a lesser extent covered by banking products and services, but feeling the need for the development of production and circulation through credit and payment services. Credit expansion in a similar situation allows one to explore new territory, to promote the development of individual industries and the regional economy, and socio-economic development of the country as a whole.

In all these cases, credit expansion manifests itself not as a mere expansion of credit, and as the penetration of credit in new spheres of human activity, intensive, large-scale development of credit, accompanied by an increase in the supply of credit, the expansion of what is being loaned.

The expansion of credit is one of the moments of credit expansion, however, it may occur out of credit expansion. In this sense, the expansion of credit is not yet a credit expansion. It is known, for example, that in times of economic depression, in the post-crisis economy there exist some recovery of loans, the repayment to the pre-crisis positions. We can say that following the economic recovery credit expansion reflects the recovery of the credit relations after the crisis. Full credit expansion begins to manifest itself after the depression, on the stage of recovery, during the accumulation of loan capital, seeking monetary support significantly expanding business activity of economic entities.

The source in the characteristic of credit expansion is the sources of its implementation. There are two types: expansion, developing based on real savings, and the so-called fiduciary expansion. In the first case, we are talking about a natural process occurring when free resources, reflecting really created and accumulated savings are accumulated in banks and redistributed on a returnable basis. In the second case, the credit expansion is carried out through the issuance of debt instruments, reflecting only future income, and is not an expression of real savings. As practice shows, such credit expansion is widely used for speculative purposes, generates bubbles, and requires perfect control mechanism, attention from the state and its respective regulatory frameworks.

The second type of credit expansion associated with the instruments of its implementation. It either occurs through lending or based on the loan (bond). As one knows, the European model of investment prefers banking (credit) form; it occurs based on the expansion in the supply of credit in the form of bank loans. This does not exclude borrowings of credit resources in the form of issuers of debt obligations (bonds). As practice shows, the second direction is less expensive (for the use of credit, as is the case for loans, the borrower does not need to pay the lending rate). Bank lending, in contrast to the bond loan, is in its consequences less risky form as the loan is accompanied by bank analysis of the creditworthiness of the borrower, which is impossible in the situation of the bonds.

Credit expansion can impact both the economy and individual economic actors. The expansion of credit at the macro level may not coincide with the trend of development of lending to individual borrowers. It may well be that the expansion of lending to the economy, the volume of loans granted to companies of different industries can be reduced. This situation is clearly observed in Russia, for example, in the period of reform processes, when the overall credit growth in the economy, the scale of lending to enterprises of light industry was significantly reduced.

Possible regulation of credit expansion can be both of managed and unmanaged nature. It is no secret that the credit for the modern economy is spontaneous. The state, in accordance with the selected doctrine does not regulate lending activities of each individual bank; each bank, based on the amount of accumulated resources and in accordance with their interests and their credit policy, provides decentralized redistribution of capital. This does not mean, however, that the role of the regulator of credit relations can be played only by the market. The government's goal is not only to show what is happening in the credit sector, but in a skillful and timely prevention and neutralization of the resulting imbalances. Unfortunately, this regulation is not always timely, but it is. It is known that during the current financial economic crisis in several countries, including Russia, the state, regulating the general economic environment, gave significant credit support to banks.

We believe that regulation of the credit must be carried out not only in critical situations, it is reasonable to implement in the context of structural, industrial policy, in the form of macroeconomic prudential requirements and regulations. Credit expansion, in our view, is not so much an uncertain phenomena in the economy, rather how to be a managed process, aimed at prevention of overheating of the economy, and promote its sustainable development.

Credit expansion in the pace of its expansion can be moderate and accelerated. Moderate credit expansion follows the economic growth by acceleration in lending ahead of this growth, causing different effects.

The effects of credit expansion may be destructive or positive. Predominant, unfortunately, is the idea that credit expansion has a negative effect on economic development. As it was shown, credit expansion as it turns out, is largely constructive, its negative impact only occurs if credit boundaries are violated.

Credit expansion can lead to very productive impact on the economy. It is known that in the middle of the XIX century in the world there was a wide development of railway construction of the railway network. Only in one decade in Europe the number of railways has doubled, in America—3.5 times. In 50-ies of the XIX century, there was also intense volumes' increase in coal, steel, cotton and other industries production. All this was accompanied by a significant increase in credit issuance. The banks issued short-term loans, and participated in financing industry.

Industrial growth in Germany in the early 70-ies of the XIX century was also accompanied by credit expansion, accelerated economic growth of the country. Unfortunately, credit expansion is often combined with speculation and subsequent fall in the price of securities that affect the loan and its repayment. Economic history and modern practice suggests that providing credit under inflated securities (promissory notes, shares and others), banks expanded credit opportunities to borrowers, adding in the form of imaginary deposits a lot of money, reflecting not available monetary resources, and divorced from the real value of money, which in turn brought high upward pressure on their prices. Sudden credit stress in the economy inevitably led to the loss of value of loan commitments and bank loan defaults rose, bank shares and other securities depreciated.

It is hardly possible to call credit expansion what is called a credit boom. The credit boom is, of course, the expansion of credit, however, due to its characteristics, target orientation and economic consequence it is significantly different from credit expansion.

Credit expansion is, in a sense, a strategic maneuver of lender, affecting his long-term plans. The credit boom is more of a tactical measure, the operational step in the development of credit services.

The credit expansion is of the broader goal. As noted, credit expansion is aimed at expanding the sphere of influence, gaining new opportunities, markets, gain new positions, including in a competitive environment. The credit boom pursues more local goals—not to lag behind the other, taking advantage of the situation to get more profit.

An important difference is that credit expansion, as noted, expresses the process of constant development within the economic cycle. Credit boom as the expansion of credit is the only episode in credit activity, often associated with mass, high output by banks on the credit market, reflects herding pattern, reminiscent of the pre-sale, sale, the excitement of buyers willing to purchase the product at a cheaper price.

In a sense, the credit boom resembles a kind of coming fashion. Usually, it is associated with the extension to a certain direction of development of the banking activity, the expansion of lending to certain types of borrowers or types of credit, when the former traditional spheres of its functioning remain largely unchanged. Credit booms often act as the culmination (critical point) in rise of one of the lines of credit expansion. (Burakov, 2014a)

The emergence of credit booms is usually associated with surplus capital seeking profitable manifestation, maintenance of speculative tendencies (for example, transactions in the real estate market, consumer lending).

Credit boom as a local splash is often characterized by excessive loan growth, extensive saturation of credit, which subsequently leads to a different drop in its volume, causing a decline in the financial stability of both borrowers and lenders.

Studies of American authors, E. Mendoza, and Marco E. Terrones bring forth the evidence of the fact that the average duration of the credit boom of course is not measured by several days, and is 6-7 years. This fact allowed them to determine the credit boom as the episode in which the growth of credit to the private sector exceeds the usual extension of credit during the economic cycle. (Mendoza & Terrones, 2008) According to other authors, the average duration of one credit boom, as a rule, is 3.5 years, sometimes from two to five years. (World Economic Outlook, 2004)

In any case, it is obvious that credit expansion expresses the continuous process, the long-term trend in the extension of credit, while credit boom—only episodic process that spans a relatively short historical period in credit activities.

Comparing credit expansion and credit boom it is impossible not to draw attention to the fact that credit expansion manifests itself in both domestic and foreign markets, while the credit boom is associated mainly with the internal movement of credit capital.

Credit expansion is hardly can be identified by normal acceleration of credit. The acceleration of credit growth (growth rate) during the period of credit expansion may occur repeatedly, this acceleration is not always can be described as the credit boom. Effects of credit booms can be very diverse.

Liberalization in the process of lending according to the experts of the International Monetary Fund is often associated with the rapid growth in housing prices. In the pursuit of clients and volume of loans banks often did not bother themselves with credit analysis, did not show proper requirements for loan documentation, which subsequently meant defaulted loans. The lending standards declined and in those cases, in those regions, where banks carried out the sale of debts to third parties (securitization). (IMF, 2008) Financial liberalization is the second most important factor accompanying a credit boom. It accounts for 1/6 of the cases, the formation of credit booms.

Credit expansion is largely connected with the compliance of the boundaries of credit.

### 3. Borders of Credit

The border of credit issuance and credit expansion is probably one of the most difficult. From a practical point of view, the accurate answer is not there yet. The society has no satisfactory recommendations about the scope of credit as at the macroeconomic and microeconomic level of credit relations.

The unresolved question about credit limits is also of quite significance from a theoretical point of view.

From the perspective of theoretical analysis it is somehow linked to the original and often differing scientific views about the nature of credit, its functions, purposes, causes. Knowledge of the boundaries of credit represents a synthesis of the most important categorical structures; without their prior understanding in the context of use of the credit our knowledge about the subject can be superficial, inadequate. (Burakov, 2014b)

The limit as the boundary expresses the limit of the knowledge of things, its essence and purpose, as well as the measure. Measuring the limits is in turn converted to the limit manifestations of something, the definition of a sense of proportion, symmetry. Important prerequisites for the analysis gives the term norm characterizing typically the border to use as well as (for example, in philosophy) causative reason or another action. From the perspective of philosophy the border not only separates one object from another, but is the foundation of their relationship.

All these terminological interpretations from a theoretical point of view one way or another consider the border of a particular process through the prism of its essence.

If we turn to Aristotle, we will find his uncompromising statement that limit expresses the essence of each thing and its essence of being.

Departing from the entity, including the entity's credit, ignoring the specific properties, using contrary to those of the entity within which it expresses, is inevitably in practice leads to the destruction of those relations, which are characteristics of the return movement of the loaned amount.

Let's not forget that the loan is not only the activity of the lender or the borrower, but the relationship between them, therefore, from a methodological point of view it is important that the boundaries of the loan express activity not one of them, but equally treat each of them, as well as to the third element of credit relations—what is being loaned amount. This means that the boundaries of the loan should be considered as the boundary of its functioning as a whole. This does not exclude, however, that each of the elements of a loan has its own limit (border) function. If, for example, we talk about the boundaries of the lender, although this will be the scope of its activities, but not the boundaries of the loan as a more comprehensive entity.

Borders of credit and borders of lending are different concepts. The first is a broader concept; it is addressed to the credit relations, affects the boundaries of the functioning of three components: the lender, the borrower and the loaned value. The second concept is associated with the activities of the lender providing the loan to the borrower. But here, it is always important to consider that the boundaries of the loan or credit are always a correlation with the position of the entity of the loan, its objective necessity and possibility of compliance with the terms of the credit transaction; it is always the problem of sizing the needs of alienation (receipt) of the loan and the calculation of participants' existing credit process relevant opportunities, for example in the form of resources. (Burakov, 2014c)

Let's not forget that the transfer of what is being loaned by the creditor and its receipt by the borrower in committing these acts should be of interest to both sides. The creditor must be aware of the need for the loan, and the borrower of necessity of its receipt. However, in the credit transaction it is always important not only necessity, but also the possibility to comply with its norms. Such features of the lender and the borrower are always different,

and without them, the credit relationship will not become a reality. Credit is a voluntary relationship, so its boundary is always the comparison of the need and feasibility of compliance with the loan agreement.

When exploring borders of credit corresponding to its specificity, it is important to connect it with those properties that separate this economic relationship from other monetary institutions.

The boundaries of credit is a kind of watershed (line, frame), beyond which the loan turns into its opposite, ceases to exist as a process with a specific entity.

Departing from the essence of the loan, ignoring its specific properties, the use of the intrinsic limits, which he expresses, inevitably, in practice, leads to the destruction of those relations, which are characteristics of the return movement of the loaned amount.

Such a specific property that restricts the functioning of credit is its recoverability. Violation of recovery as a basic limit inevitably leads to the loss of credit of its specific qualities, turns a loan into another form of relations, not peculiar to its nature. Credit beyond the return movement, turns into its opposite, ceases to exist.

One should also not forget that the boundary is, however, not the only a thing that separates the subject from the other subjects, but also what connects it with them. Such a link, as is known, can be implemented through the laws that are expressing significant connections, reflect the relationship between entities. Such laws are the laws of repayment of the loan, the balance between released and redistributed resources based on return, the preservation of what is being loaned, the cost and time of operation. Violation of these laws is a violation of the borders of credit, which inevitably lead to the involvement of credit to cover the needs of not its nature, the emergence of imbalances and contradictions in credit sphere.

Border of credit relations can therefore be defined as the limit of the transmission by lender of loan value available for use by the borrower to meet its objective needs while preserving the essential properties and laws of credit. In conventional theory, credit boundaries, reflecting its essence, are most often associated not with credit in general, and limit the functioning of its individual forms, in particular the banking, commercial and consumer credit.

Borders of credit, however, do not depend on forms of credit. In whichever form the credit is not functioning (in the form of banking, commercial, consumer, and international credit) basic, essential features always permeate all stages of movement of the loaned amount. This does not exclude, however, that in each form of credit specific financial prerequisites exist. In each form, credit as materialistic entity becomes dependent and limited by well-defined flows. The expression boundaries of credit, so can be not only a baseline of compliance, but more, reflecting the peculiarities of the application of one or another form. It is therefore important not only to forget all that is inherent in the credit as an economic category, but also do not ignore what reflects the movement of credit in its concrete form.

The boundaries of credit can be divided into qualitative and quantitative; internal and external; time and space; due to supply and demand; starting and ending.

Qualitative border of credit is the most important thing in its essence, it is the basis of credit. Such basis, as noted earlier, is the return of what is being loaned. Practice shows that in a modern economy the boundaries of the loan in a number of areas are disturbed. This was manifested in violation of the basic principles of lending, the continuing growth of bad loans' issuance. Artificial prolongation of bank loans, highweight of non-performing loans, the maturity mismatch of resources to invest in long-term projects, the devaluation of deposits at an interest rate lower than inflation, etc. are not to be taken into account and present themselves a hidden violation of the boundaries of credit, when credit is drawn in covering unsustainable costs, the needs of borrowers, unsecured by actual savings.

Quantitative borders of credit are often linked to the specific needs of one of the participants of the credit process. Justified in this connection looks the treatment to the satisfaction of using the credit for needs of the production and circulation of additional capital, and not all of them, but only those the circuit of which provides the return of the loaned amount. We can say that this upper limit of credit that addresses the needs of the borrower is intended to highlight those needs, the limit of which is not contrary to the nature of the loan. In quantitative terms, it is important, therefore, not only to highlight what the borrower needs, but also something that can be returned to the creditor.

From a quantitative point of view, equally important is the lower boundary of credit. Typically, such a boundary is associated with the resources available, for example, for the creditor. We know that loaned is often can be only that what is with the lender, resources not employed in his own business. Resources obtained by the creditor, are the objective limit, which accounts for possibility of loan issuance. At the same time resources are the limit that defines not only the creditors' side, but also the borrower's one.

On a practical level, the limit of credit is often considered as gross domestic product, which creates the material preconditions for the return of what is being loaned. In practice, however, the loan amount is often more than you could expect to be used for gross domestic product. This situation is quite understandable, because the loan can repeatedly mediate different parts of the production and circulation and, therefore, exceed the amount of product produced.

Practice shows that the interpretation of the resources and/or their growth rate does not allow you to use this indicator as a reliable information about the observance of the boundaries of the loan. It is important to take into account the fact that the size of the manufactured product does not mean that those who borrowed, would have many opportunities for its repayment. It is not the fact that in the case of production of the respective gross domestic product borrowers will be able to return what was originally borrowed.

More productive information on the observance of boundaries have accumulations of capital created by society. Accumulation quantity as a limit of credit is equally important for the expression of the limit to meet the needs of the borrower in the use of additional capital, and for lender to grant the loan and its receive it back.

#### 4. Conclusion

The disclosure of these boundaries is complicated because the boundaries are not an unchanged line, defining the limits of a certain subject. However, this does not give reason to believe that due to their volatility, such boundaries do not exist. In fact, the line as the limit may develop, however, the limits of this development and operation must exist under the stable entity.

From a theoretical and a practical point of view, it is important to consider the boundaries of credit, including their role in the economy. It is known that the purpose of credit is to ensure continuity of circulation and the turnover value in the form of circulating and fixed capital; acceleration of the circulation and circulation of capital; savings in public expenditure.

Each of these purposes, of course, is achieved in society, not only with credit. For example, to accelerate the speed one can use private capital. The feature, however, is that in this case is that other methods and tools will be used. Since credit can act as other monetary entities, its borders are movable, changeable, however, they always represent the essence of credit; deviation from this entity indicates the misalignment of credit use within its borders, the termination of its existence.

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