CESEE DELEVERAGING AND CREDIT MONITOR[1]

February 14, 2014

BIS reporting banks continued to scale back their funding to Central, Eastern and South Eastern Europe (CESEE) in Q3 2013, at broadly the same pace as in Q2 2013, alleviating concerns that foreign banks' pullback from the region may have intensified following the Fed taper talk in May 2013. That said, the overall external funding conditions have become more challenging for the CESEE countries, with borrowing costs rising and portfolio outflows adding to the negative momentum from continued banking outflows. Private sector credit growth remained subdued in many CESEE countries outside CIS and Turkey, with credit growth to nonfinancial firms still in the negative territory in some countries. Prospects in 2014 are for further tightening in external funding conditions for emerging markets, as Fed tapering and the upcoming European bank AQR/stress tests proceed. The recent episode of volatility underscores challenges that will likely persist along the transition path to higher global interest rates.

I. CROSS-BORDER BANK FUNDING

BIS reporting banks continued to scale back their external positions vis-à-vis CESEE countries in Q3 at broadly the same pace as in Q2, notwithstanding increased market volatility and tightening in global liquidity conditions during the summer of 2013. The BIS reporting banks' external positions vis-à-vis CESEE as a whole were reduced at the same pace as in Q2 (by 0.2 percent of GDP), while funding to CESEE, excluding Russia and Turkey, declined at a somewhat slower pace (by 0.2 percent of GDP in Q3 versus 0.4 percent of GDP in Q2) (Figure 1). Of note is the fact that foreign banks have scaled back their funding to Turkey in Q3 by 0.6 percent of GDP. The cumulative reduction of the BIS reporting banks' external positions reached almost 10 percent of GDP in CESEE, excluding Russia and Turkey, and close to 4 percent of GDP for the CESEE region as a whole (Figure 2).

While foreign banks reduced external positions vis-à-vis the majority of the CESEE countries in Q3 (14 out of 20), the scale of funding reductions varied significantly across countries.

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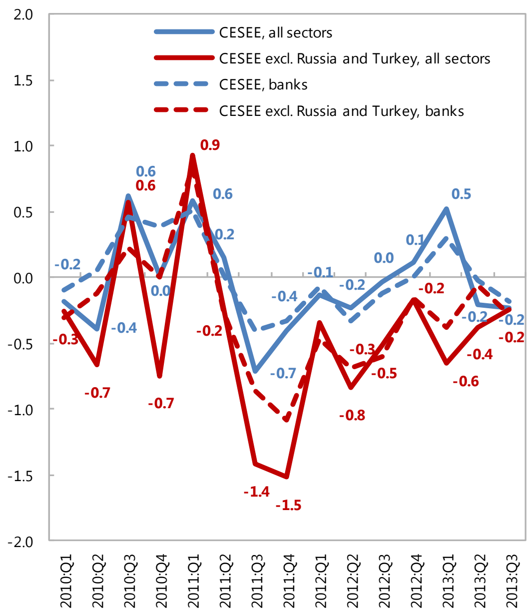
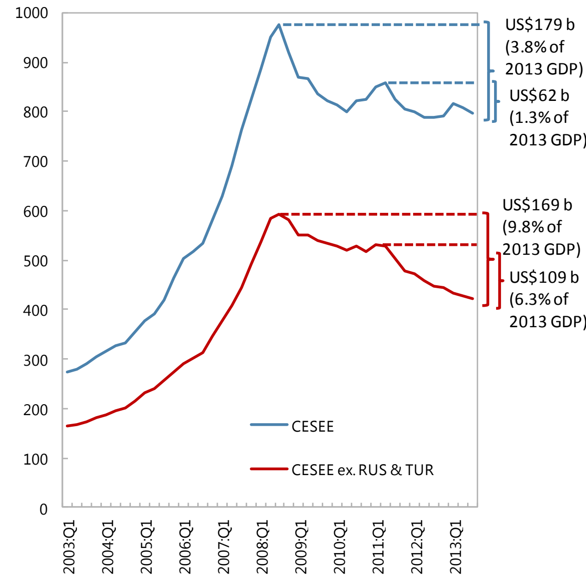
[1] Prepared by the staff of the international financial institutions participating in the Vienna Initiative's Steering Committee. Reflects comments on earlier versions received from the Steering Committee at its meeting on January 13, 2014 in Vienna. Previous editions of this quarterly monitor are available at http://vienna-initiative.com.

Figure 1. CESEE: Change in External Positions of BIS-reporting Banks, 2010:Q1-2013:Q3
(Percent of 2013 GDP, exchange-rate adjusted)



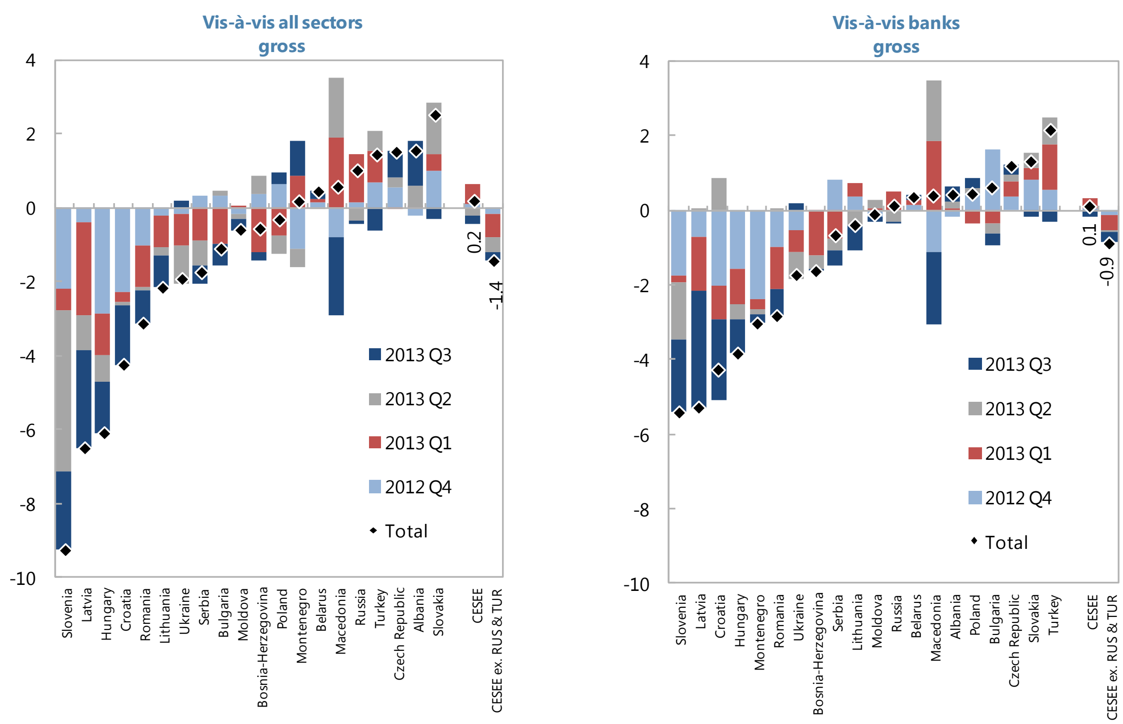
Sources: BIS, Locational Banking Statistics; and IMF staff calculations.

Figure 2. CESEE: External Position of BIS-reporting Banks, 2003:Q1-2013:Q3
(Billions of US dollars, exchange-rate adjusted, vis-à-vis all sectors)



Sources: BIS, Locational Banking Statistics; and IMF staff calculations.

Figure 3. CESEE: External Positions of BIS-reporting Banks, 2012:Q4-2013:Q3
(Change, percent of 2013 GDP, exchange-rate adjusted)



Sources: BIS, Locational Banking Statistics; and IMF staff calculations.

Slovenia, Hungary, and Croatia experienced the largest reductions in foreign bank funding vis-à-vis all sectors, as well as in both gross and net positions of foreign banks vis-à-vis local banking sectors (Figure 3). In all three cases, concerns related to growth, fiscal, external or financial vulnerabilities, together with the more adverse global environment in Q3, likely affected banks' outlook for asset quality and profitably, which in turn may have affected their lending decisions (as discussed below). In the case of Hungary, a potential FX mortgage conversion may have played a role as well. For Latvia, the sizable funding decline in Q3 represents a continuation of the trend reduction of parent bank funding by Nordic banks. For Macedonia, the volatility in recent data reflects a large one-off transaction in Q2 that was subsequently unwound in Q3. On the other hand, the Czech Republic, Poland, Albania, Montenegro, Ukraine and Belarus saw positive changes in the BIS reporting banks' external positions in Q3 (in Poland and Ukraine[2], these increases were predominantly vis-à-vis banking sectors, while in Albania and Montenegro – mainly vis-à-vis non-bank sectors).

The BIS consolidated bank data reveals a broadly similar picture, with Slovenia, Croatia and Latvia experiencing the largest drops in total exposures of BIS reporting banks (Figure 4). In contrast, in the case of Hungary, the decline in international claims was more than offset by the increase in local currency claims, resulting in the overall positive change in foreign banks' exposures in Q3 (on exchange rate-adjusted basis)[3]. At the same time, domestic deposit base in the CESEE countries continued to expand at the same pace of around 3 percent of GDP (Figure 5).

The overall external funding conditions have become more challenging for the CESEE countries since May 2013. The Q3 2013 balance of payments registered overall ***negative*** flows into CESEE, excluding Russia and Turkey, with portfolio flows turning negative for the first time since 2009 (Figure 6). Hence, the withdrawal of foreign bank funding from the CESEE region during Q3 was accompanied by a sharp decline in foreign portfolio flows, as the Fed taper talk in May 2013 triggered a spike in market volatility and a pickup in long-term yields globally, prompting investors to reassess the risk-return tradeoffs of emerging market assets. Countries with sizable external and/or fiscal financing requirements were most affected. Some of the countries that suffered portfolio outflows were also the ones that experienced large foreign bank funding reductions in Q3 (Figure 7).

II. CREDIT DEVELOPMENTS

Domestic private sector credit developments have continued to diverge across CESEE countries. While in CIS and Turkey credit growth through September 2013 (in exchange-rate adjusted nominal terms) remained strong, in CEE and SEE credit growth weakened, turning negative in some countries (Figure 8). As of September 2013, the year-on-year credit growth in CESEE, excluding CIS and Turkey, was close to zero.

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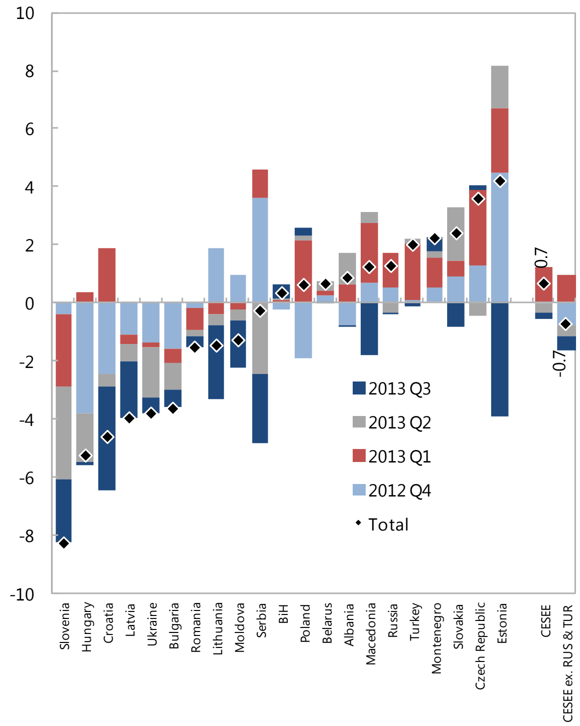
[2] Based on the bilateral Q3 2013 consolidated BIS statistics, it appears that European banks have reduced their exposure to Ukraine, while other banks have increased.

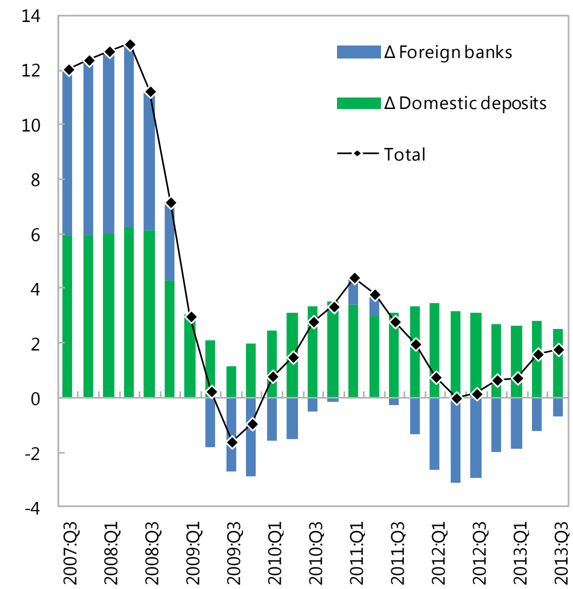
[3] The exchange-rate adjustment for consolidated data is based on the exchange-rate adjustment of the BIS-reporting banks external exposures to all sectors.

Figure 4. CESEE: Foreign Claims of BIS-reporting Banks, 2012:Q4-2013:Q3
(Change, percent of 2013 GDP)



Sources: BIS, Locational and Consolidated Banking Statistics; and IMF staff calculations.

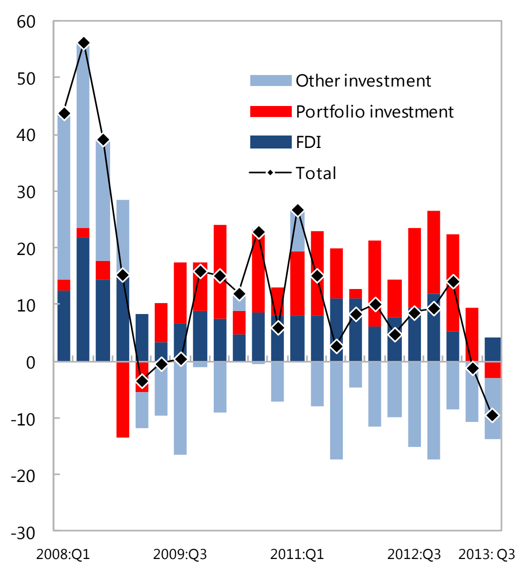
Figure 5. CESEE excl. Russia and Turkey: Evolution of Main Bank Funding Sources, 2007:Q3-2013:Q3* (Percent of GDP, 4-quarter moving average, exchange-rate adjusted)



* Excludes Montenegro and Kosovo because of data unavailability.

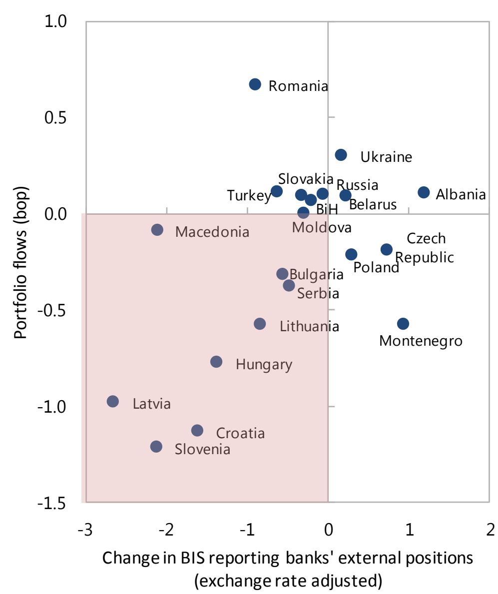
Sources: BIS, Locational Banking Statistics; IMF, *International Financial Statistics*; and IMF staff calculations.

Figure 6. CESEE excl. Russia and Turkey: Capital Flows, 2008:Q1- 2013:Q3
(Billions of US dollars, balance of payments data)



Sources: Haver Analytics; and IMF staff calculations

Figure 7. Portfolio Flows versus Changes in External Positions of BIS reporting banks, Q3 2013 (Percent of GDP)



Sources: BIS, Locational Banking Statistics; Haver Analytics; and IMF staff calculations.

While there are signs of revival of bank lending to households, credit to the non-financial corporations (NFCs) has continued to contract in many CEE and SEE countries (Figure 8). Growth in credit to households has picked up in Poland, Bosnia and Macedonia, and has continued at a strong pace in Serbia and Slovakia (as of end September 2013) (Figure 9). Positive developments in household lending reflect some relaxation of lending standards for consumer credit, as well as improving credit demand. As discussed in the October 2013 Deleveraging and Credit Monitor, lending standards remain tight for SMEs and large companies as well as for housing purchases, but have improved for consumer credit. On the demand side, while household credit demand has been improving, demand from large companies remains weak, reflecting depressed capital expenditures.

The survey data suggest that supply side factors may have played a larger role in explaining credit developments in Q3 2013 than demand side factors. The IIF EM bank lending survey reveals that lending conditions in EM Europe tightened in Q3 2013 after having eased in previous quarters, reflecting a substantial tightening in funding conditions for CESEE banks, while loan demand grew at a slower pace.[4] This again highlights the need to address the supply side-constraints to ensure that they do not put brakes on the recovery once credit demand picks up.

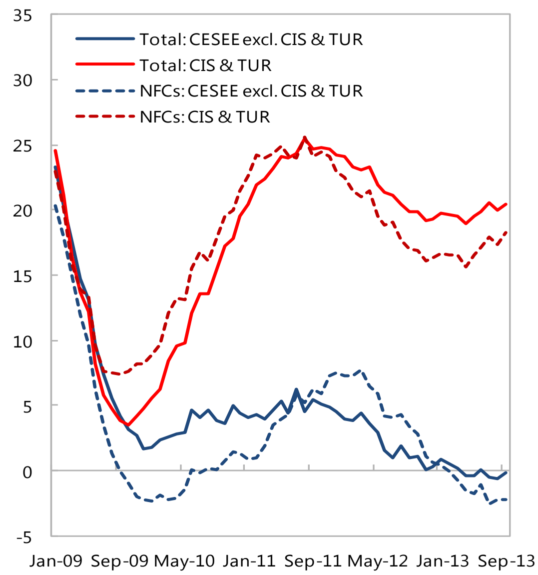
Countries with the sharpest credit contractions and foreign bank funding reductions tend to have similar weaknesses in bank fundamentals. Indeed, changes in domestic bank credit to the private sector are positively correlated with changes in foreign banks' external positions vis-à-vis all sectors (Figure 11). Unsurprisingly, such countries tend to have similar weaknesses. Figure 10 shows that banks in countries that suffered total foreign bank funding reductions in excess of 10 percent of GPD since end-2009– Hungary, Slovenia, Latvia, Lithuania, Croatia, Bulgaria, Romania, and Ukraine (Figure 8) – tend to exhibit one or more of the following: (i) poor (and significant deterioration in) asset quality; (ii) low (and significant decline in) profitability; and (iii) high dependence on non-deposit funding (including from parent banks)[5]. This means that all else equal, foreign funding reductions and credit contractions tend to correlated with weaker bank fundamentals.[6] This underscores the importance of addressing crisis legacies, such as the high levels of NPLs, in order to restart credit growth and to reduce vulnerability to further pullback in cross-border bank funding. The latest available bank balance sheet data (Q1-Q3 2013) for selected CESEE subsidiaries of foreign banks show notably weaker profitability in Hungary, Slovenia, and Ukraine than in other countries in the region (Figure 13).

[4] There are notable differences in coverage between the IIF survey (28 banks from EM Europe) and the EIB CESEE bank lending survey (14 international groups active in CESEE and 90 local subsidiaries or domestic banks).

[5] Note that these countries tend to fall in the shaded areas in Figure 9 which highlight worse-than-median cases.

[6] The April 2013 REI finds that credit growth slowdown in CESEE since 2008 has been driven by both macroeconomic factors (GDP growth and exchange rate changes) and bank fundamentals (asset quality, profitability, liquidity and solvency). In particular, during 2010-11, it was banks' own weakened fundamentals that had put most drag on credit growth. The Vienna Initiative 2 "Working Group on NPLs in Central, Eastern and Southeastern Europe" (March 2012) report discusses mechanisms through which high NPLs affect credit supply.

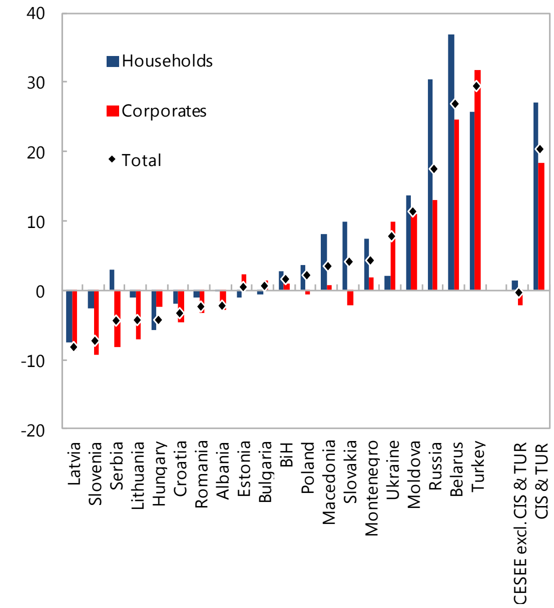
Figure 8. Credit to Private Sector, Jan 2009 – Sep 2013 (Percent change, year-over-year, nominal, exchange-rate adjusted)*



* weighted by GDP (at PPP) of individual countries.

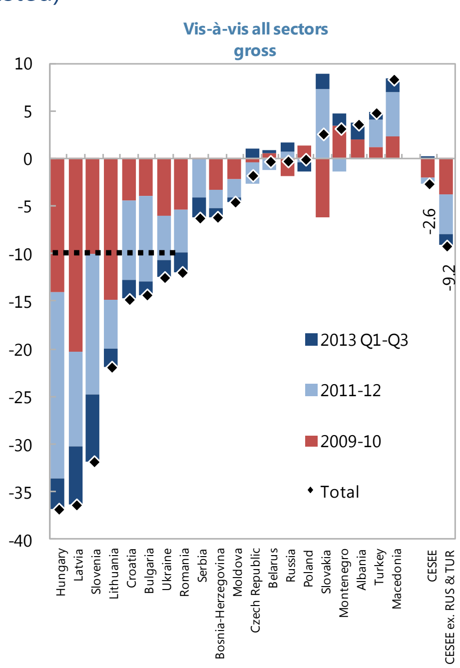
Sources: National authorities; BIS, EBRD and IMF staff calculations.

Figure 9. CESEE: Growth of Credit to Households and Corporations, September 2013 (Percent change, year-over-year, nominal, exchange-rate adjusted)



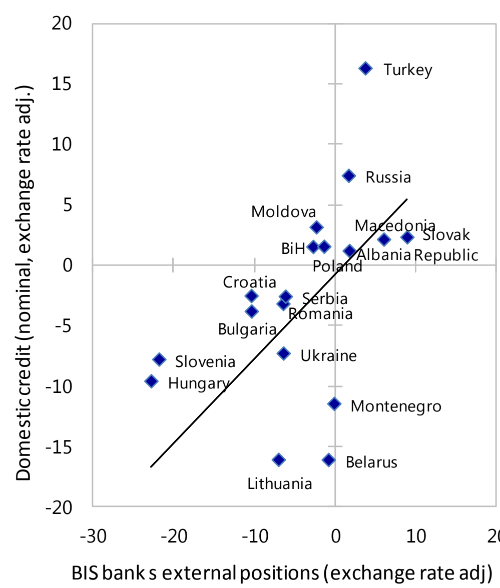
Sources: National authorities; BIS, EBRD and IMF staff calculations.

Figure 10. CESEE: External Positions of BIS-reporting Banks, 2009:Q1-2013:Q3 (Change, percent of 2013 GDP, exchange-rate adjusted)



Sources: BIS, Locational Banking Statistics; and IMF staff calculations.

Figure 11: Changes in Credit to Private Sector versus Changes in External Positions of BIS reporting banks (2011-2013:Q3, percent of GDP)*



*Domestic credit is scaled by nominal GDP for the same year.

Sources: National authorities; BIS, EBRD and IMF staff calculations.

III. WHAT TO EXPECT?

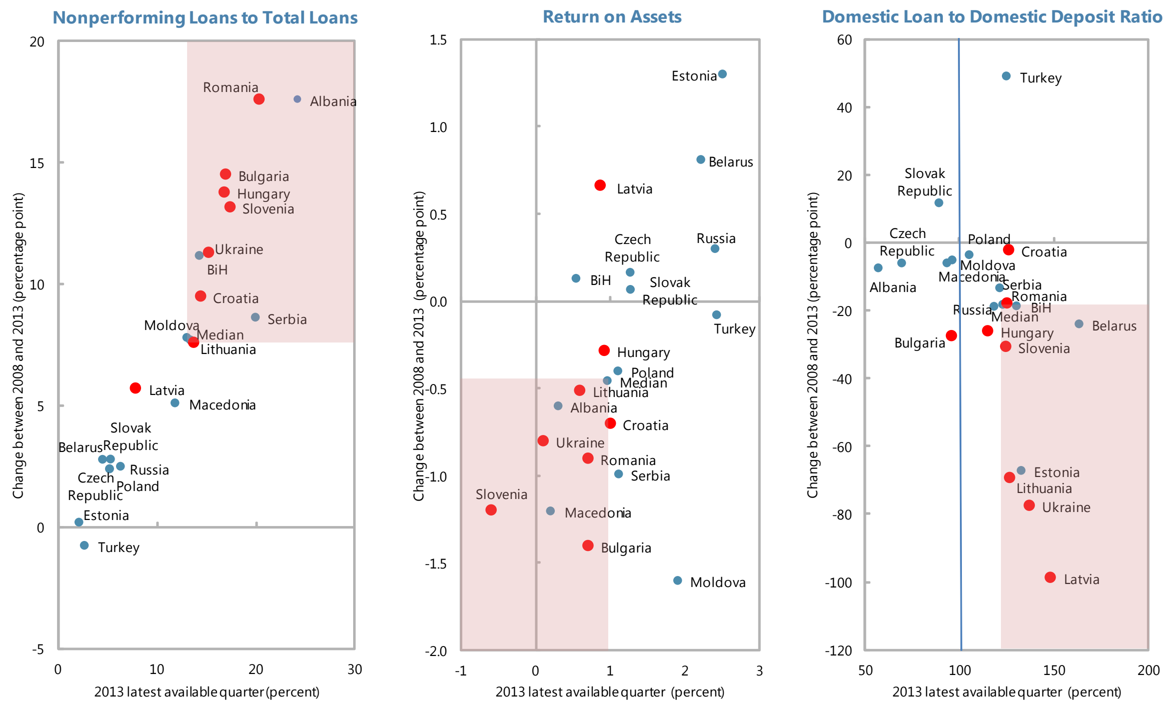
Economic recovery in CESEE appears to be taking hold, but is still fragile. Despite some growth pick-up in Q3 2013, recovery in many CESEE countries outside CIS and Turkey remains creditless and mainly driven by net exports.

2014 is likely to be a challenging year for CESEE, with further tightening in external financing conditions representing a headwind to growth. Two forces will be at play:

- The unwinding of the unconventional monetary policy actions by the advanced economy central banks may lead to continued portfolio outflows from emerging markets and bouts of market volatility (as in summer 2013 and in January 2014); and could contribute to keeping bank funding conditions and bank credit standards tight (as was seen in Q3 2013).
- The ongoing deleveraging and de-risking of the European banks' balance sheets will likely continue and may intensify amid the euro area AQR/stress tests, leading to further tightening of credit supply for CESEE, especially for countries with weaker fundamentals and growth prospects. According to the latest ECB data, a sharp drop in euro area banks' aggregate balance sheets in December 2013 (Figure 14) was in part driven by a decline in their external assets, which presumably included a decline in their funding to emerging markets.

The recent episode of volatility underscores challenges that will likely persist along the transition path to higher global interest rates. Turbulence in EM markets in recent weeks has again highlighted the need for coherent macroeconomic and financial policies, and, in some cases, the need for urgent policy action to improve fundamentals and policy credibility.

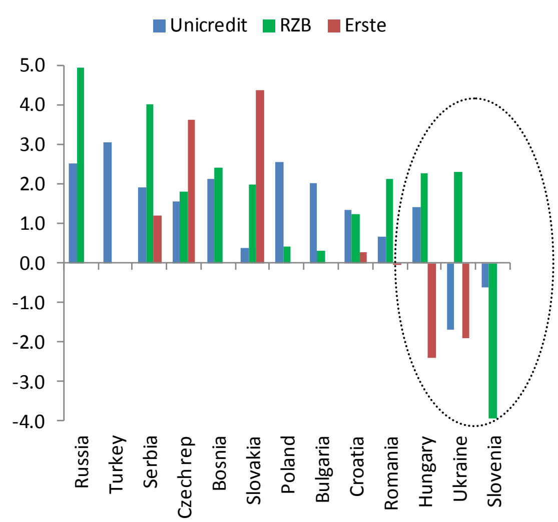
Figure 12. CESEE Banking Systems: Selected Financial Soundness Indicators: 2008 – 2013*



* For most FSIs the latest observation is Q2 or Q1 2013; shaded areas show values of x and y variables above/below medians; red dots highlight countries that experienced the largest reductions in foreign bank funding (over 10 percent of GDP) since 2009 (shown in Figure 10).
Sources: IMF country desks; IMF, *International Financial Statistics*; and IMF Statistics Department.

Figure 13. Profitability of Selected Western Banks' Subsidiaries in CESEE

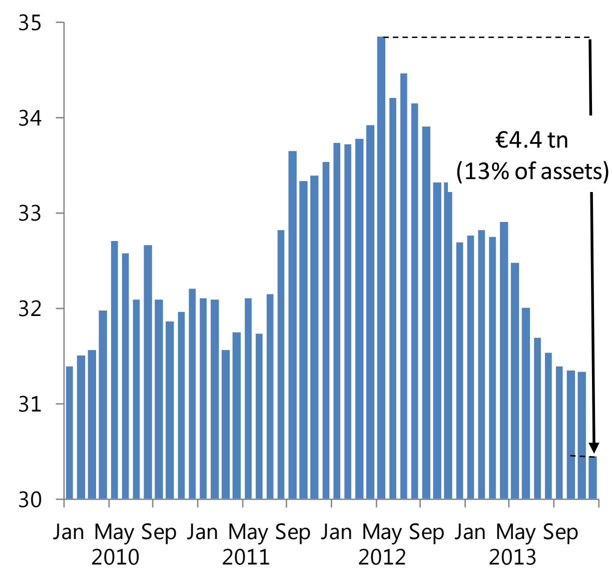
(Pre-tax profit in percent of RWA; first nine months of 2013)



Sources: Q3 bank reports; and staff calculations.

Figure 14. Euro Area Bank Balance Sheets

(January 2010 – December 2013, trillions of euros)



Source: ECB and IMF staff calculations.