EBCI Vienna Initiative

CESEE DELEVERAGING AND CREDIT MONITOR[1]

May 27, 2014

In 2013:Q4, BIS reporting banks reduced their external positions to CESEE countries by 0.3 percent of GDP, roughly by the same amount as in Q3. The scale of funding reductions continued to vary significantly across countries in Q4. Overall external funding conditions improved for the region in Q4 with a sharp rebound in portfolio inflows. Credit developments also improved at the margin mainly on account of household credit. Credit growth in Turkey and CIS countries remains buoyant; however the rest of the region is yet to see clear signs of a revival in overall credit growth. The fourth run of EIB's bank lending survey shows that while cross-border banks remain committed to the region, they are being more selective in their country strategies. Both credit demand and supply conditions are expected to improve in the next six months.

I. CROSS-BORDER BANK FUNDING

BIS reporting banks continued to scale back their external positions vis-à-vis CESEE countries in 2013:Q4, roughly at the same pace as in the previous quarter. External position vis-à-vis CESEE as a whole and excluding Russia and Turkey both declined by 0.3 percent of GDP (Figure 1). Since 2008Q3, when the BIS banks' external position in the region was at its peak, cumulative reduction in BIS reporting banks' external positions to the region as a whole, has reached 4 percent of GDP and, excluding Russia and Turkey, over 10 percent of GDP (Figure 2).

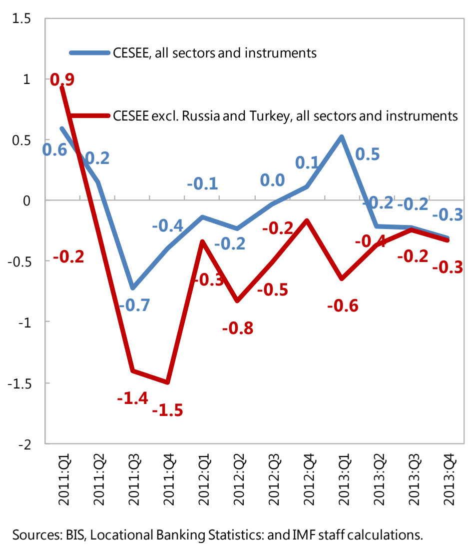
While foreign banks reduced their external position in about two-thirds of CESEE countries (13 out of 21) in 2013Q4, the scale of funding reductions varied significantly across countries. Hungary and Macedonia experienced the largest reductions in foreign bank funding with a pickup in reduction relative to Q3.[2] Other countries that saw a pickup in funding reduction relative to Q3 include Russia, Bulgaria, and Estonia, while the pace slowed in Croatia,

[1] Prepared by the staff of the international financial institutions participating in the Vienna Initiative's Steering Committee. This note is based on the BIS International Banking Statistics published on April 25th, 2014.

[2] The large change in exposure in Slovakia and Czech Republic is likely related to the UniCredit subsidiary in Slovakia changing its legal status to a branch of UniCredit Czech Republic.

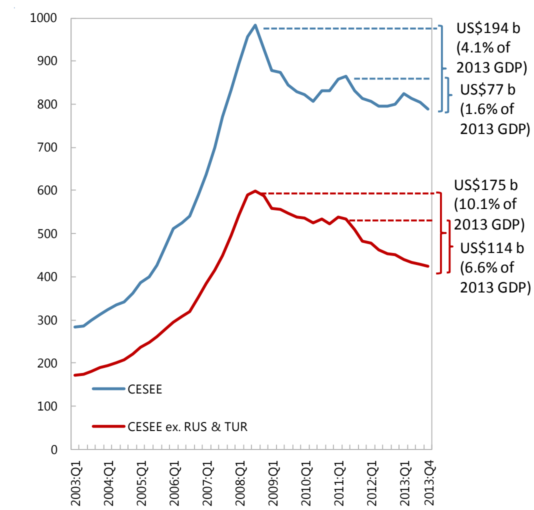
Latvia, Romania, Serbia, and Slovenia (Figure 3, Table 1). Lingering vulnerabilities and the weak macroeconomic outlook continue to weigh on banks' outlook for asset quality and profitability in these countries. In contrast, BIS banks' cross-border flows turned positive in Q4 in Bosnia and Herzegovina, Lithuania, and Turkey, and continued to expand in Poland and Ukraine.

Figure 1. CESEE: Change in External Positions of BIS-reporting Banks, 2011:Q1–2013:Q4
(Percent of 2013 GDP, exchange-rate adjusted)



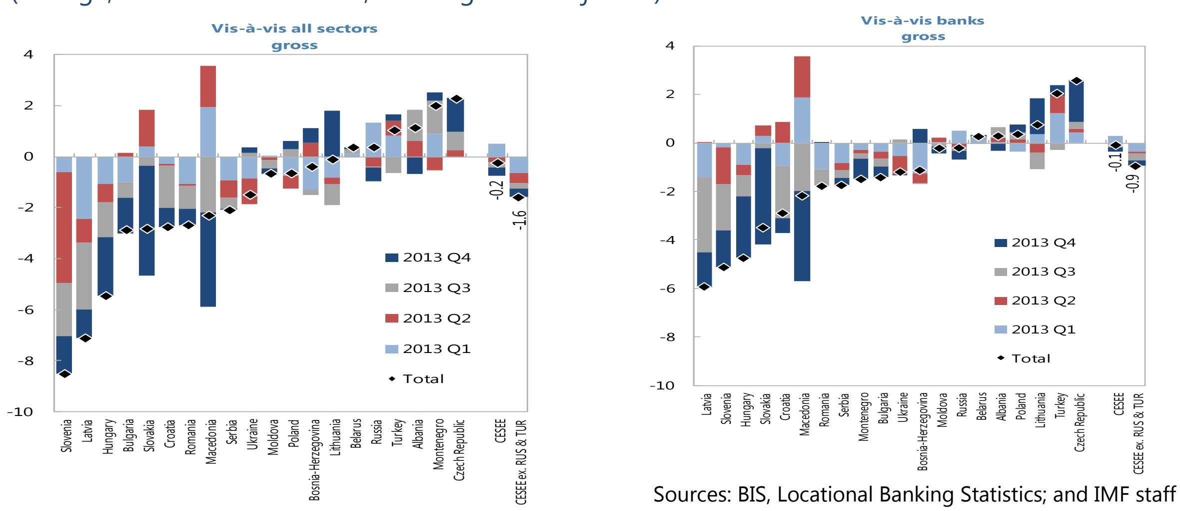
Sources: BIS, Locational Banking Statistics; and IMF staff calculations.

Figure 2. CESEE: External Position of BIS-reporting Banks, 2003:Q1–2013:Q4
(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, 2013:Q1–2013:Q4
(Change, Percent of 2013 GDP, exchange-rate adjusted)



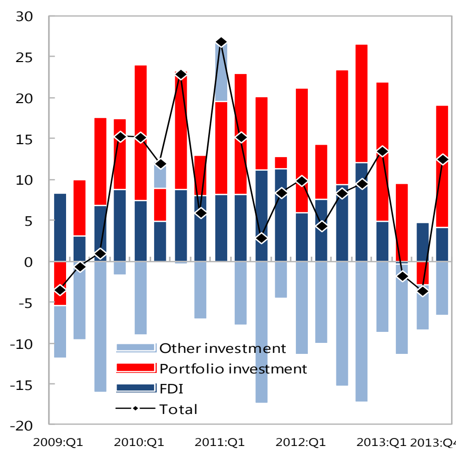
Sources: BIS, Locational Banking Statistics; and IMF staff calculations

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

Overall external funding availability improved for the CESEE region in 2013Q4. While portfolio flows into CESEE (excluding Russia and Turkey) turned negative in Q3, there was a vigorous rebound in Q4 (Figure 4). The rebound was led by Ukraine, Slovenia, Slovakia, Hungary, and Croatia as sovereigns issued bonds in the international market. Portfolio flows also recovered in Turkey. Taking into account both portfolio and cross-border bank flows, funding in Q4 worsened in only four countries: Latvia, Macedonia, Russia, and Romania (pink shaded area in Figure 5), compared to nine countries in Q4 (see *CESEE Deleveraging and Credit Monitor*, February 2014).

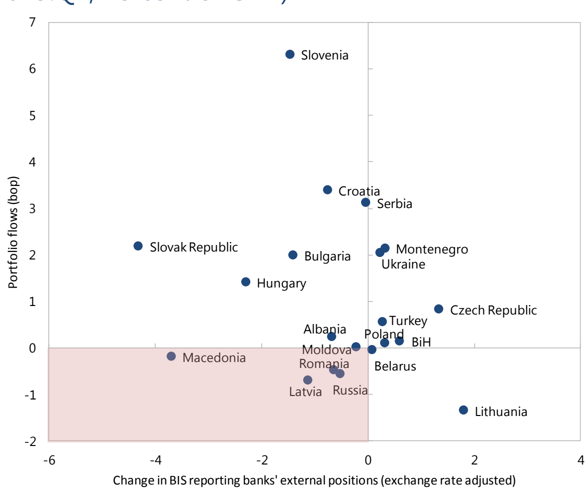
Domestic deposits growth continues to compensate for the decline in foreign funding (Figure 6). While BIS reporting banks continue to reduce their external positions in the region, the increase in domestic deposits (y-o-y change in percent of GDP) has on average more than offset the decrease in foreign bank funding since the beginning of 2013.

Figure 4. CESEE excl. Russia and Turkey: Capital Flows
(2008:Q1–2013:Q4, USD Billions)



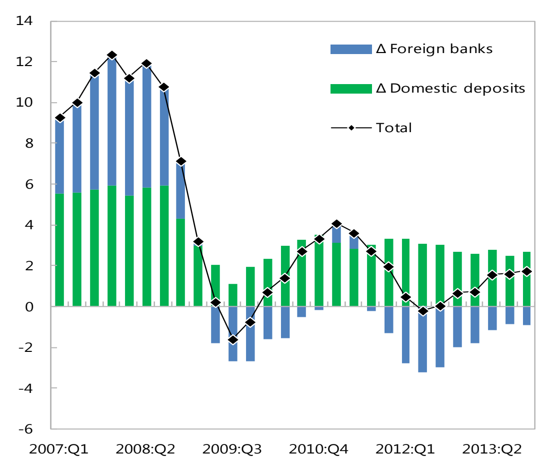
Sources: Haver Analytics; and IMF staff calculations

Figure 5. Portfolio Flows versus Changes in External Positions of BIS reporting banks
(2013:Q4, Percent of GDP)



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

Figure 6. Evolution of Main Bank Funding Sources
(2007:Q1–2013:Q4, Percent of GDP)



* Excludes Montenegro and Kosovo because of data unavailability.

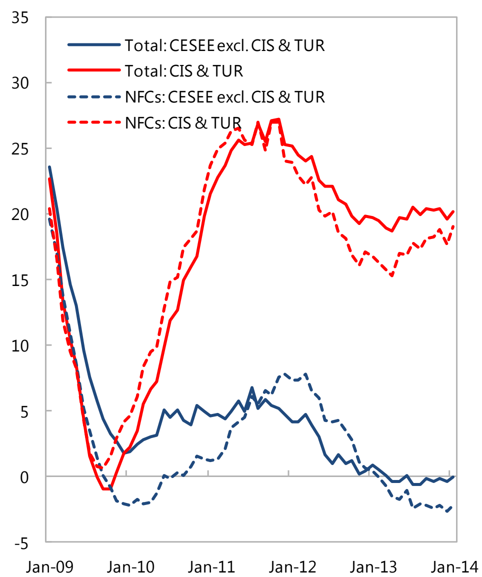
Notes: CESEE excl. Russia and Turkey; year-on-year change in the stock of BIS banks' exposure and domestic deposits in percent of GDP, exchange-rate adjusted.
Sources: BIS, Locational Banking Statistics; IMF, *International Financial Statistics*; and IMF staff calculations.

II. Credit Developments

Domestic private sector credit developments continue to diverge across CESEE countries. While in CIS and Turkey, overall credit growth through January 2014 (in exchange-rate adjusted nominal terms) remained strong, in the rest of the region clear signs of a revival in overall credit are yet to emerge (Figure 7). As of January 2014, the y-o-y credit contraction in CESEE, excluding CIS and Turkey, was 0.1 percent.

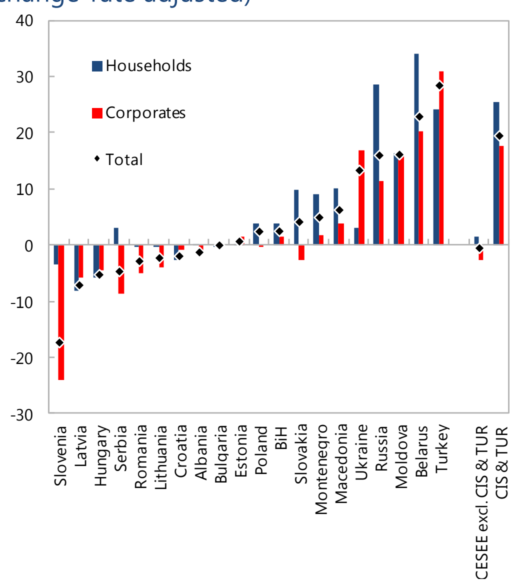
While there are signs of revival of bank lending to households, credit to non-financial corporates (NFCs) continued to contract in many countries (Figure 7). Growth in household credit picked up in Bosnia and Herzegovina, Macedonia, Poland and Slovakia (Figure 8). Positive developments in household lending reflect some relaxation of lending standards for consumer credit, as well as improving credit demand (see next section). Credit to NFCs remained buoyant and in the double digits in Russia, Belarus, Moldova, and Turkey but contracted in almost all other countries[3].

Figure 7. Credit to Private Sector, Jan. 2009–Jan. 2014 (Percent change, year-over-year, nominal, exchange-rate adjusted)*



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

Figure 8. CESEE: Growth of Credit to Households and Corporations, December 2013 (Percent change, year-over-year, nominal, exchange-rate adjusted)



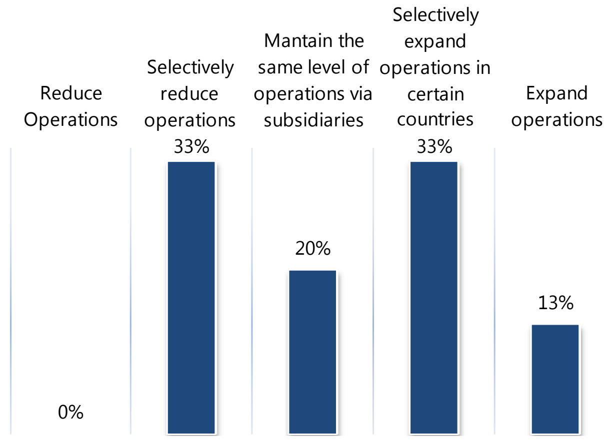
Sources: National authorities; BIS, EBRD and IMF staff calculations

[3] The large decline in credit in Slovenia reflects a transfer of non-performing loans from the three biggest banks to the public asset management company outside the banking system in December 2013.

III. EIB Bank Lending Survey for CESEE: Fourth Run

EIB survey shows that while cross-border banks remain committed to the CESEE region, they are more selective in their country strategies.[4] Operations in the CESEE region remain a key component of the global strategy for the majority of international groups operating in the region. Their CESEE operations also remain profitable, delivering higher returns on assets relative to the overall group operations in slightly more than half of the sample. In addition, these profitability levels are expected to increase further in the next six months, signalling the region's enhanced attractiveness. However, cross-border banking groups remain selective regarding destination (Figure 9). Roughly 46 percent of the groups surveyed expect to expand operations in the future while 33 percent expect to reduce operations. This is broadly unchanged from the September 2013 run of the survey.

Figure 9. Longer Term Operations in CESEE—Groups' Intentions

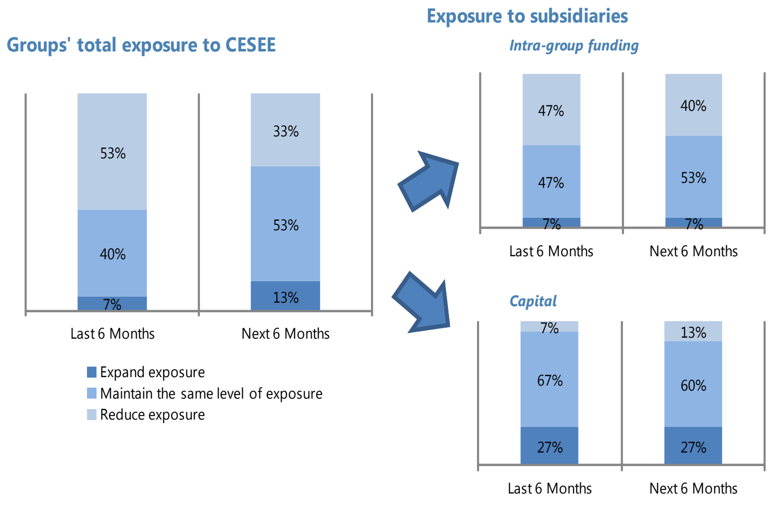


Source: EIB Bank Lending Survey

Going forward, a lower share of bank groups expect to continue the reduction in their external position. Slightly more than 50 percent of the groups signal that they have been reducing their total exposure to the region, but only 33 percent expect to continue this over the next six months. Most of the decrease in exposure is derived from reduced intra-group funding of subsidiaries, a trend expected to continue in the next six months (Figure 10), albeit at slightly reduced levels. Weak local demand may be directly influencing the amount of intra-group funding needed to sustain local business activities. In contrast, the vast majority of parent banks report their intention to maintain the same level of capital exposure to their subsidiaries, or even increase it, and only a very limited number of banks reported a decline in such exposure. All in all, increased capital exposures seem to have partially compensated decreased intra-group funding. In addition, the survey detected that global financial market volatility and FED tapering may have some, but limited, negative impact on groups' exposures to the CESEE region. Again, the impact is expected to be only on intra-group funding exposure, while capital exposures are expected to remain unaffected.

[4] The fourth run of the survey took place in March 2014 and targeted cross-border banks at the group and subsidiary levels, while also including on a stand-alone basis locally controlled banks with sizable market shares. The survey covers 15 cross-border banking groups and 82 subsidiaries and locally controlled banks, accounting on average for over half of the assets of the relevant banking systems. Market coverage has thus been substantially increased in this run of the survey for several countries, notably Poland and Hungary. One new group and nine subsidiaries and locally-controlled banks have been added. "Last" refers to six months ending in February 2014 and "Next" refers to six months starting March 2014 in all charts.

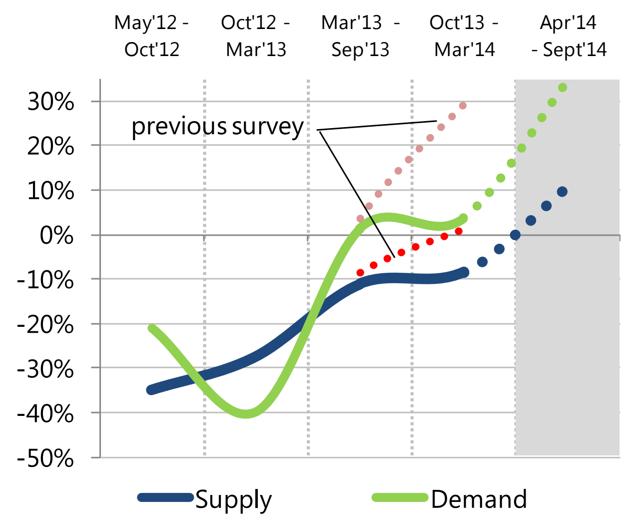
Figure 10. Groups Total Exposure—Cross-Border Operations to CESEE countries



Source: EIB Bank Lending Survey

CESEE subsidiaries report a stabilisation of credit demand and supply conditions, albeit at low levels. Both demand and supply are expected to improve in the next six months. In the last six months, demand for loans and credit lines has been marginally improving, although at a very slow pace (Figure 11) and mostly on account of debt restructuring and working capital needs. On the other hand, investment demand has been very weak. Supply conditions tightened marginally at a pace similar to that observed in the September 2013 run of the survey. Across the client spectrum, supply conditions (credit standards) have been on an easing trend for household lending (especially consumer credit), but still on a tightening trend for corporates (including SMEs). In the period ahead, banks expect a pickup in credit demand and an easing of supply conditions. On top of debt restructuring and working capital, consumer confidence and non-housing related expenditures are expected to make a positive contribution to demand. Household demand for credit is expected to experience a more robust recovery than corporate (and SME) demand. Aggregate supply conditions are expected to ease for the first time since the survey was launched, with the easing being primarily driven by short-term maturities and consumer credit, while some mild tightening is still

Figure 11. Demand and Supply Conditions, Past Developments and Outlook
(Net percentages: negative supply-side values indicate a tightening of credit standards and positive demand-side values indicate an increase of credit demand)

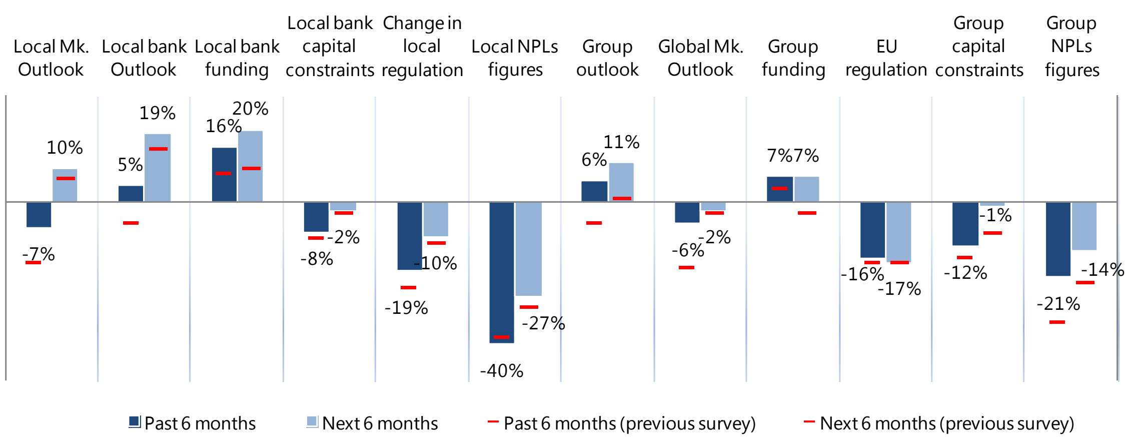


Note: Net percentage refers to percentage difference between positive and negative answers, discarding the neutral responses.
Source: EIB Bank Lending Survey

expected for large corporates. The terms and conditions for loan supply to the corporate market segment, especially collateral requirements, are expected to tighten further, although the maturity dimension has eased marginally. These trends are less marked for other market segments.

NPLs and uncertainty concerning the regulatory environment, both at national and group levels, continue to be the most constraining factors affecting supply. When looking at the reported causes of tightened supply, both international and domestic factors play a role (Figure 12). As in the previous run of the survey, access to domestic funding does not appear to be a constraining factor, unlike international funding. The global market outlook, group-level capital constraints, EU regulation and group-wide NPL levels are all mentioned as having a negative effect on credit conditions. In addition, changes in local regulation, local bank capital constraints, and NPLs at the subsidiary level are key constraining factors domestically.

Figure 12. Domestic and International Factors Affecting Supply of Credit
(Net percentage; negative values indicate a negative contribution to credit conditions)



Note: Net percentage refers to percentage difference between positive and negative answers, discarding the neutral responses. The numbers show observations for the fourth run of the survey.
Source: EIB Bank Lending Survey

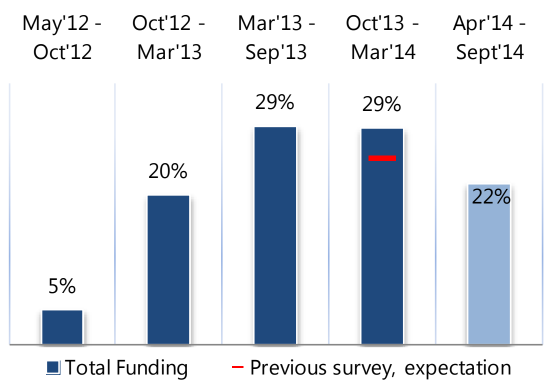
CESEE funding availability continues to improve. Easier access to retail and corporate deposits and increased funding from IFIs support a positive outlook (Figure 13). In addition, CESEE subsidiaries see easier access to short-term funding as making a positive contribution to overall funding activities. For the first time, slightly easier longer-term funding has been a positive contributor to overall funding. This may allow banks to begin reducing their maturity mismatches and start boosting their long-term funding ratios. Subsidiaries still indicate that access to intra-group funding remains on a declining trend, which is consistent with the decrease in intra-group lending exposures to the region reported at the group level (see Figure 10).

Credit quality deteriorated further and remains a key concern for the region's banks. According to the survey results, NPL ratios have yet to peak, but the speed of deterioration has moderated (Figure 14). In absolute terms, less than 40 percent of the banks continue to expect an increase in NPLs over the next six months. The share of subsidiaries indicating an increase in their NPL ratio fell to roughly 50 percent over the past six months, compared to 60 percent a year

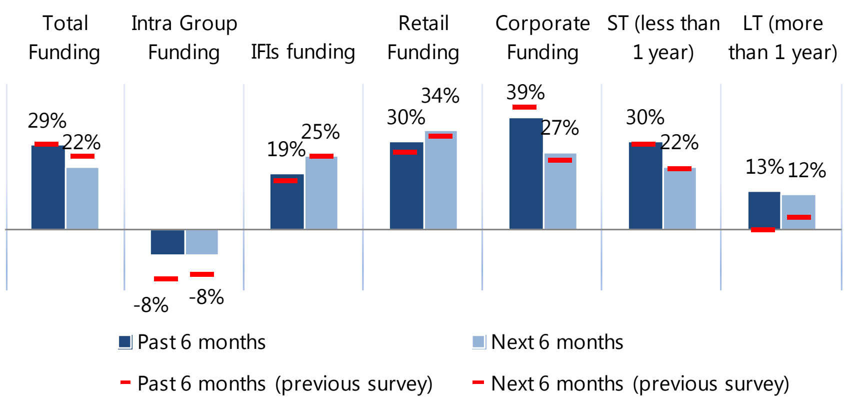
Figure 13. Access to Funding by CESEE Subsidiaries

(Net percentages; positive values indicate an increased access to funding)

A. Trend in total funding conditions (light blue bar - expectations)



B. Breakdown of funding conditions – results from last draw of the survey



Note: Net percentage refers to percentage difference between positive and negative answers, discarding the neutral responses. The numbers show responses for the fourth run of the survey.
Source: EIB Bank Lending Survey

ago. All in all, there has been an increase in the share of subsidiaries indicating either a stabilisation of the NPL ratio, or its decrease. NPL ratios in the corporate segment are expected to increase much less than in the retail segment, confirming the results already obtained in the September 2013 run of the survey.

Overall the survey highlights some common risks across the region. NPLs remain a drag on credit supply conditions, and NPL ratios are expected to continue to increase over the horizon of the survey. Therefore initiatives to tackle this problem remain a high priority for the policy agenda. The resolution of NPLs is key to ensuring a healthy flow of credit into the economy. Access to funding does not seem to be of particular concern at the current level of demand.

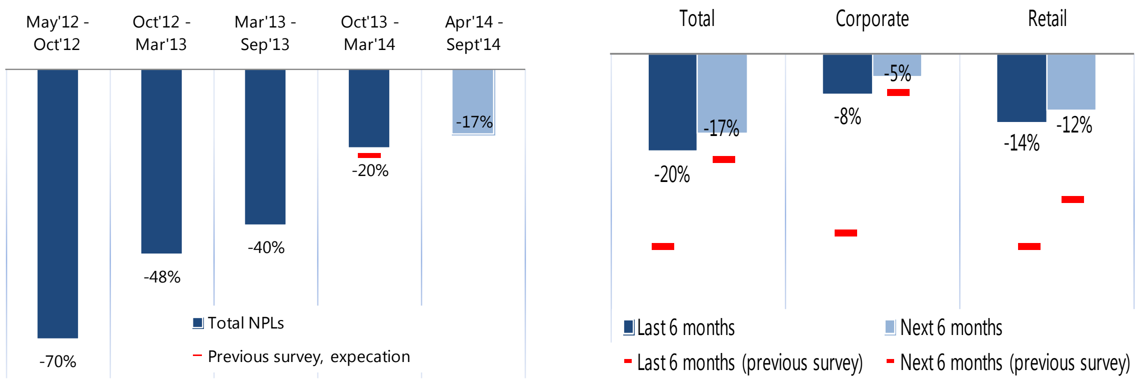
However, should demand for productive investment pick up, supplementary financing sources may be needed to ensure the resumption of convergence in CESEE countries.

Figure 14. Gross Non-Performing Loan Ratio

(Net percentages; negative values indicate that the majority of respondents expect the NPL ratio to increase)

A. Trend in NPL ratio (shaded bar - expectations)

B. Breakdown of NPL ratio – results from March 2014 run of the survey



Note: Net percentage refers to percentage difference between positive and negative answers, discarding the neutral responses.
Source: EIB Bank Lending Survey

IV. What to Expect?

Growth is picking up in most of the region benefiting from the recovery in the euro area. Although real GDP growth in the region is expected to pick up only modestly in 2014 to 1.9 percent from 1.8 percent in 2013, excluding Russia and Turkey the pickup is much stronger (from 1.2 percent in 2013 to 2.3 percent in 2014). Central European economies are also seeing a firming of domestic demand on the back of rising consumption.

The region, however, faces a number of downside risks which could impact external funding, including cross-border flows. These risks include rising geopolitical risks in Russia/Ukraine, faster than presently envisaged normalization of US monetary policy, possible fallout from the upcoming euro area AQR/stress tests for banks' appetite for CESEE exposure, and prolonged low growth and/or low inflation in the euro area. If these risks were to materialize, CESEE countries could face bouts of volatility in financial markets with higher risk premiums, strained access, and stronger deleveraging pressures. Maintaining exchange rate flexibility (where applicable), creating fiscal policy space, making tangible progress toward NPL resolution, and maintaining close coordination with international lenders remain important in countering these shocks.

CESEE: External Position of BIS-Reporting Banks, 2013:Q1–2013:Q4

(Vis-à-vis all sectors)

	2013 Q4 stocks		Exchange-rate adjusted flows (US$m)					Exchange-rate adjusted stocks (% change)					Exchange-rate adjusted flows (% of 2013 GDP)				
	US$ m	% of 2013 GDP	2013 Q1	2013 Q2	2013 Q3	2013 Q4	Total	2013 Q1	2013 Q2	2013 Q3	2013 Q4	Total	2013 Q1	2013 Q2	2013 Q3	2013 Q4	Total
Albania	1,362	10.6	1	79	155	-88	147	0.1	6.5	12.0	-6.1	12.1	0.0	0.6	1.2	-0.7	1.1
Belarus	3,009	4.2	73	-5	150	52	270	2.7	-0.2	5.3	1.8	9.9	0.1	0.0	0.2	0.1	0.4
Bosnia-Herzegovina	3,693	20.7	-230	97	-40	105	-68	-6.1	2.7	-1.1	2.9	-1.8	-1.3	0.5	-0.2	0.6	-0.4
Bulgaria	15,716	29.6	-537	72	-307	-750	-1,522	-3.1	0.4	-1.8	-4.6	-8.8	-1.0	0.1	-0.6	-1.4	-2.9
Croatia	35,194	60.6	-154	-53	-949	-442	-1,598	-0.4	-0.1	-2.6	-1.2	-4.3	-0.3	-0.1	-1.6	-0.8	-2.8
Czech Republic	49,360	24.9	-28	501	1,445	2,636	4,554	-0.1	1.1	3.2	5.6	10.2	0.0	0.3	0.7	1.3	2.3
Estonia	9,601	39.2	-319	-453	-68	-262	-1,102	-3.0	-4.4	-0.7	-2.7	-10.3	-1.3	-1.9	-0.3	-1.1	-4.5
Hungary	42,546	32.1	-1,427	-950	-1,803	-3,045	-7,225	-2.9	-2.0	-3.8	-6.7	-14.5	-1.1	-0.7	-1.4	-2.3	-5.5
Latvia	10,734	34.7	-759	-282	-811	-351	-2,203	-5.9	-2.3	-6.8	-3.2	-17.0	-2.5	-0.9	-2.6	-1.1	-7.1
Lithuania	12,444	26.2	-387	-117	-396	854	-46	-3.1	-1.0	-3.3	7.4	-0.4	-0.8	-0.2	-0.8	1.8	-0.1
Macedonia	1,382	13.5	200	166	-222	-379	-235	12.4	9.1	-11.2	-21.5	-14.5	2.0	1.6	-2.2	-3.7	-2.3
Moldova	366	4.6	2	-12	-24	-18	-52	0.5	-2.9	-5.9	-4.7	-12.4	0.0	-0.2	-0.3	-0.2	-0.7
Montenegro	1,662	38.0	39	-23	58	14	88	2.5	-1.4	3.6	0.8	5.6	0.9	-0.5	1.3	0.3	2.0
Poland	121,246	23.5	-3,870	-2,538	1,502	1,615	-3,291	-3.1	-2.1	1.3	1.3	-2.6	-0.7	-0.5	0.3	0.3	-0.6
Romania	46,167	24.3	-2,030	-158	-1,661	-1,229	-5,078	-4.0	-0.3	-3.4	-2.6	-9.9	-1.1	-0.1	-0.9	-0.6	-2.7
Russia	173,723	8.2	28,440	-8,037	-1,231	-11,176	7,996	17.2	-4.1	-0.7	-6.0	4.8	1.3	-0.4	-0.1	-0.5	0.4
Serbia	8,996	21.2	-394	-295	-180	-19	-888	-4.0	-3.1	-2.0	-0.2	-9.0	-0.9	-0.7	-0.4	0.0	-2.1
Slovakia	25,981	27.1	396	1,372	-321	-4,144	-2,697	1.4	4.7	-1.1	-13.8	-9.4	0.4	1.4	-0.3	-4.3	-2.8
Slovenia	18,723	40.0	-287	-2,026	-989	-688	-3,990	-1.3	-9.0	-4.8	-3.5	-17.6	-0.6	-4.3	-2.1	-1.5	-8.5
Turkey	191,703	23.2	7,046	4,563	-5,164	2,224	8,669	3.8	2.4	-2.7	1.2	4.7	0.9	0.6	-0.6	0.3	1.0
Ukraine	15,429	8.7	-1,487	-1,830	290	398	-2,629	-8.2	-11.0	2.0	2.6	-14.6	-0.8	-1.0	0.2	0.2	-1.5
CESEE 1/	789,037	16.8	24,288	-9,929	-10,566	-14,693	-10,900	3.0	-1.2	-1.3	-1.8	-1.4	0.5	-0.2	-0.2	-0.3	-0.2
Emerging Europe 2/	674,638	15.7	25,285	-9,041	-9,822	-11,884	-5,462	3.7	-1.3	-1.4	-1.7	-0.8	0.6	-0.2	-0.2	-0.3	-0.1
CESEE ex. RUS & TUR	423,611	24.4	-11,198	-6,455	-4,171	-5,741	-27,565	-2.5	-1.5	-1.0	-1.3	-6.1	-0.6	-0.4	-0.2	-0.3	-1.6

Sources: BIS and IMF staff calculations.

1/ All countries listed above. 2/ CESEE excluding the Czech Republic, Estonia, Latvia, Slovakia, and Slovenia.