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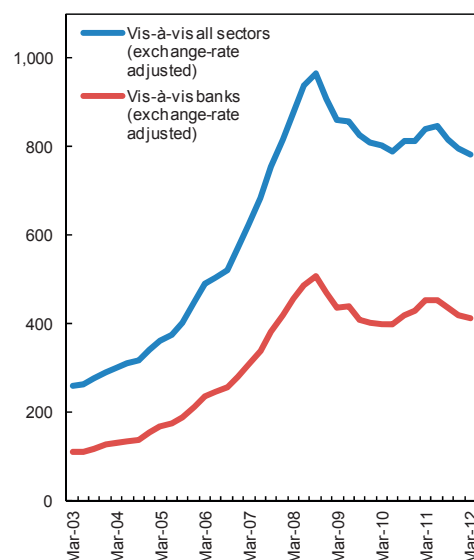
CESEE DELEVERAGING MONITOR^{1,2}

July 20, 2012

The withdrawal of funding by western banks from central, eastern, and southeastern Europe (CESEE) remains a headwind for the economies of the region at best and a potential threat to external and financial stability if downside risks materialized. Deleveraging pressures on the region have eased in the early months of this year from the worrisome levels in the second half of last year, but they remain substantial in several countries. Moreover, high frequency indicators and market intelligence suggest that relief may not be sustained as the effects from the ECB's long term refinancing operations (LTROs) are wearing off and the eurozone crisis persists. While deleveraging is part of transitioning to more robust banking models, it is essential that the process be gradual in a region where systemically important banks are typically funded and/or owned by foreign banks. Hasty moves could jeopardize external payments positions, strain financial systems' liquidity, and disrupt credit supply, especially where banks have little access to alternative funding sources.

The risk of disruptive funding withdrawals by western banks from CESEE has been a longstanding concern. After bankrolling CESEE's boom for many years, BIS-reporting banks' external position vis-à-vis the region stood at US\$970 billion at the eve of the Lehman Brothers collapse in September 2008 (Figure 1). This corresponded to 23 percent of GDP for the region on average, but reached as high as 60-80 percent of GDP in individual countries, such as Croatia, Estonia, Hungary, or Latvia. Roughly half of the funding provided by western banks was intermediated by local banks, which are typically subsidiaries of western European banking groups. With most systemically important banks foreign owned and reliant on foreign funding, any hasty unwinding of the large positions of western banks

Figure 1. CESEE: External Position of BIS-reporting Banks, 2003:Q1-2012:Q1
(Billions of US\$)



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

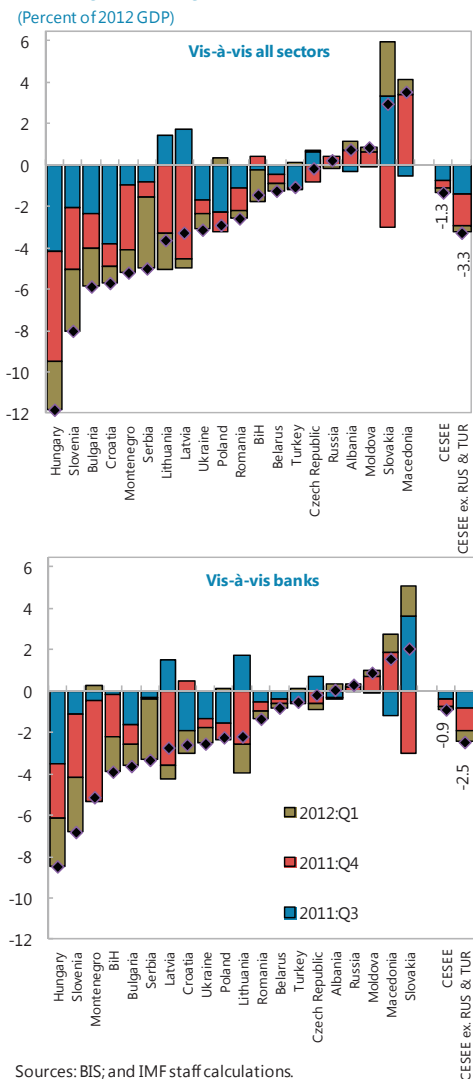
¹ Prepared by staff of the International Financial Institutions participating in the Vienna Initiative for the meeting of its Steering Committee on July 18, 2012 in Warsaw, Poland. Updated with subsequently released banking statistics of the Bank for International Settlements (BIS).

² This note is the first in a series of quarterly deleveraging monitors. Future editions will take up in greater detail a number of issues that are not covered here. This includes: intra-regional differences in the deleveraging process; strategies of locally and foreign-owned banks; the role of demand and supply-side factors in credit growth; and the economic implications of different forms of deleveraging.

would wreak havoc on CESEE economies. Under these special circumstances, the International Financial Institutions attached great importance to keeping western banks engaged in CESEE during the 2008/09 crisis, including through the Vienna Initiative. Funding withdrawals were successfully contained and western banks' external position vis-à-vis the region started to edge up again from mid-2010 to reach US\$885 billion a year later.

The deleveraging of western banks vis-à-vis CESEE resumed from mid-2011 and reached worrisome levels for many countries, although ECB action brought relief in early 2012. The combination of intensifying funding strains in the markets, regulatory and market pressures to improve capitalization, and weak credit demand prompted western European banking groups to resume the withdrawal of funding from CESEE. Between June 2011 and March 2012, BIS-reporting banks reduced their external positions vis-à-vis a number of countries substantially—in excess of 5 percent of GDP in Bulgaria, Croatia, Hungary, Montenegro, and Slovenia (Figure 2).³ In addition, strategies of some cross-border banks devised at the group level paid insufficient attention to the local implications, thereby unduly straining some local market segments. In many of the strongly affected countries, concerns about domestic policies and economic vulnerabilities compounded the outflows. For the CESEE region the aggregate decline came to a more contained 1.3 percent of GDP, or US\$60 billion, because Russia and Turkey with their more limited dependence on foreign-bank funding were less affected and have a large weight in the regional aggregate. Funding withdrawals were largest in the third and fourth quarters of 2011 (0.7 and 0.4 percent of GDP, respectively). With the ECB's 3-year LTRO's in December and February easing liquidity strains for western European banking groups, withdrawals from CESEE declined to 0.2 percent of GDP in the first quarter of 2012.

Figure 2. CESEE: Change in External Positions of BIS-reporting Banks, 2011:Q3-2012:Q1*



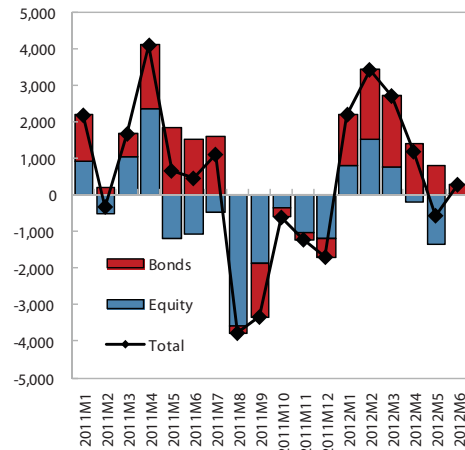
Sources: BIS; and IMF staff calculations.
* Data for Estonia not separately shown.

³ The decline was also extremely large in the case of Estonia but this reflects primarily technical factors related to the 2011 euro adoption. The lowering of the required reserve ratio to the eurozone level freed up liquidity that is being returned to parent banks.

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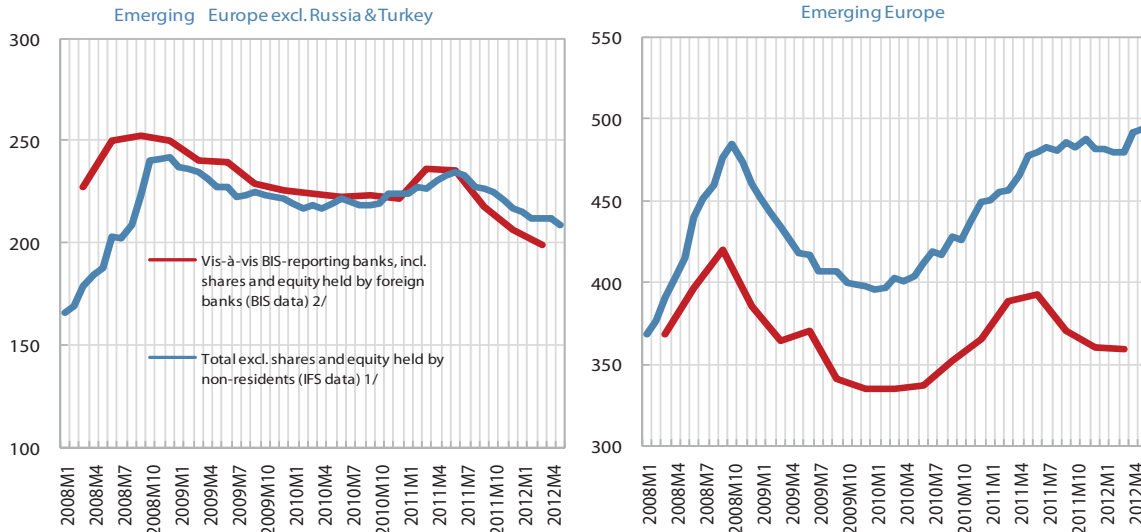
In the second quarter of 2012 funding withdrawals of western banks are likely to have picked up again, although not to the pace of the second half of last year. High-frequency data on flows into funds dedicated to emerging Europe suggest that the sentiment toward the region has deteriorated with the waning effect to the ECB’s LTROs and continued profound concerns about the eurozone crisis (Figure 3). The same sentiments are also important drivers of western banks’ funding decisions for the region. Banking survey data also point to a continuation of deleveraging. The liabilities of CESEE banks to nonresidents declined in April and May, at least if Russia and Turkey are excluded (Figure 4).⁴ Anecdotal evidence of western parent banks asking their CESEE subsidiaries to be repaid ahead of schedule further corroborates the impression that funding withdrawals continue. However, these withdrawals are probably smaller than in the second half of 2011, as evidenced by relatively more contained balance-of-payments pressures.

Figure 3. Emerging Europe: Flows into Dedicated ETFs and Mutual Funds, January 2011 - June 2012 (Millions of US\$)



Source: EPFR, equity and bond country flows.

Figure 4. External Liabilities of Banks, 2008:M1-2012:M5 (Billions of US\$)

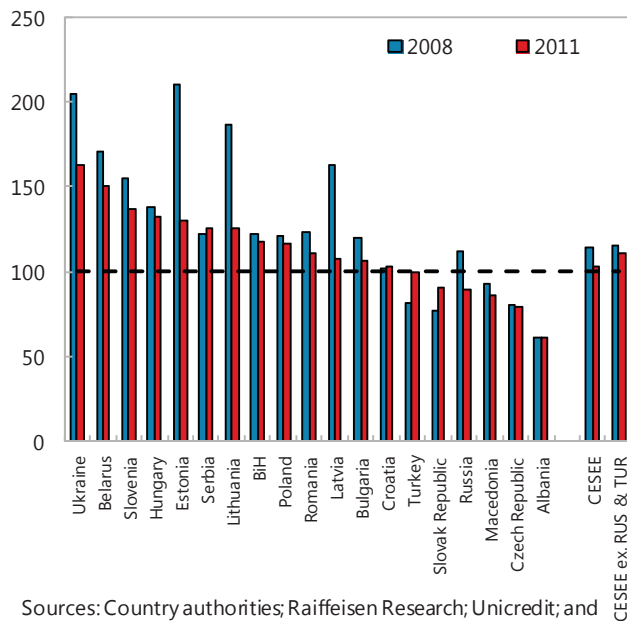


1/ Other depository institutions’ liabilities to non-residents, exchange rate adjusted.
 2/ BIS-reporting banks’ claims on banks in emerging Europe (locational statistics, exchange-rate adjusted).
 Sources: BIS, IMF-IFS; and IMF staff calculations.

⁴ Liabilities in the “Other Depository Corporations Survey” comprise all nonequity liabilities vis-à-vis nonresident banks and nonbanks. The increase of liabilities in April/May for the full CESEE aggregate reflects developments in Russia and Turkey. Higher foreign liabilities of their banking systems might well reflect increased recourse to financing in international capital markets. This would explain the recent divergence of external positions as per BIS Locational Banking Statistics and foreign liabilities as per International Financial Statistics (Figure 4, right panel).

Deleveraging is likely to continue going forward as it also reflects structural factors. As beleaguered western banking groups shrink their balance sheets over the next few years, their CESEE operations cannot reasonably be expected to escape unscathed.⁵ Furthermore, some excesses from the past need to be unwound and this will ultimately strengthen CESEE banking systems. Some progress has been made in bringing down loan-to-deposit ratios, which now stand at 103 percent on average compared to 115 percent in 2008 (Figure 5). However, prospects vary widely among the countries of the region and the banking sector structure in the region is fluid, with traditional players generally still committed but more constrained in their operations and some newcomers at the door. Relevant drivers of country prospects are, on the one hand, capital constraints and access to financing of the banking groups that operate locally. On the other hand, local conditions in terms of self-sustainability of funding, the quality of local portfolios, and the operating environment for the banking sector are key.

Figure 5. CESEE: Loan-to-Deposit Ratios
(Percent)



Sources: Country authorities; Raiffeisen Research; Unicredit; and IMF staff calculations.

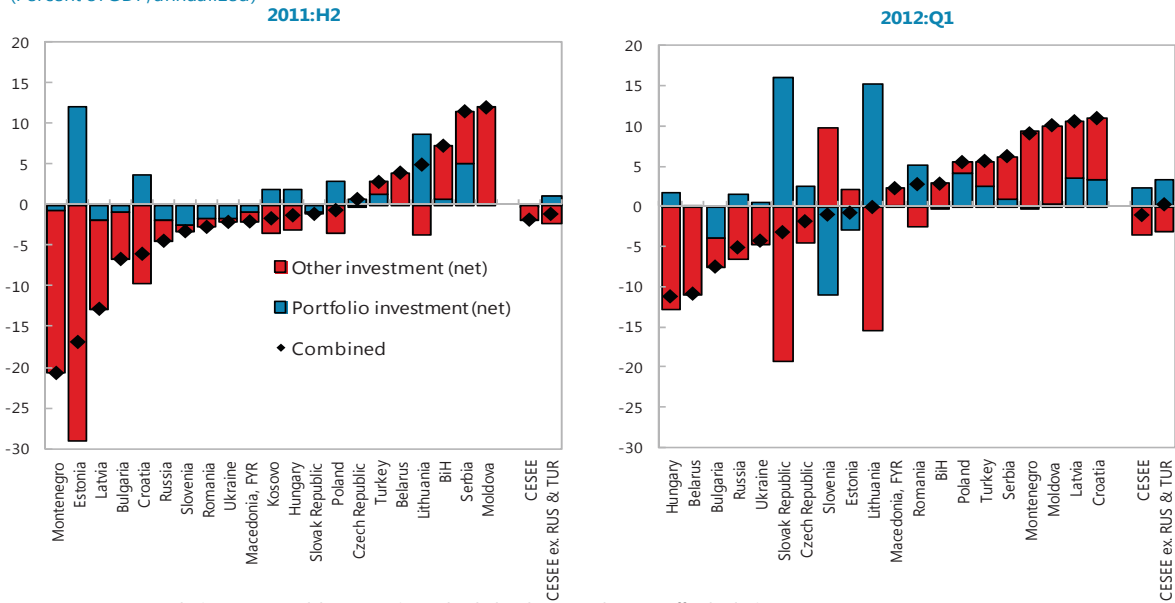
It is critical that deleveraging proceeds at a measured pace and in a growth friendly manner. With external positions of western banks vis-à-vis CESEE still very large, any abrupt reductions continue to have the potential to inflict material damage to the economies of the region. Countries' balance of payments could come under pressure, with exchange rates depreciating and international reserves draining. In the financial sector, the loss of funding could set off a severe credit crunch, which would not only hurt aggregate demand and the recovery but also inhibit investment needed to redeploy resources to the tradable sector. Large funding cuts would have progressively graver implications and can ultimately undermine financial stability. All this can be avoided if deleveraging proceeds at a pace not exceeding the development of domestic savings and alternative funding sources. Adverse economic effects are further mitigated if the deleveraging of some banking groups is compensated by others stepping in.

⁵ The IMF's Global Financial Stability Report (April 2012) estimates that the largest EU-based banks will reduce their balance sheets by 7 percent between September 2011 and end-2013. While the bulk of the shrinkage comes from the disposal of noncore business lines, lending in CESEE will still be affected. The effect on lending would be lessened to the extent that these banks sell CESEE operations to stronger parents, as is indeed happening. For a summary of recent M&As see Raiffeisen, CEE Banking Sector Report, June 2012, p. 67, www.rbinternational.com/ceebankingreport2012.

The recent bout of deleveraging has left its mark in the external accounts of CESEE countries. Balance-of-payments recorded large deficits under “other investment,” where cross-border bank financing is captured (Figure 6). With portfolio flows not providing much of an offset, CESEE suffered losses of international reserves and currency depreciations in countries with flexible exchange rate regimes. Pressures were intense in the second half of 2011 and eased in the first quarter of this year, although they were still large for many countries.

Figure 6. CESEE: Capital Flows in the Balance of Payments

(Percent of GDP, annualized)

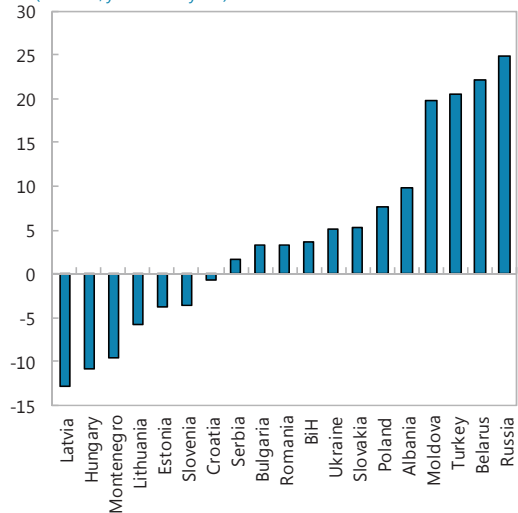


Sources: Haver Analytics; IMF, World Economic Outlook database, and IMF staff calculations.

The withdrawal of foreign bank funding has been a factor in the slow credit growth observed in many countries of the region, although disentangling supply and demand factors is difficult (Figure 7). Over the last twelve months, credit growth has been negative in the Baltic countries, Croatia, Hungary, Montenegro, and Slovenia, even in nominal terms. Bulgaria, Romania, and Serbia recorded positive but very weak credit activity. All these countries have suffered large funding withdrawals from western banks during this period. However, other factors are also at work, notably weak credit demand and high ratios of nonperforming loans in banks’ portfolios, which tend to weight on the

Figure 7: Nominal Credit Growth, May 2012*

(Percent, year-over-year)



Source: EBRD staff calculations.

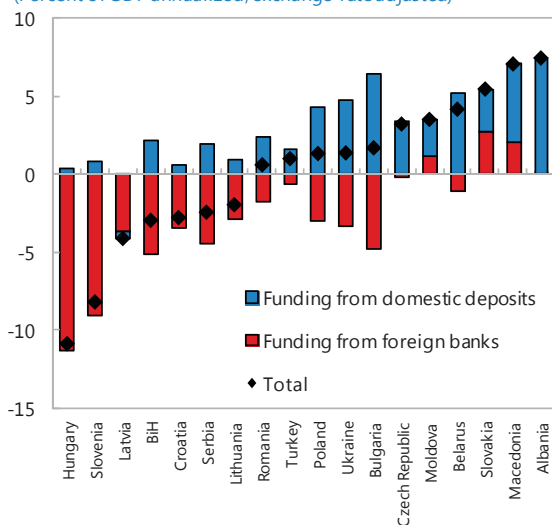
* April 2012 for Ukraine. Exchange rate adjusted.

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willingness and ability of banks to extend fresh loans.⁶ Some countries managed to offset, or even overcompensate, the loss of external funding by growing local deposits, thereby easing any funding constraints on new lending (Figure 8). Nonetheless, the shift in banks' funding patterns since 2008 has been radical, with foreign funding now a drag and domestic deposit growth bringing overall funding growth barely into positive territory (Figure 9). While a return to the pre-2008/09 credit boom is certainly not desirable, the concern is now that developments are overshooting in the other direction.

Figure 8: Change in Banks' Funding Sources, 2011:Q3-2012:Q1

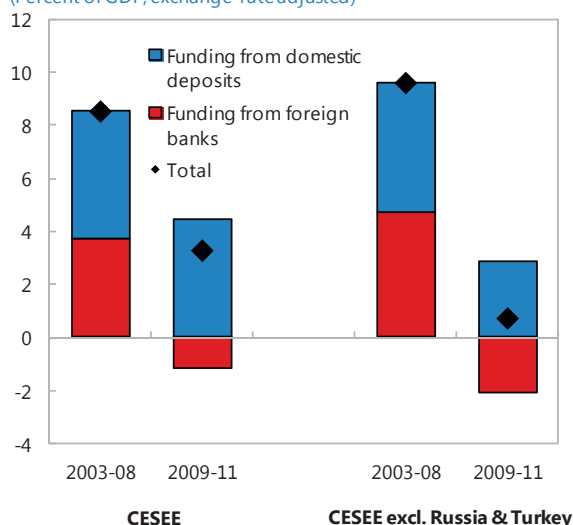
(Percent of GDP annualized, exchange-rate adjusted)



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

Figure 9. CESEE: Change in Banks' Funding Sources

(Percent of GDP, exchange-rate adjusted)



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

⁶ For the effect of non-performing loans on credit supply see EBCI, Working Group on NPLs in Central, Eastern, and Southeastern Europe, March 2012, www.imf.org/external/region/eur/pdf/2012/030112.pdf.