

CESEE DELEVERAGING MONITOR¹

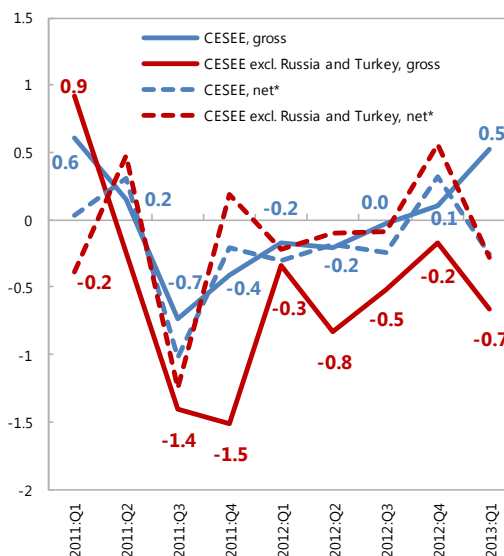
July 26, 2013

Funding reductions of western banks to Central, Eastern, and South Eastern Europe (CESEE) excluding Russia and Turkey picked up in the first quarter of 2013. Private sector credit growth remained weak, with the exception of the CIS countries and Turkey, and loan-to-deposit ratios declined further. There is a concern that the deterioration in market sentiment vis-à-vis emerging market countries that started in late May may intensify funding reductions.

The external position of BIS-reporting banks vis-à-vis CESEE excluding Russia and Turkey continued to decline in the first quarter of 2013, with sizeable cross-country differences. The external position declined by 0.7 percent of GDP—a pick-up from the reduction of 0.2 percent of GDP in 2012:Q4. The expectation in the previous Deleveraging Monitor that the second wave of funding reductions that started in mid-2011 would moderate further thus did not materialize. Including Russia and Turkey—countries where the ownership share of foreign banks is small—the gross funding picture was more positive and CESEE as a whole saw an increase in funding of 0.5 percent of GDP.²

On average and over a single quarter the reductions were moderate, but the accumulated amounts over the last several quarters have been quite large, especially for some countries. The cumulative funding decline since mid-2011 comes to 5½ percent of GDP on average. The largest reductions occurred in Hungary (23 percent of GDP) and Slovenia (17 percent of GDP). In these countries and many others (Croatia, Latvia,

Figure 1. CESEE: Change of External Positions of BIS-reporting Banks, 2011:Q1-2013:Q1
(Percent of 2012 GDP)



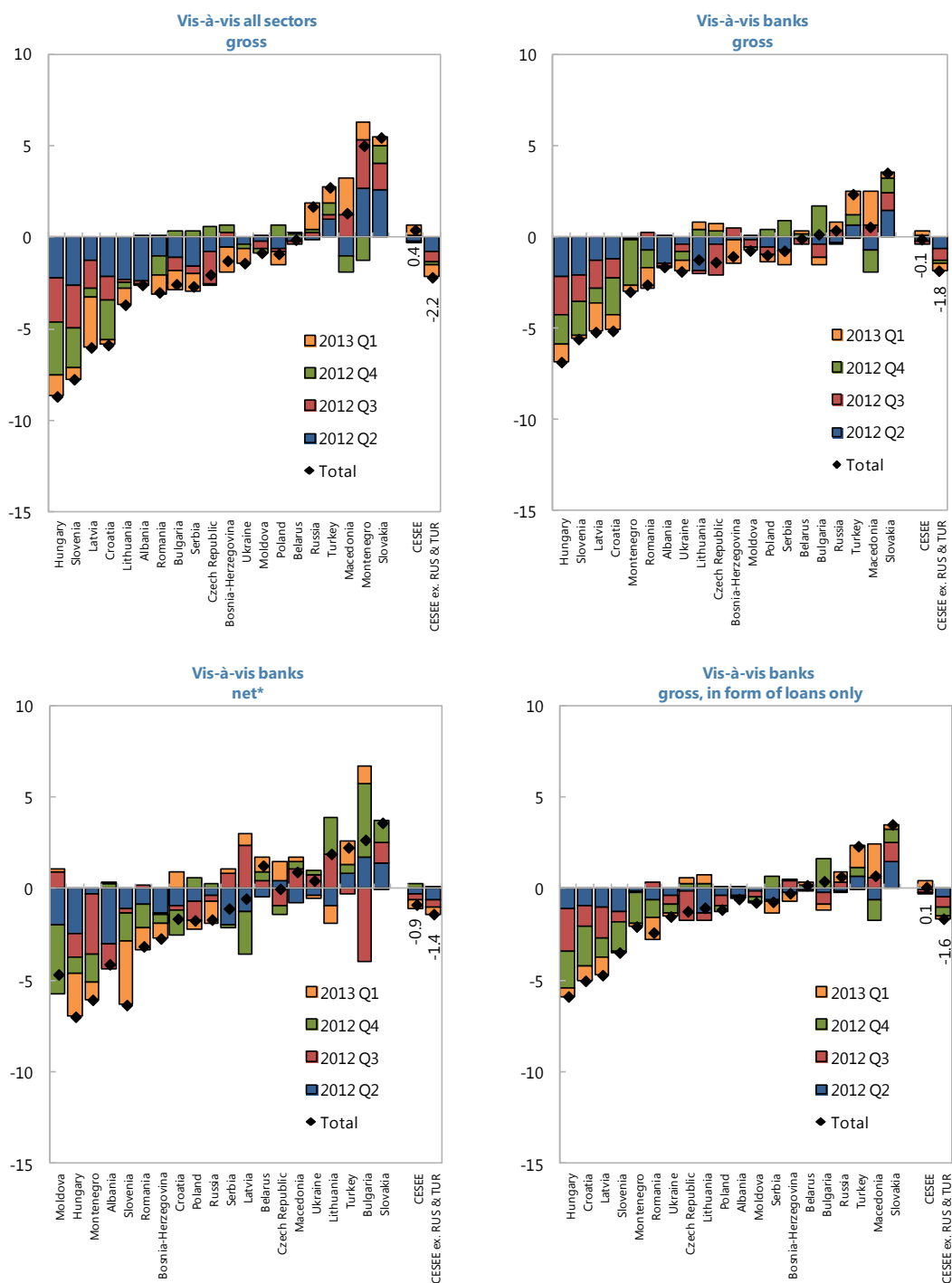
Sources: BIS, Locational Banking Statistics; and IMF staff calculations.
* Net of liabilities vis-à-vis banks.

¹ Prepared by the staff of the international financial institutions participating in the Vienna Initiative's Steering Committee. Reflects comments on an earlier version received from the Steering Committee at its meeting on July 17, 2013 in Luxembourg. Previous editions of the quarterly deleveraging monitor are available at <http://vienna-initiative.com>.

² However, strong gross inflows in Russia partly reflect technical factors, and the increase of the external position of western banks by US\$28.6 billion was accompanied by an even larger increase of western banks' liabilities toward Russia in the amount of US\$35.6 billion.

Lithuania, Romania, and Ukraine) funding reductions continued in 2013:Q1. In Bosnia-Herzegovina, Bulgaria, Estonia, Poland, and Serbia outflows resumed after inflows in 2012:Q4. In Macedonia, Moldova and Montenegro flows from western banks turned positive in 2013:Q1. In the case of Slovakia they were positive all along (Figure 2).

Figure 2. CESEE: External Positions of BIS-reporting Banks, 2012:Q2 - 2013:Q1
(Change, Percent of GDP)



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

* Includes changes of positions by CESEE central banks with BIS-reporting banks.

The IMF's International Financial Statistics (IFS) confirm the continued reduction in foreign bank funding for banks in CESEE (excluding Russia and Turkey). Foreign liabilities of banks in emerging Europe as reported in IFS should be the broad mirror image of the external

position of BIS-reporting banks vis-à-vis banks in emerging Europe. Indeed, IFS and BIS data generally track each other fairly closely (Figure 3).

Credit growth remained weak, with the exception of the CIS countries and Turkey. In exchange-rate adjusted nominal terms, private sector credit grew by just one percent in CESEE excluding Russia and Turkey (Figure 4). In many countries, weak credit *demand* is likely to have been an important factor behind weak credit growth—8 countries in the region were in recession in 2012.

Figure 3. Emerging Europe excl. Russia and Turkey: External Liabilities of Banks, 2008:M1-2013:M5

(Billions of US\$)

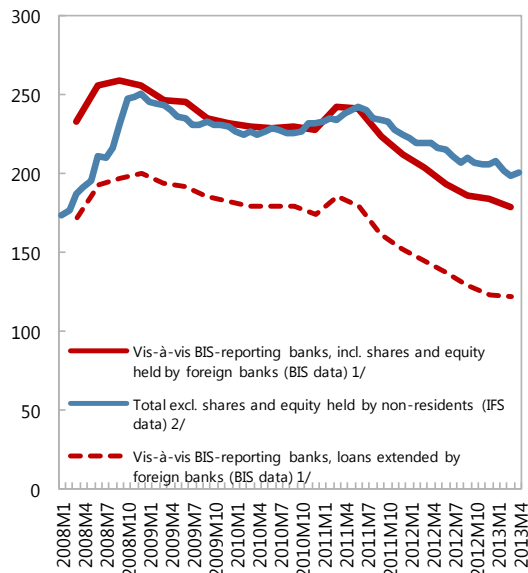
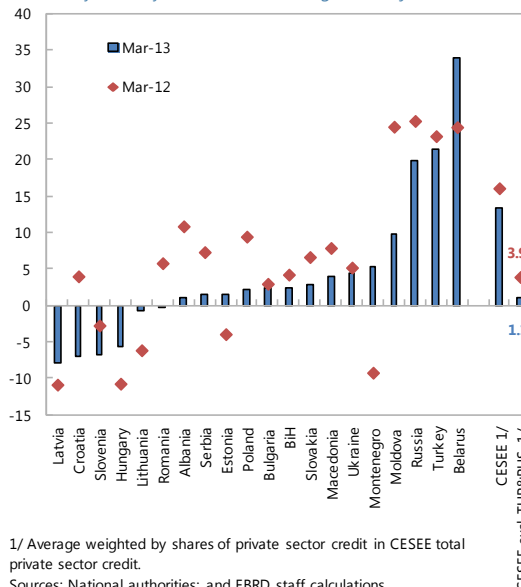


Figure 4. Growth of Credit to Households and Enterprises

(Percent, year-on-year, nominal, exchange-rate adjusted)

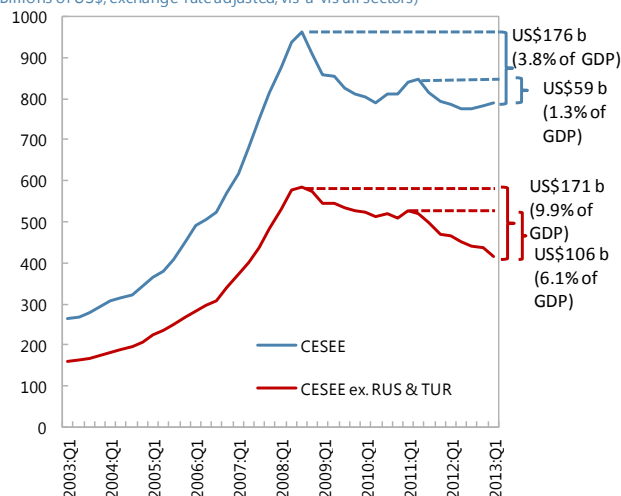


Since the onset of the 2008/09 crisis, there has been a significant change in the funding model of banks in CESEE.

- External funding has declined significantly. Funding in CESEE excluding Russia and Turkey is now almost 30 percent lower than it was at the peak (Figure 5). These funding reductions have not been indiscriminate; countries that had seen the largest funding increases during the boom years, have seen the largest outflows since (Figure 6).

Figure 5. CESEE: External Position of BIS-reporting Banks, 2003:Q1-2013:Q1

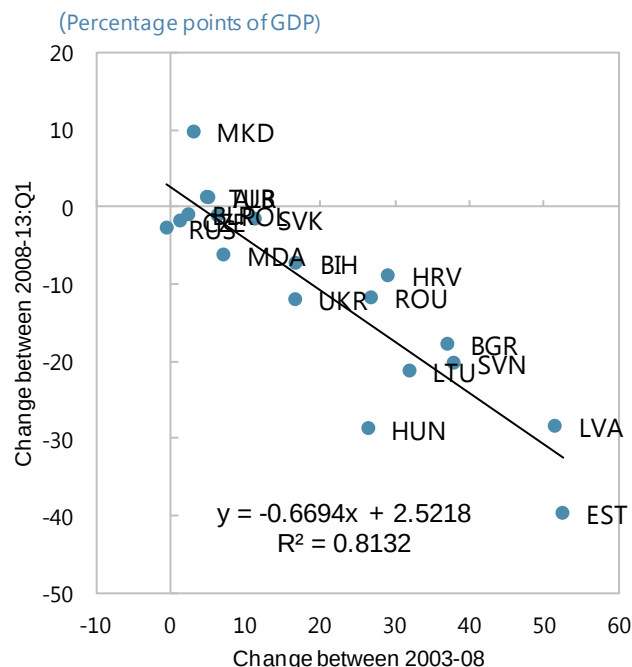
(Billions of US\$, exchange-rate adjusted, vis-à-vis all sectors)



Source: BIS, Locational Banking Statistics.

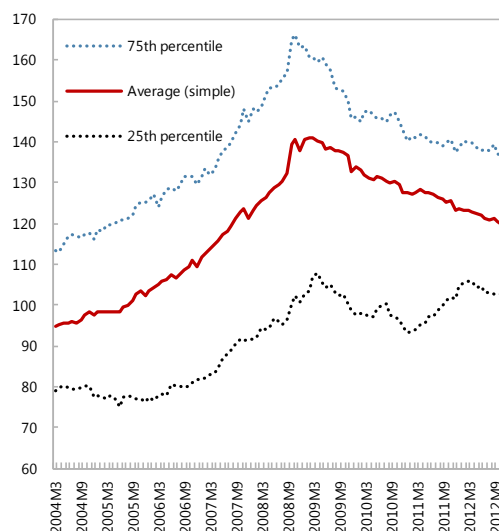
- To a large extent, this has been offset by an increase in funding from domestic deposits. As a result, the loan-to deposit ratio, which peaked at 140 percent in 2008, is now below 120 percent.

Figure 6. Change in funding from BIS-reporting countries' banks, 2003-08 vs 2008-13:Q1
(Percentage points of GDP)



Sources: BIS, International Banking Statistics (Table 6); and IMF, World Economic Outlook database.

Figure 7. CESEE: Domestic Loan to Domestic Deposit Ratio, 2004:M4 - 2012:M12*
(Percent)

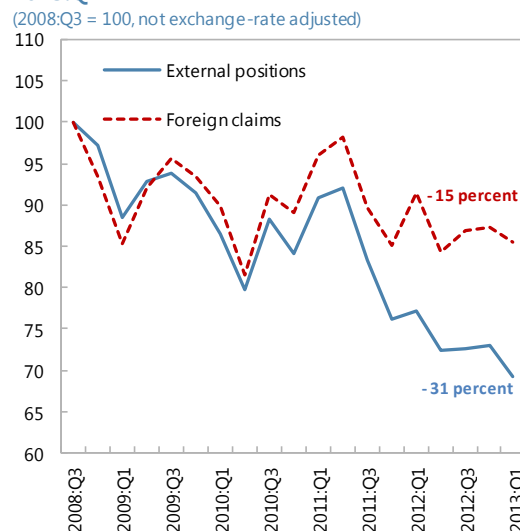


Sources: IMF, Monetary and Financial Statistics; IMF, International Financial Statistics; and IMF staff calculations.
* Excludes loans and deposits from other financial institutions. Derived from Standardized Reporting Forms. May differ from "headline" ratios reported by national authorities. In the case of Russia, derived from IFS as ratio of claims on the private and nonfinancial public sectors to all deposits.

As a result of this funding shift, western banks' exposure to CESEE (as measured by "foreign claims" in the BIS Consolidated Banking Statistics) has declined less than funding (as measured by "external positions" in the BIS Locational Banking Statistics): 15 percent against 31 percent, in non-exchange rate adjusted terms (Figure 8).

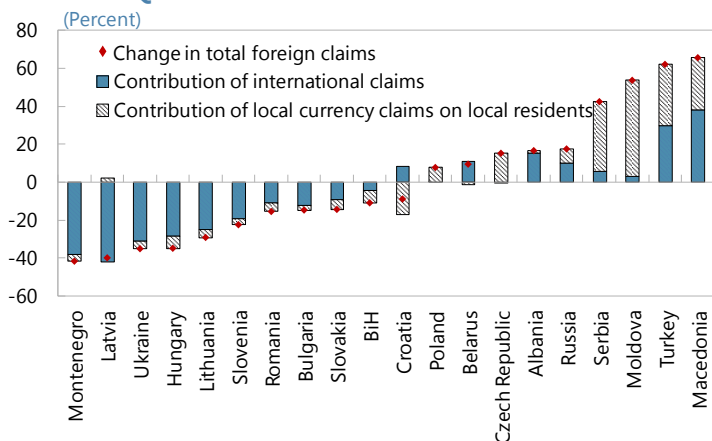
In many countries, the increase in local funding has not fully compensated for the decline in cross-border funding, and overall funding has declined. The foreign claims of BIS reporting banks—which include all assets of subsidiaries, including those funded by local deposits—have declined, both since late 2008, (Figure 9) and in the last year (Figure 10)

Figure 8. CESEE excluding Russia and Turkey: External Positions and Foreign Claims, 2008:Q3 - 2013:Q1
(2008:Q3 = 100, not exchange-rate adjusted)



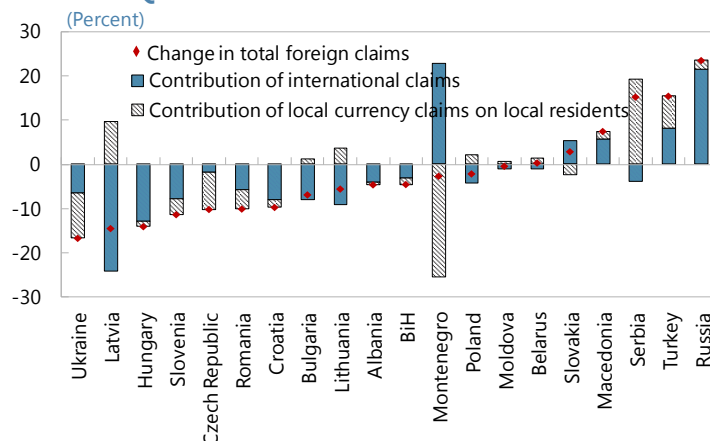
Source: BIS, Locational and Consolidated Banking Statistics.

Figure 9. Change in total foreign claims 2008:Q4-2013:Q1



Source: BIS, Consolidated Banking Statistics (Table 9A).

Figure 10. Change in total foreign claims 2012:Q1-2013:Q1

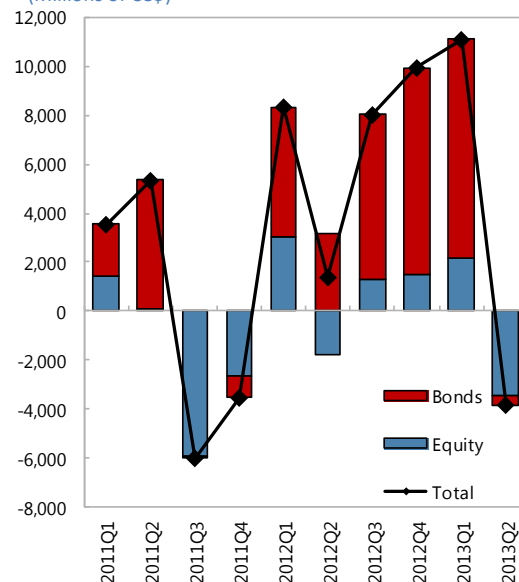


Source: BIS, Consolidated Banking Statistics (Table 9A).

Since the second half of 2012, funding reductions vis-à-vis CESEE had been mitigated by the very favorable market sentiment vis-à-vis emerging markets. The second wave of external funding reductions that started in 2011 was triggered by the deterioration of market sentiment that resulted from the intensification of the euro area crisis. The importance of supply factors diminished in the second half of 2012 when supportive actions by major central banks improved market sentiment and reduced risk aversion.³ The funding environment for emerging market economies was unusually favorable in the first quarter of 2013 when local-currency bond yields reached record lows and equity markets soared. Notwithstanding the favorable funding environment, other countervailing forces kept credit growth low: weak credit demand, associated with the weak economy, and the trend reduction in external funding to correct the excesses of the boom years.

There is a concern that the deterioration in market sentiment that started in late May may intensify funding reductions. Portfolio inflows reversed sharply in late May (Figure 9), apparently precipitated by shifting market expectations regarding the timing and speed of scaling back of the U.S. Federal Reserve's program of quantitative easing. While the scale of the implications for emerging market economies is still a matter of debate, it is clear that conditions as favorable as in the first quarter of this year are unlikely to

Figure 11. Emerging Europe: Flows into Dedicated ETFs and Mutual Funds, 2011:Q1 - 2013:Q2
(Millions of US\$)



Source: EPFR, equity and bond country flows.

³ A BIS Study "The euro area crisis and cross-border bank lending to emerging market" (http://www.bis.org/publ/qtrpdf/r_qt1212f.htm) confirms that between mid 2011 and mid 2012 it was primarily parent bank stress that drove deleveraging.

recur in the near term. With weaker financial market sentiment, a more difficult terrain lies ahead.

A decline in portfolio inflows would also mean that the impact of funding reductions could be more severe. Portfolio inflows in the region had been large in recent years, and (from a balance of payments perspective) compensated for the outflow of bank funding. The deterioration in market sentiment could well lead to a “double whammy”—larger bank outflows and smaller portfolio inflows.