CESEE DELEVERAGING MONITOR[1]

November 9, 2012

The withdrawal of funding by western banks from central, eastern, and southeastern Europe (CESEE) continued at a moderate pace in the second quarter of 2012—somewhat higher than in the first quarter but much lower than the worrisome levels seen in the second half of last year. Nonetheless, the cumulative funding withdrawal from the region excluding Russia and Turkey since mid-2011 has been a material 4 percent of GDP, with several countries hit significantly harder. At the same time, credit growth has ground to a halt. Preliminary analysis and the results from a novel survey of banks carried out by the EIB for the Vienna Initiative suggest that tightening credit supply played a role, although weak credit demand is certainly also a driver at the moment. Supply-side constraints encompass not only international factors, such as receding parent-bank funding, but also local factors. Improved financial market conditions in the wake of the ECB's OMT announcement and the Fed's QE3 should have tempered immediate deleveraging pressures vis-à-vis CESEE. However, even with a letup in the tightening of international supply-side constraints, a pickup in credit demand could make credit supply more of a bottleneck for credit growth and recovery. This is a particular challenge for countries that cannot fall back on domestic sources of financing as cross-border banking groups proceed toward their strategic objective of making CESEE subsidiaries more reliant on local funding. It remains imperative that this process take place in an orderly fashion.

Recent developments

In the second quarter of 2012, the external position of BIS-reporting banks fell by a moderate 0.8 percent of GDP vis-à-vis CESEE excluding Russia and Turkey (Figure 1). Including Russia and Turkey the reduction was only 0.2 percent of GDP thanks to large offsetting inflows into Turkey. As anticipated in the previous *CESEE Deleveraging Monitor*,

[1] Prepared by staff of the institutions participating in the Steering Committee of the Vienna Initiative for the Full-Forum Meeting of the Vienna Initiative on November 9, 2012 in Brussels, Belgium.

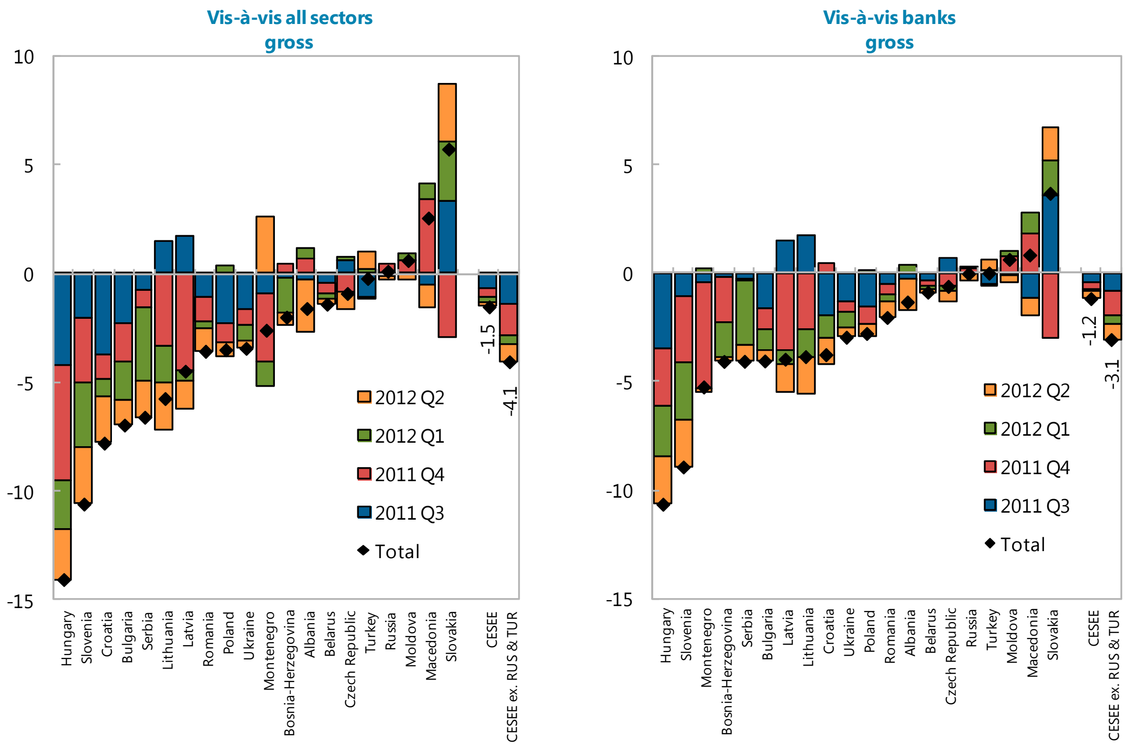
This note is the second in a series of quarterly deleveraging monitors. The first edition can be found at www.imf.org/external/np/sec/pr/2012/pdf/pr12265.pdf.

Throughout this note, the term deleveraging refers to the phenomenon of western banks reducing financing to (affiliated and non-affiliated) banks and non-banks in CESEE. Deleveraging in this sense may or may not coincide with cross-border banking groups headquartered in the west and operating affiliates in CESEE reducing exposure to the region on a consolidated basis. The focus is on financing because sudden, large-scale withdrawals of financing would imperil macroeconomic performance and financial stability in CESEE—risks that the Vienna Initiative was set up to help guard against.

deleveraging was somewhat higher than in the first quarter (0.3 percent of GDP) but only half the pace observed in the second half of last year (1.5 percent of GDP per quarter). As in previous quarters, the exposure reduction fell disproportionately on CESEE banks rather than cross-border loans to non-financial companies. Each category makes up roughly half of BIS-reporting banks' external position, but non-financial companies accounted for only about a quarter of the total external position reduction vis-à-vis CESEE excluding Russia and Turkey.

Figure 1. CESEE: External Positions of BIS-reporting Banks, 2011:Q3 - 2012:Q2

(Change, Percent of GDP*)



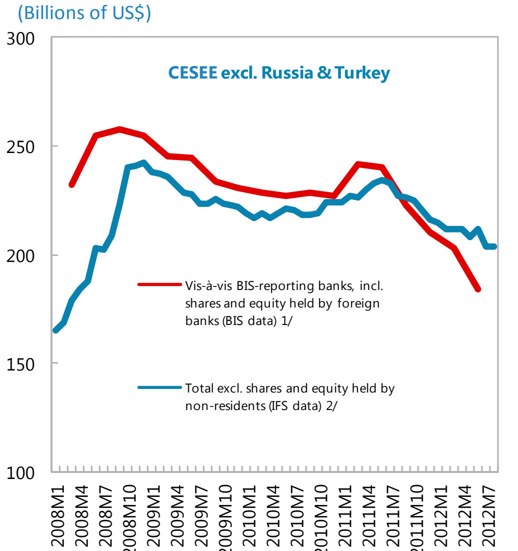
Sources: BIS, Locational Banking Statistics; and IMF staff calculations.
* Full year 2012 GDP.

After four consecutive quarters of falling external positions, funding withdrawals by western banks have cumulated to large amounts for some CESEE countries. Leaving aside Russia and Turkey, CESEE has lost foreign bank funding to the tune of 4.1 percent of GDP since deleveraging resumed in mid-2011. Six countries have seen an exposure reduction in excess of 5 percent of GDP: Hungary and Slovenia lost between 10-15 percent of GDP in funding; for Bulgaria, Croatia, Lithuania, and Serbia the loss was between 5 and 10 percent of GDP. Offsets through external position reductions of CESEE banks' vis-à-vis BIS-reporting banks were a relatively small 0.3 percent of GDP over the same period and did not make a material difference to the challenges faced by countries subject to large funding withdrawals.

Improved financial market sentiment should have tempered underlying deleveraging trends since mid-2012. Hard data on the development of western banks' external positions vis-à-vis CESEE beyond the second quarter are not yet available. However, the IMF's

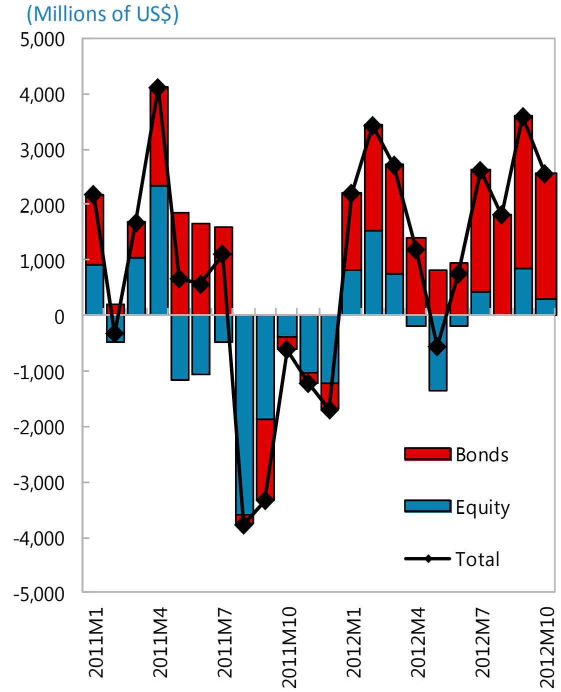
International Financial Statistics (IFS) suggest that moderate deleveraging continued in July and August (Figure 2). IFS track the external liabilities of CESEE banks, thus providing an approximate mirror image of the external positions of western banks vis-à-vis CESEE.[2] For CESEE excluding Russia and Turkey IFS data track the BIS data on external positions reasonably well. Continued deleveraging is also consistent with the strategic goal of cross-border banks to make their subsidiaries more reliant on domestic funding rather than parent-bank funding (see below for more on this point). On the other hand, near-term deleveraging is also driven by financial market sentiment. This has improved substantially over the summer following the ECB's announcement of Outright Monetary Transactions (OMT), and a new round of quantitative easing (QE3) by the US Federal Reserve. As a result of these measures and other policy steps, several CESEE sovereigns regained market access and western banks' access to unsecured funding improved as well. Flows into the bond and equity markets of CESEE increased substantially (Figure 3). The Institute of International Finance finds a substantial easing of funding conditions for emerging Europe's banks in its Emerging Markets Bank Lending Condition Survey for the third quarter of 2012.[3] With these countervailing forces at work one would expect only small changes in external positions of western banks vis-à-vis CESEE to have taken place since mid-2012.

Figure 2. External Liabilities of Banks, 2008:M1-2012:M8
(Billions of US$)



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

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



Source: EPFR, equity and bond country flows.

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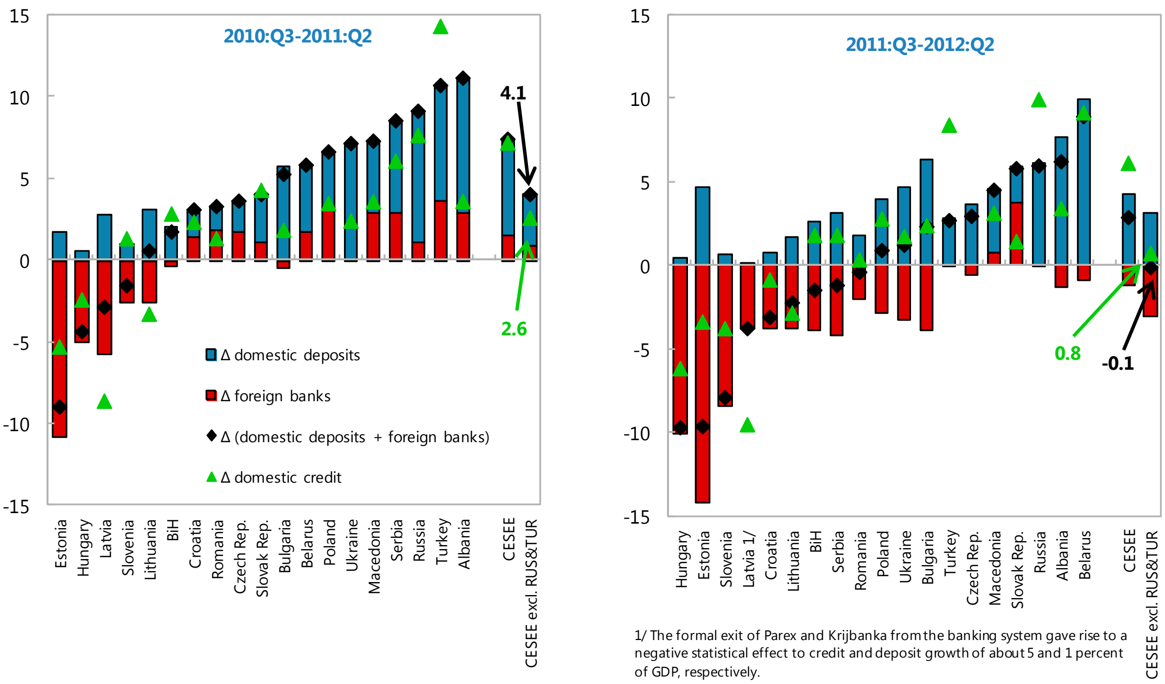
[2] The match is not perfect. For example, external liabilities of CESEE banks in IFS capture financing from foreign capital markets, which has no counterpart in the BIS banking statistics. Conversely, foreign equity positions of western banks in CESEE banks are included in external positions in the BIS statistics but not in CESEE banks' external liabilities in IFS. Due to these conceptual differences, IFS and BIS statistics diverge substantially for countries like Turkey and Russia, where banks tap foreign capital markets extensively.

[3] For more detail see http://www.iif.com/emr/resources+2317.php.

The renewed funding withdrawal by western banks over the last four quarters contributed to an overall stalling of credit growth—and outright contractions in many countries. In the twelve months to June 2012, credit to households and enterprises increased by as little as 1.3 percent in CESEE excluding Russia and Turkey (in nominal and exchange-rate adjusted terms). Credit contracted in seven countries: the three Baltic countries, Croatia, Hungary, Montenegro, and Slovenia. A year earlier, credit growth had been considerably stronger at 5.7 percent. The principal sources for banks to fund credit growth—domestic deposits and foreign banks—show a stable contribution from domestic deposits of about 3 percent of GDP in the twelve months to June as well as in the previous twelve-month period. What changed was foreign bank funding, which went from making a small positive contribution to making a sizable negative contribution. In effect, funding gains from domestic deposits were fully offset by losses in foreign bank financing in the 12 months to June 2012. Overall funding remained essentially flat and so did private sector credit (Figure 4).

Figure 4. CESEE: Banks' Funding Sources and Credit Developments
(Percent of GDP, exchange-rate adjusted)



Sources: BIS, Locational Banking Statistics; IMF, IFS; IMF, WEO; national authorities; EBRD; and IMF staff calculations.

The role of receding parent-bank funding in weak credit growth

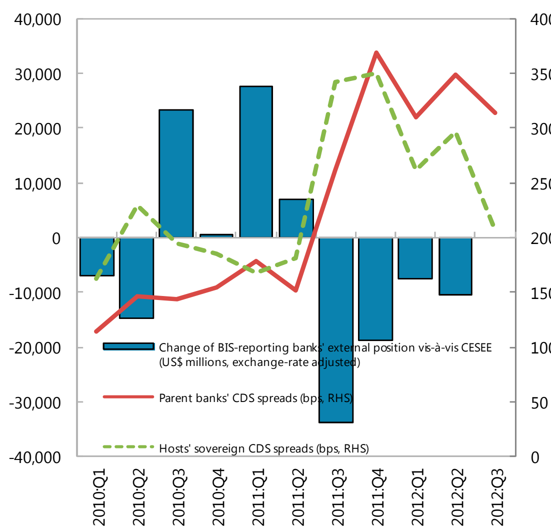
Weak CESEE credit growth could be driven by the withdrawal of funding by western banks or by feeble credit demand. The observed pattern of credit and funding developments is open to two competing interpretations. One the one hand, one could argue that the withdrawal of funding by western banks is the root cause as it leads to a shortage of funding in CESEE subsidiaries prompting them to curtail lending. On the other hand, it could also be the case that feeble credit demand is at the beginning of the causal chain, giving rise to excess funds in subsidiaries that they then choose to return to their parent banks.

Demand factors certainly explain a good part of the weak CESEE credit growth. The weakening over the last four quarters may well reflect the renewed clouding of the economic outlook, as the euro area crisis proves protracted and the economies in other parts of the world are also losing strength. The IMF currently projects growth for CESEE excluding Russia and Turkey of 1.5 and 2.1 percent for 2012 and 2013, respectively—a considerable slowdown from the 3.4 percent achieved in 2011. More broadly, the hangover from the credit boom that ended with the crisis of 2008/09 is likely to still weigh on credit demand. It left many households and enterprises with too much debt, which they are now trying to reduce and bring into line with less lofty post-crisis income expectations, as well as widespread problems with non-performing loans.

Nonetheless, supply factors should not be discounted.

- **Sharply deteriorating financial market conditions from mid-2011 made funding of western parent banks for their CESEE subsidiaries more expensive.** Deleveraging resumed when western banks themselves came under intense funding pressure. Their CDS spreads rose sharply, as did those of CESEE sovereigns (Figure 5). The scarcity of funding might not only have prompted western banks to recall funding from CESEE, it also made parent bank funding for their CESEE subsidiaries much more expensive. Intergroup funding is typically priced at the cost of funding of the parent plus the CDS spread of the sovereign where the subsidiary is located. With both elements sharply up, subsidiaries ended up strongly incentivized to pay down debt owed to parents.

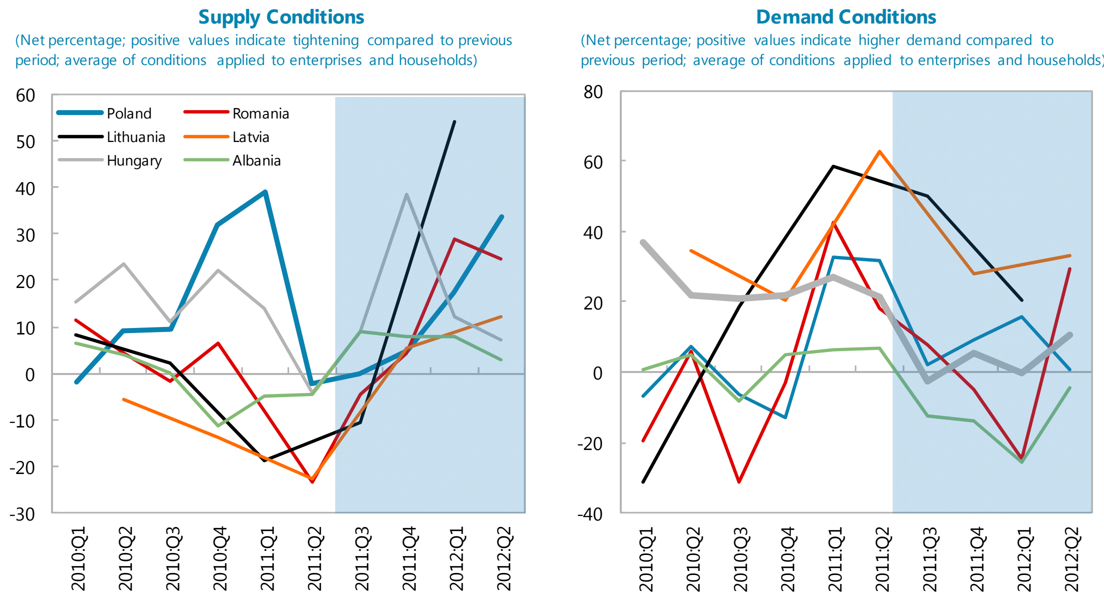
Figure 5. CESEE: Funding by Western Banks and Their Funding Costs, 2010:Q1 - 2012:Q2



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

- **Credit supply conditions in CESEE were tightened when funding withdrawals of western banks from CESEE resumed.** Only six countries in CESEE excluding Russia and Turkey conduct regular lending surveys that shed light on supply and demand conditions in credit developments. Senior loan officers reported a significant tightening of credit supply conditions from mid-2011 onward in all reporting countries. At the same time, they assessed credit demand as still increasing in most countries, albeit by not as much as before (Figure 6). As one would expect, tighter supply conditions are empirically associated with lower credit growth and better demand conditions are empirically associated with higher credit growth (Figure 7). If anything, supply conditions have higher explanatory power for credit developments during 2010:Q1-2012:Q2 than demand conditions.[4] It should be noted though that the evolution of supply conditions reflects many more factors than just the changing availability of foreign bank funding. Some of the reported tightening may well be due to domestic supply factors, such as local regulation, monetary policy, or high NPLs, or simply a reassessment of the economic outlook by banks.[5]

Figure 6: Selected CESEE Countries: Credit Supply and Demand Conditions, 2010:Q1 - 2012:Q2



Sources: Lending surveys of central banks; and IMF staff calculations.

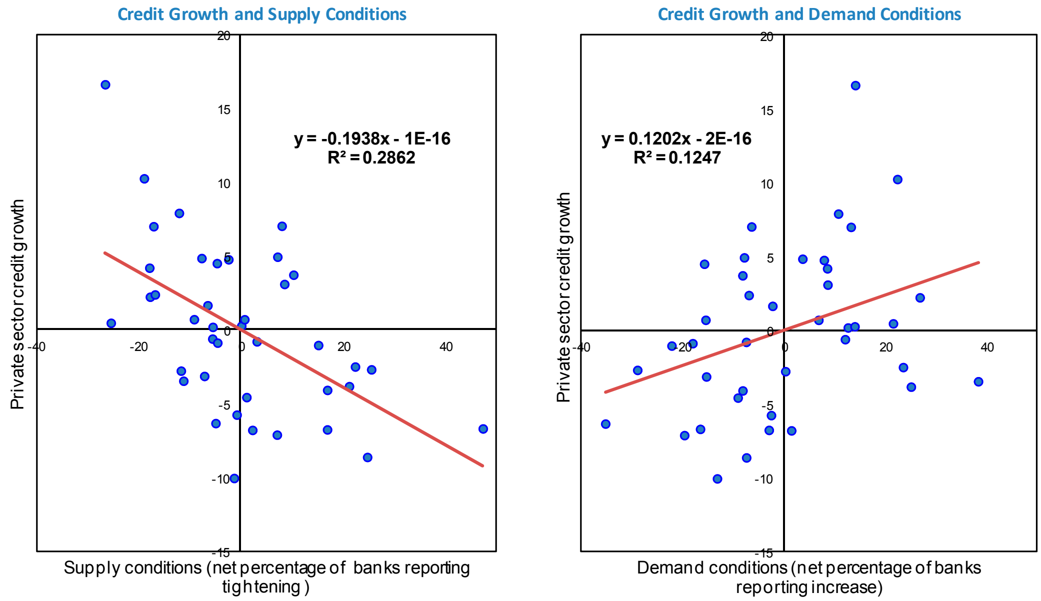
- **Banking groups' objective to make subsidiaries more reliant on local funding adds an autonomous restricting factor for CESEE credit growth, particularly as local capital markets are still underdeveloped.** With the experience of the credit boom-bust cycle in emerging Europe fresh on banks' minds, the pre-crisis banking paradigm where centralized treasuries distributed funds throughout the group with little regard to country-by-country funding is in retreat. The emerging new paradigm is one where funding and lending are matched more closely country-by-country. In the transition, parent bank funding is withdrawn with adverse consequences for credit growth everything else equal. Indeed, analysis of a large sample of CESEE banks shows that banks with initially higher loan-to-deposit ratios exhibit significantly less credit growth during 2010-11. For each 10 percentage point increase in the loan-to-deposit ratio, credit growth is about one percentage point lower. The same is true at the level of the banking group: a higher loan-to-deposit ratio at the group level is

[4] In univariate regressions supply conditions are a better fit for credit growth than demand conditions, as indicated in Figure 7. In a bivariate regression of credit growth on demand and supply conditions only the latter are statistically significant.

[5] A report on dealing with the high NPLs in CESEE by a Vienna Initiative working group confirms the adverse effect of NPLs on credit supply (www.imf.org/external/region/eur/.../030112.pdf). Multiple efforts by the IFIs to support the authorities of the region in resolving NPLs are underway.

associated with significantly lower credit growth in the associated CESEE subsidiaries.

Figure 7. Selected CESEE Countries: Credit Growth and Supply and Demand Conditions, 2010:Q3-2012:Q2



Notes: Quarterly data for Albania, Hungary, Poland, and Romania; semi-annual data for Latvia and Lithuania; private sector credit growth is the annualized percent change for loans to households and enterprises, exchange-rate adjusted and demeaned by the respective country averages during 2010:Q3-2012:Q2; credit conditions give a 50 percent weight to loans to enterprises, 25 percent to household mortgages and 25 percent to consumer loans; credit conditions are demeaned by the respective country averages during 2010:Q3-2012:Q2.

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

- **The tightening of supply conditions in the wake of the global financial crisis likely contributed to the current weakness of credit demand via macroeconomic feedback effects**. The abrupt stop of new foreign bank financing for CESEE in late 2008 was one of the key channels that transmitted the global financial crisis to the region. While western parent banks remained committed to the region and supported their local subsidiaries, a deep economic downturn could not be avoided as credit-fueled domestic demand booms came to an end.[6] This downturn and the debt accumulated by households and enterprises in the boom years are now weighing on credit demand.

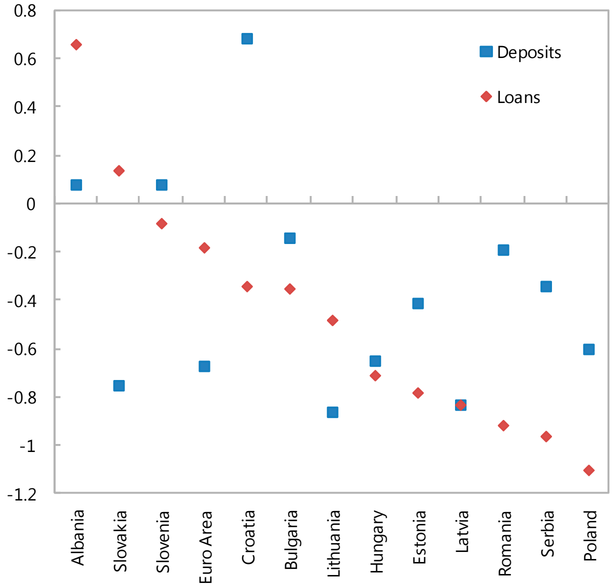
Interest rate developments point to a strong role of demand factors in recent credit weakness, while credit supply might well have tightened primarily through means other than price. In principle interest rate developments should offer clues about whether weak demand or tight supply is the dominant force behind weak credit growth. If interest rates fall, demand factors dominate, and if they rise, supply factors are more important. With interest rates declining somewhat in most CESEE countries over the 12-month period to June 2012,

[6] For more background on the boom-bust cycle in emerging Europe refer to Bakker and Klingen (2012), http://www.imfbookstore.org/ProdDetails.asp?ID=HEECEA&PG=1&Type=RLA2.

demand factors seem to have played an important role (Figure 8).[7] Further analysis is needed to determine whether demand or supply factors dominated, as supply tightened through non-price mechanisms and changes in quality composition of borrowers would also need to be taken into account. In any event, underlying supply constraints might well become the most critical bottleneck as credit demand recovers. Considering that external positions of BIS-reporting banks still average 13 percent of GDP vis-à-vis banks and 8 percent of GDP vis-à-vis non-financial companies in CESEE excluding Russia and Turkey, considerable supply-side headwinds lie ahead as the shift to locally funded subsidiaries occurs.

Figure 8. Selected CESEE Countries and Euro Area: Interest Rate Developments

(Percentage Point Change June 2011 - June 2012; on €-denominated loans and deposits of enterprises; new business where available)



Sources: National central banks; and Haver Analytics.

The EIB's CESEE Bank Lending Survey: preliminary findings

A new survey of banks sheds additional light on the role of demand and supply conditions in credit growth, the domestic and international determinants influencing these conditions, and future deleveraging prospects as seen by banks. The CESEE bank lending survey was developed by the EIB for the Vienna Initiative and targets all cross-border banking groups active in the region, both at the parent bank level and at the subsidiary level. In its first administration during October 2012, the survey was conducted with 8 cross-border groups and 42 subsidiaries in the region. For the countries involved, this corresponds to a 40 percent coverage of banking assets on average.

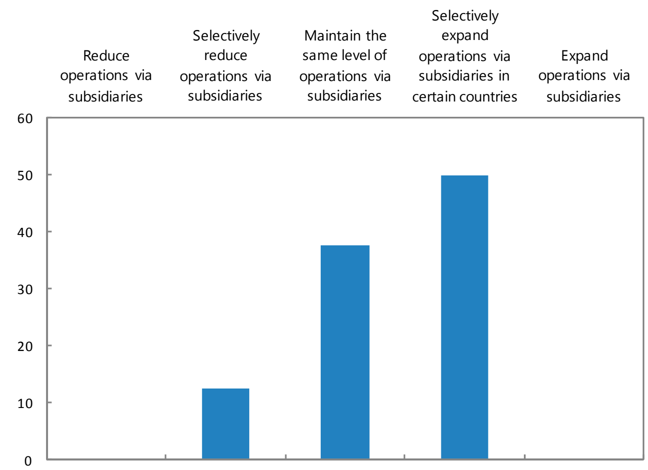
Cross-border banking groups remain committed to CESEE in general, but they are becoming more selective in their strategies at the country level according to the survey (Figure 9). The global financial crisis and the euro area crisis have left their marks on the cross-border banking groups active in the region. All of them have engaged, and expect to continue to engage, in various strategic operations to increase capitalization. At the same time, they are deleveraging at the group level. All surveyed groups signal their continued commitment to their operations in the CESEE. However, they are clearly taking a more selective approach toward different local markets, in particular with a view to rebalancing toward a more self-sustained local banking model. This implies a larger adjustment for those countries where market and local funding opportunities are relatively weak and reliance on

[7] Interest rate developments for local-currency loans and deposits paint a similar picture to that of the euro-denominated loans and deposits shown in Figure 8. However, local-currency interest rate developments are harder to interpret in light of significant changes in policy-interest rates in many CESEE countries during this period.

parent-bank funding is currently relatively high.

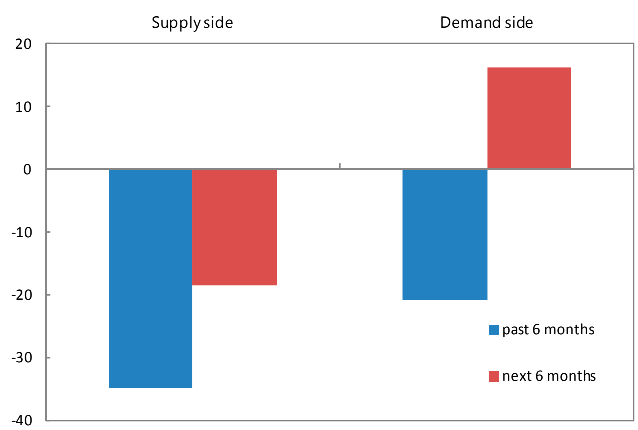
Banks report that, in addition to subdued credit demand, domestic and international supply-side factors are also responsible for sluggish credit growth at the moment (Figures 10 and 11). With cross-border banking groups pushing for a more self-sustained local banking model and weak local market conditions, CESEE subsidiaries have generally been experiencing a period of both soft credit demand and tight credit supply. On the demand side, the list of negative factors is long: low consumer confidence, unfavorable housing price prospects, subdued M&A activities, and weak fixed investment dynamics. Progress with debt restructuring was reported as the only positive demand-side development over the last six months. As to the international determinates of credit supply, the global market outlook, group funding conditions, group capital constraints, and group-level non-performing loans were all quoted as having had a clear negative influence on local credit standards over the past six months. Notably, while the impact of group funding continues to exert a negative impact, many fewer subsidiaries mention it in their expectation for the next six months. As to the local determinants of credit supply, the local market outlook, local regulation, compliance with often high local capital requirements, and non-performing loans at the subsidiary level were the key constraining factors over the last six months. Local bank funding on the other hand was increasingly seen as improving, thereby making a contribution toward less tight supply conditions. Indeed, as the shift toward a more self-sustained local banking model proceeds, improved access to local funding, be it retail deposits or capital markets, becomes pivotal for restarting credit growth. This highlights the renewed focus on local capital market development.

Figure 9. Group-level Longer-term Strategies
Looking at operations via subsidiaries in CESEE, the group intends to…



Source: EIB, CESEE Bank Lending Survey.

Figure 10. Developments of Credit Conditions
(Net percentage; negative supply-side values indicate tightening credit standards; positive demand-side values indicate demand increase)

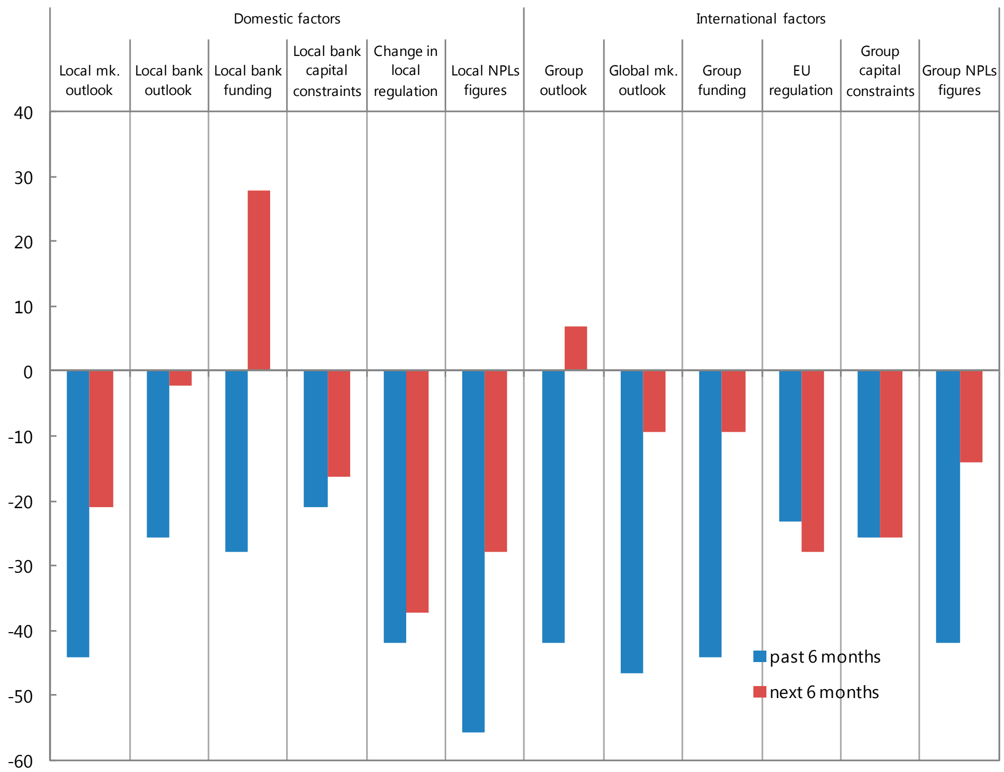


Source: EIB, CESEE Bank Lending Survey.

Going forward, banks expect a pickup of credit demand, continued tight international supply conditions, and somewhat easier access to domestic funding. On the demand side, expectations are improving and progressively more subsidiaries expect some rebound in demand for credit across different products and maturities over the next six months. On the supply side, continued tightness seems generally in store. However, the picture is far from homogeneous across banks. Most of those reporting a tightening over the past six months report a neutral stance for the outlook over the next six months. International factors will continue to contribute to credit standard tightening, as well as domestic features, like local regulation or local NPLs, whereas subsidiaries' access to domestic funding is expected to contribute positively. Supply side constraints could thus become selectively more binding, depending on whether improvements in local funding conditions provide enough room to accommodate the prospective pickup of credit demand.

Figure 11. Domestic and International Factors Affecting the Supply of Credit

(Net percentage; negative values indicate tightening of credit conditions)



Source: EIB, CESEE Bank Lending Survey.