EBCI Vienna Initiative

CESEE DELEVERAGING MONITOR[1]

January 24, 2013

Funding reductions of western banks vis-à-vis Central, Eastern, and South Eastern Europe (CESEE) moderated further in the third quarter of 2012, but did not stop or reverse. This is the fifth consecutive quarter of funding withdrawals. CESEE excluding Russia and Turkey lost funding equivalent to 4.6 percent of GDP over this period. At the same time private sector credit growth slowed to a weak 1.4 percent (year-on-year). That funding reductions continued despite much improved financial conditions for western European banks, whose subsidiaries make up much of CESEE's banking systems, attests to the underlying trend to rebalance the financing of CESEE subsidiaries toward local sources, along with generally weak credit demand. If subsidiaries had to become fully locally funded, many years of weak credit growth would lie ahead given the limited potential for local deposit growth to offset reductions in foreign funding.

BIS-reporting banks reduced their external position toward CESEE as a whole by less than 0.1 percent of GDP in the third quarter of 2012, compared to 0.2 percent of GDP in each of the preceding quarters. The result for the region as a whole owes much to significant increases of external positions toward Russia and Turkey that compensated for reductions elsewhere in CESEE.

When excluding Russia and Turkey, the third-quarter reduction of the external position amounted to 0.5 percent of GDP. As anticipated in the *CESEE Deleveraging Monitor* published in November, this is a modest pace of deleveraging and constitutes a slowdown relative to the first half of 2012, which itself constituted a slowdown from the second half of 2011 (Figure 1). The entire third-quarter reduction was due to falling external positions vis-à-vis CESEE banks, with cross-border loans extended to the non-financial sector recording a slight uptick. Once again, intra-regional differences in funding changes

[1] Prepared by staff of the institutions participating in the Steering Committee of the Vienna Initiative for the Steering Committee Meeting on January 14, 2013 in Vienna, Austria. Subsequently updated.

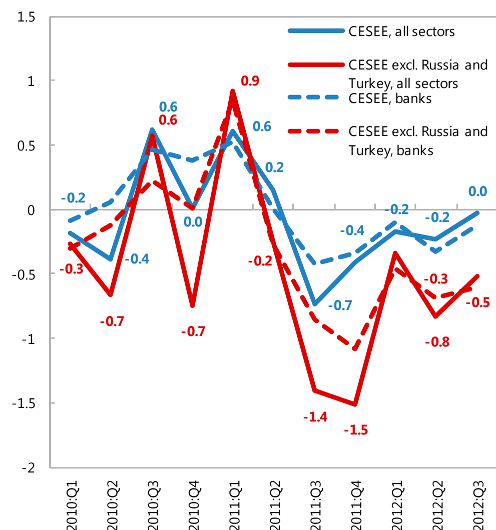
Previous editions of the quarterly deleveraging monitor are available at http://vienna-initiative.com.

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.

from BIS-reporting banks were large. The Hungary and Slovenia saw funding reductions of 2 percent of GDP or more. Slovakia, along with Montenegro, received large inflows.

Despite the recent slowdown, cumulative exposure reductions over the last four quarters have been significant—and very large in some countries. Leaving aside Russia and Turkey, CESEE has lost foreign bank funding to the tune of 3.2 percent of GDP over the last 12 months (Figure 2). Bulgaria, Croatia, Hungary, Latvia, Lithuania, Slovenia, and Serbia were most affected with losses in excess of 5 percent of GDP. Funding losses for CESEE excluding Russia and Turkey were somewhat smaller vis-à-vis banks alone (2.8 percent of GDP) as part of the withdrawals related to direct cross-border loans extended to non-financial companies. Moreover, banks compensated some of the funding losses by drawing down their assets placed with western bank, bringing their net funding loss to 2.1 percent of GDP. Finally, the change of the external position as per the BIS Locational Banking Statistics could potentially overstate the true extent of funding withdrawals as external positions include equity stakes that are subject to valuation changes. Considering only those external positions vis-à-vis banks that take the form of loans, puts funding withdrawals at 2.4 percent of GDP, compared to the 2.8 percent of GDP when all instruments are considered.

Figure 1. CESEE: Change of External Positions of BIS-reporting Banks, 2010:Q1-2012:Q3
(Percent of GDP)

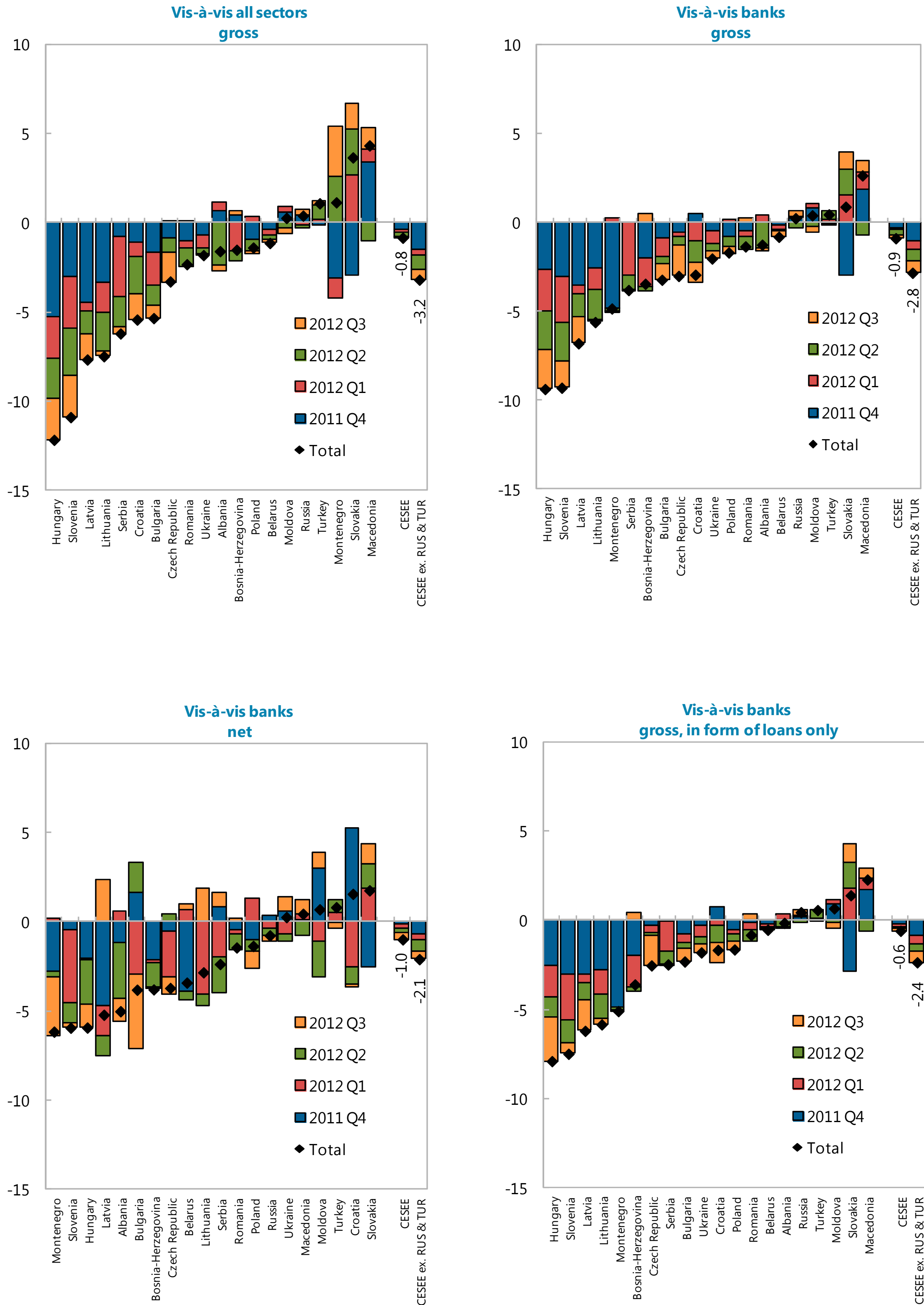


Sources: BIS, Locational Banking Statistics: and IMF staff calculations.

The deleveraging trend in the BIS data is confirmed by the IMF's *International Financial Statistics* (IFS), although not to its full extent. 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). Russia and Turkey have been an exception for many quarters already, with IFS data indicating less deleveraging than BIS data. This pattern is now also emerging for the rest of the region. One possible explanation of the discrepancy is that banks in emerging Europe partly compensate the loss of funding from western banks by tapping other foreign funding sources, such as nonbank investors in international capital markets. This would slow the decline of foreign liabilities in IFS but not in the BIS Banking Statistics.

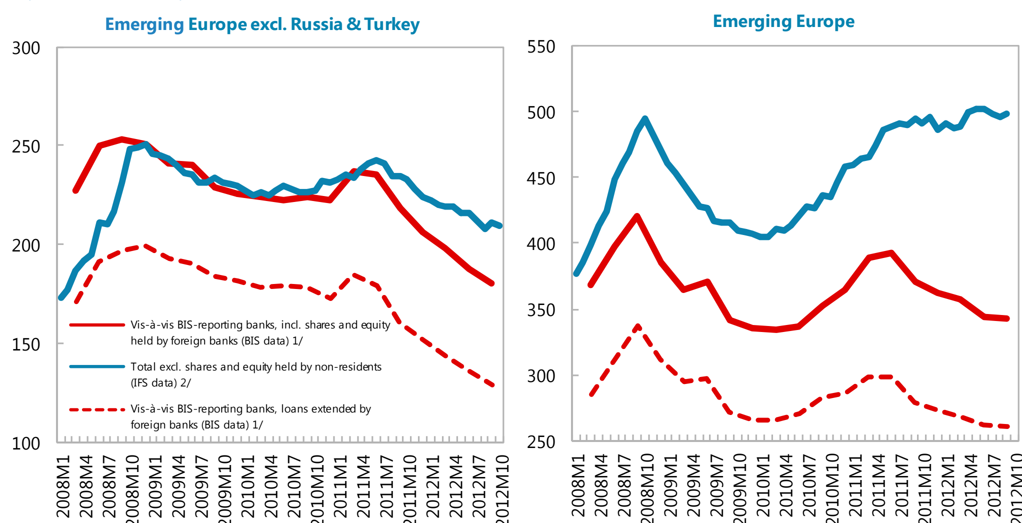
Figure 2. CESEE: External Positions of BIS-reporting Banks, 2011:Q4 - 2012:Q3

(Change, Percent of GDP*)



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

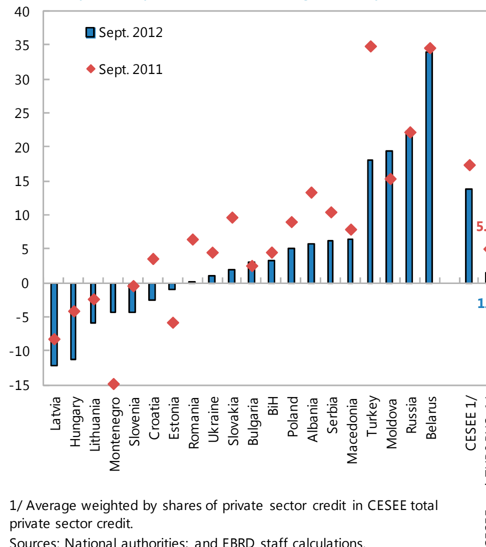
Figure 3. External Liabilities of Banks, 2008:M1-2012:M10
(Billions of US$)



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.

Credit growth in CESEE remains muted, a small uptick in the third quarter notwithstanding. Excluding Russia and Turkey, private sector credit grew by only 1.4 percent in the 12 months to September 2012 (in nominal and exchange-rate adjusted terms, Figure 4). This constitutes a marked deceleration from the 5.1 percent credit growth rate recorded a year earlier, before the euro area crisis intensified in the second half 2011 and the subsequent slowdown of economic growth across Europe. On a quarter-on-quarter basis, credit growth has hovered around zero during 2011:Q4–2012:Q2. It picked up to 1 percent (not annualized) in the third quarter.

Figure 4. CESEE: Growth of Credit to Households and Enterprises
(Percent, year-on-year, nominal, exchange-rate adjusted)



1/ Average weighted by shares of private sector credit in CESEE total private sector credit.
Sources: National authorities; and EBRD staff calculations.

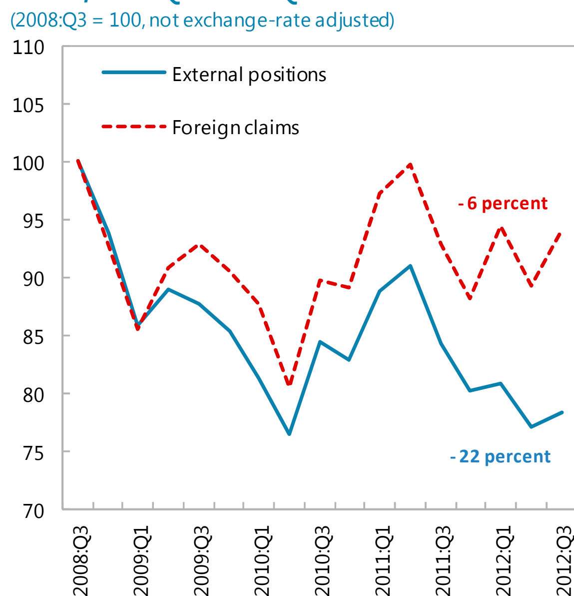
The slowdown of deleveraging in the third quarter of 2012 likely reflects improved financing conditions for cross-border banking groups based in Western European. CDS spreads of western banking groups active in CESEE, a key supply-side driver of funding from foreign banks, were some 100 bps lower than in the previous quarter on average, likely reflecting the ECB's announcement of Outright Monetary Transactions and other progress in tackling the euro area crisis. Moreover, sovereign spreads in CESEE declined by a similar magnitude, which should have reduced the pricing of interoffice loans from parents. Both of these effects should have moderated deleveraging. In contrast, CESEE's GDP growth, a key demand-side driver of funding from foreign banks, declined from 2.6 to 1.6 percent year-on-year from the second to the third quarter of 2012. If anything, this would work toward a

pickup of deleveraging and can therefore not explain the observed moderation in the third quarter of 2012. More generally, a recent BIS paper finds that the second wave of deleveraging that started in mid-2011 was predominately driven by home factors of euro area banks.[2] As these cross-border banking groups came under pressure they curtailed the supply of funding for their CESEE subsidiaries.

The continuation of deleveraging even at times when financial conditions for cross-border banking groups are favorable might reflect an underlying trend of declining funding from western banks, along with a weak economy and overextended balance sheets of many CESEE borrowers. Banks are in the process of rebalancing the funding of their subsidiaries toward local sources, in an effort to roll back the excesses of the boom period. In so doing, funding from foreign banks (as captured in the "external positions" of the BIS Locational Banking Statistics) declines more than the exposure of the cross-border banking groups to CESEE on a consolidated basis (as captured by "foreign claims" in the BIS Consolidated Banking Statistics). Since the height of the global financial crisis in the third quarter of 2008, external positions have declined by 22 percent while foreign claims came down by only 6 percent (Figure 5)[3]. A separate important factor behind deleveraging is reduced appetite by households and firms to take out new bank loans. The outlook for economic growth in the region is mediocre and many households and firms have already taken on more debt than they can shoulder during the credit boom of 2003-08, judging from high non-performing loan ratios in most CESEE countries.

Figure 5. CESEE: External Positions and Foreign Claims, 2008:Q3 - 2012:Q3

(2008:Q3 = 100, not exchange-rate adjusted)



Source: BIS, Locational and Consolidated Banking Statistics.

The rebalancing of subsidiaries' financing toward local sources could spell many years of meager credit growth. As a legacy of the foreign-funded credit boom and despite the funding withdrawals since, the stock of outstanding financing from foreign banks is still large. For CESEE excluding Russia and Turkey it amounts to 26 percent of GDP or 29 percent of private credit (Figures 6a and 6b). For some countries the ratios are much higher. Were it all withdrawn in a change of strategy toward fully locally financed subsidiaries, the funding drain would be difficult to offset while still ensuring reasonably

[2] Avdjiev, S., Z. Kuti, and E. Takats, 2012, "The euro area crisis and cross-border bank lending to emerging markets," *BIS Quarterly Review*, December 2012.

[3] Unlike in Figures 1, 2, and 7, this paragraph and Figure 5 discuss external positions in exchange-rate unadjusted terms. This is to improve comparability with foreign claims, which are available in exchange-rate-unadjusted terms only.

strong credit growth in CESEE. The main local funding source is domestic deposits and those have not generated much more than 3 percent of GDP in bank funding a year recently (Figure 7). A multipronged approach to avert crimping credit growth for years to come could include: making some interoffice financing of CESEE subsidiaries permanent, spreading the rebalancing over time, strengthening local capital markets as alternative sources for bank funding, and relieving banks to some extent from extending credit to governments and large companies that can fund themselves on local and international capital markets.

Figure 6a. CESEE: External Positions of BIS Reporting Banks Vis-à-vis All Sectors
(Percent of GDP)

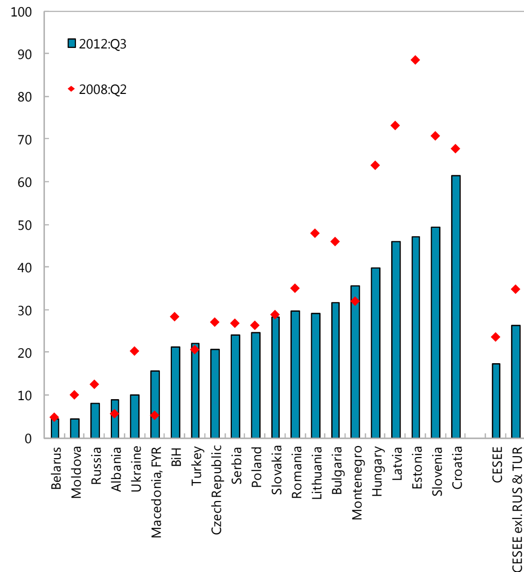
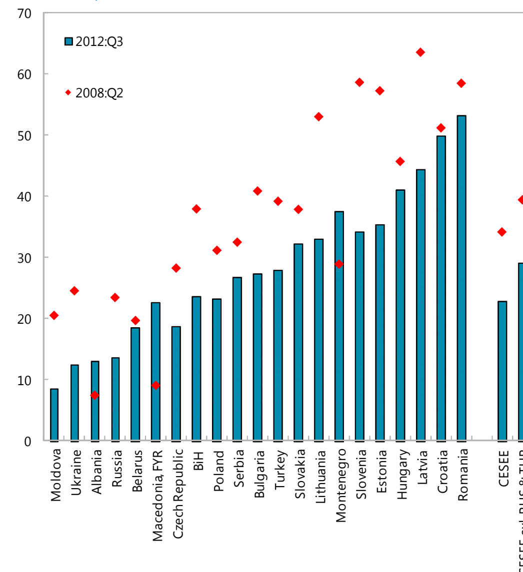
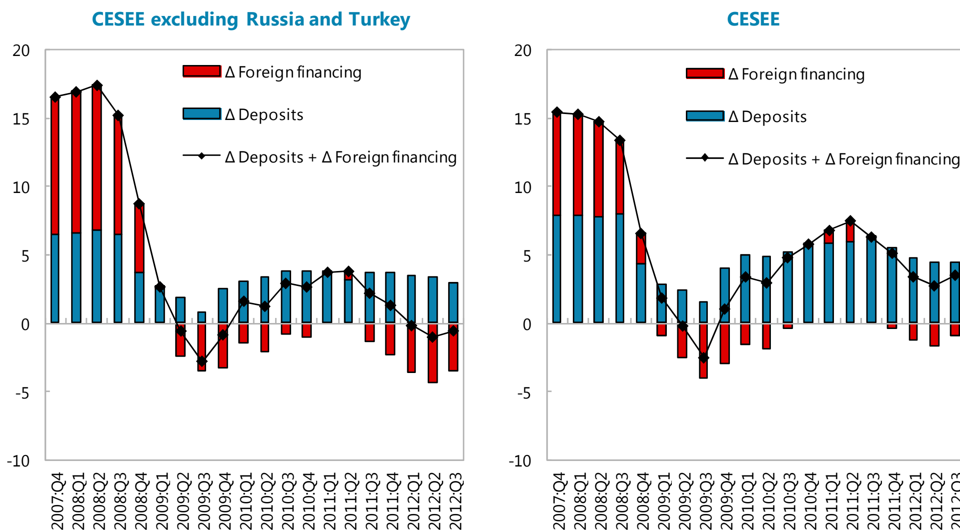


Figure 6b. CESEE: External Loans of BIS Reporting Banks Vis-à-vis All Sectors
(Percent of private credit and external loans vis-à-vis non-banks)



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

Figure 7. Evolution of Bank Funding, 2007:Q4 - 2012:Q3
(Percent of GDP, 4-quarter moving average, exchange-rate adjusted)



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