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CESEE Deleveraging and Credit Monitor[1]

November 4, 2014

Key Developments in BIS Banks' External Positions and Domestic Credit

- In 2014:Q2, BIS reporting banks reduced their external positions to CESEE countries by 0.1 percent of GDP, a slowdown compared to 2014:Q1 (Figure 1). Excluding Russia and Turkey, external positions of BIS reporting banks to the region declined by 0.4 percent of GDP, also a slowdown compared to 2014:Q1 (0.6 percent of GDP). Cumulative reduction in banks' external position since 2008:Q3 amounts to 4.6 percent of CESEE regional GDP, and excluding Russia and Turkey, 11 percent (Figure 2).

- The scale of funding reductions continued to vary across countries in 2014:Q2 with Latvia, Croatia, and Slovenia experiencing large reductions in line with earlier patterns (Figure 3). Flows turned negative in Hungary and Slovakia after a brief increase in 2014:Q1 and positive in Czech Republic after a large one-off decline in 2014:Q1.[2]

- Overall net capital flows to the region (excluding Russia) recovered in 2014:Q2 on the back of portfolio inflows after a sharp decline in 2014:Q1 driven by decrease in foreign liabilities (partly owing to debt repayments) (Figure 4). External bond issuance by CESEE sovereigns and corporates remained strong in 2014:H2. Russia continued to experience outflows in Q2, albeit at a more moderate scale (Figure 5).

- Overall credit growth slowed in Turkey, Russia and Belarus in Q2, and contracted in Ukraine. Elsewhere in the region overall credit growth remained subdued (Figure 6). Credit, particularly corporate credit, continued to contract in most of Southeastern Europe (Figure 7).Corporate credit growth turned positive in Q2 in Baltics (Estonia, Lithuania) and Central Europe (Poland, Slovakia).

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[1] Prepared by the staff of the international financial institutions participating in the Vienna Initiative's Steering Committee. This note contains preliminary analysis that will form the basis for the next Quarterly CESEE Deleveraging and Credit Monitor based on the published BIS International Banking Statistics scheduled for release no later than October 23, 2014.

[2] The large one-off outflows from the Czech Republic in Q1 reflect repayments to parent banks of loans provided during November 2013, when the Czech National Bank bought about 8 billion euros from the banks.

- Funding reductions by parent banks have had a bearing on credit slowdown. Since 2008, credit growth of foreign bank subsidiaries, on average, has slowed more than that of domestic banks. At the aggregate level, there is also a strong positive correlation between reduction of foreign bank funding and credit slowdown that is not explained by domestic demand (Figure 8).

- Domestic deposits grew everywhere in Q2 but in Hungary (in its 4th quarter of decline) and Ukraine (contraction for the first time since 2009). Although the rate of deposit growth slowed in the region in 2014:H1, its increase (y-o-y) on average continued to more than offset the decrease in foreign bank funding (Figure 9).

Key Messages from the Sixth CESEE Bank Lending Survey[3]: H2-2014

- **Cross-border banking groups operating in CESEE region continue to restructure at the global level, notably via sales of assets or branches.** Capital ratios have improved, including through equity issuance. However, most respondents signal a rather elevated level of activity in terms of sales of assets. On the other hand, there was no resort to capital provision from the government. Contributions to increased capital ratios and to the strengthening of core activities also came from sales of branches, as foreshadowed in previous runs of this survey. Deleveraging at the group level continues, with still roughly half the groups expecting a decrease in their group-level loan-to-deposit ratios.

- **Cross-border banks continue to discriminate among operations in CESEE countries, with a lower share expecting to expand operation in the longer term.** For only about half of the groups, operations in the CESEE region are expected to deliver higher returns on assets than the overall group operations (Figure 10). As a result of this and also taking into account structural changes in individual countries' economic and political outlooks, cross-border banking groups continue to reassess their country-specific strategies. Currently about a third of the groups surveyed expect to expand their operations, down from 46 percent in the March 2014 survey, while the share (33 percent) expecting selective reductions beyond the next 12 months has remained the same (Figure 11).

- **Cross-border banks continue to decrease their exposure to the region.** Slightly less than half the groups surveyed (46 percent) indicate that they have reduced their total exposure to the region in the last six months, but a smaller share (38 percent) expects to continue doing so over the next six months (Figure 12). Almost all the decrease in exposure comes from reduced intra-group funding to subsidiaries. All parent banks surveyed intend to maintain the current level of capital exposure to their subsidiaries, or even increase it. On balance, increasing capital exposures seem to have partially compensated for decreased intra-group funding.

[3] A full report, including country chapters, for the September 2014 survey will be published in early November 2014 on the EIB website. The survey includes 15 parent banks and 80 subsidiaries.

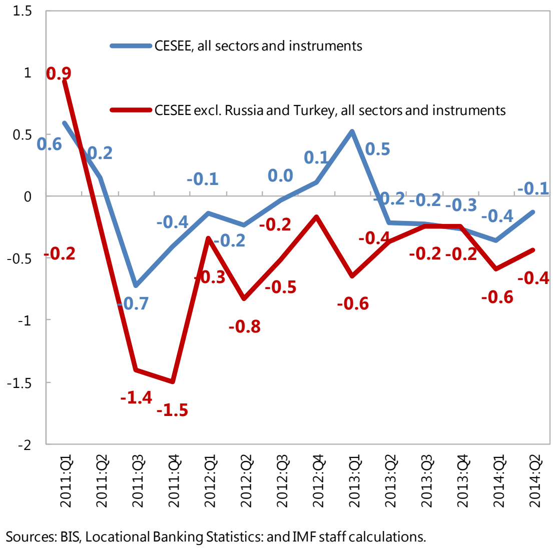
- **Demand for credit seems to be improving.** In the last six months, demand for loans and credit lines has improved (Figure 13, LHS). This was the first significant improvement since the inception of the EIB lending survey, mostly accounted for by debt restructuring and working capital requirements. Demand for credit to finance investments however remains very weak. In the period ahead, consumer confidence and non-housing-related expenditures are expected to make a positive contribution to credit demand. For the first time, credit demand from enterprises (including SMEs) is also expected to rebound significantly.

- **Supply conditions stabilized on the margin, in contrast to the still clear tightening pattern observed in the March 2014 survey**. Across the client spectrum, supply conditions (i.e. credit standards) continued to ease for consumer credit. Going forward, aggregate supply conditions are expected to ease, with the easing primarily driven by short-term maturities and consumer credit. Overall, Figure 13 (RHS chart) shows an improvement in both supply and demand conditions in the last half year, although by less than what had been expected six months ago. The chart also hints at a widening gap between demand and supply conditions going forward whereby growing optimism on the demand side, if confirmed, could be frustrated by the expected slow improvement on the supply side.

- **Credit supply continues to be negatively affected by a few domestic and international factors**. As in the previous surveys, access to domestic funding does not appear to be a constraining factor while high NPLs and change in local regulations remain the main constraining factors on the domestic front (Figure 14). Local bank capital constraints are still a limiting factor but less so than in the previous survey. International funding conditions have started to ease with a smaller set of factors playing a constraining role compared to the March 2014 survey. EU regulations, and group-wide NPL levels and capital constraints are all mentioned as having a negative effect on credit conditions. Global market outlook, not considered a negative factor in the last six months, is expected to become one going forward.

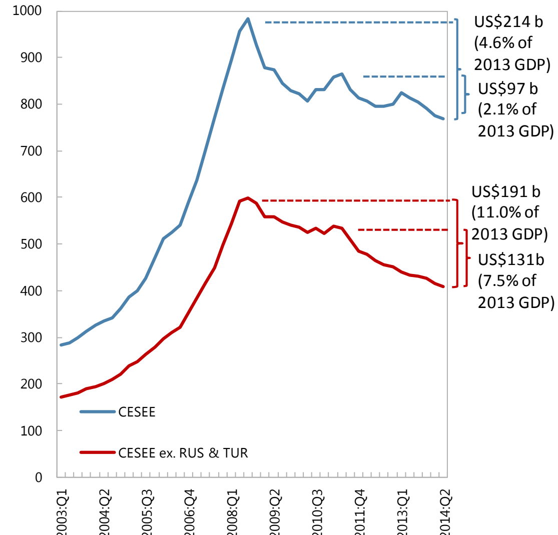
- **Credit quality continues to deteriorate, although banks expect some stabilization ahead.** According to the survey, the peak in NPL ratios has not yet been reached although the speed of deterioration has moderated (Figure 15). In absolute terms, less than 30 percent of banks continue to expect an increase in NPLs over the next six months (down from 40 percent in the March 2014 survey). NPL ratios for the corporate segment are expected to decrease, while NPLs in the retail segment are still expected to increase marginally, providing more positive signals than in March.

Figure 1. CESEE: Change in External Positions of BIS-reporting Banks, 2011:Q1–2014:Q2
(Percent of 2013 GDP, exchange-rate adjusted)



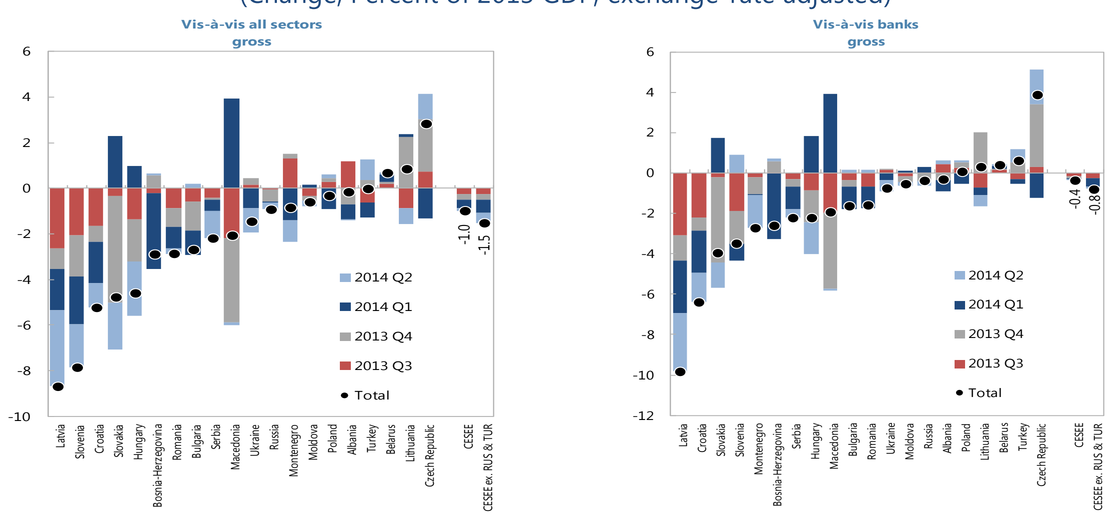
Sources: BIS, Locational Banking Statistics; IMF, World Economic Outlook database; and IMF staff calculations.

Figure 2. CESEE: External Position of BIS-reporting Banks, 2003:Q1–2014:Q2
(Billions of US dollars, exchange-rate adjusted, vis-à-vis all sectors)



Sources: BIS, Locational Banking Statistics; IMF, World Economic Outlook database; and IMF staff calculations.

Figure 3. CESEE: External Positions of BIS-reporting Banks, 2013:Q3–2014:Q2
(Change, Percent of 2013 GDP, exchange-rate adjusted)



Sources: BIS, Locational Banking Statistics; IMF, World Economic Outlook database; and IMF staff calculations.

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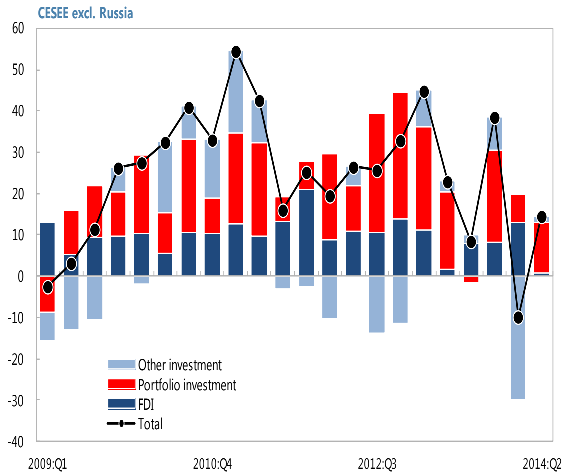
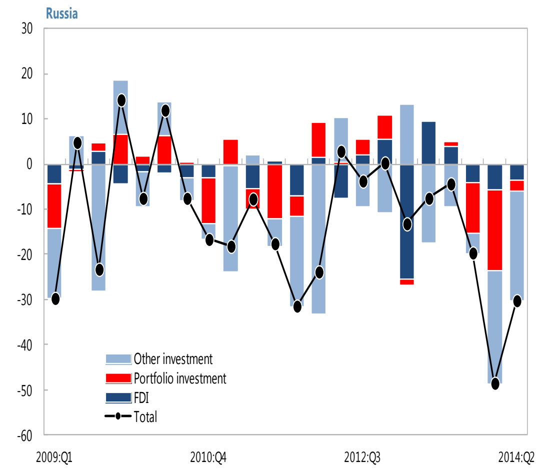
Figure 4. CESEE: Net Capital Flows (excl. Russia)
(2009:Q1–2014:Q2, USD Billions)



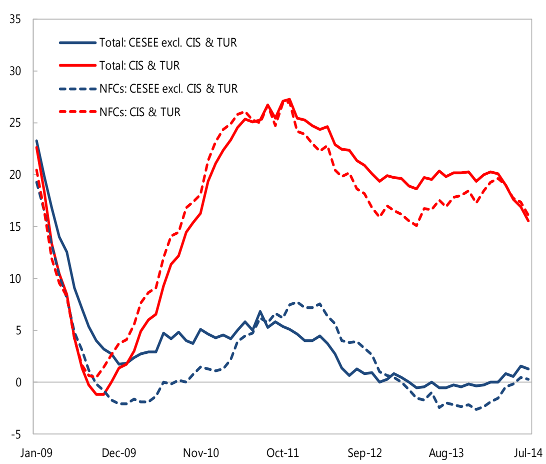
Sources: Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.

Figure 5. Net Capital Flows, Russia
(2009:Q1–2014:Q2, USD Billions)



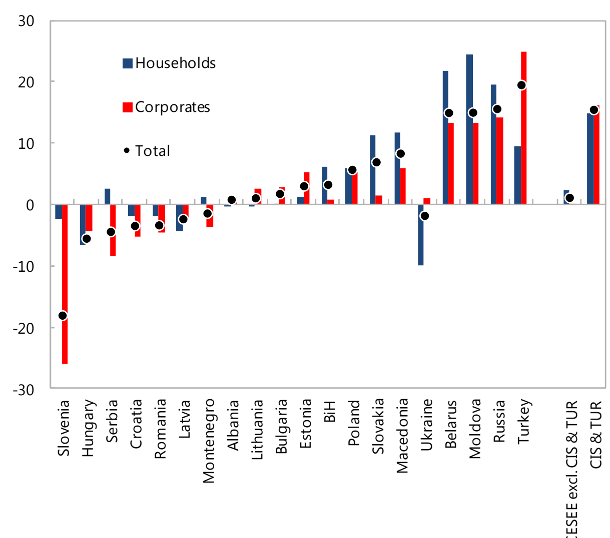
Sources: Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.

Figure 6. Credit to Private Sector, January 2009–July 2014 (Percent change, year-over-year, nominal, exchange-rate adjusted, GDP-weighted)



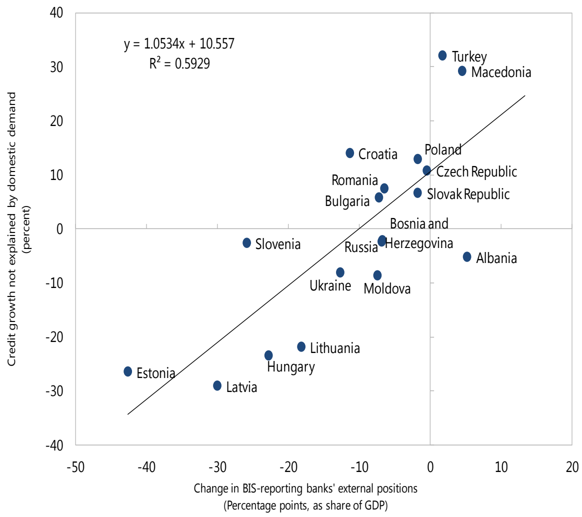
Sources: National authorities; BIS, EBRD and IMF staff calculations.

Figure 7. Credit Growth to Households and Corporations, July 2014 (Percent change, year-over-year, nominal, exchange-rate adjusted)



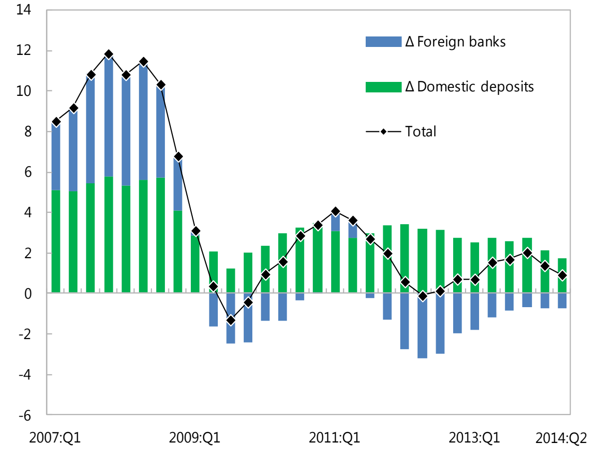
Sources: ECB; EBRD and IMF staff calculations.

Figure 8. Deleveraging and Credit Growth, 2008–13 (Percent)



Note: Residuals from regressing cumulative credit growth on cumulative domestic demand growth between 2008 and 2013.
Sources: BIS, Locational Banking Statistics; IMF, World Economic Outlook database; and IMF staff estimates.

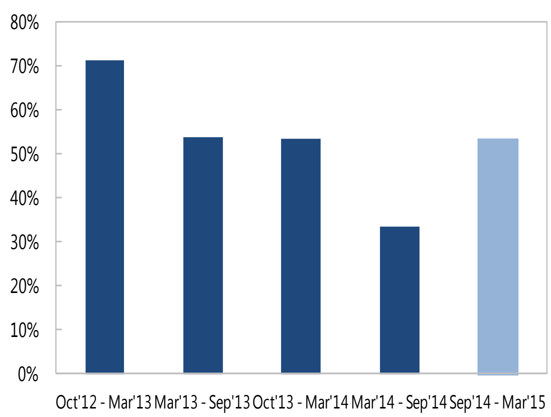
Figure 9. Evolution of Main Bank Funding Sources
(2007:Q1–2014:Q2, Percent of GDP)



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. Excludes Latvia prior to 2011:Q3, Montenegro and Kosovo because of data unavailability.

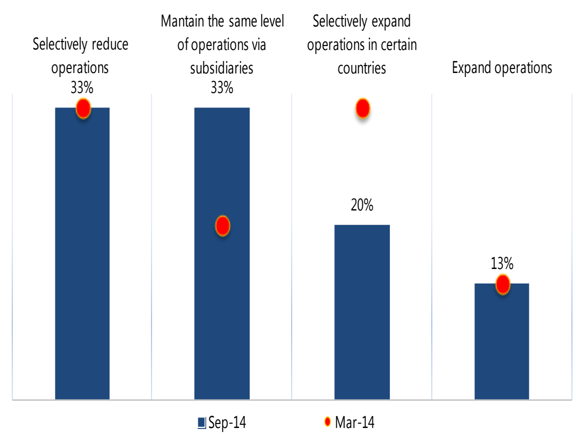
Sources: BIS, Locational Banking Statistics; IMF International Financial Statistics database; and IMF staff calculations.

Figure 10. CESEE: Groups Reporting Higher ROA in CESEE Relative to Overall Group Operations



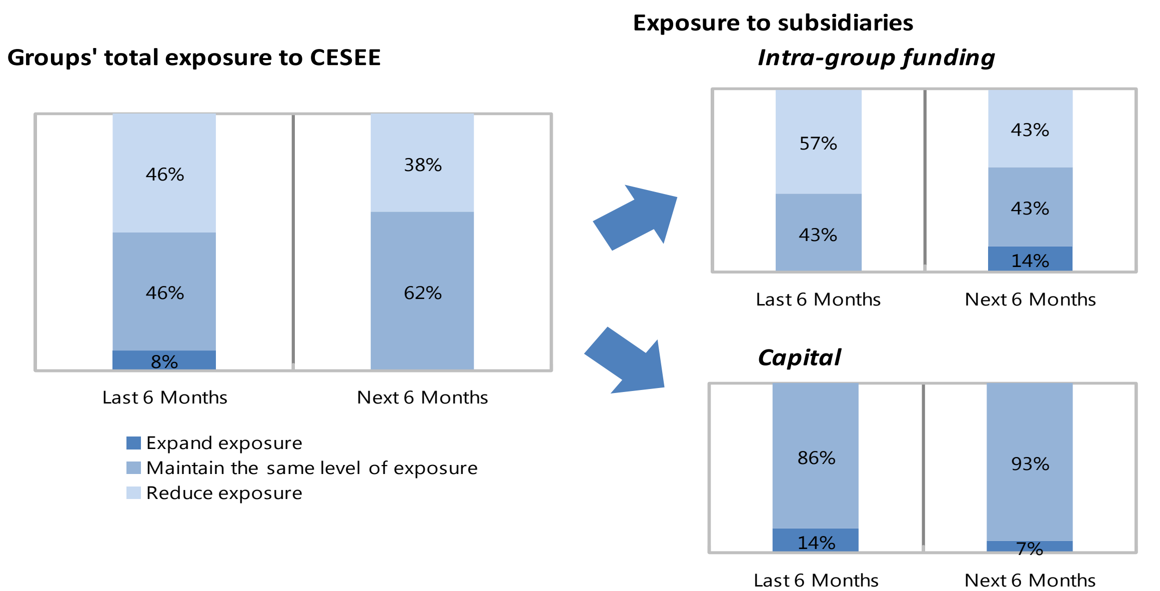
Sources: EIB Bank Lending Survey.

Figure 11. Longer Term Operations in CESEE—Groups' Intentions (beyond next 12 months)



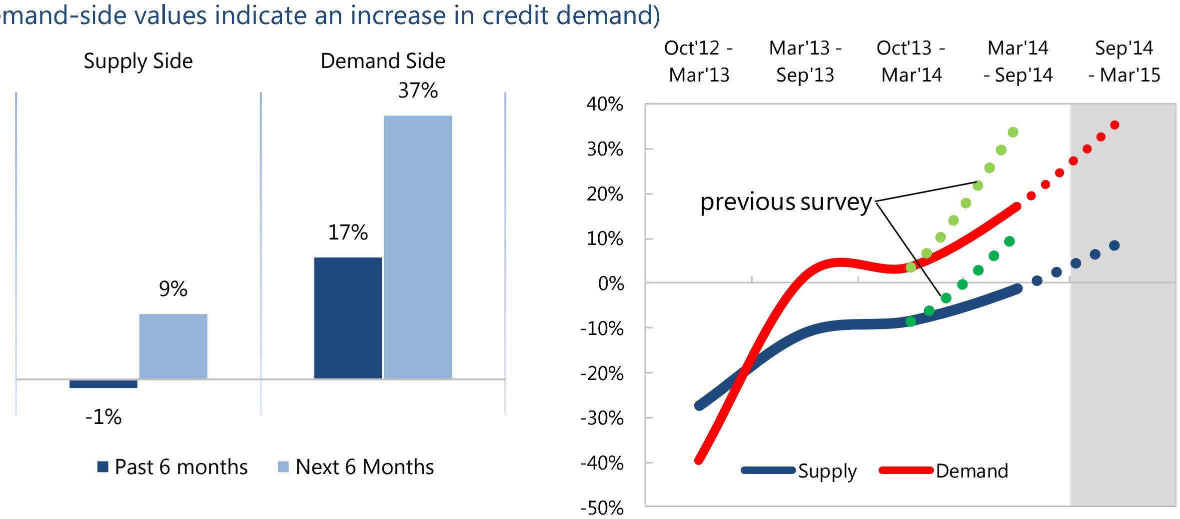
Sources: EIB Bank Lending Survey.

Figure 12. Groups' Total Exposure—Cross-Border Operations in CESEE Countries



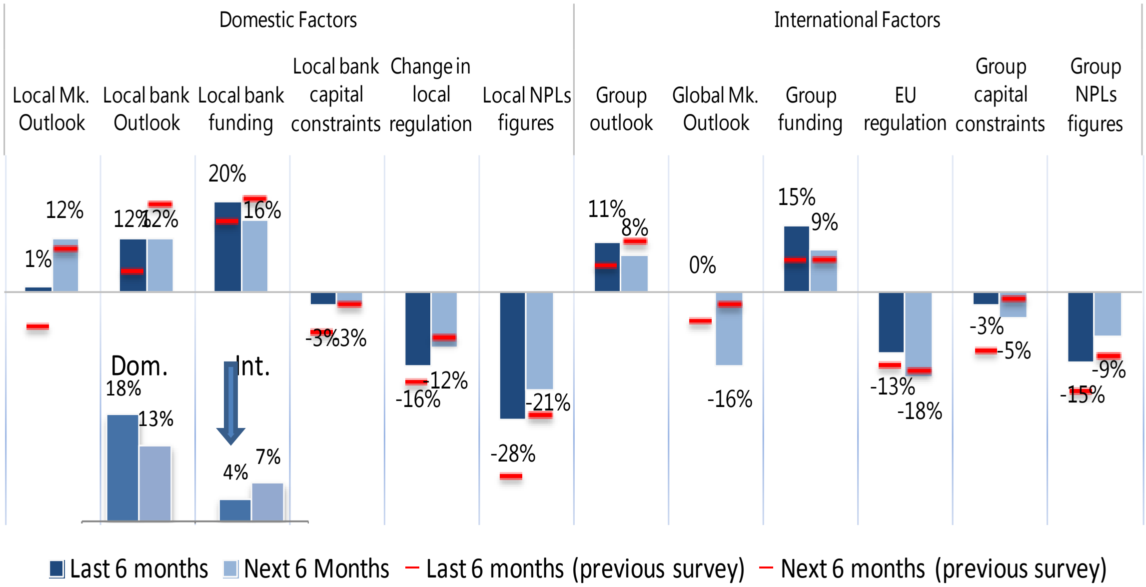
Source: EIB Bank Lending Survey.

Figure 13. Demand and Supply Conditions—Recent Past and Near-Term Outlook (Net percentages: Negative supply-side values indicate a tightening of credit standards and positive demand-side values indicate an increase in credit demand)



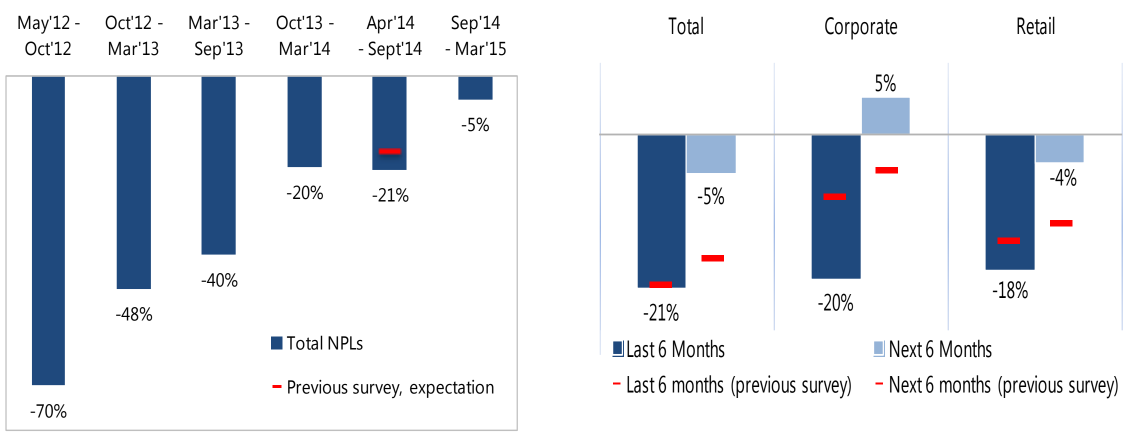
Note: Net percentage refers to percentage difference between positive and negative answers, discarding the neutral responses.
Source: EIB Bank Lending Survey.

Figure 14. CESEE: Domestic and International Factors Affecting Credit Supply (Net percentages: 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 from this round (sixth) of the survey.
Source: EIB Bank Lending Survey.

Figure 15. Gross NPL Ratio (net percentages; negative values indicate increasing NPL ratios)



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

__Table. CESEE: External Position of BIS-reporting Banks, 2013:Q3 - 2014:Q2__

__(Vis-à-vis all sectors)__

	2014 Q2 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 Q3	2013 Q4	2014 Q1	2014 Q2	Total	2013 Q3	2013 Q4	2014 Q1	2014 Q2	Total	2013 Q3	2013 Q4	2014 Q1	2014 Q2	Total
Albania	1,271	10.0	154	-87	-85	-1	-19	11.9	-6.0	-6.3	-0.1	-1.5	1.2	-0.7	-0.7	0.0	-0.1
Belarus	3,308	4.6	150	53	235	56	494	5.3	1.8	7.8	1.7	17.6	0.2	0.1	0.3	0.1	0.7
Bosnia-Herzegovina	3,088	17.2	-40	105	-596	15	-516	-1.1	2.9	-16.2	0.5	-14.3	-0.2	0.6	-3.3	0.1	-2.9
Bulgaria	15,270	28.8	-308	-669	-565	120	-1,422	-1.8	-4.1	-3.6	0.8	-8.5	-0.6	-1.3	-1.1	0.2	-2.7
Croatia	33,406	58.2	-949	-389	-1,045	-614	-2,997	-2.6	-1.1	-3.0	-1.8	-8.2	-1.7	-0.7	-1.8	-1.1	-5.2
Czech Republic	50,722	25.6	1,446	4,583	-2,612	2,230	5,647	3.2	9.9	-5.1	4.6	12.5	0.7	2.3	-1.3	1.1	2.8
Estonia	10,069	40.5	-68	-252	236	100	16	-0.7	-2.5	2.4	1.0	0.2	-0.3	-1.0	0.9	0.4	0.1
Hungary	41,067	31.1	-1,805	-2,404	1,298	-3,157	-6,068	-3.8	-5.3	3.0	-7.1	-12.9	-1.4	-1.8	1.0	-2.4	-4.6
Latvia	9,181	29.7	-810	-285	-560	-1,034	-2,689	-6.8	-2.6	-5.2	-10.1	-22.7	-2.6	-0.9	-1.8	-3.3	-8.7
Lithuania	12,689	27.3	-396	1,049	68	-320	401	-3.2	8.8	0.5	-2.5	3.3	-0.9	2.3	0.1	-0.7	0.9
Macedonia	1,765	17.3	-222	-379	404	-13	-210	-11.2	-21.6	29.4	-0.7	-10.6	-2.2	-3.7	4.0	-0.1	-2.1
Moldova	361	4.5	-25	-18	14	-18	-47	-6.1	-4.7	3.8	-4.7	-11.5	-0.3	-0.2	0.2	-0.2	-0.6
Montenegro	1,546	34.9	58	9	-61	-43	-37	3.7	0.5	-3.7	-2.7	-2.3	1.3	0.2	-1.4	-1.0	-0.8
Poland	118,192	22.8	1,502	825	-4,767	821	-1,619	1.3	0.7	-3.9	0.7	-1.4	0.3	0.2	-0.9	0.2	-0.3
Romania	43,402	23.0	-1,662	-1,539	-1,732	-460	-5,393	-3.4	-3.3	-3.8	-1.0	-11.1	-0.9	-0.8	-0.9	-0.2	-2.9
Russia	166,494	7.9	-1,232	-11,174	-833	-5,965	-19,204	-0.7	-6.1	-0.5	-3.5	-10.3	-0.1	-0.5	0.0	-0.3	-0.9
Serbia	8,214	19.3	-180	-37	-196	-514	-927	-2.0	-0.4	-2.2	-5.9	-10.1	-0.4	-0.1	-0.5	-1.2	-2.2
Slovakia	25,627	26.7	-320	-4,479	2,222	-1,987	-4,564	-1.1	-15.0	8.8	-7.2	-15.1	-0.3	-4.7	2.3	-2.1	-4.8
Slovenia	16,516	34.4	-989	-872	-1,000	-906	-3,767	-4.9	-4.5	-5.4	-5.2	-18.6	-2.1	-1.8	-2.1	-1.9	-7.8
Turkey	194,631	23.7	-5,164	3,096	-5,393	7,406	-55	-2.7	1.6	-2.8	4.0	0.0	-0.6	0.4	-0.7	0.9	0.0
Ukraine	12,104	6.8	290	543	-1,524	-1,882	-2,573	2.0	3.6	-9.8	-13.5	-17.5	0.2	0.3	-0.9	-1.1	-1.4
CESEE 1/	768,923	16.5	-10,570	-12,321	-16,492	-6,166	-45,549	-1.3	-1.5	-2.1	-0.8	-5.6	-0.2	-0.3	-0.4	-0.1	-1.0
Emerging Europe 2/	656,808	15.4	-9,829	-11,016	-14,778	-4,569	-40,192	-1.4	-1.6	-2.2	-0.7	-5.8	-0.2	-0.3	-0.3	-0.1	-0.9
CESEE ex. RUS & TUR	407,798	23.4	-4,174	-4,243	-10,266	-7,607	-26,290	-1.0	-1.0	-2.4	-1.8	-6.1	-0.2	-0.2	-0.6	-0.4	-1.5

Sources: BIS and IMF staff calculations.

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