Global deleveraging: is CEE in the eye of the storm?

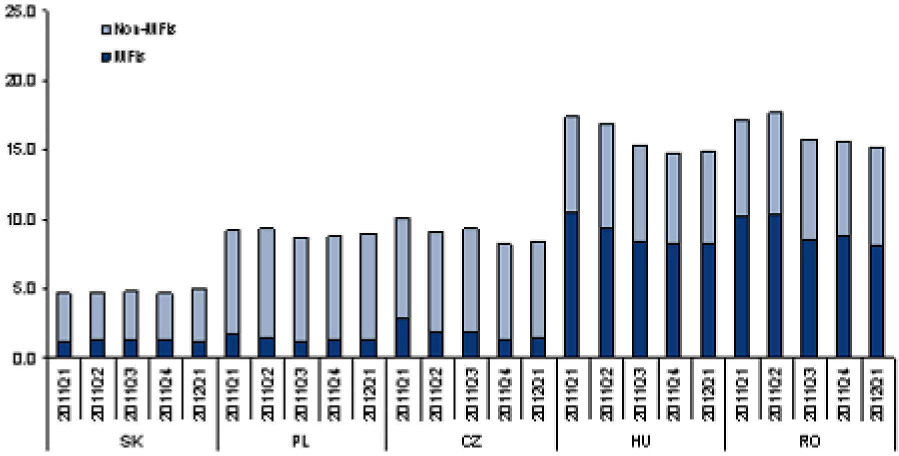
27.06.2012

- **Anglo-Saxon banks and funds most aggressive in deleveraging; Austrian banks mostly linked to Germany not relying on funding from countries in hotspots of deleveraging**
- **Limited deleveraging of foreign banks in CEE6[1] (except Hungary); no massive reduction of parent bank exposure expected in the region**
- **CEE6 net external financing need halved vs. pre-Lehman era; combined FDIs and net EU flows cover entire C/A in CEE6 countries (except Romania)**
- **CEE diversifying away from being a German manufacturing hub only with Asian companies increasing their footprint in the region**

Global deleveraging caused by international banks cutting their cross-border lending has sparked serious concerns about Central and Eastern Europe's vulnerability, due to its high foreign bank ownership. Erste Group analysts have crunched the numbers to show why CEE6 (except Hungary) has been neither on the direct nor on the indirect axis of heavy global deleveraging. "One key reason for the limited deleveraging in CEE is that Austrian banks, which dominate the region's funding, are mostly linked to Germany and do not rely too much on funding from the UK (which has been the most aggressive in deleveraging) and the periphery. A second reason is that due to their lower public debt and relatively small size of the banking sector, CEE economies were able to avoid the sovereign debt-leveraged banking sector vicious circle that countries like Greece and Spain are struggling with," explains Juraj Kotian, Head CEE Macro/FI Research at Erste Group.

At the same time, foreign liabilities of banks have been declining in some CEE6 countries, especially those with a large share of FX loans, which have been declining due to regulatory constraints or intervention. Additionally, syndicated loans to emerging Europe have shrunk considerably in the first four months of 2012, as shown by a recent World Bank report[2]. "However, in an international comparison, overall deleveraging has been very moderate in CEE6 (apart from Hungary) and we expect no massive reduction of exposure from parent banks going forward. Moreover, the domestic deposit base has been increasing across the board, gradually shifting the weight towards a more sustainable model of domestically-funded assets," according to Kotian.

Austrian banks keep the funding relatively stable
(Cross-border assets of Austrian banks to selected countries; in EUR bn, end of quarter)



Source: ECB, Erste Group Research

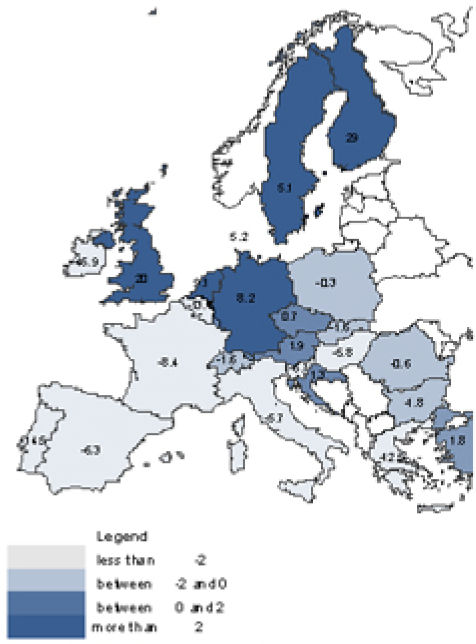
Anglo-Saxon banks and funds most aggressive in deleveraging; Austrian banks mostly linked to Germany, do not rely on funding from countries in hotspots of deleveraging

UK banks and US funds were the most aggressive in cutting cross-border lending across the globe in 4Q11. At the same time, cross-border lending shifted to safe havens (Scandinavia and core euro area) at the expense of peripheral countries.

One essential factor for the CEE region is that its two most important trading partners, Austria and Germany, have been among the most resilient to global deleveraging. Despite massive cross-border deleveraging in the peripheral Euro Area banks, data on banks' change in foreign liabilities show there has been hardly any reduction of foreign funding of banks in CEE, except for Hungary. In Poland, foreign assets have remained flat y/y as of March 2012; in the Czech Republic, they even slightly increased (despite the country not having a triple A rating). The low level of public debt and relatively small size of the banking sector put CEE economies at lower risk compared to many highly-leveraged Euro Area economies. In this respect, Hungary is an outlier in CEE. The low predictability of economic governance and unorthodox measures (which enabled early repayment of Swiss franc loans) resulted in a reduction of both sides of Hungarian banks' balance sheets.

The speed of deleveraging in the Euro Area banking sector will be decisive for the future development of cross-border lending. The hottest candidates for primary deleveraging are UK banks; the next in line are banks in peripheral Euro Area countries, which will be under pressure, on concerns of a vicious circle of mounting sovereign debt, low growth outlook and struggling banks. Fortunately, CEE6 and even Austrian banks, which are the backbone of funding of the CEE6, get only limited funding from the above-mentioned countries that are prone to deleveraging

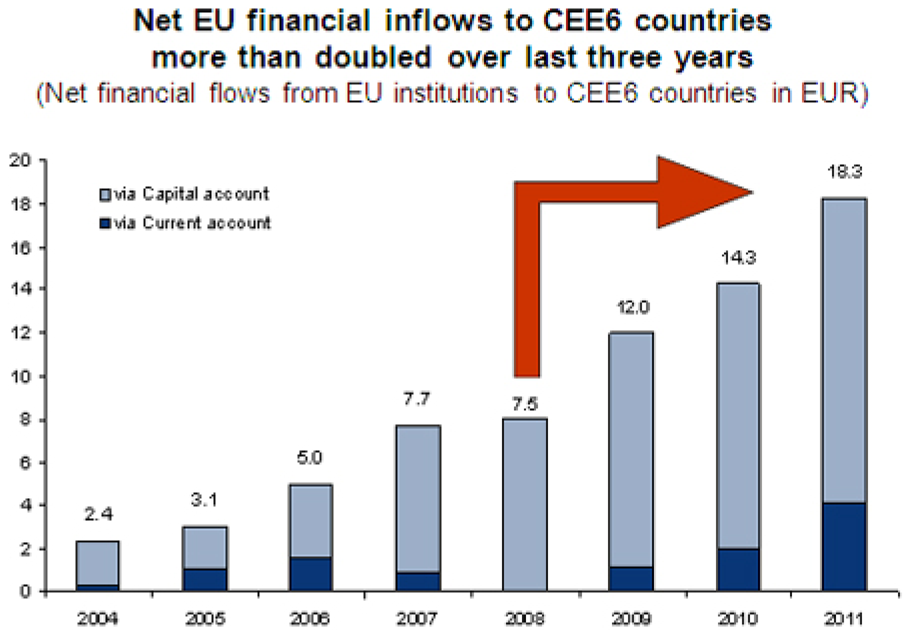
Change in foreign liabilities of banks
(% GDP, March 2012 vs. March 2011)



Source: ECB, Erste Group Research

Limited reduction of foreign funding of banks in CEE, except for Hungary; no massive reduction of parent bank exposure expected in the region

How firmly will Austrian banks hold onto their exposure in CEE6 if there is renewed pressure? Even without a new Vienna Initiative, it is unlikely that European parent banks would spontaneously liquidate their exposure to CEE markets. However, the clear trend going forward as pointed out by regulators and international financial institutions is towards a domestically funded model, which means that in the mid run CEE subsidiaries will become less reliant on parent bank funding. Given that many CEE countries introduced restrictions on FX lending to households in recent years, FX debt redemptions can indeed slowly contribute to a reduction of foreign liabilities in the mid run (). However no massive reduction of exposure to CEE (on a consolidated basis) is expected. Among the CEE6 countries, Czech Republic and Slovakia are least vulnerable to deleveraging, as they have lowest share of foreign liabilities in their balance sheets (less than 10% of total assets).



Source: Eurostat, Erste Group Research

CEE6 net external financing need halved vs. pre-Lehman era; combined FDIs and net EU flows cover entire C/A in CEE6 countries (except Romania)

Given that many CEE6 countries have efficiently narrowed their current accounts deficits, the slowdown of capital inflows does not endanger the economic and financial stability of the CEE6 region as much as in the period right after the Lehman collapse. “Demand for net external financing halved compared to the pre-Lehman period (to about EUR 25bn). In the meantime, net EU flows have more than doubled in the last year (to EUR 18bn). Countries enjoy a strong portfolio capital inflow, especially into government bonds, which offset denting cross-border loans. But more important is that combined FDIs and net EU flows, which represent non-debt financing, now cover the entire current account in almost all CEE6 countries,” Kotian points out.

CEE diversifying away from being a German manufacturing hub only; Asian companies increase footprint in the region

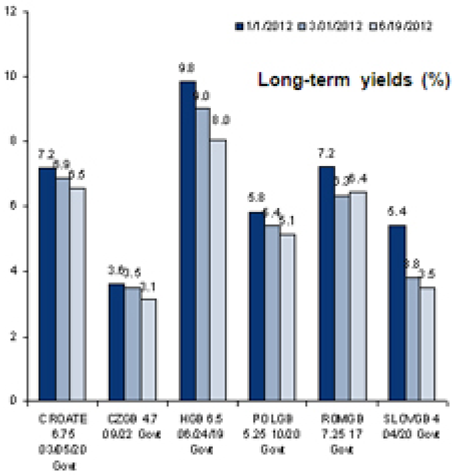
Last year, CEE6 countries attracted net foreign capital inflow worth EUR 36bn in total - about half of the inflows in the peak year of 2007, but about the average volume in the period of 2002-06. It is very likely that CEE countries will witness a moderation of FDI inflow, due to the negative effect of the global economic slowdown on investments and profits in 2011. However, having German and Austrian companies among their top investors has an advantage, as their production is highly competitive and companies there are among the least stressed by deleveraging in the banking sector. Says Kotian: “After the integration of new member states into the EU, we could see an increased footprint of Asian companies in the region. Their presence in the CEE region offers perfect access to the common EU consumer market, with labor costs at a reasonable level. At present, two of the top three exporters in Slovakia and the Czech Republic are Asian companies, so CEE is no longer solely a German manufacturing hub. We expect that Asian companies will continue to reinvest their profits in the CEE region in the following years.”

No sharp sell-off of CEE6 government bonds

Despite persistent tensions on the sovereign bond market in peripheral countries and ongoing deleveraging in the European banking sector, CEE6 has not witnessed any sharp sell-off of government bonds. The LTRO programs launched by the ECB in December and February helped to increase foreign demand as well. Domestic yields have collapsed and CEE governments have good access to foreign markets. Almost every government was active on foreign markets issuing Eurobonds in 1Q12. The European Commission has been positive on fiscal consolidation in CEE so far and predicts that countries will bring their deficits below 3% of GDP by 2012 (or 2013 at the latest).

Europe has apparently been moving faster toward the crossroads of deeper integration or disintegration. While the cross-border deleveraging within the Euro Area and home-bias investment policies of local banks and their regulators could be seen as effective (financial) disintegration, at the end of the day, Erste Group analysts bet on deeper integration. However, a lot of volatility is expected to continue on the market. If the ECB restore some of their extraordinary tools (LTRO, SMP) it would have a positive impact on portfolio capital inflows. “We see the highest investment opportunity in investing in 10Y Hungarian government bonds, where the yield is to collapse below 7% (-100bp) once the new IMF program is put in place. Czech bonds would be a very conservative investment for investors who want to bet on persisting high-risk aversion in Europe. However, if European policy makers make progress towards higher risk sharing in the Euro Area, Czech yields would likely follow the upward correction of German yields. Polish government bonds seem to be the most neutral investment for the coming months. The deeper view on EU flows into Poland’s economy show that financing of the widened C/A does not need to be as challenging as one would have thought,” concludes Kotian.

Foreign demand for CEE government debt remains robust



Source: Bloomberg, Erste Group Research

Download - CEE Special Report [pdf; 194.5 KB]

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[1] CEE6: Croatia, Czech Republic, Hungary, Poland, Romania and Slovakia

[2] See the World Bank’s report “Global Economic Prospect – June 2012”

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