ERSTE Group

CEE deleveraging remains moderate, mitigated by portfolio investments and EU funds

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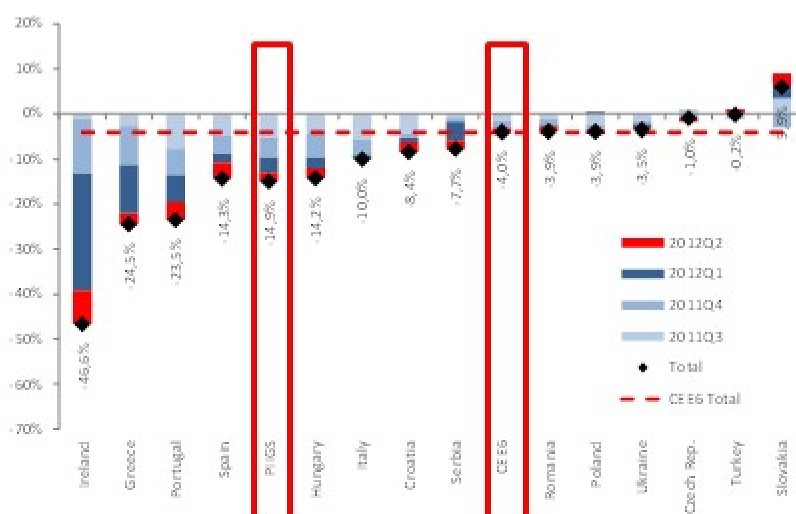
- **CEE6[1] bank deleveraging in 3Q11-2Q12 moderate (4% of GDP) in international context**
- **Strong portfolio capital inflows (EUR 4.6bn) offset more than half of the outflows**
- **Net EU funds inflows to CEE doubled over past three years, making the region less vulnerable vs. 2008**
- **Austrian, German and Italian banks kept lending to CEE6 (except Hungary) relatively stable**
- **High demand for CEE government securities to further boost portfolio capital inflows in Q3 2012**
- **Outlook: shifts in foreign capital structure and allocation from private to public sector might pose risks to future growth**

Cross-border bank deleveraging in most CEE countries remained relatively benign and was cushioned by strong portfolio capital inflows and doubled EU funds, finds the 2nd edition of the Erste Group study "**Living in a time of global deleveraging**", published today. This, along with the fact that the region has largely managed to substantially lower its external financing needs, renders CEE less vulnerable to the global slowdown of capital inflows. On the other hand, Erste analysts warn that changes in the structure of foreign capital pose a risk in the case of a global sell-off, while allocation shifts from the private to the public sector could undermine potential growth

Changes in external position of BIS-reporting banks to selected countries 3Q11-2Q12 (as % of GDP 2012)



Source: BIS (locational data), IMF (WEO Oct2012), Erste Group Research

CEE6 deleveraging in 3Q11-2Q12 moderate (4% of GDP) in international context

"Over the 3Q11-2Q12 time span bank deleveraging in CEE amounted to USD 45bn or 4% of GDP. If we put it into the broader context of European banks facing huge regulatory pressure and the steepest deleveraging since the Lehman collapse, these levels remain benign and a far cry from the deleveraging occurring in the Eurozone periphery, which amounted to USD 600bn or 14.9% of GDP", explains Juraj Kotian, Head of CEE Macro/Fixed income at Erste Group and

author of the report.

According to the latest BIS data[2], foreign banks reduced their external assets to CEE6 (Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia) by about USD 8.6bn in 2Q12 (or 0.8% of their GDP) and USD 45bn in the period 3Q11-2Q12 (or 4% of their GDP), with Hungary responsible for 40% of overall outflows from the region. Hungary has clearly been an outlier in the region, both in terms of magnitude and the reasons behind the steep deleveraging – which were mainly unorthodox measures including the early pre-payment of FX loans, which freed up part of FX funding. On an annual basis, the global banking sector reduced its external position to Hungary by about USD 18bn, or 14.2% of Hungarian GDP compared to Spain with 14.3% of GDP.

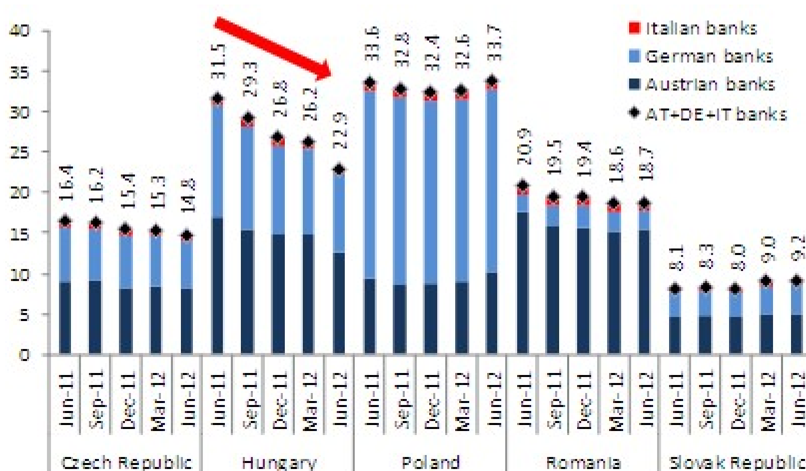
“Although deleveraging numbers are nowadays presented as a proxy for investors’ confidence in Central and Eastern Europe, simply assessing the fluctuations in banks’ external liabilities is not enough to get a relevant picture. Other leading indicators, particularly the balance of payments data and the stock of government bonds held by non-residents, which are also indicative for capital flows into CEE economies, should be taken into account”, recommends Kotian.

Overall outflow from CEE offset by strong portfolio capital inflows
A look at the balance of all capital flows between domestic and foreign counterparties reveals that, on an aggregate level, deleveraging in CEE looks even less striking. Overall in the period 3Q11 – 2Q12, investors withdrew only EUR 1.7bn or 0.2% of GDP from CEE6 versus 39.6% in Portugal or 26.4% in Spain, when adjusted for central bank liabilities and official support. Foreign investors withdrew only EUR 3bn from CEE6 in 2Q12 (or EUR 1.5bn when adjusted for central bank liabilities resp. 0.2% of GDP). In 2Q12 strong portfolio capital inflows worth EUR 4.6bn (0.5% of GDP) offset more than half of the capital outflows in other investments (EUR -7.6bn or -0.9% of GDP), which mainly represents flows of the banking sector, but also includes changes in liabilities of local central banks (i.e. Target2) and official support to governments. “In the international context, the withdrawal of foreign capital from the CEE region (apart from Hungary) was very benign and unlikely to cause any significant pressure on balance of payments like in the Eurozone periphery”, underlines Kotian.

Net EU funds inflow to CEE doubled over last three years
“EU funds have doubled over the past three years (EUR 18bn in 2011 for CEE6), proving to be a game-changer in the external financing of the CEE region. Many CEE countries have managed to substantially lower their net external financing needs, which means the slowdown of capital inflows does not pose a big risk to the external stability of the CEE region”, emphasizes Kotian. This makes the region less vulnerable to global deleveraging compared to 2008. Combined FDIs and net EU flows, which represent non-debt financing, now cover almost the entire current account in all CEE6 countries. This is not (yet) the case for Romania, which has been lagging in drawing EU funds compared to its regional peers who joined the EU three years earlier.

Austrian, German and Italian banks strongly committed to CEE
Austrian, German and Italian banks kept their lending to CEE5 countries relatively stable, with Hungary again remaining an outlier, according to the ECB data on cross-border claims of Austrian, German and Italian banks to individual EU members on unconsolidated basis.

Cross-border lending of Austrian, German and Italian banks to selected CEE countries (EUR bn)



Source: ECB (unconsolidated data, including securities), Erste Group Research

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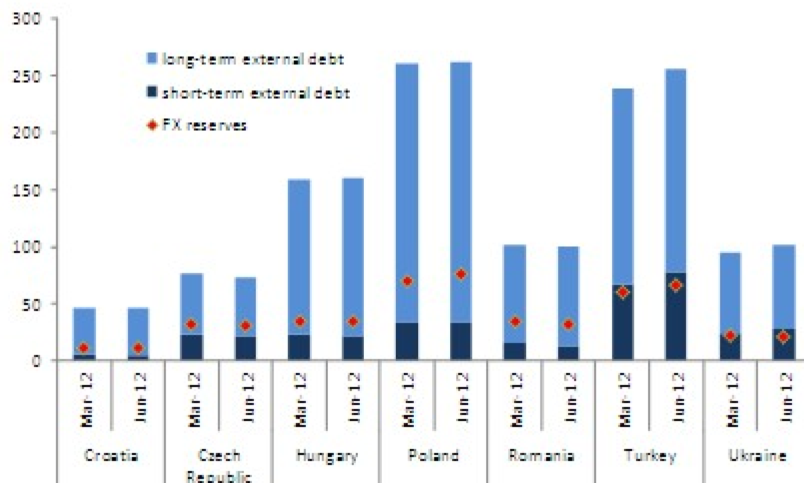
Outlook Q3 2012: High demand for CEE government securities will boost portfolio capital inflows
CEE government bonds have rallied strongly (yields have declined by another 50-100bp) on reduced tail risks in the Eurozone based on Draghi's pledge to do 'whatever it takes' and later facilitated by OMT and the FED’s QE3. Polish and Hungarian local currency government securities reached an all-time high in 3Q12 as non-residents increased their holdings by in total EUR 4bn in 3Q. Additionally, CEE6 governments placed Eurobonds worth EUR 6.3bn on international markets in

September and October. “High frequency data on government bonds held by non-residents suggests that portfolio capital inflows will continue to cushion the potential outflow of other capital investments in the third quarter”, foresees Kotian.

Conclusion: Deleveraging doesn’t threaten CEE’s external stability, but shifts in foreign capital structure and allocation from private to public sector might pose risks to future growth

So far, the pace of cross-border deleveraging in CEE did not dent the stock of international reserves beyond the amount, which would correspond to the reduction of short-term external debt in 2Q12.

Coverage of short-term external debt by FX reserves (EUR bn)



Source: IMF, Erste Group Research

“However, the change in structure of foreign capital could represent a potential risk for the CEE region in the future. Increased portfolio capital inflows could backfire in the case of a global sell-off and be a source of increased volatility, especially in countries with a high stock of government bonds held by non-residents (Poland and Hungary). The second concern is that the allocation of foreign capital has been changing - less foreign capital is directed to the private sector (through FDIs, loans) but more inflows are channeled via the public sector (through government bonds, EU funds), which can undermine potential growth unless the capital is efficiently utilized in a productive sector”, summarizes Juraj Kotian.

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

[2] BIS locational data aggregate the balance sheets of individual banks across the globe (unconsolidated data).

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