Deutsche Bank Research

Eastern Europe

October 19, 2010

Revival of credit?

Key views

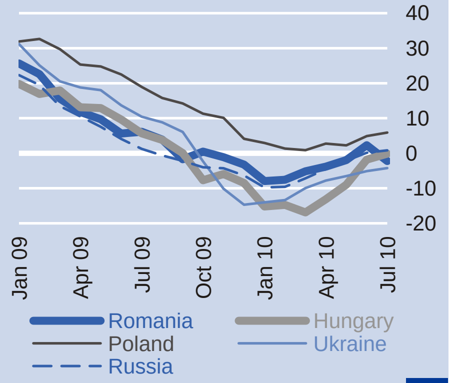
— **Credit bottoms out in some countries.** Recession has ended in all Eastern European countries. Although year-on-year real credit growth is still negative in most countries, Q1 seems to have marked the bottom in some countries. The credit impulse (i.e. net new credit in relation to GDP) shows a strong improvement and thus positive contribution to real GDP growth in all countries but Kazakhstan.

— **NPLs stuck at high levels.** The peak NPL levels expected by us last year have been reached in nearly all Eastern European countries. However, no tangible decline in NPLs is likely over the next 12 months.

— **Foreign bank credit has proved relatively stable.** External bank financing in the CEE-8 declined less than in other EM regions in the global crisis, due to the region's deep integration with the Western European financial sector. But it has also picked up less than in other regions post-crisis.

Group A: Bottomed out

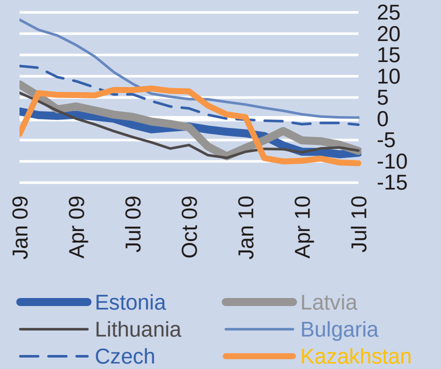
Real credit growth, % yoy



Sources: IFS, DB Research 1

Group B: No turning point yet

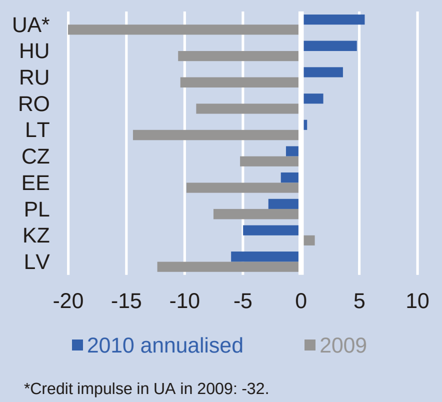
Real credit growth, % yoy



Sources: IFS, DB Research 2

Improvement in credit impulse

Yoy change in net new credit as % of GDP



*Credit impulse in UA in 2009: -32.

Sources: IFS, DB Research 3

Real credit to private sector: Finally bottoming out

Recent releases of Q2 GDP data showed a positive reading for all[1] Eastern European countries on a quarterly basis, in most countries for the second consecutive quarter. Thus, we expect recession to have ended even in the recovery laggards like Romania and the Baltics. While a tangible rebound in credit growth is still not visible in the yoy figures, the bottom seems to have been reached in several countries in early 2010 (see chart 1). However, in some countries (among them the ones with fixed exchange-rate regimes undergoing a painful internal devaluation) no recovery in credit growth is in sight (see chart 2). To gauge more properly the stimulus of credit on real GDP growth, we take a look at the so-called credit impulse.[2] Except in Kazakhstan, it shows a strong improvement in H1 2010 compared with 2009 and it is positive for half of the countries (see chart 3).

NPLs might prove sticky at high levels

Non-performing loans (NPLs) in Eastern Europe have already reached or are close to the levels we forecasted one year ago (see chart 4). Russia and Ukraine are the only countries where our NPL forecasts look too conservative. However, one should take into account concerns voiced by the IMF and rating agencies regarding possible NPL (under-)reporting in these countries.[3] Given a visible stabilisation in NPL dynamics across

1 Bulgaria does not publish qoq real GDP data.

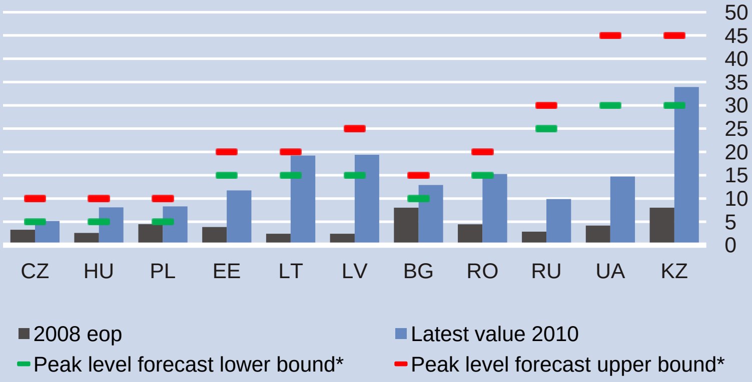
2 Defined as increase or decrease of net new credit (as % of GDP). For methodology please see Michael Biggs/Thomas Mayer "The myth of credit-less recovery". Global Markets Research. December 2009.

3 See for example IMF Russia Country Report 10/96, April 2010 and IMF Ukraine Country Report 10/262, August 2010.

Contact: Marion Muehlberger, Gunter Deuber ☎ +49 69 910-31815

the region we expect NPL peak levels to be reached over the next 3-6 months. However, a decline in NPLs will happen only gradually for several reasons. Firstly, some rescheduled loans may still turn non-performing. This may actually be in the lender's interest as steps to collect the principal or underlying can only be taken once a loan has been classified as non-performing. Secondly, as described above, credit growth remains weak, so that a reduction in the NPL ratio via an increase in the denominator will take time. Thirdly, a write-back of NPLs will be slow as the respective loans have to perform continuously and fully for a long period before they can be reclassified. Estonia – the country that together with Latvia entered recession earliest in Eastern Europe – is an instructive example of "sticky NPLs". There, NPLs have been hovering around the 12% level since February 2009. Recently the Estonian government drafted a bill on regulating principles to facilitate an orderly restructuring (lowering) of household sector debt in court proceedings. The bill may become effective in the upcoming months and may set a benchmark for other countries with high debt levels in the household sector (e.g. Latvia, Lithuania, Hungary or Ukraine).

Estimated NPL peak level reached
NPLs in % of total loans (national definitions)



*Forecasts DBR Credit Monitor Eastern Europe, 20 August 2009
Sources: National central banks and regulators, DB Research
4

Foreign bank credit: Stabilisation ahead

As we now have six quarters of data on foreign lending to Eastern Europe, it is possible to analyse the behaviour of international banks in and after the crisis. Contrary to expectations, the CEE-8[4] registered smaller bank outflows than other EM regions in the context of the crisis (see chart 5). This performance can be explained by the deep financial integration with the Western European financial sector as well as crisis management actions by the EBRD, the ECB and other Western European central banks such as the Vienna Initiative. Moreover, substantial FDI links in the non-bank corporate sector also helped to stabilise cross-border bank financing.

However, foreign claims to the CEE-8 are not picking up in comparison to Asia or Latin America. How long will this deleveraging go on? Comparing deleveraging patterns after the

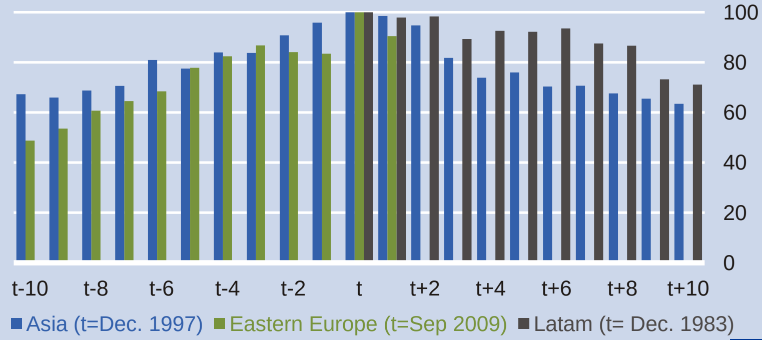
Foreign lending to CEE remains sluggish
Foreign claims, BIS reporting banks, % change qoq

Sources: BIS, DB Research
5

[4] CEE-8: Eastern European countries which are EU members but not EMU members (Czech Republic, Hungary, Poland, Estonia, Lithuania, Latvia, Bulgaria and Romania).

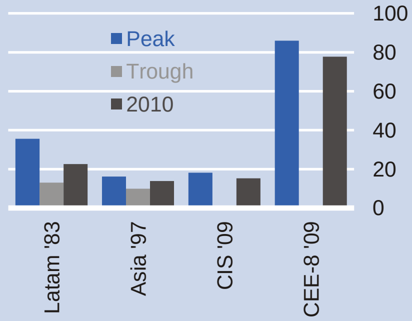
Latin American crisis in 1983 and the Asian crisis in 1997 suggests that deleveraging[5] could go on as long as 5 years and may stabilise at only 60-70% of peak pre-crisis lending levels (see chart 6).

Will this time be different?
Exposure of BIS banks, in % of recipient country GDP, peak = 100



Sources: IMF, BIS, DB Research 6

Does deep integration prevent sharp deleveraging?
Foreign claims, % of recipient region GDP



Sources: BIS, DB Research 7

However, there are reasons to believe that the bank lending slump in Eastern Europe will not be as severe. First, the level of financial integration is much deeper in Eastern Europe than it was in pre-crisis Latin America or Asia (see chart 7) and thus the creditor-borrower interdependence is much stronger. Second, in absolute USD terms foreign claims have reached their trough in all countries except the Baltics and Romania and have started to grow again (although currency effects contributed to this performance as well). That growth has been very strong in Poland, where current lending volumes in absolute terms are almost back to pre-crisis peak levels (see chart 8). Third, due to wider interest rate margins and an incipient economic recovery profit prospects in Eastern European retail banking markets remain more benign than in a lot of Western European countries (i.e. home markets of foreign banks focused on Eastern Europe). Fourth, banking sectors in Eastern Europe should not be affected much by increasing international capital requirements. Capitalisation ratios in nearly all Eastern European banking sectors are already well above new capital requirements under the Basel III regime, as indicated for example by the favourable performance of some domestic-owned CEE banks in the 2010 EU-wide stress testing.

Exposure to Poland close to pre-crisis levels
Total foreign bank claims in USD, % change

*Trough not reached yet.

Sources: BIS, DB Research 8

[5] Defined as the reduction in foreign bank claims as % of the recipient region's GDP.