Financial Stability in Central, Eastern and South Eastern Europe

Josef Christl
Member of the Executive Board of the OeNB

Cross Border Cooperation in Central, Eastern and South Eastern Europe – A Supervisory Challenge
A Conference hosted by the Austrian FMA and the World Bank

Vienna, June 20th 2007

Introduction

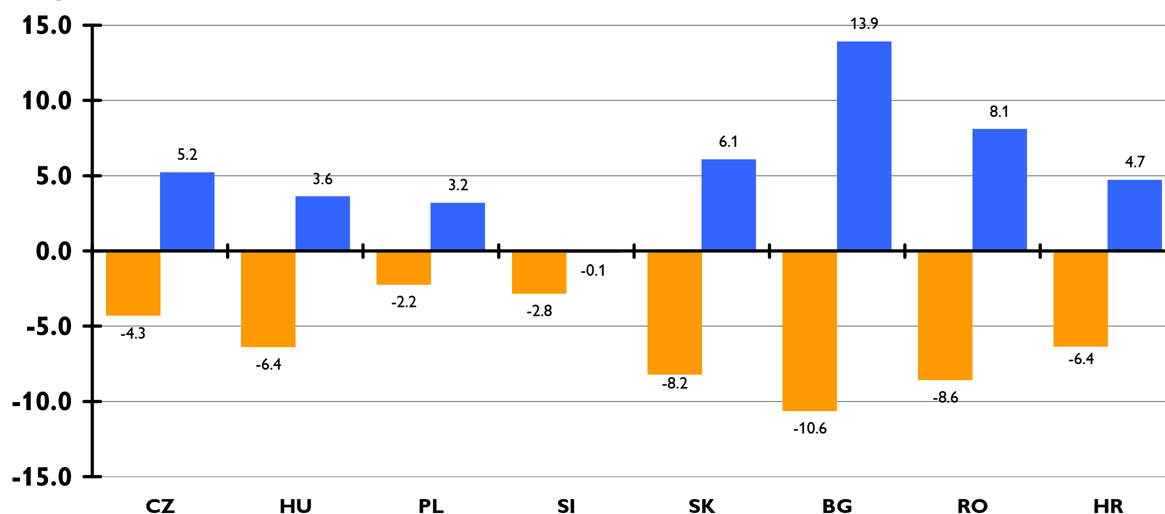
For analyzing financial stability (which is usually defined as the ability of a financial system to ensure the efficient allocation of capital in an economy, including periods of stress), I will follow in my presentation two main avenues: One is the analysis of the macroeconomic financial risks in Central and Eastern European Countries (CEEC). Here, I will take a look at the current account (CA) deficits, including their financing as well as to the balance sheet factors that increase the risk exposure linked to the external sector. The second avenue is to discuss some observations of the structural features and the recent performance of the banking sector itself. Obviously, both areas may constitute a source of financial instability and they are undoubtedly interrelated. Finally, I will analyse the exposure of Austrian banks in Central and Eastern Europe (CEE). While Austrian banks would particularly suffer from a financial stability crisis in CEEC, recent stress-tests provide comforting results.

Macrofinancial risks

Before presenting details, let me figure out some of the main economic features in the CEECs: Namely

- over the last few years GDP growth rates in a range of 4 % to 6 % p.a., with consumption growth in most cases lower than GDP growth;
- sizeable external imbalances, but largely covered by net FDI inflows;
- deterioration of fiscal balances in Bulgaria (declining surplus) and Romania (increasing deficit), but hopefully a successful correction of fiscal developments in Hungary;
- strong domestic credit growth in practically all countries of the region, but particularly pronounced in Slovenia, Croatia, Romania and (to a lesser extent) in Bulgaria; and
- high foreign currency debt burden of private non-banks, especially in Bulgaria, Romania and Croatia.

Current & capital account balance and DI net inflows: avg 2004 - 2006
in percent of GDP



Source: NCBs.

■ Combined current and capital account balance ■ DI net inflows

From a risk perspective, let me start with external stability, as this is linked to exchange rate stability and national solvency. In Slovakia, Bulgaria, Romania and Croatia current account deficits are close or above 10% of GDP; so far, however, they are largely covered by net FDI inflows. But how sustainable is this situation, given the fact that proceeds from privatisation com to an end in several countries? To answer this question, we have to investigate what are the driving factors of the current account (CA) deficits:

1. FDI inflows are not only a source for financing CA deficits, but they often also induce additional imports (investment goods) that cause CA deficits to rise, while exports resulting from FDI typically lag behind. Therefore, in case of lower FDI inflows, we can also expect a dampening of the CA deficit.

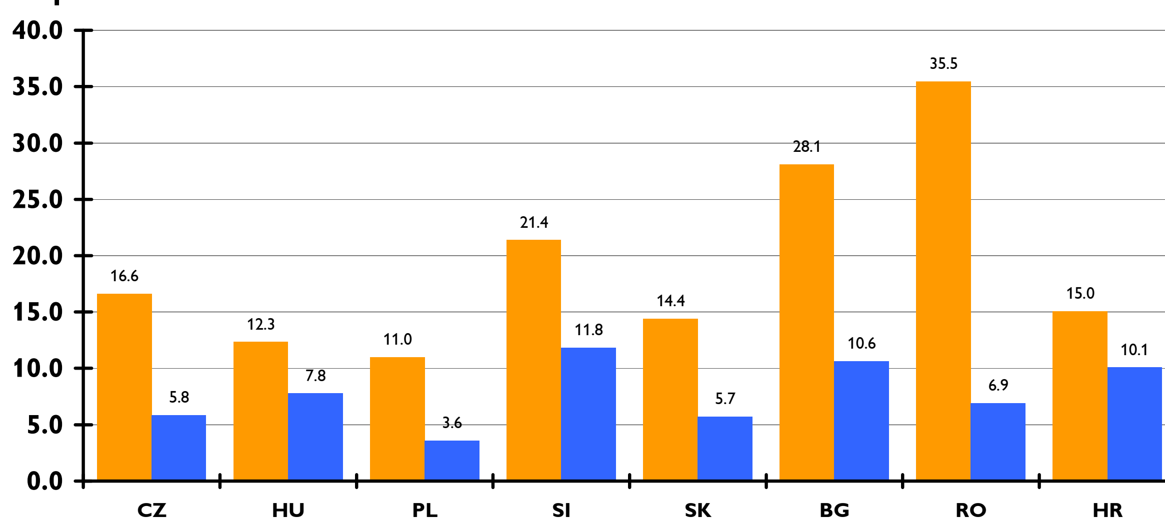
2. Another set of factors that contribute to excessive current account deficits are wage, fiscal and credit developments. Usually– due to the Balassa-Samuelson effect – catching-up countries experience rapid increases in unit labour costs. In this case, wage growth outpaces productivity growth and results in higher deficits in the goods and services balance. The impact on inflation sometimes can be offset by currency appreciation. Similarly, fiscal deficits which often reflect inefficient public sectors contribute to external imbalances.

In any case, recent figures give a clear indication that in some countries a reduction in CA deficits would be desirable to reduce the danger of sudden exchange rate corrections.

With respect to credit growth, high rates of growth were visible especially in Slovenia, Croatia, Romania and Bulgaria during the last years.

Domestic credit to non-government non-banks: Dynamics in 2004-2006

in percent



Source: NCBs.

annual average y-o-y change in year-end stock, as growth rate, HICP-deflated

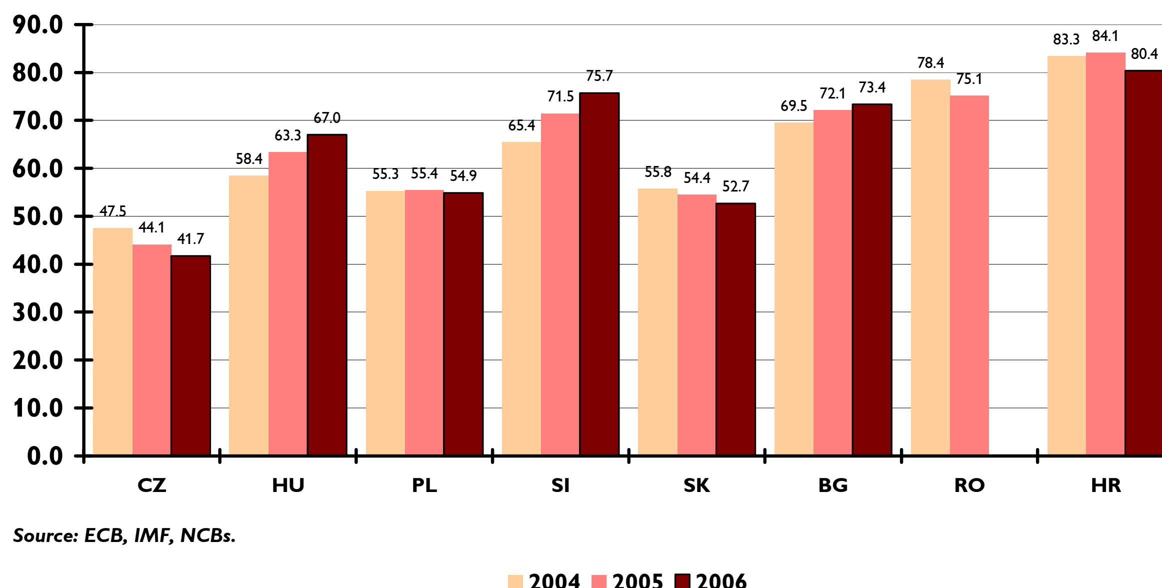
annual average y-o-y change in year-end stock, as ratio to GDP

These strong increases are to a certain extent natural and due to the catching-up process. They lead to a desired financial deepening as measured by the credit stock to GDP. In some countries, however, credit growth has been too rapid according to standard equilibrium estimates for the credit flow-to-GDP stock and the danger of bubble is present. According to a study of OeNB[1] - this seems to be the case in Slovenia, Croatia, Romania and to a lesser extent in Bulgaria, where several prudential and administrative measures succeeded in dampening domestic credit.

---

[1] See, for instance, the historic global evidence for catching-up economies since the second world war in: Arpa, Reininger, Walko: Can banking intermediation in CEE ever catch-up with the euro area? in Focus on European Economic Integration, 2005-02.

Total foreign currency debt: end-2004 to end-2006
Share in total (domestic and cross-border) debt of non-bank non-govt.
in percent



Source: ECB, IMF, NCBs.

Let me also stress, that balance sheet factors may increase the risk exposure linked to the external sector: In case of substantial exchange rate depreciations due to a disorderly unwinding of external imbalances or in case of contagion, the level of the outstanding debt denominated in foreign currency plays an important role for the size of the impact. The chart above shows the recent development of the foreign currency exposure of private households and non-financial corporations.[2] This exposure results

- firstly from the gross external debt of this sector, mostly cross-border loans from foreign banks; and
- secondly, it stems from domestic foreign currency denominated loans of domestic (mostly foreign-owned) banks.

The share of foreign currency loans on total loans to the private sector ranges from above 50% in Romania to close to 10% in the Czech Republic presently. In Many CEECs foreign currency loans to private households increase steadily, which is clearly of high concern. In

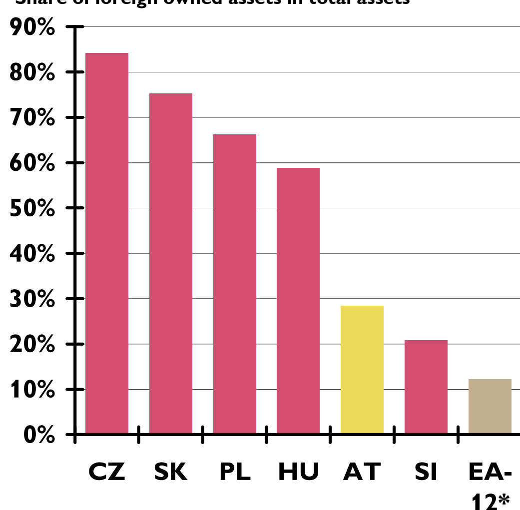
[2] Note on SIovenia: The high share of foreign currency debt in total (domestic and cross-border) debt of private non-banks drastically plunged as a result of euro adoption on 1 January 2007, as both euro-denominated domestic and euro-denominated cross-border debt could not be considered foreign currency debt anymore.

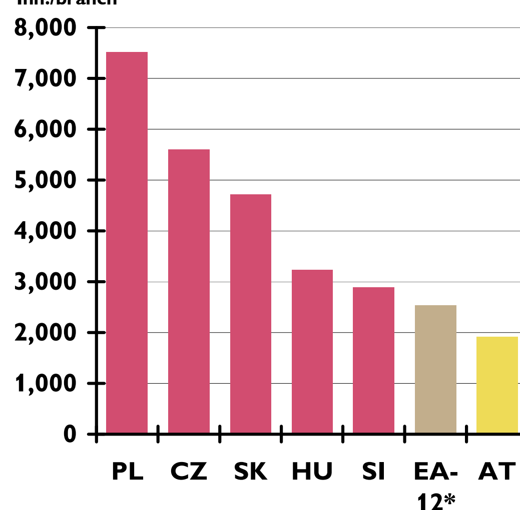
any case, possible exchange rate depreciations would imply major adverse balance sheet effects for the non-bank corporate sector and private households. At the same time, this foreign exchange risk constitutes an indirect credit risk for banks abroad as well as for domestic banks. It is obvious that these risks pose a challenge not only to the supervisory authority of the borrowers' country, but also to the supervisory authorities of the countries where the ultimate lenders of cross-border loans and/or domestic loans are situated.

Banking sector characteristics in Central and Eastern Europe

The second avenue to examine financial stability issues is to provide a closer look at the characteristics of the banking sector. Again, before going into details, let me briefly elaborate some of the main features of the banking sector in the CEEC:

- foreign ownership is dominant in most countries of the region;
- branch density is still comparatively low;
- high profitability ratios prevail across the region;
- the non-performing loans ratios are mostly low and/or declining;
- the capital adequacy ratios are comfortable but gradually declining and
- there exists a positive spill-over from EU membership.





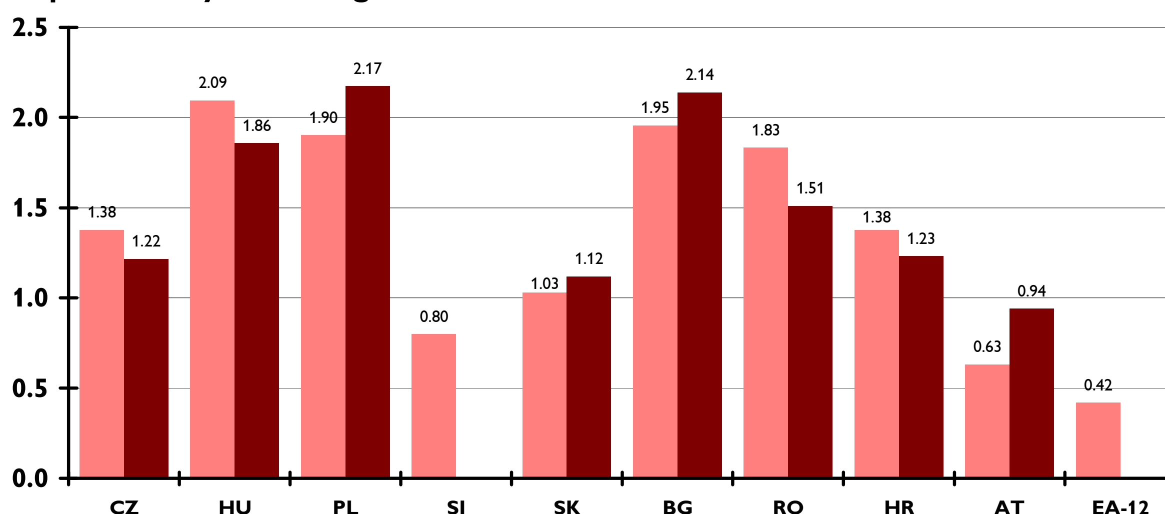
*Source: ECB, OeNB; Data 2005 except for * 2004; Data on AT already includes the sale of BAWAG/PSK and the planned sale of Hypo Alpe Adria Bank*

The share of foreign ownership in the countries considered is particularly high in the Czech and Slovakia. Not surprisingly, foreign owners of CEE banks are primarily based in EU-15 countries. On the one hand, the high share of foreign ownership strengthens the stability of the banking sectors, improves risk management techniques and sets the stage for rapid financial deepening. On the other hand, it makes the successful implementation of supervisory policy more complex and it exposes the CEEC national banking sectors to potential problems of the parent banks. Cross border cooperation between home and host supervisors thus is of particular importance in these countries' financial stability toolboxes. Austria is in a particular situation in this respect: With a share of foreign ownership of almost 30% - i.e. significantly above the Euro-area average – the country is both a home and a host country at the same time.

Another characteristic of the CEE banking market – as already mentioned in the context of credit growth – is the potential for further financial deepening. This can also be observed when looking at branch density levels: While the number of inhabitants per branch in the Euro-area is about 2.600, this ratio amounts to 7.500 in Poland and 5.700 in the Czech Republic. In parallel to the general economic catching-up process, the existing gap in the branch density level will certainly diminish.

Return on Assets (RoA): based on after-tax profit 2005 and 2006

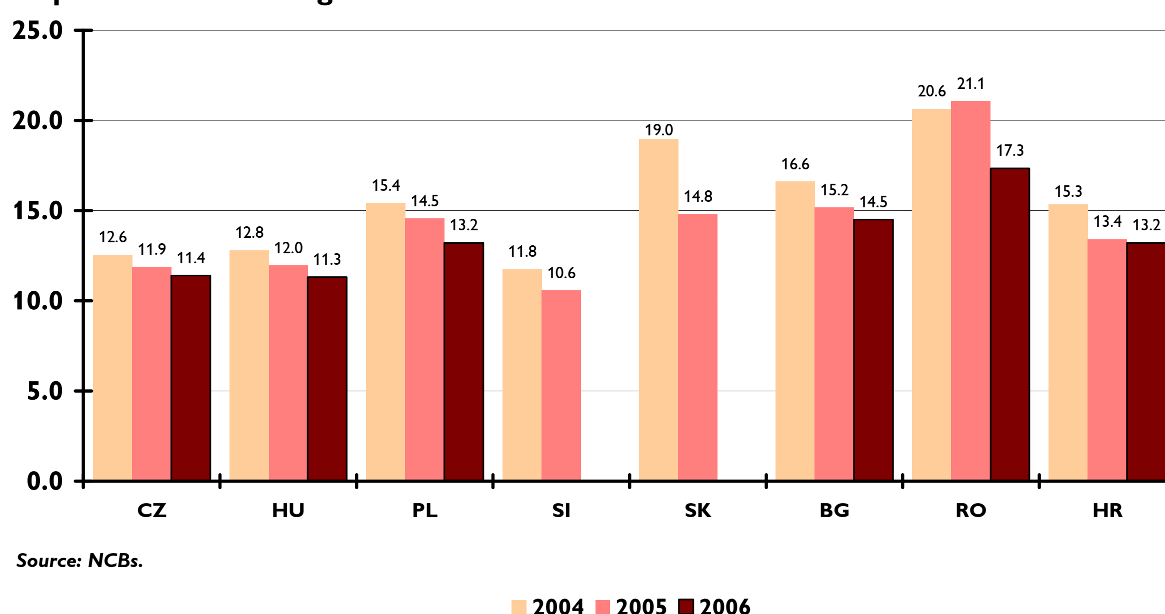
in percent of year-average assets



Source: NCBs, ECB.

2005 2006

In recent years, the banking sector performed well in most CEECs, reflecting not only the dynamic economic growth and improved credit quality, but also declining operating costs. As shown in the chart above, return on assets (RoA) is three to five times as high as in the Euro area. Therefore, in fact CEE banks do have a comfortable first line of defence in face of potential loan losses. This is quite a comforting message in the context of financial stability.



On the other hand, strong credit growth has led to a gradual decline in capital adequacy ratios, albeit from previously high levels. Romanian banks e.g. have a CAR of well above 15% and solvency ratio have remained at double-digit levels across the region. This clearly offers a sizeable buffer against potential deteriorations in banks' asset quality. This assessment is supported by recent stress tests of national central banks and the IMF. But the ability of the CEE banking sectors to withstand "real-life" stress is so far largely untested. And it goes without saying that all these factors, like the rapid credit growth in general and currency mismatch in particular, the NPL ratio and the CAR need further close monitoring both from banks' and supervisors'. In this context, it has also to be stressed that the European integration underpins the strengthening of the supervisory frameworks in CEE.

Some observers, including the IMF, have compared the present economic situation in CEE with that of East Asia just before the crisis in 1997. In particular, they referred to some existing macroeconomic similarities large and widening current account deficits, fast private-sector credit growth and currency mismatches in lending to private non-banks. Although some similarities cannot be denied, there exist several striking differences:

- First of all, in the CEEC the financing structure of CA deficits (with FDI) is more favourable.
- Second, a non-negligible part of external debt comes from foreign parent companies.
- Third, the maturity of external debt in CEEC is longer and their reserve coverage higher.
- Fourth, much more transparency in data and economic statistics in the CEEC than in East Asia 1997.
- Finally and in my view most important, the financial sector in CEEC is sounder with respect to capital, governance and supervision.

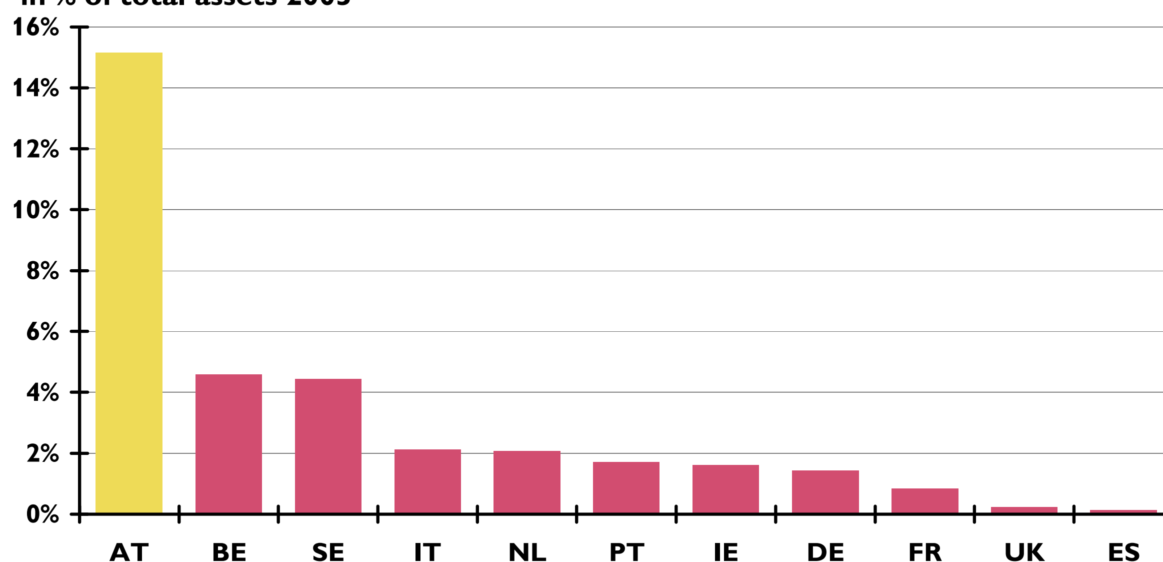
Therefore, at this moment in time, it seems fair to conclude that the differences outweigh the similarities. Nevertheless, given the various macro and micro financial risks I have highlighted in this presentation, developments in the region have to be monitored continuously very closely. One of the most important issues in this context is the improvement of home-host supervisory co-operation, to which today's conference is aiming at.

Austrian banks in CEE

Over the course of the last decade, Austrian banks have successfully seized the opportunity to expand their presence in the CEE banking markets. Against the background of strong banking sector profitability in CEE, today almost 40% of the Austrian banking sector's total profits are earned by CEE operations. The presence of Austrian banks today is spread all across the region and thus well diversified. The market share of Austrian banks in CEE (excluding Russia and Turkey) stands at almost 24%; Austrian banks are among the largest players with market shares at or above 40% in Albania, Bosnia, Croatia, the Czech Republic, Romania, Serbia and Slovakia. Therefore, the issues of Austrian and CEE financial stability are closely interlinked.

The outstanding importance of CEE banking markets for Austrian banks is unique among Western European banking markets - with a share of 15.2% of CEE exposure in total

consolidated assets of its banking sector, Austria is by far the most exposed country to the CEE region.



Stress tests simulating the effects of extreme yet still plausible shocks to the Austrian banking system are a valuable tool to quantify the risk going along with this exposure of Austrian banks to CEE banking markets. The size of the stress is determined by the scenario assumed. Our scenario thereby goes deliberately beyond historic worst case scenarios, as currently dynamic markets feature low NPL (non performing loan) ratios. In order not to be biased downwards, the stress scenario reflects the higher of

- (1) a relative increase or
- (2) an absolute increase of the NPL ratio.

The size of the shock varies in line with the underlying country risk, ranging from low (i.e. a relative increase of the NPL ratio by 50% or absolute increase by 6 percentage points) to medium (i.e. a relative increase of the NPL ratio by 75% or absolute increase by 8 percentage points) to high (i.e. a relative increase of the NPL ratio by 100% or absolute increase by 10 percentage points), as one can see from the following table. The different risk buckets reflect above all the notion that EU membership reduces the risk exposure of individual countries. However, individual countries can separately be parameterized, as the

case of Hungary (in the medium bucket) shows. Furthermore, we assume that a shock is perfectly correlated among all countries of the region, which means that it hits all countries at the same time. It should be noted that the size of the stress generated by this scenario is in the range of - or even more severe than - the stress tests conducted by the IMF during local FSAPs.

	Δ Abs.	Δ Rel.	Relative Change NPLs
AL	10%	100%	388%
BA			116%
BY			106%
CS			119%
RU			167%
UA			105%
BG	8%	75%	112%
HR			121%
RO			271%
HU			218%
CZ	6%	50%	161%
PL			81%
SI			181%
SK			119%

Data: Q2 2006, Source: OeNB

The results of these tests show that the Austrian banking sector would be able to absorb a severe shock multiplying the current NPL volume at many subsidiary banks. In this scenario, the banking system's consolidated capital ratio would fall from 11.61% to 10.66% at the end of 2006 and would thus still remain well above the statutory 8% threshold. Moreover, the good performance of Austrian subsidiary banks in CEEC itself serves as a significant first line of defence against possible loan losses: If all 2006 profits from the CEE business segment are considered, more than 2/3 of the shock is absorbed. Therefore, at present the CEE exposure of Austrian banks appears to be under control. Austrian banks are able to absorb regional shocks and would not spread them across the region.

But it is very clear the great effort will be required to maintain this bright picture, namely to maintain adequate capital buffers. Banks particularly exposed to CEE risks must act with foresight and take into account the regions macro-financial vulnerabilities as well as the fast

loan growth - also in foreign currencies - which constitute a permanent challenge to banks' risk management.

Conclusions

Thus, let me conclude:

- Overall, the development of the economies and the banking sectors in CEE has been quite positive in the recent past.
- However, the risk of substantial exchange rate corrections (due to sudden swings in investor risk aversion and/or to the disorderly unwinding of external deficits) is present.
- Risk exposure is considerable due to the high levels of indebtedness in foreign currency (in some countries even mainly non-euro).
- While foreign ownership of the banking sectors and higher profitability are reassuring, declining solvency ratios have to be monitored closely.
- Results of stress tests on the CEE exposure of Austrian banks remain still comforting
- High domestic and cross-border credit growth deserve continued close monitoring.

All these issues pose a serious challenge for economic policy, supervisory co-operation and bank risk management. I am sure that today's conference will contribute to a better understanding of these challenges ahead.