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The eurozone's problems could wreak havoc on the banking systems of Europe's emerging economies. Alex Hawkes reports

As speculation swirled around the solvency of Greece, Italy and Spain late last year, a new and, to many, unexpected item crept onto the financial agenda. Hungary formally asked for financial assistance from the International Monetary Fund (IMF). Was this the canary in the coalmine that showed the financial crisis was moving east?

With losses on loans growing for Eastern European banks, and connections that extend beyond simple export trading, Eastern Europe is braced for the worst that the eurozone crisis has to offer. But the financial crisis, which began in New York and is transforming European politics, is likely to take a different form again as it moves from Brussels to Budapest.

Eastern Europe's banks are, in many respects, better capitalised than Western Europe's; but there remain many tricky interconnections that could yet have unexpected effects. And the eurozone's problems, with all the unpredictability they entail, could wreak havoc on fragile emerging economies.

Hungary's problems, which caused jitters across markets in late 2011 and early 2012, carry echoes of the eurozone's travails. But where Greece had a government deficit, Hungary's problems came from soaring public and private debt, denominated in foreign currency (the Swiss franc). When the Hungarian forint declined in 2011, those problems emerged. The crisis has raised questions about the strength of Eastern European banks and the economies on which they rely.

"Most of the banks in the region – both local and the subsidiaries of major cross-border groups – are relatively well capitalised at the moment and stable," says Anthony Williams, a spokesman for the European Bank for Reconstruction and Development (EBRD), the bank founded in 1991 to help former satellite states of the USSR to become market economies.

Latest available data from the IMF shows that deposit-taking banks in Croatia boast a core tier one capital ratio of 18%, the major regulatory measure of a bank's strength. Polish banks, at the lower end of the scale, have a core tier one capital ratio of 11.8%. On the same measure, Italian banks come in at 9.5%, Spanish banks at 10.6% and Greek banks are in negative territory.

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But while the capital cushions look strong, not everyone is entirely convinced.

"For some banks, loan losses have not yet materialised," says David Renz, an analyst at technology firm SunGard, who advises banks on liquidity risks.

In Bulgaria, the ratings agency Moody's says banks' non-performing loans will hit 20% by 2013. Czech banks face growing losses on loans, too, after a splurge in unsecured consumer lending, which grew at an average of 18% a year over the past five years. There is, Moody's says, enough capital to absorb many of the problems across Eastern Europe, but the economic situation could get worse before it gets better.

Economic growth in what the EBRD calls its 'transition region' – encompassing Eastern Europe and parts of Central Asia – declined in 2012 to 2.7% from 4.6% in 2011.

The worst hit countries were those in Central Europe and the Baltics, with Croatia already in a double-dip recession – and Hungary threatening to go the same way.

Lower commodity prices further east have also hit Russia and Central Asian economies.

While Western European economies would settle for 2.7% growth, Renz warns that there are further risks on the horizon.

"If there is a collapse in demand again, the exporters could face a severe issue in keeping up production, especially with populist backlashes against outsourcing [in the west]. If you have your own currency and there is renewed weakness in the euro, terms of trade could also disintegrate."

Deleveraging

One of Eastern Europe's biggest problems is a fear that, with so many banks foreign-owned, those banks' problems could cause cash to be sucked out.

"Crisis-driven, cross-border bank deleveraging in the region seems to be carrying on, albeit at a slower pace," the EBRD said in July.

Bulgaria is particularly exposed. As at March 2012, Moody's said that the four largest Greek banks controlled around 23% of assets and 20% of deposits in the Bulgarian banking system, through local subsidiaries or branch operations. Serbia is similarly compromised – with almost 20% of banking assets held

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by Greek banks, and a similar proportion by Italian banks.

Levels of foreign ownership in Eastern European banking are extremely high elsewhere, too. Romania's banks are more than 80% foreign-owned, according to data from investment bank Société Générale, while the figure for Poland is above 60% and for Hungary above 50%.

The fear is great enough that international institutions have begun to track deleveraging under the auspices of the Vienna Initiative, a move to ensure capital support for banks in Central and Southeastern Europe that launched in 2008.

Some say that the investor anxiety about deleveraging may be overdone – not least the IMF.

Bas Bakker, division chief of the emerging Europe regional division at the fund, and his deputy, Christoph Klingen, have recently argued that the problem is not that big. As long as Western banks reduce their exposure gradually, local banks could come in to fill the void, the pair say.

The worst periods of the eurozone crisis have not caused convulsions further east, they say. In the second half of 2011, for instance, Western banks reduced their funding to banks in the region by 8%.

"Yet, during the same period, banks in Eastern Europe managed to attract substantial additional domestic deposits. The combined funding from both sources still grew in almost all countries, with the notable exceptions

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WHICH WESTERN BANKS ARE EXPOSED?

The huge foreign ownership of Eastern Europe's banks means that many big-name Western banks are exposed, according to figures from the European Banking Authority's stress tests

The largest exposures are by Austrian (Erste, Raiffeisen, Volksbank), Belgian (KBC), German (Bayerische Landesbank) and Italian (Intesa, UniCredit) banks

European Banking Authority stress tests in 2011 showed Erste of Austria had a total exposure of €20.3bn to Romania, and €11.3bn to Slovakia

Belgium's KBC has an exposure of €12bn to Hungary and the same amount to Poland – as well as a €37bn exposure to the Czech Republic

Germany's Bayerische Landesbank has €7bn in Hungary; UniCredit has €35bn of exposure to Eastern European countries not in the European Economic Area

Greek banks have been big players in the Balkans while Scandinavian banks are bigger in the Baltics

UK banks have largely stayed clear of the fray. RBS has €7bn of exposure to non-EEA Eastern Europe; HSBC has a €33bn exposure to non-EEA Eastern Europe, but as part of a balance sheet of more than €1 trillion

of Slovenia and Hungary," say Bakker and Klingen.

Guillaume Salomon, an emerging markets strategist at French bank Société Générale, agrees: "I think the deleveraging has happened. I think Western banks have deleveraged in Western Europe, rather than in the east. The performance [of Eastern European investments] has been excellent for big European banks."

He argues that Eastern Europe's growth rates and potential, while moderating, are creating much better prospects than are available in the developed parts of Europe – and that banks will want to stay invested.

Other eurozone risks

Just as they are in Western Europe, international institutions are engaged in firefighting many of the issues thrown up by the financial crisis in the east.

Poland, one of the region's largest economies, recently moved to neutralise a risk it faced in its exposure to the soaring Swiss franc, for instance. As much as 21% of total Polish loans are denominated in Swiss francs, due to the low interest rates on francs that the Poles could get during the credit boom. That left the banks concerned, which do not take Swiss deposits, with a funding mismatch.

The Swiss National Bank reached an agreement in June that will allow Poland's central bank to swap zlotys for francs if its lenders are unable to obtain them through other means.

While that particular example of interdependence has been dealt with, there are plenty of others. Renz points to an issue relating to Eastern European banks' funding. "[Eastern European] domestic capital markets are not sufficiently deep and broad for bonds, which could be used as a liquidity buffer," he says.

So, the sovereigns cannot issue enough debt for local banks to use in their reserves – leading them, in many cases, to use euro-denominated assets to serve the same purpose, with all the risks that those now pose.

He adds that politics may ultimately play a role as the issues in Eastern Europe develop: "If you have a government that is not very experienced in handling crisis situations, you could run into a problem like Ireland did, where you could be forced to guarantee all bank debt. That could lead you into a storm on the capital markets."

For now, major world financial institutions are alive to the financial problems of Eastern Europe – and many remain optimistic that they can be dealt with.

But, as the IMF puts the finishing touches to its agreements with Hungary this autumn, the big players will be hoping for no new shocks, from the eurozone or elsewhere.

WHICH RISKS EXIST FOR WESTERN COMPANIES?

- The key differentiator in Eastern Europe in terms of assessing the current risk of doing business in the east is where the country is – with the northern countries such as Poland more exposed to the engine of the eurozone, Germany – and those in the south heavily connected with Greece and Italy.
- Beyond that general yardstick, the World Bank's *Ease of Doing Business* survey provides another guide – with key indices being those on how well countries protect investors, how easy it is to get credit and to enforce contracts, and how well the countries resolve insolvency.
- Poland, which ranks 62nd in the survey overall out of 183, does well on getting credit (joint 8th), decently (46th) on protecting investors, and less well (68th and 87th) on enforcing contracts and resolving insolvency.
- Hungary ranked 51st in the survey, scoring badly (122nd) on protecting investors and better elsewhere.
- The Czech Republic (64th) also did badly on investor protection, coming in at 97th on that metric. Bulgaria is 59th, scoring badly on its enforcement of contracts (87th) and its insolvency regime (90th), while the Ukraine does considerably worse than all the other four, which make up five of the bigger economies in Eastern Europe. It came 152nd, let down by protection of investors (111th) and its insolvency regime (156th), among other things.

See the World Bank's data at www.doingbusiness.org/rankings

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Alex Hawkes is a freelance business journalist. He has written for the *Mail on Sunday*, *The Times*, *The Guardian* and *Accountancy Age*