Box 2

BANK FUNDING AND LENDING ACTIVITY IN CENTRAL AND EASTERN EUROPE

Since the global crisis hit central and eastern Europe the external liabilities of banks in this region have been falling. This development has also been visible in a reduction, in an environment of subdued loan growth, of the exposure of (mostly western European) parent banks to their subsidiaries and branches operating in the region. This box takes stock of this process, assesses its impact on the economies under review and discusses the outlook. The focus is on the period from December 2008 until May 2013 (the latest data available) and the group of seven central and eastern European EU Member States that were outside the euro area in that period.

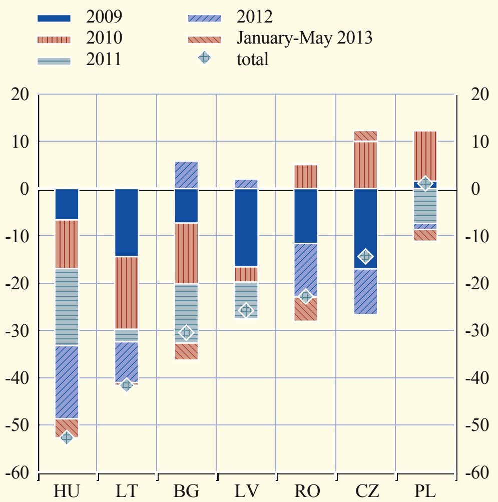
The average cumulative reduction in the external liabilities of banks in this country group was substantial in the period under consideration (-27%). The differences across individual countries were major, however, ranging from a decline by more than half in Hungary to no reduction at all in Poland (see Chart A). In most cases, the bulk of the reduction in banks' external liabilities occurred in 2009-10, but in some countries (especially Hungary) a significant decline was still taking place in 2012. In the first five months of 2013 there was no significant further decline in external liabilities other than in Romania, Hungary and Bulgaria.

This process has been the outcome of several factors.[1] It is first and foremost the legacy of the boom-bust cycle in several countries of the region, but also stems from the ongoing change in the

1 For a related discussion of factors driving banks' deleveraging see the special feature entitled "EU bank deleveraging – driving forces and strategies", *Financial Stability Review*, ECB, June 2012 and the box entitled "Deleveraging by euro area banks", *Financial Stability Review*, ECB, May 2013.

Chart A External liabilities of MFIs

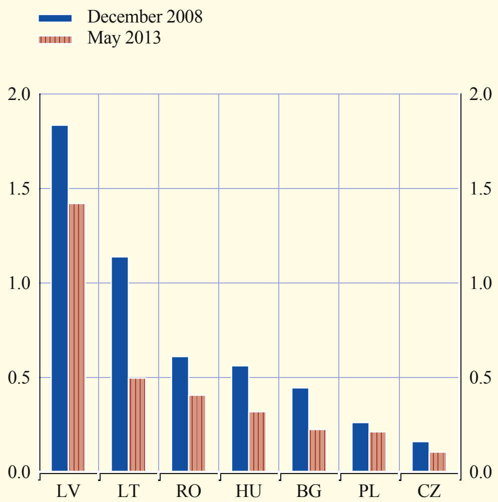
(total: percentage change between May 2013 and December 2008; periods: contribution to percentage change in percentage points)



Source: ECB.

Chart B MFIs' deposit mix

(external deposits in EUR per euro of domestic deposits)



Source: ECB.
Note: Includes all sectors in the economy.

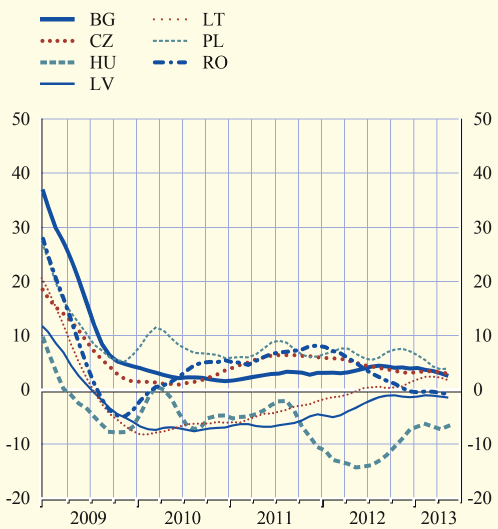
banks' funding model. Regarding the latter development, the centralised funding model that had prevailed before the crisis – with parent banks funding the lending of their central and eastern European subsidiaries – is being replaced by increasing reliance on local sources of funding, such as domestic deposits. Chart B shows that in all seven countries under review banks' reliance on external deposits as a source of funding has declined relative to domestic deposits. External deposits comprise all deposits from abroad, including (i) deposits provided by parent banks and (ii) deposits of foreign non-MFI private sector agents ("non-resident deposits"). In Latvia, non-resident deposits constitute around half the non-MFI deposit base and have increased markedly in the past two years, thus partly offsetting a reduction of deposits by (mainly) Scandinavian parent banks. In May 2013, external deposits ranged between around 150% of domestic deposits in Latvia and 10% in the Czech Republic.

The interplay of these structural changes with the need to reduce indebtedness in the private sector has resulted in subdued private sector loan growth. Annual growth in loans to the non-MFI private sector has now been weak or negative for around four years (see Chart C). There are significant differences across the countries concerned, with Hungary experiencing the largest contraction and the Baltic States a gradual improvement. While some countries have been able to expand their economic activity in the absence of credit growth, the sustainability of such recoveries depends on credit growth normalising again.[2] It remains, therefore, a challenge to promote credit

2 See, for example, Bijsterbosch, M. and Dahlhaus, T., "Determinants of credit-less recoveries", *Working Paper Series*, No 1358, ECB, Frankfurt am Main, June 2011.

Chart C Loans to the non-MFI private sector

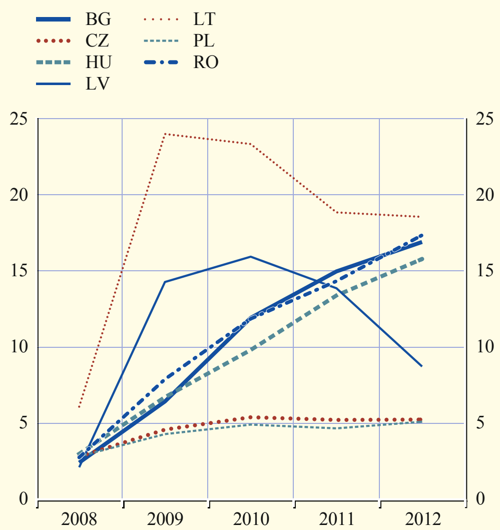
(three-month moving average of annual rates of change in percentages)



Source: ECB.

Chart D Non-performing loans

(as a percentage of total gross loans)



Source: IMF Financial Soundness Indicators.
Notes: End-of-year data. Data for 2012 correspond to the third quarter of 2012 for Lithuania, Poland and Romania, and to the second quarter of 2012 for Bulgaria.

conditions that can underpin a sustainable recovery in output while, at the same time, not fuelling unsustainable credit booms such as those witnessed in the years preceding the crisis.

According to the European Investment Bank's most recent bank lending survey for the region, a key factor constraining credit supply was high levels of non-performing loans.[3] The quality of the banks' loan portfolios has recently improved in some countries, but the share of non-performing loans in the total loan portfolio remains generally high in all countries except the Czech Republic and Poland (see Chart D). Analysis carried out in the context of the European Bank Coordination Initiative, also known as the "Vienna Initiative", has concluded that non-performing loans can be a serious drag on credit supply.[4] They drive up banks' funding costs and interest margins and drain bank profits and capital. On the credit demand side, lacklustre consumer confidence, weak housing market prospects and sluggish investment dynamics seem to dampen demand for new loans.

Looking ahead, considerable uncertainties remain concerning the credit outlook, especially in countries where the banking system is confronted with a high and rising share of non-performing loans, as well as in the countries characterised by policy uncertainty. A key challenge for policy-makers thus remains to ensure a more rapid resolution of non-performing loans, which seem to be acting as a significant hurdle for the supply of credit and a durable economic recovery in the region.

3 See *CESEE Deleveraging Monitor*, European Bank Coordination (or "Vienna") Initiative, 30 April 2013, including the European Investment Bank's central, eastern and south-eastern Europe (CESEE) bank lending survey, available at http://vienna-initiative.com.

4 See the report of the Working Group on NPLs in Central, Eastern and South-Eastern Europe, European Bank Coordination (or "Vienna") Initiative, March 2012.