



A credit-less recovery

May 7, 2010

Key views

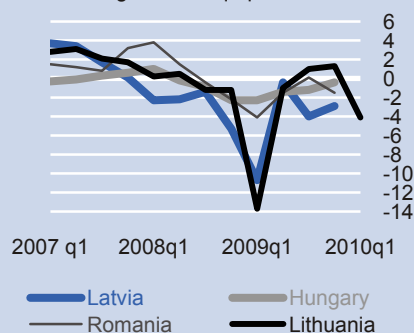
- **Economic recovery under way, no revival in credit growth.** Most CEE countries have left recession and will record modest positive growth rates this year. But we do not expect any significant growth stimulus to come from credit.
- **Gradual external deleveraging ongoing.** External asset-to-liability ratios have inched down across the board and are expected to continue to do so. CEE banking sectors still characterised by high external leverage should profit from the very moderate monetary tightening outlook of the ECB.
- **NPLs are close to peak levels, no significant risks from further provisioning needs.** NPLs continue to trend up in almost all CEE countries. With the exception of Ukraine, Lithuania and Russia, provisioning levels stand at comfortable levels.
- **Assessing contagion risk from Greek debt crisis.** Our contagion matrix shows that Bulgaria, Macedonia and Serbia would suffer most from a potential withdrawal of Greek parent banks and reduced exports to Greece. Hungary seems most exposed to a reduction of foreign investor holdings of local assets, if global risk aversion increases.

A credit-less recovery

Although Eastern Europe is lagging other EM regions in terms of recovery, most countries have left recession and will record modestly positive growth rates this year. Only the worst or latest hit countries (Latvia, Lithuania, Hungary, Romania and Bulgaria) were still in recession in Q4 2009 or Q1 2010 (see chart). But the recovery has been credit-less so far. Credit is still declining in most countries (see charts) and will only pick up slowly. The availability of (external) funding and the evolution of NPLs (and subsequent risks to profitability and capital) will be important determinants for credit growth over the next few months.

Only few countries still in recession

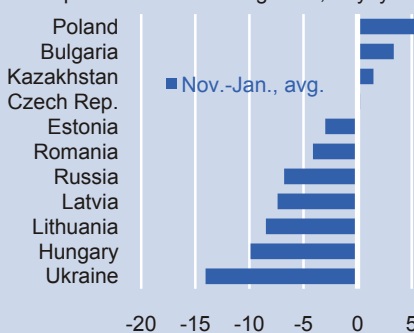
Real GDP growth, % qoq sa



Sources: Eurostat, Nat. authorities, DB Research

Credit is contracting almost everywhere

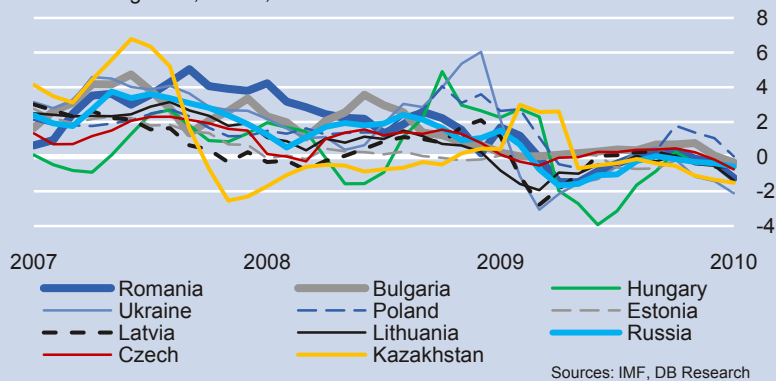
Real private sector credit growth, % yoy



Sources: IMF, National central banks, DB Research

No credit impulse in CEE countries

Real credit growth, 3mma, % mom



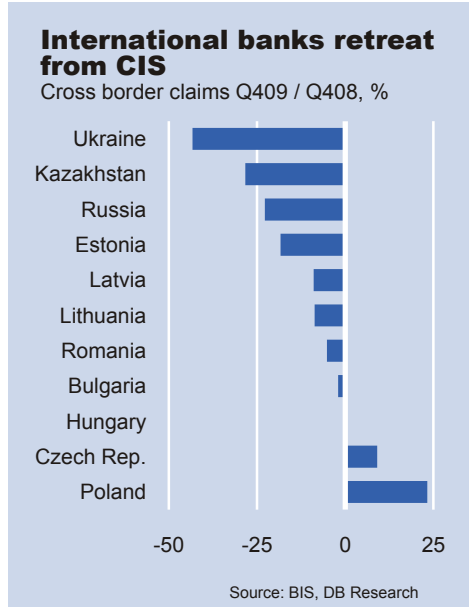
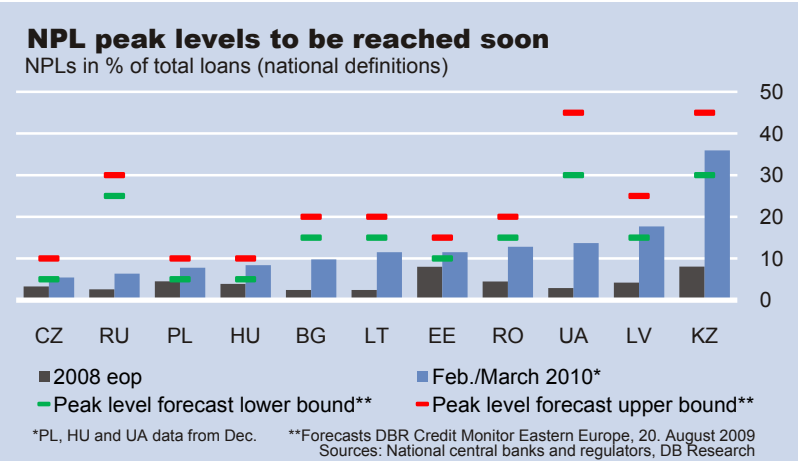
Sources: IMF, DB Research

Gradual external deleveraging in CEE

External deleveraging is taking place gradually in CEE as external asset-to-liability ratios are inching down across the board (see chart). Ukraine, Kazakhstan and Russia have seen the strongest drop, while Czech Republic, Hungary and Poland have recorded the smallest decline. This mirrors data on cross-border exposure of BIS-reporting banks as of Q4 2009, which show large decreases in exposure to CIS countries (20% yoy at least), but stable or even increasing exposure to Poland, Czech Republic and Hungary (see chart). In our view, further gradual deleveraging is still in the cards, especially in the Baltics. On a positive note, CEE banking sectors still characterised by high external leverage should profit indirectly from the very moderate monetary tightening outlook of the ECB and slow removal of liquidity expansion.

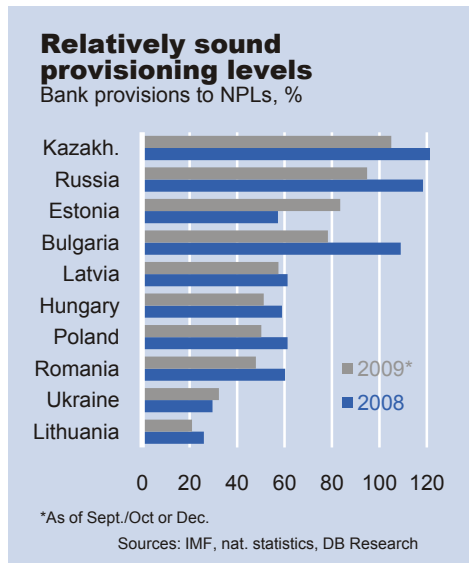
NPLs already close to expected peak levels

In tandem with weak economic performance and rising unemployment NPLs are continuing to trend up in almost all countries. While NPLs may already have reached their peak levels in Kazakhstan and Estonia, we expect further strong increases in Bulgaria and Romania, as they lag the other countries in terms of economic recovery. In Ukraine and Russia NPLs are estimated to be much higher than official figures, as these include only overdue loan payments and not the full outstanding loan amount or restructured loans (Moody's estimates NPL levels in Russia at 20% and 20-25% in Ukraine). Given NPL levels above 20% in several countries, strategies to clean up bank balance sheets have to be developed, e.g. writing off of fully provisioned loans or the creation of bad-asset management companies. Overall, we expect our NPL peak level forecasts (see chart) to be reached within the next few months.



No significant risks to profitability and capital from further provisioning needs

Adequate provisioning helps banks to avoid negative surprises in terms of profitability or capital needs. We have taken a close look at current provisioning levels in CEE. The chart on the right shows that provisioning levels have declined since last year in almost all countries but still stand at relatively comfortable levels. We consider 60-70% loan-loss provision coverage of NPLs as appropriate, given that a considerable share of loans is collateralised by mortgages. In Lithuania, Ukraine and Russia,



however, either due to current low provisioning levels or underreported NPLs, we see a need for increased loan-loss provisions and thus potential negative surprises to profitability and capital needs. Thus the recent improvements in capital adequacy ratios for these countries (see chart) have to be taken with a grain of salt. In all other countries, provisioning needs should decrease over time and well-diversified CEE banks should be able to support the real economy with new credit later in 2010.

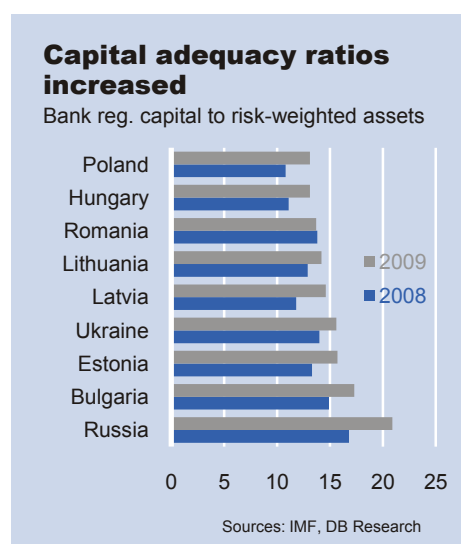
Assessing contagion risks from Greek debt crisis

After S&P's downgrade of Greece to sub-investment grade on April 28 and resulting negative financial market reactions, the question of possible contagion channels to CEE has resurfaced. In our contagion matrix we present the three main contagion channels, i.e. contagion via reduced bank lending from Greek parent banks, contagion via reduced exports to Greece and contagion via foreign investors selling their portfolio equity and debt holdings. We grouped the CEE countries into three categories according to the relative contagion risk they face.

We start our analysis with the banking channel, which we regard as the most relevant. Our matrix shows that Bulgaria, Macedonia and Serbia would suffer most from a potential withdrawal of Greek parent banks. The recent rescue package for Greece mitigates the risk of a fire sale of Eastern European assets by Greek banks in two ways. First, Greek banks access to ECB funding cannot be jeopardised by another sovereign downgrade as the ECB suspended the minimum credit rating threshold. Second, the package includes EUR 10 bn for a financial stability fund to support Greek banks. Nevertheless, it is unrealistic to expect the same level of commitment of Greek parent banks as before the crisis.

With regard to the second contagion channel, the real economy, Albania, Bulgaria and Macedonia would be most affected by lower import demand from Greece.

The third contagion channel captures indirect spillover potential resulting from an increase in general risk aversion due to Greek/PIIGS troubles. Here, Hungary seems most exposed to a reduction of foreign investor holdings of local assets.



	Banking sector	Real economy	Capital outflows
	Greek foreign claims, in % of local GDP, Dec. 2009	Exports to Greece in % of total exports, Oct. 2009	Portfolio investment (equity + debt), in % of local GDP, 2008 eop
High (15-25%)	Bulgaria, Macedonia, Serbia		Hungary
Medium (5-15%)	Albania, Romania	Albania, Bulgaria, Macedonia	Bulgaria, Croatia, Czech Republic, Estonia, Lithuania, Poland, Slovakia
Low (<5%)	Croatia, Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Russia, Slovakia, Ukraine	Croatia, Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Romania, Russia, Serbia, Slovakia, Ukraine	Albania, Kazakhstan, Latvia, Macedonia, Romania, Russia, Serbia, Ukraine

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