Research

24. February 2009

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Euro area: Exposure to the crisis in Central and Eastern Europe

- Euro area banks' losses on loans in Central and Eastern Europe (CEE) will be substantial due to an unfortunate mix of collapsing property prices, economic downturn and exchange rate depreciation.

- Austria is by far the most exposed country, but the government can afford to absorb the losses. Belgium, which is a high debt country with a fiscal budget that's already stretched, is in for smaller losses, but they also have less room for manoeuvre.

- We look at three risk scenarios. A mild scenario, which is comparable to the Swedish banking crisis; a hard scenario, where the hardest hit CEE countries face more substantial looses; and finally an ugly scenario which is more comparable to the Asian crisis. In these scenarios Austrian banks face losses of 3½-11% of GDP, Swedish banks loose 2-6% of GDP and Belgian banks loose1-3½% of GDP.

- Governments in the euro area will not be eager to provide rescue packages aimed at supporting lending in the CEE region. The CEE governments will be much more willing to provide rescue packages or direct loans, but they are less able and will need support from international institutions.

Too much credit in Central and Eastern Europe

The deepening of the financial sector in the CEE over the last two decades has to a large extent been driven by Western European banks' willingness to set up subsidiary banks in the region and provide the means for a lending boom. High lending growth was accompanied by strong economic growth, but also by increasingly visible bubbles in the property markets. Now that the bubbles are bursting and the global economic crisis is hitting the CEE countries, the negative spill-back effect on the Euro Area countries is an increasing concern.

Part of the credit provided by Western European banks in the CEE region appears to have been given on subprime-like conditions, i.e. loans were given on the assumption that asset prices – and in particular property prices – would continue to rise or at least never fall. In addition, many loans have been given in euro or Swiss franc. The unfortunate mix of collapsing property prices and significant exchange rate depreciation has made it evident that a substantial part of the loans given in the CEE countries will not be fully repaid. Even loans given on the basis of sound credit assessment will see a sharp increase in default ratios as a result of the crisis.

Euro area banks are reacting to the increased risk in the CEE region by withdrawing capital – indeed substantial capital withdrawal is already taking place. A sizeable part of the CEE region debt is short term, which makes a major credit contraction even more likely. This puts further pressure on the region. We expect that credit withdrawal will be most pronounced from the countries with the gloomiest economic prospects. Rather than a homogeneous credit contraction across the CEE region, it is likely that we will see a very pronounced credit flight from the most vulnerable countries.

In our view the economic prospects are gloomiest in the Baltic countries, Bulgaria, Romania and Ukraine, which may face double digit declines in GDP. We expect to see the region's bluest skies in the Czech Republic.

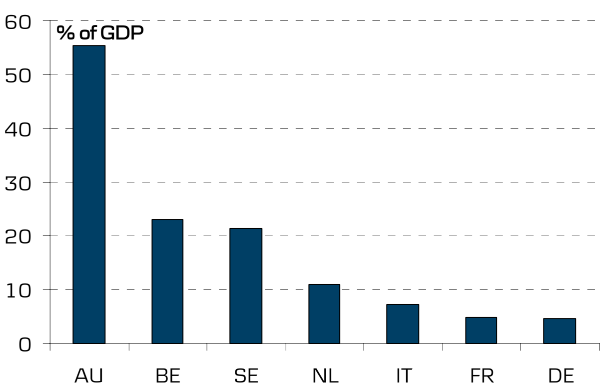
Given that some CEE countries are in for a much more pleasant ride than others, it matters not only how much exposure euro area countries have to the CEE. It is also crucial to know which CEE countries they are exposed to.

So, who's been lending to whom?

The CEE has borrowed USD 1.4 trillion from BIS reporting banks abroad and most of it from Western European banks (USD 1.3 trillion). The top lenders to the CEE region are Austria (USD 246 billion), Germany (USD 182 billion), Italy (USD 181 billion) and France (USD 147 billion), cf. table 1 in the Annex.

The most exposed countries relative to their own size (loans as share of GDP) are Austria, Belgium and Sweden. Austria's claims on the CEE add up to 55% of Austria's GDP while Belgium and Sweden have claims equivalent to 23% and 21% of their GDP respectively, cf. table 2 in the Annex.

Bank lending to CEE



Sources: BIS Quarterly Review December 2008, European Commission AMECO database, Ecowin and own calculations

Austria is particularly exposed to the Czech Republic, Romania, Hungary and Slovakia while Sweden primarily is exposed to the Baltic countries. Belgium has almost half of its exposure in the region to the Czech Republic and a fifth to Poland. Greece is also exposed – in particular in Bulgaria – but we do not have BIS figures on Greece's bilateral claims.

The potential losses are substantial

The potential losses to be incurred in the CEE region by Euro area banks are substantial. The European Bank for Reconstruction and Development (EBRD) estimates that bad debt may reach 20% (Daily Telegraph, 15 Feb 2009).

We look at three scenarios. A *mild* scenario, which is comparable to the Swedish banking crisis where losses in Sweden added up to about 8% of GDP (maybe it isn't really fair to call that a mild scenario), a *hard* scenario, where the hardest hit CEE countries face more substantial losses, and finally an *ugly* scenario which is more comparable to the Asian crisis.

In the mild scenario we assume losses of 5% in the Czech Republic, Slovakia, Poland, Hungary, Belarus and Russia, and 10% in Bulgaria, Romania, the Baltic countries and Ukraine. This will inflict losses of USD 16 billion on Austrian banks (3.5% of Austrian GDP), Swedish banks will loose USD 10 billion (2.0% of GDP) and Belgium banks will loose USD 6.5 billion (1.2% of GDP), cf. table 3 in the Annex. Total losses to Western Banks add up to USD 83 billion in this scenario.

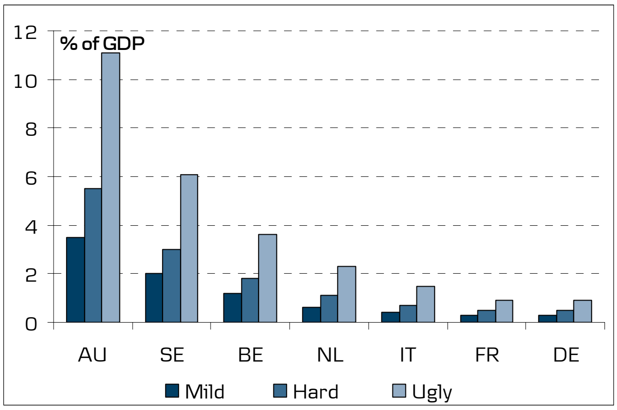
In the hard scenario, the Czech Republic still faces losses of 5%. Poland, Slovakia Hungary, Belarus and Russia face 10% losses and Bulgaria, Romania, the Baltic countries and Ukraine face 15% losses. This results in losses of 5.5% GDP in Austria, 3.0% of GDP in Sweden and 1.8% of GDP in Belgium, cf. table 4 in the Annex.

In the ugly scenario we assume 10% losses in the Czech Republic, 20% losses in Poland, Slovakia Hungary, Belarus and Russia, and 30% losses in Bulgaria, Romania, the Baltic countries and Ukraine. This is a risk scenario and we by no means intend to imply that these losses will incur.

In the ugly scenario Austrian banks looses USD 49 billion or about 11% of Austrian GDP, Swedish banks loose USD 31 billion (6.1% of GDP) and Belgian banks loose USD 20 billion (3.6% of GDP), cf. table 5 in the Annex. Total losses to Western Banks then add up to USD 275 billion. This is a lot of money – but to put it in perspective the IMF now estimates the total losses on US-originated credit assets at USD 2.200 billion. Thus even if the ugly scenario occurs it would still be wrong to equal this to the US subprime crisis. It is not even on the same scale.

In the risk scenarios, Belgian banks do relatively well due to the large exposure to the Czech Republic, (which we consider "low risk") and limited exposure to the "high risk" countries.

Losses in three risk scenarios



Sources: BIS Quarterly Review December 2008, European Commission AMECO database, Ecowin and own calculations

Adding pressure on fiscal sustainability

Given the presence of state guaranties for banks in all western European countries, it is to be expected that if large losses occur a substantial part of the losses will end up adding to government debt. However, the potential losses are not so large that they would in themselves endanger the fiscal sustainability of the parent countries – even if the full losses were added to their public debt.

Austria is by far the most exposed country, but it can afford it. Austria's public debt is expected to reach 62.3% of GDP in 2009 according to the European Commission's recent interim forecast. A loss of up to 11% of GDP would be very unpleasant but absorbable by the government.

However, if the Austrian government is unwilling to bail out the losses that the Austrian financial sector incurs in its subsidiary banks abroad, and the CEE governments are unwilling or unable to help the subsidiary banks, this would put the Austrian financial sector in a very grim situation. Losses of up to 11% of GDP would indeed bring the banks involved to their knees and endanger the whole financial sector in Austria. We doubt that the Austrian government will let this happen and given the presence of state guaranties they have at least to some extent promised not to. But this is not the same as saying that they will help to keep credit flowing to the CEE.

Fiscal strength of some parent countries

% of GDP (2008)	Austria	Sweden	Belgium	Italy
Fiscal surplus/deficit	-0.6	2.3	-0.9	-2.8
Gross debt	59.4	34.8	88.3	105.7

Source: European Commission interim forecast jan. 2009.

Belgium and Italy, which are high debt countries with a fiscal budget that's already stretched, are in for smaller losses, but they also have less room for manoeuvre. In our "ugly" risk scenario, Belgium incurs losses equivalent to 3.6% of GDP while Italy incurs a 1.5% of GDP loss.

Who will provide rescue packages to CEE?

We doubt that governments in the parent bank countries will be eager to provide rescue packages aimed at supporting lending in the CEE region. On the contrary, Greek banks have been requested by their central bank governor not to use money from the Greek bank support package for the CEE subsidiaries. Even if euro area governments would be willing to rescue the CEE, it would prove difficult to design a package that would ensure that money would flow to the CEE countries in need. With or without bank packages, the parent banks in the euro area will be reluctant to put new money in the gloomiest markets.

Indeed, concern about the willingness and ability of parent banks to support their CEE subsidiaries has already led to rating adjustments of some CEE subsidiaries.

The governments of the CEE countries themselves might be more willing to provide rescue packages or direct loans, but they are certainly less able and outside help will be needed.

They will have to hope for help from the international institutions – most prominently IMF, the World Bank and the European Commission. These institutions have already coordinated rescue packages for Latvia and Hungary. The IMF has also provided assistance for Ukraine and Belarus. IMF has a USD 250 billion reserve, but even the IMF may have to be selective in terms of where and how much help they can provide.

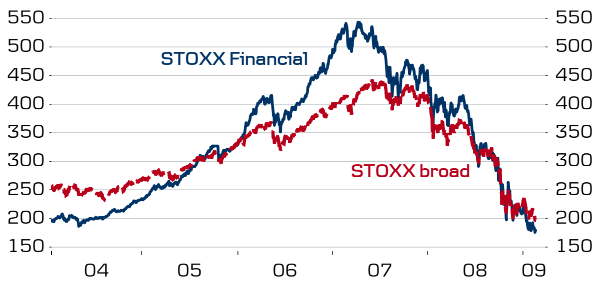
The European Commission can provide emergency funding for EU member countries (The overall financial assistance ceiling was raised from EUR 12 billion to EUR 25 billion in December 2008), but the European Commission may find it hard to gain support for sufficient financial assistance for non-member countries. On our list of hard-hit countries we thus believe that the Baltic States, Bulgaria and Romania are likely to receive substantial help from the EU, while Ukraine may not. Austria and France are particularly exposed to Ukraine.

Market reaction

Markets are increasingly concerned about the impact of the crisis in the CEE on parent banks and the sustainability of government budgets in the most exposed countries

Financial sector shares have fallen rapidly across the world since the subprime crisis came on the agenda. In recent weeks concerns about developments in the CEE have added further pressure on European bank shares.

Financial sector stock prices

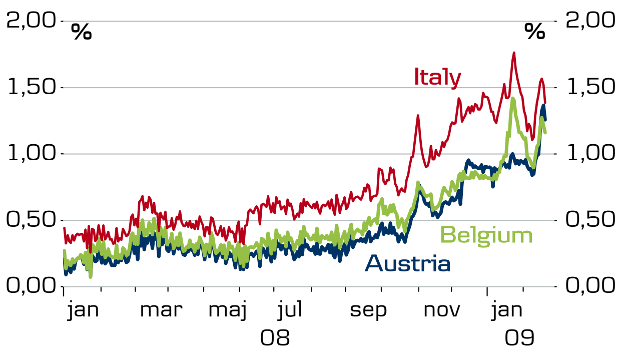


Sources: EcoWin.

There is also increasing concern about how the losses in the CEE may affect fiscal sustainability in the most exposed western European countries. Government bond spreads to Germany have widened substantially as the subprime crisis escalated in autumn. Further widening in early 2009 seems to reflect increased concern about the potential losses in the CEE. Austrian government bonds currently have slightly higher spreads to Germany than Belgian government bonds, which may reflect a very downbeat view on the CEE and strong risk aversion in the market.

Markets are concerned about sustainability

(10 year government bond yield spreads)



Sources: EcoWin.

ANNEX

Table 1: Western European Banks' claims on Central and Eastern Europe

billion USD	Austria	Belgium	France	Germany	Italy	Netherlands	Sweden	Western Europe
Bulgaria	5.7	2	3.6	2.8	8.1	0.7	0	41.5
Czech Rep	65.1	56.7	38.6	12.7	19	6.2	0.2	205.7
Hungary	38.3	18.7	11.9	37.9	29.3	5.6	0.3	153.3
Poland	17.2	25.2	22.9	55.4	54.4	41.2	8.1	287.4
Romania	46.5	1.2	17.6	3.8	12.9	11	0.2	124.1
Slovakia	33.2	10.9	6.4	4.1	23.6	6.7	0.2	87.3
Estonia	0.3	0.1	0.1	1.1	0.4	0	32.7	40.2
Latvia	0.8	0	0.4	4.8	1.4	0	25.0	43.3
Lithuania	0.3	0.1	0.4	3.8	0.7	0	28.9	45.5
Belarus	2.1	0.1	0.2	0.9	0.2	0.1	0	3.8
Russia	23.9	10.3	34.7	49.5	25.7	25.5	9.9	222.6
Ukraine	12.9	0.8	10.6	5	4.9	3.7	5.4	52.8
CEE	246.3	126.1	147.4	181.8	180.6	100.7	110.9	1307.5

Source: BIS Quarterly Review, December 2008

Table 2: Western European Banks' claims on Central and Eastern Europe Share of GDP (2008) of the lending country

	Austria	Belgium	France	Germany	Italy	Netherlands	Sweden
Bulgaria	1.3%	0.4%	0.1%	0.1%	0.3%	0.1%	0.0%
Czech Rep	**14.6%**	**10.4%**	1.3%	0.3%	0.8%	0.7%	0.0%
Hungary	**8.6%**	3.4%	0.4%	1.0%	1.2%	0.6%	0.1%
Poland	3.9%	**4.6%**	0.7%	1.4%	2.2%	**4.5%**	1.6%
Romania	**10.4%**	0.2%	0.6%	0.1%	0.5%	1.2%	0.0%
Slovakia	**7.4%**	2.0%	0.2%	0.1%	0.9%	0.7%	0.0%
Estonia	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	**6.3%**
Latvia	0.2%	0.0%	0.0%	0.1%	0.1%	0.0%	**4.8%**
Lithuania	0.1%	0.0%	0.0%	0.1%	0.0%	0.0%	**5.6%**
Belarus	0.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Russia	**5.4%**	1.9%	1.1%	1.3%	1.0%	2.8%	1.9%
Ukraine	2.9%	0.1%	0.3%	0.1%	0.2%	0.4%	1.0%
CEE	**55.3%**	**23.0%**	**4.8%**	**4.6%**	**7.3%**	**10.9%**	**21.4%**

Sources: BIS Quarterly Review December 2008, European Commission AMECO database, Ecowin and own calculations

ANNEX

Table 3: The "mild" risk scenario - losses in billion USD

billion USD	Austria	Belgium	France	Germany	Italy	Netherlands	Sweden	Western Europe
Bulgaria	0.6	0.2	0.4	0.3	0.8	0.1	0.0	4.2
Czech Rep	3.3	2.8	1.9	0.6	1.0	0.3	0.0	10.3
Hungary	1.9	0.9	0.6	1.9	1.5	0.3	0.0	7.7
Poland	0.9	1.3	1.1	2.8	2.7	2.1	0.4	14.4
Romania	4.7	0.1	1.8	0.4	1.3	1.1	0.0	12.4
Slovakia	1.7	0.5	0.3	0.2	1.2	0.3	0.0	4.4
Estonia	0.0	0.0	0.0	0.1	0.0	0.0	3.3	4.0
Latvia	0.1	0.0	0.0	0.5	0.1	0.0	2.5	4.3
Lithuania	0.0	0.0	0.0	0.4	0.1	0.0	2.9	4.6
Belarus	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.2
Russia	1.2	0.5	1.7	2.5	1.3	1.3	0.5	11.1
Ukraine	1.3	0.1	1.1	0.5	0.5	0.4	0.5	5.3
Total	15.6	6.5	9.0	10.2	10.5	5.8	10.2	82.7
% of GDP	**3.5%**	**1.2%**	**0.3%**	**0.3%**	**0.4%**	**0.6%**	**2.0%**	

Sources: BIS Quarterly Review December 2008, European Commission AMECO database, Ecowin and own calculations

Table 4: The "hard" risk scenario - losses in billion USD

HARD SCENARIO

billion USD	Austria	Belgium	France	Germany	Italy	Netherlands	Sweden	Western Europe
Bulgaria	0.9	0.3	0.5	0.4	1.2	0.1	0.0	6.2
Czech Rep	3.3	2.8	1.9	0.6	1.0	0.3	0.0	10.3
Hungary	3.8	1.9	1.2	3.8	2.9	0.6	0.0	15.3
Poland	1.7	2.5	2.3	5.5	5.4	4.1	0.8	28.7
Romania	7.0	0.2	2.6	0.6	1.9	1.7	0.0	18.6
Slovakia	3.3	1.1	0.6	0.4	2.4	0.7	0.0	8.7
Estonia	0.0	0.0	0.0	0.2	0.1	0.0	4.9	6.0
Latvia	0.1	0.0	0.1	0.7	0.2	0.0	3.8	6.5
Lithuania	0.0	0.0	0.1	0.6	0.1	0.0	4.3	6.8
Belarus	0.2	0.0	0.0	0.1	0.0	0.0	0.0	0.4
Russia	2.4	1.0	3.5	5.0	2.6	2.6	1.0	22.3
Ukraine	1.9	0.1	1.6	0.8	0.7	0.6	0.8	7.9
Total	24.7	10.0	14.4	18.6	18.5	10.5	15.7	137.8
% of GDP	**5.5%**	**1.8%**	**0.5%**	**0.5%**	**0.7%**	**1.1%**	**3.0%**	

Sources: BIS Quarterly Review December 2008, European Commission AMECO database, Ecowin and own calculations

Table 5: The “ugly” risk scenario - losses in billion USD

billion USD	Austria	Belgium	France	Germany	Italy	Netherlands	Sweden	Western Europe
Bulgaria	1.7	0.6	1.1	0.8	2.4	0.2	0.0	12.5
Czech Rep	6.5	5.7	3.9	1.3	1.9	0.6	0.0	20.6
Hungary	7.7	3.7	2.4	7.6	5.9	1.1	0.1	30.7
Poland	3.4	5.0	4.6	11.1	10.9	8.2	1.6	57.5
Romania	14.0	0.4	5.3	1.1	3.9	3.3	0.1	37.2
Slovakia	6.6	2.2	1.3	0.8	4.7	1.3	0.0	17.5
Estonia	0.1	0.0	0.0	0.3	0.1	0.0	9.8	12.1
Latvia	0.2	0.0	0.1	1.4	0.4	0.0	7.5	13.0
Lithuania	0.1	0.0	0.1	1.1	0.2	0.0	8.7	13.7
Belarus	0.4	0.0	0.0	0.2	0.0	0.0	0.0	0.8
Russia	4.8	2.1	6.9	9.9	5.1	5.1	2.0	44.5
Ukraine	3.9	0.2	3.2	1.5	1.5	1.1	1.6	15.8
Total	49.4	20.0	28.9	37.2	37.1	21.1	31.4	275.7
% of GDP	**11.1%**	**3.6%**	**0.9%**	**0.9%**	**1.5%**	**2.3%**	**6.1%**	

Sources: BIS Quarterly Review December 2008, European Commission AMECO database, Ecowin and own calculations

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