Emerging Europe: growing with fewer risks

Since 2014, emerging Europe[1] countries have posted several consecutive years of solid growth, with an average GDP growth above 3% per year. For 2018, the outlook remains positive: the consensus of analysts and major international institutions expect the region to continue to grow strongly. In this context, and given that, in previous expansionary cycles, especially in the period leading up to the global financial crisis, the region's growth was accompanied by increased macroeconomic imbalances (such as a sharp rise in private debt levels and a significant deterioration of the external position), it is important to determine whether such vulnerabilities are being built up in the current expansion. In order to answer this question, we analyse the evolution of the main macrofinancial imbalances that were present in the region in 2008.

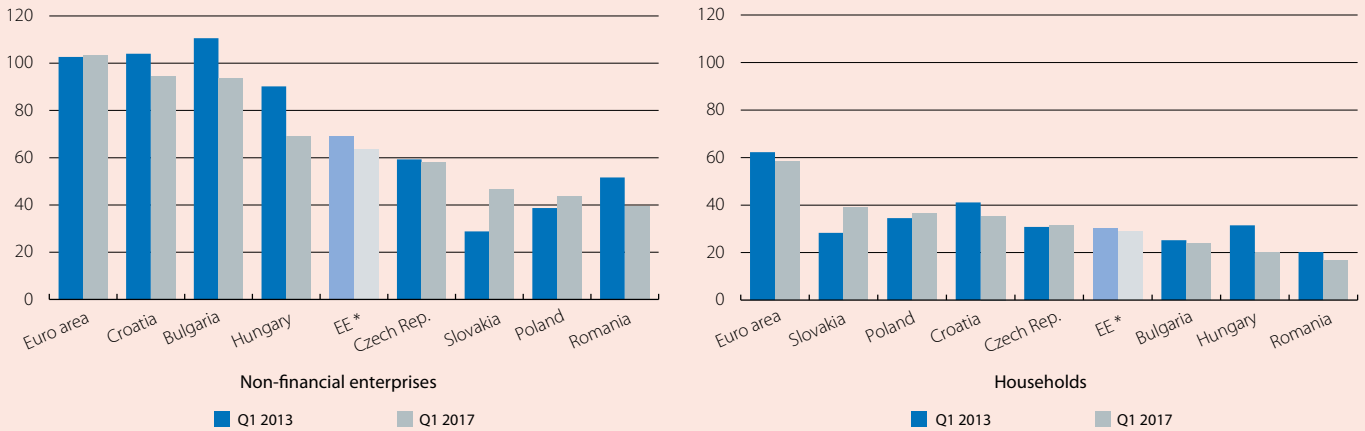
Firstly, the recent economic upswing has not been accompanied by an increase in private debt levels. Quite the opposite: private sector leveraging has fallen in most of these countries. As the first chart shows, corporate debt has decreased by 5.4 pp on average, to 63.7% of GDP in 2017, while household debt has fallen by 1.2 pp on average, to 29.0% of GDP, well below the euro area average[2] and the threshold set by the European Commission in its Macroeconomic Imbalance Procedure (MIP).[3] However, private debt levels are still relatively high in Croatia (almost 130% of GDP) and Bulgaria (117% of GDP), and have risen considerably in Slovakia,[4] albeit from a relatively low base.

Similarly, bank credit, both to corporates and households, has started to recover, and is advancing at a moderate pace, below nominal GDP growth. Moreover, credit is increasingly denominated in local currency, unlike the period leading up to the financial crisis, when a significant proportion of credit was denominated in foreign currency. In particular, loans to households denominated in local currency account for circa 82% of total loans, compared with 61% in 2013; while loans to non-financial corporates denominated in local currency have increased slightly, to 63% of total loans (57% in 2013). Nevertheless, developments in some countries warrant close monitoring. For example, credit is growing at a much faster pace (10% year-on-year) in Slovakia and the Czech Republic. And in Croatia, Poland, and Romania a considerable proportion of loans is still denominated in foreign currency, which makes them vulnerable to a depreciation of the currency.

Secondly, these countries' external position, which was a significant source of vulnerability before the global financial crisis, has improved considerably over the past few years, placing the region in a better position when confronted with changes in global financial conditions. In particular, over the past four years, the net international investment position (NIIP) has improved by 18.1 pp, to –53.2% of GDP in 2017, although it remains above the European Commission's vulnerability threshold (–35% of GDP).

Emerging Europe: gross private debt

(% of GDP)



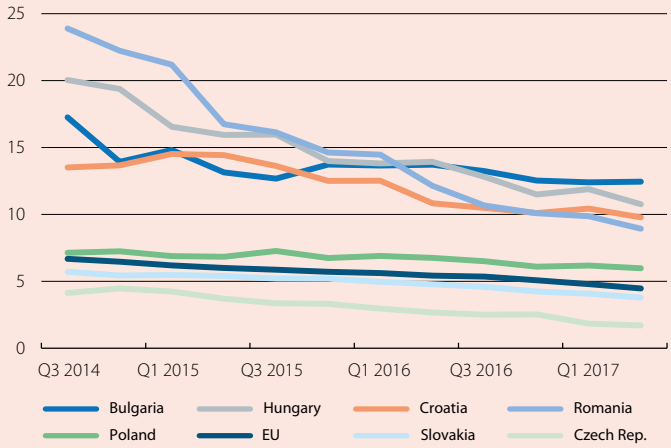
Note: ** EE refers to the average for the emerging Europe countries analysed (Croatia, Bulgaria, Hungary, Czech Republic, Slovakia, Poland and Romania).*
Source: *CaixaBank Research, based on data from Eurostat.*

1. Bulgaria, Slovakia, Hungary, Poland, Czech Republic and Romania.
2. From 161.2% of GDP in total (enterprises and households), according to Eurostat figures for Q1 2017.
3. 133% of GDP for all private debt.
4. 28.7 pp of GDP between Q1 2013 and Q1 2017.
5. External liabilities account for approximately 100% of GDP on average.
6. IMF (2017), «Regional Economic Issues: Central, Eastern and Southeastern Europe».

Moreover, the composition of these countries' external liabilities[5] is a mitigating factor, given that the bulk of the stock is direct investment and intercompany lending, which are generally more stable.[6] Likewise, current accounts have also improved considerably. In fact, most of these countries have replaced their high external deficits, which reached 9.7% of the GDP on average in 2007, with surpluses, which will help to improve their debt position should they continue to post surpluses. Lastly, international reserves, one of the buffers against external crises, are within the levels deemed safe by the IMF.

Emerging Europe: NPL ratio

Non-performing loans (% of total credit)



Source: *CaixaBank Research, based on data from the EBA Quarterly Dashboard.*

Banks are also in a stronger position to continue to support the region's growth. The sector is generally well-capitalised, with CET1 (fully-loaded) capital ratios above the European average (14.0%), and with coverage ratios[7] above 60% on average. Moreover, profitability is also relatively high (average ROE is 13%, compared with 7.0% in the EU) although it has also been affected by factors that are impacting all European banks, such as the low interest rate environment and the increased regulatory pressure.

Similarly, over the past few years, efforts have been made to repair bank balance sheets. In particular, asset quality has improved considerably thanks to sales of NPLs, the conversion of loans denominated in foreign currency (with higher default rates) into local currency and the more favourable economic context. The average NPL ratio has fallen from 13.1% of total credit in 2014 to 7.6% in 2017, although in some countries, such as Bulgaria and Hungary, NPLs are still high (see the second chart). In this context, a recent report by the Vienna Initiative[8] notes that some factors are still hindering the resolution and sale of non-performing loans, and recommends strengthening the legal framework for bankruptcy and foreclosure proceedings to deepen the secondary market for NPL.

Nonetheless, some sources of vulnerability persist. Over the past few years, some policies have had a strong impact on the banking sector, such as the bank levies in Hungary and Poland and the FX-denominated mortgage conversion programmes in Hungary and Croatia.[9] Such policies have reduced profitability and had a negative impact on credit activity. Although some of this risk has diminished recently,[10] the political sphere is still a source of uncertainty in some countries. For instance, Poland has yet to specify the conversion plan of FX-denominated mortgages into zlotys. Although the initial proposals, which entailed considerable costs for banks, appear to have been ruled out, uncertainty remains high. Meanwhile, in Hungary, Romania and Poland, the correlation between sovereign and bank risk is increasing, as domestic banks are holding increasingly more sovereign bonds, which now account for over 15% of all bank assets.

To sum up, the region's improved macroeconomic situation has been accompanied by a reduction of macrofinancial imbalances, although some sources of vulnerability remain and should be closely monitored.

Roser Ferrer
Macroeconomics Unit, Strategic Planning and Research Department, CaixaBank

7. Reserves as a share of total non-performing assets.
8. Public-private initiative set up in 2009 whose aim is to safeguard the financial stability of emerging Europe.
9. Prior to the GFC crisis, many consumers in the region took out loans denominated in Swiss francs, attracted by Switzerland's lower interest rates. However, with the global financial crisis and, subsequently, with the abandonment by the Swiss National Bank of fixed exchange rate with the euro, the Swiss franc appreciated sharply in relation to these countries' currencies, increasing debt service costs substantially.
10. In 2015, the Hungarian government signed an agreement with the EBRD, in which the Hungarian government committed itself to promote a stable and predictable policy framework to encourage macroeconomic stability; to gradually reduce the bank levy, and to implement measures to help reduce NPLs. In Romania, risks have decreased for now after two rulings of the Constitutional Court against the conversion law of FX-denominated mortgages and part of the law on debt repayment (which allowed mortgage holders to pay off their debts without penalty if the bank took over the mortgaged property).