Deutsche Bank Research

Tough times ahead

December 18, 2008

Key views

— **Global financial turmoil hits Eastern Europe.** Over the last few months the economic outlook for Eastern Europe deteriorated rapidly. Several countries (Hungary, Ukraine and Latvia) even had to turn to the IMF for financial support. Eastern European banks face sharply slowing economic growth, tough external financing conditions, elevated risk aversion and a tense liquidity situation.

— **Sharp credit slowdown due to local and foreign funding constraints.** International bond issuance and syndicated loan volumes already declined in H1 2008. While parental intra-bank funding has remained more stable so far, there is increasing evidence that credit lines are frozen at current levels. As any further growth of the loan book has to be financed locally, we expect credit to slow down sharply.

— **No reversal of financial deepening yet.** So far only Kazakhstan has seen credit shrink in relation to GDP. But as the global deleveraging continues we expect intermediation levels to fall in several countries.

— **No signs of a deposit run yet.** Although household deposits started to decline across the board in October, only in Latvia, Kazakhstan, Russia and Ukraine we see first signs of a loss in confidence in the local banking system.

Global financial turmoil hits Eastern Europe

Sharp economic slowdown to drive up NPLs: As external demand and credit-driven domestic consumption are weakening simultaneously and for the CIS countries key export commodity prices are falling the countries are faced with slowing economic growth or even recession (see chart). For this reason, and due to a seasoning credit portfolio (i.e. an increasing share of maturing loans), we expect corporate and household defaults to increase sharply over the next few months.

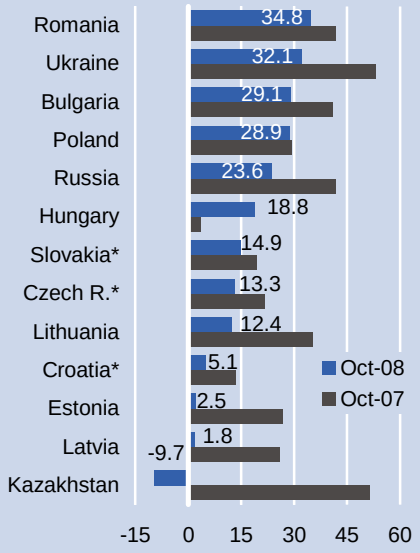
FX depreciation hits dollar/euroised banking sectors: Given the high ratio of FX-denominated credits (e.g. in the Baltics, Ukraine, Hungary and Romania) further potentially strong FX depreciation will put asset quality at risk. Additionally, given the equally high share of FX-denominated deposits banks might face FX liquidity shortages if households step up withdrawals.

Liquidity squeeze in the banking sector: Central banks have taken several measures to alleviate liquidity tightness recently, e.g. injection of short-term liquidity into the banking system (Russia), reduction of reserve requirements (Hungary, Croatia, Russia, Ukraine, Bulgaria), and an increase in the range of acceptable collateral for bank refinancing (Russia). In Poland, Hungary and Latvia European central banks provided facilities to borrow EUR 10/5/0.5 bn in swap lines. Despite all those measures we expect banking system liquidity to remain tight.

Reduction in foreign funding to clamp down further on credit growth

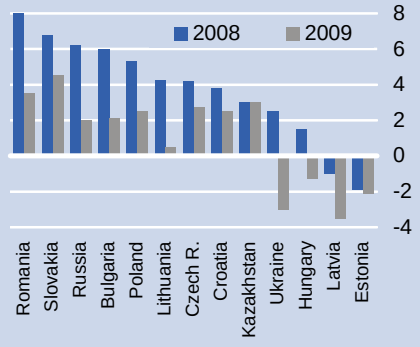
All three main sources of external bank funding are affected by the international financial crisis, but to varying degrees.

Ranking of "credit boomers"
Real private sector credit growth, % yoy



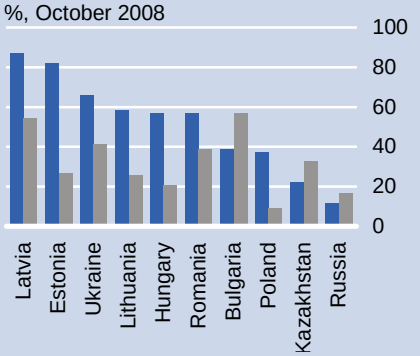
*Sep. Sources: IMF, National central banks, DB Research

Sharp growth slowdown
Real GDP growth, % yoy



Source: DB Research

Currency depreciation puts banking systems at risk
%, October 2008



Sources: National central banks, DB Research

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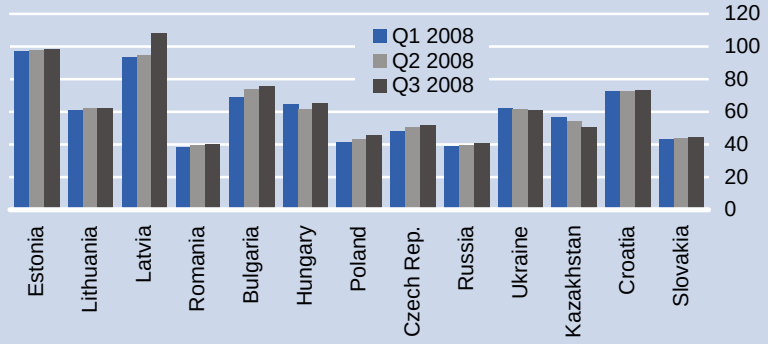
International bond issuance by banks, most important in the CIS countries, already declined sharply in H1 2008 (see chart). Syndicated loan volumes, also important in CIS countries, have also started to shrink over recent months, too. Parental intra-bank funding (most important for the highly foreign-owned banking sectors of the EU members) has remained more stable. But there is increasing anecdotal evidence that credit lines are frozen at current levels and local subsidiaries are encouraged to fund themselves domestically at higher costs.

Level of financial intermediation not falling yet

Because of external funding constraints any further growth of the loan book has to be financed locally. But as loan-to-deposit ratios stand above 100 almost everywhere (see chart), we expect loan books to stagnate – or even shrink – over the next few quarters. So far only Kazakhstan has seen credit shrink in relation to GDP, i.e. a reversal of financial deepening (see chart). But credit growth will slow particularly sharply in the countries that rely most on external funding and whose deposit base is shrinking fastest (e.g. Baltics, Ukraine, Kazakhstan and Russia).

No reversal of financial deepening yet
Credit to the private sector, as % of GDP

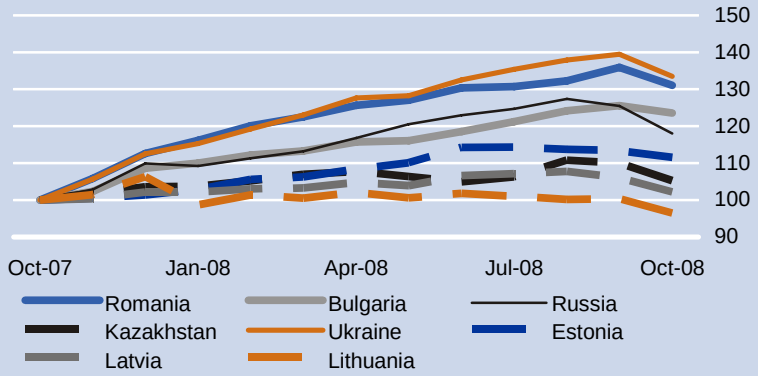


Sources: Eurostat, IMF, National central banks, DB Research

Deposit base holding up relatively well

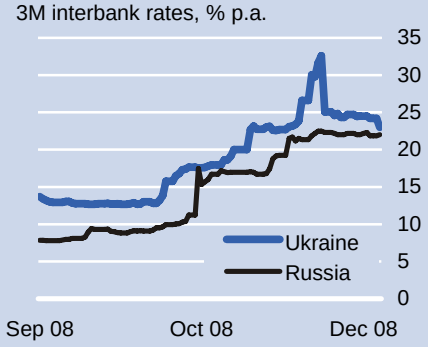
Household deposits (volume and composition) are an important leading indicator of banking sector stress since they reflect households' confidence in the local banking sector and currency. So far, we have seen increasing dollar/euroisation and a decline in deposits in almost all countries as of October (see chart). But only in Russia, Latvia and Kazakhstan deposits have dropped more than 5% yoy in the last two months.

First signs of household deposit flight?
Total household deposits (October 2007=100)



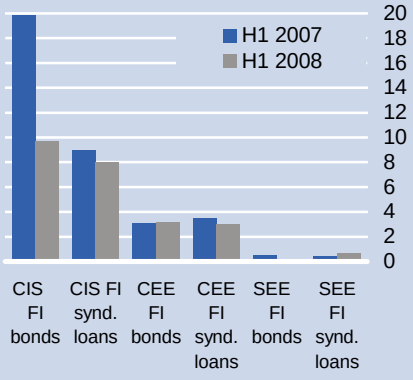
Sources: National central banks, DB Research

Liquidity squeeze in Russia & Ukraine
3M interbank rates, % p.a.



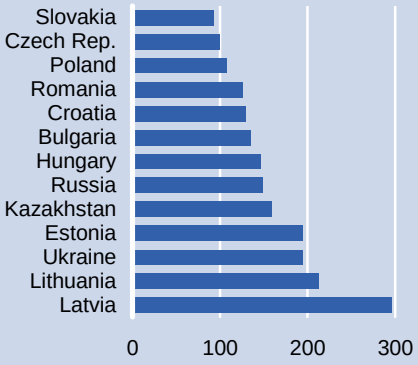
Sources: Bloomberg, DB Research

CIS banks hit by reduced capital markets access
USD, bn



Source: EBRD

Highly dependent on wholesale funding
Loan-to-deposit ratio, Sept./Oct. 2008



Sources: National central banks, DB Research

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