

Economic Watch

Cross-Country Emerging Markets Analysis

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Markets Analysis

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Emerging Europe feels first spill-overs from Eurozone crisis

- **Emerging Europe undershoots**

Eastern Europe (EE) countries are being especially penalized by global risk aversion, especially when comparing with other Emerging Markets (EM), such as Latin America and especially Southeast Asia.

EMBI Global spreads for the Europe region more than doubled between the beginning of July and the first days of October, narrowing the negative gap they had with Latam and widening the differential with Asian countries (Chart 1). The trend was partially reversed by the end of October, but levels for these risk variables remain above the average for July/10-June/11. Croatia, Hungary and, in a lesser extent Lithuania, show the worst relative performance, as current EMBI spreads are not far away from October maximums (Chart 2). Exchange rates have significantly depreciated against the euro in the last 3 months, led by the Hungarian forint (14.6%) (Chart 3). The Russian ruble and the Turkish lira were also heavily affected initially, but rapidly appreciated afterwards.

- **Global risk aversion and the fiscal situation are not behind the undershooting**

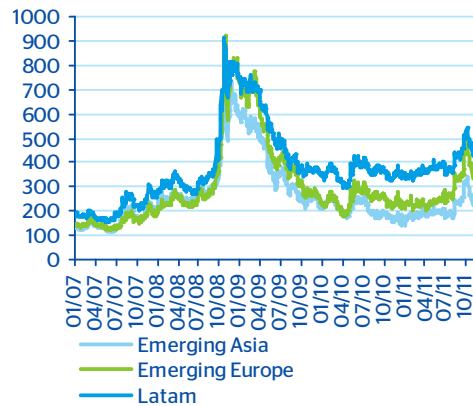
- **Global risk aversion** spreads rapidly through the so called "marginal calls". As portfolio managers are required to reduce risk exposure, the negative effects used to be amplified for countries with higher relative shares in global indexes (EMBI or MSCI). In this sense, Turkey and Russia are the clear big players (both a 9% in EMBI and Russia a 7% in MSCI), followed by Poland and Hungary (Charts 4&5). However, Russia and Turkey have not been specially penalized and the rest of the region exposure to international indexes is not especially relevant.
- **The fiscal situation** of the region remains an asset and is not a good candidate to explain the divergence with the rest of the emerging markets. Except in Hungary, where public debt-to-GDP ratio remains over 60% the fiscal situation of the rest of the countries is not especially worrisome (Chart 6). Estonia, Turkey and Russia maintain almost balanced budgets projected for 2011 and low public debt. Then there is a large group of low-medium debt but high-deficit levels, composed by Romania, Serbia, Croatia, Latvia, Lithuania, Slovenia, Slovakia and Poland.

- **Trade, capital flows, bank dependence and currency mismatch place important idiosyncratic regional risks**

- **The trade Channel:** Reliance on Eurozone demand is considerably high in some EE markets. That is especially the case of Hungary, Slovakia and Slovenia, with a share of exports to GDP (a combination of exports share and trade openness) above 30%. Estonia, also a member of the Eurozone, has a ratio of 25% and then Bulgaria, Macedonia, Poland, Romania and Lithuania present values in a range of 14-18% (Chart 7). The less exposed countries in this sense are Croatia, Russia, Latvia, Serbia and Turkey, with ratios between 7% and 9%. In fact, Central and Eastern Europe is the emerging region with the bigger loss of trade momentum since the beginning of the year, showing relatively strong declines of exports during the summer (Chart 8).

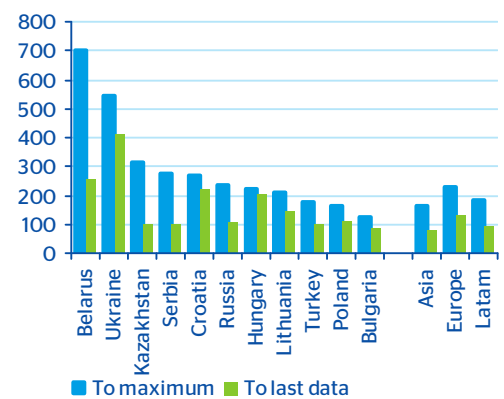
- **The Trade Finance Channel:** One of the triggers of trade collapse after Lehman's episode was the heavy tightening of trade finance. Fears of a repetition of these events have been detected in recent banking surveys. The latest Emerging Countries Lending Conditions shows some tightening in EM lending conditions, although we are still far away from the Lehman's collapse situation. According to the report, funding conditions in international emerging markets deteriorated significantly in the 3Q, with Emerging Europe showing the hardest tightening, followed by Asia and Latam (Chart 9). This is especially true in the case of trade finance where Emerging Europe appears as the most tightened region (Chart 10). French banks are the major providers, with around a World share of 25% and close to a 40% in Export Credit Agencies (ECA) transactions (Chart 11). These high ratios suggest potential high spill-overs if European crisis intensifies and trade finances come to a halt. In fact, some analysts' signal that the sudden stop in trade finance by European Banks is already in place.
- **Sudden Stop in Capital flows:** A sudden stop in capital inflows could have a significant impact in some EE countries due to several reasons:
 - **External debt remains high in some of the countries:** Latvia and Hungary are in the worst position, with ratios over GDP around 150%, but other countries overpass the 100% mark (Estonia, Croatia, Bulgaria, Lithuania and Serbia) (Chart 12). Finally, Turkey and Russia positions remain comfortable (less than 40% of GDP). The external burden with respect to the Eurozone is significant in Bulgaria and Hungary, with ratios between 34% and 45%, and, to a lesser extent, in Macedonia, and Romania, (above 20%).
 - **External financing needs are also worrisome:** EBRD projections for 2011 show significant current account deficits for Turkey (10.3%) and Serbia (7.7%) and to a lesser extent in Macedonia (5.5%), Poland (4.8%) and Romania (4.5%) (Chart 13). However, none of them are in the top of short-term external debt ratios (25% of GDP or less).
 - **International reserve adequacy to cope with a potential sudden stop is not homogeneous** across the region. Russia plays its own league due to oil revenues and has as a ratio to short-term external debt of more than 300% (Chart 14). Serbia and Romania are also above 100%. However, international reserves do not cover short term external debt in some countries, posing special risk (Turkey, Croatia and Hungary and the Baltic countries).
- **Bank lending channel:** Loans to deposit ratios are normally high across the region and normally banks rely on alternative sources to finance credit, the main candidates being the wholesale markets and the foreign parent banks (usually Nordic, Italian, German and Austrian banks) (Chart 15). As parent banks are facing increasing difficulties and recapitalization needs are now higher, there is a risk of relying or stop credit to their emerging Europe branches. In this sense, foreign owned banks have a very significant presence in the Baltic and Balkan countries, as well as in Slovakia, Romania and Poland.
- **Currency Mismatch:** The highest risk for the region is the general practice (with some exceptions as Turkey) of foreign currencies denominated liabilities ("currency mismatch"). An important share of loans (consumer, housing and corporate) is denominated in Euros or Swiss francs (Chart 16). Thus, any depreciation of foreign exchange rates implies the facto a monetary tightening. This places significant risks for households, corporate and the financial system balance sheets. As the later is still recovering from the previous crisis, a new round of exchange rates depreciation would increase non-performing loans again, rising tensions in Eastern Europe bank balance sheets (and their headquarters in West Europe). Thus, maintaining foreign exchange stability should constitute a primer goal in macro-prudential policies. This is especially the case of Hungary, Latvia and Croatia. Last, but not least, Hungary's intention to limit the amount to be paid by households in foreign exchange denominated loans translates directly the risks to bank balance sheets.

Chart 1
EMBI Global spread by Region
Basis points



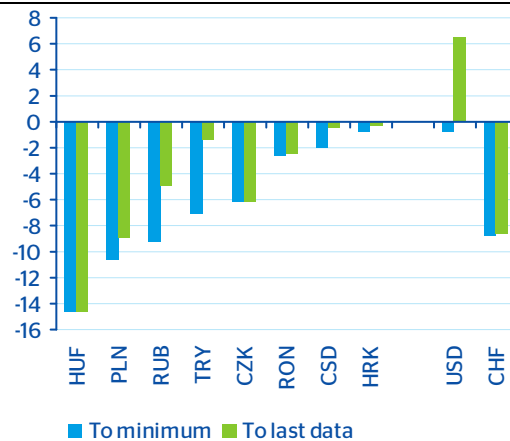
Source: BBVA Research and Haver

Chart 2
EMBI Global spread in Emerging Europe
Change in bp since 29/07/11



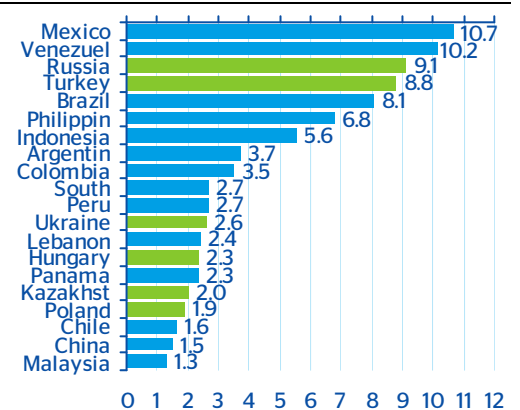
Source: BBVA Research and Haver

Chart 3
Exchange rate against the Euro
Change in % since 29/07/11
+ (-) indicates appreciation (depreciation)



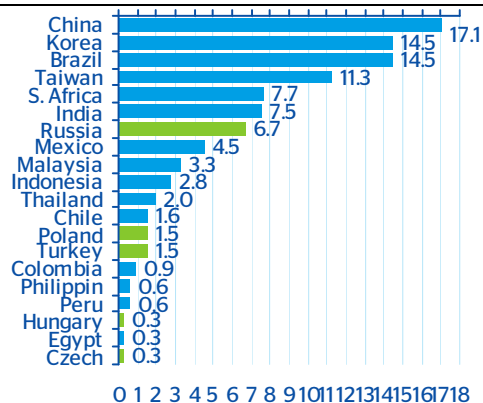
Source: BBVA Research and Haver

Chart 4
EMBI weights by country
As a % of total indexes



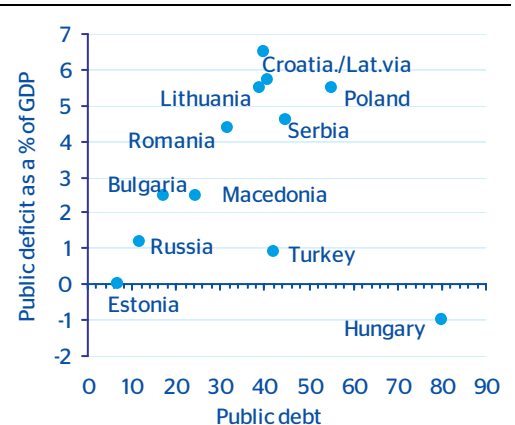
Source: BBVA Research and JPMorgan

Chart 5
MSCI weights by country
As a % of total index



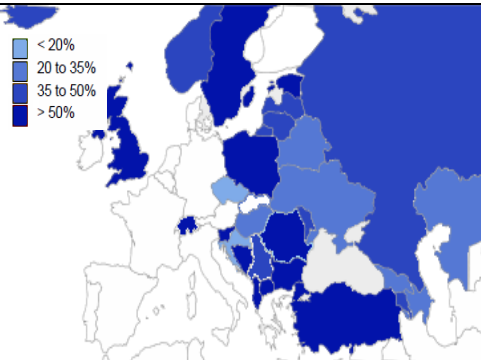
Source: BBVA Research and Morgan Stanley

Chart 6
Fiscal vulnerability
As a % of GDP



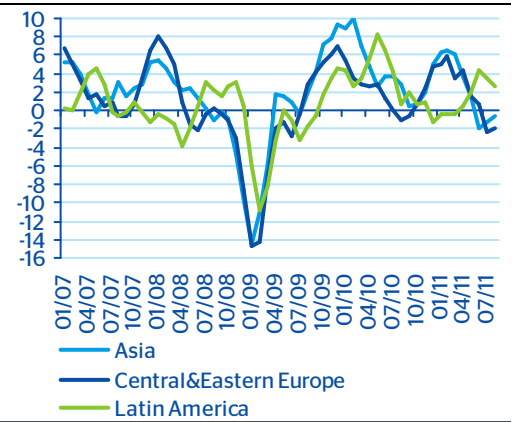
Source: BBVA Research and EBRD

Chart 7
Exports exposure to Eurozone in Emerging Europe.
Exports to Eurozone as a % of total exports



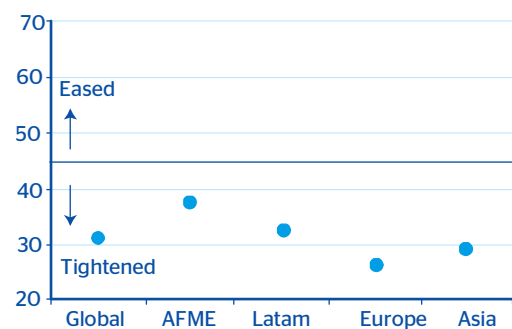
Source: IMF

Chart 8
Trade momentum by Region
Quarterly change of exports in 3m average (%)



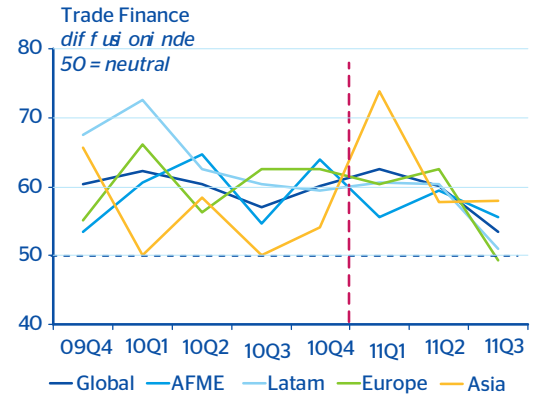
Source: BBVA Research and World Trade Monitor

Chart 9
Banks funding conditions in international markets .Change in 3Q11 (net answers in pp)



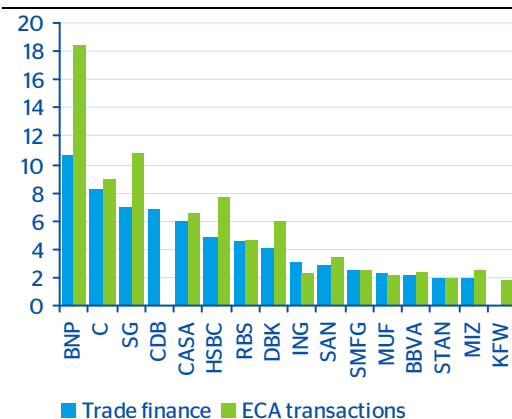
Source: IIF

Chart 10
International Trade Finance Conditions Index
Basis points



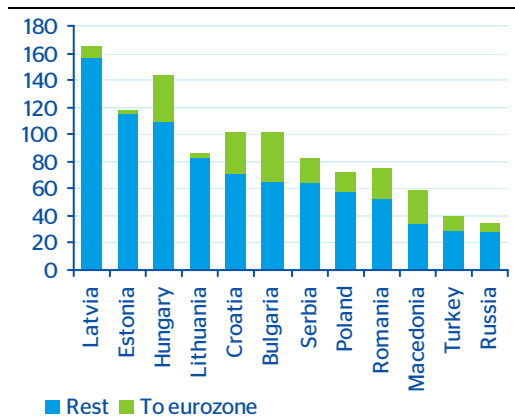
Source: IIF

Chart 11
Banks by market share in trade finance
As a % of total



Source: Morgan Stanley

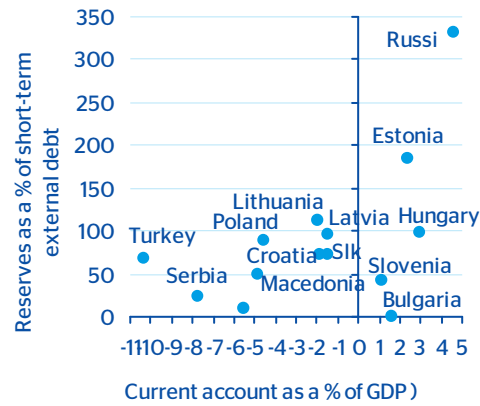
Chart 12
External debt in Emerging Europe
As a % of GDP



Source: EBRD

Chart 13

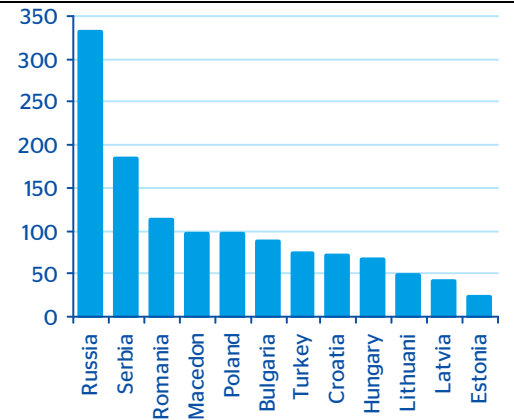
External Vulnerability: International Reserves and current account deficit



Source: BBVA Research and EBRD

Chart 14

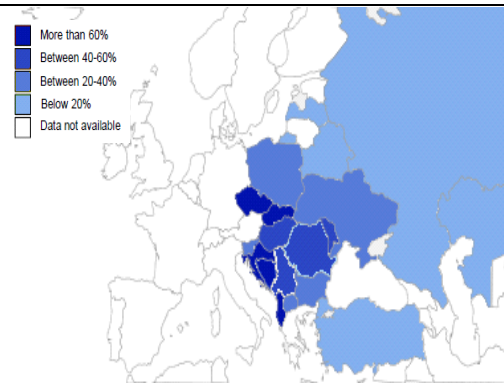
International reserves in Emerging Europe As a % of short-term external debt



Source: EBRD

Chart 15

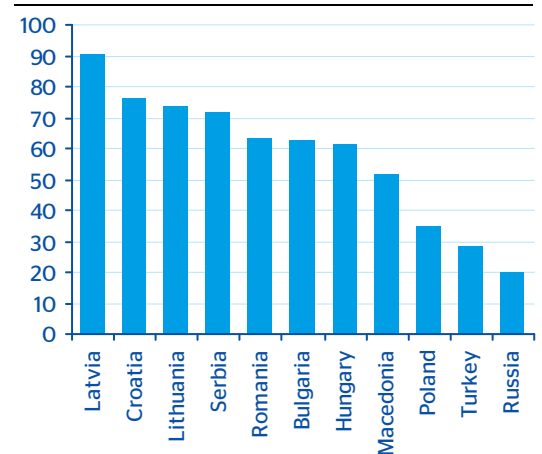
Emerging Europe: Bank links with Eurozone Share of Eurozone owned asset in total assets



Source: IMF

Chart 16

FX credit in Emerging Europe In % of total loans



Source: EBRD

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