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Emerging Europe

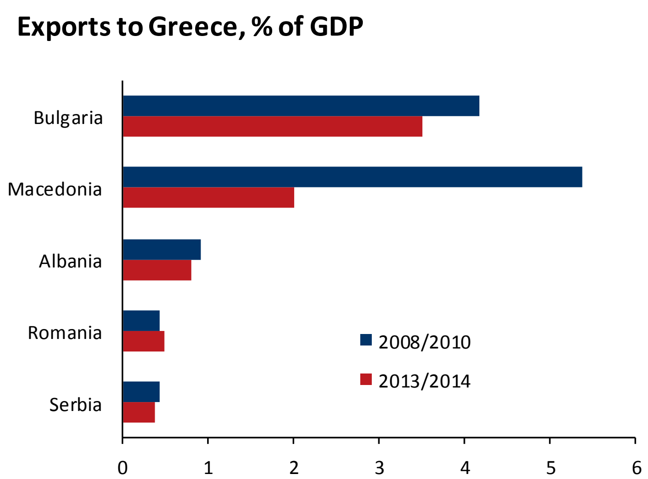
Southeast Europe still vulnerable to a Greek default

- **As the chance of Greece defaulting on its debt is increasing, and so is the risk of it exiting the Eurozone, Southeast European countries (SEE) stand as most exposed to Greece through financial, trade and investment linkages. While trade exposures do not exceed 3.5% of GDP (in Bulgaria), banking sector exposures are much larger. Greece's four largest banks hold between 14% (in Serbia) and 22-23% (Macedonia and Bulgaria) of total banking sector assets in Southeast Europe, and their claims stand at 8%-19% of host countries' GDP.**
- **Impact and outlook:**
  - Exposures to Greece are only part of the problem in the SEE banking sector, which is suffering from a legacy of boom and bust dating back to the global financial crisis. Weak growth and inefficient debt restructuring mechanisms prevented the repair of corporate and banking sector balance sheets, which continue to suffer from bad debts, weighing down on credit growth.
  - Greek banks have been in a crisis mode for five years now, and a fair share of asset downsizing has already taken place, without having triggered a crisis. Most banks with Greek capital in the SEE are subsidiaries, which have limited reliance on parent funding for lending, and Greek parents can only withdraw statutory capital through sale. Therefore the main transmission channel from a possible Greek default is a potential contagion, whereby a loss of confidence triggers a bank run, rather than direct linkages. Recent verbal interventions from central bank governors across the region suggest such pressure is mounting.
  - High debt overhang (and, in some cases, high current account deficits), make SEE economies highly dependent on global monetary conditions. On the positive side, the current global liquidity boom arrived just at a time when SEE economies needed to undertake major balance sheet adjustment. However, any sharp yield normalization, e.g. triggered by a "Grexit", growth slowdown in the Eurozone or faster-than-expected US rate normalization, could cause liquidity problems for countries in the region.

Figure 1. Significant banking sector exposures

Greek banks' foreign claims by country, Eastern Europe — % of recipient country's GDP	2013	2014
Bulgaria	27.6	18.9
Macedonia	19.5	17.0
Albania	13.8	14.6
Serbia	18.0	11.3
Romania	12.0	7.9
Turkey	4.2	3.9
Montenegro	0.6	2.2
Croatia	0.3	0.1
Poland	1.7	0.1
Bosnia and Herzegovina	0.0	0.1
Czech Republic	0.0	0.0
Hungary	0.2	0.0
Latvia	0.0	0.0
Lithuania	0.1	0.0

Figure 2. Trade flows already hit by weak demand



Source: IMF, Bankscope, Oxford Economics

Economist: Evghenia Sleptsova, Economist | Tel: +44 207 803 1420 | e-mail: esleptsova@oxfordeconomics.com

Greek default around the corner…

The Greek debt crisis remains unresolved and no deal with the international creditors is in sight as the June 30 deadline for the June IMF payment approaches. If Greece defaults on its IMF payments due by the end of June, the ECB will most likely suspend its emergency liquidity assistance (ELA), which would cause a liquidity crunch and a likely run on Greek banks. For the Eurozone the key transmission channels concern the risk of contagion to other Eurozone periphery economies, a hit to the credibility of the currency union, and losses on holdings of Greek sovereign debt. We discussed these channels at length in our March 2015 Research Briefing, and here we focus only on Eastern Europe.

Southeast Europe most exposed…

Southeast Europe (SEE), due to its geographic proximity, is exposed to Greece through most economic channels – banking sector, trade, investment and labour migrants' remittances. The direct effect of the latter three, while important, tends to be gradual and does not cause shocks as sharp as those to the financial sector, and these flows have to a large extent already adjusted since 2010 on the back of a continuously weak Greek demand (Figure 2).

Banking sector exposures are therefore the main transmission channel, **being both more volatile and larger as a share of GDP**: Greek banks' claims on SEE economies range from 8% to 19% of GDP in SEE countries (Figure 1), versus 0.3%-3.5% of GDP in the case of trade exposures (Figure 2).

Table 1. Eastern Europe: Banking sector exposures to Greece and systemic vulnerabilities

	Greek banks' claims, % of GDP	Regulatory capital to RWA, %	Return on Equity	NPLs / Total Loans, %	NPLs net of provisions	Loan/ Deposit	FX Lending, % of total lending	Credit growth, % y/y	Banks' foreign borrowing, % of GDP
Bulgaria	18.9	21.9	7.2	16.7	8.5	0.9	49.0	-11.5	1.2
Macedonia	17.0	15.7	7.4	10.8	2.0	0.9	50.5	7.3	1.9
Albania	14.6	16.8	10.5	22.8	7.5			2.5	2.5
Serbia	11.3	20.4	5.0	23.0	-3.1	1.2		3.0	2.8
Romania	7.9	17.1	-5.6	15.3	5.2	1.0	56.7	-6.9	3.7
Turkey	3.9	15.9	15.2	2.8	0.8	1.3	27.8	23.8	8.3
Montenegro	2.2	15.1	2.4	17.2	9.3				3.3
No direct exposure in the rest of CESEE									
Poland	0.1	14.9	12.6	4.9	1.5	1.1	29.1	8.3	4.2
Croatia	0.1	21.5	5.0	16.7	8.2	1.2	73.5	-6.7	4.7
Bosnia & Herzegovina	0.0	16.3	6.0	14.0	4.2	1.1	62.4	-2.9	4.8
Czech Republic	0.0	16.7	16.4	5.6	2.9	0.8	28.9	0.9	5.8
Estonia		31.5	8.8	1.4	1.0	1.1	1.7	3.9	0.1
Hungary	0.0	17.9	-17.2	15.6	6.3	1.1		-1.8	4.1
Kosovo		17.6	10.5	8.2	0.9	0.8	0.3		
Latvia	0.0	19.7	12.7	4.9	1.0	0.7	26.2	-5.9	0.2
Lithuania	0.0	21.3	9.7	8.2	5.9	1.0	68.8	3.8	1.6
Slovenia		18.0	-1.9	11.7	4.4	1.3		-21.5	1.3
Slovakia		17.3	10.4	5.3	2.7	0.9	1.9	-1.7	1.7

Source: IMF IFS, IMF Global Financial Stability Report, BIS, Haver, Oxford Economics estimates
Note: Heat map was generated using values in each column across all CESEE countries. Red = high risk.

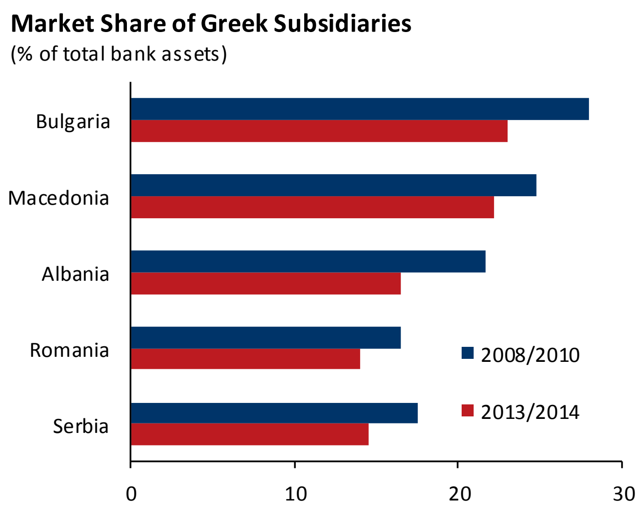
Greece's four largest banks – Alpha Bank, Eurobank Ergasias, National Bank of Greece (NBG) and Piraeus bank – control between 15% to 23% of the banking sectors in South-eastern Europe, most notably in Bulgaria, Macedonia, Albania, Romania and Serbia, despite some downsizing since 2010 (Figure 3). Central and Eastern Europe, on the other hand, is hardly exposed, as Figure 2 and Table 1 show.

Moreover, the parent banks are themselves suffering from an outflow of deposits: in Q1 2014 the NBG lost 8.3% of its deposits y/y, Alpha bank 14% and Piraeus 15%.

In Bulgaria and Macedonia Greek banks control a similarly large share of total banking system assets (23% and 22.2% respectively), however the impact may be disproportionately larger on Macedonia, where National Bank of Greece owns the largest bank in terms of assets (Stopanska Banka AD Skopje, 20% of total banking sector assets), while in Bulgaria the largest bank controlled by a Greek parent is fourth in terms of assets (United Bulgarian bank, owned by the National Bank of Greece). In Albania, Romania and Serbia Greek banks are also not among the top three, however their presence is still sizeable.

How these banks will react to a potential crisis in Greece will be decisive for the economic performance of the host countries, some of which still struggle from a debt overhang and sluggish recovery.

Figure 3. Greek banks control a significant market share of the SEE banking systems



Source: IMF, Bankscope, Oxford Economics

Loss of confidence – most important channel

The direct transmission channel is limited. The risk of Greek banks withdrawing capital or cutting off funding to their foreign outlets is mitigated by the fact that most Greek-controlled banks in SEE are subsidiaries, rather than branches (Bulgaria's Alpha Bank is a branch, however), which means that they can only exit host markets through sale. In Bulgaria, Macedonia and Albania the Greek subsidiaries are fully funded by deposits, while in Romania and Serbia reliance on parent and wholesale funding is still sizable (Figure 5).

Therefore, a loss of confidence, triggering a deposit flight, remains the main risk factor. Central banks across the SEE, most recently in the most exposed Macedonia and Bulgaria, have already had to verbally intervene to diffuse the risk of a run on deposits – a worrying sign of mounting pressure on the banking system. If materialised, a run on Greek-owned banks in SEE would create a case for recapitalisation and, possibly, compensation of depositors, on a scale that SEE governments may not be able to afford.

Uncertainty over the knock-on effects on the banking system can also trigger investors to rebalance their portfolios away from most of the assets of a host country or a region altogether, putting pressure on sovereign debt yields and private sector borrowing costs.

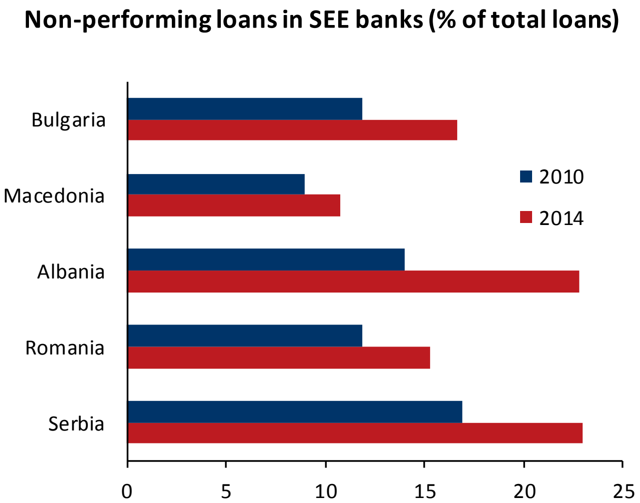
High NPLs will be the main drag on banks' balance sheets…

The health of the banking system and macroeconomic imbalances will determine both the extent of a possible bank run and the ability to weather a crisis. Table 1 shows a heat map of risks in the banking sectors of the most exposed SEE economies and in the rest of the region. What differentiates SEE:

- **A high share of non-performing loans** on banks' balance sheets, even net of provisions. Bulgaria, Albania, Romania and Montenegro stand out as most vulnerable in this respect. While in the CEE the NPLs have declined (except in Hungary, whose banking system is shouldering the cost of conversion of Swiss franc-denominated loans into forint), in the SEE they have significantly increased. This partially reflects delayed recognition of NPLs, but also the lack of efficient debt resolution frameworks and capacity and incentives for banks to deal with non-performing loans;

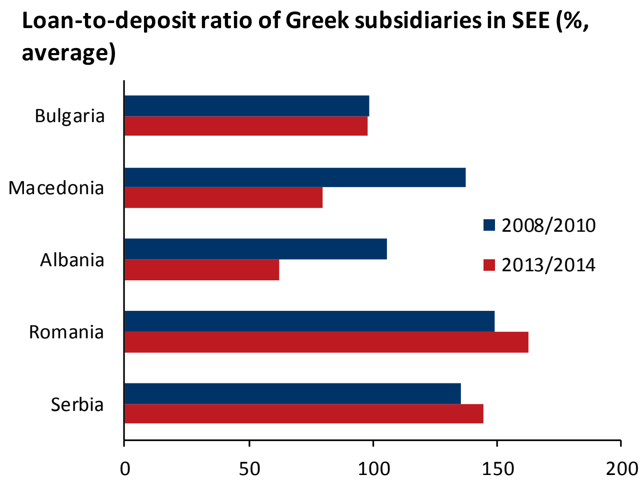
- **Provisions for NPLs are on average higher**, at 75% for the group of exposed SEE, versus 56% for the rest of the region. In Bulgaria and Romania, however, provisions have not caught up with the increase in NPLs and declined as a share of NPLs since 2010;
- **But reliance on wholesale and parent financing is high in Romania and Serbia**, while loans are just about covered by deposits in Bulgaria's Greek-owned subsidiaries (with a loan-to-deposit ratio of 98%) (Figure 4).

Figure 4. NPLs high and rising



Source: IMF, Bankscope, Oxford Economics

Figure 5. Some subsidiaries still reliant on parent borrowing



Source: IMF, Bankscope, Oxford Economics

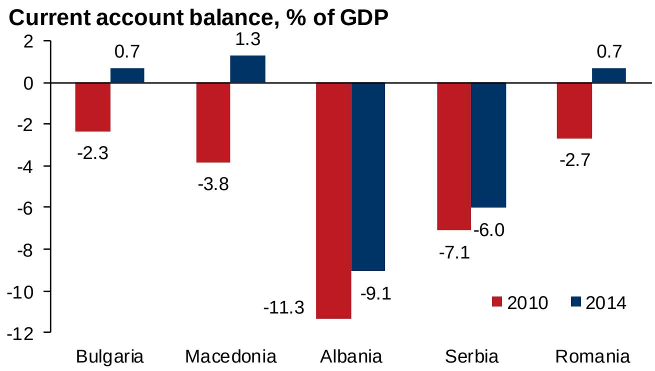
- **A much higher share of foreign currency-denominated lending than in the CEE**, which tends to be mostly in Euros; this is favourable as long as the Euro is weakening, but is a source of stress in case of depreciation pressure on local currencies. Countries with pegged and semi-pegged regimes, such as Bulgaria, Macedonia, Bosnia and Herzegovina, will also experience pressure on their foreign exchange reserves in case of a capital flight;
- **Relatively low reliance on cross-border borrowing relative to GDP**, compared to the rest of the region (except Turkey, with the highest ratio of 8.3% of GDP). This should contain the effect of deleveraging in case of an external shock.

Macroeconomic imbalances and weak growth – a banking crisis can be a tipping point

As the IMF notes in its latest report on Central and Southeast Europe, SEE economies, unlike those in Central and Eastern Europe, have been less successful in deleveraging, and the resulting private sector debt overhang, along with less supportive fiscal policies, have served as an important drag on growth. Lack of efficient debt resolution practices and poor bankruptcy legislation prevented banks from clearing their balance sheets of non-performing loans.

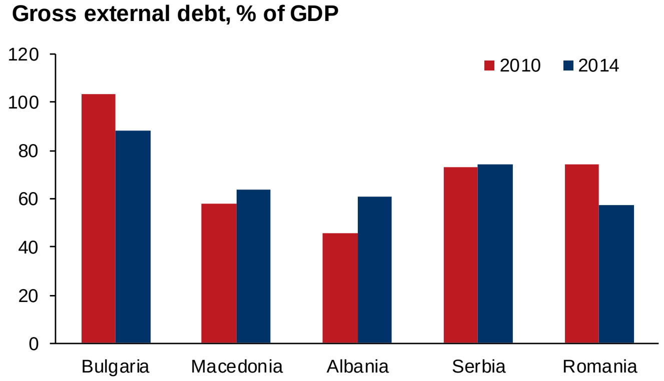
External imbalances persist. Despite the fact that there was meaningful current account correction in some SEE economies (Bulgaria, Macedonia and Romania, albeit from a lower base), external deleveraging has been disappointing in most SEE (Figure 5 and 6). Albania and Serbia also continue to suffer from large current account deficits, which prevent deleveraging and weigh on growth.

Figure 5. Current account rebalancing in SEE



Source : Oxford Economics/Haver Analytics

Figure 6. But less extensive external deleveraging



Source : Oxford Economics/Haver Analytics

Macroeconomic weaknesses increase the vulnerability to a potential Greece-triggered banking crisis and may dent their already weak growth rates (Figure 7):

- Growth has been sluggish in most SEE, except Romania, and even negative in Serbia (RS)
- Credit growth is weak (Albania, Serbia) or negative (Bulgaria and Romania), except in Macedonia.
- Large fiscal deficits across all SEE imply that there is no space for fiscal support, in particular in case of a potential banking sector crisis.
- Unemployment is dangerously high across all SEE economies except Romania.
- Judging from economic and lending growth rates, Bulgaria and Serbia appear relatively more vulnerable to a potential banking sector crisis, which could cause another credit crunch and thus tip these economies back into recession.

Figure 7. Weak growth, fiscal deficits and sluggish credit growth

Selected economic indicators
2014, %

	AL	BG	MK	RO	RS
GDP growth, y/y %	2.4	1.7	2.8	3.8	-1.8
Fiscal balance, % of GDP	-5.6	-3.7	-4.2	-1.9	-6.3
Government debt, % of GDP	72.6	26.9	38.0	40.4	72.4
Unemployment, %	14.0	11.5	28.5	6.8	19.7
Private sector credit growth, % y/y	2.5	-11.5	7.3	-6.9	3.0
CPI, average % y/y	1.6	-1.6	-0.1	1.1	2.1

Given Bulgaria's recent banking sector crisis in mid-2014 and its highest exposure to Greek parent banks, we take a closer look at its banking system in Box 1 overleaf.

Box: A snapshot on Bulgaria

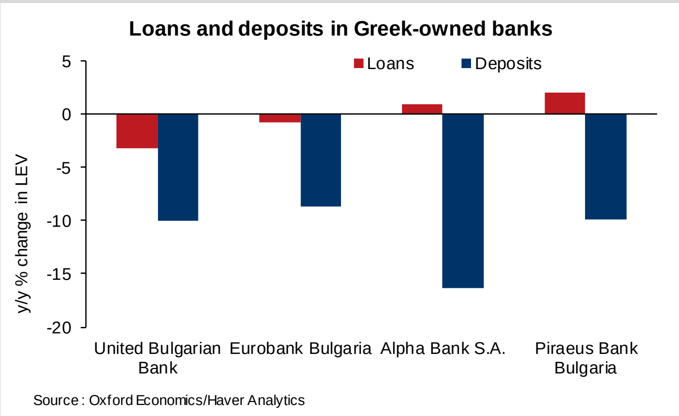
Bulgaria has already gone through a banking crisis in mid-2014, allegedly caused by a spat between the oligarchs, when two of its largest banks suffered a run on their deposits – CCB (4th largest by assets), and FIB (3rd largest). FIB was quickly resolved and recapitalised, while in the CCB the asset quality was found to be very poor and the bank remained closed for five months before being put into administration and having its licence revoked. After a prolonged period of uncertainty, due to the lack of resources in the deposit insurance fund, the European Commission stepped in and the government eventually spent 4.7% of GDP to repay eligible depositors of CCB, which brought Bulgaria's fiscal deficit to 3.7% of GDP, above the EU Maastricht criteria.

There are four Greek-owned banks in Bulgaria: United Bulgarian Bank, Eurobank Bulgaria and Piraeus Bank Bulgaria, which are subsidiaries and are therefore local companies, and one branch of the Greek bank – Alpha Bank, which is primarily subject to Greek regulations and is therefore more at risk. Together they account for 23% of total banking sector assets.

Greek-owned banks in Bulgaria have already experienced an outflow of deposits over the past year, as Figure 7 shows, and the Central Bank (BNB) recommended all banks with Greek capital to clean their balance sheets of Greek exposures (central banks in other SEE have taken similar measures). To what extent this measure can help insulate the risks, given that these banks rely on Greek parents for their capital, remains to be seen.

The 2014 banking crisis demonstrated that even with solid levels of capitalisation and liquidity in the banking system, weak institutions and inappropriate supervision can pave the way for a crisis. One year on, the right supervision and debt resolution mechanisms are still not in place, [according to the Bulgarian Association of Banks].

Figure 8. Deposits in Greek banks are shrinking



Note: Banks are sorted in descending order of their share of total assets in Bulgaria.