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Emerging Markets Commentary

January 15, 2010

Central and Eastern Europe: The Rebalancing of Debt and Equity Capital In-Flows

Overview

- **Capital In-Flows to Emerging Europe will increase from USD 20.3 billion in 2009 to USD 179.4 billion in 2010 while external financing will be equity dominated.**
- **Direct equity investment is expected to rise by approximately 150% and reach its pre-crisis level in 2010.**
- **Although local commercial banks show a slight recovery in 2010, their ability to boost lending volume to support the region's growth remains limited.**

The recent financial crisis characterized by the fallout of Lehman Brothers, Bear Stearns, and Merrill Lynch significantly hit Europe's emerging markets. Although the crisis already reached the world's developed economies in 2007, many countries in the region, with exception of the Baltic States and Kazakhstan, were enjoying an extraordinary period of decoupling of output and credit growth.

Once the crisis reached emerging Europe in the last quarter of 2008, many of the CEE countries suffered a much larger output decline than was experienced in any of the world's other regions. Even though the CEE region was significantly affected due to the negative double digit GDP growth in several countries, positive single digit growth was observed in several other emerging European economies. Despite the financial crisis that griped the majority of the CEE region, Poland emerged as a country with a positive GDP output of 1.4% year over year.

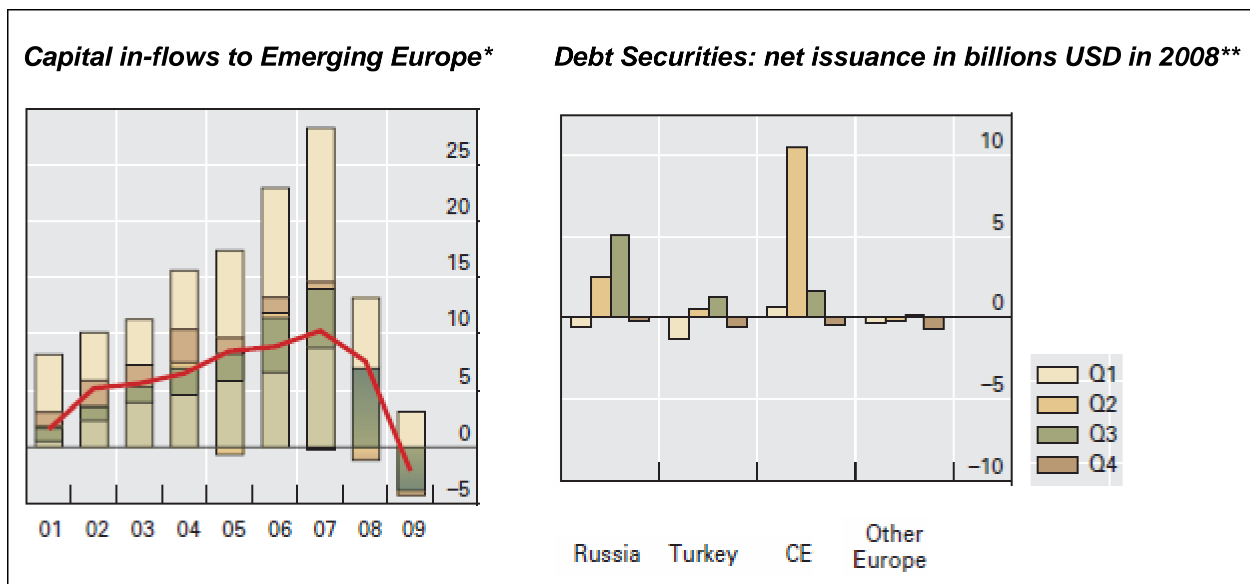
From 2001 to the first half of 2008, emerging Europe experienced high volumes of capital inflow, rapid expansion in investment and consumption, as well as a credit boom through strong external indebtedness of the private sector. Most of the emerging European economies debt was denominated in foreign currencies; therefore strong depreciations of domestic currencies made creditor banks, corporate and household borrowers even more vulnerable.

Foreign Direct Investments

The FDI flows to emerging market economies in particular Asia and Latin America, were more stable than other classes of capital. However, the behavior of FDI flows into emerging Europe raised concerns. With FDI growth reaching its peak in 2007 yet remaining attractive despite previous financial crises, FDI into Central and Eastern Europe and the CIS states strongly decreased for first time in 2009.

One of the reasons cited is that 30% of FDI was related to M&A activities which were often financed by funding from international banks. This is justified based on the issuance data of syndicated loans which significantly decreased in 2009. Another factor which contributed to a sharp decline in FDI, especially in the Czech Republic and Poland, has been withdrawal of funding by international banks in order to overcome liquidity shortages in their domestic markets.

Distressed market conditions - following their path from advanced to emerging economies - put further pressure on emerging European markets, resulted in limited availability of external finance and rising costs. Additionally, a strong decline in private equity inflows, a weakening of domestic currencies, rising spreads on sovereign debt and rising bond yields were all seen as well.
Primary issuance of debt reached its bottom in international markets while secondary trading of emerging markets bonds was significantly reduced even for sovereigns.



Source: BIS 79th Annual Report

- foreign direct investments
- debt
- equity
- to banks
- to non-bank private sector
- net private equity inflows as % of GDP

* ***Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Turkey***

** ***CE: The Czech Republic, Hungary, Poland and Slovakia***

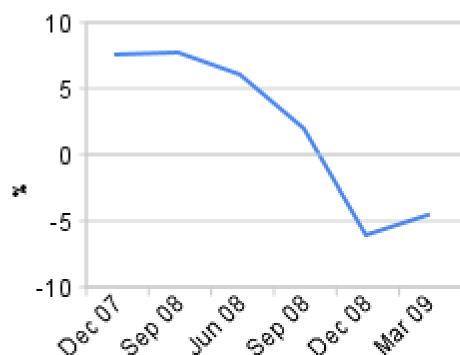
Other Europe: Bulgaria, Croatia, Estonia, Latvia, Lithuania, Romania and Serbia

The crisis arrived to CE countries (Czech Republic, Poland, Hungary and Slovakia) only in third quarter of 2008 and significantly worsened in last quarter of 2008. In the case of Hungary there was no bidder for governmental bond auctions in October 2008. This example clearly expresses the concerns and doubts of investors on Hungary's ability to meets its external financing commitments.

Cross-Border and Local Lending

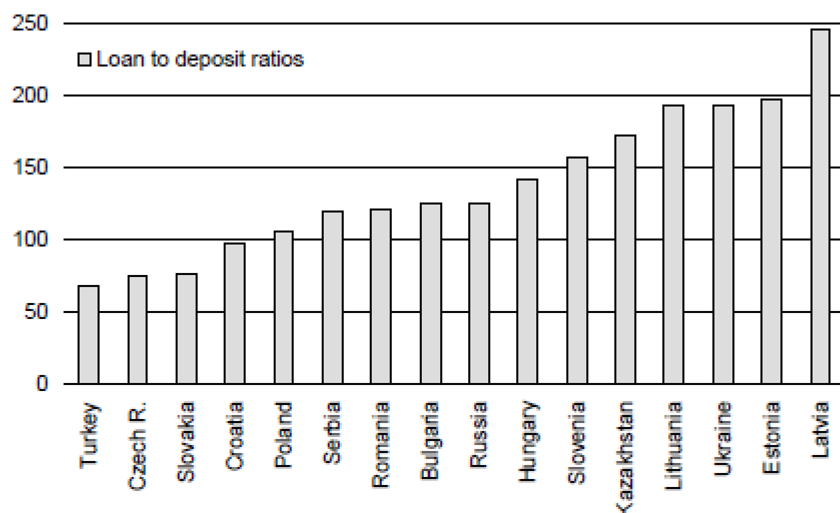
The financial crisis worsened once investors, in particular non-residents, started to withdraw funds from domestic bond markets in the CEE region and invest them into more liquid foreign securities. Another factor which significantly limited the ability of emerging European corporations to borrow in international markets was the reversal in cross-border lending.

Cross-border bank lending



According to the Bank of International Settlement, banks from advanced economies significantly reduced their cross-border lending activity to emerging markets by USD 205bn in the last quarter of 2008 by limiting their exposures to all sectors of the economy and in particular to banks. A sharp decline in cross-border bank lending in Europe pushed domestic corporate borrowers to borrow in local markets instead.

The question of interest is whether local markets have the capacity to provide capital needed and how much should local lending increase if all external borrowings were shifted to local banks. This is measured by relating non-bank cross-border borrowings to banks' domestic lending. The ratio reached 30% at the end of 2008, suggesting banks' lending would have to rise by 1/3. The ability of local banks to boost its lending volume remains limited as they currently moderate the lending in order to reduce loan to deposit ratios which reached over 100% in most of CEE region.



Source: Fitch and UniCredit

The financial crisis of the last 18 months left a negative impact on many countries within the CEE. Being cut off from credit on one hand and equity flows on another, the region suffered a strong cyclical downturn resulting in a significant decline in output in 2009. Although region's output will outperform the output of advanced economies, the outlook for 2010 remains challenging compared to other emerging economies.

Emerging Economies Global Output Growth
Percentage change over previous year

	2007	*2008*	*2009f*	*21010f*
Emerging Europe	**6.5**	**4.0**	**-6.8**	**2.8**
Russia	8.1	5.6	-9.0	2.5
Turkey	4.7	0.9	-6.3	4.0
Latin America	5.4	4.0	-2.4	3.9
Argentina	8.7	7.0	-2.4	3.9
Brazil	5.7	5.1	-0.2	4.3
Mexico	3.3	1.4	-6.9	4.4
Asia/Pacific	9.9	7.0	5.8	8.2
China	13.0	9.0	8.5	10.0
India	9.0	6.7	6.0	8.0
Africa/Middle East	5.1	5.1	0.0	3.4
South Africa	5.1	3.1	-1.9	2.6
Emerging Economies	**7.7**	**5.5**	**0.7**	**5.7**

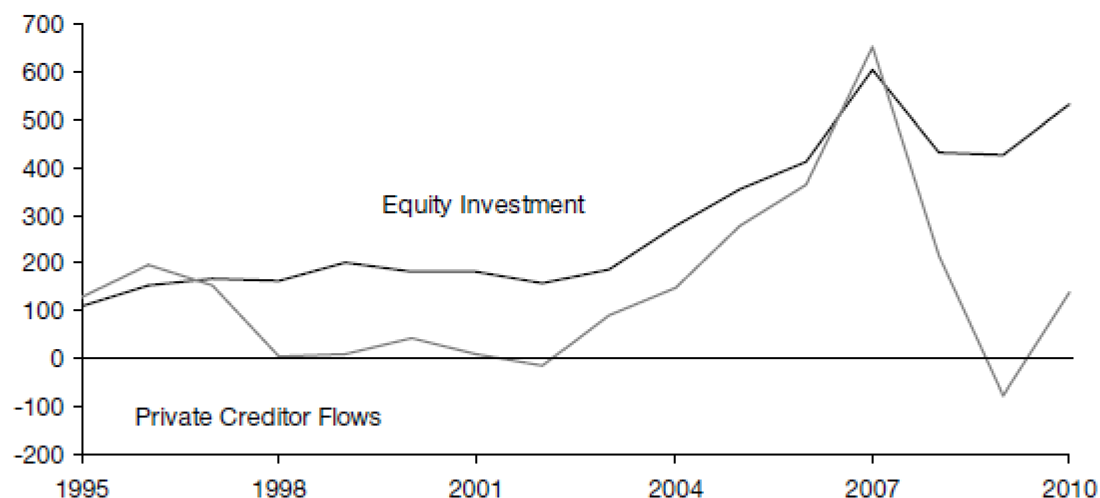
Source: Institute of International Finance, Capital Flows to Emerging Market Economies

Trends in Capital In-Flows

Severity of financial crisis was characterized by unprecedented slowdown of global economic activity, therefore exact assessments on how and what amounts of private capital inflows will go to emerging markets in coming years is highly uncertain. However, the Institute of International Finance projects strong increase in equity investments over debt to all emerging market economies.

The data from pre-crisis capital flows to emerging markets was strongly dominated by rapid growth in commercial bank lending; **the post-crisis capital inflows will shift to more equity dominated inflows leading to an important shift in the debt-equity mix for emerging economies' external financing**.

USD billions



Source: Institute of International Finance, Capital Flows to Emerging Market Economies

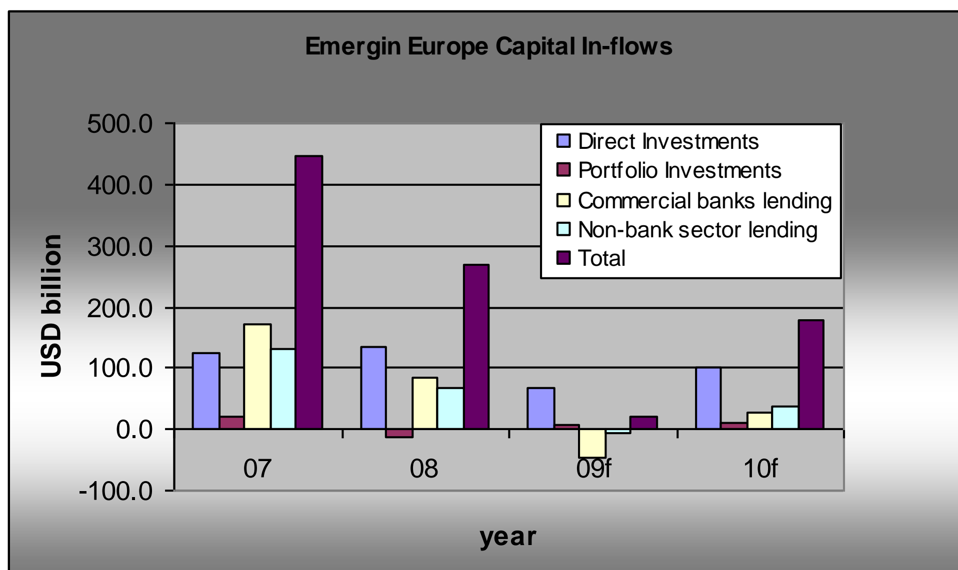
Although emerging Europe absorbed drastic losses from the sharpest decrease in net in-flows in 2009, it will benefit from the strongest net improvement in 2010. Total private capital in-flows to the region are forecasted to reach USD 179.3 billion; USD 112.9 billion will be equity based investments.

Private Capital Flows to Emerging Economies
USD billion

	2007	*2008*	*2009f*	*21010f*
Latin America	228.9	132.4	99.8	150.9
Emerging Europe	**445.7**	**270.1**	**20.4**	**179.3**
Africa/Middle East	155.4	75.3	37.4	68.7
Emerging Asia	442.2	171.2	191.1	272.9

Source: Institute of International Finance, Capital Flows to Emerging Market Economies

In case of emerging Europe, the projected equity based capital flows will increase from USD 74.8 billion in 2009 to USD 112.9 billion in 2010 while credit volume is expected to reach USD 66.4 in 2010 billion from USD -54.4 billion as of 2009.The contribution of commercial banks to the local capital supply is anticipated to be meager 16% comparing to approx. 40% as of 2007.



Emerging Europe's external financing will be strongly dominated by equity in 2010. Among equity in-flows, direct investment will outperform all other capital types and will almost reach its pre-crisis level. This cannot be concluded about banking sector which shows very moderate recovery in 2010 while remaining far behind its pre-crisis level. This is in particular the case for those countries where commercial banks' loan-to deposit ratio reached more than 100%.

The growing role of emerging economies as capital exporters is clearly seen in the case of China and the US whereas capital flows tend to go uphill – from developing economies to developed economies. The situation in Europe follows a different path whereby capital flows downhill from rich to poor countries, providing the opportunity to boost the region's growth and consumption. The tighter the integration within Europe the higher the volume of cross-border capital in-flows. This allowed investors and lenders to diversify their financial risks while earning higher yields.

During the pre-crisis period, cheap capital (USD) passed over emerging Europe and market share of foreign banks heavily increased while loan-to deposit ratios skyrocketed. Since credit supply to bank and non-bank sectors in many CEE countries was denominated in foreign currency, this brought greater vulnerability to the region once domestic currencies devalued resulting in a higher rate of non-performing loans.

Although the lending ability of commercial banks is expected to recover in 2010, the volume will likely differ from pre-crisis levels. Stricter regulation on capital requirements has been imposed by the Bank of International Settlements (BIS). Accordingly, the moderate lending activity by commercial banks in order to decrease high loan-to-deposit ratios will not allow for sufficient credit supply to return to the region for at least the next two years. Therefore the region is forecasted to see its strongest debt to equity rotation in 2010 with direct investment expected to double.

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