

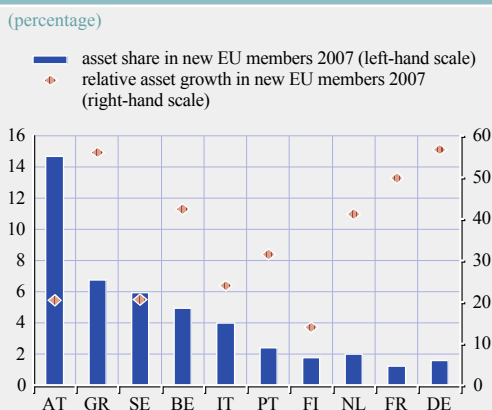
Box 2

RISKS TO FINANCIAL STABILITY FROM NEW EU MEMBER STATES

Following a period of buoyant economic activity, which was also associated with the build-up of some financial imbalances, macroeconomic conditions in many new EU Member States deteriorated in the first half of 2008, albeit with marked differences across individual countries. Furthermore, in October 2008 financial markets in some central and eastern European (CEE) countries also suffered from heightened risk aversion as concerns about the negative macroeconomic impact of the financial turmoil spread to emerging markets. In view of the strong financial links between different parts of the EU, this also served as a reminder of the importance of channels for potential contagion between banking sectors in the euro area and those in the new Member States. Against this background, this box explores the extent to which the remote possibility of severe and prolonged macroeconomic stress in the new EU Member States could give rise to risks to euro area financial stability. The findings presented here are that the risks for euro area financial stability from adverse developments in new EU Member States are unlikely to cause systemic stress in the euro area banking sector. However, some euro area banks with sizeable exposures to new EU Member States could face a significant slowdown of their earnings growth in the event of a sharper-than-expected downturn in host countries.

On average, cross-border exposures of banks in euro area and non-euro area EU countries vis-à-vis new EU Member States are relatively contained, but vary significantly across different banking systems. In relative terms, the share of assets in new EU Member States was just above 3.3% of total assets in 2007 (see Chart A). Looking at individual countries, this share was the highest for banks in Austria (around 14%), Greece (6%), Sweden (6%), Belgium and Italy (both around 4%), while other euro area countries were exposed less. Despite this fact, new EU Member States recently presented a growth opportunity for euro area banking sector. On average in 2007, the growth of euro area banks' assets in this region was 35 percentage points higher than their total asset growth (see Chart A).

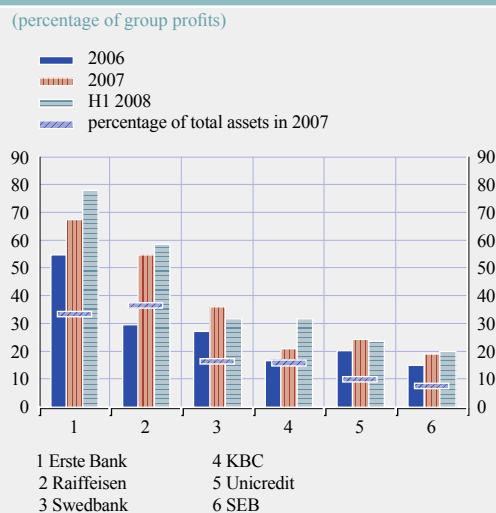
Chart A Asset share of EU banks' subsidiaries in new EU Member States and relative asset growth in 2007



Sources: BIS, BSC and ECB calculations.

The country-level figures on asset shares could mask significant differences across individual banks. Furthermore, given the higher profit margins that can be realised in the banking markets of new EU Member States, the contribution of subsidiaries in the new EU Member States to group profits can be more substantial. Indeed, for the sample of large euro area banks and non-euro area EU banks which are most active in this region, the share of assets in new EU Member States in 2007 ranged between 7.5% and 36.5%, while the share of profits varied between 20% and 78.1% (see Chart B). This suggests that some large banks that are active in the region could be negatively affected in a scenario involving a possibly sharp deterioration in macroeconomic conditions in new EU members, which would cause higher delinquency rates and defaults on corporate and household loans in these countries.

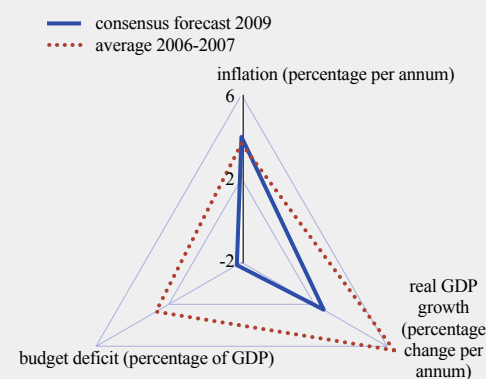
Chart B Contribution of selected EU banks' subsidiaries in the new EU Member States to the profits of selected EU banking groups



Sources: Individual institutions' financial reports and ECB calculations.
 Note: In some cases, these figures also include the contribution of subsidiaries in non-EU countries (e.g. in countries of south-eastern Europe).

Against this background, adverse developments in new EU Member States could pose downside risks to the earnings growth of some euro area banks, in particular if the asset quality in this area deteriorates significantly, which could cause a sharper-than-expected increase in loan impairment charges. It is important to note that, for the region as a whole, the central scenario implies a substantial deterioration of macroeconomic conditions in 2009, as projected by market participants (see Chart C). Downside risks to growth have increased in most EU Member States of central and eastern Europe, owing to the prospect of declining export growth on account of a possible significant slowdown in euro area economies, a correction in some property markets and tightening credit conditions, with the latter partly due to increased funding difficulties. It should be noted that large differences exist between different parts of the CEE region as some new EU Member States have experienced a significant economic slowdown, while economic activity has remained relatively strong in many other CEE countries.

Chart C Macroeconomic developments and forecasts for new EU Member States



Sources: ECB and Consensus Economics.

The earnings prospects of banking groups active in this region will depend on the country-specific outlook. Given the deceleration of economic growth in the first half of 2008 and a significant correction of the housing markets, non-performing loan ratios have started to increase in some new EU Member States, albeit from a low level. In the face of a deterioration in loan quality, some euro area

and non-euro area parent banks had to significantly increase the loan impairment charges in their new EU Member State operations in the first half of 2008. This notwithstanding, the share of profits from operations in the new EU Member States remained stable or even increased for a number of banks in the first half of 2008.

However, those cross-border banking groups that are most exposed to the new EU Member States could face increasing earnings risks going forward if macroeconomic conditions in the host countries were to deteriorate significantly. In particular, banks that generate a substantial share of their profits from this region could see the contribution of operations in the new EU Member States to group profits decreasing due to slowing growth of operating income and increasing loan impairment charges.

Overall, exposures of the euro area banking system to new EU members are relatively contained, but vary greatly across different euro area banking sectors and institutions. In particular, some euro area banks derive a substantial proportion of their profits from their CEE operations, and could thus see their earnings growth slow considerably in the event of a sharper-than-expected downturn in host countries. Therefore, while risks stemming from banking operations in new Member States are unlikely to cause systemic stress in the euro area, they could – if coupled with other types of risk (liquidity risks and/or turmoil-related risks) – contribute to deeper systemic stress in the euro area financial sector. In this context, policies aimed at adjusting macroeconomic imbalances and addressing liquidity stresses are considered an important prerequisite for improving the access of financial intermediaries in the new Member States to funding markets and thereby mitigating risks to financial and macroeconomic stability in individual new Member States as well as their relevance for euro area financial stability.