

Fragile Post-Recession Recovery

Industrialized Countries: Modest Economic Downturn Forecast for 2011

The IMF economic outlook for fall 2010 projects economic growth in the *industrialized countries* to be relatively robust in 2010, following the severe slump in 2009. Growth is currently being fueled by buoyant economic activity in Asia and the recovery of world trade, among other factors. Compared with the IMF's World Economic Outlook released in spring 2010, GDP growth for 2010 was revised down by 0.5 percentage points for the U.S.A. and up by 0.7 percentage points for the euro area. The IMF forecast of fall 2010 expects a modest slowdown in growth in the industrialized countries for 2011.

In the *U.S.A.*, real GDP in the third quarter of 2010 grew by 0.6% on the previous quarter (Q1 10: +0.9%, Q2 10: +0.4%), i.e. +3.2% year on year. In the third quarter of 2010, private consumption, private corporate investment, inventory changes and

public sector demand (consumption and investment) made a substantial contribution to quarterly growth while net exports and private residential investment provided a significantly negative contribution. The residential real estate market is recovering only at a sluggish pace. The Case-Shiller price index for single-family homes is volatile, and the number of nonperforming mortgage loans is still high. In September 2010, the jobless rate remained unchanged at 9.6% and is not expected to improve significantly by end-2011. Inflation has been visibly easing since early 2010. In September 2010, the annual change in CPI and the core inflation rate were 1.1% and 0.8%, respectively. In October 2010, the IMF projected a rise in annual average CPI of 1.4% (2010) and 1% (2011). At its meeting of September 21, 2010, the U.S. Federal Reserve's Open Market Committee (FOMC) left the target range for the federal funds rate unchanged at close to 0%. It also announced it would leave the federal funds rate "at its current level for an ex-

Table 1

IMF and OeNB Economic Outlook: Industrialized Countries

	Real GDP				CPI				Current Account Balance			
	2008	2009	2010 ¹	2011 ¹	2008	2009	2010 ¹	2011 ¹	2008	2009	2010 ¹	2011 ¹
	Annual change, %				Change of annual average, %				% of GDP			
Industrialized countries	0.2	-3.2	2.7	2.2	3.4	0.1	1.4	1.3	-1.2	-0.3	-0.3	-0.1
U.S.A.	0.0	-2.6	2.6	2.3	3.8	-0.3	1.4	1.0	-4.7	-2.7	-3.2	-2.6
Euro area	0.5	-4.1	1.7	1.5	3.3	0.3	1.6	1.5	-0.7	-0.4	0.2	0.5
Germany	1.0	-4.7	3.3	2.0	2.8	0.2	1.3	1.4	6.7	4.9	6.1	5.8
France	0.1	-2.5	1.6	1.6	3.2	0.1	1.6	1.6	-1.9	-1.9	-1.8	-1.8
Italy	-1.3	-5.0	1.0	1.0	3.5	0.8	1.6	1.7	-3.4	-3.2	-2.9	-2.7
Spain	0.9	-3.7	-0.3	0.7	4.1	-0.2	1.5	1.1	-9.7	-5.5	-5.2	-4.8
Austria	2.2	-3.9	1.6	1.6	3.2	0.4	1.5	1.7	3.3	2.3	2.3	2.4
Austria ²	1.9	-3.7	1.9	2.1	3.2	0.4	1.7	2.2	4.9	2.9	2.5	3.4
United Kingdom	-0.1	-4.9	1.7	2.0	3.6	2.1	3.1	2.5	-1.6	-1.1	-2.2	-2.0
Japan	-1.2	-5.2	2.8	1.5	1.4	-1.4	-1.0	-0.3	3.2	2.8	3.1	2.3

Source: IMF (World Economic Outlook), October 2010, OeNB.

¹ Forecast.

² OeNB Forecast, December 2010.

tended period” and support the recovery by purchasing further government bonds, if necessary.

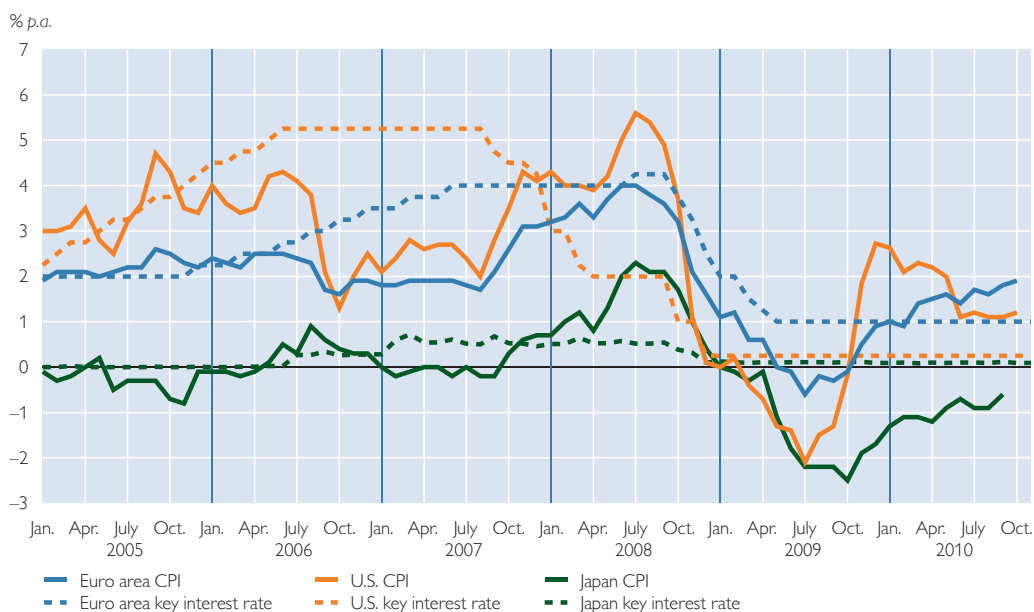
In the *euro area*, real GDP in the third quarter of 2010 grew by 0.4% on the previous quarter (Q1 10: +0.3%, Q2 10: +1.0%), i.e. +1.9% year on year. In the second quarter of 2010, above all exports and gross fixed capital formation made a positive contribution to quarterly growth while private consumption grew at a very sluggish pace. Within the euro area, the countries registering the highest quarterly growth rates were Finland (1.3%), Austria and Slovakia (0.9%, each), as well as Germany (0.7%). By contrast, Greece suffered a drop in GDP of 1.1% on a quarterly basis. Data for Ireland, Luxembourg, Malta and Slovenia were still unavailable at the cutoff date. The HICP inflation rate climbed from 1.0% in early 2010 to 1.8% in September 2010, primarily owing to considerably higher energy prices on a year-on-year

basis. However, core inflation (excluding energy and unprocessed foods) remained unchanged at 1.0% in September 2010. In October 2010, the IMF projected equally low HICP inflation for 2011. The Governing Council of the ECB left key interest rates unchanged at 1.0% in early October 2010, but at the same time began to gradually reduce the crisis-induced liquidity provision for commercial banks. One-year tenders expired in October 2010.

The *Japanese* economy in the third quarter of 2010 grew by 0.9% on the previous quarter (Q1 10: 1.6%, Q2 10: 0.4%). In the third quarter of 2010, quarterly growth was generated primarily by private consumption while the contribution of net exports to growth further declined to zero, consistent with the strength of the Japanese yen. In August 2010, annual inflation stood at -0.9% . Deflation is expected to persist until 2011. In September 2010, the Bank of Japan inter-

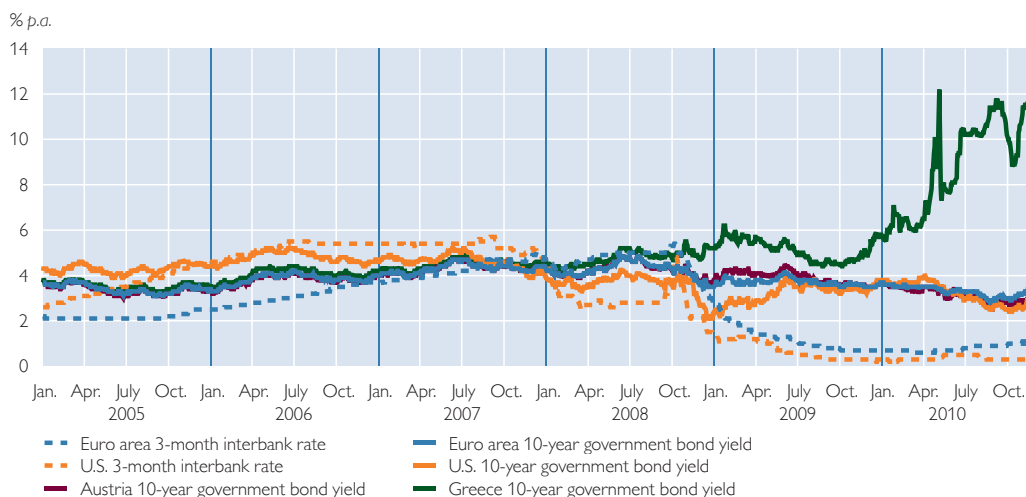
Chart 1

Euro Area, U.S.A., Japan: Inflation and Key Interest Rates



Source: Eurostat, national statistical offices, Thomson Reuters, OeNB.

Euro Area and U.S.A.: 3-Month Money Market Rates and 10-Year Government Bond Yields



Source: Thomson Reuters, OeNB.

vened in foreign exchange markets to curb the appreciation of the Japanese yen. In early October 2010, it pursued further monetary policy easing, launching securities purchase programs.

In the U.S. and euro area *money markets*, LIBOR and EURIBOR interest rates have stabilized at a low level since fall 2009. Risk premiums in the U.S. money market remained below those in the euro area. In the *government bond markets*, long-term interest rates fell by approximately 0.5 percentage points between the start of the year and November 2010. However, some differentials in 10-year government bond yields between Germany and other euro area countries again widened significantly. In early September 2010, risk premiums briefly came close to reaching the record levels of May 2010 when the rescue package for Greece was set in place. As financial markets perceive a debt restructuring risk of euro area countries with high sovereign debt, the euro area countries created the European Financial Stability Facility (EFSF) of EUR 440 billion

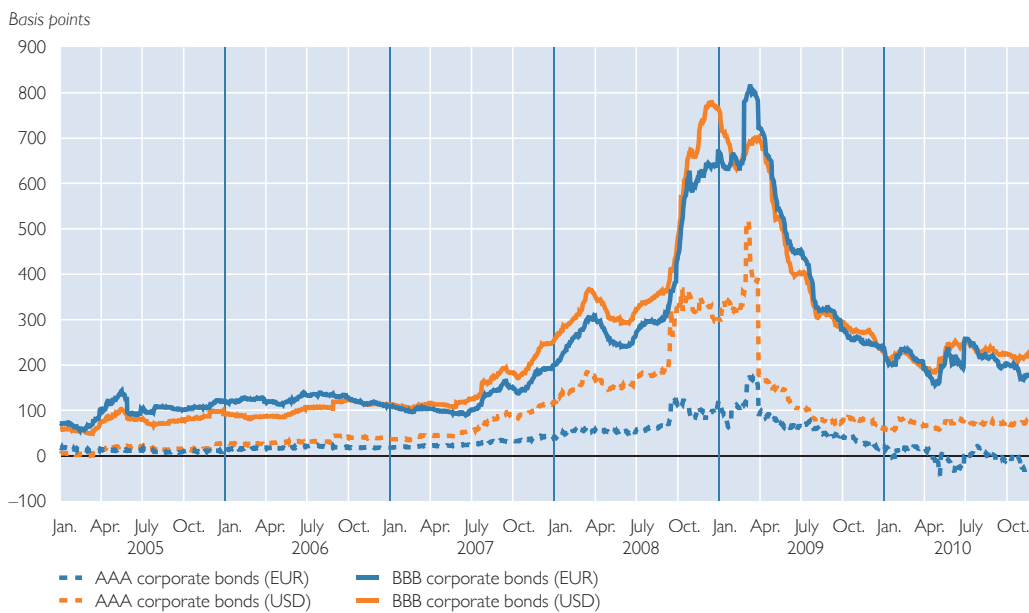
in early May 2010, guaranteed by euro area countries. In addition, the ECB and the national central banks of the euro area have carried out euro area government bond purchases since May 10, 2010. The ratification of the EFSF and a triple A rating assignment to the EFSF helped narrow spreads by mid-October 2010. In addition, the announcement that in Greece, the stringent saving requirements have largely been fulfilled so far despite continued recession, and the fact that the fiscal consolidation programs in Ireland, Portugal and Spain were expanded, are likely to have contributed to the reduction in the spreads. After the disclosure of including the bank bailout costs in the current government budget deficit had briefly interrupted the narrowing of government bond spreads in Ireland in early October 2010, spreads declined further until mid-October. Thereafter, however, fears of an additional recapitalization requirement for now nationalized Irish banks, statements about the potential (future) involvement of private creditors in reducing government

debt and, last but not least, the Irish government's hesitation to accept international support, resulted in the spreads re-widening by a large margin.

Only the emergence of an EU/IMF rescue package led to a narrowing of the spreads, which nonetheless widened again owing to uncertainty about

Chart 3

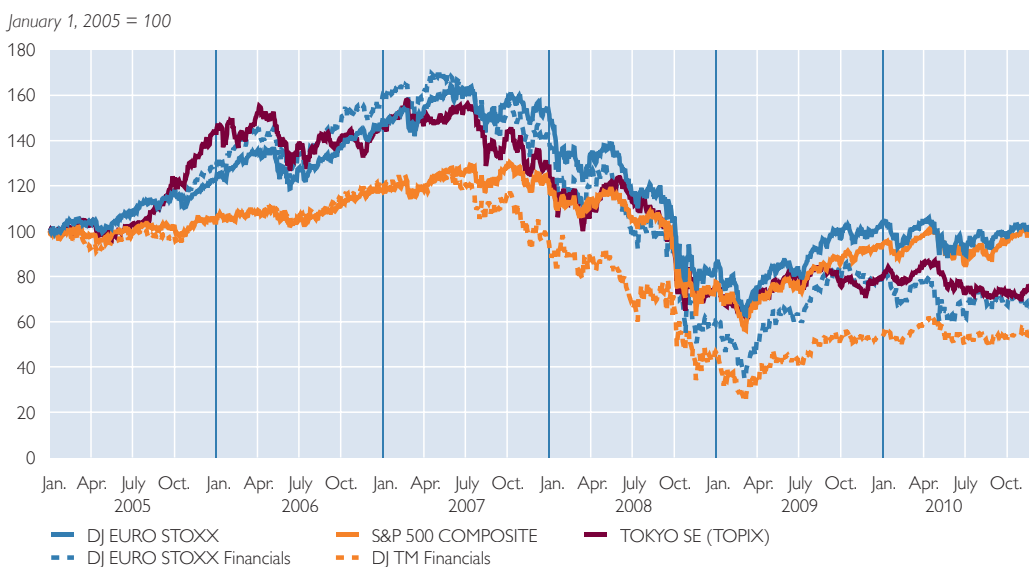
**Euro Area and U.S.A.:
Spreads of 7-Year to 10-Year Corporate Bonds against Government Bonds**



Source: Thomson Reuters, OeNB.

Chart 4

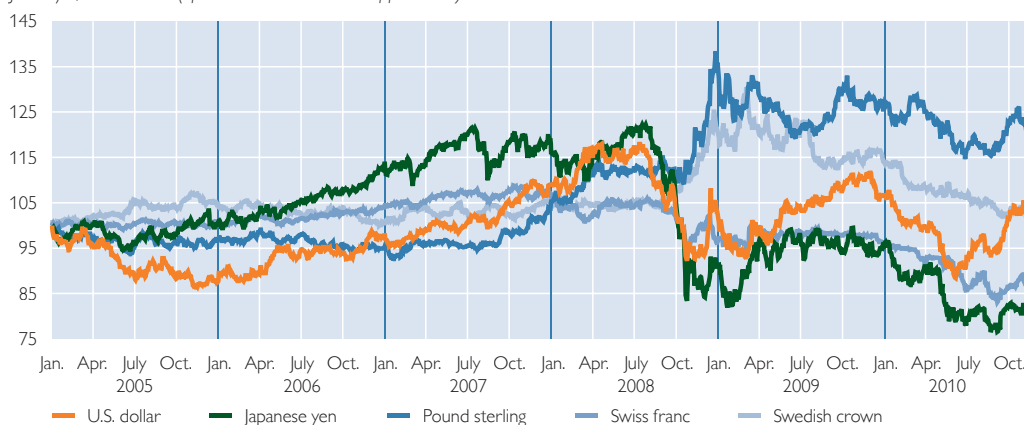
**Euro Area, U.S.A. and Japan:
Stock Market Indices and Subindices for Financial Institution Stocks**



Source: Thomson Reuters, OeNB.

Industrialized Countries: Exchange Rates against the Euro

January 1, 2005 = 100 (upward movement = euro appreciation)



Source: Thomson Reuters, OeNB.

Note: National currency per euro unit.

whether there was enough political support in Ireland for this bailout route.

The yield spreads of *corporate bonds* in the U.S.A. and the euro area registered only relatively moderate fluctuations in 2010, which were smaller for AAA bonds than for BBB bonds. Generally, corporate bond spreads in the euro area were lower than their U.S. counterparts.

Following the *equity markets'* global recovery since their low in March 2009, they have since early 2010 fluctuated around the values attained at that time. Corporate financial results, outlooks for the U.S. and EU economies, as well as announcements of stabilization measures in the euro area, were key factors influencing equity market developments.

In the *foreign exchange* markets, the euro has firmed against other major currencies since early September 2010, recouping most of its losses suffered since the start of the year. This was attributable not only to measures for ensuring the sustainability of public debt in certain euro area countries, but also to somewhat better-than-expected GDP growth in the euro area.

CESEE Compared with Other Emerging Markets

After contracting by 0.6% in 2009, the *global economy* is likely to have expanded by almost 5% in 2010, i.e. about its average growth rate in the period from 2004 to 2007 and about 0.5 percentage points higher than expected in spring 2010. For 2011, the IMF projected growth of just over 4%. Compared with its 2010 spring forecast, the IMF revised its 2010 fall outlook for all emerging markets up by 0.7 percentage points to just over 7%, leaving its outlook for 2011 unchanged at some 6.5%. This upgrade was particularly marked in the following regions: Latin America (+1.7 percentage points), Asia (+0.7 percentage points) and Central, Eastern and Southeastern Europe (CESEE, here: excluding CIS) (+1 percentage point). The CESEE and Asia upward revisions were made in parallel with those for the euro area and Japan. Of all world regions (including the industrialized countries), Asian emerging markets will continue to make the largest contribution to global GDP growth. Emerging Asia's GDP growth of almost 9.5% in 2010 also

fostered global commodity exports and thus growth in other emerging market regions such as the CIS, in particular. In both Asia and Latin America, growth driven in 2009 by extensive stimulus measures based on macroeconomically sound initial fundamentals has already been fueled substantially by private domestic demand in 2010. Therefore, several of this region's major economies began to ease their stimulus policy as early as in mid-2010. Taking this into account and the anticipated slowdown of economic growth in the industrialized countries (especially, Japan), the IMF expects growth will decline in Asia and Latin America in 2011. Since the dampening of global growth momentum will not, however, be so marked as to send energy and commodity prices tumbling, GDP growth in the Middle East and North Africa, Sub-Saharan Africa and CIS is not likely to be hit in 2011. In CESEE, the modest growth slowdown in the euro area,

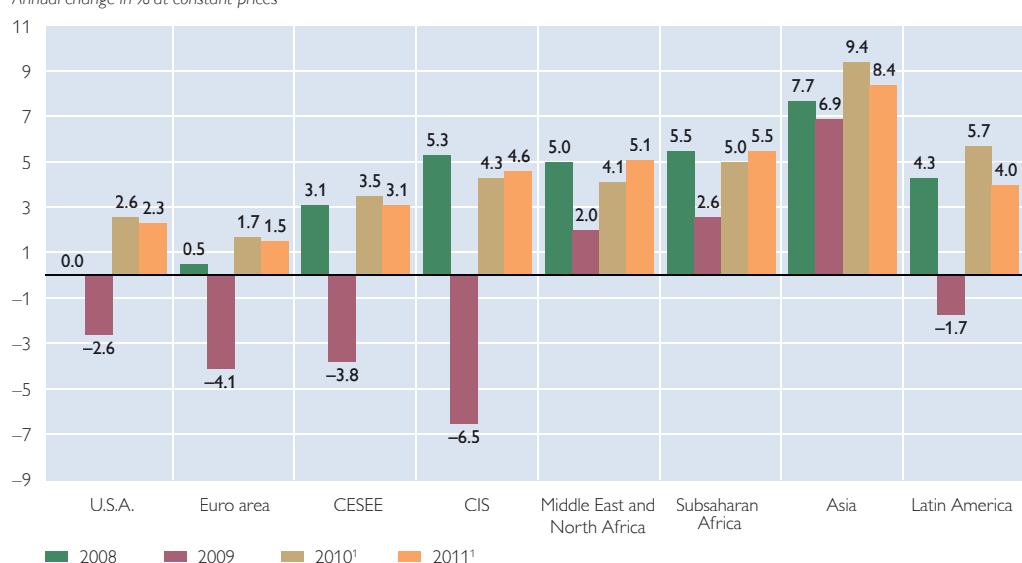
which is primarily hampering CESEE exports of industrialized goods, is likely to be offset by the now incipient recovery of domestic demand in most of the region's countries. The decline in the CESEE aggregate is solely due to the anticipated slowdown in currently high growth in Turkey.

In line with the shift to more domestic demand-led growth, the *current account* surplus of Asian emerging markets is likely to have further decreased in 2010. By contrast, the current account surpluses of the Middle East and North Africa, as well as the CIS region, increased on the back of rising energy and commodity prices, although falling short of pre-crisis levels. In CESEE, where in 2009 imports fell and the current account deficit contracted particularly sharply owing to the export slump and the dissipation of domestic demand growth, the deficit is likely to have increased modestly in 2010. In each region, net FDI inflows

Chart 6

Emerging Economies and Selected Industrialized Countries: GDP Forecast

Annual change in % at constant prices

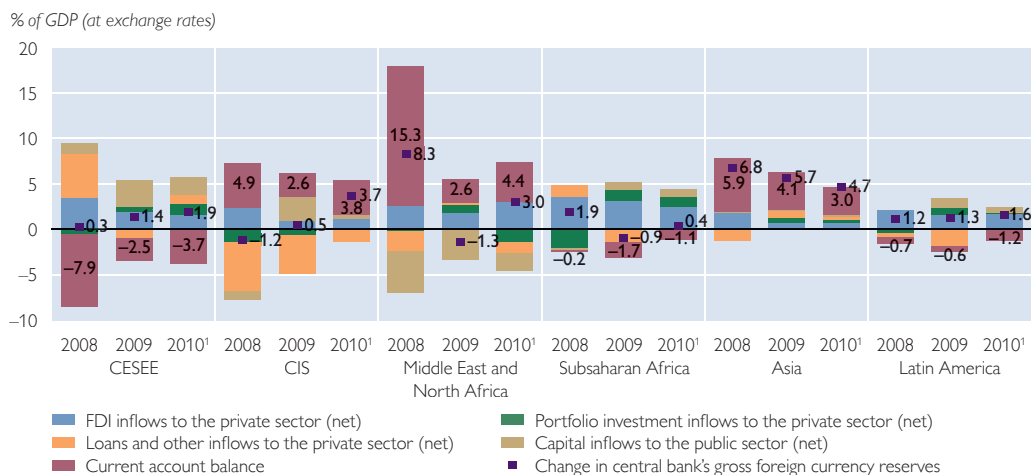


Source: IMF (World Economic Outlook), October 2010.

¹ Forecast.

Note: CESEE excluding European CIS countries. Asia excluding (newly) industrialized countries. Latin America including Caribbean countries.

Emerging Markets: Current Account Balances and Net Capital Inflows



Source: IMF, OeNB.

¹ IMF Forecast.

Note: Negative net capital inflows (to the public sector) refer to net capital outflows from the public sector (to industrialized countries). Positive values for the change in official gross reserves indicate an increase. CESEE excluding European CIS countries, the Czech Republic, Slovakia and Slovenia. Asia excluding South Korea, Taiwan, Hong Kong and Singapore.

were the key components of net capital flows to the private sector in 2010. In Latin America and in Subsaharan Africa, they have also been sufficient to cover moderate current account deficits. In CESEE, they are likely to have financed less than 50% of the current account deficit. Here, net capital inflow to the public sector, which was connected with the disbursements under the IMF/EU programs and the issuance of sovereign Eurobonds, was higher than in the other regions. In 2010, as in the two previous years, the CIS is the only region that seems to have experienced net capital outflows from the private sector, albeit (as in 2008) to a degree that is smaller than the current account surplus. These outflows originated from capital movements in the area of cross-border credit. By contrast, CESEE is likely to have witnessed a net inflow in this area in 2010 after registering net outflows in 2009. This inflow was far higher

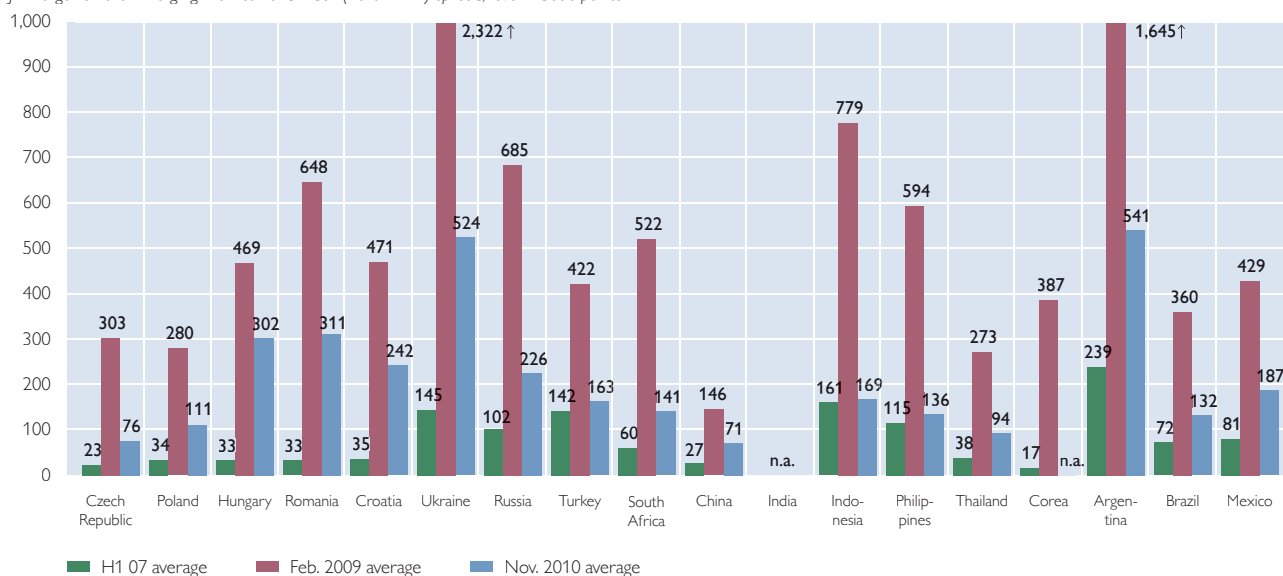
than in other regions although some of these (Latin America, Subsaharan Africa) had also registered outflows in 2009.

*Consolidated cross-border credit claims on private nonbanks in emerging markets by BIS reporting banks,*¹ which are largely from industrialized countries, had expanded at a particularly vigorous pace in the CIS by September 2008. Its growth in the Middle East and North Africa and, to a lesser extent, in CESEE had also been above-average. The slump in consolidated cross-border claims on private nonbanks seen afterwards – in the period up to end-2009 – was steepest in the CIS, and CESEE and Latin America also witnessed a modest decline in this respect. In the second half of 2009, only the CIS registered a further drop. In the first half of 2010, Asian emerging markets registered a sharp rise in consolidated claims on private nonbanks. Latin America, as well as the Middle East and North

¹ Excluding credit claims on offshore financial centers.

Emerging Markets: Spreads of Government Bonds Issued Abroad in Foreign Currency

JP Morgan's Euro Emerging Market Bond Index (Euro EMBI) spread, level in basis points



Source: Bloomberg, Thomson Reuters, OeNB.

Note: Spreads refer to yield differentials vis-à-vis euro area government bonds of the same maturity. For Russia, Indonesia and Argentina: (USD-based) EMBI and U.S. government bonds; for the Czech Republic, Korea and Thailand: 5-year CDS premiums serve as a proxy.

Africa regions, experienced a similar phenomenon, albeit on a far smaller scale, while claims on CESEE stagnated.

In the *financial markets (equity markets, international bond markets) of emerging economies*, the decrease in international investors' risk aversion, the low interest rates in industrialized countries, widening interest rate gaps, and projected growth and currency appreciation in many emerging markets, resulted in strong net inflows in 2010. According to the IMF, emerging markets accounted for more than 50% of total global equity issues in the first half of 2010, with a high share of issuers hailing from Asia. In addition, total international bonds issued by issuers from emerging markets (with a significant share from – mostly sovereign – issuers

from CESEE and the CIS) exceeded the volume of corporate bonds issued in industrialized countries. Moreover, investors increasingly opted for emerging market debt securities denominated in national currency. Uncertainties in the international financial market owing to the fiscal problems of certain euro area countries were reflected only temporarily and to a relatively small extent in the asset performance of emerging markets. Given signs of investors again failing to differentiate properly between risks, the medium-term risks of bubbles, overheating, excessive currency appreciation in emerging markets with an open (fully liberalized) financial account² and both internal and external imbalances are on the rise.

² According to current IMF definitions of the balance of payments, transactions that were previously included under the capital account (e.g. FDI, portfolio investment, loans) are now shown in the financial account.

Varying Pace of Economic Recovery in CESEE³

The economic upturn and gradual financial market recovery continued in CESEE (here: including the European part of the CIS) in the second and third quarters of 2010, albeit at a varying pace. The banking sector reflected this development: With continued high credit risk across the entire region, profits started to largely stabilize in Central Europe while further declining in Southeastern Europe. In the currency markets, countries with a flexible exchange-rate regime mostly suffered modest exchange rate losses against the euro while equity market developments were broadly in line with the corresponding growth outlooks.

For most of the countries under review,⁴ export demand, which had bounced back strongly, was responsible for GDP *growth*. The upsurge in exports triggered inventory changes at the very latest in the second quarter of 2010, making a positive contribution to GDP growth on a 12-month basis, with inventory build-ups accelerating (in most countries) and, in others, inventory rundowns slowing. Only Croatia experienced a slowdown in inventory build-up, which resulted in a negative contribution to growth.

In the second quarter of 2010, GDP growth was strongest in Ukraine (5.9%), Russia (5.2%), Slovakia (4.7%) and Poland (4.0%) on a 12-month basis. Particularly in Ukraine, the country that was hit hardest by the crisis of those under review, the robust growth

rate is also attributable to base effects. In Russia, Ukraine and Poland, private consumption growth accelerated too. In almost each country under review, gross fixed capital formation continued to shrink in the second quarter of 2010 on a 12-month basis. Russia, which registered an increase in gross fixed capital formation of 9%, is the sole exception in this respect. In the region under review, GDP growth in the second quarter of 2010 was weakest in Southeastern Europe: the Bulgarian and Romanian economies stagnated while Croatia's shrank (−2.5%) on a 12-month basis.

Provisional figures for the third quarter of 2010 showed that GDP growth accelerated in the Czech Republic and in Hungary whereas it slowed markedly in Ukraine and Russia, partly owing to weather-induced slumps (losses arising from a record heat wave and drought).

The previously relatively high deficits on the *combined current and capital account*⁵ continued to decrease in the countries of Southeastern Europe. In the four quarters to mid-2010, for instance, the deficits in Croatia, Bulgaria and Romania came to 3.0%, 4.3% and 5.0% of GDP respectively. In Bulgaria's case, this decline corresponded to a correction of almost 13 percentage points, compared with the previous period to mid-2009. In the Central European countries too, the already previously modest current and capital account deficits continued to decrease. Whereas the Czech Republic (−0.3% of GDP), Poland (−0.8%), Slovenia

³ For a detailed description of macroeconomic developments in these countries, see the article "Recent Economic Developments" in the OeNB publication "Focus on European Economic Integration Q4/10".

⁴ The focus of this section is on Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Russia, Slovakia, Slovenia and Ukraine.

⁵ According to current IMF balance of payments definitions, the capital account comprises only a few transactions, including primarily those previously part of the current account (as a component of the transfers balance). Transactions that were previously included under the capital account (e.g. FDI, portfolio investment, loans) are now shown in the financial account.

Chart 9

Current and Capital Account Balance and Its Financing

Moving sum of four quarters in % of GDP of this rolling period



Source: ECB, national central banks, OeNB.

(−1.2%) and Slovakia (−1.9%) showed negative balances, Hungary’s deficit (−3.6% of GDP) turned into a surplus (2.2% of GDP). In Ukraine, the combined current and capital account deficit was reduced from 4.2% to 0.5%. In general, these balance improvements were largely attributable to export growth whereas, in previous quarters, they had primarily resulted from a slump in imports. In Russia, despite the ruble’s appreciation and an increase in domestic and, hence, import demand, the current and capital account surplus continued to grow – to 5.2% – owing to rising oil prices, in particular.

The *financial account* balance was positive in almost all the countries under review in the four quarters to mid-2010 – only Russia showed a slight deficit. In Bulgaria and Ukraine, the financial account’s largest component was (net) FDI whereas its largest component in Slovenia, Poland, Russia and the Czech Republic was (net) portfolio investment, as was “(net) other invest-

ment” (especially, loans) in Slovakia, Hungary, Romania and Croatia. In Bulgaria and Ukraine, portfolio investment and other investment recorded net capital outflows. In Slovenia, Slovakia, Romania and Croatia, net FDI inflows were not enough to cover the (reduced) deficit of the combined current and capital account.

IMF and/or IMF/EU stabilization programs continue to be operative in Hungary (albeit suspended since July 2010), Romania and Ukraine. In Romania, a reform of the pension scheme was essential in paving the way for the release of further disbursements. The IMF therefore transferred its sixth tranche (EUR 0.9 billion) and the EU its third tranche (EUR 1.2 billion). For Ukraine, a new IMF stand-by arrangement (totaling EUR 12.8 billion) has been in place since summer 2010.

The impact of the recession or the slump in growth in 2009 continued to have an adverse effect on *government*

budgets. In 2010, however, budget deficits are unlikely to increase sharply year on year. Hungary is set to have one of the lowest deficits as a result of consolidation measures implemented in 2007–2009. The Hungarian government intends to tackle further budget consolidation over the next three years to a substantial extent by increasing revenues via an increase in taxes in the energy and telecommunications sectors, and via the introduction of a bank levy (in summer 2010). In compliance with the (currently suspended) credit agreement with the IMF and the EU, Hungary's target deficit is 3.8% of GDP for 2010 and less than 3% for 2011. Government debt (as a percentage of GDP) is expected to keep rising in every country under review in 2010, with the smallest increase to be seen in Hungary, where the debt ratio at almost 80% of GDP is nonetheless by far the highest among the countries under review. Government debt is likely to increase the most in Slovakia, Romania and Poland; in the former two, however, this rise will be from a relatively modest base. In Poland, gov-

ernment debt could climb to more than 55% of GDP. In all the EU Member States under review, excessive deficit procedures (EDP) are now in progress. Bulgaria was the last country in this group for which an EDP was opened, due to its deficit revision for 2009.

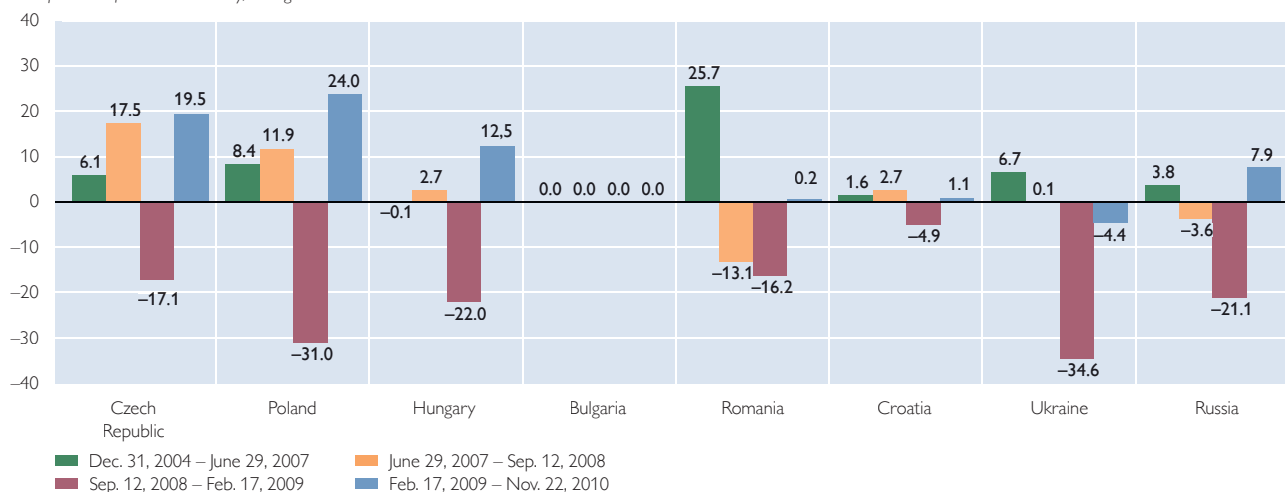
In September 2010, *annual inflation* was much lower than in March this year especially in Ukraine, but also in Hungary and Poland, although it had ticked up again to some extent in August and September. In Ukraine, the latest acceleration resulted from a rise in food and gas prices. Only Bulgaria (rise in food prices partly induced by crop failures in Russia) and Romania (increase in VAT) saw much higher annual inflation in September 2010 than in March this year.

Among the *currencies* of the countries under review which have not yet adopted the euro and do not have a fixed or quasi-fixed currency peg, the Czech koruna was the only currency to (further) appreciate against the reference currency from March to September 2010. Currency depreciation in this period was seen in Romania (−4.1%),

Chart 10

National Currencies and the Euro

Euro per unit of national currency, change in %



Source: Thomson Reuters, OeNB.

Poland (−2.9%), Hungary (−3.6%) and Russia (about −4%). By contrast, the Ukrainian hryvnia remained stable. In September 2010, however, the country's central bank sold foreign exchange (USD 0.6 billion) in a bid to support the currency. Recently approved additional reserves requirements are currently being used for the same purpose. Compared with the historical record lows of February 2009, however, the currencies of the Czech Republic and Poland and, to lesser extent, those of Hungary and Russia appreciated sharply. In September 2010, the Czech koruna was at its pre-crisis levels of mid-September 2008. The Polish zloty, the Hungarian forint, the Romanian lei and the Russian ruble were weaker by some 15% and the Ukrainian hryvnia weaker by about 38%. In September 2010, the Russian central bank widened the trading band of the ruble

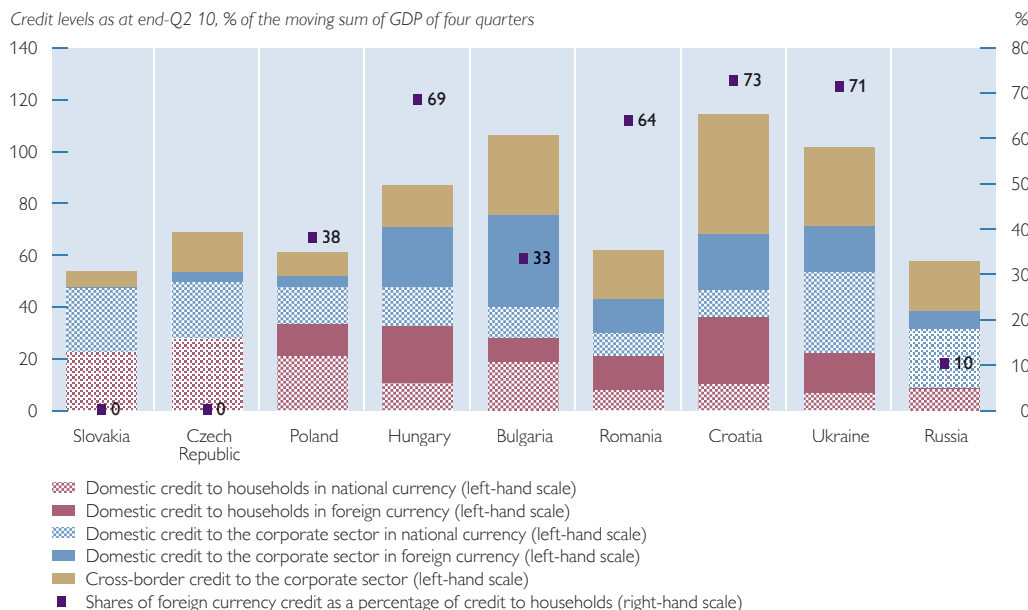
against a basket of currencies to create some scope for further (controlled) appreciation but also to increase the depreciation risk to dampen speculative capital inflows.

In almost all the countries under review, the spreads of *short-term interbank rates* relative to the euro area were down from March to September 2010. Only Croatia saw a slight increase (at a low level). The lowest interest rates were seen in the Czech Republic, Bulgaria and Croatia, followed by Poland and Russia. Yields on *10-year government bonds denominated in national currency* decreased slightly in Slovakia and the Czech Republic, which had the lowest yields to date of the countries under review, between March and September 2010; however, spreads widened owing to the larger yield decline of euro area reference bonds. In the other countries of the group, yields

Chart 11

Outstanding Total (Domestic and Cross-Border) Household and Corporate Credit

Credit levels as at end-Q2 10, % of the moving sum of GDP of four quarters



Source: ECB, Eurostat, national central banks, national statistical offices, OeNB.

Note: Foreign currency credit also includes credit in national currency that is indexed to a foreign currency. Cross-border credit does not include trade credits and intra-company loans. Points refer to the shares of foreign currency credits to households in total credit to households in % (right-hand scale).

were at roughly the same level in September 2010 as in March 2010, which also meant a widening in spreads. In the *equity markets*, most countries under review saw equity price gains. In Croatia and Slovenia, where growth outlooks were subdued, the share price index fell, however.

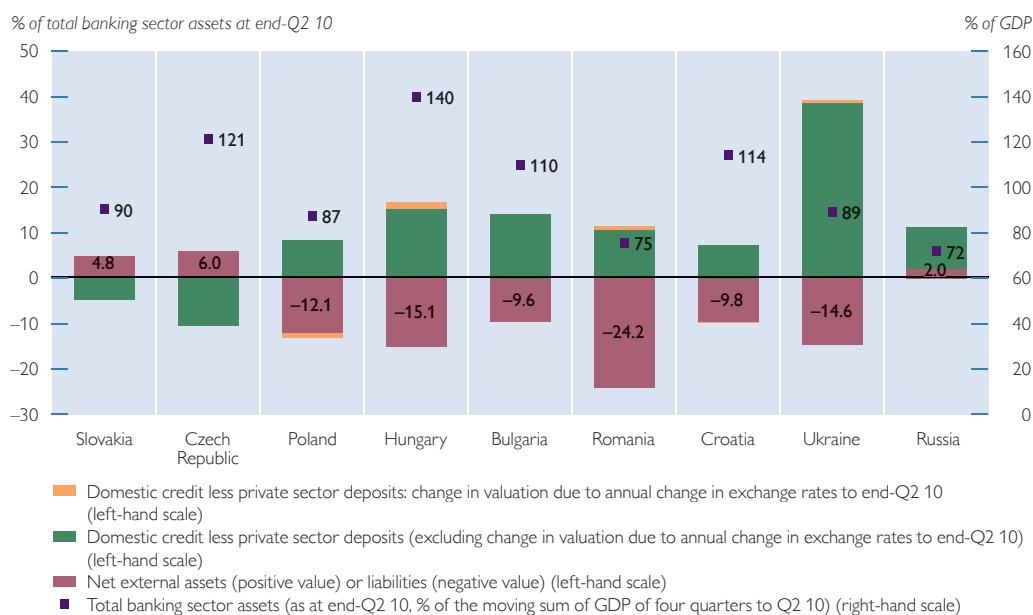
In the *credit markets*, annual exchange rate-adjusted growth in credit to the private sector (households and companies) was in positive single digits in most of the countries under review at mid-2010. In the Czech Republic, Ukraine and Russia, however, the volume of lending stagnated while visibly shrinking in Hungary. Broken down by sector, a (to some extent) very heterogeneous picture emerges. The volume of *outstanding corporate loans* shrank sharply not only in Hungary but also in Slovakia, the Czech Republic and in Poland. (In the Czech Republic and in Hungary, however, this was partly offset by direct foreign cross-

border loans.) By contrast, the volume of *outstanding household loans* shrank markedly only in Ukraine. Overall, Romania, Croatia, Ukraine and Russia saw a more favorable development in corporate lending than in household lending; in the other countries under review, this was the exact reverse.

In Bulgaria, Romania and Croatia, *foreign currency loans (including exchange-rate indexed loans) to households* grew at a rapid pace year on year on a currency-adjusted basis to mid-2010 while the corresponding loans denominated in national currency declined. Foreign currency loans grew modestly in Poland, but the pace was far slower than that of loans denominated in national currency. At some 70%, the *share of foreign currency loans as a percentage of household lending* was still very high in Hungary, Romania, Croatia and Ukraine at the end of the second quarter of 2010. By contrast, total household lending denominated in foreign

Chart 12

Banking Sector: Gap between Loans and Deposits and Net External Liabilities



Source: ECB, Eurostat, national central banks, national statistical offices, OeNB.

currency was very low in the Czech Republic and in Slovakia, as it also was in Russia.

At the end of the second quarter of 2010, *the volume of outstanding domestic loans exceeded that of domestic deposits (in terms of total assets)* in all the countries under review, except for Slovakia and the Czech Republic. In the Ukrainian banking sector, the gap between domestic loans and deposits was particularly wide. In addition, the banking sector's net external liabilities did not cover the entire financing requirement of the domestic credit overhang. The Romanian banking sector had significantly high net external liabilities (mainly to foreign parent banks) at the end of the second quarter of 2010. On a 12-month basis to mid-2010, the overhang of loans to deposits (in terms of total assets) had substantially declined only in Bulgaria, Ukraine and Russia and, in each case, due to both the asset and the liability side. Banking sector total assets ranged between 72% and 90% of GDP in Slovakia, Poland, Romania, Ukraine and Russia, and between 110% and 140% of GDP in the other countries under review.

Credit risk in the banking sector in terms of the *share of nonperforming loans as a percentage of total domestic lending to nonbanks* was still markedly higher at the end of the second quarter of 2010 than before the crisis. The heterogeneous economic recovery across the region will induce an equally varied decline in nonperforming loans. The low level of lending growth makes it difficult to reduce this share. From mid-2009 to mid-2010, the steepest rise in the share of nonperforming

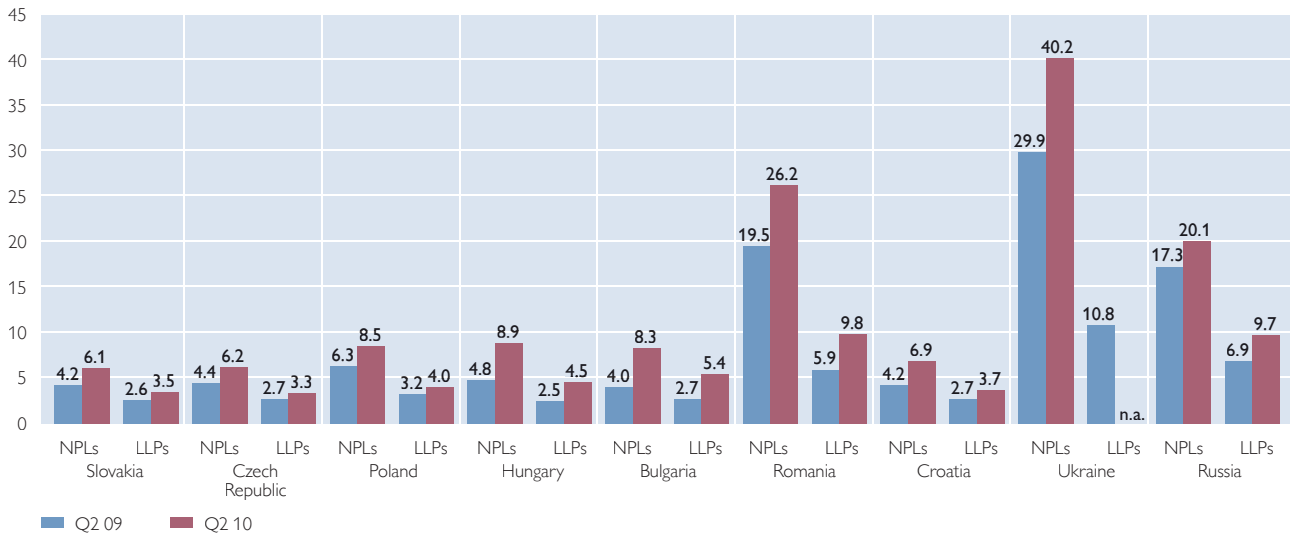
loans (in percentage points) was seen in Ukraine, followed by Romania, Bulgaria and Hungary. In most Central and Southeastern European countries (except for Hungary, Bulgaria and Croatia), the increase in the share of nonperforming loans had slowed down in the first half of 2010, compared with the second half of 2009.

As regards *profitability in the banking sector*, profits grew moderately in most Central European countries in the first half of 2010 on a 12-month basis. In Southeastern Europe, however, profits fell on a year-on-year basis, with Romania even suffering losses. In Ukraine, the banking sector significantly reduced its losses, but they were still at a high level in the first half of 2010. This situation was attributable to a steep increase in loan loss provisions on the back of a rise in nonperforming loans. Russia's banking sector, in contrast, registered the strongest profit growth among the countries under review. Capital adequacy was for the most part higher at mid-2010 than at end-2009, the two exceptions being Hungary and Russia where capital adequacy fell by 2 percentage points in each case. At 18.9%, however, capital adequacy in Russia continues to be high. The sharpest rise was registered by Croatia (more than 3 percentage points) and Ukraine (3 percentage points). As a result, the capital adequacy ratio ranged between 12% and 15% in Slovakia, the Czech Republic, Poland, Romania and Hungary, and between 18% and 23% in Croatia, Bulgaria, Russia and Ukraine at mid-2010.

Chart 13

Banking Sector: Credit Quality

Nonperforming loans (NPLs) and loan loss provisions (LLPs) in % of total credit, at end of period



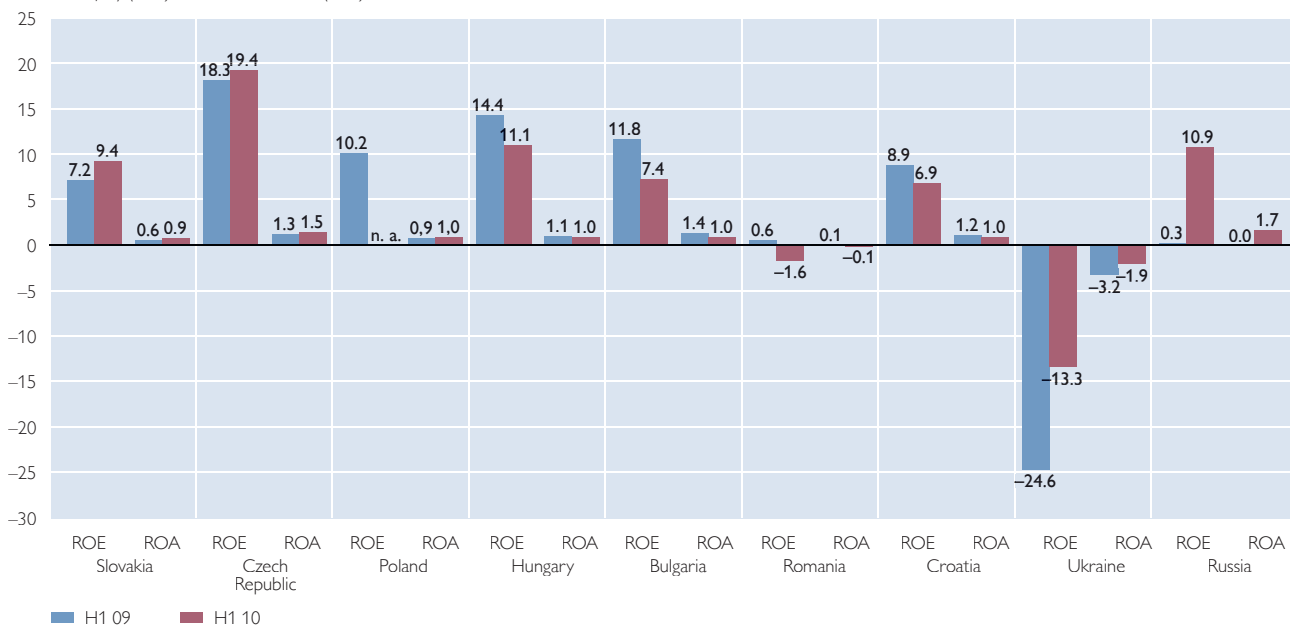
Source: IMF, national central banks, OeNB.

Note: Data are not comparable across countries. NPLs include substandard, doubtful and loss loans. Poland: including so-called irregular loans. Poland: loan loss provisions as at Q4 09 instead of Q2 10. Ukraine: NPLs as at Q4 09 instead of Q2 10.

Chart 14

Banking Sector: Profitability

Return on equity (ROE) and return on assets (ROA), in %



Source: IMF, national central banks, OeNB.

Note: Data are not comparable across countries. Data are based on annualized after-tax profit, except for Russia's, which are based on pre-tax profit.