

# Deteriorating Outlook for the World Economy

## **Industrialized Countries: Slowdown in GDP Growth Expected for 2011 and 2012**

The outlook for the world economy is deteriorating. The IMF's World Economic Outlook (WEO) of September 2011 projects economic growth for 2011 and 2012 to slow in industrialized countries, following the recovery of the world economy in 2010. Compared with the June 2011 WEO, the September 2011 WEO revised real GDP growth for the U.S.A. down by 1.0 percentage point to 1.5% (2011) and by 0.9 percentage points to 1.8% (2012). For the euro area, the IMF downgraded its growth forecast by 0.4 percentage points to 1.6% (2011) and by 0.6 percentage points to 1.1% (2012). For industrialized countries as a whole, the IMF projects real GDP growth of only 1.6% (2011) and 1.9% (2012). Compared with the June 2011 WEO, this is equivalent to a downward revision of 0.6 (2011) and 0.7 percentage points (2012). A portion of the lower-than-average growth in industrialized countries will be offset by continued robust economic momentum in emerging markets and developing countries, which have so far largely escaped the current crisis. With projected GDP growth of 9.5% (2011) and 9.0% (2012), China remains the engine of world economic growth. Slowing growth in industrialized countries is connected e.g. with the earthquake in Japan, which had a negative impact on global supply chains. Other determinants are the end of government stimulus programs, the need for household and public sector deleveraging, the decline in real disposable income due to high commodity prices, as well as the banking sector's reluctance to lend. Emerging market growth, which is still

robust albeit slowing, is primarily attributable to four factors: anticyclical economic policy measures, the recovery of commodity prices since mid-2009, the increase in real wages and the fact that banks in less developed countries were hardly affected by the international financial crisis and were able to extend credit without constraints. Growth in emerging markets and developing countries is also increasingly attributable to the expansion of their domestic markets, which means they are becoming less dependent on industrialized countries' economic development.

Owing to the deteriorating outlook for global GDP growth and the continuing debt problems of some peripheral countries in the euro area, downside risks to economic development currently prevail in the euro area. Risks to economic recovery are currently arising from both the financial and banking system. These risks are fueled by the sovereign debt crisis in Europe and the still unstable situation in the housing market in the U.S.A. The risks to emerging markets are caused by the fact that the worsening debt crisis in Europe and the U.S.A. is heightening the risk aversion of investors; the latter are siphoning away money, which is putting downward pressure on emerging market currencies. Compared with the highly indebted Western industrialized countries, however, emerging markets have a considerably larger scope in their monetary and budgetary policies to curb the depreciation of their currencies and to prevent a steep slump in growth.

Since the September 2011 WEO was published, the outlook for the world economy has further deteriorated – particularly, in industrialized

countries. This picture is also evident in the European Commission's fall 2011 economic forecast released in mid-November, which sharply downgraded the growth outlook for industrialized countries. The IMF is therefore also expected to make further downward adjustments to its outlook for industrialized countries in the near future.

Housing market situation still problematic

In the U.S.A., the results of the latest major revision of GDP data reveal that the cumulated slump in growth during the 2008/09 recession was significantly higher than shown in the original calculations. Also, the recovery of the U.S. economy in the first half of 2011 was weaker than previously assumed. At +0.4% (quarter on quarter, on an annualized basis) in the first quarter of 2011 and at +1.3% in the second quarter of 2011, GDP growth proved to be unexpectedly sluggish. With growth of 2.0%, economic momentum in the third quarter of 2011 was slower than initially assumed. Growth in the third quarter of 2011 was fueled primarily by an increase in private consumption, corporate investment and exports. Leading economic indicators currently suggest that the economy will grow modestly in the fourth quarter of 2011.

Slowing U.S. economic recovery in the first half of 2011, stronger momentum in the third quarter

Rating agency S&P downgraded U.S. long-term credit rating from AAA to AA+ with a negative outlook in early August 2011

Situation in U.S. labor market remains tight

The U.S. jobless rate only fell by 1 percentage point or so from its high of 10.1% (October 2009) and recently climbed back sharply to 9.7% (October 2011). In a bid to revive the labor market, on September 8, 2011, President Obama proposed a new economic rescue package, which will largely take effect in 2012. Core components of this package are extending the payroll tax cut for workers and jobless benefits for the unemployed, as well as offering tax incentives to employers who create new jobs. A bipartisan congressional committee has been set up to ensure the counterfinancing of these measures.

U.S. Fed keeps target federal funds rate unchanged but approves further unconventional measures

The approval of this package by the Republicans remains uncertain, however. The IMF endorses Obama's plan to stimulate the economy in the short term and to shore up the government budget in the medium term only.

The situation in the U.S. housing market remains difficult. As in previous months, housing estate prices (based on the S&P/Case-Shiller Homes Price Index) remained unchanged in August 2011. The coming months will continue to see downside risks primarily arising from the low number of house sales, the still high number of foreclosures, stringent mortgage lending conditions and falling disposable income.

On August 5, 2011, rating agency Standard & Poor's (S&P) – for the first time in the country's history – downgraded its long-term credit rating for the U.S.A. by one notch from AAA to AA+ with a negative outlook. S&P justified its decision by citing the worryingly high budget deficit, the inadequate cost saving plans and the confidence-shaking political feud relating to the raising of the U.S. debt ceiling, which will also impede budget consolidation measures in future. In the days following the U.S. credit rating downgrade, the sale of U.S. government bonds rose surprisingly. This development is likely to be connected with growing uncertainties in other bond market segments at this time and with the shift from stocks into bonds. U.S. government bonds are clearly still seen as a safe haven in uncertain times – especially since Moody's and Fitch, the two other major rating agencies, still award the U.S. their top AAA credit rating.

Fueled by higher energy and food prices, the annual CPI inflation rate stood at 3.5% in October 2011. Core inflation, which has been trending up

Table 1

**IMF and WIFO Economic Outlook: Industrialized Countries**

	Real GDP				CPI				Current account			
	2009	2010	2011 <sup>1</sup>	2012 <sup>1</sup>	2009	2010	2011 <sup>1</sup>	2012 <sup>1</sup>	2009	2010	2011 <sup>1</sup>	2012 <sup>1</sup>
	Annual change, %				Annual change, %				% of GDP			
<b>Industrialized countries</b>	<b>-3.7</b>	<b>3.1</b>	<b>1.6</b>	<b>1.9</b>	<b>0.1</b>	<b>1.6</b>	<b>2.6</b>	<b>1.4</b>	<b>-0.2</b>	<b>-0.2</b>	<b>-0.3</b>	<b>0.1</b>
<b>U.S.A.</b>	<b>-3.5</b>	<b>3.0</b>	<b>1.5</b>	<b>1.8</b>	<b>-0.3</b>	<b>1.6</b>	<b>3.0</b>	<b>1.2</b>	<b>-2.7</b>	<b>-3.2</b>	<b>-3.1</b>	<b>-2.1</b>
<b>Euro area</b>	<b>-4.3</b>	<b>1.8</b>	<b>1.6</b>	<b>1.1</b>	<b>0.3</b>	<b>1.6</b>	<b>2.5</b>	<b>1.5</b>	<b>0.1</b>	<b>0.3</b>	<b>0.1</b>	<b>0.4</b>
Germany	-5.1	3.6	2.7	1.3	0.2	1.2	2.2	1.3	5.6	5.7	5.0	4.9
France	-2.6	1.4	1.7	1.4	0.1	1.7	2.1	1.4	-1.5	-1.7	-2.7	-2.5
Italy	-5.2	1.3	0.6	0.3	0.8	1.6	2.6	1.6	-2.1	-3.3	-3.5	-3.0
Spain	-3.7	-0.1	0.8	1.1	-0.2	2.0	2.9	1.5	-5.2	-4.6	-3.8	-3.1
Austria	-3.9	2.1	3.3	1.6	0.4	1.7	3.2	2.2	3.1	2.7	2.8	2.7
Austria (WIFO)	-3.8	2.3	2.9	0.8	0.4	1.7	3.5	2.3	3.1	2.7	2.8	2.8
<b>United Kingdom</b>	<b>-4.9</b>	<b>1.4</b>	<b>1.1</b>	<b>1.6</b>	<b>2.1</b>	<b>3.3</b>	<b>4.5</b>	<b>2.4</b>	<b>-1.7</b>	<b>-3.2</b>	<b>-2.7</b>	<b>-2.3</b>
<b>Japan</b>	<b>-6.3</b>	<b>4.0</b>	<b>-0.5</b>	<b>2.3</b>	<b>-1.4</b>	<b>-0.7</b>	<b>-0.4</b>	<b>-0.5</b>	<b>2.8</b>	<b>3.6</b>	<b>2.5</b>	<b>2.8</b>

Source: IMF (World Economic Outlook, September 2011). Austria (WIFO): WIFO forecast (September 2011).

<sup>1</sup> Forecast.

since early 2011, was recently 2.1%. The U.S. Fed nevertheless maintained the target federal funds rate at a range of 0–0.25%, i.e. unchanged for almost three years now. In a bid to support the economy, the Fed announced, already in August 2011, that it would continue its zero interest policy to at least mid-2013. Since the U.S. Fed has now largely exhausted the conventional instruments at its disposal, it is now employing this unusual arrangement in an attempt to influence expectations.

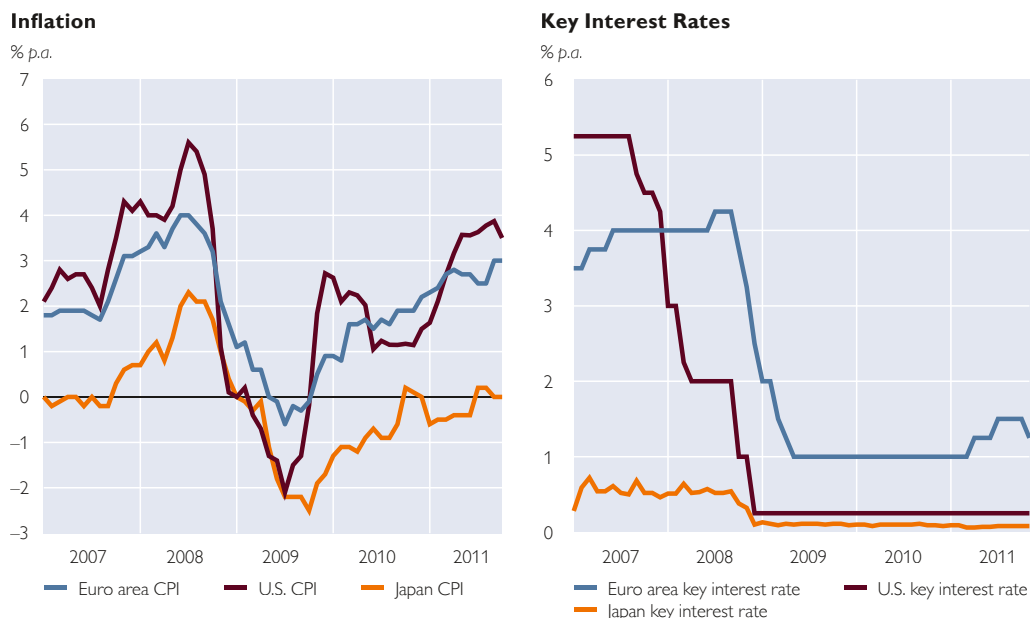
In September 2011, the Fed approved a further unconventional measure. It will purchase long-term bonds worth USD 400 billion until end-June 2012 and simultaneously sell short-term bonds of the same value in order to keep the Fed's balance sheets unchanged. This measure first trialed in the 1960s under the designation "Operation Twist" aims to lower long-term interest rates.

In the euro area, real GDP growth slowed markedly during the first half of 2011. After quarterly growth of 0.8% in the first quarter of 2011, economic output expanded by only 0.2% in the

second quarter of 2011. Compared with the second quarter of 2010, growth stood at 1.6%. The contraction was generally expected, as the first quarter of 2011 was strongly marked by catching-up and backlog effects following a severe winter. Private consumption was down on the previous quarter, which the development in retail sales had already signaled. This is attributable to two sets of factors: first, the need for household and public sector deleveraging, as well as the decline in real disposable income due to high commodity prices. Second, uncertainty about the debt crisis in some peripheral countries of the euro area is also likely to have adversely affected the propensity to consume. External trade made the largest contribution to growth in the second quarter of 2011. In Germany, GDP growth slumped particularly sharply to 0.1% in the second quarter of 2011 (first quarter of 2011: 1.3%). Although external trade gained momentum with both imports and exports up, the rise in imports exceeded that in exports. As a result, external trade made a visibly negative contribu-

After a strong first quarter, euro area GDP growth slumps in the second quarter of 2011

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



Source: Eurostat, ECB.

tion to growth, which dampened the momentum of the German economy. In other major euro area countries, growth also proved to be sluggish in the second quarter of 2011. France registered zero growth (first quarter of 2011: +0.9%), and neither Italy (+0.3%) nor Spain (+0.2%) expanded much. Growth is likely to have remained sluggish in the third quarter of 2011. According to a Eurostat flash estimate, it was 0.2% in this period. The fourth quarter of 2011 is also likely to have seen continued sluggish growth.

#### ECB cuts key interest rate in November 2011

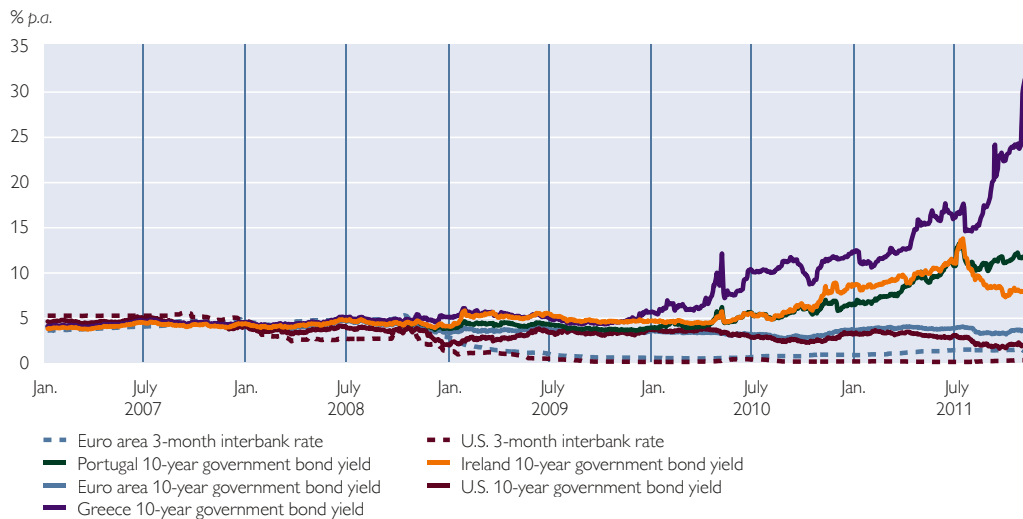
At its meeting in early November 2011, the Governing Council of the ECB decided to cut its key interest rate by 25 basis points, as strains in the financial markets are likely to dampen both GDP growth and inflation in the euro area in the second half of 2011 and beyond. Since November 3, 2011, therefore, the key interest rate has stood at 1.25%. To meet banks' increased need for liquidity, for the time being all tenders are being processed

with full allotment. As at the height of the economic and financial crisis, banks used the deposit facility to deposit with the ECB a growing portion of the liquidity thus allotted. This behavior is a sign of increased mistrust between banks as well as refinancing difficulties in the interbank market. In early October 2011, the Governing Council of the ECB also decided to recommence the covered bond purchase program, which was already used in 2008. Under this program, mortgage bonds (Pfandbriefe) totaling EUR 40 billion should be purchased in the period from November 2011 to October 2012. Owing to high surplus liquidity, the Euro Overnight Index Average (EONIA) remained relatively stable for a long time at around 1%. However, after the key interest rate was cut in early November 2011, it fell to 0.7%.

In the U.S. money market, LIBOR interest rates have been relatively stable since fall 2009. In the euro area money market, however, EURIBOR interest

Chart 2

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



Source: Thomson Reuters.

rates have been rising slightly since early 2011. In the U.S. money market, risk premiums remained below those in the euro area.

Discussions about Greece's solvency caused risk premiums on Greek bonds to soar until mid-July 2011, with spill-over effects on Irish and Portuguese government bond yields. Following an extraordinary summit of the European Council on July 21, 2011, which approved a comprehensive stabilization package (second Greek package), greater flexibility of the EFSF and the ESM<sup>1</sup>), yield spreads between Greek, Portuguese and Irish government bonds, on the one hand, and German Bunds, on the other, narrowed considerably. In August 2011, the debate about the guarantees demanded by the Finnish government for Finland to participate in the euro rescue fund, as well as the package's tentative implementation in the national parlia-

ments, triggered further steep increases in risk premiums.

Finally, the steadily deteriorating growth outlook, together with overall very low sales, resulted in new record premiums on Greek government bonds. It is worth noting the increasing decoupling of this development in risk premiums on Greek government bonds, on the one hand, and the risk premiums on Portuguese and Irish government bonds, on the other. After public attention had increasingly focused on Spain's and, especially, Italy's budgeting, political intervention was necessary for long-term stabilization. The measures agreed by European leaders at the EU summit of October 26, 2011, consist of a voluntary debt haircut of 50% for Greece, a substantial increase of the funds of the EFSF (without increasing its total guarantee commitments), and bank recapitalization measures.

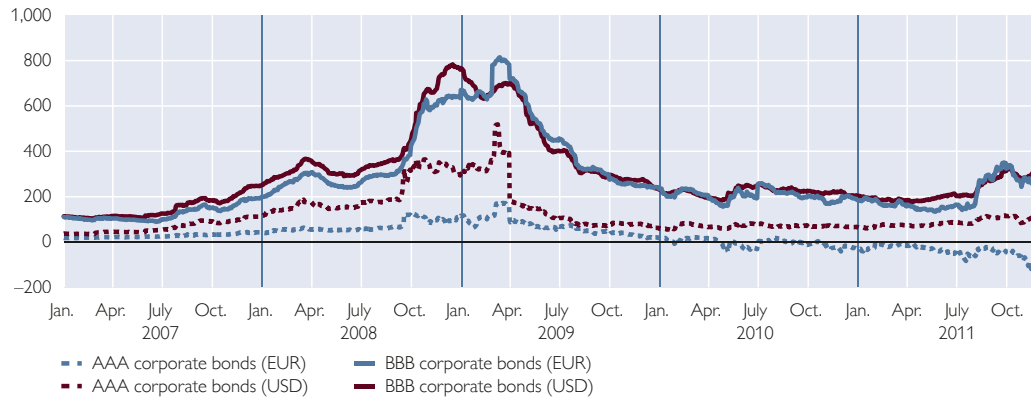
Continued turmoil in government bond markets – EU summit of October 26, 2011: agreement on voluntary Greek debt haircut of 50%

<sup>1</sup> EFSF: European Financial Stability Facility; ESM: European Stability Mechanism.

Chart 3

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

Basis points; against government bonds (U.S. and euro area average)



Source: Thomson Reuters, OeNB.

#### Rising corporate bond premiums

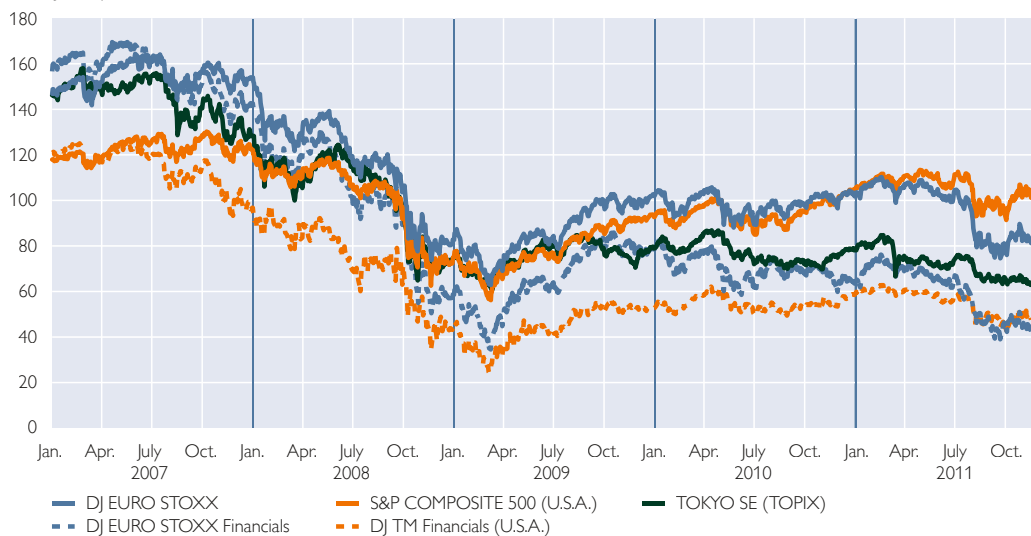
Renewed flare-ups in the debate on sovereign debt in the euro area and protracted discussions in the U.S.A. about raising the debt ceiling also had a detrimental impact on the financing costs of companies, which are currently financing themselves in the bond market more dearly, compared with a few months ago. The yield spreads for BBB-rated corporate bonds in the euro area

and the U.S.A. have widened sharply since August 2011. For AAA-rated bonds, the rise in yield spreads was significantly smaller in the U.S.A. In the euro area, yield spreads for such bonds even experienced a slight narrowing. The spreads for AAA-rated corporate bonds in the euro area were generally at a lower level than those in the U.S.A.

Chart 4

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

Index: January 1, 2005 = 100

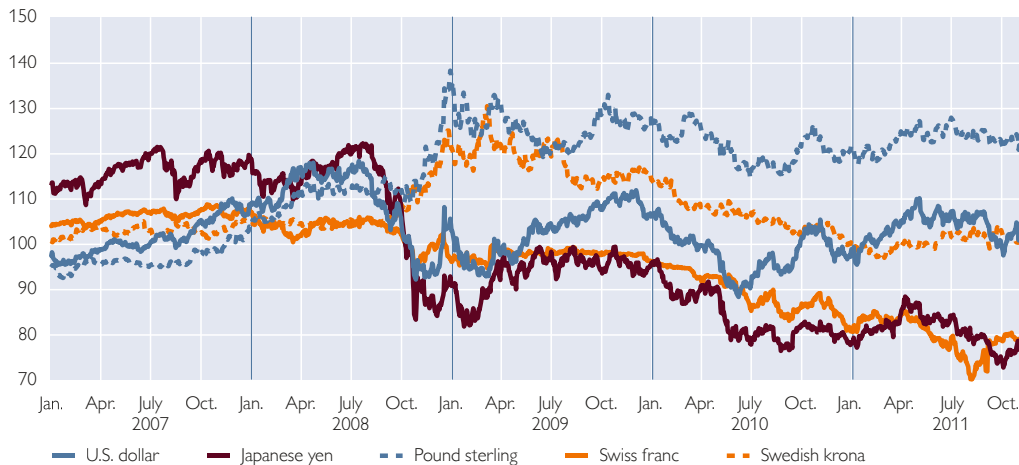


Source: Thomson Reuters, OeNB.

Chart 5

### Industrialized Countries: Exchange Rates Against the Euro

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



Source: Thomson Reuters, OeNB.

Note: National currency per euro unit.

Since reaching an annual high in February 2011, the Dow Jones EURO STOXX has lost about 25% of its value and now stands only just above its crisis-induced low of spring 2009. Most of these losses were recorded after July 21, 2011, i.e. following the EU special summit. European bank stocks suffered most, having lost some 45% of their value since their annual high in February 2011 (and some 30% since the EU special summit).

The same trends are evident in U.S. equity markets: Since February 2011, major U.S. banks have suffered price losses of about 40%, although the all-items index of large U.S. companies has merely lost 7% or so of its value.

Recent fluctuations in the EUR/USD exchange rate were closely connected with developments in the European debt crisis. The decisions taken at the EU Summit on October 26, 2011, had triggered a rally on the markets. European equity indices generated the largest weekly gains since 2009, with the EUR/USD exchange rate rising temporarily above USD 1.42 per euro for the first time since September 6,

2011. The EUR/USD exchange rate, however, has since fallen to below USD 1.35 per euro.

On September 6, 2011, the Swiss National Bank (SNB) set the minimum exchange rate at CHF 1.20 per euro, as its monetary policy measures designed to weaken the Swiss franc had not had a lasting effect. As a result of this measure, the Swiss currency softened markedly. The SNB justified its action by explaining that in particular exports and tourism were suffering from the strong currency.

### CESEE Compared with Other Emerging Markets

According to the latest IMF estimates of September 2011, the world economy will grow by 4% in 2011 (2010: 5.1%). Compared with April 2011, the IMF has downgraded its world GDP growth forecast for 2011 by 0.4 percentage points, primarily owing to slower economic momentum in developed countries (e.g. U.S.A., Japan). For emerging markets as a whole, however, the growth outlook was confirmed at some +6.5%. At +8.2% – primarily owing

The SNB sets exchange rate target

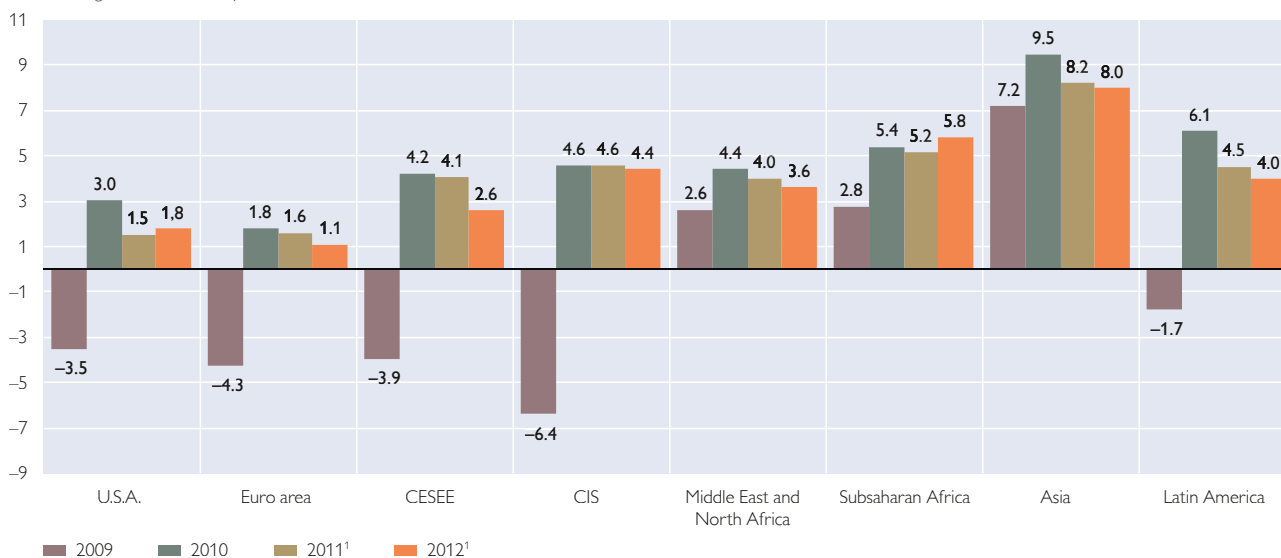
Further equity market losses – particularly sharp deterioration in financial stocks

Modest slowdown in emerging markets' GDP growth

High volatility of EUR/USD exchange rate due to developments in euro area peripheral countries

## Emerging Markets and Selected Industrialized Countries: GDP Forecast

Annual change in % at constant prices



Source: IMF (World Economic Outlook), September 2011

<sup>1</sup> IMF forecast.

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

to still favorable GDP growth in China and India – Asia will generate the fastest growth among emerging market regions, which means it will remain the engine of global economic growth in 2011. For Central, Eastern and South-eastern Europe (CESEE), the IMF projects GDP growth of +4.1%, owing to still high growth momentum in Turkey. However, this figure is below the growth rates forecast for other emerging market regions such as Latin America, Subsaharan Africa and the CIS. The Middle East and North Africa region, which has been badly affected by social unrest and military conflict, will be the only emerging market region to grow more slowly than CESEE, albeit only marginally so.

For 2012, the IMF again projected world GDP growth of 4%. This figure is half a percentage point lower than that predicted in spring 2011, with significantly increased downside risks owing to the tight global financial situ-

ation and uncertainties about fiscal policy in developed countries, among other factors. In 2012, GDP growth will slow marginally in emerging markets as a whole owing to more sluggish export demand from developed countries and to increasingly restrictive economic policies in many emerging markets. Compared with 2011, every emerging market region – except for Subsaharan Africa – will suffer a more or less pronounced slowdown of growth. For emerging market regions as a whole, however, the growth outlook still remains relatively favorable at +6.1%. The pace of growth will, however, sharply diverge between and within these regions also in 2012. With projected GDP growth of +8%, Asia maintains its lead, followed by Subsaharan Africa (almost +6%). The CIS, Middle East and North Africa regions will advance more or less in line with the world economy. Owing to a sharp slump in growth in Turkey and the



deteriorating Western European economy, CESEE will expand at a slower than average pace (projected GDP growth: + 2.6%), compared with emerging markets and the world economy.

In the light of soaring energy and food prices, global inflationary pressures visibly rose in the first half of 2011. This phenomenon applies all the more to emerging markets, as energy and food have a higher weight in the baskets of goods belonging to countries with lower per-capita income. In certain rapidly growing countries (e.g. China, India), however, demand-side factors also fueled consumer price inflation. Although inflation seems to have largely peaked in summer 2011, average annual inflation in emerging markets as a whole will climb to 7.5%, which is 1.4 percentage points higher than in 2010 and 0.6 percentage points higher than expected in the spring 2011 WEO. In the CIS, Middle East, North Africa and Subsaharan Africa regions, consumer price inflation exceeds this figure while, in Asia, Latin America and CESEE, it is below this value. To

counter inflationary pressures, many emerging markets tightened their monetary policies by raising key interest rates and increasing minimum reserve requirements in the first half of 2011 and/or allowed their currencies to appreciate. According to the IMF, restrictive monetary policy stimuli, together with slowing global economic momentum and a slight easing in commodity markets in 2012, will result in a drop in inflation particularly in the Middle East, North Africa and Asia. Of the emerging market regions, CESEE is expected to have the most favorable inflationary environment (4.2%).

As in the previous year, the IMF expects external imbalances to increase in most emerging market regions in 2011. Although the current account surplus in Asia is expected to remain at its 2010 level, considerably higher surpluses are anticipated in the CIS, the Middle East and in North Africa (despite partially disrupted production in some countries), owing to persistently high commodity prices. For the same reason, after disclosing a deficit in 2010, the cumulated current account

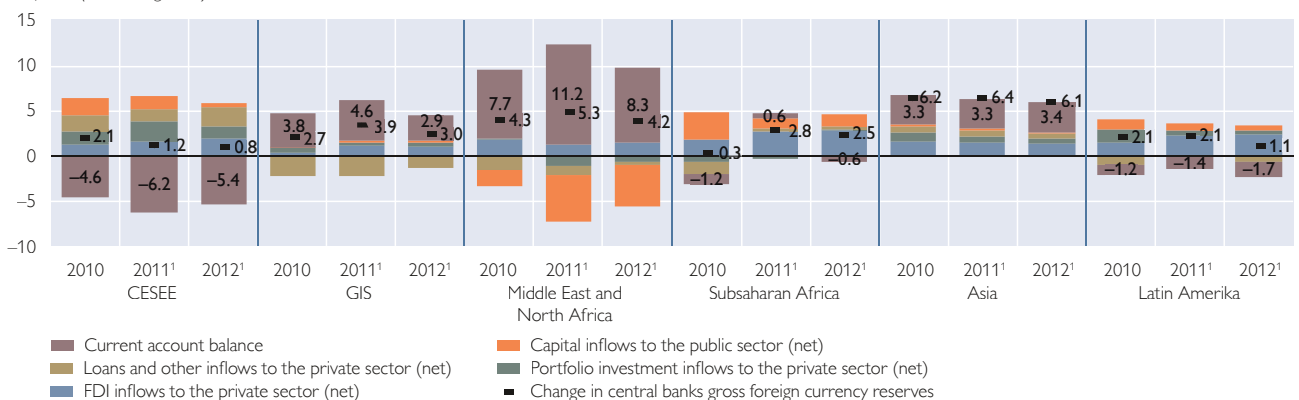
Energy and food prices drive up inflation

External imbalances will continue to increase

Chart 7

### Emerging Markets: Current Account Balances and Net Capital Inflows

% of GDP (at exchange rate)



Source: IMF, OeNB.

<sup>1</sup> 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.

of the Sub-Saharan Africa region will show a surplus in 2011. At the same time, the current account deficit in CESEE and Latin America is increasing more or less steeply.

For 2012, the IMF anticipates a reduction in current account surpluses in commodity-exporting countries and regions due to slowing global growth and lower oil prices. For CESEE, the IMF forecasts a modest deterioration in the external positions of almost every country in the region owing to the EU's expected economic downturn, accompanied by lower export demand of CESEE's key trading partners (e.g. Germany, Italy). Within the CESEE region, the IMF expects a marked improvement only in Turkey's current account balance, which is connected with the projected slowdown of growth in 2012.

At some 2.3% of GDP, net capital inflow to the private sector in emerging markets as a whole is likely to be as high in 2011 and 2012 as in 2010, according to the IMF. In 2011, every emerging market should see robust positive net capital inflow to the private sector – except for the CIS, Middle East and North Africa regions, which were faced with capital outflows owing to high current account surpluses and geopolitical uncertainties. In Latin America, above all, capital inflows to the private sector increased particularly steeply owing to rapid growth momentum and rising commodity prices. In CESEE too, the private sector will attract more capital inflows in 2011, although they will remain well below their precrisis levels.

With a share of some three-fourths of total private capital inflow to emerging markets, foreign direct investment (FDI) is the most important form of capital. Compared with the previous year, its share in total capital inflow has

been increasing steeply to the detriment of portfolio investment in 2011. This development can be seen as a certain normalization following the relatively robust flow of portfolio investment especially to Latin America, Asia and some CESEE countries in 2009 and 2010. In addition, the decline in portfolio investment can be seen as a sign of growing risk aversion due to the re-emerging uncertainties in global financial markets. FDI fully covered the aggregate current account deficit in Latin America while, in CESEE, it financed almost a third of the current account deficit on average.

At  $-0.1\%$  of GDP, capital flow to the public sector was marginally negative in emerging markets taken as a whole, although net capital inflow to the public sector was positive in almost every region. These inflows were however offset by vigorous capital outflow from the public sector in the Middle East and North Africa. Last but not least, owing to high and growing current account surpluses and despite increased foreign currency market interventions in support of some emerging markets' national currencies in early fall 2011, foreign currency reserves in all emerging market regions will continue to accumulate in 2011, according to the IMF.

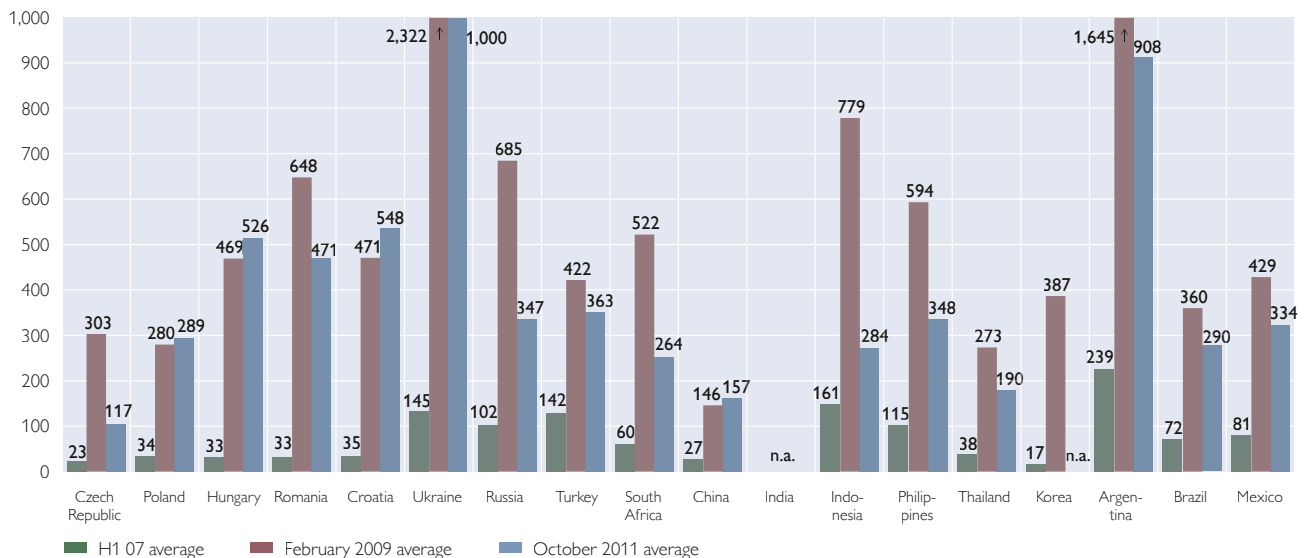
Since May 2011 – and even more since early August 2011 – key financial indicators (equity, government bond and CDS markets) in emerging markets have been showing a negative trend in line with developments in industrialized countries. Key factors behind this phenomenon are, in particular, increasingly jittery global financial markets owing to the European debt crisis and the deteriorating global outlook for GDP growth. However, partial capital withdrawals from emerging market equity funds designed to safeguard

High capital inflow poses challenge to some emerging markets

Global uncertainties also weigh emerging financial markets down

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

J.P. Morgan 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 government CDS premiums serve as a proxy.

liquidity and increasing economic risks of overheating in certain emerging markets are also likely to have strengthened this development recently. For instance, the MSCI Emerging Markets Price Index has lost around 14.3% of its value since May 2011. The subindices for Central and Eastern Europe (MSCI EM Europe) and Asia (MSCI EM Asia) have lost some 17% since May 2011, while the MSCI EM Latin America Index registered a more moderate loss of some 10%. Of the equity indices in CESEE and CIS countries that are not included in the MSCI EM Europe, most have recorded far more considerable losses than the benchmark.

Owing to growing uncertainty and the related increased risk aversion on global financial markets, Eurobond spreads have been largely trending up – especially since late summer 2011. For most of the countries under review, the spreads are still well below the levels reached when the financial crisis

peaked in spring 2009 – for some countries, however, e. g. Poland, Hungary and Croatia, the spreads have exceeded their previous records by a slight margin. The same also goes for other emerging markets and/or regions. Especially in the Middle East and North Africa regions, social unrest was accompanied by foreign investor uncertainty and hence rising risk premiums and falling stock market prices.

### CESEE: Economic Recovery Slows

Uncertainties about future economic development in CESEE countries have increased considerably in recent months. After growth in the first quarter of 2011 had accelerated slightly and the economy had expanded by a regional average of 3.7% (year on year), signs indicating a cooling off in the economy have been proliferating since early summer. For instance, several high frequency, leading and confidence indicators for CESEE countries have

### Weaker growth in the second quarter of 2011

deteriorated recently. This situation applies to industry, in particular. Since early 2011, growth in industrial production has halved from some 8.5% to most recently (September 2011) some 5% (year on year), and confidence indicators have deteriorated significantly. The decisive factor was primarily the slowdown in international demand momentum.

This development was also reflected in the numbers for the second quarter of 2011. GDP growth slowed in most of the countries under review. Hungary, Slovenia, Romania, the Czech Republic and Russia registered seasonally and working day-adjusted growth rates ranging between only 0.0% and 0.2% on a quarterly basis. Owing to the sharp slowdown in year-on-year non-seasonally-adjusted growth, Ukraine is also expected to fall into this group of countries (adjusted GDP data are not currently available for Ukraine). Continued robust growth in Poland, how-

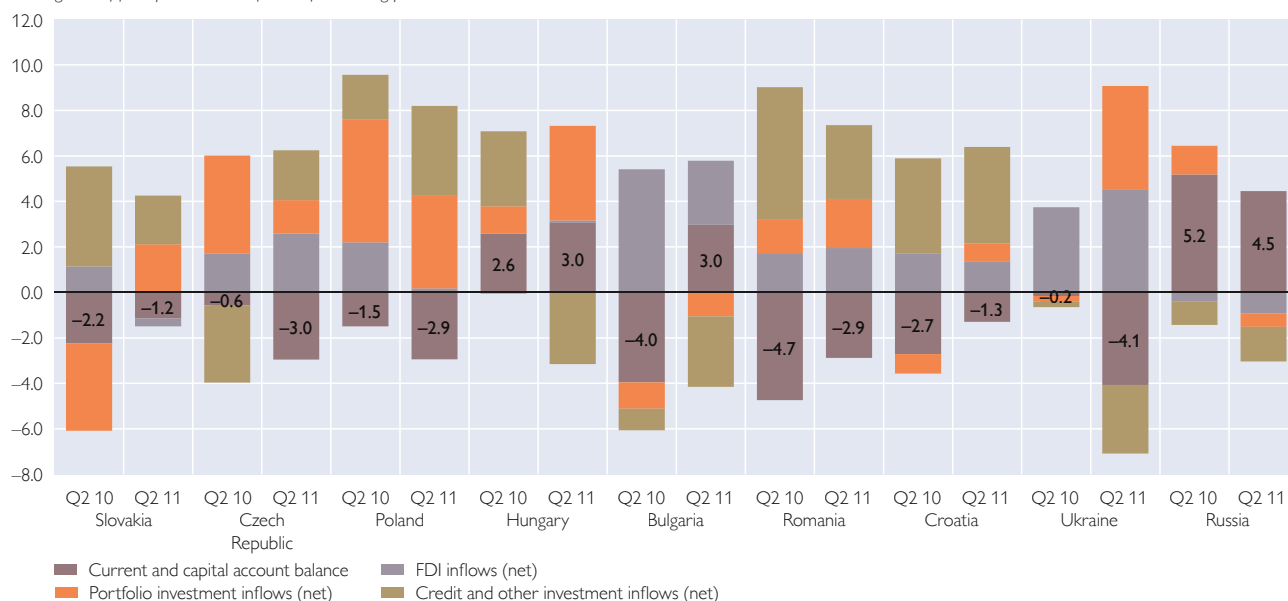
ever, had a favorable impact on the region as a whole (+1.1% on the previous quarter).

Although slackening international demand in the second quarter of 2011 was already reflected in lower export growth, the external economy remained a key pillar for growth in most EU Member States of this region and in Croatia. However, a visibly negative contribution to growth by net exports had a dampening effect on economic momentum in Russia and Ukraine. In some countries, a trend toward stronger domestic demand was observed. This applies primarily to Poland, Ukraine and Russia, where both private consumption and investment made a significant contribution to growth. Recently, a certain pick-up in investment activity was also observed in the Czech Republic and Slovakia. The reason is likely to be found, above all, in the pent-up need for investment after several quarters of falling investment

Chart 9

## Current and Capital Account Balance and Its Financing

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



Source: Eurostat, national central banks, OeNB.

spending during the crisis. However, Hungary, Romania and Bulgaria – the slowest growing countries of the region – still reported wholly negative contributions to growth from domestic demand. In these countries, growth remains constrained by a greater need for public sector consolidation, continuing household deleveraging and a faltering construction sector.

The international climate continued to deteriorate from August 2011 (further loss in confidence levels, increased volatility and risk aversion in international financial markets, continuing sovereign debt crisis in some euro area countries and – against this background – doubts about the stability of the European banking system). In view of the close economic and financial ties between CESEE countries and Western European economies, GDP growth of the region under review is expected to slow markedly to a range between some 2% and 2.5% in 2012, which still signifies a fairly large edge over Western Europe in growth terms.

The international financial crisis resulted in a marked reduction in external imbalances in CESEE. This trend persisted in many countries of the region (e.g. in Slovakia, Bulgaria, Romania and Croatia) in the first half of 2011. In Poland, Ukraine and the Czech Republic, however, a slight increase in current account deficits could already be detected again. In the first two countries this development is primarily explicable by strong domestic demand and the related growing trade balance deficit, while in the Czech Republic it was due to the deepening income account deficit. Companies under foreign ownership chalked up profits, of which a proportion was distributed to their parent companies.<sup>2</sup>

In almost all the countries under review, the financial account was positive for the sum of the four quarters to mid-2011. It was slightly in the red only in Russia and Bulgaria (both countries, however, show a current account surplus). In Bulgaria and the Czech Republic, the largest positive component of the financial account was (net) FDI; in Slovakia, Hungary, Poland and Ukraine, it was (net) portfolio investment, and in Romania and Croatia other investment (net; especially loans) predominated. In Russia, capital outflows from all three categories were reported during the reporting period. Net FDI inflows covered the total combined current and capital account deficit only in Croatia and Ukraine.

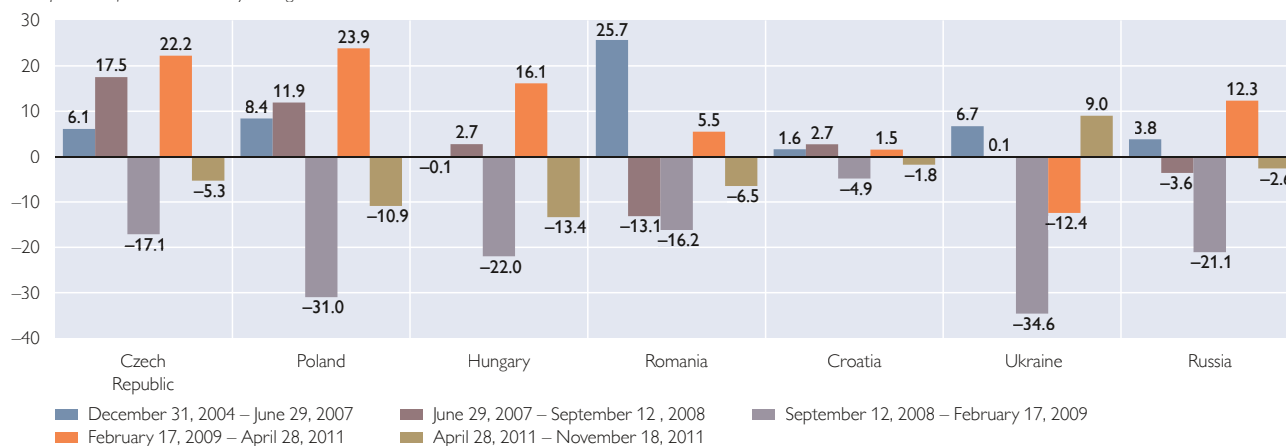
IMF/EU as well as IMF stabilization programs remain in force in Romania and Ukraine. In Romania, a precautionary stand-by arrangement for the IMF program that is coming to an end was concluded in March 2011. This arrangement comprises funds equaling around EUR 3.6 billion. The EU (EUR 1.4 billion) and the World Bank (EUR 0.4 billion) also contributed to this package. Romania has so far not used any of the three IMF tranches available (totaling EUR 1 billion) and has confirmed that it does not intend to do so in future. As for Ukraine, an IMF stabilization program (totaling EUR 11.6 billion), through which two tranches totaling EUR 2.6 billion have already been disbursed, has been in force in the country since summer 2010. Since spring 2011, however, the program has been suspended, as the Ukrainian authorities have been dilatory in implementing the agreed measures. Although some progress has since been made (e.g. the passing of a new pensions law), the IMF's key con-

Further improvement in many CESEE countries' current account positions

<sup>2</sup> The bulk of these profits was however reinvested, thereby strengthening the financial account.

## National Currencies and the Euro

Euro per unit of national currency, change in %



Source: Thomson Reuters, OeNB.

dition of raising household gas prices has so far still to be met. As for Hungary, against a background of growing refinancing problems, it turned to the IMF and the European Commission in mid-November 2011 to open talks about a contingent credit line facility.

After particularly high budget deficits owing to the recession in 2009, in 2010 deficits decreased slightly in several countries. In the entire region, nevertheless, deficits mostly exceeded the ceiling of 3% of GDP and, in all EU Member States belonging to this group of countries, an excessive deficit procedure is currently in force. According to the current stability and convergence programs, the target dates scheduled for reducing budget deficits should be met in all the countries in the region (2011 for Hungary and Bulgaria, 2012 for Poland and Romania, 2013 for the Czech Republic and Slovakia). After evaluating these programs, however, the European Commission's assessment is somewhat more skeptical. Poland may have to implement further measures, in addition to those submitted in the draft budget for 2012. As for

Hungary, it cannot be ruled out that, following a budget surplus due to temporary factors in 2011, the deficit target will be exceeded in 2012 unless further measures are adopted.

In the first half of 2011, price pressures were comparatively high in most of the countries under review. Inflation remained at a relatively modest level only in Slovenia, the Czech Republic and Croatia. Increased price pressure was primarily attributable to a surge in food prices in connection with poor harvests in 2010. Furthermore, high energy and commodity prices, alongside hikes in indirect taxes in some countries, also acted to spur inflation. The latter effect was particularly marked in Poland and Slovakia. In both countries, VAT was increased in early 2011. The surge in inflation peaked in summer 2011, however. In recent months, the region has seen an easing off in inflation owing to two factors. First, base effects (e.g. following the VAT increase in Romania in July 2010) contributed to this development. Second, pressures on food prices subsided in the wake of the harvests in 2011. In September 2011, inflation ranged

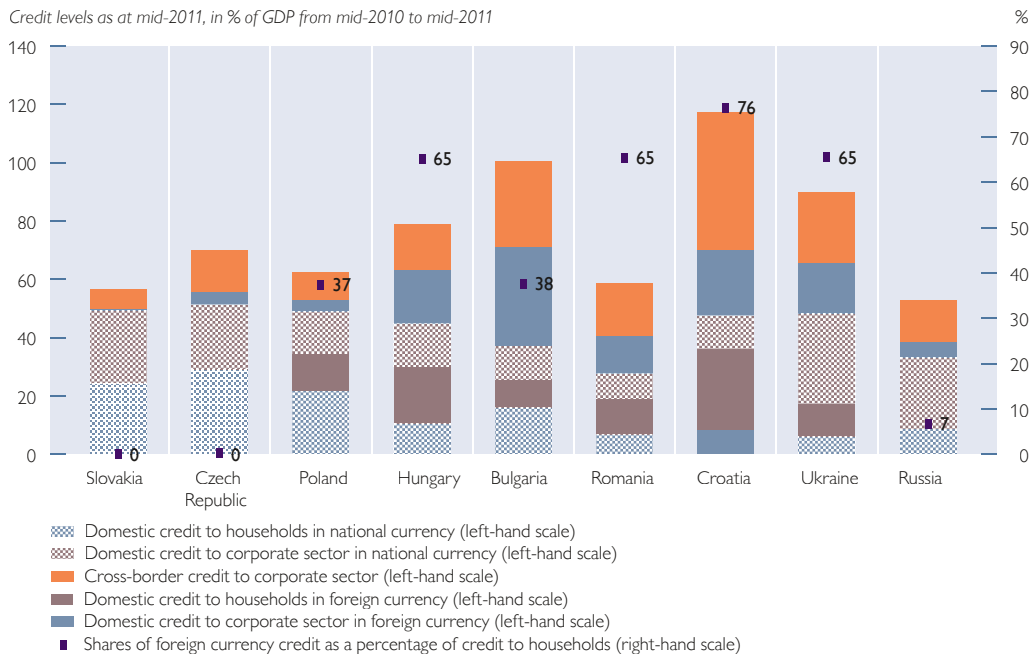
Continued high budget deficits despite a modest decline in 2010

Surge in inflation peaked in summer 2011

Chart 11

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

Credit levels as at mid-2011, in % of GDP from mid-2010 to mid-2011



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

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

between 2.1% in the Czech Republic and Croatia to 6.7% in Russia.

Looking at the currencies of the countries under review that have yet to adopt the euro and that lack fixed or quasi-fixed currency pegging, all currencies except for the Ukrainian hryvnia depreciated against the reference currency, some of them sharply, in the observation period – and, especially, toward the end of this period. These instances of depreciation were concentrated particularly in the period from mid-June 2011. Several central banks – especially, the Romanian, Polish, Croatian and Russian central bank – intervened on the foreign exchange markets in a bid to support their currencies. In Croatia, moreover, the minimum reserve rate was raised from 13% to 14% and, in Russia, the exchange rate band

of the ruble relative to its USD/EUR currency basket was adjusted from 32.15–37.15 to 32.60–37.60.

Increased levels of uncertainty owing to the flagging world economy and the repercussions of the debt crisis took its toll on the financial markets. Since mid-2011, every CESEE country covered in this report has suffered equity market losses, which on average did not prove as high as in Western Europe, however. The Ukrainian, Czech and Hungarian stock exchanges incurred the heaviest losses, while their Slovakian counterpart registered only modest ones.

The increase in global risk aversion also had a knock-on effect on CESEE countries, raising their financing costs. Risk premiums as measured by CDS spreads have risen across the region

Depreciation pressures prompt central bank intervention

Increased risk aversion grips financial markets

since mid-2011. This increase was particularly steep in Ukraine and Hungary. In addition, Eurobond spreads widened in the entire region, with the increase most pronounced in Ukraine, Hungary and Croatia. Short-term interbank rates showed a varying picture. In the Czech Republic and in Bulgaria, the spreads relative to the euro area have narrowed moderately since mid-2011. While short-term interbank rates fell slightly in both these countries, they remained largely constant in the euro area. In Poland and Romania, by contrast, spreads grew modestly while, in Croatia, they widened considerably. The noticeable rise in short-term interest rates in Croatia is explained by the tightening of liquidity in the domestic money market (partly via the issuance of bonds and the announced increase in minimum reserves in October 2011).

In most countries of Central Europe, total outstanding loans to private households (relative to GDP) were higher in mid-2011 than at end-2010. By contrast, they were marginally

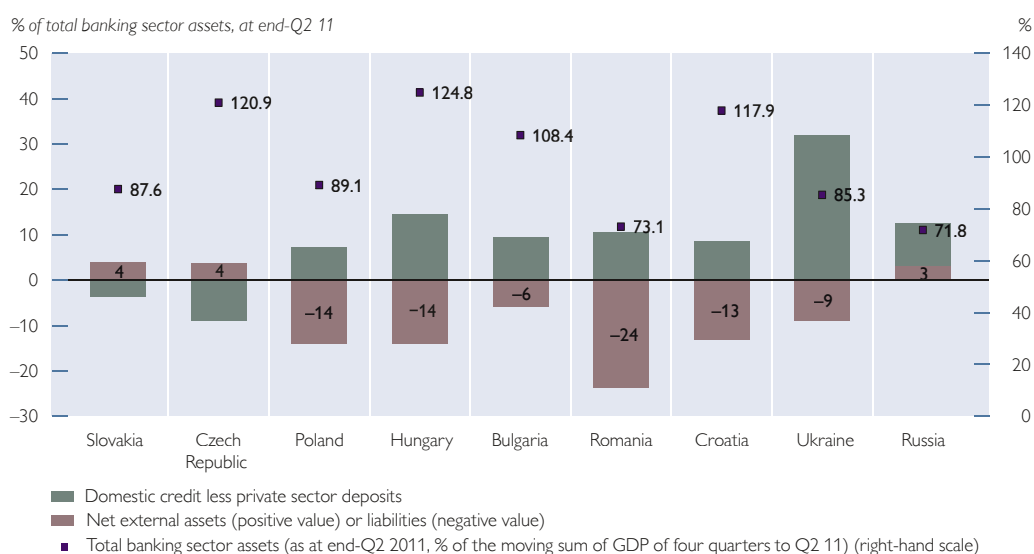
down in Romania and Croatia and markedly so in Bulgaria, Ukraine and Hungary. Total outstanding loans (relative to GDP) to nonfinancial companies largely grew in tandem with household loans. Loans in this sector showed a divergent development only in Russia, Croatia and Romania. Whereas non-financial corporate loans rose in the latter two countries, they were in decline in Russia. With the exception of Hungary, every Central European country's domestic loan market registered (currency-adjusted) modest growth in household and nonfinancial corporate loans. Cross-border loans to corporates declined in the entire region, however.

At 65 % to 76 %, the share of foreign currency loans to households remained very high in Hungary, Romania, Ukraine and Croatia at mid-2011. Compared with end-2010, however, it was considerably lower in Hungary, Ukraine and in Russia (albeit at a lower level) while it rose in Croatia and Bulgaria (from a lower level). Total

Share of foreign currency loans to households down in some countries  
Modest loan growth in Central Europe

Chart 12

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



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



foreign currency loans to households (currency-adjusted) were up in Croatia and Bulgaria, while the volume of household loans denominated in domestic currency contracted.

At mid-2011, total outstanding domestic loans exceeded total domestic deposits (as measured by total assets) in the majority of countries under review. In most countries, however, the loan-to-deposit ratio is trending down. Domestic deposits continued to exceed domestic loans only in Slovakia and the Czech Republic. Both countries also registered positive net external assets. The gap between domestic loans and deposits yawned particularly widely in the Ukrainian banking sector (31.9%), while ranging between 7.1% and 14.5% of total assets in the other countries. Compared with 2010, the gap between domestic loans and deposits narrowed markedly in Hungary, Bulgaria and Ukraine and, to a lesser extent, in Romania. Among the countries under review, Romania is also the country

where the banking system's net external liabilities – of which some comprise liabilities to foreign parent banks – are the highest relative to GDP.

The share of nonperforming loans in the banking sector remained high at the end of the second quarter of 2011. After the share of bad loans started to be significantly reduced in the second half of 2010, in the first half of 2011 most countries saw a marked increase in the share of nonperforming loans. The rise was highest in Romania (6.4 percentage points) – from an already high base level – Bulgaria (3.4 percentage points) and Hungary (2.8 percentage points). Croatia (1.7 percentage points) and the Czech Republic (0.4 percentage points) witnessed a slight increase. As for Russia, Poland and Slovakia, they saw a modest decline year on year. Looking at quarterly development, countries which registered increases in the share of bad loans on a 12-month basis saw a particularly steep rise in these shares in the

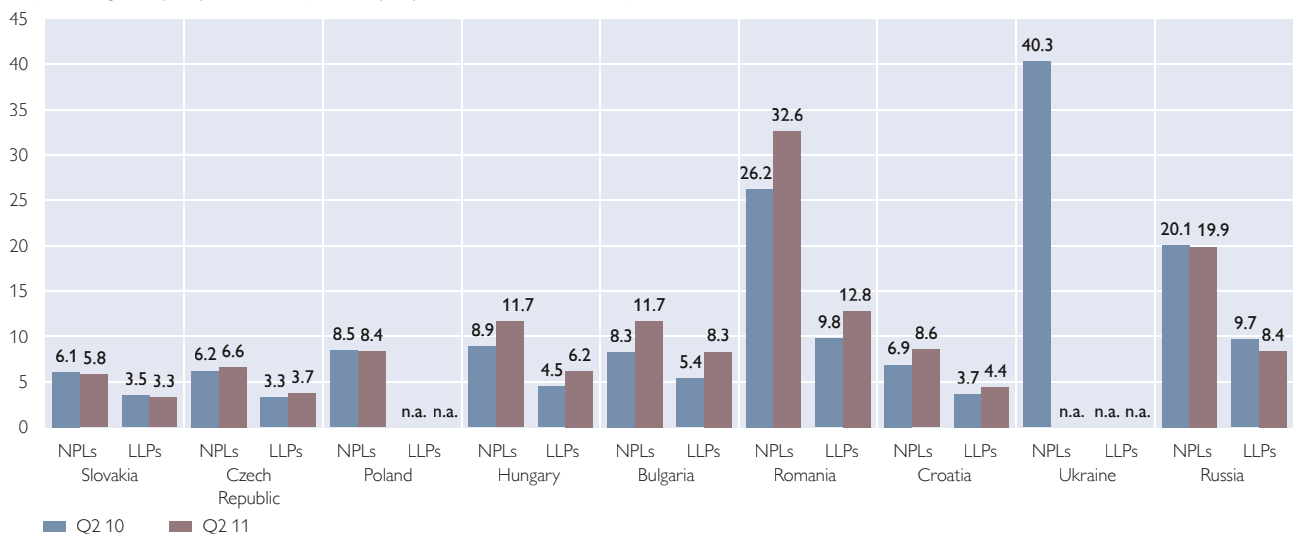
Credit risk remains high in banking sector

Credit gap narrows in some countries

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 between countries. NPLs include substandard, doubtful and loss loans. Poland including so-called irregular loans.

**Banking Sector: Profitability**

Return on equity (RoE) and return on assets (RoA), in %



Source: IMF, national central banks, OeNB.

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

**Banks' capital adequacy up in Central Europe**

first quarter of 2011. In the second quarter of 2011, quarter-on-quarter increase was relatively small.

**Banking sector profitability up slightly**

In the first half of 2011, banking sector profitability stabilized or, in some cases, slightly improved in most of the countries under review. Profits rose particularly sharply in Slovakia and Russia, while falling on a year-on-year basis only in the Czech Republic (from a high level) and Bulgaria (from a lower level). In Romania, the banking sector generated small profits in the first half of 2011 after incurring losses in the previous period. Owing to still high loan loss provisions necessary due to an increase in nonperforming loans, the Ukrainian banking sector continued to post losses. Compared with 2010, however, these losses were reduced by a significant margin.

Except for Poland, which experienced a slight decline, the capital adequacy of banks in most Central European countries was higher at mid-2011 than at end-2010. In the Czech Republic, it grew by 0.8 percentage points and now stands at 16%, well exceeding the level of other Central European countries. Although banks' capital adequacy in Russia (-1.3 percentage points) and Ukraine (-1.6 percentage points) was lower at mid-2011 than at end-2010, it remained at a high level. At mid-2011, this means the capital adequacy ratio ranged between 12.7% and 14.2% in Slovakia, Poland, Hungary and Romania and between 16% and 17.7% in the Czech Republic, Russia and Bulgaria. In Ukraine, banks' capital adequacy stood at 21.7%.