# Return to Growth

### Industrialized Countries: Positive Growth Outlooks for the U.S.A. and Japan, Mixed Ones for the Euro Area

For the *industrialized countries*, particularly the U.S.A. and Japan, the IMF economic outlook of spring 2010 predicts positive economic growth in 2010 following the severe recession in 2009. Growth will inter alia be fueled by the robust development of the Asian economy and by the recovery in world trade (2010 outlook: +7%). Compared with the IMF outlook of autumn 2009, the forecast for GDP growth in 2010 was revised up by 1.6 percentage points for the U.S.A. and by 0.6 percentage points for the euro area.

In the *U.S.A.,* real GDP grew by 0.8% quarter on quarter in the first quarter of 2010 (annualized: 3.2%) and was 2.5% higher than in the same period a year ago. Private consumption and a return to inventory building accounted for the largest positive contributions to quarterly growth. The residential real estate market recently also reported positive news. Although the Case-Shiller price index for single-family homes fell month on month in March 2010 for the first time after having risen eight times in a row, year on year it improved for the first time since December 2006. Overall, however, the real estate market remains exposed to risks (e.g. impairment of commercial real estate, rising indebtedness of public mortgage institutions). The financial crisis brought about a sea change in the U.S. labor market. Although unemployment of 9.7% in April 2010 was below the record high of October 2009 (10.1%), the U.S.A. is currently struggling with growing long-term joblessness for the first time in its history. Meantime, 44% of the 15 million U.S. unemployed have been without work for more than 27 weeks. In addition, the labor market is not expected to improve significantly until end-2011. Although the year-on-year rise in the consumer price index (CPI) reached 2.7% in December 2009, it slipped to 2.3% by March 2010. In that month, the core inflation rate stood at a 1.1% year on year. At its meeting of April 27 and 28,

Table 1

**IMF World Economic Outlook: Industrialized Countries**

| | GDP (real annual change) | | | | | | CPI (change of annual average) | | | | | | Current account balance | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Apr. 10 | Oct. 09 | | Apr. 10 | | | Apr. 10 | Oct. 09 | | Apr. 10 | | | Apr. 10 | | | |
| | 2008 | 2009[1] | 2010[1] | 2009 | 2010[1] | 2011[1] | 2008 | 2009[1] | 2010[1] | 2009 | 2010[1] | 2011[1] | 2008 | 2009 | 2010[1] | 2011[1] |
| | % | | | | | | % | | | | | | *% of GDP* | | | |
| **Industrialized countries** | **0.5** | **–3.4** | **1.3** | **–3.2** | **2.3** | **2.4** | **3.4** | **0.1** | **1.1** | **0.1** | **1.5** | **1.4** | **–1.3** | **–0.4** | **–0.4** | **–0.5** |
| **U.S.A.** | **0.4** | **–2.7** | **1.5** | **–2.4** | **3.1** | **2.6** | **3.8** | **–0.4** | **1.7** | **–0.3** | **2.1** | **1.7** | **–4.9** | **–2.9** | **–3.3** | **–3.4** |
| **Euro area** | **0.6** | **–4.2** | **0.3** | **–4.1** | **1.0** | **1.5** | **3.3** | **0.3** | **0.8** | **0.3** | **1.1** | **1.3** | **–0.8** | **–0.4** | **0.0** | **0.1** |
| Germany | 1.2 | –5.3 | 0.3 | –5.0 | 1.2 | 1.7 | 2.8 | 0.1 | 0.2 | 0.1 | 0.9 | 1.0 | 6.7 | 4.8 | 5.5 | 5.6 |
| France | 0.3 | –2.4 | 0.9 | –2.2 | 1.5 | 1.8 | 3.2 | 0.3 | 1.1 | 0.1 | 1.2 | 1.5 | –2.3 | –1.5 | –1.9 | –1.8 |
| Italy | –1.3 | –5.1 | 0.2 | –5.0 | 0.8 | 1.2 | 3.5 | 0.8 | 0.9 | 0.8 | 1.4 | 1.7 | –3.4 | –3.4 | –2.8 | –2.7 |
| Austria | 2.0 | –3.8 | 0.3 | –3.6 | 1.3 | 1.7 | 3.2 | 0.5 | 1.0 | 0.4 | 1.3 | 1.5 | 3.5 | 1.4 | 1.8 | 1.7 |
| **United Kingdom** | **0.5** | **–4.4** | **0.9** | **–4.9** | **1.3** | **2.5** | **3.6** | **1.9** | **1.5** | **2.2** | **2.7** | **1.6** | **–1.5** | **–1.3** | **–1.7** | **–1.6** |
| **Japan** | **–1.2** | **–5.4** | **1.7** | **–5.2** | **1.9** | **2.0** | **1.4** | **–1.1** | **–0.8** | **–1.4** | **–1.4** | **–0.5** | **3.2** | **2.8** | **2.8** | **2.4** |

*Source: IMF (World Economic Outlook), October 2009 and April 2010.*

[1] *Forecast.*

2010, the Federal Reserve's Open Market Committee (FOMC) left the target range for the Federal Funds rate unchanged at close to 0%. Furthermore, the wording that the FOMC continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the key interest rate for an extended period remained unchanged.

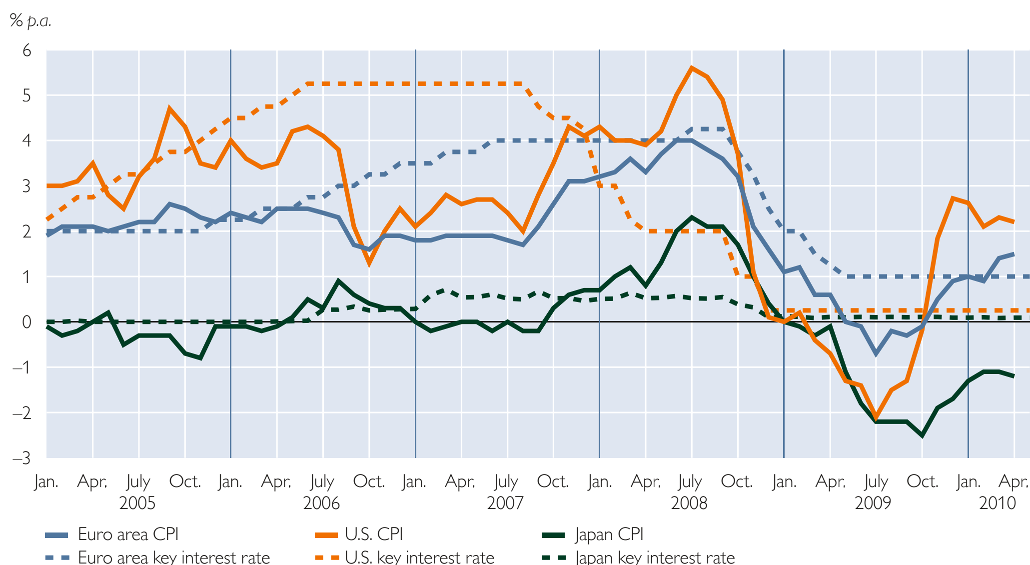
In the *euro area*, real GDP grew by 0.2% quarter on quarter in the first quarter of 2010 and was 0.6% higher than in the same period of 2009. Exports and inventory changes accounted for the largest positive contributions to quarterly growth. In the fourth quarter of 2009, real GDP had gone up by 0.1% quarter on quarter. The annual HICP rate climbed from 0.9% in December 2009 to 1.4% in March 2010, primarily owing to considerably higher energy prices on a year-on-year basis. Core inflation (excluding energy and unprocessed food) accordingly eased from 1.0% to 0.9%. At its meeting in early-April 2010, the Governing Council of the ECB decided to keep the key interest rate at 1%. At the same meeting, the ECB also extended the application period of the regulations governing collateral for central bank refinancing. In early May 2010, the minimum rating for collateral in the form of Greek government debt securities was suspended.

In the first quarter of 2010, the *Japanese* economy expanded by 1.2% quarter on quarter (+4.2% against the same quarter of the previous year). Growth was fueled in roughly equal measure by net exports – to Asia, in particular – and by domestic demand. In March 2010, annual inflation stood at –1.1%. The inflation rate is not expected to return to positive territory until 2011. The Bank of Japan adhered to its zero interest rate policy at end-April 2010. This means Japan will continue to have the lowest interest rates of all the G7 countries.

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 continued to re-

Chart 1

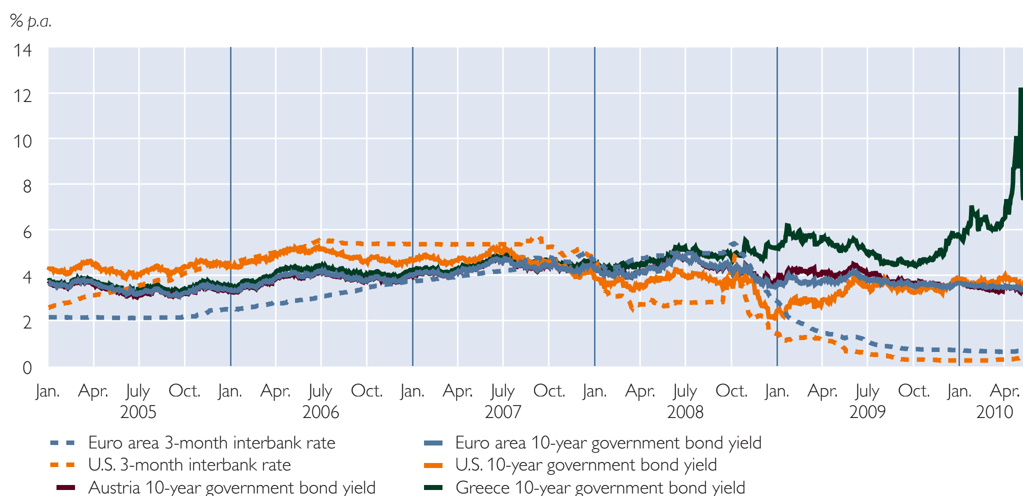
**Euro Area, U.S.A., Japan: Inflation and Key Interest Rates**




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

Chart 2

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




*Source: Thomson Reuters, OeNB.*

main below those in the euro area. In *government bond markets*, long-term interest rates remained relatively stable until March 2010, compared with the start of the year. However, 10-year government bond yield spreads between Germany and some other euro area countries widened significantly again. In particular, the risk premiums on Greek government bonds reached record values of over 700 basis points at the end of April 2010, forcing Greek Prime Minister Georgios Papandreou to make an official request for assistance from the EU and IMF. On May 2, 2010, a rescue package for Greece was set in place, totaling EUR 110 billion in bilateral loans from both euro area countries (EUR 80 billion) and the IMF (EUR 30 billion). One condition for the assistance is that Greece implements a rigorous government budget austerity program. In the financial markets, however, uncertainties persisted about the implementation of savings targets despite the recession and about the possible escalation of fiscal problems in other euro area countries as well as, coupled with this, speculative transactions. Only the EU and IMF measures announced on May 9, 2010 (provision of an immediately available facility for external stabilization amounting to EUR 60 billion and establishment of a credit limit in the amount of EUR 660 billion, cofinanced with EUR 440 billion from the EU and EUR 220 billion from the IMF) and the ensuing government bond purchases by euro area central banks from May 10, 2010, stabilized the government debt markets in the euro area. In addition, the EUR-USD swap line to ensure the banking sector's U.S. dollar liquidity was reinitiated.

The yield spreads of U.S. and euro area *corporate bonds* further normalized for both AAA- and BBB-rated bonds. After an interruption in early 2010, the global recovery observed in the *stock markets* since March 2009 continued until end-April 2010. Early that month, for the first time since the collapse of Lehman Brothers, the Dow Jones closed at over 11,000 points. Moreover, the stock markets rallied in response to the euro area's stabilization measures.

Chart 3

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

*Basis points*

900
800
700
600
500
400
300
200
100
0
–100

Jan. Apr. July Oct. Jan. Apr. July Oct. Jan. Apr. July Oct. Jan. Apr. July Oct. Jan. Apr. July Oct. Jan. Apr.
2005 2006 2007 2008 2009 2010

AAA corporate bonds (EUR)
AAA corporate bonds (USD)
BBB corporate bonds (EUR)
BBB corporate bonds (USD)

*Source: Thomson Reuters, OeNB.*

Chart 4

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

*1. Jänner 2005 = 100*

180
160
140
120
100
80
60
40
20
0

Jan. Apr. July Oct. Jan. Apr. July Oct. Jan. Apr. July Oct. Jan. Apr. July Oct. Jan. Apr. July Oct. Jan. Apr.
2005 2006 2007 2008 2009 2010

DJ EURO STOXX
DJ EURO STOXX Financials
S&P 500 COMPOSITE
DJ TM Financials
TOKYO SE (TOPIX)

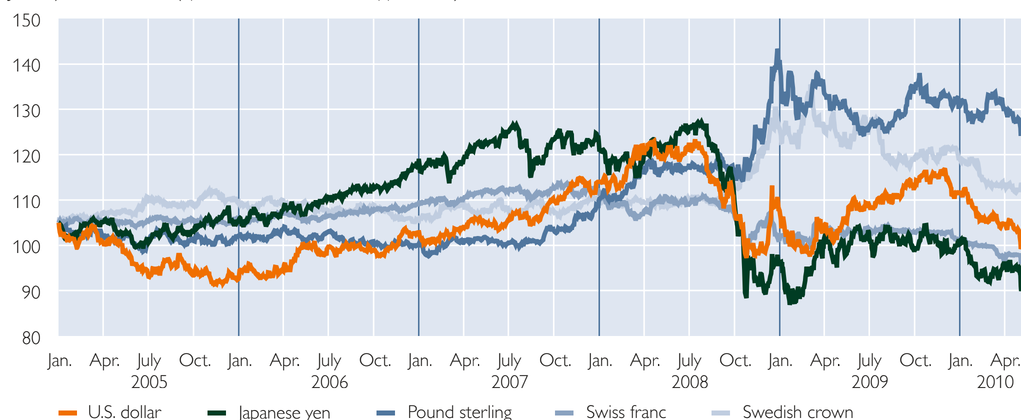
*Source: Thomson Reuters, OeNB.*

In response to both the improved growth outlook for the U.S.A. and Japan and to the government debt problems in some euro area countries, the euro has, in recent months, been depreciating against other important currencies in the *foreign exchange markets* despite the prevailing interest rate differential.

Chart 5

**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.*

## CESEE Compared with Other Emerging Markets

After annual global economic growth of some 5% from 2004 to 2007, the *world economy* grew by no more than 3% in 2008 and shrank by around 0.5% in 2009. For both 2010 and 2011, the IMF spring outlook predicts growth of just over 4%. Of all regions of the world (including the industrialized countries), Asia's emerging markets will make the largest contribution to global GDP growth, as has been the case for some years now. In 2009, despite Japanese GDP shrinking by 5.2%, Asian emerging markets only suffered a relatively modest decline in GDP growth. By contrast, GDP slumped in the three regions of CESEE (here excluding the CIS), the CIS and Latin America. Owing to these three regions' very close economic and financial ties with the euro area and the U.S.A., respectively, this slump reflected in particular the recession in the euro area and the U.S., as well as – in the CIS and Latin American countries – the (recession-induced) downward spiral of commodity prices. In parallel to this, there were naturally some major differences within the individual economic areas. For instance, Poland, which has a weight of more than 20% in the CESEE aggregate, registered positive growth. According to the IMF, the economy will again expand at a far faster pace in the CESEE and CIS regions than in the euro area in 2010 and 2011 and the convergence process of average per capita income will increasingly get under way again. At the same time, however, growth will lag behind that of other emerging market regions (particularly, Asia), which still have a much lower base of GDP per capita. Compared with its outlook in autumn 2009, the IMF has upgraded its 2010 forecast for all emerging economies by 1.3 percentage points, with the CESEE and CIS regions up by 1 percentage point and 1.8 percentage points, respectively.

Global *external imbalances* decreased in 2009. Although emerging market regions which had previously had current account surpluses still showed surpluses (with the exception of Subsaharan Africa), some of these were now

Chart 6

## Emerging Economies and Selected Industrialized Countries: GDP Forecast

*Annual change in % at constant prices*

*Source: IMF (World Economic Outlook), April 2010.*

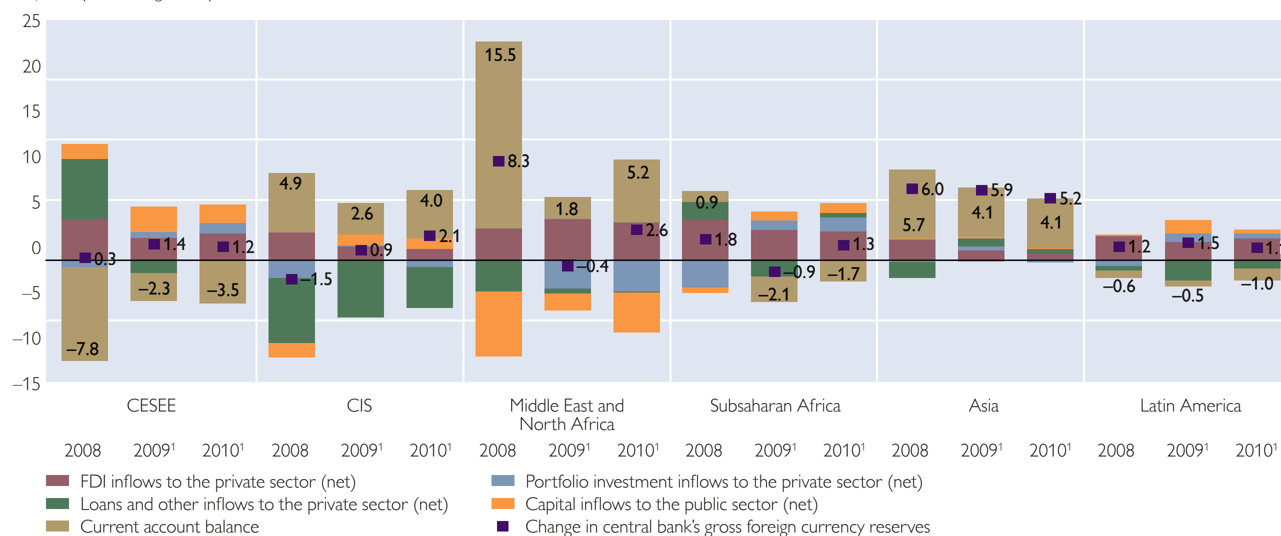
[1] *Forecast.*

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

Chart 7

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

*% of GDP (at exchange rates)*




*Source: IMF, OeNB.*

[1] *Forecast.*

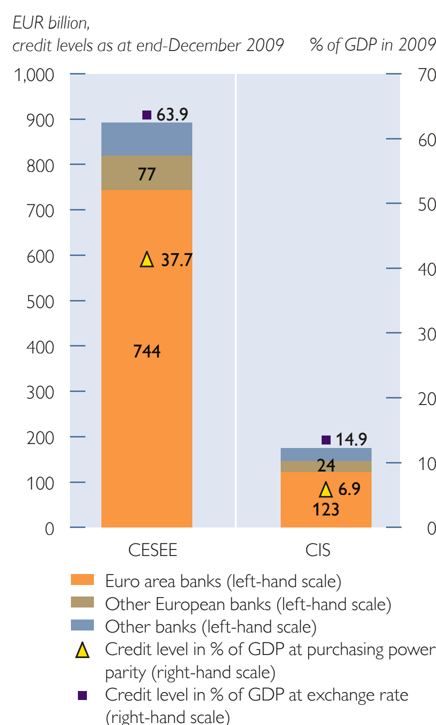
*Note: Negative net capital inflows (to the pubic sector) refer to net capital outflows from the public sector (to industrialized countries). Positive values for the change in official gross reserves indicate an increase. CESEE excluding European CIS countries, the Czech Republic, Slovakia and Slovenia.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

drastically reduced. This situation is attributable to, above all, the decline in the U.S. current account deficit and – particularly in the case of the CIS as well as the Middle East and North Africa – to the (recession-induced) slump in commodity prices. In respect of emerging Asian markets, a lower current account surplus is expected in 2010 compared with 2008 while GDP growth is likely to be more robust, indicating a slight shift toward domestic demand-driven economic growth. In 2009, the CESEE current account deficit decreased at a much faster pace than net FDI inflows, which meant the latter almost entirely covered the deficit for the first time in years. In Subsaharan Africa, which had a current account deficit in 2009 for the first time since 2005, and in Latin America, which saw current account deficits in 2008 and 2009 after several years of surpluses, net FDI inflows also covered the deficits. In 2010, as in the two previous years, only the CIS is likely to witness net capital outflows from the private sector, albeit again (as in 2008) on a smaller scale than the expected current account surplus.

From end-September 2008 to end-2009, *cross-border credit claims on emerging markets by BIS reporting banks*, which are largely from industrialized countries, declined at a slower pace vis-à-vis CESEE banks than vis-à-vis Latin American and Asian banks – despite the (deeper) recession in CESEE and the previously more buoyant increase of credit claims on CESEE banks. This situation is attributable to two factors: first, most CESEE countries' banking sectors are almost wholly owned by BIS-reporting banks (particularly, those from the euro area) and, second, the credit lines to their own subsidiary banks in CESEE were kept almost stable. In this way, both the banking sector's ownership structure and the business policies of group headquarters in relation to their own subsidiary banks differ from the situation in Latin America and Asia. By contrast, credit claims on banks in the CIS, which had previously expanded especially strongly, declined at a faster pace compared with lending to banks in Latin America and Asia. The latter situation is also likely to reflect the particularly deep recession and problems specific to certain heavyweights (Ukraine, Kazakhstan). Credit claims on banks in CESEE and – to an even greater extent – on banks in Latin America and Asia did not pick up until the fourth quarter of 2009. As

Chart 8

**CESEE and CIS: Domestic and Cross-Border Credit to CESEE and CIS by BIS Reporting Banks**

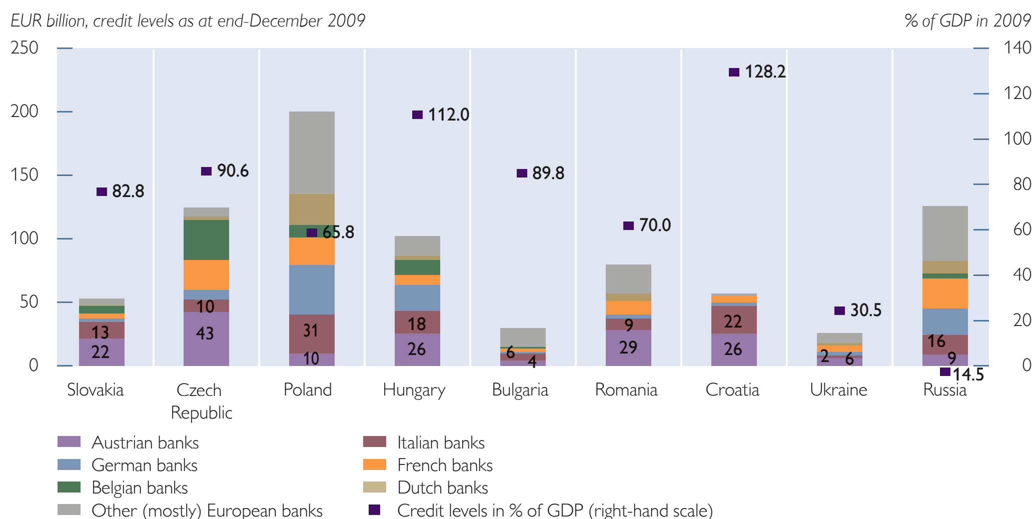



*Source: IMF, BIS, OeNB.*

*Note: CESEE excluding European CIS countries. Proxy for euro area banks (including Danish and Norwegian, excluding Luxembourg banks). Points: credit levels of all BIS reporting banks in % of GDP of the recipient region (right-hand scale).*

Chart 9

**CESEE and CIS: Domestic and Cross-Border Credit to CESEE and CIS Countries of BIS-Reporting Banks**




*Source: BIS, IMF, OeNB.*

*Note: Austrian banks not including UniCredit Bank Austria (assigned to Italy). Points: credit levels of all BIS reporting banks in % of GDP (at exchange rates) of the recipient region (right-hand scale).*

for the CIS, lending to banks in this region continued to decline.

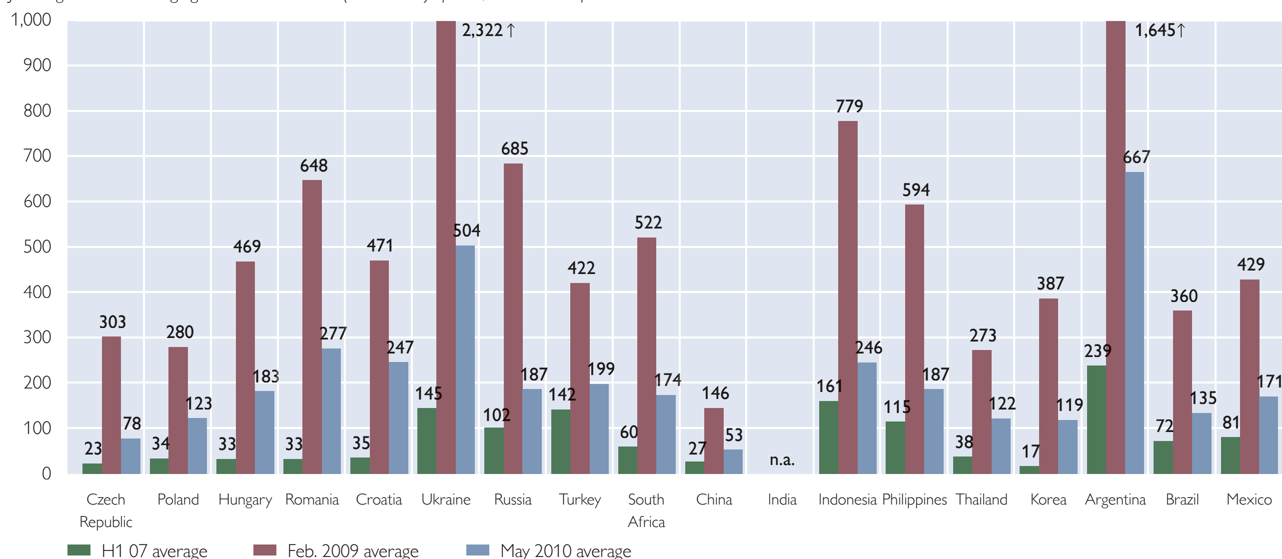
A breakdown by individual CESEE countries and by the BIS reporting banks' countries of origin shows that Austrian, Italian, German and French banks control a considerable share of the lending market in most countries of the region. In certain CESEE countries, however, Belgian and Dutch (in the Baltic countries, also Swedish and in SEE also Greek) banks are represented to a greater extent.

In the *financial markets (stock market, foreign bond market) of emerging economies*, the global environment (low level of interest rates in industrialized countries, prospects for growth and currency appreciation in emerging markets) and the decline in international investors' risk aversion were reflected in strong net inflows in the first quarter of 2010. Net inflows cumulated since 2001 have now reached pre-crisis levels (debt securities) and, in some cases, exceeded these levels (stocks). Despite a high issuance volume (of government bonds and, especially in Latin America, corporate bonds) – as in the fourth quarter of 2009 – , foreign bonds generated higher total return in the first quarter of 2010 than shares issued by enterprises in industrialized countries and emerging markets since the bond spreads continued to narrow significantly. Investment is increasingly likely to be made in emerging market debt securities denominated in national currency, which will increase pressure for currency reappreciation. Uncertainties in the international financial market stemming from 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 visible signs of a renewed lack of risk differentiation, the medium-term risks of bubble formation, overheating and imbalances are increasing.

Chart 10

**Emerging Markets: Spreads of Foreign Government Bonds 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. Russia, Indonesia and Argentina: (USD-based) EMBI and U.S. government bonds; Czech Republic, Thailand and Korea: 5-year sovereign CDS premiums serve as a proxy.*

## CESEE: Stabilization Continues[1]

Financial market developments in the CESEE countries (here including the European part of the CIS) were largely characterized by incipient stabilization. In the banking sector, furthermore, the share of nonperforming loans (NPLs) rose to a somewhat smaller extent in most countries in the fourth quarter of 2009 than in previous quarters. In the second half of 2009 and the first quarter of 2010, currency markets, national currency denominated-government bond markets and credit markets in CESEE were also still marked primarily by the gradual abatement of the global crisis' financial and economic impact. Greece's refinancing problems, which have generally somewhat dampened international investors' willingness to take risks – at least temporarily –, had a relatively small impact on CESEE markets.

*Stabilization of the real economy*, which had already commenced in most countries in the second quarter of 2009, also continued in the fourth quarter of 2009 and the first quarter of 2010. In terms of seasonally-adjusted real GDP, the Czech Republic, Slovakia and Poland each registered a further acceleration in quarter-on-quarter growth in the fourth quarter of 2009. Also for Russia, which saw robust quarterly growth as early as in the third quarter of 2009, the growth rate released for the entire year implies an increase in quarter-on-quarter growth in the fourth quarter of 2009. Similar momentum was seen in Hungary where the economy was shrinking at a steadily slower pace before returning to the growth path in the fourth quarter of

[1] *For a detailed description of the macroeconomic development of these countries, see "Recent Economic Developments" in OeNB, Focus on European Economic Integration Q2/10.*

2009. While in Slovenia and Romania, economic growth had been positive in the third quarter of 2009, GDP went down again in both countries later on.

Even if some countries started to see positive quarter-on-quarter growth, in the fourth quarter of 2009 real GDP was at a lower level year on year in almost every CESEE country – namely 2% to 4.5% lower than the previous year's level in Slovakia, the Czech Republic, Hungary, Croatia and Russia, and 5% to 7.5% lower in Bulgaria, Slovenia, Romania and Ukraine. With GDP growth of 3.6%, Poland was the only CESEE country to buckle this trend. Its lower weight of exports relative to overall demand, sharp currency depreciation and fiscal policies also contributed to this growth. In the fourth quarter of 2009, Poland registered annual growth of gross fixed capital formation for the first time since the start of the crisis. During the crisis, the inventory levels in the region decreased owing to weakening foreign demand and the decline in both gross fixed capital formation and private consumption. In the fourth quarter of 2009, inventory build-up in Bulgaria and Croatia and slowing inventory rundowns in Ukraine made a positive contribution to growth again, thereby curtailing the year-on-year decline in GDP. Across the entire CESEE region, net exports again made stronger positive contribution to the year-on-year change in GDP in the fourth quarter of 2009. This development was only partly attributable to a stronger decline in imports over exports: In Poland, the Czech Republic, Hungary, Bulgaria, Romania and Russia, in the fourth quarter of 2009 exports started to grow again year on year, while imports continued to fall. This situation was for the most part accompanied by a reduction in the combined current and capital account deficits.[2]

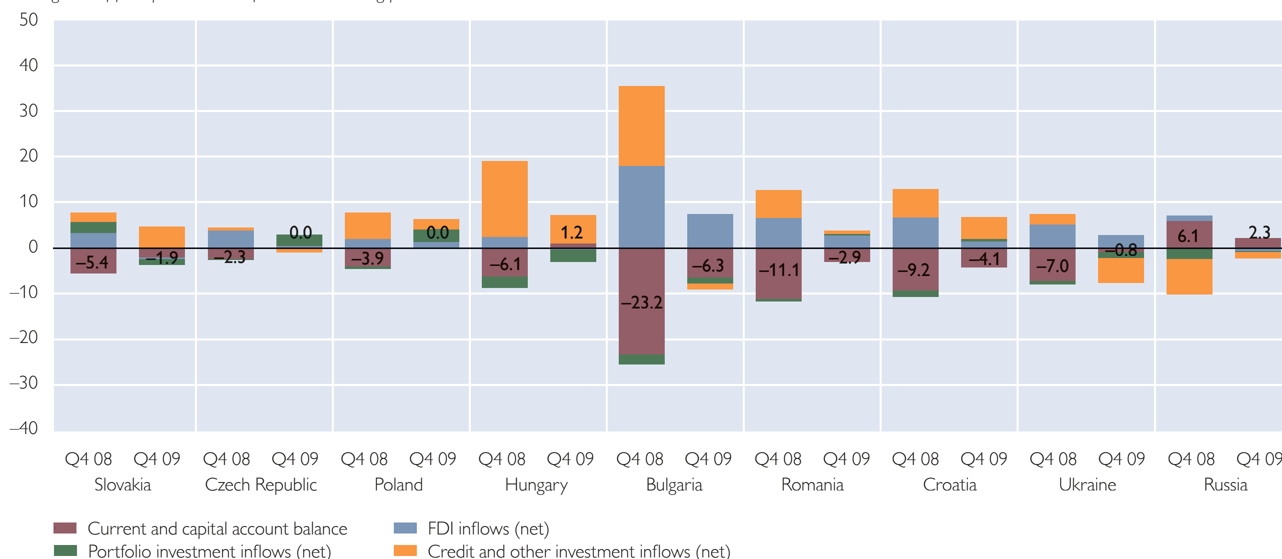
The correction – having started already in the first half of 2009 – of partly high deficits in the *combined current and capital account* in Southeastern European countries was also reflected in a much reduced balance for the year as a whole. For instance, the deficit in Bulgaria amounted to 6.3% of GDP in 2009 and that in Romania and Croatia to 2.9% and 4.1% of GDP, respectively. In the case of Bulgaria, this is equivalent to a correction by more than 15 percentage points of GDP compared with 2008. Even the Central European countries saw a year-on-year reduction in current account deficits (here largely resulting from profit and interest transfers abroad). Hungary, Poland and the Czech Republic even registered modest current account surpluses. The development in Hungary, whose current account deficit of 6.1% of GDP turned into a surplus of 1.2% of GDP in 2009 (owing to positive quarterly export growth in the previous three quarters), was particularly pronounced. In addition to a slump in domestic demand, currency depreciations in the case of countries without a fixed currency peg especially helped reduce the current account deficits, in particular via imports. Although Russia still posted a current account surplus, the latter shrank from 6.1% of GDP in 2008 to 2.3% in 2009. The main reason for this development was the slide in oil prices, in particular. This situation reflects the Russian economy's continued heavy dependence on the price development of

[2] *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 "capital account" (e.g. direct investment, portfolio investment, loans) are now shown in the so-called "financial account."*

Chart 11

## Current and Capital Account Balance and Its Financing

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




*Source: Eurostat, national central banks, OeNB.*

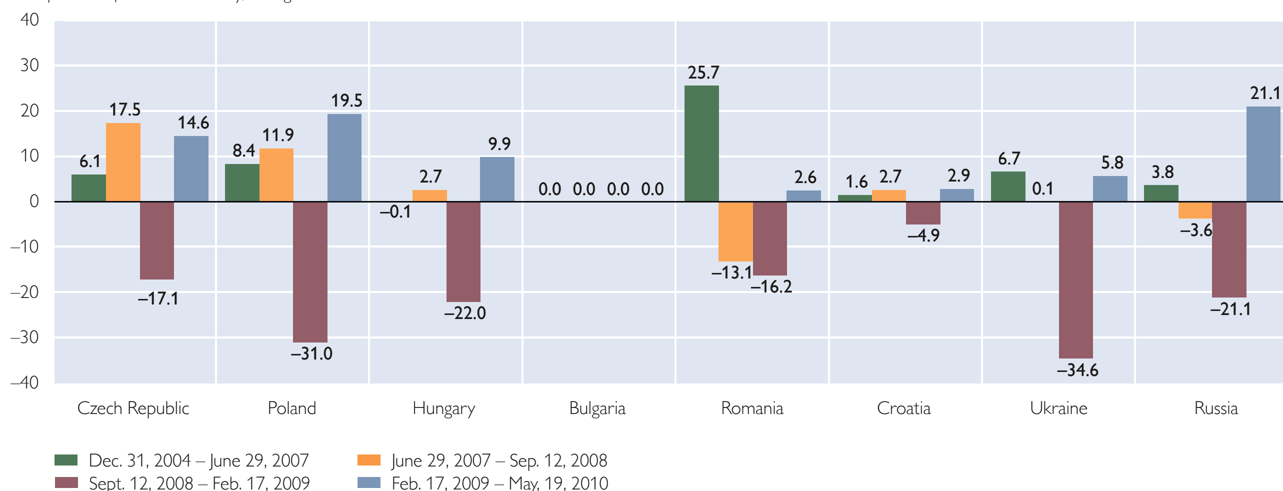
energy and commodities. In Ukraine, the current account deficit narrowed from 7% of GDP for 2008 as a whole to 0.8% in the entire year 2009, which – in addition to the slump in domestic demand and currency depreciation – the recovery of steel prices in the course of the year can explain.

In 2009 as a whole, *financial account* surpluses decreased year on year in every country of the CESEE region, with the exception of Russia, which recorded a declining financial account deficit due to the sharp contraction in credit and investment outflows (as a percentage of GDP). In other CESEE countries, by contrast, net inflows of credit and other investment went down significantly. In 2009 as a whole, Bulgaria and the Czech Republic even registered modest net outflows in this category, while net outflows from Ukraine were heavy. What is more, net FDI inflows as a percentage of GDP also decreased year on year in every CESEE country. In the course of 2009, net FDI inflows further contracted year on year in most of the countries under review in both the third and fourth quarters of 2009. In Slovakia, Hungary and Russia, this situation even gave rise to (modest) net FDI outflows in 2009 as a whole.

The impact of the recession, as well as of sluggish growth, had a negative effect on the *fiscal balance* on both the revenue and expenditure side (impact of automatic stabilizers). In 2009, public debt levels increased in every country in this region. In Ukraine, Romania and Slovenia, they rose particularly steeply compared with end-2008, albeit from a relatively low level. Currently, 20 EU Member States are subject to excessive deficit procedures. Also in the CESEE EU Member States, budget deficits ranged between 3.9% and 8.3% of GDP in 2009, i.e. above the 3% threshold, although CESEE countries responded to the economic downturn with only very mild fiscal stimuli; some countries went as far as adopting procyclical consolidation mea-

Chart 12

**National Currencies and the Euro**




*Source: Thomson Reuters, OeNB.*

sures in the crisis in a bid to stabilize international investors' confidence. Among the Central European countries, only the Hungarian budget deficit (4% of GDP) came relatively close to the Maastricht ceiling, with the EU and IMF stabilization programs both rendering the deficit possible and limiting it at one and the same time. Even Bulgaria and Russia, which still generated budget surpluses in 2008, registered a budget deficit of 3.9% and 6.2% of GDP, respectively, in 2009. In Russia, in addition to other factors, oil price developments, in particular, had a negative effect on public finances (compared with 2008).

In some countries, budgetary developments are a key factor for the further payment of tranches of *EU and IMF rescue loans*. In Ukraine, an important measure was implemented in this respect at the end of March 2010, and the 2010 government budget was approved in parliament. At 5.3% of GDP, the consolidated[3] budget deficit is in compliance with the IMF's stipulated ceiling of 6% of GDP. The stabilization program, which was launched at end-2008 and has since been put on hold, provides for a total payment of EUR 12.8 billion, of which some EUR 4.5 million can be disbursed if the program is reignited. Talks are currently under way between the IMF and the Ukrainian authorities in relation to this matter. In Romania too, major groundwork for further disbursements under the EU and IMF stabilization program was laid at end-March 2010. For instance, Romanian legislation relating to the preparation and execution of the government budget was amended in coordination with the IMF (including a three-year budgetary framework, the legal restriction of budgetary revisions, the establishment of an independent oversight committee, etc.). Under the IMF program, which will run until March 2011, EUR 9.4 billion of a total EUR 13 billion has already been disbursed. The final EU tranche is ex-

[3] *The consolidated budget includes Naftogaz, the state oil and gas company.*

pected in the second quarter of 2011. To date, EUR 2.5 billion of a total EUR 5 billion has been disbursed under the EU program.

In the first quarter of 2010, most of the countries under review saw a modest rise in *inflation* year on year. In Hungary, the Czech Republic, Bulgaria, Romania and Slovenia, the HICP's energy components, in particular, contributed to the price uptrend. In Russia, Ukraine and Poland, disinflation persisted, albeit starting at widely differing levels. In Slovakia, the price level stagnated in the second half of 2009. In January and February 2010, Slovakia was the only CESEE country under review that recorded falling prices, while in March 2010, prices began to climb again slightly on a year on year basis.

In respect of the *currencies* of the countries under review, the stabilization period, which commenced in March 2009, continued in the reporting period (to May 2010). Compared with the record lows of February 2009, in particular the Polish złoty (+19.5), the Czech koruna (+14.6%), the Hungarian forint (+9.9%) and the Russian ruble (+21.1%) firmed strongly against the euro. To counter the appreciation pressure on the Polish złoty, in March 2010 Polish central bank intervened in the foreign exchange markets for the first time in 12 years. In Russia (currency basket: U.S. dollar 55%, euro 45%) and Ukraine (currency primarily pegged to the U.S. dollar), the depreciation of the euro relative to the U.S. dollar gave rise, ceteris paribus, to the appreciation of the national currencies relative to the euro. The Bank of Russia, too, recently repeatedly countered the upward pressure on the Russian ruble via substantial foreign currency purchases and, what is more, lowered key interest rates by 25 basis points to 8%. By contrast, the Romanian (+2.9%) and Croatian (+2.9%) national currencies appreciated only slightly. Despite these appreciations, only the Czech koruna has so far approached its pre-crisis exchange rate, the level of which may have signified an excessive valuation of the national currency in many countries, however.

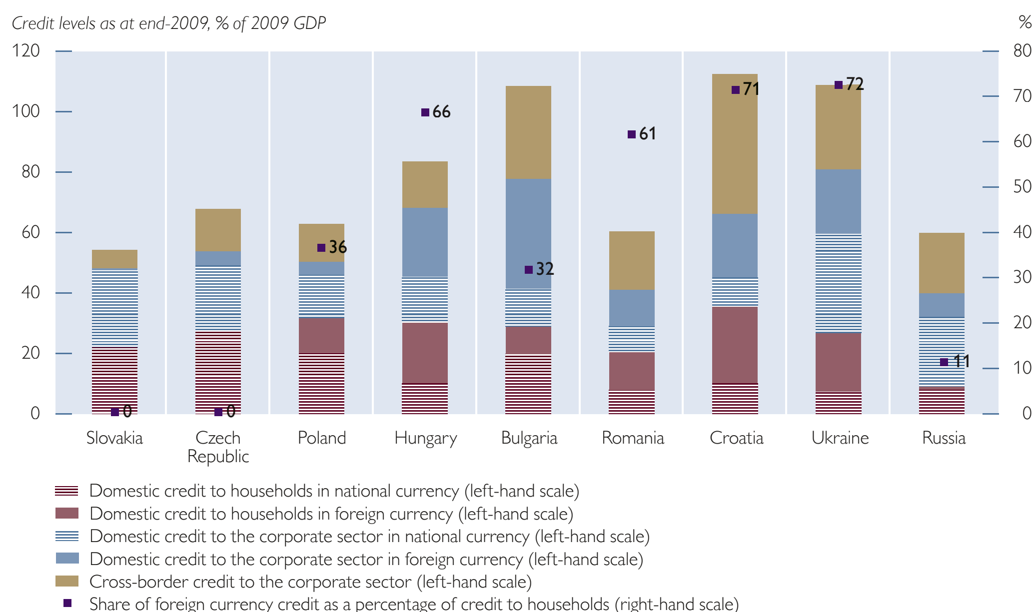
Despite the turmoil since early 2010 surrounding the Greek national budget and the corresponding significantly widening spreads of Greek government debt securities, for most countries in the region *yields on ten-year government bonds denominated in national currency* remained unchanged or were slightly lower in the first quarter of 2010 compared with the fourth quarter of 2009. Unlike in the other CESEE countries, yields on ten-year government bonds denominated in national currency increased in both Romania and Bulgaria in the first quarter of 2010. In Romania's case, yields rose despite gradual key interest cuts from 8% at end-2009 to 7% in March 2010. In most CESEE countries, short-term interbank rates remained almost unchanged or were slightly lower in the first quarter of 2010, compared with the fourth quarter of 2009. In most of these countries, this development was accompanied by further cuts in key interest rates. Romania and Croatia even witnessed sharper decreases in interbank rates by the order of 3 and 4 percentage points, respectively. At the end of the first quarter of 2010, the yield curve was sloping upward in Slovakia, the Czech Republic, Poland, Hungary, Bulgaria and Romania. In this respect, Romania's yield curve normalized since short-term interest rates had been still higher than ten-year government bond yields in the fourth quarter of 2009.

In the *credit markets* of almost all the countries under review, exchange rate-adjusted year-on-year growth in household and corporate lending was lower at end-2009 than at mid-2009. In Slovakia, Hungary, Romania, Ukraine and Russia, the volume of credit outstanding was even lower at end-2009 than a year earlier (negative exchange rate-adjusted year-on-year change). In Slovakia, the Czech Republic and Hungary, the volume of outstanding corporate loans was lower at end-2009 than at end-2008, while in Croatia, Ukraine and Russia, by contrast, household loans recorded lower volumes at end-2009. As for Romania, lending to both sectors was lower at end-2009 than a year earlier. Only Poland and Bulgaria did not suffer a decline in either sector. In January 2010, most CESEE countries (except for Bulgaria and Ukraine) registered modest monthly lending growth.

At 61% to 72%, the share of *foreign currency loans* as a percentage of loans to households remained very high in Hungary, Romania, Croatia and Ukraine at end-2009. In the current reporting period, it has continued to rise in Romania and Croatia as well as in Bulgaria (albeit to a still relatively low level of 32%). By contrast, the share of foreign currency loans as a percentage of loans to households was extremely small in the Czech Republic and in Slovakia, as well as in Russia. The ratio between (foreign and national currency-denominated) domestic household lending and domestic corporate lending (including cross-border credit) is relatively balanced in the Central European countries. In the Southeastern European countries, by contrast, the volume of corporate loans outstanding was roughly twice as high as that of outstanding household loans. In Russia, even as much as five times as many cor-

Chart 13

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

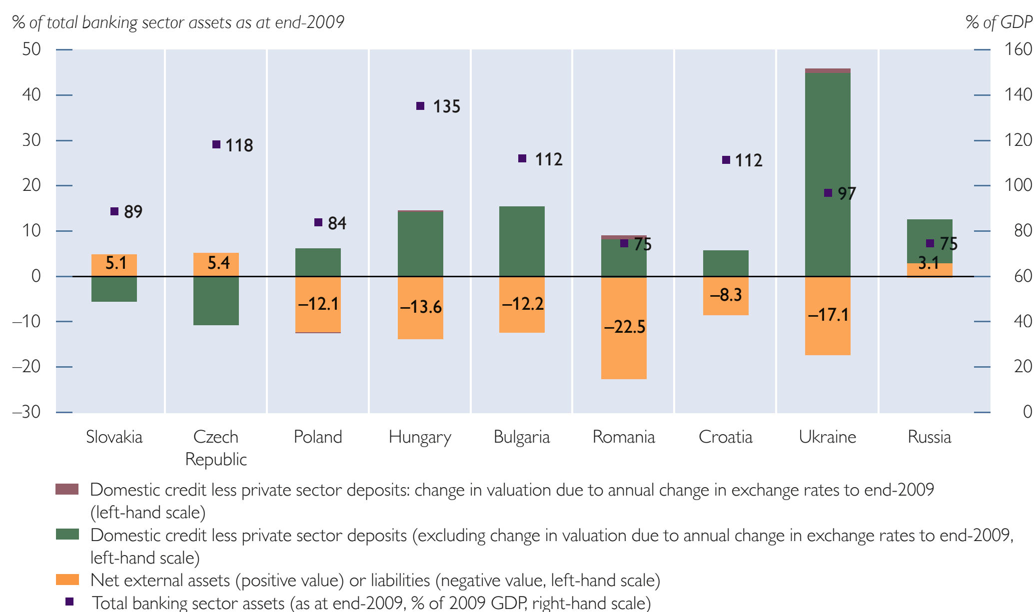



*Source: ECB, Eurostat, national central banks, OeNB.*

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

Chart 14

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




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

porate loans than household loans were outstanding at end-2009.

At end-2009, the outstanding volume of *domestic loans* exceeded that of *domestic deposits* (in terms of total banking sector assets) by a particularly wide margin in Ukraine, followed by Bulgaria and Hungary and then Romania and Russia. The *banking sector's net external liabilities* in these countries (except for Russia) are used primarily to finance this domestic credit overhang. Banks have part of these net external liabilities vis-à-vis foreign parent banks. For these countries, mobilizing domestic deposits remains a task of utmost priority. In Slovakia and the Czech Republic, however, domestic deposits exceeded loans – and their respective banking sectors held net external assets.

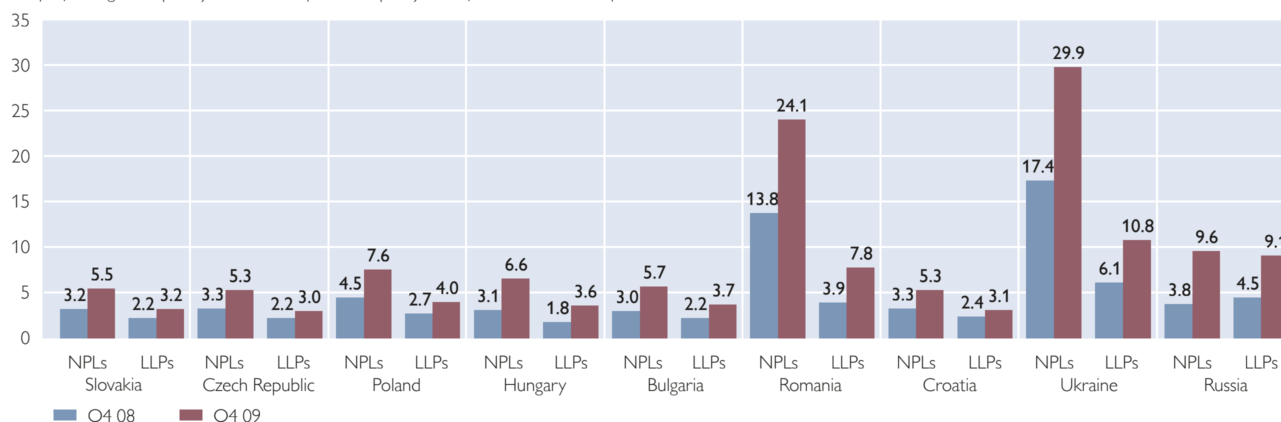
The impact of the recession and persistently sluggish growth continued to heighten *credit risk* in the banking sector. For most of the countries under review, however, the quarter-on-quarter rise in the share of NPLs slowed in the fourth quarter of 2009 – with the exception of Croatia, which saw a quarterly increase over the same period. Despite the incipient stabilization, the share of nonperforming loans in every CESEE country was higher at end-2009 than a year earlier. In Romania, NPLs rose particularly sharply by some 10 percentage points. In Ukraine, NPLs also went up sharply in the first half of 2009 (more recent data are not available).

At the same time, in 2009 *banking sector profitability* was down year on year in all the countries of the region – except for the Czech Republic. While every CESEE country experienced a more or less sharp fall in profits, Ukraine suffered substantial losses. The steep increase in loan loss provisions as a result of the rise in NPLs is responsible for this situation. However, in almost the entire region *capital adequacy* was higher at end-2009 than a year earlier. This increase was particularly

Chart 15

**Banking Sector: Credit Quality**

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



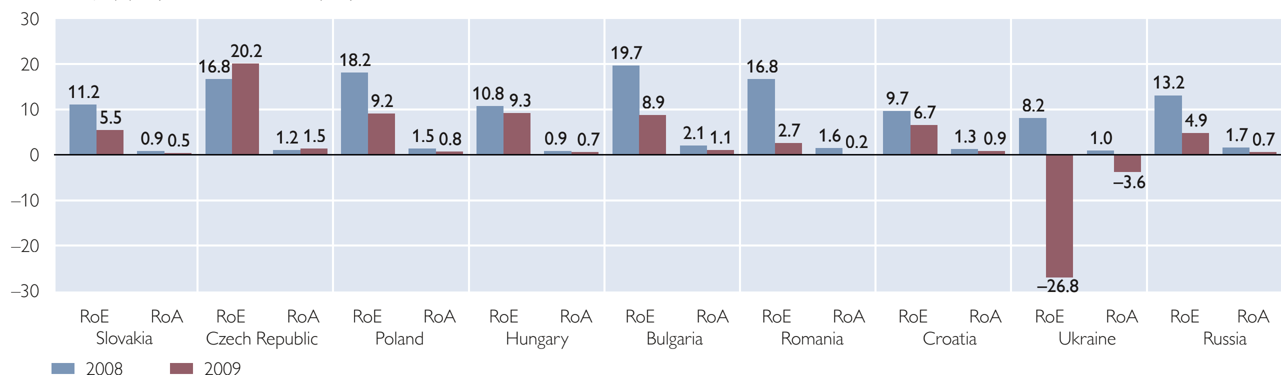

*Source: IMF, national central banks, OeNB.*

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

Chart 16

**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 annual after-tax profit, except for Russia's, which are based on pre-tax profit.*

steep in Russia, Ukraine and Bulgaria. This situation was attributable to two factors: first, recapitalization measures carried out by governments and parent banks and, second, sluggish and, in some cases, negative credit growth. At the end of 2009, therefore, the capital adequacy ratio ranged between around 13% (Slovakia, the Czech Republic, Poland and Hungary) and 20% (Russia and Ukraine).

Future financial market developments in CESEE remain exposed to a number of *risks*. First, recent developments concerning the fiscal situation in some developed economies are dampening international investors' willingness to take risks. Second, the economic recovery of the countries under review is closely tied to the sustained recovery of the euro area, which is their core sales market. As in most EU

countries, the fiscal situation is tense in many CESEE countries and will require (continuous) consolidation in the short to medium term. Country-specific risks related to political decision-making processes and upcoming elections represent further risk potential.