

CESEE: Modest Impact of Sovereign Debt Crisis

Industrialized Countries: Marked Slowdown in Recovery, But Some Positive Signs Recently

Global GDP growth loses momentum

Global GDP growth started to lose momentum from summer 2011. This development was accelerated by a marked rise in crude oil prices at the turn of the year, which also ramped up global price pressures. Recently, global GDP growth has, on balance, shown positive signs again, despite U.S. GDP growth receiving a slight dent in the first quarter of 2012. U.S. GDP growth decelerated for the first time since early 2011, although it remained clearly positive at 2.2%. Growth in domestic demand was particularly robust. U.S. unemployment has fallen slowly but steadily since fall 2011. Inflation topped 3% in the second half of 2011, dropping below this level only recently. Monetary policy remained expansionary. At 0% to 0.25%, the target for the federal funds rate has remained unchanged for almost three and a half years. This level will be maintained until end-2014, according to expectations published by the Fed's Board of Governors.

GDP growth in euro area down since mid-2011

Real GDP growth in the euro area slowed increasingly by end-2011, falling by 0.3% quarter on quarter in the fourth quarter of 2011 and only just stagnating in the first quarter of 2012. External trade made the only significant positive contribution to growth in these two quarters mainly because demand in the euro area shrank more quickly compared with the euro area's key trading partners. The contribution of private consumption and gross fixed capital formation to growth was largely balanced or even negative. Public consumption has stopped making a significant contribution to growth in the last two years. These developments came about primarily because the public and

private sectors in many European countries were both being deleveraged at the same time. At 11%, unemployment in April 2012 was at a record level last seen in February 1997. High oil prices in early 2012 sent inflation climbing to well above 2%.

Growth performance in the euro area remains very heterogeneous across countries despite a slight decrease in imbalances within Europe. Developments were uneven in those euro area countries affected by the debt crisis. In Ireland, the situation has eased markedly and Portugal has implemented key reforms. In Italy and Spain, economic output slumped visibly in early 2012. Italy nonetheless intends to balance its budget by 2014. Spain still has to contend with the consequences of the housing bubble for its banking sector. After financial assistance for bailing out its banks reached ever higher volumes and Fitch downgraded Spain's credit rating by three notches to BBB, Spain announced in early June 2012 that it would apply for emergency aid either via the temporary rescue fund, the European Financial Stability Facility (EFSF), or via the permanent one, the European Stability Mechanism (ESM). Financial ministers thereupon allocated funds of up to EUR 100 billion with the specific purpose of promoting the recovery of the Spanish banking sector, on which conditions will also be concentrated. Markets were relieved for only a short while, with yields on 10-year bonds climbing to a new record level of more than 7% in the days that followed.

Financial markets and European institutions positively noted the solid majority achieved by those political forces in Greece who subscribed to the goals agreed with the troika – the European Commission, the ECB and the IMF.

After temporarily increasing MRO rates in summer 2011, the ECB cut them to 1% in fall 2011. Likewise, long-term refinancing operations totaling some EUR 1,000 billion were carried out at the turn of the year and in early 2012 in order to provide the banking industry with additional liquidity. These monetary policy operations will be conducted as a fixed-rate full allotment tender against a wide-ranging list of securities until end-2012 at least.

On September 6, 2011, the Swiss National Bank (SNB) set an exchange rate target at a maximum of CHF 1.20 per euro. Although this target has been repeatedly breached, momentarily and marginally, during 2012, the SNB has largely succeeded in defending it to date.

CESEE: Modest Macrofinancial Impact of the Sovereign Debt Crisis

Heterogeneous Growth Performance, Improving External and Fiscal Positions

Despite growing tension in the context of the euro area debt crisis, which led to a deterioration in the risk assessment of the CESEE region¹, CESEE economic activity slowed only marginally on balance in the second half of 2011. Although GDP growth declined in some countries and was sluggish or even slightly negative (e.g. in the Czech Republic, Bulgaria and Croatia), many other countries registered relatively robust GDP growth in both the third and fourth quarters of 2011. For instance, year-on-year growth in both these quarters stood at around 3% in Slovakia and at more than 4% in Poland.

In both Russia and Ukraine, economic output grew by as much as nearly 5%. As a result, the CESEE region registered average GDP growth of 4.4% and 3.9% in the third and fourth quarters of 2011, respectively. However, preliminary figures available for GDP growth in the first quarter of 2012 indicate a sharper economic downturn. Economic output has started to contract both in the Czech Republic and in Hungary, and the Romanian economy has lost considerable steam. Poland and Slovakia, however, have continued to register dynamic growth (+3.6% and +3%, respectively).

On the production side, growth was often driven by higher contributions by agriculture in the second half of 2011². Countries benefiting from this situation included, for instance, Russia and Ukraine, as well as Romania and Hungary, where the economy would have probably lost much momentum otherwise. On the expenditure side, private consumption and investment strongly contributed to growth in Poland, Ukraine and Russia while, in Slovakia, the external sector represented the most important pillar of economic growth. The latter also applies to countries with weaker GDP growth. In the Czech Republic and in Hungary, only net exports made a positive contribution to growth in the last two quarters of 2011. In Croatia and Bulgaria, also inventory changes had a slightly positive effect on growth.

According to the current expectations of the OeNB and BOFIT (Bank of Finland Institute for Economies in Transition) for selected CESEE coun-

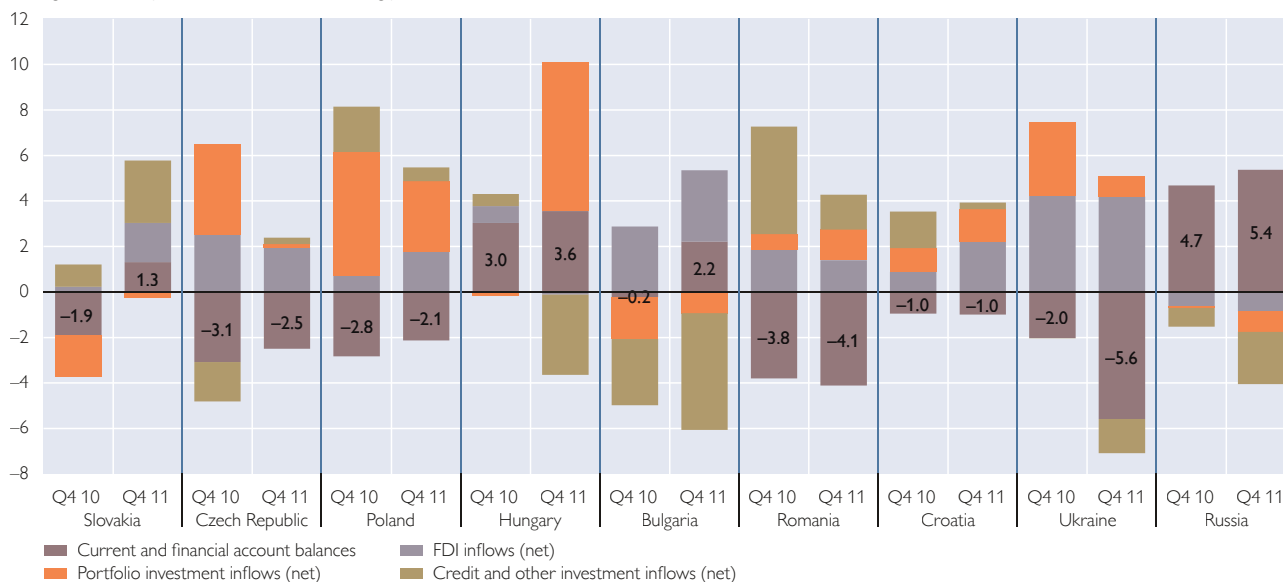
SNB defends exchange rate target

¹ The CESEE region comprises Slovakia, Hungary, the Czech Republic, Poland, Bulgaria, Romania, Croatia, Ukraine and Russia.

² Detailed data for the first quarter of 2012 were not available at the cutoff date.

Current and Financial Account Balances and Their Financing

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



Source: Eurostat, national central banks, OeNB.

Current account positions continue to improve in many CESEE countries

tries³, average growth in this region will amount to some 2.7% in 2012 before accelerating to 3.2% in 2013. Regional growth momentum will be fueled primarily by Russia, which will expand at a well above-average rate in both 2012 and 2013.

The international financial crisis triggered a marked reduction in external imbalances in the CESEE region from 2009 onward. In most CESEE countries (e.g. Slovakia, the Czech Republic, Poland, Hungary, Bulgaria and Russia), this trend continued in the second half of 2011. Only Romania and Ukraine saw their current account deficits increase – marginally in Romania's case and substantially in Ukraine's. External positions were driven primarily by improving trade balances (in Russia, high oil prices also played a role in the

period under review). In this respect, the CESEE region benefited from robust economic development in Germany – the main trading partner for many countries in this region – which dampened the negative impact of the general deterioration in the international environment. In addition, sluggish domestic demand in many countries had a dampening effect on import growth.

The financial account was positive in almost every country under review in 2011. Only Russia and Bulgaria reported a deficit (both countries had a current account surplus, however). In Bulgaria, the Czech Republic, Croatia and the Ukraine, net FDI inflows made up the largest positive component of the financial account. By contrast, (net) portfolio investment represented the financial account's largest positive com-

³ See *Developments in Selected CESEE Countries: Heterogeneous Growth Performance, Improving Fiscal and External Accounts. Focus on European Economic Integration Q2/12*, OeNB, 8–37. The group of countries included in the OeNB-BOFIT Outlook comprises Bulgaria, the Czech Republic, Hungary, Poland, Romania, Croatia and Russia.

ponent in Poland and Hungary, and (net) other investment – in particular, loans – made up its counterpart in Romania and Slovakia. In Russia, capital outflows in all three categories were reported in the period under review. FDI covered more than 75% of the remaining current account deficits in every CESEE country except Romania.

With the exception of Croatia, budget deficits decreased in every country under review in 2011. In Russia and Hungary, deficits even turned into surpluses. While a healthy economy, high oil prices and the withdrawal of some of the fiscal stimuli introduced in the wake of the 2008/09 crisis were responsible for this development in Russia, in Hungary one-off receipts from the de facto abolition of formerly compulsory private pension funds (the pension system’s “second pillar”) had a positive impact on the budget. The European Commission, however, deemed this development to be unsustainable and thus inadequate for terminating Hungary’s ongoing excessive deficit procedure (EDP) at its target date of 2011. On the contrary, the country’s EDP was escalated. If, according to the decision of the Economic and Financial Affairs Council (Ecofin) of March 2012, Hungary does not implement adequate measures to reduce its excessive deficit by September 2012 at the latest, funds for Hungary totaling EUR 500 million (or 0.5% of Hungarian GDP) granted by the European Cohesion Fund will be frozen from early 2013. By contrast, Bulgaria managed to reduce its budget deficit to below 3% of GDP in 2011, which means its EDP is likely to be terminated on time by mid-

2012. The other EU Member States in the CESEE region are still in an EDP (target dates scheduled for reducing excessive deficits: 2012 for Poland and Romania, 2013 for the Czech Republic and Slovakia).

Price pressures eased in most CESEE countries in recent months. This development was heavily influenced by good harvests, which had a price-dampening effect on food in many of these countries. Rising inflation rates were seen only in Hungary and the Czech Republic. In Hungary, the standard VAT rate was raised from 25% to 27%. In the Czech Republic, the reduced rate for VAT was increased from 10% to 14%. In both countries, furthermore, energy price rises were steeper than the regional average, which especially in Hungary’s case can be explained by the strong depreciation of the forint until end-2011. Against this background and in response to rising risk premiums on Hungarian financial instruments, the Hungarian central bank increased its key interest rate in November and December 2011, in two steps of 50 basis points each, bringing it to 7%. The Polish central bank increased its key interest rate by 25 basis points to 4.75% in May 2012, owing to the overshooting of its inflation target. By contrast, the Ukrainian, Romanian and Russian central banks reacted to disinflation by cutting their key interest rates.⁴

Looking at the currencies of the countries under review that have not yet adopted the euro and that lack a fixed or quasi-fixed currency pegging, most currencies appreciated slightly against their reference currency from end-November 2011 to early June 2012.⁵

Easing price pressures

Budget deficits decreased in 2011

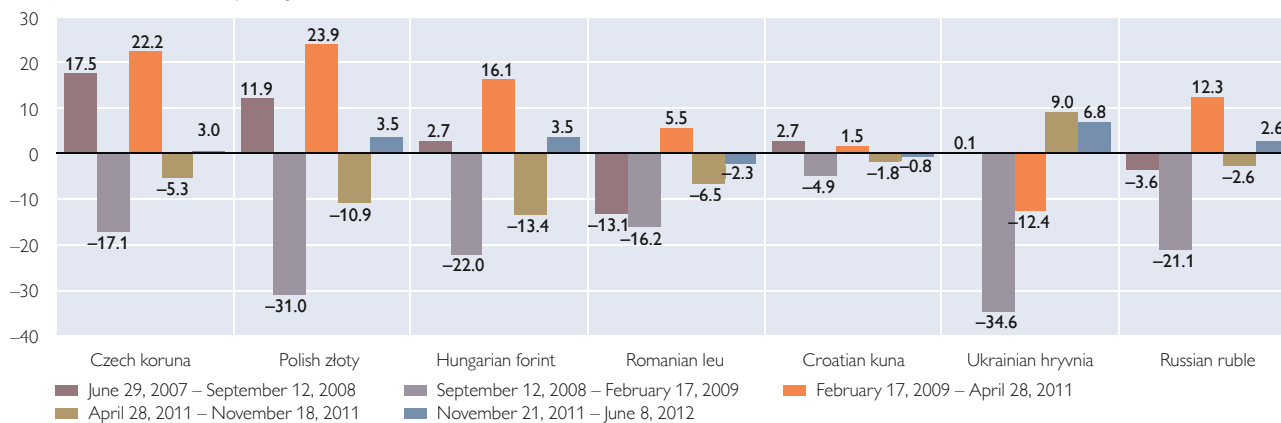
After sharp depreciations in fall 2011, exchange rates appreciate moderately in many CESEE countries with flexible exchange rates

⁴ See *Developments in Selected CESEE Countries: Heterogeneous Growth Performance, Improving Fiscal and External Accounts. Focus on European Economic Integration Q2/12*, OeNB, 8–37.

⁵ With the exception of Ukraine (U.S. dollar) and Russia (basket of currencies consisting of U.S. dollar and euro at a ratio of 55% to 45%), the reference currency of these countries is the euro.

National Currencies and the Euro

Euro per unit of national currency, change in %



Source: Thomson Reuters, OeNB.

As a result, depreciation that had been incurred especially in early fall 2011 was partially offset in many countries. The development of the Czech koruna and Croatian kuna was largely stable, although the latter currency had to be supported by foreign exchange interventions.

Uneven Banking and Financial Sector Trends

Whereas the performance of most CESEE countries' financial markets was unremarkable toward the end of 2011, a sharp rise of equity indices was seen on the Ukrainian and Russian stock exchanges. In early 2012, a moderate uptrend on other stock exchanges emerged in a slightly improved global financial environment. The exception was Slovakia, whose stock exchange continued to show a modest downtrend. Since the start of the second quarter of 2012, however, the steep rises in the Ukrainian and Russian equity indices have been offset by falling stock prices, at least to some extent. Other stock exchanges in the CESEE region also saw stock prices tumble from the middle of the second quarter of 2012 at the latest.

Risk premiums as measured by 10-year CDS spreads narrowed in the first few months of 2012. They fell particularly sharply in Croatia, Romania and Bulgaria. At the start of the second quarter of 2012, however, they increased once more across the CESEE region, as in other emerging markets. The development of Eurobond spreads was similar in all countries of the region: a modest decline in early 2012, which was strongest in Hungary and Ukraine, followed by spreads widening slightly again early in the second quarter of 2012. The development of short-term interbank rates mirrored that of Eurobond spreads to some extent. In Poland, the Czech Republic and in Hungary, the interest rate gap relative to the euro area continued to widen in early 2012.

In the CESEE region, total outstanding loans to households (relative to GDP) have been growing divergently since mid-2011. In Slovakia, the Czech Republic and in Russia, they were moderately higher on an exchange rate-adjusted basis at end-2011, compared with mid-2011. In Poland, Bulgaria, Romania and Croatia, by contrast, they were marginally down and, between mid-2011

Modest recovery on financial markets in the first few months of 2012

Divergent lending growth in CESEE

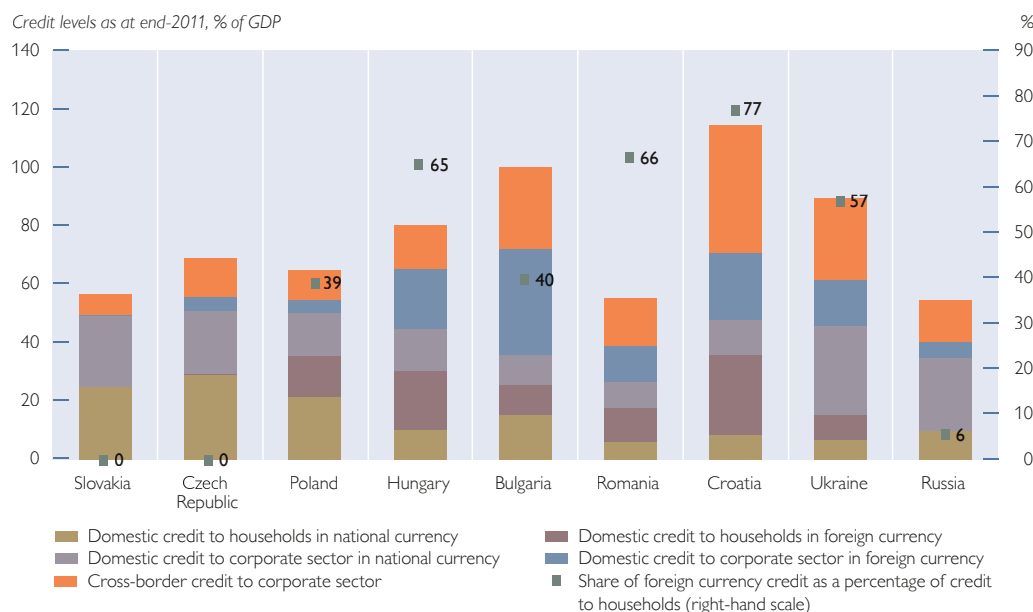
and end-2011, markedly so in Hungary (−3.4 percentage points) and Ukraine (− 2.3 percentage points). The decline in Hungary was partly attributable to the fact that households were able to repay foreign currency mortgage loans early. As a result, almost one-quarter of Hungary’s foreign currency mortgage loan portfolio was repaid (at end-September 2011: some 20% of GDP). In some CESEE countries, total outstanding loans (relative to GDP) to nonfinancial corporations developed in a diametrically opposite way to those issued to households. For instance, Poland, Bulgaria and Croatia saw modest exchange rate-adjusted growth in total outstanding loans to nonfinancial corporations whereas Slovakia registered a decline. In the Czech Republic and Russia, lending growth was positive in both the household and corporate sector whereas total outstanding

loans contracted in both sectors in Hungary, Romania and Ukraine. In particular, Hungary and Ukraine registered marked slumps, even in loans to nonfinancial corporations. In Ukraine, robust growth in cross-border loans (3.6 percentage points) has more than offset the decline in domestic loans to the corporate sector since mid-2011. Cross-border loans to businesses also grew slightly in Poland and Russia while falling at a considerable rate in Hungary, Bulgaria, Romania and Croatia. Overall, total (domestic and cross-border) credit to the private sector – i.e. to households and nonfinancial corporations – relative to GDP fell on an exchange rate-adjusted basis in around half of the countries under review in the second half of 2011. Hungary experienced particularly pronounced deleveraging amounting to 6.7 percentage points. By contrast, total outstanding

Chart 3

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

Credit levels as at end-2011, % of GDP



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 intragroup loans.

Share of foreign currency loans to households down in some CESEE countries

Reduction in loan-to-deposit ratio

Continued credit risk in banking sector

loans to the private sector rose in the Czech Republic and in Russia.⁶

At 65% to 77%, the share of foreign currency loans in total loans to households remained at a very high level in Hungary, Romania, Ukraine and Croatia at end-2011. In Ukraine and Hungary, this share slumped sharply (on an exchange rate-adjusted basis) compared with mid-2011, while a marginal decline and a slight rise were registered in Croatia and Romania, respectively. Only Bulgaria saw the share of (exchange rate-adjusted) foreign currency loans to households continue to climb appreciably from a high level.

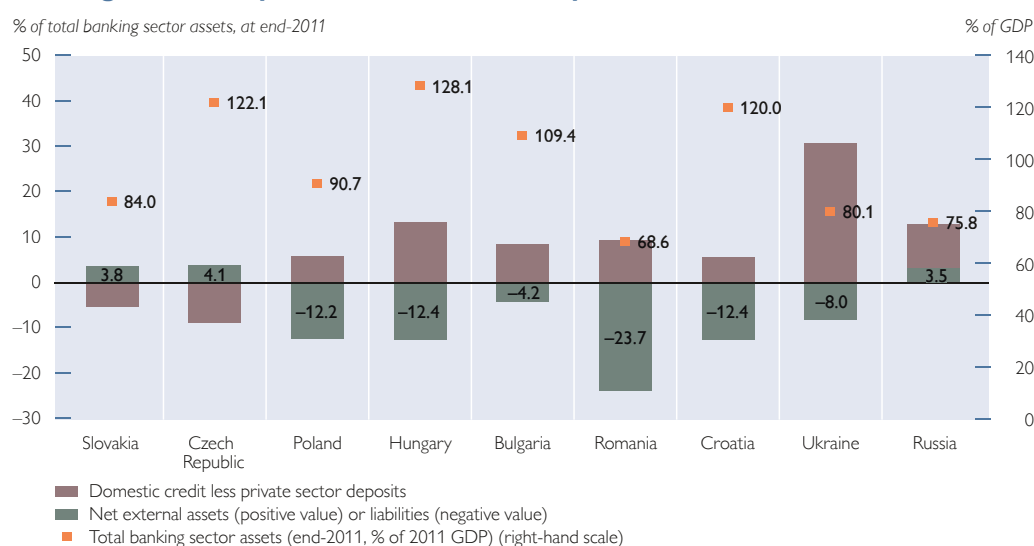
In the majority of the countries under review, total outstanding domestic loans continued to exceed total domestic deposits (as measured by total assets) at end-2011. Loan-to-deposit ratios have been improving, however. In Ukraine, the gap between domestic loans and deposits yawned particularly widely, but it narrowed in the second

half of 2011 primarily owing to rising deposits. A similar trend was also seen in Poland, Bulgaria and Romania. By contrast, falling (exchange rate-adjusted) total outstanding loans were responsible for the gap narrowing particularly in Hungary and, to a lesser extent, in Croatia and Russia. Only Slovakia and the Czech Republic continued to show a surplus of domestic deposits, which further increased in the course of 2011. This situation is also reflected in the positive net external assets registered by both countries' banking sectors. In Romania, net external liabilities – in part comprised of liabilities to foreign parent banks – were still substantial and considerably higher than in other countries of the region.

The share of nonperforming loans as a percentage of total loans remained high in the second half of 2011, indicating continued credit risk in most CESEE countries. This applies especially to Hungary, Bulgaria, Romania and Croa-

Chart 4

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



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

⁶ Preliminary monthly data has shown no significant change in the trends of the second half of 2011 from early 2012 onward.

tia, where the share of nonperforming loans continued to rise from an already high level, with Hungary registering the steepest rise⁷ (+3.9 percentage points, year on year) and Romania the largest share (some 34%). In the Czech Republic, Poland and Slovakia, the share of nonperforming loans decreased slightly – in Russia, the decline was sharper (–2.5 percentage points) – compared with the same period of the previous year. Intra-year data show that the rise in nonperforming loans accelerated particularly in Hungary and Bulgaria in the second half of 2011. Croatia, by contrast, saw quarterly growth in the share of nonperforming loans slow during 2011 while Romania registered a slight decline in the fourth quarter of 2011 after previously having witnessed an increase. In Russia and the Czech Republic, the downtrend in nonperform-

ing loans strengthened in the second half of 2011.

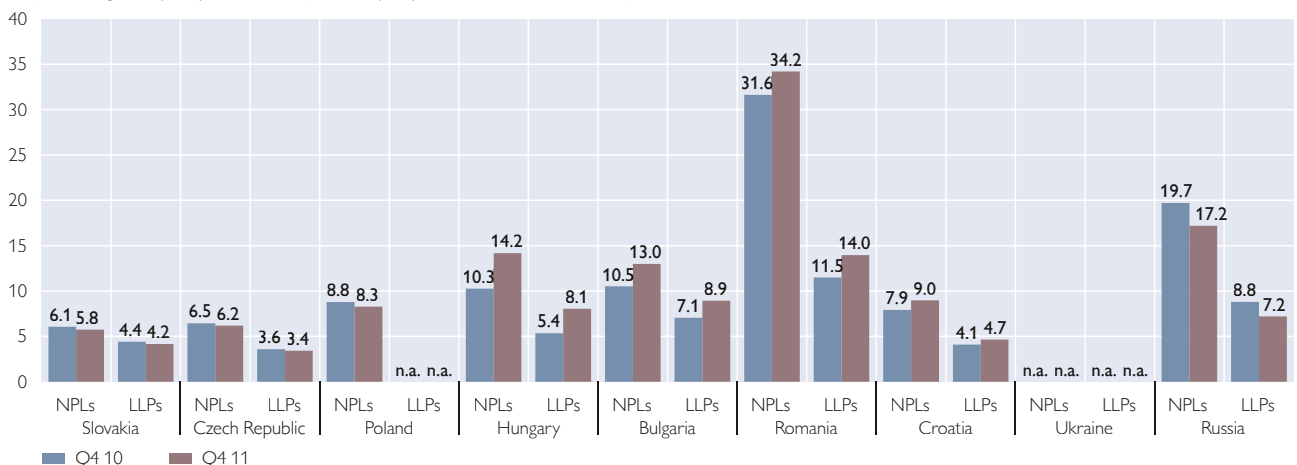
Banking sector profitability remained dampened owing to the need for high loan loss provisions in most CESEE countries in the period under review. The Hungarian, Romanian and Ukrainian banking sectors registered slumps in profit. In Hungary, the need for considerably higher loan loss provisions, loan redemptions⁸ and banking taxes plunged banks into loss in the second half of 2011. In Romania, bank losses, despite increased loan loss provisions, declined marginally during 2011 whereas Ukrainian banks almost halved their losses on the previous year. By contrast, profit growth was registered by the Slovakian, Croatian, Polish and Russian bank industries, with profits up marginally in the first two sectors and more sharply in the latter two.

Dampened profitability in the banking sector

Chart 5

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.

⁷ In Hungary, the rise in the share of nonperforming loans as a percentage of total loans in the fourth quarter of 2011 was partly attributable to the final repayment of many loans and thus to the reduction in total outstanding loans.

⁸ The difference between the book value of loans at current exchange rates and their discounted redemption value had to be depreciated.

Largely consistent capital adequacy

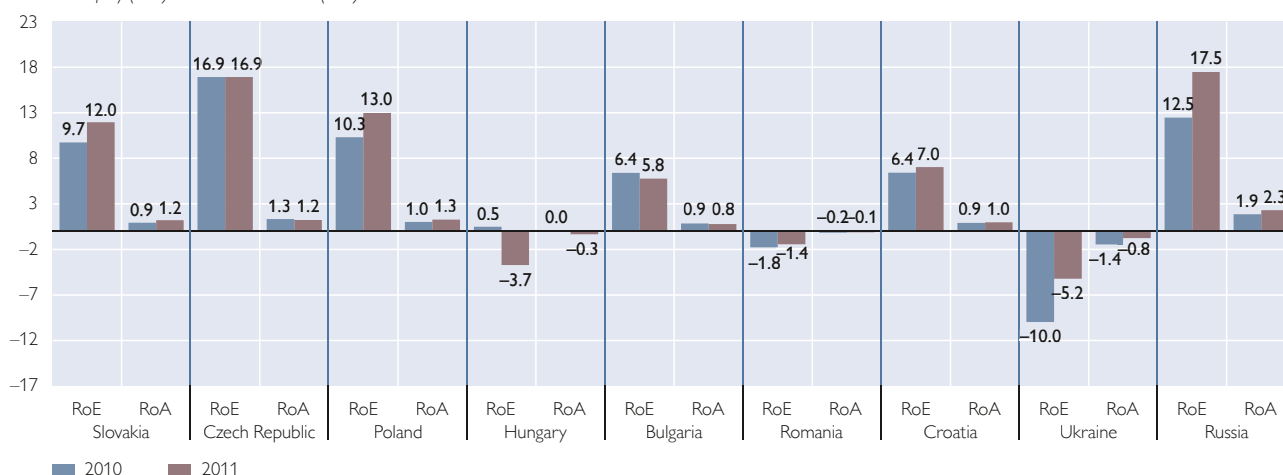
The capital adequacy of banks in most CESEE countries remained largely unchanged on the previous year. In Bulgaria, Croatia and Ukraine, it ranged between 17.5% and 19.2% at end-2011. In Central Europe, Romania and Russia, it reached between 13.1% and 14.7%. A modest increase was registered in Slovakia (+0.7 percentage points),

Hungary (+0.5 percentage points) and Croatia (+0.4 percentage points). In the Czech Republic, Poland and Romania, capital adequacy decreased only slightly. A steep decline was seen in Ukraine (−1.9 percentage points) and Russia (−3.4 percentage points) although, unlike in Russia, capital adequacy in Ukraine remained at a relatively high level.

Chart 6

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