

Economic Recovery to Continue, Commodity Price Surge Dampens Growth

Slowdown in U.S. economic recovery in Q1 2011

Industrialized Countries: Modest GDP Growth Forecast for 2011

The IMF World Economic Outlook (WEO) of April 2011 projects economic recovery, which commenced in 2010 following the severe slump in 2009, to continue in the *industrialized countries*. The economic revival is still being fueled by two factors: robust economic expansion in Asian emerging markets and Latin America, and the recovery of world trade. Global economic growth is also strengthening and broadening – albeit not enough to significantly cut unemployment and slash budget deficits from the high levels they had risen to because of the crisis. The upturn is occurring at differing speeds worldwide. While industrialized countries are expanding at a pace that is only modest, particularly compared with previous recessions, emerging markets and developing countries are currently faced with a tendency to overheat. In the April 2011 WEO, the IMF revised real GDP growth for 2011 down by 0.2 percentage points to 2.8% for the U.S.A. and up by 0.1 percentage point to 1.6% for the euro area compared with the January 2011 WEO. For industrialized countries as a whole, the IMF revised its 2011 growth outlook down slightly to 2.4%.

Risks to economic recovery are currently arising from rising commodity and food prices, as well as from the financial and banking system. The latter type of risk is fueled by the sovereign debt crisis in Europe and by the still unstable situation of the housing market in the U.S.A. In addition, the change of course from hitherto very expansionary economic policies in industrialized countries to consolidation measures in some EU countries will have a dampening impact on growth.

After increasing steeply by 2.6% and 3.1% (quarter on quarter) in the third and fourth quarters of 2010, respectively, annualized real GDP growth in the U.S.A. slowed to 1.8% in the first quarter of 2011. While private consumption contributed most to GDP growth (1.5 percentage points), it nevertheless expanded far more sluggishly at +2.2% in the first quarter of 2011 than in the fourth quarter of 2010 (+4%). Conversely, government spending (–1.1 percentage points), housing investment and net exports dampened growth. Since largely temporary factors, such as the surge in consumer prices, bad weather and the sharp reduction in defense spending, weighed on growth, the economy is expected to expand more vigorously in the second quarter of 2011. Key leading indicators, such as purchasing managers' indices, retail sales or the Conference Board's Index of Leading Indicators, all signal moderate growth momentum in the coming months. As at end-April 2011, the Federal Reserve System (Fed) revised its GDP forecast down to 3.1% to 3.3% (January 2011: 3.4% to 3.9%).

The U.S. labor market situation is improving slowly. This phenomenon is evident in the modest increase in the unemployment rate to 9% in April 2011. However, the nonfarm payroll employment rose by a relatively robust 244,000 that month.

The housing market remains a major weakness of the U.S. economy. In recent months, after three years of decline, house prices have fallen somewhat less sharply than up to the second half of 2010. However, a noticeable recovery has not yet begun. The housing market situation is affecting not only the construction industry but also the banking sector owing to ongoing credit defaults.

U.S. labor market slowly improves

Shortly before the budget deadline expired in the night of April 8, 2011, the U.S. Congress reached a basic agreement to generate savings of just under USD 40 billion for the remaining six months of the fiscal year 2011. The background to this dispute between Democrats and Republicans is the huge budget deficit of an expected USD 1,650 billion in the current fiscal year (around 10% of GDP). A further challenge is the aggregate debt of currently more than USD 14,200 billion. In mid-April 2011, the IMF noted that the U.S. debt ratio would not stabilize in the coming years and projected it would rise from about 90% of GDP (as at end-2010) to more than 110% of GDP as at end-2016. According to the ratings agency Standard & Poor's, the U.S.A.'s top credit rating is at risk. Although it still awards the U.S. its top AAA credit rating, it has amended its outlook from stable to negative. This is the first time in the history of all rating agencies that the U.S. outlook has been downgraded. (For three months in 1995, Fitch put

the U.S. on rating watch negative but left the outlook unchanged at stable).

At its most recent meeting on April 26/27, 2011, the U.S. Fed's Federal Open Market Committee (FOMC) left the target federal funds rate at 0% to 0.25% (i.e. unchanged for almost two and a half years). At end-June 2011, the Fed intends to conclude the purchase of U.S. government bonds worth USD 600 billion. The FOMC is currently debating a strategy to tighten monetary policy in the future. Most of its members prefer increasing interest rates to selling mortgage instruments and reducing the Fed's government bond portfolio. From the current perspective, an interest rate hike is expected for 2012 at the earliest. The Fed introduced regular press conferences starting on April 27, 2011 (four times a year when the new economic outlook is released). In this way, it intends to increase the clarity of monetary policy communication. In April 2011, annual CPI inflation and core inflation rose to 3.2% (March: 2.7%) and 1.3%, respectively.

U.S. budget crisis averted; public debt ratio rises further

Fed's purchases of U.S. government bonds to conclude by end-June 2011; no change in U.S. interest rate policy before 2012

Table 1

IMF and OeNB Economic Outlook: Industrialized Countries

	Real GDP				CPI				Current account			
	2009	2010	2011 ¹	2012 ¹	2009	2010	2011 ¹	2012 ¹	2009	2010	2011 ¹	2012 ¹
	Annual change, %				Change of annual average, %				% of GDP			
Industrialized countries	-3.4	3.0	2.4	2.6	0.1	1.6	2.2	1.7	-0.3	-0.2	-0.3	-0.2
U.S.A.	-2.6	2.8	2.8	2.9	-0.3	1.6	2.2	1.6	-2.7	-3.2	-3.2	-2.8
Euro area²	-4.1	1.8	1.6	1.8	0.3	1.6	2.3	1.7	-0.6	-0.4	0.0	0.0
Germany ²	-4.7	3.6	2.5	2.1	0.2	1.2	2.2	1.5	5.0	5.1	5.1	4.6
France ²	-2.6	1.6	1.6	1.8	0.1	1.7	2.1	1.7	-2.9	-3.5	-2.8	-2.7
Italy ²	-5.2	1.3	1.1	1.3	0.8	1.6	2.0	2.1	-3.0	-4.2	-3.4	-3.0
Spain ²	-3.7	-0.1	0.8	1.6	-0.2	2.0	2.6	1.5	-5.5	-4.5	-4.8	-4.5
Austria ²	-3.9	2.0	2.4	2.3	0.4	1.7	2.5	2.0	2.6	3.2	3.1	3.1
Austria (OeNB) ³	-3.9	2.2	3.3	2.3	0.4	1.7	3.2	2.1	3.1	2.7	4.0	4.8
United Kingdom	-4.9	1.3	1.7	2.3	2.1	3.3	4.2	2.0	-1.7	-2.5	-2.4	-1.9
Japan	-6.3	3.9	1.4	2.1	-1.4	-0.7	0.2	0.2	2.8	3.6	2.3	2.3

Source: IMF (World Economic Outlook, April 2011), OeNB forecast (June 2011).

¹ Forecast.

² 2009, 2010: Eurostat.

³ OeNB forecast, June 2011.

Net exports largely fuel euro area GDP growth in 2010

The *euro area* economy remains on a growth track, registering quarterly GDP growth of 0.4% and 0.3% (quarter on quarter) for the third and fourth quarter of 2010, respectively. For 2010, this means annual GDP growth of 1.8%. As in the fourth quarter of 2010, growth stimuli came largely from net exports and, to a lesser extent, from domestic consumer demand. Gross fixed capital formation made a slight negative contribution to growth. Following robust investment growth in the second quarter of 2010, companies curtailed their investment activities, which meant the annual growth rate was negative overall. The positive growth recorded in 2010 was largely fueled by developments in Germany. At an above-average 3.6%, Germany registered the strongest growth among the major euro area countries. Growth was a mere 1.6% in France and 1.3% in Italy, and contracted in Spain (−0.1%), Ireland (−1.0%) and Greece (−4.5%).

ECB key interest rate raised on April 7, 2011, but left unchanged in May

Great uncertainty about the impact of Japan's earthquake, GDP down by 0.9% in Q1 2011

The annual HICP rate for the euro area climbed steadily in the first four months of 2011. After 2.3% in January, 2.4% in February and 2.7% in March, it reached 2.8% in April. Inflation was pushed up by price increases in unprocessed food and energy, which account for a significant share of the basket of goods at a weight of 7.4% and 10.3%, respectively. In April 2011, annual core inflation (HICP excluding energy and unprocessed foods) came to 1.8% year on year. To ensure price stability in the future, the Governing Council of the ECB decided to increase the key interest rate by 25 basis points to 1.25% on April 7, 2011 (but left rates unchanged on May 5, 2011). This rate hike will help to anchor medium- to longer-term inflation expectations for the euro area at their target value of below, but close to 2%.

Portugal followed Greece and Ireland (2010) in seeking financial aid

Following Greece and Ireland (2010), Portugal recently also requested financial

aid from the EU and the IMF. Although the country is one of a handful in the euro area not to have suffered a banking crisis, like Greece it also came under pressure from high government debt levels and weak competitiveness. By early April 2011, yields on Portuguese 10-year government bonds had climbed steeply on the back of high risk premiums. That month, the premium came to 500 basis points for the first time relative to German government bonds. In early May 2011, an agreement was reached on giving Portugal rescue loans totaling EUR 78 billion. This agreement also stipulates a reduction in the country's budget deficit to 3% by 2013 although more than 50% of the consolidation is to occur as early as 2011. Of the EUR 78 billion, EUR 12 billion are provided for assisting the banking sector. Structural reforms are intended to step up competitiveness, and the economy is set to start recovering in the first half of 2013.

Uncertainty still prevails over the definitive economic impact of the natural and nuclear disaster in *Japan*. In its spring outlook of end-May 2011, the OECD revised real GDP growth for 2011 down by 2.6 percentage points (compared with its fall outlook of November 2010) and now expects growth to slow by 0.9%. For 2012, the OECD projects growth of +2.2%. At end-April 2011, the Bank of Japan downgraded its growth outlook for the fiscal year 2011 (from April 2011 to March 2012) to +0.6% (January 2011: +1.6%) and upgraded it to +2.9% for the fiscal year 2012. In the first quarter of 2011, real GDP contracted by 0.9% on the previous quarter and thus much more sharply than expected, with the recession commencing as early as the fourth quarter of 2010 (−0.8%). At the end of April, Standard & Poor's downgraded its outlook for Japan's sovereign rating (cur-

rently: AA-) from stable to negative in view of the high costs incurred from rebuilding the country, which are further widening its already very high budget deficit. About a year ago, S&P had cut Japan's credit rating by a notch owing to high government debt levels.

Even if the region directly affected by the disaster accounts for only 6% to 7% of Japan's population and production, key automotive and electronics suppliers are based there, which has caused constraints in the value chain. Car manufacturers have now resumed production at almost all locations. Although initial power outages were stopped thanks to energy saving measures, they could return in the air-conditioning season. The outages affect a region which produces 40% of Japan's GDP. Overall, exports slumped by 8% in March 2011 (following the uptrend prior to the earthquake). In March 2011, industrial output was down by 15.3% from the previous month. In addition,

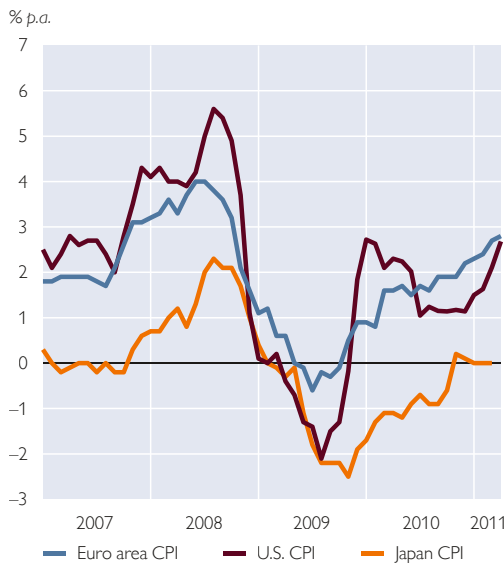
consumer confidence collapsed in both March and April 2011 although it is expected to revive in May. The increase in machine orders came as a pleasant surprise recently. The damage directly caused by the earthquake will amount to up to 5% of GDP, and budgetary costs are estimated to be some 2% of GDP. The IMF projects a budget deficit of 10% for 2011. In May 2011, initial government support measures totaling JPY 4,000 billion (0.8% of GDP) were approved to rebuild the country. Excluding further spending on the recovery (which will probably be necessary), this means gross government debt will reach 219% of GDP by 2012. The Bank of Japan reacted rapidly by injecting additional liquidity to stabilize the financial markets, doubling its asset purchase program to JPY 10,000 billion (2% of GDP) and, at its most recent monetary policy meeting on April 28, 2011, providing low interest loans totaling JPY 1,000 billion for banks in the disaster

Japanese industrial production down by 15.3% in March 2011, exports down by 8%

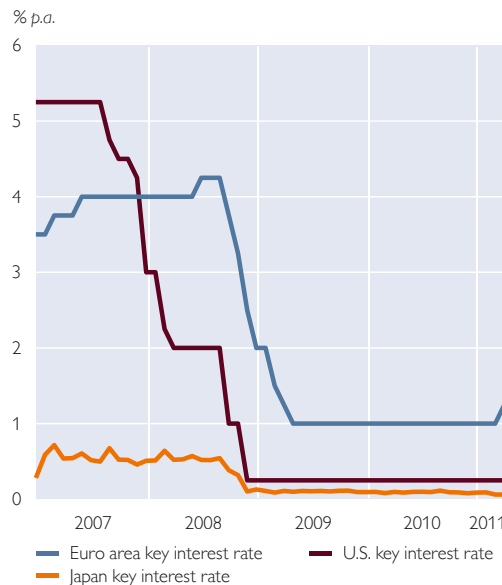
Chart 1

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

Inflation



Key Interest Rates



Source: Eurostat, ECB.

areas. As for the current account, its surplus is expected to decrease from 3.6% in 2010 to 2.5% in 2011/2012, primarily owing to the increase in oil imports used to temporarily offset the loss in nuclear energy.

In the euro area and U.S. *money markets*, LIBOR and EURIBOR interest rates have been relatively stable since fall 2009, although those in the euro area have recently risen slightly. Risk premiums in the U.S. money market were still below those in the euro area.

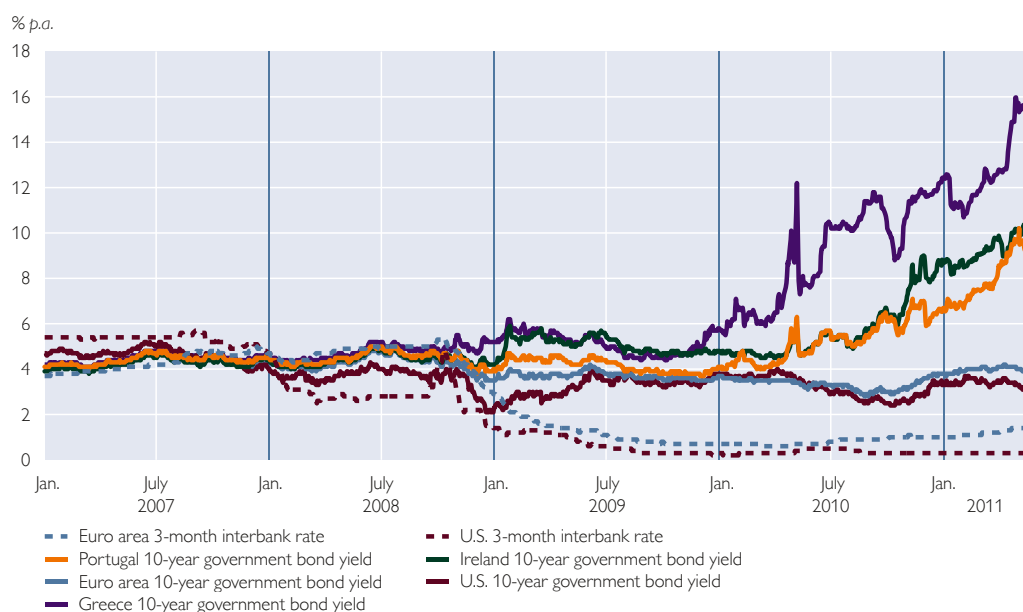
Differences between German 10-year *government bond yields* and those of selected other euro area countries have been steadily widening since the start of the financial crisis. In particular, Greek, Portuguese and Irish government bond yields rose sharply in 2010 and continued to trend up in early 2011, reaching new record highs at end-April 2011. Although EU Member States granted bridging loans to Greece and Ireland in 2010 in the face of drastic

market reactions and the related rise in refinancing costs, yields rose again on the back of credit rating downgrades by rating agencies in March and April 2011 and rumors that debt might be rescheduled in these countries. Given the debt crisis in Greece and Ireland and the related general market jitters about peripheral countries, risk premiums on Portuguese government bonds also rose markedly in 2010. Although Portugal approved an ambitious fiscal consolidation package in 2010 in order to reduce its budget deficit, risk premiums on its government bonds have continued to increase since January 2011. In March 2011, the Portuguese government announced additional consolidation measures for 2011 to ensure its declared deficit target for that year is met. When this austerity package was rejected in parliament by the country's opposition parties and the Prime Minister consequently stepped down, the rating agencies further downgraded

In particular Greek, Irish and Portuguese government bond yields are still trending up

Chart 2

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

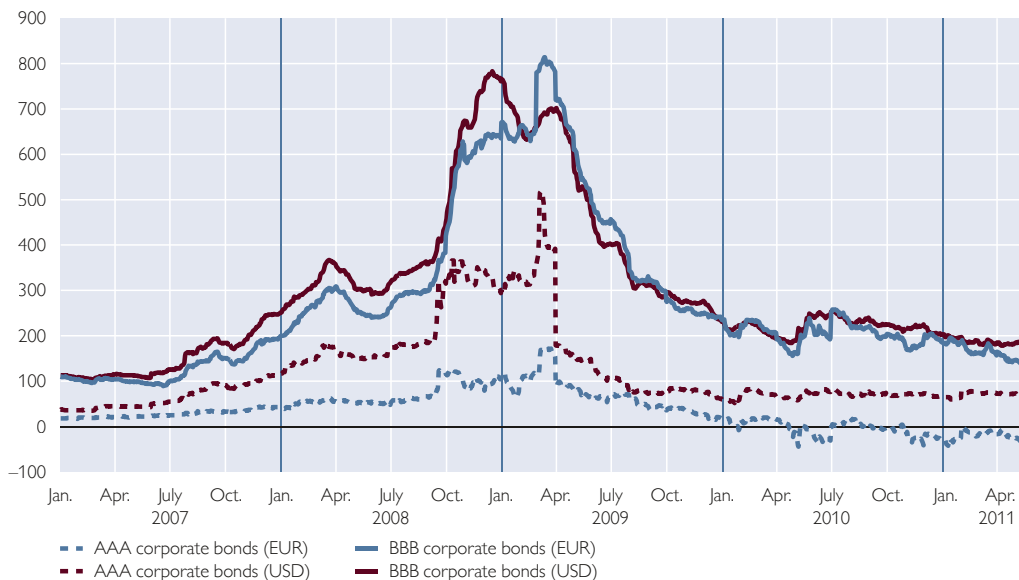


Source: Thomson Reuters.

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.

Portugal's credit rating. In early April 2011, yields on 10-year government bonds already exceeded 8%. Faced with higher refinancing costs, Portugal finally asked for financial assistance from the EU and the IMF. In the first week of May 2011, Portugal reached an agreement with representatives of the European Commission, the ECB and the IMF on a three-year rescue package totaling EUR 78 billion.

Since early 2011, yield spreads on *corporate bonds* in the euro area and, even more so, the U.S.A. have registered relatively small fluctuations, with fluctuations in yield spreads for AAA-rated bonds being smaller than those for BBB-rated bonds. In general, the spreads on corporate bonds in the euro area were larger than those in the U.S.A.

The *equity markets*, which have slowly but surely rallied worldwide since their low in March 2009, continued to perform relatively favorably until early March 2011, when the situation deteri-

orated due to the dramatic developments in Japan. This shock, in conjunction with the latest developments in North Africa and the Middle East, triggered a sharp increase in risk aversion as well as a sell-off in many capital markets. Recently, the U.S., euro area and Japanese equity markets showed a slight downtrend. A sector-by-sector analysis shows that both euro area and U.S. financial stocks have recovered only mildly since their low in March 2009 and, since end-2009, have fluctuated within a relatively narrow range at a low level. Industrial stocks, by contrast, performed far more favorably in both regions.

In the *foreign exchange markets*, the euro has appreciated against the major currencies since early 2011. This appreciation is attributable in particular to the economic recovery and the ECB's interest rate hike. The euro appreciated by 5.4% against the U.S. dollar. At end-May 2011, the EUR/USD exchange rate was 1.42.

Portugal receives 3-year rescue package worth EUR 78 billion from the EU and the IMF

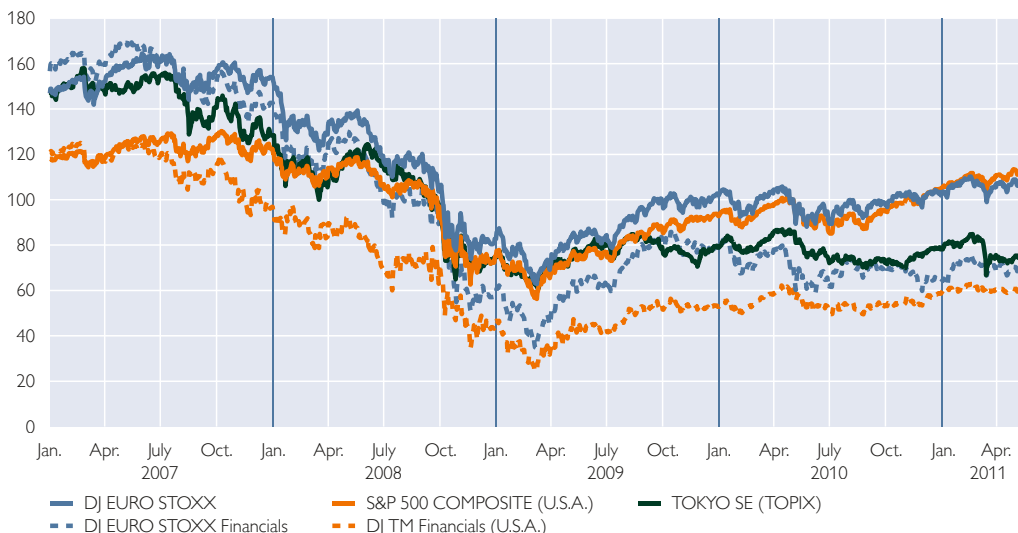
Sluggish recovery on equity markets since the trough in March 2009 – only modest improvement in financial stocks

Euro appreciating against major world currencies since early 2011

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

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



Source: Thomson Reuters, OeNB.

Note: National currency per euro unit.

CESEE Compared with Other Emerging Markets

Growth outlook for emerging markets still robust

The global economy grew by 5% in 2010 after contracting by 0.5% in 2009, according to the IMF. Emerging markets generated growth of 7.3% in 2010, with Asian emerging markets expanding

the most at 9.5%. Although growth in Central, Eastern and Southeastern Europe (CESEE, excluding the CIS) lagged behind that of three other regions (Latin America, Sub-Saharan Africa and the CIS), it outstripped that of North Africa and the Middle East. The IMF

economic outlook of spring 2011 projects global GDP growth of almost 4.5% in 2011. Even if aggregate growth in emerging markets is expected to slow somewhat, the outlook remains healthy at 6.5%. The pace of growth will continue to differ widely between and within emerging market regions. In Asia and Latin America, growth will slow from a high level in 2011. CESEE economies will also expand somewhat more slowly than before (primarily owing to much lower growth in Turkey), while growth in the CIS, Middle East, North Africa and Subsaharan Africa regions is expected to accelerate. Compared with the IMF outlook of fall 2010, growth prospects for 2011 for the CESEE, CIS and Latin America regions were revised up by around one-half percentage point. By contrast, the outlook for the Middle East and North Africa regions was revised down by one percentage point, primarily owing to social unrest and

rising risk premiums. The IMF issued a warning about overheating in Asia and sees signs of this phenomenon in some Latin American countries, too.

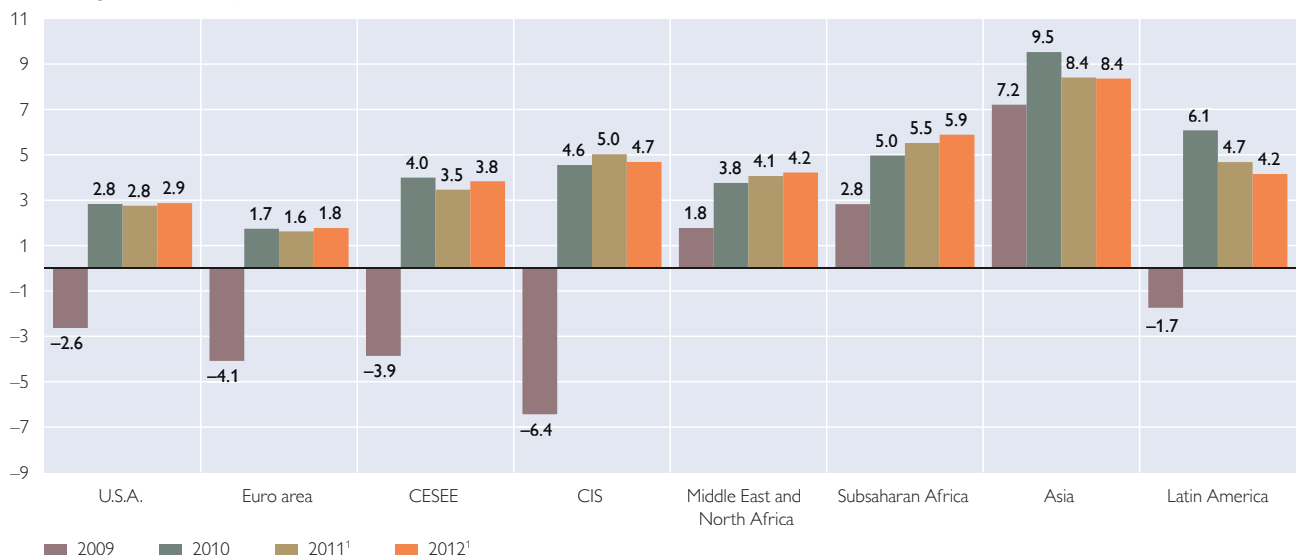
In all emerging market regions, the rapid increase in energy and food prices induced a spurt in inflation. Rising energy and food prices generally hit emerging markets worse than developed countries, as these components have a higher weight in the basket of goods in countries with low per-capita income. The IMF outlook of spring 2011 sharply upgraded both its oil price forecast and its inflation forecasts for 2011. In 2011, the IMF expects the year-on-year rise in annual average inflation to be steepest in the CIS, Middle East and North Africa regions (by 2.4 to 3 percentage points) while remaining unchanged in CESEE (excluding Turkey, annual average inflation in this region would rise by a mere 1.3 percentage points, though). Against this backdrop of growing inflation,

Energy and food prices drive up inflation

Chart 6

Emerging Markets and Selected Industrialized Countries: GDP Forecast

Annual change in % at constant prices



Source: IMF (World Economic Outlook), April 2011.

¹ IWF-Prognose.

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

External imbalances are expected to widen again

High Capital Inflows Pose a Challenge to Some Emerging Markets

many emerging markets tightened their monetary policies by raising key interest rates and minimum reserve requirements.

The reduction registered in 2009 in emerging markets' external imbalances continued only to some extent in 2010. That year, the current account surplus continued to decrease in Asia, but widened in the CIS, the Middle East and North Africa owing to rising demand and increasing prices for commodities. At the same time, the CESEE and Latin America regions saw a modest increase in their current account deficit.¹ In 2011, the IMF expects the current account surplus in Asian emerging markets to remain unchanged but China's surplus to advance for the first time since 2007. For the region as a whole, this development will be offset by deepening current account deficits in other countries (especially India). Current account surpluses in the CIS, Middle East and North Africa regions are expected to

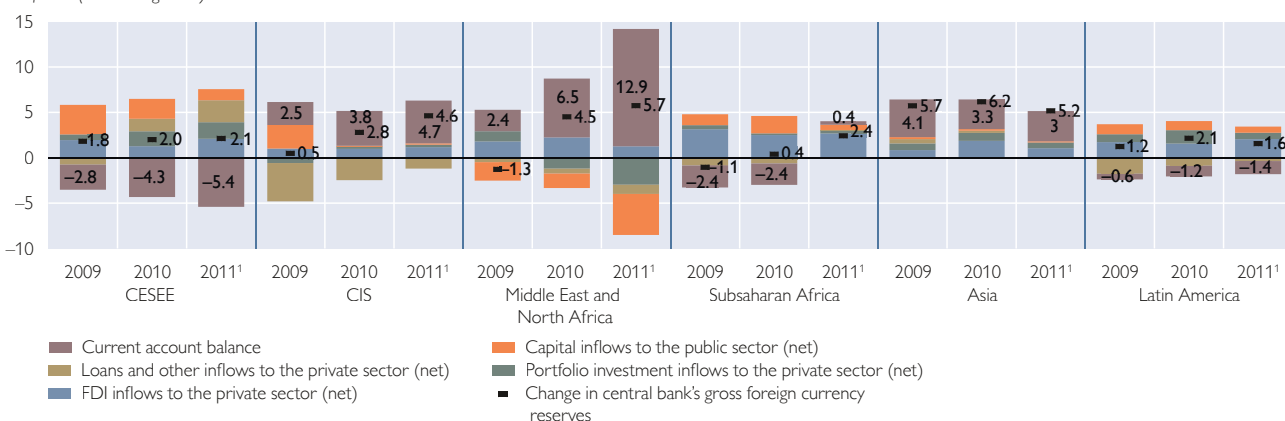
increase, while current account deficits in CESEE and Latin America will continue to rise modestly. External imbalances will be appreciably smaller in 2011 than they were prior to the crisis, but are expected to expand gradually in the medium term.

In 2010, every region under review except for the CIS registered positive net capital inflows to the private sector. Overall, net capital inflows to the private sector in GDP terms were lower than the average for the period from 2004 to 2007. In Asia and Latin America, however, net capital inflows were higher than the average for this period. Owing to their favorable growth performance and high yields, both these regions are likely to have been particularly appealing to foreign investors. Although foreign direct investment (FDI) was the most important form of external financing in emerging markets as a whole, unlike portfolio investment it fell short of the levels seen in the period from 2004 to

Chart 7

Emerging Markets: Current Account Balances and Net Capital Inflows

% of GDP (at exchange rate)



Source: IMF, OeNB.

¹ IWF-Prognose.

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.

¹ Whereas the current account positions in most CESEE countries were stable, they deteriorated in some countries (see section on "CESEE: Gradual Economic Recovery Continues").

2007. In 2010, FDI as a percentage of GDP grew only in the Asia, Middle East and North Africa regions, whereas portfolio investment increased fairly substantially in the CESEE, CIS, Latin America and Asia regions.

FDI covered current account deficits in Latin America and Sub-Saharan Africa, whereas average FDI in CESEE financed almost 30% of the current account deficit. In 2010, (net) credit and other inflows to the private sector moved into the black in CESEE, while the CIS continued to experience net outflows from the private sector. Net credit inflows were negative overall and were below their precrisis levels particularly in the CESEE and CIS regions, where this component was an important source of external financing.

The aggregates of most regions are strongly marked by higher than average net capital inflows to major markets. Several non-European emerging markets reacted to high capital inflows by accumulating foreign currency reserves, adopting macroprudential measures and establishing capital controls.

In 2010, high portfolio investment inflows were partly absorbed by further increases in issuance volumes in many emerging markets. In Brazil and China, for instance, equity issues have reached record highs. In all emerging markets, this situation is also applicable to the corporate bond segment, which is attributable particularly to brisk issuance activity in Latin America. However, owing to the issuance of debt instruments, the debt-to-equity ratio of companies rose in some emerging markets.

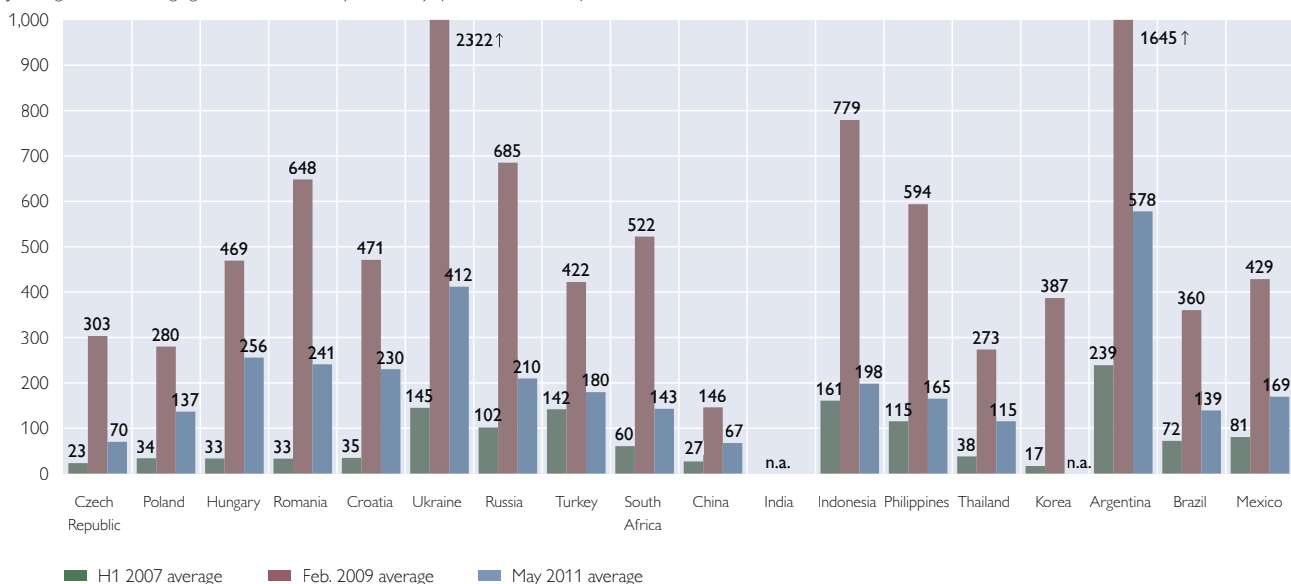
Since early 2011, the financial indicators (equity, bond and CDS markets) of emerging markets as a whole have not developed uniformly, but generally, no massive changes in valuations were recorded. Expectations of rising inflation and related further monetary policy tightening measures are offsetting good growth prospects. At end-May 2011, the MSCI Emerging Markets Price Index fell somewhat short of its level at the start of the year. Since early 2011, the subindex for CESEE (MSCI EM Europe) and its equivalent for Asia (MSCI EM Asia) have outperformed their counterpart for Latin America (MSCI EM Latin America), as losses on the first two subindices proved to be considerably lower.² Equity market indices of CESEE and CIS countries, which are included in MSCI EM Europe, posted largely modest gains in recent months. Compared with emerging market regions, the favorable performance of financial indicators in many CESEE and CIS countries in recent months must, however, be seen in the light of their weaker performance previously (since the start of the crisis). In addition, eurobond spreads trended mainly sideways, although some CESEE and CIS countries saw spreads narrow. Social unrest in the Middle East and North Africa was accompanied by foreign investor uncertainty and, consequently, by rising risk premiums and falling equity market prices within the region. Spillover effects on to other emerging markets outside the region were insignificant, however.

Issuance volumes reach record highs in some countries

² The MSCI EM Europe index includes the Czech Republic, Hungary, Poland, Turkey and Russia. The MSCI EM Asia index includes China, India, Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand, and the MSCI EM Latin America index is comprised of Brazil, Chile, Columbia, Mexico and Peru.

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

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



Source: Bloomberg, Thomson Reuters, OeNB.

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

CESEE: Economy Continues to Recover Gradually

Following the crisis in 2009, the year 2010 and the first few months of 2011 were characterized by a gradual economic recovery in CESEE countries³ as a whole. Although in the CESEE countries under review, drought and forest fires in Russia led to average growth temporarily falling to 2.9% in the third quarter of 2010, growth bounced back to 3.7% (on a year-on-year basis) as early as the fourth quarter of 2010. While these growth rates are noticeably lower than in the period directly before the onset of the crisis, the economic boom at that time occurred in particularly favorable conditions and should not be seen as entirely sustainable in view of the imbalances that arose during the boom.

Domestic demand becomes a major engine of growth

In addition, individual countries of the region saw economic trends reconverge in 2010. However, a certain degree of heterogeneity still remains, which is evident from continued dampened growth in Romania and Croatia, among other factors. In the fourth quarter of 2010, economic output in both these countries contracted by 0.6% year on year whereas growth rates in Russia and Poland, for instance, had already exceeded 4%.

Although inventory changes and the external sector in many countries continued to make key contributions to GDP growth, in the second half of 2010 domestic demand became an important engine of growth again in some countries, particularly in Poland, Slovakia, Ukraine, Russia and, to a somewhat lesser extent, in Bulgaria. The stimulus

³ The focus of this section is on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania, Russia, Slovakia, Slovenia and Ukraine.

for growth came from both investment and private consumption. Further contributions to growth came from dynamic exports and robust growth in industrial production, which led to higher levels of capacity utilization as well. In addition, the labor market situation in the region stabilized, and general sentiment is currently mutedly positive. Growth, however, is still constrained by three factors: further household deleveraging required in some countries, a greater need for public sector consolidation in many countries, and a flagging construction sector.

Following marked improvements in 2009 and the first half of 2010, the balances of the combined current and capital account in most countries of the region were largely stable and even continued to look up in the second half of 2010. A particularly pronounced reduction in combined current and capital account deficits were seen in Bulgaria and Croatia. In Russia and Hungary, combined current and capital account surpluses grew considerably. By contrast, the external position of Poland and the Czech Republic deteriorated somewhat. In both countries, this

situation was primarily attributable to increasing trade balance deficits in the wake of recently more dynamic economic growth.

In almost all the countries under review, the financial account was positive for the sum of four quarters to end-2010. It was slightly in the red only in Russia and Slovakia. In Bulgaria, Hungary and Ukraine, the largest component of the financial account was (net) FDI; in Slovakia, the Czech Republic and Poland it was (net) portfolio investment, and other investment (net; especially loans) predominated in Romania, Croatia and Russia. Net FDI inflows were much lower than the combined current and capital account deficit only in Romania and Slovakia.

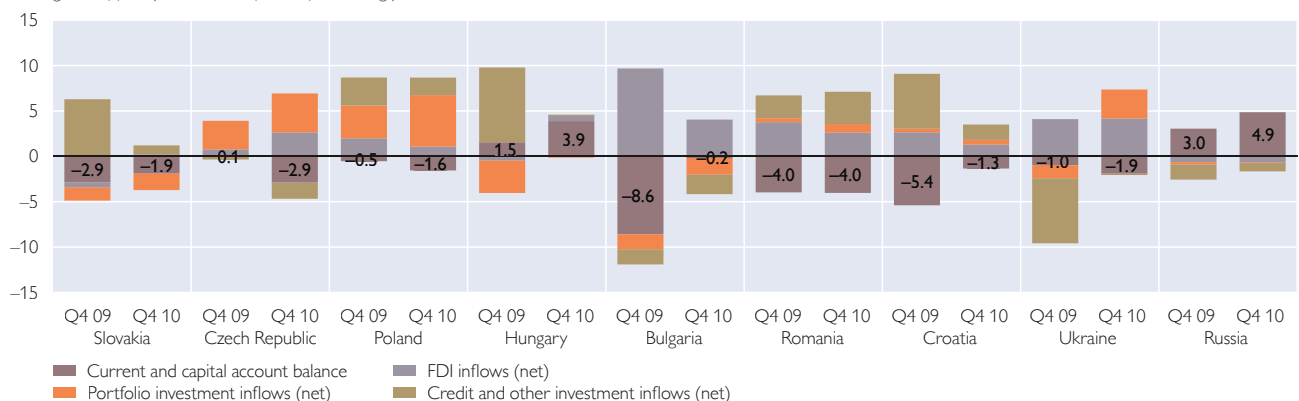
IMF/EU and/or IMF stabilization programs are still in force in Romania and Ukraine. In Romania, the IMF and EU disbursed tranches totaling EUR 2.1 billion in the first quarter of 2011. Although the Romanian government decided against utilizing the last remaining tranche of the IMF program (EUR 1 billion) that has come to an end, it applied for a precautionary stand-by arrangement to underscore its readiness

Current account positions in many countries continue to improve

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.

Increasing food and energy prices trigger inflation

Continued high deficits despite modest decline in 2010

for reform and to strengthen investor confidence. In March 2010, the IMF approved this arrangement, which comprises funds totaling EUR 3.6 billion. The EU (EUR 1.4 billion) and the World Bank (EUR 0.4 billion) also contributed to this package. There are currently no plans to draw upon the funds provided. As for Ukraine, a new IMF stabilization program (totaling EUR 12.8 billion) has been in force in the country since summer 2010. The conclusion of the second review is currently delayed, as the implementation of some envisaged reforms is still outstanding.

After particularly high budget deficits owing to the recession in 2009, in 2010 deficits decreased slightly in most countries (except in Croatia and Poland). In the entire region, nevertheless, deficits mostly well exceeded the ceiling of 3% of GDP and, in all the EU Member States belonging to this group of countries, an excessive deficit procedure is currently in force.⁴ In 2010, government debt (in percent of GDP) continued to

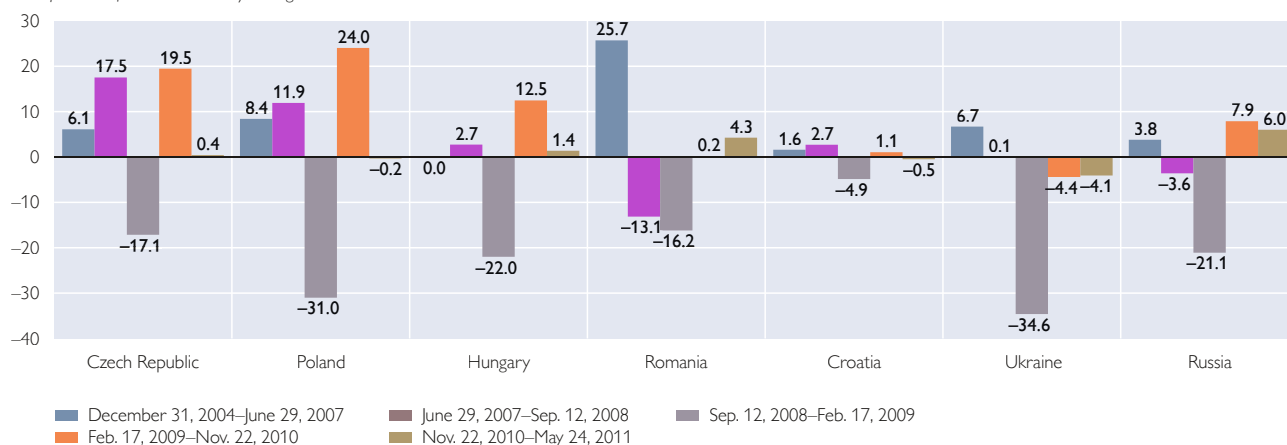
rise in every country except for Russia, and was by far the highest in Hungary (80.2%). It increased particularly steeply in Poland, Slovakia, Ukraine, Croatia (between 4% and 5% of GDP) and in Romania (more than 6% of GDP).

In the second half of 2010 and in early 2011, inflation rose in all the countries under review – in some cases, sharply – and, in April 2011, ranged between 1.6% in the Czech Republic and 9.6% in Russia. This situation was primarily attributable to rising food and energy prices. In addition, VAT increases fueled inflation in some countries. These increases had been approved owing to the frequently tight public finance situation. This effect is most observable in the case of Romania. An increase in the key VAT rate from 19% to 24% in summer 2010 led to inflation almost doubling in the second half of 2010. In early 2010, the VAT rate was also increased in the Czech Republic (from 19% to 20%) and, in early 2011, in Poland and Slovakia (from 22% to 23% and from 19% to 20%, respectively).

Chart 10

National Currencies and the Euro

Euro per unit of national currency, change in %



Source: Thomson Reuters, OeNB.

⁴ Estonia, which joined the euro area on January 1, 2011, is the only Eastern European country which does not currently have an excessive deficit procedure in force (2010 budget deficit: 0.1% of GDP).

The central banks in the region reacted to the growing inflationary pressures by tightening monetary policy. The Polish central bank raised its key interest rate in three steps by 25 basis points each time to 4.25%, the Hungarian central bank did the same in three equal steps of 25 basis points each to 6%, and the Russian central bank followed suit, raising its key interest rate in two steps of 25 basis points to 8.25%. In addition, the latter broadened the ruble's trading range from RUB 4 to RUB 5 by expanding it by its key interest rate relative to a basket of currencies consisting of the U.S. dollar and the euro and increased its minimum reserve requirements.

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, the Hungarian forint, the Romanian leu and the Russian ruble (further) appreciated against the reference currency in the period from November 2010 to May 2011⁵. Other currencies traded largely soundly relative to the relevant reference currency. At end-May 2011, the Czech koruna was at about the same precrisis level of early September 2008, whereas the Polish zloty, the Hungarian forint, the Romanian leu and the Russian ruble traded some 10% to 15% lower; the Ukrainian hryvnia was some 40% lower.

In the reporting period, the recovery of the economic situation was also apparent in the financial markets. Since early 2011, the spreads of short-term interbank rates in most CESEE countries have narrowed relative to the euro area. A crucial co-factor was the increase in key interest rates in the euro area (+25 basis points).

While the narrowing in spreads proved modest in most of the countries under review, it was somewhat stronger in Croatia, Romania and Bulgaria. In the Czech Republic, short-term interest rates are currently lower than in the euro area and the spreads are consequently negative. In most countries under review, equity markets saw gains, which were by and large modest. The Bulgarian stock exchange posted higher gains. This positive price trend is likely to reflect upgraded growth outlooks. The economic recovery is also discernible from the risk assessment of financial markets. Since early 2011, risk premiums in terms of CDS spreads have narrowed in most of the countries under review. They decreased particularly sharply in Hungary and Romania, but also in Ukraine and Bulgaria. In Hungary, the steep rise in risk premiums of June 2010 was corrected on the back of downgraded GDP prospects and increased uncertainty owing to political factors.

In 2010, total outstanding loans to private households (relative to GDP) rose in most countries. They stagnated in Romania and Russia and were in marked decline in Bulgaria and, especially, Ukraine. Unlike household loans, total outstanding loans to nonfinancial companies (relative to GDP) increased only in two countries: Croatia and Romania. Although corporate loans were significantly lower in Ukraine, they declined to a lesser extent in the other countries under review. Cross-border corporate loans grew in tandem with domestic corporate loans, with the exception of Slovakia and the Czech Republic, where they rose slightly without, however, being able to offset the decline in total domestic loans. In most countries, the correction of corporate

Central banks react by tightening monetary policy

Currencies largely stable

Continued correction of corporate balance sheets

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

Share of foreign currency loans to households rises in some countries

Credit risk still high – positive quarterly momentum

balance sheets is still in progress. Pronounced further deleveraging was carried out in Ukraine, in particular.

At 65% to 75%, the share of foreign currency loans to households remained very high in Hungary, Romania, Croatia and Ukraine at end-2010. Compared with end-2009, it was significantly lower only in Ukraine (and in Russia too at a lower level) while rising markedly in Romania and Croatia (as well as in Bulgaria at a lower level). Although total foreign currency loans to households grew in the latter three countries, total household loans denominated in domestic currency were down.

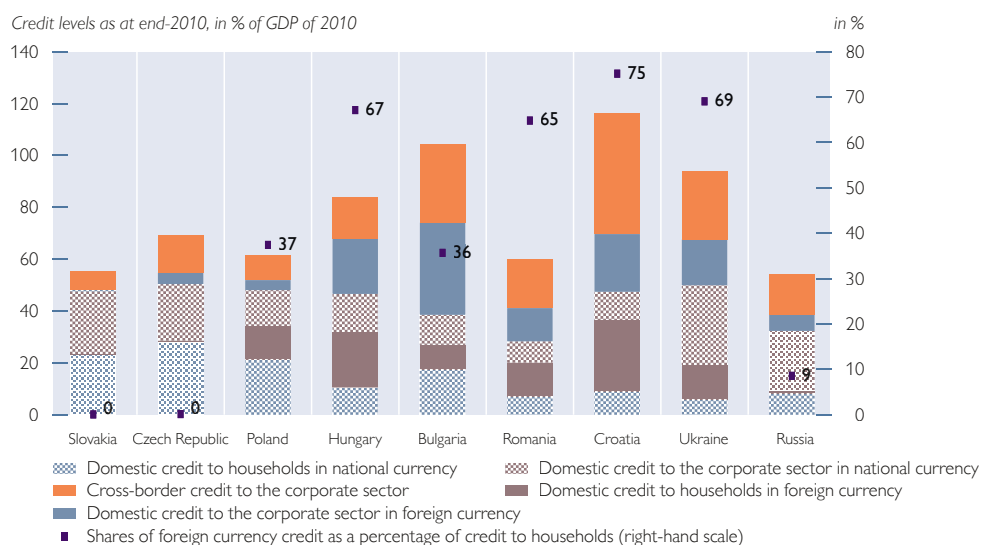
At end-2010, total outstanding loans exceeded total outstanding deposits (in terms of total assets) in every country under review except for Slovakia and the Czech Republic. The gap between domestic loans and deposits in the Ukrainian banking sector widened to a particularly high degree. The domestic credit overhang was financed partly by

net external liabilities and partly by equity. At end-2010, the Romanian banking sector had very high net external liabilities, of which some were to foreign parent banks. Compared with end-2009, however, the gap between domestic loans and deposits narrowed markedly in Ukraine and Russia (primarily due to growing deposits) and, to a lesser extent, in Bulgaria, Hungary and Poland (primarily owing to falling lending volumes). In Ukraine and Bulgaria, this situation brought about a reduction in the banking sector's net external liabilities.

Credit risk in the banking sector was still high at the end of the fourth quarter of 2010. Across the entire region under review, the share of non-performing loans as a percentage of total loans was up on a year-on-year basis. This increase was higher in Hungary, Bulgaria and Romania (3.6 to 7.6 percentage points) than in Russia, Slovakia, the Czech Republic, Poland and Croatia

Chart 11

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

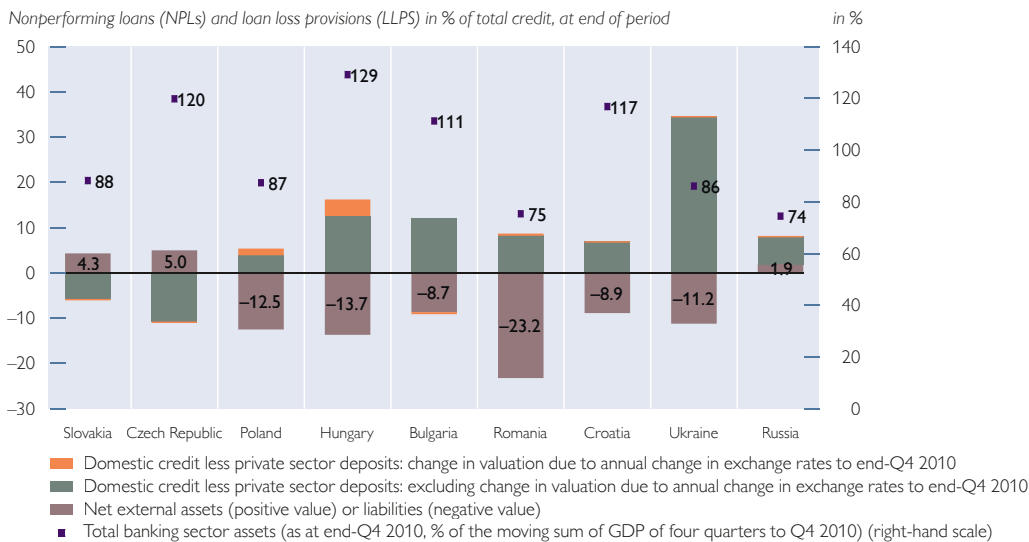


Source: ECB, Eurostat, national central banks, national statistical offices, OeNB.

Note: Foreign currency credit also includes credit in national currency that is indexed to a foreign currency. Cross-border credit does not include trade credits and 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).

Chart 12

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



(0.2 to 2.5 percentage points). In Ukraine, the share of nonperforming loans continued to rise steeply in the third quarter of 2010 (fresher data are not available). While the levels of shares of nonperforming loans thus continued to climb on a year-on-year basis, the second half of 2010 saw the start of positive momentum. Except for Romania, in the second half of 2010 the rise in the share of nonperforming loans slowed in all the countries under review, compared with the first half of the year. In Poland, the Czech Republic, Slovakia and Russia, the share of nonperforming loans was even lower at the end of the fourth quarter of 2010 than at the end of the previous quarter. This decline was particularly pronounced in Russia.

Profitability in the banking sector is largely still impaired by high required loan loss provisions. Whereas profits in the Czech Republic declined from a high level, in Hungary levies on banks introduced in mid-2010 are one of the likely factors for the considerable slump in profits. By contrast, profits rose modestly in Poland while growing more

vigorously in Slovakia and Russia. Except in Croatia, banking sector profits fell in Southeastern European countries on a year-on-year basis. Romania's banking sector even suffered modest losses. Owing to still high required loan loss provisions due to an increase in nonperforming loans, the Ukrainian banking sector continued to post heavy losses. Compared with 2010, however, these losses were down by almost a third.

At end-2010, the capital adequacy of banks in CESEE countries was higher than in the previous period. In Croatia and the Czech Republic, capital adequacy grew particularly strongly (2 percentage points); Ukraine posted the steepest increase in capital adequacy (3 percentage points). Although capital adequacy declined only in Russia (-3 percentage points), it continued to remain at a very high level (18.1%). At end-2010, this means the capital adequacy ratio ranged between 13% and 16% in Slovakia, the Czech Republic, Poland, Romania and Hungary and between 17% and 23% in Croatia, Bulgaria, Russia and Ukraine.

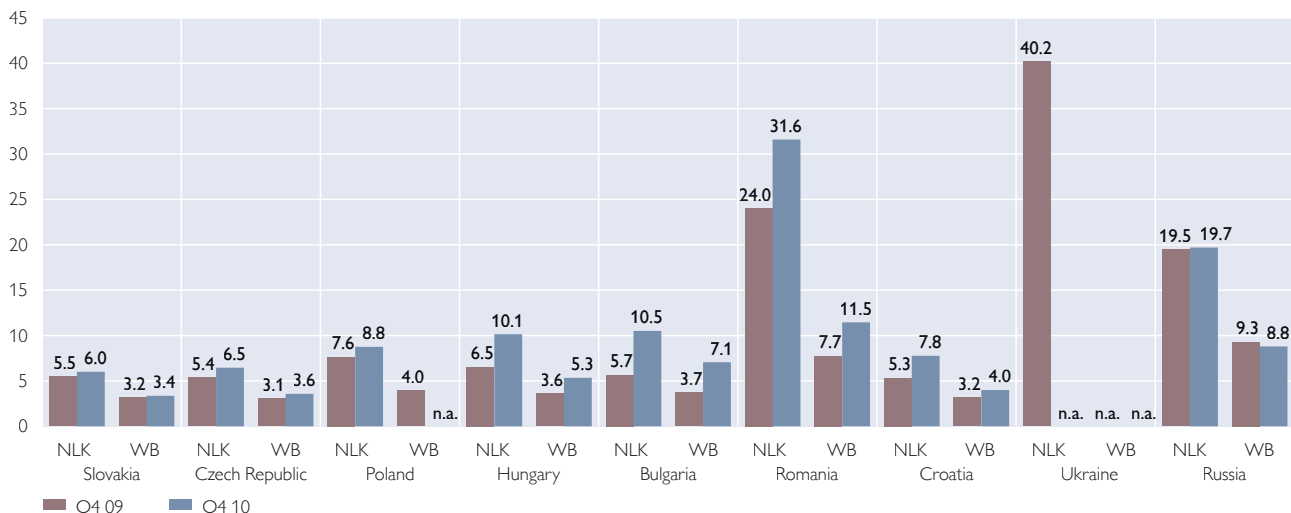
Banks' capital adequacy up for the most part

Banking sector profitability still muted

Chart 13

Banking Sector: Credit Quality

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



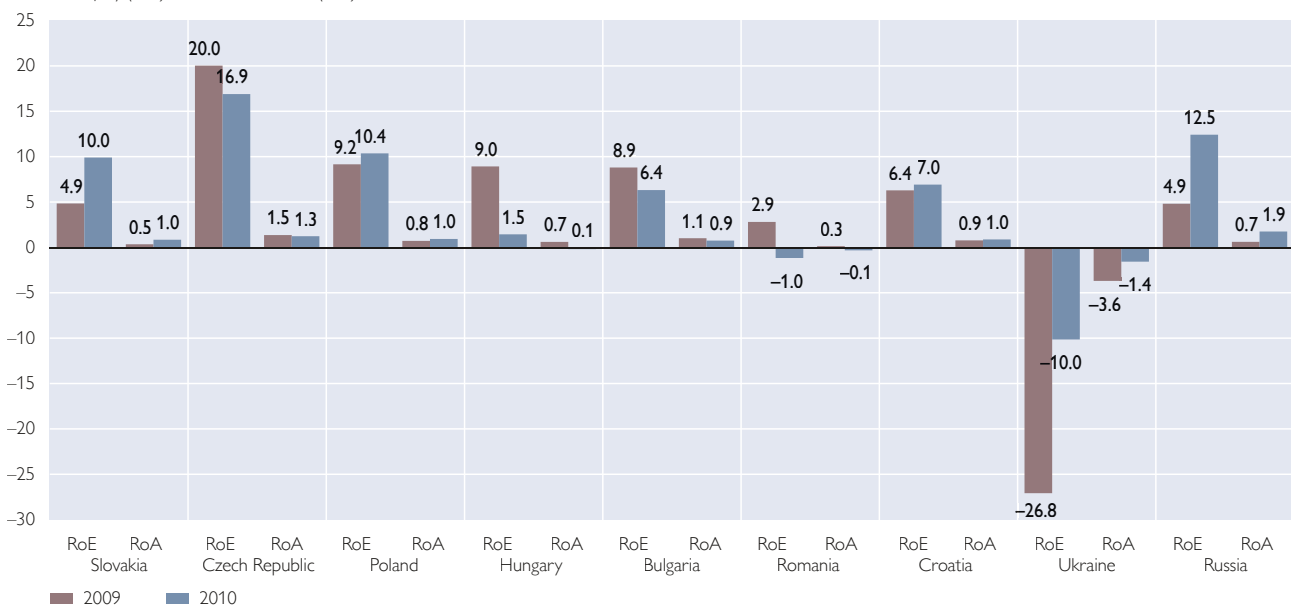
Source: IMF, national central banks, OeNB.

Note: Data are not comparable across countries. NPLs include substandard, doubtful and loss loans. Poland including so-called irregular loans.

Chart 14

Banking Sector: Profitability

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



Source: IMF, national central banks, OeNB.

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