

From Financial Crisis to Global Economic Crisis

World Economy Enters Deep Recession

The current global financial and economic crisis is posing extraordinary challenges for economic policy makers. This is because the crisis is global, its occurrence was sudden and the recession reached a scale not seen in recent decades.

In response, monetary and economic policies treaded new paths in both managing and combating the crisis. Central banks countered disruptions in financial markets by introducing extraordinary and historically unparalleled measures. Key policy rates worldwide are currently at historically very low levels. Moreover, a number of quantitative measures were established to support lending. This economic policy intervention basically had a two-pronged strategy: on the one hand, to stabilize the financial sector and, on the other hand, to develop economic stimulus packages given the swift spillover of the financial crisis into the real economy.

Dynamic measures implemented by central banks and governments prevented the financial crisis from escalating further. In spring 2009, early signs of stabilization were evident in international financial markets. Equity markets rallied modestly, and the spreads between money market and key interest rates narrowed from record highs.

In addition, the U.S.A., which was the first country to introduce comprehensive economic stimulus packages, witnessed the first signs of a possible stabilization of the economy. In the euro area, by contrast, the recession deepened in the first six months of 2009, and the outlook for the rest of the year remains bleak.

The repercussions of the recession also reached Central, Eastern and Southeastern European (CESEE) economies. The recession in this region is attributable to general factors such as the tightening of external financing conditions and the decline in external demand, as well as to specific circumstances in certain countries' situation at the start of the crisis (overheating of domestic demand, high external imbalances). Owing to the stabilization of international financial markets and to the economic support measures of the EU, the G-20 and international financial institutions, the financial markets of the emerging economies rallied modestly from March 2009.

Economic Downturn in Austria

The international economic crisis also reached the Austrian economy, with Austrian real GDP declining since the fourth quarter of 2008. The strength and speed of the downturn exceeded those of the country's previous recessions by a wide margin. Tax reform and economic stimulus packages should help stabilize the economy during the rest of 2009.

The financial crisis also adversely affected corporate financing conditions. In particular, borrowing in the equity market almost came to a standstill. Although bank lending continued to grow, banks tightened their credit standards and have been factoring in borrowers' risk-bearing capacity and their economic prospects more strongly into their lending decisions. Financing costs, which had risen markedly up to fall 2008, have thus far fallen in 2009. However, increased drawing of credit facilities deepened corporate debt and, after years of rising, capital ratios decreased in 2008.

The recession did not leave household balance sheets unscathed and, in this context, materialized especially in the form of heavy valuation losses for capital market securities. These losses not only affected households' financial assets but also had an impact on both funded pensions, which have become more important in recent years, and the repayment vehicles of bullet loans. New household borrowing, by contrast, went down significantly. However, the foreign currency share of household financing remained high.

Austrian Banks Increasingly Affected by Recession

The financial crisis and the downturn in the real economy had a clearly adverse effect on banks' profitability. In particular, marked valuation losses in trading income and higher loan loss provisions reduced profitability. In 2008, nevertheless, the Austrian banking system still generated a profit, albeit a considerably diminished one.

The CESEE business of banks active in the region accounted for a significant share of this profitability. Profits generated in this segment largely offset falling profits in others. In view of the gloomy economic outlook, international financial markets' risk aversion to this region increased sharply. Austrian banks' investment in CESEE countries increasingly came under the spotlight of critical international atten-

tion. This group of countries should not, however, be seen as a homogeneous region. Instead, the financial crisis affected individual countries to widely varying degrees. Furthermore, the activities of the IMF and the EU in the region created confidence and helped reduce significantly the likelihood of extremely negative developments.

Liquidity constraints, which marked bank refinancing in autumn 2008, became weaker, but have so far remained at historically high levels. Admittedly, in view of increasing feedback effects on the real economy from the financial system, the deterioration of Austrian banks' loan portfolio in both CESEE and Austria has only just begun.

However, the implementation of the bank support package helped prepare banks for an increase in loan loss provisions. Since the fourth quarter of 2008, both capital ratios and core capital ratios, after decreasing in previous periods, have risen via increased internal financing (retained earnings) and external financing (by core shareholders and by means of government participation capital).

To date, banks have been the financial intermediaries hardest hit by the crisis. However, the financial crisis also squeezed the investment results of insurance companies, investment funds and pension funds.