

Global Financial and Economic Crisis Hits Eastern Europe

Industrialized Countries: IMF Sees Economic Contraction

The *industrialized countries* have been in recession since mid-2008. According to the IMF's April 2009 World Economic Outlook, it is the deepest and most synchronized recession of the postwar period. The industrialized economies are expected to shrink by 3.8% in 2009, and global trade is anticipated to plunge by 11%. For 2010, the IMF predicts both growth and global trade volumes to stagnate.

While real GDP in the *U.S.A.* continued to contract in the first quarter of 2009, there were also some signs of a possible stabilization. Industrial production declined again, shrinking by 1.5% in March compared with the previous month. Real estate prices continued to slump, too, albeit at a slightly slower pace than before according to the Case-Shiller Index. The labor market situation again deteriorated markedly, with the unemployment rate climbing to 8.5% in March. While the annual inflation rate dipped

in March for the first time since 1955 (–0.4%), the core rate (which excludes energy and food prices) still came to 1.8%. Against this background, the Fed expanded its unconventional policy tools. To help improve conditions in the credit markets, the Federal Open Market Committee (FOMC) decided on March 17 and 18, 2009, to increase its purchases of mortgage-backed securities and unsecured bonds issued by federal housing agencies to a total of USD 1.45 trillion. Moreover, the Fed will purchase up to USD 300 billion of longer-term Treasury securities to help cut long-term interest rates.

In the *euro area*, too, the recession has deepened, with real GDP shrinking by 2.5% in the first quarter of 2009 compared with the previous quarter. The unemployment rate rose to 8.9% in March, a significantly higher value than last year. Annual HICP inflation stood at 0.6% in April. On May 7, 2009, the Governing Council of the ECB decided to lower the key interest rate by another 25 basis points to

Table 1

IMF World Economic Outlook: Industrialized Countries

	GDP (real annual change)					CPI (annual change)					Current account		
	Oct. 08	Apr. 09	Oct. 08	Apr. 09		Oct. 08	Apr. 09	Oct. 08	Apr. 09		Apr. 09		
	2008 ¹	2008	2009 ¹	2009 ¹	2010 ¹	2008 ¹	2008	2009 ¹	2009 ¹	2010 ¹	2008	2009 ¹	2010 ¹
	%					%					% of GDP		
Industrialized countries	1.5	0.9	0.5	-3.8	0.0	3.6	3.4	2.0	-0.2	0.3	-1.1	-1.0	-1.0
U.S.A.	1.6	1.1	0.1	-2.8	0.0	4.2	3.8	1.8	-0.9	-0.1	-4.7	-2.8	-2.8
Euro area	1.3	0.9	0.2	-4.2	-0.4	3.5	3.3	1.9	0.4	0.6	-0.7	-1.1	-1.2
Germany	1.8	1.3	0.0	-5.6	-1.0	2.9	2.8	1.4	0.1	-0.4	6.4	2.3	2.4
France	0.8	0.7	0.2	-3.0	0.4	3.4	3.2	1.6	0.5	1.0	-1.6	-0.4	-0.9
Italy	-0.1	-1.0	-0.2	-4.4	-0.4	3.4	3.5	1.9	0.7	0.6	-3.2	-3.0	-3.1
Austria	2.0	1.8	0.8	-3.0	0.2	3.5	3.2	2.3	0.5	1.3	2.9	1.3	1.3
United Kingdom	1.0	0.7	-0.1	-4.1	-0.4	3.8	3.6	2.9	1.5	0.8	-1.7	-2.0	-1.5
Japan	0.7	-0.6	0.5	-6.2	0.5	1.6	1.4	0.9	-1.0	-0.6	3.2	1.5	1.2

Source: IMF (World Economic Outlook), October 2008 and April 2009.

¹ Forecast.

1.00%, which means that the ECB's key rate has been cut by 1.5 percentage points since the beginning of the year. Subsiding inflationary pressures allowed the ECB to continue monetary easing in response to the deteriorating economic outlook.

Japan is afflicted by the worst recession of the postwar period. In the fourth quarter of 2008, GDP was down by as much as 3.8% on the previous quarter and shrank by another 4.0% in the first quarter of 2009. In February 2009, both CPI and core inflation stood at -0.1%. At its meeting in early April, the Bank of Japan (BoJ) left its key interest rate unchanged at 0.1%. To strengthen financial institutions' capital base and thus improve their scope for lending, the BoJ is buying highly rated short-term debt securities as well as highly rated corporate bonds from commercial banks. Since early March 2009, banks have also had the opportunity to sell equity holdings to the BoJ.

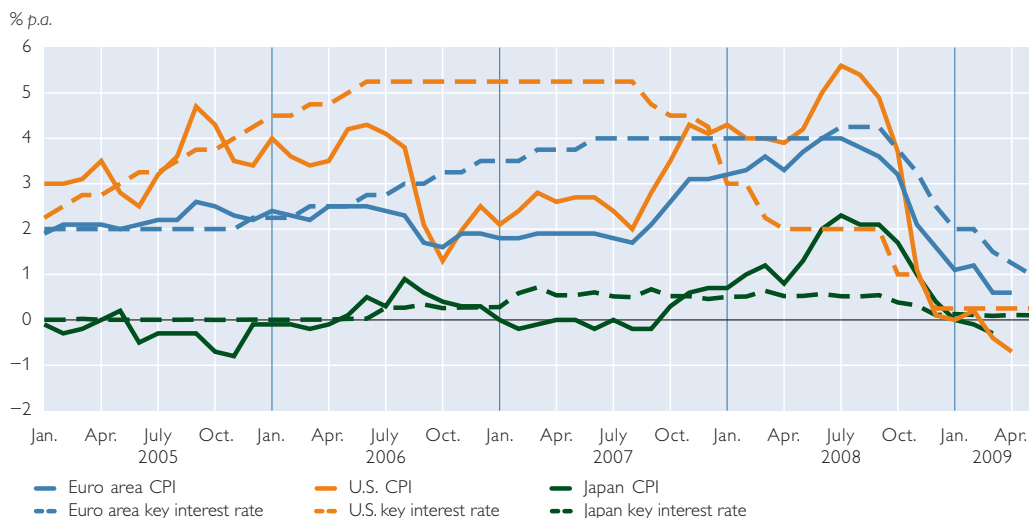
In U.S. and euro area *money markets*, the measures taken by central banks and governments caused tensions

to moderate and interest rates to drop. In April and May 2009, the three-month EURIBOR and the U.S. dollar three-month LIBOR came in at about 1%. In U.S. and euro area bond markets, ten-year *government bond* yields tended to move sideways in recent months.

Yields dropped markedly when the Fed announced it would purchase large volumes of government bonds in the secondary market. After that, long-term U.S. yields climbed again as stock markets stabilized. In the ten-year segment, the yield spreads between German bunds and government bonds issued by other euro area countries widened to high levels until February 2009 and then narrowed again. The highest value recorded for Austria was 100 basis points. The financial crisis also led to a substantial rise in yield spreads on *corporate bonds* in the U.S.A. and the euro area, which declined again significantly in April, though, especially those on AAA bonds. Since March 2009, international *stock markets* have recovered from a several-year low.

Chart 1

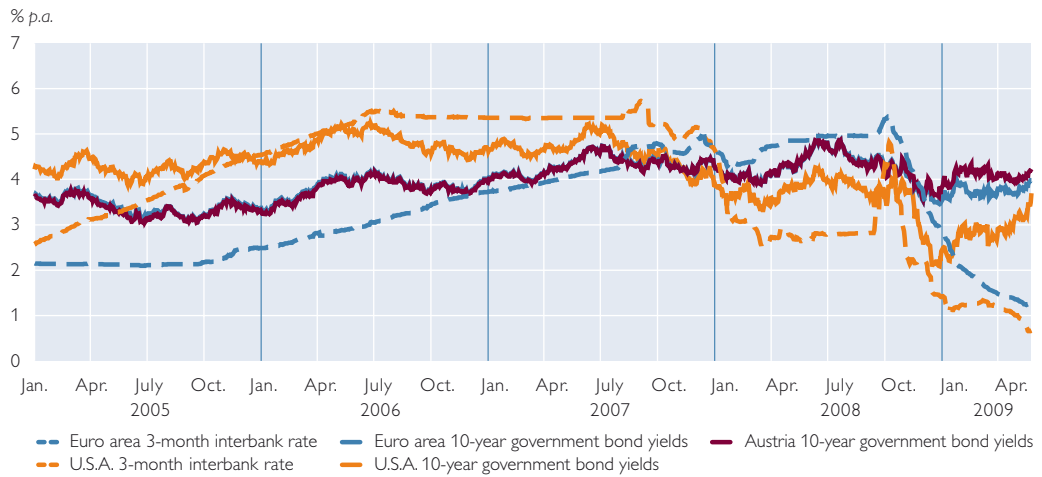
Euro Area, U.S.A. and Japan: Inflation and Key Interest Rates



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

Chart 2

Euro Area, U.S.A. and Austria: 3-Month Interbank Rates and 10-Year Government Bond Yields



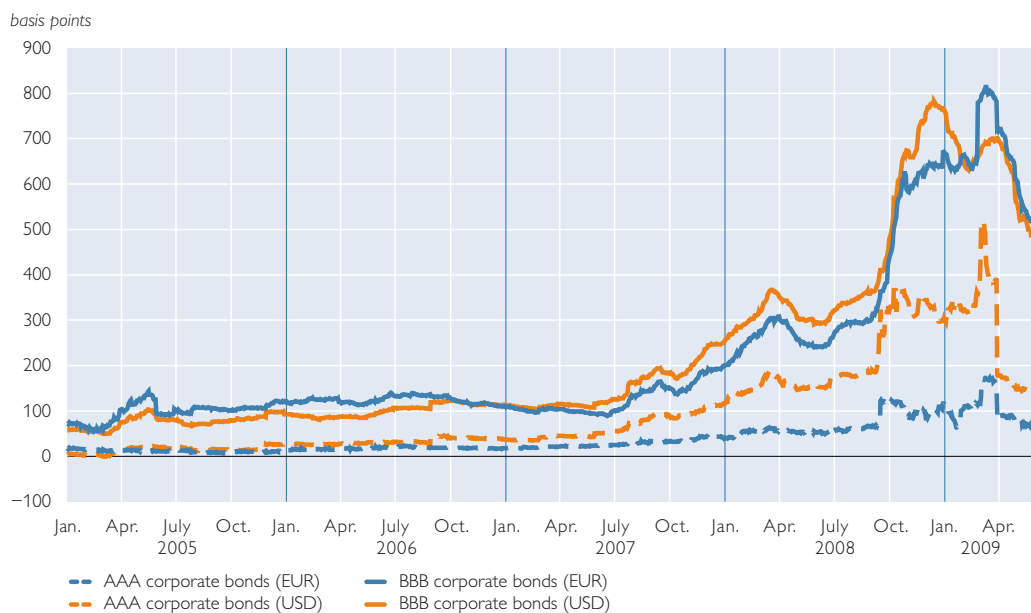
Source: Thomson Reuters, OeNB.

In the euro area, the stock market index rose by about 30% from early March to end of May, with banks' and insurance companies' stocks performing significantly above average. This sharp rise was driven by announce-

ments that the U.S. authorities would launch further support packages, by several banks reporting favorable results, and by the outcome of the G-20 summit.

Chart 3

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

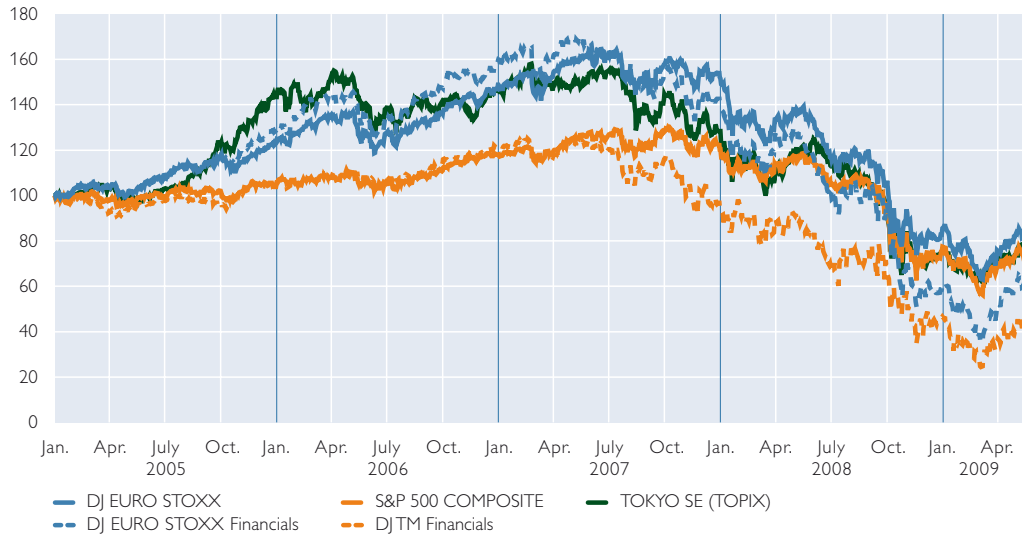


Source: Thomson Reuters, OeNB.

Chart 4

Euro Area, U.S.A. and Japan: Stock Market Indices and Bank Stock Subindices

January 1, 2005 = 100



Source: Thomson Reuters, OeNB.

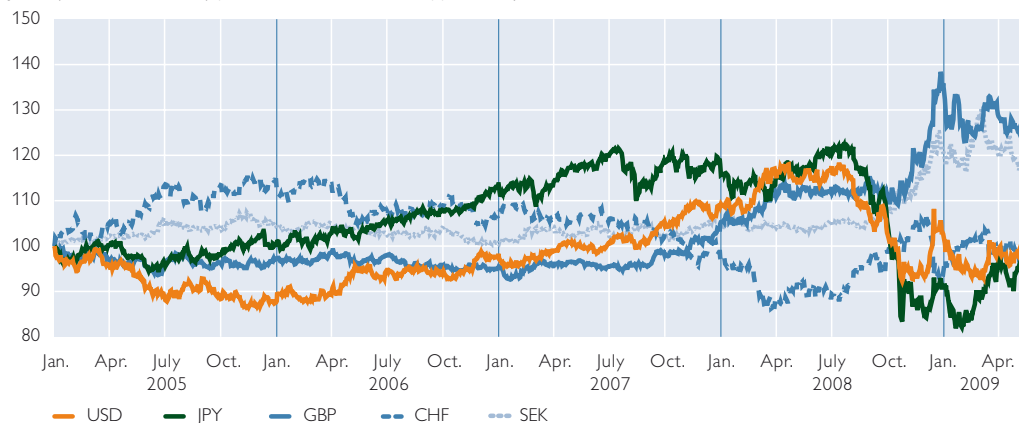
In *foreign exchange markets*, the USD/EUR exchange rate moved sideways amid temporarily large fluctuations, which reflected differing expectations about the relative economic

outlook. The Japanese yen and the Swiss franc continued to be affected by fluctuations in international investors' risk appetite.

Chart 5

Industrialized Countries: Exchange Rates against the Euro

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



Source: Thomson Reuters, OeNB.

Note: In national currency per unit of euro.

Comparing Developments in Central, Eastern and Southeastern Europe with Other Emerging Market Economies

The global financial and economic crisis triggered by the U.S. subprime crisis has affected emerging market economies (EMEs) through both financial sector and real economy channels. Looking at EME regions, the IMF predicts that, like the industrialized countries, the Commonwealth of Independent States (CIS), CESEE (excluding CIS) and Latin America will be in recession in 2009. In the CIS, this recession is expected to be deepest and, in particular, more severe than in the industrialized countries. For the other regions (Middle East, Africa, Asia), the IMF predicts growth to slow down sharply but remain positive.

Differences between the individual countries of a region are partly substantial, though. Developments in aggre-

gate Asia, for instance, are dominated by China's economic weight. Similarly, CESEE is anything but a homogeneous region – the differences between individual countries are huge. The IMF expects that, apart from the Baltic states, Romania will experience the largest decline in GDP growth from 2008 to 2009 and will be affected by the deepest recession in the region. Still, contrary to expected GDP developments in the Baltic and CIS countries, Romanian GDP is not forecast to shrink more sharply than euro area GDP. According to this outlook, the CESEE countries will likely be able to maintain the level they achieved in recent years in catching up with average per-capita income in the euro area. However, this outlook also takes into account the effect of international support packages for some countries of the region (e.g. Romania, Serbia and Latvia).

Chart 6

GDP Forecast

Annual changes in %, at constant prices



Source: IMF (World Economic Outlook), April 2009.

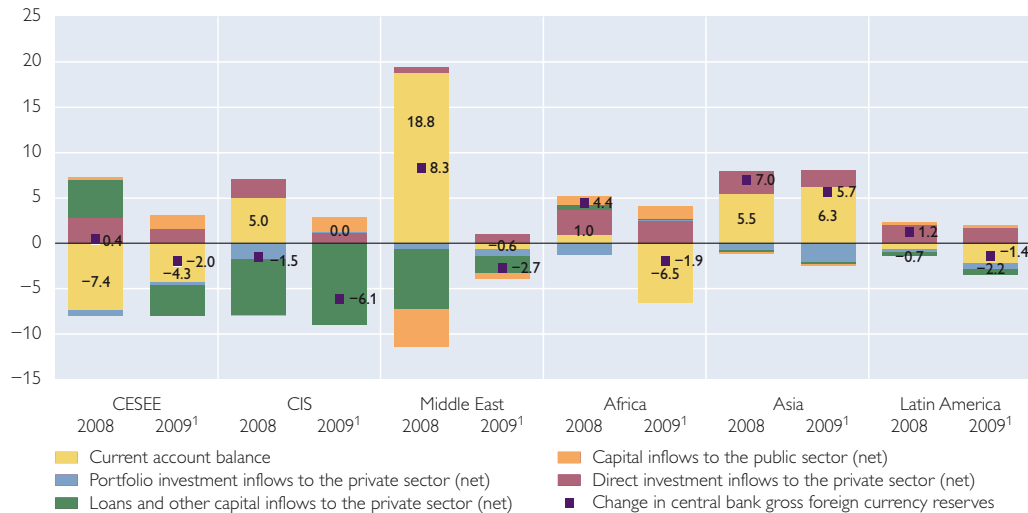
¹ Forecast.

Note: CESEE aggregate excluding European CIS 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 public sector) refer to net capital outflows from the public sector to the industrialized countries. Positive values for the change in official gross reserves indicate an increase. CESEE aggregate excluding European CIS countries; Asia aggregate including South Korea, Taiwan, Hong Kong and Singapore.

The extent to which individual emerging market economies or entire regions are affected by the financial and economic crisis depends on these economies' *structures and degree of openness*, among other things. Since most of the CESEE countries are highly open economies that have already achieved an especially high degree of economic integration (in terms of financing and the real economy) as well as institutional and political integration with the larger European economic area, developments in CESEE economies have closely followed those of the euro area and the EU-15. The CIS has been severely affected by the massive withdrawal of foreign credit and by the decline in commodity prices. The latter has also played a decisive role in the Middle East (where the current account surplus has disappeared as in CESEE) and in Africa (where a current account deficit has emerged). How severely a country is

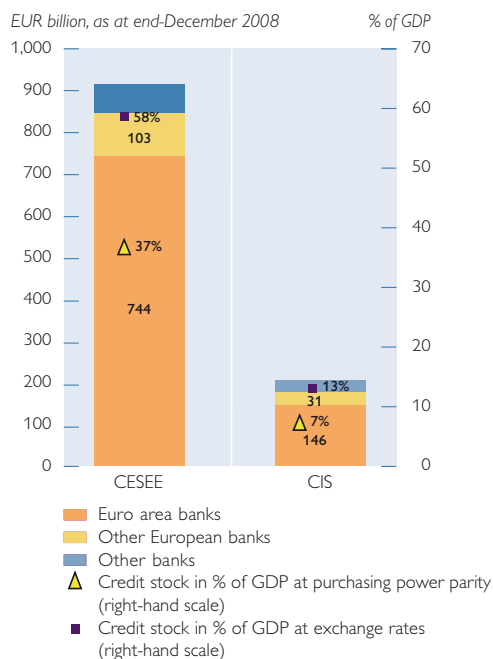
hit by the crisis also depends on the *magnitude of imbalances before the onset of the crisis*. Countries that posted high current account surpluses in the past and thus accumulated large foreign reserves now have better means to address current developments proactively. In some CESEE countries, however, the current account deficits were not just a result of the catching-up process and of deepening integration – they were also due to overheating domestic demand.

Among total *credit claims on emerging markets held by BIS reporting banks* (which are mainly based in industrialized countries), claims on CESEE (excluding CIS) are particularly high – both in euro and as a percentage of the recipient region's GDP.¹ The large exposure to this region is mainly attributable to the fact that banks reporting to the BIS (especially banks from the euro area) own almost the entire banking sectors

¹ Credit extended to offshore centers is even higher, though.

Chart 8

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



Source: BIS, IMF, OeNB.

Note: CESEE excluding European CIS countries; proxy for euro area banks (including Danish and Norwegian banks, excluding banks from Luxembourg); points: credit stock in % of GDP of the recipient region (right-hand scale).

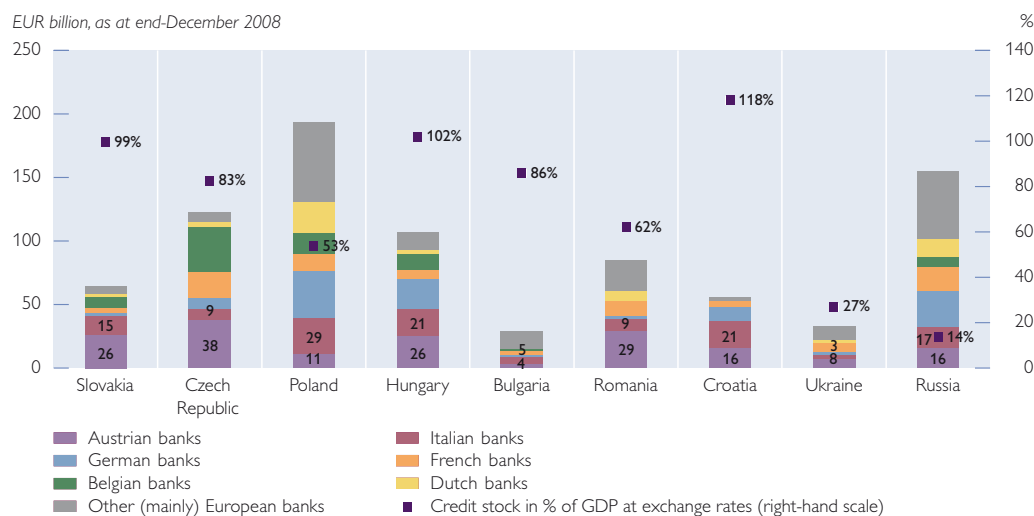
of most CESEE countries; therefore, the volume of claims outstanding is enhanced by domestic credit that is funded through domestic deposits. Among the banks reporting to the BIS, Austrian, Italian, German and French banks have substantial claims on most CESEE countries, while banks from Belgium and the Netherlands have substantial claims on individual countries of the region, and Swedish banks are particularly exposed to the Baltic countries.

Developments in *emerging market economies' financial markets (stock markets, euro bond markets)* are characterized, on the one hand, by large differences between countries (also within one region) in both boom and bust cycles.

On the other hand, the underlying pattern is clearly driven by developments in the industrialized countries and the associated risk appetite trends. The price gains and the decline in yield spreads observed since February 2009

Chart 9

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

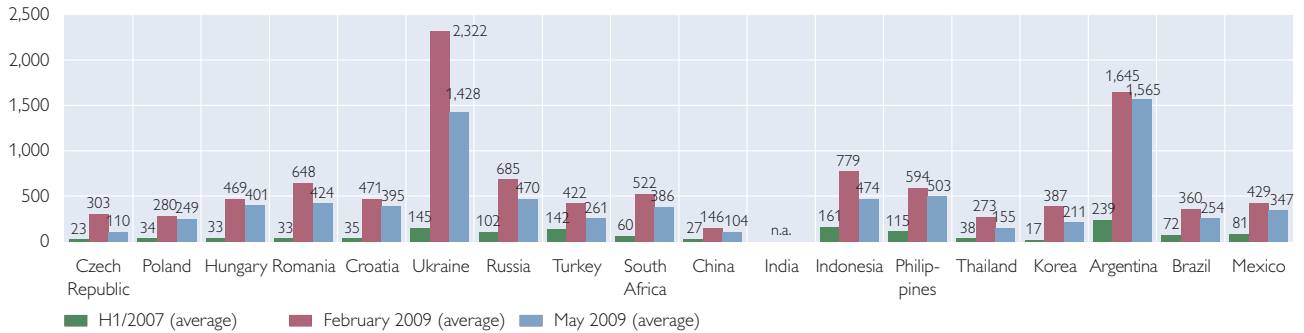


Source: BIS, IMF, OeNB.

Note: Austrian banks excluding UniCredit Bank Austria (assigned to Italy) and Hypo Group Alpe Adria (assigned to Germany). Points: credit stock in % of GDP (at exchange rates) of the recipient country (right-hand scale).

Emerging Markets: Spreads on Sovereign Eurobonds in Foreign Currency

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



Source: Bloomberg, Thomson Reuters, OeNB.

Note: Spreads refer to yield spreads 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 premia serve as a proxy.

partly reflect (preparations for) the G-20 decisions taken in early April (additional IMF funds and new IMF facilities), the increase in the EU balance of payments support facility and specific agreements on IMF and/or EU credit lines with individual countries of the region.

CESEE: International Financial and Economic Crisis Causes Recession and an Adjustment of Imbalances

The global financial and economic crisis has led to a slump in growth in CESEE (here including European CIS countries), with annual *real GDP growth* dropping in all countries in the fourth quarter of 2008 compared with the previous quarter. The downturn was especially pronounced in Romania and Ukraine and led to negative growth in Hungary and Ukraine, which was mainly attributable to a sharp decline in export demand (notably due to a fall in euro area imports) and to slower growth of domestic demand (in particular investments). In the first quarter of 2009, the downturn intensified in tandem with developments in the euro area, and almost all CESEE countries were in a recession as measured by an-

nual GDP change (albeit to markedly different degrees). Poland was the only country to post a rise in annual GDP (+1.9%).

Ukraine was among the countries that were hit hardest by the crisis (in addition to political uncertainties), with GDP tumbling by 8% in the fourth quarter of 2008. In February, the IMF suspended the release of the second tranche of a EUR 12.8 billion loan to Ukraine that had been agreed upon in November 2008. In early May, an agreement was reached to adjust the loan terms and a higher tranche than originally scheduled (EUR 2.1 billion instead of 1.5 billion) was disbursed. *Romania* secured a EUR 20 billion loan with a maturity of 24 months from international financial institutions and the EU in March 2009. On May 4, 2009, the IMF approved its EUR 12.9 billion share in that agreement; EUR 4.9 billion of this amount was made available immediately. In addition to loans under Stand-By Arrangements, which are only disbursed in tranches provided the recipients gradually fulfill certain conditions, the IMF introduced a Flexible Credit Line facility for countries with very strong fundamentals (ex ante conditionality) in late March

2009. On May 6, 2009, the IMF gave Poland unlimited access to a one-year flexible credit line in the amount of EUR 15.4 billion.

In 2008, the Southeastern European countries (notably Bulgaria) posted large deficits in the *combined current and capital account* that were primarily due to the goods and services balance. In Romania, the deficit was slightly smaller than in 2007, partly because of a depreciation of the leu. In Ukraine, the deficit rose as a result of plummeting steel prices, higher oil and gas import prices as well as overheating domestic demand in the first half of 2008. A drastic reduction of imbalances was reported for several countries in the first quarter of 2009. As goods and services imports dropped more sharply than exports, the current account deficit of Ukraine declined by 72% compared with 2008, while that of Romania and Bulgaria fell by 76% and 56%, respectively (Poland –80%). In Russia, the current account surplus shrank from EUR 25 billion to EUR 8 billion.

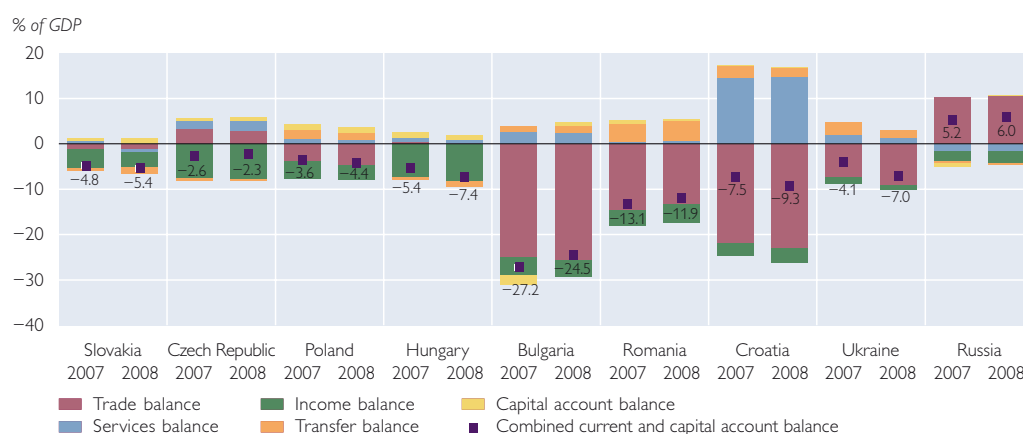
Only in the Czech Republic, *foreign direct investment* in 2008 still more than

offset the combined current and capital account deficit. The coverage level declined markedly in Bulgaria, Croatia, Ukraine and Poland, which implied *ceteris paribus* a higher demand for external funding (new debt).

Among the *currencies* of the CESEE countries here under study, only the Romanian leu depreciated significantly against the euro in the period from the onset of the financial market turbulence in mid-2007 to the collapse of Lehman Brothers in September 2008, whereas the Czech koruna and the Polish zloty still appreciated strongly in that period. After that, however, the Polish zloty, the Czech koruna and the Hungarian forint depreciated sharply against the euro until mid-February 2009. While these developments were partly attributable to general factors (an overall rise in risk aversion, the deleveraging of risky assets by internationally active financial institutions and the deterioration of the (export) growth outlook), specific factors also played a role (e.g. losses on foreign exchange options in Poland, and the supportive effect of the credit agreement with the IMF and the EU as well as of increases

Chart 11

Current and Capital Account Balances and Components



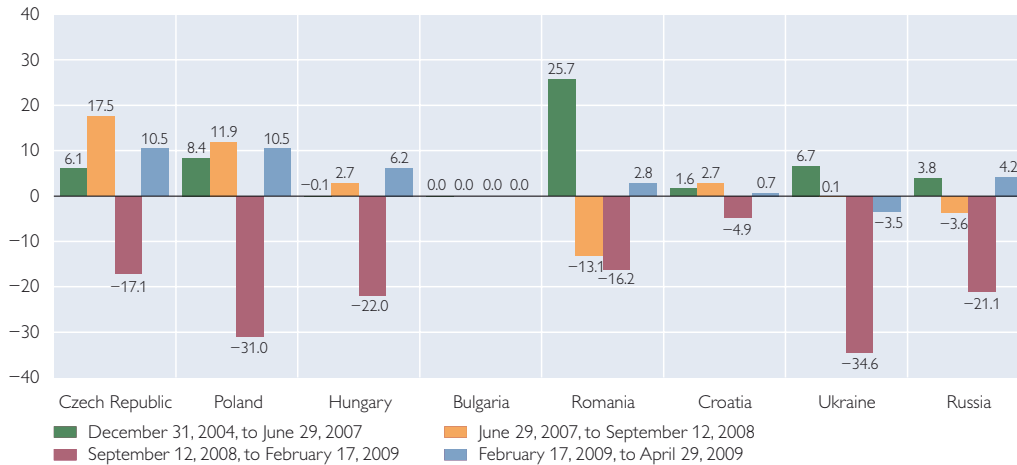
Source: Eurostat, national central banks, OeNB.

Note: Points refer to the combined current and capital account balance (sum of subaccounts) in % of GDP.

Chart 12

National Currencies and the Euro

Euro per unit of the respective national currency change in %



Source: Thomson Reuters, OeNB.

in key interest rates in Hungary). In Romania and Croatia, the currency depreciation was slowed down by central bank interventions. The Russian ruble also depreciated markedly in relation to the central bank's dual-currency basket (45% euro, 55% U.S. dollar), driven by the decline in oil prices and by capital outflows that had started already during the armed conflict with Georgia. Between November 2008 and January 2009, the Central Bank of the Russian Federation gradually widened the trading band against the basket, thus permitting a controlled depreciation of the currency. The Ukrainian hryvnia reached its low already in December 2008. Since then, the National Bank of Ukraine has managed to prevent the currency from tumbling further by making interventions and regulatory changes. While currency depreciations may support growth in the depreciating countries with some lag by fueling net exports (provided that the resulting losses on foreign exchange options do not weaken export businesses), they also have a negative impact on domestic demand in coun-

tries where a large share of household debt is denominated in foreign currency. Between February and May 2009, most of the currencies that had depreciated previously stabilized or even appreciated slightly in parallel to international developments.

Falling energy and food prices and the onset of recession had a dampening effect on *price developments*, which more than offset the inflationary effect of currency depreciation. Inflation declined sharply above all in Bulgaria and Croatia, two countries whose currencies had depreciated only slightly or not at all because of their currency regimes. In the first quarter of 2009, only Ukraine and Russia still posted double-digit inflation rates.

According to the spring forecast of the European Commission, the recession will lead to the widening or the emergence (Bulgaria and Russia) of *fiscal deficits* in all countries of the region in 2009. This is chiefly attributable to automatic stabilizers and only partly to discretionary measures. The latter play a role above all in Russia (accounting for more than 4% of GDP)

and Poland (where tax reductions that were scheduled some time ago will become effective). Public debt will continue to rise from relatively high levels first and foremost in Hungary, but also in Poland. Obtaining funding from capital markets is also difficult for countries with lower public debt levels, though. Loan arrangements with the IMF and the EU have helped to fill this gap for Romania and Ukraine.

In April 2009, government financing costs as measured by the *yields on ten-year government bonds in national currency* remained unchanged from August 2008 in Slovakia and (because of key interest rate cuts) in Poland. In light of lower average yields in the euro area, spreads (reflecting sovereign risk and exchange rate risk) have widened for these countries, as well. In the other CESEE countries, yields and spreads have risen markedly. In Romania and Hungary, this was also ascribable to higher *short-term interbank rates* as a result of (partly foreign exchange intervention-related) liquidity bottlenecks and key interest rate hikes to stabilize the currency. Hungary's key rate was lifted by 3 percentage points to 11.5% in October 2008 and then cut in several steps to reach 9.5% in January 2009. After raising the key interest rate by 0.25 percentage points to 10.25% in early August 2008, Romania's central bank waited until early February 2009 to cut the key interest rate by the same amount to 10.0% and reduced it further to 9.5% in early May 2009. Following the conclusion of the credit arrangement with the IMF and the EU, the central bank decided on March 31, 2009, to lower the reserve ratio for liabilities denominated in foreign currency with a residual maturity of more than two years from 40% to 0%, thus continuing monetary easing. In the Czech Republic and Poland, interbank

rates have declined thanks to key interest rate cuts by 200 basis points and 225 basis points, respectively, that were made since August 2008.

Among the CESEE countries, the *degree of intermediation* (as measured by the stock of domestic credit to the private sector as a ratio of GDP) is highest in Hungary, Bulgaria, Croatia and Ukraine; but even in these countries, intermediation is still markedly below the euro area average. This group also reports a large share of foreign currency credit in both credit to households and total (domestic and cross-border) corporate credit; Hungary, Bulgaria and Croatia also post the largest stock of cross-border corporate credit in the region. Only Croatia reported a considerable decline in the share of foreign currency credit to households over the past few years.

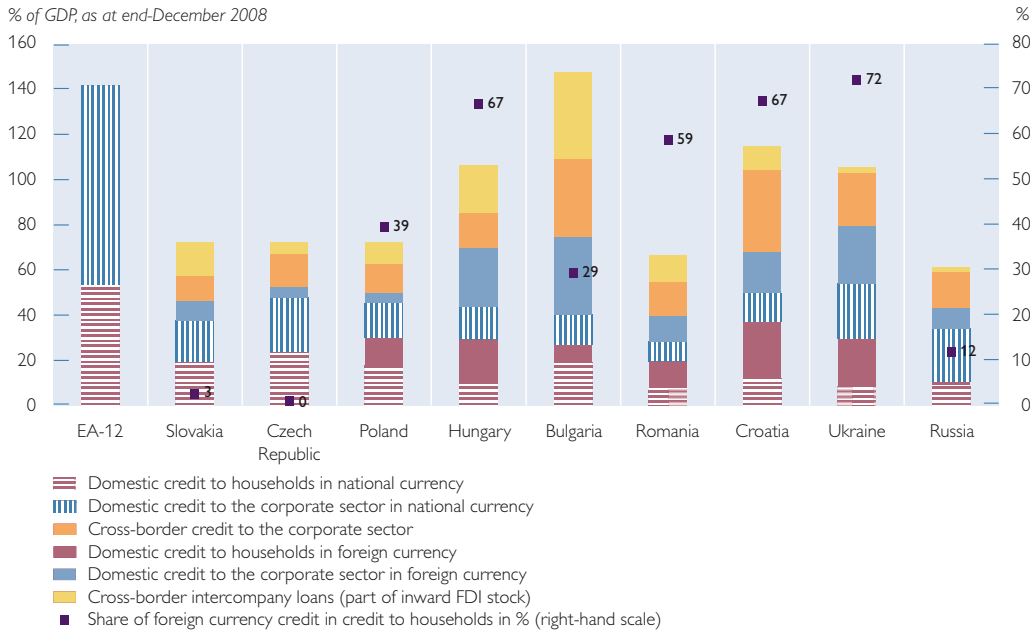
In the fourth quarter of 2008, total (i.e. domestic and cross-border) net lending to the private sector came to a halt in most countries (except Bulgaria and Croatia), and the volume of credit outstanding even declined in some countries. Cross-border corporate lending declined in all CESEE countries but Croatia. The volume of domestic corporate credit dropped in the Czech Republic, Hungary, Romania and Russia, while that of household credit fell in Romania, Russia and Ukraine. In countries where domestic credit aggregates did not decline, their growth slowed substantially (except in Croatia, where regulatory provisions were eased). Overall, both demand and supply factors seem to have been responsible for these credit developments.

In Hungary, Bulgaria, Romania and Ukraine, the *volume of credit outstanding* (as a percentage of total assets) at end-2008 was significantly higher than that of deposits, whereas in Slovakia and the

Chart 13

Outstanding Total (Domestic and Cross-Border) Credit to Households and the Corporate Sector

% of GDP, as at end-December 2008



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

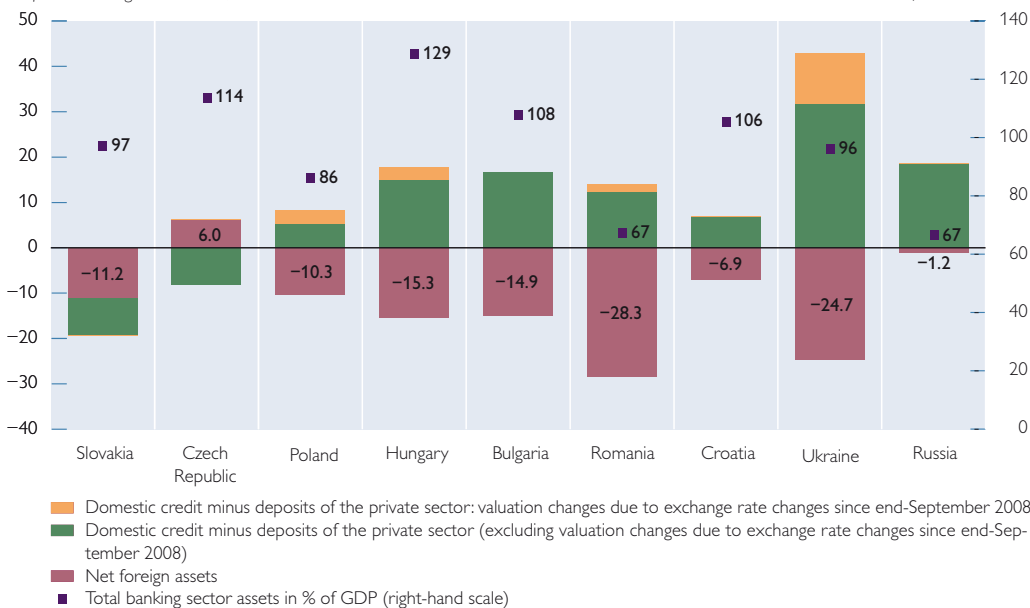
Note: Foreign currency credit also includes credit in national currency that is indexed to a foreign currency. EA-12 (the first 12 euro area members): Domestic credit in national currency (i.e. euro) includes also domestic credit in foreign currency. Points refer to the share of foreign currency credit in credit to households in % (right-hand scale).

Chart 14

Banking Sector: Gap between Credit and Deposits and Net Foreign Assets

% of total banking sector assets, end-2008

% of GDP, end-2008



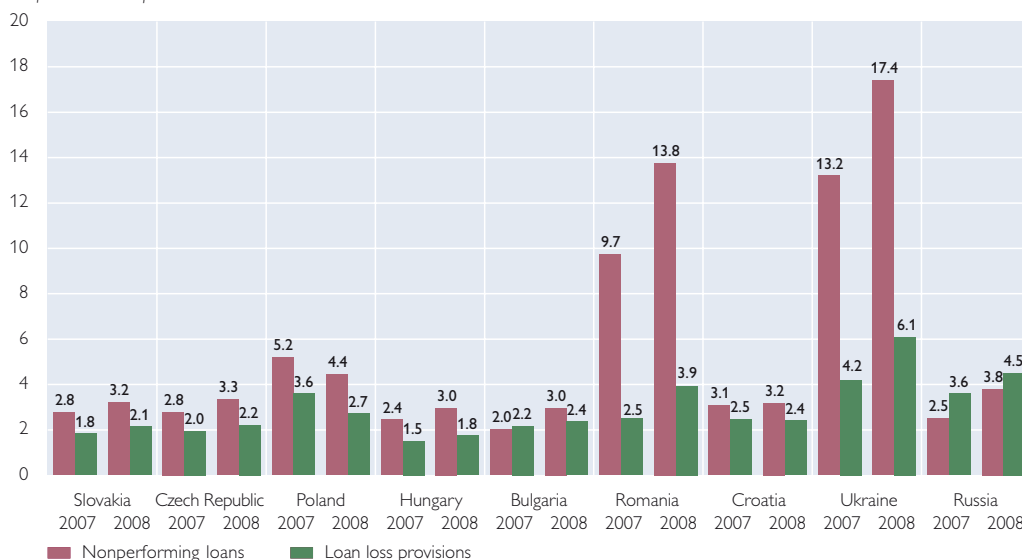
Source: ECB, Eurostat, national central banks, national statistical offices, OeNB.

Note: Points: Total banking sector assets in % of GDP (right-hand scale).

Chart 15

Banking Sector: Credit Quality

% of total loans at period-end



Source: IMF national central banks, OeNB.

Note: The data for the different countries are not comparable. Nonperforming loans comprise substandard, doubtful and loss loans. Poland: including irregular loans.

Czech Republic, the volume of deposits was higher than that of credit. Especially in Romania and Ukraine, and to a lesser extent also in Hungary and Bulgaria, banks continue to have substantial net *external liabilities*, primarily vis-à-vis foreign parent banks.

Currency depreciation and above all the recession have caused an increase in *credit risk in the banking sector*. At end-2008, the share of nonperforming loans was higher than it had been one year earlier in all CESEE countries except Poland; the rise was especially strong

Chart 16

Banking Sector: Profitability

%



Source: IMF national central banks, OeNB.

Note: Based on after-tax profit. The data for the different countries are not comparable.

in Romania. At the same time, *banking sector profitability* in terms of return on equity (RoE) and return on assets (RoA) was on the decline in all countries except Romania, where both indicators improved, and Croatia, where RoA remained stable. *Capital adequacy* with regard to market and trading risk varied widely in 2008: While some countries reported a decline in the

capital adequacy ratio (CAR), the CAR remained unchanged in Hungary and Ukraine and increased in the Czech Republic, Bulgaria and – due to state measures for banking sector recapitalization – Russia. At the end of 2008, the CAR was between around 11% (Slovakia, Poland and Hungary) and some 17% (Russia).