

Abatement of Global Crisis

Industrialized Countries: Growth after Four Quarters of Decline

In the *industrialized countries*, the economic situation, after a sharp downturn in the fourth quarter of 2008 and in the first quarter of 2009, appears to have stabilized at a low level. Comprehensive monetary and fiscal policy measures implemented in many countries seem to have contributed to this stabilization. In its latest outlook of October 2009, the IMF revised upwards its GDP growth projections for 2010 for the U.S.A., the euro area and Japan compared with April 2009.

In the *U.S.A.*, real GDP growth in the third quarter of 2009 grew by 0.9% on a quarterly basis (annualized: 3.5%), but was 2.3% lower than in same period a year ago. This resumption of growth is primarily attributable to economic policy measures designed to stimulate the economy. The housing market also received positive news recently. In particular, tax breaks for house buyers are likely to assist the recovery of the real estate market. In June 2009, the Case-Shiller price index

for single-family homes improved for the first time in about three years. The financial crisis led to a partial decline in global imbalances. For instance, at 2.6% of GDP, the U.S. current account deficit in 2009 is likely to be less than half as high as in 2006 (6% of GDP). The year-on-year decline in the consumer price index reached 2.1% in July 2009, slowing to 1.3% by September 2009. The core inflation rate stood at a constant 1.5% on an annual basis. At its meeting of September 22 and 23, 2009, the U.S. Federal Reserve's Open Market Committee left the target range for the Federal Funds rate unchanged at close to 0%. In parallel with the interest rate decision, the renewal of purchasing programs for mortgage bonds was approved. It had been decided as early as August 2009 to terminate the program for purchasing U.S. government bonds as at end-October 2009.

In the *euro area* too economic support measures had a stimulating impact. Real GDP in the third quarter of 2009 grew by 0.4% on a quarterly ba-

Table 1

IMF World Economic Outlook: Industrialized Countries

	GDP (real annual change)					CPI (annual change)					Current account		
	Apr. 09	Oct. 09	Apr. 09	Oct. 09		Apr. 09	Oct. 09	Apr. 09	Oct. 09		Oct. 09		
	2008	2008	2009 ¹	2009 ¹	2010 ¹	2008	2008	2009 ¹	2009 ¹	2010 ¹	2008	2009 ¹	2010 ¹
	%					%					% of GDP		
Industrialized countries	0.9	0.6	-3.8	-3.4	1.3	3.4	3.4	-0.2	0.1	1.1	-1.3	-0.7	-0.4
U.S.A.	1.1	0.4	-2.8	-2.7	1.5	3.8	3.8	-0.9	-0.4	1.7	-4.9	-2.6	-2.2
Euro area	0.9	0.7	-4.2	-4.2	0.3	3.3	3.3	0.4	0.3	0.8	-0.7	-0.7	-0.3
Germany	1.3	1.2	-5.6	-5.3	0.3	2.8	2.8	0.1	0.1	0.2	6.4	2.9	3.6
France	0.7	0.3	-3.0	-2.4	0.9	3.2	3.2	0.5	0.3	1.1	-2.3	-1.2	-1.4
Italy	-1.0	-1.0	-4.4	-5.1	0.2	3.5	3.5	0.7	0.8	0.9	-3.4	-2.5	-2.3
Austria	1.8	2.0	-3.0	-3.8	0.3	3.2	3.2	0.5	0.5	1.0	3.5	2.1	2.0
United Kingdom	0.7	0.7	-4.1	-4.4	0.9	3.6	3.6	1.5	1.9	1.5	-1.7	-2.0	-1.9
Japan	-0.6	-0.7	-6.2	-5.4	1.7	1.4	1.4	-1.0	-1.1	-0.8	3.2	1.9	2.0

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

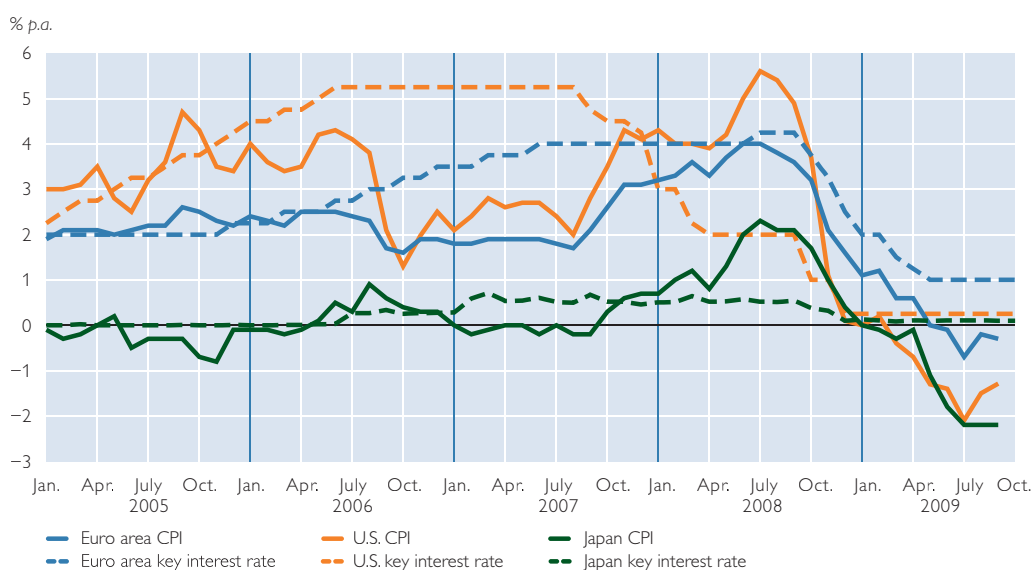
¹ Forecast.

sis, but it was 4.1% lower than in the same period a year ago. In addition to net exports, positive growth stimuli came from both private and government consumption. On a country-by-country basis, quarterly growth was exceptionally positive in Austria, Ger-

many, Portugal and Italy. From June to September 2009, the annual HICP inflation rate was negative, primarily owing to the price of crude oil, which was far lower than one year earlier. Since mid-May 2009, the Governing Council of the ECB has kept key interest rates at

Chart 1

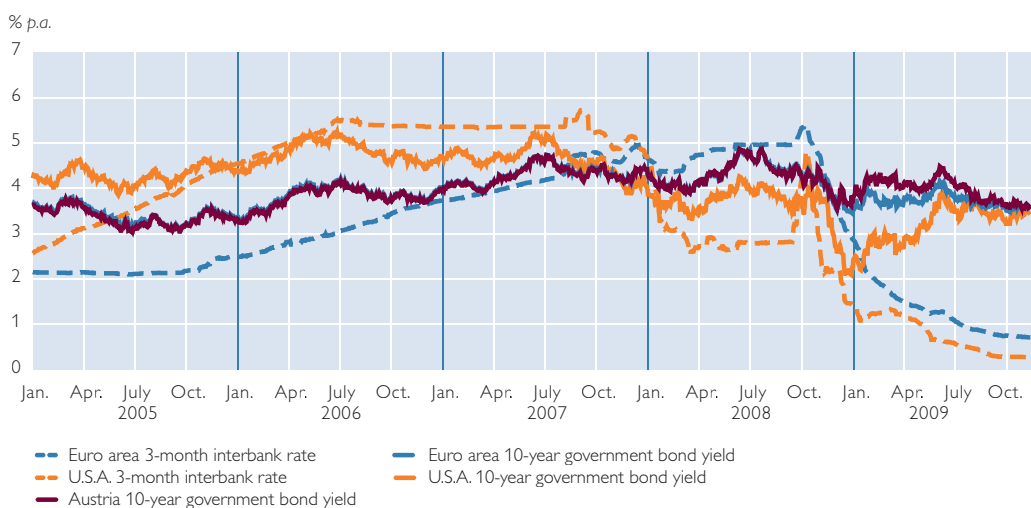
Euro Area, U.S.A., Japan: Inflation and Key Interest Rates



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

Chart 2

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



Source: Thomson Reuters, OeNB.

1%. Under its policy of enhanced credit support, the ECB carried out purchases of covered bonds and longer-term refinancing operations with a maturity of one year.

The *Japanese* economy bounced back as early as the second quarter of 2009 (+0.7% quarter on quarter), but GDP growth was 7% lower than in the same period a year earlier. Growth was primarily driven by exports (especially to Asia) and government investment programs. Private investment continued to fall sharply. In September 2009, the annual inflation rate was -2.2%. For the time being, the Bank of Japan intends to stick to its zero interest rate policy and its generous provision of liquidity. The most important programs introduced during the crisis were rolled over to end-2009.

In U.S. and euro area *money markets*, LIBOR and EURIBOR continued

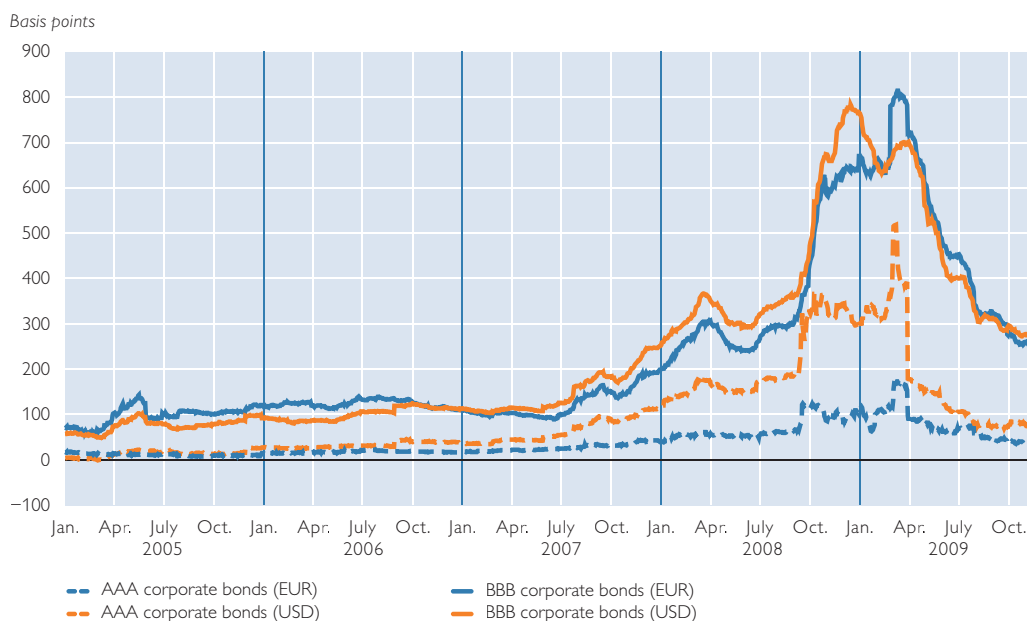
to fall. Risk premiums in the U.S. money market narrowed to a greater extent than in the euro area. In *government bond markets*, long-term interest rates rose on the back of a stock market rally until June 2009, since when they have again been in decline. The ten-year government bond yield spreads between Germany and other euro area countries have continued to narrow.

The global *stock market* recovery since March 2009 has continued on the whole. Financial enterprises reported particularly high prices gains. The rally primarily reflects a return to a certain readiness to take risks as well as an improvement in general sentiment. The yield spreads of U.S. and euro area *corporate bonds* further narrowed owing to lower liquidity premiums and risk premiums for both AAA and BBB bonds.

In the *foreign exchange markets*, the euro appreciated against other major

Chart 3

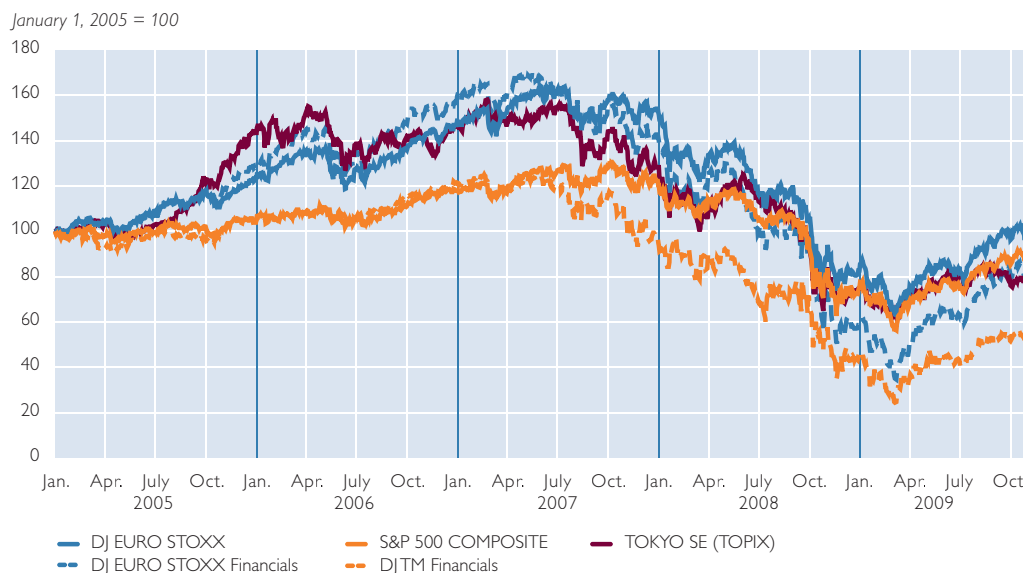
Euro Area and U.S.A.: Spreads of 7-Year to 10-Year Corporate Bonds against Government Bonds



Source: Thomson Reuters, OeNB.

Chart 4

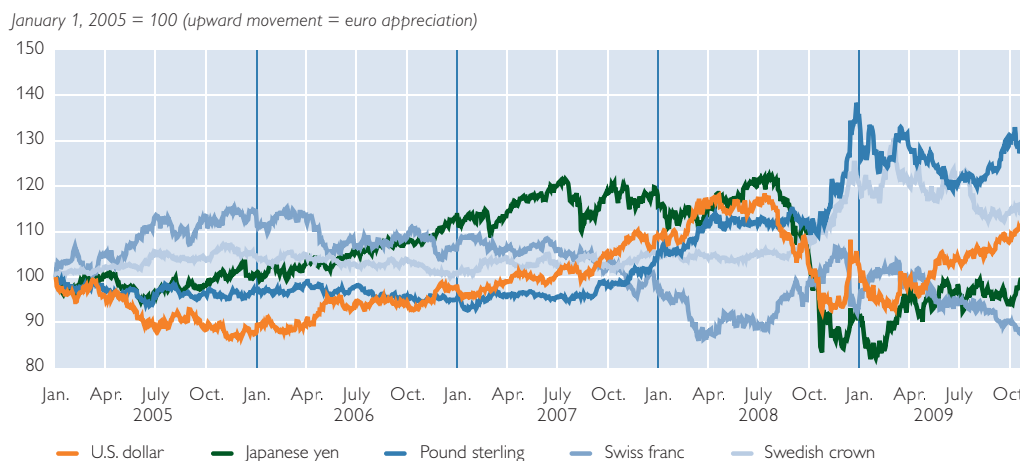
Euro Area, U.S.A., Japan: Stock Market Indices and Subindices for Financial Institution Stocks



Source: Thomson Reuters, OeNB.

Chart 5

Industrialized Countries: Exchange Rates against the Euro



Source: Thomson Reuters, OeNB.

Note: National currency per euro unit.

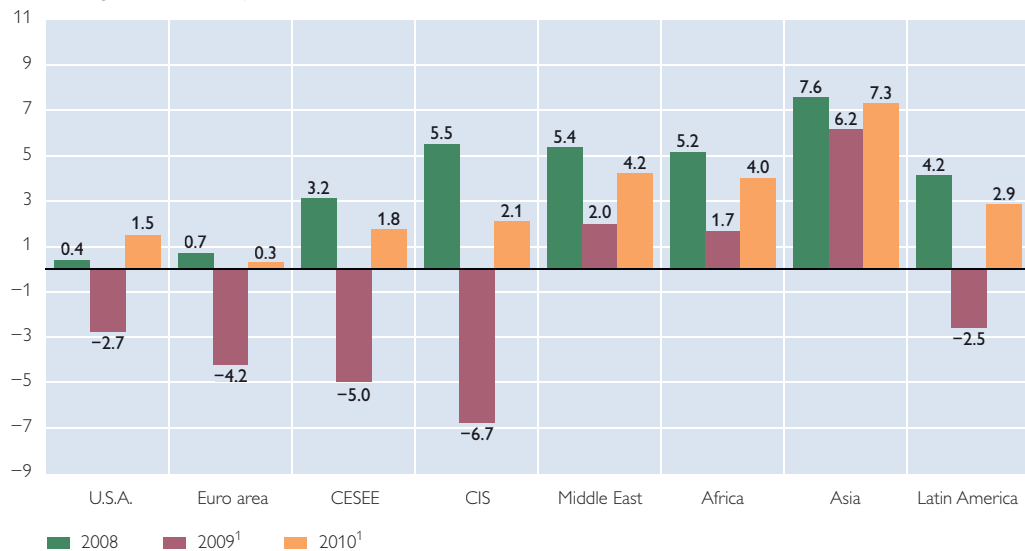
currencies. This development should be seen as a reaction to contrary trends around the peak of the financial crisis, when the euro depreciated owing to the euro area being hit by the crisis.

CESEE Compared with Other Emerging Markets

In fall 2009, the IMF, in line with its forecast for industrialized countries, revised upwards its 2010 forecast for all emerging economy regions of the world

Emerging Economies and Selected Industrialized Countries: GDP Forecast

Annual change in % at constant prices



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

¹ Forecast.

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

(except for Africa) by about 1 percentage point compared with spring 2009. For 2009, by contrast, the IMF further downgraded its forecast for the three regions of Central, Eastern and South-eastern Europe (CESEE, here excluding CIS), CIS and Latin America by some 1 to 1½ percentage points while barely changing its forecasts for the U.S.A. and the euro area and revised upwards its forecast for Japan and Asian developing countries by the same extent. Of course, there are some significant differences within individual economic areas such as CESEE.

In 2009, the *collapse of industrialized countries' import demand* deepened at double-digit annual rates after having commenced in the U.S.A. as early as the fourth quarter of 2007 and in the euro area the second quarter of 2008. This drastic decline in external demand posed major challenges to all export-led emerging economies. Strongly export-oriented *China*, which had avoided

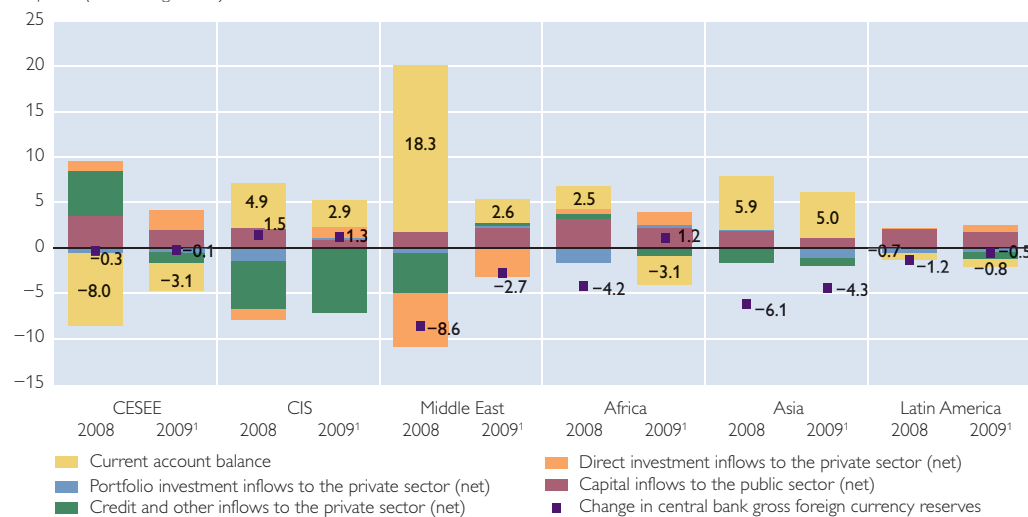
a sharp effective appreciation of its currency prior to the crisis despite high external trade surpluses, did not however come under devaluation pressure and checked the slowdown in growth by massively stimulating domestic demand – a measure approved and rapidly implemented as early as November 2008 – to the tune of 15% of GDP (based on previously accumulated surpluses). In the third quarter of 2009, annual GDP growth accelerated to almost 9% after having fallen to 6% in the first quarter of 2009 – from 10% in the second quarter of 2008 and from 14% in the second quarter of 2007. This influenced the performance of the aggregate of Asian developing countries.

By contrast, particularly *those CESEE and CIS economies* that had a significant need for foreign currency funds owing to their current account deficits (which had increased by the overheating of domestic demand), external debt

Chart 7

Emerging Economies: 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 industrialized countries. Negative 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.

levels and domestic foreign currency lending registered above-average declines in GDP. Even *Russia*, which had accumulated surpluses on the back of high commodity prices, did not succeed in averting the economic downturn. However, owing not least to more comprehensive countervailing fiscal policy measures, the downturn in the Russian economy was smaller than in *Ukraine*, which has experienced political instability problems in addition to a deterioration in the relationship between export and import prices and to the withdrawal of capital (by both Western and Russian investors).

In parallel with the reduction of global imbalances between industrialized countries, the *external imbalances* of emerging economies also decreased in 2009. While the collapse of commodity prices hit surplus regions, deficit regions suffered currency depreciations on the back of falling exports, bleak export prospects and trade fi-

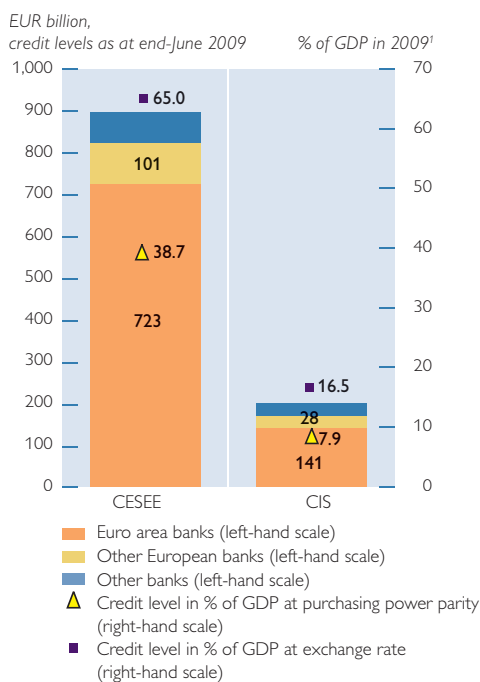
ancing restrictions and were faced with a slump in (export-linked) domestic demand and, as a result, registered very sharp declines in imports.

After 2009 saw many CESEE and CIS countries suffer losses in the *convergence process* of average per-capita income relative to the euro area, 2010 is likely to witness the catching-up process recommencing in most cases.

Cross-border credit claims on emerging economies by BIS reporting banks, of which most are from industrialized countries, pointed to stabilization in the second quarter of 2009 after two quarters of decline (especially of claims on Asian and Latin American economies). Broken down by region, *total credit* by BIS reporting banks to CESEE (excluding CIS) is particularly high – both in terms of absolute amounts and as a percentage of the recipient region's GDP. The large exposure to CESEE is mainly attributable to the fact that most of these countries' banking sectors are

Chart 8

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



Source: BIS, IMF, OeNB.

¹ Prognose.

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

almost entirely owned by BIS reporting banks (primarily from the euro area). A substantial share of BIS reporting banks' total credit to the CESEE region is therefore accounted for by credit granted within these countries that is financed by domestic deposits. A breakdown by individual CESEE country and by the BIS reporting banks' country of origin shows that Austrian, Italian, German and French banks hold a considerable share of the claims on most countries of this region; in certain countries Belgian and Dutch (in the

Baltic countries, also Swedish) banks are represented quite strongly.

In *emerging economies'* financial markets (stock market, eurobond market) price rallies and reductions in spreads have since February 2009 reflected not only the rebound in industrialized countries' markets but also, above all, (expectations of) decisions by the G-20 in early April 2009 (fresh IMF funds and facilities), the increase in the EU balance-of-payments assistance and the specific agreement of IMF and EU credit arrangements with individual countries of this region (together with additional stabilization measures). While losses and increases in spreads since fall 2008 were largely more than recouped in Asian and Latin American economies by November 2009, in CESEE and CIS countries a large part of the losses was made good (similar to the development in the euro area and U.S. stock market).

CESEE: Initial Signs of Stabilization¹

In 2009, the trend in the financial markets (currency markets, national-currency government bond markets, credit markets) in CESEE countries (here including the European part of CIS) was primarily marked by the development of the global crisis and by international stabilization measures.² In addition, there were significant country-specific particularities, which had mostly already emerged before the crisis. The global financial and economic crisis as well as economic policy reactions impacted on the financial markets of CESEE countries both directly on the financing front and indirectly via real economic developments.

¹ For a detailed description of the macroeconomic development of these countries, see the section "Recent Economic Developments" in the OeNB publication "Focus on European Economic Integration Q4/09."

² Although this article does not examine the aforementioned eurobond and equities markets in great detail, most of the observations made are applicable to these markets.

Chart 9

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

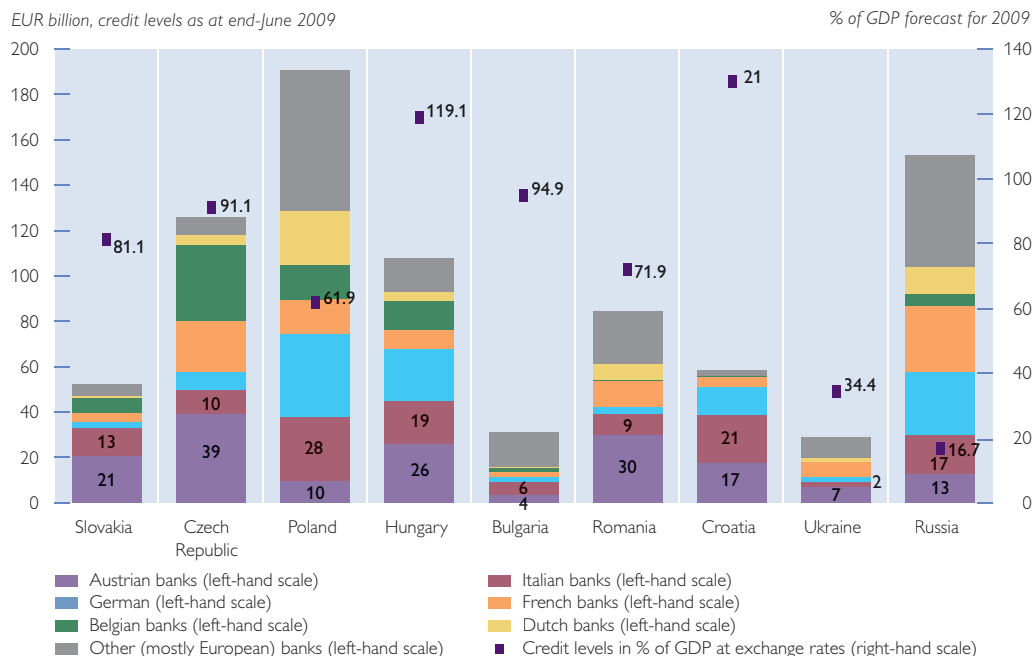
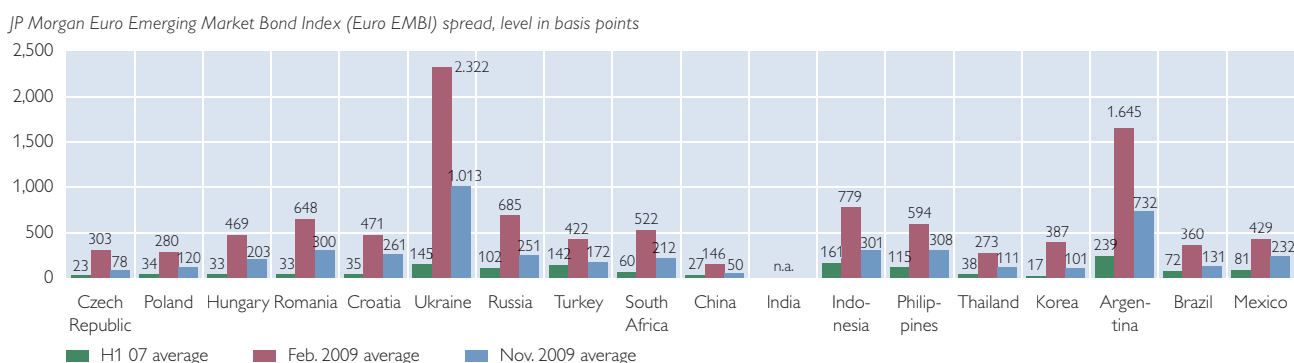


Chart 10

Emerging Markets: Spreads of Sovereign Eurobonds in Foreign Currency



In line with global economic growth and, in particular, euro area (especially, German) GDP growth, *initial signs of economic stabilization* became apparent in the second and third quarters of 2009. In terms of seasonally-adjusted

real GDP growth on a quarterly basis, the pace of the downturn slowed in Hungary and Romania. In Slovenia, Slovakia and the Czech Republic, positive growth rates were generated as early as the second quarter of 2009,

with growth accelerating in the third quarter. Poland, the only country in CESEE and in the entire EU, which had not slid into recession, experienced a rise in quarterly growth in the first half of 2009. In Russia, after shrinking over three quarters, GDP in the third quarter of 2009 increased by 0.6% on the previous quarter on a seasonally adjusted basis.

Compared with 2008, however, real GDP in the second and third quarters of 2009 stood at a 4% to 6% (Slovakia, Czech Republic, Bulgaria), 8% to 10% (Slovenia, Hungary, Romania, Russia), and 18% (Ukraine) lower level in almost all CESEE countries as a result of the marked economic slump, which had commenced at the end of 2008. With GDP growing by 1.1%, Poland was the only exception to this rule. The lower weight of exports relative to overall demand, sharp currency depreciation, fiscal policy and infrastructure investment (part-financed by the EU) all contributed to Poland's performance. In the region as a whole, the economic crisis resulted primarily from weakening external demand, which had triggered a slump in both export demand and, subsequently, fixed capital formation, as well as from inventory rundowns and (mostly recently) a decline in private consumption. In most countries of the region, imports fell more rapidly than exports, as a result of which a positive contribution of net exports dampened the decline in GDP growth and helped stabilize it. This situation was for the most part accompanied by a reduction in the deficit of the combined current and capital account³.

After especially Southeastern European countries had registered high and, in some cases, rising combined *current and capital account* deficits until 2008 (primarily attributable to the goods and services balance), a correction took place in 2009. Likewise, Central European countries saw a sharp year-on-year reduction in current account deficits (which had largely resulted from profit and interest transfers abroad), generating even current account surpluses of between 0.5% and 1.5% of GDP in the first half of 2009 in Slovenia, the Czech Republic, Poland and Hungary. The correction was even more marked in Southeastern Europe and Ukraine. In Bulgaria, Romania and Ukraine, high current account deficits of some 28%, 15% and 8% of GDP in the first half of 2008 were reduced to around 12%, 5% and 1% of GDP in the first half of 2009, respectively. In addition to the slump in domestic demand, currency depreciation also contributed to the reduction in current account deficits in some countries. By significantly reducing and/or eliminating their current account deficits, the countries of this region assumed a large part of the crisis-induced burden of adjusting to the new economic climate.

In the first half of 2009, the problems in international financial markets and increased investor risk aversion were also reflected in a drastic year-on-year decline in the *financial account* surplus of all CESEE countries – Ukraine and Russia even suffered a financial account deficit, i.e. an overall net capital outflow. In Slovakia, the Czech Republic, Hungary, Bulgaria and Romania, the overall financial account remained

³ According to current IMF balance of payments definitions, the capital account comprises only a few transactions, including primarily those previously part of the current account (as a component of the transfers balance). Those (usually much more comprehensive) transactions that were previously included under "capital account" (e.g. direct investment, portfolio investment, loans) are now shown in the so-called "financial account".

Chart 11

Current and Capital Account Balances and Its Financing

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



Source: Eurostat, national central banks, OeNB.

positive but certain components were negative. Slovakia and Hungary (as well as Russia) experienced a modest outflow of foreign direct investment too.

As part of the *international stabilization efforts*, Hungary and Ukraine were the CESEE countries under review here that sealed credit arrangements with the IMF and (in the case of CESEE EU Member States) with the EU as early as the fourth quarter of 2008, as did Romania early in the second quarter of 2009. At end-September 2009, following a third review, the credit arrangement with Hungary was extended until October 2010 and disbursement of a further tranche was approved. Additional tranches (EUR 1.8 billion and EUR 3.3 billion, respectively) were released also for Romania and Ukraine after agreement had been reached about, among other things, easing fiscal policy conditions given the depth of the downturn. In respect of Romania's government crisis, the EU and the IMF released a joint statement in early No-

vember 2009, stating that although recent economic developments were encouraging and the reform measures taken under the support program were satisfactory, the current political situation prevented the 2010 budget (consonant with the agreements already made) from being approved. As soon as the political situation was clarified, the completion of the next review could be resumed. The IMF postponed payment of its November tranche to Ukraine after agreements made had not been met as (against the backdrop of the presidential elections scheduled for January 2010) the Ukrainian president did not veto a law to raise minimum wages and pensions, and the government did not implement increases in natural gas prices for households.

In connection with the IMF and EU credit arrangements with Hungary and Romania, the largest banks operating in these two countries pledged under the *Vienna Initiative* to maintain their exposures (cross-border or domestic loans) to these countries. In conjunc-

tion with the credit extended by the IMF and the EU, these measures, which also had a positive external impact on other countries in the region, helped stabilize the financial account and thus limit the burden of adjustment borne by these countries.

In every CESEE country, the recession gave rise to a strained situation in the *fiscal sector*. In most cases, the rise in government deficits has been solely induced by the operation of automatic stabilizers (particularly, the slump in government revenue), even though this was even partially limited by procyclical measures. Government debt too will generally rise in tandem, although it is still for the most part relatively low compared with the rest of Europe – only in Poland and, in particular, Hungary is it at an already fairly high base level. (Re)financing in capital markets has, however, tended to become more difficult generally and hence also for countries with lower debt levels.

In 2009, the emergence of a strongly negative output gap (between actual output and potential output) and the correction of international energy and food prices led to a *drop in inflation* in most CESEE countries. In some, however, these effects were partly offset by the impact of currency depreciation. For instance, Ukraine and Russia still posted double-digit price growth rates despite a significant fall in inflation.

The development of CESEE *currencies* in 2009 was marked by two sets of factors: international factors and country-specific ones. The international stabilization measures, the recovery of international financial markets and the sharp reduction in current account deficits in the wake of the recession helped all CESEE currencies that do not firmly peg their currencies to stabilize their exchange rate (against their anchor

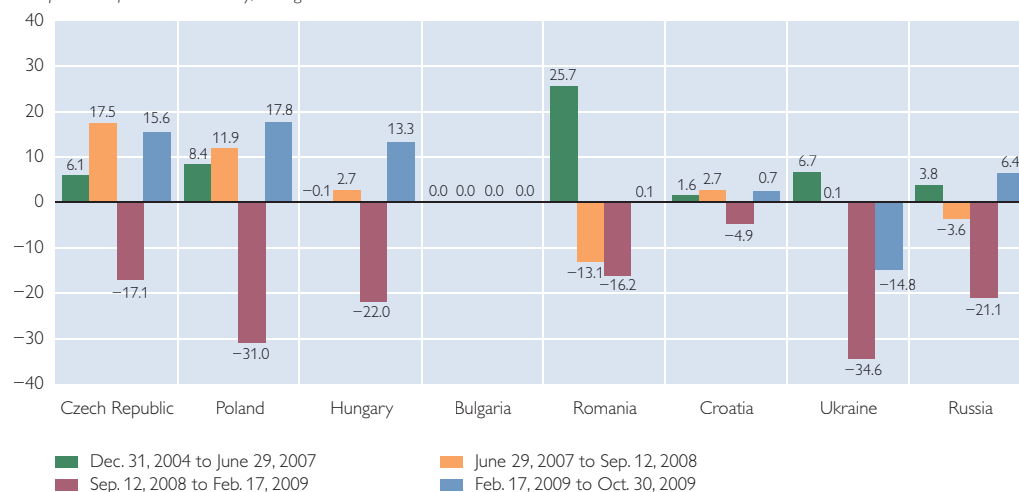
currency) or to appreciate. Previously, the problems in international financial markets (e.g. in the interbank market for swap transactions), the sharp rise in risk aversion and the dramatic deterioration in both export and growth prospects resulted in pronounced depreciations from September 2008 to mid-February/early March 2009. The differences between CESEE countries existing in various spheres were critical as to how strongly the individual currencies depreciated and whether or to what extent the relevant currency appreciated subsequently. In addition to the currency regime, some key factors in these developments include: the extent of the (reduction in) current account deficits; the pre-crisis level of appreciation and the (partly related) amount of losses arising from export companies' foreign currency option transactions; the level of foreign currency refinancing requirements resulting from the outstanding volume of foreign currency loans; the rate of inflation that has persisted despite its fall; the level of the interest rate differential; and, last but not least, the political situation in the relevant country.

The Ukrainian hryvnia, which had suffered the sharpest depreciation by end-February 2009, also firmed against its anchor currency – the U.S. dollar – by July 2009 and, despite the currency's subsequent depreciation, had by November still not reached its record low of February 2009. The hryvnia's stabilization was attributable to three factors: first, support provided under the IMF stand-by arrangement; second, the reduction in both the current and capital account deficits; and third, the measures adopted by Ukrainian monetary and supervisory authorities (interventions, regulatory restrictions). The Romanian leu revealed a similar trend: after firming slightly by the summer, it

Chart 12

National Currencies and the Euro

Euro per unit of national currency, change in %



Source: Thomson Reuters, OeNB.

had by November 2009 approached its record low of February 2009.

By contrast, the Czech koruna, the Polish zloty, the Hungarian forint, the Croatian kuna and the Russian ruble (against its reference currency basket consisting of the U.S. dollar and the euro) had recouped a substantial part of their mostly (except for the Croatian kuna) sharp depreciation by November 2009. However, especially the zloty, forint and the ruble are still well below their respective levels of the third quarter of 2008, which may fuel the contribution of net exports to growth. This situation is partially offset by a dampening effect on domestic demand in CESEE countries with a high share of foreign currency household debt, though, in as far as these loans in most cases had not been granted mostly to relatively high income households.

In the *bond markets*, after having previously risen sharply, the *yield on ten-year government bonds denominated in national currency* in the third quarter of 2009 was unchanged or lower compared with the first quarter of 2009.

The decline in yields was particularly pronounced in Hungary and Russia. The general stabilization in financial markets commencing from March 2009 was therefore also reflected in these markets. Of the CESEE countries under review, Romania was the sole exception, with the yield continuing to rise sharply in the second quarter of 2009 to fall only slightly subsequently. Except for Croatia, *short-term interbank interest rates* in all CESEE countries declined in line with mostly sharply falling inflation and corresponding inflation expectations. In most of these countries, this development was accompanied by key interest rate cuts. In Slovakia, the Czech Republic, Poland, Bulgaria and Romania, this situation resulted in a (partly even more steeply) rising yield curve at the end of the third quarter of 2009 while being flat in Hungary and continuing to be falling in Russia (albeit at a slower pace than before).

In the *credit markets*, outstanding volumes of cross-border loans⁴ and domestic loans to private nonbanks rose

year on year in every CESEE country under review until mid-2009 (on an exchange rate-adjusted basis). The fact that outstanding credit volumes did not fall sharply can be interpreted as a result of the international stabilization efforts. At the same time, however, the increase was markedly smaller than in the preceding 12 months. Credit growth slowed particularly sharply in Bulgaria, Romania, Ukraine and Russia. While the growth of domestic credit to the *household sector* declined at a modest pace in Slovakia, the Czech Republic, Poland, Hungary and Bulgaria, the growth of domestic credit to the *corporate sector* in these countries slowed notably. By contrast, domestic lending to households stagnated in Russia and slumped in Ukraine while

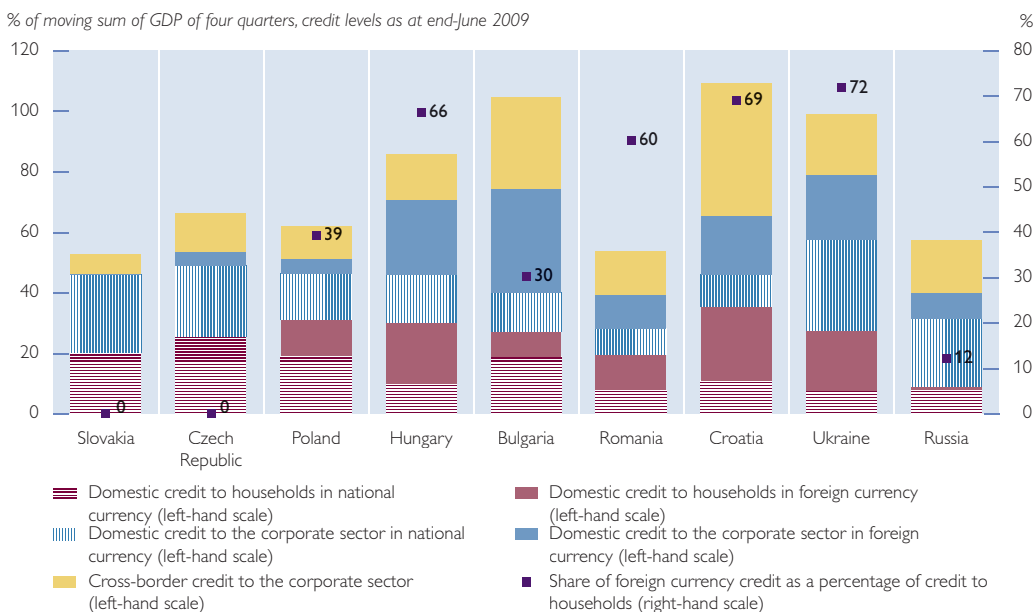
domestic corporate lending in both countries registered just a sharp slowdown in growth. In Romania, lending to both the household and the corporate sectors stagnated. In the first half of 2009, the credit aggregates in all the CESEE countries under review stagnated overall despite a decline in real GDP.

In the third quarter of 2009, the share of *foreign currency loans* as a percentage of *credit to households* was still high particularly in Hungary, Romania, Croatia and Ukraine, but remained stable year on year (on an exchange rate-adjusted basis), except for a slight increase in Croatia (and in Bulgaria). By contrast, this share has been extremely small in the Czech Republic and in Slovakia.

Chart 13

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

% of moving sum of GDP of four quarters, credit levels as at end-June 2009



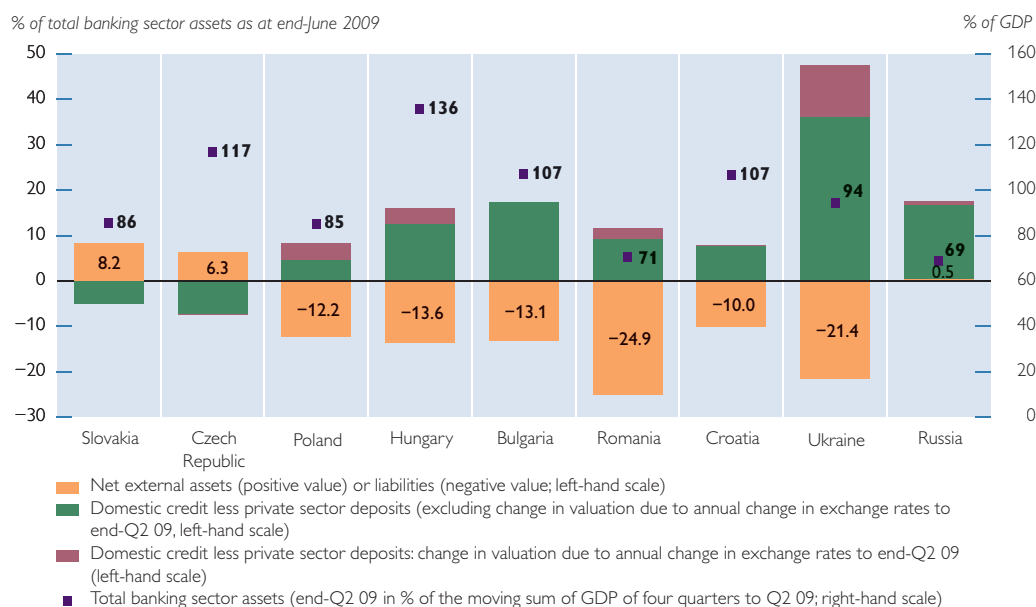
Source: ECB, Eurostat, national central banks, national statistical offices, OeNB.

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

⁴ Loans excluding trade credits, which are granted between companies, and excluding inter-company loans, which are granted within groups as part of direct investment.

Chart 14

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



At the end of the second quarter of 2009, the outstanding *volume of credit* exceeded that of *deposits* (in terms of overall assets) to a particularly large extent in Ukraine, Russia, Bulgaria, Hungary and Romania. Net external liabilities in these countries (except for Russia) are (also) used to finance this domestic credit overhang. Banks have some of these net external liabilities vis-à-vis foreign parent banks. For these countries, mobilizing domestic deposits is a task of utmost priority. In Slovakia and the Czech Republic, however, deposits exceeded credit – and their respective banking sectors held net external assets.

The recession at end-2008 and in the first half of 2009 led to an increase in *credit risk*. In the first half of 2009, the share of nonperforming loans in all CESEE countries was higher than in the same period a year ago, with Romania and Ukraine registering a particularly sharp increase. Over the same pe-

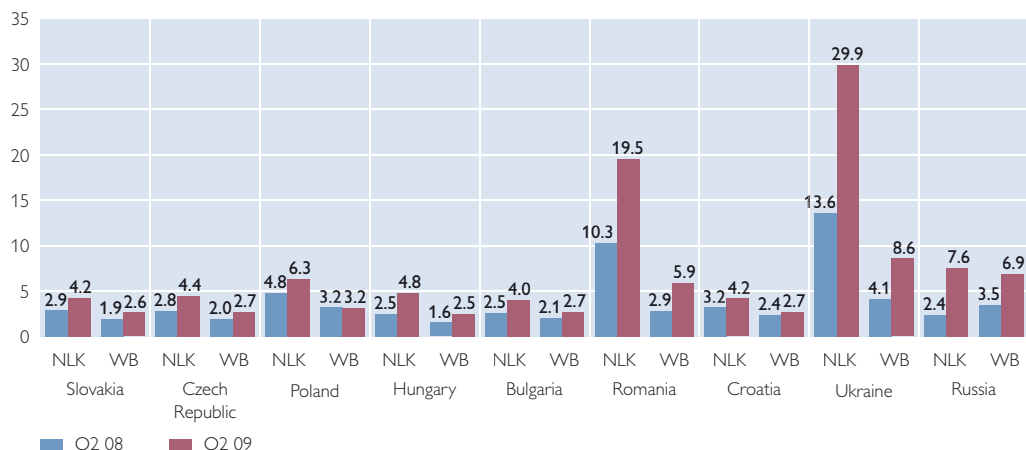
riod, *banking sector profitability* in every CESEE country was down on a year-on-year basis. While the Russian and Romanian banking sectors posted almost no profits, the Ukrainian banking industry even posted substantial losses. The steep rise in nonperforming loans and loan loss provisions owing to the recession and marked currency depreciations (with a high share of foreign currency credit to households) is responsible for this situation. However, *capital adequacy* in the region as a whole was higher in mid-2009 than a year ago, with a particularly steep increase in Bulgaria and – owing to government recapitalization measures – in Russia. In the first half of 2009, the capital adequacy ratio ranged between around 12% (Slovakia, the Czech Republic, Poland and Hungary) and 18% (Russia and Bulgaria).

The *future development of CESEE financial markets* remains subject to a number of risks, including, in particu-

Chart 15

Banking Sector: Credit Quality

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



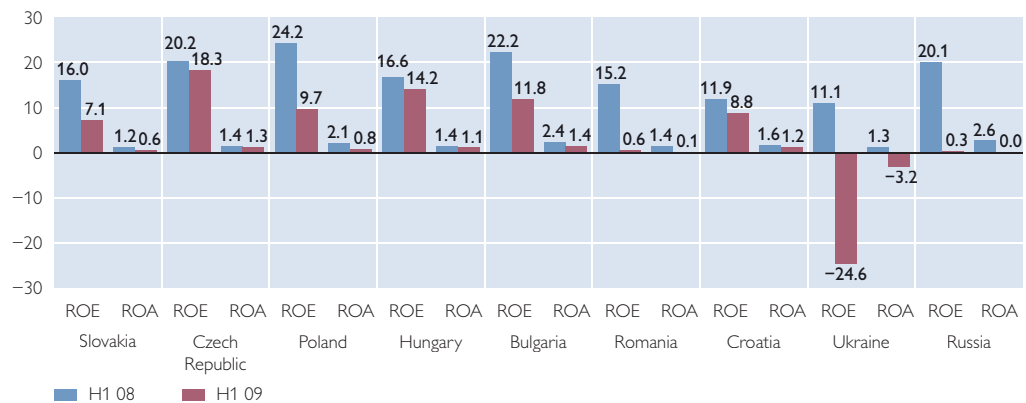
Source: IMF, national central banks, OeNB.

Note: The data are not comparable across countries. Nonperforming loans comprise substandard, doubtful and loss loans. Poland: including so-called irregular loans. Ukraine: loan loss provisions as at end-Q1 2009 instead of Q2 2009.

Chart 16

Banking Sector: Profitability

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



Source: IMF, national central banks, OeNB.

Note: The data are not comparable across countries. The data are linearly annualized figures based on H1 after-tax profit, except for Russia's, which are based on pre-tax profit.

lar, first, potential turmoil in global financial markets; second, a possibly unsustainable recovery of the real economy in industrialized countries (e.g. in the event of stimulus measures being withdrawn prematurely); third, any

premature weakening of international stabilization measures for CESEE; and fourth, country-specific risks (not least in connection with the political decision-making process in certain CESEE countries).