

EU Support Measures Underpin Fragile Recovery – Financial Markets Still Face Challenges

Economic Recovery Stronger than Expected

In 2010, euro area economic activity was much more robust than expected. Even so, full-year GDP growth in the euro area lagged behind that in the U.S.A. and Japan. Although the upturn in the euro area was largely attributable to the contribution of net exports, domestic demand components increasingly fueled economic growth. Economic momentum varied very widely across countries. In Austria, it stood at roughly the euro area average. The recovery currently under way will remain fragile, as most countries are faced with high government debt and comparatively elevated jobless numbers. For 2011, the economy is expected to slow marginally in industrialized countries while inflation is set to remain weak. Internationally, both short-term and long-term interest rates stood at historically very low levels.

Following the sharp increase in risk premiums on several euro area countries' government bonds during 2010 due to uncertainties about fiscal sustainability, spreads shrank again in the wake of both the ratification of the European financial stabilization mechanism and the already gaugeable partial effects of the implementation of consolidation programs. Sustained high equity market volatility and the fear that certain euro area countries would have to restructure their public debt meant that, despite low yield levels, investors piled more money into the government bonds of countries they considered to have a safe rating, which contributed to a further narrowing in these yields. In parallel, however, corporate bond yields also narrowed and net capital

inflows to emerging markets surged, which to some extent also induced currencies to appreciate.

In Central, Eastern and Southeastern Europe (CESEE), most economies continued to recover, with Central Europe and the CIS outperforming most of the Southeastern European countries in the region. Overall, the recovery was primarily export-led with continued sluggish momentum in domestic demand, which had to do with low lending expansion, among other factors. Once again, CESEE growth rates exceed those of the EU-15 by far, indicating that the region has resumed the catching-up process.

Financing Conditions of Austrian Households and Corporations Have Stabilized

In addition, in the wake of the world economic recovery, the Austrian economy improved markedly to the third quarter of 2010. In 2010, the domestic corporate profit situation ameliorated significantly on the back of the economic recovery, among other factors. In the first half of 2010, the corporate sector's external financing also expanded. This sector's financial strength indicators, of which some had significantly deteriorated in 2009 in the wake of the recession, stabilized in the first half of 2010. The equity-to-debt ratio remained largely unchanged, and improved profitability meant a decline in the number of insolvencies.

Growth in lending to households and nonfinancial corporations stagnated. In the first nine months of 2010, growth in household lending was driven by housing finance while the further decline in corporate lending came to

a halt. In particular, however, foreign currency loans fell steeply on a currency-adjusted basis. As of September 2010, foreign currency loans accounted for some 17.8% of loans to nonbanks.

Although the first half of 2010 saw a further increase in households' financial investment, valuation losses which had arisen during the financial crisis were recouped only in part. Owing to low interest rates, both corporate and household interest charges were relatively light at last count. In view of Austria's high share of variable rate loans compared with the rest of Europe, higher interest rates in future will result in higher interest expenses for borrowers once again.

Austrian Banks Recover, Credit Risk Costs Remain High

In 2010, the profitability of the Austrian banking system staged an overall recovery in tandem with the global economy after experiencing a tough year in 2009 due to the financial crisis. For 2010, Austrian banks anticipate unconsolidated annual net profit of approximately EUR 3 billion, which – although falling well short of prerecession levels – will exceed those of 2008 and 2009. This forecast is based on stable interest income and net fee income growth. In addition, the Austrian banking sector's trading income proved to be significantly positive once again, generating operating income of some EUR 3.8 billion as at mid-2010, 14.0% above the comparable level of the previous year. Owing to the persistent deterioration of credit quality, high risk costs will continue to hit net income. However, their steep rise of the last few periods appears to be losing steam, which at least in recent periods is reflected in

flattening growth in the specific loan loss provision rate. In Austria, the latter stagnated at almost 3.1% in the first half of 2010.

After slumping in the wake of the financial crisis, growth in Austrian subsidiary banks in CESEE is now back on track. Exchange rate-effects certainly had a material impact on this moderate growth. Overall, Austrian banks' activities in the CESEE region continued to make a positive contribution to the sector's performance. For 2010, the return on assets (ROA) is expected to be around 0.9%, i.e. a slight improvement on 2009. At mid-2010, the refinancing position of Austrian banks' CESEE subsidiaries was marginally better, with the loan-to-deposit ratio standing at almost 109% (2009: 113%). The increase in credit risks, nonetheless, prompted a deterioration in the loan loss provision rate, which now amounts to 6.2%. At the same time, however, subsidiaries were able to strengthen their capital buffers, as their capital ratio was boosted to 15.1%.

Austrian banks' continued below-average capital adequacy compared with the rest of the world represents a challenge – particularly in respect of future regulatory requirements – even if their consolidated core capital ratio since 2008 has increased sharply to 9.8%¹.

Austria's insurance sector also staged a comeback in 2010. At mid-2010, domestic insurance institutions' financial income had almost returned to the prerecession levels of 2008. However, the high exposure to the financial sector, as well as low interest rates, will continue to pose risks to the insurance sector.

¹ The ratio was adjusted for a one-off effect in the second quarter of 2010.