Advanced Economies: Diverging Developments

The global recovery lost steam over the first half of 2012. GDP growth rates slowed down further in the major economies in the second quarter. After the summer, however, the outlook for the U.S. and the Chinese economy brightened somewhat while the recovery in Japan and the euro area was again put on hold. At the same time, the risks to growth remained elevated and tilted to the downside.

In the U.S.A., domestic demand has been the main engine of economic growth. Private consumption was supported by positive signals from the labor and housing markets. More recently, leading indicators pointed also toward increased business confidence. According to the recent forecast of the European Commission, the U.S. economy is set to expand by 2.1% in 2012 and by 2.3% in 2013. Monetary policy has remained expansive at a policy rate of 0% to 0.25%. In September the Board of Governors of the Federal Reserve System (Fed) announced its third round of quantitative easing (QE3). Markets expect that the Fed will buy up to USD 600 billion of mortgage-backed securities. At the beginning of 2013, major tax cuts are set to expire, and government expenditure cuts will take effect. Without a political agreement, the U.S.A. may slip back into recession in 2013, according to the Congressional Budget Office (CBO).

Since the end of 2011 euro area growth has decelerated steadily. After zero growth in the first quarter of 2012 real GDP decreased in the second and in the third quarters (quarter on quarter). The downturn has been driven by a combination of fiscal consolidation and elevated uncertainty among businesses and investors, both weighing on domestic demand. The majority of business and consumer confidence indicators point toward a further economic weakening and a recovery no earlier than the first half of 2013. The European Commission expects moderate growth of only 0.1% in 2013. At the same time developments within the euro area have remained quite heterogeneous. Real GDP dropped substantially in Spain and Italy whereas growth was still positive in Germany, where it is also expected to lose momentum, however. Inflation in the euro area has remained elevated, driven by unprocessed food and oil prices.

Throughout 2012 the euro area suffered from increased financial fragility. According to the IMF, funds worth 15% of GDP were withdrawn from Italy and funds worth 27% of GDP from Spain between mid-2011 and mid-2012. In July 2012, the Governing Council of the ECB cut its key interest rates by 25 basis points, bringing the interest rate on main refinancing operations to a historical low of 0.75%. In early September 2012, the ECB initiated a new government bond purchase program termed Outright Monetary Transactions (OMTs) program, under which the Eurosystem may make secondary market purchases (limited neither by volume nor by time) of sovereign bonds issued by countries that are eligible and have applied for support under the European Financial Stability Facility/European Stability Mechanism (ESM). Together with the envisaged steps toward a single supervisory mechanism (SSM), this measure is an impor-
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A tant element in calming the markets and thus in contributing to a prospective resolution of the government debt crisis. After the announcement of the OMTs program, risk spreads for government bonds narrowed considerably, especially for short maturities. This, in turn, has supported the functioning of the monetary transmission mechanism. For monetary policy to be effective it is essential that interest rate cuts actually feed through to retail lending conditions, which are often linked to bond yields.

The Swiss National Bank (SNB) has remained committed to its exchange rate ceiling of CHF 1.20 per euro. The SNB established this cap in September 2011 in the wake of a new wave of capital inflows triggered by increasing uncertainty in the euro area in spring 2011. The necessary exchange rate interventions by the SNB inflated its foreign exchange reserves and, consequently, its balance sheet risks.

CESEE: Recovery in Financial Markets Contrasts with Subdued Profitability in the Banking Sector and Deteriorating Real Economy

Growth Decelerates Further as External Positions Improve and Price Pressures Increase

Economic growth in the CESEE region1 slowed down markedly in the first half of 2012. Average annual growth declined from its peak of 4.4% in the third quarter of 2011 to 2.7% in the second quarter of 2012. Some countries even slipped into technical recession (Czech Republic, Hungary) or continued to report contracting economic activity (Croatia). It needs to be noted, however, that despite a deceleration, growth remained comparatively solid at around 3% and above in some other countries (Slovakia, Russia).2

Economic dynamics in most countries were increasingly driven by net exports, which constituted the only component contributing positively to growth in Slovakia, the Czech Republic, Hungary and Croatia. Although losing some steam, export growth remained in positive territory, while imports stagnated or even declined against the background of anemic domestic demand in these countries. Domestic demand growth in these countries was held back by weak or even negative credit growth, ongoing fiscal consolidation, below-average capacity utilization, subdued labor market conditions, declining real wages and deteriorating sentiment. Contrary to that, private consumption continued to be a noticeable driving force of growth in Ukraine and Russia and as of late also in Bulgaria. In these countries consumption benefited from more dynamic real wage growth as above-average (in cases substantial) nominal wage increases were coupled with moderating price pressure in the first half of 2012. Capital formation was the most important component of growth only in Romania, where construction activity boosted investment.

According to the current OeNB and BOFIT (Bank of Finland Institute for Economies in Transition) outlook for selected CESEE countries,3 average

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1 The CESEE region comprises Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Russia, Romania, Slovakia and Ukraine.
2 Flash estimates for growth in the third quarter available by the cutoff date point toward a further weakening of economic dynamics.
3 See Outlook for Selected CESEE Countries: Renewed Slowdown Followed by Modest Recovery. In: Focus on European Economic Integration Q4/12. OeNB. 38–46. The group of countries included in the OeNB-BOFIT Outlook comprises Bulgaria, the Czech Republic, Hungary, Poland, Romania, Croatia and Russia.
growth in the region will amount to some 2.6% in 2012 before accelerating to 3.0% in 2013. Regional growth momentum will be fueled primarily by Russia, whose economy will expand at an above-average rate in both 2012 and 2013. This compares with growth prospects of 0.1% and 1.4% for the euro area in 2012 and 2013 (according to the European Commission’s autumn forecast).

The international financial crisis triggered a marked reduction in external imbalances (combined current and capital account balances) in the CESEE region from 2009 onward. In most CESEE countries (e.g. Slovakia, the Czech Republic, Poland, Hungary, Romania, Croatia and Russia), this trend continued in the first half of 2012 (chart 1). Especially trade balances improved in many countries. A smaller deficit in the income account of the Czech Republic and a higher surplus in Romania’s capital account, however, played a role too. Only Bulgaria and Ukraine saw their external accounts deteriorating as trade deficits trended upward. In both countries this was related to strong consumption growth. In Ukraine, a weakening of price competitiveness, given the hryvnia’s quasi-peg to the U.S. dollar, which recently appreciated against the currencies of most of Ukraine’s trading partners, may have also contributed to this development.

The financial account was positive or balanced in most countries under review in the first half of 2012. Only Russia and Hungary reported a deficit (both countries had a current account surplus, however). In Bulgaria, the Czech Republic, Romania and Ukraine, net FDI inflows made up the largest positive component of the financial account. By contrast, (net) portfolio investment represented the financial account’s largest positive component in Slovakia, Poland and Croatia. (Net) other investment – in particular loans – were negative in all countries under review. In Russia, capital outflows in all three categories were reported. Net FDI inflows covered more than 100% of the current account deficits in the Czech Republic, Bulgaria and Croatia, around 85% in Poland and around 50% in Romania and Ukraine.

With the exception of Croatia, budget deficits decreased in all the countries under review in 2011. In Russia and Hungary, deficits even turned into...
surpluses. In Hungary one-off receipts from the de facto abolition of formerly compulsory private pension funds (the pension system’s second pillar) had a positive impact on the budget. The European Commission, however, deemed this development to be unsustainable and thus inadequate for terminating Hungary’s ongoing excessive deficit procedure (EDP) at its target date of 2011. The Council thereafter set 2012 as the new target year for a credible and sustainable correction of Hungary’s budget deficit and concluded in late June that Hungary had taken the necessary measures to achieve this goal. Bulgaria managed to reduce its budget deficit to 2% of GDP in 2011. Hence, the EDP against the country was abrogated on June 22, 2012. The other EU Member States in the CESEE region are still in an EDP (with the target dates for reducing their excessive deficits being 2012 for Poland and Romania and 2013 for the Czech Republic and Slovakia).

The majority of CESEE EU countries continued fiscal consolidation in 2012. The deficits are set to decrease most strongly in Poland and Romania and should decline to (or stay) below the level of 3% of GDP in Bulgaria, Hungary, Poland and Romania, according to the budget plans of early 2012. While fulfilling the 3% of GDP criterion, Hungary’s headline budget balance, however, is set to deteriorate markedly given last year’s substantial one-off receipts. Budgetary targets had to be adjusted in many CESEE EU countries already in the course of the year as the pace of growth decelerated (e.g. in Slovakia, the Czech Republic, Poland and Hungary). As far as the remaining non-EU countries in the CESEE region under review are concerned, the deficit in Croatia is set to decrease, while Ukraine will post a higher budget deficit and Russia a lower budget surplus in 2012.

Price developments in CESEE can be roughly divided into two periods: disinflation in the first half of the year and some rise in price pressures since summer. Inflation declined in nearly each country under observation in the first and second quarters of 2012. This development was most pronounced in Ukraine, where an annual inflation rate of 5.1% in the final quarter of 2011 turned into deflation by the second quarter (−0.4%). Notable spikes in inflation rates in the Czech Republic, Hungary and Croatia were related to VAT hikes at the beginning of the year (in the case of the former two and in March in the case of Croatia). Inflation, however, generally started to pick up in summer, with only few countries reporting continuing disinflation (e.g. the Czech Republic and Poland). This development was strongly driven by rising prices of unprocessed food items brought about by the impact of hot, dry weather in many CESEE countries and also by higher world market prices. Contrary to the development of headline HICP and CPI inflation, house prices in the region continued to decline in the review period (within a range from −0.1% in Hungary to −8.9% in Romania year on year in the second quarter).  

In the review period, the central bank of Russia increased its policy rate by 25 basis points to 8.25% in September in view of accelerating inflation. The Czech central bank (CNB) cut its key interest rate in June and September by 25 basis points each and in November by 20 basis points to 0.05%; the National Bank of Poland (NBP) low-

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4 Comparable house price indices are not available for Poland, Croatia, Russia and Ukraine.
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The central banks of many countries have lowered their key interest rates. The Hungarian central bank (MNB) lowered its key interest rate by 25 basis points to 4.5% in November and the Hungarian central bank (MNB) did so in August, September and October (25 basis points each to 6.25%). The CNB argued that the monetary policy-relevant inflation rate (CPI adjusted for first-round effects of changes in indirect taxes) will be in the lower half of the tolerance band around its inflation target over the policy horizon (12 to 18 months in the future). The NBP stated that incoming data confirm a considerable economic slowdown, which has contained wage and inflationary pressure. The interest rate cuts by the MNB were based on the view – held by a slim majority of MNB Monetary Council members – that the inflation target was still likely to be met despite a substantial upward revision in the central bank’s inflation forecasts for 2012 and 2013. The Monetary Council members backing the interest rate cut pointed at significant spare capacity and weak domestic demand as well as an expected fall in domestic risk premiums. Looking at the currencies of the countries under review that have not yet adopted the euro and operate a float or a managed float, most currencies traded broadly stable against their reference currency from mid-June 2012 to mid-November 2012. Several currencies, however, came under temporary pressure. In Ukraine, households’ depreciation expectations and spikes of risk aversion in international financial markets led to interventions of the central bank to support the hryvnia’s quasi-peg to the U.S. dollar. Together with sovereign debt repayments they were responsible for a steady decline of foreign exchange reserves before a eurobond issue of USD 2 billion in July made them temporarily rise. The Ukrainian foreign exchange reserves stood at EUR 22.7 billion at end-September (about 17% of GDP). The Romanian leu too had to be supported by foreign exchange interventions due to political turbulence, according to market participants. When the central bank started to restrict leu liquidity by

### National Currencies and the Euro

<table>
<thead>
<tr>
<th>Country</th>
<th>Czech koruna</th>
<th>Polish złoty</th>
<th>Hungarian forint</th>
<th>Romanian leu</th>
<th>Croatian kuna</th>
<th>Ukrainian hryvnia</th>
<th>Russian ruble</th>
</tr>
</thead>
<tbody>
<tr>
<td>February 17, 2009 – April 28, 2011</td>
<td>-5.3</td>
<td>-0.7</td>
<td>-1.3</td>
<td>-3.3</td>
<td>-1.5</td>
<td>-1.8</td>
<td>-0.8</td>
</tr>
<tr>
<td>June 11, 2011 – November 8, 2012</td>
<td>-2.3</td>
<td>1.5</td>
<td>4.1</td>
<td>-6.2</td>
<td>0.1</td>
<td>5.8</td>
<td>9.0</td>
</tr>
<tr>
<td>April 28, 2011 – November 18, 2011</td>
<td>-12.4</td>
<td>-1.3</td>
<td>-3.6</td>
<td>-2.6</td>
<td>-1.3</td>
<td>-2.6</td>
<td>-2.6</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters, OeNB.

*With the exception of Ukraine (U.S. dollar) and Russia (basket of currencies consisting of U.S. dollar and euro at a ratio of 55% to 45%), the reference currency of these countries is the euro.*
capping the volumes allocated at weekly repo operations, the currency stabilized. The Croatian central bank (HNB) also intervened several times to mitigate exchange rate pressures. In its most recent intervention in September, the HNB purchased foreign currency from the market (EUR 58 million) after having sold foreign currency (totaling EUR 1.5 billion) between November 2011 and mid-2012. Croatia’s foreign exchange reserves decreased by 7.5% between April and August 2012 and amounted to EUR 11.4 billion (about 25% of GDP) at the end of September. Finally, the Russian central bank widened the ruble’s fluctuation corridor slightly in mid-July to provide greater exchange rate flexibility.

**Improvements in Risk Premiums amid Subdued Profitability in the Banking Sector**

In line with global trends, financial markets picked up in CESEE throughout the review period (June 2012 to mid-November 2012). The introduction of the Outright Monetary Transactions program of the ECB as well as recent institutional steps within the euro area and improvements in the regulatory framework for the banking sector increased investor confidence, which, in turn, had a positive impact on financial market developments in almost all market segments in CESEE. Improvements were most pronounced in eurobond and CDS markets, but also equities performed broadly well. Only in Ukraine stock markets incurred moderate losses. Since June 2012, 5-year CDS premiums have been downtrending, with pronounced decreases having been recorded in Hungary and Croatia (by 320 basis points each), Bulgaria (by 274 basis points), Romania (by 221 basis points) and Ukraine (by 215 basis points). The strong reduction of risk premiums in Hungary is attributable partially to positive signals from the government about signing a precautionary credit line with the IMF and the EU. In the other countries of the region, risk premiums declined between 66 basis points (Czech Republic) and 167 basis points (Poland). In parallel with risk premiums, eurobond spreads declined throughout the region. Short-term interbank rates remained broadly stable in most CESEE countries. Since June 2012 they have declined strongly in Hungary and the Czech Republic, primarily owing to two policy rate cuts totaling 50 basis points in both countries.

Total outstanding (domestic and cross-border) loans to the private sector – i.e. to households and nonfinancial corporations – increased in most CESEE countries between end-2011 and mid-2012. In particular, Russia saw a marked rise of 7.1% in total outstanding loans on an exchange rate-adjusted basis. In the Czech Republic, Ukraine and Poland, credit growth was in the range of 2% to 2.5% in the first half of 2012, while in Slovakia and Bulgaria modest increases of 1.3% and 0.4%, respectively, were recorded. In contrast, total outstanding loans fell markedly in Hungary (–4.5%) and Croatia (–2%) and modestly so in Romania (–0.1%). At 52% to 77% at mid-2012, the share of foreign currency loans in total loans to households remained at a very high level in Ukraine, Hungary, Romania and Croatia. In Ukraine and Hungary, this share slumped sharply (on an exchange rate-adjusted basis) compared with end-2011, while a marginal decline was registered in Poland. In Hungary the reduction of foreign currency loans, in particular those to households, contributed strongly to the decline in total outstanding loans. These dynamics were influenced by several
measures introduced by the government to reduce outstanding household debt denominated in foreign currency. In Croatia the fall in total outstanding loans was driven by a firm reduction in foreign currency-denominated (or -indexed) debt of corporates. Although foreign currency debt of households in Ukraine was shrinking at a considerable rate, total outstanding loans still grew in the first half of 2012 owing to a strong increase in cross-border credit to the corporate sector. Cross-border loans to businesses also grew markedly in the Czech Republic and Poland while falling in Hungary, Bulgaria and Romania.

The ratio between (foreign and national currency-denominated) domestic household borrowing and domestic corporate borrowing (including cross-border credit) was relatively balanced in Slovakia, the Czech Republic, Hungary and Poland as at mid-2012 (see chart 3). By contrast, in Bulgaria, Croatia, Romania, and in particular in Ukraine and Russia, the volume of outstanding corporate loans was markedly higher than that of outstanding household loans. Comparably strong lending growth in Russia in the first half of 2012 was driven almost equally by the growth of loans to households and that of loans to corporates. In Bulgaria, Romania and Ukraine the positive contribution of growth in lending to corporates was partially offset by a decline in total loans to households. Household sector and corporate sector loan dynamics showed similar trends in the Czech Republic and Poland (i.e. an increase in outstanding loans) on the one hand and in Hungary and Croatia (a decline in outstanding loans) on the other hand. Total loans to households expanded only in Slovakia, where loans to corporates declined, though.

In the majority of the countries under review, total outstanding domestic loans continued to exceed total domestic deposits (relative to GDP) at mid-2012 (see chart 4). However, this funding gap broadly continued to narrow in
the first half of 2012. The gap between domestic loans and deposits declined in particular in Hungary and Croatia, primarily owing to domestic loans shrinking more strongly than domestic deposits. In Ukraine and Bulgaria, the gap narrowed due to a strong increase in deposits outpacing growth in total outstanding loans. In Romania, an increase in domestic deposits coupled with falling total outstanding loans was responsible for the gap narrowing. In Russia, by contrast, the gap widened markedly owing to the swift growth in domestic loans. Only Slovakia and the Czech Republic continued to show a surplus of domestic deposits over loans, which is also reflected in the positive net external assets registered by both countries’ banking sectors. The surplus further increased in the course of the first half of 2012 in Slovakia, while it decreased in the Czech Republic. In Romania, Croatia and Hungary net external liabilities — in part comprising liabilities to foreign parent banks — were still substantial (relative to GDP) and considerably higher than in the other countries of the region.

Credit quality still remains a challenge in CESEE but improvements between mid-2011 and mid-2012 were recorded in some countries (see chart 5). Credit quality improved modestly in Romania, Slovakia and the Czech Republic. The banking sectors of Russia and Ukraine witnessed more pronounced reductions in the share of nonperforming loans in total loans (−3.2 percentage points and −1.3 percentage points, respectively, year on year). In Russia, the decline can be partially attributed to positive lending growth. By contrast, the share of nonperforming loans in total loans was higher in Hungary (+3.7 percentage points in line with profitability developments in the banking sector, which tend to show a seasonal pattern, credit quality is assessed on a year-on-year basis.

Source: IMF, national central banks, DeNB.

Note: Data are not comparable between countries. NPLs include substandard, doubtful and loss loans. Poland including so-called irregular loans.
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Intra-year data show that the rise in nonperforming loans accelerated slightly in Croatia and Bulgaria in the first half of 2012. In Hungary, by contrast, growth in the share of nonperforming loans slowed during 2012. The reduction in the share of nonperforming loans in total loans accelerated in Romania and Slovakia in the first half of 2012, while it lost momentum in Russia and the Czech Republic.

Banking sector profits continued to be subdued in the first half of 2012 in most CESEE countries, as is evident from chart 6. Compared to the same period in the previous year, profits declined strongly in Hungary and Slovakia and modestly in Poland, Romania, Croatia and Bulgaria. In Hungary, profitability fell to zero due to government measures to reduce outstanding foreign currency debt of households, the main burden of which was put on the banks, and owing to very high sectoral taxes on banks. Romania is the only country that recorded losses in the banking sector. By contrast, profit growth was registered by the Ukrainian, Russian and Czech banking industries. In the first half of 2012, Ukrainian banks posted profits for the first time since 2008.

The banking sectors in CESEE remained well capitalized in the first half of 2012. In Poland, Russia, Romania, Hungary and the Czech Republic, capital adequacy ratios ranged between 13.6% and 16.3% at mid-2012. The banking sector’s average capital position was particularly strong in Ukraine (18%) and Croatia (20.2%). Compared to end-2011, capital adequacy increased modestly in Poland (+0.5 percentage points), Croatia (+0.6 percentage points) and the Czech Republic (+1.1 percentage points) and more strongly in Hungary (+1.8 percentage points) and Slovakia (+1.9 percentage points). In the case of Hungary the broadening of the capital base was partially driven by capital injections from parent banks. Capital adequacy decreased slightly in Romania (–0.2 percentage points), Bulgaria (–0.8 percentage points) and Russia (–0.9 percentage points).

### Banking Sector: Profitability

<table>
<thead>
<tr>
<th>Country</th>
<th>H1 11</th>
<th>H1 12</th>
<th>RoE</th>
<th>RoA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slovakia</td>
<td>15.8</td>
<td>8.9</td>
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<tr>
<td>Czech Republic</td>
<td>20.0</td>
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<td>1.0</td>
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<tr>
<td>Poland</td>
<td>1.3</td>
<td>1.2</td>
<td>1.0</td>
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</tr>
<tr>
<td>Hungary</td>
<td>11.4</td>
<td>1.4</td>
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<tr>
<td>Bulgaria</td>
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<td>-1.1</td>
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<td>0.8</td>
</tr>
<tr>
<td>Romania</td>
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<td>0.1</td>
<td>7.6</td>
<td>6.3</td>
</tr>
<tr>
<td>Croatia</td>
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</tr>
<tr>
<td>Russia</td>
<td>18.9</td>
<td>2.6</td>
<td>2.4</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Source: IMF, national central banks, OeNB.

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

The banking sector remains well capitalized in the first half of 2012. In Poland, Russia, Romania, Hungary and the Czech Republic, capital adequacy ratios ranged between 13.6% and 16.3% at mid-2012. The banking sector’s average capital position was particularly strong in Ukraine (18%) and Croatia (20.2%). Compared to end-2011, capital adequacy increased modestly in Poland (+0.5 percentage points), Croatia (+0.6 percentage points) and the Czech Republic (+1.1 percentage points) and more strongly in Hungary (+1.8 percentage points) and Slovakia (+1.9 percentage points). In the case of Hungary the broadening of the capital base was partially driven by capital injections from parent banks. Capital adequacy decreased slightly in Romania (–0.2 percentage points), Bulgaria (–0.8 percentage points) and Russia (–0.9 percentage points).