Sovereign Debt Crisis Has Minimal Macrofinancial Impact on CESEE

The sovereign debt crisis in some peripheral countries of the euro area continued to influence the economic performance of the euro area in the first half of 2012. Even though external trade contributed positively to growth, real economic output in the euro area contracted toward end-2011 and in the first few months of 2012, given the deleveraging processes the public and private sectors in many European countries are both currently going through.

Economic activity in Central, Eastern and Southeastern Europe (CESEE) slowed only moderately on balance in the second half of 2011, although continuing tension in the context of the euro area debt crisis led to the region’s risk assessment deteriorating. The growth performance of individual countries was very heterogeneous. Both external and fiscal positions improved in most countries of the region. Risk premiums as measured by 10-year CDS spreads narrowed slightly in the first few months of 2012.

High Valuation Losses in Households’ Financial Assets

After stagnating in the second half of 2011, the Austrian economy stabilized in the first few months of 2012, albeit at a low level. Although corporate profit growth continued in 2011, it lost momentum during the year in parallel with the economy. The favorable profit situation was mirrored in a sharp rise in internal financing of the corporate sector whereas external financing was about one-third less than in 2011. Bank loans contributed somewhat more than one-quarter to external financing in 2011. The modest tightening in banks’ lending policy seen in the second half of 2011 did not stop bank lending growth from accelerating in 2011 and in the first few months of 2012. The contribution made by bond issues to funds raised – more than one and a half times that made by bank loans – was especially high in 2011. Financing via the stock exchange remained adversely affected by the crisis.

On the costs side, low lending rates continued to ease the strain on the corporate sector and households. However, an exceptionally high share of variable rate loans also poses significant interest rate risks. Although both corporate and household debt grew only modestly in 2011, debt in relation to income still exceeded pre-crisis levels. A significant risk factor for households (and the banking sector) is the still high share of foreign currency loans. Almost 28% of total household loans were denominated in foreign currency in the first quarter of 2012.

Households’ financial investment was very subdued in 2011. The fact, however, that households’ financial assets at end-2011 fell slightly short of the comparable level in the previous year was attributable to substantial (unrealized) valuation losses in securities portfolios owing to losses on international capital markets.

Uncertain Environment Requires Strengthening of Austrian Banks’ Capital Adequacy

The difficult economic environment the Austrian banking sector faced in 2011 reduced its profitability significantly. Although banks’ consolidated operating income proved to be relatively resilient owing to their retail focus, increasing expenditure incurred by write-off requirements markedly depressed Austrian credit institutions’ total income. Although risk provisions were a good 20% lower in 2011 compared with 2010, they still remained well above pre-crisis levels. Risk costs for securities rose steeply in 2011.
Austrian banks’ investment in CESEE continued to make an important contribution to their total income, despite losses in some countries of the region in 2011. Higher profitability in CESEE business is however accompanied by increased credit risk. The exposure of mostly Austrian-owned banks to the CESEE region amounted to some EUR 216 billion at end-2011 and continues to be widely diversified. The bulk of this exposure was to those CESEE countries that joined the EU in 2004. However, in these countries political risk has increased again in the recent past. The Austrian banking system’s exposure to the euro area countries most strongly affected by debt problems continued to fall in 2011. However, the share of foreign currency loans as a percentage of total loans in CESEE remains high and is even rising slightly, which is a further source for heightened credit risk.

The liquidity situation of Austrian banks was marked by a recovery of the economic environment in Europe, which was helped considerably by long-term liquidity provided by the European Central Bank (ECB) in the form of two refinancing operations with a maturity of three years in December 2011 and February 2012.

Although Austrian banks continued to increase their aggregate core capital ratio in 2011, the gap between Austrian banks and other international banks active in CESEE widened in this respect. In view of the implementation of Basel III in Europe and the requirements of the European Banking Association (EBA), large Austrian banks are required to improve their capital ratios over a short-term horizon. Although both national and international bank regulatory projects pose challenges to banks, in the medium to long term they strengthen financial stability.

Nonbank financial intermediaries also faced a bleak market environment in 2011. Austrian insurance companies suffered a decline in premium income and an increase in costs. Assets under management decreased as a result of equity market losses, and the low level of interest rates represented a continued challenge to insurance companies and pension funds.

**Actions Recommended by the Oesterreichische Nationalbank (OeNB)**

The OeNB reiterates and supplements its recommendations for strengthening financial stability as published in Financial Stability Report No. 22.

- The OeNB and the Austrian Financial Market Authority (FMA) call upon large Austrian banks active in CESEE to improve their capital situation. The need for improved capitalization is justified by increased CESEE business-related risk.
- The OeNB and FMA call upon large Austrian banks active in CESEE to implement measures for ensuring the largely independent and long-term refinancing of their subsidiary banks. This requirement stems from the fact that the refinancing of local credit at many CESEE subsidiary banks largely depends on intra-company liquidity transfers, which has in the past resulted in increased credit defaults in conjunction with high loan-to-deposit ratios.
- The OeNB maintains its position that the issuance of new foreign currency loans that are not hedged against currency risk in Austria is not desirable and expects banks to substantially downsize this business in the CESEE region as well.