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CESEE Less Affected by Emerging Market Sell-Off

While the U.S. economy has picked up steam and euro area GDP growth shows continued signs of recovery, several emerging economies feel the dual challenges of slowing growth and tighter global financial conditions. The central banks in the advanced economies remain committed to providing sufficient liquidity to financial markets and keep interest rates low for a prolonged period. As a consequence, and supported by bold steps toward a euro area banking union, the remaining financial tensions have eased further.

In general, financial markets in Central, Eastern and Southeastern Europe (CESEE) have been less affected than other emerging market regions by the broader emerging market sell-off that followed the Federal Reserve’s communication on the future of its asset purchase program in May 2013. The impact of the Fed’s communication was felt more strongly only in markets that received substantial capital inflows in recent years and/or in countries with other pronounced economic imbalances.

Credit dynamics in CESEE were only moderate in the first half of 2013. Most countries reported low or even negative credit growth rates. In part this resulted from their weak economic momentum but also from problems in the respective domestic banking sectors. Credit quality continued to deteriorate in roughly half of the CESEE countries against the backdrop of their weak economic performance and the private sector’s impaired credit servicing capacity. Nevertheless, for the CESEE region as a whole lending conditions eased somewhat and consolidated foreign claims of BIS-reporting banks went up in the first half of 2013. In most CESEE countries, the share of foreign currency loans in total loans to households declined somewhat.

Debt Burden of Austrian Corporate and Household Sector Reduced

The Austrian economy remained in the doldrums in the first half of 2013, reflecting above all the difficult external economic conditions. Consequently, corporate profitability continued its downward trend, which began in 2012. Driven by both supply- and demand-side factors, growth of bank loans to corporates has continuously lost momentum since the second half of last year. On the one hand, credit standards for corporate loans had been tightened slightly but continuously for two years in a row. On the other hand, credit demand weakened as firms’ financing needs for fixed investment went down somewhat, and at the same time firms increasingly accessed other sources of finance such as bonds, which continued to exceed new bank lending. Although the debt-to-equity ratio increased slightly, the corporate sector’s debt servicing capacity remains broadly stable. At the moment, the low interest rates support firms’ debt servicing ability although, in the long run, the high share of variable rate loans might expose Austrian enterprises to considerable interest rate risk.

The real disposable income of Austrian households declined in the first half of 2013 on the back of weak wage and economic growth and a slowdown in property income driven, inter alia, by an environment of low interest rates. Reflecting a decline in the savings rate, households reduced their financial investments; bank deposits were even reduced in absolute terms. Growth of banks’ lending to households has been
subdued in 2013 so far, with housing loans continuing to grow moderately. Following the successful implementation of various supervisory measures, new foreign currency-denominated lending in Austria is negligible. Nevertheless, the still high proportion of foreign currency loans in total loans remains a major risk factor for Austrian households.

In the first half of 2013, the prices on the Austrian residential property market continued to rise, albeit at a slightly slower pace than in the previous year. In part, this price increase reflects a catching-up movement, as prices had been virtually flat before 2007. Although growth rates of mortgage loans remained moderate during the residential property price hikes, from a financial stability point of view developments of residential property prices certainly merit closer attention.

**More Sustainable Earnings and a Stronger Capital Base as Key Challenges for Austrian Banks**

The underlying conditions for the Austrian financial sector continued to be challenging in 2013. After a rebound in profitability in 2012, which was driven, inter alia, by one-off effects, banks’ profits in 2013 came under pressure from modest new business, rising operating costs and a renewed increase in risk costs as asset quality deteriorated further. To ensure a sustainable recovery, Austrian banks will have to become attuned to a new normality of slow growth, lower profitability and tighter regulation.

Austrian banks’ activities in CESEE again contributed substantially to the Austrian banking sector’s consolidated profit. However, developments in banks’ profitability and credit quality in individual CESEE countries have become more heterogeneous. On the upside, banks are profiting from their strategy of diversifying assets broadly across the region. On the downside, however, the increasing concentration of profits in a small number of countries leads to a higher vulnerability to adverse developments in countries that show high aggregate lending growth. Besides, the higher interest margins of Austrian banks’ subsidiaries in CESEE have to be seen in the context of higher risks, as nonperforming loans are still on the rise.

With profits concentrating in a smaller number of countries, Austrian banks started to slightly restructure their balance sheets. Nevertheless, concerns about a widespread deleveraging in CESEE have not materialized. Since the height of the CESEE market turmoil in early 2009, Austrian banks’ exposure to the region has even increased and remains broadly diversified, with a focus on investment-grade countries in CESEE.

In the first half of 2013, the Austrian banking system further improved its capitalization. In view of the continuously difficult economic environment and the higher capitalization levels of their international peers, Austrian banks will, however, need to improve their risk-bearing capacity further.

Institutionally, a major step toward a genuine European banking union was achieved with the formal start of the single supervisory mechanism (SSM). Before the SSM will become fully operational, the ECB – together with the competent national authorities – is carrying out a comprehensive assessment of the asset quality of significant banking groups, six of which are Austrian. Among other things, this exercise intends to increase the transparency and comparability of European banks and thereby aims to strengthen public confidence in European financial stability.
In addition to these important micro-prudential developments, the institutional landscape will see the implementation of a macroprudential policy framework as of 2014. In Austria, the Financial Market Stability Board will be the central body for macroprudential policy coordination. The complementary instruments provided for in the EU legislation that implements Basel III constitute an important step toward macroprudential supervision.

Action Recommended by the OeNB

The OeNB acknowledges the Austrian financial sector’s progress toward making the Austrian financial market more stable. Nevertheless, there is still a long way to go toward stronger crisis resilience. Therefore, the OeNB reiterates its recommendations to Austrian banks, calling for

- further improvements in bank capitalization,
- the application of sustainable business models and adequate risk-adjusted pricing in all market segments,
- improvements in banks’ efficiency and operational leverage,
- maintaining restraint in foreign currency lending,
- a cautious expansion of business with a particular focus on risk management particularly in markets that show high aggregate lending growth.