Management Summary

Subdued Economic Growth in the EU and in CESEE

The global recovery lost steam over the first half of 2012. While the outlook for the U.S. and the Chinese economy brightened somewhat after the summer, the recovery in Japan and the euro area was again put on hold. In the U.S.A., domestic demand has been the main engine of economic growth whereas euro area growth has decelerated steadily. The downturn has been driven by a combination of fiscal consolidation and elevated uncertainty among businesses and investors. To improve the situation, a range of comprehensive countermeasures has been launched. The ECB initiated a new government bond purchase program, and the EU put forward proposals for steps toward a single supervisory mechanism (SSM). All these measures together were important elements in contributing to calming the markets.

Developments in CESEE were characterized by ups and downs. While the financial sector started to recover, economic growth in the region slowed down markedly. Due to ongoing fiscal consolidation, subdued labor market conditions, declining real wages and deteriorating sentiment, some countries slipped into technical recession or continued to report contracting economic activity. Budgetary targets had to be adjusted in many CESEE EU countries already in the course of the year as the pace of growth decelerated. Nevertheless, average growth in the region is expected to stay higher than in the euro area.

House prices in CESEE continued to decline, and inflation generally started to pick up in the summer. The situation in the financial markets, however, brightened because improvements in the regulatory framework for the banking sector increased investor confidence. Short-term interbank rates remained broadly stable in most of the CESEE countries. Despite sustained credit growth in most countries, banks were able to reduce their funding gaps. Fears of excessive deleveraging did not materialize but some countries like Hungary were negatively affected by increasing political and economic risks.

Austrian Real Economy Benefits from Low Interest Rates

The Austrian economy slowed down in the course of 2012 against the backdrop of a weakened global economic environment, and corporate profit growth lost momentum. Despite tighter credit standards, which mainly reflected stronger risk differentiation by banks, bank lending to nonfinancial corporations gained momentum. At the same time equity financing almost came to a standstill while bond issues, which were considerably above the average of the previous years, contributed considerably to corporate financing. Lower interest rates reduced new financing costs and the costs of servicing existing debt. As variable rate loans make up an above-average share in total loans to companies in Austria, domestic businesses are considerably more exposed to interest rate risk than their euro area peers.

Austrian households' disposable income increased in 2012 thanks to relatively high wage settlements and lively employment growth and despite inflation acting as a drag on household incomes. Growth in bank lending to households was subdued, while loan conditions remained favorable. Housing loans still grew, albeit at a slower pace. The debt ratio of households in Austria continued to be lower than in the euro area. Low interest rates and a higher preference for liquidity led to a shift in the maturity structure of new deposits. Inflows were mainly recorded for overnight and short-term deposits.

Austrian Banks Faced with Challenging Market Conditions

Austrian banks strengthened their retail business in recent years, while gradually reducing interbank activities. Concerns about a credit crunch in Austria due to higher capital requirements, strained funding markets or deteriorating asset quality have not materialized so far. Neither was there widespread deleveraging by Austrian banks in CESEE as the overall exposure to the region increased. Yet data indicate significant differences at the country level, especially for countries with a challenging economic and/or macroeconomic environment. Claims on euro area countries with high risk premiums continued to decline from already comparatively low levels.

The stock of foreign currency loans in Austria has been on a steady decline since autumn 2008, and new foreign-currency lending has almost come to a halt. In CESEE, the share of foreign currency lending in total lending has started to decline slowly, but the outstanding amount continues to be a challenge to borrowers and a potential burden on banks' future profitability.

The profitability of the Austrian banking sector improved considerably in the first half of 2012 compared with 2011. However, net profits were upward-biased because of extraordinary revenues related to capital buyback measures. Risk provisions were almost 10% lower compared with the previous year, but they still remained well above pre-crisis levels. In the first half of 2012 the CESEE business of Austrian banks was again a major source of revenue and growth. The stock of foreign currency loans remained high but loan-to-deposit ratios continued to decline.

Although Austrian credit institutions continued to increase their aggregate core capital ratio in the first half of 2012 by a mixture of retained earnings, buybacks of hybrid capital and reductions in risk-weighted assets, the gap in terms of capital ratios between Austrian banks and other international banks active in CESEE remained. Given the higher credit risk in CESEE, Austrian banks should seek to further increase their risk-bearing capacity and catch up with their peers in this respect.

Nonbank financial intermediaries also faced a challenging market environment in 2012. Life insurers and pension funds were beginning to feel the negative effects of the low interest environment and the resulting decline in investment earnings. The implications of the financial and economic crisis and related investor restraint have led to a reduction of assets under management by Austrian mutual funds.

Action Recommended by the OeNB

Considering all these aspects, the OeNB reiterates its recommendations for strengthening financial stability as published in its Financial Stability Report 23, namely to improve banks' capital situation further and to take steps aimed at ensuring a more balanced and sustainable refinancing of subsidiaries (which are two pillars of the sustainability package adopted by the OeNB and the FMA in March 2012) and to rein in new unhedged foreign currency lending in Austria and CESEE.