

International Macroeconomic Environment:

Central Bank Action Supports Economic Outlook and Reduces Financial Tensions in the Euro Area and in CESEE

Advanced Economies: Reduced Downward Risks in a Still Weak Global Environment

Global economic activity remained subdued in the review period from November 2012 to May 2013 despite bold policy action to improve financial stability. While GDP growth in emerging economies was slightly below expectations, the IMF's World Economic Outlook expects the recovery in advanced economies to gradually accelerate in the second half of 2013. Whereas the euro area is still struggling to grow, economic activity has been stronger in the U.S.A. and – to a lesser extent – Japan.

In the U.S.A., private domestic demand has been the main engine of economic growth. The negative impact of progressing consolidation – linked to the fiscal cliff and the budget sequester – has been muted by a decrease in the saving ratio of U.S. households, which stabilized private consumption. While the recovery of the housing market has shown further progress, the reduction in unemployment continued to be associated with a gradual decline in the participation rate. So far, the Federal Reserve Board has dismissed calls to end its third round of quantitative easing (QE3), announced in December 2012, and continues to inject USD 85 billion per month into capital markets by buying mortgage-backed securities as well as government bonds. Moreover, in its current “forward guidance,” the Fed has announced to retain its policy rate close to zero until the unemployment rate falls to a threshold of 6.5%, given that inflation rates remain close to the long-term goal of 2%.

In Japan, the newly elected government has set out plans to stimulate

GDP growth by combining expansive monetary and fiscal policies with structural reforms. Surprisingly, the government embarked on an aggressive strategy to reach an inflation target of 2% within the next two years. In early April 2013 the Bank of Japan announced its plans to double the size of the monetary base, mainly by buying long-term government bonds in the secondary market via its framework of quantitative and qualitative monetary easing (QQME). While stock and bond market volatility increased and the yen depreciated sharply after the announcement of the policy shift, inflation rates have not yet reacted and remained negative so far. However, the IMF's World Economic Outlook expects both positive inflation rates and solid growth for 2013.

The Swiss National Bank (SNB) has remained committed to its exchange rate ceiling of CHF 1.20 per euro. Given the credible threat of further interventions, upward pressure remained subdued in the period under review.

The euro area is facing its second year of economic weakness. After negative growth in 2012, the IMF's World Economic Outlook forecasts real GDP to contract by 0.5% year on year in 2013. The majority of leading indicators signals a weak recovery around the second half of 2013. While private sector deleveraging and uncertainty among businesses and investors remain elevated, the relaxation of deficit targets should help stabilize effective demand in the euro area's peripheral economies and France. Overall, growth remains quite heterogeneous across countries: Growth rates are positive in Germany and Austria, whereas the deep recessions in Spain and Italy could

Expansive monetary policy supports recovery

Financial tensions in the euro area ease despite ongoing recession

be accompanied by a mild recession in France. While unemployment has continued to rise in nearly all euro area countries, inflation has slowed down considerably, mostly reflecting negative base effects in the energy and food components of the HICP.

Following the collapse of its two biggest banks, Cyprus agreed with the troika – the European Commission, the ECB, and the IMF – in March 2013 on a financial assistance program of EUR 10 billion for a period of three years. While Cyprus had initially imposed capital controls, the bail-in of unsecured deposits has not led to a new wave of capital flight in other peripheral economies. On the contrary, most euro area economies have seen an improvement in financial stability, also reflected in smaller sovereign bond yields in stressed economies. The general decline in risk aversion started with the ECB's announcement of Outright Monetary Transactions (OMTs) in late summer 2012 and reflects the progress in restoring competitiveness in peripheral economies, in restructuring the Spanish banking system and in setting up an EU-wide banking union. The European Council reached a final agreement on the single supervisory mechanism (SSM) in March 2013, giving the ECB a key role in the supervision of euro area banks in cooperation with a newly established Supervisory Council and the national supervisors. A strict separation of tasks within the ECB will ensure the independence of both monetary policy and banking supervision.

The Governing Council of the ECB cut its key interest rates by 25 basis points in early May 2013, bringing the interest rate on main refinancing operations to a historical low of 0.50%. Despite significant improvements, the transmission of monetary policy is still

impaired for some countries and economic sectors. While lending conditions for large firms ameliorated in the first half of 2013, access to finance remains somewhat challenging for SMEs, particularly in countries under stress. Better funding conditions have allowed banks in the euro area to repay around 30% of outstanding longer-term central bank liquidity since late January 2013. So far, the reduction in excess liquidity has not driven money market rates upward.

CESEE: Financial Sector Activity Subdued amid Weakening Economic Growth

Against the background of important measures taken to tackle the crisis in the euro area and reflecting the ongoing accommodative stance of some key central banks as well as a generally more positive sentiment vis-à-vis Europe, no heightened stress could be observed in CESEE financial markets during the review period from November 2012 to May 2013. After a marked downward adjustment in autumn 2012, Eurobond spreads and CDS premiums have remained broadly stable, reflecting stabilizing confidence in CESEE markets. In mid-May 2013, CDS premiums as well as Eurobond spreads stood at levels roughly comparable to those of spring 2011 – a comparatively calm period – throughout most of the region. A more notable deterioration against this benchmark could only be observed in Ukraine, Croatia, Slovenia and (to a somewhat lesser extent) Hungary, the economically weaker countries of the region. Political uncertainty and/or rating downgrades may well have played a role in this respect. Especially in Hungary and Slovenia, risk perception deteriorated markedly during Cyprus's banking turmoil in March 2013, but improved already in April. In early

Financial market
situation has
stabilized

June, CDS premiums went up again in several CESEE countries amid a weakening of investor sentiment across emerging market assets. Equity prices increased throughout most of the region. More notable losses were reported only for Russia and Ukraine. Short-term inter-bank rates continued to be low in most of CESEE. Since October 2012 they have declined most strongly in Hungary, the Czech Republic, Poland and Romania; in the latter, rates have been decreasing after the central bank gradually reduced its tight control over money market liquidity. In the other three countries, the development was related to policy rate cuts, for which abating price pressures and a weakening economic momentum had provided room. The Hungarian central bank cut its key policy rate in ten steps by a cumulative 250 basis points from a high of 7% in August 2012 to 4.5% in

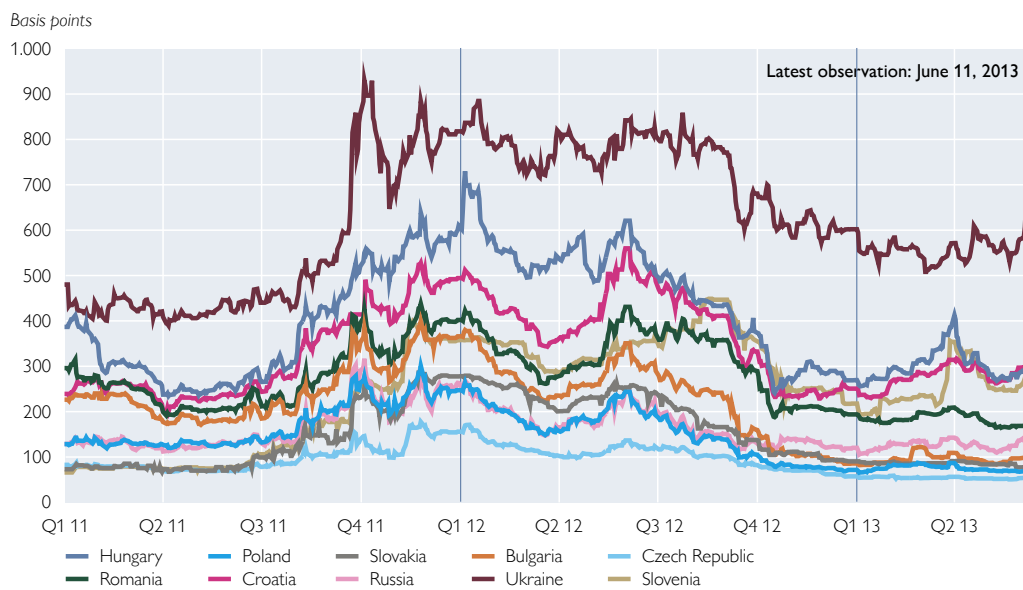
May 2013; the central bank of Poland reduced its rates in six steps by a cumulative 175 basis points from 4.75% in November 2012 to 3% in May 2013; and the Czech central bank lowered its policy rate in three steps by a cumulative 70 basis points from 0.75% in June 2012 to 0.05% in November.

Looking at the currencies of the countries under review that have not yet adopted the euro and do not maintain a fixed currency peg, most currencies traded broadly stable against their reference currency from mid-November to early-May.¹ Some more pronounced exchange rate swings were observed only in Hungary and Romania. The Romanian leu appreciated somewhat against the euro, which was partly related to a reversal of earlier losses but in part also fueled by comparatively attractive interest rate conditions and an improving international perception

No substantial swings in exchange rates

Chart 1

Five-Year Credit Default Swap Premiums



Source: Thomson Reuters.

¹ 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.

of the country following its inclusion in the JP Morgan Global Bond Index. The Hungarian forint, by contrast, suffered from increasing uncertainty related to the appointment of a new central bank management and the suspension of IMF talks in early 2013, and lost some value against the euro. Some pressure on exchange rates could also be observed in Croatia and Ukraine. The Croatian central bank intervened in foreign exchange markets in mid-April by selling EUR 215 million (or some 0.5% of GDP) to support the kuna. This was less than the amount spent on interventions in the respective period of the previous year. In Ukraine, pressure on the hryvnia's de facto pegged exchange rate – and in turn on foreign exchange reserves – eased due to administrative measures introduced in late 2012 and declining foreign currency demand by households.

The change in total outstanding loans to the private sector (domestic and cross-border loans, adjusted for exchange rate changes and measured in percent of annual GDP) was negative in most countries under observation between mid-2012 and end-2012 (most strongly so in Hungary, Slovenia and Croatia); the change was positive only in the

Czech Republic, Russia and Ukraine. While in the latter the increase was driven mostly by cross-border loans, it was domestic loans to households in the Czech Republic and loans to the whole private sector in Russia that fueled the increase. In the rest of the region, it was especially cross-border loans (mainly to enterprises) and domestic credit denominated in foreign currency (both to enterprises and households) that decreased, while there was an increase in domestic local currency loans to households (Slovakia, Poland) or to enterprises (Bulgaria, Romania), except for Hungary and Slovenia, where all credit segments declined.

Against this background, the share of foreign currency loans to households declined in most countries, and most strongly in Ukraine (by 6.6 percentage points to 45.3% between mid-2012 and end-2012). However, ranging between 56% and 76% in December 2012, the share of foreign currency loans in total loans to the private sector remained at high levels in Hungary, Romania and Croatia.

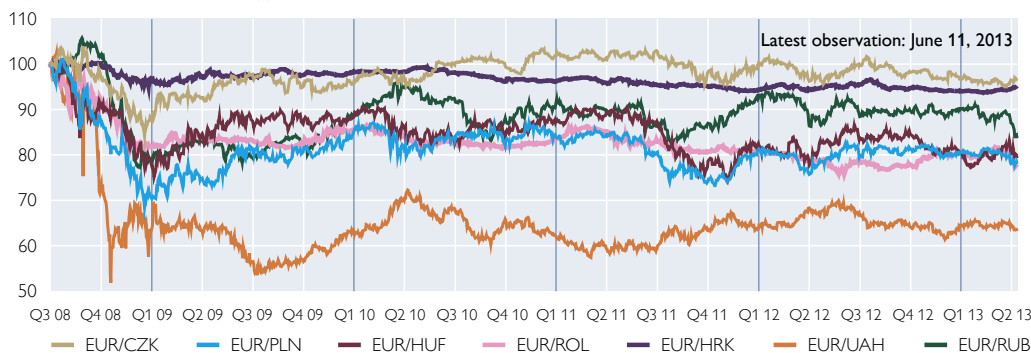
Consolidated BIS data provide further tentative evidence on credit developments in the region. The exposure of European banking groups vis-à-vis the

Muted credit growth throughout most of the region

Chart 2

Exchange Rates of CESEE Currencies against the Euro

September 1, 2008 = 100; rise = appreciation



Source: Thomson Reuters.

region decreased by EUR 11 billion (0.4% of annual GDP) between mid-2012 and end-2012.² Relative to total outstanding exposure, bank deleveraging was most pronounced in Ukraine, Hungary and Slovenia, while the decline as a percentage of annual GDP was largest in Hungary, Slovenia and Croatia. By contrast, Slovakia and Russia even recorded inflows.

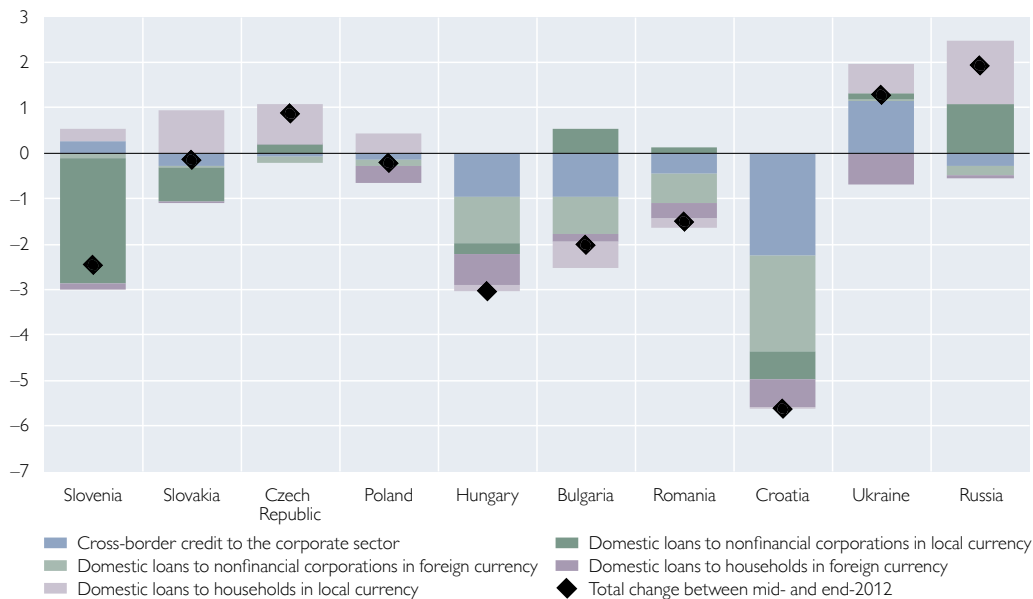
These heterogeneous credit developments seem to have been influenced – at least in some countries – by factors related primarily to credit supply. At the same time, deteriorating macroeconomic conditions are very likely to have adversely impacted on credit demand in the review period. Economic growth in the region (as a weighted average) decelerated from 2.7% in the second quarter of 2012 to 0.9% in the final

quarter (year on year), with four countries reporting negative annual growth in the second half of 2012. Labor markets have also remained slack. Unemployment rates have increased in nearly all CESEE countries since mid-2012 (most pronouncedly in Croatia, by 3.5 percentage points) and were in the double digits in more than half of the countries of the region in March 2013. Also, youth and long-term unemployment trended upward and employment declined in most of the countries. Real wage growth also decelerated or was even negative throughout most of the region. House prices continued to decline in all countries for which data are available. Furthermore, fiscal consolidation has been cutting into households' debt servicing capacity and has also negatively impacted consumption.

Chart 3

Banking Sector: Domestic and Cross-Border Credit to Private Nonbanks by Sector and Currency

Change between mid- and end-2012 as a percentage of GDP (four-quarter rolling sum); adjusted for exchange rate changes



Source: ECB, Eurostat, national central banks, national statistical offices, OeNB.

² This figure does not include all loan loss provisions and is to some extent adjusted for exchange rate changes; shifts in bank ownership between Europe and the rest of the world are not taken into account.

Deteriorating credit quality

Businesses are reluctant to invest, given unfavorable domestic and external demand conditions, low capacity utilization rates and an uncertain economic outlook. Sentiment indicators are also far below their long-term averages, with the household sector and construction being particularly pessimistic.

Reduction in loan-to-deposit ratio

There is some recent tentative evidence that credit growth may start to recover in the coming months. The Emerging Market Bank Lending Conditions Survey by the Institute of International Finance, for example, shows that lending conditions in emerging Europe have been easing in late 2012 and in early 2013. Developments in the first quarter of 2013 were driven especially by easing credit standards, suggesting that the credit tightening

cycle may be coming to an end. Furthermore, demand for loans started to increase in the first three months of the year, after declining in the previous two quarters.

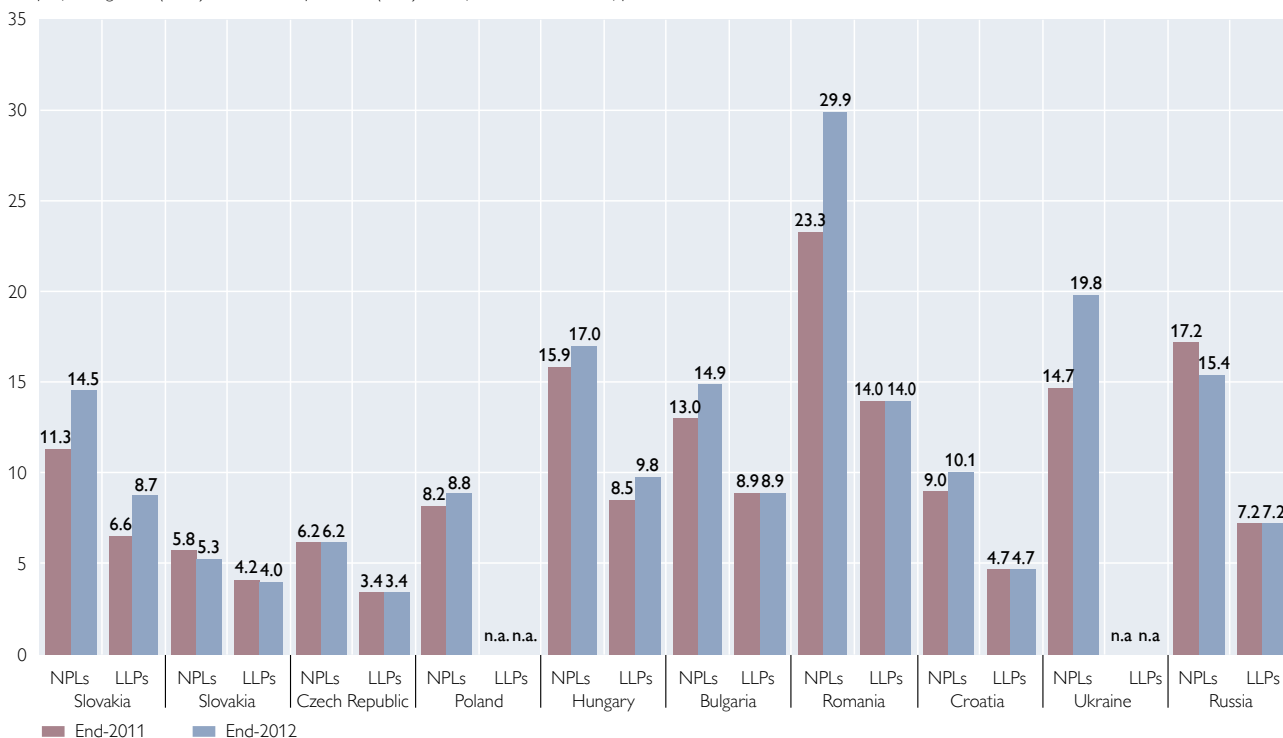
Credit quality continued to deteriorate in many CESEE countries. This development was most pronounced in Slovenia, Romania and Ukraine in 2012. Also, nonperforming loans (NPLs) increased in Poland, Hungary, Bulgaria and Croatia, which must be seen in the context of weakening economic conditions including low credit growth and the private sector's impaired credit servicing capacity. Some countries, however, also reported a slight improvement in credit quality (Slovakia and Russia).

In all the countries under review, with the exception of Slovakia and the

Chart 4

Banking Sector: Credit Quality

Nonperforming loans (NPLs) and loan loss provisions (LLPs) in % of total credit at end of period



Source: IMF, national central banks, OeNB.

Note: Data are not comparable between countries. NPLs include substandard, doubtful and loss loans. Poland including so-called irregular loans.

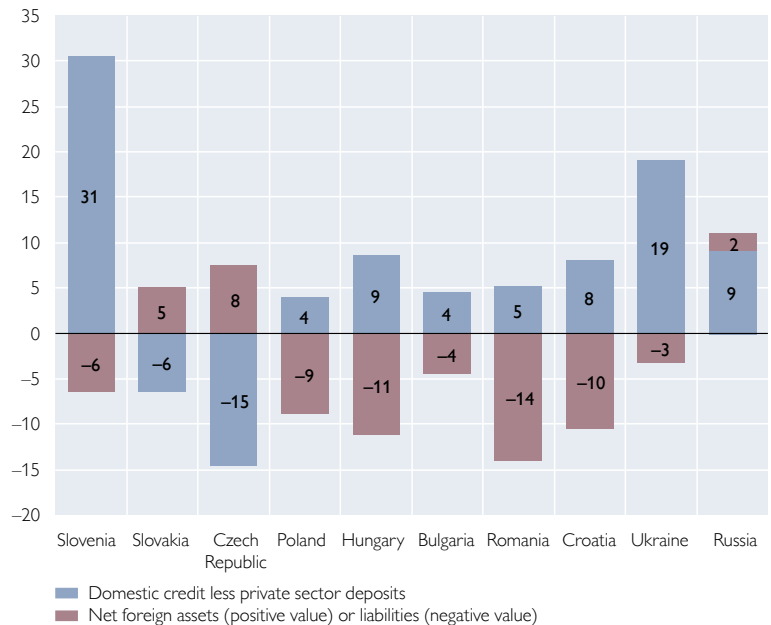
Chart 5

Czech Republic, total outstanding domestic claims continued to exceed total domestic deposits (relative to GDP) in 2012. However, this funding gap had been narrowing substantially since late 2011 and continued to do so in the observation period. The gap between domestic claims and deposits contracted throughout CESEE, and particularly strongly in Slovenia, Hungary, Croatia and Ukraine. In most countries, the decline was driven by the muted growth or – in several cases – decrease in claims, while deposits increased throughout the region. In Slovenia, however, the gap remained at a comparatively high level, given a credit boom financed by foreign wholesale funding before the crisis. At the same time, banking sectors in CESEE reduced their reliance on external funding in the second half of 2012. Despite the implied improvement in banks' net external position, the banking sector continued to hold net external liabilities in most countries, which – as a percentage of GDP – were particularly high in Romania, Hungary, Croatia and Poland. Only Slovakia and the Czech Republic continued to show a surplus of domestic deposits over claims, which is also reflected in the positive net external assets registered by both countries' banking sectors. Furthermore, in both countries the surplus of domestic deposits increased and their international creditor position expanded in the review period.

Banking sector profits continued to be subdued in 2012 in most CESEE countries. Compared to the previous year, profits declined strongly in Slovakia, Slovenia, Romania and Croatia, and banking groups reported losses in Slovenia, Hungary and Romania. In Romania, banking system profitability has been in negative territory since August 2011, mainly due to large net

Banking Sector: Gap between Claims and Deposits and Net External Position

As a percentage of GDP at end-2012



Source: ECB, Eurostat, national central banks, national statistical offices, OeNB.

provisioning costs as well as to weaker operating profits. In Hungary, profitability was negatively impacted by government measures to reduce outstanding foreign currency debt of households. Banks, which are already fraught with high sectoral taxes, have to carry the main burden of these measures. In Slovenia, the strong increase in loan loss provisions resulted in another year of bank losses, although the cost-to-income ratio markedly improved to a relatively low level. Somewhat higher profits were reported for the Czech Republic and Russia, and the Ukrainian banking sector managed to turn a loss in 2011 into a profit in 2012.

The banking sectors in CESEE remained well capitalized in 2012. Capital adequacy ratios (CARs) ranged between 11.5% in Slovenia and 20.6% in Croatia. Compared to end-2011, the CARs increased particularly strongly in Hungary (+2.7 percentage points,

Banking sectors remain well capitalized

Profitability of CESEE banking sectors remains subdued

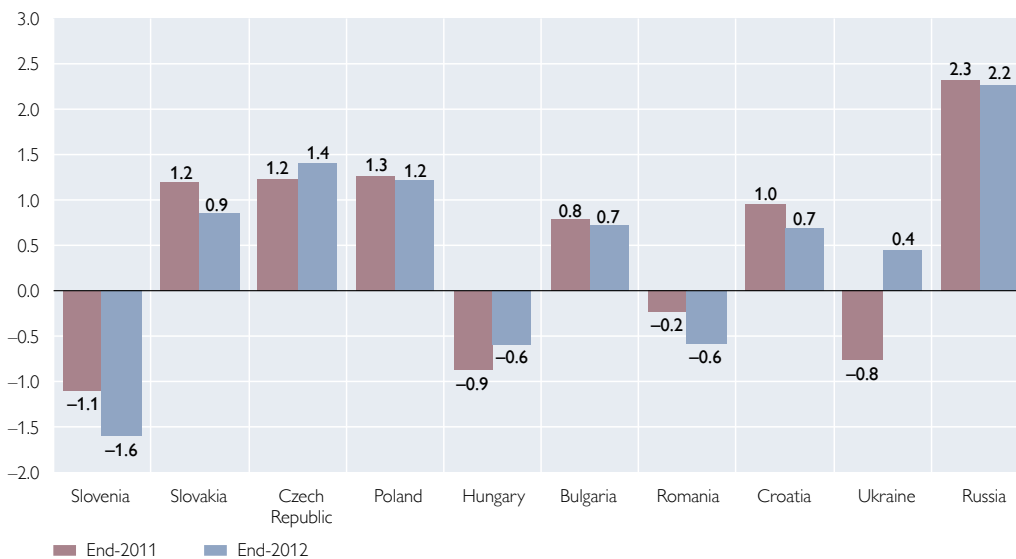
driven also by the asset side) and Slovakia (+2.3 percentage points), followed by the Czech Republic, Poland and Croatia (between +1.0 and +1.6 per-

centage points). By contrast, the CARs decreased in Bulgaria and Ukraine (where they are still at a relatively high level, though) as well as in Russia.

Chart 6

Banking Sector: Profitability

Return on assets in %



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.