

International macroeconomic environment: war in Ukraine endangers global recovery amid high uncertainty and surging inflation

Geopolitical uncertainty, supply bottlenecks and slowdown in global trade

The war in Ukraine has exacerbated uncertainties in the global environment. After one year of recovering from the health and economic crisis, the global economy began to slow down again at the end of 2021 due to the spreading of the Omicron variant of COVID-19, persistent supply bottlenecks and rising inflation. The Russian invasion of Ukraine has made the global environment even more uncertain, aggravating some of the vulnerabilities that had built up during the pandemic and posing further humanitarian, economic and political challenges. Energy and food prices have risen sharply, and their volatility has soared. Constraints to production are expected to persist, while sanctions against Russia, sharply rising inflation and the withdrawal of expansionary policies further contribute to slowing down economic recovery. Given the worsening global scenario, the IMF’s projections expect global growth to decline from 6.1% in 2021 to 3.6% in 2022, i.e. to be 0.8 percentage points lower than projected in its January 2022 World Economic Outlook (WEO). While commodity price increases, supply shortages and tightening financial conditions will affect the entire world economy, Europe bears a greater risk due to its proximity to the war in Ukraine, its reliance on Russian energy and the exposure of some businesses and financial institutions to Russia’s financial markets. Among European economies, Germany, Italy and several CESEE countries are facing particular challenges. As Austria is situated right between these countries, its economy might also suffer from the slower growth trend in its neighboring countries. The main risks to the global economic and financial outlook in the short run stem from (1) high energy prices and rising inflation; (2) disruptions in commodity markets and global value chains; (3) monetary policy tightening amid high market uncertainty; (4) high global debt leverage; and (5) increasingly exhausted fiscal space. In addition, other global risks such as a slowdown of growth in China, the risk of trade fragmentation in the world economy and the threat to energy security, which may put climate transition at risk, are weighing on the outlook.

The war is driving up commodity prices, threatening the anchor of medium-term inflation expectations. According to the latest readings, inflation proved to be higher and more persistent than previously expected. Inflation developments have been mainly driven by rising energy prices and supply shortages, which had already materialized during the pandemic and have now worsened because of the war. The Hamburg Institute of International Economics (HWWI) commodity

Table 1.1

GDP growth and inflation forecasts

IMF WEO projections of April 2022

	Real GDP growth		Annual HICP/ CPI inflation	
	2022	2023	2022	2023
	%			
Euro area	2.8	2.3	5.7	2.5
UK	3.7	1.2	7.4	5.3
Japan	2.4	2.3	1.0	0.8
China	4.4	5.1	2.1	1.8
USA	3.7	2.3	7.7	2.9
World	3.6	3.6	5.7	2.5

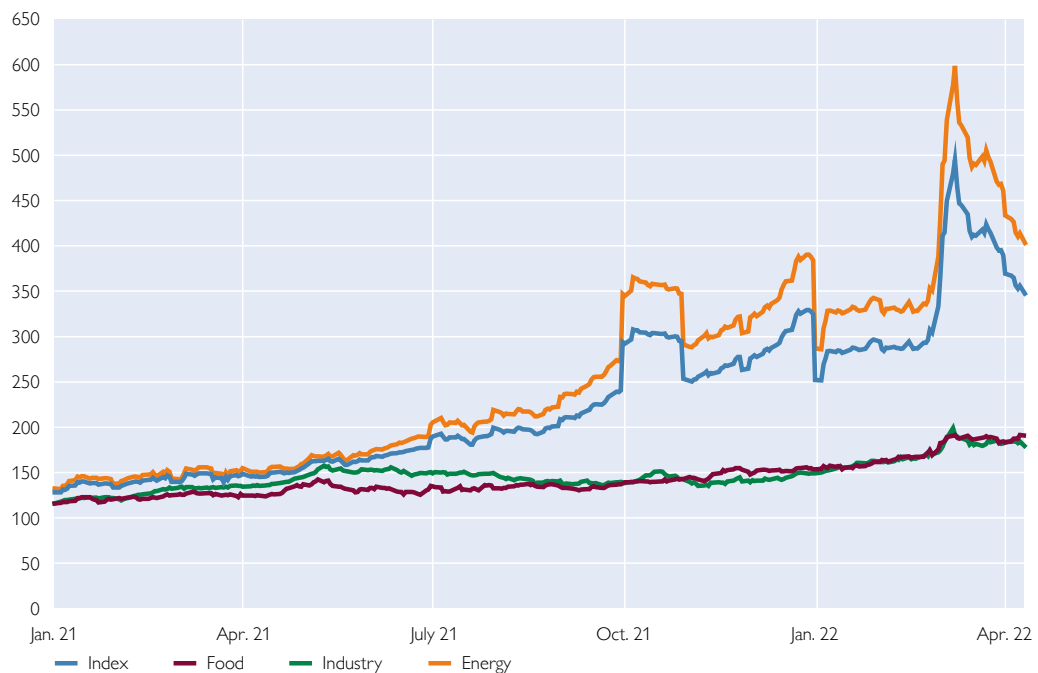
Source: IMF World Economic Outlook (WEO).

price index rose by an average of 32% in March 2022 on a US dollar basis (41.1% on a euro basis) compared with the previous month, but declined by 12% in April. Crude oil prices increased from around USD 80 per barrel to above USD 100 per barrel from the beginning of the year, reaching a peak of USD 130 per barrel in early March. In April 2022, gas prices were about four times higher than the year before. Accordingly, the IMF revised its inflation projections for 2022 to 5.7% in advanced economies and 8.7% in emerging economies (1.8 and 2.8 percentage points higher than in its January forecast). In some countries, including the USA and the UK, rising inflation rates led to monetary policy tightening via interest rate hikes. In the United States, inflation has reached the highest level across large advanced economies (followed by the UK), with markets starting to price in inflation for a longer period of time. In fact, labor markets have tightened since the beginning of the pandemic in both the USA and the UK.¹ In contrast, as labor markets have tightened less strongly in the euro area, wage growth has not yet picked up excessively in the region – a fact which still reduces the risk that inflation expectations become de-anchored. The IMF expects inflation to decrease gradually in 2023 on the back of tightening monetary policy and the fading commodity price shock. Yet risks are present, as higher inflation expectations could become more widespread and prompt adjustments in nominal wages, thus exerting further inflationary pressure. Especially in developing and emerging markets, high inflation could trigger political instability. In the euro area, inflation could also remain above target in 2023.

Chart 1.1

World commodity prices

EUR, HWWI index "Euroland" 2015=100, daily figures



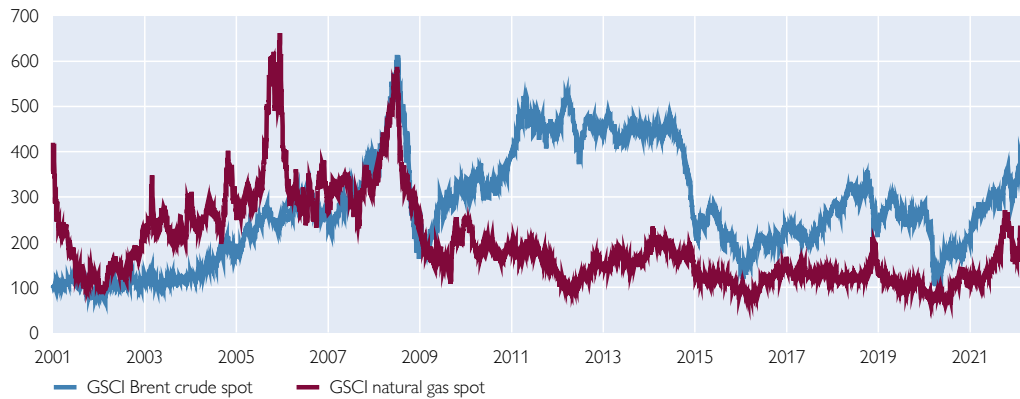
Source: HWWI.

¹ Tighter labor markets are estimated to have directly driven up overall nominal UK and US wage inflation by approximately 1.5 percentage points (IMF. 2022. WEO – April 2022).

Chart 1.2

S&P GSCI energy price index

January 1, 1999=100



Source: Macrobond.

Supply bottlenecks have been building up and global trade is expected to slow down. Supply shortages have aggravated in sectors where Russia and Ukraine played a crucial role in world trade. On top of the list are gas and oil, but also fertilizers, metals and wheat. Fears of supply stops have materialized in an already tight market where inventories have been low since the outbreak of the pandemic, causing prices to surge. Moreover, the extreme volatility in commodity prices is amplified by pressures in commodity trade finance and derivatives markets. Supply shortages and price increases have strong implications for global production chains, including the automobile sector and the renewable energy industry. Furthermore, the rise in prices of agricultural products has important spillover effects on developing and emerging markets that are close trading partners of Russia and Ukraine (such as CESEE, the Caucasus, the Middle East and North Africa). Supply and production chain disruptions could intensify due to the prolongation of the war and further sanctions, the impact of which has begun to materialize with the reduction of industrial output and trade. Detrimental second-round effects could spill from a drop in investments and production chain issues in the medium term. Moreover, the discontinuation of extraordinary policy support provided during the pandemic is also expected to slow down global demand for goods. Reflecting these forces, global trade growth is expected to decline in 2022 after its rebound in 2021. Demand is expected to rebalance back toward services, but cross-border services trade is forecast to remain subdued because of the war and the prolonged effects of the pandemic. The IMF projects global trade growth to slow from the rate of 10.1% estimated in 2021 to a rate of 5% in 2022 (1 percentage point lower than in its January forecast). Over the medium term, trade growth is expected to decline to about 3.5%. According to the Kiel Institute for the World Economy, EU trade has so far been affected most strongly by the war in Ukraine, with exports going down by 5.6% and imports by 3.4% in March 2022 compared with February. The impact on the USA was milder, with exports falling by 3.4% and imports by only 0.6%, while the effect on China was negligible.

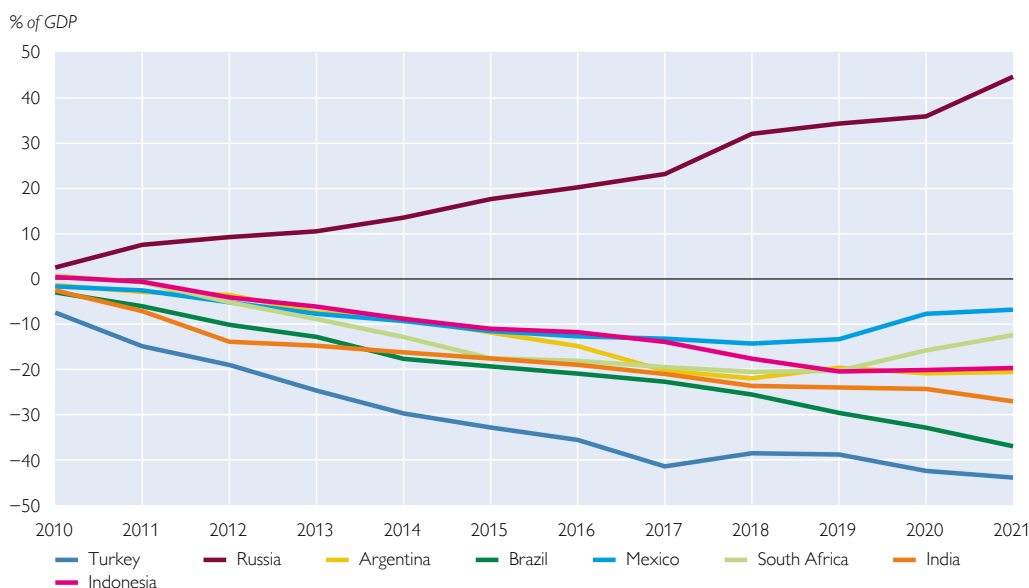
Central banks are moving further and faster toward monetary policy tightening to contain inflation, which leads to tighter global financial conditions. With the sharp rise in commodity prices adding to the already growing inflationary pressure, central banks are facing the challenge of bringing inflation back to target without hampering the post-pandemic recovery, and of ensuring financial stability. In fact, an excessive increase in both inflation and inflation expectations as well as an excessive tightening of financial conditions could add to previous vulnerabilities and weigh on economic growth.

Against the backdrop of high inflation levels and tight labor markets, the US Federal Reserve has increased its target federal funds rate for the first time since 2018. In March 2022, the Fed hiked the rate by 25 basis points, and in May 2022 by 50 basis points, bringing the target range to between 0.75% and 1%. Markets are pricing in two further half-point rate rises for the next two policy meetings and further quarter-point increases, so that the federal funds rate would reach between 2.5% and 2.75% by the end of the year. Concerns about the economic outlook and the possibility that the Fed’s monetary policy tightening would depress growth in 2022 are reflected by a considerable yield increase in the ten-year segment of the yield curve, which has flattened significantly since the beginning of the year. Advanced estimates for the first quarter of 2022 show US GDP to have decreased by 1.4%. Nevertheless, financial conditions remained favorable and household finances continue to be strong.

Conversely, emerging markets are facing tighter external financing conditions on the back of US monetary policy normalization and heightened geopolitical uncertainty, the risk of devaluation and higher risks of capital outflows. Financing costs have risen above their pre-pandemic levels for many emerging market economies which have seen their gross external debt positions increase along with persistent current account deficits. Moreover,

Chart 1.3

Emerging markets: cumulative current account surplus or deficit since 2010

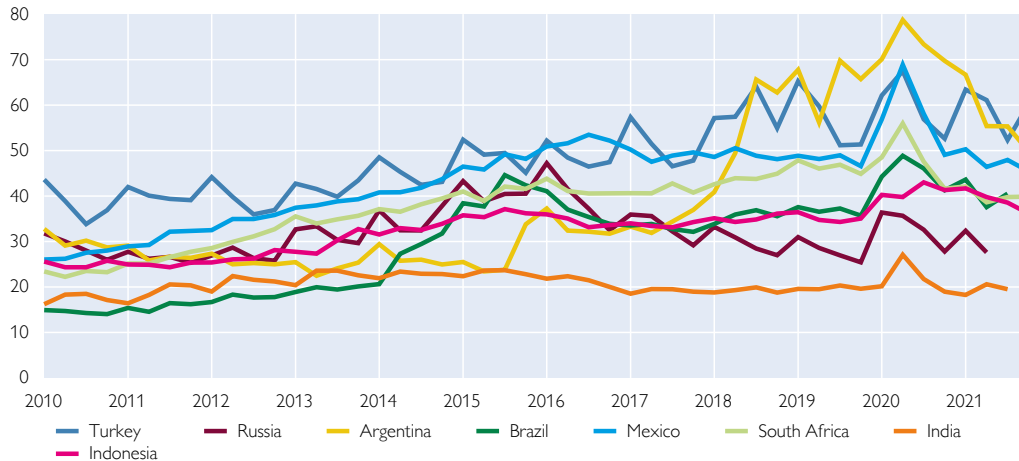


Source: Macrobond, IMF.

Chart 1.4

Emerging markets: gross external debt positions

Joint External Debt Hub (JEDH), % of GDP



Source: Macrobond.

bank holdings of domestic sovereign debt have strongly increased in the past two years, which could trigger a feedback loop between sovereigns and banks, potentially reducing bank soundness and lending.²

The ECB is moving carefully toward policy normalization amid weak euro area growth. Preliminary estimates point toward GDP growth of 0.2% in the euro area during the first quarter of 2022 compared with 0.3% growth in the last quarter of 2021. This growth weakness is attributable to COVID-19-related restrictions and the outbreak of the war in Ukraine weighing on the confidence of businesses and consumers. The sharp rise in energy and commodity prices has increased the cost of living and production costs for households and firms, respectively, while supply chain bottlenecks persist due to the war and new lockdowns in China. Nevertheless, the exceptional fiscal measures and the rise of households' savings during the pandemic in combination with strengthening labor markets will continue to support incomes and spending and underpin the ongoing recovery. Downside risks are mainly related to the prolongation of the war in Ukraine, a possible further escalation of sanctions and embargos against Russia, and the consequent further surge in energy costs and threat to energy security, amid post-pandemic high public debt levels and limited fiscal space. The rise in energy prices constitutes a significant adverse terms-of-trade shock for the euro area, and countries which most heavily rely on energy supply from Russia will suffer most.

In light of inflation hikes after the outbreak of the war in Ukraine, the ECB has slowed down asset purchases faster than previously expected. It announced that net asset purchases should be terminated in the third quarter of 2022. The interest rates on the main refinancing operations, the marginal lending facility and the deposit facility remain unchanged at 0.00%, 0.25% and -0.50%, respectively. At its monetary policy meeting of April 2022, the Governing Council of the ECB decided that rate hikes will be discussed after

² IMF. 2022. *WEO – April 2022*.

the termination of the asset purchase program in July. According to the euro area bank lending survey, credit standards have started tightening in the region and are expected to tighten further. Nevertheless, financial conditions are still close to historical averages, real interest rates remain accommodative in most countries, lending is holding up and the banking system has not encountered liquidity constraints. The ECB is more cautious about early interest rate hikes than other central banks, given the euro area's less advanced position in the business cycle, the stronger impact of the war in Ukraine on the European economy and the relatively lower contribution of domestic forces to inflation. An earlier-than-anticipated interest rate tightening might prevent the euro from devaluing against other international currencies. However, it might also weigh on credit markets and on the interest rate spreads of the euro area countries that are facing structural challenges and high public indebtedness. The euro area government deficit stood at 5.1% of GDP in 2021, with government debt at 95.6%. Both government deficit and debt decreased since the end of 2020 (when they came to 7.1% and 97.2%, respectively), but their levels remain high compared with the pre-pandemic period.³

The war in Ukraine has caused uncertainty for European financial intermediaries and markets. Following the recovery of the banking and financial sector observed in 2021, the war in Ukraine has caused exceptional uncertainty in European financial markets, which start showing fears of rising inflation and heightened uncertainty regarding the economic outlook. Core euro area interest rates have been on the rise, with the three-year German Bund yield back in positive territory for the first time since 2014. The Ifo Business Climate Index for Germany indicated fears of recession in March 2022, before giving signs of stabilization in April. Looking at the European corporate sector, the tightening of credit spreads has buffered borrowing costs, especially in the high-yield segment. While European banks' direct exposures to Russia are relatively small,⁴ their indirect exposures are more difficult to identify and could lead to second-round effects, increased volatility in financial markets or a repricing of assets. European investment funds also have only limited exposure to Russian assets (as a share of total assets), as emerging market funds had been reducing their exposure to Russia already after Russia invaded the Crimea.⁵ Euro area financial institutions are currently also reducing their exposures to Russia. According to the Bank for International Settlements (BIS), among the countries with stronger financial linkages to Russia and Ukraine, European countries such as France, Italy and Austria have the lead. For a more detailed analysis of the risks arising from the war in Ukraine for Austrian banks and the Austrian financial sector, see box 2, "[Implications of the Russian invasion of Ukraine for financial stability in Austria](#)," in this report.

Other global risks are related to the slowdown of the Chinese economy, the potential fragmentation of the world economy and the threat to energy security and climate transition. Economic growth in China is expected to slow down due to pandemic-related disruptions (considering,

³ Eurostat. 2022. *euroindicators 46/2022*. April 22.

⁴ Credit exposures to Russian counterparties at the end of 2021 were around EUR 70 billion and mostly concentrated among a handful of significant banks. Securities exposures and derivatives exposures are also limited.

⁵ Emerging market funds have reduced their share of Russian debt from more than 10% in 2014 to just over 4% in 2022. Funds benchmarked to global indices have an even smaller exposure to Russia, with their average share of Russian debt coming to 0.2% in 2022.

in particular, the recent spread of the Omicron variant in Shanghai and Beijing), the recent equity sell-off in the technology segment and the ongoing contraction in the real estate sector. The slowdown of the Chinese economy could have repercussions for supply chains in Europe but also for emerging market economies and thus increase financial stability risks. Moreover, concerns are mounting about the humanitarian consequences of the war in Ukraine and a possible fragmentation into geopolitical blocks, which could have implications for overall global welfare. The IMF also underlined that crypto asset trading against some emerging market currencies has increased after sanctions were imposed against Russia, highlighting the challenges of applying capital flow measures. Moreover, the risk and possibility of cyberattacks increase as payment systems become more decentralized. Finally, while the war in Ukraine has made evident the need to cut the dependency on carbon-intensive energy and to accelerate the transition to renewables, concerns about energy security and access to energy sources might hamper energy transition as rising inflationary pressure may also lead authorities, especially in developing countries, to resort to providing subsidies or other forms of fiscal support to households or firms for fossil fuel consumption.⁶

Post-pandemic recovery in CESEE increasingly dwarfed by soaring prices and macroeconomic uncertainty

The Russian invasion of Ukraine on February 24, 2022, marked a watershed moment for European post-Cold War history. This tectonic shift has drastically altered the political and military situation in Europe and will have profound impacts on the CESEE⁷ economies in the short, medium and, most likely, also in the long run.

Yet, in the run-up to the war in Ukraine, macroeconomic dynamics in CESEE were generally solid as the region continued to recover from the pandemic-induced disruptions of 2020. The revival was initially driven by dynamic exports and, as time progressed, by capital formation and later by private consumption as well. As a result, annual real GDP growth in 2021 averaged 6.5%, a level last seen before the global financial crisis. The economic momentum also fed through to labor market conditions in CESEE, causing unemployment rates to revert to the historically low levels of 2019. Yet, new COVID-19 infection waves and persistent bottlenecks in global supply chains eventually increased the risks to growth again toward the end of 2021.

At the beginning of 2022, the outlook for the CESEE region was for a somewhat weaker though still solid GDP expansion in 2022. This assumption was based on easing pandemic-related economic constraints (including constraints on value chains), the beginning disbursement of EU funding (with resources from the current financial framework and the *NextGenerationEU (NGEU)* reconstruction fund) that would support investment and construction activity and – in the case of Russia – high oil prices.

With the war in Ukraine, the situation has clearly deteriorated. For Ukraine, forecasters pencil in a GDP decline by as much as 35% in 2022. According

⁶ IMF. 2022. *WEO – April 2022*.

⁷ *Central, Eastern and Southeastern Europe. This report covers Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Russia, Slovakia, Slovenia, Turkey and Ukraine.*

to the Ukrainian ministry of economy, the total costs of war-related destructions could add up to more than EUR 500 billion (including loss of infrastructure, GDP losses, losses incurred by the civilian population, losses of enterprises and organizations, losses of FDI in the Ukrainian economy and losses of the state budget). This compares to a GDP of some EUR 170 billion in 2021. Russia's economy is set to contract by about 10% this year in light of uncertainty, Western economic and trade sanctions and the country's own countersanctions. With that, economic activity in Russia will decline to a level seen a decade ago, i.e. prior to Russia's annexation of the Crimea. Projections do not yet see the other CESEE countries slipping into recession, but higher energy and commodity prices, trade spillovers from the contracting Russian economy (and – to a lesser extent – from economic contraction in Ukraine), an impaired availability of selected inputs and commodities and general confidence effects will shave off some 1.5 percentage points from expected growth in 2022.

Rising energy prices, the economic recovery and the aftermath of the pandemic lifted inflation in the CESEE countries to its highest level in more than 15 years. In March 2022, inflation ranged between 7.3% in Croatia and as much as 61.1% in Turkey.

Price pressures have broadened from energy and commodity prices to larger segments of the consumption basket over the past months. The latest price surge since the turn of the year was already strongly based on core inflation (services, industrial goods and processed food). This development reflected, in part, skyrocketing producer prices fueled by raw material shortages, bottlenecks in the production of certain intermediate goods (e.g. semiconductors), tight international transport capacity (especially in shipping), pent-up consumer demand and higher demand in certain sectors. Many companies also used the turn of the year to reset their prices and pass on some of their increased input costs to consumers. The presence of second-round effects of rising inflation and an incipient price-wage spiral is still hard to assess, but several indicators point to faster wage growth since mid-2021 and to rising labor supply shortages. In most countries, however, wage dynamics remain far behind the increases observed in 2018 and 2019.

By contrast, the momentum in energy prices in early 2022 was somewhat contained by widespread government intervention to limit price increases for household energy (and in some cases also for food items). These measures ranged from compensatory payments to consumers and companies to reductions in VAT rates and/or network fees and to direct interventions in the price structure (price cuts or price caps). All efforts, however, were not sufficient to shield households fully from the renewed push to energy prices brought about by the war in Ukraine.

CESEE central banks responded to rising prices with large interest rate hikes, thus abandoning the monetary policy easing that was called for during the pandemic in 2020. Until the outbreak of the war in Ukraine, the Polish central bank had raised its key interest rate in five steps from October 2021, bringing it up from 0.1% to 2.75%. The Czech central bank had adjusted its key interest rate in six steps from June 2021, raising it from 0.25% to 4.5%. The Hungarian central bank had increased its key interest rate in nine steps from June 2021, namely from 0.6% to 3.4%, and the Romanian central bank had taken four

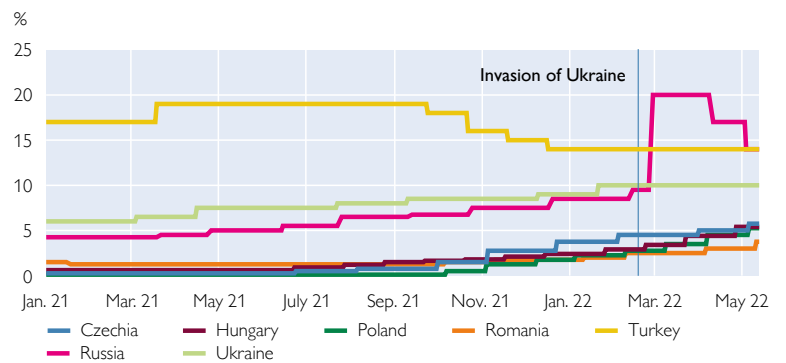
interest rate steps since October 2021, raising its key rate from 1.25% to 2.5%. The Russian central bank had raised its policy rate in eight steps from March 2021, from 4.25% to 9.5%. And finally, the Ukrainian central bank had increased its interest rates in six steps from 6% in March 2021 to 10%. In addition to raising key interest rates, some monetary policymakers in CESEE have also been tightening their stance by adjusting other interest rates, by engaging in active liquidity management designed to raise money market rates or by withdrawing unconventional monetary policy measures. In several countries, monetary policy tightening was reinforced by macroprudential measures (including capital and borrower-based measures) with a view to preventing real estate markets from overheating. Only the Turkish central bank slashed rates from 19% to 14% between September and December 2021, arguing that inflation was driven by transitory factors and – in part – by factors beyond the control of monetary policy.

Decisive monetary action had mixed impacts on the region’s currencies.

The cycle of monetary easing at a time of widespread (anticipated) global tightening pushed the Turkish lira down and the currency traded at a record level of TRL 20 per EUR in December 2021. The widening interest rate differential against the euro area (and the prospect of further rising interest rates) had less of an influence on exchange rates in the CESEE EU member states. The Polish zloty, the Hungarian

Chart 1.5

Policy rates in CESEE

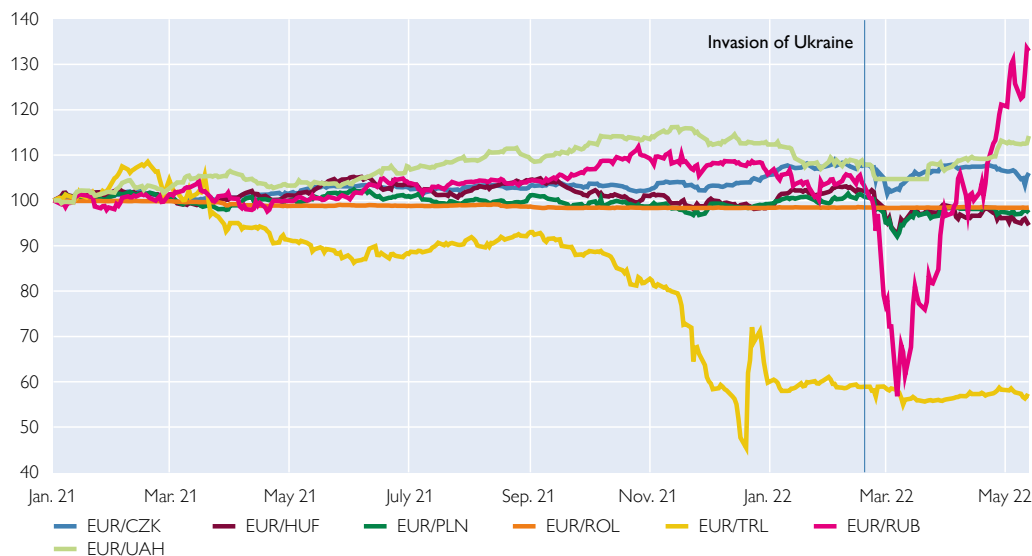


Source: Macrobond.

Chart 1.6

Exchange rate of CESEE currencies against the euro

Index: January 2021=100; rise = appreciation



Source: Macrobond.

forint and the Romanian leu were relatively stable or even depreciated slightly against the euro in the second half of 2021. Only since the turn of the year, a cautious upward trend has been observed. Currencies were supported by an increased credibility of the interest rate turnaround and central bank communication emphasizing the importance of the exchange rate for achieving the inflation target. The Russian ruble and the Ukraine hryvnia appreciated until November 2021, helped by the oil price rally (Russia) and strong agricultural exports amid rising global food prices and a bumper harvest (Ukraine). In late 2021, a flood of negative news about a potential Russian invasion of Ukraine led to a sharp trend reversal in both countries.

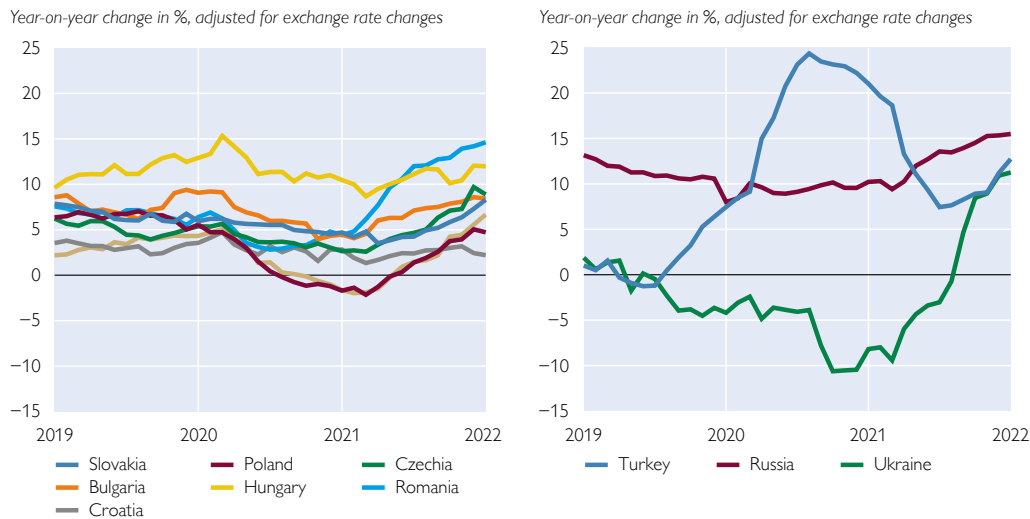
Since the war in Ukraine began, the stability of the Russian ruble has been upheld thanks to a sharp upward key rate adjustment. Western sanctions and uncertainty hit the Russian economy very swiftly, and the ruble depreciated by some 40% against the US dollar within a week. In response, the Russian central bank more than doubled its policy rate from 9.5% to 20%. The Russian authorities also introduced several further measures to stabilize the foreign exchange market (including an obligation imposed on Russian exporters to exchange 80% of their foreign currency revenues into Russian ruble, the introduction of a commission fee on foreign currency purchases, and restrictions on the transfer of foreign currency to other countries). Under these restrictions, the exchange rate of the Russian ruble has practically ceased to be determined by market factors, and liquidity in the ruble market is low. The currency is also supported by Russia's structural current account surplus based on ongoing exports of commodities, a terms-of-trade shock and a slump in (partly sanctioned) imports. This explains why the Russian ruble has strengthened since the second half of March 2022; easing tensions allowed the central bank to reduce its policy rate by 600 basis points to 14% in mid-May.

Several other central banks also adjusted policy rates to contain financial market turbulences after the outbreak of the war in Ukraine. Among the CESEE countries not directly involved in the war, policy rates have been raised by 200 basis points to 5.4% in Hungary, by 250 basis points to 5.25% in Poland, by 125 basis points to 5.75% in Czechia and by 125 basis points to 3.75% in Romania since February 24, 2022. The Croatian, Czech and Polish central banks intervened to stabilize their currencies after these lost quite some of their external value against the euro (and even more so against the US dollar) in the first days following the invasion of Ukraine. By mid-May, regional currencies had recovered some of their initial losses but generally failed to return to pre-war levels. Notwithstanding a favorable interest rate environment, geopolitical risk premiums will likely continue to weigh on foreign currency markets as long as the war continues.

CESEE banking sectors recovered swiftly from pandemic-induced disruptions. This favorable momentum relied on several pillars: First, most CESEE banking sectors were in a generally solid shape when the pandemic hit (with respect to, inter alia, capital buffers, asset quality, the regulatory environment and a refinancing structure strongly based on local deposits). Second, policy action supported banking sectors at the height of the pandemic (e.g. by allowing flexibility in the treatment of NPLs, a relaxation of liquidity ratio requirements, providing various forms of capital relief measures, guarantees and long-term liquidity

Chart 1.7

CESEE: growth of credit to the private sector



provisions). Third, improving general economic conditions and brightening sentiment after the phasing-out of the most severe COVID-19 containment measures since spring 2021 have bolstered banking activity.

Credit growth accelerated across the region and across credit segments.

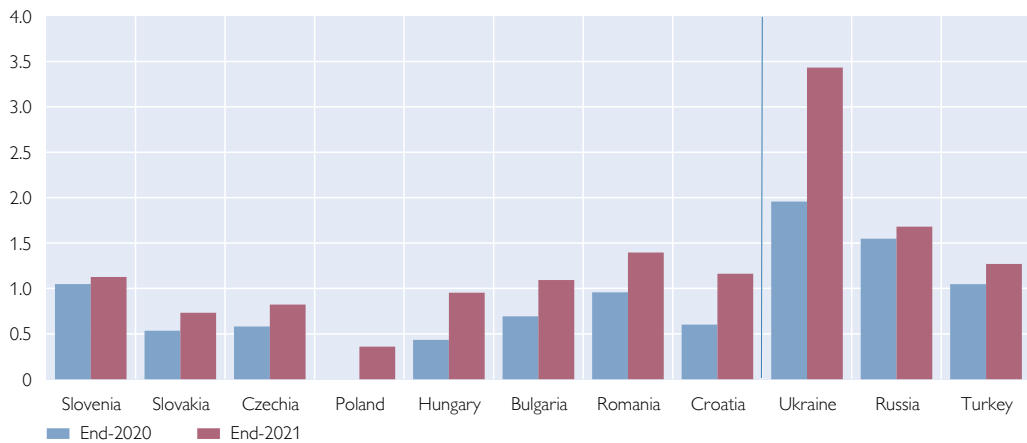
While higher demand was initially confined to certain demand segments only (e.g. to working capital needs, debt restructuring and positive housing market prospects), it notably broadened in the course of 2021. In particular, the contribution from investment needs to loan growth turned positive again after severe contractions in 2020 and early 2021. More recently, supply conditions also eased after having tightened in 2020 and early 2021. This was especially true for credit standards for households, while credit standards for companies, particularly for SMEs, remained comparatively tight. Surveys suggest that before the war in Ukraine broke out, CESEE banks were rather optimistic regarding their operations in 2022. They expected further increases in credit demand, supported by all credit segments but with a strong contribution from fixed investment. Aggregate supply conditions were expected to ease further as well, also for large corporates and SMEs.

The general resilience of the CESEE banking sector is also evidenced by its rising profitability. The average return on assets (ROA) increased from its trough averaging 0.9% at the end of 2020 to an average of 1.3% at the end of 2021 (ranging between 0.4% in Poland and 3.4% in Ukraine). This was very much in line with pre-pandemic levels. The improvement mainly reflected the release of 2020 crisis provisioning as the economic situation improved and the outlook brightened. Although net interest income remained at a comparatively low level, the downward trend has stopped. Banks reported a slight uptick in the final quarter of 2021, reflecting both higher interest rates and asset growth. Despite strong inflationary tendencies in the region, operating costs remained under control and even declined moderately in several countries.

Chart 1.8

CESEE banking sector: profitability

Return on assets (ROA) in %



Source: IMF, national central banks, OeNB.

Note: Data based on annual after-tax profits.

At the same time, capital adequacy ratios (CAR tier 1) decreased somewhat in many CESEE countries. This had to do with advances of regulatory capital which – especially in the second half of 2021 – did not keep up with growth in risk-weighted assets. Furthermore, banks resumed profit distributions after meager dividend payments in 2020. Generally, however, bank capitalization remained satisfactory especially in the CESEE EU member states with CARs hovering between 16.8% in Slovenia and 25.1% in Croatia at the end of 2021. Substantially lower figures were reported for Russia, Turkey and Ukraine (9.6%, 13.2% and 12%, respectively).

Nonperforming loan ratios (NPLs) trended down somewhat in the review period and stood below their pre-pandemic levels in all CESEE countries at the end of 2021. While this was in part related to accelerating asset growth, it is also a sign that borrowers were able to service their debt despite rising interest rates and borrowing costs in the second half of the year. The debt servicing capacity benefited from the general economic recovery (including the strong momentum prevailing on the region’s labor markets), and policy responses (such as loan moratoria, guarantees and the renegotiation of existing loan contracts) played a mitigating role as well.

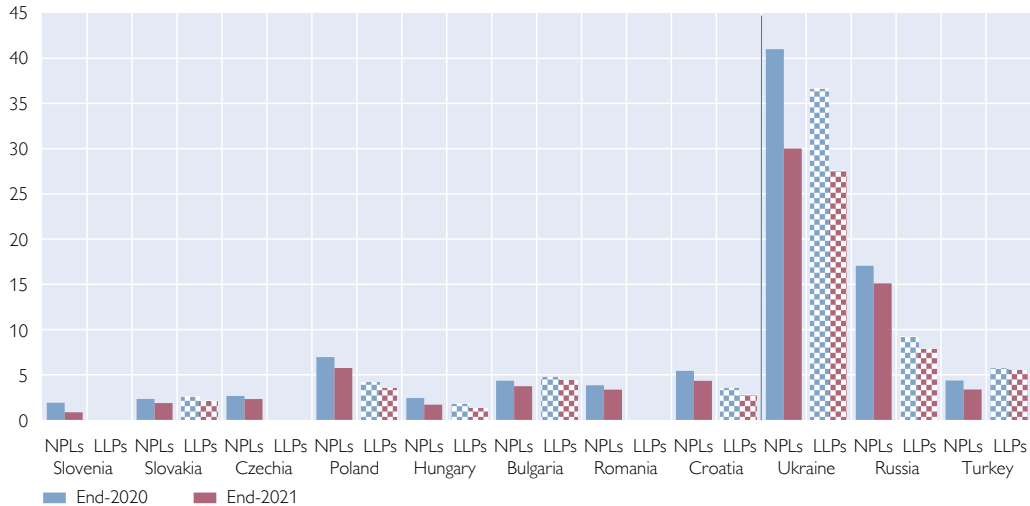
For the coming quarters, however, NPL ratios are no longer expected to decline further. This signals uncertainty as the phasing-out of COVID-19-related public support measures is still incomplete and a negative impact may come with some time lag. Loans under current moratoria decreased to very low levels by the end of 2021, but – according to EBA data – the NPL ratio for loans with expired moratoria trended upward and stood clearly above the general NPL ratio in several countries. Banks also reported an elevated Stage 2 allocation of such loans.⁸

⁸ According to IFRS 9, Stage 2 loans are loans whose credit risks have increased significantly since their initial recognition.

Chart 1.9

CESEE 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 across countries. NPLs generally refer to loans that are in arrears for more than 90 days except for Poland, Russia, Slovakia and Turkey, where NPLs refer to substandard, doubtful and loss loans.

Western punitive sanctions profoundly changed the playing field for the Russian banking sector. The most important sanctions comprise the exclusion of some Russian banks from the international payment system SWIFT, the prohibition of funding in EU/G7 financial markets for the Russian sovereign, the Russian central bank and several large Russian banks (some Western funding restrictions had already been in place before the war began) and the freezing of assets of the central bank and of some large Russian banks that had been placed in EU/G7 countries. To safeguard banking sector stability, the Russian central bank provided extensive regulatory lenience for the measurement of banks' assets and encouraged banks to grant temporary credit holidays for distressed borrowers. As deposit rates shot up in tandem with the policy rate, mass bank runs following the plunge of the Russian ruble have not materialized so far.

The Ukrainian financial system is now functioning under war conditions and martial law. Bank branches have been kept open and ATMs have been replenished as far as possible in areas not occupied by Russian forces. Customers thus have access to cash in most parts of the country. In contrast to previous crises, there have been no bank runs. This is related to limits on cash withdrawals, security risks associated with holding cash outside banks and difficulties in exchanging hryvnia abroad. Cashless payments continue to work properly. The Ukrainian foreign currency market is operating under significant restrictions. Authorized institutions are in fact prohibited from trading in currency valuables, except in a few cases. Most transactions in the interbank market, both to purchase and to sell foreign currency, are taking place with the participation of the Ukrainian central bank.

As the exposure of other CESEE banking sectors to Russia and Ukraine is generally low, the war appears to have only limited direct

first-round effects on their asset quality. According to EBA data, only Hungary reported a somewhat higher exposure to Russian and Ukrainian counterparties, which amounted to EUR 2.7 billion and EUR 2.4 billion, respectively, at the end of 2021. Indirect effects, however, cannot be ruled out given exposures via customers with commercial ties to Russia and/or Ukraine. Moreover, there are some indirect connections with Russia and Ukraine via parent banks in Western Europe. (For further information on the exposure of Austria's banking system to Russia and Ukraine, see [box 2](#).)

Second-round effects, however, may have a more notable impact. Real economic repercussions will weigh on credit demand and soaring prices will render further monetary action necessary. While higher interest rates support banks' operating income, they will also impair lending demand further. The sanctioning regime established against Russia comes with a bundle of new risks also for non-Russian banks: credit risks (e.g. clients being unable to service their loans because of payment or foreign exchange restrictions), market risks (e.g. through elevated financial market volatility), liquidity and funding risks (e.g. through payment restrictions resulting in liquidity challenges), operational risks (e.g. through new legal requirements) and reputational risks.