

International macroeconomic environment: global and European economies see sustained upswing amid growing risks

Global economic growth withstands trade tensions, oil price rise, monetary tightening and market volatility

The global economic upswing remains sustained and well synchronized despite the impact of trade tensions, with the forecast for worldwide GDP growth being revised upward to 3.9% in 2018. In the first quarter of the same year, however, a temporary dip occurred in several countries. Before, in 2017, the world economy had reported its fastest expansion since 2011 based on rising global investment and trade. Global financial conditions remained supportive, in line with still accommodative, albeit gradually tightening, monetary policies, and apart from recent equity market volatility and increases in bond yields. The announcements of intended U.S. import tariffs on certain goods as well as the rise in U.S. government bond yields led to a temporary increase in non-European emerging market bond spreads. Inflation dynamics continued to be moderate, despite rising oil prices.

The risks to the global activity outlook are broadly balanced in the short term, but skewed to the downside in the medium term, reflecting threatening trade protectionism, uncertainty about the speed of monetary policy normalization and geopolitical tensions.

In the United States economic activity is expected to grow above potential in 2018 amid sizeable procyclical fiscal expansion, notwithstanding a – probably temporary – retreat from earlier highs in the first quarter. Tax cuts on households' and corporates' income, which became effective at the beginning of this year, are likely to increase spending and investment. Whether this will translate into growth depends, among other things, on U.S. trade policies toward major trading partners. While the U.S.A. has already imposed punitive tariffs on Chinese imports, prompting retaliatory measures by the Chinese authorities, a similar trade conflict is looming with the European Union. Robust employment and wage growth is contributing to moderately increasing inflation. The Federal Reserve System has continued to tighten monetary policy by raising its key interest rate twice, in December 2017 and March 2018, and to normalize its balance sheet by no longer reinvesting all of the maturing assets it holds on its balance sheet.

In Japan economic activity contracted slightly in the first quarter of 2018 owing to weak investment and low real wage increases after a few relatively strong quarters that built on public investment and external demand. Japan's economy is expected to regain steam throughout the rest of the year before a planned sales tax hike is likely to dampen economic activity again. The Bank of Japan expects inflation to stay well below its target and therefore maintains its quantitative and qualitative monetary easing.

In China economic growth driven by investment, consumer spending and net exports exceeded the official target in 2017. Rapid growth continued in the first quarter of 2018 despite narrowing external surpluses – as growth is rebalancing toward internal sources – and a stronger exchange rate of the Chinese renminbi against the U.S. dollar. Growth is projected to soften only slightly in 2018 as tighter regulation of nonbank intermediation, which is aimed at reducing financial risks becomes effective. There is still policy space to respond to risks from trade tensions should they materialize. Lately, inflation has shown some volatility at still moderate levels.

Synchronized
expansion in the
U.S.A., Japan and
China

In the United Kingdom growth continued its slowdown and is forecast to moderate further due to feeble private consumption growth. Investment is expected to remain weak because of persisting uncertainty, and net trade is expected to decline. Inflation decreased despite a tight labor market and the recent stabilization of the pound sterling. The Bank of England has maintained its bank rate marginally above zero and kept its stock of corporate and government bond purchases.

Notwithstanding some recent weakness, the Swiss economy displayed broad-based growth and very low inflation in 2017. Whether exports will continue their recovery depends on the Swiss franc, which, however, has recently shown some volatility, re-approaching the exchange rate of CHF 1.18 against the euro. The Swiss National Bank has maintained its expansionary monetary policy with negative key interest rates, while being prepared to intervene in foreign exchange markets.

Euro area recovery becomes stronger and more broadly based

After its best performance for a decade in 2017 (2.4%), economic growth in the euro area cooled somewhat in the first quarter of 2018, mainly due to temporary factors. Nevertheless, the euro area's growth momentum continues to be solid and broadly based as employment creation supports private consumption, financial conditions and profits favor business investment, and foreign demand boosts exports even with some strengthening of the euro. The euro area fiscal stance is expected to contribute to the expansion in 2018 before turning neutral thereafter. In their latest projections, ECB staff forecast the same growth rate for 2018 as for the previous year, which is, however, expected to somewhat decelerate in the years ahead. Risks to the growth outlook are balanced between positive cyclical dynamics and negative global factors, including the threat of rising protectionism.

The output gap is considered to be positive and expected to widen over the projection horizon. Nevertheless, HICP inflation is seen to rise only in 2020, mostly driven by internal forces, reflecting further labor market recovery. So far, however, downward risks seem to have materialized despite higher-than-expected oil and food prices. Subdued underlying inflation (0.7% in April 2018) can be explained by moderate wage increases due to labor underutilization masked by buoyant employment creation. The ECB forecasts headline (HICP) inflation to even decline, from 1.5% in 2017 to 1.4% in the following two years, before rising again to reach 1.7% in 2020. Market- and survey-based long-term inflation expectations have remained broadly unchanged.

At its April 2018 meeting, the Governing Council of the ECB kept interest rates on its main refinancing operations, the marginal lending facility and the deposit facility unchanged at 0.00%, 0.25% and -0.40%, respectively. Key interest rates are expected to remain at the present levels well past the horizon of the Eurosystem's asset purchase programme (APP), which will last until the end of September 2018, or beyond, if needed. In January 2018, the monthly pace of net asset purchases was reduced from EUR 60 billion to EUR 30 billion. Furthermore, maturing securities will be reinvested as long as deemed necessary. The APP has had an easing effect on credit terms and conditions. The annual growth rate for loans to the private sector remained on a path of moderate expansion. Bank lending rates have been close to their historical lows although credit standards eased further and loan demand increased.

ECB holds firm to accommodative monetary policy stance

Since November 2017 the yields of German ten-year government bonds have further increased by some 27 basis points to 0.64% (in mid-May). The spreads of Greek, Portuguese and Spanish bonds to German benchmark yields have substantially narrowed, indicating improved confidence of financial markets toward the euro area. Less pronounced declines have been observed with regard to the spreads of Italian and French bonds. After the period of observation, however, that market confidence turned out to be fragile as risk premiums of Italian and Spanish bonds surged temporarily due to political instability. Meanwhile the spreads between 10-year U.S. Treasuries and German Bunds have come close to their 30-year high. During the same period, the exchange rate of the euro in nominal terms appreciated by some 2.3% to roughly USD 1.19 per EUR, while losing 1.4% against the Japanese yen. In general, volatility in foreign exchange markets remained subdued. In contrast, international stock exchanges went through turbulences in February and March 2018. By mid-May the representative stock index DJ Euro Stoxx had gained almost 2% since the beginning of the year – benefiting from falling long-term yields –, while the Dow Jones Industrial Index and the FTSE 100 had hardly improved at all, albeit being close to all-time highs. Brent crude oil prices rose by more than 17% in the course of the first four-and-a-half months of 2018 to above USD 78 per barrel – amid growing demand and intensifying geopolitical tensions.

CESEE: fastest economic expansion in years amid broadly sound banking sector developments

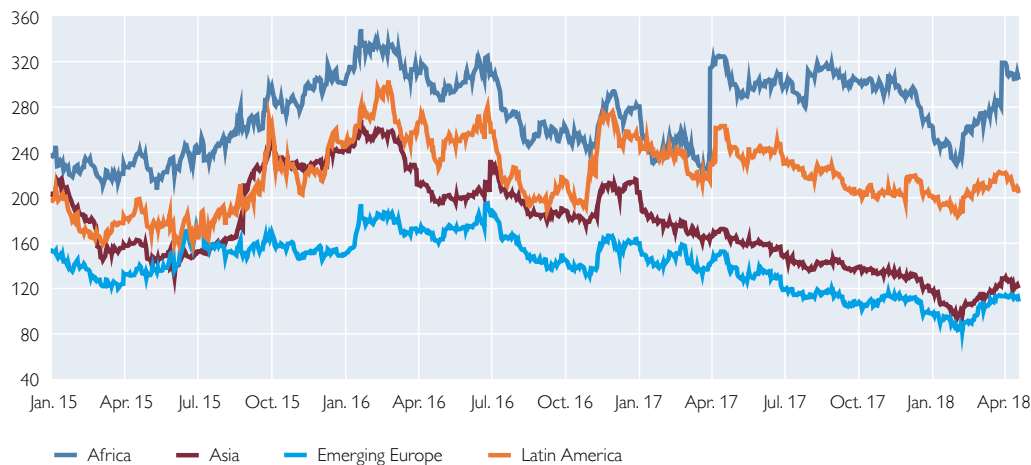
The synchronized upswing of the big engines of the global economy – the U.S.A, China and the euro area – provided a favorable external environment for the CESEE region. Based on rising global investment and trade, the world economy reported its fastest expansion in 2017 since 2011. Within the euro area, growth was again vivid in Germany, the central anchor for many of the CESEE economies. Via their integration into global value chains, CESEE countries benefited not only

International environment remains supportive for CESEE region

Chart 1.1

Spreads of euro-denominated sovereign bonds issued in selected emerging market regions

Euro EMBIG spread in basis points



Source: Macrobond.

Note: EMBIG = Emerging Markets Bond Index Global.

directly from strong international demand for final goods but also from increasing demand for intermediate goods.

International financial conditions remained broadly supportive as well, despite the turbulences occurring in February and March 2018 following the announcement of U.S. import tariffs on certain goods. These events led to a temporary increase in emerging market bond spreads. However, spreads of euro-denominated sovereign bonds for European emerging markets remained at multi-annual lows, and notably below those for other emerging market regions.

Growth reaches highest level in years

Against this background, economic conditions in CESEE remained favorable in the second half of 2017, and the region experienced one of the strongest economic upswings since 2008. This was especially true for the CESEE EU Member States, where the economic momentum was strong and broadly based, leading to an average growth rate of 4.7% in 2017. Positive contributions from private consumption were increasingly supplemented by strengthening investments. Domestic demand stayed strong given dynamic private consumption growth based on good sentiment, higher wages, private sector deleveraging and tightening labor markets. Firms are approaching the limits of their production capacity and were increasingly prepared to spend on extending their capital formation given favorable financing conditions. Public investment and construction continued to be supported by inflows of EU funds.

Outside the EU, extraordinarily high growth rates were reported for Turkey, reflecting a combination of government stimulus and exceptionally strong external demand. Growth was less swift in Russia and Ukraine. Russia continued its recovery from recession. At 1.5% in 2017, economic dynamics remained moderate by regional standards, however, reflecting structural weaknesses and a low growth potential. Ukraine reported a growth rate of 2.5% in 2017 as private consumption and fixed investment continued to recover from a low base.

The generally favorable picture was blurred mainly by political risks that might affect the region's economies in the short to medium term. Several events are keeping relations tense between Russia and the West. The most recent U.S. sanctions against Russia (comprising extensive transaction bans on 24 Russian businessmen and 15 companies), for example, have already had a strong impact on the Russian ruble, temporarily pushing down its external value by about 10%. Furthermore, an escalating trade conflict between the U.S. and the EU would disproportionately affect the highly open CESEE region. Ongoing disputes with the European Commission and European partners could impact the CESEE EU Member States' standing in the upcoming negotiations for the 2021–2027 EU budget. Those negotiations will be dominated by Brexit, and the size and composition of the EU budget will possibly be altered. Moreover, EU funds could be made conditional on adherence to the rule of law and common European values. Finally, employment growth, record low unemployment and emigration to Western Europe laid bare labor shortages especially in Central European economies, which could start weighing on economic growth. The missing workforce has already become a major issue for companies across the region and surveys find companies struggling to find workers as labor shortages expand from manufacturing to labor-intensive sectors such as construction and services.

Inflationary pressure moderate in most CESEE EU Member States

Strong economic growth, tightening labor markets, swiftly rising wages and generally strong domestic economic momentum in the CESEE EU Member States

were not reflected in rising inflationary pressure in the review period. After a trough in mid-2016, inflation accelerated slowly in late 2016 and early 2017. In the second half of 2017, however, inflation stabilized at around 2% throughout most of the CESEE region. In fact, price pressures moderated in several countries in early 2018.

A notable increase in inflation was reported for Romania only, where strong demand pressure, higher administered prices and a base effect after adjustments to indirect taxes in 2017 lifted price growth to 4% in March 2018. Accordingly, the Romanian central bank (NBR) increased its policy rate from 1.75% to 2.25% in January and February 2018, after having repeatedly adjusted the rates on its deposit and lending facility in late 2017 and early 2018. The NBR expects inflation to pick up further in the short term before returning to the upper bound of the variation band around its inflation target toward the end of this year.

Despite some moderation in inflation, the Czech central bank (CNB) continued its rate hikes that had started in August 2017 by lifting its policy rate to 0.75% in November 2017 and February 2018. The CNB projects inflation to be above target for the rest of 2018 and to return to target at the beginning of 2019.

The Hungarian central bank (MNB) expects inflation to remain below its target at least until mid-2019. Against this background, the MNB continued to further selectively loosen its monetary policy by reducing the cap on its three-month deposit facility, by extending its foreign currency swap facility in order to boost forint liquidity in the system and by introducing two new tools to its monetary policy tool kit (interest rate swaps to banks and regular purchases of mortgage bonds with at least three-year maturity).

In the non-EU CESEE countries, inflation accelerated in Turkey and Ukraine. A large depreciation of the Turkish lira and a positive output gap pushed price growth in Turkey to above 10% throughout the review period, thus well above the year-end inflation target of 5%. The Turkish central bank (CBRT) kept its policy rate at 8%. However, it lifted the rate on its late liquidity window in two steps (in December 2017 and April 2018) from 12.25% to 13.5%, thus increasing the effective cost of bank funding. In addition, with the aim of curbing depreciation pressures, the CBRT introduced several instruments aimed at providing foreign exchange liquidity to the banking and corporate sector as of January 2017.

In Ukraine, rising production costs and global oil prices, a weak harvest and utility tariff hikes pushed up annual CPI inflation to 16.4% in September 2017, which prompted the central bank of Ukraine (NBU) to interrupt and partly reverse its series of key policy rate cuts over the last one-and-a-half years. Therefore, the NBU sharply increased the key rate in four steps (in October and December 2017, in January and March 2018) by a cumulative 450 basis points to 17%. Inflation still stood at 14.0% at end-February 2018 (despite a marked slowdown of the Ukrainian hryvnia's nominal depreciation in 2017), which is substantially above the NBU's target of 6% \pm 2 percentage points for end-2018. The monetary authority expects inflation to slow down and return to target in mid-2019.

In Russia, the sluggish economic recovery and the oil price-related appreciation of the Russian ruble (by 13% against the euro in 2017) drove inflation down to 2.2% in February 2018. This is a historically low level and notably below the inflation target of the Russian central bank (CBR). Accordingly, the CBR continued to cautiously cut its key policy rate in the six months to end-March 2018 by a cumulative 125 basis points to 7.25%.

Strong price
increases in Turkey
and Ukraine

Solid credit expansion amid strong demand and some easing in supply conditions

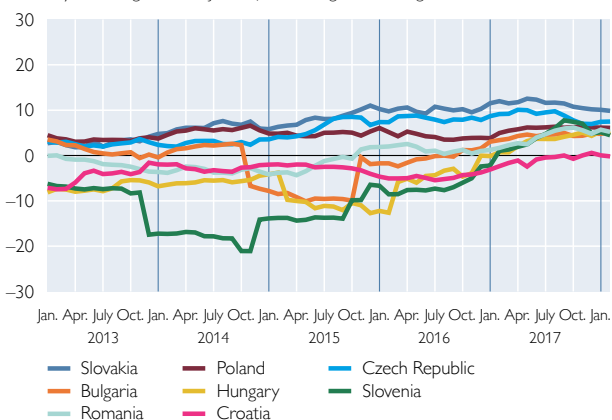
Growth of domestic credit to the private sector (nominal lending to the nonbank private sector adjusted for exchange rate changes) was solid in the review period. Most CESEE EU Member States reported credit growth rates of around 5% year on year, reflecting favorable general economic conditions in an environment of low interest rates, heightened competition among banks and monetary accommodation in the euro area. Furthermore, rising real estate prices went hand in hand with a substantial increase in housing loans. House prices rose by some 7% year on year in the second half of 2017 on average, showing especially strong increases in the Czech Republic (above 10%).

Lending surveys indicate continued strength in demand for credit. Notably, investment accounted for a good part of the strengthening in demand, while debt restructuring was almost irrelevant. At the same time, aggregate supply conditions eased for the first time in two years. Across the customer spectrum, credit standards eased especially on SME lending and consumer credit, while they tightened on mortgages. However, the gap between credit demand and credit supply that had been perceived for several quarters still persists. This suggests that most new credit may be considered to be of a better quality on average than in previous credit cycles.

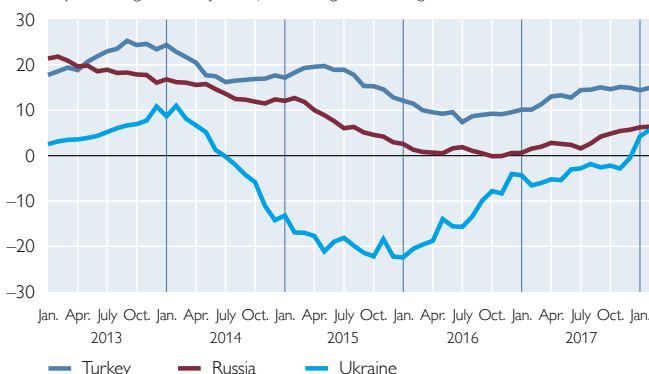
Chart 1.2

CESEE: growth of credit to the private sector

Year-on-year change in %, adjusted for exchange rate changes



Year-on-year change in %, adjusted for exchange rate changes



Source: ECB, national central banks.

Czech Republic and Slovakia further raise countercyclical capital buffer

In the Czech Republic and Slovakia, credit growth declined somewhat from its peaks in mid-2017 but continued to stand at the highest level among all CESEE EU Member States. In Slovakia, especially growth of credit to households remained above a notable 10% throughout the review period. Both countries introduced countercyclical capital buffers of 0.5% of total risk exposures in 2017. The Czech Republic announced that it would raise buffers further to 1% and 1.25% in July 2018 and January 2019, respectively. Slovakia will increase its countercyclical capital buffer to 1% by August 2018. Furthermore, both countries introduced measures to put a brake on the expansion of housing loans. The Slovak central bank (NBS) decreed that new borrowers have to be assessed for their ability to repay a loan in the event of an increase in interest rates and is considering further

measures to contain household credit growth. The CNB introduced loan-to-value ratios for housing loans as an additional macroprudential measure.

Outside the EU, credit growth was swiftest in Turkey, where accommodative macroprudential policies and loans backed by Turkey's Credit Guarantee Fund kept credit growth at around 15%. Improving dynamics on the credit market were observed in Ukraine, where credit growth increased from negative levels throughout most of 2017 to above 5% in February 2018 as consumer lending rose sharply and corporate lending started to recover.

Some acceleration in credit dynamics was also reported for Russia, despite some trouble in the country's banking sector. In the second half of 2017, the CBR nationalized three medium-sized privately owned credit institutions – Otkrytie, B&N and Promsvyazbank. All three players (together accounting for about 7% to 8% of banking assets) had expanded aggressively in recent years, suffered from bad loans and become subject to bank runs. Their nationalization has lifted the share of state-owned banks to around 70% of total sector assets and delayed the overall improvement of credit quality, profitability and capital adequacy in the Russian banking sector. The ongoing consolidation in Russia and two other larger one-off transactions in Poland (UniCredit) and in Ukraine (Privatbank) have boosted both, local and state ownership in CESEE banking sectors during the past years. Today, the share of foreign ownership in the CESEE EU Member States is some 10 percentage points below its level of 2008.

Recovery of credit growth in Russia despite trouble in the banking sector

Almost all CESEE countries made progress in shoring up their banking sectors in recent years and continued doing so in the review period. For example, credit risk was reduced further. Nonperforming loans (NPLs) decreased in all CESEE EU Member States when compared to a year earlier. In several countries, NPL ratios reached their lowest levels since 2009. This positive momentum was attributable to favorable lending developments as well as to the strong general economic momentum. Furthermore, active portfolio cleansing measures – including writing off bad debt, selling NPL portfolios as well as restructuring and forbearance agreements and the transfer of NPLs to bad banks – also positively impacted the stock of nonperforming assets.

NPLs continue their downward trend

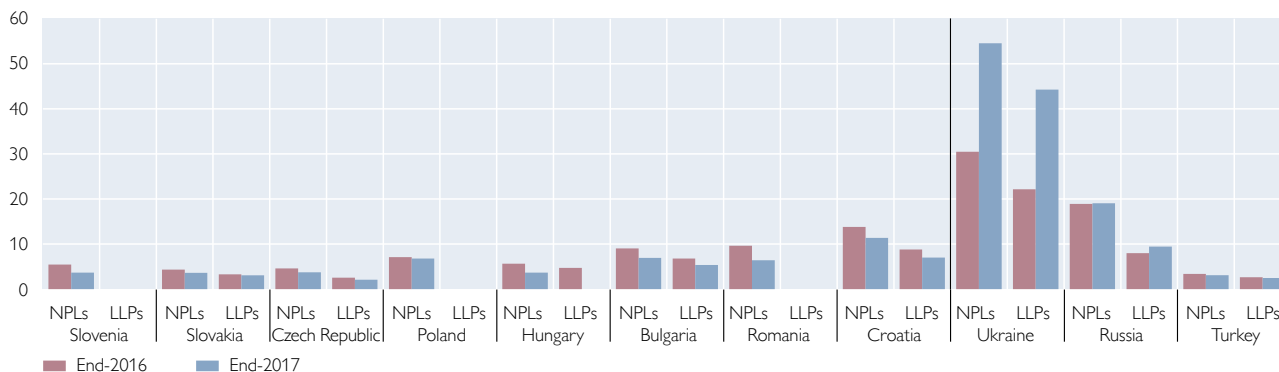
While NPLs in Russia and Turkey remained virtually unchanged, bad assets shot up in Ukraine. This can be explained by a change in the methodology for collecting NPLs. The new framework captures loans that are more than 90 days past due as well as loans with a low probability of repayment. Intra-annual trends are more promising, though: The share of NPLs in total loans declined from a record level of 57.7% at mid-2017 to 54.5% at the end of the year against the background of a gradual increase in new lending. However, the NBU found a high probability that most of the current stock of NPLs will not be serviced properly again and prompted banks to step up their efforts to clean up balance sheets by selling or writing off NPLs.

The reduction of NPL ratios in many CESEE countries was accompanied by a further decrease in foreign currency-denominated credit. This is especially true for households in the Czech Republic, Hungary, Russia and Slovakia, whose share of foreign currency-denominated credit in total credit is already close to zero. In the other countries, the average share declined by around 3 percentage points to a level of 27% since mid-2017.

Chart 1.3

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 the Czech Republic, Poland, Russia, Slovakia and Turkey, where NPLs refer to substandard, doubtful and loss loans.

Credit fully funded by local deposits in most countries

The refinancing structure of CESEE banking sectors has increasingly shifted toward domestic deposits over the past few years and continued doing so in the review period. This is especially true for the CESEE EU Member States that had no substantial gap or a negative gap between total outstanding domestic claims and total domestic deposits relative to GDP as at end-2017. However, it has to be noted that this trend has come to a halt in Slovakia, where the gap widened in the review period (from -0.8% of GDP at the end of 2016 to 1.5% of GDP at the end of 2017) against the background of strongly expanding claims amid a broadly stable depositary base.

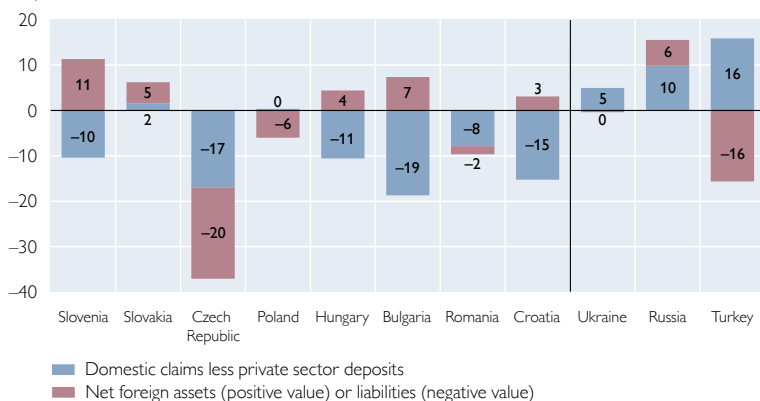
Profitability largely unchanged

Compared to the CESEE EU Member States, Russia, Turkey and Ukraine exhibited positive and large funding gaps of between 5% and 16% of GDP. While the gap narrowed in Ukraine (by 4.6% of GDP within a year) against the backdrop of negative credit growth especially in the first half of 2017, it widened somewhat in Turkey as deposits trended down.

Chart 1.4

CESEE banking sector: gap between claims and deposits, and net external position

% of GDP at end-2017



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

The banking sectors of four of the eleven CESEE countries under observation reported net external liabilities by the end of 2017. Liabilities were especially high in the Czech Republic, where they shot up in anticipation of the abolition of the exchange rate floor of the Czech koruna against the euro in the first quarter of 2017. In Turkey, external liabilities remained broadly unchanged compared to a year earlier but stayed at a high level.

Average banking sector profitability in the CESEE EU Member States stood at 1.1% (return on assets; ROA) in 2017,

which is broadly comparable to the figures of the previous year (2016: 1.2%). Throughout the region, both operating income and operating expenses declined moderately. Provisioning needs also trended lower in most countries against the backdrop of improving asset quality. The latter translated into a notable increase in profits in Hungary and a more moderate increase in Romania and Slovenia. Bulgaria, the Czech Republic and Slovakia reported some decline in profits. A stronger decrease in the ROA, however, was only reported for Croatia against the backdrop of the banking sector's provisioning for its exposure to Agrokor, the country's ailing retailer.

The Ukrainian banking sector recovered from its record losses in 2016 after the nationalization of Privatbank in December of that year. In fact, operating profits increased thanks to lower funding costs and higher commission income. Provisioning also decreased substantially. However, provisioning for the whole year remained at a level high enough to drive aggregate banking sector profitability into the reds. In Turkey, the profitability of the banking sector reached one of the highest levels in the past four years, mainly due to strong net interest income, improvements in asset quality and a relative decrease in noninterest expenses.

Chart 1.5

CESEE banking sector: profitability



Source: IMF, national central banks, OeNB.

Note: Data are not comparable across countries. They are based on annual after-tax profits, except for Russia's data, which are based on pretax profits.

Capital adequacy ratios (CARs) remained high and increased further in several CESEE EU Member States. At the end of 2017, CARs ranged between 18.6% in Slovakia and 23.2% in Croatia. In the other countries of the region, capitalization was markedly lower (between 12.1% in Russia and 16.5% in Turkey). However, it improved in Turkey (on the back of profitability growth and subordinated debt acquisitions) and in Ukraine (on the back of the capitalization of state-owned banks).

Most CESEE banking sectors remain well capitalized