

International Macroeconomic Environment: Broadly Stable Macroeconomic Development despite Market Turbulences

Advanced Economies: Signs of Moderate Recovery

Global economic activity remained subdued in the review period from June 2013 to October 2013, but the IMF's World Economic Outlook expects further acceleration toward 2014. Economic indicators point toward stronger growth in the United States, and the euro area shows continued signs of recovery as well.

In the U.S.A., year-on-year GDP growth accelerated from 1.3% in the first quarter of 2013 to 1.6% in the second quarter. Driven by the recovery of the real estate sector, an increase in household wealth, the easing of bank lending conditions and a rise in borrowing, private domestic demand remained the main engine of growth while public consumption expenditure, in particular expenditure for national defense, continued to fall. The uncertainty regarding the future path of fiscal policy is a clear downward risk for the 2014 outlook. The Federal Reserve Board's decision of September 2013 not to scale down its asset purchase program calmed the discussion about a possible tapering of its third round of quantitative easing. As the U.S. unemployment rate fell below 7.5% in the review period, markets continue to expect a decrease in asset purchases in the near future. However, the substantial rise in long-term U.S. interest rates for both mortgages and government bonds has slowed down somewhat recently.

Global uncertainty about the U.S. approach to quantitative easing has led to a sharp repricing of emerging market assets since May. In Brazil, India, Indonesia and South Africa, national currencies and bond markets came

under intense downward pressure as current account deficits persist, inflation remains elevated and monetary policy room seems limited in the face of decelerating growth rates. Although the IMF's Global Financial Stability Report assumes the situation to stabilize, several emerging market economies remain highly vulnerable to sudden outflows. For 2013, the growth rate of the aggregate of emerging market and developing economies is expected to be 3 percentage points lower than in 2010, while that of advanced economies is expected to be about 2 percentage points lower. A detailed discussion concerning CESEE economies is provided in the next section.

The Swiss National Bank (SNB) has remained committed to its exchange rate ceiling of CHF 1.20 per euro. Although the upward pressure on the Swiss franc was muted in the review period, the SNB is not considering an abolition of the ceiling yet.

In the euro area, quarterly GDP growth was positive at 0.1% in the third quarter of 2013, marking the second consecutive increase in economic activity after six quarters of decline, while the corresponding year-on-year growth rate was still negative at -0.4%. For the full year of 2013, the IMF expects GDP to contract by 0.4%, implying a slight improvement against the July update. While private sector deleveraging, tight lending conditions and uncertainty among businesses and investors remain a drag on growth, the slower pace of fiscal tightening should help stabilize actual demand, especially in 2014. Growth expectations for 2013 and 2014 remain quite heterogeneous across countries: Whereas Spain and

Intensified global discussion about possible future monetary tightening in the U.S.A.

Steps toward banking union support euro area recovery

Italy as well as some smaller countries (Greece, Cyprus, the Netherlands, Portugal and Slovenia) will face recessions, economic growth is expected to be relatively strong in Germany and slightly positive in France. Unemployment rates have stabilized in most euro area countries, while inflation has slowed down considerably, mostly reflecting negative base effects in the energy and food components of the HICP.

During the review period, financial stability improved throughout most of the euro area – a fact that was reflected, inter alia, in slightly lower sovereign risk spreads in stressed economies. The Cypriot authorities have taken decisive steps to stabilize the financial sector, meet the fiscal targets and implement structural reforms, although further challenges lie ahead. Financial assistance programs for individual countries are on track, according to the recent program reviews, with Ireland possibly completing its program by the end of 2013.

The Governing Council of the ECB cut the ECB's key interest rates by 25 basis points in early November 2013, bringing the interest rate on main refinancing operations to a historical low of 0.25%. To anchor market expectations even better, the Governing Council had already announced at its meeting in July that policy rates will remain at low levels for an extended period of time in line with the subdued medium-term outlook for inflation, monetary dynamics and the real economy. Despite significant improvements, the transmission of monetary policy remains impaired for some countries and some economic sectors. Better funding conditions allowed banks in the euro area to repay around EUR 360 billion of outstanding longer-term central bank liquidity since late January 2013, which is around 35% of the original amount of slightly more

than EUR 1,000 billion. So far, the reduction in excess liquidity has not driven money market rates upward.

Recent progress toward a full banking union has reinforced the euro area's collective commitment to the euro. Box 3 below provides an update on the implementation of the single supervisory mechanism (SSM), the upcoming asset quality review (AQR) and the submitted proposals for a single resolution mechanism (SRM).

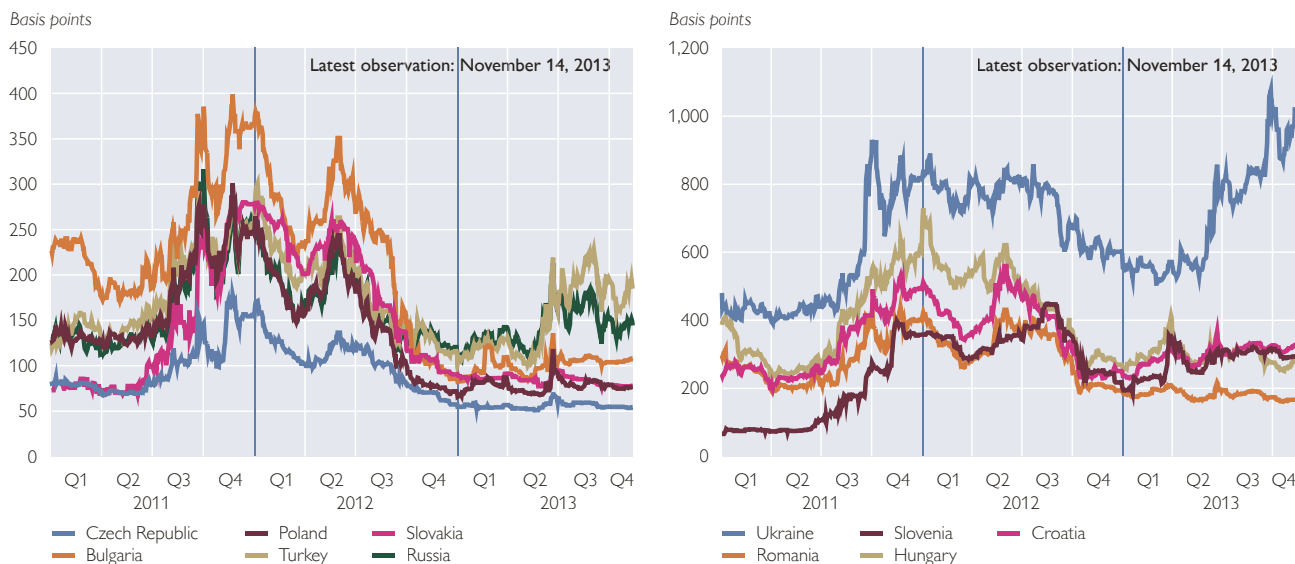
CESEE: Credit Dynamics Often Muted despite Relatively Little Impact of Financial Market Turmoil

CESEE financial markets have generally been less affected than other regions by the broader emerging market sell-off that followed the Fed's communication on the future of its asset purchase program in May. The risk assessment for the region deteriorated somewhat in June. For most countries, however, this was a temporary phenomenon and CDS premiums and eurobond spreads remained close to the levels observed in early 2013 throughout most of the review period (see chart 1). The impact was felt more strongly and more persistently only in those markets that received more substantial capital inflows in recent years and/or in countries with more pronounced economic imbalances. This is especially true for Russia, Turkey and Ukraine (with the deterioration of the risk assessment for Turkey coinciding with domestic political unrest). For Russia and Turkey, however, financial market sentiment improved in September, when it became clear that the Fed would not scale back its bond buying program as early as previously expected. Only Ukraine saw a further rating downgrade, which reflected weak economic fundamentals including a high current account deficit, declining

Comparatively little impact of international financial market turmoil on CESEE

Chart 1

Five-Year Credit Default Swap Premiums



Source: Thomson Reuters.

foreign currency reserves and deteriorating international competitiveness.

CESEE equity markets developed in a broadly stable manner between mid-May and mid-November. More remarkable increases of equity prices were reported for Poland (by around 20%) and Romania (by around 13%), while a strong decrease of equity prices was observed only in Turkey (by around 35%). The sell-off in Turkish equity markets started with the Taksim protests in late May. After another episode of pronounced stock market losses in mid-August, markets recovered somewhat in September. It needs to be noted, however, that Turkish equities are still trading around 50% above their low of late 2011.

Short-term interbank rates continued to be low in most of CESEE. Since May 2013 they have declined more markedly in Hungary, Poland and Romania. This development was related to policy

rate cuts, room for which was provided by abating price pressures and a weak economic momentum. In Turkey, however, money market rates increased more notably. Elevated uncertainties regarding global monetary policies caused fluctuations in financial markets, which prompted the Turkish central bank (CBRT) to raise its interest rates (see below) and to tighten its liquidity policy by changing the composition of liquidity injected into the market.

Most of the currencies of the countries under review that have not yet adopted the euro or do not follow a fixed currency peg regime traded at a broadly stable rate against their reference currency from mid-May to mid-November.¹ Some more pronounced exchange rate swings were once again only observed in Russia and Turkey, as these countries were more exposed to international investors' risk reassessment of emerging markets.

Exchange rate pressure has become more pronounced only in a few countries

¹ With the exception of Russia (basket of currencies consisting of U.S. dollar and euro at a ratio of 55% to 45%), Turkey (U.S. dollar) and Ukraine, the reference currency of these countries is the euro.

The Turkish lira depreciated by some 9% against the U.S. dollar from mid-May to mid-October 2013 and was traded at record lows in early September. In stabilizing the currency and fighting capital outflows, the CBRT was reluctant to raise interest rates and relied mainly on direct interventions and liquidity instruments. This policy showed some initial success but proved not to be sufficient in stopping depreciation pressures. Eventually, the lending rate (i.e. the upper band of its interest rate corridor) was raised in two steps from 6.5% in June to 7.75% in August, not yet offsetting previous rate reductions of early 2013, while the one-week repo and borrowing rates have been held constant at 4.5% and 3.5%, respectively.

In Russia, depreciation was less pronounced than in Turkey. The Russian ruble, however, still lost some 5% against its currency basket. As of October 7, 2013, the Russian central bank (CBR) widened the range of the currency baskets' floating operational band (within which it does not conduct interventions) from RUB 1 to RUB 3.1, after the band had been adjusted upward several times over the previous months.

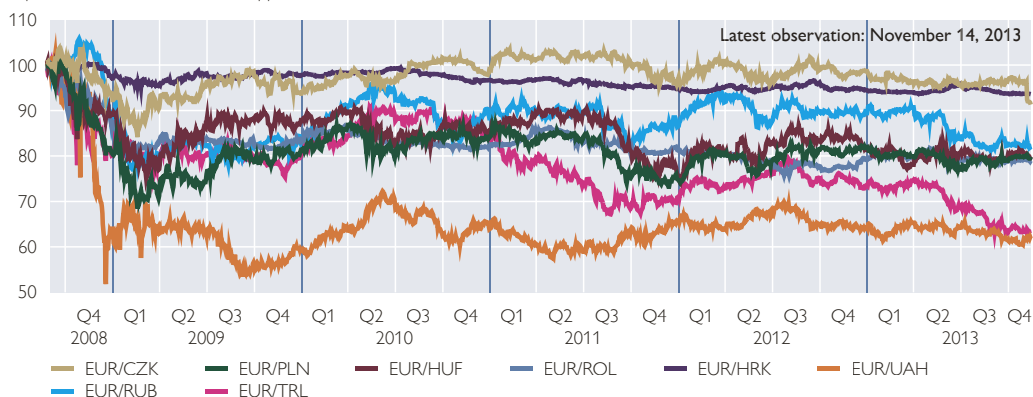
This change was implemented in order to further increase the flexibility of the ruble's exchange rate and to proceed with the gradual transition to a floating exchange rate regime by 2015.

In line with a deteriorating risk assessment, the Ukraine's de facto peg against the U.S. dollar also came under some pressure in September. The Ukrainian central bank resumed direct currency intervention by selling around USD 580 million. It was the first time since April 2013 that Ukraine had intervened in the foreign exchange market to support the country's currency. At the same time and despite the hike in foreign currency demand, depreciation expectations seem to have remained subdued, which is confirmed by abundant liquidity in the local banking system and a continuing shift of retail deposits into the Ukrainian hryvnia. Foreign currency reserves have been declining since May, given redemptions of eurobonds and repayments of IMF funds, and stood at USD 21.64 billion at the end of October 2013 (covering less than three import months). The country is set to repay USD 1.85 billion to its overseas creditors by the end of 2013.

Chart 2

Exchange Rates of Selected Currencies against the Euro

September 1, 2008 = 100; rise = appreciation



Source: Thomson Reuters.

Credit dynamics were only moderate during the review period. Most countries under observation reported low or even negative credit growth rates. This is especially true for Croatia, Hungary and Slovenia and, to a somewhat lesser extent, also for Bulgaria and Romania.

This development can in part be explained by the weak economic momentum in these countries. Unlike in many other countries of the region, Bulgaria, Croatia and Slovenia remained in recession or stagnation also in the second quarter of 2013, and (quarter-on-quarter) growth in Hungary decelerated markedly from the comparatively good first quarter to the second quarter. Only Romania managed a turnaround, reporting positive GDP growth rates in the first half of 2013.

This development, however, was in part also related to domestic banking sector problems in some countries. In Slovenia a high stock of nonperforming loans (NPLs) is weighing on bank profitability and credit expansion, and banking sector capitalization is low by

regional comparison. In an effort to stabilize its banking system, the country is currently working on a transfer of bad assets from its three biggest, systemically important state-owned banks to a bank asset management company. This transfer is set to be accompanied by capital injections into the respective banks to strengthen their capital base. The budgetary costs of these injections are estimated at a minimum of EUR 1.3 billion, or 3.7% of GDP. In Hungary, the banking system is impaired by various government measures to reduce households' outstanding foreign currency debt as well as by very high sectoral taxes on banks. In order to ease access to credit for SMEs, the Magyar Nemzeti Bank (MNB) started a Funding for Growth Scheme in June 2013. Under this scheme, the MNB provides banks with long-term refinancing at an interest rate of 0%; banks can then lend on these funds to SMEs (with a maximum all-in margin of 2.5%) either for the financing of investment and working capital or the conversion of

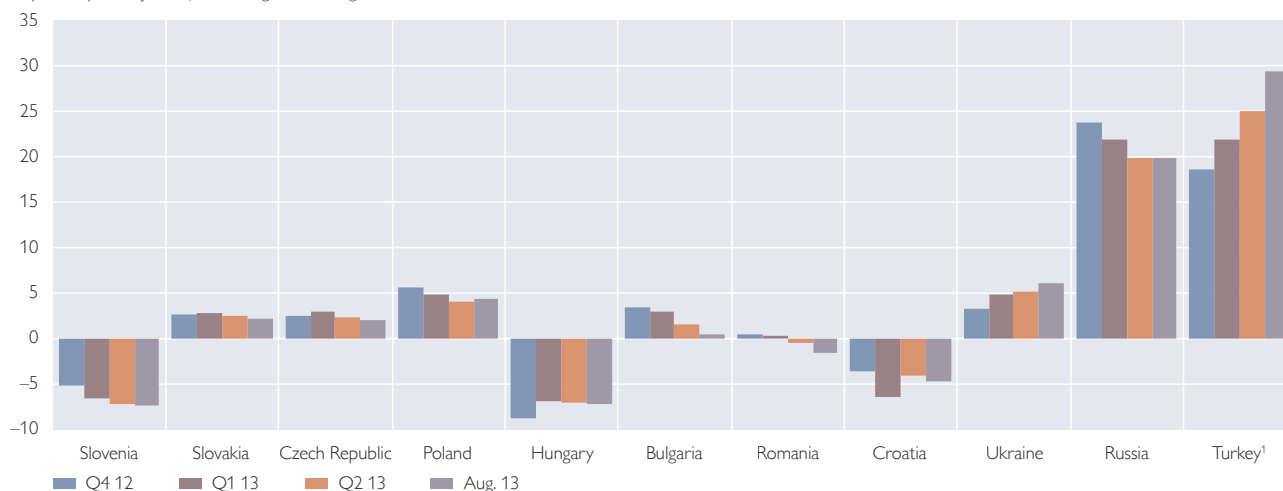
Credit dynamics remained muted in many CESEE countries...

... which was partly related to problems in their domestic banking sectors

Chart 3

Growth of Credit to the Private Sector

%, year on year, adjusted for exchange rate changes



Source: National central banks.

¹ Nonadjusted.

foreign currency loans into Hungarian forint-denominated loans (the MNB also provides the necessary foreign currency for such conversions). As for households, on top of measures already taken, the Hungarian government in November 2013 proposed to expand its existing exchange rate cap scheme in support of foreign currency mortgage holders to borrowers who are more than 90 days behind on their payments or owe more than HUF 20 million (EUR 67,000).

The general weakness of credit expansion is also mirrored in lower consolidated bank exposures of BIS-reporting banks (adjusted for exchange rate changes). More specifically, exposures vis-à-vis Hungary, Romania, Slovenia and Ukraine had been declining for several quarters and continued doing so in the first half of 2013. Bulgaria also reported outflows in the final quarter of 2012 and the first half of 2013.

For the region as a whole, however, consolidated banking exposures of BIS-reporting banks went up in the first half of 2013 against end-2012. The highest increases relative to outstanding stocks were observed in Russia and Turkey, but the Czech Republic, Poland and Slovakia also reported notable rises. Furthermore, surveys like the Emerging Markets Bank Lending Conditions Survey of the Institute of International Finance show that lending conditions in Emerging Europe eased in the first half of 2013. This improvement was driven by an easing of credit standards for most credit categories, growing loan demand (for consumer, housing and particularly business loans, as manufacturing activity and consumption stayed relatively stable) as

well as easing domestic funding conditions. International funding conditions, however, tightened toward the end of the second quarter of 2013 (for the first time since the third quarter of 2012) as expectations about a tapering of asset purchases by the Federal Reserve drove up financial market volatility. As mentioned above, however, this development had a notable impact only on a few CESEE countries.

Against this background and also given an incipient economic recovery, credit stocks increased moderately in the Czech Republic and Slovakia, more substantially in Poland and Ukraine and strongly in Russia and Turkey.

In Turkey, the growth of credit to the private sector gained pace in late 2012 and continued to remain clearly above the central banks' indicative reference value of 15% in August 2013. Waning capital inflows coupled with stricter liquidity conditions did not bring about a notable tightening of credit supply in the second quarter of 2013. Loan demand continued to be robust given that Turkey's was the strongest growth performance in the region. Demand was further fueled by low interest rates and a growing perception that the CBRT's policy rate-cutting cycle has come to an end.

In Russia, credit growth was driven especially by lending to households. This development has to be assessed against the background of strong consumption dynamics fueled in part by rapid increases in wages and pensions. The CBR reacted to the (partly unsecured) consumer credit boom by moral suasion and by passing some prudential measures in late 2012 and early 2013.²

While the share of foreign currency loans in total loans to households declined

Easing lending conditions contributed to more notable credit growth in some countries, however

² For further information concerning credit developments in Russia, see Barisitz, S. 2013. *Credit Boom in Russia despite Global Woes – Driving Forces and Risks*, in this issue of the FSR.

somewhat in most CESEE countries, and most strongly so in Ukraine (by 4.3 percentage points to 39.9% between end-2012 and mid-2013), it remained at high levels in Croatia, Hungary and Romania (between 55% and 76.5% in July 2013).

Credit quality continued to deteriorate in roughly half of the CESEE countries. This trend was most pronounced in Hungary, Romania and Slovenia, where NPL ratios were more than 3 percentage points higher in mid-2013 than in mid-2012. NPLs also increased noticeably in Croatia and Ukraine, which has to be seen in the context of continuing weak economic conditions as well as low credit dynamics and an impaired credit servicing capacity of the private sector. In some other CESEE countries, however, the quality of the credit portfolio remained stable (Czech Republic, Poland, Slovakia, Turkey) or even improved somewhat (Russia). Nevertheless, NPL ratios remained clearly elevated by historical comparison in all countries of the region but Turkey.

With the exception of the Czech Republic and Slovakia, total outstanding

domestic claims continued to exceed total domestic deposits (relative to GDP) in all CESEE countries in mid-2013. Everywhere but in Turkey, however, this funding gap has been narrowing substantially since late 2011. In Turkey, an overhang of deposits over claims turned into a funding gap of close to 9% of GDP in the second quarter of 2013 as deposit growth could not keep pace with vivid credit expansion. Among the other countries of the CESEE region, the funding gap narrowed most pronouncedly in Hungary, Romania, Slovenia and Ukraine (by about some 5 percentage points of GDP between mid-2012 and mid-2013). While in Ukraine deposits grew more strongly than claims, the narrowing of the funding gap was driven by a reduction in claims in the other CESEE countries.

The development of funding gaps outlined above is broadly reflected in banks' net external positions. Countries that reported a narrowing funding gap reduced their reliance on external funding, while countries with larger funding gaps (e.g. Turkey) increasingly turned to international sources to finance

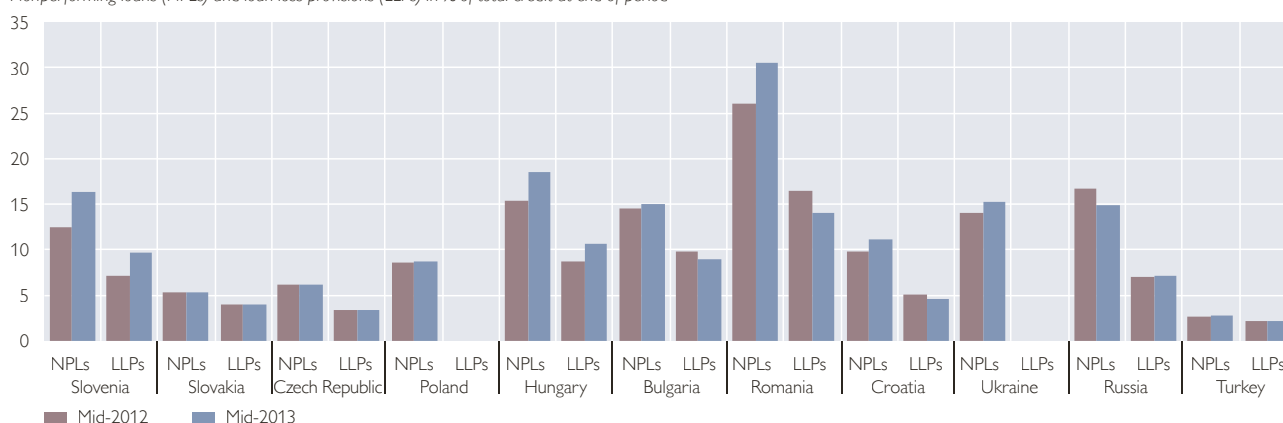
Credit quality continues to be weak

Loan-to-deposit ratio has gone down

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 loans (except for Romania and Ukraine), doubtful and loss loans.

Profits continue to be subdued...

credit expansion. The banking sector continued to hold net external liabilities in most countries, in Croatia, Hungary,

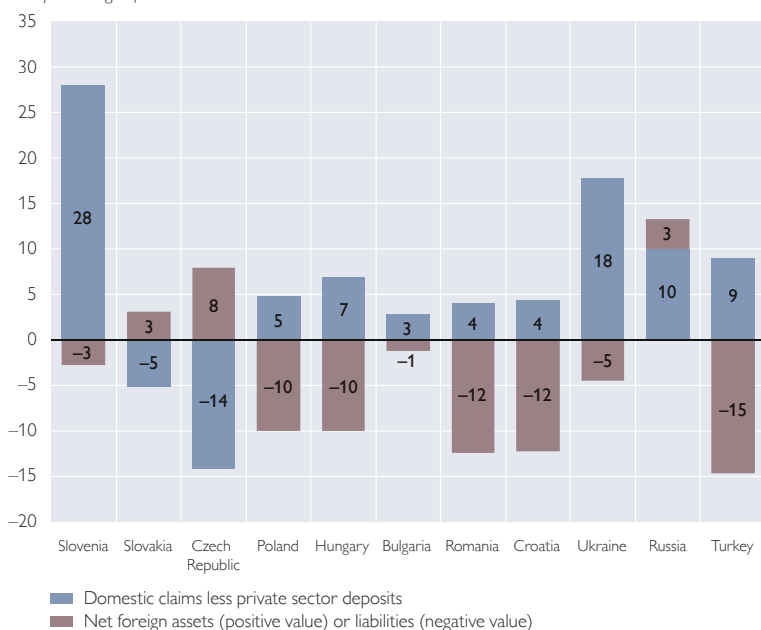
Poland, Romania and Turkey at a comparatively high level relative to GDP. The Czech Republic and Slovakia – which both continued to show a surplus of domestic deposits over claims – reported positive net external assets, just like Russia. In the case of Slovakia, however, its international creditor position deteriorated somewhat in the review period.

Banking sector profits remained subdued by historical standards and ranged from a return on assets (RoA) of 0.2% in Ukraine to 2.5% in Turkey in mid-2013. Slovenia was the only country to report losses in the review period (recording a RoA of –1.1%). Here, the weak operating environment, decreasing loan volumes, the deteriorating quality of the credit portfolio and increased competition for deposits are reflected in banks' profitability. Year on year, profitability was somewhat lower also in Croatia and Russia. In both countries this fact was related to higher provisioning. In Croatia, lower operating income played

Chart 5

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

As a percentage of GDP at mid-2013

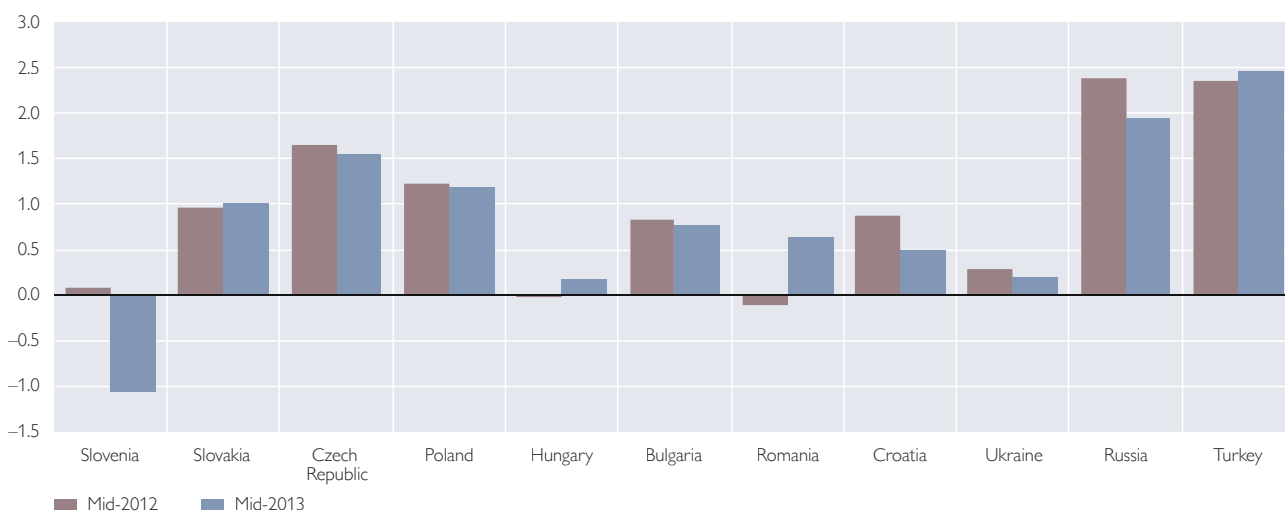


Source: ECB, Eurostat, national central banks, national statistical offices, OeNB.

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.

a role as well. Some countries of the region, however, reported higher RoAs (e.g. Hungary, Slovakia, Turkey and especially Romania) which were driven mostly by higher operating incomes, and, in Romania, by lower provisions and write-offs.

Mid-2013 data confirm that the banking sectors in CESEE remain well capitalized. Capital adequacy ratios

ranged between 13.5% in Russia and 20.8% in Croatia. Compared to mid-2012, the capital adequacy ratio increased in Bulgaria, the Czech Republic, Hungary, Poland and Slovakia (in a range from 0.3 to 0.8 percentage points), while it decreased in the rest of the region. The decrease, however, was comparatively pronounced only in Turkey (–1.6 percentage points).

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