

International macroeconomic environment: modest global recovery amid resurging market volatilities

U.S. and euro area economies recover at different paces

Global economic dynamics lost momentum in the review period from November to May 2015 and the global economy is expected to expand less than anticipated in 2015. Disappointing economic performance in the U.S.A. contrasted with favorable developments in Europe, while growth in emerging economies continued its slowdown, with financial outflows bringing sustainability issues to the fore. Subdued data on U.S. economic activity created uncertainty about the pace of monetary policy normalization in the U.S.A. In the euro area, the asset purchase program of the Eurosystem, generally low energy prices and a relatively low exchange rate have contributed to positive surprises in terms of growth since the beginning of the year. Given the accommodative stance of monetary policy and a still subdued inflation outlook, the yields on euro area government bonds continued to decline in the first months of 2015, benefiting both core and stressed economies in the euro area. More recently, volatility in bond markets, stock exchanges, foreign exchange rates and commodity prices has intensified. Whether the abrupt reversal of compressed global risk premia observed since May reflects merely temporary corrections amplified by low market liquidity or more fundamental drivers such as global growth rebalancing is an issue that will shape the future financial risk environment.

In the U.S.A., economic activity disappointed due to temporary factors in the first quarter of 2015 resulting in a quarter-on-quarter decline of 0.2%, after growth had already slowed down

in the previous quarter. GDP has been dampened by private consumption, investment and negative net exports. Nevertheless, labor markets continue to improve as vivid job creation has reduced unemployment to 5.4%, albeit at historically low participation rates. Low productivity growth implies, however, that much of the employment creation has been taking place in low wage sectors. Fiscal policy no longer represents a significant drag on economic growth and monetary policy has remained accommodative. The Federal Reserve is preparing the public for a raise in the federal funds rate “at some point” this year conditional on continued improvement in labor markets and reasonable confidence that inflation will move back to 2% over the medium term. Consumer price inflation has hovered around 0% since the beginning of 2015 but has been showing a modest upward tendency more recently. Even if one excludes the volatile components food and energy, inflation remains below the Fed’s objective.

In Japan, GDP growth surprised on the positive side by doubling to 0.6% (quarter on quarter) in the first quarter of 2015, surmounting a short but deep recession in 2014 that had followed a hike of consumption tax. Apart from a stable contribution of private consumption, the main boost to the economy came from a rebound of inventories. Given Japan’s improving current account balance, net exports are likely to become a growth driver again. The Japanese economy is expected to continue recovering moderately. So far, neither the growth dynamics nor higher pay settlements have helped to raise wage growth substantially, despite the fact

Economic growth below expectations in the U.S.A. and emerging markets but stronger than expected in Japan

that the unemployment rate fell to 3.4%, the lowest level seen for almost 18 years. Inflation decreased to below 1% in April 2015 with consumption tax-adjusted inflation plummeting to -1.7%. Longer-term inflation expectations appear to be declining marginally. Since October 2014, the Bank of Japan has been expanding its expansive monetary policy measures, referred to as quantitative and qualitative monetary easing (QQE), with the aim of “converting people’s deflationary mindset.” Long-term growth is viewed to depend on structural reforms – the third arrow of the Japanese prime minister’s “Abenomics.”

China’s economic growth continues to decelerate, with GDP expanding at an annual rate of 7% in the first quarter of 2015, due to contracting investment in construction, which was partly compensated by external demand. Inflation stayed constant at 1.5% – half the value targeted by the People’s Bank of China, which reduced its key interest rate by 25 basis points and extended the collateral pool for monetary policy operations in May 2015 against the background of sinking industrial producer prices.

On January 15, 2015, the Swiss National Bank (SNB) discontinued its currency ceiling, set at CHF 1.20 to the euro, which it had maintained for four years. The Swiss franc appreciated immediately and has since floated below parity with the euro.

Euro area recovery picks up speed in low-inflation environment

The recovery of the euro area economy has gathered pace: GDP grew by 0.4% (quarter on quarter) in the first quarter of 2015 – 0.1 percentage points faster than in the preceding quarter. Among the larger euro area economies, Spain and France performed best, with growth

rates of 0.9% and 0.6%, respectively; both Germany and Italy reached 0.3%, signifying a slowdown for the former and improvement for the latter. Euro area inflation entered negative territory in late 2014 but has gradually emerged from it since then. The recent volatility has mainly been driven by energy and food prices, while core inflation has gradually decreased to 0.6% given the output gap stemming from the last double-dip recession. In early 2015, inflation was below 1% in almost every country of the euro area; Spain and Greece continued to experience deflation even. Euro area-wide inflation expectations reached a low in January 2015, but have improved since then. The unemployment rate has continued to decline slowly but steadily, reaching 11.3% in the first quarter. Employment creation weakened at the end of 2014 but is expected to accelerate during 2015.

Following contractionary tendencies in previous years, the fiscal stance turned neutral in 2014, while monetary policy became even more accommodative. The Eurosystem’s conventional policies remained unchanged, with the key interest rates at record low levels (negative deposit facility rate). Additionally, the ECB’s Governing Council decided to expand its asset purchase program by adding purchases of public sector securities to the existing private sector asset purchases in order to address the risks of a too prolonged period of low inflation. Monthly purchases of public and private sector securities amount to EUR 60 billion under the new expanded asset purchase program. They are intended to be carried out until the end of September 2016 and in any case until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates

ECB implements further nonstandard monetary policy measures

below, but close to, 2% over the medium term. In order to boost lending to SMEs, the Eurosystem continued its targeted longer-term refinancing operations (TLTROs). In the review period, the euro exchange rate continued to depreciate gradually in line with the increasingly expansionary monetary policy stance and low inflation expectations, losing more than 13% against the U.S. dollar and above 8% in nominal effective terms against a basket of 21 currencies. In mid-May 2015, the euro showed signs of strengthening in view of uncertainties about the Fed's path of monetary normalization, but then fell back to below USD 1.1/EUR.

In the review period, the representative stock index DJ Euro Stoxx rose by around 19%, more than twice the increase of the comparable U.S. Dow Jones Industrials. More recently, European stock markets have become more volatile as the DJ Euro Stoxx fell from its peak in mid-April 2015 but recovered thereafter. Given the accommodative stance of monetary policy and a subdued inflation outlook, the yields on euro area government bonds continued to decline in the first months of 2015. Yields of German ten-year government bonds fell temporarily to record lows of 0.08% at the end of April. The significant yield decline also benefited euro area economies under stress (with the exception of Greece) as a search for yield in a low-interest environment caused risk premiums to contract. Spanish ten-year government bonds, for instance, had fallen by almost 100 basis points to 1.14% by March 2015 but rebounded as negotiations between the newly elected Greek government and its creditors proved more challenging and drawn out than anticipated. Greek benchmark bond yields peaked at 13.6% at the end of April but have softened since then. Vol-

atility also reemerged in global energy markets. Brent crude oil prices, for instance, fell from almost USD 85 per barrel in early November 2014 to above USD 45 in mid-January 2015 and then gradually increased to around USD 68 in early May before moderating once again.

CESEE: banking sector profitability weakens in an otherwise broadly stable macrofinancial environment

The economic recovery that had set in in mid-2013 in many countries of Central, Eastern and Southeastern Europe (CESEE) continued in the second half of 2014. It did not really gain speed, however. This is partly due to the ongoing weaknesses in the euro area during this period and the consequent lack of substantial trade impulses from the CESEE region's number one trading partner. Economic and political uncertainties also weighed on the region's economic performance. This is especially true for Russia, where growth basically stagnated, and Ukraine, which went into a deep recession. However, preliminary figures for the first quarter of 2015 are promising, with growth accelerating especially in the Czech Republic, Poland and Romania.

Financial markets developed broadly favorable, especially in the CESEE EU Member States, reflecting a comparatively sound macrofinancial environment and favorable global liquidity conditions. However, some more volatility was observed in Bulgaria and Turkey, and turbulences in Russia and Ukraine persisted.

In Bulgaria, the risk assessment deteriorated in late 2014 in the context of ongoing problems related to Corporate Commercial Bank (CCB). In November 2014, the Bulgarian National Bank revoked CCB's banking license. In order to pay back guaranteed deposits,

Economic recovery continues in many CESEE countries amid broadly stable macrofinancial conditions

the center-right government that had been brought to power in early elections in October 2014 had to extend a loan to the Bulgarian bank deposit guarantee fund, which was not sufficiently equipped to pay out all insured CCB deposits. This step helped to calm the situation and CDS premiums have embarked on a downward trend since. The spillovers of CCB's problems to the rest of the Bulgarian banking sector have been contained. Also, the country's currency board arrangement has not come under pressure as the abundant coverage of base money by gross foreign reserves has remained unchanged.

The Turkish lira has depreciated notably against the U.S. dollar and weakened by more than 14% since the beginning of the year. In early June 2015, the currency reached a historic low against the U.S. dollar. The depreciation against the euro was more moderate but still amounted to some 7%. In early March 2015, the Central Bank of the Republic of Turkey (CBRT) attempted to counter the depreciation pressure by changes to foreign currency (FX) auctions and FX borrowing facilities for banks, after having cut the benchmark interest rate by 75 basis points in two steps in January and February 2015 to 7.5%. The two consecutive rate reductions followed pressure from the government which threatened the CBRT's independence and which persisted until the CBRT Governor and the President of the Republic jointly confirmed the benefits of the monetary policy focus on price stability and the risk of loose monetary policy for the currency on March 12, 2015.

The military conflict in Eastern Ukraine hit the Ukrainian economy¹

through various channels. Risk indicators deteriorated markedly, massive capital outflows led to a drop in FX reserves and the depreciation of the hryvnia continued. The currency even reached new lows against the euro and the U.S. dollar in February 2015. The exchange rate pass-through, together with rising administered prices, drove inflation up to 58.4% year on year in May 2015. Supported by the depreciation and despite production losses in the heavily industrialized east and trade disruptions with Russia, Ukraine's current account deficit decreased to 4% of GDP in 2014 as imports declined faster than exports.

Some stabilization on the FX market could be achieved in March 2015, following a ceasefire agreement, the introduction of further capital controls, a key policy rate hike to 30% and the announcement of an Extended Fund Facility (EFF) with the IMF amounting to USD 17.5 billion. The EFF forms part of an international support package (IMF, EU, international financial institutions and bilateral aid from several countries) set up to cover a large part of Ukraine's USD 40 billion funding needs over the next four years. Financial support is connected to a comprehensive reform agenda, on which the Ukrainian authorities have already started to deliver. External debt restructuring is expected to yield a financing contribution of USD 15 billion and to restore Ukraine's debt sustainability. Discussions with sovereign and quasi-sovereign eurobond holders were initiated in March. After the disbursement of the first USD 5 billion IMF tranche, FX reserves almost doubled to about USD 10 billion in March.

Further international financial support for Ukraine

¹ For in-depth information on the macroeconomic environment and banking sector developments in Ukraine see: Barisitz, S. and Z. Fungáčová. 2015. *Ukraine: struggling banking sector amid substantial uncertainty*. In: OeNB. *Financial Stability Report* 29.

The development of the Russian ruble was marked by substantial ups and downs in the review period. Against the background of the oil price decline and of strong capital outflows in the course of 2014, the currency's external value declined especially in late 2014. The Bank of Russia (CBR) announced its official move to inflation targeting and declared that from November 10, 2014, it would no longer intervene to support the currency unless financial stability was in danger. This announcement was flanked by two increases of the key interest rate in the fall of 2014 by a total of 250 basis points to 10.5%. Still, in the wake of the acceleration of the oil price decline in early December 2014, the CBR stepped up FX interventions to support the ruble and, when the plunge of the ruble intensified in mid-December, sharply increased the key interest rate to 17%.

The recovery of the oil price in early 2015 as well as the substantial interest rate hike have supported the ruble and reined in market tensions. In

February, March, April and June, the CBR lowered the key rate by a cumulative 550 basis points to 11.5% in order to account for the “shift in the balance of risks” toward the “cooling economy.” The ruble has appreciated substantially since then, also due to carry trades by Russian banks.

Increased uncertainty due to the oil price decline and the sanctions is largely responsible for record-high capital outflows: Private net capital outflows reached USD 154 billion in 2014 (of which almost half occurred in the fourth quarter) and USD 32.6 billion in the first quarter of 2015. Due to repeated sizable interventions in the six months following late September 2014, the country's international reserves had shrunk by about one-fifth to USD 357 billion by May 2015.

Domestic credit growth developed broadly favorably in roughly half the CESEE countries under observation. In the Czech Republic, it hovered around 4% year on year in the first months of 2015; in Slovakia and Poland, it was

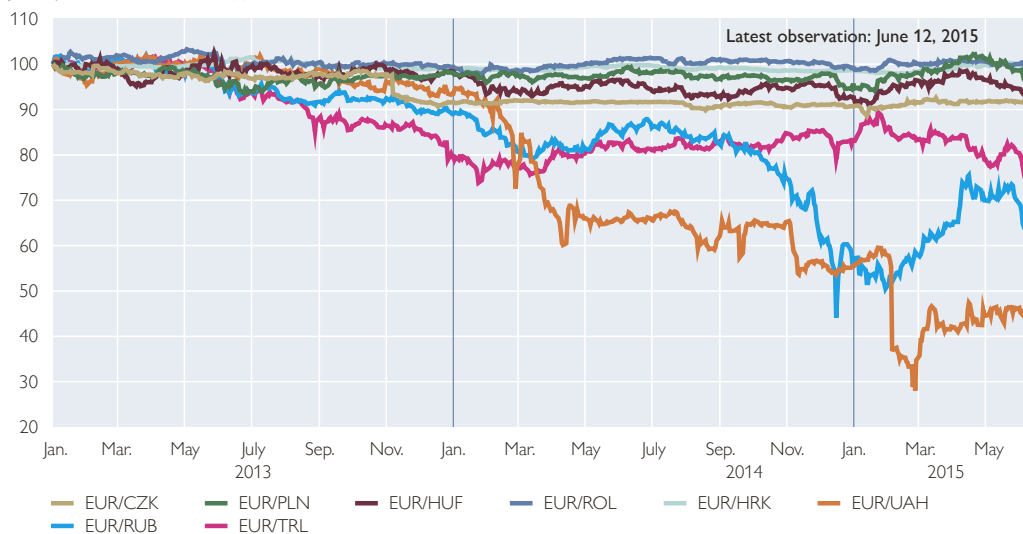
Russian ruble very volatile

Heterogeneous credit developments in CESEE

Chart 1

Exchange rates of selected currencies against the euro

January 1, 2013 = 100; rise = appreciation



Source: Thomson Reuters.

even somewhat higher at 6%. In Croatia and Slovenia, the credit stock continued to decline, however less so than previously. In Slovenia, the restructuring of the banking sector continued: In December 2014, the European Commission approved the restructuring plan for Banka Celje and its merger with the previously rescued Abanka, which was followed by a recapitalization and the transfer of bad assets to a bank asset management company. Also, the privatization of Nova KBM has progressed and the sale is expected to be finalized in the second quarter of 2015.

The most important change in credit dynamics was observed in Hungary. The exchange rate-adjusted credit stock in the country began to expand again for the first time since mid-2009. While part of this development is due to statistical reasons related to the mandated conversion of foreign currency consumer mortgage loans into forint loans at the prevailing market exchange rate of early November 2014, credit developments were also supported by the Hungarian central bank's (MNB) Funding for Growth Scheme (FGS). The scheme was expanded and extended in autumn 2014 and is now scheduled to run out at mid-2016. In addition, in mid-March 2015 the MNB launched an additional FGS+ scheme with similar conditions, but also temporarily assumed part of the credit losses from banks to enable the participation of less creditworthy SMEs. So far almost 22,000 enterprises have participated in the schemes, drawing funds of almost HUF 1,400 billion (some EUR 4.5 billion). In order to safeguard financial stability once the credit cycle turns, the central bank introduced new payment-to-income and loan-to-value ratios with effect from the beginning of 2015 (penalizing foreign currency loans).

Deteriorating credit dynamics were reported for Russia and Ukraine against the background of an increasingly fragile general economic environment and substantial policy rate hikes. Credit growth also decelerated somewhat in Turkey in late 2014 promoted by several macroprudential measures by the Turkish central bank to put a brake on swift credit expansion. The first months of 2015, however, again brought some reacceleration of credit growth, bringing credit expansion further away from the central banks' target.

The most substantial deterioration was reported for Bulgaria. This development, however, was largely related to statistical reasons. As already mentioned, the Bulgarian National Bank revoked Corporate Commercial Bank's banking license. With this move, loans previously granted by the bank (amounting to some BGN 5.3 billion) were no longer included in the official monetary statistics.

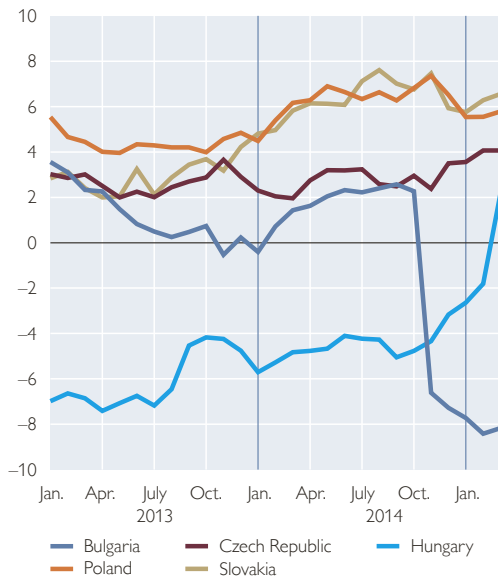
Lending surveys paint a heterogeneous picture of the CESEE region: The bank lending conditions index for Emerging Europe as compiled by the Institute of International Finance tightened in the first quarter of 2015, after having eased for three consecutive quarters in 2014. At 49.6, the index stood slightly below the threshold of 50 which indicates easing lending conditions. This development was driven by a plunge in loan demand, after banks had reported (at times substantially) rising demand throughout most of 2014. In particular demand for corporate and housing loans nose-dived. On the positive side, funding conditions improved slightly, driven by a further easing in international funding conditions, while domestic funding conditions continued to tighten. Although nonperforming loans (NPLs) continued to trend up in early 2015, banks expect NPLs to start

Lending surveys
paint uneven picture
of future banking
sector develop-
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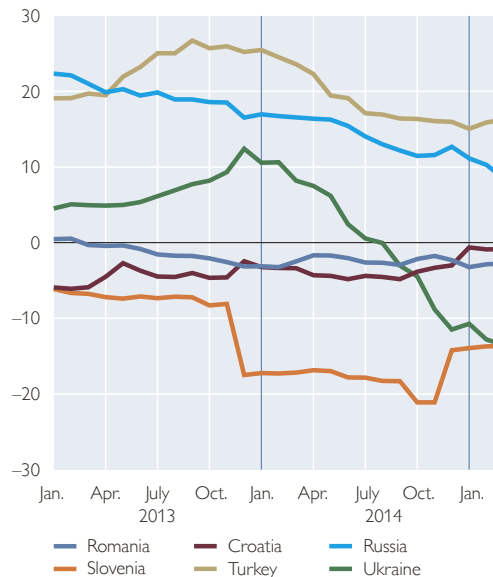
Chart 2

Growth of credit to the private sector

% , year on year, adjusted for exchange rate changes



% , year on year, adjusted for exchange rate changes



Source: national central banks.

declining in the near future, helping the overall NPL index to rise to 51.

The most recent CESEE Bank Lending Survey of the European Investment Bank (EIB), published in late 2014, reported an increase in credit demand and a stabilization of supply conditions (such as credit standards and credit terms and conditions), although both supply and demand levels remain low. Supply and demand are expected to improve in the first half of 2015. Banks' assessment of credit demand is now close to the level observed in late 2012. The EIB reports funding conditions to be fairly favorable, with access to funding positive across all sources. It also finds increasing evidence of a new funding model emerging, with local funding playing a more prominent role, substituting for decreased cross-border funding (i.e. mainly intra-group funding of foreign-owned banks by their parent institutions).

This is in part confirmed by exposure data provided by the Bank for In-

ternational Settlements (BIS): The exposure of BIS reporting banks vis-à-vis the CESEE region declined by EUR 8 billion and EUR 16.4 billion in the third and fourth quarters of 2014, respectively (locational statistics, exchange rate adjusted). Reductions were reported for most countries, but especially for Russia. At the same time, domestic deposits kept increasing in all CESEE countries in the second half of 2014, at least partly making up for the reduction in external funding.

The EIB survey found that CESEE remains clearly relevant in the strategies of international banking groups operating in the region. However, international banks continue to be selective in their country-by-country strategies. Roughly one-third of the groups surveyed expect to expand their operations in CESEE, while another third were found likely to reduce their operations in the region. Roughly half of the groups signal that they have been reducing their total exposure to CESEE,

while only one-third expects to continue doing so. The profitability of banks' CESEE operations is emerging as a challenge. Expected returns on assets for CESEE operations have been decreasing compared with overall group results. Banks are also reviewing their assessments of the potential of some CESEE markets.

Foreign currency loans continue their downward trend

Another issue characterizing the region is a high share of foreign currency loans. The share of foreign currency loans in total loans to households declined most strongly in Hungary (from 52.9% in September 2014 to 5% in March 2015) as the conversion of foreign currency consumer mortgage loans into forint loans started. A notable reduction in the order of 2 percentage points was also reported for Bulgaria and Romania. Ukraine was the only country that reported a strong increase in the share of foreign currency loans in the review period (from 43.9% to 56.9%) as the depreciation of the hryvnia had a strong valuation effect on the FX credit stock.

Credit quality improves somewhat

Swiss franc loans play a role in Poland and Croatia

In March 2015, the share of foreign currency loans in total loans to households was highest in Croatia (72%), followed by Ukraine and Romania (55% to 60%) and Poland and Bulgaria (30% to 35%). The share was below 10% in all other CESEE countries. Most of the foreign currency loan stock was denominated in euro. Other foreign currencies played a role in Ukraine (55%), in Poland and Croatia (around 25%) and to a lesser extent in Romania and Slovenia (around 10%). Apart from Ukraine (U.S. dollar) most of these loans were denominated in Swiss franc and therefore exposed to an exchange rate shock after the Swiss National Bank abandoned its exchange rate cap vis-à-vis the euro from January 15, 2015. By mid-May, local currencies of the region had lost some 10% to 15% of

Credit expansion increasingly financed by domestic deposits

their value against the Swiss franc. While the Polish banking sector should be able to cope with the effects of the exchange rate shock (comparatively low NPL ratio, broadly sound and sustainable credit expansion), the impacts on Croatia could turn out somewhat more pronounced. The country had been stuck in recession for several years and only managed a return to positive growth rates in the final quarter of 2014. Furthermore, its banking sector is already burdened with a comparatively high share of distressed loans. Against this background, the Croatian government froze the loan repayment exchange rate for housing loans indexed to or denominated in Swiss francs at HRK 6.39/CHF for one year. The costs from exchange rate differences have to be born completely by the commercial banks.

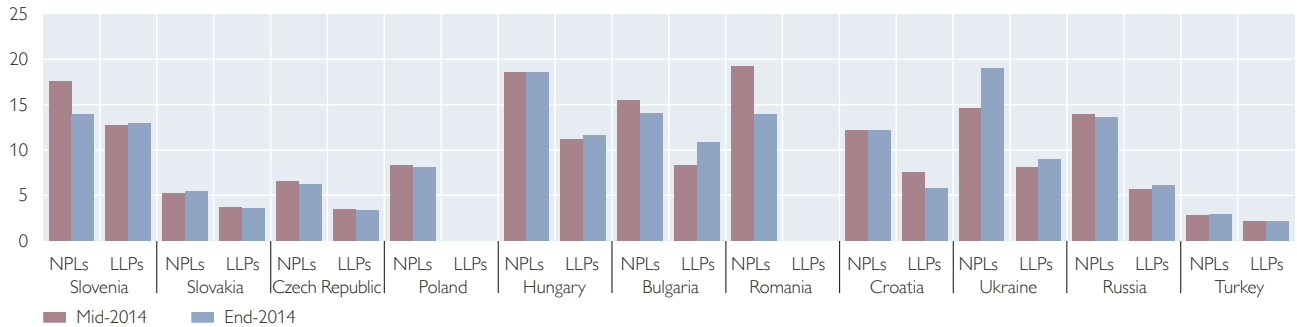
Most countries of the region reported broadly stable NPL ratios in the review period. Notable reductions, however, were reported for Slovenia and Romania. In Slovenia, this development was fueled by the transfer of a further tranche of nonperforming loans to a bad bank, while in Romania some banks removed uncollectible loans from their balance sheets that were fully or largely covered by adjustments for impairment. The NPL ratio also declined in Bulgaria, but less so than in the previous two countries. A marked increase in bad loans was only reported for Ukraine, against the background of the current economic hardship in the country.

The gap between total outstanding domestic claims and total domestic deposits (relative to GDP) was largely closed or even negative in all CESEE EU Member States under observation. Over the past years, a slowly growing deposit stock has been matched by a steady or at times declining credit

Chart 3

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, except for Ukraine (doubtful and loss loans) and for Romania and Slovenia (in arrears for more than 90 days).

stock. This trend continued in the review period: The funding gap declined by 7 percentage points of GDP in Bulgaria and by more than 8 percentage points of GDP in Slovenia between mid-2014 and end-2014. Hungary, Romania and Croatia reported reductions in a range of three to four percentage points of GDP. Only Slovakia recorded a merely modest reduction (0.2 percentage points of GDP). The country, however, has reported an overhang of deposits over claims for several years.

In Ukraine and Russia, the funding gap remained unchanged at a rather high level at the end of 2014. Turkey was the only CESEE country to report an increase in the gap. In the review period it increased by 2 percentage points of GDP as deposit growth could not keep pace with claims.

The developments outlined above are broadly reflected in banks' net external positions, which improved somewhat in most CESEE countries. This is especially true for Bulgaria and Croatia, but also for Hungary. A notable deterioration was only reported for Turkey, as domestic funding sources were not sufficient to cover the credit expansion. The banking sector continued to

hold net external liabilities in half of the countries under observation, mostly in a range of 6% to 9% of GDP. Only Turkey recorded substantially larger net external liabilities.

Profits still subdued...

Banking sector profits were rather muted in 2014, with only three coun-

Chart 4

Banking sector: gap between claims and deposits and net external position

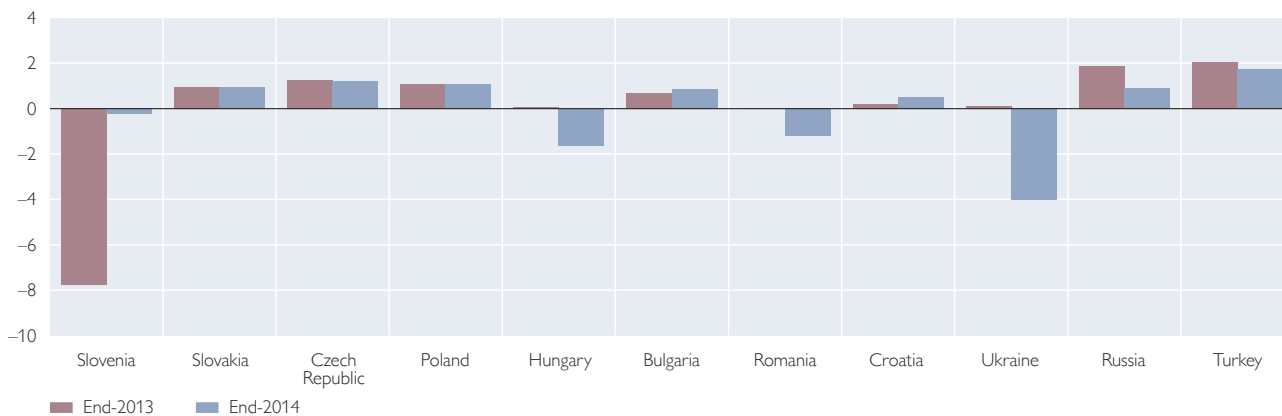
% of GDP at end-2014



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

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 profits, except for Russia's, which are based on pretax profits.

...but banking sectors remain well capitalized

tries reporting a return on assets of more than 1% (Czech Republic, Poland, Turkey). Profitability deteriorated somewhat in several countries compared to a year earlier. This is especially true for Ukraine, where a marginally positive return on assets in 2013 turned into a loss of 4% in 2014 as loan provisions nearly quadrupled against the background of the severe recession. Increasing provisions and write-offs also took their toll on the banking sectors in Russia, Hungary and Romania; they even pushed profitability into the red in the latter two countries. The reasons for this development relate to the difficult general economic environment in Russia, compensation payments for unlawful terms in loan contracts and the conversion of foreign currency loans in Hungary and write-offs of nonperforming loans in Romania. The only CESEE country to report

a notable improvement in profitability was Slovenia as efforts toward banking sector restructuring bore fruit. The country, however, still reported a moderately negative return on assets in 2014.

At the end of 2014, capital adequacy ratios ranged from 14.9% in Poland to 21.9% in Bulgaria. At 12.5%, only Russia recorded a capital adequacy ratio that was notably lower than the CESEE average. Compared to the end of 2013, the banking sectors in Turkey, Romania, Slovenia and Bulgaria could increase their capital base notably in 2014. In Bulgaria, the capital adequacy ratio even jumped from 16.9% to 21.9%. In contrast, banks in Russia and Ukraine are less capitalized today than they were a year ago (decline in capital adequacy ratio: -1 percentage point and -2.7 percentage points, respectively).