Advanced Economies: Economic Recovery Strengthens

Global economic activity broadly strengthened in the review period from October 2013 to May 2014 and is expected to improve further in 2014 and 2015. Much of the recent impetus is coming from advanced economies while, on average, growth in emerging economies remained high but largely unchanged in a less favorable external financial environment. In the euro area, macrofinancial risks arise from the low nominal growth environment, in particular from a slowdown in inflation rates reflecting still large output gaps, the recent decline in commodity prices as well as the appreciation of the euro’s nominal effective exchange rate.

In the U.S.A., growth in economic activity lost some momentum during winter but is expected to pick up in the coming quarters. Labor market indicators were mixed but on balance showed further improvement. While private spending remains robust, fiscal policy is holding back the recovery, although to a lesser extent than in 2012 and 2013. Inflation has been running below the long-run objective of 2%, but long-term inflation expectations have remained anchored thus far. In 2014, the Federal Reserve Board reduced its monthly asset purchases further. Improved communication reduced adverse spillovers to emerging economies in early 2014 as compared to mid-2013. Given that the employment-to-population ratio still signals a significant amount of economic slack, the federal funds rate is expected to remain between 0% and 0.25% for still some time.

In Japan, some underlying growth drivers, notably private investment and exports, have strengthened thanks to the increased growth of trading partners and the substantial yen depreciation over the past 12 months or so. Nevertheless, overall activity is projected to slow in response to the two rounds of consumption tax hikes in April 2014 and October 2015. The unemployment rate has declined further and the inflation rate has picked up substantially, already influencing long-term inflation expectations and actual wage and price settings. The Bank of Japan continues its quantitative and qualitative monetary easing to increase the monetary base at an annual pace of about JPY 60 to 70 trillion. However, according to the IMF, the remaining two arrows of Abenomics – structural reforms and fiscal consolidation beyond 2015 – are essential to achieve the inflation target and higher sustained growth in the long run.

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

The moderate recovery of the euro area economy is proceeding but remains fragile and uneven. Preliminary GDP estimates for the first quarter of 2014 surprised on the downside, while inflation rates have decreased to below 1% in most euro area countries. In Germany, supportive monetary conditions, robust labor market conditions and improving confidence have underpinned a pickup in domestic demand. Across the euro area, a strong reduction in the pace of fiscal tightening is
expected to lift growth, while net exports support the turnaround in the peripheral economies. Unemployment rates have stabilized but are expected to remain at elevated levels throughout 2016. For 2014, the IMF expects only Cyprus to remain in recession.

On June 5, 2014, the Governing Council of the ECB cut its main refinancing rate by 10 basis points to 0.15%, its deposit facility rate by 10 basis points to –0.10% and its marginal lending facility rate by 35 basis points to 0.40%. At the subsequent press conference, ECB President Draghi indicated that policy rates will remain at current levels for an extended period and announced further liquidity measures: a series of targeted longer-term (four-year) refinancing operations to the amount of some EUR 400 billion that are designed to support bank lending to the real economy; the continuation of fixed rate full allotment tender procedures; a suspension of the sterilization of liquidity injected under the Securities Markets Programme; and preparations for outright quantitative easing purchases. Despite significant improvements, the transmission of monetary policy is still impaired for some countries and economic sectors, which is also reflected in still tight lending standards for nonfinancial businesses. Better funding conditions for banks have allowed them to repay around EUR 550 billion of outstanding longer-term central bank liquidity since late January 2013. The associated increase in money market rates has been muted thus far.

Within the review period, euro area financial stability improved further, reflected inter alia in slightly lower sovereign risk spreads in stressed economies. Ireland, Spain and Portugal have left their respective financial assistance programs successfully, while the programs for Greece and Cyprus remain on track. Adverse effects associated with the crisis in Ukraine have been moderate so far. The implementation of banking union is progressing and market sentiment toward euro area banks has improved – particularly toward those in stressed economies, which however, remain burdened by the large and growing stock of nonperforming loans.

**CESEE: Geopolitical Developments Increase Financial Market Tensions amid Persistently Weak Credit Dynamics**

In line with developments in the euro area, economic conditions in Central, Eastern and Southeastern Europe (CESEE) improved somewhat in the second half of 2013. Most of the CESEE region covered in this report benefited from improving sentiment in Europe, more favorable economic activity in the euro area and an incipient recovery of domestic demand.

Against the background of the U.S. Federal Reserve System’s departure from its quantitative easing policy through the gradual reduction (“tapering”) of its bond purchases and especially the geopolitical tensions caused by the situation in Ukraine, financial market developments were less benign, however. The Fed’s decision to scale back its asset purchases caused international investors to relocate some of their funds from emerging markets back to now higher-yielding U.S. assets, which sent shockwaves throughout emerging markets worldwide in mid-2013. In the CESEE region, Russia, Turkey and Ukraine were affected in particular and experienced capital outflows and pressure on their respective domestic currencies. These developments were exacerbated by rising political risks, at first only in Turkey in connection
with the government’s response to the Gezi park protests and, more recently, to corruption allegations. Starting from mid-January, however, the escalating Maidan protests in Ukraine and the subsequent conflict around Crimea and the eastern part of the country, put Russia and Ukraine into the spotlight.

Since end-January, all three major rating agencies have cut their Ukraine ratings (Moody’s to Caa3, Fitch to CCC and S&P to CCC), and CDS premiums and Eurobond spreads rose markedly to maximum levels of 1,300 and 1,800 basis points, respectively, in February and March as well as in early May. Then, however, CDS premiums and eurobond spreads retreated noticeably and came down to 800 and 950 basis points at the end of May. In February, the National Bank of Ukraine (NBU) abolished its relatively tight de facto peg to the U.S. dollar, after pressure on the currency intensified and the NBU ran down its foreign currency reserves to very low levels. Foreign currency reserves declined from USD 20.4 billion in December 2013 to USD 14.2 billion in April 2014, covering less than two months of imports (this reduction, however, was in part also caused by repayments of state and state-guaranteed debt). From early 2014, the hryvnia depreciated by some 35% against the euro and the U.S. dollar and traded at historical lows in April 2014. Against the background of a notable pass-through of currency depreciation to inflation (which rose from 1.2% in February to 3.4% in March), the central bank increased its policy rate by 300 basis points to 9.5% in April 2014, which helped to stabilize the currency somewhat.

Furthermore, the exchange rate also benefited from the approval of a two-year stand-by arrangement with the IMF. The program totals USD 17 billion, of which USD 3.2 billion have already been disbursed. This forms part of a broader support package by the international community, which is set to total USD 27 billion over the next two years. International financial aid to cover the sizeable external financing gap became necessary after a support package that the old Yanukovich administra-
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Financial market conditions deteriorate also in Russia

The political tensions in Ukraine also adversely affected financial market developments in Russia. CDS premiums and eurobond spreads increased considerably from early 2014 with spikes around 300 and 350 basis points in March and April before declining again in May. The Russian ruble’s steady depreciation over 2013 sharply accelerated in January and February 2014 (10% from end-2013 to end-February 2014 against the U.S. dollar and the euro). This was largely caused by the Fed’s tapering, coupled with Russia’s weakening growth outlook. After the outbreak of the Crimean crisis (end-February), the ruble declined by another 2% to 3% before starting a strengthening trend in mid-March. The Central Bank of the Russian Federation (CBR) contributed to this restabilization by strongly intervening in the foreign exchange market. Foreign exchange sales were substantially larger than provided for by the CBR’s automatic intervention mechanism (daily interventions of up to some USD 11 billion), and foreign currency reserves declined by about USD 40 billion (or 8%) to USD 471 billion from end-December 2013 to early May 2014. Furthermore, the CBR raised its key interest rate by 150 basis points in late February 2014 and by a further 50 basis points in late April (to 7.5%) because of a notable pass-through of ruble weakness to consumer prices and because of a rise in inflation expectations. Inflation increased to 7.3% in April from 6.1% in January 2014.

In 2013, the total outflow of private capital from Russia came to USD 60 billion (about 3% of GDP), which exceeded the comparable 2012 value.

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**Exchange Rates of Selected Currencies against the Euro**

*January 1, 2013 = 100; rise = appreciation*

[Chart 2: Exchange Rates of Selected Currencies against the Euro]

*Latest observation: May 30, 2014*

Source: Thomson Reuters.
(USD 54 billion). Outflows further accelerated to USD 51 billion in the first quarter of 2014. Against this background and given the weakening economic momentum as well as the threat of more far-reaching sanctions against Russia, S&P downgraded its country rating to BBB-; Fitch and Moody’s set their outlook for the country to negative.

The impact of the developments in Ukraine on other CESEE countries has been broadly contained so far. The region has relatively limited direct export linkages with Ukraine, and gas exports from Russia so far seem to run smoothly.

Nevertheless, Turkey and the Czech Republic (to a lesser extent, also Hungary) experienced currency depreciation as well. As mentioned above, the Fed’s tapering as well as rising political risk put pressure on the Turkish lira. In late January 2014, the currency even reached an all-time low after recording a cumulative depreciation of 28% against the U.S. dollar and to 36% against the euro since mid-May 2013. Following a decisive interest rate hike (4.5% to 10%) by the Turkish central bank (TCMB) on January 28, 2014, the currency has stabilized and regained roughly 9% against both U.S. dollar and euro. As bank funding was provided at the overnight lending rate of 7.75% prior to the interest rate decision, the effective rate hike was only 225 basis points, however. The currency and other financial market indicators also benefited from a clear vote in favor of the ruling AKP party at local elections at the end of March 2014. As uncertainties declined and risk premium indicators improved, the TCMB decided to reduce the main policy rate by 50 basis points to 9.5% in late May 2014.

In the Czech Republic, the central bank (CNB) decided to start using the exchange rate as an additional instrument for easing monetary conditions in early November 2013, as the policy rate has been standing at “technically zero” since October 2012 and inflation has declined strongly, increasing the risk of deflation. As a result, the Czech koruna weakened by approximately 5% against the euro and the CNB will intervene to keep the new level of about CZK 27/EUR 1 at least until early 2015.

Falling price pressures were also reported for many other countries of the region in the past months. Against this background, several CESEE central banks continued to pursue a policy of monetary accommodation. Both the Hungarian central bank and the Romanian central bank cut their policy rates in several steps (by a total of 120 basis points to 2.4% in Hungary and by a total of 75 basis points to 3.5% in Romania from mid-October 2013 to late May 2014).

The improvement in economic activity was not accompanied by more vivid financial sector dynamics. Growth of domestic credit to the private sector remained anemic throughout most of CESEE; annual growth rates (adjusted for exchange rate changes) only amounted to around 2% or less in many countries and even showed a downward trend in several cases. The latter is especially true for Slovenia (where the transfer of nonperforming assets into a bad bank caused the credit stock to shrink) but also for Hungary, Bulgaria, Croatia and Romania. These countries have faced a deleveraging of households and/or corporations, which was attributable not only to comparatively weak economic momentum, but also in part to domestic banking sector problems. Credit growth also declined markedly in Russia and Ukraine in the past months in the context of heightened geopolitical tensions in the region.
Furthermore, lower growth rates were reported for Turkey in February and March 2014 given monetary policy tightening and macroprudential measures. Nevertheless, credit expansion remained rather vivid in the country.

In Slovenia, a large stock of nonperforming loans (NPLs) is weighing on bank profitability and credit expansion, and the capitalization of the banking sector is low by regional comparison. In mid-December 2013, the government recapitalized five banks with EUR 3.2 billion (9.1% of GDP). Subsequently, NPLs in the value of EUR 3.3 billion were transferred to a bank asset management company. The transfer of a further EUR 1.1 billion of NPLs is expected once the European Commission approves restructuring plans. As a further element of the consolidation of the banking sector, the government has committed itself to fully privatizing two state-owned banks by end-2014 and to reducing its stake in the biggest bank to a blocking minority in the medium term. In order to prevent a further accumulation of NPLs, a new legislative framework for corporate restructuring was put into place in December 2013.

In Hungary, the banking system has been negatively affected by various government measures to reduce outstanding foreign currency debt of households as well as by very high sectoral taxes on banks. After Hungarian banks had failed to deliver measures to ease households’ debt servicing burden by the deadline set by the government (November 1, 2013), the existing exchange rate cap scheme for foreign currency loans was extended. Furthermore, the government called on the supreme court and the constitutional court to deliver opinions about the legal status of foreign currency loans in November 2013. Following a final clarification, the government intends to deliver a broad-based solution to foreign currency loans. In order to ease SMEs’ access to credit, the Hungarian central bank (MNB) started a Funding for Growth Scheme (FGS) in June 2013. In September 2013, the MNB decided to prolong the FGS until end-2014 and to expand its volume (to a total of close to 10% of GDP) and coverage. According to first indications, however, the utilization of the first new tranche of the prolonged scheme is lagging behind expectations.

**Chart 3**

**Growth of Credit to the Private Sector**

% year on year, adjusted for exchange rate changes

- Slovenia
- Slovakia
- Czech Republic
- Poland
- Hungary
- Bulgaria
- Romania
- Croatia
- Ukraine
- Russia
- Turkey

**Source:** National central banks.

1 Nonadjusted.
While the negative effects of low demand seem to lose some importance for explaining weak credit developments, survey evidence suggests that supply-side factors may also have played a role in the observation period. For example, the Emerging Markets Bank Lending Conditions Survey of the Institute of International Finance (IIF) for the fourth quarter of 2013 reports that loan demand continued to improve across all loan categories. Demand for consumer credit was particularly strong, reflecting policy rate cuts and a recovery in private consumption in the region, at least in Central Europe. However, the survey also finds that credit standards were tightened across all loan categories and that funding conditions deteriorated. This development continued in 2014. The IIF survey for the first quarter of 2014 found that bank lending conditions tightened significantly given a marked increase in NPLs and a sharp deterioration in funding conditions. In fact, CESEE witnessed the most aggressive tightening in both domestic and external funding conditions compared to other regions as geopolitical tensions increased market volatility. Against this backdrop, banks tightened credit standards further across all loan categories. This is especially true for consumer loans, the demand for which subsequently plunged. Loan demand by businesses, in contrast, continued to increase, given the recovery in investment. However, it needs to be noted that not all CESEE countries were equally affected by this development. In Poland and the Czech Republic, for example, both external positions of BIS reporting banks as well as domestic deposits increased notably.

The share of foreign currency loans in total loans to households declined in all countries, most strongly so in Poland (by 3.4 percentage points to 30.7% between mid-2013 and the first quarter of 2014). The share, however, remained at high levels in Hungary, Romania and Croatia (ranging from 54.3% to 74.9% in March 2014). While foreign currency loans do not play an important role for the household credit stock in Russia, their share came to 41.2% in Ukraine in the first quarter of 2014. The most recent depreciation

**Chart 4**

Banking Sector: Credit Quality

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

Source: IMF, national central banks, OeNB.

Note: Data are not comparable between countries. NPLs include substandard, doubtful and loss loans, except for Romania and Ukraine (doubtful and loss loans) and for Slovenia (in arrears for more than 90 days).
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Credit quality remains weak

While NPL ratios remained clearly elevated by historical standards, credit quality improved somewhat between 2012 and 2013 in most CESEE countries. This development was most pronounced in Ukraine, followed by Slovenia, where nonperforming assets were transferred into a bad bank in December 2013 (see above). Deteriorating credit quality was reported for Croatia, Romania and Hungary. In the latter two countries, this development was driven by the credit stock declining more strongly than nonperforming assets.

In most countries of the region, total outstanding domestic claims continued to exceed total domestic deposits (relative to GDP) at the end of 2013. However, this funding gap has been narrowing substantially since late 2011 and was practically closed in Romania, Bulgaria and Croatia by the fourth quarter of 2013. It decreased by 3 to 5.5 percentage points of GDP between end-2012 and end-2013 in those countries. The reduction in Hungary was roughly of the same magnitude, while the funding gap decreased by nearly 15 percentage points of GDP in Slovenia against the backdrop of asset write-offs. A wider gap between claims and deposits was reported especially for Turkey as deposit growth could not keep pace with the vigorous expansion of credit. As of late, the gap has also started to increase somewhat in Russia and Ukraine.

The development outlined above is broadly reflected in banks’ net external positions. Countries that reported a declining funding gap reduced their reliance on external funding, while countries with larger funding gaps increasingly turned to international sources to finance credit expansion (Turkey and Ukraine). The banking sector continued to hold net external liabilities in most countries; in Poland, Hungary, Romania, Croatia and Turkey these liabilities were comparatively high relative to GDP. Slovenia and Bulgaria became international creditors in the review period, while the Czech Republic and Slovakia continued to report positive net external assets, as did Russia. In the case of the Czech Republic, however, the international creditor position deteriorated somewhat.

Banking sector profits remained subdued by historical standards and ranged from a return on assets (RoA) of 0.1% in Romania and Ukraine to 1.3% in the Czech Republic at the end of 2013. A somewhat higher RoA of around 2% was reported for Russia and Turkey. Slovenia was the only country to report losses in the review period (−7.5% RoA) as write-offs weighed on profitability. Operating income only declined marginally, however.
Compared to a year earlier, profitability was somewhat lower in 2013 in most CESEE countries. Only the Slovakian banking sector generated a higher profit, and Hungary and Romania managed to turn a loss in 2012 into a minor profit in 2013 on the back of higher operating profits. In Romania, this development was also fueled by lower provisioning, while in Hungary higher other income played an additional role.

The banking sectors in CESEE remain well capitalized. At end-2013, capital adequacy ratios ranged from 13.5% in Russia to 20.9% in Croatia. Compared to end-2012, all countries recorded increases in their capital adequacy ratios (in a range from 0.1 to 1.6 percentage points) except Russia and Turkey. While the decline in Russia was rather modest (–0.2 percentage points), it was more notable in Turkey (–2.7 percentage points to 14.6%).

**Banking Sector: Profitability**

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.*