

International macroeconomic environment: global growth outlook more favorable

Improved global financial conditions amid political uncertainty

The growth momentum of the global economy has improved since the beginning of 2017. This is evidenced by upward growth revisions for advanced economies and a pickup in international trade according to the most recent international forecasts (IMF, European Commission and OECD). While rising commodity prices have improved the prospects for commodity-exporting emerging countries, growth in some other emerging markets has been revised downward. Trade growth has recovered from its slowest five-year period since the 1980s despite the danger of a backlash to globalization amid heightened political uncertainty. The medium-term outlook remains clouded, however, given still weak, albeit improving productivity trends and risks that are predominantly skewed to the downside. At the same time, the monetary policy stance has been very accommodative in general, which helped deflation pressures to recede. Political uncertainty remains the key risk, although so far markets seem to be little impressed by disintegration tendencies (Brexit) or anti-globalization rhetoric by individual key politicians. In the euro area the broad-based upswing of the domestic economy continues, and in CESEE (without Russia and Turkey) the economic recovery is driven by consumption and (EU-cofinanced) investment and reviving growth in Russia.

Rising contribution of advanced economies to global growth

The world economy is expected to grow by roughly 3.5% in 2017 and 2018 (IMF, European Commission, OECD). While the industrialized countries are set to make a stronger

contribution to global growth, for many emerging economies the growth projections have been lowered, in particular for India, Brazil, Mexico, but also for several countries in the Middle East and Africa, amid increased uncertainty about the future course of U.S. economic policies as well as the progress and impact of China's rebalancing. In the medium term, structural barriers, low productivity growth and persistently high income inequality could also prevent a stronger upturn.

U.S. growth is expected to accelerate to 2.3% in 2017 and even more strongly in 2018 on the back of expected fiscal expansion measures, which, however, will promote investments in private-public partnership projects with uncertain productivity gains. In the first quarter of 2017, real GDP only grew by an annual 1.2%, driven by increased housing investment and private consumption spending, whereas government consumption had a dampening effect. However, special seasonal factors also seem to have played a role. The unemployment rate fell again in May, reaching 4.3%, the lowest level since 2001, and employment growth was robust. Despite the constantly improving situation in the labor market, there has been no appreciable increase in real wages. The consumer price index fell to 2.2% in April, down from record highs in February 2017, due to declining fuel prices. Core inflation was also down, dropping below 2.0% as the prices of a number of nonenergy product groups also declined. Political uncertainty remains the main risk to U.S. growth; a more expansive fiscal policy and financial market deregulation are likely to have positive effects only in the short term while implying destabilization in finan-

Accelerating growth in the U.S.A., Japan, China, the U.K. and Switzerland despite uncertainties

cial markets in the long term. In addition, negative effects may also result from increased protectionist economic policy intervention. Stable labor market developments and rising consumer prices prompted the Federal Reserve (Fed) to raise the target range for the federal funds rate by 25 basis points to 0.75% to 1.0% at its meeting in mid-March; this was the third rate hike in the current recovery after the global financial crisis, and market participants seem to expect interest rates to increase further in the course of 2017.

Japan's economy expanded by 0.1% in real terms (quarter on quarter) in the first three months of 2017. Private consumption was the main driver of growth, followed by net exports, which weakened against the background of a strengthening yen. GDP growth is forecast to be at or above 1% in 2017 but to slow down to just above 0.5% in 2018, given the planned phasing-out of fiscal measures and stronger import demand, which could cancel out the positive effects of foreign demand and investment in the context of the 2020 Tokyo Olympics. Despite the persistently weak economy, the unemployment rate fell further, reaching 2.8% in February. Nevertheless, there are still no signs of substantial wage growth. Inflation fell again in February (to 0.2%; core inflation: -0.1%). After its monetary policy meeting in mid-March, the Bank of Japan announced that it would not change its monetary policy orientation with its key interest rate at -0.1%.

In China, real GDP rose by 6.9% (year on year) in the first quarter of 2017, surpassing not only the previous quarter's growth rate of 6.7% but also the 2017 annual growth target of 6.5%. Private consumption seems to be providing strong growth impulses, while the contribution of investment appears to have been decreasing. For the first

time since mid-2015, net trade also provided a minimal positive contribution to growth owing to recovering exports to the U.S.A. and Asia, which had possibly been fostered by the depreciation of the renminbi in the second half of 2016. That said, the official figures may be too high, given that they rely on local production reports as well as underestimated price deflators. The rate of inflation declined sharply, dropping from 2.5% in January to below 1% in February and March, with core inflation coming in at roughly 2%. The People's Bank of China (PBC) raised key interest rates in February, including those on open market transactions and short-term loans to banks. Following the Fed's interest rate hike of March, the PBC also raised the interest rates in the interbank market with a view to counteracting increasing corporate debt and further capital outflows.

The U.K. economy grew robustly – at 1.8% – in 2016, contrary to widespread expectations after a majority of the British electorate had voted in favor of leaving the EU in the referendum of June 2016. In the first quarter of 2017, however, real economic growth was just 0.2%, as the positive contribution by investment was mainly offset by the negative contribution by net foreign trade. Growth is forecast to accelerate to 2% in 2017 and to still reach 1.8% in 2018. At present, there is great dispersion between available forecasts, which illustrates the persistent uncertainty that came with the result of the referendum. The unemployment rate is currently at a historically low 4.6%, but long-term unemployment has slightly increased recently. Nominal wage growth has recovered from its decline in winter but still hardly matches the inflation rate, which reached 2.6% in April – the highest value since Septem-

ber 2013 – partly on the back of a weaker pound. At its last meeting in mid-May, the Bank of England decided to keep the key interest rate at 0.25%, unchanged since the summer of 2016, and to continue its purchase program of government and corporate bonds. The Bank of England indicated that interest rate normalization could proceed faster than expected under a smooth Brexit scenario. In the June general elections, Prime Minister Theresa May lost the Conservative Party's overall majority in parliament; since her announcement in mid-April of holding an early election, the pound sterling exchange rate fell by 6 cent to below EUR 1.14 per GBP 1, reflecting expectations that a government potentially weakened by a bad election result would be in a worse negotiating position vis-à-vis the EU.

In Switzerland, the economy gained traction after a weak second half of 2016 so that a moderate expansion of around 1.5% is expected for 2017 and 2018. With both domestic demand and the external sector picking up, real GDP appears to have recovered from the erosion of Swiss export competitiveness due to a strengthening currency, unaffected by signs of protectionist trade policies in the U.S.A. and elsewhere. The exchange rate of the Swiss franc followed an upward trend that peaked in mid-May as the French presidential elections resulted in the victory of pro-EU candidate Emmanuel Macron; since then it has declined slightly to CHF 1.085 per EUR 1. In mid-March, the Swiss National Bank (SNB) reiterated its assessment that the franc was still overvalued and maintained its deposit rate at a record low of –0.75% while forecasting inflation for 2017 at 0.3%. The waning appeal of the Swiss franc as a safe haven currency against the euro has relieved the SNB of the need to continue to buy euro-de-

nominated assets. At present, the balance sheet of the SNB is still roughly five times larger than it was before the crisis.

Euro area recovery becomes stronger and more broad-based

Despite uncertainties arising from geopolitical events (Brexit, U.S. presidential elections) economic growth in the euro area reached 1.7% in 2016, mainly driven by domestic demand. At an estimated 0.6%, real GDP growth was even higher in the first quarter of 2017 than in the previous quarter, and recent sentiment indicators even point to a further strengthening of the upturn. While industrial and construction output figures do not fully reflect this optimism, the prospects for 2017 are positive on account of improved global demand and investment expectations. This is also reflected in the ECB's June forecast, which included a slight upward revision of real GDP growth to 1.9% and 1.8% for 2017 and 2018, respectively. The ECB explained that the revision was due to higher investment on the back of improved economic sentiment, monetary stimulus and higher foreign demand. The downward risks to the forecast are mainly associated with the external environment (Brexit, emerging markets, oil price), but also derive from the banking sector and government bond markets. According to the ECB, the negative output gap will only close toward the end of the forecast horizon (2019), even though potential output is estimated to be growing at just above 1%, which is clearly below the pre-crisis level. Productivity growth has been dampened by historically low investment levels and by an aging population. In view of the moderate economic recovery, the labor market situation is improving steadily but slowly. The euro area

unemployment rate fell to 9.3% in April 2017, reaching its lowest level in eight years, and is expected to gradually decline further to around 9% in 2018. The euro area countries recovering from a particularly deep recession – Greece, Ireland, Portugal and Spain – recorded particularly strong declines in unemployment. Recently accelerating actual and expected employment growth indicates sustained positive, but not very dynamic labor market growth.

Over the last twelve months consumer price inflation in the euro area (HICP) increased from negative levels to 1.4% in May 2017, mainly driven by energy prices. Annual core inflation, which includes the volatile components energy and food, reached just 0.9% in May, given weak wage growth. Inflation is forecast at 1.5% in 2017 and

slightly down at 1.3% in 2018. In June 2017, the Governing Council of the ECB kept the interest rate on the main refinancing operations, the marginal lending facility and the deposit facility unchanged at 0.00%, 0.25% and –0.40%, respectively. The Governing Council expects the key interest rates to remain at the present levels – and no longer considers the possibility of lower interest rates – for an extended period of time and well past the horizon of its net asset purchases. With regard to nonstandard monetary policy measures, the Governing Council confirmed its intention to run its net asset purchases at a monthly pace of EUR 60 billion – reduced from EUR 80 billion in March – until the end of December 2017, or beyond, if necessary, and in any case until a sustained adjustment in

ECB maintains accommodative monetary policy stance

Chart 1

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

Euro EMBIG spread in basis points



Source: Bloomberg.

Note: EMBIG = Emerging Markets Bond Index Global.

the inflation path consistent with its primary objective can be seen. Meanwhile fiscal policy in the euro area has been broadly neutral.

The annual growth rate of MFI loans to the private sector has been stable in recent months at just over 2%. Loans to households grew at a slightly higher pace than loans to nonfinancial corporations. Banks in the euro area slightly relaxed their guidelines for loans to companies in the first quarter of 2017. The benchmark yields of German ten-year government bonds have increased by some 5 basis points to 0.25% since the beginning of 2017. Market-based long-term inflation expectations have fallen below 1.5%. The ten-year spread between Italian and German government bonds has widened somewhat, whereas the spread between Portuguese, Cypriot and Greek bonds vis-à-vis German bonds has narrowed substantially. At the same time, emerging market spreads showed some volatility, particularly in Africa and Latin America.

Since the beginning of 2017 the exchange rate of the euro has appreciated by some 3% to roughly USD 1.09 per EUR 1 but it hardly increased against the Japanese yen. International stock exchanges performed well, with stock indexes at new – in some cases, record – highs. By mid-May 2017, the representative stock index DJ Euro Stoxx had gained around 11% against the previous year. Over the same period, the Dow Jones Industrial Index gained 6% and the FTSE 100 more than 3%. Brent crude oil prices oscillated around USD 50 per barrel – down by almost 12% due to still full inventories in industrialized economies.

CESEE: credit growth accelerates in an improving macrofinancial environment

There have been concerns that the high degree of uncertainty in the international political environment could also affect the countries of Central, Eastern and Southeastern Europe (CESEE). After all, a number of recent events have contested some of the building blocks of the political order in Europe: Brexit was a setback for European integration and put an end to the move toward an “ever closer union.” And finally, there are uncertainties related to the policy decisions of the new U.S. administration, particularly with regard to the global trade and security architecture.

So far, however, these political events have had no substantial impact on most of the CESEE region. Quite the contrary, the region’s risk assessment remained broadly favorable in the review period: Euro-denominated Eurobond spreads for Eastern Europe remained notably below the comparable figures for other emerging market regions and – despite some volatility – trended down after a peak related to the Brexit vote in June 2016.

Other financial market segments performed positively as well. In particular, equity prices increased substantially in most countries. This development reflects solid fundamentals: sentiment has brightened, initial Brexit concerns have eased, global trade has picked up speed, deflation fears have ebbed away and inflation concerns have not yet set in, and the economic outlook has improved. In fact, economic conditions were generally solid in the second half of 2016. The CESEE EU

Stable macrofinancial environment in CESEE EU Member States

Member States reported strong economic momentum firmly based on domestic demand and benign labor market and wage developments.¹ The favorable economic situation was also substantiated by rating and/or rating outlook upgrades for several countries (e.g. Slovenia, Slovakia, Poland, Hungary, Romania and Croatia). Furthermore, after a prolonged period of deflation, prices started to increase in the CESEE EU countries, mainly on the back of rising energy prices.

Against this background, the Czech National Bank (CNB) officially discontinued the exchange rate floor of the koruna against the euro in early April 2017 as inflation approached its target. The floor had been in place since November 2013 in order to prevent the exchange rate of the Czech koruna from appreciating to levels below CZK 27 per EUR 1. It was installed as an additional instrument to ease monetary conditions after the CNB's policy rate had reached "technically zero." The immediate reaction after the removal of the exchange rate floor was an appreciation of the Czech koruna against the euro by around 1.9% to around CZK 26.5 per EUR 1. In the following days, the Czech koruna depreciated again, reaching a level that was very close to that of the original exchange rate floor. The CNB underlined its commitment to use its instruments to mitigate potential excessive exchange rate fluctuations if needed.

Looking beyond the CESEE EU members, it is worth noting that annual growth in Russia returned to positive territory in late 2016 for the first time since the final quarter of 2014. Also,

the recovery in Ukraine strengthened. Following a deep recession in 2014 and 2015, annual GDP growth accelerated to 4.8% in the fourth quarter of 2016.

Largely driven by oil price increases, the exchange rate of the Russian ruble recovered notably throughout 2016 and 2017. This appreciation in combination with the Central Bank of Russia's (CBR) continued tight monetary policy (with the key repo auction rate at 10% from September 2016 to March 2017) and the country's 2016 record harvest contributed to dampening inflation to a five-year low in March 2017. The CBR thus decided to cut its key policy rate in two steps from 10% to 9.25% in May 2017. Furthermore, all major rating agencies upgraded their ratings outlooks.

In Ukraine, the central bank saw its inflation targets for 2017 and 2018 (8% +/-2 percentage points and 6% +/-2 percentage points, respectively) within reach – despite a temporary uptick in inflation in early 2017 – and cut its key policy rate by 100 basis points to 13% in April 2017. Also in April, the IMF Executive Board completed its third review of Ukraine's economic program under the Extended Fund Facility, enabling the disbursement of about USD 1 billion. The nationalization of the largest Ukrainian bank (Privatbank) in December 2016 was a priority for the Ukrainian authorities² and a step that had to be taken before the completion of the third review. Furthermore, Fitch increased its rating for Ukraine to B–.

Turkey has been an outlier in CESEE in terms of economic activity, with growth having decelerated notably from its peak in late 2015. Rising polit-

Improving situation
in Russia and
Ukraine

Czech National
Bank discontinues
unconventional
measures

Slowing growth in
Turkey amid rising
political uncertainty

¹ Schreiner, J. 2017. *Developments in selected CESEE countries*. In: OeNB. *Focus on European Economic Integration Q2/17*. Hildebrandt, A. 2017. *Outlook for selected CESEE countries*. *Ibid*.

² For in-depth information on banking sector developments in Ukraine, see Barisitz, S. and M. Lahnsteiner. 2017. *Ukraine's banking sector: still very weak, but some signs of improvement*, in this *Financial Stability Report*.

Credit growth accelerates throughout the region

ical uncertainty in connection with the failed coup in mid-2016 and the tense security situation had a negative impact on capital formation and the tourism sector and sent the Turkish lira on a downward trend. Fiscal stimulus bolstered growth in the final quarter of 2016 but the political and economic situation remained challenging. The implications of the constitutional referendum of April 16, 2017, in which a majority voted in favor of an executive presidency, are not yet clear, in particular as regards the possible impact this result might have on Turkey's relations with the EU. Immediate financial market reactions to the referendum have been positive so far. The Turkish lira also benefited from a tightening of monetary policy: The Central Bank of the Republic of Turkey (CBRT) raised the late liquidity window lending rate by 50 basis points to 12.25% at the end of April, bringing the weighted average cost of CBRT funding up to 11.8% in early May (from 8.2% just before the coup). This marked increase was also fueled by several other upward adjustments of the CBRT's policy rates in the review period, most importantly an increase in the key policy rate (one-week repo lending rate) by 50 basis points to 8% in late November 2016.

As regards credit growth in CESEE, lending to the private sector (nominal lending to the nonbank private sector adjusted for exchange rate changes) finally gained speed in the review period, reflecting solid general economic conditions in an environment of low interest rates, monetary accommodation in the euro area and ample global liquidity.

Among the CESEE EU Member States, credit growth was highest in the Czech Republic and Slovakia at 9.2% and 11.5% in annual terms, respectively, in March 2017. While credit

growth had remained broadly stable throughout most of 2016, some acceleration was observed in early 2017 as corporate credit growth gathered momentum. In both countries, macroprudential measures were taken in response to strong loan growth with the aim of building up buffers and preserving lending standards. The Czech Republic was the first EU country to introduce a countercyclical capital buffer of 0.5% of total risk exposure as of January 1, 2017, and the buffer rate will be increased to 1% with effect from July 1, 2018. Slovakia will follow suit and put into effect a similar buffer of 0.5% in August 2017. Furthermore, the CNB issued recommendations on loan-to-value limits and the Slovak central bank introduced a package of measures to address the strong growth of housing loans, including limits on the loan-to-value ratio and on the debt service-to-income ratio as well as maturity limits.

Credit growth was also rather swift in Poland but nevertheless fell short of the growth rates recorded in the Czech Republic and Slovakia. This might in part be related to heightened levels of uncertainty regarding institutional (mainly legal and tax) changes that contributed to the tightening of lending standards in some credit segments. Furthermore, Poland still reports a substantial share of foreign currency loans (especially denominated in Swiss francs) in total loans.

In Romania, credit growth accelerated to 2.3% in March 2017 after having come to a standstill in August 2016. Especially household credit expanded at a robust pace, while corporate credit remained a drag on overall credit growth. Progress has been achieved in shoring up the banking sector in recent years and banking sector uncertainty declined. In particular, the constitu-

dential policies, the CBRT's liquidity measures and government incentives. Consumer loans in particular performed strongly. In Russia, the incipient recovery fueled loan demand, especially by households. In Ukraine, the contraction of the credit stock moderated to –6% in March 2017.

Lending surveys corroborate positive trends

The most recent CESEE Bank Lending Survey carried out by the European Investment Bank³ (EIB) found that demand for loans further improved across the board in the first half of 2017. Access to funding also continued to improve in CESEE, supported by easy access to domestic sources (mainly retail and corporate deposits).

Aggregate supply conditions remained basically neutral over the first half of 2017. Across the client spectrum, credit standards eased slightly only for corporates while they tightened on mortgages and consumer credit. Changes in regulation and banks' capital constraints are perceived

as key factors that adversely affect supply conditions. Moreover, the EIB survey also consistently indicates nonperforming loans (NPLs) as a drag on credit supply.

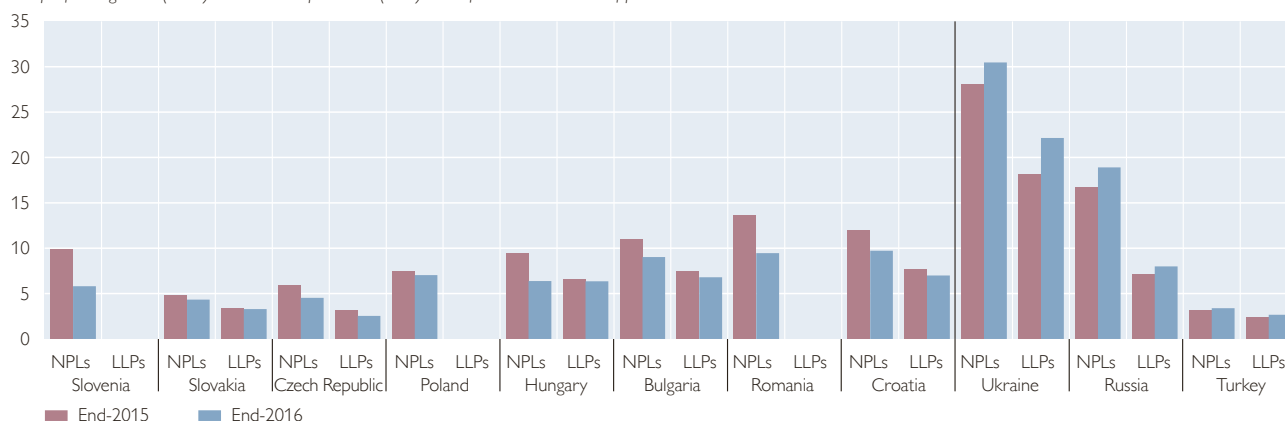
In the period ahead, banks foresee a pickup in expected credit demand and an easing of expected supply conditions. Aggregate supply conditions are expected to ease, and the easing is expected to be more broadly based than before. However, the gap between credit demand and supply positions seems to be widening further: Optimism on the demand side is still not fully reflected by aggregate conditions on the supply side.

Notably, the cross-border deleveraging trend seems to be bottoming out, as more and more banking groups expect exposure to stabilize over the second half of 2017 according to the EIB survey. While cross-border banking groups continue to discriminate between countries of operation as they reassess their country-by-country strat-

Chart 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 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).

³ http://www.eib.org/attachments/efs/economics_cesee_bls_2017_h1_en.pdf.

egies, they are also increasingly signaling their intentions to expand operations selectively across the region.

The resolution of NPLs in CESEE progressed in the review period. All CESEE EU Member States reported a reduction of NPL ratios. This positive momentum was attributable to the pickup in credit growth on the one hand and to active portfolio cleansing measures on the other hand. For example, the strong decrease in nonperforming assets in Slovenia and Romania (more than –4 percentage points between end-2015 and end-2016) was related to writing off bad debt, selling NPL portfolios as well as to restructuring and forbearance agreements. In addition, in Slovenia, a further tranche of bad claims was transferred to the Bank Asset Management Company. Given those measures, NPL ratios reached the lowest level since 2010 in both countries. Contrary to the positive developments in the CESEE EU Member States, credit quality deteriorated further in Russia and Ukraine. In Turkey, the share of NPLs in total loans increased somewhat but remained at a comparatively low level, with the provision coverage ratio coming to around 75%.

The average return on assets (ROA) in the CESEE EU Member States reached 1.2% at the end of 2016. This corresponds to a doubling of average profitability compared to 2015. The ROA improved particularly in Hungary and Croatia, increasing by 1.4 percentage points and 2.4 percentage points, respectively. In both countries operating (especially noninterest) income was higher in 2016 than in 2015. Most of the improvement, however, was related to lower costs for provisioning and write-offs. In Hungary, a reduction in the bank tax played a role too. In most of the other CESEE EU Member States,

profitability also improved somewhat, the changes vis-à-vis 2015 were smaller, however. Only Romania reported a slight decline in ROA on the back of lower other income.

Returns also improved in Russia and Turkey. In Russia, lower provisions and write-offs drove the results, while in Turkey operating income was somewhat higher as interest income performed well. Ukraine was the only country of the region to report a substantial deterioration in profitability, with the ROA declining from –5.9% at the end of 2015 to –12.5% at the end of 2016 and losses in the banking sector reaching record highs (UAH 159 billion). This deterioration resulted mainly from provisioning for Privatbank after the nationalization of the institute in December 2016.

Capital adequacy ratios remained high and broadly stable in most of the CESEE countries under review at the end of 2016. In the CESEE EU Member States, they ranged between 17.7% in

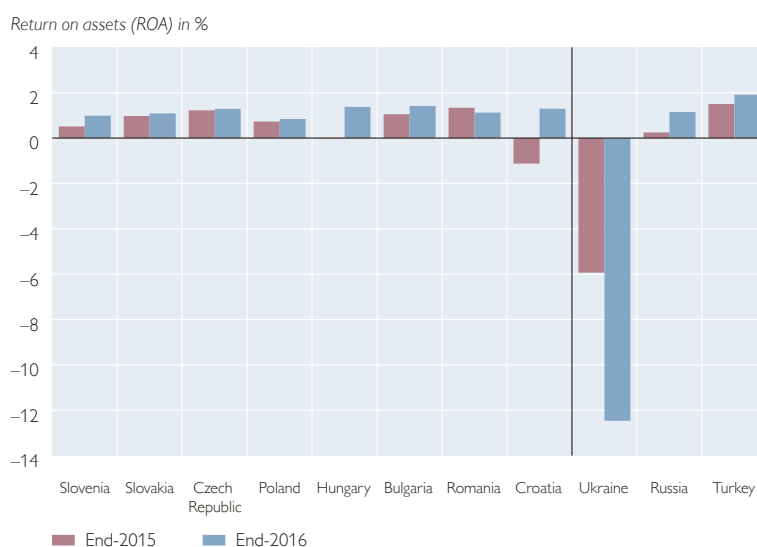
Most CESEE banking sectors remain well capitalized

NPL resolution progresses

Profitability on the rise

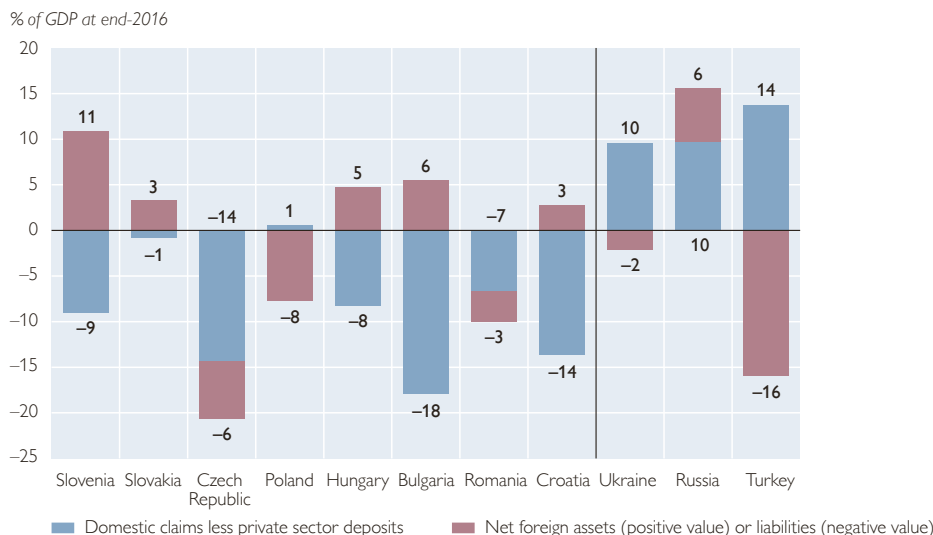
Chart 4

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.

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

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

Poland and 22.2% in Bulgaria. In the non-EU Member States of the region, capitalization was notably lower (between 12.7% in Ukraine and 15.1% in Turkey).

The refinancing structure of CESEE banking sectors has increasingly shifted toward domestic deposits over the past few years. 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) at the end of 2016. The overhang of deposits over claims even increased notably in Hungary, Croatia and Slovenia. In all three countries, claims were lower at the end of 2016 than a year earlier, while deposits continued their upward trend.

Compared to the EU Member States, Ukraine, Russia and Turkey exhibited positive and large funding gaps of between 10% and 14% of GDP. While the gap narrowed somewhat in Ukraine and Turkey, it widened by 4% of GDP in Russia, as deposits declined notably.

The banking sectors of five of the eleven CESEE countries under observation reported net external liabilities at the end of 2016, mostly ranging between 2% and 8% of GDP. Only Turkey recorded substantially higher net external liabilities of 16% of GDP. Despite its negative funding gap, the Czech Republic's banking sector became a net debtor in the review period. At the same time, the Hungarian banking sector managed to turn from a net debtor into a net creditor.

Funding gaps still moderate in most CESEE countries