

International macroeconomic environment: strengthening global and European growth outlook

Global economic growth gains traction on the back of supportive financial conditions

The expansion in global economic activity is broadening, with worldwide GDP growth expected to rise slightly to 3.7% in 2018,¹ after a temporary slowdown in some countries in early 2017. Improvements are visible in investment, trade, industrial production as well as business and consumer confidence. International financing conditions remain benign amid an environment of still accommodative, albeit in many cases gradually tightening, monetary policies. Financial markets in emerging market economies remain resilient and capital inflows continue to be robust.

Still, the pace of global expansion remains below pre-crisis rates as lower growth potential across most advanced and emerging economies reflects trends in demographics, investment, trade and productivity. Although output gaps are narrowing or have even closed in some cases, inflation is below target in most advanced economies. Commodity exporters start to recover from a sharp drop in foreign revenues with prices of raw materials, including crude oil, picking up.

Risks to global growth are still tilted to the downside, reflecting threatening trade protectionism, economic policy uncertainty, possible financial market disruptions and weaker potential growth.

In the United States economic activity is increasing at a solid pace. The pick-up in growth in 2017 and 2018 is buoyed by private consumption and investment. However, strong job

creation is not triggering upward pressure on wage growth and inflation, partly due to higher labor force participation and part-time working. The growth effects of future tax cuts and regulatory reforms currently under consideration remain uncertain. Household debt is firmly rising but still below pre-crisis levels in terms of GDP. Monetary policy is gradually tightening as the Federal Reserve System raised its key interest rate twice, in March and June 2017, and started to normalize its balance sheet in October 2017 by no longer reinvesting all of its maturing assets.

In Japan public investment and exports support the growth upturn in 2017. However, fiscal consolidation is likely to dampen economic activity in 2018. While business investment benefits from rising corporate profits, the tight labor market does not boost wage growth as yet. The Bank of Japan expects inflation to stay at current very low levels, and it continues to maintain its accommodative monetary policy.

In China economic growth is likely to exceed the official target in 2017, particularly driven by credit-financed consumer spending. High and fast rising debt of households and state-owned enterprises is raising financial stability concerns, but net capital inflows have turned positive. The pace of economic expansion is expected to remain steady in 2018 amid recent regulatory measures effectively tightening financial conditions and rebalancing the economy.

In the U.K. the economy has lost some steam as Brexit-related economic uncertainty and the connected slide in

Solid expansion in
U.S.A., Japan and
China; muted
growth in U.K. and
Switzerland

¹ IMF. 2017. *World Economic Outlook Fall 2017*.

the exchange rate of the pound sterling are taking their toll, while consumer credit has increased rapidly.

The Swiss economy shows relatively weak GDP momentum and very low inflation levels. The Swiss franc has weakened to around CHF 1.16 against the euro, helping to reduce the significant overvaluation of the currency. Imbalances on the mortgage and real estate markets persist. The Swiss National Bank has maintained its expansionary monetary policy with negative key interest rates and is ready to intervene in foreign exchange markets.

Euro area recovery becomes stronger and more broad-based

In the euro area economic growth momentum continues to be robust and broad-based, driven by private consumption and business investment. Furthermore, growth is supported by steadily rising income and profits as well as expanded lending spurred by favorable financing conditions. Additionally, euro area exports benefit from stronger foreign demand offsetting the effect of the euro appreciation (5% in nominal effective terms since early 2017). The euro area fiscal stance is expected to be mildly expansionary in 2017 and turn neutral in the following two years. Given recent upward surprises in GDP data the ECB has revised its growth projections for 2017 upwards to 2.2%, but has maintained the forecast for 2018 at 1.8%.² Risks to the growth outlook are considered to be balanced. External risks are rather negative and relate to an overshooting euro exchange rate, geopolitical tensions, trade protectionism, vulnerability of emerging markets to global monetary policy tightening, adverse implications

of Brexit, and the rebalancing of crude oil markets. Internal risks point in both directions and refer to an underestimated recovery, de-anchoring inflation expectations and increasing banking vulnerabilities.

The negative output gap is expected to close in the second half of 2018 as potential output is estimated to grow at below its pre-crisis pace, which is related to historically moderate investment over recent years. Labor market recovery continues, with sustained employment creation. However, labor underutilization, in terms of involuntary part-time employment and discouraged workers, might explain why wages are rising slowly and why underlying inflation is subdued. The ECB forecasts headline (HICP) inflation to even decline, from 1.5% in 2017 to 1.2% in 2018, driven mainly by base effects in the energy component, before rising again to reach 1.5% in 2019. Market-based long-term inflation expectations (five-year forward inflation swaps starting in five years) have increased slightly, to 1.6%.

At its October 2017 meeting, the Governing Council of the ECB kept interest rates on main refinancing operations, the marginal lending facility and the deposit facility unchanged at 0.00%, 0.25% and –0.40%, respectively. Key interest rates are expected to remain at the present levels well past the horizon of the Eurosystem's asset purchase programme (APP), which was extended until the end of September 2018, or beyond, if needed – subject to the decision to reduce the monthly pace of net asset purchases from currently EUR 60 billion to EUR 30 billion as of January 2018. At the same time, the Governing Council stands ready to re-increase APP purchases, depending

ECB prolongs accommodative monetary policy stance

² ECB staff macroeconomic projections for the euro area, September 2017. <https://www.ecb.europa.eu/pub/pdf/other/ecb.ecbstaffprojections201709.en.pdf?13047040af5611b7e0cda69c6a88bf2>.

on whether the inflation path approaches the Eurosystem's medium-term objective of below, but close to, 2%. Furthermore, maturing securities will be reinvested as long as deemed necessary. Finally, main and three-month longer-term refinancing operations with commercial banks will be continued as fixed rate tender procedures with full allotment at least until the end of the last reserve maintenance period of 2019.³ The APP has had an easing effect on credit terms and conditions. Its impact on banks' liquidity position has also been positive, whereas its impact on their profitability has been negative. With regard to the second half of 2017, banks reported to have left their credit standards for loans to enterprises

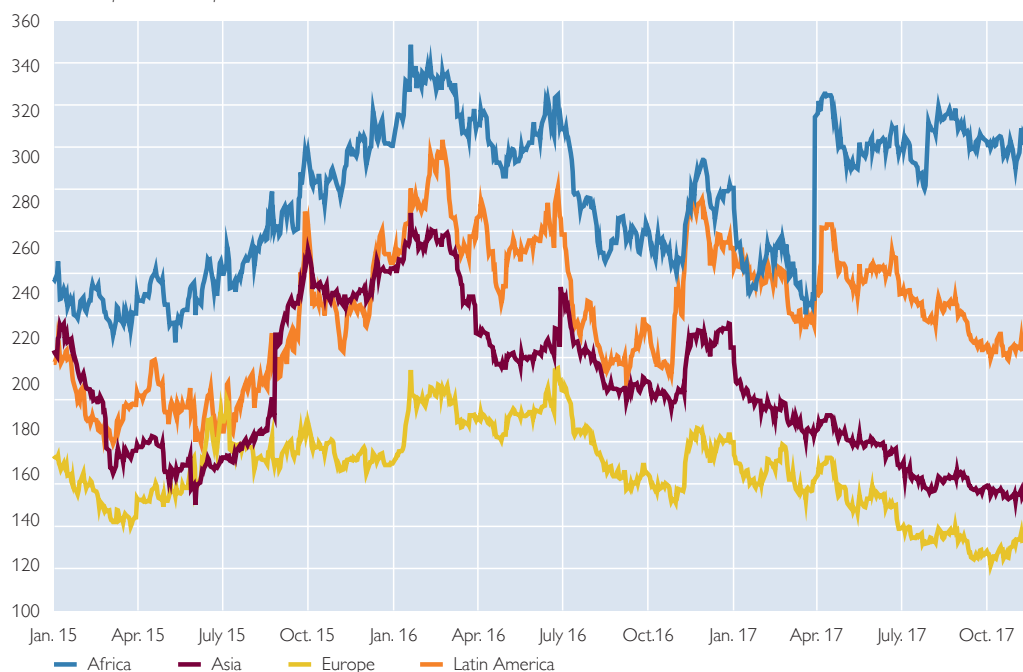
broadly unchanged, but to have eased their standards for loans to households. The low general level of interest rates contributed to continuously increasing net loan demand across all loan categories.

Since early 2017 the yields of German ten-year government bonds have increased by some 20 basis points, to 0.41%. The spreads of Portuguese and Greek bonds to German benchmark yields have substantially narrowed. Less pronounced declines were observed with regard to the spreads of Italian and French bonds. During the same period, the exchange rate of the euro in nominal terms appreciated by some 11.5% to roughly USD 1.17 per EUR and 6% against the Japanese yen. International stock exchanges indices rose to new

Chart 1

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

Euro EMBIG spread in basis points



Source: Macrobond.

Note: EMBIG = Emerging Market Bonds Index Global.

³ Mario Draghi, Introductory statement at press conference on October 26, 2017. <https://www.ecb.europa.eu/press/pressconf/2017/html/ecb.is171026.en.html>.

highs. By end-October 2017, the representative stock index DJ Euro Stoxx had gained more than 8% since January. Over the same period, the Dow Jones Industrial Index gained 19% and the FTSE 100 around 4%, both being at or close to all-time highs. Price-earnings ratios well above their historical averages, low stock market volatility and compressed corporate yield spreads increase the risk of market sentiment reversals. Brent crude oil prices rose by more than 12% in 2017 to above USD 63 per barrel, as increasing demand was tightly matched by constrained supply amid geopolitical tensions.

CESEE: credit growth accelerates against the backdrop of an improving macroeconomic environment

Global macroeconomic and financial market conditions remained favorable in the review period. Equity prices were on an upward trend amid strong earnings, improvements in consumer and business confidence, and favorable macroeconomic data. At the same time, market volatility remained low and risk appetite strong. Capital flows to emerging market economies have remained resilient in recent months and continued their recovery. This was reflected in a notable and rather broad-based decline in spreads of euro-denominated sovereign bonds across most emerging market regions throughout 2017 (see chart 1). In Central, Eastern and Southeastern Europe (CESEE), spreads remained substantially below the level observed in other peer regions, and most other financial market segments performed broadly positive as well.

At the same time, the acceleration in the global momentum appears to be well entrenched with notable upward revisions in major regions of the world

economy (including the euro area, Japan, China and Canada) pushing up global GDP growth to its highest level since 2011. Moreover, global trade also returned to its most dynamic level in years despite constant fears of a return of protectionist tendencies: The upturn in emerging markets and advanced economies, reviving investment activity and moderately higher commodity prices lifted world trade growth to 5% annually in summer 2017. Further, several risks for the CESEE region have not materialized so far: Brexit has not yet altered the functioning of the European economy and common European principles (including the free movement of persons). Also more narrowly confined problems like the Volkswagen emission violations have not acted as a game changer: So far, passenger car registrations in the EU have continued their upward trend, with a drop in diesel sales offset by an increase in petrol vehicles. This development supports the region's key automotive sector. Finally, while geopolitical risks for CESEE remain elevated, they have not intensified over the review period, and increasing anti-European sentiment and rising populism in some countries have not yet shown an impact on economic developments.

The favorable international environment has provided the backdrop for a continuing strong growth momentum. Average GDP growth in the CESEE EU Member States accelerated noticeably in the first half of 2017 and the region's economies reported one of the fastest expansions since the downturn in 2008. Economic growth was driven by private consumption in an environment of record employment, tightening labor markets and rising real wages. Gross fixed capital formation also gained speed amid capacities approaching their limits, strong industrial confidence and

Strong GDP growth in CESEE EU Member States supported by domestic demand

improved credit market conditions. Furthermore, investment in construction and public investment picked up, being supported by stepped-up utilization of EU funds in several countries. The CESEE EU Member States' trade openness and integration into international production networks provided for a quick and comprehensive absorption of external growth impulses. Several rating and/or rating outlook upgrades substantiated the favorable economic situation (e.g. Bulgaria, Croatia, Hungary and Slovenia). On a more negative note, labor shortages are beginning to emerge in several countries and strong wage growth is increasingly cutting into price competitiveness. Further, current strong growth dynamics are increasingly supported by a pro-cyclical fiscal policy stance.

After a prolonged period of deflation, inflation in the CESEE EU Member States finally started to rise again in mid-2016 and was clearly positive by September 2017 in all countries. With inflation rates ranging between 1.3% in Romania and Bulgaria and 2.5% in the Czech Republic and Hungary, however, price rises remained moderate in historical comparison. While the pick-up in inflation was initially mainly driven by rising energy prices, other and less volatile components – especially processed food (including alcohol and tobacco) and services – started to play a bigger role more recently. This might be an indication of increasing domestic price pressures emanating from a rising utilization of domestic means of production and an increasingly positive output gap.

Against this backdrop, some countries took first steps to end the period of monetary accommodation. Most importantly, the Czech central bank (CNB) increased its policy rate by 20 basis points, to 0.25% in August 2017.

Monetary conditions already tightened somewhat as the Czech koruna appreciated by around 4.5% after the CNB discontinued the observance of an exchange rate floor against the euro in April 2017.

The Romanian central bank (NBR) in September 2017 decided to narrow the symmetrical corridor of interest rates on its standing facilities around the policy rate to ± 1.25 percentage points from ± 1.5 percentage points. Accordingly, it raised the deposit facility rate to 0.5%, lowered the interest rate on the lending facility to 3% and kept the monetary policy rate unchanged at 1.75%.

In contrast, a favorable price outlook provided policy space for the Hungarian central bank (MNB) to further selectively loosen its monetary policy. In September 2017, the overnight deposit rate was cut from -0.05% to -0.15% . The MNB also repeatedly reduced the cap on its three-month deposit facility and extended its foreign currency swap facility in order to boost forint liquidity in the system.

Turning to the non-EU CESEE countries, growth also picked up in Turkey and Russia. In Turkey, dynamics benefited especially from expansionary fiscal policies. In addition, a rebound in external demand, not least related to a more competitive lira and the lifting of the Russian ban on certain Turkish goods and services, and abating political uncertainty after the April referendum supported the economy. The Turkish central bank (CBRT) tightened policy between November 2016 and May 2017 in response to sharp falls in the value of the lira in November 2016 and January 2017. The strong depreciation contributed to a surge in inflation: Price rises reached levels of close to 12% in April and May 2017 and have been hovering between 10% and 11% in recent

Turkey remains susceptible to currency depreciation

First countries start to tighten monetary policy

months. By raising its late liquidity window lending rate and reducing the volume of its lending to banks at lower rates, the CBRT increased the weighted average cost of its funding to banks from less than 8% in late 2016 to around 12% in October 2017. Recently, the Turkish lira again embarked on a downward trend following political tensions between Turkey and the U.S., depreciating by 3% against the euro and by 4.8% against the U.S. dollar between September 28 and October 9, 2017. This underlines the continuing vulnerability of the Turkish economy to changes in political risks amid an elevated current account deficit and external financing needs.

Russian economic growth accelerated in line with a recovery of private consumption and fixed investment. The economic upturn was also certainly helped by the partial recovery of the oil price, which on average gained almost one-third in the first half of 2017 from its low level of a year before. However, the ruble also revalued in this period, by about one-fifth. Both the revaluation of the Russian currency and the Central Bank of Russia's (CBR) continued tight monetary policy contributed to the historically low level of CPI inflation (3.0% at end-September 2017). Easing inflation, conservative bank lending and firming economic recovery allowed the CBR to resume its cautious key policy rate cuts in late April, mid-June and mid-September, by a cumulative 125 basis points to 8.5%.

The Ukrainian economy continued its moderate recovery and grew at a similar rate as in 2016 despite adverse shocks related to the still unresolved conflict in parts of Eastern Ukraine (trade embargo imposed by Ukraine vis-à-vis the non-government controlled area, seizure of enterprises by Russian-backed separatists). In 2017, the

Ukrainian central bank (NBU) cut its key policy rate by 50 basis points twice, in April and May, to 12.5%. Yet, after falling to single digits in the course of 2016, the annual inflation rate accelerated to 16.2% in August, mainly due to food and administered prices. A noteworthy aspect is that Ukraine regained access to international markets in September. The Ukrainian government sold USD 3 billion in 15-year bonds with a 7.375% percent annual yield, partially to buy back USD 1.6 billion of 2019 and 2020 bonds, alleviating forthcoming repayment spikes somewhat. The bond issue was more than three times oversubscribed. The smooth issuance is a sign of macroeconomic stabilization, but also of benign global liquidity conditions and low risk aversion.

As regards credit growth in CESEE, lending to the private sector (nominal lending to the nonbank private sector adjusted for exchange rate changes) gained further 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 (see chart 2). Lending surveys suggest that demand for loans picked up strongly. Notably, investment accounted for a good part of the strengthening in demand, while debt restructuring was almost irrelevant. At the same time, aggregate supply conditions remained broadly unchanged over the first half of 2017. Across the customer spectrum, supply conditions eased partially in the corporate segment, including SME lending, while credit standards have tightened on mortgage loans and consumer credit. The mismatch between rising demand and broadly unchanged supply conditions may imply that credit allocation has become more prudent and that most of the new credit can be

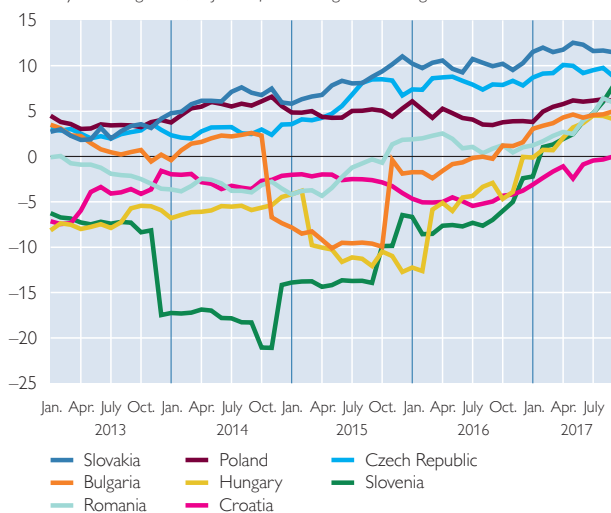
Oil price bolsters recovery in Russia

Strong and broad-based acceleration of credit growth in CESEE

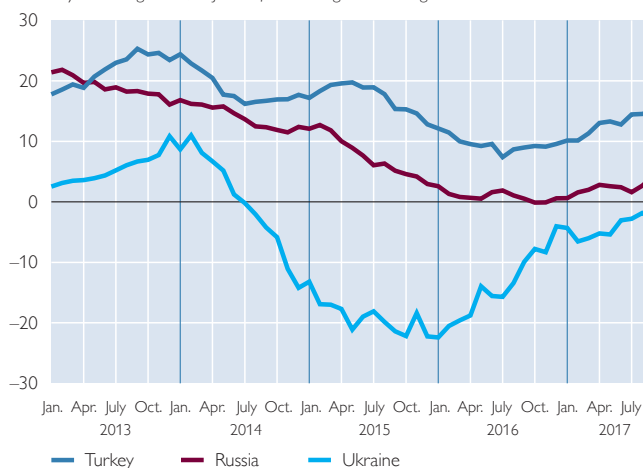
Ukraine regains access to international markets

CESEE: growth of credit to the private sector

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



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



Source: ECB, national central banks.

considered to be of a better quality on average than in prior credit cycles.

Credit growth picked up especially in Bulgaria, Hungary, Romania and Slovenia, which had experienced only very moderate or even negative credit expansion back in 2016. All of these countries reported improving banking sector conditions in recent years. Credit developments also benefited from reduced uncertainty (e.g. in Romania) and central bank measures (e.g. in Hungary).

Among the CESEE EU Member States, the Czech Republic and Slovakia reported the strongest loan growth at or above 10% in annual terms. Central banks in both countries introduced a countercyclical capital buffer of 0.5% of total risk exposure as of January and August 2017, respectively, to counter rash credit expansion. This capital buffer is to be raised to 1% in the Czech Republic by July 2018, and to 1.25% in Slovakia by August 2018. Rapid growth in loans went hand in hand with strong growth in real estate prices. The CNB, for example, considers residential property in the Czech Republic to be

moderately overvalued and lending standards for the provision of mortgage loans to be highly relaxed, which is why it has issued recommendations on loan-to-value limits. The Slovak central bank also introduced a package of measures to address the strong growth in housing loans, including limits on the loan-to-value ratio and on the debt service-to-income ratio, as well as maturity limits.

Among the CESEE countries that are not members of the EU, credit growth was highest in Turkey, where fiscal measures and incentives pushed up credit expansion to close to 15%. The volume of private sector loans in Ukraine shrank by about 2% year on year in September 2017, but month-on-month growth rates have shown a stabilizing private sector loan volume since April. Lending growth in Russia remained broadly unchanged in the review period at roughly 2%.

Almost all CESEE countries made progress in shoring up their banking sectors in recent years and continued doing so in the review period. For example, credit risk was reduced

Czech Republic and Slovakia to raise countercyclical capital buffer

NPLs continue their downward trend

further. Nonperforming loans (NPLs) decreased in all CESEE EU Member States when compared to a year earlier (see chart 3). In several countries, NPL ratios reached their lowest levels since 2009. This positive momentum was attributable to the pick-up in credit growth on the one hand and to active portfolio cleansing measures – including writing off bad debt, selling NPL portfolios as well as restructuring and forbearance agreements and the transfer of NPLs to bad banks – on the other.

In Turkey, NPLs remained broadly unchanged, while in Russia they increased moderately to 18.9% in the second quarter of 2017. In September 2017, the CBR nationalized Russia's eighth- and twelfth-largest bank, which together accounted for 5% to 6% of total sector assets. Both banks had been expanding aggressively in recent years, suffered from swelling bad loans, and became subject to runs on their deposits.

The doubling of the NPL ratio in Ukraine to above 50% can be explained by a change in methodology. The new framework captures loans that are more than 90 days past due as well as loans

with a low probability of repayment. NPLs are especially high in the country's largest bank at 88.8, which was nationalized in December 2016. This brought the share of state-owned banks in the banking sector to over one half.

The reduction of NPL ratios in many CESEE countries was accompanied by a further decrease in foreign currency denominated credit. This is especially true for households, whose share of foreign currency denominated credit in total credit is already close to zero in the Czech Republic, Hungary, Russia and Slovakia. In the other countries, the average share declined by around 10 percentage points since early 2016, to a level of 30%.

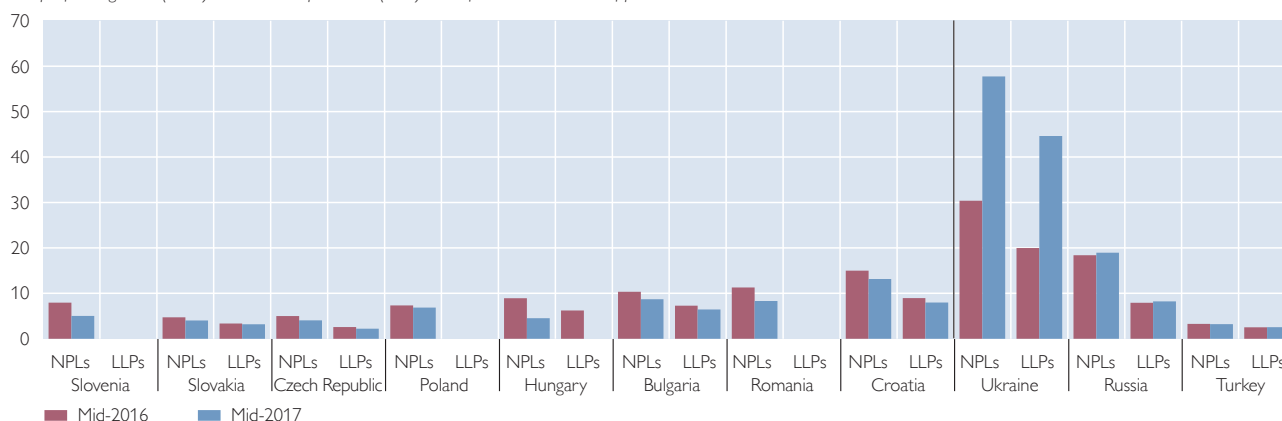
The refinancing structure of CESEE banking sectors has increasingly shifted toward domestic deposits over the past few years and continued doing so in the review period. This is especially true for the CESEE EU Member States that had no substantial gap or a negative gap between total outstanding domestic claims and total domestic deposits relative to GDP as at mid-2017 (see chart 4). However, this trend has

Funding gaps stay moderate in most CESEE countries

Chart 3

CESEE banking sector: credit quality

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

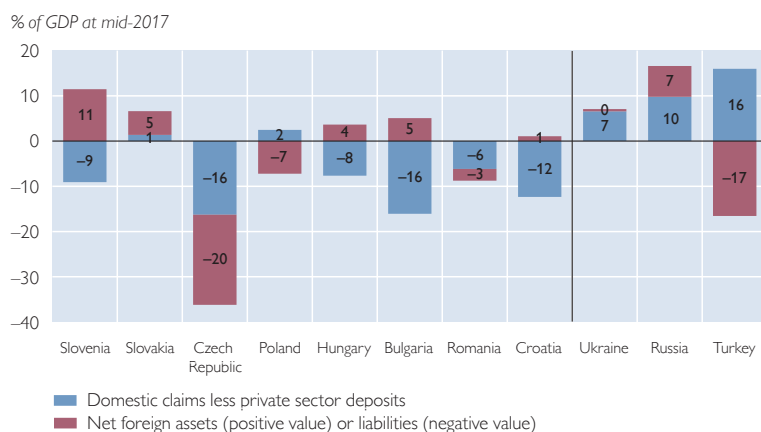


Source: IMF, national central banks, OeNB.

Note: Data are not comparable across countries. NPLs generally refer to loans that are in arrears for more than 90 days except for the Czech Republic, Poland, Russia, Slovakia and Turkey, where NPLs refer to substandard, doubtful and loss loans.

Chart 4

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



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

Profitability is broadly comparable to 2016

already come to a halt in Slovakia, where the gap widened in the review period (from -2.8% of GDP in mid-2016 to 1.4% in mid-2017) against the background of strongly expanding claims amid a stable depository base.

Compared to the CESEE EU Member States, Ukraine, Russia and Turkey exhibited positive and large funding gaps of between 7% and 16% of GDP. While the gap narrowed in Russia and especially in Ukraine (by some 4% of GDP within a year) against the backdrop of moderate or negative credit growth, it widened notably in Turkey as deposit growth could not keep pace with strongly expanding claims.

Most CESEE banking sectors remain well capitalized

The banking sectors of four of the eleven CESEE countries under observation reported net external liabilities by mid-2017. Liabilities were especially high in the Czech Republic, where they shot up in anticipation of the abolition of the exchange rate floor of the koruna against the euro in the first quarter of 2017. In Turkey, external liabilities

increased moderately compared to a year earlier and remained on a high level.

Banking sector profitability remained broadly satisfactory in the CESEE EU Member States. Return on (average) assets (ROA) amounted to 1.2% at mid-2017 (see chart 5). This is somewhat below mid-year figures for 2016, but broadly in line with the results for 2016 as a whole. The ROA declined especially in Croatia against the backdrop of the banking sector's provisioning for its exposure to Agrokor, the country's ailing retailer. Several other countries of the region reported a moderate decline in profitability as well, mainly related to lower interest and non-interest income. At the same time, the need for provisioning declined throughout the region.

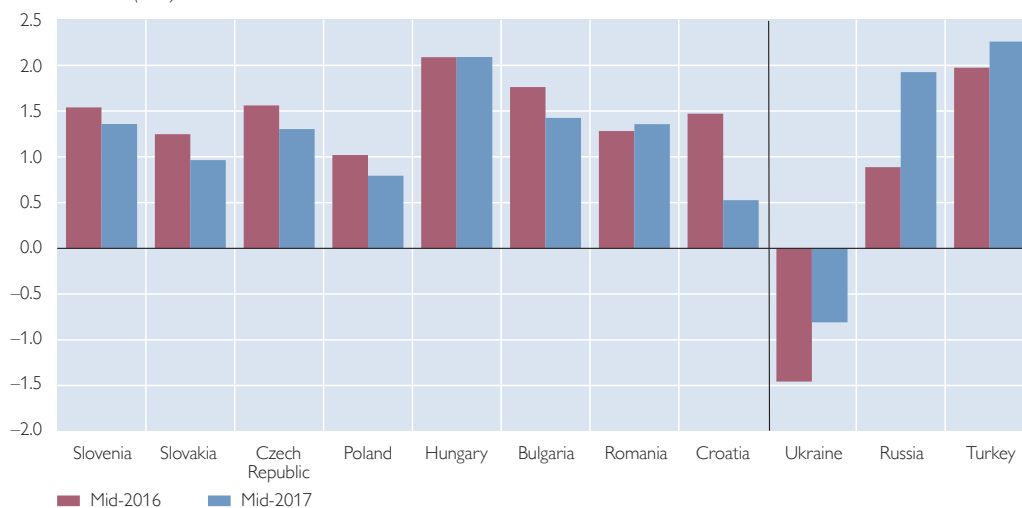
The ROA increased moderately in Turkey and strongly in Russia. In both countries, profitability reached the highest level since 2013. The Turkish banking sector benefited from higher interest income, while the recovery of interest rate margins, intensified cost control measures and lately also the pick-up in economic growth supported profitability in Russia. After a substantial loss in 2016, mainly due to provisioning needs at the country's largest bank, the ROA in Ukraine recovered to -0.8% in mid-2017.

Capital adequacy ratios (CARs) remained high and even increased further in most CESEE EU Member States. By mid-2017, CARs ranged between 17.9% in Poland and 23.2% in Croatia. In the other countries of the region, capitalization was markedly lower (between 12.4% in Ukraine and 16.4% in Turkey) but also increased somewhat in Turkey and Russia.

Chart 5

CESEE banking sector: profitability

Return on assets (ROA) in %



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.