

International macroeconomic environment: global outlook improved despite divergent recoveries and high uncertainty

Global activity remains resilient to resurgent pandemic

The economic impact of the resurgent pandemic has been more muted than in early 2020 as firms and households have learned to cope with lockdowns. It is increasingly visible that most advanced economies will soon have overcome the worst of the health and economic crisis. Recently, significant vaccination progress has suggested a faster loosening of containment measures. Also, large fiscal support and accommodative financial conditions underpin optimism across global financial markets. Trade in goods has fared better than expected, while trade in services remains subdued due to travel restrictions and other containment measures that particularly affect tourism-based economies. Supply bottlenecks pose a short-term risk to the recovery. Temporarily rising commodity and input prices are putting upward pressure on headline inflation, which however, is being dampened by low capacity utilization. Current data indicate a sustained recovery in global economic activity and world trade. In the first quarter of 2021, China recorded a huge real GDP expansion of 18.3% (year on year), which, however, mainly reflected a base effect due to a severe contraction in the first quarter of 2020. The corresponding figures are 0.4% for the USA and -1.8% for the euro area (both year on year).¹

Based on a substantially improved outlook, the IMF expects global real GDP to rise by 6.0% in 2021. This reflects an increase of more than 9 percentage points against the recession year 2020 and a substantial upward revision against the forecast of last autumn.² The reasons for the improved outlook are the better than expected developments in the second half of 2020, the large US fiscal package and the expectation of a strong recovery in the second half of 2021 enabled by accelerated vaccinations. The IMF stresses that uncertainty is high and that downside risks prevail, not only in connection with the further course of the pandemic and possible delays in vaccinations but also in connection with deteriorating financing conditions, more frequent natural disasters as well as geopolitical and

Table 1.1

Projections of real GDP growth

	IMF WEO projections of April 2021 in %			Revisions to October 2020 WEO in percentage points	
	2020	2021	2022	2021	2022
Euro area	-6.6	4.4	3.8	-0.8	0.2
Austria	-6.6	3.5	4.0	-1.1	..
UK	-9.9	5.3	5.1	-0.6	1.9
Japan	-4.8	3.3	2.5	1.0	0.8
China	2.3	8.4	5.6	0.2	-0.2
USA	-3.5	6.4	3.5	3.3	0.6
World	-3.3	6.0	4.4	0.8	0.2

Source: IMF World Economic Outlook (WEO).

¹ OECD. 2021. Quarterly GDP.

² IMF. 2021. World Economic Outlook – April 2021.

trade policy risks. A rapid return of real GDP to pre-crisis levels will be made more difficult by so-called scarring effects on productivity and human capital in economic sectors that have suffered lasting damage. Moreover, the consequences of rising inequality are increasing the risk of social unrest.

While unprecedented macroeconomic policy measures have contained financial stability risks, they may have promoted excessive risk taking in markets. Equity markets have rallied on rising earnings expectations since mid-2020; however, equity prices have exceeded levels suggested by fundamental-based models run by the IMF.³ Similarly, low risk-free rates have narrowed corporate bond spreads considerably. Emerging economies with large external financing needs may be confronted with a repricing of risk and tighter financial conditions as soon as advanced economies normalize their policies. Recently rising long-term US yields may have contributed to declining capital inflows into emerging economies, particularly those with high US dollar-denominated debt. Yet markets remain generally confident, as inflation has broadly been under control in most large emerging economies apart from Turkey. The pandemic has left the corporate sector overindebted in many countries, which has raised concerns about loan quality and reduced banks' risk appetite. These issues may become exacerbated by a wave of bankruptcies, even in advanced economies, as soon as debtor protection measures and tax deferrals are repealed. So far however, banks have been resilient in the pandemic thanks to capital and liquidity buffers amplified in response to the global financial crisis.

The economic effects and response measures in the wake of the pandemic also pose a challenge to fiscal sustainability. In 2020, average overall deficits reached 11.7% of GDP in 2020 in advanced economies and 9.8% in emerging economies. Revenues fell everywhere, whereas pandemic-related spending was higher, mostly in advanced economies (6% of GDP in 2021). Spending will decline only gradually, given recovery plans including 18% climate-related investment.⁴ While fiscal support and automatic stabilizers have prevented deeper recessions, average public debt has risen to unprecedented levels and is expected to stabilize at 99% of GDP worldwide in 2021.⁵ In the advanced economies, the average debt ratio will have risen by 18.7 percentage points to 122.5% from 2019 to 2021 – almost twice the change and level expected for emerging economies. This leaves governments with the difficult task of avoiding a premature withdrawal of fiscal support while preparing for medium-term fiscal consolidation. Still, public households are being supported by a trend decline in market interest rates and accommodative policies of central banks. Given limited market access, however, the situation is more difficult for low-income countries.

In the USA, economic recovery is gaining momentum amid rapid vaccination progress and extensive fiscal incentives. The IMF has raised its growth forecasts for the USA by more than 3 percentage points and expects that real GDP will grow by 6.4% in 2021 as a result of fiscal incentives – even if a considerable part of the spending package (USD 1.9 trillion in total) is temporarily being set aside as savings by private households. In addition, President Biden has

³ IMF. 2021. *Global Financial Stability Report. Preempting a Legacy of Vulnerabilities*. April 2021.

⁴ UNDP. 2021. *How are Countries Investing in Recovery? Report*.

⁵ IMF. 2021. *Fiscal Monitor*. April 2021.

announced two plans that are supposed to be partly financed by tax increases: a USD 2.3 trillion plan for infrastructure and low-carbon transition and a USD 1.8 trillion plan for families and education. These measures are expected to shift the output gap into positive territory for two years from 2021. The US Federal Reserve (Fed) therefore assumes that core PCE inflation (part of its monetary policy target) will rise above 2% in the course of 2021 and reach 2.2% in December 2021. Public debates about a possible overheating of the economy have been fueled by the fact that longer-term US yields have temporarily increased due to higher inflation expectations and risk premiums. Nevertheless, the Fed has maintained its accommodative policy stance, keeping the federal funds rate in a target range of 0% to 0.25% and continuing monthly purchases of at least USD 120 billion in Treasuries and asset-backed securities.

China already returned to pre-pandemic GDP levels in 2020, supported by effective containment measures, strong public investment and ample central bank liquidity. The rapid rebound of the Chinese economy has, however, led to a further buildup in financial vulnerabilities. Corporate debt has risen sharply, particularly driven by riskier borrowers, and public debt has increased by 10 percentage points to 66.4% in 2020. The IMF has revised its autumn forecast upward, expecting real economic growth of 8.4% for 2021 and a return to long-term trend growth at 5.6% for 2022. In line with a rebalancing needed to return to a sustainable growth path, the Chinese authorities plan to gradually reduce their fiscal support, increasingly shifting it toward private households, and to reduce the deficit through higher revenues. Inflation turned positive in the first quarter of 2021 but is still very muted despite high producer price inflation. The People's Bank of China has announced that it will maintain its flexible and targeted monetary policy and pay more attention to the containment of financial risks. Since May 2020, the renminbi has appreciated against the US dollar.

Japan is expected to return to end-2019 activity levels in the second half of 2021. The outlook for the Japanese economy has improved, thanks to unprecedented domestic policy support and favorable external conditions, with growth projected at 3.3% in 2021 and 2.5% in 2022. The government announced sizable fiscal support for 2021 after public debt had risen by more than 20 percentage points to 256.2% of GDP in 2020. The Bank of Japan continues its monetary easing by flexibly cutting interest rates, controlling the yield curve via fixed-rate purchase operations as well as by purchasing exchange-traded funds and real estate investment trusts.

The United Kingdom suffered one of the strongest economic contractions in Europe, with GDP dropping by almost 10% in 2020. The IMF expects the UK's real GDP to grow by 5.3% in 2021 and at a similar rate in 2022. The reopening of retail and catering businesses and the steep decline in COVID-19 cases thanks to swift vaccine uptakes should allow the recovery to build momentum. UK exports to the EU fell sharply in early 2021, reflecting the resumption of EU custom controls in the wake of Brexit. Very moderate consumer price inflation (0.7% in March) is likely to rise soon. The Bank of England maintains its accommodative monetary policy stance with a base rate of 0.1% and a total target stock of asset purchases of almost GBP 900 billion.

In Switzerland, the decline in economic growth was comparatively modest. After a drop by 3% in 2020, the IMF expects Switzerland's GDP growth

to pick up to 3.5% in 2021 and a slightly lower rate thereafter. Inflation is forecast to remain barely positive. The exchange rate of the Swiss franc has declined to around CHF 1.1 against the euro since early 2021. The Swiss National Bank has maintained its expansionary monetary policy with negative key interest rates (−0.75%) and generous liquidity supply, while standing ready to intervene in foreign exchange markets to counter overvaluation.

In the euro area, a third wave of the COVID-19 pandemic has delayed the projected return to growth. After the euro area economy experienced another mild contraction in the first quarter of 2021, a rebound is expected to start from the second quarter of 2021, driven by global and domestic demand, positive profit growth, favorable financing conditions as well as coordinated crisis response and solidarity instruments. After a decline by 6.6% in 2020, the IMF expects growth to return to positive levels of 4.4% for 2021 and 3.8% for 2022. The IMF's forecast for 2021 is more optimistic than a previous forecast by the ECB, not least because it is based on upwardly revised GDP figures for 2020. Inflation was close to zero in 2020 but is forecast to rise to 1.5% in 2021, before weakening somewhat in the following years.

Divergent growth within the euro area is increasing financial stability risks, often concentrated in countries and sectors with pre-existing vulnerabilities. The euro area countries most negatively affected in 2020 were Spain (−11%) and Italy (−8.9%), while Germany performed better than average (−4.9%), and Ireland was an outlier recording positive growth (2.5%). Now, in the recovery phase, the picture is changing, and the IMF expects Spain to become the fastest-growing economy in the euro area (6.4%) in 2021, followed by France (5.8%), while Germany and Italy are expected to remain below the euro area average (3.6% and 4.2%, respectively). These differences are accounted for by various factors such as the relative importance of tourism. The crisis also entailed diverging debt ratios of up to 205.6% of GDP in Greece and 155.8% in Italy, while Germany's debt ratio of 69.8% stayed below the euro area average of 98%.⁶ Financial stability concerns also stem from potential corrections in stretched asset valuations, higher corporate debt across all economic sectors, low bank profitability and concentrated exposures to low-carbon transition risks.⁷

Fiscal policy in the euro area has provided critical support for incomes, employment, businesses and financial stability. According to the ECB, discretionary fiscal policy measures related to the COVID-19 crisis, including the recovery fund branded “Next Generation EU” (NGEU), amount to 4¼% of GDP for 2020, 3.3% for 2021 and about 1.5% for 2022 and 2023 each. Their growth impact is estimated at 1.7 percentage points in 2020 and 0.5 percentage points in 2021.⁸ Additionally, automatic stabilizers (amounting to about 5% of GDP) are estimated to have contributed about 0.8 percentage points in 2020. Furthermore, government loan guarantees totaling 17% of GDP and capital injections have alleviated liquidity constraints. The high level of savings is likely to support household investment, while digital and environmental projects funded by the NGEU will mobilize private investments beyond the forecast horizon.

⁶ Eurostat. 2021. Government debt up to 98.0% of GDP in euro area. *euroindicators of April 23, 2021*.

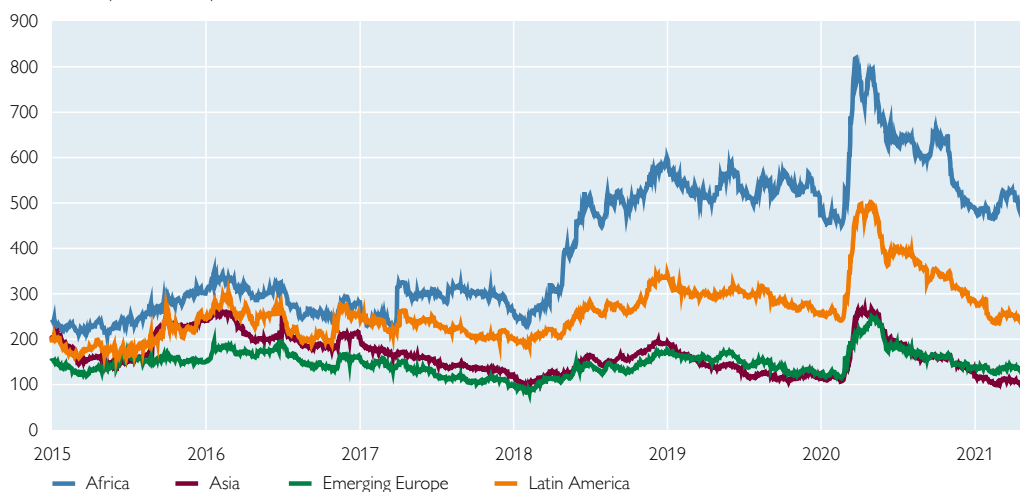
⁷ ECB. 2021. *Financial Stability Review*. May 19, 2021.

⁸ ECB. 2021. *Economic Bulletin*. Issue 2.

Chart 1.1

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

Euro EMBIG spread in basis points



Source: Macrobond.

Note: EMBIG = Emerging Markets Bond Index Global.

The ECB has reacted to the crisis with wide-ranging measures to mitigate the economic and financial consequences of the pandemic.

The ECB's Governing Council has announced that it will continue the ECB's pandemic emergency purchase programme (PEPP) until at least March 2022 with a total envelope of potentially used EUR 1,850 billion. Net purchases under the expanded asset purchase programme (APP) are scheduled to continue at a monthly pace of EUR 20 billion. Moreover, the Eurosystem will continue to provide the banking sector with ample liquidity through its refinancing operations, mainly through its targeted longer-term refinancing operations (TLTRO III) supporting bank lending to firms and households. Since the start of the pandemic, the Eurosystem's asset purchases and refinancing operations have provided roughly EUR 2,800 billion in liquidity. In addition, supervisory and macroprudential policies have freed up bank capital for absorbing losses and supporting credit flows to the real economy. These policies included the release of capital buffers, guidance to reduce procyclical provisioning and measures to preserve banks' loss-absorbing capacity. It is assumed that, taken together, fiscal, monetary and prudential policy will help avoid severe real-financial feedback loops.

Financial markets data reflect optimism. Since the beginning of 2021, the exchange rate of the euro in nominal terms has depreciated by 0.8% to roughly USD/EUR 1.22 and appreciated by 4.6% against the Japanese yen. Since the beginning of 2021, the yields of German 10-year government bonds have increased by more than 30 basis points but remain negative at -0.3% . Spreads between German benchmark yields and Portuguese, Spanish, French Italian and Greek bond yields have remained stable, with only the latter two exceeding 100 basis points. The spreads between 10-year US Treasuries and German bund yields have risen by 68 to 181 basis points. International stock indices increased in the first quarter of 2021. Since January 2021, the representative stock index DJ EURO STOXX has

gained around 13%. The Dow Jones Industrial Index and the FTSE 100 have shown similar increases although their rally was steeper last year. Brent crude oil prices rose by about 33% in the first months of 2021, to almost 69 per barrel.

Coronavirus sent CESEE into a deep recession, but banking sectors have been performing reasonably well so far

The spread of coronavirus across the world in spring 2020 brought economic activity in CESEE⁹ to a sudden halt. Output in the region shrank by 2.2% on average in 2020, with several countries reporting notably sharper setbacks. Thus, 2020 will go down in history as a year with some of the sharpest economic downturns in the region since the transformation years of the early 1990s.

And yet, the recession was less severe than in the euro area. A large part of the positive growth differential was due to the resilience of the CESEE region's two largest economies – Russia and Turkey. Turkey stands out in particular, as it was one of only two countries in Europe that reported an economic expansion in 2020 on the back of a notable credit impulse from state-owned banks. However, also the CESEE EU member states and Ukraine recorded a somewhat milder recession than the average euro area country.

CESEE was more resilient because of two factors: In the first half of 2020, a more gradual spread of the pandemic eastward and a quick reaction by local authorities prevented the type of public health crises that were observed in e.g. Italy or Spain and enabled CESEE to start lifting restrictions on public life and the economy at a comparatively early stage. Later in 2020, CESEE benefited from a rebound in world trade that allowed industrial dynamics to break away from trends seen in most other sectors, especially services. Unlike in spring, lockdown measures mainly targeted contact-intensive sectors like services and retail trade, while industrial production remained largely unrestricted. Structural features of CESEE economies (especially a comparatively high share of industry and a comparatively low share of services in gross value added) acted as further stabilizing factors.

Industrial strength was mirrored in a clear revival of exports in late 2020. Export performance improved throughout the second half of 2020 and export volumes again embarked on an upward trend in the final quarter of 2020 in half of the CESEE countries. As weak domestic demand put a brake on imports, this often translated into a positive growth contribution of net exports to GDP growth. However, it needs to be noted that, in some parts of CESEE, the external sector also substantially reduced growth. This is particularly true for the countries that are most reliant on tourism, i.e. Bulgaria, Croatia and Turkey, where a strong reduction of tourist visits due to COVID-19-related travel restrictions weighed on services exports.

⁹ *Central, Eastern and Southeastern Europe. This report covers Slovakia, Slovenia, Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Turkey, Russia and Ukraine.*

While public consumption bolstered economic activity – in part thanks to large-scale fiscal crisis mitigation packages – the remaining components of domestic demand stayed weak throughout CESEE. COVID-19-related shutdowns in services and retail, sour sentiment, decelerating credit momentum and weaker labor markets weighed on consumer spending, and uncertainty about the further course of the pandemic kept capital spending low. Investment dynamics, however, picked up somewhat toward the end of 2020, reflecting rising capacity utilization rates amid the recovery of external demand and industrial production.

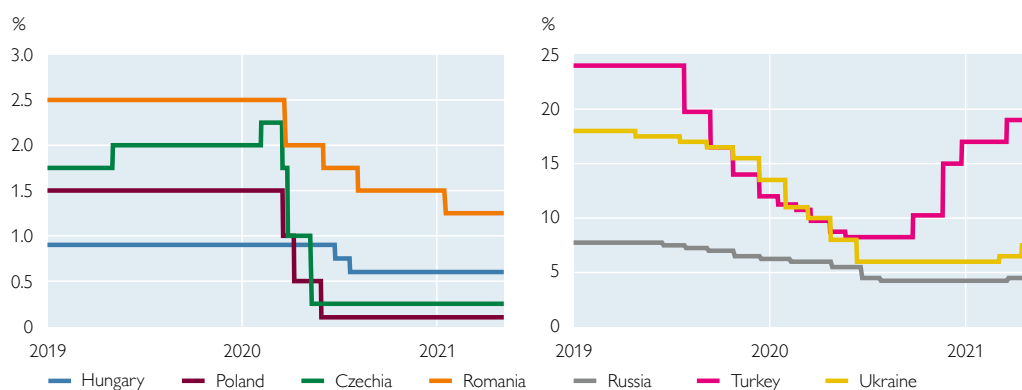
Despite weak economic activity, inflation declined only very moderately following the onset of the coronavirus pandemic. In the CESEE EU member states, average inflation fell from 3.2% in March 2020 to 2.4% in December 2020. The decline, however, was not evenly spread across the region, and inflation fell more in euro area countries and countries that have pegged their currency to the euro (i.e. Slovakia, Slovenia, Bulgaria and Croatia). This suggests that the exchange rate pass-through prevented prices from falling more strongly in the countries with a freely floating exchange rate. In the first quarter of 2021, the Czech koruna, the Hungarian forint and the Polish złoty traded 1.7%, 6.1% and 4.9%, respectively, below their corresponding euro values in the same period of the previous year. On the level of individual HICP components, lower price growth in the CESEE EU member states was mainly related to lower price pressure from non-core items (i.e. energy and unprocessed food) and processed food. Consequently, core inflation remained constant in the second half of 2020 and stood at an average of 3.3% in December 2020 (3.3% in March 2020). The first two months of 2021 brought about some reacceleration of regional headline inflation (to 3.1% in March 2021) on the back of higher energy prices, while core inflation remained broadly unchanged (3.1% in March 2021).

In non-EU CESEE countries, inflation was not only higher, it also accelerated notably in recent months. In March 2021, headline inflation came in at 5.8% in Russia, 8.5% in Ukraine and 16.2% in Turkey. In addition to some temporary factors (e.g. a low yield of agricultural crops in Ukraine in 2020), all three countries struggled with higher exchange rate volatility that passed through to price growth in the past quarters, fueled by political uncertainty and – in the case of Russia – oil price developments. In the first quarter of 2021, the Russian ruble, the Ukrainian hryvnia and the Turkish lira traded 17.9%, 18.2% and 24.3%, respectively, below their corresponding euro values in the same period of 2020.

Monetary policy and financial conditions remain highly accommodative in the CESEE EU member states. Monetary policymakers took swift and comprehensive action in response to the COVID-19-related recessions. While the Eurosystem's monetary policy decisions enhanced monetary accommodation in those CESEE economies that are part of the euro area, most non-euro area countries in the region lowered their national policy rates. For instance, the Czech central bank cut its key policy rate in three steps, from 2.25% to 0.25%, the Polish central bank, also in three steps, from 1.5% to 0.1%, the Hungarian central bank in two steps, from 0.9% to 0.6%, and the Romanian central bank in four steps, from 2.5% to 1.25% (see chart 1.2).

Chart 1.2

Policy rates in CESEE



Source: Macrobond.

Furthermore, several central banks (including those of Croatia, Hungary, Poland, Romania and Turkey) started to buy sovereign bonds issued by their respective countries. To provide the banking sector with sufficient liquidity, some national central banks in the region also adjusted minimum reserve requirements for banks and conducted longer-term refinancing operations. The adequate provision of liquidity was further supported through the establishment of liquidity lines with the ECB. Such lines include repo facilities with the central banks of Hungary and Romania (EUR 4 billion and EUR 4.5 billion, respectively, until March 2022) and swap facilities with the central bank of Croatia (EUR 2 billion, until March 2022) and the central bank of Bulgaria (EUR 2 billion, expired at end-2020). A number of countries also implemented loan repayment moratoria and eased macroprudential regulations for the banking sector, for instance with regard to the size of anticyclical capital buffers (e.g. in Bulgaria, Czechia and Slovakia) or with regard to the collateral framework and debt-servicing capacity rules for borrowers (e.g. in Slovenia).

Russia, Ukraine and Turkey have tightened their monetary policy in recent months. In March and April 2021, Russia increased its policy rate by a total of 75 basis points to 4.5%. In the same months, Ukraine raised its policy rate in two steps by a total of 150 basis points to 7.5%. In both countries, inflation ran above target in early 2021.

In Turkey, rates were raised in four steps from September 2020, by a total of 1,075 basis points to 19%, after a loose policy stance and repeated rate cuts in the first half of 2020 had helped economic activity recover but had contributed to high annual consumer price inflation, a persistent current account deficit, a rapid loss of foreign exchange reserves and a sell-off in the lira. As noted above, the Turkish lira depreciated substantially in the course of 2020 and reached a historical low in early November 2020 against the euro and the US dollar. After rallying markedly between November 2020 and February 2021, it started to weaken again from mid-February onward. Although the lira's latest weaknesses were partly related to global trends – emerging-market currencies have been hit by expectations of higher US interest rates – they may also have reflected renewed concern about the Turkish authorities' commitment to policy tightening.

Financial market turbulences were largely contained throughout most of CESEE in the wake of the pandemic. Uncertainty at the start of the first COVID-19 wave led to currency depreciation, an increase in sovereign spreads and capital outflows from the region but monetary and financial easing in advanced economies contained financial stress and stabilized international markets. High-frequency fund flow data show that outflows from CESEE were mainly concentrated to the second half of March 2020. After this short episode, net fund flows hovered around zero before global investment funds started to flock back to CESEE bond markets in autumn 2020. This trend was interrupted in February 2021, when bond flows suddenly declined and eventually dried up. The last two weeks of March 2021 brought about a certain reversal of this trend, and especially the CESEE EU member states' bond markets again attracted international capital. The situation remained more tense in Russia and Turkey, however.

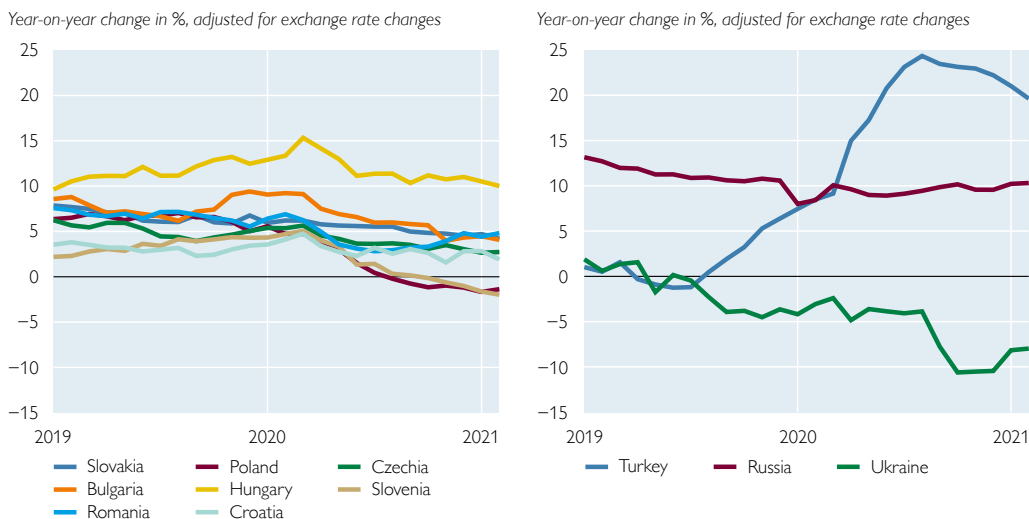
Expectations of higher US interest rates following the announcement of the US fiscal stimulus in late 2020 have had limited spillovers on European yields so far. In the CESEE EU member states, 10-year government bond yields have increased between 12 basis points in Romania and 59 basis points in Czechia since the beginning of 2021 (with some moderate decline in Croatia). The increase in US bond yields was more pronounced (+66 basis points). In several CESEE EU member states, yields in mid-April 2021 were lower than in early March 2020. Central banks' large-scale purchases of government securities in the framework of their quantitative easing programs were probably instrumental in keeping yields low despite increased financing requirements for government budgets. In addition, stepped-up liquidity provision to banks and decreased credit demand by the private sector also likely helped absorb increased government bond supply. Stronger increases in 10-year government bond yields, however, were reported for Russia and Turkey (+117 basis points and +556 basis points, respectively, until mid-April 2021), where domestic (political) factors amplified global trends.

In the banking sector, the coronavirus pandemic brought about a reversal of previous years' trends. Its impact on banking sector indicators, however, was much weaker than in the global financial crisis of 2008. On the one hand, this was related to the very nature of the shock that sent the region into recession. On the other hand, CESEE banks entered the downturn on a much stronger footing than in 2008 (i.e. with stronger capital buffers, less excessive loan growth, a much lower foreign currency-denominated exposure and/or a strengthened regulatory environment).

Weaker demand and worsening credit supply conditions dampened loan growth in nearly all CESEE countries (see chart 1.3). Demand suffered from faltering domestic demand and souring sentiment. Supply was negatively affected by tightened collateral requirements and groups' limited funding, a weakening local and international environment and nonperforming exposures. The decline in credit expansion, however, was rather moderate in many countries, as the recession turned out weaker than initially expected. Furthermore, surveys suggest that regulatory action (e.g. more flexible treatment of NPLs, relaxation of liquidity ratios, various forms of capital relief measures and adjustments of risk weights), monetary policy measures (e.g. long-term liquidity provision) and public guarantee schemes have supported lending activity.

Chart 1.3

CESEE: growth of credit to the private sector



Source: ECB, national central banks.

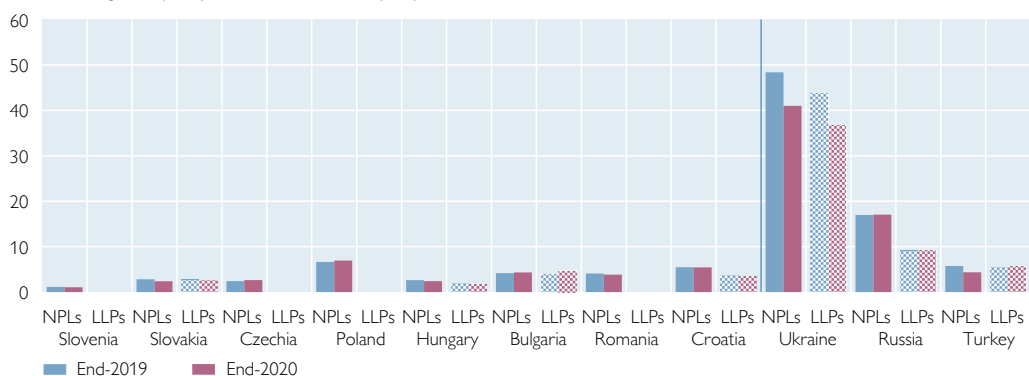
All countries introduced moratoria on the repayment of loans to alleviate financial strains for borrowers. Surveys indicate that no more than 20% of borrowers renegotiated loan repayments in most CESEE countries. Even in countries where blanket moratoria were imposed by law (e.g. Hungary), penetration did not reach higher levels than some 50% of private sector loans. This is a sign that the remaining borrowers were able to service their debt amid falling interest rates and borrowing costs and despite the economic downturn.

Against this backdrop, NPLs have not yet embarked on a clear upward trend. In fact, NPL ratios declined somewhat throughout 2020 in more than half of the countries under observation (see chart 1.4). The most notable decline was reported for Ukraine, where state-owned banks stepped up the resolution of (fully

Chart 1.4

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 Czechia, Poland, Russia, Slovakia and Turkey, where NPLs refer to substandard, doubtful and loss loans.

provisioned) nonperforming exposures. Banks, however, expect that the quality of loan applications in the region will deteriorate across the client spectrum and that NPLs will increase notably in the future.

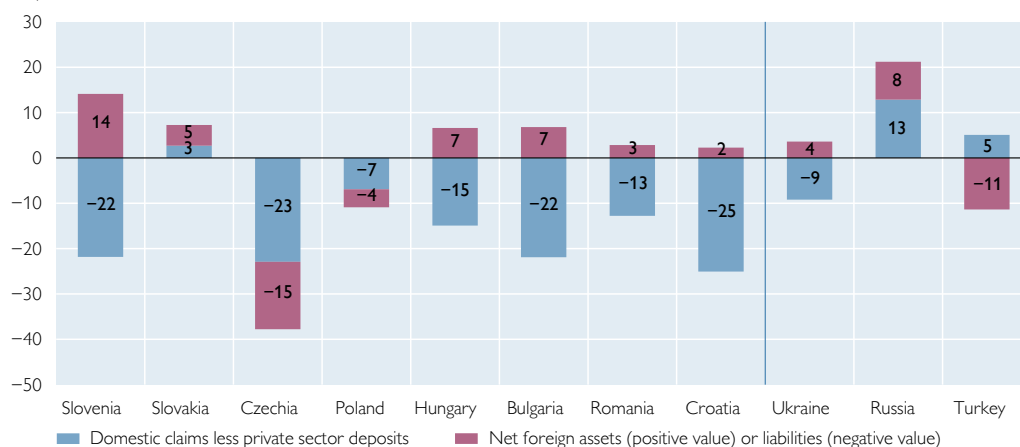
The COVID-19 pandemic further supported a shift in the refinancing structure of CESEE banking sectors toward domestic deposits. A moderate decline in domestic claims was accompanied by a notable increase of private sector deposits in the year 2020 (see chart 1.5). Apparently, corporations and households increased savings as consumption and investment decisions were postponed in an uncertain environment. This resulted in the largest overhang of deposits over claims in the past 20 years throughout most of CESEE, with gaps reaching more than –20% of GDP in Czechia, Bulgaria, Croatia and Slovenia. A substantially positive funding gap was only reported for Russia and Turkey, where loan growth was particularly strong.

The crisis, finally, had a notable impact on the profitability of banking sectors in CESEE. The return on assets (ROA) in 2020 was notably lower than in 2019 and declined by close to 40% on average. Especially strong reductions were reported for several CESEE EU member states, including Hungary, Bulgaria and Croatia. The ROA nevertheless remained positive and ranged between 0.3% in Poland and 2% in Ukraine at the end of 2020 (see chart 1.6). Rising loan loss provisions in response to the recession were a main driver of lower bank profits. Central bank rate cuts put additional pressure on net interest margins, and lower loan growth weighed on operating income. Profitability will likely remain under stress, as eased regulatory requirements and loan moratoria only temporarily sheltered banks from some of the COVID-19-related impact. Deteriorating profitability coupled with rising NPLs will likely weigh on banks' capital ratios. At the end of 2020, however, most CESEE banking sectors continued to report substantial capital buffers. The capital adequacy ratio (tier 1) hovered between 14.1% in Turkey and 24.3% in Croatia. Substantially lower figures were only reported for Russia (9.7%).

Chart 1.5

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

% of GDP at end-2020

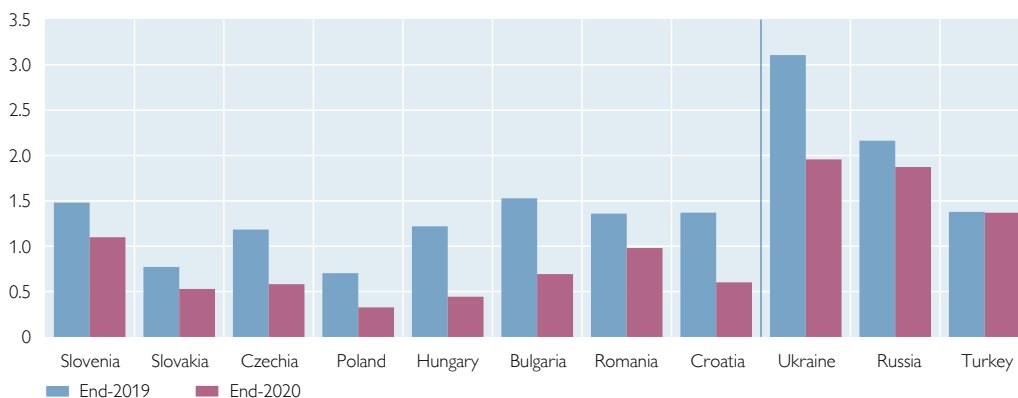


Source: ECB, Eurostat, national central banks, national statistical offices, OeNB.

Chart 1.6

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 pre-tax profits.

Box 1

European banks in Russia from 2017 through the COVID-19 pandemic – recent developments and perspectives¹⁰

Europe's significant banks have remained committed to the Russian banking sector despite challenges linked to the COVID-19 pandemic. Though European banks qualifying as significant institutions for banking supervision purposes have pursued different strategies in the Russian banking sector, they remain committed to this market, with a resilient performance.¹¹ Nonetheless, they face several challenges linked with the wide-ranging impacts of the COVID-19 pandemic on the Russian and global economy. In the years prior to the pandemic (2017 to 2019), European banks slightly increased their market presence in Russia, with different underlying trajectories. They experienced dynamic revenue growth, even if profitability ratios faced some pressure. Their credit quality tended to improve, and compliance with capital requirements was ensured. Besides, while Russia's pre-pandemic GDP growth had suffered from a weak investment climate, oil price volatility and sanctions, the country and its banking system had built up sizable financial buffers. In 2020, the COVID-19 pandemic stopped European banks' lending expansion and provisioning drove a moderate crisis-related profitability contraction. At the same time, the banking sector entered a regime of regulatory forbearance. Measures decided by the Bank of Russia in response to the crisis, as well as key rate reductions and targeted government subsidies, have supported banks' and businesses' activity. Overall, the economic recession was rather mild on the back of limited restrictive measures and fiscal stimulus. In March and April 2021, the key rate was raised against the backdrop of inflationary pressures and incipient economic recovery tendencies.

Looking ahead, credit risk remains a central risk driver for European banks, as crisis-related measures are slated to expire in mid-2021, and the second half of the year may well be a test for the market. The banking sector would in general appear sufficiently capitalized to cover a potential swelling of loan losses and provisioning needs. This goes especially for European banks that tend to have better than average asset quality and a sound capital basis. But European banks also keep facing exogenous risks, such as ruble volatility or sanctions, which are still among the major risks when operating in Russia. Climate risk is

¹⁰ This box includes highlights of a study to be published in: *Focus on European Economic Integration Q3/21*. OeNB.

¹¹ The analysis covers the Russian subsidiaries of Raiffeisen Bank International, Société Générale and UniCredit.

also an upcoming challenge. Likewise, dynamic digitalization trends bring both risks and opportunities in this competitive market, and the pandemic served as a real test to European banks' digitalization capacities.

Russia's banking sector and economy will be strongly influenced by the further course of the COVID-19 pandemic and the effectiveness of vaccines. That said, the still weak overall investment climate may slow down the recovery. While their combined profitability in Russia has so far been quite resilient despite different underlying trajectories, European banks qualifying as significant institutions will have to continue to maneuver through prospects of oil price and ruble volatility, persisting sanction risks and moderate growth trends. This will continue to provide a challenging environment, even if generous reserves remain at the disposal of the authorities should financial problems emerge for the banking sector, a scenario whose implications remain untested in the case of European banks.