The economic outlook remains characterized by high and persistent inflationary pressures

Global growth held back amid persistent inflation, monetary tightening and high uncertainty

The global economy showed some resilience in the second half of 2022, but fragilities have started to materialize. Despite price pressures, tightening monetary and financial conditions and increasing geopolitical tensions, the global economy showed some resilience on the back of the fiscal support provided during the pandemic and strong pent-up demand. Nevertheless, fragilities have started to materialize as persistent inflation and increasing borrowing costs revealed financial stability risk, while the world economy is facing increasing geopolitical fragmentation and high levels of both private and sovereign debt. Moreover, energy security and climate concerns are still looming. Due to the challenges ahead and the highly uncertain global economic outlook, the International Monetary Fund (IMF) has revised downward the world growth forecast, now projecting a deceleration from 3.4% in 2022 to 2.8% in 2023. According to the IMF, advanced economies are going to experience a very pronounced slowdown, from 2.7% in 2022 to 1.3% in 2023 in the baseline scenario. In a more adverse scenario with further financial stress materializing, growth is expected to be even lower.

The global economic outlook remains characterized by high and persistent inflationary pressures. Energy price shocks hitting in 2022, stronger than expected domestic conditions and tight labor markets have put further pressure on prices and wages after the pandemic and have caused global inflation to reach its highest level since the 1980s, which weighs on the cost of living of households, especially those on lower incomes. As a response to high and persistent

Table 1.1

GDP growth and inflation forecasts

	April 2023 IMF WEO projections			
	Real GDP growth		Annual HICP/CPI inflation	
	2023	2024	2023	2024
	%			
Euro area	0.8	1.4	5.3	2.9
UK	–0.3	1.0	6.8	3.0
Japan	1.3	1.0	2.7	2.2
China	5.2	4.5	2.0	2.2
USA	1.6	1.1	4.5	2.3
World	2.8	3.0	7.0	4.9

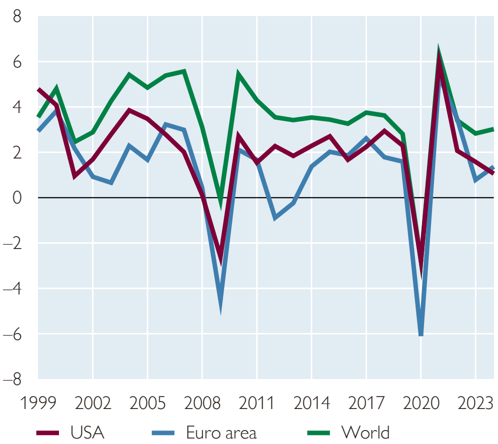
Source: IMF.

Note: WEO = World Economic Outlook.

Chart 1.1

World GDP

Annual increase in %



Source: Macrobond, IMF.

Note: Forecast data are based on the April 2023 IMF World Economic Outlook.

inflation, central banks around the world have undertaken monetary policy tightening unprecedented in its speed, size and width. Due to increasing rates and the fallout from the energy price shock of 2022, global headline inflation peaked in the third quarter of 2022. Nevertheless, inflation remains well above target. Its core component was still on the rise in most advanced economies in March 2023 and is expected to decrease only sluggishly in 2023 and 2024 due to the persistence of second-round effects. Moreover, additional risks are looming on the horizon – the threat of growing commodity prices persists because of renewed pressures to supply chains due to increasing geopolitical fragmentation, possible further energy supply shocks and a rise in demand for commodities from China, which suddenly discontinued its zero-COVID policy in December 2022.[1] All of these factors might put renewed pressure on inflation and, consequently, on monetary authorities that would have to keep interest rates high for longer.

Monetary policy tightening and restrictive financing conditions reveal fragilities in the financial system. The rapid rise of borrowing costs and the asset depreciation accompanying the policy reversal after a decade of ultralow interest rates have revealed financial stability risks. Low interest rates and ample liquidity provision granted after the global financial crisis and additional support during the pandemic have favored the buildup of debt and financial leverage. Global nonfinancial debt rose from 182% to 257% of global GDP between 2008 and 2021 and increasing financial leverage has been observed especially in nonbank financial institutions.[2] Giving rise to the risk of liquidity mismatch, the latter might trigger investor runs and asset fire sales which, in turn, amplify price declines.[3] Financial market volatility has been elevated during the last months; yields on ten-year UK, US and German government debt have increased by over 200 basis points since the start of 2022, currently standing at their highest levels since the global financial crisis. The rapid increases in interest rates on long-term government debt globally and considerably tightened financial conditions could lead to sharp adjustments. Banks hold large portfolios of debt on their balance sheet including long-term government debt and real estate debt the prices of which have been affected since monetary tightening started. Signs of financial distress materialized in September 2022, with the liquidity spiral in UK pension funds caused by the so-called mini-budget, and in the spring of 2023, with the failure of several banks in the USA and of Credit Suisse in Europe, which led to a sharp drop in share prices around the world. While there are concerns that persistent inflation and monetary tightening could cause further stress in credit and financial markets, risks have to date been contained thanks to public intervention, regulatory requirements and the injection of short-term liquidity in the banking sector.

Financing conditions have tightened significantly and some sectors are facing contraction and increasing bankruptcy rates. With the steep

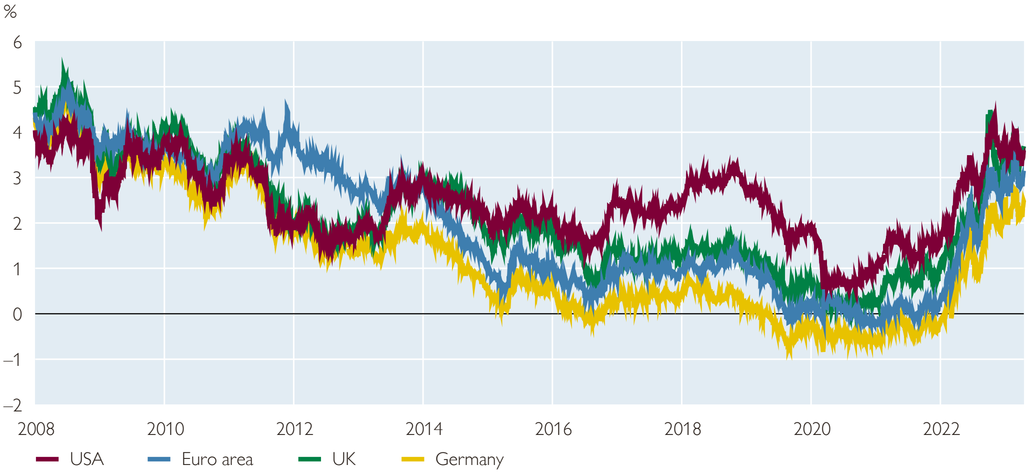
[1] *According to OeNB simulations with the Oxford Global Economics Model, increasing activity in China (with GDP growth going up from 3% in 2022 to 5.2% in 2023 and 4.5% in 2024 as forecast by the IMF in its April 2023 World Economic Outlook) might drive up world oil and gas prices by 8.3% and 4.5%, respectively. As a consequence, global inflation would rise by 0.3 percentage points compared to a scenario in which Chinese growth remains at 2022 levels.*

[2] *See the IMF Global Financial Stability Report (GFSR) of April 2023.*

[3] *According to the IMF GFSR, the main vulnerabilities are related to high financial leverage, liquidity and interconnectedness.*

Chart 1.2

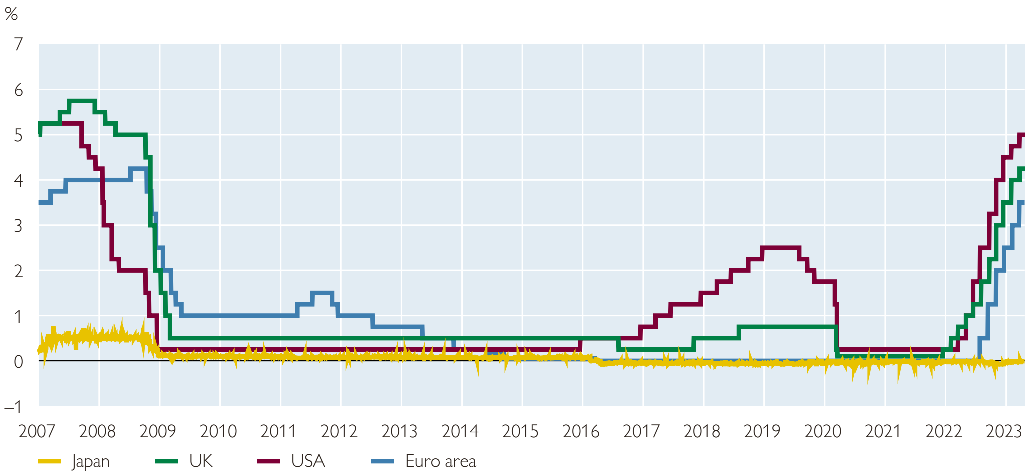
Advanced economies: yield of ten-year government benchmark bonds



Source: Macrobond.

Chart 1.3

Advanced economies: policy rates



Source: Macrobond.

rise of interest rates, credit volumes started to fall, and the real estate sector showed signs of slowdown in most regions in 2022.[4] In the business sector, bankruptcies also started going up in several countries. In Europe, business bankruptcy declarations increased substantially in 2022, reaching the highest levels since the start of data collection in 2015 (see chart 1.4).[5] The sharpest increases in bankruptcy declarations between the third and fourth quarter of 2022 were observed

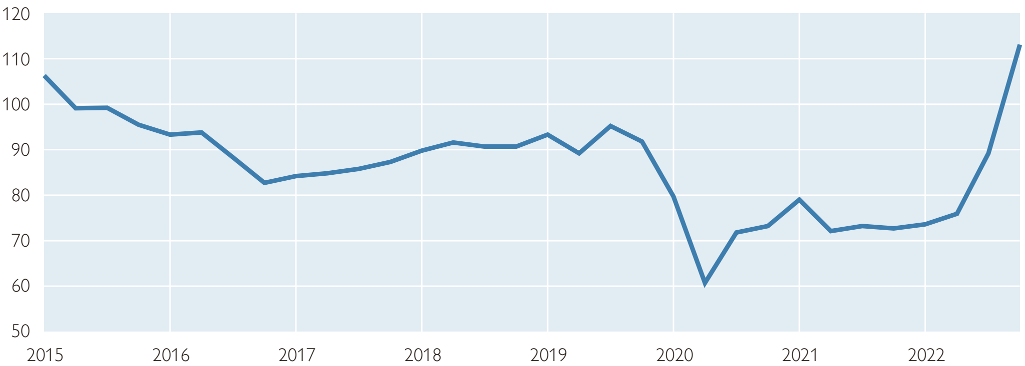
[4] *Real house prices decreased from peaks reached in 2021/early 2022 in most European, American as well as Asian and Pacific developed economies, with a few exceptions (e.g. Japan).*

[5] *Eurostat data. Please note that, in the first two quarters of 2020, bankruptcy declarations decreased on account of the extraordinary financial support provided by governments in the first months of the pandemic.*

Chart 1.4

European Union (EU-27): bankruptcy declarations

Index: 2015 = 100



Source: Eurostat.

in Luxembourg (71.8%), Spain (59.5%) and Hungary (41.6%). Loan defaults are also expected to increase as interest rates rise. For instance, a jump in defaults has recently been observed in the UK as interest rate hikes continue and price increases remain in double-digit territory. Even if defaults and nonperforming loans (NPLs) so far remain below pre-pandemic levels in most countries, the risks of global debt vulnerabilities crystallizing have increased, both in the private sector and at the sovereign level. Low-income and emerging economies are struggling to pay rising debt-servicing costs, while facing high commodity prices and low growth prospects amid weak global demand and limited fiscal space.

Geopolitical tensions, trade fragmentation, commodity markets security risks and climate risks continue to loom ahead. Given the high uncertainty in the economic, financial and geopolitical environment, the outlook has deteriorated over recent months, while downward risks still prevail. The volatility of data and expectations is particularly high and might trigger speculative behavior and increase risk aversion among investors. The currently intensifying geopolitical fragmentation, including the use of sanctions and protectionist measures, also reduces the diversification of investments and poses a risk both to commodity markets security and to investments in the energy transition.[6] Multiple challenges arise from the persistently high inflation and uncertainty about monetary policy reactions, together with reduced opportunities to diversify investments across regions and sectors; this also raises volatility both in the real economy and in financial markets.[7] Moreover, the effect of market fragmentation might be even more pronounced in emerging markets and developing economies which, already dependent on commodity imports and high level of external debt, are more exposed to sudden reversals of cross-border capital flows.

[6] *Both the EU and the USA strongly rely on Chinese imports of critical components for the development of electric vehicles and solar energy devices.*

[7] *The IMF warns that barriers to trade, investment and technological transfer would limit growth and estimates that the long-term cost of trade fragmentation between the USA and China could amount to around 7% of global GDP.*

CESEE: Banking sectors perform reasonably well despite strong headwinds – for growth and inflation – resulting from the war in Ukraine

The war in Ukraine clearly determined economic activity in Central, Eastern and Southeastern Europe (CESEE) in 2022. Average economic growth in the region declined from 7% in 2021 to 0.7% in 2022, mainly driven by contractions of Russian and Ukrainian output.

Even so, economic activity proved to be surprisingly robust to the initial effects of the war in the first half of 2022, at least in the CESEE EU member states. In this period, GDP growth was mainly supported by solid consumer demand, which can be attributed to the earlier boost in savings as people were spending less during the lockdowns, and to favorable labor market conditions. At somewhat below 4% throughout 2022, the average unemployment rate was only marginally above its end-2019 trough. In the middle of the year, both employment and labor participation rates rose to historic highs or even beyond, which translated into strong nominal wage increases. Investment also provided a stable contribution to growth, reflecting high capacity utilization, high corporate financial surpluses, increased inventory accumulation following the restoration of key supply chains and, in some cases, beginning disbursements of EU funds.

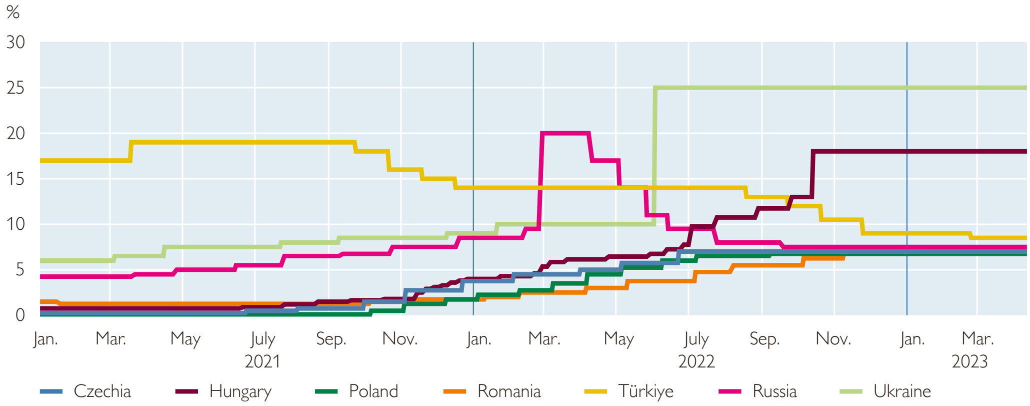
However, as the year 2022 progressed, the economy became a lot less resilient to the effects of the war in Ukraine. Confidence indicators were deteriorating significantly from early summer 2022 onward, with consumer confidence falling to a lower level than at any time during the COVID-19 pandemic. From fall 2022 onward, activity indicators were weakening as well. Almost all segments of the industrial sector were affected by the downturn, in particular export-oriented industries. In the retail sector, sales of everyday goods increased, while sales of durable goods and fuels weakened. The loss of purchasing power in the wake of strong inflation became increasingly apparent as well. As a result, quarter-on-quarter GDP growth largely turned negative in the second half of 2022, with Czechia and Hungary meeting the criteria for a technical recession.

The war in Ukraine fueled inflation in CESEE. It did so by exacerbating supply-demand imbalances in some areas, increasing energy and food prices and significantly weakening, at least temporarily, the external value of some CESEE currencies. This pushed up inflation to the highest level in decades. In contrast to 2021, almost all areas of the consumption basket were affected by inflationary pressures in 2022, which caused core inflation to go up markedly as well. At the end of the year, however, inflation rates stabilized somewhat after lower world market prices for crude oil and country-specific household energy relief packages had led to a slowdown of energy inflation.

CESEE central banks tightened monetary policy in the face of rising inflation and the associated risks of second-round effects as well as the risk of a de-anchoring of inflation expectations. Interest rate hikes not only continued in 2022, but even picked up speed in most countries, also in response to pressures emanating from foreign exchange markets. Ultimately, key interest rates were at a multiyear high at the end of 2022. However, during the year, the underlying conditions for monetary policy became increasingly challenging, as any further interest rate moves had to be weighed against the incipient economic slowdown. The Czech and Polish central banks have therefore refrained from any further interest

Chart 1.5

Selected CESEE countries: policy rates



Source: Macrobond.

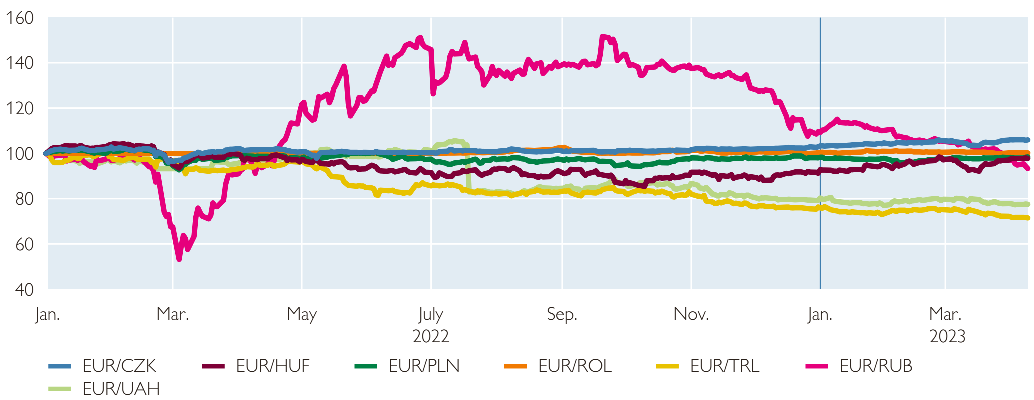
rate hikes since June and September 2022, respectively. And the Hungarian central bank (MNB) has not changed its operational policy rate further since October 2022. However, this was preceded by a strong monetary tightening in reaction to a depreciation of the forint: after the MNB had hiked its operational policy rate by 125 basis points to 13% in late September 2022, it communicated the end of its hiking cycle. This collided with market expectations and the forint came under pressure and, on October 13, 2022, depreciated to its lowest value against the euro (HUF 430 per EUR). The following day, the MNB called an emergency meeting in which it made several adjustments to its rate tool kit and hiked its operational policy rate to 18%. Since then, the policy rate has stayed at this level – the highest since 1998.

Restrictive monetary conditions should have a significantly dampening effect on prices going forward. Real (ex ante) interest rates have turned positive in recent months. The large interest rate differential to the euro area and a more constructive risk environment have supported regional currencies. This applies not

Chart 1.6

Selected CESEE countries: exchange rates versus the euro

Index: Jan. 2022 = 100, rise = appreciation



Source: Macrobond.

least to Hungary, where the forint has recovered significantly from its crash in October 2022 and is currently trading around 2% below its value from the beginning of 2022. This compares to a depreciation of 2% of the Polish złoty, a largely stable development of the Romanian leu and an appreciation of the Czech koruna by 6%.

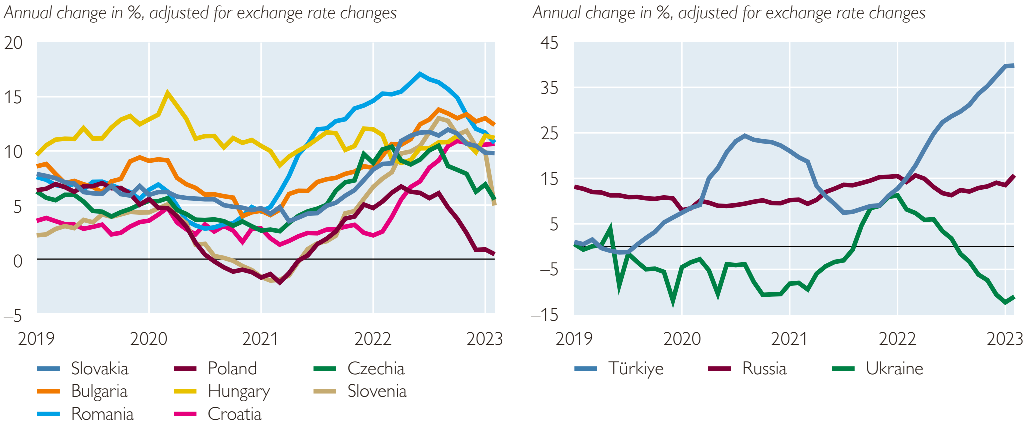
CESEE foreign exchange markets were only temporarily impacted by the most recent turmoil in the global financial sector following troubles at several mid-sized US banks and Credit Suisse. The Czech koruna lost 2.5% and the Hungarian forint 6% of value against the euro in mid-March 2023, but both currencies recovered quickly.

Surveys suggest that credit supply conditions already tightened over the second half of 2022. The most important reason for this development was said to be a weak local market outlook (related to the war in Ukraine, high inflation and the general economic slowdown). All credit segments have been affected by tighter credit standards, though the tightening has been particularly strong in the mortgage market. More resilient than supply, credit demand has increasingly been driven by short-term demand for working capital and debt restructuring. At the same time, geopolitical uncertainty and the weak economic outlook have started to negatively influence long-term fixed investments and consumer confidence. Among households, housing market prospects as well as non-housing-related consumption expenditure are expected to drag down demand further.

This increasingly restrictive momentum in CESEE banking sectors is not yet fully reflected in credit market data. Credit dynamics in the CESEE region decelerated in the second half of 2022 against a slowdown in new lending due to higher interest rates, more early repayments than in previous years and declining volumes in housing transactions. The weakening, however, was not observed across countries and sectors evenly. Credit growth rates, for example, remained broadly stable in Croatia and Hungary amid some deceleration in credit growth to households and largely unabated corporate sector credit dynamics. Meanwhile, credit growth to corporates weighed heavily on credit market developments in Czechia, Poland and Romania.

Chart 1.7

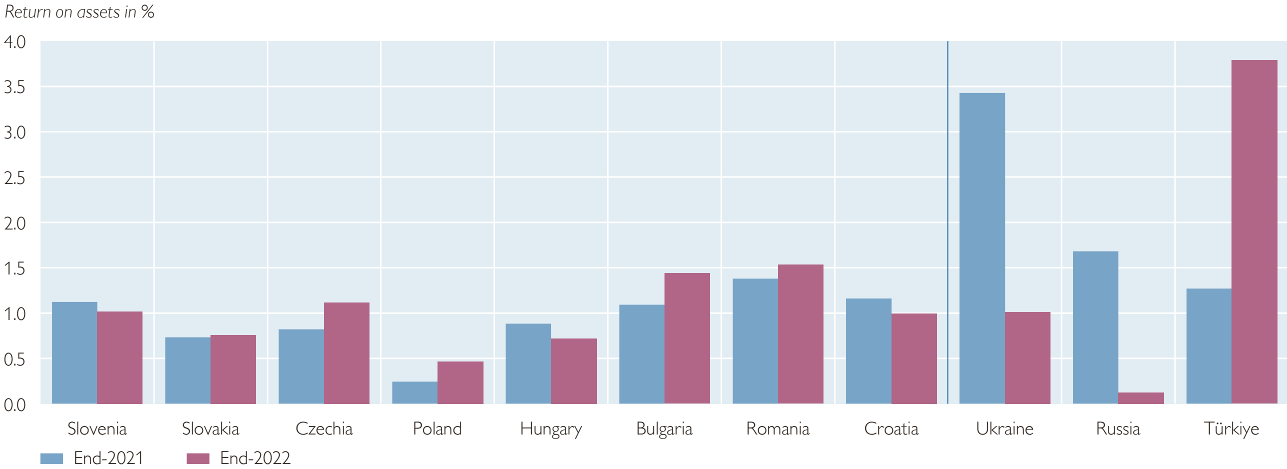
CESEE banking sector: growth of credit to the private sector



Source: ECB, national central banks.

Chart 1.8

CESEE banking sector: profitability



Source: IMF, national central banks, OeNB.

Note: Data based on annual after-tax profits.

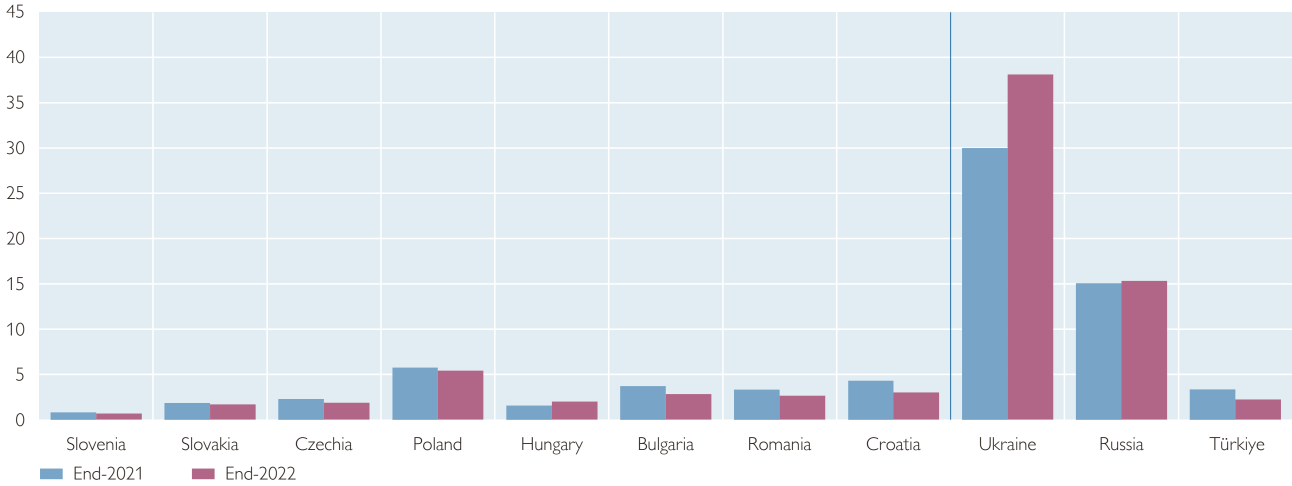
Despite the economic headwinds, the CESEE banking sectors posted generally sound results and balance sheets in 2022. Profitability was bolstered by higher net interest income and – despite partly higher (personnel) expenses and provisioning – remained at around the levels observed in 2021. Credit quality also improved across CESEE, and NPL ratios even reached multiannual lows in some countries. Pockets of vulnerabilities exist, however. While NPL ratios are at a historic low, stage 2 loans (for which banks are less certain of credit quality) are well above NPLs and increasing in several cases (e.g. Czechia, Croatia and Hungary). Furthermore, fast rising interest rates could expose banks with large fixed income assets (as shown by the example of Silicon Valley Bank in the USA). In case of need, for instance due to funding shocks triggered by changing market sentiment, these assets would have to be sold at a loss. Such unrealized losses, often associated with sovereign assets held to maturity, are significant for a number of countries, but high capital adequacy ratios provide a buffer. Tier 1 capital ratios hovered between 16.7% in Hungary and 24% in Croatia at the end of 2022.

Russia's banking sector operated in a difficult environment amid far-reaching international sanctions. The Russian economy has proven remarkably resilient to the international sanctions imposed after Russia's invasion of Ukraine. Once the first shock had been digested, GDP growth bounced back in the second half of 2022. Quarter-on-quarter growth came in at 0.5% in both the third and the fourth quarter, limiting the annual GDP contraction to –2.1% for the whole year. Russian GDP dynamics benefited from higher (war-related) government spending and from substantially higher prices for energy. Despite international sanctions, the country managed to provide the world market with substantial quantities of its energy carriers, in part by redirecting crude oil exports from sanctioning to non-sanctioning countries. With sanctions severely curtailing imports from Western economies, the current account surplus rose to more than

Chart 1.9

CESEE banking sector: credit quality

Nonperforming loans in % of total credit at end of period



Source: IMF, national central banks, OeNB.

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

10% of GDP in 2022. After having depreciated by some 40% against the US dollar within the first week after the invasion, the Russian ruble recovered rather quickly. It was buoyed by a huge hike in the Russian key policy rate (from 9.5% to 20%), several measures targeted at the foreign exchange market and the large current account surplus. The strong currency and subdued domestic demand lowered consumer price growth substantially and allowed the Russian central bank to normalize its policy rate. After several cuts that had started in April 2022, the policy rate has since September 2022 remained at 7.5% or 100 basis points below its pre-war level. More recently, the ruble also returned to its external value observed at the beginning of 2022 as both new EU and the US sanctions on Russia's energy exports in late 2022 and early 2023 weighed on the price of Urals crude oil. Banks continue to do business in a regime of regulatory lenience by the local regulator, flanked by subsidized lending programs related to strategic enterprises, SMEs and households. Mortgage loans continue to benefit from a preferential state program providing generous interest rate subsidies and rates had largely returned to pre-invasion levels. This kept the expansion of credit to the private sector broadly stable throughout 2022. The banking sector had suffered a loss of around USD 25 billion (or about 12% of the sector's regulatory capital) in the first half of 2022, largely due to foreign exchange transaction losses in the wake of the imposition of financial sanctions in February/March 2022 and to sharply rising provisions. Banks subsequently recovered somewhat, thus offsetting the loss in the second half of 2022 and achieving a very modest overall profit of about USD 3 billion in 2022 as a whole (which is less than one-tenth of the 2021 figure). While a number of banks had to raise additional capital, a systemic recapitalization exercise has (so far) not been necessary, according to the Central Bank of the Russian Federation.