International macroeconomic environment: COVID-19 pandemic sparks severe global downturn

Health crisis triggers a global recession

The global coronavirus outbreak in early 2020 and the ensuing massive containment measures have led to a dramatic fall in global economic activity. Initial hopes that the epidemic could be confined to China and the global economy would only be impacted through trade spillovers were soon dashed. Instead, the virus spread from Asia to Europe and the rest of the world within only a few weeks. Virtually every country had to go into shutdown and introduce social distancing measures to block the transmission of the virus, which had dramatic consequences for the economy: In the first quarter, China recorded the first economic contraction in decades, at –6.8% (year on year) a particularly severe one, and the euro area economy contracted by 3.1%. In the U.S.A., the economy grew by only 0.3% year on year, although the disease had just started to spread at the end of the first quarter.[1]

The IMF expects global real GDP to decline by 4.9% in 2020 – putting global growth almost 8 percentage points below the performance of 2019 –, which is a significantly deeper slump than that seen during the global financial crisis.[2] Under the assumption that the pandemic will be fading and restrictions will be gradually lifted in the second half of 2020, the IMF expects a V-shaped recovery, with global economic growth rebounding sharply to 5.4% in 2021. Depending on the fiscal response, the recovery is unlikely to be completed by the end of the forecast period. Inflation is expected to be subdued given low demand and record low crude oil prices. However, the high level of uncertainty about the course of the COVID-19 pandemic makes economic forecasts extremely difficult.

The crisis is aggravated further by the contracting real economy elevating the risks to financial stability.[3] The sudden interruption of economic activity and the associated uncertainty have led to strong asset price corrections. Investors are fleeing to safe havens, while funds and companies are trying to increase their liquidity buffers, and speculative dynamics can trigger emergency sales. As a result, borrowing costs are increasing, particularly in countries that rely more heavily on capital market financing. This, in turn, has been dampening economic activity even further and exacerbating default risks, while rising unemployment has elevated the risks of household loans. All these factors are affecting especially countries dependent on foreign funding. Sudden and record high capital outflows have raised concerns over currency and debt crises in emerging and developing economies. Over 90 countries are already seeking emergency financial assistance from the IMF, which has secured USD 1 trillion in lending capacity.

[1] *OECD.Stat Web Browser.*

[2] *IMF. 2020. World Economic Outlook – June 2020 Update.*

[3] *IMF. 2020. Global Financial Stability Report, April.*

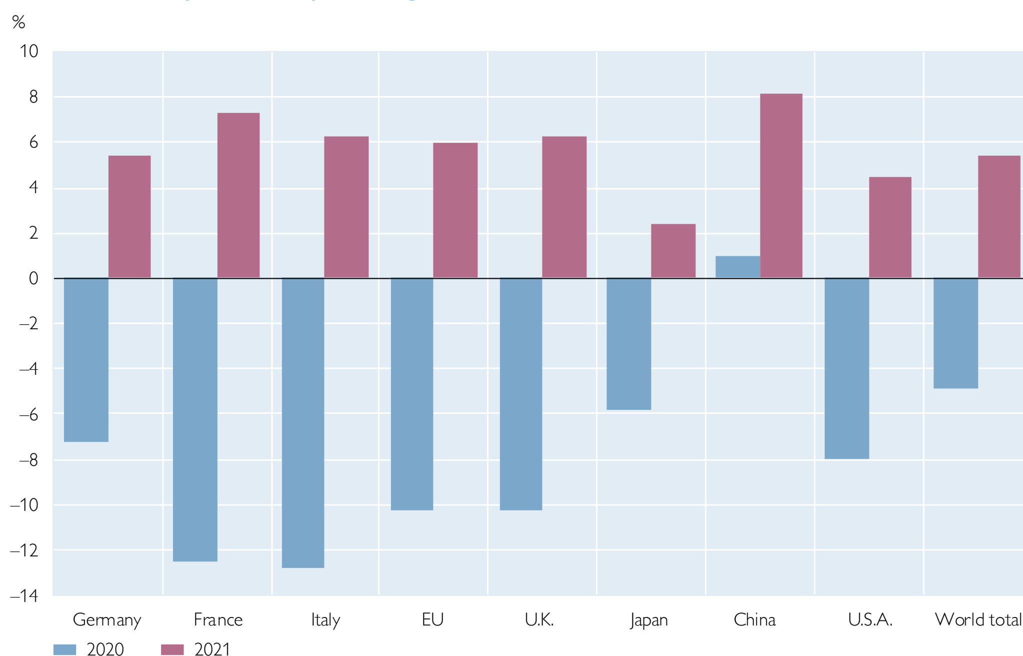
Unprecedented monetary, financial and fiscal policy measures applied simultaneously all over the world have helped to stabilize market sentiment. However, volatility and risks remain high. Unlike in 2008, finance is now just a transmitter and amplifier of the crisis, but not a trigger. After the financial crisis, the banking sector was trimmed back and, in advanced economies, it is now better capitalized, but the shadow banking sector is bigger than it was during the great financial crisis. Corporate loans have peaked recently and could pose significant vulnerabilities, particularly in the energy sector, which has also been hit by a concurrent oil price war between OPEC and Russia.

The combined supply and demand shock has led to sharp increases in public debt. First, health expenditure started to increase. Second, automatic stabilizers started to work via increasing expenditure on unemployment and decreasing government revenues. Third, historically unique fiscal packages were launched in order to prevent the collapse of entire economic sectors and to partially compensate for the loss of business and household incomes. In addition to an increase in private debt, these measures also imply a rapid buildup of public debt. In the wake of the pandemic, the question of debt sustainability will need to be addressed again, particularly in the euro area due to the unfinished architecture of Economic and Monetary Union, where several Member States are lacking fiscal space.

The U.S. economy is expected to suffer a dramatic contraction in 2020 despite exceptionally supportive macroeconomic policies. The IMF projects the economy to shrink by 8.0% in 2020 (see chart 1.1), with unemployment rising above 10%, a level that has not been reached for many decades. In 2021, growth is expected to rebound to 4.5%, supported by unprecedented monetary and fiscal policies. The U.S. Federal Reserve (Fed) cut its federal funds

Chart 1.1

IMF forecast (June 2020): GDP growth in 2020 and 2021



Source: IMF (WEO).

target rate by 150 basis points to a range of 0% to 0.25% and started an unrestricted purchase of Treasury securities and asset-backed securities at a faster pace than during the global financial crisis. Several other unconventional measures have also been taken, including swap lines for other currencies in exchange for U.S. dollars, aimed at providing liquidity, restoring regular market functioning and supporting financing conditions. Meanwhile, the U.S. Treasury launched a fiscal stimulus package worth some USD 2.2 trillion (around 11% of GDP) to ease the effects of the partial shutdown on economic activity. The IMF expects the general government deficit to soar to above 15% of GDP in 2020 and the debt level to increase to over 130% of GDP.

China was the first country hit by the pandemic and saw a sharp contraction of economic activity in the first two months of 2020. The Chinese economy was also first to start to gradually recover; however, this recovery has been dampened by a slump in external demand and a potential renewed trade dispute with the U.S.A. The IMF expects the Chinese economy to still grow by 1.0% in 2020 and to pick up by 8.2% in 2021, but this forecast is subject to great uncertainty.

In Japan, GDP is set to slump in 2020 due to a shock to external demand and lockdown-related demand suppression. The IMF expects GDP to decline by 5.8% and a gradual recovery leading to 2.4% growth in 2021. Despite limited policy space and high uncertainty, the government has adopted a record JPY 117 trillion emergency spending package, and the Bank of Japan has announced unlimited purchases of government bonds and that it would multiply its buying of corporate debt.

The euro area economy is expected to shrink even more dramatically. The Eurosystem forecasts GDP to plummet by 8.7% in 2020 – more than ever before – and to grow by 5.2% and 3.3%, respectively, in 2021 and 2022. Given elevated uncertainty, the forecast is based on specific assumptions about the course of the COVID-19 pandemic and the associated containment measures. The European Commission's spring forecast projects a milder drop in GDP for Austria (–5.5%) and Germany (–6.5%), while Italy (–9.5%), Spain (–9.4%) and France (–8.2%) will be hit harder. The subsequent recovery across countries will depend on various factors, such as tourism and other overproportionally COVID-19-impacted sectors. Fiscal deficits are expected to increase, entailing a further rise in – already high – public debt levels, particularly in Greece and Italy (to roughly 196% and 159% of GDP, respectively, in 2020).

Together, the EU and its Member States have mobilized 3% of EU GDP in fiscal measures and 16% of EU GDP in liquidity support. Against the backdrop of increased divergences between Member States and debt sustainability concerns with regard to potential ramifications for the resilience of Economic and Monetary Union, there have been debates about a coordinated crisis response and solidarity instruments. So far, the European Council has agreed on three safety nets for workers, businesses and Member States, with funds totaling EUR 540 billion. These include temporary support to mitigate unemployment risks in an emergency (SURE), an EIB guarantee fund and a European Stability Mechanism precautionary credit line (ECCL). Furthermore, the European Commission has put forward a proposal for a recovery plan for Europe, funded by the Commission issuing bonds of up to EUR 750 billion, mainly in the period 2020 to

2024. The Commission would then grant and lend proceeds to EU countries to finance their reform and resilience plans in line with the objectives identified in the European Semester, including the green and digital transitions. The repayment of funds raised would start in the next multiannual financial framework and continue for decades, partly via additional EU resources. Negotiations on the proposal with the European Council and the European Parliament are underway.

The ECB has responded to the crisis by adopting a wide-ranging set of measures that help mitigate the economic and financial fallout of the pandemic. In March 2020, the ECB's Governing Council announced a temporary pandemic emergency purchase programme (PEPP). Its initial volume of EUR 750 billion was increased to EUR 1,350 billion in June, and its horizon was extended to mid-2021. This measure came on top of an additional EUR 120 billion envelope under the asset purchase programme (APP). Together, these measures amount to roughly 10% of euro area GDP. Given subdued inflation expectations, the Governing Council left the key interest rates unchanged at 0.0% (main refinancing operations), 0.25% (marginal lending facility) and –0.50% (deposit facility). Its forward guidance on low key interest rates for an extended period of time also remained unchanged depending on its assessment of the outlook for price stability (since September 2019). Furthermore, the ECB is channeling funds directly to banks under stress at an interest rate below its deposit facility rate at –0.75%. In sum, the Eurosystem is making available up to EUR 3 trillion in liquidity through refinancing operations. Moreover, European banking supervisors have also freed up an estimated EUR 120 billion of extra bank capital, allowing banks to operate temporarily below the level of capital defined by the Pillar 2 Guidance and bringing forward the implementation of less stringent Capital Requirements Directive V rules on the composition of Pillar 2 requirements (P2R).

CESEE: deteriorating international environment dented GDP growth in 2019 but banking sector profitability remained solid

The pace of global economic activity remained weak throughout 2019 as the momentum in manufacturing activity had weakened substantially. Rising trade and geopolitical tensions increased uncertainty about the future of the global trading system and international cooperation more generally, taking a toll on business confidence, investment decisions and global trade already in the course of 2019. World trade growth contracted throughout the second half of 2019 and declined to its lowest level since 2009.

External headwinds led to a deceleration of GDP growth in Central, Eastern and Southeastern Europe (CESEE). In the CESEE EU Member States, growth weakened especially in the second half of 2019 as lower international demand fed through to industrial production, investments and exports in many countries. At the same time, private consumption remained broadly robust, fueled by the ongoing momentum in the region's labor markets reflecting strong wage

growth, low unemployment and stable consumer sentiment. Against this backdrop, growth came in at an average 3.7% in 2019, after 4.4% in the previous year.[4]

Russia and Turkey reported lower GDP growth in 2019 than in 2018. In both countries, however, economic activity strengthened in the second half of the year. In Russia, it was especially private consumption that drove the uptick, while the lower oil price and lackluster fixed investment continued to weigh on the economy and kept annual growth at a moderate 1.3% in 2019. Turkey benefited from a positive base effect, recovering from a severe recession in the second half of 2018, and private consumption growth accelerated on the back of a sharp credit expansion. Despite notably higher growth readings at the end of 2019, average annual growth was weak at only 0.9% in 2019, however. Economic activity in Ukraine remained broadly unchanged at 3.2% in 2019. In all CESEE countries, the ensuing coronavirus crisis led to a notable deceleration of economic activity in the first quarter of 2020.

Despite somewhat lower growth rates, inflation has been mostly trending higher in the CESEE EU Member States. Strong economic activity in the past three years, emigration and a lack of skilled workers translated into rising unit labor costs that increasingly impacted on the general price level. In January 2020, average inflation in the CESEE EU Member States rose to 3.7%, the highest level since late 2012. Price pressures, however, abated somewhat in February 2020.

Against this backdrop, the central banks of the Czech Republic, Hungary, Poland and Romania missed their inflation targets in 2019, at least temporarily. The Czech central bank increased its policy rate by 25 basis points in May 2019 and by another 25 basis points to 2.25% in February 2020 to put a hold on this development. The other central banks left their policy rates unchanged until the corona- virus pandemic reached CESEE.

In Turkey, price growth was highly volatile in 2019 and early 2020. Inflation came down from around 25% in late 2018 to a three-year low of 8.6% in October 2019. From November onward, inflation accelerated again, reaching 12.4% in February 2020, owing in part to unfavorable base effects and higher energy prices. The Turkish central bank cut its one-week repo rate, the main policy rate, in three steps from 24% in May 2019 to 14% in October 2019 and then continued to reduce it step by step to 10.75% by the end of February 2020, despite currency depreciation and the uptick in inflation.

Russia and Ukraine were the only countries with a clear downward trend in inflation in recent months. In Russia, price growth declined to 2.3% in February 2020 (from 5.4% a year earlier), well below the central bank's target of 4%. The most important building block of this development was a base effect from a value-added tax increase in January 2019. Other disinflationary factors include a decline in prices of food products and non-food goods. In Ukraine, consumer price inflation fell to 4.1% at end-2019 and thus reached the National Bank of Ukraine's inflation target range of 5% ±1 percentage point. Lower energy

[4] *For a more thorough overview of recent macroeconomic developments in CESEE and the outlook for the region, see: Developments in selected CESEE countries: Coronavirus overruns the region. In: Focus on European Economic Integration Q2/20. OeNB. 7–49; and Outlook for selected CESEE countries: Economic activity in the CESEE-6 region will take a deep dive in 2020 and then recover hesitantly, Russian economy set to contract in 2020. In: Focus on European Economic Integration Q2/20. OeNB. 50–64.*

Table 1.1

Selected macroeconomic and banking sector indicators for CESEE

		Slovenia	Slovakia	Czech Republic	Poland	Hungary	Bulgaria	Romania	Croatia	Ukraine	Russia	Turkey
		%										
Real GDP growth (year on year)	2018	4.1	4.0	2.8	5.1	5.1	3.1	4.4	2.7	3.4	2.5	2.8
	2019	2.4	2.3	2.6	4.1	4.9	3.4	4.1	2.9	3.2	1.3	0.9
HICP inflation (year on year)	2018	1.9	2.5	2.0	1.2	2.9	2.6	4.1	1.6	11.0	3.0	16.3
	2019	1.7	2.8	2.6	2.1	3.4	2.5	3.9	0.8	7.9	4.6	15.2
Policy rate (end of period)	2018	0.0	0.0	1.8	1.5	0.9	..	2.5	..	18.0	7.8	24.0
	2019	0.0	0.0	2.0	1.5	0.9	..	2.5	..	13.5	6.3	12.0
Growth of credit to the private sector (year on year, end of period)	2018	1.9	8.4	6.8	6.4	9.9	8.3	7.9	2.4	6.5	12.3	1.2
	2019	4.3	6.8	5.0	5.0	12.4	9.4	5.5	3.4	–3.6	10.4	6.4
Share of foreign currency-enominated credit (as a share of total credit to the private sector, end of period)	2018	2.0	0.1	14.1	20.8	24.0	34.9	34.0	54.7	42.9	13.6	41.3
	2019	1.7	0.1	14.5	19.2	23.8	33.2	32.4	51.5	37.0	11.4	38.6
Nonperforming loans (as a share of total credit, end of period)	2018	2.3	3.0	3.1	6.8	2.2	5.1	5.0	9.8	52.9	18.0	4.1
	2019	1.1	2.8	2.4	6.4	2.6	4.2	4.1	5.5	48.4	17.1	5.7
Return on assets	2018	1.4	0.8	1.1	0.7	1.4	1.7	1.6	1.2	0.9	1.5	1.8
	2019	1.5	0.8	1.2	0.7	1.2	1.5	1.4	1.4	3.1	2.2	1.4
Capital adequacy ratio	2018	19.8	18.3	19.6	19.0	19.7	20.4	20.7	23.1	16.2	12.2	16.9
	2019	18.5	18.2	21.3	19.1	16.9	20.2	20.0	23.2	19.7	12.3	18.0

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

prices and declining core inflation (supported by the appreciation of the hryvnia) brought down headline inflation rates.

Against the backdrop of disinflationary developments, both central banks adjusted their policy rates. The Russian central bank cut its key rate in six steps from 7.75% in January 2019 to 6% in late February 2020, citing disinflationary pressures and – in its February move – rising risks of a substantial global economic slowdown. The Ukrainian central bank cut its key police rate in six steps from 18% in April 2019 to 11% in February 2020.

Growth of domestic loans to the private sector was solid and broadly in line with fundamentals throughout most of CESEE, reflecting strong domestic demand in an environment of low interest rates and ample liquidity. On average, however, loan growth (nominal lending to the nonbank private sector adjusted for exchange rate changes) decelerated somewhat in the CESEE EU Member States (to around 5.5% annually at the end of 2019). This was attributable to lower GDP growth rates and regulatory action aimed at putting a brake on loan growth, which had become too swift in certain loan segments, in particular for housing loans. The latter have been fueled by strong housing demand and ever-increasing house prices (+8.9% in 2019). Several CESEE countries introduced macroprudential measures and/or recommendations to slow down these developments. Furthermore, countercyclical capital buffers were activated in Bulgaria, the Czech Republic and Slovakia. Before the coronavirus crisis hit

the region, those buffers stood at 1%, 1.75% and 1,5% respectively, at the end of February 2020.

In Russia, loan growth was among the highest of the region despite sluggish economic activity and a relatively high nonperforming loans (NPL) ratio. Retail lending (as opposed to corporate lending) continued to expand swiftly (+18.5% in December 2019). That said, the spike of the retail lending expansion – notably that of unsecured consumer loans – has passed, thanks to the central bank's prudential tightening measures and the easing of loan demand on the back of unstable household income growth.

After a trough in mid-2019, accelerating consumer loan growth substantially heated up general credit dynamics in Turkey. Loans to households expanded strongly on the back of easing credit standards, falling interest rates and recovering domestic demand. The growth of loans to corporations recovered as well but remained on a much lower level.

Ukraine was the only country in the region that reported a clear deceleration of loan growth amid strongly contracting lending to corporations. The decline was driven by banks' efforts to resolve bad debt (through write-offs, repayments and restructuring) and by a statistical effect related to the exclusion of data from banks that were undergoing liquidation. Lending activities also continued to be hampered by the large share of NPLs and outstanding issues concerning the protection of creditor rights.

NPLs continued their downward trend also in 2019 and returned to levels seen up to 2008 throughout most of the region. In Slovakia and Slovenia, NPL ratios even reached historical lows. A notable increase in NPLs was reported only for Turkey, reflecting the financial difficulties associated with the 2018 financial turbulences faced by indebted companies, particularly those with debt in foreign currency (FX).

The reduction of NPL ratios was accompanied by a further decrease in FX loans. This is especially true for loans to households, whose share in total loans is already close to zero in the Czech Republic, Hungary, Russia, Slovakia and Slovenia. In the other countries, the average share of FX loans in total loans declined from around 24% in late 2018 to 19.4% at the end of 2019.

It needs to be noted, however, that the FX share in loans to corporates remains notably higher and is trending down only slowly. At the end of 2019, such loans on average accounted for 32.2% of total loans, down only 1 percentage point from the previous year. FX loans to corporates have received more attention from policymakers recently.[5] In October 2019, the IMF intensified its warnings on high levels of corporate debt in emerging markets, as the search for yield in a prolonged low interest rate environment has led to stretched valuations in risky asset markets, raising the possibility of sharp, sudden adjustments in financial conditions. The sharp depreciation of the Turkish lira in 2018 illustrated potential risks.

Robust loan growth and improving asset quality have contributed to sound banking sector profitability in most of the CESEE region. Compared to 2018, the average return on assets (RoA) in the CESEE EU Member

[5] *It needs to be noted that corporates are usually hedged to a certain extent against exchange rate swings, as part of their (export) income is denominated in foreign currency.*

States remained unchanged at 1.2% at end-2019. Profitability has hovered around this level for the past four years and came close to the figures observed in the boom period prior to the great financial crisis. The Ukrainian banking sector continued to recover from a long period of losses and reported a record high RoA of 3.2% at the end of 2019. This positive development reflected a decline of provisioning to the lowest level since 2007 after the nationalization of Privatbank in December 2016. Furthermore, strong operational profitability driven by a high net interest margin positively impacted on annual results. In Russia, profitability increased on the back of a release of provisions and profitable retail loan expansion. The banking sector's RoA climbed from 1.5% in 2018 to 2.2% in 2019.

The profitability of Turkish banks declined in the review period and reached a long-term low, with the RoA standing at 1.4%. This primarily reflected higher provisioning needs for NPLs, while net interest income and other noninterest income (especially from derivative transactions) also weighed on profitability.

Capital adequacy ratios have remained mostly solid, ranging between 16.9% in Hungary and 23.1% in Croatia in the CESEE EU Member States at the end of 2019. A notable decrease in capitalization was only observed in Hungary as risk-weighted asset outgrew regulatory capital. Capital adequacy ratios in Turkey and Ukraine were at a level comparable to that seen in the EU Member States. In Ukraine, a clear upward trend in capitalization was reported as profitability shot up, while capitalization was markedly below CESEE regional averages only in Russia (at 12.3%).