

International macroeconomic environment: global and European growth slows down somewhat as downside risks prevail

Uncertainties weigh on global growth

Global growth has been weakening, leading to downward revisions of current forecasts. In the second half of 2018, global economic growth softened noticeably due to a significant downturn in global trade, which was attributable, among other things, to the intensifying trade conflict between the U.S.A. and China. In addition, China introduced stricter rules for the shadow banking system in 2018, which had a depressing effect on import demand. In the euro area, momentum weakened especially because of problems in the German car industry in connection with the introduction of new emission standards. Against this backdrop, the current IMF forecast (published in April) predicted world economic growth to reach 3.3% in 2019 and 3.6% in 2020. Compared with the October 2018 forecast, this represents a downward revision of 0.4 percentage points for 2019. The slowdown mainly affects the manufacturing sector and countries whose exports of industrial goods contribute strongly to GDP growth. At the same time, services growth has continued to be robust, supporting both employment and consumption. Financial conditions have remained more restrictive than in the fall of 2018 due to the trade tensions' impact on business confidence. Nevertheless, there was some easing in 2019 due to a more accommodative monetary policy in key advanced economies and cautious optimism about a forthcoming U.S.-Chinese trade deal. Inflation pressures remained subdued thanks to lower commodity and energy prices.

The IMF has identified various factors that may dampen economic growth. The IMF stresses that globally, downside risks are prevailing. For instance, a resurgence of trade disputes and related political uncertainty could again dampen economic growth. Global financial markets remain vulnerable to investors' dwindling risk appetite and a renewed flight to safe assets. A crisis of confidence could be triggered, for example, by a hard Brexit or a prolonged period of heightened yields on Italian government bonds as well as contagion effects on the euro area.

Concerns over global financial stability have remained elevated in several systemic countries. The most recent IMF's Global Financial Stability Report distinguishes between financial vulnerabilities and possible crisis triggers. In particular, the IMF identifies the following vulnerabilities: increased corporate debt in advanced economies, China's financial imbalances, volatile portfolio flows to emerging markets and unsustainably high house prices in many countries. Spiking risk aversion might be triggered by a further growth slowdown, a less dovish monetary policy outlook or geopolitical tensions. Similarly, the ECB's recently published Financial Stability Review finds that the financial stability environment in the euro area has become more challenging since the end of 2018. Apart from downside risks to economic growth, the report warns against a renewed search for yields and low return on equity for banks. Meanwhile, remaining risks are seen in a sudden correction in risk premiums, corporate and sovereign debt concerns, weak bank profitability and increased risk-taking in nonbanking finance.

Growth is expected to weaken in the U.S.A. The IMF has significantly revised downward its 2019 growth forecast for the U.S.A. The phasing out of fiscal stimulus and the impact of the government shutdown is expected to depress growth to 2.3% in 2019. For 2020, the IMF has revised its outlook up to 1.9% because of a somewhat more expansionary monetary policy stance. Despite the downward revision of the 2019 growth outlook, real GDP expansion will outpace potential growth. The IMF expects that strong growth in domestic demand will also increase import demand. As a result, the current account deficit is expected to widen somewhat despite restrictive trade policy measures. In spite of a strong labor market, the U.S. Federal Reserve (Fed) indicated in March that it would not raise interest rates in the course of the year, given slowing household spending and investment as well as low inflation. In addition, the Fed has slowed down the pace of reducing its reserves.

In Japan and China, government measures have continued to stimulate growth. In Japan, additional fiscal stimulus, including the planned measures to cushion the VAT increase in the fall of 2019, will contribute to an upward revision of the growth outlook to 1% in 2019 and 0.5% in the following year. Given still very low inflation, the Bank of Japan announced that it would maintain key interest rates at zero until spring 2020 and took further measures of quantitative and qualitative monetary easing. In China, revised assumptions about the trade dispute with the U.S.A. resulted in an upward revision of GDP growth to 6.3% for 2019 and 6.1% for 2020. Government policies, particularly fiscal and monetary measures, continue to support growth. In early 2019, the minimum reserve ratio for commercial banks was lowered further. The funds thus freed up will be used for additional loans to households and businesses, stimulating consumption and investment, but also adding to existing indebtedness risks. Inflation has been hovering between 1.5% and 2% over the past few months.

Brexit-related uncertainties have been weighing on the growth outlook for the U.K., while economic growth in Switzerland is set to pick up. The IMF expects real GDP growth in the U.K. to reach 1.2% in 2019 and 1.4% in 2020, rates that are somewhat lower than in the previous forecast, due to ongoing uncertainty over the country's withdrawal from the EU. Fiscal stimulus measures budgeted for 2019 are supporting domestic demand, limiting the downward revision. The economic outlook depends significantly on a smooth transition to a new trade relations framework between the U.K. and the EU. Despite tight labor markets, inflation is expected to remain slightly below 2%. In May 2019, the Bank of England left the Bank Rate unchanged at 0.75% and lowered its expected rise to just around 1% by the end of its forecast period. In Switzerland, the IMF expects GDP growth to pick up again, after a stagnation in the second half of 2018, to reach around 1.1% and 1.5%, respectively, in 2019 and 2020. Inflation is forecast at below 1% for the same period. The exchange rate of the Swiss franc has declined to around CHF 1.14 against the euro since the beginning of 2019; in trade-weighted terms, however, the value of the Swiss franc is still high. The Swiss National Bank has maintained its expansionary monetary policy with negative key interest rates while signaling its readiness to intervene in foreign exchange markets to avoid overvaluation.

Temporary factors are dampening growth in the euro area. The outlook for the economy in the euro area is weak. At 0.4%, growth in the first

quarter of 2019 was better than expected because of favorable weather conditions and trailing effects. In the third and fourth quarters of 2018, however, the euro area economy grew by only 0.1% and 0.2%, respectively. Looking forward, weaker leading indicators are signaling significant drops in the second quarter. While economic activity has remained strong in Spain, and France's economy has been supported by strong export growth as well as expansive fiscal measures, growth in Germany has been stagnating, and Italy has just emerged from a technical recession.

The ECB has lowered its GDP forecast for 2019 and 2020 by roughly half a percentage point to 1.2% and 1.4%, respectively. The forecasts for the euro area reflect the decline in confidence indicators, which is attributable to domestic and global uncertainties, as well as an earlier than expected weakening of the underlying cyclical momentum. The ECB assessed the euro area fiscal stance to have been broadly neutral in 2018 and expects a loosening from 2019 onward. However, weakening growth may further impact private and public debt sustainability, while the high level of indebtedness in individual Member States can magnify identified vulnerabilities. The risks surrounding the euro area growth outlook remain tilted to the downside, given uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets.

Inflation in the euro area has been falling recently, and the economic outlook suggests a delay in the return to the target rate. Euro area annual headline HICP inflation was estimated at 1.2% in May 2019, down from 1.7% in April. Core inflation – excluding the volatile items energy, food, alcohol and tobacco – has oscillated around 1% over the last months. The future path of inflation is expected to reflect price pressures from labor costs, which continued to strengthen in the fourth quarter of 2018. The Eurosystem expects inflation to reach 1.3% in 2019 and to pick up afterward, reaching 1.6% in 2021. These muted price pressures are attributable to an oil price-driven decrease in energy inflation and a dampened growth outlook. Financial market-based inflation expectations suggest that the current economic downturn will further delay the return to the price stability target in the euro area.

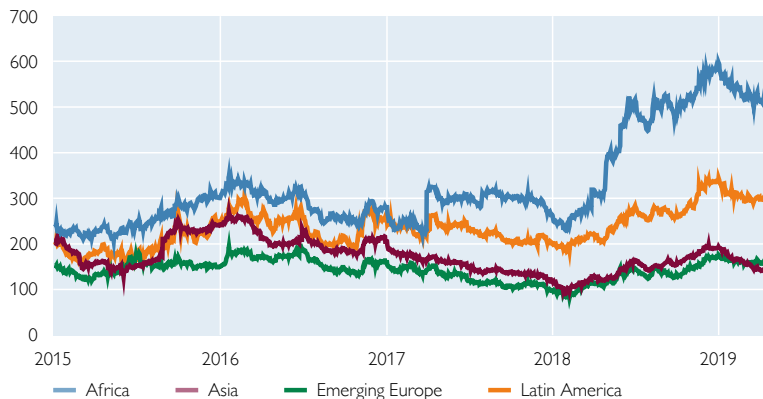
The ECB is expanding its accommodative monetary policy stance. At its June 2019 meeting, the Governing Council of the ECB decided to keep the interest rates on main refinancing operations, the marginal lending facility and the deposit facility unchanged at 0.00%, 0.25% and –0.40%, respectively. The ECB expects its key interest rates to remain at their present levels at least through the first half of 2020. It intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase program for an extended period after the start of interest rate normalization. Already in March, the Governing Council decided to launch a new series of quarterly targeted longer-term refinancing operations (TLTRO-III), starting in September 2019 and ending in March 2021, each with a maturity of two years.

The euro has depreciated while stock indices have lost some of their gains seen earlier this year. Since the beginning of 2019, the yields of German ten-year government bonds have declined by almost 50 basis points to –0.3%. Spreads have narrowed further between German benchmark yields and Greek, Portuguese, Spanish and French bonds, while Italian bond spreads contracted less sharply. The spreads between ten-year U.S. Treasuries and German bund yields declined as well. Also since the beginning of the year, the exchange rate of the

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 Market Bonds Index Global.

euro in nominal terms has depreciated by some 1.7% to roughly USD/EUR 1.12 and by 3.2% against the Japanese yen. International stock indices have recovered from their drop at the end of 2018. Between January and early June, the representative stock index DJ Euro Stoxx gained around 11%, but saw some losses later in the year. The Dow Jones Industrial Index and the FTSE 100 followed a similar path. Amid intensifying geopolitical tensions, Brent crude oil prices rose by more than 30% in the first months of 2019, to above USD 70 per barrel, but have lost part of their gains since May.

CESEE: favorable economic environment has supported banking sector activity in most countries

Against the backdrop of a softening global economy and weakening world trade, spreads of euro-denominated sovereign bonds increased in all emerging market regions throughout 2018. However, growing optimism about ongoing U.S.-Chinese trade negotiations and major central banks' more patient and flexible approach to monetary policy normalization contributed to a moderation of spreads in the first four months of 2019 (see chart 1.1). Compared to other emerging market regions, CESEE bond markets continued to perform solidly (also taking into account heightened pressure on bond spreads in Turkey against the backdrop of the economic turbulences since mid-2018).

Despite international headwinds, economic activity has remained strong in the CESEE EU Member States. High GDP readings in the first three quarters of 2018 pushed annual average growth to 4.3% in 2018. This represents one of the strongest expansions since 2008. Output growth rested mostly upon domestic demand. Private consumption continued to benefit from benign labor market conditions and swift wage growth that positively impacted on sentiment and prompted consumers to take out credit. Capital formation was fueled by high capacity utilization rates, full order books, EU financing and improved credit market conditions amid low real interest rates and ample liquidity.

However, growth in the CESEE EU Member States seems to have surpassed its cyclical peak. Several pieces of evidence support this assessment: Activity and sentiment indicators were weakening throughout 2018 and partly reached multiannual lows in early 2019. Furthermore, the closely watched purchasing manager indices (PMI) that are available for the Czech Republic and Poland declined to a level of below 50 points (the threshold indicating an expansion) in late 2018 and remained below this threshold also in the first three months of 2019. The last prolonged period of such weak PMI readings dates back to early 2013. This is mirrored in a notable deceleration of GDP growth in the final quarter

of 2018. Recently moderating wage growth rates and softening labor market shortages also suggest weakening economic momentum.

In Russia, growth picked up to 2.3% in 2018, the highest rate since 2012. The stronger momentum can be traced back mainly to a substantial expansion of net exports against the backdrop of higher oil prices and a weaker ruble. The external value of the Russian currency suffered from elevated uncertainty triggered by waves of U.S. sanctions and threats thereof. Growth of domestic demand decelerated owing to stagnating real incomes and a tight fiscal and monetary stance as well as international sanctions taking a toll on foreign investment.

In Ukraine, GDP growth accelerated to 3.3% in 2018. Private consumption grew briskly, benefiting from increasing real wages and pensions as well as from remittances and the growth of loans to households. Growth of gross fixed capital formation decelerated slightly but remained dynamic. Yet, the country's export performance was rather weak, reflecting, among other things, transportation bottlenecks related to the conflict in the Sea of Azov and repairs at several large metallurgical enterprises. Moreover, external price competitiveness suffered from ULC increases. The negative contribution of net exports declined, however, as import growth decelerated notably because of markedly lower gas purchases.

A combination of factors has triggered a marked slowdown in Turkey's economic momentum. Those factors include financial and macro-economic imbalances that have been building up over the past years, deteriorating international relations with the U.S.A. and concerns about the future course of economic policy. Policy tightening to reduce imbalances led to a slump in economic activity in the second half of 2018 and sent the Turkish economy into recession for the first time since the global financial crisis. The decline in GDP was driven by private consumption and investments that suffered from souring sentiment and a sharp reduction of credit growth as financing conditions tightened. Net exports, by contrast, contributed positively to growth against the backdrop of weak domestic demand and a sharp depreciation of the Turkish lira.

Inflation was rather contained in the CESEE EU Member States throughout 2018, despite an economy in full swing. Inflation rates mostly hovered at around 2.5%, with some downward trend toward the end of 2018. The path of inflation was primarily related to volatile energy prices, so that core inflation remained largely stable at around 1.5% on average. Since January 2019, however, inflationary pressures have increased. Both headline and core inflation have been trending up. Core inflation even increased to the highest level since November 2012 and reached an average 2.4% in March 2019. This may reflect domestic price pressures that have been building up over the past two years but have failed to materialize in measured inflation. These price pressures emanated from tight labor markets and strong wage growth pushing up aggregate ULC growth, record high capacity utilization and a positive output gap.

So far, only the Czech National Bank (CNB) and the Romanian National Bank (NBR) have substantially tightened their monetary policy. The CNB raised its policy rate in six steps from 0.5% at the beginning of 2018 to 2.0% in May 2019. The NBR increased its policy rate from 1.75% in early January 2018 to 2.5% in May 2018. In its April 2019 monetary policy meeting, the NBR admitted that inflation had exceeded its expectations in the first two months of 2019 and that inflation would remain above the upper limit of the inflation

target over the short-time horizon. It also stated that it would maintain strict control over money market liquidity.

The Hungarian central bank (MNB) raised its overnight deposit rate to –0.05% in March 2019, while leaving other rates (including the main policy rate) unchanged. It thereby acknowledged the clear upward trend in core inflation and that it had repeatedly missed its inflation target. Furthermore, the MNB reduced the average amount of liquidity to be absorbed by HUF 100 billion to between HUF 300 billion and HUF 500 billion, starting in the second quarter of 2019.

Ukraine was the only CESEE country that reported a clear decline of price pressures in the review period. After a temporary spike toward the end of 2018, inflation resumed its downward trend to reach the lowest level in two and a half years in February 2019. After a hike to 18% in September 2018, the National Bank of Ukraine (NBU) left its key policy rate unchanged. In March 2019, the NBU pointed out that tight monetary conditions continue to be an important prerequisite for gradually reducing inflation to the 5% target in 2020, but also signaled the possibility of future rate cuts under certain conditions.

Accelerating inflation was reported for Russia and Turkey, which, in both cases, was strongly related to currency depreciations. In Russia, inflation doubled from a historical low in mid-2018 and reached 5.4% in February 2019. Besides a weaker ruble, increases of indexed housing and communal tariffs as well as an increase of the VAT rate in January 2019 put upward pressure on prices. The Central Bank of Russia (CBR) increased its policy rate in two steps by a total of 50 basis points in the second half of 2018 to preempt the impact of the VAT increase and to manage the risk of a potential currency shock from further U.S. sanctions.

In Turkey, the weakening of the lira pushed annual price rises to above 25% in October 2018. Since then, inflation has retreated somewhat on the back of weak demand conditions and a more stable value of the Turkish currency. After the currency depreciation had gained speed in the second quarter of 2018, the Turkish central bank (CBRT) hiked up its policy rate from 8% to 17.75% in June 2018. In September 2018, it increased its policy rate by a further 625 basis points to 24% after a further pronounced decline of the external value of the lira. Those measures were flanked by a number of liquidity and regulatory measures targeted at banks. Since then, the central bank has refrained from making any further adjustments to its policy rate. In late March 2019, however, the CBRT increased its average cost of funding from 24% to 25.5%, possibly in response to a renewed currency depreciation and a drop in foreign exchange reserves. It also decided to suspend its one-week repo auctions for an undetermined period and thus limited domestic liquidity in Turkish lira.

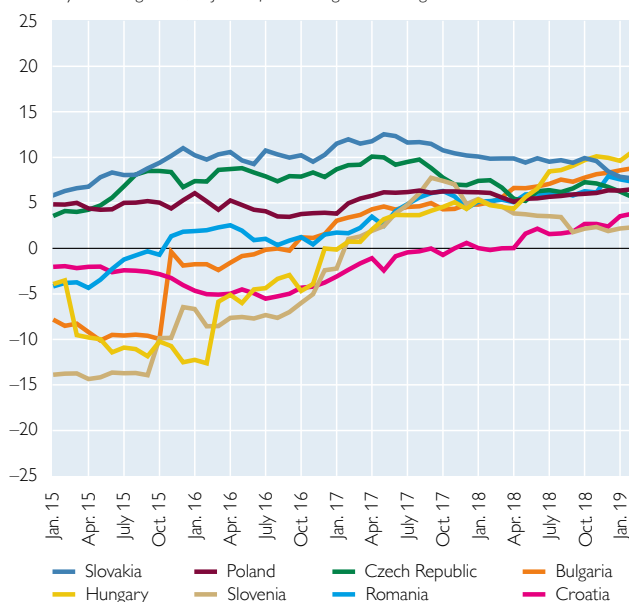
Growth of domestic credit to the private sector was solid and broadly in line with fundamentals throughout most of CESEE. Credit growth (nominal lending to the nonbank private sector adjusted for exchange rate changes) accelerated moderately in most CESEE countries, reflecting favorable general economic conditions in an environment of low interest rates and heightened competition among banks (see chart 1.2).

Among the CESEE EU Member States, the strongest credit expansion was reported for Hungary and Bulgaria in early 2019. In Hungary, lending

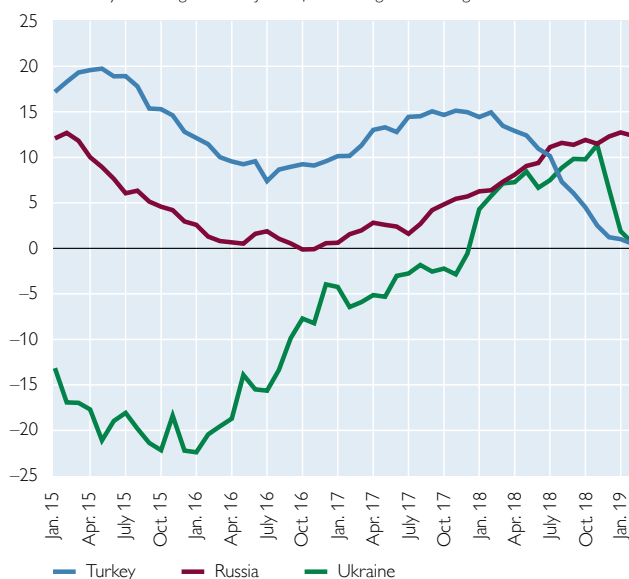
Chart 1.2

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.

was supported by various central bank measures. At the beginning of 2019, for example, the MNB expanded its toolkit by its “Funding for Growth Scheme Fix,” targeted at long-term lending to SMEs at fixed interest rates. In both countries, however, credit growth was especially strong in the household sector. Within this segment, housing loans have been growing particularly briskly.

Housing loans also grew vividly in other countries of the region, which went hand in hand with rising real estate prices. Housing prices in the CESEE EU Member States rose on average by some 8.4% year on year in the fourth quarter of 2018 (with growth rates ranging between 5.3% in Romania and 18.2% in Slovenia). While this represents some moderation compared to early 2018, housing prices continued to grow substantially more strongly than in the EU on average. Those dynamics were related to strong housing demand against the backdrop of high wage growth, healthy consumer sentiment as well as favorable expectations concerning future income and general economic conditions. At the same time, regulatory requirements and a lack of skilled labor in the construction sector prevented supply from keeping track with demand.

After several CESEE countries had introduced macroprudential measures and/or recommendations to put a brake on the expansion of housing loans, there was a further tightening of standards in the review period. The measures that are already in effect include debt service-to-income ratios (e.g. in the Czech Republic, Hungary, Romania, Slovakia and Slovenia), higher risk weights (e.g. in Poland and Slovenia), loan-to-value ratios (e.g. in the Czech Republic and Slovakia) as well as loan-to-income ratios (e.g. in the Czech

Republic and Slovakia).¹ So far, they have contributed to a notable slowdown in mortgage loan growth especially in the Czech Republic and Slovakia (where such regulations have been in force for longest).

In the Czech Republic and Slovakia, credit growth has declined from levels of 10% year on year and above, reaching around 6% and 8% respectively, in February 2019. Apart from slower housing loan growth, the imposition and subsequent increase of countercyclical capital buffers might have contributed to the moderation. In the Czech Republic, the buffer currently stands at 1.25% and is to be raised to 1.5% in July 2019 and 1.75% in January 2020. In Slovakia, the buffer will be raised to 1.5% in August 2019 from its current level of 1.25%.

Slovenia has reported the strongest deceleration of credit growth among the CESEE EU Member States. Growth rates came down from close to 8% in late 2017 to 2.3% in February 2019. The reduction was driven by credit to corporations, where lower demand for loans was primarily the result of a change in corporate financing methods, with other instruments (internal resources, equity financing and trade credits) having become more important.

Country-level bank lending surveys conducted by national central banks suggest some tightening of credit conditions in late 2018 and early 2019. Demand for loans has decreased, especially demand from households (e.g. in the Czech Republic and Romania), which may reflect a general slowdown of economic activity. Lending conditions also appear to have tightened somewhat according to several country-level bank lending surveys, especially for housing and consumer loans (e.g. in the Czech Republic, Romania and Poland).

Bank lending has gained momentum in Russia. However, this revival has been largely driven by retail loans, while credit to enterprises has remained sluggish. Mortgage loans and unsecured consumer credit have grown particularly briskly, which gives rise to some concern. The CBR responded by increasing risk weightings for high-interest mortgage and consumer loans and is planning to tighten requirements further if necessary. This has already been reflected in tightening price conditions for consumer loans.

Turkey and Ukraine, by contrast, have experienced a notable deceleration in credit growth. In Ukraine, the growth of the domestic loan stock vis-à-vis the private sector peaked at 11.4% in November 2018, before decelerating to 1.9% in January 2019, partly related to write-offs. In general, banks expect lending growth to persist in 2019, according to the lending survey conducted by the Ukrainian central bank. Driven by local currency lending, household loans (in particular consumer loans) had been growing swiftly, with year-on-year growth hitting 26% in November, before coming down to 13.9% in January 2019. The growth of loans to nonbank corporations remained below 10% throughout 2018 and was marginally negative in January 2019.

In Turkey, credit growth came to a virtual standstill in early 2019, despite support from the government's subsidized loan scheme. Tightening global financial conditions, increasing risks and adverse exchange rate developments contributed to tightening loan supply, while weakening domestic

¹ See also Wittenberger, T. 2018. *Lending to households in CESEE with regard to Austrian banking subsidiaries and macroprudential measures addressing credit-related risks*. In: *Financial Stability Report 36*. OeNB. 82–94.

Chart 1.3

demand and a pronounced rise in interest rates weighed on loan demand.

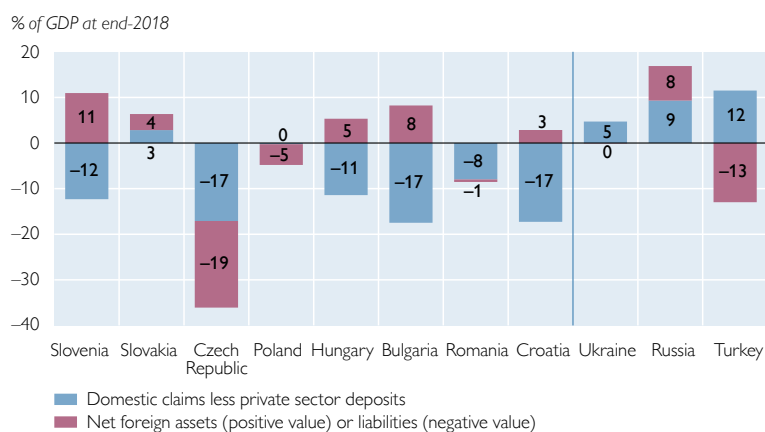
The strong growth of credit throughout 2018 has not impacted on the refinancing structure of CESEE banking sectors. The refinancing structure has increasingly been shifting toward domestic deposits over the past few years and also in the review period. This is especially true for the CESEE EU Member States where the gap between total outstanding domestic claims and total domestic deposits relative to GDP had not been substantial or had been negative at end-2018 (see chart 1.3). However, it has to be noted that this trend has come to a halt in Slovakia, where the gap turned positive in early 2017 and continued to expand moderately throughout 2018 as claims expanded substantially and the deposit base remained broadly stable. Compared to the CESEE EU Member States, Russia, Turkey and Ukraine exhibited positive funding gaps between 5% and 12% of GDP. In all countries, however, those gaps have narrowed, and especially so in Turkey (−4.4% of GDP between end-2017 and end-2018), reflecting a decline of the credit stock in relation to GDP.

The banking sectors of four of the eleven CESEE countries under observation reported net external liabilities by the end of 2018. Liabilities were especially high in the Czech Republic, where they had shot up in anticipation of the abolition of the exchange rate floor of the Czech koruna against the euro in the first quarter of 2017 and have only moderately declined since. In Turkey, external liabilities declined notably in the review period.

Banks' asset quality continued to improve amid robust general economic activity and credit growth. In the CESEE EU Member States, the share of nonperforming loans (NPLs) in total loans declined notably, reaching between 2.2% in Hungary and 9.8% in Croatia at the end of 2018 (see chart 1.4). Hence, NPLs returned to pre-crisis levels throughout most of the region. In Hungary and Slovenia, NPL ratios even reached historical lows.

The strongest reduction in NPLs was reported for Bulgaria (−1.8 percentage points between end-2017 and end-2018). Following Bulgaria's application for close cooperation with the ECB in the context of the SSM, in November 2018, the ECB started its comprehensive assessment of the Bulgarian banking sector, which focuses on the country's six largest banks. The results of the related asset quality review and stress tests are expected to be published in July 2019 and would be followed by the implementation of identified follow-up measures (if any). The start of legislative amendments to prepare for participation in banking union has been accompanied by policy measures in other areas, in line with the Action Plan approved by the Bulgarian government in August 2018.

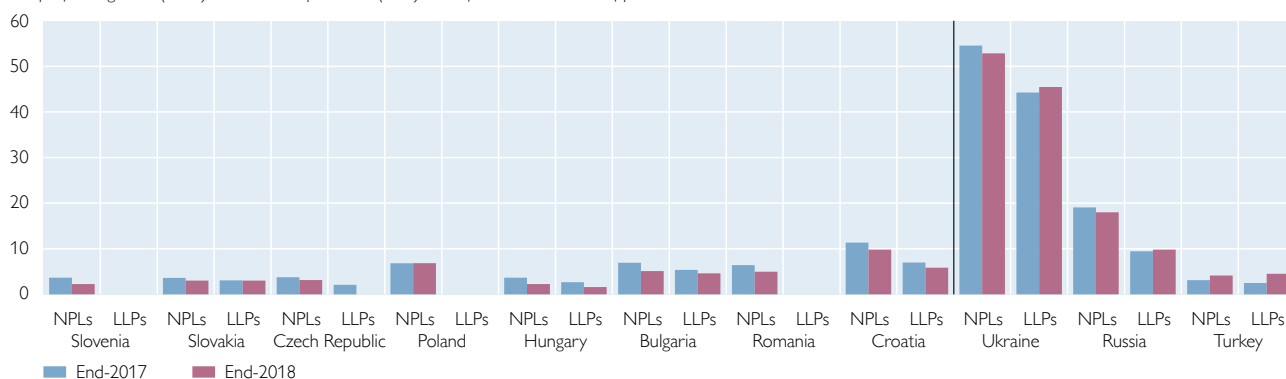
CESEE banking sectors: gap between claims and deposits, and net external position



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

CESEE banking sectors: 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.

Some improvement in asset quality was also reported for Russia and Ukraine. Standing at 18% and 52.9%, respectively, at the end of 2018, NPLs remained at a high level, however.

Unlike in the other countries of the region, the NPL ratio in Turkey increased from 3.1% at the end of 2017 to 4.1% at the end of 2018. The increase in NPLs reflected the financial difficulties faced by indebted companies, particularly those with debts in foreign currency. Moreover, the quality of bank assets might be lower than reflected in these figures due to sales of NPLs to asset management companies and the rollover of potentially distressed loans under the government's loan guarantee scheme. In addition, the Turkish Banking Regulation and Supervision Agency (BRSA) introduced several measures to facilitate loan restructuring, which took effect in September 2018. The BRSA undertook an asset quality review in December 2018, finding that the NPL ratio might increase to 6% of total loans.

The reduction of NPL ratios in many CESEE countries has been accompanied by a further decrease in foreign currency-denominated credit. This is especially true for lending to households, where the share of foreign currency-denominated credit in total credit is already close to zero in the Czech Republic, Hungary, Russia, Slovakia and Slovenia. In the other countries, the average share declined from around 28% at the end of 2017 to 23% in February 2019.

In Turkey, households have been banned from borrowing in foreign currency. The share of foreign currency loans in total loans to corporations, however, increased from 44% at the beginning of 2018 to 57% in August 2018, reflecting a large-scale depreciation in the exchange rate. The share came back to 47.8% in February 2019 as the exchange rate recovered some of its earlier losses and as the stock of foreign currency loans declined in exchange rate-adjusted terms.

Robust credit growth and improving asset quality have contributed to rising banking sector profitability in most of the CESEE region. The

average return on assets (ROA) in the CESEE EU Member States increased from 1.1% at the end of 2017 to 1.3% at the end of 2018 – one of the highest readings since 2008 (see chart 1.5). Throughout most of the region, operating income trended up somewhat, with positive momentum coming from noninterest income. At the same time, operating expenses remained broadly unchanged. Lower provisioning needs contributed strongest to rising profitability, especially in Bulgaria, Croatia and Romania. Hungary was the only CESEE EU Member State to report a decline of its ROA, which was primarily due to lower net reversals of provisions, but operating expenses increased somewhat too.

The Ukrainian banking sector has recovered from a long period of losses. An ROA of 0.9% at the end of 2018 reflected a massive decline of provisioning after the nationalization of Privatbank in December 2016 as well as positive effects of a comprehensive clean-up of the banking system carried out by the Ukrainian central bank in recent years.

In Russia, bank profitability surged on the back of lower provisions and higher interest income. The banking sector's ROA increased from 1% in 2017 to 1.5% in 2018. At the same time, the sector remained highly concentrated and controlled by the government. Five large state-owned banks account for 60% of the sector's assets, up from 52% at the end of 2013. After a series of bailouts in the second half of 2017, the sector clean-up has continued, and some smaller banks have received liquidity or capital injections.

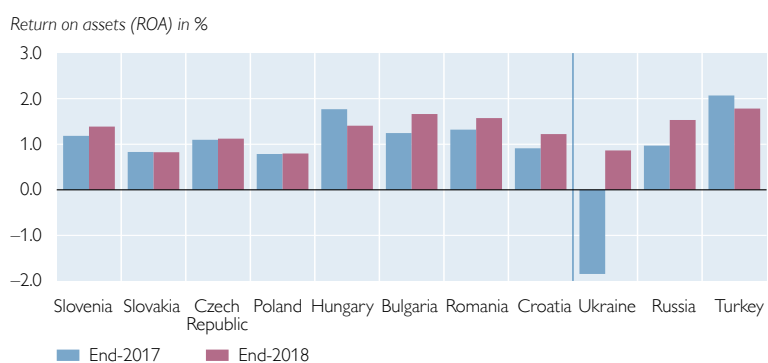
The profitability of Turkish banks declined in the review period and reached the lowest level in three years. This primarily reflected higher provisioning needs for nonperforming loans.

Capital adequacy ratios (CARs) have remained high in the CESEE EU Member States. At the end of 2018, CARs ranged between 18.2% in Slovakia and 22.9% in Croatia. A decrease in capitalization, however, was observed in Bulgaria and Hungary as risk-weighted assets increased notably.

In the other countries of the region, capitalization was markedly lower, ranging from 12.2% in Russia to 16.9% in Turkey. In Turkey, the sharp depreciation of the lira weighed on the capital ratio, given that risk-weighted assets are partially denominated in foreign currency. However, the Turkish supervisor's ruling that banks may use the exchange rate of end-June 2018 to calculate capital ratios contributed to a recovery of the capital base in the second half of 2018.

Chart 1.5

CESEE banking sectors: profitability



Source: IMF, national central banks, OeNB.

Note: Data are not comparable across countries. They are based on annual after-tax profits, except for Russia's data, which are based on pretax profits.