

International Macroeconomic Environment: Weaker Global Growth and Geopolitical Tensions Rekindle Financial Sector Volatilities

Advanced Economies: Uneven Economic Recovery

Global economic activity showed signs of softening in the review period from June to October 2014 and is expected to expand less than anticipated until 2015. Contradictory signs in advanced economies have been going hand in hand with a slowdown of growth in emerging economies in a less favorable external financial environment. In the euro area, macrofinancial risks have been nourished by low nominal growth reflecting both economic slack and very low inflation. Muted price pressures, in turn, have resulted from subdued demand and falling commodity prices, which have more than offset a depreciation of the euro's nominal effective exchange rate.

In the U.S.A., economic growth accelerated during the second and third quarters of 2014 but is expected to smooth out in the coming quarters. Labor market indicators have shown further improvement in employment and unemployment despite declining participation rates. The biggest drivers of growth have been private investment and consumption; also, fiscal policy has been less tight, and monetary policy has remained accommodative. While the Federal Reserve decided in October to end its large-scale bond purchasing program, it pledged to keep its benchmark federal funds rate near zero “for a considerable time.” Inflation has been gradually decreasing below the long-run target of 2%, and inflation expectations over ten years have also declined below this rate.

In Japan, GDP growth has been very volatile: After a strong start in early 2014, it contracted severely in the

second quarter – after a hike of the consumption tax in April – and appeared to rebound somewhat thereafter. The negative effects of declining real disposable incomes have been partly offset by the main growth drivers – private investment and exports – supported by a great fiscal stimulus, a cut in the corporate income tax rate and a substantial depreciation of the yen (by 25% in trade-weighted terms since late 2012). However, the downtrend of the unemployment rate seems to have stopped recently, and the inflation rate has started to fall from its recent peak in the second quarter. In line with its proactive stance against deflation and in the face of a second consumption tax hike (which, in the meantime, has been postponed until early 2016), the Bank of Japan further expanded its quantitative and qualitative monetary easing at the end of October, primarily through purchases of government bonds. In the long run, sustainable growth will also depend on structural reforms, the “third arrow” of the Japanese prime minister’s “Abenomics.”

The Swiss National Bank (SNB) has remained committed to its exchange rate ceiling of CHF 1.20 per euro and reiterated its readiness to buy “unlimited quantities” of foreign currencies to protect the barrier.

The weak recovery of the euro area economy has further softened as GDP grew by 0.1% in the second quarter and by 0.2% in the third quarter. Generally, growth in the larger euro area economies, such as Germany, France and Italy, has been disappointing, whereas stressed economies, such as Spain, have shown signs of a pick-up, as rebalancing efforts have improved their

Economic growth faster in the U.S.A. but slower in Japan and emerging markets

Euro area recovery stalls, with inflation running very low

competitiveness and current accounts. The inflation rate fell below 0.5% in the summer and has remained there since then. This can be partly explained by energy and food prices, but core inflation has also remained considerably below 1% given the amount of idle capacities. Even in Germany, which had seen relatively more growth until the recent dip owing to a decrease of export demand, headline inflation has continued to slide, falling below 1%. Across the euro area, an almost neutral fiscal stance is expected to lift growth after years of procyclicality. The gradual decline of unemployment rates, however, has stalled since the summer. Although employment has been increasing, unemployment is expected to remain at elevated levels throughout 2016.

The ECB implements further conventional and nonstandard monetary policy measures

Turning to monetary policy, the Governing Council of the ECB cut its main refinancing rate to 0.05%, its deposit facility rate to -0.20% and its marginal lending facility rate to 0.30% in two steps in June and September. In order to boost lending to SMEs, the Governing Council decided to implement targeted longer-term refinancing operations (TLTROs) in two steps (September and December). Moreover, the ECB announced to purchase non-financial private sector assets, i.e. asset-backed securities and covered bonds, and suspended the sterilization of its expiring Securities Markets Programme (SMP). Under its forward guidance, the ECB continued to reassure markets that it would maintain its accommodative stance for as long as necessary (at least until end-2016). All these measures are expected to enhance the functioning of the monetary policy transmission mechanism, facilitate lending to the broader economy as well as underpin the anchoring of medium- to long-term inflation expectations. The Governing Council also communicated

its readiness to use additional unconventional instruments if needed to address risks of too prolonged a period of low inflation. Since the beginning of May, the euro exchange rate has gradually depreciated following news about ECB measures and a weaker growth outlook for the euro area, losing about 10% against the U.S. dollar and roughly 5% in nominal effective terms against a basket of 21 currencies.

After a period of constantly improving stability, volatility has returned to financial markets recently. Global stock markets dropped in the first half of October due to fears of recession and geopolitical uncertainty, notably the crisis in Ukraine. Despite its recent recovery, at the end of October the representative stock index DJ Euro Stoxx remained around 5% below its value of one month earlier. At the same time, sovereign risk spreads in stressed economies widened after a period of constant narrowing. On the one hand, yields of German ten-year sovereign bonds fell temporarily to record lows (0.72%) as investors' mounting risk awareness implied safe haven effects. On the other hand, risk premiums of Greek government bonds rose by around 1 percentage point, reflecting uncertainty surrounding the country's program exit, while the risk premiums on Irish, Italian and Portuguese sovereign bonds rose by still roughly ¼ percentage point. On a positive note, the market reaction to the publication of the ECB's bank stress test results at the end of October was relatively benign. It is hoped that this further step toward the implementation of the banking union helps to improve market sentiment toward euro area banks – particularly toward those in stressed economies with large stocks of nonperforming loans.

CESEE: Overall Sound Macro-financial Developments Overshadowed by Russia and Ukraine

The economic recovery in Central, Eastern and Southeastern Europe (CESEE) lost some steam in the first half of 2014 and especially in recent months, as weaker growth in the euro area and heightened geopolitical tensions started to weigh on sentiment and external demand.¹

Financial market developments, however, were stable in the review period, with the major exceptions of Russia and Ukraine (see below). Exchange rates against the euro as well as CDS premiums remained broadly stable throughout the past few months, reflecting a comparatively sound macro-financial environment and favorable global liquidity conditions. Notable increases in CDS premiums, however, were observed in Turkey and Bulgaria.

The risk assessment of Turkey had improved since the beginning of the year against the background of decreasing domestic political risk. Starting in early September, however, CDS premiums again embarked on an upward path, which was probably related to the escalating conflict in neighboring Syria and Iraq. The Turkish lira stabilized following a decisive policy rate hike in late January 2014 (leading to an effective increase by 225 basis points to 10%), but has remained weak since then, in a setting of monetary easing (in three consecutive steps by a cumulative 125 basis points to 8.25%) that started in May.

In Bulgaria, bank runs on Corporate Commercial Bank (CCB) and First Investment Bank (FIB) in June 2014 pushed CDS premiums moderately upward. The two banks account for about 20% of the banking system's total

assets. The Bulgarian National Bank revoked the banking license of CCB in early November. The reimbursement of guaranteed deposits has to start within 20 business days, but this deadline could be extended by another 10 business days under exceptional circumstances. As the existing assets of the deposit insurance fund cover only 60% of all guaranteed deposits at CCB, the shortfall of about 2% of GDP will have to be covered with funds from the domestic debt market and/or the fiscal reserve account. The spillovers of CCB's problems to the rest of the Bulgarian banking sector have been contained (at least as suggested by figures for the second quarter of 2014). Neither has the country's currency board arrangement come under pressure as the abundant coverage of base money by gross foreign reserves (of about 180%) has remained unchanged.

The situation was vastly different in Ukraine due to the armed conflict in the eastern part of the country. CDS premiums retreated somewhat – to around 800 basis points – from May to July amid international financial support, before climbing up to more than 1,500 basis points again from August to mid-November. The ceasefire between separatists in eastern Ukraine and Ukrainian forces of early September, which has remained fragile, did not bring about a reversal of this trend.

Following the sizeable depreciation of the hryvnia in early 2014, the situation on the foreign exchange market stayed tense, while deposit outflows from the banking system continued and high foreign currency demand met low supply. The hryvnia repeatedly came under considerable pressure, prompting the central bank to raise its key

Financial markets are broadly stable in most CESEE countries

Armed conflict weighs on risk assessment of Ukraine

¹ For a more thorough examination of macroeconomic conditions and the outlook for CESEE countries, see the OeNB's Focus on European Economic Integration Q4/14.

policy rate (currently at 12.5%), introduce new administrative measures and tighten existing ones and to conduct regular foreign exchange auctions. In mid-November, the currency hit an all-time low at UAH 15.85 against the U.S. dollar amid rising tensions on the Russian-Ukrainian border. The depreciation since the beginning of the year (−47% against the U.S. dollar and −41% against the euro) negatively affected unhedged foreign currency debtors.

Despite the very difficult environment, Ukrainian authorities have so far implemented policies broadly as agreed under the IMF Stand-by Arrangement. The positive conclusion of the first review in August enabled the disbursement of a further USD 1.4 billion tranche. This notwithstanding, the IMF noted that a deterioration in the economic outlook, fiscal and quasi-fiscal pressures, and heightened balance of payment difficulties are putting the initial program targets in jeopardy. The policy effort should focus on compensatory measures to meet key program ob-

jectives, while allowing some temporary deviations from initial targets.

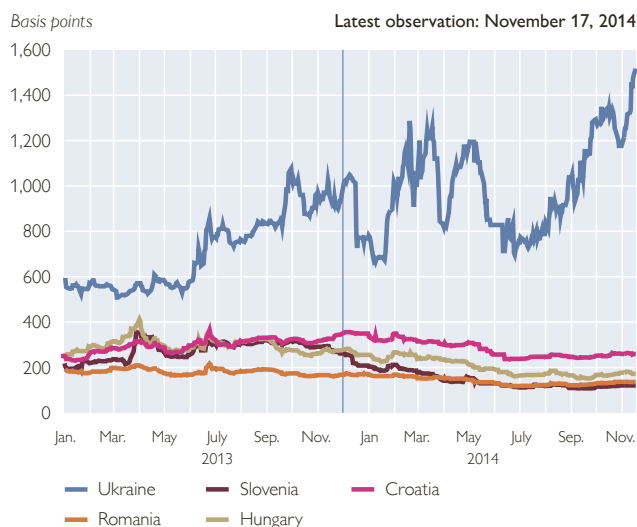
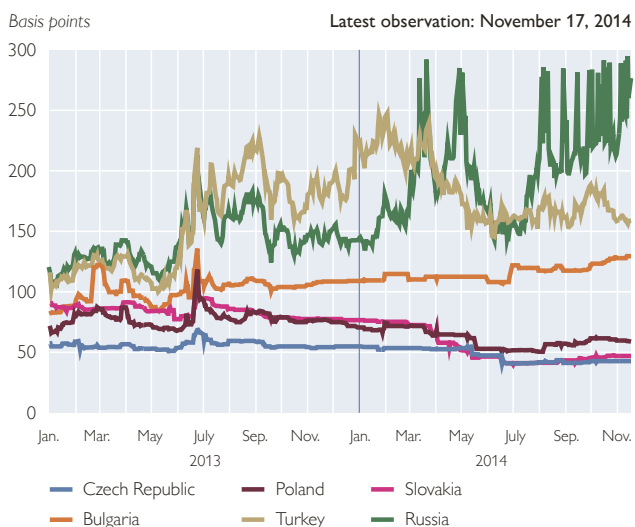
Frictions between Ukraine and Russia had escalated due to Russia's annexation of Crimea and support for separatist forces in eastern Ukraine, but have also been fueled by the ongoing gas conflict and pressure from Moscow on Kiev not to implement any parts of its Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU, which was ratified in September. The provisional application of the DCFTA was postponed until end-2015.

The political tensions triggered by the conflict in eastern Ukraine have also adversely affected Russian financial markets. CDS premiums increased strongly in July and have oscillated between 200 and 300 basis points during the past few months, displaying a high degree of volatility. Capital outflows have been swelling recently against the background of the persistently tough investment climate, actual and expected tapering by the U.S. Federal Reserve, the downgrading of Russia's sovereign rating, the step-by-step

Financial market conditions deteriorate also in Russia

Chart 1

Five-Year Credit Default Swap Premiums



Source: Thomson Reuters.

strengthening of Western sanctions and adverse expectations emanating from the latter: Over the first three quarters of 2014, private net capital outflows came to USD 85.2 billion, by far exceeding the outflows of 2013 as a whole. In the third quarter, net capital outflows declined compared to the first half of the year, as banks on a large scale repatriated capital invested abroad.

Capital flight and falling oil prices were primarily responsible for the depreciation of the ruble, which lost 31% against the U.S. dollar and 23.5% against the euro from the beginning of 2014 to mid-November. The ruble would have fallen even more if the Central Bank of Russia (CBR) had not taken countermeasures, including increases of the key interest rate by 400 basis points to 9.5% between March and July. Furthermore, the CBR formally abolished its exchange rate policy mechanism and moved to a floating exchange rate regime in early November. The new approach, however, does not imply the complete abandonment of foreign exchange interventions, which can be implemented in case financial stability is under threat. Mainly as a result of foreign exchange interventions, the CBR's international reserves have declined by about USD 88 billion (or 17%) since the beginning of the year. In early-November, however, international reserves still stood at a comfortable USD 421 billion (about 22% of GDP).

The current sanctions against Russia include selective travel bans and account freezes, bans on arms trade, restrictions on the transfer of high technology for oil extraction and on the export of dual-use goods (usable for military as well as civilian purposes) as well as tight limits on Russian state-owned banks' and oil and defense com-

panies' access to EU and U.S. capital markets and bank loans.

The economic impact of financing restrictions on the Russian banking sector is expected to be limited in the short term, as its external position is fairly robust (showing a net external creditor position, see below). Yet, refinancing costs are likely to rise through direct and indirect effects. The direct impact on sanctioned nonfinancial companies is more difficult to assess due to the lack of sectoral data (e.g. for the oil sector), but also non-sanctioned companies might find it more difficult to access international markets. Available figures show, that "other sectors" (nonfinancial corporations and households) hold a net external debtor position. Gross external liabilities mainly consist of long-term debt (at original maturity) and equity portfolio investments. However, other sectors' external debt repayments (excluding maturing FDI debt liabilities) until end-2015 amount to USD 72 billion. Against this background, some nonfinancial companies might be vulnerable also in the short term. However, current macrofinancial conditions give Russia sufficient room for maneuver for the time being, and the government as well as the central bank stand ready to provide support if necessary.

In the medium to long term, the sanctions may have more tangible and sustained negative effects on the Russian economy. Indirect effects resulting from heightened uncertainty have already triggered larger capital outflows and impacted negatively on investment. Direct investor restraint and the suspension of technology transfers in certain fields are further clouding the outlook for a modernization of the Russian economy in the medium to long term.

Impact of sanctions on the Russian economy expected to be more tangible in the medium to long term

Spillovers of sanctions to other CESEE countries remain contained so far

The direct spillovers of the geopolitical tensions emanating from the Ukraine-Russia crisis and the accompanying sanctions to other CESEE countries have so far been contained. Nevertheless, a further escalation of the conflict, including tit-for-tat sanctions, poses a non-negligible risk. Exports to Russia amount to more than 2% of GDP in Poland and Hungary and to more than 3% in the Czech Republic, Slovenia and Slovakia. Given these large export shares, a prolonged economic stagnation or even recession in Russia could become a notable factor for GDP growth in CESEE, especially if this factor were amplified further by adverse repercussions resulting from deteriorating sentiment and demand in the euro area. As far as the euro area is concerned, trade with Russia accounts for only 0.9% of GDP; however, this share is higher for a number of euro

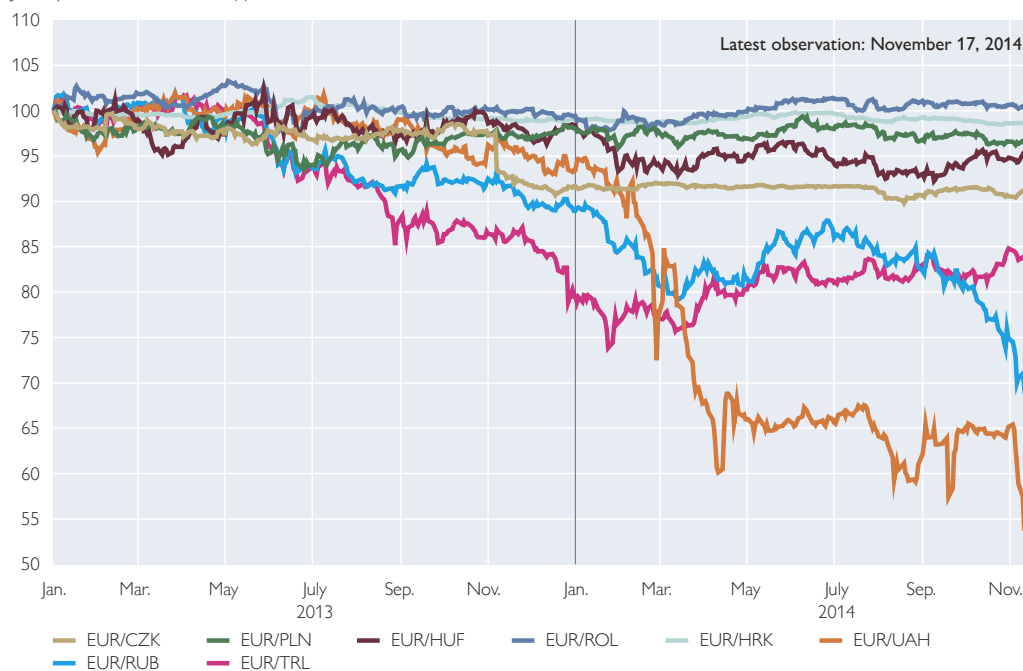
area countries that are important trading partners of CESEE (e.g. Germany, whose trade with Russia amounts to 1.3% of GDP). The impact of the sanctions on Austria is discussed in detail in box 3.

The Russian trade embargo on selected food items from the EU imposed in August has a fairly limited impact on CESEE EU Member States. The sanctioned products account for a fairly high share in total exports to Russia only in Poland and, to a lesser extent, in Hungary and Bulgaria. But even in these countries, only 0.1% to 0.6% of total exports are affected. The embargo might even help Turkey's agricultural exports to Russia, as Russian importers seek to substitute supplies from EU markets. Turkey trades substantial volumes of goods that are covered by Russia's sanctions against the EU (especially fruit and vegetables), and these food exports could be stepped up quickly.

Chart 2

Exchange Rates of Selected Currencies against the Euro

January 1, 2013 = 100; rise = appreciation



Source: Thomson Reuters.

While fewer exports to Russia could dampen economic activity only to a limited extent, a disruption of supplies from Russia, especially of energy, would have a severe impact on CESEE countries. Most CESEE EU Member States are heavily dependent on Russian gas supplies. As a case in point, Bulgaria, Slovakia and Hungary obtain more than 80% of their gas from Russia. The two notable exceptions from this pattern are Romania, where the share of Russian gas in total gas consumption is rather moderate, and Croatia, which does not buy gas from Russia at all.

In comparison to their linkages in the real economy, the CESEE countries' direct financial linkages with Russia are less important. Nevertheless, a further escalation of the conflict could induce spillovers to CESEE financial markets. This risk would again be most pronounced if sanctions were to affect energy supplies.

Turning to banking sector developments, credit growth in CESEE was ei-

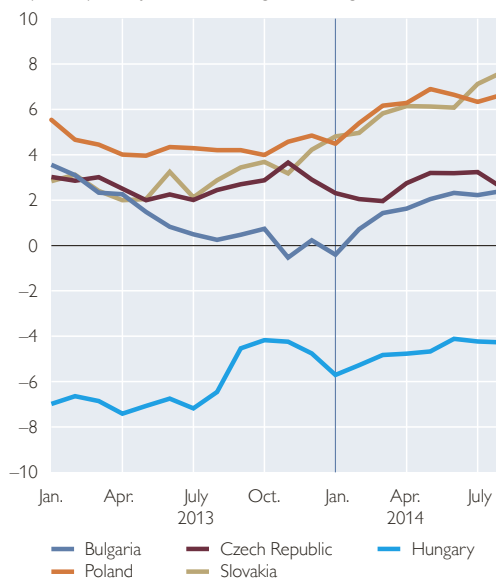
ther unchanged or somewhat improving in most countries during the review period. The latter is especially true for Poland, Slovakia, the Czech Republic and Bulgaria. In Hungary, central bank measures to support credit expansion had some positive effect; the utilization of the funding for growth scheme (FGS) increased during the review period. Against this background, the Hungarian central bank (MNB) decided to double the maximum refinancing volume of the current tranche (available until end-2014) to around 3.3% of GDP. Credit growth beyond the FGS has remained weak, however. Banks' profitability and capital positions received a blow in July 2014, when the Hungarian parliament passed legislation which obliges banks to retroactively apply the MNB's official exchange rate for the disbursement and servicing of consumer loans denominated in foreign currency (and hence pay back exchange rate margins) and to compensate consumers for unilateral

Credit growth picks up moderately in Central Europe

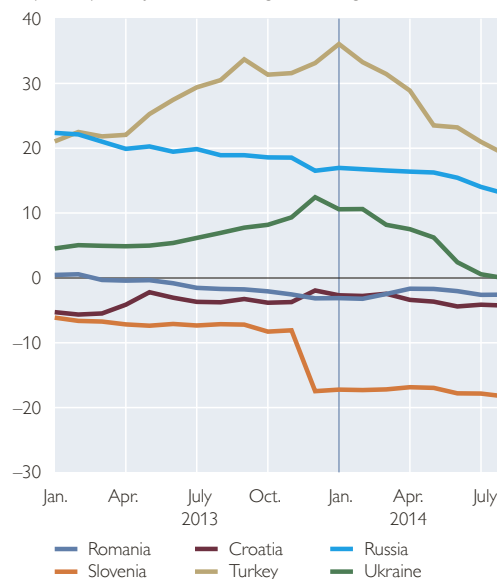
Chart 3

Growth of Credit to the Private Sector

% , year on year, adjusted for exchange rate changes



% , year on year, adjusted for exchange rate changes



Source: National central banks.

increases in interest rates, charges and fees relating to local and foreign currency loans. The two measures are expected to cost financial institutions around 3% of GDP or nearly 30% of their capital. Moreover, the government announced legislation to convert households' foreign currency loans into domestic currency loans at market exchange rates. The MNB already started to provide foreign currency liquidity to banks for the conversion.

Lending surveys point to stabilizing supply and demand conditions

According to lending surveys covering CESEE, stable or improved credit supply and demand conditions can be expected for the region:² For example, the bank lending conditions index in emerging Europe as collected by the Institute of International Finance showed some easing for the first time since the second quarter of 2013, with the overall index increasing noticeably by 6 points in the second quarter of 2014. The index for funding conditions even surged by 17 points as both domestic and international funding conditions eased considerably for the first time in a year. Loan demand also increased amidst a recovery in domestic demand. The demand for business loans continued to trend higher, and the demand for consumer loans recovered after dipping temporarily in the previous quarter. On the other hand, nonperforming loans (NPLs) continued to trend up, though banks expect NPLs to start declining in the coming quarters.

Credit expansion, however, remains weak in several countries

The CESEE Bank Lending Survey by the European Investment Bank is only marginally less optimistic. Banks reported a stabilization of credit demand and supply conditions, albeit at comparatively low levels. Both supply and demand are expected to improve in the next six months, however. Credit

supply has eased for households (especially consumer credit), but continued to be tight for corporates. Banks expect an easing of supply conditions. NPLs and regulation, at both the national and international level, remain the most evident factors constraining supply. Demand for loans has improved marginally, although at a slow pace. Funding conditions are considered to be fairly favorable, with access to funding rated positive across all sources other than intragroup funding. Easy access to retail and corporate deposits supports a positive outlook. NPL figures have deteriorated further and remain a key concern for the region's banks. However, the speed of deterioration has been decreasing.

Unlike in the larger Central European countries, credit growth remained negative in Slovenia, Romania and Croatia, and it continued to decelerate in Turkey, Russia and Ukraine. In the latter, credit growth even came to a standstill in August.

In Slovenia, the banking sector is still in a process of restructuring, including the transfer of nonperforming loans to a bank asset management company and the recapitalization of banks. The European Commission approved Abanka's restructuring plan in mid-August, thus giving green light to the second tranche of recapitalization and the transfer of bad assets to the Bank Asset Management Company. Furthermore, Slovenia has committed itself to merging Abanka with Banka Celje (a small bank which requested state aid at end-April 2014) and to submit a restructuring plan for the joint entity by end-2014. The ECB's comprehensive assessment revealed a combined capital shortage of the country's two biggest

² It needs to be noted, however, that those surveys were conducted in May and June 2014, before the recent deterioration in the international environment.

banks (Nova Ljubljanska Banka and Nova Kreditna Banka Maribor) of EUR 65.3 million in the adverse stress test scenario and a substantial reclassification of bad loans.

Turning to credit growth in the remaining CESEE countries, the ongoing recession and economic uncertainty have weighed on loan developments in Croatia, even though the central bank has already taken measures to stimulate private sector lending (e.g. lower reserve requirements provided that the released liquidity is used to grant loans to nonfinancial enterprises). The Turkish central bank vigorously tightened monetary policy in January 2014 and set several macroprudential measures to put a brake on the swift credit expansion seen recently. Short-term growth figures, however, suggest that credit growth started to pick up again after the central bank began to lower policy rates in May. In Russia and Ukraine, credit growth was negatively affected by geopolitical tensions weighing on sentiment and the outlook and limiting international refinancing pos-

sibilities. Furthermore, policy rates have increased markedly since March 2014.

The share of foreign currency loans in total loans to households declined in most CESEE countries, most strongly in Romania (by 5 percentage points to 61.5% between end-2013 and September 2014), but remained high not only in Romania but also in Hungary and Croatia (at 52.9% and 72.5%, respectively, in September 2014). While in Russia foreign currency loans do not play an important role in the household credit stock, in Ukraine, their share came to 43.9% in the third quarter of 2014, having substantially risen from 35% at the end of 2013 against the background of a substantial depreciation of the hryvnia.

NPL ratios remained clearly elevated and credit quality even deteriorated somewhat further in many countries of the region in the first half of 2014. This trend was most pronounced in Ukraine, but also Bulgaria reported a notable increase in NPLs. Furthermore, NPLs rose again somewhat in Slovenia after a first tranche of bad as-

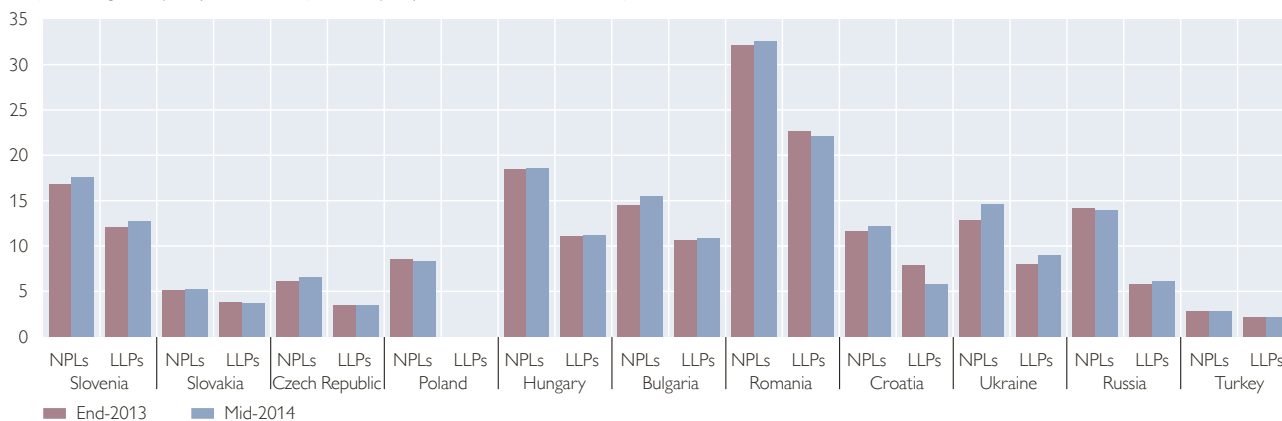
Foreign currency loans continue their downward trend

Credit quality still weak

Chart 4

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 between countries. NPLs include substandard, doubtful and loss loans, except for Romania and Ukraine (doubtful and loss loans) and Slovenia (loans in arrears for more than 90 days).

Chart 5

Banking Sector: Gap between Claims and Deposits and Net External Position

As a percentage of GDP at mid-2014



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

Loan-to-deposit ratio deteriorates especially in Ukraine

Profits continue to be subdued...

...but banking sectors remain well capitalized

sets had been transferred to a bad bank in December 2013.

The gap between total outstanding domestic claims and total domestic deposits (relative to GDP) remained broadly unchanged in many countries during the review period. A fairly strong narrowing of the funding gap was observed only in Slovenia (-5 percentage points of GDP) while it widened noticeably in Poland, Russia, Turkey and especially Ukraine, where it was by far the largest in the region (24% of GDP). In all of the latter countries, deposits were somewhat lower in the second quarter of 2014 than they had been at the end of 2013. At the same time, claims continued to grow moderately. Only in Ukraine did the growth of claims turn negative in the second quarter.

The developments outlined above are broadly reflected in banks' net external positions, which have not changed substantially in most cases.

Slovenia has reduced its reliance on external funding noticeably against the background of a declining funding gap, while Ukraine has increasingly turned to international sources to finance credit expansion as its funding gap has been widening. The banking sector continued to hold net external liabilities in many countries, mostly at around 8% to 9% of GDP. Only in Turkey were net external liabilities substantially larger. Slovenia and Bulgaria became international creditors in 2013 and further consolidated this position in the review period. The Czech Republic and Slovakia continued to report positive net external assets, as did Russia.

Banking sector profits in CESEE remained rather subdued by historical standards, ranging from a return on assets (RoA) of 0.1% in Romania to an RoA of 1.7% in Turkey in mid-2014. Hungary was the only country to report losses in the review period (-2.3% RoA) as profitability suffered due to higher reserves and provisions against the background of new legislation concerning foreign currency loans. Operating income increased marginally, however.

Compared to a year earlier, profitability remained broadly unchanged in mid-2014 in many CESEE countries. Only the Slovenian banking sector generated a substantially higher profit, given higher operating income and lower provisioning. Russia, Turkey and Romania, by contrast, reported a notable decline in RoA. In Romania, the deterioration was mostly due to higher taxes on profits, in Turkey and Russia lower operating income was responsible, and higher provisioning also played a role.

The banking sectors in CESEE have remained well capitalized. In mid-2014, capital adequacy ratios ranged

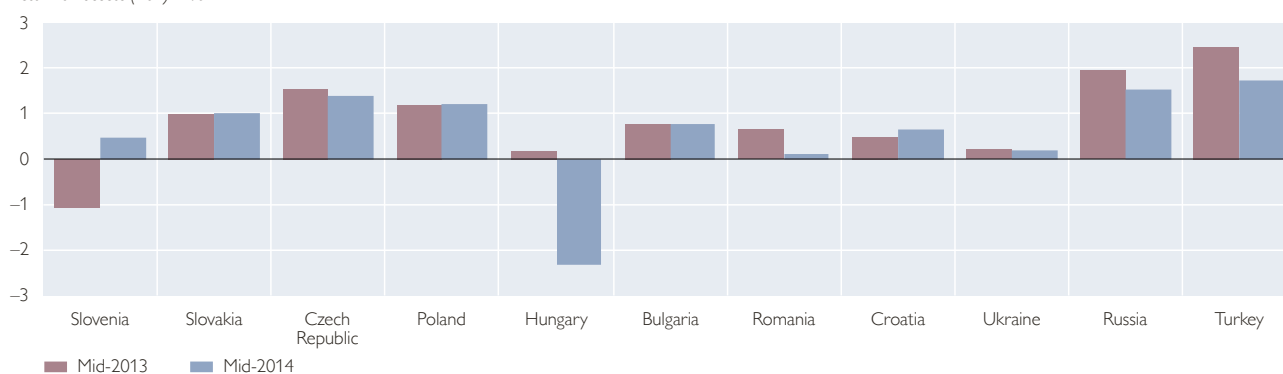
from 12.8% in Russia to 21.1% in Croatia. Compared to mid-2014, all countries recorded increases in their capital adequacy ratios (in a range from 0.3 to 4.2 percentage points), except for Poland, Russia and Ukraine. While the

decline in Poland and Russia was rather modest (–0.4 and –0.7 percentage points to 14.8% and 12.8%, respectively), it was more notable in Ukraine (–2.1 percentage points to 15.9%).

Chart 6

Banking Sector: Profitability

Return on assets (RoA) in %



Source: IMF, national central banks, OeNB.

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