

International macroeconomic environment: growth outlook in advanced economies remains subdued

Sluggish world economy and political uncertainty shape financial conditions

The outlook for the global economy has remained subdued since last spring, with downward revisions in growth for advanced economies, while prospects for emerging market economies have brightened somewhat notwithstanding a further slowdown of international trade. In China, the situation has stabilized despite remaining rebalancing challenges; expansionary policies have kept growth in the targeted range. Firming prices of raw materials, notably crude oil, have improved the outlook for commodity-exporting countries. Advanced economies, however, still racked by weak growth as well as very low inflation and interest rates, face heightened political uncertainties amid a potential backlash to globalization. Monetary policies diverge between exiting and stepping up the very accommodative policy stance, with the U.S.A. and Japan on opposite sides of the range and the euro area in the middle. In Europe, second- and third-quarter data have reconfirmed the feebleness of the recovery, and risks related to credit quality have materialized in the banking sector. The U.K. referendum vote in favor of leaving the EU (Brexit) compounded uncertainties by raising political concerns about the future of European integration amid rising populism and geopolitical tensions. Catching up continues in the economies of Central, Eastern and Southeastern Europe (CESEE), but they are struggling with deflation. CESEE financial markets broadly developed favorably, with the exception of the Turkish financial market.

Weaker conditions in advanced economies partly offset by emerging markets

World economic growth remained subdued and is projected to expand slowly in 2016 and 2017. Defying downward-revised forecasts, in the third quarter, U.S. economic activity picked up at the fastest pace in two years, strengthening the case for renewed monetary policy tightening toward the end of the year. In the euro area, the economic recovery stayed moderate but resilient to the Brexit shock. Up to the third quarter, euro area growth was driven by domestic demand that benefited from an accommodative monetary policy and low energy prices. Economic activity expanded very slowly in Japan but recovered in China within the targeted range amid rising financial imbalances. While risks to the global outlook remain tilted to the downside, persistently low price pressures kept worldwide inflation low. Global merchandise trade stagnated in the first half of 2016, and annual trade growth is expected to be below GDP growth for the first time in 15 years, mainly due to the decline in imports by developing and emerging economies. More recent data, however, pointed to a strong acceleration in global trade in the fourth quarter. Monetary policy action taken by central banks continues to exert an important impact on financial markets. Bond yields generally stabilized at very low levels in advanced economies. Global stock markets recovered from the sharp decline in January. Over the first ten months of 2016, stock market indices posted gains in the U.S.A. and the U.K. but losses in Europe, Japan and China.

Resilience in the
U.S.A. and U.K.,
fragile growth in
Japan, rebalancing in
China

U.S. GDP grew by an unexpected (annualized) 2.9% in the third quarter of 2016, twice the speed of the previous quarter. The expansion was mainly powered by personal consumption expenditures, but exports, inventory building, federal government spending, and nonresidential investment also contributed positively. Unemployment, however, marginally increased to 5.0% in September, although hours worked and wages rose. Inflation as measured by personal consumption expenditures rose to 1.2% in September. The IMF revised its forecasts for 2016 and 2017 down to 1.6% and 2.2%, respectively, in view of weak (energy) investment, a relatively stronger (trade-weighted) U.S. dollar exchange rate and global risks. The Federal Reserve (Fed) paused its exit from the accommodative monetary policy that it had started in December 2015; it kept the federal funds rate at 0.5% to help achieve its goals of maximum employment and 2% inflation. Given improving data, the Fed is expected to take a further tightening step toward the end of 2016. On November 10, 2016, ten-year U.S. Treasury yields reached the highest level since the beginning of the year as uncertainty over the U.S. presidential election turned into growth optimism, lowering the demand for safe-haven assets.

The Japanese economy grew by 0.2% in the second quarter (quarter on quarter) after bouncing back 0.5% from a contraction in the last quarter of 2015. Apart from a leap-year gain in consumer spending in the first quarter, weak growth reflected external demand driven by a 10% appreciation of the Japanese yen, low corporate investment and the mid-run trend of a shrinking workforce. September figures for Japan's manufacturing output and retail sales suggest a lukewarm expansion in the third quarter of 2016. In

September, the unemployment rate also declined to 3.0%, and consumer price inflation stayed at -0.5% – in negative territory for the seventh month straight. According to the slightly upgraded IMF forecast, GDP growth in Japan is expected to remain fragile at 0.5% in 2016 and 0.6% in 2017, despite additional government spending, a further postponement of the planned value added tax hike and continued monetary easing, including a -0.1% key interest rate and annual asset purchases of JPY 80 trillion (USD 763 billion). Not taken into account were additional stimulus measures of the Bank of Japan (BoJ) taken since the summer: The BoJ doubled purchases of exchange-traded funds; more importantly, it intends to control interest rates over the whole yield curve across different maturities and to target ten year government bonds yields at 0%; and finally, it is committed to temporary inflation overshooting beyond the medium-term target. Later, however, the BoJ announced a further delay of the expected attainment of its 2% inflation target to March 2019 as well as sales of longer-dated bonds meant to increase their (currently negative) yields.

Chinese GDP expanded at annualized 6.7% in the third quarter, unchanged from the first half of 2016 and matching expectations, although policy support has faded out. Consistent with China's transition to a sustainable growth path, the expansion in the service and agricultural sectors accelerated at the cost of industry and construction, alongside sharply slowing exports in September. Nominal GDP growth accelerated to the fastest pace it has posted since 2014, particularly in the overindebted industry sector. Producer price deflation came to an end with the first (albeit minimal) price increase since January 2012. Chinese CPI

inflation rose to 1.9% in September 2016. The IMF projects an expansion of 6.6% this year and 6.2% in 2017 for China's economy. Still unusually high credit growth and debt service ratios as estimated by the Bank for International Settlements point to potential concerns. In September 2016, several municipalities imposed restrictions on buying real estate and mandated higher mortgage down payments to cool down overheated property markets. In October 2016, measures to facilitate corporate debt restructuring were announced, including the establishment of a USD 50 billion fund. In line with growth rebalancing, the current account surplus is projected to decline to 2.5% of GDP in 2016 (down from 3% in 2015) as imports and outbound tourism increase. In September 2016, China's foreign exchange reserves declined gradually to USD 3.2 trillion from their all-time high of USD 4.0 trillion in 2014 as capital outflows related to repayment of external debt moderated in 2016. Since February 2016, the Chinese renminbi (RMB) has depreciated by some 7.3% from close-to-peak levels, as it is broadly in line with fundamentals. Since its latest interest rate cut in October 2015, the People's Bank of China (PBoC) has left the base interest rate unchanged at 4.35%. Having met all conditions for being freely usable, the RMB was added to the IMF's Special Drawing Right (SDR) currency basket in October 2016, where it was given the third-largest weight, about 10.9%.

After the U.K. had voted to leave the EU in June 2016, its GDP growth dropped to 0.5% in the third quarter, remaining stronger than forecast but down from 0.7% in the previous quarter. The strong performance of the service sector and consumption kept the economy resilient, whereas industrial

production and construction contracted. The unemployment rate tumbled to 4.9%, and the employment rate is close to record levels, yet productivity growth is slow, partly related to the troubled oil and finance industries. Wages increased slowly but faster than inflation, growing by 1% in September 2016. However, price pressure is rising in line with the depreciation of the pound sterling (22% lower against the euro compared to the beginning of 2016). The Bank of England reacted to the EU referendum by easing its key interest rate to 0.25%. Although financial market reaction to the EU referendum has been contained, the IMF marked down its forecast for U.K. growth to 1.8% for this year and 1.1% in 2017. It also reduced medium-term projections, as the rising uncertainty and the likely thinning of economic flows between the U.K. and the EU are expected to weigh on growth potential.

Moderate recovery with modest inflation in the euro area

Even with the Brexit referendum, the cyclical recovery in the euro area continues to exhibit resilience, albeit at a lackluster pace. Real GDP rose by 0.3% in the third quarter of 2016. As in the second quarter, growth was backed by consumption, residential real estate investment and, to a lesser extent, business investment, whereas foreign demand remained weak. Unemployment has stagnated at 10.1% since April despite robust employment growth. Credit growth is held back by high non-performing exposures faced by banks in a number of countries alongside the challenges of low profitability and overcapacity in a low interest rate and growth environment. HICP headline inflation turned positive in June, but its increase to 0.5% in October was very gradual, given a diminishing drag from

ECB continues
 standard and
 nonstandard
 monetary policy
 easing

energy prices and some upward pressure from past euro exchange rate depreciation. Underlying inflation, however, still declined due to low wage growth. Long-term market-based inflation expectations recovered, but remain at extremely low levels. On a positive note, a number of near-term political risks appear to have abated: Spain avoided a third election by forming a minority government; the Greek government continued compliance with the third assistance program although the IMF conditioned its participation on a further debt restructuring; receding flows of migrants relieved some pressure; and a free trade agreement between Canada and the EU was passed. Uncertainty is nonetheless nurtured by the U.S. presidential election results, signaling possible damage to trade, a critical referendum in Italy on Senate reform in December 2016 that

threatens political stability and recent remarks from U.K. and EU politicians pointing to a “hard” Brexit that would leave the U.K. cut off from common market access. Growth is projected to decline slightly to 1.7% in 2016 and 1.5% in 2017 – still higher than demographically driven medium-term potential growth.

Euro area fiscal policy has been broadly neutral, while monetary policy has stayed very accommodative, both for standard and nonstandard measures. Since March 2016, the ECB’s Governing Council has maintained the Eurosystem’s policy interest rates at 0% (main refinancing operations) and its deposit facility rate at –0.4%. It expects rates to remain at those or lower levels for an extended period of time. Among nonstandard monetary policy measures, the Eurosystem started its corporate sector purchase program

Chart 1

Eurobond spreads in selected emerging market regions

Euro EMBIG spread in basis points



Source: Bloomberg.

Note: EMBIG = Emerging Markets Bond Index Global.

(CSPP) as well as its new series of targeted longer-term refinancing operations in June 2016. The ECB repeatedly stated that it would continue its monthly asset purchases of EUR 80 billion until the end of March 2017 or beyond, if necessary, dependent on a sustained adjustment of inflation consistent with its inflation aim of below, but close to, 2% over the medium term. It also announced that it would assess options to ensure the smooth implementation of the CSPP, given a scarcity of eligible assets. Markets took some comfort from the announcement by ECB President Draghi that a “sudden stop” of monetary easing was “unlikely” and calmed somewhat, after having experienced some volatility in the run-up to the U.S. presidential election: German ten-year government bond yields re-entered positive territory; long-term inflation expectations increased to more than 1.5%; and yield spreads in Portugal and Italy widened against those in Germany, but narrowed against those in Spain. In the third quarter, financial conditions for housing loans improved further in the euro area, and external financing to nonfinancial corporations gradually firmed. Bank equity, however, remains depressed despite some recovery over the past few weeks. With lending rates declining further, banks face reduced margins not just on new lending, but also on existing loans.

Since mid-2016, the exchange rate of the euro has hovered around USD/EUR 1.1, but it started to weaken against the U.S. dollar and strengthen against the Japanese yen still close to its three-year low. The euro also broadly maintained its value in nominal and real effective terms against a trade-weighted basket of currencies amid high but diminishing current account surpluses in the euro area. The euro gained only against the pound sterling,

rising by around 22% in the first ten months of 2016. So far, the Swiss franc exchange rate to the euro has been impacted marginally by the Brexit referendum and the U.S. presidential election due to safe-haven effects. Partly, tactical currency interventions carried out by the Swiss National Bank have prevented the Swiss franc’s value from rising against the euro. By November 10, 2016, the representative stock index DJ Euro Stoxx had lost around 6.7% against the value recorded at end-2015, mirroring similar developments in China and Japan. In contrast, the U.S. Dow Jones Industrial Average and the British FTSE-100 Index overcompensated the losses they had suffered from the Chinese equity slump in January 2016. Euro area sovereign bonds remained generally strong over the review period. Given monetary easing and the subdued inflation outlook, yields on ten-year government bonds were down by roughly 30 basis points or more compared to early 2016, with the exception of the yields of the respective Italian, Portuguese and Cypriot securities, which saw increases. Since the second quarter, Brent crude oil prices had oscillated around USD 50 per barrel, tending to weaken toward the end of the review period as a result of a likely failure of OPEC and other oil exporters to agree on supply limits.

CESEE: banking sectors benefit from stable macrofinancial environment

The CESEE regional risk assessment remained broadly favorable in the review period: Euro-denominated Euro-bond spreads for Eastern Europe remained below the respective figures for other emerging market regions. CESEE spreads fluctuated around 170 basis points throughout the first half of the year and reached a peak after the U.K.’s

vote to leave the EU in June. However, the situation improved substantially in July and August against the background of favorable global liquidity conditions: Brexit put downward pressure on global interest rates, as monetary policy is now expected to remain accommodative for a longer time.

Broadly stable
macrofinancial
environment across
most of the CESEE
region

In the CESEE EU Member States of the country sample (Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Slovakia and Slovenia), most financial market segments developed positively. Equity prices trended up, and Eurobond spreads and credit default swap (CDS) premiums were mostly lower in mid-October 2016 than at the beginning of the year. Currencies displayed some volatility against the euro but appreciated compared to January 2016. The momentum was underlined by rating upgrades: Fitch and S&P raised their ratings for Slovenia against the background of positive government deficit and debt developments. Both agencies also upgraded Hungary's rating, reflecting a sharp improvement in Hungary's external balance sheet and a reduction of vulnerability, the gradual decline in government debt and in the external and foreign currency component and an improvement in the banking sector's overall situation. Positive real economic developments framed financial market trends: Although growth in the CESEE EU Member States experienced a temporary setback especially in the first quarter of 2016, as investments suffered from lower inflows of EU funds, economic output accelerated again in the second quarter of 2016, bringing average growth back to a robust 3.2%.

Gradual improve-
ment in Russia and
Ukraine

Financial markets and economic activity also improved in Russia and Ukraine. In Russia, the ruble recovered from its trough in early 2016, and Eurobond spreads as well as CDS premiums declined (by some 150 basis points

between early 2016 and mid-October 2016). Furthermore, the contraction of the Russian economy slowed down considerably in the review period. Price pressure eased due to persistent weak demand, the shrinking ratio of imports to GDP and the Central Bank of Russia's (CBR) continuing tight monetary policy (holding the repo auction rate at 11% until June 2016). Disinflation finally provided room for two rate cuts: The CBR lowered its policy rate to 10.5% in June and cut it to 10% in September. Net private capital outflows shrank to USD 10 billion from January to August 2016 (compared to USD 51 billion from January to August 2015). Capital outflows shrank, largely owing to reduced debt service payments and to the repatriation of assets from abroad. Russia's total external debt remained more or less stable in the first half of 2016, coming to USD 525.3 billion at mid-2016 (43% of GDP). The improving general economic situation is substantiated by rating actions: Fitch revised the outlook on its BBB- rating from negative to stable, as the country has implemented a "coherent and credible policy response" to the fall in oil prices.

Following a deep recession in 2014 and 2015, economic activity in Ukraine grew by 0.8% in the first half of 2016. After peaking at 60.9% in April 2015, inflation trended downward to 7.9% in September 2016. Moreover, disinflation allowed the central bank to cut its key policy rate in several steps to 14% in October 2016 from 22% at end-2015. Throughout this period, the Ukrainian hryvnia traded broadly stable against the euro. Fiscal consolidation, energy and banking sector reforms as well as the fight against corruption paved the way for a completion of the second review under the IMF Extended Fund Facility (EFF) in Sep-

tember 2016. The IMF points out that notwithstanding the overall headway made in implementing the program, political resistance slowed down progress in tackling corruption, privatizing state-owned enterprises and advancing the pension reform. The conclusion of the second review enabled the disbursement of the third tranche of USD 1 billion, bringing total disbursements under the EFF to about USD 7.6 billion (out of USD 17.5 billion). Moreover, Ukraine issued a USD 1 billion U.S. guaranteed Eurobond in September 2016. As a result, foreign currency reserves rose to USD 15.6 billion (equivalent to 3.9 months of imports) in September 2016. Since the successful de-escalation of the conflict in parts of eastern Ukraine in the course of 2015, the situation has remained broadly unchanged, with regular ceasefire violations along the contact line.

Among the non-EU countries of the region, Turkey stands out with its development in the review period. The risk assessment of the country deteriorated markedly after the failed military coup on July 15, 2016. CDS premiums and Eurobond spreads increased strongly, and the Turkish lira lost 5% against the euro within a week following the attempted coup. S&P lowered Turkey's sovereign debt rating from BB+ to BB on July 20, 2016, warning that rising political uncertainty could scare off investors and undermine fiscal management. On September 23, 2016, Moody's also cut Turkey's sovereign debt rating to non-investment grade (from Baa3 to Ba1), citing rising risks related to the sizable external financing needs and a deterioration of the country's credit profile. In the aftermath of the downgrade by Moody's, the Turkish lira again embarked on a depreciation trend. In mid-November 2016, it traded 8.1% lower against the euro

than at the beginning of 2016. The general economic momentum of the country was already decelerating before the attempted coup, as ongoing economic downturns in major trading partners (e.g. Iraq), economic sanctions imposed by Russia as from January 2016 and a sharp deterioration in the tourism sector weighed on growth.

The Central Bank of Republic of Turkey (CBRT) adopted several measures after the attempted coup with the aim of preserving financial stability. At the same time, the CBRT continued its rate-cutting cycle and reduced the overnight lending rate in five steps from 10.50% in April to 8.25% in September 2016. This narrowed the interest rate corridor around the main policy rate (one-week repo lending rate at 7.5%), as the lower band (overnight borrowing rate) remained unchanged at 7.25%.

The development of domestic credit to the private sector (nominal lending to the nonbank private sector adjusted for exchange rate changes) was somewhat heterogeneous in the review period. Among the EU Member States, the Czech Republic and Slovakia showed the highest credit growth at 7.9% and 10%, respectively, in September 2016. While the dynamics were broadly unchanged in Slovakia, credit growth decelerated somewhat in the Czech Republic as corporate credit growth lost speed. Because solid credit developments in both countries were fueled by favorable expectations for general economic developments and a sound liquidity position, local supervisors stipulated a countercyclical capital buffer as of 2017. Furthermore, both countries' banking sectors are in healthy shape.

Credit growth was also rather swift in Poland. Key indicators of the country's banking sector, however, are

Turkey negatively affected by the failed military coup

Credit developments heterogeneous in the CESEE EU Member States

somewhat weaker than those in Slovakia and in the Czech Republic. For example, the country still reports a substantial share of foreign currency loans (especially Swiss franc loans) in total loans. The discussion about a conversion of those loans is ongoing, adding to banking sector uncertainty. Furthermore, a bank asset tax in effect since February 2016 could well dent banks' profitability and capital ratios in the future. Bank lending has already softened moderately in recent months.

In Romania, credit growth was positive throughout the review period but declined to close to zero in August. Especially corporate credit dragged down credit growth, while household credit actually accelerated. Progress in shoring up the banking sector has been made in recent years, especially in the areas of nonperforming assets and the refinancing structure. Foreign currency-denominated lending trended down as well, but generally remained at a high level. The law on debt discharge in effect since mid-May (allowing retail mortgage borrowers to return real es-

tate collateral to banks in exchange for writing off their loans) might have negative implications for banks' profitability and capitalization.

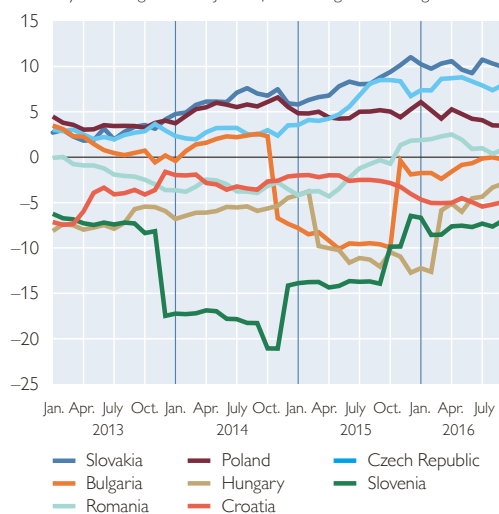
The contraction of the credit stock in Bulgaria ground to a halt in August 2016. The development was driven by the extension of new loans in both the corporate and the household segment. At the same time, the continuous optimization of bank portfolios weighed on the credit stock, as bad and restructured loans posted a notable decline. The Bulgarian banking sector reports a comparatively high but declining share of credit denominated in foreign currency.

The credit stock continued to decrease in Hungary, Croatia and Slovenia in the review period. Especially in Hungary, however, the contraction moderated. This was in part related to a statistical effect: The conversion of foreign currency loans to households at an exchange rate below the prevailing market exchange rate in the first quarter of 2015 dropped out of the base. Furthermore, both household and corporate

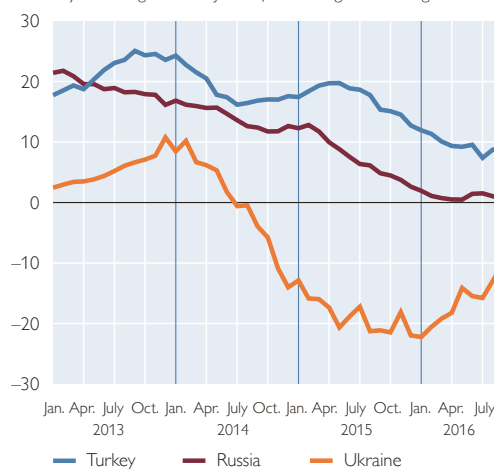
Chart 2

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.

loans displayed somewhat more favorable momentum in recent months, partly owing to central bank measures (Funding for Growth Scheme and Growth Supporting Programme).

In Croatia, the corporate sector saw a reduction in debt to domestic credit institutions but an increase in borrowing from abroad. The development of household debt was largely influenced by the conversion in late 2015 of Swiss franc loans into euro loans at historical exchange rates. According to the Croatian National Bank, household loans in Swiss francs and household loans indexed to Swiss francs stood at HRK 21.7 billion at the end of November 2015 and at HRK 1.6 billion at the end of August 2016, respectively. Nevertheless, the share of loans denominated in foreign currency (predominantly euro) remains high. The loan conversion could have longer-lasting effects, as the EU has assessed the measures as “disproportionate.” Several banks are preparing or have already filed lawsuits against the government.

In Slovenia, credit to households expanded moderately. This rise, however, was not sufficient to offset the effect of strongly contracting corporate credit on private sector credit growth. Nevertheless, the country made some progress in cleaning up balance sheets, raising banking sector profitability and improving capitalization.

Among the non-EU Member States of the country sample, Turkey and Russia exhibited slowing credit growth. In Turkey, loan growth had been declining since mid-2015 and came down to 7.4% in July before picking up somewhat again to 9% in September 2016 (year on year). Macroprudential measures adopted in previous years impacted especially on household credit.

In Russia, banks’ caution in providing credits was largely due to the persistent weakness of the economy (even if the recession is fading) and notably to the still ailing credit quality.

In Ukraine, credit developments displayed a somewhat more favorable momentum as the contraction in both household and corporate credit eased. The credit stock, however, continued to decline in the review period. Ukrainian authorities are working on legislation to guide the restructuring of foreign currency mortgage loans. The framework principles (voluntary approach, focus on financial condition of borrowers, only applicable for primary residence) appear reasonable overall, but it is not clear how stringent legislation will be or which incentives banks will get to restructure loans. Costs for banks are estimated to not exceed USD 370 million (0.4% of GDP or 0.6% of banks’ total assets and 10% of core capital).

Lending surveys clearly indicated a pickup of credit demand in the CESEE region. The most recent CESEE Bank Lending Survey of the European Investment Bank (EIB)¹ found that demand for loans improved across the board in the first half of 2016, the sixth consecutive semester of favorable developments. All factors influencing loan demand made a positive contribution. Access to funding also continued to ease in the CESEE region and was supported by easy access to domestic sources, mainly retail and corporate deposits. The development of supply conditions, however, was less straightforward, as already observed in the second half of 2015. Credit standards continued to ease for loans to consumers as well as to corporates. However, the regulatory environment and banks’ capital constraints adversely affected

Lending surveys indicate a rise in credit demand

Weak momentum of credit growth in Russia, Ukraine and Turkey

¹ <http://www.eib.org/infocentre/publications/all/cesee-bls-2016-h1.htm>.

supply conditions. Nonperforming loans (NPLs) are also consistently cited as a drag on supply in the EIB survey.

In the second half of 2016, banks expect demand to continue to increase robustly. However, supply conditions are expected to improve significantly less. As a result, the demand-supply gap is likely to widen.

Country-level bank lending surveys reported mixed findings that only partly support this general picture. A positive development of supply and demand conditions was found only in Hungary and the Czech Republic. In the other countries, lending standards remained unchanged or were tightened, depending on the particular loan segment. Demand for consumer loans has been increasing in most countries, while demand for corporate loans and housing loans was stable or in some cases weaker.

Analyzing the operation of international banking groups in the region, the EIB survey found that 27% of banking groups continued to reduce their total exposure to the region in the first half of 2016. However, this negative trend

seems to be bottoming out, as more and more groups expect exposure to stabilize over the second half of 2016. While cross-border banking groups continue to discriminate in terms of the countries of operation as they reassess their country-by-country strategies, they are also increasingly signaling their intentions to expand operations selectively in the region. The survey also found that roughly 70% of groups describe the profitability of CESEE operations as outperforming the profitability of the group as a whole. Under special topics, this issue of the Financial Stability Report includes a detailed analysis of the profitability of Austrian subsidiaries in the CESEE region.

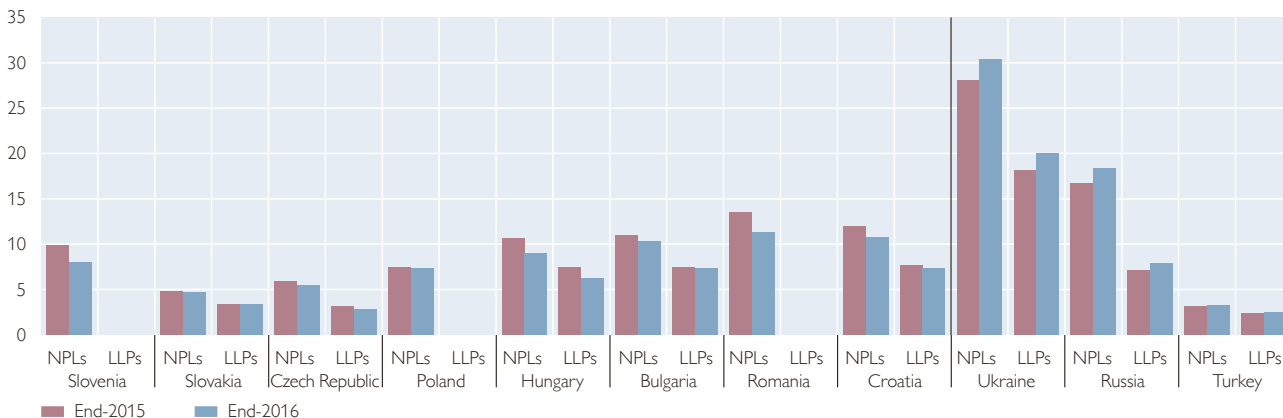
NPL resolution progressed in the review period. All CESEE EU Member States reported a reduction in NPL ratios. The decrease was especially strong in Slovenia. The country's NPLs declined to 8% of total credit in mid-2016 from 11.6% a year earlier against the background of a further transfer of bad claims to the Bank Asset Management Company, increased write-offs as well as restructuring and forbearance

NPL resolution progresses

Chart 3

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 Ukraine (doubtful and loss loans) and for Romania and Slovenia (in arrears for more than 90 days).

agreements. Credit quality improved notably also in Bulgaria, Croatia, Hungary and Romania due to banks' active portfolio cleansing (including sales of NPL portfolios). In Bulgaria, this happened against the background of an asset quality review and stress test based on financial data from end-2015.

Russia and Ukraine reported a strong increase in NPL ratios, as the general economic situation remained challenging. In Turkey, the share of NPLs in total loans increased somewhat but remained at a comparatively low level, with the provision coverage ratio coming to around 75%.

Banking sector profitability improved in all countries of the region as portfolio quality improved. In the CESEE EU Member States, the return on assets increased to between 1% in Poland and 2.1% in Hungary in June 2016. The improvement was especially pronounced in Croatia, Hungary and Slovenia; in all three countries, the return on assets doubled from mid-2015 to mid-2016. In Croatia, the conversion of Swiss franc loans impacted negatively on profitability in 2015. As this one-off factor faded, the return on assets improved quickly and increased to 1.5% on the back of rising income. In Slovenia, higher profitability was helped by the decline in provisioning and value adjustments and by improvements in noninterest income. The former was again linked to the improvement in banks' asset quality. In Hungary, both operating income and other income posted better results.

Returns also improved in Ukraine, Russia and Turkey. In Ukraine, however, profitability remained negative at mid-2016 on the back of still substantial (though noticeably lower) provisioning and write-offs. In Russia, profitability has reappeared owing to the slow recovery of interest rate margins and to inten-

sified cost control measures. In Turkey, the return on assets rose further from an already high level on the back of higher income and somewhat lower costs.

Capital adequacy ratios remained high and broadly stable in most of the countries under review in mid-2016. In the CESEE EU Member States, they ranged between 17.3% in Slovakia and 22.7% in Bulgaria. In August 2016, the Bulgarian central bank released the results of an asset quality review and stress test for the whole banking sector. The stress test confirmed that the Bulgarian banking sector remains well capitalized. The asset quality review will lead to additional adjustments of BGN 665 million (1.3% of risk-weighted assets of the Bulgarian banking sector) that will be reflected in banks' 2016 financial statements.

In the non-EU Member States of the country sample, capitalization was notably lower (between 12.4% in Russia and 15.3% in Turkey). Especially Ukraine, however, managed to improve its capital base substantially: The capital adequacy

Most CESEE banking sectors remain well capitalized...

...and profitability is rising

Chart 4

Banking sector: profitability

Return on assets (RoA) in %



Source: IMF, national central banks, OeNB.

Note: The 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.

Funding gaps stay moderate in most CESEE countries

ratio increased to 13% in June 2016, up from only 9% a year earlier on the back of lower risk-weighted assets and recapitalization efforts.

The refinancing structure of CESEE banking sectors has increasingly shifted toward domestic deposits over the past few years. This is especially true for the CESEE EU Member States that had no substantial gap or a negative gap between total outstanding domestic claims and total domestic deposits (relative to GDP) at mid-2016. Funding gaps in this region were still broadly unchanged in the review period. Only Slovenia reported a notable decline. The overhang of deposits over claims increased by 3.7% of GDP between end-2015 and mid-2016 as claims sustained their downward trend and deposits edged up marginally.

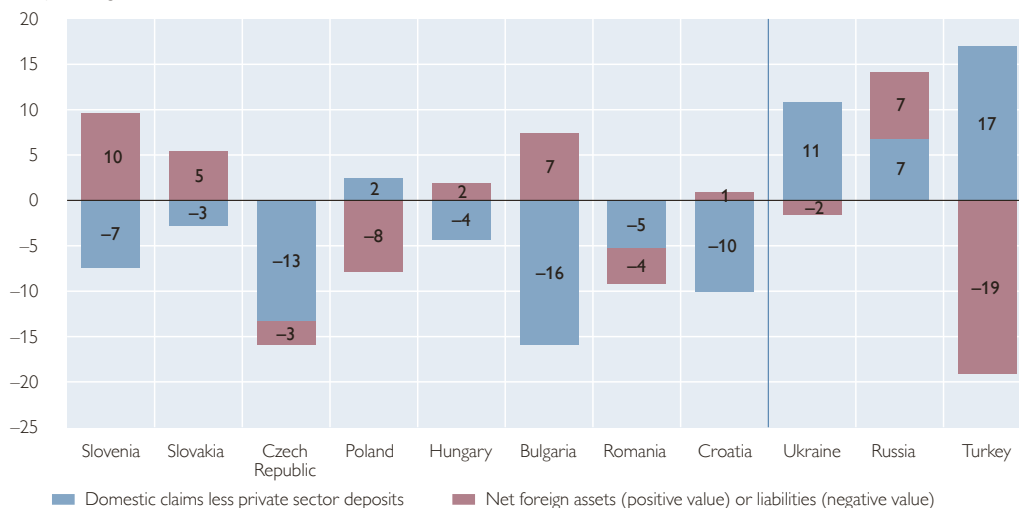
Compared to the EU Member States, Russia exhibited a somewhat larger funding gap; the gap was substantially larger in Ukraine and Turkey. While the gap remained broadly unchanged in Russia and Turkey, it decreased notably in Ukraine against the background of continued deleveraging.

The banking sectors of five of the eleven countries under observation reported net external liabilities at mid-2016, mostly ranging between 2% and 8% of GDP. Only Turkey recorded substantially higher net external liabilities. Despite its negative funding gap, the Czech Republic's banking sector became a net debtor in the review period. At the same time, the Hungarian bank sector managed to switch from a debtor to a creditor position.

Chart 5

Banking sector: gap between claims and deposits, and net external position

As a percentage of GDP at mid-2016



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