Economic Developments and Financial Markets

Strong Global Upswing Loses Momentum in Euro Area

After accelerating significantly in 2003, global economic activity continued its uptrend at the beginning of 2004. While the recovery was substantial in the U.S.A., Asia and Latin America, euro area growth remained only moderate.

The upturn gained momentum particularly in the U.S.A. on the back of strong private consumption and investment. Consumer spending has been fueled by tax cuts as well as low interest rates, which households have taken advantage of to refinance their mortgage loans. In the third and fourth quarters of 2003, U.S. growth accelerated substantially, coming to 3.1% for the year 2003. Lower interest rates and a much improved industrial confidence have ushered in a turnaround in corporate investment. With productivity growth steady and strong, the uptrend only translated into higher employment rates in the first quarter of 2004. The medium-term economic outlook for the U.S.A. is positive. According to the IMF's spring forecast, real GDP growth is expected to come to 4.6% in 2004 and 3.9% in 2005, thus slowly moving back in line with trend growth. Next to weaker consumer spending due to rising interest rates, the forecast identifies the continuously high U.S. twin deficit as a potential risk factor.

The economic recovery has also remained unbroken in Asia. Despite persistent, albeit dampened deflation, even Japan appears to have overcome the years of economic slowdown: In 2003, GDP went up 2.7%. Faster growth was attributable to a rise in both external and domestic demand. Japan's exports mainly went to the expanding economies of Asia. China and other countries in the region, such as Thailand, Singapore and Malaysia, are currently profiting from rising demand in the U.S.A. In parallel, greater consumer confidence in these countries should lead to healthy growth in domestic demand. With its economy overheating in individual sectors, China poses a risk to the sustainability of the economic upswing in Asia. All told, the surge in intraregional trade since the Asian crisis has shown that the entire region now tends to be less dependent on the economic cycles of major industrialized countries. To become an engine of global economy, the region would now have to step up financial reforms, improve governance and boost labor productivity further.

Unlike in the U.S.A. and Japan, the economic upturn in the euro area has remained hesitant. Although the upswing gained a foothold in the second half of 2003, euro area GDP went up by no more than 0.4% over the entire year 2003. Investment picked up considerably in the last quarter of 2003, however, which was mainly attributable to a rise in business confidence; moreover, the level of euro area interest rates, which was significantly below long-term averages, may also have contributed to boosting investment.

Consumer spending, which had been weak since the first quarter of 2002, stagnated at the previous quarter's level in the fourth quarter of 2003. This weakness in demand may be traced to the slow growth in disposable income and the ongoing lackluster consumer confidence. The trend is reflected in the European Commission's survey of consumer confidence, which has continuously

Chart 1

Strong Economic Recovery in the U.S.A. and Japan

(Year-on-year GDP growth)

Source: Eurostat.

improved since March 2003, but still remains at a low level. While households assess the general state of the economy more positively, they do not anticipate any improvement in their own financial situation. On the one hand, this conclusion is attributable to the labor market situation: As the uptrend has so far only been moderate, the unemployment rate has not gone down, and employment figures have remained stagnant over the last few quarters. On the other hand, uncertainties about the future of social security systems in the field of health care and pensions may also have temporarily suppressed consumer demand.

The economic outlook for the euro area still points to gradual improvement. After having been on an uptrend since mid-2003, the European Commission's Economic Sentiment Indicator flattened at the beginning of 2004. The marked growth of the euro area's international trading partners' economies should offset the effects of the strong euro on net exports. Likewise, throughout 2004 favorable financing conditions should tend to strengthen domestic demand in the euro area, which has not lived up to expectations so far. In its spring forecast, the IMF expects euro area GDP to advance by 1.7% in 2004 and growth to accelerate to 2.3% in 2005. According to the IMF, euro area inflation will come to 1.7% for the entire year.

Lower Risk Aversion Determines International Financial Markets

Corporate balance sheets have improved and risk aversion has generally decreased as a consequence of the global economic upswing that began in mid-2003 and the largely favorable growth and inflation prospects along with rather low interest rates. These developments in turn created a positive environment for risk capital markets. Expectations of interest rate increases in the U.S.A. and the euro area, which were still present in late

Chart 2

Capital Flows to High-Yield Bonds Reduce Spreads

Source: Thomson Datastream, J.P. Morgan.

fall 2003, were dampened at the beginning of 2004 by the publication of weaker than projected cyclical data, which temporarily caused prices in both U.S. and euro area bond markets to surge. Moreover, greater geopolitical uncertainties following the Madrid terrorist attack at the beginning of March 2004 may, on a short-term basis, have played a role in the flattening of the yield curve in the industrialized economies. While the negative interest rate spread between U.S. and euro area long-term benchmark bonds initially continued to expand, the spread turned positive in April 2004 given the stronger rise in U.S. interest rates. The main reason for this repeated trend reversal was the publication of U.S. labor market data that were significantly more positive than in previous months.

According to the EMBI Plus index for emerging markets' U.S. dollar-denominated bonds, interest rate spreads over U.S. government bonds have more than halved since fall 2002, declining from more than 1,000 basis points to below 500 basis points. Corporate spreads in the BBB-rated sector went down to approximately one third of the spreads measured one and a half years ago. Apart from the pickup in economic growth and a continuously brighter economic outlook, the major driving forces behind these capital flows were the historically low level of interest rates in the industrialized countries and the related move toward higher-yield – and higher-risk – instruments. In the medium term, the question whether the financial situation of low-rated issuers will stay stable may depend on future interest rate developments in the industrialized countries. If investors reassess the relation between interest rate levels, fundamentals and investor risks, capital flows may well become more differentiated, causing a rise in both the relative and absolute refinancing costs for individual issuers.

Together, the positive economic development originating in the U.S.A. and Asia and the fall in long-term interest rates were key factors behind the bullish trend on international stock markets. Combined with favorable financing conditions, the rising demand for goods and services should have a positive impact on enterprise profitability, where profit announce-

ments for the fourth quarter of 2003 were in many cases better than expected and are anticipated to remain positive. However, the Madrid terrorist attack at the beginning of March 2004 and a rise in risk aversion prompted a short-term interruption in this trend.

To counteract a too rapid appreciation of the Japanese yen vis-à-vis the U.S. dollar, Japan continued its intervention policy. Between end-2002 and March 2004, Japan's foreign reserves climbed by close to 80% to USD 806 billion, with foreign exchange interventions intensifying in particular during the past few months. Until March 2004, China, India and many emerging economies in Southeast Asia massively expanded their foreign currency holdings as well; this may, in turn, have contributed to the relatively low level of interest rates for U.S. government bonds. Also, there have been strong movements in the USD/EUR exchange rate over the last few months. Both the changing interest rate spread in the long-term yield segment and continued concerns about the U.S. twin deficit may be among the reasons for the appreciation of the euro against the U.S. dollar in the fourth quarter of 2003 and at the beginning of 2004. In January, the USD/EUR exchange rate peaked at 1.29, only to weaken continuously afterwards as a consequence of statements by individual members of the Governing Council of the ECB. The communiqué issued after the G7 meeting in Boca Raton, Florida, in February 2004 is also considered to have played a role in this trend reversal. The most recent USD/EUR exchange rates were below 1.20, a level which most likely reflects the different growth perspectives according to recently published cyclical data as well as the positive (from the U.S. perspective) interest rate spread at the long end. At the end of 2003 and during the first quarter of 2004, the pound sterling appreciated against the euro and the U.S. dollar. This movement is traceable on the one hand to robust economic growth (based on a booming real estate market and a strong rise in consumer spending) and on the other hand to the anticipated widening of interest rate differentials between Europe and the U.S.A. Interest rate expectations were confirmed by the Bank of England's repo rate increase by 25 basis points in November 2003 and February 2004, respectively. The Swiss franc was weak throughout 2003 and into 2004. Heightened risk aversion in the global financial markets in the wake of the Madrid terrorist attack, however, has resulted in a slight appreciation of the Swiss franc against the euro.

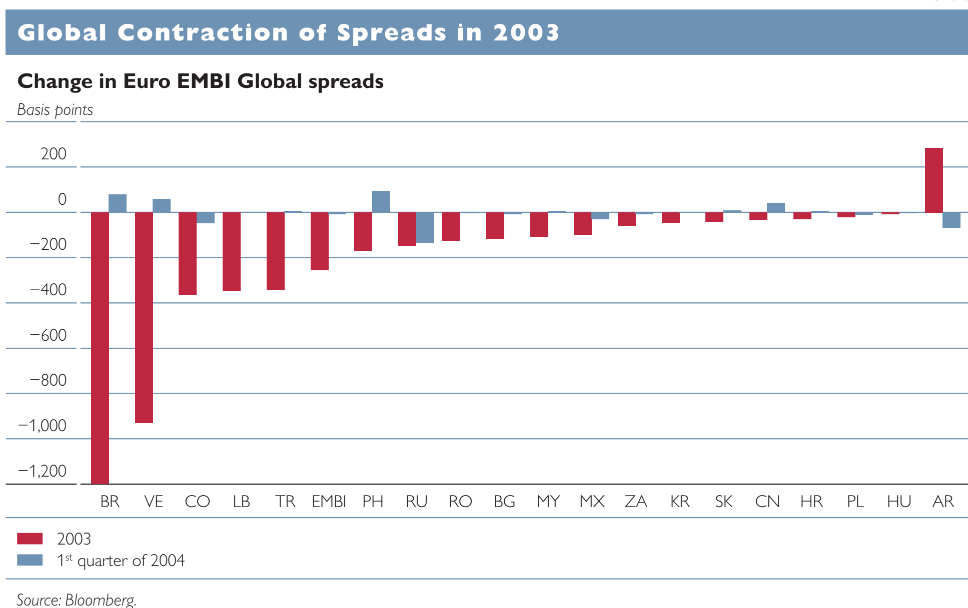
Central and Eastern Europe

Eurobond Risk Premiums Decline

Emerging market issuers' bonds performed well in 2003. The spread of government bond yields denominated in euro and U.S. dollars against euro area and U.S. benchmark bonds sank by an average of 322 and 254 basis points, respectively, in the course of 2003 (on the basis of J.P. Morgan's EMBI Global and Euro EMBI Global). This corresponds to a total return of 25.7% (denominated in U.S. dollars) and 18% (denominated in euro).

The evident homogeneity of the spread changes across all countries covered by the Euro EMBI Global (drop in spreads in all countries except Argentina) suggests that global factors were at work, above all low interest rates in the main industrialized countries and the high liquidity they entail. While the low interest rates reduced the cost of financial investment

Chart 3



in emerging markets, it also drove investors to seek higher yields.

However, the individual country factors also played a role in compressing spreads. Many issuer countries' economic fundamentals improved, as is reflected by higher ratings. In particular, Russia was given an investment grade rating, opening this market for a larger group of investors. Russia's upgrade was justified by the boost higher oil prices gave its economy in the form above all of high growth, declining inflation and a strong external position (surplus on current account, rising direct investment inflows, doubling of gross reserve assets). Among the CEECs, Bulgaria and Romania registered the largest declines in spreads over euro area benchmark bonds, which corresponded to a return of some 13% to 14%. Both countries achieved further progress in EU accession negotiations. Their economies were characterized by robust growth along with subsiding inflation. This performance was marred somewhat by rising current account shortfalls, with direct investment inflows offsetting the entire deficit in Bulgaria and only half the deficit in Romania. Higher ratings reflect both countries' improved fundamentals. Slovakia posted further progress

Table 1

Rating Improvements since the Beginning of 2003

Changes of ratings for long-term foreign currency debt

	Moody's			Standard & Poor's			Fitch		
	Rating	Since	Change	Rating	Since	Change	Rating	Since	Change
Bulgaria	Ba2	June 5, 2003	⇑	BB+	May 22, 2003	⇑	BB+	July 24, 2003	⇑
Romania	Ba3	Dec. 11, 2003	⇑	BB	Sep. 17, 2003	⇑	BB	Dec. 18, 2003	⇑
Russia	Baa3	Oct. 10, 2003	⇑	BB+	Jan. 27, 2004	⇑	BB+	May 13, 2003	⇑
Slowak Republic	A3	Nov. 12, 2002		BBB+	Mar. 2, 2004	⇑	BBB+	Jan. 22, 2004	⇑
Slovenia	Aa3	Nov. 12, 2002		A+	Mar. 26, 2003	⇑	A+	May 6, 2003	⇑
Czech Republic	A1	Nov. 12, 2002		A–	Nov. 5, 1998		A–	June 20, 2003	⇑
Turkey	B1	Dec. 21, 2000		B+	Oct. 16, 2003	⇑	B+	Feb. 9, 2004	⇑

Source: Bloomberg.

with structural and fiscal policy reform coupled with a manifest reduction of the current account deficit, causing the Slovak eurobond spread to plummet and entailing a rating upgrade in March 2004.

At the beginning of 2004, the downtrend in yield spreads came to a temporary halt when the market was flooded with new issues and when there were fears that the interest rate cycle in the U.S.A. could turn upward earlier than expected. Spreads did not respond the same in each country, however, which points to an increasingly selective approach of investors. After the specter of rising interest rates had been calmed, spreads generally resumed their decline from mid-March.

Considering the historical lows of yield spreads and market expectations that U.S. interest rates would climb over the year, eurobonds are not likely to repeat their 2003 performance. Over the coming months speculation above all about when the interest rate cycle will turn in the U.S.A. may cause swings in the spread in both directions. However, the prospective recovery of the global economy and the pickup in most issuing countries' fundamentals as well as in particular the better debt profile of many countries appear to suggest that there will be no large-scale disruptions on these capital markets.

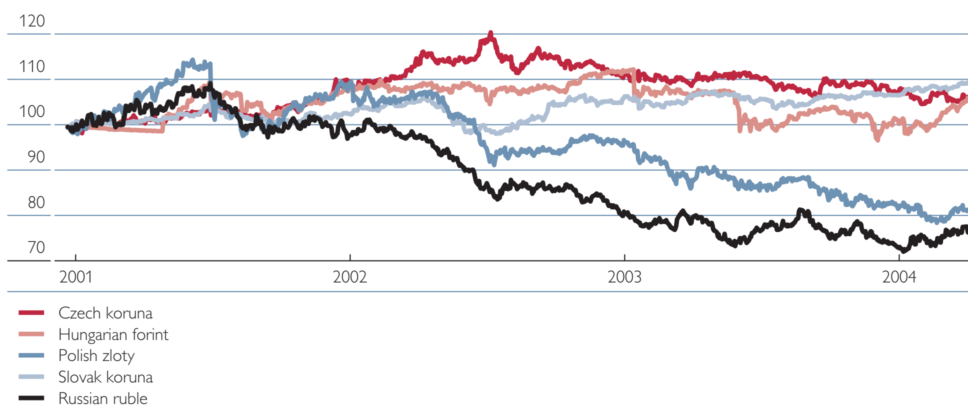
Exchange Rate Trends

Exchange rate developments diverged across the CEECs in 2003. Whereas the Polish zloty, the Hungarian forint and the Russian ruble closed with the greatest losses against the euro, the Czech koruna depreciated by only around 2.6% against the euro. The Slovenian tolar closed with a nominal depreciation of roughly the same order against the euro. The Slovak koruna remained unaffected by the depreciation of neighboring countries' currencies and firmed against the euro by nearly 1%. In the first quarter of 2004, the Czech koruna, the Polish zloty and the Slovenian tolar lost further ground. The zloty began to recover at the end of February. The Hungarian forint and the Russian ruble regained about half the terrain lost in 2003. The Slovak koruna re-

Chart 4

Ruble and Zloty Strongly Influenced by EUR/USD Development

December 31, 2000 = 100



Source: Bloomberg.
Note: Exchange rate: euro per unit of national currency.

mained under unmitigated appreciation pressure.

Whereas the Slovak government's continuation of its reform policy is strengthening trust in the country's currency, Poland and Hungary posted a disappointing budget outturn for 2003 and have to contend with increasing scepticism about the credibility of their fiscal consolidation intentions. The development of the Polish zloty against the euro remains influenced by the euro's development against the U.S. dollar as well.

Moreover, Slovakia succeeded in slashing its current account deficit by about 7 percentage points of GDP against 2002. Slovakia also remains an important destination of foreign direct investment, which represents a good source of finance to offset the current account deficit. Poland also closed 2003 with an improved current account as a result of exchange rate changes and improved unit labor costs. The shortfall was fully offset by direct investment inflows. By contrast, the animated rise in domestic demand triggered a surge in Hungary's current account deficit to almost 9% of GDP (from 7% in 2002) and raised foreign debt. Signs of an improvement began during the fourth quarter of 2003 and should multiply during the year 2004 as a consequence of more moderate wage growth and fiscal consolidation. The Czech Republic's current account deficit widened considerably in the second half of 2003. Moreover, unlike in the two preceding years, only half of the deficit was financed by net direct investment inflows. The stability of the Croatian kuna concealed the growing economic imbalances. Croatia did not observe its agreements with the IMF: the budget deficit climbed to 5.5% rather than 4.6% of GDP, the current account deficit mounted to 6.7% rather than 5.9% of GDP, and the country's foreign debt expanded to 75% of GDP at the end of 2003 (2002: 61.7%).

Magyar Nemzeti Bank (MNB) took crucial interest rate policy steps in 2003 to counteract large exchange rate fluctuations. While the bank lowered interest rates at the beginning of the year to fend off speculations of a revaluation, it hiked interest rates by a total of 600 basis points to 12.5% in the second half of 2003. Thanks to the pronounced interest rate differential, the announcement of austerity measures and better current account data, MNB managed to reverse the depreciation trend and even had sufficient room to cut interest rates twice by 25 basis points each time from the end of March 2004. *Narodowy Bank Polski* has left its key interest rates unchanged at 5.25% since mid-2003. With the economy on the recovery track and slightly higher inflation, expectations that interest rates would be cut were replaced by the assumption that the interest rate trend could turn around, which, along with the government's first success in gaining the support of parliament for its austerity package, propped up the Polish currency. The positive economic factors have, however, contrasted with increased political risk since the end of March after the news spread that the prime minister would step down. Exchange rate developments over the upcoming months are likely to be contingent on whether the new government will be able to summon a parliamentary majority. The deterioration of the balance of portfolio investment in the Czech Republic (higher outflows of residents' portfolio capital as well as weaker inflows from nonresidents) are likely to be linked to low

interest rate and yield levels as well as the anticipation that yields would rise. Whereas *Národná banka Slovenska* intervened on the foreign exchange market in the first half of 2003 to prevent the Slovak koruna from strengthening, in the second half it slashed key interest rates by 50 basis points all in all and further reduced them by 50 basis points to 5.5% in March 2004. In addition, the central bank intervened from December 2003 to bring the appreciation of the Slovak koruna to a halt. If the revaluation pressure should continue, additional central bank intervention and interest rate measures may well be in the cards in the course of the next few months. *Banka Slovenije,* meanwhile, continues to pursue its policy of gradual devaluation in line with the interest rate differential between Slovenia and the euro area. In this respect, interest rates have been cut repeatedly in recent months and thus the devaluation rate was slowed. Banka Slovenije also hopes that ebbing inflation will permit it to reduce interest rates in the next few months and that its devaluation policy, which is oriented on the interest rate differential, will help the exchange rate to stabilize more and more.

The trend of the Russian ruble against the euro will remain influenced primarily by the development of the euro against the U.S. dollar. The ruble firmed gradually and consistently against its reference currency, the U.S. dollar, by a total of more than 9% over 2003. Since the end of January 2004 the ruble's exchange rate has been stable against the U.S. dollar, so that the currency firmed against the euro as a result of the development of the euro against the U.S. dollar. In this connection, the Russian central bank is pondering a stronger orientation of the ruble's exchange rate on an EUR/USD currency basket.

Local Currency Government Bonds

The yield differential between local currency-denominated government bonds and euro area benchmark bonds widened in the Czech Republic, Hungary, Poland and Slovakia in 2003, but to quite different degrees.

Differentials increased most in Hungary, where the yield spread in the ten-year segment augmented by 140 basis points to some 400 basis points. Polish ten-year bonds ended the year 2003 with a differential of 220 basis points, up by nearly 90 basis points from the beginning of the year. Yield spreads on Czech long-term bonds advanced by 55 basis points, those of Slovak ten-year government bonds edged up by just 16 basis points. Hungarian and Polish spreads continued to expand at the beginning of 2004. In Poland the situation stabilized mid-January, while Hungarian yield spreads have been dropping since the end of February. Czech and Slovak yield differentials stayed fairly stable during the first three months of 2004.

Yields were impacted by several factors: Apart from the pickup in inflation in the second half of 2003 in all four countries analyzed, uncertainties about fiscal policy and the exchange rate in Poland and Hungary and the boost in key interest rates in Hungary influenced yield developments.

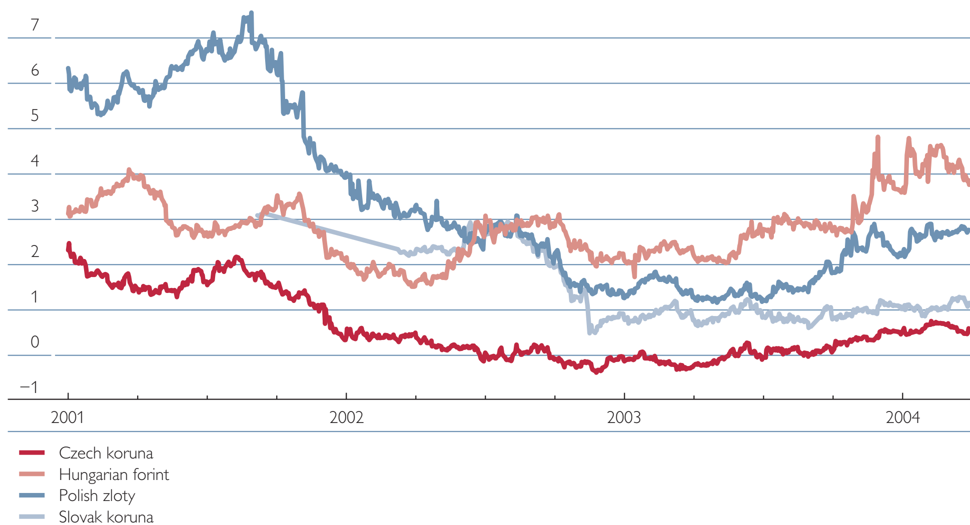
The bond marked evolved against a changing inflationary background in the course of 2003. Deflation in the Czech Republic was replaced by a rise in inflation from the fourth quarter of 2003 to 2% by February 2004. Considering that the Czech koruna is expected to strengthen against the euro in the long term

Chart 5

Yield Spreads Widen in the Second Half of 2003

Yield differentials of ten-year government bonds against euro area benchmark bonds

Percentage points



Source: Bloomberg.

and that money market rates are forecast to stay unchanged in the medium term (as measured by the implied three-month rate in nine months), the rise in Czech yields are probably attributable in particular to the (expected) quickening of inflation. Polish inflation also gained momentum gradually from 0.5% in the first three quarters of 2003 to just under 2% in February 2004. Disinflation reversed in Hungary in mid-2003, with inflation doubling to 7% by February 2004. In Slovakia, increases in regulated prices and indirect tax changes fueled steady high inflation (8% to 9%) and also caused core inflation to rise, though by a still fairly moderate rate.

In the second half of 2003 budgetary developments in Poland and Hungary in tandem with doubts about the credibility of the governments' fiscal consolidation plans led to investor uncertainty about the medium-term outlook for yields. First signs of improvement in the fiscal area were at the heart of the narrowing of spreads in the first quarter of 2004. Conversely, in the Czech Republic, the budget shortfall was nearly unchanged against the 2002 deficit (following a revision for an unanticipated one-off effect in connection with a state guarantee) and was perceptibly lower than the value announced in mid-2003. However, the consolidation plan presented in mid-2003 implies that the deficit will not sink below 3% of GDP before 2007 at the earliest. By contrast, not only did Slovakia's fiscal situation improve patently in 2003, but the country also announced that it was aiming to bring the deficit to below 3% already in 2006. A factor which is likely to be linked to the budget situation is that investors' high expectations regarding the time for the euro introduction have been revised: In February 2003 the expectation was that these four countries would introduce the euro in 2008. A year later, this outlook had changed to 2009 for Hungary and Slo-

vakia and to 2010 for the Czech Republic and Poland (Source: Reuters.)

Especially in Poland and Hungary, uncertainty about near-term exchange rate developments is a further factor implicated in the yield increases in the second half of 2003 and the first quarter of 2004. Moreover, this uncertainty was reinforced by a lack of clarity about fiscal policy in both countries, the deterioration of the current account (Hungary), the fragility of the political process and the influence of the EUR/USD exchange rate (Poland) and probably hesitation to conduct stabilizing foreign exchange intervention.

In the fourth quarter of 2003 expectations that money market rates in Poland would decline was superseded by the outlook that money market rates would rise in the medium term (three-month rate in nine months). In Hungary, too, market participants revised upward their expectations for interest rates after key interest rates had been hiked in the second half of 2003. Increasing interest rates bolstered the rise in long-term yields, whereas the prospect of interest rate cuts which arose in March 2004 added to the decline in yields.

The Banking Sector in Central Europe[1]

Income Performance and Profit Developments

The nominal and real (adjusted for consumer price inflation) return on equity of banks in Croatia, Slovakia, Slovenia and the Czech Republic deteriorated moderately in 2003, albeit from a fairly high level in 2002. This performance is likely to reflect the weaker economic conditions above all during the first half of 2003. Banks in Poland and Hungary, by contrast, succeded in marginally lifting return on equity from a comparatively low level in 2002.[2]

Table 2

Return on Equity Figures Converge

	2001	2002	H1 02	Q1–3 02	H1 03	Q1–3 03	2003
	%						
Nominal Return on Equity							
Croatia	6.6	13.7	20.4	18.6	17.9	16.3	. .
Poland	12.8	5.2	8.4	8.4	9.7	9.5	5.9
Slovak Republic	21.3	30.1	28.9	26.4	30.9	30.6	27.9
Slovenia	4.8	13.3	18.4	. .	14.0	. .	. .
Czech Republic	16.6	27.4	29.3	29.4	22.7	22.1	23.7
Hungary	16.0	16.1	17.2	17.2	21.9	23.3	17.6
Real Return on Equity							
Croatia	1.5	11.8	17.7	16.5	15.9	14.3	. .
Poland	7.1	3.2	5.6	6.1	9.3	9.0	5.1
Slovak Republic	13.3	26.0	24.2	22.3	21.2	20.4	17.6
Slovenia	–3.5	5.4	9.8	. .	7.4	. .	. .
Czech Republic	11.6	25.6	25.9	27.0	23.2	22.4	23.8
Hungary	6.3	10.4	10.8	11.2	16.9	18.1	12.3

Source: National central banks.
Note: Nominal yield adjusted for consumer price inflation (period average). Subperiod data are linearly annualized.

[1] *This chapter reviews the development of the banking industry in the Czech Republic, Hungary, Poland, Slovakia, Slovenia and Croatia. The section "Financial Intermediaries in Austria" analyzes the development of all subsidiaries of Austrian banks established in these countries.*

[2] *For methodological reasons, a comparison of the subperiod values with annual values does not provide very useful results wherever aggregates are not based solely on stocks.*

Table 3

Divergent Development of Profit Components

	2001	2002	H1 02	Q1–3 02	H1 03	Q1–3 03	2003
	% of annual average bank assets						
Net Interest Income							
Croatia	3.6	3.3	3.2	. .	3.4	. .	. .
Poland	3.5	3.3	3.1	3.2	3.0	3.0	3.0
Slovak Republic	2.5	2.7	2.6	2.5	2.9	2.9	2.9
Slovenia	3.6	3.7	3.7	. .	3.4	. .	. .
Czech Republic	2.5	2.4	2.5	2.4	2.1	2.1	2.1
Hungary	4.2	4.3	4.0	4.2	3.9	3.9	3.9
	% of current operating revenues						
Current Operating Costs							
Croatia	65.6	59.3	59.1	. .	54.5	. .	. .
Poland	61.9	62.9	60.5	60.0	65.8	66.6	68.0
Slovak Republic	65.7	57.9	58.8	59.5	58.9	61.2	63.5
Slovenia	65.2	59.6	60.3	. .	63.1	. .	. .
Czech Republic	53.4	51.4	48.8	49.1	49.4	50.0	52.7
Hungary	66.7	64.7	65.6	64.1	57.6	56.6	61.2
Net Changes in Loan Loss Provisions							
Croatia	13.7	6.6	–0.4	. .	8.6	. .	. .
Poland	19.8	24.2	21.9	22.6	11.8	11.8	15.9
Slovak Republic	–33.4	–9.8	–6.4	–9.8	–13.1	–12.4	–12.4
Slovenia	25.9	19.7	11.1	. .	12.9	. .	. .
Czech Republic	22.8	9.3	13.9	10.1	16.1	5.3	0.9
Hungary	4.3	4.7	2.3	4.0	4.3	3.5	5.2

Source: National central banks.
Note: Data are not comparable between countries. Subperiod data are linearly annualized.

In Poland nominal return on equity advanced from 5.2% to 5.9% in 2003. Adjusted for sinking inflation, real return on equity mounted even more, rising from 3.2% to 5.1%. The pickup was attributable primarily to the lower loan loss provisions required as a consequence of the stabilization of portfolio quality in terms of the ratio of nonperforming loans[3] to total loans (roughly 22% in 2003). At the same time, net interest income (in percent of average assets) and current operating income contracted, signaling that profitability has still not gained a firm foothold despite the economic recovery in 2003. This may be linked in particular to the fact that net exports were the prime growth accelerator. That impression is further reinforced by the fact that after a strong first-quarter performance profitability sagged slightly during the remainder of the year.

Hungarian banks closed 2003 with a further rise in nominal and real return on equity to 17.6% and 12.3%, respectively. With net interest income (in percent of average assets) diminishing somewhat and loan loss provisions (in percent of current operating income) higher, this result is traceable to a higher contribution of noninterest income. This revenue stemmed partly from banks' business with state-subsidized home loans, bank cards and guarantees and partly from a large one-off dividend received by a single bank. The latter factor along with the reduction in the state subsidies for home loans from December 2003 appear to indicate a trend reversal even though banks reacted to the subsidy cuts by introducing foreign currency-denominated home loans. The drop in the cost-to-income ratio represents an additional success factor. Despite the enlargement of home

[3] *Nonperforming loans are defined as "substandard," "doubtful" or "irrecoverable."*

loans, the ratio of nonperforming loans to total loans slipped to 3% at the end of 2003.

Czech banks' return on equity worsened in 2003 compared with the high score of 2003, but at 24% remained the second-highest result in the region. Real return on equity was just as high because of stable prices. Whereas net interest income and current operating income as well as the cost-to-income ratio deteriorated, the expenses for loan loss provisions (including the write-off of receivables and the costs of the transfer of receivables) lessened. The decline in expenses for loan loss provisions was accompanied by an improvement of portfolio quality: the share of nonperforming loans declined from 8.5% at the end of 2002 to just under 5% at the end of 2003.

Slovak banks closed 2003 with the highest nominal return on equity, but real return on equity diminished markedly against 2002 on account of the rise in inflation. After getting off to an unspectacular start in 2003, net interest income for the entire year surpassed the 2002 value (2.9% against 2.7% of average assets). The release of loan loss provisions also contributed more to total income in 2003 than a year earlier, which corresponded to the shrinking share of bad loans (from 11.7% to 9.4% in total loans). Hence, the drop in nominal return on equity resulted exclusively from the deterioration of the cost-to-income ratio.

Croatian banks also succeeded in enhancing their net interest income position in the first half of 2003 compared with the first half of 2002. In addition, current operating expenditure grew less strongly than operating income, resulting in a considerably better cost-to-income ratio. Profitability worsened above all because loan loss provisions jumped (by comparison with the net release of loan loss provisions in the first half of 2002) Loan loss provisions surged not because portfolio quality eroded, but for other reasons: For one thing, Croatian banks were intent on writing down more loans to make room for new lending in the light of the Croatian central bank's restrictions on the growth rate of loans outstanding. For another thing, several banks changed hands in the first half of 2003, and acquisitions marked a good opportunity to clean up portfolios.

In Slovenia falling net interest and noninterest income (in percent of average assets) and a deterioration of the current operating expenditure-to-income ratio were at the heart of the slippage of banks' return on equity in the first half of 2003. Also, loan loss provisioning was a bit higher than in the first half of 2002, although the share of nonperforming loans in total loans dipped from 7% at the end of 2002 to 6.5% at the end of 2003.

Capital Adequacy

Posting double-digit rates, capital adequacy (the ratio of equity to risk-weighted assets) remained satisfactory in all six countries under review. In Croatia and Hungary, capital adequacy dipped, largely because business activity (asset growth) was too animated for capital increases to keep pace.

Table 4

Capital Adequacy Ratios Remain Largely Stable

	2001	2002	H1 02	Q1–3 02	H1 03	Q1–3 03	2003
	Capital adequacy, %						
Croatia	18.5	17.2	17.5	17.3	16.9	16.0	. .
Poland	15.1	13.8	13.7	14.0	13.3	13.6	13.6
Slovak Republic	19.8	21.3	21.0	22.3	22.8	22.2	21.7
Slovenia	11.9	11.9	11.4	. .	11.6	. .	. .
Czech Republic	15.4	14.3	15.4	15.3	15.8	15.5	14.5
Hungary	13.9	13.0	12.5	11.5	11.6	10.8	10.7

Source: National central banks.
Note: Equity in percent of risk-weighted capital.

The Capital Markets of the New EU Member States

The new EU Member States' nominal GDP is only roughly 5.5% of the euro area equivalent. These ten countries' financial markets combine to an even smaller percentage of euro area financial markets.

The total assets of the "other monetary financial institutions" (banks excluding the central bank) of the new Member States amounted to about EUR 353 billion at the end of 2003, less than 2% of the euro area value. This low amount reflects not just the smaller size of the ten countries, but also the partly considerably lower degree of financial intermediation compared to the euro area: Whereas banking assets correspond to 270% of GDP in the euro area, this figure is only 81% in the new Member States, with banking intermediation in the eight CEECs averaging some 75%. This figure breaks down to reveal large differences ranging from 39% (Lithuania) to 105% (Czech Republic).

The outstanding volume of bonds issued by domestic entities in the ten new EU Member States on the domestic market and abroad, irrespective of the currency, came to just under EUR 180 billion at the end of 2002, only 2.4% of the corresponding euro area figure. The three largest markets – the Czech Republic, Hungary and Poland – accounted for 82% of the total amount outstanding. In terms of GDP, the outstanding volume on the new Member States' bond markets averaged some 40%, falling far short of the like figure for the euro area (105%). Here, too, the figures span a wide range, varying from 3.4% (Estonia) to 69% (Malta).

The ten new Member countries' stock market capitalization accounted for just over 2% of the euro area's stock market capitalization in 2003. The stock markets were largest in Poland, the Czech Republic and Hungary. The stock markets of the ten countries also played a smaller role than in the euro area: market capitalization averaged 18% of GDP in the new Member States against 48% in the euro area. The stock market serves as a key source of finance only in three of the countries – Cyprus, Estonia and Malta – with market capitalization in Estonia dominated by a single issuer, Eesti Telekom.

What are the reasons for these differences? First, the low degree of financial intermediation in several of the new Member States stems from lower government debt ratios. Whereas the ten countries' government debt ratio averaged just under 40% at the end of 2002, it came to 69% in the euro area. Second, foreign direct investment (including cross-border intracompany loans) is an important factor in the financing structure of the corporate sector. Consequently, demand for external (noncompany) financing is generally reduced. Also, full liberalization of capital transactions provided companies with a high credit standing access to foreign capital. Finally, while the volume of lending to households expanded markedly in some countries in recent years, it is still quite low.

Bank Assets

December 31, 2003	Assets	Domestic receivables	Assets	Domestic receivables
	EUR million		*% of GDP*	
Poland	112,189	88,948	60.6	48.1
Slovak Republic	24,159	20,434	83.8	70.9
Slovenia	21,528	18,621	88.8	76.8
Czech Republic	79,424	60,653	104.9	80.1
Hungary	55,980	48,845	76.4	66.7
Estonia	6,302	4,986	84.9	67.2
Latvia	8,393	4,730	92.3	52.0
Lithuania	6,301	5,055	39.1	31.3
Malta[1]	10,205	6,179	254.6	154.1
Cyprus	28,317	20,725	255.4	183.0
Total	352,798	279,176	81.2	64.2
Total (excluding Malta and Cyprus)	314,277	252,272	74.9	60.1
EU-12	19,791,100	16,028,800	272.8	221.0
Austria	605,107	409,261	269.8	182.5

Source: National central banks.

[1] *As at September 2003 or GDP from the fourth quarter of 2002 to the third quarter of 2003.*

Outstanding Volume of Bonds

December 31, 2002	Public sector	Monetary financial institutions	Other financial corporations	Total
	% of GDP			
Poland	26.5	2.4	3.6	32.5
Slovak Republic	32.6	0.1	0.5	33.2
Slovenia	27.8	18.9	0.7	47.4
Czech Republic	19.5	33.9	3.4	56.8
Hungary	46.6	8.2	1.1	55.9
Estonia	1.7	1.1	0.6	3.4
Latvia	10.1	1.2	0.0	11.3
Lithuania	15.3	0.0	0.7	16.0
Malta	60.0	3.2	5.8	69.0
Cyprus	42.3	6.9	0.5	49.7
Total	28.5	9.3	2.6	40.4
Total (excluding Malta and Cyprus)	27.9	9.4	2.6	39.9
EU-12	54.0	38.0	13.2	105.2
Austria	58.2	60.2	9.2	127.6

Source: ECB.

Stock Market 2003

Annual averages	Market capitalization		Trading volume	
	EUR billion	*% of GDP*	*EUR billion*	*% of market capitalization*
Poland	26,4	14.3	18,5	70.2
Slovak Republic	2,6	9.1	0,6	22.4
Slovenia	4,8	19.8	0,9	18.3
Czech Republic	17,8	23.5	7,9	44.7
Hungary	12,2	16.9	7,2	59.4
Estonia	2,6	35.7	1,1	41.1
Latvia	0,8	9.0	0,1	15.0
Lithuania	3,6	23.4	0,2	4.7
Malta	1,4	30.6	0,0	2.9
Cyprus	4,0	35.7	0,3	6.6
Total	76,3	17.6	37,1	48.6
Total (excluding Malta and Cyprus)	70,9	. .	36,8	51.9
EU-12[1]	3.470,8	47.8	4.518,9	130.2
Austria	37,5	16.8	9,8	26.1

Source: Eurostat.

[1] *Trading volume from November 2002 to October 2003.*