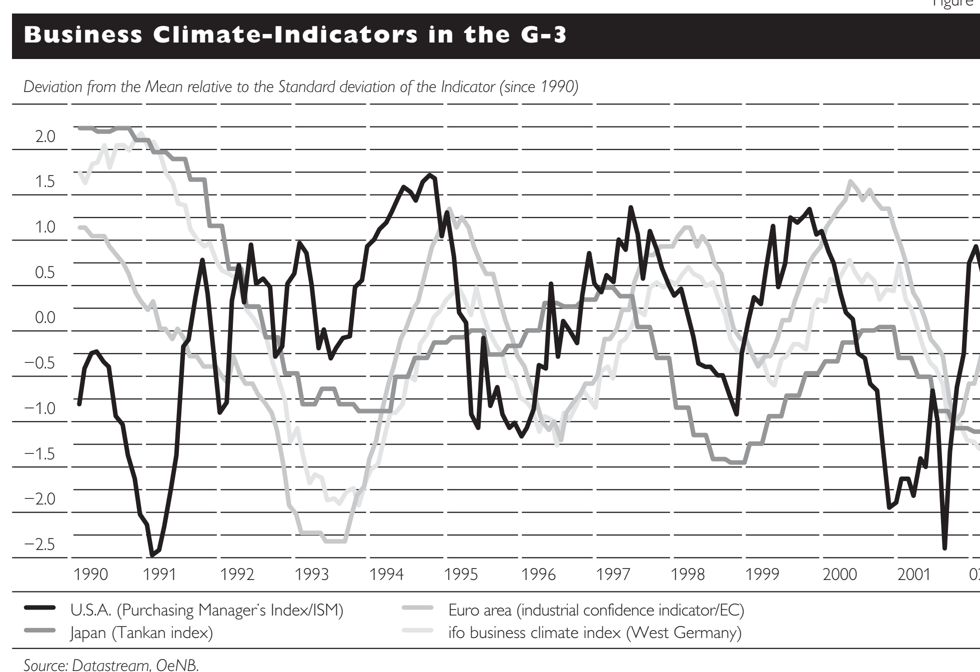
International Economic Developments

The synchronous global cyclical downturn in 2001, which was led by the U.S.A. and was largely caused by overinvestments in the high technology sector as well as a surge in oil prices, bottomed out at the turn of 2001. Growing prices on risk capital markets in the fourth quarter of 2001 and, later on, improving economic indicators and rising input prices (e.g. in semiconductor technology) were the first signs of an economic revival. By now, an increasing number of "hard facts," including the rise in industrial output in the U.S.A. since January 2002, have corroborated the assumption that the U.S.A. are leading the global economy back to growth. Although growth rates are highly divergent across the world in the first half of the year, they should converge as the year progresses so that most areas should see at least moderately positive output growth, more or less without inflationary pressures, by the end of 2002.

Figure 1



The rapid emergence from the global economic trough was largely made possible by the strong response of monetary and fiscal policies in the U.S.A. and, to a lesser degree, in the euro area, as well as by a moderation of oil prices in the fourth quarter of 2001 and most of the first quarter of 2002.

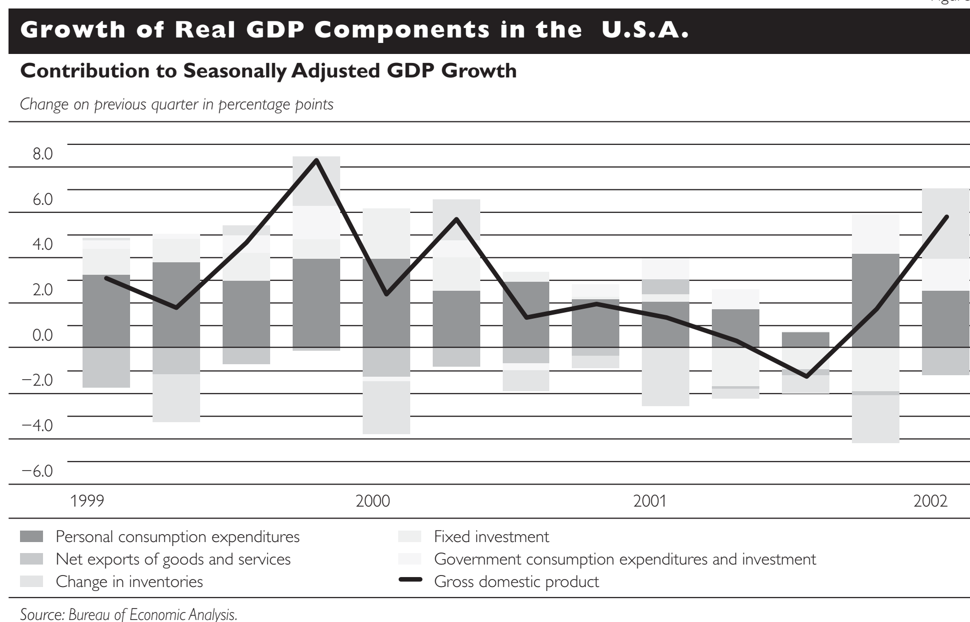
The sustainability and strength of the global economic recovery, however, remain subject to uncertainty, in particular because of financial imbalances in the U.S.A. (low saving rate and large current account deficit) and Japan (fragile banking sector and high budget deficit) and the future development of oil prices.

Rapid Turnaround of the U.S. Economy

The economic trend reversal in the U.S.A. at the end of 2001 turned out to be more marked than first expected. Real GDP expanded at an annualized quarterly growth rate of (preliminary) 5.8% in the first quarter of 2002, after 1.7% in the fourth quarter of 2001. The annual growth rate of real GDP came to 1.2% in 2001.

Figure 2

Growth of Real GDP Components in the U.S.A.



Source: Bureau of Economic Analysis.

The terrorist attacks of September 11, 2001, had an immediate negative impact on the U.S. economy, triggering a short-term slump in private consumption, a noticeable decline in industrial and consumer confidence, layoffs of staff and the postponement of business investments. In the fourth quarter of 2001, private consumption rebounded powerfully, also on account of numerous special offers for consumer durables. In addition, the U.S. economy was fueled by greatly increased government expenditures in the wake of the terrorist attacks. Private investment, however, continued to go down in the U.S.A., and inventories were further reduced.

In the first quarter of 2002, U.S. economic activity gained considerable momentum, as – in addition to continued solid personal consumption and rising government expenditures – destocking clearly decelerated, which, in turn, boosted industrial output. Although the vigorous economic growth should abate somewhat after the first quarter, most forecasters expect the economic revival to continue throughout 2002.

But we cannot speak of a sustainable economic upswing in the U.S.A. before private investment again registers positive growth rates and unless private consumer demand retains its robust pace. As corporate investment has so far remained rather weak, the danger of a considerable deceleration of the pace of expansion still remains. High private debt and the widening current account deficit represent a latent risk for the U.S. economy and for U.S. capital markets, in particular in case of a confidence shock of U.S. consumers or a reestimation of the yields to be expected by (foreign) investors from investments in the U.S.A.

The Federal Reserve System considerably cut interest rates in response to last year's recession. Most recently, the target federal funds rate was lowered to 1.75% in December 2001.

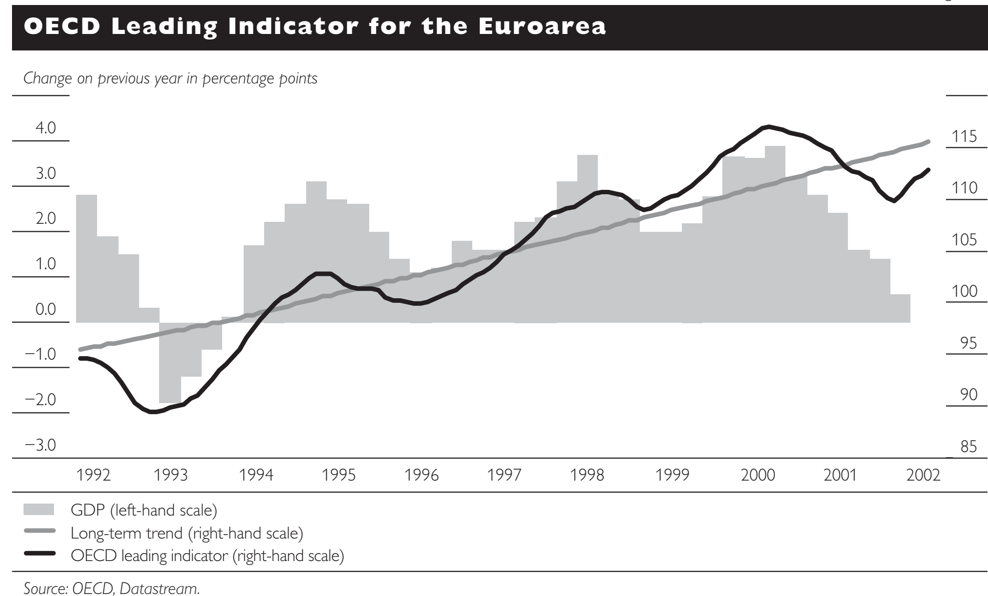
Restrained Recovery in the Euro Area

As in previous quarters, real GDP developments in the euro area were characterized by weak domestic demand in the fourth quarter of 2001, which was only partially offset by a positive contribution of net exports to output growth. In the fourth quarter of 2001, real GDP retreated 0.2% against the previous quarter. 2001 economic growth amounted to 1.5%.

The continuous contraction of economic growth between the middle of 2000 and the end of 2001 was largely attributable to global factors, such as the oil price hikes in 1999 and 2000, overinvestments in the high technology sector, marked price losses in "growth" stocks and the economic downturn in the U.S.A. In addition, developments rooted in Europe or individual countries weighed down the euro area economy and caused rather great differences in the growth rates of individual euro area countries in 2001, ranging from 0.6% in Germany and 2% in France to 6.6% in Ireland.

Figure 3

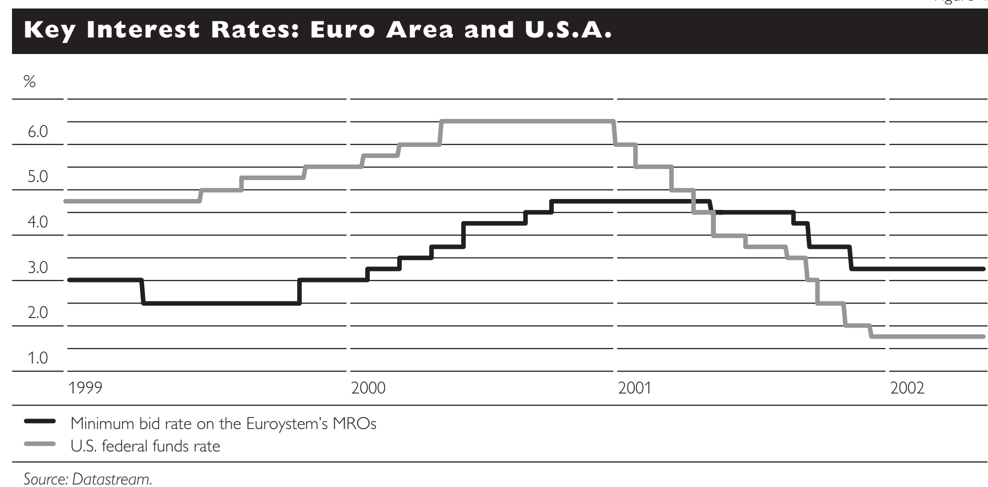
OECD Leading Indicator for the Euroarea



Source: OECD, Datastream.

Figure 4

Key Interest Rates: Euro Area and U.S.A.



Source: Datastream.

The expectation of a slow economic revival in the euro area in the first half of 2002 has been corroborated by improving confidence indicators, especially in industry, since the beginning of the year. Most recent forecasts of real GDP growth in the euro area thus predict restrained growth rates in the first half of 2002 and a more robust pace of expansion in the second half of 2002.

Sluggish economic activity and reduced price effects from crude oil and meat prices caused euro area inflation to further ease in the fourth quarter of 2001. Despite a temporary rise to 2.7% in January 2002, mainly because of special factors, both the Eurosystem and most forecasters assume the trend of sinking inflation rates to continue in 2002. In the light of these developments, the Governing Council of the ECB again cut the key interest rate by 50 basis points to 3.25% in November 2001.

Difficult Economic Situation in Japan Continues

As of the second quarter of 2001, the Japanese economy registered negative real GDP growth rates quarter on quarter, as domestic demand was weak. Uncertain employment prospects, in particular, dented personal consumption expenditure. In addition, subdued international demand dampened Japanese exports. Overall, real GDP contracted 0.5% in 2001. In the first quarter of 2002, the Bank of Japan's Tankan sentiment barometer did not yet show any improvements, but there were first indications that the global economic warming might jumpstart Japanese exports. The most problematic factors are the protracted deflation, the high budget deficit, a surging government debt ratio and the large number of nonperforming loans, which are a strain on the banking sector and impair its function as intermediary. These factors as well as the imminent restructuring of the private and public sectors and rising unemployment are likely to continue to contain domestic demand, thus perpetuating weak growth for the time being.

Emerging Market Economies Detached Themselves from the Argentine Crisis

The economic development in the emerging market economies was determined by the business cycle in industrialized countries. Only large and relatively closed economies, such as China, India or Russia, managed to detach themselves from the global economic downtrend. In the fourth quarter of 2001, the "tiger countries" were still hit by retreating high-technology investments, and in Latin America, the Argentine crisis aggravated increasingly. At the beginning of 2002, however, the outlook brightened for Southeast Asia as export demand revived and consumer and business confidence improved.

Argentina, in contrast, had to announce its insolvency at the turn of 2001, and, as a consequence, severed the peso's peg to the U.S. dollar. By the beginning of May 2002, the Argentine peso had depreciated from a ratio of 1:1 to about 1:3 USD/ARS. Although the other Latin American countries could not escape the global economic downtrend, they remained largely unscathed from spillover effects from Argentina.

That Argentina's insolvency has so far had hardly any substantial contagious effects on other emerging markets is most likely linked to the fact that financial markets had anticipated such a development, which was subsequently reflected in the prices of Argentine debt securities. Furthermore, financial market par-

ticipants seem to differentiate rather clearly between the situation in Argentina and in other emerging market economies. But since Argentina's prospects are still rather uncertain, it is too early to completely exclude any spillover effects of this crisis on other emerging markets.

The EU Economy also Influences Central and Eastern Europe

In 2001, the overall economic development in Central and Eastern Europe was determined by the growth deceleration in the European Union and, in the case of Russia, by the decline in oil prices. Only those countries which were hit by the global economic downturn amid a strong rebounding of domestic demand could record an acceleration of growth against 2000 (Croatia, Slovak Republic, Czech Republic). In Croatia and the Slovak Republic, the combination of vigorous domestic demand and low export growth caused the current account deficit to widen considerably, in Slovakia even to surge to a very high level. In both countries, however, the current account deficit was largely offset by net inward direct investments. Croatia thus even registered a rise in official gross reserves, measured by monthly imports of goods and services. In Slovakia, reserves slightly declined and recorded the lowest figure from among the countries under review, as in 2000.

The overall 2002 development of this region will be determined by how quickly and to what extent the economy of the European Union (EU) and thus export growth revives. In the case of the Slovak economy, a dampening of domestic demand growth will probably be needed in addition to further extensive direct investment inflows. Both factors, however, will be substantially influenced by political developments, in particular the parliamentary elections to be held in the fall of 2002. Exchange rate developments in Poland will essentially depend on the import propensity of the future upswing of domestic investment demand.

International Financial Markets

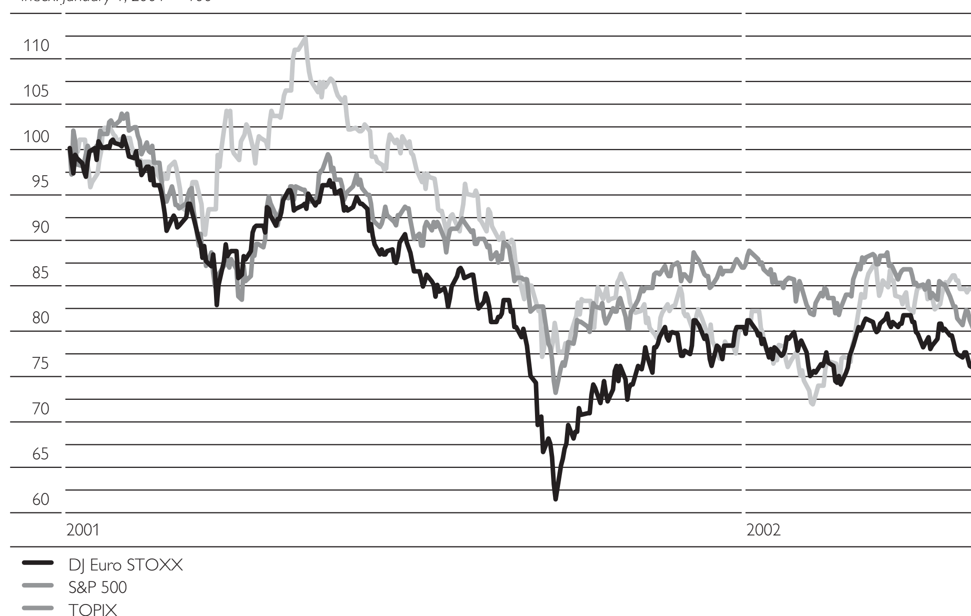
Guarded Revival of Financial Markets in the Fourth Quarter of 2001

The capital market trend of fleeing into "high quality," which has been evident since the second quarter of 2000, strengthened directly after the terrorist attacks of September 11, 2001. Prices on risk capital markets declined sharply, with low-rated stocks and corporate bonds plummeting in particular. Risk-free securities, on the other hand, especially Western government bonds, registered substantial price gains.

Figure 5

DJ Euro STOXX – Standard & Poor's 500 – Tokyo SE Price Index

January 1, 2001, to May 10, 2002

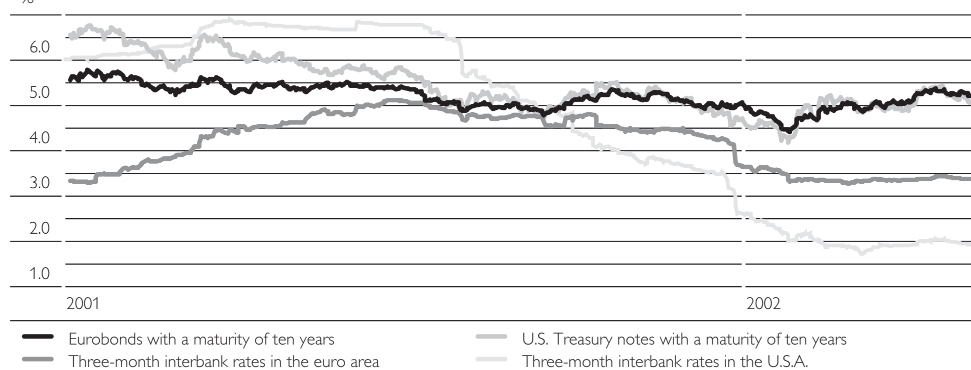


Source: Datastream, OeNB.

Figure 6

Interest Rates in the Euro Area and in the U.S.A.

January 1, 2001, to May 10, 2002



Source: Datastream.

This development, however, did not last very long. Already at the end of September 2001, volatility receded, and prices on risk capital markets bounced back in anticipation of an imminent global and largely inflation-free economic revival. Price/earnings (P/E) ratios surged temporarily, mainly in the U.S.A., as a consequence of these anticipative stock prices, which were as yet unsubstantiated by real-economy developments and plummeting corporate profits.

On government bond markets, an imminent economic recovery was expected as of November 2001, which quickly resulted in partly substantial price losses and yield gains and – together with key interest rate cuts – in much steeper yield curves.

Furthermore, spreads between corporate and government bonds also retreated in the course of the fourth quarter, as financial market evaluations generally turned more optimistic.

At the end of 2001, the general financial market outlook was much brighter than at the end of the third quarter of 2001.

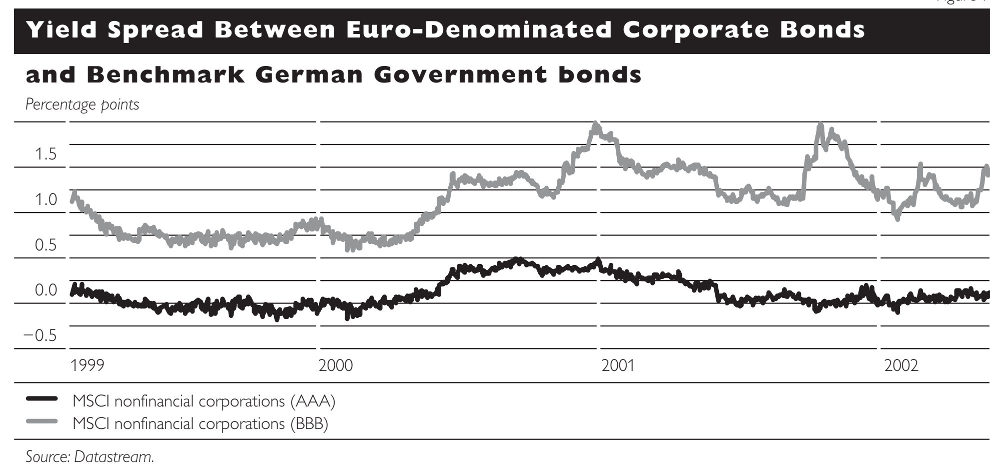
Open Questions on Corporate Governance Characterized the First Months of 2002

Financial markets were largely characterized by two developments in the first months of 2002: On the one hand, the economic outlook improved continuously, on the other, the corporate failure of the energy group Enron, in particular, posed questions on corporate governance and the transparency of corporate balance sheets.[1]) As of the end of January 2002, the latter dealt a considerable blow to the credibility of corporate financial information, which especially hit growth companies with a large share of outside capital, such as many high-technology corporations.

Consequently, corporate stocks from this segment and very low-rated corporate bonds suffered in part considerable price losses. By contrast, the brightening economic outlook and slightly improved profit expectations favored those stocks and corporate bonds which investors did not associate with doubtful accounting methods and excessive debt ratios. Under these circumstances the

Figure 7

Yield Spread Between Euro-Denominated Corporate Bonds and Benchmark German Government bonds

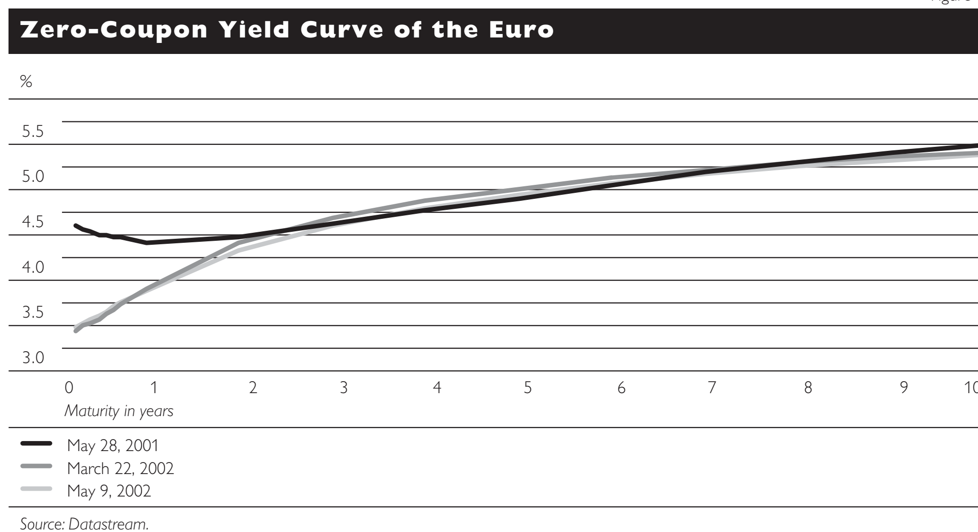


Source: Datastream.

1 *Enron initially caused this discussion, but there were numerous other cases, such as Swissair in Europe, which were used as examples in debates on corporate governance.*

Figure 8

Zero-Coupon Yield Curve of the Euro



Source: Datastream.

DJ Euro STOXX index and the U.S. index Standard & Poor's (S&P) 500 largely moved sidewards in the first four months of 2002, whereas the Japanese TOPIX index slightly gained in value.

The yield curve in the euro area and especially in the U.S.A. turned even steeper on account of a slight rise in long-term government bond interest rates during the first quarter of 2002, probably most of all due to the expected economic upswing and less to an anticipated increase of inflation. At the beginning of the second quarter, long-term interest rates eased somewhat, especially in the U.S.A.

In Japan, short-term interest rates lingered at zero, yields of government bonds with a maturity of ten years remained rather constantly around 1.4%, despite a downgrading by Moody's for domestic government bonds.

Bond and stock markets in the emerging economies largely showed a positive development in the fourth quarter of 2001 and the first months of 2002, despite the aggravated crisis in Argentina, and some government issuers from these regions returned to the international capital market with new issues. This was mostly made possible by a greater willingness of investors to incur risk and a rapid reflux of capital into these areas. High-risk debtors, however, continue to be in a precarious situation, as was illustrated at the beginning of May 2002 in Brazil, where domestic political problems caused bond spreads to widen again and private Brazilian issuers to delay planned issues.

Little Volatility of the Euro Exchange Rate against the U.S. Dollar

The euro exchange rate against the U.S. dollar revolved around 0.90 USD/EUR in the fourth quarter of 2001, dipped slightly below that level in the first quarter of 2002 and returned to around 0.90 USD/EUR at the end of April/beginning of May. The low volatility of the exchange rate during the entire period was remarkable. It may have been caused by the fact that, from the point of view of financial markets, the events of September 11, 2001, represented a largely symmetrical shock. On the other hand, capital flows into the U.S.A. seem to have declined in the reporting period, which is probably less ascribable to relative

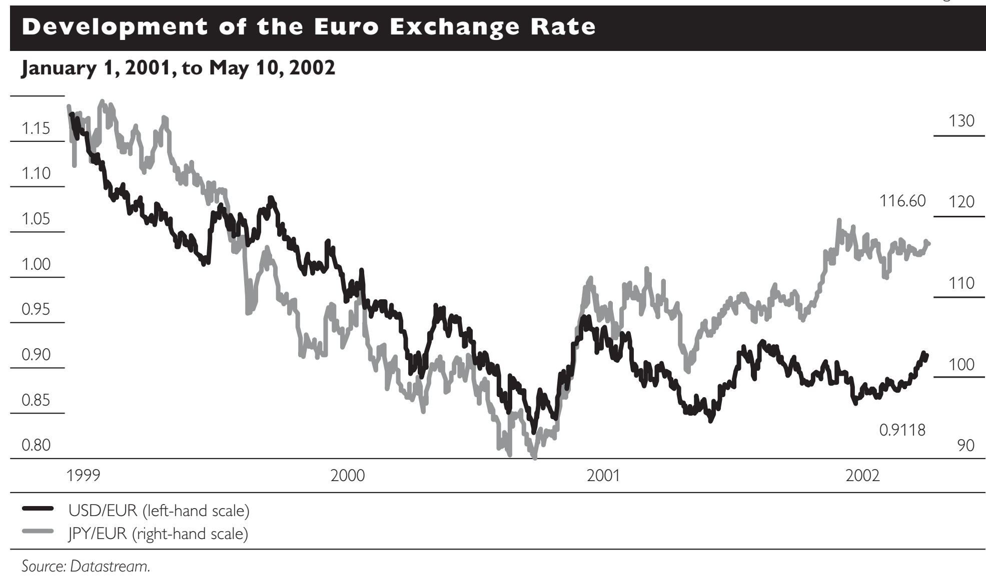


Figure 9

Development of the Euro Exchange Rate

January 1, 2001, to May 10, 2002

Source: Datastream.

growth prospects than to the relative yield expectations of euro area investments against U.S. portfolio and direct investments.

The euro exchange rate against the Japanese yen climbed by up to 10% to 120 JPY/EUR in the second half of the fourth quarter of 2001 and fluctuated around 115 JPY/EUR afterwards. The weakness of the Japanese yen in the fourth quarter 2001 was mainly due to the negative economic outlook in Japan, declining stock prices and their effect on the fragile Japanese banking sector.

Within Europe, the euro exchange rate remained mostly stable during the reporting period. Against the pound sterling, the euro hovered around 0.61 GBP/EUR. Directly after the terrorist attacks, the Swiss franc profited from "safe haven" inflows. Later on, the euro exchange rate against the Swiss franc remained relatively stable between 1.48 and 1.46 SFR/EUR. As of the end of April 2002, the Swiss franc appreciated again, causing the Swiss National Bank at the beginning of May 2002 to lower its three-month LIBOR target range by 0.5 percentage point to between 0.75% and 1.75%. After this decision, the euro exchange rate fluctuated around 1.4550 SFR/EUR.

Appreciation of Financial Assets of Central and Eastern Europe

Argentine Crisis Causes no Lasting Widening of Euro-Denominated Bond Spreads

The international market valuation of euro-denominated bonds in Central and Eastern European countries should reflect the estimated ability of these sovereign debtors to meet payment obligations.

But this valuation is also determined by the developments in other economies. With a view to analyzing to what extent a differentiated evaluation of sovereign risks in Central and Eastern Europe is being made already, figure 10 shows bond spreads of euro-denominated government bonds issued by Argentina, Turkey and various Central and Eastern European countries. Obviously, the drastic widening of Argentine spreads as of July 2001 caused a widening of spreads or the breaking of a narrowing spread trend in Russia, Rumania, Croatia and the Slovak Republic only temporarily, i.e. between July and

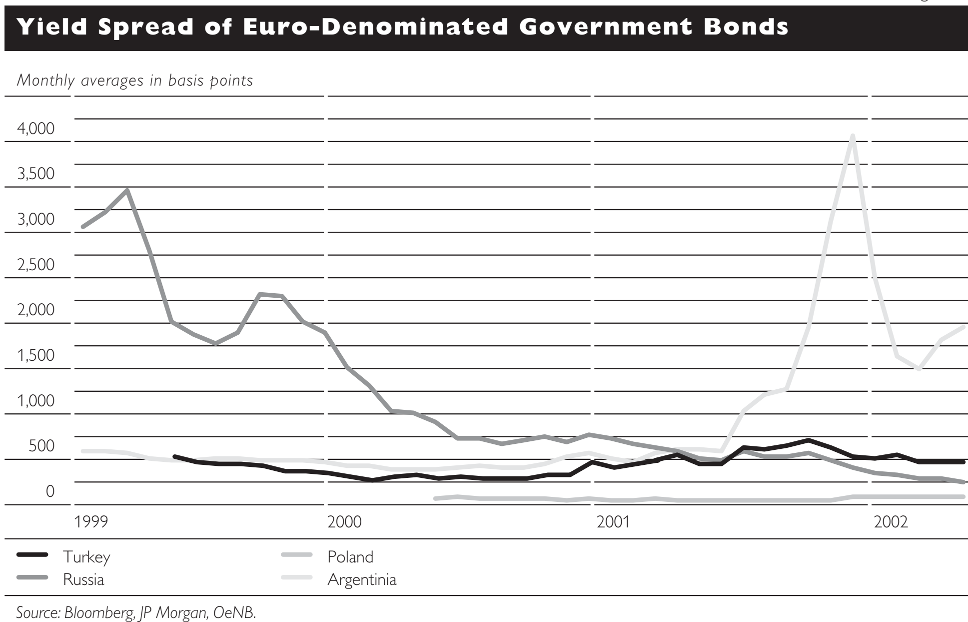


Figure 10a

Yield Spread of Euro-Denominated Government Bonds

Source: Bloomberg, JP Morgan, OeNB.

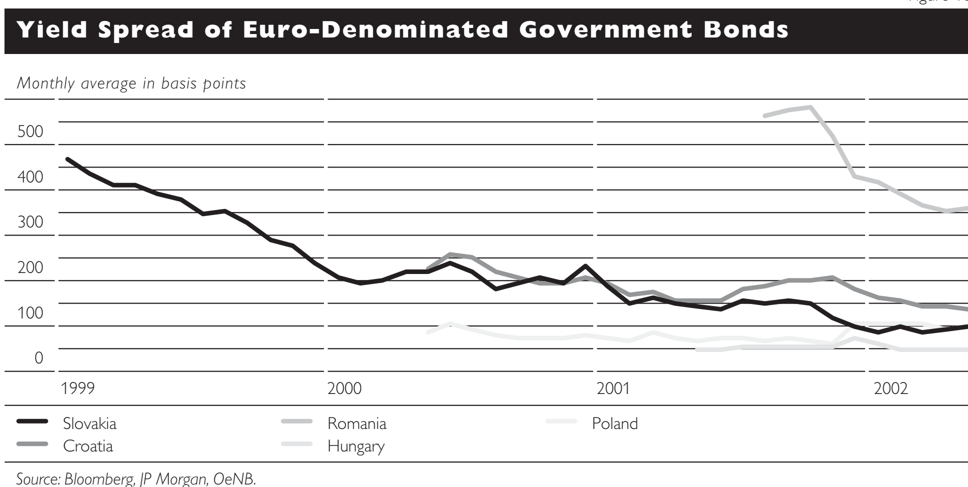


Figure 10b

Yield Spread of Euro-Denominated Government Bonds

Source: Bloomberg, JP Morgan, OeNB.

October 2001. In these countries, government bond spreads were considerably or, in the case of Croatia, slightly lower in April 2002 than before the rise in Argentine spreads in July 2001. In particular EU accession countries as well as Russia could thus avoid lasting contagious effects of the Argentine crisis. By contrast, bond spreads of euro-denominated Brazilian government bonds for instance clearly remained above the level of June 2001 until May 2002 (the cut-off date for this report).

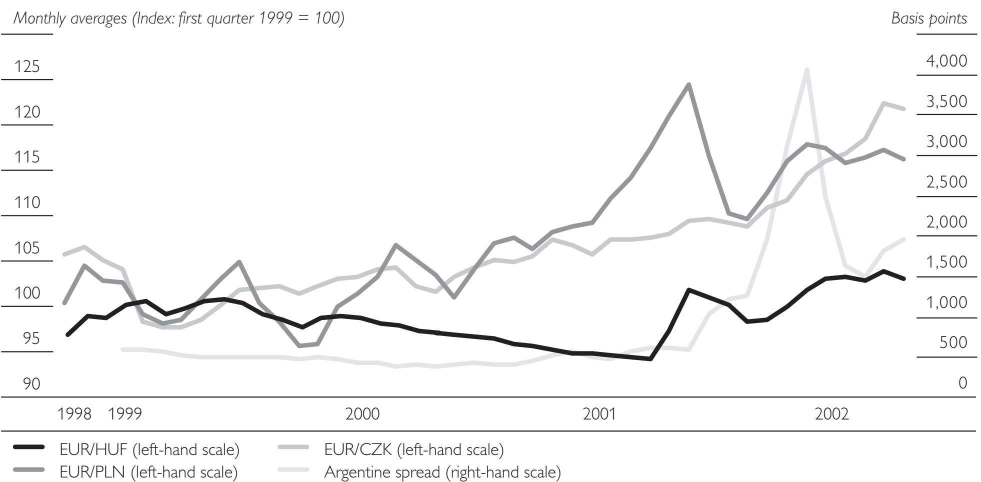
Despite Argentine Crisis Mostly Both Real and Nominal Currency Appreciations

The fundamental reevaluation of Argentine debt securities on the international financial market in July 2001 lead spreads of euro-denominated Argentinean bonds to dramatically double to about 1,050 basis points (see figure 11, right-hand scale). Whereas this widening of spreads did not noticeably influence

Polish and Hungarian spreads, this marked reevaluation seems to have had a direct impact on the assessment of Central and Eastern European currencies. As a consequence, the currencies of Russia, Poland and – to a somewhat lesser degree – Hungary, which had initially shown a very strong nominal appreciation against the euro, depreciated substantially between July and September/Octo-

Figure 11a

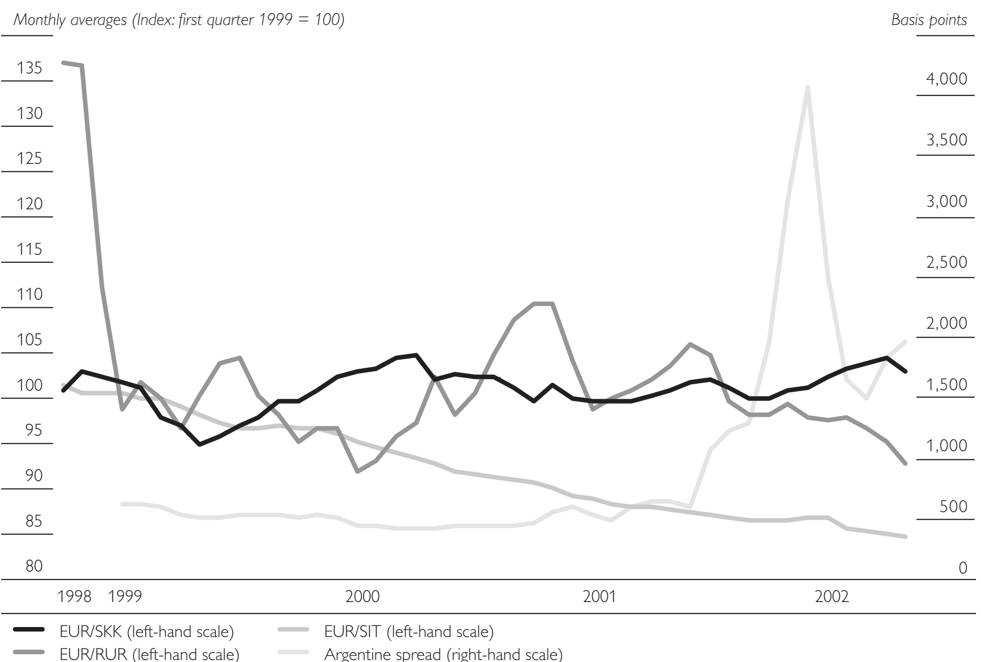
Euro Exchange Rate of Central and Eastern European Currencies and Bond Spread of Euro-Denominated Argentine Government Bonds



Source: Bloomberg, Datastream, JP Morgan, OeNB.

Figure 11b

Euro Exchange Rate of Central and Eastern European Currencies and Bond Spread of Euro-Denominated Argentine Bonds



Source: Bloomberg, Datastream, JP Morgan, OeNB.

ber 2001. The currencies of the Slovak and Czech Republics depreciated slightly as well, and only the tendency of the Slovenian currency remained completely untouched (see figure 11).

In the course of the fourth quarter of 2001, however, a more differentiated risk evaluation obviously gained ground on the market, as another doubling of the spreads of Argentine euro-denominated bonds did not lead to a further (strong) weakening of Central and Eastern European currencies. But in April 2002 the exchange rates for the Hungarian forint, the Czech koruna and the Slovak koruna were already much higher than before July 2001. The nominal appreciation of the Slovak koruna between October 2001 and April 2002 seems to be in line with fundamentals to a limited extent as the current account deficit was financed by net inward direct investments. But to a certain extent, a spill-over effect from the Czech koruna might also have had an impact here. As of October 2001, the Polish zloty also experienced a trend reversal toward a nominal appreciation, without reaching the, by comparison, extremely high previous level. A decline in interest differential and burgeoning domestic demand growth, however, might lead to another depreciation of the zloty. Only in the case of the Russian rouble the nominal currency depreciation as of July 2001 continued in a moderate way until May 2002.

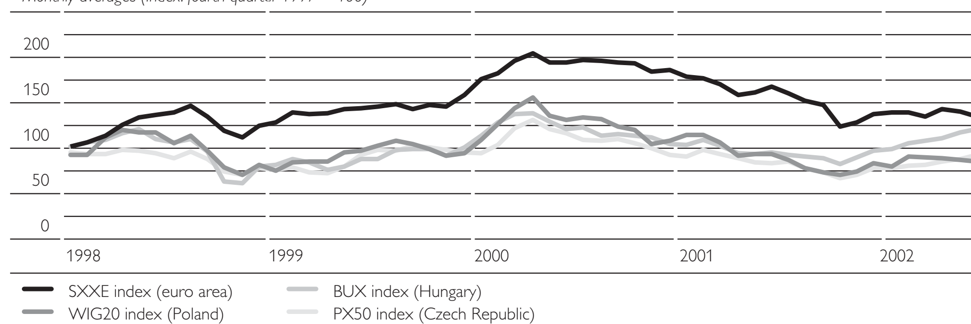
Global Developments Dominate Stock Markets

The long-term stock market developments of the Czech Republic, Hungary and Poland are only to a very small degree fundamentally determined by national factors, as is illustrated by figure 12. Stock indices move in parallel with the DJ Euro STOXX index (SXXE), but typically with much greater proportional differences between successive lows and highs. These more extensive relative fluctuations are probably due to the basically higher risk rating attributed to these markets by international equity funds. In a longer-term perspective, between their lows in October 1998 on account of the Russian crisis and April 2002, the Czech and Polish indices registered about the same upwards movement as the DJ Euro STOXX, while the Hungarian index surged even more strongly. But as the Russia-based slump was much more extensive in Central European stock indices than in the DJ Euro STOXX, the index highs of before the Russian crisis have not even been reached by the Hungarian BUX.

Figure 12

Stock Indices in the Euro Area and in the Accession

Monthly averages (Index: fourth quarter 1997 = 100)



Source: Bloomberg, OeNB.

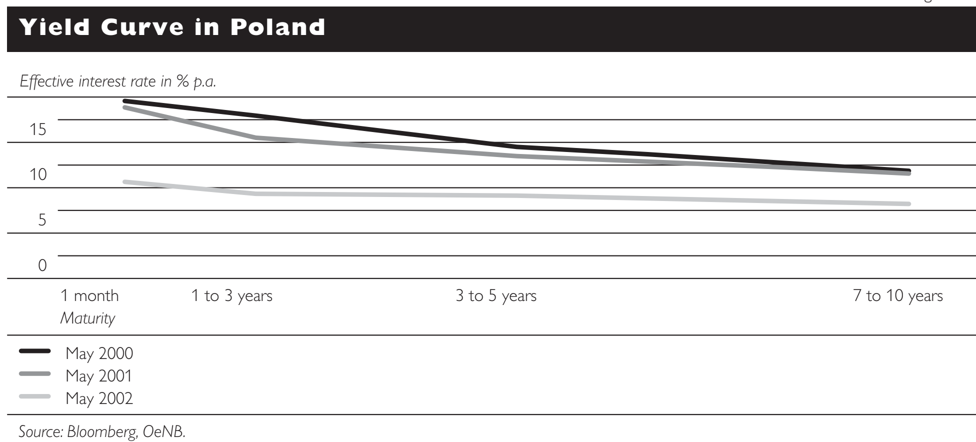
Polish Interest Rates and Long-Term Yields Both Far Exceed Inflation

Both Poland and Hungary have depicted inverted yield curves since the creation of a multi-year debt security market in the first half of the 1990s, whereas the Czech Republic has shown a rising yield pattern already for a number of years (see figure 13). The inverted curve pattern reflects an expected long-term disinflation process. This is corroborated by the fact that the inflation decline in Poland in the past twelve months was accompanied by reduced inversion, i.e. less steepness of the inverted curve.

Since the beginning of 2000, Poland has shown highly positive differentials between both interest rates and short- and long-term yields on the one hand and inflation on the other hand. In Hungary, inflation did not dip below the yield level until the second half of 2001 and to a much lesser degree. This striking contrast can, first of all, be explained by different monetary policies, which are also reflected in one-month money market interest rates. Secondly, structural inflation expectations might still be somewhat higher in Poland than in Hungary. At the beginning of 2002, however, the difference between long-term

Figure 13a

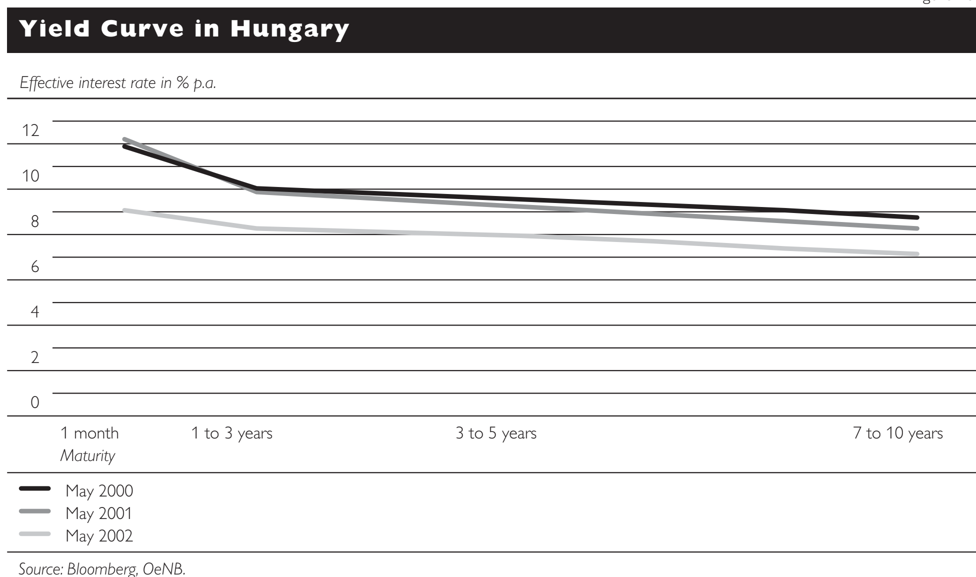
Yield Curve in Poland



Source: Bloomberg, OeNB.

Figure 13b

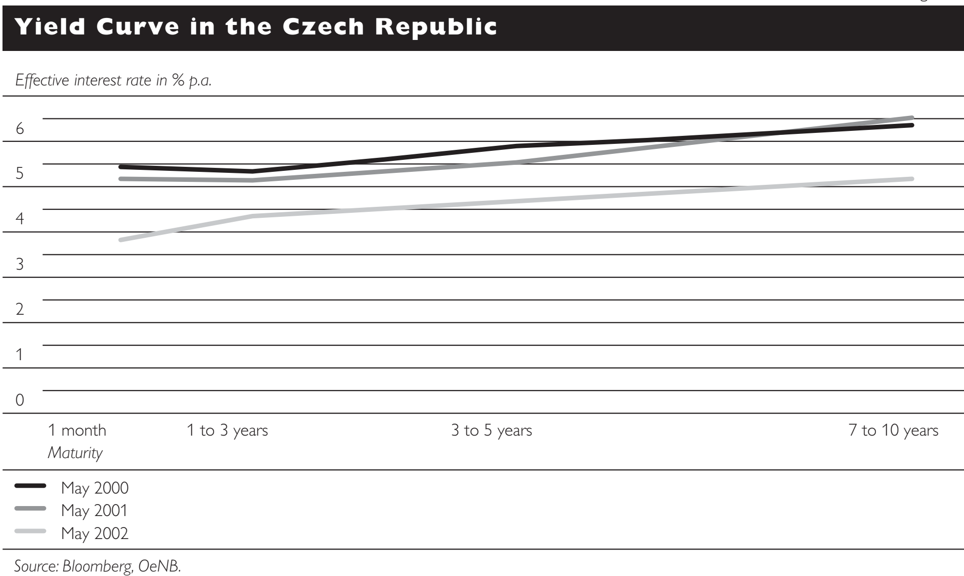
Yield Curve in Hungary



Source: Bloomberg, OeNB.

Figure 13c

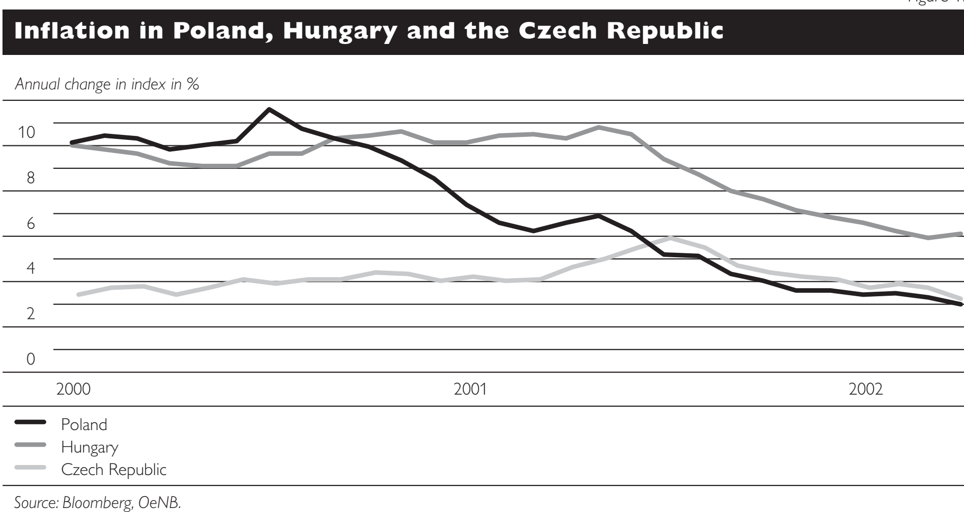
Yield Curve in the Czech Republic



Source: Bloomberg, OeNB.

Figure 13d

Inflation in Poland, Hungary and the Czech Republic



Source: Bloomberg, OeNB.

yields and current year-on-year inflation might also have increased in Hungary on the basis of long-term inflation expectations, with the most recent disinflation success being interpreted in part also as the result of the positive supply shock of an oil price decline, and with further disinflation prospects being considered more subdued now. Even if divergent patterns in inflation expectation serve as an explanation, it is still questionable whether they may sufficiently account for the substantial differences in the gap between short-term yields and inflation, in particular. As third and last determinant we refer to the potentially divergent expectations of future exchange rate changes. Prices of zloty-denominated government bonds, for instance, might include expectations of much higher short- and long-term currency depreciations than bonds denominated in Hungarian forint and especially in Czech koruna.

Banking in Central Europe Ever More Profitable

Growth Slows Down in the First Half of 2001

In the first half of 2001, the development of total banking sector assets in Central Europe varied considerably across countries, but real growth was mostly below the full-year figures for 2000. From January to June 2001, annualized real growth of banking assets ranged from 9.5% in Slovenia to almost –4% in the Slovak Republic. Compared to 2000, real asset growth in the banking sector accelerated in the Czech Republic, while slowing down in Poland, Hungary, the Slovak Republic and Croatia, and remaining practically unchanged in Slovenia.

In Slovenia, Croatia and Hungary, loans to businesses and households grew faster than total assets; in Poland and the Czech and Slovak Republics, by contrast, these balance sheet items grew at a slower pace, with Slovakia even reporting a decline in the absolute level (as in 2000). Given the strength of the Polish zloty and the substantial positive interest rate differential, the bulk of new loans were denominated in foreign currencies, driving the share of foreign currency loans in all commercial bank claims on nonfinancial institutions up to 24% by the end of June 2001. In the Czech Republic, where in 1999 and 2000, in the course of cleansing their loan portfolios, banks had also registered a decline in the volume of loans outstanding to the private sector, this position was observed to rise in the first half of 2001, indicating the end of this weeding-out process.

Further Increase of Profitability in the Central European Banking Sector

With the exception of Poland, return on equity (ROE) went up year on year in all countries under review in the first half of 2001.

In the case of Hungary, however, growth was influenced by one-time factors (provisions released following the sale of equity interests and legal adjustments), which accounted for around 60% of the rise in profit before tax. Even so, the (nominal) increase in operating income compared with the first half of 2000 was 29%.

Table 1

Return on Equity

	1997	1998	1999	2000	First half	
					2000	2001
	%					
Croatia	. .	–16.1	4.8	10.7	13.5	16.2
Poland	37.7	9.2	12.9	14.6	16.8	15.4
Slovakia	. .	–13.4	–36.5	25.2	1.3	21.3
Slovenia	10.3	11.3	7.8	11.3	12.2	12.5
Czech Republic	– 5.3	– 5.2	– 4.3	12.0	6.6	15.1
Hungary	11.9	7.5	4.0	10.9	15.2	21.2

Source: National central banks, OeNB.

After operating income had been on the decline for two years, banks in the Czech Republic recorded an increase in the first half of 2001. With operating expenses augmenting only moderately, the Czech banking sector appears to have sustainably improved its operating performance. Preliminary results for the year 2001 are already available for Slovakia, indicating a further pronounced rise of the annual banking sector surplus. This rise in net profits is mainly attrib-

utable to the release of provisions, but operating income went up as well. In Poland, by contrast, given the slow growth in operating revenues and the simultaneous rise in loan loss provisions, ROE went down slightly during the first six months of the reporting year compared to the first half of 2000, although the contribution of some less sustainable income components (such as foreign exchange gains) increased somewhat. The decline in the absolute level of operating expenses, however, indicates that the cost discipline of Polish banks is comparably high.

The net interest rate spreads recorded in most of the countries under review in the first half of 2001 largely corresponded to those for the entire year 2000; only in Poland, this indicator went down markedly. The considerable decline in net interest income as a percentage of average total assets in Poland can be ascribed to a combination of narrowing interest rate margins, a rise in the importance of foreign currency loans (on which fees are higher but margins lower) and a deterioriation of banks' loan portfolios.

Table 2

Net Interest Rate Spread

Net Interest Income as a Percentage of Average Total Assets

	1997	1998	1999	2000	First half	
					2000	2001
	%					
Croatia	. .	. .	. .	. .	. .	3.78
Poland	4.77	4.62	4.04	4.28	4.40	3.38
Slovakia	. .	. .	6.70	6.40	. .	. .
Slovenia	4.18	3.84	3.53	3.86	4.05	3.64
Czech Republic	1.81	2.97	2.50	2.21	2.05	2.04
Hungary	3.83	4.32	3.99	3.94	4.07	4.01

Source: National central banks, OeNB.

Compared with the first half of 2000, operational efficiency (measured in terms of the cost/income ratio) improved in all countries under review but Slovenia.[1]) In Hungary, this ratio deteriorated vis-à-vis 2000 as special factors had caused an upward distortion of operating expenses in 2000.

Table 3

Cost/Income Ratio

	1997	1998	1999	2000	First half	
					2000	2001
Croatia	. .	. .	. .	. .	. .	58.9
Poland	55.6	63.0	65.2	63.2	62.5	61.3
Slovakia	. .	62.0	78.6	67.7	. .	64.2
Slovenia	61.4	63.3	65.2	58.9	59.5	63.7
Czech Republic	48.6	49.2	56.6	65.7	64.3	59.2
Hungary	53.0	59.6	87.0	57.9	73.7	66.7

Source: National central banks, OeNB.

Owing to seasonal factors, there are certain restrictions to interpreting the development of loan loss provisions in the first half of 2001. Compared to the reference period of 2000, risk costs in Poland, however, appear to have risen even further.

1 *No reference values are available for Croatia and the Slovak Republic.*

Table 4

Risk Provisions as a Percentage of Operating Income

	1997	1998	1999	2000	First half 2000	First half 2001
	%					
Croatia	. .	. .	. .	. .	. .	0.1
Poland	4.4	9.9	14.3	16.3	11.2	14.0
Slovakia	. .	38.4	103.3	–17.1	. .	–46.1
Slovenia	19.8	15.4	19.7	21.9	18.7	13.7
Czech Republic	34.0	14.6	0.1	–46.7	–108.3	9.7
Hungary	1.4	8.1	1.1	0.2	1.8	– 6.2

Source: National central banks, OeNB.

With the exception of Croatia, which posts the highest capital adequacy ratio of the countries under review, capital adequacy ratios remained unchanged or went up in the first half of 2001.

Table 5

Banks' Capital as a Percentage of Risk-Weighted Assets

	1997	1998	1999	2000	First half 2000	First half 2001
	%					
Croatia	. .	. .	. .	21.3	. .	18.8
Poland	12.4	11.7	13.2	13.0	12.4	14.4
Slovakia		3.1	5.3	12.5	11.7	. .
Slovenia	. .	. .	. .	13.5	13.6	13.5
Czech Republic	9.5	12.1	13.6	14.9	16.7	15.2
Hungary	16.7	16.5	15.0	15.2	14.0	15.1

Source: National central banks.

Profitability Improves in All Countries, but Economic Conditions Deteriorate in Poland

The development of operating profit over the first half of 2001 suggests that results for the year 2001 might even surpass those of the previous year, which was the most successful business year to date in the countries under review. The improvement of profitability both in 2000 and 2001 in Slovakia and in the Czech Republic, in particular, reflects the rising profitability of some large credit institutions majority-owned by Austrian banks. The fact that operating income improved in the Czech Republic from January to June 2001 compared with the first half of 2000 after having been in decline for two years may imply that banking has become a more profitable business in the Czech Republic. The banking sectors in Hungary and Slovenia appear to maintain their comparably stable situation. By contrast, risks for the Polish banking sector are likely to keep going up. The weak cyclical situation and the high level of real interest rates indicate that risk costs will continue to rise. In addition, the growing importance of foreign currency loans makes the real sector more vulnerable to exchange rate fluctuations. However, as Polish banks have achieved comparably good operating results (despite the difficult macroeconomic situation) and continue to apply strict cost control measures, the Polish banking sector's resistance to macroeconomic risk factors can be deemed to be relatively high.