

## **Global Economic Developments and Financial Markets**

### **Higher Oil Price Dampens Global Economic Growth**

From mid-2003 to spring 2004, the economic situation improved in many industrialized countries and emerging market economies, which posted growth rates that were in part significantly above long-term averages. The inflation rates stayed at a relatively low level during that period, but price rises of a number of commodities increasingly exerted upward pressure on prices. The pronounced oil price hike observed in the second quarter of 2004 continued into the third quarter. Averaged out over the year, the oil price currently stands some 20% above the 2003 level. This oil price hike may be traceable above all to fears about a future supply crunch kindled by geopolitical risk factors and capacity constraints as well as to consistently higher demand, in particular from China. In many countries, the rallying oil price entailed a perceptible slowdown of economic activity. The monetary policy stance of numerous countries remained accommodative, as reflected either by low key interest rates, most notably in the U.S.A., the euro area and in Japan, or by interventions to curb the upward pressure on national currencies against the U.S. dollar, as was the case in some Asian countries. Many countries recorded relatively high budget deficits.

In the United States, consumer spending was buoyant thanks to rising disposable incomes, positive wealth effects, growing employment and improved consumer confidence but for the drag in the second quarter of 2004 traceable to the negative terms-of-trade effects of the higher

oil price. Amid low capital costs, high profits and positive sales prospects, fixed capital formation was dynamic until the second quarter of 2004. With defense spending significantly stepped up, government spending also contributed to the strong growth in demand. In Asia, exports were boosted by the dynamic investment activity in the U.S.A. and China. At the same time, domestic demand started to look up in many countries. Given its tremendous growth rates, China showed signs of overheating, with inflation on the rise, while in Japan, a much improved labor market spurred economic activity and the slight deflation persisted. Growth in the euro area trailed that in other economic areas and was mostly export-driven. Vibrant growth in export markets partly offset the marked appreciation of the euro in 2003, whereas investment and consumer spending remained rather weak in the euro area. Unemployment continued to be high and both employment growth and capacity utilization in the industrial sector were low. Inflation rose in the wake of the oil price rally, but has hardly spawned any second-round effects, i.e. effects on wage settlements, to date.

Most forecasts for the euro area, the U.S.A. and Asia envisage that although the oil price will have some dampening effect, economic growth will be relatively robust in 2005. The recent Consensus Forecast pegged growth in the euro area at 2% and in the U.S. at 3.5% and included a favorable inflationary outlook of 1.8% for the euro area and 2.3% for the United States. However, if the oil price stays at its current level or rises even further, these forecasts will have to be revised.

In determining the quantitative impact of the oil price on growth and inflation, a number of factors have to be taken into account: the trigger of the oil price surge, i.e. whether it was caused by increased demand or supply restrictions; the expected duration of the oil price spike; the oil intensity of consumption and production and their flexibility; the propensity to spend of the oil-producing countries; the capacity utilization of the economy at the time of the oil price shock and the labor market

situation; the development of nominal wages, including trade unions' wage demands, and lastly, the reaction of the financial markets (especially bond markets) and of monetary policy. Table 1 provides an overview of several estimates,<sup>1</sup> according to which a higher oil price puts a damper on growth and raises inflation, with the effects differing from region to region. It should be noted that these models forecast rather lesser effects, whereas in reality such effects could be more pronounced.

Table 1

### Selected Estimates of the Impact of a Consistently 10% Higher Oil Price

	Average effect in the first years after the shock					
	GDP growth			Inflation		
	Euro area	U.S.A.	Japan	Euro area	U.S.A.	Japan
	<i>in percentage points</i>					
IMF	-0.05	-0.06	-0.01	+0.28	+0.18	+0.08
National Institute of Economic and Social Research (NIESR)	-0.15	-0.25	..	+0.04	+0.17	..
European Commission	-0.04	-0.05	-0.04	+0.05	+0.06	+0.02

Source: IMF, NIESR, European Commission.

In addition to the oil price, the U.S. current account deficit, which probably cannot be sustained in the long run, poses a risk. In the previous years, the monetary policy measures of several Asian central banks played a significant role in financing this deficit, which exists mainly vis-à-vis Asian countries. Abandoning this policy of accumulating liquid U.S. dollar-denominated reserves without it being offset by emerging private capital flows would considerably pressure these currencies to appreciate

against the U.S. dollar. Such adjustments could also impact the euro, even though it is difficult to identify precisely the potential repercussions on the monetary conditions of the euro area. Judged by the market reactions to the G-7 statement of September 2003, a cessation of the interventions by itself would lead to appreciation pressure on the euro against the U.S. dollar and depreciation pressure on the euro against the Asian currencies.<sup>2</sup> However, the effects on the exchange rates also hinge on the

<sup>1</sup> See also Schneider, M. 2004. *The Impact of Oil Price Changes on Growth and Inflation*. In: *Monetary Policy & the Economy Q2/2004*. OeNB. 27–36. The table shows the deviations from a benchmark solution of the simulation models.

<sup>2</sup> See also Greenspan, A. 2004. *Current Account*. Remarks before the Economic Club of New York. The Federal Reserve Board. March, 2. For another view, see Eichengreen, B. 2004. *Global Imbalances and the Lessons of Bretton Woods*. NBER Working Paper 10497.

macroeconomic conditions and on the monetary policy responses in the respective economies.

**Key Interest Rates Are Raised in Some Countries, Inflation Risk Premia Rise Slightly**

During the second and third quarter of 2004, the U.S. key interest rates, which had stayed at a very low level for a long period, were raised in three moves, by 25 basis points each, to 1.75%. Already in May 2004, the Federal Reserve signaled that it was set to remove policy accommodation at a measured pace. The U.S. money market rates thereafter took their cue from this indication. Key interest rates were raised also in other countries, such as the United Kingdom and Canada, following economic recovery and a growing inflationary threat. In the euro area, key interest rates remained at 2%. Analogous to developments in the U.S, the euro area encountered a slight steepening of the money market yield curve, which, however, started to reverse in June 2004.

In April, the U.S. and euro area long-term bond market rates rose sharply by some 100 and 50 basis points, respectively. This hike was triggered by strong U.S. labor market figures, which boosted business confidence and sparked expectations of a speedier tightening of key interest rates, and was amplified further by the rising oil price, which contributed to the increase in the inflation risk premia, or inflationary expectations, priced into indexed bonds. The yields reached a high in May to fall to close to 4% irrespective of the higher interest rate level in the money market.

The oil price surge seems to have triggered a revision of the outlook for economic growth. By contrast, the reduction in the implicit inflation risk premia or inflation expectations is likely to be ascribable to the relatively minor direct effects the oil price increase has so far had on inflation as well as the intact credibility of the central banks as guardians of price stability over the medium term. In this context, the interest rate hikes of the Fed may have played a positive, i.e. confidence-building, role. The U.S. and euro area stock markets have continued to move sideways since the beginning of 2004. By June the effects of favorable corporate news and of higher interest rates on both the short and the long end seemed to have balanced each other out. Thereafter, concerns over the repercussions of the higher oil price kept a lid on stock prices. Not least owing to the rapid rise of corporate earnings, the fundamental valuations, as measured by price/earnings ratios, came close to long-term means over the past quarters. Uncertainty in terms of implied volatilities remained at a low level. The risk premia in the corporate bond markets continued to be small, which is ascribable to companies' improved balance sheets and the strong demand for bonds.

In the currency markets, the euro moved sideways relative to most currencies and in particular to the U.S. dollar for quite some time, most likely driven by the uncertainty about the economic prospects for the U.S.A. and the euro area. Most recently, the euro appreciated substantially against the U.S. dollar due to the dollar's weakness.

## Financial Flows into Emerging Markets

### Bright Economic Prospects Contrast with Declining Net Capital Inflows

The economic outlook has brightened markedly for the emerging market economies (EMEs) over the course of 2004, which is due to mostly robust domestic demand, stepped-up export activity and – in some EMEs – higher commodity prices. The IMF revised upward its forecast for 2004 of real GDP growth in the EMEs from 6.1% to 6.6% and envisages a slightly less vibrant upswing for 2005 amid slower price growth. Boasting booming investments, Asia's EMEs are projected to continue to be the main global engine of growth, next to the United States, despite the spike in the oil price. By keeping their national currencies stable against the U.S. dollar, they manage to safeguard their competitiveness, with China intent on curbing its frenzied growth. The Russian economy is forecast to be

favored by the high oil price. Europe's EMEs (including the new EU Member States and Turkey) are expanding by 5.5% in 2004, according to the IMF. This year's economic growth in Turkey has been astonishingly vibrant at 7% owing to economic reforms. Inflation has been on the decline, whereas the current account deficit has been widening. The IMF has extended considerable financial assistance to Turkey, which compares with still just a trickle of private capital inflows. In structural policy terms, Asia's EMEs put priority on reorganizing the financial industry and reforming the corporate sector. Latin America is preparing to improve the investment climate, and in the Middle East, efforts are under way to establish an institutional infrastructure to develop non-oil industries. In Africa, emphasis is placed on strengthening institutions and improving governance. All of these structural reforms in the EMEs serve to prepare the ground for the substantial trade liber-

Table 2

## Private Capital Flows into Emerging Markets

### and Developing Countries according to the IMF<sup>1</sup>

	2001	2002	2003	2004	2005
	USD billion				
<b>Net capital flows (IMF)</b>	47.8	61.2	120.4	81.6	47.5
<b>By instrument</b>					
Direct investment	191.2	143.5	147.6	166.9	175.2
Portfolio investment	-91.3	-99.6	-11.0	-21.3	-23.4
Other flows	-52.0	17.3	-16.2	-64.0	-104.4
<b>By region (country)</b>					
Latin America (31)	22.2	1.4	0.0	-3.3	14.2
Europe (13)	12.1	55.3	51.5	53.2	49.3
CIS (12)	-1.7	-9.2	15.2	-19.2	-5.8
Middle East (14)	-7.9	-23.6	-14.0	-45.5	-32.5
Africa (46)	13.5	11.9	14.8	16.6	13.7
Asia (15)	9.6	25.4	52.8	79.8	8.6
<b>Memorandum items</b>					
Current account balance	89.7	145.0	235.3	285.7	269.2
Foreign reserve assets (- = increase)	-113.2	-197.1	-367.0	-350.1	-291.2
of which China	-47.4	-75.7	-117.2	-148.7	-96.7

Source: IMF (WEO).

<sup>1</sup> This table shows aggregated balance-of-payments data sets of 131 non-industrialized countries, including the 44 EMEs posting the largest volumes. Given repeated revisions of the national balances of payments, which also affect the data sets of previous years, the capital flows may differ substantially after such revisions.

### Claims of BIS Reporting Banks on Central and Eastern Europe and Turkey as at End-March 2004

Countries of origin of the BIS reporting banks with the largest external positions vis-à-vis the individual regions

	Austria	Germany	Italy	France	Netherlands	Sweden	Belgium	United Kingdom	Europe <sup>1</sup>	U.S.A.	Japan
	% of GDP of the recipient country										
<b>CEE plus Turkey</b>	3.0	10.5	2.1	2.0	1.6	1.32	1.1	1.0	26.0	1.1	0.6
<b>Central European EU Member States</b>											
Poland	2.8	..	2.6	1.1	1.3	0.45	0.7	0.4	22.5	0.8	0.7
Slovakia	6.3	..	6.1	1.6	0.6	0.00	2.7	0.2	29.4	0.7	0.5
Slovenia	7.6	..	2.5	2.6	0.7	0.01	2.1	0.0	31.7	0.1	0.4
Czech Republic	7.0	..	0.8	1.5	1.1	0.03	3.9	0.0	23.5	0.5	0.4
Hungary	6.8	..	3.9	2.8	1.8	0.04	4.8	1.2	50.4	1.0	1.1
<b>Other CEECs</b>											
Bulgaria	0.8	..	3.6	1.3	1.0	0.01	0.2	0.3	23.5	1.3	0.2
Croatia	13.9	..	25.0	0.9	0.6	0.03	0.6	1.0	73.3	0.9	1.7
Romania	1.4	..	1.4	2.5	2.9	0.17	0.2	0.4	18.5	1.0	0.0
Russia	0.7	..	0.3	1.9	1.6	0.06	0.1	0.0	13.7	1.0	0.4
<b>Turkey</b>	0.2	..	1.0	2.3	1.8	0.13	0.6	0.0	16.5	1.4	0.8

Source: BIS, Eurostat, IMF, national sources and OeNB calculations.

Note: The claims shown here correspond to the "Consolidated international claims of BIS reporting banks" released by the BIS (BIS Quarterly Review September 2004, Table 9C). The BIS statistics cover cross-border claims denominated in all currencies as well as the claims held by subsidiaries – with the exception of Austria and the U.S.A. – which are denominated in a currency other than that of the recipient country.

<sup>1</sup> The column "Europe" comprises the countries of origin listed here as well as DK, GR, IE, PT, FI, ES, CH and NO.

alization agreed upon in the Doha Round of WTO negotiations.

The IMF predicts net capital inflows into the EMEs in 2004 to contract perceptibly year on year. The increasing net direct investment inflows are expected to be more than offset by net outflows in portfolio investment and other flows, such as bank loans, trade credits and derivatives. In several EMEs local capital markets helped to partly bridge the funding gap. The Asian EMEs, most notably China and India, have continued to attract the bulk of net capital inflows. Including the USD 45 billion of capital inflows that China used at the end of 2003 to recapitalize two state-run commercial banks and which are not part of table 2, net inflows into Asia's EMEs in 2004 seem to trail the 2003 figures by USD 18 billion. On the back of the policy of keeping the national currencies stable, the re-

serves of this region are expected to augment further by more than USD 230 billion to almost USD 1,500 billion or nine months' import cover, which would translate into eight times the short-term debt of the region. Even though the current account surpluses of the Asian EMEs are anticipated to shrink further in 2005, China's measures to cool the economy are likely to lessen the demand for foreign capital. Thus, the European EMEs would become the largest net capital importer among the EME regions. As their economic policy framework is now largely determined by the EU, Europe's EMEs are deemed less risky. The Commonwealth of Independent States (CIS) and the Middle East will continue to be net capital exporters given their persistently high energy export proceeds.

### Claims of Austrian Banks Denominated in Foreign Currency on Central and Eastern Europe – An International Comparison

At the end of March 2004, the ten new EU Member States accounted for over 57%, and Central and Eastern Europe, including the CIS, for more than 75% of the Austrian banking sector's total foreign currency-denominated claims on EMEs and developing countries.

The Austrian banking sector took first place in an international ranking of foreign currency-denominated claims on the new Central European Member States as at the end of March 2004, provided the German banking sector, for which no disaggregated data are available, is factored out.

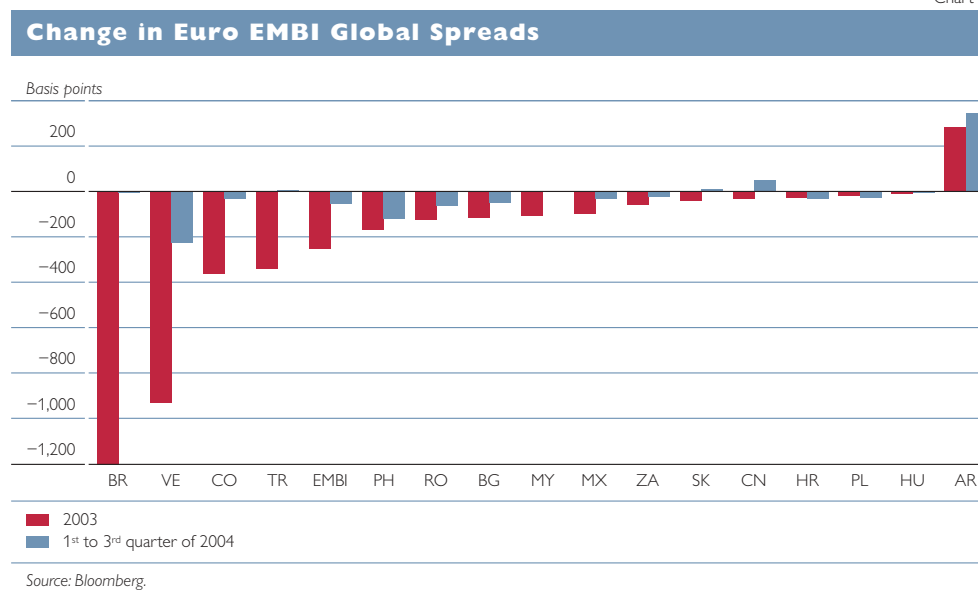
### Central and Eastern Europe Eurobonds Weathered U.S. Interest Rate Reversal

Bonds issued by emerging market economies weathered the turnaround in the U.S. interest rate cycle at the middle of 2004. Following the temporary rise in the yield spreads of U.S. dollar-denominated and euro-deno-

minated government bonds vis-à-vis the U.S. and euro area benchmark bonds (measured by JP Morgan's EMBI Global index and euro EMBI Global index, respectively) between mid-April and mid-May 2004, the spreads have narrowed steadily ever since. At end-September 2004, the yield spreads of U.S. dollar-denominated government bonds came again close to the level of mid-April (400 basis points), while the spreads of euro-denominated government bonds recorded new lows (125 basis points). Since the beginning of 2004, investors have thus reaped nonannualized returns totaling 6.5% (EMBI Global) and 7.0% (Euro EMBI Global), respectively.

The Federal Reserve had alerted the markets to the upcoming tightening of interest rates, which supported this development. Furthermore, the mixed data on the U.S. economy released since then corroborated investors' expectations that the interest rate tightening would be rather measured and slower than they had originally feared. Beyond these common factors, the yield spreads bene-

Chart 1



fited from the fundamentals of many countries. In turn, the ratings of long-term foreign currency liabilities of several CEECs were upgraded.

Among the Central and Eastern European issuers, only *Romania* and *Bulgaria* posted an above-average contraction of spreads since early 2004 compared with the Euro EMBI Global index. The yield spreads of *Romanian* eurobonds shrank by 62 basis points to 99 basis points, which translated into a total return of 9.1%. The yield spreads of *Bulgarian* government bonds recently came to 81 basis points, having fallen by 52 basis points since the beginning of 2004; those of *Croatian* eurobonds narrowed by 32 basis points to 64 basis points

over the same period. This development is quite remarkable as the current account deficits had widened markedly in Bulgaria and Romania in 2003, remained at a high level in all three countries in 2003 (between 5.7% and 8.5% of GDP) and continued to expand in the first half of 2004. The good news includes the provisional conclusion of accession negotiation chapters between Bulgaria and the EU, the conclusion of all but four negotiation chapters with Romania and the granting of candidate status to Croatia. In the summer, the IMF approved stand-by arrangements with these three countries, and Bulgaria's and Romania's ratings were upgraded.

Table 4

#### Changes in Ratings of Long-Term Foreign Currency Debt as of early 2004

	Moody's			Standard & Poor's			Fitch		
	Rating	Since	Change	Rating	Since	Change	Rating	Since	Change
Bulgaria	Ba2	05. 06. 03	↑	BBB-	24. 06. 04	↑	BBB-	04. 08. 04	↑
Romania	Ba3	11. 12. 03	↑	BB+	14. 09. 04	↑	BB	18. 12. 03	↑
Russia	Baa3	08. 10. 03	↑	BB+	27. 01. 04	↑	BB+	13. 05. 03	↑
Slovakia	A3	12. 11. 02		BBB+	02. 03. 04	↑	A-	21. 09. 04	↑
Slovenia	Aa3	12. 11. 02		AA-	13. 05. 04	↑	AA-	07. 07. 04	↑
Turkey	B1	21. 12. 00		BB-	17. 08. 04	↑	B+	09. 02. 04	↑

Source: Bloomberg.

Among the five new Central European EU Member States, the *Czech Republic's* debut sovereign issue of ten-year eurobonds worth EUR 1.4 billion at the end of June 2004 deserves special mention. The yield spread stayed within the narrow range of 16 to 23 basis points over the previous months, which corresponds more or less with the yield spreads of Hungarian and Slovakian eurobonds and stands some 15 basis points below that of Polish eurobonds. Having contracted by a total of 221 basis points in

2003, the yield spreads of *Russia's* U.S. dollar-denominated government bonds<sup>3</sup> increased by 41 basis points over the first nine months of 2004. Approximately until the end of June Russian spreads had moved in synch with the overall market. Negative news stories (for instance about the "Yukos affair," the mini banking crisis of June/July 2004 and the announcement of the German government in June to issue bonds secured by Russia's debt<sup>4</sup>) contrasted with the continued oil price rally and favorable funda-

<sup>3</sup> EMBI Global because since March 1, 2004, no Euro EMBI Global data have been available for Russia.

<sup>4</sup> This basically raises the supply of Russian debt instruments in the market.



mentals (high growth, subsiding inflation and a substantial current account surplus that showed no signs of let-up). As a consequence, the yield spread of Russian bonds has largely stayed stable at around 300 basis points since end-June, while the overall spread narrowed by close to 70 basis points.

The most serious risk factors for eurobonds in the months ahead include sharper-than-expected interest rate hikes in the U.S.A. and a persistently high oil price, which would drive up inflation, increase current account deficits and weaken growth in the oil-importing countries. The fact that the spreads are currently very close to historical lows would even amplify such effects.

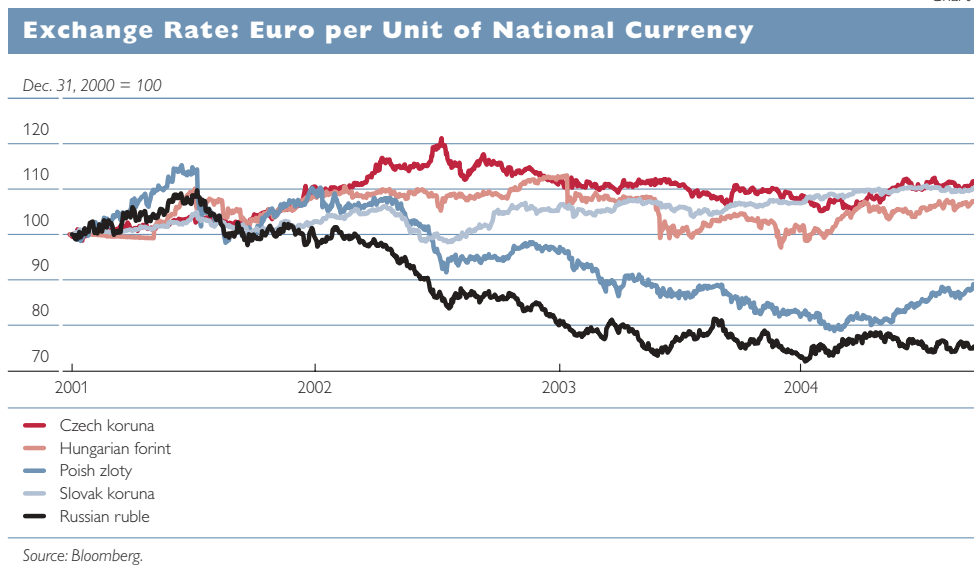
### Currencies of Most CEECs Firmed Up

The currencies of most CEECs firmed up against the euro in the first nine months of 2004. In 2003, all currencies of that region had depreciated against the euro except for the *Slovak koruna*, which had already felt upward pressure then, and the *Bulgarian lev*, whose exchange rate was fixed

through a currency board arrangement in mid-1997. The *Polish zloty*, sliding the most the year before, posted the largest gain in 2004. Similarly, in 2004, the *Hungarian forint* made up more than half of the previous year's dip. The *Slovak koruna* continued to firm up against the euro (+2.8%). Since Slovenia's entering the Exchange Rate Mechanism II (ERM II) on June 28, 2004, which put a stop to its policy of devaluation, the *Slovenian tolar* has remained stable vis-à-vis the euro. Both the *Czech koruna* and the *Croatian kuna* appreciated against the euro (by 2.6% and 0.7%, respectively). By contrast, the *Romanian lev*, having depreciated around 14% against the euro in 2003, remained stable throughout the first nine months of 2004. The *Russian ruble* rebounded only modestly from its slide against the euro in 2003; in April 2004, it started to fade again slightly against both the euro and the U.S. dollar.

In the first half of 2004, the appreciation or stability of the currencies went hand in hand with a high or higher current account deficit, most

Chart 2





notably in *Bulgaria, Croatia, Romania* and *Hungary* and, to a lesser extent, also in the *Czech Republic*. This coincided with continued robust and partly accelerating growth of domestic demand, driven by dynamic credit growth and, in the case of Romania, also substantial gains in real wages. Moreover, the higher oil price took its toll on the current account balances of these countries. Croatia was in addition saddled with a pronounced decline in export growth of the sum of goods and services. In contrast, the current account balance improved considerably in *Slovakia* and slightly in *Poland* and *Slovenia*.

*Bulgaria's* net direct investment inflows entirely financed its excessively high current account deficit for the time being. The net direct investment inflows into *Croatia, Romania* and *Hungary* did not suffice to finance the deficits there, which augmented these countries' foreign debt. The considerable outflows of private capital from Russia in the second quarter of 2004 and the central bank interventions against the national currency seem to have contributed substantially to the weakening of the Russian ruble starting from April this year despite the sizeable current account surplus.

Of the countries for which data are publicly available (Czech Republic, Croatia, Hungary, Romania, Slovakia), only Slovakia's and Romania's central banks conducted noteworthy foreign exchange interventions. *Národná banka Slovenska* bought foreign exchange worth EUR 1.2 billion between January and August 2004, whereas *Banca Națională a României* acquired foreign exchange to the amount of EUR 1.4 billion. Since early 2004, *Národná banka Slovenska* has cut its key interest rate

in six steps by a total of 150 basis points to 4.5%, above all to ease the upward pressure on the koruna. For the same reason, the *Romanian central bank* also trimmed the key interest rate in four steps between July and early October 2004, by an overall 250 basis points, to 18.75%. Not least because of the Hungarian forint's firming up, *Magyar Nemzeti Bank* trimmed the key interest rate three times between March and September 2004, paring it down to the still relatively high level of 11.0%. *Hrvatska narodna banka*, in contrast, responded to Croatia's rising foreign debt by introducing in mid-July 2004 the requirement for banks to deposit 24% of their foreign liabilities' net increase over June 2004 in the form of an interest-free foreign currency deposit into a special account held with the central bank. Prior to Slovenia's entry into ERM II, *Banka Slovenije* cut its key interest rate by 200 basis points from January to June 2004; these interest rate decisions were taken against the background of a decline in inflation and the objective to decrease the interest rate differential vis-à-vis the euro area. As at end-September 2004, the spread between the three-month interbank rate in Slovenia and the euro area amounted to 195 basis points, compared with 400 basis points at the beginning of the year.

The nominal appreciation of *most CEE currencies* during the first nine months of 2004 coincided with accelerating price growth, except for *Slovakia, Romania* and *Russia*. As a result, the real appreciation against the euro, measured by consumer prices as of December 2003, was in part remarkable. In *most countries*, the nominal decline or very modest nominal growth in labor unit costs in

the industrial sector cushioned the negative impact of the real appreciation on competitiveness, though. This did not work for *Romania*, however.

Overall, the partly high current account deficits and their financing through new foreign debt pose a certain risk to the respective currencies in the coming months. Sharp exchange rate movements are relevant to Austrian banks, both with a view to the conversion into euro of subsidiaries' profit contributions and given the credit risk inherent in outstanding foreign exchange claims (see also the sections "Financial Flows into Emerging Markets" and "The Banking Sector in Central and Eastern Europe" in this issue). The high interest rate premium is likely to remain central to the stability or appreciation of the *Hungarian forint* until external imbalances are smoothed and the markets regain confidence in fiscal policy. In *Croatia*, the medium-term balance-of-payments outlook has been improving owing to the slowdown in loan growth, but the measures intended to rein in foreign debt could spark temporary downward pressure on the kuna.

#### **Yield Spreads of Government Bonds Denominated in National Currencies Rise vis-à-vis Euro Area Benchmark Bonds**

In the course of the first nine months of 2004, the yield spreads of ten-year government bonds denominated in national currencies expanded vis-à-vis the euro area's benchmark bonds in the *Czech Republic*, *Hungary* and *Poland* by up to 80 basis points. In contrast, the spreads of Slovakian government bonds remained largely unchanged over the same period. The development of yield spreads vis-à-vis the euro area thus contrasted

with the recovery of the respective currencies against the euro. By now the increased spreads have raised both the attractiveness of investments in these currencies and the pressure to appreciate.

The rise in inflation and in the inflation differential vis-à-vis the euro area that was observed for the *Czech Republic*, *Hungary* and *Poland* in the first half of 2004 seems to have left its mark on the yield spread. Since the pace of inflation in the *Czech Republic* and *Hungary* was less dynamic during a couple of months than anticipated by the markets and medium-term inflationary expectations decreased slightly at times, the yield spreads likewise narrowed somewhat in March and April 2004. In *Poland*, where the course of inflation clearly exceeded expectations following the country's EU accession and a robust economic recovery drove up inflationary expectations, the yield spreads were on a steady rise until the end of May 2004.

In the *Czech Republic* and *Poland*, the central banks' interest rate hikes in response to increasing inflation also led to a temporary widening of the yield spreads. In the light of the inflationary peak in the *Czech Republic*, *Hungary* and *Poland* in summer and expectations of a slide of inflation over the next few months, the negative effects of price growth on the yield spreads should subside.

Fiscal policy continued to wield considerable influence on the bond markets. A case in point is *Hungary*, where the medium-term budget outlook deteriorated further (first in May and once again in September) and thus contributed to the upward drive of the yield spreads starting in May. In *Poland*, chances are that the overall 2004 deficit will widen less

than expected year on year, which in turn may have favored the development of the yield differentials as from mid-August. In the *Czech Republic*, the convergence program of May 2004 included a slight downward revision of the deficit target for 2004, which translated into an even greater reduction on the 2003 deficit. On the other hand, Prime Minister Spidla's resignation at the end of July over irreconcilable economic policy differences within his own party entailed certain unease about budgetary developments over the medium term and thus weighed on the bond market. In 2004, the medium-term fiscal plans of the *Slovak* government have so far not seen any major revisions. The radical tax reform that took effect at the beginning of 2004 has not led to a deterioration of the budget position as feared.

The parliamentary elections coming up in *Poland* in 2005 and in the *Czech Republic*, *Hungary* and *Slovakia*

in 2006 represent a wild card in budgetary developments over the medium term, which may well sway yield spreads in the course of 2005. In all four countries the poll numbers do not look good for the incumbent parties, which could lead to some fiscal easing in the run-up to the parliamentary elections and a deviation from the convergence programs of May 2004. This could, by extension, cause markets to see the date for the introduction of the euro in these four countries slip further into the future. According to Reuters' quarterly market forecast of the euro adoption dates, the expected date of 2009 was moved to 2010 for Poland and Hungary between the beginning of 2004 and August; 2010 is also the date expected for the *Czech Republic*, while *Slovakia* is anticipated to be ready to introduce the euro already in 2009.

Concerns over budgetary discipline led to the downgrading of the

Chart 3

### Yield Spreads of Ten-Year Government Bonds against Euro Area Benchmark Bonds

Percentage points



Source: Bloomberg.

ratings of Poland's zloty-denominated debt (in May 2004 by Fitch from A+ to A) and the Czech Republic's koruna-denominated debt (in September 2004 by Standard and Poor's from A+ to A). In September 2004, Hungary was likewise warned by Standard and Poor's that a deterioration in its budget situation would trigger a downgrade of forint-denominated debt (currently rated A). While the same rating agency had alerted Poland of a potential further downgrade in April 2004 (since November 2003: A– with a negative outlook), it changed the outlook from negative to stable in September 2004, referring to the slightly better-than-expected fiscal performance.

### **The Banking Sector in Central and Eastern Europe<sup>5</sup>**

#### **High Credit Growth, Enhanced Portfolio Quality and Increasing Foreign Currency Share**

The *economic environment* for banking in Central and Eastern Europe improved during the first nine months of 2004. All eight countries covered in this analysis except for Croatia posted accelerated economic growth owing in part to an uptick in investment activity. With the exception of Croatia and Poland, lending to the private sector (adjusted for inflation) picked up on the back of the economic recovery (Slovakia, Slovenia and the Czech Republic) or stayed at a very high level (Hungary, Bulgaria, Romania). In Poland, credit growth re-

mained subdued despite the upswing, primarily because companies either deferred investments (with import-intensive investments, this was also due to sharp exchange rate fluctuations) or relied on internal financing, while household loan demand continued to be strong. In Croatia, the monetary policy measures of early 2003 aimed at curbing credit growth proved very effective.

Even though the credit volume expanded, the share of *nonperforming loans*<sup>6</sup> in total claims continued to decrease in most countries in 2003 and the first half of 2004. In general, refined risk management procedures and the cleaning of banks' balance sheets (write-off or transfer of nonperforming loans in the course of bank consolidations) seem to have helped improve the portfolio quality over the recent years. Hungary was an exception to this trend as its share of bad loans rose slightly in the first half of 2004. This was traceable to a downgrade in the ratings of claims on the corporate sector and of external claims. In Poland, much of the credit for the reduction of the share of nonperforming claims was due to regulatory modifications, which became effective in early 2004 and brought an easing of especially strict provisions on the classification of loans and of the rules on loan loss provisioning as well as greater recognition of guarantees in the classification process. The improvement of the financial position of many companies helped by stepped-up economic growth and the

<sup>5</sup> This section reviews the development of the banking industry in Bulgaria, the Czech Republic, Hungary, Poland, Slovakia, Slovenia, Croatia and – with certain restrictions given data problems – Romania. The section "Financial Intermediaries in Austria" analyzes the development of all subsidiaries of Austrian banks established in these countries.

<sup>6</sup> Nonperforming loans are defined as "substandard," "doubtful" or "irrecoverable." The data do not lend themselves for a cross-country comparison given differences in the national classification systems and the breadth of coverage of claims.

pronounced decrease in real interest rates also contributed substantially to this development.

Even though the *open foreign currency positions* of Central and Eastern European banks are low,<sup>7</sup> the relatively high share of foreign currency loans to domestic companies and households (excluding general government and banks) involves credit risk. This is ascribable to the fact that households and part of the corporate sector are not in a position to hedge against a depreciation of the local currency against the borrowing currency. As at July 2004, the share of foreign currency loans (as a percentage of total loans extended to domestic enterprises and households) was highest in Romania and Bulgaria, standing at 59.6% and 46.9%, respectively, but it was also considerable in Hungary (36.2%), Slovenia (30.9%) and Poland (26.9%). Croatia posted the lowest share (9.6%) of foreign currency loans. Especially in Croatia, but also in Slovenia, the overall exchange rate-related credit risk is, however, higher, because part of the loans denominated in the local currency (about one third in Croatia) are indexed to the exchange rate. During the first seven months of 2004, the share of foreign currency loans continued to expand in Romania (+4.2 percentage points), Slovakia (+4.1 percentage points), Slovenia (+3.8 percentage points), Bulgaria (+3.6 percentage points) and Hungary (+2.5 percentage points). By contrast, it shrank in the Czech Republic (−0.6 percentage point) and

Poland (−4.7 percentage points), which, however, also partly reflects a valuation effect.

The *decrease in the corporate income tax rates* in Poland, Slovakia, the Czech Republic and Hungary as of the beginning of 2004 has been one of the most important cross-country determining factors in the banking sector and should have a positive impact on banks' net profits. In the Czech Republic, the second stage of a three-stage reduction of the corporate income tax rate will take effect at the beginning of 2005. By contrast, in Hungary the tax burden on financial institutions will rise temporarily in the years 2005 and 2006. Another common factor, the *liberalization of services* (and the single European passport in banking), presents the banks in the new EU Member States with both a risk (stiffening competition on the home market) and an opportunity (provision of services in other EU Member States).

#### **Largely Stable Profitability**

*Slovak banks* managed to further improve their return on equity in the first half of 2004. The increase in total operating income was mainly attributable to markedly higher noninterest income, while the cost/income ratio improved slightly as well. The release of provisions likewise contributed to the increase in income more strongly than in the first half of 2003.

The boost in the profitability of *Hungarian banks* in the first half of 2004 was above all attributable to the expanded loan volume amid high

<sup>7</sup> Official data on outstanding on-balance-sheet and off-balance-sheet positions show minor open positions for Bulgarian, Czech, Croatian, Hungarian and Polish banks (less than 1% of total assets except for Croatia, which has a long position of some 1.6% of total assets). Slovak banks posted an on-balance-sheet net short position of around 2% in March 2004, Slovenian banks an on-balance-sheet net short position of 1.3% at the end of 2003.

Table 5

## Return on Equity

	2001	2002	2003	Q1 03	H1 03	Q1 04	H1 04
	%						
<b>In Nominal Terms</b>							
Bulgaria	18.9	14.6	14.8	24.0	20.8	18.9	18.5
Croatia	6.6	13.7	14.5	18.8	17.9	..	..
Poland	12.1	5.8	6.2	11.2	9.9	17.1	17.1
Slovakia	21.3	30.1	28.1	32.9	30.9	29.2	33.7
Slovenia	4.8	13.3	12.6	..	14.0	..	14.8
Czech Republic	16.6	27.4	23.4	24.4	22.7	21.5	22.5
Hungary	16.0	16.1	18.7	22.1	21.9	23.1	25.9
<b>In Real Terms</b>							
Bulgaria	10.7	8.3	12.2	23.2	19.8	11.8	11.1
Croatia	1.5	11.8	12.5	16.7	15.9	..	..
Poland	6.5	3.8	5.5	10.7	9.5	15.0	14.1
Slovakia	13.1	25.7	18.1	23.6	21.6	19.4	23.7
Slovenia	-3.5	5.4	6.5	..	7.4	..	10.7
Czech Republic	11.6	25.6	23.5	25.1	23.2	19.1	19.9
Hungary	6.3	10.4	13.4	16.6	16.9	15.2	17.5

Source: National central banks.

Note: Slovenia: before taxes, all other countries: after taxes. Linear annualization was used for quarterly and semiannual data. Nominal yield adjusted for consumer price inflation (period average).

interest margins. Especially noninterest income (in particular income from fees and commissions) augmented, but net interest income (in % of average assets) improved on 2003, too. The perceptible reduction in the cost/income ratio also boosted the income position. On the other hand, the doubling of loan loss provisions diminished total operating income to a greater extent than in the first half of 2003, which is likely ascribable to the rise in the share of nonperforming claims.

In spite of the solid nominal growth in net income, *Czech banks* showed a slightly lower nominal return on equity compared with the first half of 2003. The reason for this was the even stronger growth in equity capital. The current operating result (in % of average assets) improved primarily on the back of increased net interest income. At the same time, operating expenses augmented at a slightly slower pace than the operating result, and the expenses for loan loss provisions (including the write-off of receivables and the costs

of the transfer of receivables) lessened as well relative to the first half of 2003.

*Polish banks* succeeded in substantially improving their year-on-year nominal return on equity in the first half of 2004. First, they posted higher net interest income, which had benefited from lower interest expenses to nonfinancial corporations and households, the reduction in minimum reserve requirements effective as of October 2003 and the remuneration of minimum reserves as of May 2004. Second, their cost/income ratio improved slightly as well. Third, the requirements for loan loss provisions were eased, which, together with the brighter economy, helped clearly reduce the actual loan loss provisions year on year.

In the first half of 2004, *Slovenian banks* recorded a slight year-on-year increase in the nominal return on equity. According to preliminary data, total operating income (in % of average assets) was still affected by the slide of net interest income observable already for some time. This was,



however, offset by gains in noninterest income so that the current operating income (in % of average assets) remained broadly unchanged year on year. The marked reduction in the cost/income ratio contributed to the improved result for the first half of 2004, whereas loan loss provisions (in % of the current operating income) were up somewhat on the first half of 2003.

In the first half of 2004, the nominal return on equity of *Bulgarian banks* trailed the corresponding 2003 figure. This deterioration is due to the fact that in the first half of 2003, the release of provisions had resulted

in a net increase of income, while in the first half of 2004, banks were saddled with net expenses for loan loss provisions. The current operating income (in % of average assets) improved, however, owing especially to the rise in (net) interest income. The robust expansion of loans and the increase in the net interest margin favored this development. Furthermore, noninterest income also augmented pronouncedly year on year. With operating expenses growing less than operating income, the income/cost ratio improved significantly, to boot.

Table 6

### Income and Expense Developments of the Banking Sectors up to the First Half of 2004

	2001	2002	2003	Q1 03	H1 03	Q1 04	H1 04
<i>As a percentage of average banking assets quarterly and semiannual data</i>							
<b>Net Interest Income</b>							
Bulgaria	4.2	3.9	4.7	4.4	4.6	4.7	4.9
Croatia	3.6	3.3	3.4	..	3.4	..	..
Poland	3.7	3.4	3.1	3.1	3.1	3.12	3.2
Slovakia	2.5	2.7	2.9	2.2	2.9	2.9	..
Slovenia	3.6	3.7	3.2	..	3.4	..	..
Czech Republic	2.5	2.4	2.1	2.1	2.1	2.2	2.2
Hungary	4.2	4.3	4.0	3.8	3.9	4.1	4.0
<i>As a percentage of current operating income</i>							
<b>Current Operating Expenses</b>							
Bulgaria	64.1	63.5	63.0	61.1	60.7	54.6	55.4
Croatia	65.6	59.3	57.3	..	54.5	..	..
Poland	62.4	63.5	68.6	65.5	66.4	65.3	64.8
Slovakia	65.7	57.9	64.6	56.7	58.9	55.0	56.6
Slovenia	65.2	59.7	62.5	..	63.1	..	57.8
Czech Republic	53.4	51.4	52.6	49.0	49.4	48.6	48.9
Hungary	66.7	64.7	60.1	56.3	57.6	50.2	49.8
<b>Net Change in Loan Loss Provisions</b>							
Bulgaria	-8.7	1.3	3.7	-19.3	-9.0	4.6	6.2
Croatia	13.7	6.6	7.0	..	8.6	..	..
Poland	18.9	22.9	15.1	11.9	11.2	2.9	7.1
Slovakia	-33.4	-9.8	-12.5	-5.1	-13.1	-23.0	-14.2
Slovenia	25.9	19.8	16.4	..	12.9	..	17.1
Czech Republic	22.8	9.3	0.8	18.6	16.1	13.5	11.1
Hungary	4.3	4.7	5.5	4.5	4.3	11.1	8.6

Source: National central banks

Note: The data are not comparable across countries. Linear annualization was used for subperiod data.

Stepped-up net interest income and an improved cost/income ratio helped boost the nominal return on

equity for *Croatian banks* in 2003. Less dynamic lending over the course of 2003 (no data available for the first



half of 2004), reduced noninterest income (even at current prices) and the slight increase in loan loss provisions (in % of the current operating income) kept a lid on the increase in the return on equity, though. In

2004, the continued decline in credit growth as of the beginning of the year and the tightening of the monetary policy stance as of July 2004 may adversely impact banks' profitability.