Economic Developments and Financial Markets

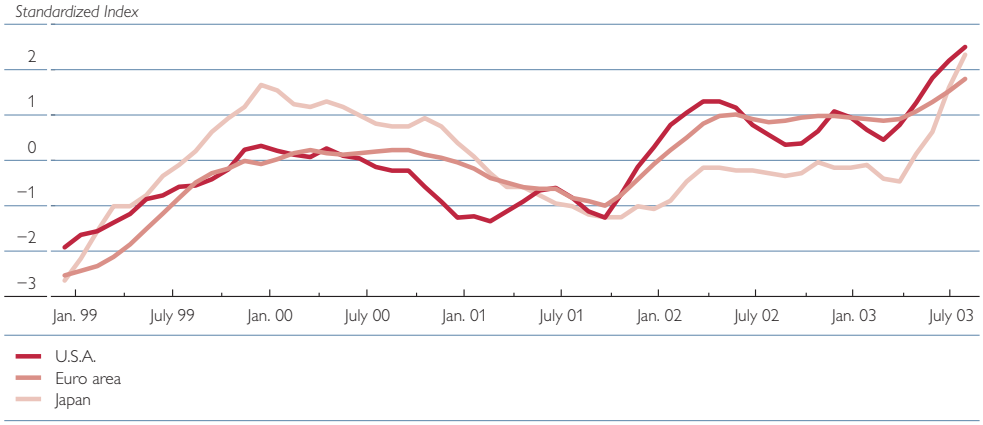
The U.S.A. Is Leading the Recovery of the Global Economy; Upswing in the Euro Area Is Relatively Weaker

The economy and the outlook for the coming quarters and 2004 have stabilized and clearly improved in the euro area, the U.S. and Japan after the negative economic effects triggered by a series of economic shocks put a damper on GDP growth in the three economic regions. In the euro area, the slowing dynamic of the economy continued in the months immediately after the end of the Iraq war, with private consumption acting as the only pillar of support. Exports decreased even further, with the appreciation of the euro in the past few quarters having apparently played a role in this development. Capital spending is still weak. However, the evidence of an economic upturn has been growing since the middle of the year. Surveys point to growing consumer and business confidence. The economy is expected to continue its recovery, albeit at a very moderate pace, for the remainder of 2003. In the U.S.A., robust consumer spending in conjunction with an increase in capital spending and a much higher level of public spending gave GDP a powerful boost in the second and third quarters. This trend seems to have been driven by the end of the uncertainties in connection with the Iraq war, the expansive monetary and fiscal policy, the firmer financial markets and the sustained high productivity growth. In Japan, the economy developed surprisingly well after the end of the Iraq war, with both exports and internal demand growing robustly. The latest surveys indicate that this development will continue in Japan in the second half of the year, which will be helped considerably by the accelerating U.S. economy.

Currently, a return of the economy in the euro area to potential output growth is to be expected in the second half of 2004. The reasons for the rather moderate recovery are to be found mainly in the continued restructuring of balance sheets in the business sector and in the appreciation of the euro. Like in the 1990s, the U.S.A. is expected to play the role of a global growth locomotive for the economy in 2004; its dynamic development will contribute to more robust economic growth in the euro

Chart 1

Development of the OECD Composite Leading Indicator



Source: OECD.

Table 1

Foreign Long-Term Portfolio Investments in U.S. Securities

	As at June 2002	Growth 2002	Annualized growth January to June 2003
	USD billion		
Euro area	912	13.9	60.1
United Kingdom	354	186.0	168.1
Japan	529	91.6	152.4
Asia excluding Japan	558	109.5	148.7
Other	1,573	146.3	246.0
Total	3,926	547.3	775.3

Source: U.S. Department of Treasury (TIC data), in-house calculations.

area and in Japan through positive effects on export demand, global financial markets and economic agents' confidence. However, this requires the transformation of the current recovery induced by an expansive monetary and fiscal policy into a self-sustaining upswing accompanied by rising private investment activity. U.S. and euro area inflation will remain subdued, above all because capacity utilization levels are currently low and unemployment rates are high, with the appreciation of the euro having the additional effect of dampening inflation in the euro area. For the year 2004, the inflation rate in the euro area is expected to stay below 2%. In Japan, the slight deflation will presumably continue in 2004 as well.

Nonetheless, the scenario of a global economic recovery starting out from the U.S.A. also carries certain risks. The volume of the current account deficit of the U.S. – frequently assessed as unsustainable (2002: USD 480.9 billion) and recently also pushed up by the sharply rising deficits in the U.S. federal government budget – could lead to a steep and rather disorderly correction of the U.S. dollar exchange rate. This could result in distortions on global financial markets and could also check global economic growth. The available data on international capital flows, which are currently serving to finance the deficit of the U.S. current account, indicate that a major portion of the financing has been coming from Asia up to now.[1])

Table 1 shows that during the first half-year 2003 persons residing in Asia invested an annualized total of USD 301.1 billion in long-term portfolio investments. Apart from the private capital flows, the exchange rate policies of a number of Asian central banks have been playing a role in this trend. These central banks contributed to financing the U.S. current account deficit by purchasing U.S. assets and until recently thereby prevented their currencies from appreciating against the U.S. dollar.

1 *When interpreting the data collected by the U.S. Department of the Treasury, one should take into account that the survey only records the residence of the initial buyer or holder. If said buyer is an intermediary with its registered office in an international financial center and acts on behalf of an investor resident in another country, this would lead to an overestimation of the financial contribution of the country in which the intermediary resides and to an underestimation of the financial contribution of the country in which the investor resides. For this reason it is necessary to exercise due caution when allocating the financing flows to regions. The system of capturing this data covers cross-border long-term portfolio investments in U.S. assets, i.e. shares in U.S. companies (excluding FDI) and bonds issued by entities resident in the U.S.A. with an original life of over 1 year.*

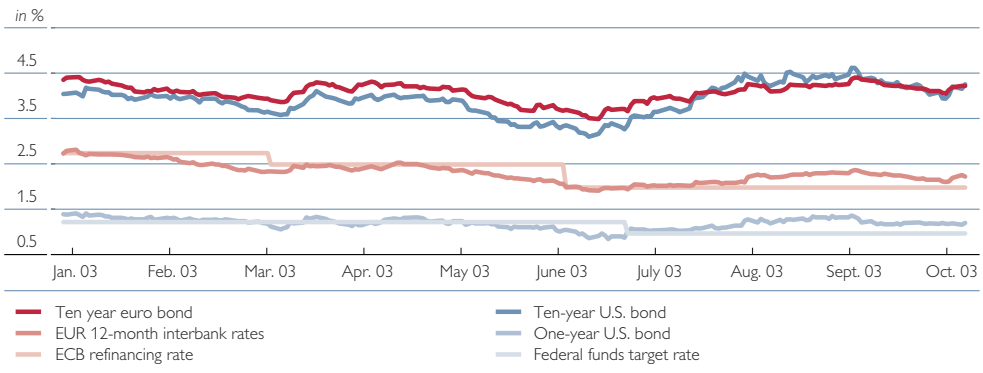
ECB and Fed Lower Interest Rates; Positive Expectations for Growth and Lower Risk Aversion Boost Global Financial Markets

The ECB lowered its key policy target rate by 50 basis points on June 5, 2003, and the Fed cut its federal funds rate by 25 basis points on June 25, 2003. According to the ECB Council, the interest rate cut to 2% took into account the improvement of the outlook for medium-term price stability as well as the downside risks for economic growth that prevailed at the time. The interest rate cut of the Fed to 1% was appropriate from the perspective of the Federal Open Market Committee (FOMC) as additional support for an accelerating U.S. economy, although it did point out – like it did in May 2003 – the low risk of an undesirable further decline of the inflation rate. In the following months, the Fed declared that it believed a continuation of its accommodative interest rate policy for a considerable period was feasible under these overall conditions. The Japanese central bank continued its zero-interest rate policy. The yield curve on the money market in the euro area and in the U.S.A. remained slightly inverted until mid-June and became increasingly steeper after the interest rate moves of the ECB and the Fed.

The yields on ten-year U.S. bonds dropped by around 70 basis points to a level of approximately 3.1% after the monetary policy statement of the Fed on May 6, 2003, which pointed out the low probability of an undesired further drop in inflation. This decline was widely attributed to speculations about possible future price-influencing interventions in the government bond market by the Fed (see box "On the Role of Announcements Effects in the Implementation of Monetary Policy – Latest Developments in the U.S.A."). After the interest rate cut by the Fed on June 25, these speculations quickly dissipated and were replaced in the bond markets by growing optimism about the economy after the release of positive economic data, which resulted in a steeper yield curve. Hedging transactions in connection with U.S. real estate financing deals reinforced the respective price trends on the U.S. bond markets. Yields in the euro area followed the lead of U.S. yields, but not fully. This caused yield spreads at the long end to widen from May to mid-June and to narrow again and reverse afterwards.

Chart 2

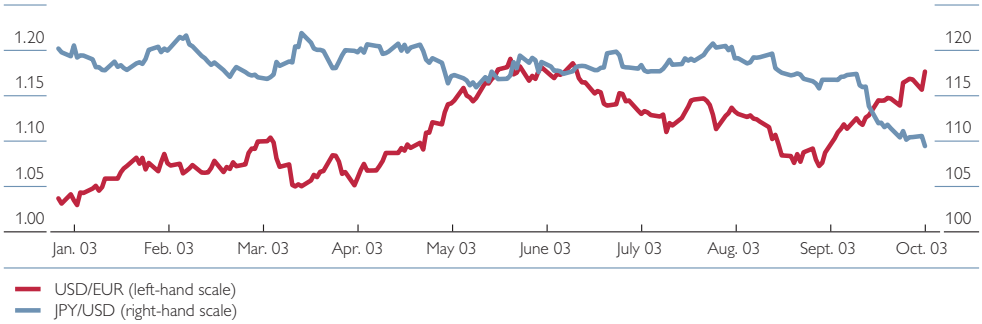
Interest Rates in the Euro Area and in the U.S.A.



Source: Thomson Datastream, Federal Reserve.

Chart 3

Exchange Rate Developments – Euro Area, U.S.A. and Japan



Source: Thomson Datastream.

Stock markets in the U.S.A., the euro area and in Japan rallied strongly from mid-March to mid-June 2003. A number of factors were responsible for this development: First, the end of the Iraq war led to a substantial decrease in risk aversion. Additionally, corporate earnings were surprisingly good, especially in the U.S.A. Finally, the decline of real interest rates on low-risk investments boosted stock markets as of the beginning of May 2003. The higher risk tolerance of investors was reflected not only in higher stock prices, but also in the further narrowing of risk premiums on corporate bonds of issuers with low credit ratings and emerging market bonds. As of mid-June, the rally slowed considerably, above all in the U.S.A., which was probably due in part to the resurgence of real yields on low-risk investments. The steep rise of Japanese stock markets was particularly remarkable, which, starting out from a very low level, clearly reflected the expectations of a global economic upswing.

On foreign exchange markets, the exchange rate of the U.S. dollar against the euro was very volatile after the end of the Iraq war, fluctuating between 1.08 and 1.19 USD/EUR. The exchange rate fluctuations often accompanied changes in yield spreads at the long end. Accordingly, the steep drop in yields in the U.S.A. from the beginning of May to mid-June 2003 was accompanied by the strong appreciation of the euro against the U.S. dollar. Afterwards the U.S. dollar firmed as a result of the improving economic outlook in the U.S.A. relative to the euro area.

There were also major changes in the exchange rate of the Japanese yen against the U.S. dollar. This exchange rate was, on average, at around 118.7 JPY/USD in the first half of 2003, with the Bank of Japan intervening on the foreign exchange market with a volume of approximately USD 120 billion to stabilize the currency and to delay the firming of the Japanese yen against the U.S. dollar. Around the time of the release of the closing communiqué of the G-7 on September 21, 2003, which contained a call for higher exchange rate flexibility based on market forces, the yen surged strongly and quickly against the U.S. dollar by some 7% as compared to the average of the first half-year. The euro also firmed against the U.S. currency after the G-7 meeting, which market experts attributed, among other things, to growing worries about financing the U.S. current

account deficit and to the persistent weakness of the U.S. labor market. The euro also weakened slightly against the Japanese yen. In the weeks that followed the release of the closing communiqué of the G-7, market sentiment on foreign exchange markets was rather volatile and nervous in the major currency pairs. The Swiss franc lost almost 5.5% on the euro from the beginning of April through mid-June 2003 and has been stable ever since in a bandwidth between 1.53 and 1.55 SFR/EUR. The weakening is probably related to the diminishing risk aversion on international financial markets. Thus, the Swiss franc is only 4% below the level it had when the euro was introduced.

On the Role of Announcements Effects in the Implementation of Monetary Policy – Latest Developments in the U.S.A.

On May 6, 2003, the Federal Reserve published the regular press release on its monetary policy decision. The press release pointed out that the risks to economic growth were balanced, while there was a low probability of an unwelcome further drop in inflation. This press release came at a time at which financial markets and economic policymakers were discussing the extent of the risk of deflation in the U.S.A. and the adequate economic policy response. Highly topical was the subject of maintaining the effectiveness of monetary policy by taking extraordinary monetary measures even when short-term rates were already at zero. Below is a brief look at one of the proposed extraordinary measures, namely the direct steering of long-term U.S. interest rates through monetary policy measures.

U.S. monetary policy is pursued through open market operations, which concentrate on buying and selling securities (mainly U.S. government bonds) on the primary and secondary markets to control the liquidity of the U.S. banking system in such a way as to keep the market interest rate for overnight loans between banks, the so-called federal funds rate, as close as possible to the target rate defined by the Federal Open Market Committee (FOMC), namely the federal funds target rate. These operations are carried out in accordance with a number of principles, the most important of which being the avoidance of influence on the prices of long-term bonds (market neutrality). This means that the direct influence on interest rates is only on overnight rates, while the long-term interest rates are determined exclusively by market forces. Nevertheless, the Federal Reserve System in principle has the possibility of suspending this principle and using its portfolio to influence long-term interest rates as well.[1])

The sharp decline in long-term interest rates after May 5, 2003, and the assessment of market participants illustrates that the statement of the Fed was interpreted as an announcement of the significant possibility of future interventions by the Fed to influence prices on the market for long-term U.S. government bonds. This expectation disappeared with the lower-than-expected interest rate cut of June 25, as did the financial markets' deflation fears, giving way to growing optimism about the economy as of mid-June.

The next press releases of the Fed on monetary policy decisions on August 12, September 16 and October 28 stated that under the given macroeconomic conditions, the accommodating interest rate policy of the Fed would be likely to be maintained for a considerable length of time. This type of announcement theoretically also has an influence on long-term interest rates. The effect, also known as the policy duration effect, influences developments through the expectations theory of the term structure of interest rates; the credible assurance that short-term interest rates will be kept low in the future can lead to lower long-term interest rates. The Japanese central bank's monetary policy since April 1999 is a case in point: the assurance of keeping short-term interest rates at zero as long as deflation prevails resulted in a significant decline in long-term interest rates in Japan.

1 *There is a historic example for this type of policy at the Fed. After the U.S.A. entered World War II, the Fed took over the obligation to keep the yields of long-term government bonds at a level of 2½%. This obligation was observed until the so-called Treasury-Federal Reserve Accord of March 4, 1951. This agreement released the Federal Reserve from the obligation to support the market for U.S. government debt at pegged prices and made possible the independent conduct of monetary policy.*

Central and Eastern Europe

High Returns on Bulgarian, Romanian and Russian Eurobonds

The development of yield spreads of U.S. dollar- and euro-denominated government bonds of emerging countries against the benchmark bonds of the U.S.A. and the euro area was very good this year: The average yield premium in U.S. dollars (J. P. Morgan's EMBI Global index) narrowed by 239 basis points to 486 basis points in the first nine months of the year, with the downtrend having flattened noticeably since mid-May. The spread in euro dropped by 200 basis points to 232 basis points until the end of September.

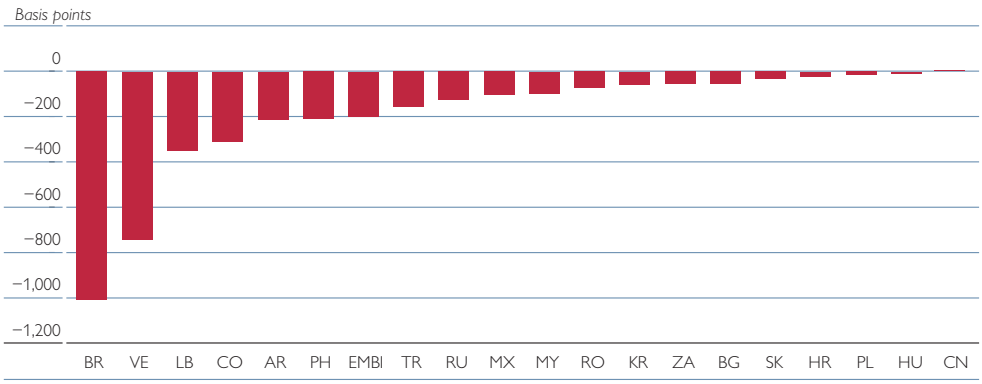
However, these average changes veil the differences between the individual issuers. Thus, the yield spread of Brazilian and Venezuelan government bonds in euro narrowed by 1,000 and 750 basis points, respectively, which is far above average. The yield spreads of bonds of Central and Eastern European (CEE) issuers changed only slightly in contrast.

Russia's yield spread diminished from 270 basis points to 100 basis points in the first half of 2003. The fundamental economic data of the country and the outlook of a higher rating encouraged this trend despite the decline in the oil price, which is important for the country. At mid-year, spreads widened to 150 basis points, reflecting the political uncertainty before the upcoming parliamentary elections in December (the communists achieved good ratings in surveys; the Yukos affair[1]) made investors wary). When Moody's Investors Service raised the rating of Russia's long-term debt denominated in foreign currency at the beginning of October 2003 to investment grade (Baa3), spreads narrowed quickly to around 115 basis points by mid-October. Near the end of October, yield spreads widened again to around 140 basis points as a reaction to the culmination of the Yukos affair.

The second-largest drop among the CEE countries was in Romania, where spreads diminished by 72 basis points (to 214 basis points). Solid fundamental data, progress in EU accession negotiations, political stability and good cooperation with the IMF are a favorable setting. This picture is completed by the rating improve-

Chart 4

Change in Euro EMBI Global Spreads (January to September 2003)

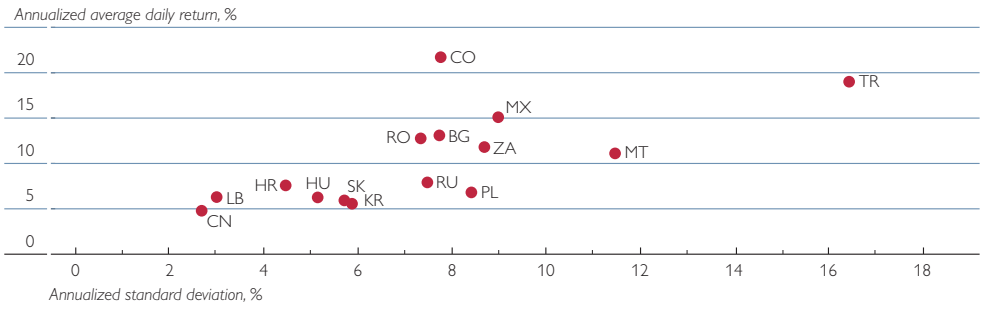


Source: Bloomberg.

1 *The authorities seized most of the stock of Yukos oil company after the arrest of its CEO.*

Chart 5

Euro EMBI Global: Risk/Return Ratio (January to September 2003)



Source: Bloomberg.

Note: The risk-return graph puts the realized return from a financial position during a specified period of time in relation to the associated risk. The return is measured by the average daily change in the value of the position, and the risk is measured by the standard deviation of these changes. Here, higher values on the x axis represent greater risk. Higher values on the y axis represent a higher return. To ensure that the values are comparable for observation periods of different length, the return and risk measures are annualized.

ments and the expectation of further upgrades. Bulgaria's yield spread decreased by 54 basis points (to 195 basis points). Higher ratings in May and June, 2003, and the provisional conclusion of two negotiation chapters with the EU encouraged this development. However, political uncertainties (the finance minister's resignation threat, the governing parties' loss of popularity) and a negative trend in the current account prevented a stronger spread narrowing. Yield spreads in Slovakia decreased by 30 basis points to 19 basis points, those in Croatia shrank by 20 basis points to 105 basis points. The upcoming parliamentary elections in conjunction with the deterioration of the trade balance and the substantial increase in foreign debt make it unlikely that we will see a further spread narrowing soon in Croatia. In Slovakia, it seems as if there is hardly any more room for a narrowing from the current spread level, despite the improving external fundamental data. Poland and Hungary are at the bottom of the list, posting a decline in yield spreads by 16 basis points and 7 basis points (to 67 basis points and 30 basis points).

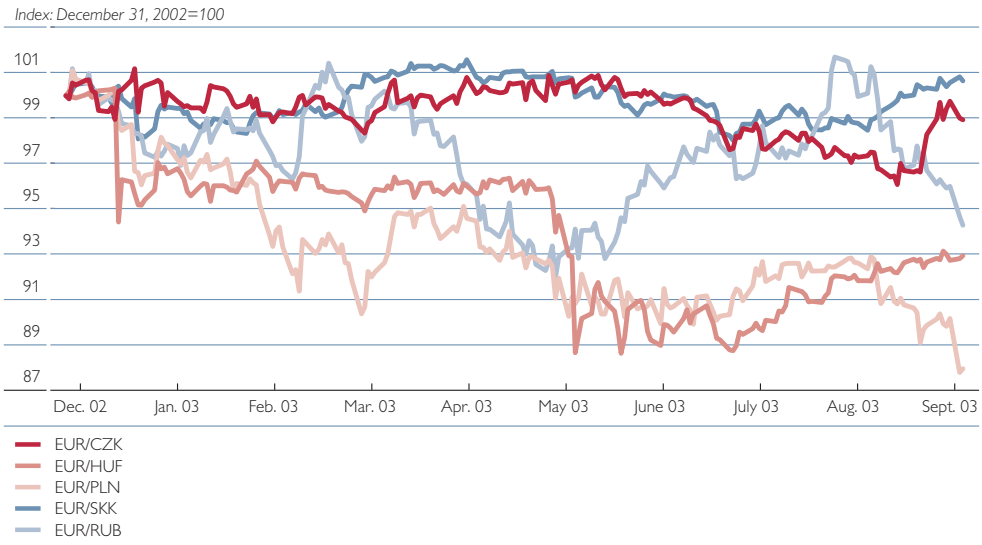
Exchange Rate Trends

With the exception of the Hungarian forint, the Polish zloty, the Russian ruble and the Romanian leu, the most important CEE currencies fluctuated only moderately against the euro (between a loss in value of 1.6% and a gain of 0.7%. In contrast, the cumulative losses of the Hungarian forint and the Polish zloty are around 7.4% and 12.7%, and 6% for the Russian ruble.

In Poland and Slovakia, the development of the current account was positive. In Poland (deficit in 2002: 3.5% of GDP) the deficit decreased in the first eight months of 2003 by 40% against the like period of the previous year (which was favorably influenced by the weakening of the currency). In Slovakia, (2002: deficit 8.2%) the deficit was 80% lower at mid-year 2003 than one year ago, and the latest trade balance data lead us to expect this trend to continue. Moreover, over 60% of the deficit in Poland was financed by direct investments, while in Slovakia inward foreign direct investment (FDI) flows were almost three times as high as the deficit.

Chart 6

Exchange Rate: Euro per Unit of National Currency



Source: Bloomberg.

In the Czech Republic (2002: deficit 6.5%) the deficit for the first half-year 2003 was slightly lower than in the first half-year 2002 despite a marked deterioration in the second quarter. Although the FDI inflows slowed down, they were high enough to finance the deficit. In Slovenia (2002: surplus 1.7%) the current account slid into deficit in the first seven months, and FDI also posted a net loss. Currently, the size of the gap (about 0.2% of the estimated full year GDP) is still very low. By contrast, in Croatia (2002: deficit 6.9%) and Hungary (2002: deficit 4%), the significant deterioration resulted in a considerable current account deficit. After the Cro-

Chart 7

Exchange Rate against the Euro: Risk/Return Ratio

(January to September 2003)

Source: Bloomberg.
Note: See note in chart 5. Here, greater values on the y axis indicate larger increases in the exchange rate per unit of euro and hence a bigger depreciation of the individual currencies.

atian current account deficit remained at the previous year's level in the first quarter of 2003, it has been widening steadily ever since and in the light of the moderate growth of the number of overnight stays by foreign tourists, it will probably also feed into a widening of the current account. In Hungary, the current account posted a deficit for the first seven months of 2003 which was as high as in the full year 2002 (EUR 2.7 billion), while inward FDI flows only amounted to a meager EUR 150 million.

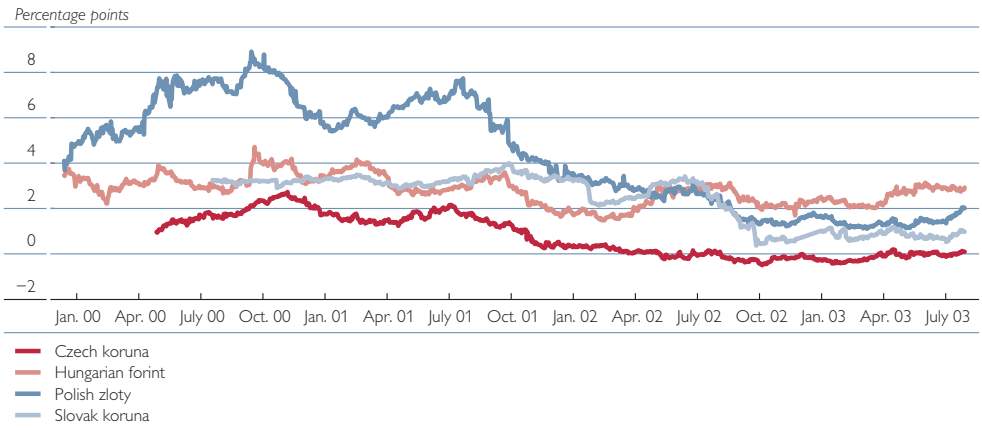
Portfolio capital flows painted a mixed picture. In Croatia and Poland, the Eurobond issues have contributed enormously to raising net income, while in Hungary and Slovakia new issues are used to refinance other issues falling due.

In the Czech Republic and in Poland, we saw net portfolio capital outflows (diminishing inflows, rising outflows) for debt securities. The drop in the yield spread against the euro area probably contributed to this development. Thus, the Czech central bank has reduced its 14-day rate sterilization rate by 75 basis points to 2% since the beginning of the year to prevent a renewed excessive appreciation of the currency. The Polish central bank lowered its key lending rate (14-day sterilization rate) in six steps from 6.75% to 5.25% in response to the favorable inflation environment. In Hungary, the capital inflows into the domestic government bond market developed largely parallel to exchange rate trends. The high yield spread since June as a result of the interest rate hike of 300 basis points revived inflows, and the stock of securities held by foreigners broke a new record by mid-September. However, the higher dependence on portfolio capital is a risk unless the economic data improve. In this context, it remains to be seen if currency developments will follow a separate path in the long run if capital outflows from the bond market, which began in the second half of September, continue. The Slovak central bank lowered its key lending rate by 25 basis points to 6.25% at the end of September. The principal motivation for this move was much slower domestic demand and the ensuing rise in net exports since the beginning of the year, the resulting appreciation pressure on the currency and the expectation that at the end of 2003, the core inflation rate would stay in the lower range of the bandwidth (2.4% to 5.0%) despite the rising overall inflation (around 9%). Finally, in this context we would also like to point out the addition of a five-year bond to the Slovene fixed-coupon tolar-denominated yield curve since March 2003 and also to the issue of a Croatian five-year fixed-coupon kuna-denominated government bond in May, which has opened up new opportunities for foreign investors.

Finally, we would like to stress the effects of the exchange rate of the U.S. dollar against the euro on the development of individual CEE currencies' exchange rates against the euro. Especially in the case of the Polish zloty, this influence appears to have been declining: Here, it seems as if the influence of the U.S. dollar is becoming less related to its former share in the basket of currencies (45%). The development in 2003 of the Russian ruble against the euro (weakening in the second quarter, firming thereafter) was again determined mainly by the trend of the U.S. dollar's exchange rate against the euro. Compared to its reference currency, the U.S. dollar, the ruble strengthened

Chart 8

Yield Spreads to Euro Benchmark Bonds



Source: Bloomberg.

steadily until mid-2003 before it fell slightly from the end of August.

Local Currency Government Bonds

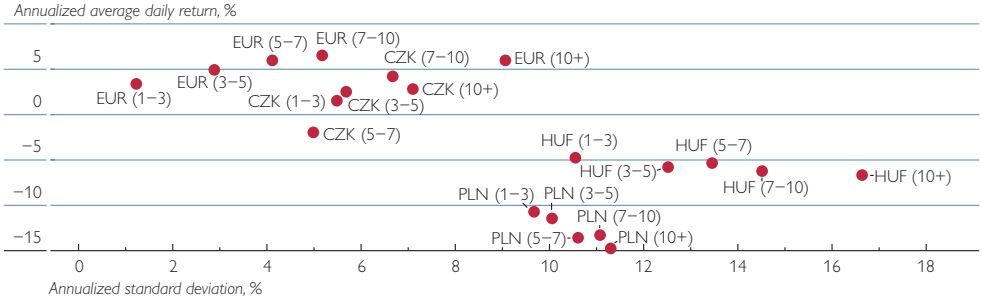
The yields of government bonds in local currency have posted rises of over 100 basis points in the Czech Republic, Hungary, Poland and Slovakia since the beginning of 2003 (with the exception of Czech and Polish short-term bonds). This was due in part to yield rises in the euro area. Country-specific factors played a great role and gave rise to partly divergent developments of the individual yield spreads against the euro.

At the short end of the yield curve, the divergent inflation trends in each country led to different developments of official interest rates and money market rates. At the long end, the movements were generally not as pronounced. In part, the development of inflation benefited bond prices (Czech koruna, Polish zloty), and in part, it was also responsible for the rise in yield spreads against euro benchmark bonds (Hungarian forint, Slovak koruna). While the direction of the change in Hungarian yield spreads was determined by the course of inflation, the extent of the

Chart 9

Local Currency Bonds: Risk/Return Ratio in Euro

(January to September 2003)



Source: Bloomberg.
Note: The figures in brackets indicate the maturity of the government bonds denominated in the currency concerned.

movements was strongly influenced by the interest rate hikes of the central bank. In Slovakia in contrast, the moderate course of core inflation seems to have had a dampening effect on spread widening.

In the Czech Republic and in Poland the yield curves have become steeper since the beginning of 2003 in comparison to the euro yield curve. In Hungary, by contrast, the spread curve flattened in mid-2003 in the wake of the massive interest rate hike. However, the narrowing yield spreads against the euro at the short end at almost constant yield spreads at the long end have resulted in a steeper spread curve since then. Fiscal policy uncertainties played a role in these movements. Thus, for example, the Czech yield curve (in the ten-year and two-year segments) is currently around 15 basis points to 20 basis points steeper than the euro yield curve, and the negative yield spreads against the euro in the ten-year and fifteen-year segments have been replaced by positive spreads of 20 basis points to 40 basis points. According to surveys, market participants expect the Czech koruna to appreciate against the euro in the next few years, so that the fiscal policy risk remains an explanation for this spread. Various factors contributed to the steeper Polish yield curve. At the short end, the firming of the economy, higher inflation expectations, subdued interest rate cut expectations and the announcement of a higher budget deficit in 2004 seem to have been decisive for the wider spreads. The impact of higher inflationary expectations and of the announcement of a rise in the budget deficit in 2004 was stronger on spreads at the long end of the yield curve. In Hungary, the high interest rate and yield spreads livened up capital inflows in the past few weeks. However, moderate decreases among yield spreads were seen only in the short maturity segments, while the spreads in the ten-year range remained steady at almost 300 basis points. The expectation that the deficit targets would be exceeded together with a still adverse trend in the current account were probably the decisive factors.

Turning to expectations, we would like to point out the common risk factors of the four markets. We expect inflation to rise next year in the Czech Republic, Hungary and Poland. In the first two countries, this would be due to temporary one-time effects, but we cannot rule out an impact on interest rate levels. As the latest developments have shown, bond markets also remain sensitive to budgetary developments. Apart from the implications of the budget deficits on the issuing volumes of government bonds, fiscal policy is important also because it may influence market expectations about the date of the introduction of the euro.

The Banking Sector in Central Europe[1])

Operating Performance and Profit Developments

With the exception of Poland and Hungary, the banks in Central Europe (CEE EU accession countries and Croatia) succeeded in raising return on equity from 2001 to 2002 despite

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.*

Table 2a

Nominal Return on Equity

	2000	2001	2002	Q1 02	H1 02	Q1 03	H1 03
	%						
Croatia	10.7	6.6	13.7	..	20.4	18.8	..
Poland	14.5	12.8	5.3	14.5	8.7	11.1	10.3
Slovak Republic	25.4	20.8	30.1	32.9	28.8	32.5	..
Slovenia	11.3	4.8	13.3	..	18.4	..	..
Czech Republic	13.0	16.5	25.4	33.1	29.5	24.6	23.5
Hungary	12.5	16.2	15.4	..	17.3	..	..

Source: National central banks, OeNB.

Table 2b

Real Return on Equity

	2000	2001	2002	Q1 02	H1 02	Q1 03	H1 03
	%						
Croatia	4.2	1.6	11.2	..	17.4	16.9	..
Poland	4.0	6.9	3.3	10.7	5.7	10.5	..
Slovak Republic	11.8	12.8	25.9	27.0	23.9	23.1	..
Slovenia	2.2	−3.4	5.4	..	9.8	..	..
Czech Republic	8.7	11.3	23.1	28.3	25.7	25.1	23.7
Hungary	2.5	6.4	9.6	..	10.8	..	..

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

the adverse economic environment. The Czech Republic and Slovakia topped the list with a return on equity of around 25% and 30%, respectively. In Poland, by contrast, the situation worsened compared to the previous year, and it is still unclear whether the data for the first quarter of 2003 are already signaling a trend reversal. Thanks to declining inflation rates, all countries reported an improvement of real (adjusted for consumer price inflation) earnings last year (except for Poland). Only the rise in inflation in Slovakia led to a slight decline in real return of equity in the first quarter of 2003.[1])

In Poland the nominal return on equity dropped by half in 2002, which is grounded primarily on the weakness of the real economy. The adverse economic environment is reflected in decreasing net interest income (as a percentage of average banking assets) and in a further rise in the share of bad loans in total loans (from 18.6% at the end of 2001 to 22.3% at the end of March 2003). In conjunction with this rise, expenses for loan loss provisions also augmented. Only at the beginning of 2003 did the ratio of these expenses to operating income drop in comparison to the like period of the previous year. However, this was not enough to improve the return on equity despite the unchanged net interest income, as the cost-to-income ratio deteriorated even further. Provisions covered 47% of bad loans[2]) as of the end of the first quarter 2003, which is a slightly worse level than at the end of 2001 (53%).

In the Czech Republic, return on equity 2002 was up from 2001. The data for the first half of 2003 reveal a deterioration, with a decline in the return on equity to 23.5% from almost 30% in the like period of the

1 *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.*
2 *Bad loans are defined as "substandard", "doubtful" or "irrecoverable."*

Table 3a

Net Interest Income

	2000	2001	2002	Q1 02	H1 02	Q1 03	H1 03
	% of annual average bank assets						
Croatia	4.2	3.6	3.3	..	3.2	..	..
Poland	4.0	3.5	3.3	3.0	3.1	3.0	3.0
Slovak Republic	2.3	2.5	2.7	2.5	2.6	2.2	..
Slovenia	4.7	3.6	3.7	..	3.7	..	..
Czech Republic	2.5	2.5	2.4	2.4	2.5	2.1	2.1
Hungary	3.6	3.7	3.6	..	3.5	..	..

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

Table 3b

Current Operating Costs

	2000	2001	2002	Q1 02	H1 02	Q1 03	H1 03
	% of current operating revenues						
Croatia	56.7	65.6	59.3	..	59.1	..	..
Poland	65.5	65.2	67.6	63.3	60.7	69.9	..
Slovak Republic	67.7	65.7	57.9	58.3	58.8	56.7	58.9
Slovenia	55.3	65.2	59.6	..	56.3	..	..
Czech Republic	53.9	53.4	51.4	48.0	48.8	49.0	49.4
Hungary	73.3	64.8	66.0	..	66.3	..	..

Source: National central banks, OeNB.

Table 3c

Net Changes in Loan Loss Provisions

	2000	2001	2002	Q1 02	H1 02	Q1 03	H1 03
	% of current operating revenues						
Croatia	20.6	13.7	6.6	..	−0.4	..	..
Poland	16.3	18.9	21.0	14.6	19.2	10.4	..
Slovak Republic	−17.1	−33.4	−9.8	−9.7	−6.4	−5.1	−13.1
Slovenia	23.9	25.9	19.7	..	12.2	..	..
Czech Republic	68.5	22.8	11.6	12.5	13.8	18.6	16.1
Hungary	0.9	7.0	4.9	..	2.1	..	..

Source: National central banks, OeNB.

previous year. This development may be attributed largely to a decreasing tendency in net interest income (as a percentage of average banking assets) which could not be compensated by higher noninterest income. The ratio of administrative costs to operating income remained almost 50%. After a substantial decline in expenses for loan loss provisions (including the writeoff of receivables and the costs of assigning receivables) in 2002, expenses in this area climbed again in the first half of 2003. By mid-2003, the share of bad loans (in total loans) had dropped to 6.5%, which is reduction by half since the end of 2001. As provisions were not released in the same amount, about 90% of the bad loans are covered by provisions.

The situation of Hungarian banks remained stable in 2002. The banking system posted a slight decline in return on equity to 15.4% (2001: 16.2%). The reason for the drop was the slight deterioration of both net interest income and noninterest income (as a percentage of average banking assets), but administrative expenses also rose somewhat faster than operating income. Expenses for loan loss provisions were reduced, while the share of bad loans remained stable at around 7% (all receivables).

In Slovakia, return on equity improved (from 20.8% to 32.5%) in 2002 thanks in part to higher net interest income (in percent of assets). The release of loan loss provisions also contributed to total income, although to a lesser extent than in 2001, when recapitalization and privatization helped achieve record levels. This factor was decisive, especially in the first half of 2003, considering that net interest income at the beginning of the year had posted a sharp drop. The cost-to-income ratio improved in 2002 and dropped from almost 66% in 2001 to 58% in 2002. The share of bad loans was reduced even further (11.7% at the end of March), with provisions covering more than 80% of these loans.

The return on equity of Slovene banks improved substantially in 2002 (from 4.8% to 13.3%). The ratio of net interest income to average assets rose slightly to 3.7%. Moreover, noninterest income was higher, and expenses for loan loss provisions were lower than in 2001. The cost-to-income ratio improved. Furthermore, changes in legal provisions contributed to improving return on equity, as equity capital no longer had to be indexed to inflation. The share of bad loans remained low at 7% and up to 90% are covered by provisions.

In Croatia, the return on equity of banks also shot up, doubling to 13.7% in 2002. This increase was driven by a rise in noninterest income, the reduction by half of the required provisions for bad loans and the improvement of the cost-to-income ratio. Net interest income was somewhat lower than in 2002. Bad loans amounted to 5.9% of total loans at the end of 2002 (2001: 7.3%), and there are enough provisions to cover these (approximately 85%).

Capital Adequacy

Capital adequacy (the ratio of equity to risk-weighted assets) was satisfactory at the end of 2002 in all six countries reviewed, with double-digit percentages of between 11.9% (Slovenia) and 21.3% (Slovakia). The slight drop in the capital adequacy ratio in four of the six countries is due partly to changes in legislation, which, among other things, have enlarged the scope for depreciation (Poland, Czech Republic) or called for higher capital requirements. Further reasons are the reappraisal of asset items (e.g. stock holdings) and the failure of capital growth to keep up with the rapid rise in risk-weighted assets (Hungary, Croatia). The improvement of capital adequacy in the Slovak banking system can be explained by the rapid growth of regulatory capital.

Table 4

Capital Adequacy

	2000	2001	2002	Q1 02	H1 02	Q1 03	H1 03
	Ratio of equity to risk-weighted assets, %						
Croatia	21.3	18.5	17.2	17.1	17.5	16.6	..
Poland	12.9	15.1	14.2	14.0	13.7	13.1	13.3
Slovak Republic	12.5	19.8	21.3	19.9	21.0	21.4	..
Slovenia	13.5	11.9	11.9	..	11.4	..	..
Czech Republic	14.9	15.5	14.2	15.0	15.6	14.1	15.7
Hungary	15.2	13.9	12.5	..	12.5	..	..

Source: National central banks, OeNB.

Banking in Romania: On the Catching-Up Route

Compared to other countries, the Romanian banking sector is small and not very developed. Total banking sector assets amount to about a third of GDP; in central European countries the respective average ratio comes to about 70%, in the euro area it reaches 260% of GDP. Throughout the 1990s, the Romanian banking sector was plagued by sluggish restructuring of the real sector, stop-and-go macroeconomic policies, weak supervision and adverse external conditions. Only after a severe economic slump (1997–99), an overhaul of banking legislation and a major clearing up effort entailing the bankruptcy of a relatively large bank and a number of small banks did the situation stabilize. Confidence slowly rose and credit institutions expanded their activities.

Total banking sector assets grew from 29.2% of GDP in 2000 to 31.6% in 2002. Loans to enterprises correspondingly rose from 9.4% to 11.9% of GDP. The year 2002 witnessed a real credit expansion to the enterprise sector of 30%, which accelerated to about 40% in the first eight months of 2003. The speed of the credit expansion gave rise to concern on the part of the central bank (Banca Naţională a României – BNR) and the IMF. The maturity structure of loans moved from predominantly short-term (i.e. below one year) to medium-term. Consumer credits, notably mortgage loans, multiplied, but from a very low starting point. Credits denominated in foreign currency expanded particularly strongly, enhancing imports. The BNR took measures to rein in credit growth, e.g. in the third quarter of 2003 the benchmark overnight deposit rate was hiked by 200 basis points to 20.25%.

While foreign-owned banks have steadily gained importance in Romania and now dominate the sector, state-owned credit institutions still play a more important role than they do in most other neighboring countries. As of July 2003, three banks (of a total of 38 banks or 39% of total banking assets) were still in majority state ownership, the two largest of which are Banca Comercială Română (BCR) and Casa de Economii si Consemnatiuni (Savings Bank). 29 credit institutions (or 57% of total banking assets) were owned by foreigners. The largest are Banca Romana pentru Dezvoltare (Romanian Development Bank, owned by Société Générale), ABN Amro Bank and Raiffeisen Bank. As regards registered statutory capital, Austrian banks are leading among foreign banks, followed by Greek and French banks. Six banks (only 4% of total banking assets) are in domestic private hands.

The BNR has been striving lately to further improve banking supervision practices. In January 2003 loan classification and loss provisioning rules were tightened. Due to increasing competition, interest rate spreads have been declining, but they are still high (July 2003: 14.5%). Banks' liquidity is generally satisfactory; profitability has been on a rising trend, though most recently it declined, due to the narrowing of spreads. In May 2003, the overall capital adequacy ratio was measured at the very favorable level of 23%. The share of non-performing loans in total loans reached 11% in June. The authorities intend to come into compliance with IAS in 2005. If framework conditions do further adjust, there remains ample growth potential for the Romanian banking sector in the medium and long term. But major shortcomings still need to be addressed, including banks' insufficient risk analysis and management capacities, weak corporate governance, continuing limited contract enforcement capacities, weak creditor protection, sprawling bureaucracy, corruption.