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Stability and Security.

F O C U S O N
E U R O P E A N E C O N O M I C
I N T E G R A T I O N

This Issue's Special Focus:
Financial Development and Integration



E U R O S Y S T E M

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Editors in chief

Peter Mooslechner, Doris Ritzberger-Grünwald

Scientific coordinator

Jarko Fidrmuc

Editorial processing

Jennifer Gredler, Ingrid Haussteiner, Rena Mühlhof, Ingeborg Schuch, Susanne Steinacher

Technical production

*Peter Buchegger (design)
OeNB Printing Office (layout, typesetting, printing and production)*

Inquiries

*Oesterreichische Nationalbank, Secretariat of the Governing Board and Public Relations
Postal address: PO Box 61, AT 1011 Vienna
Phone: (+43-1) 404 20-6666
Fax: (+43-1) 404 20-6698
E-mail: oenb.info@oenb.at*

Orders/address management

*Oesterreichische Nationalbank, Documentation Management and Communications Services
Postal address: PO Box 61, AT 1011 Vienna
Phone: (+43-1) 404 20-2345
Fax: (+43-1) 404 20-2398
E-mail: oenb.publikationen@oenb.at*

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The views expressed are those of the authors and need not necessarily coincide with the views of the Oesterreichische Nationalbank.

Dear reader,

The economic links between East and West have been strengthening continuously since the borders have been opened up. Although we may identify links in numerous economic fields – the trade of goods and services, foreign direct investment (FDI) and the labor market – from a central banker’s view, financial links may well be the most interesting and important ones.

Austria’s banking sector is a frontrunner in reinforcing financial ties with the East. Building on high trade shares and FDI, this sector has invested quite heavily in the region. As a result, Austria’s banks are not only represented in nearly every country in Eastern Europe, very often they are main shareholders, owners or investors. The developments of recent months have shown that this process is still well underway. In fact, Austrian banks made several key investments during the summer months, e.g. in Ukraine. Hence, the financial analysis of the region is highly interesting not just from an economic but also from a financial stability perspective.

Such analyses benefit not only the Oesterreichische Nationalbank (OeNB). Closely monitoring financial markets in Eastern Europe is also crucial from a European perspective. Convergence issues, the identification of the factors driving real growth, the significance of foreign ownership and the possible risks of high credit growth rates all have a broad impact on European developments. These considerations lie at the heart of the choice of the topic of this year’s OeNB Conference on European Economic Integration, which will be organized jointly with the European Central Bank (ECB) and the Center for Financial Studies, namely financial development, integration and stability in Central, Eastern and Southeastern Europe. In the runup to this event, the OeNB has intensified the relevant research, culminating in this special issue of Focus on European Economic Integration, which takes a close look at financial developments and integration and which will be available for the conference.

In his study on banking in ten countries in Central and Eastern Europe since 2000, Stephan Barisitz analyzes recent structural changes and modernization in an environment of generally strong growth. He draws the following conclusions: Selling banks to foreign strategic investors has paid off in most cases. The continued swift dissemination of IT and e-banking may help reconcile the seeming paradox of simultaneous “overbanking” and “underbanking” in the region. The near-ubiquitous credit boom, while embodying a welcome structural catching-up process, is not without risks, cautions the author, and has not yet been fully brought under control.

The study written jointly by Peter Backé and Tina Zumer (ECB) sheds more light on this credit boom. The authors review private sector credit developments in Central and Eastern European EU Member States. The analysis shows that lending to the private sector has grown dynamically in most but not all countries under review, that loans to households have risen dynamically in all countries, and that foreign currency lending has been sizeable. Macroeconomic stabilization, comprehensive reforms and privatization in the financial sector as well as the introduction of market institutions and legal reforms have promoted

credit growth. The authors point out that fast and persistent private sector credit growth frequently goes hand in hand with high current account deficits, necessitating action to keep macroeconomic vulnerabilities in check.

Tamás Mágel provides insights into the role of Austrian credit institutions in banking sector developments in Bosnia and Herzegovina. The author describes the institutional and macroeconomic background, ownership structures and concentration in the banking sector, the degree of financial intermediation, the structure of the aggregated balance sheet, the role of foreign exchange and the development of capital adequacy and profitability. The author finds that macroeconomic stabilization and the market entry of foreign banks has supported the reform process in the banking sector and has helped deepen financial intermediation while leading to a relatively high concentration of banking sector assets.

The contribution by Markus Arpa, Thomas Reininger and Zoltan Walko examines whether Central and Eastern Europe will ever catch up with the euro area in terms of banking intermediation. The authors use the private credit flow-to-GDP ratio, a flow-flow measure that complements the widely used stock-flow measure, to gauge and compare the degree of banking intermediation. The authors ascertain that, based on the flow-flow measure, the current degree of banking intermediation in most Central and Eastern European countries is significantly closer to the euro area average than suggested by the traditional stock-flow measure. Furthermore, the authors analyze the implications of the different concepts of convergence for the degree of banking intermediation. Drawing on the experience of major catching-up economies in the past 50 years worldwide, the authors tend to take a rather skeptical view on the possibility of realizing a flow-flow ratio that would be high enough to produce simultaneous convergence in the stock-flow ratio and in per capita income levels while not ruling out this possibility completely.

In the last special focus study, Ingrid Ettl and Alexandra Schober-Rhomberg take a closer look at the implementation of the Basel Core Principles in selected countries from the perspective of the International Monetary Fund (IMF). They base their analysis on the Financial System Stability Assessments (FSSAs) of the IMF in Bulgaria, the Czech Republic, Germany, Croatia, Hungary, Austria, Poland, Romania, Russia, Slovenia, Slovakia and Ukraine, covering a range of key supervisory areas. Comparing the implementation of the core principles across countries allows identifying the strengths and weaknesses of financial regulation and banking supervision. This in turn suggests in which areas there is a need for action to strengthen the supervisory regime.

All in all, these studies take a closer look at some of the topics which will be presented at the forthcoming Conference on European Economic Integration entitled “Financial Development, Integration and Stability in Central, Eastern and South-Eastern Europe.” We hope that the findings pique your interest, and are looking forward to stimulating presentations and fruitful discussions at the conference and at subsequent OeNB events on financial sector issues.

If you have further comments or are looking to exchange ideas, please do not hesitate to contact us at

Oesterreichische Nationalbank
Foreign Research Division
PO Box 61
AT 1011 Vienna

You may also fax your comments to (43-1) 404 20-5299 or mail them to doris.ritzberger-gruenwald@oenb.at, Head of the Foreign Research Division.

Klaus Liebscher
Governor

RECENT ECONOMIC DEVELOPMENTS

Stephan Barisitz,
Balázs Égert,
Antje Hildebrandt,
Silvia Kirova,
Thomas Reininger,
Zoltan Walko

1 Introduction

In the first quarter of 2005, real GDP growth in the Czech Republic, Hungary, Poland, Slovakia and Slovenia ranged between 2.6% and 5.1% year on year. Compared to the full year 2004, economic performance turned out to be weaker in most of these new Member States (NMS), while growth remained unchanged in the Czech Republic. The two candidate countries, Bulgaria and Romania, and Russia grew more strongly than the NMS, whereas Croatia lagged behind. However, these countries, with the exception of Bulgaria, also reported lower growth rates in the first quarter of 2005 compared to the full year 2004. In most countries under review the growth rate of private consumption decelerated in the first quarter of 2005 against the full year 2004, with the strongest declines being observed in Poland and Russia. The decline of consumption growth in most NMS resulted from lower real wage growth in the second half of 2004 and the beginning of 2005, as the inflationary impact of EU accession and energy price increases was not or only partially reflected in nominal wage growth. In Slovakia, Bulgaria and Romania, private consumption growth was stronger than in 2004. The highest acceleration of consumption growth took place in Slovakia and Bulgaria, while in Romania private consumption continued to grow at a double-digit growth rate (12.5%), more strongly than in the other countries under review. In these three countries, real wage growth had accelerated already by the end of 2004. In all countries with the exception of Slovakia, the growth rate of gross fixed capital formation decelerated in the first quarter of 2005; in Slovenia, it even turned negative (−0.5%) from a positive rate of 6.8%. Furthermore, Croatia had to cope with a noticeable slowdown of gross fixed capital formation growth (2004: 4.4%, first quarter of 2005: 0.3%). The slowdown in gross fixed investment growth resulted from the decline in consumption growth and from the weakening of export growth that was attributable to lower economic growth in the euro area and significant currency appreciation in some countries.

Table 1

Gross Domestic Product (Real)

	Annual change in %							
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
Czech Republic	1.2	3.9	2.6	1.5	3.2	4.4	4.6	4.4
Hungary	4.2	5.2	3.8	3.5	2.9	4.2	4.1	2.9
Poland	4.1	4.0	1.0	1.4	3.8	5.4	4.0	2.1
Slovakia	1.5	2.0	3.8	4.6	4.5	5.5	5.8	5.1
Slovenia	5.6	3.9	2.7	3.3	2.5	4.6	4.3	2.6
Bulgaria	2.4	5.4	4.1	4.9	4.5	5.6	6.2	6.0
Croatia	−0.9	2.9	4.4	5.2	4.3	3.8	3.6	1.8
Romania	−1.1	2.0	5.6	5.1	5.3	8.4	9.7	5.9
Russia	6.3	9.0	5.1	4.7	7.3	7.2	6.4	5.2

Source: Eurostat, national statistical offices, wiw.

The combination of both weaker domestic demand and lower export growth led to import growth falling more than export growth and hence to an improvement in the contribution of net exports to GDP growth in the five Central European NMS. In the Czech Republic, the contribution of net exports to

GDP growth turned from just 0.4 percentage point in the full year 2004 and –1.2 percentage points in the first quarter of 2004 to 4.1 percentage points in the first quarter of 2005¹. This more than compensated the decline in domestic demand growth and thus prevented GDP growth from falling. By contrast, the three EU candidate countries under review showed more negative contributions of net exports to GDP growth in the first quarter of 2005 than in the full year 2004. In Romania, the negative contribution even increased significantly (from –2.8 percentage points in the full year 2004 to –6.0 percentage points). Also in Bulgaria, the contribution of net exports to GDP growth was strongly negative in the first quarter of 2005 (–5.4 percentage points) – worse than in the full year 2004 (–3.9 percentage points), but significantly better than in the first quarter of 2004 (–11.3 percentage points).²

In the first quarter of 2005, the inflation rate (measured by changes in the period average HICP in all countries with the exception of Croatia and Russia, where inflation is based on CPI) declined in most countries compared to the full year 2004. In all new EU Member States but Hungary, inflation decreased further in the second quarter of 2005 and ranged between 1.2% and 3.6% year on year. Of all countries under study, only Russia reported double-digit inflation rates. In Romania, inflation declined to a single-digit rate in the last quarter of 2004 and in the first half of 2005 remained at or below 10% year on year. In the NMS, inflation decelerated strongly in 2005, as inflation-driving factors related to EU accession in 2004 led to favorable base effects in 2005 and no (substantial) inflationary second-round effects were recorded. Furthermore, the disinflation process was supported by strong currencies, falling unit labor costs in industry and a moderation of inflation expectations, despite further upward pressure from international energy prices.

Table 2

Consumer Price Index (here: HICP)

	Annual change in %							
	2000	2001	2002	2003	2004	Q1 05	Q2 05	
Czech Republic	3.9	4.5	1.4	–0.1	2.6	1.4	1.2	
Hungary	10.0	9.1	5.2	4.7	6.8	3.5	3.6	
Poland	10.1	5.3	1.9	0.7	3.6	3.6	2.2	
Slovakia	12.2	7.2	3.5	8.5	7.4	2.6	2.4	
Slovenia	8.9	8.6	7.5	5.7	3.6	2.8	2.2	
Bulgaria	10.3	7.4	5.8	2.3	6.1	3.8	4.9	
Croatia ¹⁾	6.4	5.0	1.7	1.8	2.1	3.1	3.1	
Romania	45.7	34.5	22.5	15.3	11.9	8.9	9.9	
Russia ¹⁾	20.8	21.6	16.0	13.6	11.0	12.9	13.4	

Source: Eurostat, national statistical offices, wiiv.

¹⁾ CPI.

¹ Revised data for the first quarter even show a contribution of 5.7 percentage points.

² Shortly after the cutoff date of this contribution, (preliminary) results for GDP growth in the second quarter of 2005 were released in the five Central European NMS. With the exception of Slovakia, all these countries posted higher year-on-year growth rates in the second than in the first quarter (Czech Republic 5.1%, Hungary 4.1%, Poland 2.8%, Slovakia 5.1%, Slovenia 5.2%). In Hungary, Poland and Slovenia, higher GDP growth was attributable to higher export and lower import growth, while in the Czech Republic import growth decreased more strongly than export growth. The fact that domestic demand contracted (or, in Slovenia, stagnated) stood behind the decline in import growth in these four countries; hence, the (higher) GDP growth resulted exclusively from the (higher) contribution of net exports to GDP growth.

Both Standard & Poor's and Moody's continue to award Slovenia (AA-/AA3) the highest rating for sovereign long-term foreign currency debt among the countries discussed in this contribution. The Czech Republic and Hungary share the second-highest rating by both agencies (A-/A1). Additionally, Standard & Poor's ranks Slovakia equal to the Czech Republic and Hungary. Moody's upgraded Slovakia to rank three (A2) in January 2005 and continued to place Poland at the same level. At present, both agencies rank Croatia right after the NMS (BBB/Baa3) and higher than Bulgaria (BBB-/Ba1) and Romania (BBB-/Ba1). Standard & Poor's upgraded the rating for Croatia in December 2004; Moody's upgraded Romania's rating in March 2005 and Standard and Poor's in September 2005.

Table 3

Ratings of Sovereign Long-Term Foreign Currency-Denominated Debt						
Currency	Moody's			Standard & Poor's		
	Former rating	Last change	Current rating	Former rating	Last change	Current rating
CZK	Baa1	12.11.02	A1	A	05.11.98	A-
HUF	A3	12.11.02	A1	BBB+	19.12.00	A-
PLN	Baa1	12.11.02	A2	BBB	15.05.00	BBB+
SKK	A3	12.01.05	A2	BBB+	13.12.04	A-
SIT	A2	12.11.02	Aa3	A+	13.05.04	AA-
BGN	Ba2	17.11.04	Ba1	BB+	24.06.04	BBB-
HRK		27.01.97	Baa3	BBB-	22.12.04	BBB
RON	Ba3	02.03.05	Ba1	BB+	06.09.05	BBB-
RUB	Ba2	08.10.03	Baa3	BB+	31.01.05	BBB-

Source: Bloomberg.

2 Czech Republic: Solid Economic Performance with Favorable External Conditions and a Strong Currency

In the Czech Republic, real GDP growth was 4.4% year on year in the first quarter of 2005 – the same as in the full year 2004 and marginally below GDP growth in the last quarter of 2004. In 2004 the growth rates of private and public consumption declined from quarter to quarter, resulting in growth rates of 1.7% and –3.9%, respectively, in the last quarter of 2004 (full year 2004: 2.1% and –2.0%, respectively). The composition of growth in the first quarter of 2005 was in parts similar to the one of the last quarter of 2004. In the first quarter of 2005 growth of private and public consumption was only marginally lower than in the last quarter of 2004, whereas the growth rate of gross fixed capital formation moderated from 7.0% to 5.5% (full year 2004: 7.6%). Remarkably, after the negative contribution of net exports to growth in the first nine months of 2004 (–0.8 percentage point), the contribution was strongly positive in the last quarter of 2004 (4.0 percentage points). In the first quarter of 2005, lower export growth than in the last quarter of 2004 went hand in hand with lower import growth rates. This resulted in an even slightly higher contribution of net exports to GDP growth (4.1 percentage points) than in both the previous quarter and the first quarter of 2004, leaving external trade at the forefront of growth drivers.

Table 4

Gross Domestic Product and Its Demand Components								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Real year-on-year change in %</i>								
Gross domestic product	1.2	3.9	2.6	1.5	3.2	4.4	4.6	4.4
Private consumption	2.1	2.9	2.6	2.8	4.6	2.1	1.7	1.4
Public consumption	5.4	0.2	3.8	4.5	3.8	-2.0	-3.9	-3.8
Gross fixed capital formation	-3.5	4.9	5.4	3.4	4.7	7.6	7.0	5.5
Exports of goods and services	5.5	16.5	11.5	2.1	7.5	21.9	23.0	17.9
Imports of goods and services	5.0	16.3	13.0	4.9	7.9	18.4	15.5	12.1
<i>Contribution to GDP growth in percentage points</i>								
Domestic demand	1.3	5.0	4.9	4.2	4.6	4.1	0.7	0.4
Exports	3.4	10.8	8.5	1.7	6.1	18.6	20.9	16.5
Net exports	-0.1	-1.1	-2.2	-2.7	-1.3	0.4	4.0	4.1

Source: Eurostat, OeNB.

In the first quarter of 2005, the unemployment rate (ILO definition) stood at 8.4% and was somewhat lower than the five-year peak of 8.8% of the corresponding 2004 period. In the same quarter, the employment rate increased slightly to 64.1% against 63.7% in the comparable period of 2004. In 2004, industrial production growth was outstandingly high in the Czech Republic, reaching almost 13% in the second quarter (full year: 9.8%). In the first quarter of 2005, year-on-year growth of industrial production declined to 4.3% compared to 8.7% in the first quarter of 2004, whereas industrial employment increased by 0.7% after a decline of 0.8% in the first quarter of 2004. At just 3.5%, industrial labor productivity growth was comparably low (first quarter of 2004: 9.6%). Thus, after declining (or remaining constant) in the industrial sector over the last three years, unit labor costs (ULC) increased marginally for the first time in the first quarter of 2005, although nominal wages in the industrial sector grew at a weaker rate year on year compared to the corresponding period in 2004 (3.8% against 8.8%). However, this development still supported the further decline in industrial producer price inflation during the first half of 2005. HICP inflation reached 2.5% in December 2004 year on year. Thereafter, inflation started to decline, coming to 0.9% in May 2005, which was the lowest year-on-year rise since November 2003. Inflation started to pick up in the two following months (June: 1.3%, July 1.4%), mainly driven by rising prices in transport (due to higher automotive fuel prices) and housing, while it was restrained by a further fall of food prices (favorable base effect of EU accession). The current inflation target band (until end-December 2005) announced by Česká národní banka (ČNB) is set at 2% to 4%. As of the beginning of 2006, the ČNB will move to a 3% point target with a tolerance band of $\pm 1\%$.

Table 5

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Year-on-year change of period average levels in %</i>								
Gross production of industry (real)	-3.1	5.4	6.7	4.9	5.9	9.8	9.1	4.3
Labor productivity of industry (real)	3.6	9.1	6.1	6.8	7.9	9.7	9.0	3.5
Gross average wage of industry (nominal)	6.6	7.1	6.4	6.7	5.9	7.0	6.0	3.8
Unit labor cost of industry (nominal)	3.0	-1.8	0.3	-0.1	-1.9	-2.5	-2.8	0.2
Producer price index (PPI) of industry	0.9	4.8	2.9	-0.5	-0.4	5.7	8.1	6.8
Consumer price index (here: HICP)	1.8	3.9	4.5	1.4	-0.1	2.6	2.7	1.4
Exchange rate (nominal):								
CZK ¹⁾ per 1 EUR, + = EUR appreciation	2.3	-3.5	-4.3	-9.5	3.3	0.2	-3.0	-8.7
EUR per 1 CZK, + = CZK appreciation	-2.2	3.6	4.5	10.6	-3.2	-0.2	3.1	9.5
<i>Period average levels</i>								
Unemployment rate (ILO definition, %) ²⁾	8.8	8.9	8.2	7.4	7.9	8.4	8.2	8.4
Employment rate ³⁾	65.6	65.0	65.0	65.4	64.7	64.1	64.5	64.1
Participation rate ⁴⁾	72.0	71.3	70.8	70.6	70.2	70.0	70.2	70.0
Key interest rate per annum (%)	6.7	5.3	5.1	3.6	2.3	2.2	2.5	2.3
Exchange rate (nominal):								
CZK per 1 EUR	36.9	35.6	34.1	30.8	31.8	31.9	31.1	30.0
EUR per 1 CZK	0.027	0.028	0.029	0.032	0.031	0.031	0.032	0.033

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiw.

¹⁾ CZK: Czech koruna.

²⁾ Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

³⁾ Ratio of employed persons to the working-age population (aged 15 to 64).

⁴⁾ Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

The growth of credit to the private sector stood at 13.3% year on year in the first quarter of 2005 and at 7.5% in May 2005 (first quarter 2004: 7.7%, May 2004: 6.2%). Credit growth to households remained about stable in the first quarter of 2005 against the first quarter of 2004 (31.4% and 30.8%, respectively), whereas the growth rate of credits to the corporate sector increased from 0.2% to 5.7%. Net foreign asset growth was negative (-0.1%) in the first quarter of 2005, but accelerated to 5.5% in May 2005. Overall broad money growth amounted to 5.4% in the first quarter of 2005 (May 2004: 5.8%). In 2004 and into early 2005, the Czech koruna appreciated sharply, reaching its strongest nominal value in more than two and a half years at 29.3 CZK/EUR in the beginning of March. Thereafter, the currency weakened and traded around 30 CZK/EUR. This weakening was apparently attributable above all to external factors, whereas internal factors seem to have had only a minor effect. In mid-August, the koruna started to appreciate again to nearly 29.3 CZK/EUR, partly supported by good foreign trade data. The continuous disinflation process encouraged the CNB to cut its key interest rate by 25 basis points both in January and March to 2.00%, and to 1.75% in April.

Table 6

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Nominal year-on-year change of the annual average stock in %</i>								
Broad money (including foreign currency deposits)	8.9	6.5	10.8	7.1	5.2	10.3	9.9	5.4
<i>Contributions to the nominal year-on-year change of broad money in percentage points</i>								
Net foreign assets of the banking system	13.0	8.0	8.0	7.9	1.2	2.9	5.0	-0.1
Domestic credit (net) of the banking system	-3.2	-1.1	0.2	-9.7	7.7	7.1	2.9	2.2
<i>of which: claims on the private sector</i>	-3.8	-5.0	-5.6	-12.3	0.9	6.0	7.2	7.1
<i>claims on households</i>	0.1	0.3	1.1	1.7	3.3	4.4	4.9	4.9
<i>claims on enterprises</i>	-4.0	-5.3	-6.7	-14.0	-2.5	1.5	2.3	2.1
<i>net claims on the public sector</i>	0.6	3.9	5.8	2.5	6.8	1.2	-4.4	-4.8
Other domestic assets (net) of the banking system	-0.9	-0.4	2.6	8.9	-3.7	0.3	2.1	3.3

Source: National central bank, OeNB.

Note: Data since 2003 according to ECB methodology.

In 2004, the budget deficit (-3.0% of GDP) turned out to be much less pronounced than expected, which was basically attributable to more vigorous growth and the fact that it was now possible, for the first time, to roll over unspent funds into the following year. Furthermore, the reclassification of state guarantees also helped reduce the deficit. The 2005 budget reflects a widening of the deficit and includes a target of -4.7% (convergence program of December 2004). On the back of higher-than-expected revenues, the budgetary situation has developed favorably, showing a surplus of CZK 10.26 billion over the period from January to July 2005 against a deficit of CZK 48.80 billion in the comparable 2004 period. The Ministry of Finance indicated that the 2005 deficit might turn out to be below the envisaged deficit of CZK 83.6 billion. In mid-2004, the Ecofin Council found that an excessive deficit existed and advised the Czech Republic to correct this deficit by 2008. The convergence program of December 2004 set the deficit target to 3.8% of GDP for 2006 and to 3.3% for 2007. On January 18, 2005, in its assessment of the updated convergence program, the Ecofin Council recommended the use of higher-than-planned revenues to reduce the deficit and, furthermore, emphasized the need to push forward pension and health care reforms. In its 2005 report "Public Finances in the EMU," the European Commission stated that the Czech Republic was the only country except Greece that faced the serious risk of not being able to guarantee the long-term sustainability of its public finances given expenditures related to the pension and health care system. However, decisions on pension and health care reforms are unlikely to take place before parliamentary elections in June 2006.

Table 7

Government Budget								
	1999	2000	2001	2002	2003	2004	2005 f ¹⁾	2006 f ¹⁾
	% of GDP							
General government								
Revenues	39.2	38.5	39.1	40.2	41.6	42.7	41.8	41.0
Expenditures	42.9	42.1	45.0	46.9	53.3	45.7	46.3	45.1
of which: interest payments	1.0	0.9	1.1	1.5	1.3	1.3	1.3	1.4
Balance	-3.6	-3.7	-5.9	-6.8	-11.7	-3.0	-4.5	-4.0
Primary balance	-2.6	-2.8	-4.8	-5.2	-10.3	-1.8	-3.2	-2.6
Gross public debt	16.0	18.2	27.2	30.7	38.3	37.4	36.4	37.0

Source: European Commission.

¹⁾ f stands for forecast by the European Commission.

High FDI inflows over the past few years, largely in export-oriented industries, are now positively reflected in the external side of the economy. The current account balance turned from a deficit (-2.1% of GDP) in the first quarter of 2004 to a surplus (2.2% of GDP) in the first quarter of 2005. The improvement of the trade balance was the major reason for this positive outcome. In the first quarter of 2005, the trade balance turned strongly positive to 2.8% of GDP (first quarter 2004: 0.2% of GDP); the trade surplus amounted to CZK 37.96 billion over the period from January to June 2005, against a deficit of CZK 7.81 billion in the comparable period of 2004. The current account balance was also positively affected by a payment from Slovakia, which resulted from an international arbitration award granted to the Czech bank ČSOB in February 2005. However, the income balance in the first quarter of 2005 posted a deficit of 2.7% of GDP caused by the repatriation of profits and dividend payments of foreign firms. Net FDI inflows in the first quarter of 2005 remained strong and similar in size compared to the same period of the previous year (4.2% and 4.4%, respectively).

Table 8

Balance of Payments								
	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	24,651	31,509	37,271	40,713	43,053	53,787	11,458	14,629
Merchandise exports: year-on-year change in %	6.9	27.8	18.3	9.2	5.7	24.9	8.8	27.7
Merchandise imports	26,448	34,918	40,705	43,034	45,235	54,493	11,420	13,983
Merchandise imports: year-on-year change in %	4.1	32.0	16.6	5.7	5.1	20.5	7.0	22.4
Trade balance	-1,797	-3,409	-3,434	-2,322	-2,182	-706	38	646
% of GDP	-3.2	-5.6	-5.0	-3.0	-2.7	-0.8	0.2	2.8
Services balance	1,130	1,536	1,706	706	416	389	55	56
Income balance (factor services balance)	-1,265	-1,490	-2,450	-3,760	-3,757	-4,393	-547	-604
Current transfers	552	403	524	934	494	191	36	391
Current account balance	-1,379	-2,960	-3,653	-4,442	-5,029	-4,518	-418	489
% of GDP	-2.5	-4.9	-5.4	-5.7	-6.3	-5.2	-2.1	2.2
Capital account balance	-2	-6	-10	-4	-3	-450	12	48
% of GDP	0.0	0.0	0.0	0.0	0.0	-0.5	0.1	0.2
Direct investment flows (net)	5,879	5,356	6,121	8,870	1,694	3,142	855	955
% of GDP	10.6	8.9	9.0	11.3	2.1	3.6	4.4	4.2

Source: Eurostat, national central bank, OeNB.

At the end of the first quarter of 2005, gross external debt stood at 38.3% – slightly lower than at the end of 2004. A breakdown by public and private debt showed that public external debt increased at the end of the first quarter of 2005 against end-2004, while private external debt decreased slightly. Gross official reserves went down marginally from 24.0% of GDP at end-2004 to 23.6% of GDP at the end of the first quarter of 2005.

Table 9

Gross Official Reserves and Gross External Debt

	1999	2000	2001	2002	2003	2004	Q1 05
<i>End of period, EUR million</i>							
Gross official reserves (1999 including gold, from 2000 excluding gold)	12,771	14,043	16,269	22,483	21,189	20,746	21,101
Gross external debt	22,765	23,285	25,368	25,738	27,624	33,258	34,286
<i>% of GDP¹⁾</i>							
Gross official reserves (1999 including gold, from 2000 excluding gold)	23.1	23.2	23.9	28.7	26.4	24.0	23.6
Gross external debt	41.1	38.5	37.3	32.8	34.4	38.5	38.3
<i>Import months of goods and services</i>							
Gross official reserves (1999 including gold, from 2000 excluding gold)	4.8	4.1	4.2	5.4	4.9	4.0	4.0

Source: Eurostat, national central bank, OeNB, wiiv.

¹⁾ Q1 05: As a percentage of rolling four-quarter GDP.

3 Hungary: Reduction of VAT Rate to Cause Drop in CPI in 2006

Hungarian GDP growth slowed down to 2.9% year on year in the first quarter of 2005 from 4.2% in the full year 2004. The slowdown in growth dynamics during the first quarter of 2005 was attributable both to a deceleration in domestic demand growth and to a smaller positive contribution of net exports than in 2004. Among the domestic components, domestic consumption growth during the first quarter was slightly stronger than in the full year 2004, and recovered from the stagnation observed in the last quarter of 2004, as public consumption picked up again. Private consumption also went up slightly compared to the last quarter of 2004 – a trend which was attributable mainly to the fact that real wages went up and the number of employed persons decreased at a slower pace than in the fourth quarter. However, private consumption growth remained slower than in the full year 2004. Following the standstill in the last quarter of 2004, gross fixed capital formation strengthened at the beginning of 2005, but its growth rate remained slightly below that observed for the whole year 2004. During the first quarter of 2005, both export and import dynamics slowed down considerably from the high rates registered in 2004. Given that export growth slackened more sharply than import growth, the positive contribution of net exports to GDP declined from 2.3 percentage points in 2004 to 1.3 percentage points in the first quarter of 2005, thus constituting the main reason for the weaker GDP growth in the first quarter of 2005.

Table 10

Gross Domestic Product and Its Demand Components								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Real year-on-year change in %</i>								
Gross domestic product	4.2	5.2	3.8	3.5	2.9	4.2	4.1	2.9
Private consumption	5.6	5.4	5.8	10.3	7.7	3.0	1.6	2.0
Public consumption	1.5	1.9	6.2	5.4	5.7	-1.9	-4.0	1.9
Gross fixed capital formation	5.9	7.7	5.9	9.3	2.5	7.9	0.1	6.8
Exports of goods and services	12.2	22.0	8.0	3.9	7.8	14.9	10.8	6.2
Imports of goods and services	13.3	20.2	5.3	6.5	11.0	11.6	6.2	4.8
<i>Contribution to GDP growth in percentage points</i>								
Domestic demand	5.1	4.6	1.8	5.7	6.0	1.9	0.1	1.6
Exports	7.9	15.4	6.5	3.3	6.6	13.1	10.1	6.0
Net exports	-1.0	0.6	2.1	-2.2	-3.0	2.3	3.9	1.3

Source: Eurostat, OeNB.

However, for the second quarter of 2005, industrial output and sales figures suggest a recovery of economic activity, which is supported in particular by stronger export sales. Reflecting the slowdown in economic activity, employment (according to the Labor Force Survey – LFS) continued to contract in the first quarter of 2005 in year-on-year terms, though less strongly than in the preceding three quarters. As a result, the employment rate decreased against the first quarter of 2004. At the same time, the unemployment rate climbed to 7% in the first quarter of 2005 – the highest level since the third quarter of 1999 – which reflects weak labor demand, but in part also an increase in labor supply (i.e. a higher activity rate). Following a 1% decline in 2004, net real wages grew by 7.6% during the first half of 2005. This high growth rate was largely attributable to the fact that the timing of nonregular payments in the public sector was different from 2004 and to the stronger-than-expected deceleration in inflation. The higher net real growth in total wages, however, masks the fact that nominal wage dynamics continued to decelerate in the private sector, thus supporting further disinflation. HICP growth slowed down to 3.3% year on year in March 2005 from 5.5% in December 2004, but accelerated again to 3.6% by July, mostly due to higher food and oil prices and an adverse base effect in healthcare prices. However, the underlying inflationary environment remains favorable as suggested by the continuous deceleration in core inflation (July 2005: 1.6%). This phenomenon is supported by the moderation of private consumption and by weak growth in industrial unit wage costs, especially as productivity growth is picking up again after a dip in the first quarter of 2005. In addition, stronger competition and the appreciation of the exchange rate since late May 2005 support low price dynamics. At the beginning of 2006, inflation is set to further decelerate on the back of a cut in the highest VAT rate from 25% to 20%, the direct effect of which Magyar Nemzeti Bank (MNB) estimates at 1.4 percentage points for 2006. The MNB expects inflation to rise from 1.6% in 2006 to 2.9% in 2007 (both annual averages), which would be in line with the medium-term inflation target of 3.0% (with a tolerance of ± 1 percentage point).

Table 11

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Year-on-year change of period average levels in %</i>								
Gross production of industry (real)	10.1	18.5	4.1	2.9	6.3	8.3	6.6	2.1
Labor productivity of industry (real)	5.1	17.0	5.4	4.9	8.4	10.6	9.4	4.4
Gross average wage of industry (nominal)	13.4	15.0	14.5	12.6	9.3	10.0	8.8	6.6
Unit labor cost of industry (nominal)	7.9	-1.7	8.6	7.4	0.8	-0.6	-0.6	2.1
Producer price index (PPI) of industry	5.0	11.4	5.7	-1.1	2.5	3.6	2.1	1.9
Consumer price index (here: HICP)	10.0	10.0	9.1	5.2	4.7	6.8	5.9	3.5
<i>Exchange rate (nominal)</i>								
HUF ¹⁾ per 1 EUR, + = EUR appreciation	5.2	2.9	-1.3	-5.3	4.3	-0.7	-5.3	-5.8
EUR per 1 HUF, + = HUF appreciation	-4.9	-2.8	1.4	5.6	-4.2	0.7	5.6	6.1
<i>Period average levels</i>								
Unemployment rate (ILO definition, %) ²⁾	7.1	6.4	5.8	5.9	5.9	6.1	6.3	7.0
Employment rate ³⁾	55.6	56.3	56.2	56.2	57.0	56.8	57.0	56.4
Participation rate ⁴⁾	59.8	60.1	59.6	59.7	60.6	60.5	60.8	60.7
Key interest rate per annum (%)	15.2	11.5	11.1	9.1	8.6	11.4	10.3	8.6
<i>Exchange rate (nominal)</i>								
HUF per 1 EUR	252.76	260.07	256.60	242.95	253.51	251.73	245.94	245.01
EUR per 1 HUF	0.00396	0.00385	0.00390	0.00412	0.00394	0.00397	0.00407	0.00408

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiv.

¹⁾ HUF: Hungarian forint.

²⁾ Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

³⁾ Ratio of employed persons to the working-age population (aged 15 to 64).

⁴⁾ Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

Falling inflation (in particular core inflation), slowing wage dynamics in the private sector, weaker credit growth³ and the broadly stable exchange rate paved the way for gradual monetary easing. Since the beginning of 2005, the MNB has trimmed its interest rates by a total of 325 basis points to 6.25% (August). As a result of these rate cuts, the MNB's forward-looking real policy interest rate fell to around 3.8% in July 2005 from around 5% at end-2004. Despite the positive inflationary environment, the MNB sees the budget deficit, the current account deficit and Hungary's reliance on foreign portfolio capital as the major monetary policy risks. Furthermore, the MNB has already signaled that it is looking at medium-term inflationary developments and will therefore not react to the temporarily disinflationary effect of the VAT rate cut to be effected in 2006.

³ The growth of credit to the corporate sector fell continuously from a peak of 24% year on year in the first quarter of 2004 to 15% year on year in the first quarter of 2005, while the growth of credit to households moderated continuously from a peak of 71% year on year in the second quarter of 2003 to 25% in the first quarter of 2005.

Table 12

Monetary Developments								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	<i>Nominal year-on-year change of the annual average stock in %</i>							
Broad money (including foreign currency deposits)	17.4	17.7	16.3	10.1	14.2	11.7	11.3	11.3
	<i>Contributions to the nominal year-on-year change of broad money in percentage points</i>							
Net foreign assets of the banking system	10.3	10.3	9.2	2.2	-1.1	-1.9	-1.4	-0.8
Domestic credit (net) of the banking system	6.0	6.0	10.7	12.3	22.4	17.9	14.9	14.5
<i>of which: claims on the private sector</i>	8.8	16.2	17.2	15.4	18.7	21.7	17.2	17.0
<i>claims on households</i>	1.6	2.7	4.2	6.3	10.6	9.8	8.0	7.0
<i>claims on enterprises</i>	7.1	13.4	13.0	9.1	8.1	11.9	9.3	10.0
<i>net claims on the public sector</i>	-2.7	-10.2	-6.5	-3.1	3.7	-3.8	-2.4	-2.4
Other domestic assets (net) of the banking system	1.1	-5.8	-3.6	-4.5	-7.0	-4.3	-2.2	-2.4

Source: National central bank, OeNB.

In response to the Ecofin Council's recommendation to Hungary (issued in early March 2005) to take effective action by July 8, 2005, regarding additional measures to achieve the 2005 budget deficit target, which was set at 3.8% of GDP excluding the net costs of the pension reform in the convergence program of December 2004, the Hungarian authorities officially notified the European Commission about pertinent measures at the beginning of July. These measures, which had already been publicly announced during the previous months, comprise an increase in the emergency budget reserves, a widening of the social security base, a rise in gambling tax, a change in the method of VAT collection for imports from non-EU countries and additional one-off revenues. In its assessment, the European Commission concluded that these measures were worth around 1.7% of GDP and, if implemented fully, should be sufficient to reach the 2005 deficit target. Therefore, no further steps were necessary under the excessive deficit procedure. However, the European Commission stated that Hungary's budgetary situation remained vulnerable and recommended that the Ecofin Council enhance budgetary surveillance should failures in implementing the planned corrective measures emerge at a later stage. The European Commission also suggested to closely monitor the budget plans for 2006. In its view, decisive action is needed, given that in 2006 budget revenues will decrease as one-off revenues taken in 2005 expire and tax cuts will take place (combined revenue effect of around 2% of GDP), while investment expenditure is expected to rise again also in the light of cofinancing requirements. The convergence program of December 2004 set the deficit target (excluding the net costs of the pension reform) to 3.1% of GDP for 2006 and to 2.4% for 2007.

Table 13

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f ¹⁾	2006 f ¹⁾
	% of GDP							
General government								
Revenues	..	45.3	45.0	44.1	44.5	47.5	44.0	43.2
Expenditures	..	47.6	48.7	52.6	50.8	52.0	47.8	47.1
<i>of which: interest payments</i>	..	5.6	4.7	4.0	4.0	4.3	3.8	3.4
Balance	..	-2.4	-3.7	-8.5	-6.2	-4.5	-3.9	-4.1
Primary balance	..	3.2	1.0	-4.5	-2.2	-0.2	0.0	-0.7
Gross public debt		60.9	55.4	52.2	55.5	56.9	57.6	57.9

Source: European Commission.

¹⁾ f stands for forecast by the European Commission.

The current account in Hungary showed a deficit of 7.5% of GDP during the first quarter of 2005, which was slightly higher than the deficit recorded in the same period of 2004. However, the current account deficit has been contracting continuously since mid-2004, which may be attributable to the weakening of domestic demand. The fact that the current account deficit widened against the first quarter of 2004 was attributable to a larger deficit on the income balance (due to larger net outflows on both debt and equity positions) and the disappearance of the surplus in net transfers. By contrast, the deficit on the goods and services balance declined by one percentage point to 1.1% of GDP. Annual export growth continued to outpace annual import growth in the first quarter of 2005, despite the moderation of year-on-year growth rates, which reflected both the development of real exports and imports and a deterioration of the terms of trade. Although the current account deficit widened, Hungary's financing requirement declined against the first quarter of 2004, given a significant improvement in the capital account (by 1.2% of GDP). Net FDI inflows increased and covered 54% of the financing requirement, compared to 30% in the first quarter of 2004. Strong capital inflows on the back of the issuance of government eurobonds pushed net portfolio capital inflows to 11.9% of GDP, which helped raise the central bank's reserve position.

Table 14

Balance of Payments								
	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
<i>EUR million</i>								
Merchandise exports	24,059	31,278	34,697	36,821	38,377	44,516	10,277	11,425
<i>Merchandise exports: year-on-year change in %</i>	14.3	30.0	10.9	6.1	4.2	16.0	14.3	11.2
Merchandise imports	26,102	34,457	37,193	39,024	41,274	46,907	10,679	11,614
<i>Merchandise imports: year-on-year change in %</i>	14.8	32.0	7.9	4.9	5.8	13.6	11.3	8.8
Trade balance	-2,044	-3,180	-2,496	-2,203	-2,898	-2,391	-402	-189
<i>% of GDP</i>	-4.5	-6.3	-4.3	-3.2	-4.0	-3.0	-2.2	-0.9
Services balance	816	1,234	1,661	587	-378	-6	22	-22
Income balance (factor services balance)	-2,713	-2,792	-3,192	-3,838	-3,682	-4,928	-1,021	-1,278
Current transfers	408	385	450	525	594	206	93	-8
Current account balance	-3,531	-4,352	-3,577	-4,929	-6,364	-7,118	-1,308	-1,497
<i>% of GDP</i>	-7.8	-8.6	-6.2	-7.1	-8.8	-8.8	-7.3	-7.5
Capital account balance	31.2	299.9	357.9	202.3	-32.5	321.9	-63.0	171.0
<i>% of GDP</i>	0.1	0.6	0.6	0.3	0.0	0.4	-0.3	0.9
Direct investment flows (net)	2,872	2,334	3,992	2,889	443	2,896	409	714
<i>% of GDP</i>	6.4	4.6	6.9	4.2	0.6	3.6	2.3	3.6

Source: Eurostat, national central bank, OeNB.

The country's gross external debt continued to increase, reaching 70.6% of GDP at the end of March 2005, up from 65.5% a year earlier. Net foreign debt came to 32% of GDP, up from 30.8% in 2004.

Table 15

Gross Official Reserves and Gross External Debt							
	1999	2000	2001	2002	2003	2004	Q1 05
<i>End of period, EUR million</i>							
Gross official reserves (excluding gold)	10,722	12,038	12,164	9,887	10,108	11,671	13,223
Gross external debt	29,231	32,572	37,387	38,559	46,036	54,911	58,426
<i>% of GDP¹⁾</i>							
Gross official reserves (excluding gold)	23.8	23.8	21.0	14.3	13.9	14.4	16.0
Gross external debt	64.9	64.4	64.5	55.9	63.4	67.9	70.6
<i>Import months of goods and services</i>							
Gross official reserves (excluding gold)	4.3	3.6	3.4	2.6	2.5	2.5	2.9

Source: Eurostat, national central bank, OeNB, wiiv.

¹⁾ Q1 05: As a percentage of rolling four-quarter GDP.

4 Poland: Weaker Growth, but Stronger Currency

GDP growth in Poland continued to decelerate in the first quarter of 2005, falling to 2.1% year on year from 4% in the fourth quarter and 5.4% in the full year 2004. Both in the fourth quarter of 2004 and in the first quarter of 2005, economic growth fell sharply. Private consumption growth slowed markedly in the fourth quarter, as real wages in the total economy fell. The reduction in real wages reflected the fact that nominal wage growth declined although inflation remained high as a result of higher international energy prices. Real wages con-

tinued to contract in the first quarter, notwithstanding the onset of disinflation, before slightly increasing in the second quarter of 2005. Thus, the rise in oil prices rather had a dampening effect on consumption growth than an inflationary effect. In parallel, real exports contracted in year-on-year terms in both the fourth quarter of 2004 and the first quarter of 2005, partly as a consequence of the Polish zloty's strong appreciation since March 2004. The combination of both weaker domestic consumption and contracting real exports in the fourth quarter of 2004 probably contributed to the fact that gross fixed capital formation growth decelerated markedly in the first quarter of 2005, just after having expanded for the first time after three years of contraction. In addition, the exchange rate volatility as well as the tightening of monetary conditions toward the end of 2004 may have had an adverse impact on real investment decisions. As a result of weaker domestic demand growth and shrinking real exports, real imports contracted even more clearly than real exports. Thus, net exports improved, implying a positive contribution of 1.0 percentage point to GDP growth in the first quarter of 2005, i.e. significantly more than in the full year 2004.

Table 16

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Real year-on-year change in %</i>								
Gross domestic product	4.1	4.0	1.0	1.4	3.8	5.4	4.0	2.1
Private consumption	5.2	2.8	2.1	3.3	3.1	3.4	1.9	1.7
Public consumption	1.9	1.3	0.6	0.6	0.5	3.4	2.2	2.5
Gross fixed capital formation	6.8	2.7	-8.8	-5.8	-0.2	5.3	7.4	1.0
Exports of goods and services	-2.6	23.2	3.1	4.8	14.2	10.2	-0.5	-3.1
Imports of goods and services	1.0	15.6	-5.3	2.6	9.3	8.7	-2.3	-5.5
<i>Contribution to GDP growth in percentage points</i>								
Domestic demand	5.2	2.8	-1.7	0.8	2.7	5.1	3.4	1.1
Exports	-0.7	6.2	0.9	1.3	4.2	3.5	-0.2	-1.2
Net exports	-1.1	1.2	2.7	0.6	1.1	0.3	0.6	1.0

Source: Eurostat, national statistical office, OeNB, wiw.

Despite the growth slowdown, average employment in the whole economy (LFS-based) in the first quarter was 2.3% higher than a year ago. As the employment rate increased to 51.5% (from 50.5% in the first quarter of 2004) while the activity rate declined to 63.7% (from 64.0%), the average unemployment rate fell to 19.1% (from 21.0%). For the first time since the start of the economic transformation, average employment in industry was higher year on year in the first half of 2005, although industrial output growth was markedly weaker than in the full year 2004. However, it was primarily the slowdown in output growth that implied very low labor productivity growth. As a result, nominal ULC in industry increased slightly year on year for the first time since 2001, despite a considerably lower wage growth. The oil price-driven rise in industrial producer prices continued to decline from its peak at 9.6% year on year in May 2004 to only 0.1% in the second quarter of 2005, supported by the very moderate ULC development. Inflation (HICP), which had peaked at 4.9% in

August 2004, continuously contracted to only 1.3% by July 2005 – a value outside the monetary policy target band of 2.5 percentage points ± 1 . In recent months, the further inflationary impact from oil prices was largely offset by favorable developments in food prices. There are hardly any signs of demand-driven inflation. Assessing the risk of future inflation being below target as higher than that of it being above target, the Monetary Policy Council lowered the key interest rate (two-week rate on central bank bills) by a total of 1.75 percentage points to 4.50% in five steps at the end of March, April, June, July and August 2005.

Table 17

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Year-on-year change of period average levels in %</i>								
Gross production of industry (real)	4.7	7.8	0.6	1.4	8.6	13.1	7.2	1.1
Labor productivity of industry (real)	9.6	17.9	6.1	7.4	11.4	13.5	7.3	0.2
Gross average wage of industry (nominal)	34.1	10.9	6.9	3.7	3.0	4.5	2.4	2.1
Unit labor cost of industry (nominal)	22.3	-5.9	0.8	-3.4	-7.5	-7.9	-4.6	1.9
Producer price index (PPI) of industry	5.7	7.8	1.7	1.1	2.7	7.1	6.7	3.5
Consumer price index (here: HICP)	7.2	10.1	5.3	1.9	0.7	3.6	4.5	3.6
Exchange rate (nominal):								
PLN ¹⁾ per 1 EUR, + = EUR appreciation	8.0	-5.2	-8.4	5.0	14.1	3.0	-8.4	-15.7
EUR per 1 PLN, + = PLN appreciation	-7.4	5.5	9.2	-4.7	-12.4	-2.9	9.2	18.6
<i>Period average levels</i>								
Unemployment rate (ILO definition, %) ²⁾	12.6	16.4	18.6	20.3	20.0	19.3	18.3	19.1
Employment rate ³⁾	57.5	55.0	53.4	51.5	51.2	51.7	52.4	51.5
Participation rate ⁴⁾	65.8	65.8	65.5	64.6	63.9	64.0	64.1	63.7
Key interest rate per annum (%)	13.7	17.9	16.0	8.8	5.6	5.8	6.5	6.4
Exchange rate (nominal):								
PLN per 1 EUR	4.23	4.01	3.67	3.85	4.40	4.53	4.23	4.03
EUR per 1 PLN	0.2365	0.2495	0.2725	0.2595	0.2274	0.2207	0.2362	0.2483

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiw.

¹⁾ PLN: Polish zloty.

²⁾ Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

³⁾ Ratio of employed persons to the working-age population (aged 15 to 64).

⁴⁾ Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

The real key interest rate (12-month moving average) increased continuously from a low of 0.5% in August 2004 to 4.8% in June 2005 as a consequence of the persistent disinflation since August 2004 and despite the cuts in nominal key rates effected since March 2005.⁴ Both the increase of real interest rates and the real appreciation of the zloty against the euro by 13.7% (CPI-deflated) and 9.2% (PPI-deflated) from June 2004 to June 2005 had a tightening effect on monetary conditions. The average broad money growth rate of 12% year on year in the second quarter of 2005 resulted mainly from lending to households, which rose by 18%, and from net foreign assets. The latter went up by 22% year on year in euro terms, but by 8% as measured in zloty, with the difference reflecting the strong currency appreciation. Bank lending to enterprises, by contrast, was again lower than a year earlier even in nominal terms (-2.3% year

⁴ Ex post real key interest rate per annum as measured by the real (CPI-deflated) key rates per month compounded over the past 12 months. The PPI-deflated key interest rate per annum, which is measured in a similar way, increased from a low of -4.0% in May 2004 to a high of 6.8% in May 2005, before stabilizing at 6.3% in June and July 2005.

on year), a fact which was attributable partly to the moderate ULC developments and the resulting high profitability of industry and partly to the weak demand for fixed investment.

Table 18

Monetary Developments								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Nominal year-on-year change of the annual average stock in %</i>								
Broad money (including foreign currency deposits)	24.7	15.4	12.1	2.0	1.5	6.9	8.2	10.4
<i>Contributions to the nominal year-on-year change of broad money in percentage points</i>								
Net foreign assets of the banking system	7.8	7.0	4.5	0.9	0.0	4.2	2.5	1.9
Domestic credit (net) of the banking system	25.1	13.5	7.2	7.1	5.2	3.7	2.8	2.9
<i>of which: claims on the private sector</i>	18.5	15.7	8.3	3.4	3.8	4.1	3.9	2.5
<i>claims on households</i>	6.2	7.0	4.2	2.8	2.5	4.7	5.7	4.6
<i>claims on enterprises</i>	12.3	8.7	4.1	0.5	1.3	-0.6	-1.8	-2.1
<i>net claims on the public sector</i>	6.7	-2.1	-1.1	3.7	1.4	-0.5	-1.1	0.4
Other domestic assets (net) of the banking system	-8.3	-5.1	0.4	-6.0	-3.8	-1.0	2.9	5.6

Source: National central bank, OeNB.

The convergence program of December 2004 set the deficit target for 2005 at 3.9% of GDP, departing from an assumed public deficit in 2004 of 5.4% (hence requiring a deficit reduction by 1.5 percentage points) and an economic growth of 5.0% in 2005. However, according to the March 2005 fiscal notification, the public deficit was 4.8% of GDP in 2004. In the meantime, the Polish finance minister announced that the 2005 deficit would amount to about 3.4% of GDP, implying a deficit reduction close to the originally envisaged size despite considerably lower-than-expected GDP growth. By the end of July, the central government budget deficit came to 50% of the deficit planned for the full year 2005. The convergence program set the deficit target to 3.2% of GDP for 2006 and to 2.2% for 2007. In September, however, parliamentary elections will be held, and the new government may propose a different budget for 2006. Moreover, all these deficit figures do not include the net budgetary costs of the pension reform, which will amount to about 1.8 percentage points of GDP in 2006 and 2007. Moreover, if the envisaged deficit target of 2.2% in 2007 is reached, the new requirements of the Stability and Growth Pact might imply the inclusion of only 40% (instead of 100%) of these pension reform costs (i.e. about 0.7% of GDP) into the deficit that would serve as the basis for assessing whether the 3% reference value was met and the current excessive deficit procedure could be abrogated.

Table 19

Government Budget								
	1999	2000	2001	2002	2003	2004	2005 f ¹⁾	2006 f ¹⁾
	% of GDP							
General government								
Revenues	44.9	42.5	43.8	43.9	44.3	43.8	44.2	44.2
Expenditures	47.0	45.2	47.7	47.5	48.8	48.7	48.6	48.0
of which: interest payments	2.0	3.1	3.2	2.9	2.9	2.6	2.6	2.5
Balance	-1.4	-1.6	-3.9	-3.6	-4.5	-4.8	-4.4	-3.8
Primary balance	0.6	1.6	-0.7	-0.7	-1.6	-2.2	-1.9	-1.3
Gross public debt	40.1	36.8	36.7	41.2	45.4	43.6	46.8	47.5

Source: European Commission.

¹⁾ f stands for forecast by the European Commission.

Contrary to the development of real exports, the exports of goods and services in the balance of payments continued to grow strongly year on year in the fourth quarter of 2004 and in the first quarter of 2005, implying that the goods and services balance turned from a deficit of 2.2% of GDP in the first quarter of 2004 to a balanced position in the first quarter of 2005 and that the current account balance turned into surplus. In the second quarter of 2005, both the goods and services balance and the current account balance achieved a clear surplus position, as the moderate weakening of annual export growth was more than compensated by the drop in annual import growth. The financial account, by contrast, showed net direct investment outflows roughly corresponding to the size of the current account surplus in the second quarter of 2005.

Table 20

Balance of Payments								
	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	28,215	39,028	46,487	49,324	53,814	65,639	14,451	17,469
Merchandise exports: year-on-year change in %	-2.5	38.3	19.1	6.1	9.1	22.0	19.4	20.9
Merchandise imports	42,361	52,359	55,075	57,036	58,890	70,144	15,364	17,787
Merchandise imports: year-on-year change in %	4.9	23.6	5.2	3.6	3.3	19.1	12.8	15.8
Trade balance	-14,146	-13,331	-8,588	-7,712	-5,076	-4,505	-913	-318
% of GDP	-9.2	-7.4	-4.1	-3.8	-2.7	-2.3	-2.1	-0.6
Services balance	1,297	1,551	905	852	430	724	-46	325
Income balance (factor services balance)	-948	-1,609	-1,585	-1,990	-3,189	-3,707	-564	-695
Current transfers	2,078	2,595	3,226	3,433	3,726	4,536	875	1,064
Current account balance	-11,719	-10,794	-6,042	-5,417	-4,109	-2,952	-648	376
% of GDP	-7.6	-6.0	-2.9	-2.7	-2.2	-1.5	-1.5	0.7
Current transfers	51.0	41.0	81.0	-8.0	-40.0	803.0	-32.0	616.0
	0.0	0.0	0.0	0.0	0.0	0.4	0.0	0.4
Direct investment flows (net)	6,795	10,253	6,457	4,147	3,508	4,222	1,333	800
% of GDP	4.4	5.7	3.1	2.0	1.9	2.1	3.1	1.5

Source: Eurostat, national central bank, OeNB.

In the first half of 2005, sizeable net portfolio inflows by far exceeded negative net inflows from other investment (which resulted mainly from the prepayment of Paris Club debt), so that gross official reserves increased considerably to EUR 34 billion.

Table 21

Gross Official Reserves and Gross External Debt							
	1999	2000	2001	2002	2003	2004	Q1 05
<i>End of period, EUR million</i>							
Gross official reserves (excluding gold)	26,224	28,555	29,031	27,367	26,000	25,904	28,408
Gross external debt	65,123	74,672	81,461	81,046	84,611	93,432	95,892
<i>% of GDP¹⁾</i>							
Gross official reserves (excluding gold)	17.0	15.8	14.0	13.5	14.0	13.2	13.7
Gross external debt	42.2	41.3	39.3	40.0	45.7	47.6	46.1
<i>Import months of goods and services</i>							
Gross official reserves (excluding gold)	6.4	5.5	5.4	4.9	4.6	3.9	4.2

Source: Eurostat, national central bank, OeNB, wiiv.
¹⁾ Q1 05: As a percentage of rolling four-quarter GDP.

5 Slovakia: Growth Driven by Domestic Demand

In the first quarter of 2005, real GDP growth in the Slovakia remained robust at 5.1% year on year, but was slightly lower than growth in the full year 2004 and in the fourth quarter of 2004. In the first quarter of 2005, year-on-year growth of major domestic demand components accelerated. Supported by strong wage increases, private consumption growth was much stronger than in 2004 (5.5% compared to 3.5% in the full year 2004). Growth of gross fixed capital formation jumped to 5.8%, after 2.5% in the full year 2004 and no more than 0.1% in the last quarter of 2004. Public consumption growth accelerated as well. However, the contribution of overall domestic demand to GDP declined to 5.4 percentage points, after 6.3 percentage points in the full year 2004 and 8.4 percentage points in the fourth quarter of 2004. This difference is mainly attributable to the considerably smaller contribution of inventory changes to GDP growth. In addition to weaker total domestic demand growth, the contribution of the published statistical discrepancy was significantly less positive. On the external side, real import and export growth in the first quarter of 2005 was lower than in 2004, with import growth contracting more strongly. The contribution of net exports to GDP remained negative, but went down to only –0.3 percentage point in the first quarter of 2005 from –0.8 percentage point in the full year 2004 and –2.6 percentage points in the last quarter of 2004.

Table 22

Gross Domestic Product and Its Demand Components								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Real year-on-year change in %</i>								
Gross domestic product	1.5	2.0	3.8	4.6	4.5	5.5	5.8	5.1
Private consumption	3.2	-0.8	4.7	5.5	-0.6	3.5	4.3	5.5
Public consumption	-7.1	1.6	4.6	4.9	2.7	1.1	-0.2	2.3
Gross fixed capital formation	-19.6	-7.2	13.9	-0.6	-1.5	2.5	0.1	5.8
Exports of goods and services	5.0	13.7	6.3	5.6	22.5	11.4	9.5	7.2
Imports of goods and services	-6.7	10.5	11.0	5.5	13.6	12.7	12.3	7.9
<i>Contribution to GDP growth in percentage points</i>								
Domestic demand	-7.0	0.1	7.5	4.7	-2.1	6.3	8.4	5.4
Exports	3.3	9.4	4.8	4.3	17.7	10.6	9.4	6.9
Net exports	8.4	1.9	-3.7	-0.1	6.5	-0.8	-2.6	-0.3

Source: Eurostat, national statistical office, OeNB.

The unemployment rate (ILO definition) remained at a very high level of 17.6% (period average) in the first quarter of 2005, despite a decline by almost 2 percentage points compared to the first quarter of 2004. This decline resulted from both an increase in the employment rate from 56.1% in the first quarter of 2004 to 56.9% in the first quarter of 2005 and an decrease in the participation rate. In industry, employment edged up by a considerable 3.4% in the first quarter of 2005 year on year (first half of 2005: 2.3%). Industrial output growth slumped in the first quarter of 2005 to just 0.6% (first half of 2005: 1.7%). As in the previous quarter, weak industrial output growth was largely attributable to low output in the automotive sector caused by production line upgrades. High industrial employment growth in combination with low output growth resulted in a decline of labor productivity by 2.7%. Labor productivity had already dropped in the previous quarter for the first time since mid-1999. In the first quarter of 2005, industrial wage growth (nominal) accelerated to 12.2%, leading to a further, and strong, rise of ULC (+15.3%) above producer price inflation (2.5%). After a low of 2.1% year on year in February, inflation of industrial producer prices increased to 4.0% by May 2005. Largely driven by administered prices and indirect tax changes, HICP inflation still came to 7.4% in 2004. These inflation-driving factors were much less important in 2005, when they led to a pronounced slowdown. In addition, nominal effective exchange rate developments underpinned the moderation of inflation. In July 2005, the HICP inflation rate stood at 2.0% year on year, the lowest rate since the beginning of the transition process. However, the natural gas supplier in Slovakia, which enjoys a monopoly position, is planning to increase the gas prices for households by 22% from October and has asked the state regulator for approval. Nevertheless, according to Národná banka Slovenska (NBS), the gas hike would not bring out of reach the inflation target, which the NBS has defined as an HICP inflation of 3.5% \pm 0.5 percentage point at the end of 2005 and of below 2.5% at the end of 2006.

Table 23

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Year-on-year change of period average levels in %</i>								
Gross production of industry (real)	-2.0	8.3	7.6	6.7	5.5	4.3	1.2	0.6
Labor productivity of industry (real)	1.0	11.8	6.6	6.5	4.9	3.9	-1.0	-2.7
Gross average wage of industry (nominal)	7.9	9.1	10.2	7.3	7.3	10.1	9.3	12.2
Unit labor cost of industry (nominal)	6.8	-2.4	3.4	0.7	2.3	6.0	10.4	15.3
Producer price index (PPI) of industry	3.9	10.8	6.5	2.0	8.3	3.4	4.5	2.5
Consumer price index (here: HICP)	10.4	12.2	7.2	3.5	8.5	7.4	6.0	2.6
Exchange rate (nominal):								
SKK ¹⁾ per 1 EUR, + = EUR appreciation	11.7	-3.4	1.6	-1.4	-2.8	-3.5	-4.2	-5.6
EUR per 1 SKK, + = SKK appreciation	-10.5	3.6	-1.6	1.4	2.9	3.6	4.4	5.9
<i>Period average levels</i>								
Unemployment rate (ILO definition, %) ²⁾	16.4	18.8	19.3	18.7	17.6	18.3	17.3	17.6
Employment rate ³⁾	58.1	56.8	56.8	56.8	57.7	57.0	57.5	56.9
Participation rate ⁴⁾	69.5	69.9	70.4	69.9	70.0	69.7	69.5	69.1
Key interest rate per annum (%)	..	..	8.8	7.9	6.4	4.9	4.3	3.8
Exchange rate (nominal):								
SKK per 1 EUR	44.1	42.6	43.3	42.7	41.5	40.0	39.5	38.3
EUR per 1 SKK	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiv.

¹⁾ SKK: Slovak koruna.

²⁾ Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

³⁾ Ratio of employed persons to the working-age population (aged 15 to 64).

⁴⁾ Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

Broad money growth (nominal average year on year) accelerated from 4% in the full year 2004 to close to 7% in the second quarter of 2005, driven by a stronger growth of domestic claims. While year-on-year growth of claims on the general government and on households remained high (at 14% and 38%, respectively, after 16% and 41% in the full year 2004), previously stagnant claims on enterprises started to grow at a rate of around 4%. The Slovak koruna appreciated sharply in 2004 and early 2005, reaching a rate of 37.56 SKK/EUR at the beginning of March 2005. The NBS intervened relatively heavily on the foreign exchange market to dampen the appreciation pressure. However, primarily as a result of external factors, the koruna started to depreciate in March, bottoming out at 39.85 SKK/EUR at the end of April. Thereafter, the exchange rate of the Slovak koruna has been fluctuating between 38.26 SKK/EUR and 39.36 SKK/EUR. In light of the ongoing disinflation process, the NBS continued to cut its key interest rate (two-week repo tender limit rate) by another 100 basis points to 3% in March 2005, after reductions totaled 2 percentage points in 2004. These interest rate cuts were also strongly motivated by the appreciation of the Slovak koruna.

Table 24

Monetary Developments								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
Nominal year-on-year change of the annual average stock in %								
Broad money (including foreign currency deposits)	8.1	14.1	12.7	8.7	5.5	4.0	4.7	5.1
Contributions to the nominal year-on-year change of broad money in percentage points								
Net foreign assets of the banking system	-4.9	6.6	2.7	13.5	7.7	-2.6	-3.9	-2.6
Domestic credit (net) of the banking system	13.6	3.7	12.2	0.4	-1.9	10.2	9.9	10.1
of which: claims on the private sector	4.9	2.2	-13.9	-1.0	4.9	4.0	3.5	4.6
claims on households	1.7	2.0	1.2	1.4	2.2	4.0	4.3	4.4
claims on enterprises	3.2	0.2	-15.1	-2.3	2.7	0.0	-0.8	0.1
net claims on the public sector	8.7	1.5	26.1	1.4	-6.7	6.1	6.5	5.5
Other domestic assets (net) of the banking system	-0.5	3.8	-2.2	-5.2	-0.4	-3.6	-1.3	-2.4

Source: National central bank, OeNB.
Note: Data after deduction of bad claims written off during bank consolidation.

In 2004, the budget deficit amounted to 3.3% of GDP, against an expected 3.8%. This better-than-expected outcome was largely the result of spending deferrals (e.g. of copayments for EU funds) and lower social security expenditures. For 2005, the deficit is expected to increase slightly to 3.8% of GDP including the budgetary costs of the pension reform (convergence program of November 2004), or to 3.4% excluding these costs. However, the budget deficit could turn out to be lower than targeted: In the period from January to July 2005, the budget showed a surplus of SKK 1.92 billion (January to July 2004: SKK -18.55 billion), while the full year budget deficit target amounts to SKK 61.5 billion. The ministry of finance expects that the budget deficit might be 0.15 percentage point below the original target. The convergence program set the deficit target (excluding the net budgetary costs of the pension reform of about 1% of GDP) to 2.9% of GDP for 2006 and to 1.9% for 2007. In its statement of February 17, 2005, on the latest convergence program, the Ecofin Council assessed the program as sufficient to achieve these deficit targets.

Table 25

Government Budget								
	1999	2000	2001	2002	2003	2004	2005 f ¹⁾	2006 f ¹⁾
% of GDP								
General government								
Revenues	49.8	47.6	45.5	45.2	35.4	35.1	36.1	34.8
Expenditures	56.9	59.9	51.5	50.9	39.2	38.5	39.9	38.8
of which: interest payments	3.4	4.1	4.0	3.6	2.5	2.2	2.4	2.2
Balance	-7.1	-12.3	-6.0	-5.7	-3.7	-3.3	-3.8	-4.0
Primary balance	-3.8	-8.2	-2.0	-2.1	-1.2	-1.1	-1.4	-1.7
Gross public debt	47.2	49.9	48.7	43.3	42.6	43.6	44.2	44.9

Source: European Commission.
¹⁾ f stands for forecast by the European Commission.

In the first quarter of 2005 the Slovakian current account reported a deficit of 1.9% of GDP compared to a surplus of 1.4% in the first quarter of 2004. The deterioration of the current account went hand in hand with a domestic demand growth that was considerably stronger than a year earlier. The goods and services balance turned into a deficit of 1.5% of GDP in the first quarter of 2005 (against a surplus of 0.4% in the first quarter of 2004), as goods and services export growth slowed down considerably while the corresponding import growth remained strong, contrary to the development of real imports. In addition, the income balance turned from positive to negative as high FDI inflows in recent years have led to rising dividend repatriation. At the same time, FDI inflows dropped considerably from 4.4% of GDP in the first quarter of 2004 to just 0.8% of GDP in the first quarter of 2005. FDI covered around 44% of the overall financing requirements.

Table 26

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	<i>EUR million</i>							
Merchandise exports	9,606.8	12,866.4	14,118.8	15,281.0	19,369.5	22,370.0	5,009.2	5,580.4
<i>Merchandise exports: year-on-year change in %</i>	0.5	33.9	9.7	8.2	26.8	15.5	18.7	11.4
Merchandise imports	10,633.4	13,837.7	16,494.4	17,539.5	19,935.2	23,552.8	5,026.8	5,844.8
<i>Merchandise imports: year-on-year change in %</i>	-8.8	30.1	19.2	6.3	13.7	18.1	15.3	16.3
Trade balance	-1,026.6	-971.3	-2,375.6	-2,258.5	-565.7	-1,182.8	-17.6	-264.4
<i>% of GDP</i>	-5.4	-4.4	-10.2	-8.8	-2.0	-3.6	-0.2	-3.0
Services balance	207.7	475.5	536.1	483.4	210.1	215.6	48.6	138.4
Income balance (factor services balance)	-281.0	-382.2	-349.8	-485.3	-106.9	-328.1	15.4	-59.9
Current transfers	183.9	128.1	236.6	206.2	217.4	134.4	60.8	18.3
Current account balance	-916.0	-749.9	-1,952.7	-2,054.2	-245.1	-1,160.8	107.1	-167.7
<i>% of GDP</i>	-4.8	-3.4	-8.4	-8.0	-0.8	-3.5	1.4	-1.9
Capital account balance	148.9	99.5	87.1	113.9	89.4	110.1	6.3	-0.7
<i>% of GDP</i>	0.8	0.5	0.4	0.4	0.3	0.3	0.1	0.0
Direct investment flows (net)	737.4	2,048.2	1,726.3	4,291.0	575.4	1,072.7	337.1	72.7
<i>% of GDP</i>	3.9	9.3	7.4	16.7	2.0	3.2	4.4	0.8

Source: Eurostat, national central bank, OeNB.

Gross external debt increased from 52.5% of GDP at end-2004 to 63.5% of GDP at the end of the first quarter of 2005 due to both higher official and private gross foreign debt. Gross official reserves augmented to EUR 21.732 billion at the end of the first quarter of 2005, thus covering 6.2 months' worth of imports of goods and services.

Table 27

Gross Official Reserves and Gross External Debt							
	1999	2000	2001	2002	2003	2004	Q1 05
<i>End of period, EUR million</i>							
Gross official reserves (excluding gold)	3,780.7	4,526.0	5,074.5	8,497.3	9,337.9	10,604.7	13,555.5
Gross external debt	..	..	..	12,575.9	14,323.3	17,395.7	21,731.6
<i>% of GDP¹⁾</i>							
Gross official reserves (excluding gold)	19.8	20.6	21.8	33.0	32.2	32.0	39.6
Gross external debt	..	..	..	48.9	49.5	52.5	63.5
<i>Import months of goods and services</i>							
Gross official reserves (excluding gold)	3.7	3.4	3.2	5.1	4.9	4.8	6.2

Source: Eurostat, national central bank, OeNB, wiiv.
¹⁾ Q1 05: As a percentage of rolling four-quarter GDP.

6 Slovenia: Solid Economic Background Supports Stable Currency

GDP growth in Slovenia decelerated sharply to 2.6% year on year in the first quarter of 2005, from 4.6% in the full year 2004. This deceleration was attributable to a slowdown in domestic demand, while the contribution of net real exports to the GDP growth rate improved sharply. Among the domestic demand components, consumption growth moderated slightly as a result of reduced private and accelerating public consumption growth. Private consumption was supported by robust growth in real wages and stronger real growth of lending to households, while employment growth continued to slow down. The growth rate of gross fixed capital formation fell sharply at the beginning of 2005, leading to a contraction of investment activity compared to the first quarter of 2004. Both annual export and import growth rates were lower in the first quarter of 2005 than in the previous quarters, but given the more significant decline in the growth rate of imports, net real exports contributed 1.3 percentage points to the GDP growth rate in the first quarter, following a negative contribution of 0.3 percentage point in the full year 2004.

Table 28

Gross Domestic Product and Its Demand Components								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Real year-on-year change in %</i>								
Gross domestic product	5.6	3.9	2.7	3.3	2.5	4.6	4.3	2.6
Private consumption	5.9	0.4	2.3	0.3	2.7	3.5	3.2	2.7
Public consumption	2.9	2.3	3.9	1.7	2.6	1.7	2.6	2.9
Gross fixed capital formation	21.0	0.6	4.1	3.1	6.3	6.8	5.7	-0.5
Exports of goods and services	1.6	13.0	6.3	6.7	3.2	12.6	13.3	8.9
Imports of goods and services	8.0	7.6	3.0	4.9	6.8	12.4	11.6	6.6
<i>Contribution to GDP growth in percentage points</i>								
Domestic demand	9.4	1.5	0.9	2.3	4.9	4.9	3.8	1.3
Exports	0.9	7.1	3.7	4.1	2.0	8.0	8.5	5.9
Net exports	-3.9	2.4	1.8	1.0	-2.4	-0.3	0.5	1.3

Source: Eurostat, national statistical office, OeNB.

Table 29

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Year-on-year change of period average levels in %</i>								
Gross production of industry (real)	-0.5	6.3	3.1	2.5	1.4	5.0	2.4	-2.5
Labor productivity of industry (real)	0.9	6.8	2.3	1.4	3.0	6.1	3.3	-3.0
Gross average wage of industry (nominal)	9.3	11.7	10.8	9.9	7.6	7.1	6.9	7.0
Unit labor cost of industry (nominal)	8.3	4.6	8.4	8.3	4.4	1.0	3.4	10.3
Producer price index (PPI) of industry	2.2	7.7	8.9	5.3	2.6	4.4	5.2	4.4
Consumer price index (here: HICP)	6.1	8.9	8.6	7.5	5.7	3.6	3.5	2.8
Exchange rate (nominal):								
SIT ¹⁾ per 1 EUR, + = EUR appreciation	4.6	6.3	5.5	3.6	3.5	2.2	1.6	0.9
EUR per 1 SIT, + = SIT appreciation	-4.4	-5.9	-5.2	-3.5	-3.4	-2.2	-1.5	-0.9
<i>Period average levels</i>								
Unemployment rate (ILO definition, %) ²⁾	7.6	6.9	6.3	6.5	6.8	6.5	6.6	6.9
Employment rate ³⁾	62.2	62.9	63.8	63.4	62.6	65.3	64.9	65.2
Participation rate ⁴⁾	67.3	67.5	68.1	67.8	67.1	69.8	69.5	70.0
Key interest rate per annum (%)	7.2	8.1	10.5	8.4	7.0	4.6	4.0	4.0
Exchange rate (nominal):								
SIT per 1 EUR	194.4	206.6	218.0	225.9	233.8	239.1	239.8	239.7
EUR per 1 SIT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiv.

¹⁾ SIT: Slovenian tolar.

²⁾ Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

³⁾ Ratio of employed persons to the working-age population (aged 15 to 64).

⁴⁾ Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

After industrial output growth had remained negative during the first quarter, it picked up modestly in the period from April to June 2005 (2.0% year on year), but these dynamics weakened in the course of the second quarter. Nevertheless, this development – along with a further strengthening of credit activity – suggests some economic recovery. Weaker economic activity in the first quarter went hand in hand with slower annual growth in employment. Moreover, as the further rise in the employment rate was fully matched by the increase in the participation rate, the unemployment rate declined only very slightly from 7.0% to 6.9%. Tighter labor market conditions have so far prevented a significant decline in nominal wage growth, despite the slowdown in inflation, which in fact has led to an acceleration of real net wages to 3.4% during the first half of 2005 (2004: 2%). Inflation (HICP) went down gradually in the second quarter of 2005 to 1.7% in June, before rising back to 2.0% in July. Disinflation was supported by weaker economic growth, more intense competition, a stable exchange rate, falling food and nonalcoholic beverage prices and by a sharp disinflation in recreation and culture. In the first quarter of 2005, robust wage growth coincided with decreasing industrial output and labor productivity, leading to higher unit wage costs. While output recovery in the second quarter likely mitigated the situation, moderate wage growth remains a key to keep price pressures limited in the future, as acknowledged by Banka Slovenije. In addition, fuel prices represent a risk factor, especially as the government has almost completely exhausted its room to cut excise duties in compensation for the rise in international oil prices. Banka Slovenije

expects inflation to come to around 2.4% at end-2005. Inflation should pick up modestly in the next two years, mainly because the negative output gap is set to close and turn positive.

Since Slovenia entered ERM II on June 28, 2004, the exchange rate of the Slovenian tolar against the euro has fluctuated in a very narrow range of between 0.10% on the strong side and 0.17% on the weak side of the central rate. Between early April and late June 2005, the tolar's appreciation trend, which had been observed since October 2004, gained momentum, but the currency has weakened slightly since then. However, these are still very small exchange rate movements compared to those of other currencies in the region (trading band of 0.14% since early April 2005). Banka Slovenije last changed its key policy rates at the beginning of April 2005, when it raised the interest rate it charges on buy/sell foreign exchange swap operations (through which it temporarily alters tolar liquidity) and the main refinancing rate (which is linked to the former) by 25 basis points to 1.5% and 3.5%, respectively. Correspondingly, money market rates have been stable at around 4% for the past few months. As a combination of stable interest rates and falling inflation, real interest rates went up modestly during the first half of 2005. This notwithstanding, the real growth of credit to households and enterprises has been increasing, as the nominal year-on-year growth of credit to households accelerated to 22% on average in the first quarter from 16.5% in the full year 2004, that of credit to enterprises to 22.5% from 19.5% and that of credit to general government to 19.5% from 16.5%. This "discrepancy" can most likely be explained by the ongoing shift toward foreign currency borrowing.

Table 30

Monetary Developments								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	<i>Nominal year-on-year change of the annual average stock in %</i>							
Broad money (including foreign currency deposits)	..	13.7	19.2	22.8	12.7	5.1	4.4	7.4
	<i>Contributions to the nominal year-on-year change of broad money in percentage points</i>							
Net foreign assets of the banking system	..	3.1	9.1	11.0	3.3	-8.1	-10.1	-10.1
Domestic credit (net) of the banking system	..	15.1	14.4	12.2	8.1	14.0	15.1	17.9
<i>of which: claims on the private sector</i>	..	15.1	12.6	9.1	8.0	11.5	12.4	14.9
<i>claims on households</i>	..	4.4	2.0	1.6	1.5	2.7	3.5	3.8
<i>claims on enterprises</i>	..	10.7	10.6	7.5	6.5	8.8	8.9	11.1
<i>net claims on the public sector</i>	..	0.0	1.7	3.2	0.1	2.4	2.6	3.0
Other domestic assets (net) of the banking system	..	-4.4	-4.2	-0.4	1.3	-0.8	-0.6	-0.4

Source: National central bank, OeNB.

In mid-June 2005, the Slovenian parliament approved a supplementary budget for 2005. The revised budget envisages a rise in both revenues and expenditures compared to the original budget. As an overall result of the changes, the budget deficit (national methodology) is now targeted at 1.4% of GDP, compared to the previous value of 1.7%. A revised deficit target

according to the ESA methodology is not available, but if one assumes the same reduction as in the national methodology, this would result in a deficit of 1.6% of GDP (compared to 1.9% in the March 2005 fiscal notification to the European Commission and 2.1% envisaged in the convergence program of December 2004). Following intense discussion about the introduction of a flat tax system during the first half of 2005, the government's expert commission for tax reform finally abandoned the idea for the time being and proposed to only reduce the number of income tax brackets (to three from currently five) and to introduce separate tax treatment of capital and labor income. Aside from these measures, the finance minister explained that switching to a flat income tax system with potential risks for budget revenues was too risky before the introduction of the euro. The convergence program of December 2004 set the deficit target to 1.8% of GDP for 2006 and to 1.1% for 2007.

Table 31

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f ¹⁾	2006 f ¹⁾
	% of GDP							
General government								
Revenues	..	44.7	45.1	45.7	46.2	45.8	45.5	45.2
Expenditures	..	48.2	47.9	48.1	48.2	47.7	47.6	47.2
<i>of which: interest payments</i>	..	2.4	2.4	2.3	2.1	1.9	1.7	1.6
Balance	..	-3.5	-2.8	-2.4	-2.0	-1.9	-2.2	-2.1
Primary balance	..	-1.0	-0.4	0.0	0.1	0.0	-0.5	-0.5
Gross public debt	24.9	27.4	28.1	29.5	29.4	29.4	30.2	30.4

Source: European Commission.

¹⁾ f stands for forecast by the European Commission.

Slovenia posted a current account surplus of 0.3% of GDP in the first quarter of 2005, which was smaller than the surplus recorded in the same period of 2004. The deterioration in the current account was primarily attributable to the fact that the transfer balance, which traditionally shows a surplus, turned into a deficit of 0.8% of GDP due to payments into the EU budget. By contrast, the surplus on the goods and services balance almost doubled to 1.3% of GDP against the first quarter of 2004. For the first time since then, year-on-year export growth outpaced import growth, reflecting the developments in real exports and imports. Given a negative balance on the capital account, Slovenia had a financing requirement of 0.4% of GDP in the first quarter of 2005, which was related to net FDI outflows of 3.3% of GDP (partly resulting from the reversal of previous inward FDI) and significantly larger net outflows of portfolio capital than a year earlier. The resulting financing gap was covered by a sharp increase in net inflows of other capital, mainly on the back of bank deposits by nonresidents.

Table 32

Balance of Payments								
	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
<i>EUR million</i>								
Merchandise exports	8,103.2	9,574.2	10,454.3	11,081.6	11,414.0	12,736.1	2,991.0	3,317.6
Merchandise exports: year-on-year change in %	0.2	18.2	9.2	6.0	3.0	11.6	8.3	10.9
Merchandise imports	9,267.3	10,801.2	11,138.7	11,351.0	11,959.9	13,576.0	3,088.7	3,399.7
Merchandise imports: year-on-year change in %	5.4	16.6	3.1	1.9	5.4	13.5	5.9	10.1
Trade balance	-1,164.1	-1,227.0	-684.4	-269.4	-545.9	-839.9	-97.7	-82.1
% of GDP	-5.8	-6.0	-3.1	-1.1	-2.2	-3.2	-1.6	-1.3
Services balance	329.5	489.2	535.5	616.5	538.3	671.8	139.5	162.1
Income balance (factor services balance)	58.1	29.3	43.2	-153.8	-178.0	-101.2	-15.4	-15.1
Current transfers	112.2	125.5	143.6	142.0	94.2	30.6	7.8	-49.0
Current account balance	-664.3	-583.0	37.9	335.3	-91.4	-238.7	34.2	15.9
% of GDP	-3.3	-2.8	0.2	1.4	-0.4	-0.9	0.6	0.3
Capital account balance	-0.7	4.0	-4.0	-163.6	-165.5	-178.3	-23.7	-26.8
% of GDP	0.0	0.0	0.0	-0.7	-0.7	-0.7	-0.4	-0.4
Direct investment flows (net)	54.5	77.4	251.2	1,582.3	-114.9	21.0	-109.9	-205.5
% of GDP	0.3	0.4	1.2	6.7	-0.5	0.1	-1.8	-3.3

Source: Eurostat, national central bank, OeNB.

Slovenia's gross external debt reached 62.5% of annual GDP at the end of March 2005, with the ongoing increase in the debt ratio being solely attributable to the private sector. Net debt stood at 9.1% of annual GDP, up from 1.8% one year earlier. Gross official reserves increased slightly to cover 5.1 months' worth of imports of goods and services at the end of the first quarter of 2005.

Table 33

Gross Official Reserves and Gross External Debt							
	1999	2000	2001	2002	2003	2004	Q1 05
<i>End of period, EUR million</i>							
Gross official reserves (excluding gold)	3,159.20	3,435.80	4,907.50	6,701.50	6,798.20	6,464.00	6,515.20
Gross external debt	8,012.30	9,490.60	10,402.60	11,482.90	13,305.00	15,397.00	16,313.00
<i>% of GDP¹⁾</i>							
Gross official reserves (excluding gold)	15.9	16.7	22.5	28.5	27.7	25.0	24.9
Gross external debt	40.2	46.1	47.6	48.8	54.1	59.5	62.5
<i>Import months of goods and services</i>							
Gross official reserves (excluding gold)	3.5	3.3	4.6	6.1	5.9	4.9	5.1

Source: Eurostat, national central bank, OeNB, wiiv.

¹⁾ Q1 05: As a percentage of rolling four-quarter GDP.

7 Bulgaria: Strong Economic Performance, But Current Account Problem Continues

Real GDP grew by 6.0% year on year in the first quarter of 2005, after the economy had expanded by 6.2% in the fourth quarter of 2004 and by 5.6% in the full year 2004. Private consumption and exports made the highest contributions to GDP growth. In the first quarter of 2005, growth of domestic

consumption (private and public) exceeded the level of GDP growth, increasing to 7.3% year on year from 5.0% in the full year 2004 and boosting the contribution of domestic demand to GDP growth to 11.4 percentage points. Strong private consumption was fueled in particular by increasingly high wage growth (e.g. a 25% hike of minimum wages in January 2005) and very strong consumer credit growth. Growth of gross fixed capital formation, though, declined to 9.2%. Weaker domestic investment growth and a sharp slowdown in export growth led to a decline in import growth. However, as in the full year 2004, import growth outpaced export growth in the first quarter of 2005. Net exports of goods and services became even more negative. The deterioration of net exports reduced GDP growth by 5.4 percentage points, after it had dampened growth by 3.9 percentage points in the full year 2004 and by 11.3 percentage points in the first quarter of 2004.

Table 34

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Real year-on-year change in %</i>								
Gross domestic product	2.4	5.4	4.1	4.9	4.5	5.6	6.2	6.0
Private consumption	9.6	4.3	5.2	3.5	6.3	5.4	6.8	..
Public consumption	6.3	18.8	0.3	4.4	8.1	2.8	5.6	..
Gross fixed capital formation	20.9	15.4	23.3	8.5	13.7	12.0	9.9	9.2
Exports of goods and services	-4.6	16.6	9.9	7.2	7.9	13.2	19.8	8.8
Imports of goods and services	9.3	18.7	14.8	4.9	15.3	14.1	16.9	10.8
<i>Contribution to GDP growth in percentage points</i>								
Domestic demand	11.0	8.7	9.2	4.3	12.1	9.5	10.0	11.4
Exports	-2.7	9.3	6.1	4.7	5.3	9.2	11.7	6.4
Net exports	-8.6	-3.3	-5.1	0.6	-7.6	-3.9	-3.8	-5.4

Source: Eurostat, OeNB, wiiv.

High GDP growth helped reduce the unemployment rate (ILO definition) to 11.5% in the first quarter of 2005 (average), down from 13.5% the same period a year earlier. The strength of domestic demand and the export surge contributed to the ongoing increase in industrial output in Bulgaria, which, however, continued to decelerate in the first quarter of 2005 and amounted to 11.0% year on year as compared to the exceptionally high rates observed in 2004. The slowdown of output growth reduced industrial productivity growth to 12.9% from 17.5% in the full year 2004, while nominal industrial gross wage growth accelerated despite declining inflation. However, industrial unit wage costs still continued to go down, albeit at a lower rate. Having fallen from a peak of 7.6% year on year in July 2004 to a low of 3.3% year on year in January 2005, inflation (HICP) increased to 5.1% in June 2005. The major factors driving up inflation remained primarily the sharp rises in energy prices and one-off events such as the upward adjustment of administered tariffs and excise taxes. In addition, the annual rise in both food and health care prices accelerated significantly in the course of 2005. According to the central bank, average annual inflation is forecast to decline to about 3.5% for the entire year 2005;

the Bulgarian National Bank thus warned that there were several external risk factors that might raise inflation, namely the possible surge in oil prices on global markets and the possible appreciation of the U.S. dollar against the euro.

Table 35

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Year-on-year change of period average levels in %</i>								
Gross production of industry (real)	-9.6	5.3	2.5	4.7	14.1	17.7	19.4	11.0
Labor productivity of industry (real)	1.2	8.6	4.5	2.7	12.6	17.5	23.0	12.9
Gross average wage of industry (nominal)	8.0	8.1	5.6	3.5	3.8	7.1	8.1	8.4
Unit labor cost of industry (nominal)	6.7	-0.5	1.1	0.8	-7.8	-8.8	-12.1	-4.0
Producer price index (PPI) of industry	3.2	17.0	3.8	1.4	5.0	5.9	6.9	6.2
Consumer price index (here: HICP)	2.6	10.3	7.4	5.8	2.3	6.1	4.7	3.8
Exchange rate (nominal):								
BGN ¹⁾ per 1 EUR, + = EUR appreciation	-0.7	-0.2	-0.2	0.1	0.0	0.2	0.3	0.2
EUR per 1 BGN, + = BGN appreciation	0.7	0.2	0.2	-0.1	0.0	-0.2	-0.3	-0.2
<i>Period average levels</i>								
Unemployment rate (ILO definition, %) ²⁾	..	17.0	20.5	18.3	13.9	12.2	12.0	11.5
Employment rate ³⁾	..	50.4	49.7	50.6	52.5	54.2	54.1	53.0
Participation rate ⁴⁾	..	60.7	62.5	61.9	60.9	61.8	61.5	59.9
Key interest rate per annum (%)	4.7	3.9	4.5	4.0	2.7	2.6	2.4	2.2
Exchange rate (nominal):								
BGN per 1 EUR	2.0	2.0	1.9	1.9	1.9	2.0	2.0	2.0
EUR per 1 BGN	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiw.

¹⁾ BGN: Bulgarian lev.

²⁾ Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

³⁾ Ratio of employed persons to the working-age population (aged 15 to 64).

⁴⁾ Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

In the first months of 2005, broad money growth (nominal, year on year) increased to close to 30% against 22% on average in 2004. Apart from a higher growth of net foreign assets, the very robust growth of lending to households reaccelerated to close to 80% (78.5% on average in 2004) and the growth of lending to enterprises rose to 55% in March and April (41% on average in 2004). The fact that Visa issued 126% more credit cards in Bulgaria in the first quarter of 2005 than in the same period in 2004 illustrates this credit boom. However, in May 2005, the annual growth of lending to enterprises weakened considerably. The package of measures addressed to commercial banks' credit activity, including the tightening of reserve requirements for commercial banks and the creation of ceilings for annual credit growth (in April 2005), may have contributed to this development. Nevertheless, these measures have not substantially constrained household credit expansion so far.

Table 36

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Nominal year-on-year change of the annual average stock in %</i>								
Broad money (including foreign currency deposits)	7.9	27.4	27.8	18.3	16.3	22.3	20.6	26.3
<i>Contributions to the nominal year-on-year change of broad money in percentage points</i>								
Net foreign assets of the banking system	-0.2	26.1	13.5	7.7	5.4	4.4	6.2	6.6
Domestic credit (net) of the banking system	2.0	6.8	15.0	12.1	14.5	21.8	19.8	25.4
<i>of which: claims on the private sector</i>	9.5	8.7	8.1	13.6	19.9	26.3	27.2	31.0
<i>claims on households</i>	2.6	1.1	2.4	3.3	5.9	10.0	11.1	11.9
<i>claims on enterprises</i>	6.9	7.7	5.7	10.3	14.0	16.3	16.1	19.1
<i>net claims on the public sector</i>	-7.4	-2.0	6.9	-1.5	-5.4	-4.5	-7.4	-5.6
Other domestic assets (net) of the banking system	6.0	-5.5	-0.7	-1.5	-3.6	-3.8	-5.5	-5.8

Source: National central bank, OeNB.

The Bulgarian government has been conducting a strict fiscal policy which provides for the stability of public finance and under a currency board helps ensure the country's economic stability. According to the fiscal notification by the authorities to the European Commission in March 2005, the fiscal balance in 2004 showed a surplus of 1.3% of GDP compared to an originally expected deficit of 0.7% of GDP. Based on national methodology, the consolidated fiscal budget in 2004 showed a surplus of 1.7% of GDP, which was used mainly to repay external debt. In the first quarter of 2005, the budget surplus came to about 5.5% of GDP according to this methodology and was thus higher than in the comparable period of 2004 (2.9% of GDP). The consolidated budget revenues-to-GDP ratio grew at a faster pace than the expenditures-to-GDP ratio. On account of impressive results for revenues and the strong surpluses to date given a significantly improved tax collection, Bulgaria's consolidated budget is outperforming the plan agreed in May 2005 with the IMF to reach a fiscal surplus of 1% of GDP for 2005; in November 2004, the Bulgarian government had envisaged a 2005 deficit of 0.5% in the PEP for the period from 2004 to 2007, and in March 2005 the fiscal notification had confirmed the expectation of a deficit of 0.5% of GDP in 2005. According to the law on corporate income taxation, the basic corporate tax rate on business profits has been reduced to 15% as of the 2005 financial year from 19.5% in 2004.

Table 37

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f ¹⁾	2006 f ¹⁾
	% of GDP							
General government								
Revenues	56.6	58.2	53.5	..	..	..	..	..
Expenditures	56.2	58.7	52.3	..	..	..	..	..
of which: interest payments	3.8	4.0	3.7	2.2	2.1	1.8	1.9	1.8
Balance	0.4	-0.5	1.2	-0.1	0.6	1.4	-0.5	0.0
Primary balance	4.1	3.6	4.9	2.1	2.7	3.2	1.4	1.8
Gross public debt	79.3	73.6	66.2	54.0	46.3	38.8	32.5	29.8

Source: European Commission.

¹⁾ f stands for forecast by the European Commission.

In Bulgaria, the current account usually exhibits a seasonal pattern, with large deficits in the first, second and fourth quarters of the year, which are partly compensated by a huge surplus in the third quarter related to the tourist season. Thus, it did not come as a surprise that the current account deficit-to-GDP ratio in the first quarter of 2005 at 15.9% of GDP was much higher than in the full year 2004. However, the current account deficit, the main point of concern for the Bulgarian authorities and the IMF, continued to widen in the first quarter of 2005 also compared to the first quarter of 2004, when it was 12.2% of GDP. This development was attributable almost exclusively to the deterioration of the trade balance, which reflects lasting strong internal demand for capital and consumer durable goods as well as rising oil prices and the strengthening of the U.S. dollar versus the euro. According to balance of payments data, exports and imports grew at around the same rate in the first quarter of 2005; exports increased by 20.8% (first quarter of 2004: 5.1%), imports by 22.5% (first quarter of 2004: 15.7%), which means that the trade deficit worsened. Additionally, the services balance was to blame for the remaining deterioration in the current account balance. The deficit on income items widened only slightly. In the first quarter of 2005, net FDI inflows dropped and stood at EUR 265 million (first quarter of 2004: EUR 354 million), covering about one-third of the current account deficit, compared with three-quarters in the first quarter of 2004 – significantly less than in both full years 2003 and 2004.

Table 38

Balance of Payments								
	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
<i>EUR million</i>								
Merchandise exports	3,733.8	5,253.1	5,714.1	6,062.8	6,668.0	7,993.9	1,719.2	2,077.6
Merchandise exports: year-on-year change in %	-0.3	40.7	8.8	6.1	10.0	19.9	5.1	20.8
Merchandise imports	4,741.5	6,532.9	7,492.6	7,754.5	8,867.9	10,711.8	2,227.6	2,729.2
Merchandise imports: year-on-year change in %	16.3	37.8	14.7	3.5	14.4	20.8	15.7	22.5
Trade balance	-1,007.7	-1,279.8	-1,778.5	-1,691.7	-2,199.9	-2,717.9	-508.4	-651.6
% of GDP	-8.3	-9.3	-11.7	-10.2	-12.4	-14.0	-12.4	-14.7
Services balance	305.4	547.4	454.4	486.0	523.2	723.4	-28.4	-73.7
Income balance (factor services balance)	-167.1	-345.2	-339.6	-285.3	-566.5	-340.9	-136.6	-147.4
Current transfers	282.1	316.1	562.0	565.5	612.7	888.1	174.0	167.9
Current account balance	-587.3	-761.5	-1,101.7	-925.5	-1,630.5	-1,447.3	-499.4	-704.8
% of GDP	-4.8	-5.6	-7.2	-5.6	-9.2	-7.4	-12.2	-15.9
Capital account balance	-2.3	25.4	0.0	0.0	-0.2	0.0	0.0	0.0
% of GDP	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment flows (net)	849.9	1,099.8	895.0	951.0	1,827.2	1,639.8	354.3	265.0
% of GDP	7.0	8.0	5.9	5.7	10.3	8.4	8.6	6.0

Source: Eurostat, national central bank, OeNB.

The country's gross external debt increased from 62.9% of GDP at end-2004 to 65.4% of annual GDP at end-March 2005. The position of the private sector deteriorated continuously, while the position of the public sector improved. Foreign currency reserves remained constant at EUR 6.3 billion, corresponding to about 5.7 months of import cover.

Table 39

Gross Official Reserves and Gross External Debt							
	1999	2000	2001	2002	2003	2004	Q1 05
<i>End of period, EUR million</i>							
Gross official reserves (excluding gold)	2,878.7	3,390.6	3,734.0	4,247.1	4,981.0	6,444.5	6,325.1
Gross external debt	10,846.6	11,882.7	11,934.9	10,768.9	10,638.7	12,245.9	12,940.1
<i>% of GDP¹⁾</i>							
Gross official reserves (excluding gold)	23.7	24.7	24.5	25.6	28.1	33.1	31.9
Gross external debt	89.2	86.7	78.3	64.9	60.0	62.9	65.4
<i>Import months of goods and services</i>							
Gross official reserves (excluding gold)	5.6	4.9	4.8	5.2	5.4	5.8	5.7

Source: Eurostat, national central bank, OeNB, wiiv.

¹⁾ Q1 05: As a percentage of rolling four-quarter GDP.

8 Croatia: Economic Slowdown and Stabilization of External Debt

In Croatia real GDP growth considerably decelerated to 1.8% year on year in the first quarter of 2005 compared to 3.6% in the last quarter of 2004 (full year 2004: 3.8%), the lowest growth rate since the last quarter of 2000 (0.6%). This development is attributable to a slowdown in private consumption to 2.4% in

the first quarter of 2005 from 3.8% in the last quarter of 2004 and, most importantly, can be traced to the marked drop in the growth rate of real exports to 1.0% in the first quarter of 2005 from 5.8% in the previous quarter. As import growth accelerated to 2.1% in the first quarter of 2005, net exports made a negative contribution to GDP growth (−0.8 percentage point), after a significantly positive contribution in previous quarters. Therefore, domestic demand remained the major contributor to GDP, notwithstanding the slow-down in private consumption and the stagnation of public consumption and gross fixed capital formation.

Table 40

Gross Domestic Product and Its Demand Components								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Real year-on-year change in %</i>								
Gross domestic product	−0.9	2.9	4.4	5.2	4.3	3.8	3.6	1.8
Private consumption	−2.9	4.2	4.5	7.5	4.1	3.9	3.8	2.4
Public consumption	2.8	−1.5	−6.2	−1.8	−0.3	−0.3	−0.6	−0.1
Gross fixed capital formation	−3.9	−3.8	7.1	12.0	16.8	4.4	0.9	0.3
Exports of goods and services	0.7	12.0	8.1	1.3	10.1	5.4	5.8	1.0
Imports of goods and services	−3.5	3.7	9.8	8.8	10.9	3.5	0.0	2.1
<i>Contribution to GDP growth in percentage points</i>								
Domestic demand	−3.0	−0.3	5.8	9.4	5.8	3.3	1.2	2.6
Exports	0.3	5.1	3.7	0.6	4.6	2.6	2.4	0.4
Net exports	2.1	3.2	−1.4	−4.2	−1.5	0.5	2.4	−0.8

Source: National statistical office, OeNB.

The unemployment rate (registered unemployment) amounted to 19.2% in the first quarter of 2005, compared to 19.1% in the first quarter of 2004. Growth of average net wages declined to 4.9% (full year 2004: 5.9%) in nominal terms and to 1.7% (full year 2004: 3.7%) in real (CPI-deflated) terms, contributing to the slowdown of private consumption growth. In industry, average gross wages grew by 5.6% in the first quarter of 2005 (full year 2004: 5.5%). As labor productivity growth slowed down to 2.6% (full year 2004: 4.0%) as a consequence of the significant weakening of industrial production to 0.7%, which could not be compensated for by a decline of 1.9% in industrial employment, industrial ULC rose by 3.0% against a slight increase in 2004 (1.5%). Headline inflation accelerated to 3.9% year on year in March 2005 compared to the average annual inflation of 2.1% in 2004, mainly because higher prices of food, energy and services. By May 2005, CPI inflation had dropped to 2.8%, but then slightly increased to 3.1% in July mainly because of higher prices of food, transportation (fuel), leisure and culture, and a base effect. At the same time, the inflation rate excluding energy and food stayed at a stable 1.8%. Apart from food and energy, administrative price adjustments, higher indirect taxes and price dynamics in the services sector may be considered as the main factors driving inflation.

Table 41

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Year-on-year change of period average levels in %</i>								
Gross production of industry (real)	-1.5	1.8	6.1	5.5	4.1	3.7	4.1	0.7
Labor productivity of industry (real)	1.6	4.4	7.8	7.8	3.5	4.0	4.5	2.6
Gross average wage of industry (nominal)	5.6	6.1	8.2	6.9	5.4	5.5	5.7	5.6
Unit labor cost of industry (nominal)	3.8	1.6	0.4	-0.8	1.8	1.5	1.2	3.0
Producer price index (PPI) of industry	2.5	9.5	3.4	-0.5	1.9	3.6	5.6	5.0
Consumer price index (CPI) ¹⁾	4.3	6.4	5.0	1.7	1.8	2.1	2.3	3.1
Exchange rate (nominal):								
HRK ²⁾ per 1 EUR, + = EUR appreciation	6.4	0.9	-2.1	-1.0	2.1	-0.9	-1.0	-1.3
EUR per 1 HRK, + = HRK appreciation	-6.0	-0.8	2.1	1.0	-2.1	0.9	1.0	1.3
<i>Period average levels</i>								
Unemployment rate (registered unemployed, %)	19.1	21.1	22.0	22.3	19.5	18.2	18.4	19.2
Employment rate ³⁾	53.4	53.4	54.7	54.5	..
Participation rate ⁴⁾	62.9	62.4	63.7	63.4	..
Key interest rate per annum (%)	7.5	6.5	5.9	5.6	4.5	4.5	4.5	4.5
Exchange rate (nominal):								
HRK per 1 EUR	7.6	7.6	7.5	7.4	7.6	7.5	7.6	7.5
EUR per 1 HRK	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiiv.

¹⁾ Retail price index until 2001, CPI since 2002.

²⁾ HRK: Croatian kuna.

³⁾ Ratio of employed persons to the working-age population (aged 15 to 64).

⁴⁾ Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

The exchange rate regime in Croatia is a fairly tightly managed float regime, with the central bank intervening rather frequently. After the usual seasonal depreciation at the end of 2004, the exchange rate of the Croatian kuna against the euro registered an appreciation during the first six months of 2005, going up from 7.7 HRK/EUR in January to 7.3 HRK/EUR in June. This appreciation of about 4% motivated the central bank to sell a total amount of EUR 293 million of domestic currency against the euro on six occasions from January to June. In July, the appreciation trend stopped. Broad money growth remained stable at 8.5% in the first quarter of 2005 compared to 8.8% in the last quarter of 2004 (full year 2004: 8.3%). Money growth is dominated by the growth of lending to nongovernment nonbanks, which accelerated moderately to 13% (2004: 11.8%). While net foreign assets contracted more severely in 2005 (-19.8%) compared to 2004 (-1.8%), net credit to the government surged by 42%, after it had declined by 5.5% in 2004. However, these sharp changes had no large impact on money growth as the weight of these items is only small.

Besides foreign exchange interventions, the second main pillar of monetary policy in Croatia rests on mandatory reserve regulations, foreign currency asset-to-liability ratios and other quantitative measures. In addition to a mandatory reserve ratio of 18%, Croatian banks have to maintain a minimum coverage of their foreign currency liabilities in the form of short-term foreign currency assets (32% since February 2005). The marginal reserve requirement ratio, which requires banks to deposit (free of interest) with the central bank a specified percentage of the net increase in their foreign liabilities over the level registered in June 2004, was hiked from 30% to 40% in May 2005.

Without too strongly influencing the predominance of foreign exchange interventions and mandatory reserve regulations, Hrvatska narodna banka introduced, in April 2005, a new monetary operational framework aimed at providing a clear structure of interest rate instruments. This new framework comprises an interest corridor of 0.5% to 9.5% set by means of standing facilities, which actually coincide with fluctuations observed on the money market in the past, and open market operations classified into (1) regular operations, (2) fine tuning operations and (3) structural operations.

Table 42

Monetary Developments								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Nominal year-on-year change of the annual average stock in %</i>								
Broad money (including foreign currency deposits)	2.6	14.0	30.9	32.4	11.3	8.3	8.8	8.5
<i>Contributions to the nominal year-on-year change of broad money in percentage points</i>								
Net foreign assets of the banking system	-3.7	20.3	13.4	9.8	-7.7	-0.5	-0.3	-1.7
Domestic credit (net) of the banking system¹⁾	9.8	-1.2	21.1	23.2	19.5	9.4	10.5	12.6
<i>of which: claims on the private sector</i>	5.9	-2.0	17.0	21.5	17.7	10.1	10.7	11.4
<i>claims on households</i>	5.6	3.8	10.0	11.3	11.9	7.5	7.2	7.8
<i>claims on enterprises</i>	..	..	..	..	..	..	..	..
<i>net claims on the public sector</i>	3.9	0.9	4.1	1.7	1.8	-0.7	-0.3	1.2
Other domestic assets (net) of the banking system	-3.4	-5.1	-3.6	-0.5	-0.5	-0.7	-1.4	-2.4

Source: National central bank, OeNB.
¹⁾ Local governments included in private sector. Claims on households excluding claims of the central bank.

In 2004, according to the fiscal notifications to the European Commission of March and April 2005, the general government's deficit stood at 4.9% of GDP (which corresponds to 5.2% when based on the new methodology) instead of the targeted 4.5% – a phenomenon that was chiefly attributable to weaknesses on the revenue side. Under the commitment the Croatian government set out in the PEP for 2005 to 2007, the general government's budget deficit is envisaged to decrease to 3.7% (which corresponds to 3.2% when based on the new methodology) in 2005 and further to 3.2% in 2007. The PEP expects the continued adjustment to come primarily from measures on the expenditure side; the expenditure-to-GDP ratio is expected to go down from 52.7% in 2004 to 50.8% in 2005 and 49.7% in 2007. The European Commission's 2005 spring forecast expects the general government deficit to come to 4.3% of GDP in 2005. Along these lines and in response to the revenue shortfall caused by weak economic growth, the general government deficit target envisaged for 2005 was officially acknowledged to be out of reach when Croatia and the IMF agreed on a new target of 4.2% (new methodology) during the second review of the 20-month precautionary Stand-By Arrangement with the IMF that runs until April 2006. The IMF recommends fiscal consolidation to comprise four steps: changing the pension indexation formula, reforming the health care system,

reducing public subsidies to state-owned firms and promoting privatization. In July, parliament will decide on the revised 2005 budget, which comprises a cut of HRK 1.0 billion on the expenditure side.

Table 43

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f ¹⁾	2006 f ¹⁾
	<i>% of GDP</i>							
General government								
Revenues	..	..	..	..	..	..	..	..
Expenditures	..	..	..	..	..	..	..	..
<i>of which: interest payments</i>	..	..	..	..	2.0	2.0	2.2	2.2
Balance	..	..	..	..	-6.3	-5.0	-4.3	-3.9
Primary balance	..	..	..	..	-4.4	-3.0	-2.1	-1.6
Gross public debt	..	..	..	..	51.6	53.8	53.1	52.5

Source: European Commission.

¹⁾ f stands for forecast by the European Commission.

In accordance with the long-observed seasonal pattern of the current account, the current account deficit reached 19.8% of GDP in the first quarter of 2005, slightly higher than the 19.2% registered in the comparable period of 2004 (the current account usually exhibits large deficits in the first, second and fourth quarters of the year, which are partly compensated by a huge surplus in the third quarter related to the tourist season). The slight worsening of the trade balance (-23.5% in the first quarter of 2005 against -23.2% in the comparable quarter of 2004) was counterbalanced by an improvement in current transfers, while the services and income balances remained largely unchanged compared to the first quarter of 2004.

Table 44

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	<i>EUR million</i>							
Merchandise exports	4,134.1	4,969.3	5,318.8	5,293.1	5,571.7	6,601.9	1,483.4	1,522.7
<i>Merchandise exports: year-on-year change in %</i>	1.8	20.2	7.0	-0.5	5.3	18.5	7.2	2.6
Merchandise imports	7,240.0	8,468.6	9,922.6	11,253.5	12,545.9	13,326.7	2,919.8	3,075.9
<i>Merchandise imports: year-on-year change in %</i>	-5.5	17.0	17.2	13.4	11.5	6.2	6.9	5.3
Trade balance	-3,105.9	-3,499.4	-4,603.8	-5,960.3	-6,974.2	-6,724.7	-1,436.5	-1,553.3
<i>% of GDP</i>	-16.6	-17.5	-20.8	-24.6	-27.3	-24.3	-23.2	-23.5
Services balance	1,544.5	2,470.5	3,302.8	3,284.8	5,046.9	4,903.6	221.5	203.4
Income balance (factor services balance)	-345.5	-419.8	-616.2	-573.8	-1,074.1	-626.9	-241.9	-248.5
Current transfers	594.0	958.9	1,099.5	1,152.2	1,244.5	1,189.7	269.0	291.7
Current account balance	-1,312.9	-489.9	-817.7	-2,097.2	-1,756.9	-1,258.3	-1,187.9	-1,306.7
<i>% of GDP</i>	-7.0	-2.5	-3.7	-8.7	-6.9	-4.6	-19.2	-19.8
Capital account balance	23.4	22.2	154.1	501.2	72.4	23.1	7.0	2.3
<i>% of GDP</i>	0.1	0.1	0.7	2.1	0.3	0.1	0.1	0.0
Direct investment flows (net)	1,314.8	1,140.6	1,326.9	597.2	1,695.4	696.5	233.0	147.7
<i>% of GDP</i>	7.0	5.7	6.0	2.5	6.6	2.5	3.8	2.2

Source: Eurostat, national central bank, OeNB.

Total gross foreign debt reached EUR 22.9 billion, which is equivalent to 81.6% of annual GDP at the end of the first quarter of 2005. The steady increase in foreign debt since 1994, which was particularly accentuated in 2003, came to an at least temporary halt as the foreign debt-to-GDP ratio has fluctuated within a range of 80% to 82% over the last four quarters (second quarter of 2004 to first quarter of 2005). As a matter of fact, the authorities aim at stabilizing and subsequently reducing external debt, a policy objective that – next to fiscal consolidation – represents the second cornerstone of the Stand-By Arrangement with the IMF.

Table 45

Gross Official Reserves and Gross External Debt							
	1999	2000	2001	2002	2003	2004	Q1 05
<i>End of period, EUR million</i>							
Gross official reserves (excluding gold)	3,012.60	3,783.20	5,333.60	5,651.30	6,554.10	6,436.20	6,700.40
Gross external debt	10,101.29	12,109.30	13,458.31	15,054.81	19,810.62	22,675.40	23,042.46
<i>% of GDP¹⁾</i>							
Gross official reserves (excluding gold)	16.13	18.95	24.07	23.34	25.69	23.29	23.88
Gross external debt	54.09	60.65	60.75	62.19	77.64	82.04	82.12
<i>Import months of goods and services</i>							
Gross official reserves (excluding gold)	3.93	4.35	5.29	4.91	5.18	4.76	5.40

Source: Eurostat, national central bank, OeNB, wiw.
¹⁾ Q1 05: As a percentage of rolling four-quarter GDP

9 Romania: Robust Economic Growth, but Strong Currency Appreciation and Widening Current Account Cause Concern

Real GDP growth in Romania slowed to 5.9% year on year in the first quarter of 2005 from 9.7% in the previous quarter and 8.4% in the full year 2004. The robust economic performance was driven by domestic demand, and most strongly by private consumption growth, which came to 12.5%. Private consumption growth was largely supported by rapid real wage growth (total economy net wages deflated by CPI advanced by 13.1% year on year in the first quarter of 2005) and higher disposable income as a result of the reduction of the income and profit tax. Gross fixed capital formation expanded strongly over most of 2004, but fell back in the last quarter to just 2.7% before recovering to 5.2% in the first quarter of 2005. In the first nine months of 2004, export growth accelerated to 16.8%, but dropped to just 8.8% in the last quarter of 2004 and remained at this level also in the first quarter of 2005. Against the background of stronger growth in private and public consumption and gross fixed capital formation, import growth accelerated from 10.0% in the last quarter of 2004 to 18.4% in the first quarter of 2005. The resulting deterioration in net exports implied a negative contribution to GDP growth of 6.0 percentage points, a significantly more negative contribution than in the previous quarter (-1.4 percentage points) and in the full year 2004 (-2.8 percentage points).

Table 46

Gross Domestic Product and Its Demand Components

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Real year-on-year change in %</i>								
Gross domestic product	-1.1	2.0	5.6	5.1	5.3	8.4	9.7	5.9
Private consumption ¹⁾	-1.1	0.3	6.7	5.0	7.1	11.2	12.8	12.5
Public consumption ²⁾	-1.8	5.5	4.3	3.4	3.6	5.8
Gross fixed capital formation	-5.5	5.3	10.5	7.5	9.1	9.9	2.7	5.2
Exports of goods and services	..	24.3	13.7	17.1	11.5	14.2	8.8	8.8
Imports of goods and services	..	28.5	18.9	11.8	16.0	18.1	10.0	18.4
<i>Contribution to GDP growth in percentage points</i>								
Domestic demand	..	..	8.4	4.3	7.8	11.3	11.0	12.0
Exports	..	..	4.5	5.7	4.1	5.1	2.7	4.3
Net exports	..	..	-2.8	0.9	-2.5	-2.8	-1.4	-6.0

Source: National statistical office, Eurostat, OeNB, wiiv.

¹⁾ Household consumption expenditure, expenditure for individual consumption of general government and nonprofit institutions serving households.

²⁾ Expenditure for collective consumption of general government.

The average unemployment rate (ILO definition) declined from 9.3% in the first quarter of 2004 to 8.9% in the first quarter of 2005, as the increase in the employment rate by 1.2 percentage points to 56.6% slightly exceeded the rise in the participation rate over this period. In industry, employment declined slightly by 0.2% year on year in the first quarter of 2005, while real industrial output increased by 5.4%. The resulting growth of labor productivity by 5.6% lagged behind industrial wage growth, leading to a 9.3% rise in nominal industrial unit wage costs. As a result, the decline in industrial wage growth helped moderate the rise in nominal industrial unit wage costs, which in turn will underpin the disinflation process. After having reached 10.1% in May 2005, inflation (HICP) started to decrease in June to 9.7% and further in July to 9.3%. Inflation was driven partly by supply-side factors (increases in administered prices, excise taxes and world oil prices), but also by very strong domestic demand growth. In August, the Banca Națională a României (BNR) shifted to inflation targeting and set the official inflation target at 7.5% for December 2005. For December 2006, the target is set at 5% on condition that the VAT rate will not be raised. Both targets have a $\pm 1\%$ variation interval.

Table 47

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Year-on-year change of period average levels in %</i>								
Gross production of industry (real)	-7.9	6.2	8.3	4.4	3.2	5.4	8.0	5.4
Labor productivity of industry (real)	7.2	12.5	11.6	5.4	5.2	7.1	8.6	5.6
Gross average wage of industry (nominal)	44.0	41.7	51.1	23.6	19.5	23.0	22.1	15.5
Unit labor cost of industry (nominal)	34.3	25.9	35.4	17.2	13.6	14.8	12.4	9.3
Producer price index (PPI) of industry	41.6	53.8	38.7	23.2	19.6	19.1	18.0	13.5
Consumer price index (CPI)	45.8	45.7	34.5	22.5	15.3	11.9	10.0	8.9
Exchange rate (nominal):								
RON ¹⁾ per 1 EUR, + = EUR appreciation	63.8	22.0	30.5	20.1	20.2	7.9	0.3	-8.6
EUR per 1 RON, + = RON appreciation	-39.0	-18.1	-23.4	-16.8	-16.8	-7.3	-0.3	9.4
<i>Period average levels</i>								
Unemployment rate (ILO definition, %) ²⁾	7.6	7.9	7.3	9.1	7.5	8.5	8.5	8.9
Employment rate ³⁾	63.2	63.0	62.4	57.6	57.6	57.7	57.4	56.6
Participation rate ⁴⁾	68.4	68.4	67.3	63.4	62.2	63.0	62.7	62.2
Key interest rate per annum (%)	35.0	35.0	35.0	29.6	18.8	20.3	18.5	15.4
Exchange rate (nominal):								
RON per 1 EUR	1.63	1.99	2.60	3.12	3.75	4.05	3.98	3.71
EUR per 1 RON	0.612	0.502	0.385	0.320	0.266	0.247	0.251	0.270

Source: Bloomberg, Eurostat, national statistical office, national central bank, OeNB, wiw.

¹⁾ RON: New Romanian leu; with effect from July 1, 2005, the new Romanian leu was introduced at a conversion rate of 1 RON = 10,000 ROL.

²⁾ Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

³⁾ Ratio of employed persons to the working-age population (aged 15 to 64).

⁴⁾ Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

In the first five months of 2005, growth of credit to the private sector remained strong at about 35% year on year, but this figure was considerably lower than in the first quarter of 2004 (67%) and in the full year 2004 (55%). By contrast, the annual growth rate of net foreign assets accelerated throughout the last twelve months, from 6.1% year on year in the first quarter of 2004 to 23.4% in the first quarter of 2005. As a result of both the increase in net foreign assets and the strong growth of the other items net position, overall broad money growth increased to 41% in the first quarter of 2005 from 31.5% on average in 2004 and had accelerated further to 46% by June 2005. In July 2005, the BNR introduced measures to reduce the upswing in foreign currency borrowings: Effective as of end-August, a 30% reserve ratio on all foreign currency-denominated liabilities with maturities longer than two years was implemented, while the reserve ratio on leu-denominated liabilities with maturities up to two years was reduced from 18% to 16%. To dampen lending to households and to limit household lending risk, the monthly debt service ceiling was set to 40% of the borrower's net monthly income. The Romanian leu started to appreciate strongly in October 2004. The appreciation of the currency went hand in hand with the (anticipated) abandonment of the implicit crawling band in November 2004 and the announcement of a more flexible exchange rate. Furthermore, the anticipated further liberalization of the capital account, which was implemented in April 2005 in connection with the EU accession process, led to large capital inflows. After the leu had appreciated against the euro by 4.5% from end-September to end-December and by a

further 8.5% until end-February 2005, the pace of appreciation slowed down markedly, following a massive intervention by the central bank in the foreign exchange market, namely the sale of domestic currency against the euro in order to restrain the appreciation trend. Moreover, motivated by the continuous disinflation process, but also by the aim to contain the differential between domestic and international interest rates against the background of an enhanced liberalization of the capital account, the Romanian authorities reduced the monetary policy rate step by step from 20.75% in June 2004 to 12.5% in April 2005.

Table 48

Monetary Developments

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Nominal year-on-year change of the annual average stock in %</i>								
Broad money (including foreign currency deposits)	52.0	40.4	42.5	40.9	31.2	31.5	35.9	40.8
<i>Contributions to the nominal year-on-year change of broad money in percentage points</i>								
Net foreign assets of the banking system	10.8	38.4	44.9	31.8	15.5	12.9	17.6	23.4
Domestic credit (net) of the banking system	42.3	14.0	10.2	18.7	23.9	26.0	21.6	12.9
<i>of which: claims on the private sector</i>	24.3	3.6	18.3	24.1	28.2	32.2	28.2	22.7
<i>claims on households</i>	..	..	..	..	..	..	..	..
<i>claims on enterprises</i>	..	..	..	..	..	..	..	..
<i>net claims on the public sector</i>	17.9	10.3	-8.1	-5.3	-4.3	-6.2	-6.6	-9.8
Other domestic assets (net) of the banking system	-1.0	-12.0	-12.6	-9.6	-8.3	-7.4	-3.4	4.5

Source: National central bank, OeNB.

In 2004, the Romanian budget posted a deficit of 1.4% of GDP. In the latest fiscal notification reported by the Romanian authorities to the European Commission in March 2005, the projected deficit for 2005 was set at 0.5% of GDP, largely in line with the deficit target of 0.7% of GDP published in the PEP for 2004 to 2007 in November 2004, which is also the target the authorities agreed on with the IMF. However, in its assessment of the 2005 fiscal notification, the European Commission concludes that the deficit target of 0.5% of GDP might be overambitious as the introduction of the uniform 16% flat tax on income (replacing the progressive rate that ranged between 18% and 40%) and corporate tax (previously 25%) is underfinanced. Correspondingly, the European Commission assumed a much higher deficit for 2005 (2.4% of GDP) in its Spring Forecast in April 2005. Given the severe flood damages, the Romanian authorities have recently revised the target upward to 1% of GDP.

Table 49

Government Budget

	1999	2000	2001	2002	2003	2004	2005 f ¹⁾	2006 f ¹⁾
	% of GDP							
General government								
Revenues	..	..	..	..	..	..	..	..
Expenditures	..	..	..	..	..	..	..	..
of which: interest payments	..	..	3.2	2.2	1.6	1.3	1.5	1.5
Balance	..	..	-3.5	-2.0	-2.0	-1.4	-2.4	-2.6
Primary balance	..	..	-0.3	0.2	-0.4	-0.2	-0.9	-1.1
Gross public debt	24.0	23.9	23.2	23.3	21.3	18.5	19.1	19.6

Source: European Commission.

¹⁾ f stands for forecast by the European Commission.

In the first quarter of 2005, the current account deficit expanded to 6.4% of GDP against 2.7% of GDP in the first quarter of 2004. This deterioration is partly attributable to a higher trade deficit (7.8% of GDP in the first quarter of 2005 against 6.0% of GDP in the comparable 2004 period) as a result of strong demand for capital and consumer durables. Moreover, the services balance turned negative (-1.0% of GDP) in the first quarter of 2005 from its balanced position in the first quarter of 2004, and the shortfall of the income balance more than tripled (in euro terms) during that period. In the first half of 2005, export growth was 16.6% year on year, whereas import growth amounted to 22.9% (as measured in euro). In this period, the current account deficit went up by 60.1% year on year (in euro terms). In the first quarter of 2005, net FDI inflows covered almost 50% of the current account deficit against full coverage in the first quarter of 2004.

Table 50

Balance of Payments

	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	EUR million							
Merchandise exports	7,984.0	11,279.0	12,719.0	14,644.0	15,614.0	18,917.0	4,329.0	5,091.0
Merchandise exports: year-on-year change in %	7.7	41.3	12.8	15.1	6.6	21.2	14.6	17.6
Merchandise imports	9,169.0	13,150.0	16,045.0	17,392.0	19,569.0	24,241.0	4,933.0	6,131.0
Merchandise imports: year-on-year change in %	-5.9	43.4	22.0	8.4	12.5	23.9	17.7	24.3
Trade balance	-1,185.0	-1,871.0	-3,326.0	-2,748.0	-3,955.0	-5,324.0	-604.0	-1,040.0
% of GDP	-3.6	-4.7	-7.5	-5.7	-7.9	-9.0	-6.0	-7.8
Services balance	-372.0	-260.0	-127.0	6.0	62.0	-236.0	4.0	-134.0
Income balance (factor services balance)	-388.0	-304.0	-316.0	-490.0	-623.0	-1,052.0	-94.0	-322.0
Current transfers	589.0	937.0	1,280.0	1,614.0	1,639.0	2,299.0	425.0	632.0
Current account balance	-1,356.0	-1,498.0	-2,489.0	-1,618.0	-2,877.0	-4,313.0	-269.0	-864.0
% of GDP	-4.1	-3.8	-5.6	-3.4	-5.7	-7.3	-2.7	-6.4
Capital account balance	41.0	38.0	106.0	97.0	188.0	461.0	65.0	75.0
% of GDP	0.1	0.1	0.2	0.2	0.4	0.8	0.6	0.6
Direct investment flows (net)	948.0	1,161.0	1,315.0	1,193.0	1,591.0	3,938.0	407.0	413.0
% of GDP	2.9	2.9	3.0	2.5	3.2	6.7	4.0	3.1

Source: National central bank, OeNB.

Romania's gross external debt increased from 30.0% of annual GDP at the end of 2004 to 32.8% of annual GDP at the end of the first quarter of 2005. During that period, gross official reserves went up from 18.4% to 20.1% of annual GDP, covering 5.3 months of imports of goods and services, against 4.8 at end-2004.

Table 51

Gross Official Reserves and Gross External Debt							
	1999	2000	2001	2002	2003	2004	Q1 05
<i>End of period, EUR million</i>							
Gross official reserves (excluding gold)	1,520.00	2,654.90	4,445.30	5,876.80	6,373.60	10,838.50	12,561.50
Gross external debt (medium- and long-term)	8,756.50	11,113.40	13,507.10	14,784.30	15,683.20	17,700.40	20,455.40
<i>% of GDP¹⁾</i>							
Gross official reserves (excluding gold)	4.62	6.66	9.99	12.25	12.66	18.37	20.15
Gross external debt (medium- and long-term)	26.60	27.88	30.35	30.82	31.15	29.99	32.81
<i>Import months of goods and services</i>							
Gross official reserves (excluding gold)	1.68	2.08	2.89	3.55	3.45	4.75	5.30

Source: Eurostat, national central bank, OeNB, wiiv.

¹⁾ Q1 05: As a percentage of rolling four-quarter GDP.

10 Russia: Weaker Growth Despite Record Oil Prices

Russian GDP expanded 5.2% year on year (revised data) in the first quarter of 2005. For the first half of 2005, the ministry of the economy estimates GDP growth to have accelerated slightly to 5.6%, followed by 5.7% year on year in the period from January to July 2004. Despite the slight pick-up, economic expansion weakened compared to the level it had reached in the first quarter of 2004 (7.6%) and in the full year 2004 (7.2%). This slowdown was triggered by slackening growth of gross fixed capital formation and private consumption and by a further contraction of positive net exports. While the growth rates of both exports and imports decreased, import growth persistently outstripped export growth, resulting in a negative contribution of net exports to GDP growth similar in size to that in the full year 2004. The weakening of real export growth despite 2005 record oil prices resulted from the stagnation of oil and raw material production, the drastic tightening of taxation of the energy sector as well as constraints in transport capacities. In line with weaker, but still strong domestic demand growth, import growth slowed down, but remained strong. Moreover, the continuing real appreciation of the Russian ruble is undermining the competitiveness of manufactured goods exports, while enhancing imports. In addition, the pace of structural reform has recently slowed down substantially. The contraction of gross fixed investment growth in the course of 2004, which continued in the first quarter of 2005, was linked to a business climate deterioration triggered by repercussions of the Yukos affair, the proliferation of back tax claims and other regulatory interventions of state bureaucracy. However, in the second quarter of 2005 this trend reversed, yielding a year-on-year growth of 9.4% in the first half of 2005. Although private consumption growth was lower in the first quarter of 2005 than in

previous quarters, it continued to be the main pillar of GDP growth, buoyed by wage and pension increases as well as expanding retail loans. Total economy gross wages (CPI-deflated) rose by 9.4% and retail trade turnover expanded by 11.3% in the first half of 2005.

Table 52

Gross Domestic Product and Its Demand Components								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Real year-on-year change in %</i>								
Gross domestic product	6.3	9.0	5.1	4.7	7.3	7.2	6.4	5.2
Private consumption	-2.9	6.0	9.3	8.3	7.4	10.6	11.4	8.0
Public consumption	3.1	4.8	-0.8	2.6	2.2	2.3	2.2	4.5
Gross fixed capital formation	6.3	31.1	10.3	2.8	12.8	10.8	9.4	8.9
Exports of goods and services	11.3	9.6	4.2	10.3	12.5	12.3	13.9	6.8
Imports of goods and services	-17.1	30.5	18.7	14.6	17.7	23.5	24.5	15.2
<i>Contribution to GDP growth in percentage points</i>								
Domestic demand	-2.0	11.6	7.3	3.8	6.5	7.9	7.6	6.0
Exports	4.7	4.2	1.9	4.5	5.7	5.9	7.0	3.5
Net exports	9.1	-1.9	-2.6	0.5	0.5	-1.7	-2.1	-1.6

Source: Eurostat, national statistical office, OeNB.

In line with strong economic growth, the unemployment rate decreased to 8.2% in the first quarter of 2005 and was thus by 1 percentage point lower than in the first quarter of 2004. After it had declined to around 10% year on year in the second quarter of 2004, CPI inflation turned upward to a peak of 13.6% in May 2005 and then slightly receded to 12.9% in July. Persistent inflationary pressure may be explained by the surge in industrial producer prices (24.7% in May and 20.6% in July 2005 year on year), the strong wage and consumption growth, periodic adjustments of administered prices, capacity constraints and the still high, albeit declining, growth of broad money. The Bank of Russia (CBR) revised its CPI inflation goal for December 2005 from 8.5% to a target range of 8.5% to 10.0% at the beginning of July.

Table 53

Productivity, Wages, Prices, Exchange Rate and Key Interest Rate

	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
<i>Year-on-year change of period average levels in %</i>								
Gross production of industry (real)	11.6	12.0	4.9	3.7	7.0	7.4	7.2	3.7
Labor productivity of industry (real)	15.4	9.9	5.7	7.5	13.9	..	..	..
Gross average wage of industry (nominal)	46.7	42.1	52.0	27.2	25.4	..	..	..
Unit labor cost of industry (nominal)	27.1	29.3	43.8	18.3	10.1	..	..	..
Producer price index (PPI) of industry	59.1	46.5	19.1	11.7	15.6	24.0	28.7	23.3
Consumer price index (CPI)	85.7	20.8	21.6	16.0	13.6	11.0	11.6	12.9
Exchange rate (nominal):								
RUB ¹⁾ per 1 EUR, + = EUR appreciation	137.2	-0.8	0.4	13.5	17.0	3.3	4.1	1.9
EUR per 1 RUB, + = RUB appreciation	-57.8	0.8	-0.4	-11.9	-14.5	-3.1	-4.0	-1.9
<i>Period average levels</i>								
Unemployment rate (ILO definition, %) ²⁾	12.6	10.5	9.0	8.0	8.6	8.2	8.3	8.2
Employment rate ³⁾
Participation rate ⁴⁾
Key interest rate per annum (%)	57.2	33.1	25.0	22.7	17.3	13.5	13.0	13.0
Exchange rate (nominal):								
RUB per 1 EUR	26.24	26.03	26.13	29.65	34.69	35.81	36.92	36.52
EUR per 1 RUB	0.0381	0.0384	0.0383	0.0337	0.0288	0.0279	0.0271	0.0274

Source: Bloomberg, Datastream, national statistical office, national central bank, OeNB, wiw.

¹⁾ RUB: Russian ruble.

²⁾ Ratio of unemployed persons to the number of unemployed and employed persons (aged 15 to 64).

³⁾ Ratio of employed persons to the working-age population (aged 15 to 64).

⁴⁾ Ratio of unemployed and employed persons to the working-age population (aged 15 to 64).

Broad money growth declined from 35.5% on average in the full year 2004 to 31.5% year on year in the first quarter of 2005 and further to 30% in May 2005. Money growth has been fueled by the lavish liquidity injected into the economy by high, and further expanding, current account surpluses and on-going CBR interventions intended to slow down the nominal appreciation of the ruble in order to stave off the Dutch disease. The growth rate of net foreign assets increased from 39% in the full year 2004 to 62% year on year in the first quarter of 2005 and to 63% in May. Combined with strong economic growth and low real interest rates, the available liquidity has fueled rapid credit expansion in recent years. Consumer credits and car loans have become increasingly available to the average Russian consumer, implying high growth rates from a very low point of departure. Credit to enterprises and households expanded by 40% year on year in nominal terms in the first quarter of 2005, similar to the increase in the full year 2004. In real terms (CPI-deflated), the growth rate declined slightly to 24% from 27% in the full year 2004. At the same time, the government stepped up its sterilization efforts by withdrawing a substantial part of the injected liquidity from the market, channeling it into the stabilization fund. This reduced the contribution of overall domestic credit to broad money growth to only 2 percentage points in the first quarter of 2005.

Since mid-2004, the CBR has held its refinancing rate at 13% (nominal level). As CPI inflation did not decline further, but rather increased, the real key interest rate (12-month moving average) decreased continuously from 5.1% in July 2004 to 0.3% in May 2005, before rising slightly to 0.8% in July 2005.⁵ The CBR aims at limiting the real (CPI-deflated) effective appreciation of the ruble to between 8% and 10% year on year by the end of 2005. In nominal terms, the average exchange rate of the ruble in June 2005 was stronger against the U.S. dollar by 1.9% and stronger against the euro by 1.6% compared to June 2004. In real terms against the euro, the ruble was stronger by 18.7% (PPI-deflated) and by 12.8% (CPI-deflated) in June 2005 compared to June 2004. The CBR gradually increased the weight of the euro in the dual currency basket from 10% to 20% in mid-March 2005, further to 30% in mid-May and to 35% in early August. During the first half of 2005, the ruble value of the currency basket was relatively stable.

Table 54

Monetary Developments								
	1999	2000	2001	2002	2003	2004	Q4 04	Q1 05
	<i>Nominal year-on-year change of the annual average stock in %</i>							
Broad money (including foreign currency deposits)	63.6	60.0	44.2	31.2	39.2	35.5	32.6	31.5
	<i>Contributions to the nominal year-on-year change of broad money in percentage points</i>							
Net foreign assets of the banking system	7.5	58.5	44.3	19.8	21.3	22.4	29.4	33.7
Domestic credit (net) of the banking system	120.4	30.5	22.8	30.4	29.6	17.8	8.2	1.9
<i>of which: claims on the private sector</i>	43.5	36.7	35.2	28.9	29.5	30.9	29.2	30.6
<i>claims on households</i>	..	..	..	..	..	..	..	..
<i>claims on enterprises</i>	..	..	..	..	..	..	..	..
<i>net claims on the public sector</i>	76.9	-6.2	-12.4	1.5	0.2	-13.2	-21.0	-28.7
Other domestic assets (net) of the banking system	-64.4	-29.1	-22.9	-19.1	-11.7	-4.6	-4.9	-4.1

Source: National central bank, OeNB.

On the back of record energy prices and proceeds, Russia witnessed a further widening of its large twin surpluses in the first half of 2005. The general government budget surplus reached 15% of GDP in the first quarter of 2005, after a 4.5% surplus in the full year 2004. According to preliminary data, the federal budget surplus in the first half of 2005 came to 9.8% of GDP. While certainly reflecting prudent fiscal policies, and particularly expenditure restraint, the size of the 2005 surplus is also based on “improved tax administration,” as the authorities put it, i.e. the enforcement and collection of large back tax claims and fines from oil companies considered delinquent (particularly Yukos). Owing to the very favorable budget situation and to mounting political and social pressures to distribute the proceeds of the oil boom more widely, the government passed a supplemental budget in June, which envisages

⁵ The ex-post real key interest rate per annum as measured by the real (CPI-deflated) key rates per month compounded over the past 12 months. The PPI-deflated key interest rate per annum, which is measured in a similar way, stood at -6.6% in July 2004 and at -5.6% in July 2005, remaining persistently negative.

a rise in spending by about one-tenth and a reduction in the planned federal surplus from 1.5% to about 1% of GDP in 2005. Additional financial means are to be used to shore up social reforms, cover financial gaps in the pension fund and adjust the salaries of state officials. Given the budget's important liquidity drainage function, this fiscal loosening may run counter to stabilization policy and increase inflationary pressures.

Table 55

Government Budget

	1999	2000	2001	2002	2003	2004	2005
	% of GDP						
Federal government							
Revenues	12.5	15.4	17.8	20.4	19.5	20.5	19.2
Expenditures	13.8	13.2	14.8	18.5	17.8	16.1	18.2
of which: interest payments	3.4	2.4	2.6	2.1	1.7	1.2	1.4
Balance	-1.3	2.2	3.0	1.8	1.7	4.4	1.0
Primary balance	2.1	4.6	5.6	3.9	3.4	5.6	2.4
Gross public debt, general government	94.2	57.1	44.1	37.0	31.7	23.5	..

Source: National ministry of finance, Economic Expert Group, wiiw.

Note: Data for 2005 according to revised budget law.

The current account surplus expanded to 14.0% of GDP in the first quarter of 2005, against 10.5% in the first quarter of 2004. Exceeding the surplus of EUR 21.4 billion recorded in the first half of 2004, it went up to EUR 36.1 billion in the first half of 2005 as the trade surplus reached a record level of EUR 40.3 billion in the first six months of 2005. In the first quarter of 2005, exports of goods and services (as measured in euro) grew by 32% and imports of goods and services augmented by 17% year on year. The different growth dynamics of real versus nominal exports and imports can be explained by the above-mentioned oil price surge and the corresponding further improvement of the terms of trade (by one fifth year on year at end-March 2005) for the Russian economy.

Table 56

Balance of Payments								
	1999	2000	2001	2002	2003	2004	Q1 04	Q1 05
	<i>EUR million</i>							
Merchandise exports	71,210.2	114,378.8	113,842.6	113,201.0	120,040.0	147,356.6	29,838.4	39,411.3
Merchandise exports: year-on-year change in %	7.1	60.6	-0.5	-0.6	6.0	22.8	3.0	32.1
Merchandise imports	37,167.9	48,934.5	60,137.9	64,278.1	66,507.9	77,326.1	15,709.4	18,898.0
Merchandise imports: year-on-year change in %	-28.8	31.7	22.9	6.9	3.5	16.3	6.5	20.3
Trade balance	34,042.3	65,444.3	53,704.7	48,922.9	53,532.0	70,030.4	14,129.0	20,513.2
% of GDP	18.6	23.1	15.7	13.5	14.0	15.0	14.5	17.2
Services balance	-4,034.0	-7,254.4	-10,226.9	-10,438.6	-9,773.4	-10,809.6	-2,017.3	-1,930.1
Income balance (factor services balance)	-7,290.8	-7,352.9	-4,755.8	-6,855.6	-11,543.1	-10,472.6	-1,892.5	-1,574.8
Current transfers	577.8	65.4	-912.5	-807.7	-351.6	-648.0	0.8	-227.3
Current account balance	23,295.3	50,902.5	37,809.6	30,821.1	31,864.0	48,100.3	10,220.1	16,781.1
% of GDP	12.7	18.0	11.0	8.5	8.3	10.3	10.5	14.0
Capital account balance	-311.0	12,100.3	-10,514.7	-12,599.1	-858.7	-1,294.3	-596.9	-83.1
% of GDP	-0.2	4.3	-3.1	-3.5	-0.2	-0.3	-0.6	-0.1
Direct investment flows (net)	1,041.8	-499.6	250.3	-49.0	-1,413.6	1,591.3	549.7	1,707.5
% of GDP	0.6	-0.2	0.1	0.0	-0.4	0.3	0.6	1.4

Source: National central bank, OeNB.

Driven by growing private indebtedness and held back by shrinking public indebtedness, total gross foreign debt edged up to EUR 171 billion (35% of GDP) at end-March 2005. In July and August, Russia repaid EUR 12 billion of its Paris Club debt ahead of schedule. Despite the repayment, gross official reserves (including gold) reached a near-record level of EUR 120 billion in mid-August 2005, which corresponds to over ten months' worth of imports of goods and services.

Table 57

Gross Official Reserves and Gross External Debt							
	1999	2000	2001	2002	2003	2004	Q1 05
	<i>End of period, EUR million</i>						
Gross official reserves (excluding gold)	8,386.6	26,139.0	37,025.9	42,290.5	58,530.7	88,660.6	103,141.7
Gross external debt	..	160,912.4	160,653.6	143,727.5	148,488.5	159,174.1	170,857.8
	<i>% of GDP¹⁾</i>						
Gross official reserves (excluding gold)	4.6	9.2	10.8	11.6	15.3	19.0	21.1
Gross external debt	..	56.8	46.9	39.5	38.9	34.1	34.9
	<i>Import months of goods and services</i>						
Gross official reserves (excluding gold)	2.0	4.7	5.3	5.7	7.8	10.2	12.7

Source: National central bank, OeNB, wiw.

¹⁾ Q1 05: As a percentage of rolling four-quarter GDP.

Cutoff date for data: September 6, 2005.

SPECIAL FOCUS:
FINANCIAL DEVELOPMENT
AND INTEGRATION

Banking in Central and Eastern Europe since the Turn of the Millennium – An Overview of Structural Modernization in Ten Countries

Stephan Barisitz¹

This study gives an analytical overview of the evolution of the banking sectors of ten relatively large Central and Eastern European countries (Hungary, Poland, the Czech Republic, Slovakia; Bulgaria, Romania, Croatia, Serbia; Russia and Ukraine) since 1999–2000. Set in the period following the banking crises and painful transformation of the 1990s, the analysis focuses on the newest structural changes and modernization in an environment of generally strong growth. The emphasis is on salient features of the development of banking regulation and supervision, banks' major sources of assets, liabilities, earnings and related changes, bank restructuring, rehabilitation programs and the role of foreign banks and FDI. Conclusions sum up the main findings on a comparative basis: Selling banks to foreign strategic investors has generally paid off, although there are some exceptions. The ongoing swift dissemination of IT and e-banking may help reconcile the seeming paradoxes of these countries being "overbanked" and "underbanked" at the same time. The near-ubiquitous credit boom, while embodying a welcome structural catching-up process, is not without dangers and has not yet been fully brought under control. Even in relation to the region's modest income levels, consumption of banking products remains low in Central and Eastern Europe. Thus, there is still ample room for expansion.

1 Introduction

In the context of transition, the banking system can play a pivotal role for growth and catching-up, but can also be at the center of fragility and collapse. All transition economies have gone through more or less costly banking sector cleanup programs, and only after these programs had been carried through did sustainable market-oriented economic expansion set in. Despite the banking sector's volatility, banking reforms have often been at the forefront of structural adjustment, even preceding the spread of hard budget constraints to other parts of the economy. Given that other segments of the financial sector have so far remained rather underdeveloped, the key position of banks in financial intermediation may loom even larger in the process of further real convergence with higher income countries.

This study aims at tracing, comparing and drawing conclusions from the developments of the banking systems since 1999–2000 in ten relatively large Central and Eastern European countries. Section 2 deals with four nations in Central Europe (Hungary, Poland, the Czech Republic, Slovakia), section 3 treats four countries in Southeastern Europe (Bulgaria, Romania, Croatia, Serbia), and section 4 is devoted to two countries in Eastern Europe (Russia, Ukraine). This analysis is done successively, country by country, not simultaneously. The relatively large number of analyzed countries and the variety of experiences merit consecutive treatment in the interest of clarity. The turn of the millennium was taken as a starting point, since the major thrust of market-oriented reforms (plus financial turmoil) had already been in the 1990s in most countries (exception: Serbia). Therefore, the analysis can focus on the newest structural changes and modernization in an environment of strong and partly accelerating growth and in a comparative context.

¹ Oesterreichische Nationalbank (OeNB), Foreign Research Division, stephan.barisitz@oenb.at. The standard disclaimer applies. The author wishes to thank Professor Wladimir Andreff, Université Paris I Panthéon Sorbonne, for permission to publish this paper, which corresponds to an abridged version of a chapter of the author's Habilitation à Diriger des Recherches entitled "La transformation du secteur bancaire dans les pays d'Europe centrale et orientale: de la fin de l'ère communiste à l'époque contemporaine," which is currently being written under Professor Andreff's supervision. The author is also grateful to two anonymous referees, who have provided valuable comments, as well as to Doris Ritzberger-Grünwald (OeNB) and Jarko Fidrmuc (OeNB) for helpful remarks and suggestions.

Despite the constrained space available, the study attempts to present some salient features of the evolution of legal foundations, banking supervision, banks' major sources of assets, liabilities, earnings and related changes, bank restructuring, rehabilitation programs and the role of foreign banks and foreign direct investment (FDI). Section 5 tries to draw a number of summarizing conclusions.

2 Central European Countries

Of the countries analyzed, the four Central European ones (Hungary, Poland, the Czech Republic, Slovakia) featured among the earliest and swiftest economic and banking reformers. Since May 2004, they have been members of the European Union.

2.1 Hungary

Having benefited from a head start possibly going all the way back to the original inception of market-oriented reforms in 1968, the Hungarian authorities largely upheld reform momentum and opted early on for an efficient strategy of structural transformation of banking and the economy: They had sold the lion's share of the banking sector to foreign strategic investors by 1997 (Bonin et al., 2003, 41). Today the Hungarian banking sector is one of the most mature in the new EU Member States: Lending is expanding to the small and medium-sized enterprise (SME) sector, key Hungarian credit institutions are taking over foreign ones, and spreads between deposit and lending rates compare favorably with those of neighboring countries. However, banking intermediation as measured by the ratio of total domestic deposits or credits to GDP is lower than in some of Hungary's Central European peers.

The total number of banks in Hungary has decreased from 43 in 1999 to 35 at end-2004 (see table 1), which is still relatively large for a country of 10 million people and might point to a degree of overbanking. Yet the number of branches is fairly small. The use of credit cards, telephone and Internet banking is still limited, but is expanding with technical upgrading and the spread of IT systems pushed by rising incomes, demand and competition. Banking regulation and supervision continue to improve, with the basic regulatory framework aligned to the EU's *acquis communautaire* and comparable to that of Western European countries. Consolidated supervision was introduced in 2003. The market for large corporate banking services has become highly competitive in Hungary. Given the degree of dominance of and integration with foreign capital in the real as well as the banking sectors, cross-border loans from nonresident banks or parent companies abroad have been predominant in nonfinancial corporations' borrowing since the mid-1990s (Magyar Nemzeti Bank, 2004, 41). Important elements that facilitated growth of SME lending were the launching of a credit register in 1999, government financial support and guarantees. The share of SME loans grew from a third of total corporate loans in 1999 to almost 45% in mid-2002 before slightly receding in 2003.

Based largely on FDI-injected improvements in efficiency and profitability and on the recasting of risk management systems, costs of financial intermediation have been coming down. But know-how has also been successfully acquired by OTP (Országos Takarékpénztár és Kereskedelmi Bank), the former state-

owned savings bank, which remains the largest Hungarian credit institution and the only major bank of the country not taken over by a foreign strategic investor (Gelegonya, 2003, 120–121). At 19%, its share in total banking sector assets in mid-2004 approximated the joint market shares of the second-placed K&H Bank – created in 2001 by the merger of KBC-owned K&H (Kereskedelmi és Hitel) Bank and ABN Amro Magyar Bank – and the third-placed MKB (Magyar Külkereskedelmi Bank). Furthermore, OTP turned into a foreign strategic investor: Buoyed by modernization-induced high earnings, the bank has expanded into Slovakia, Bulgaria, Romania and Croatia. But OTP is likely to face tougher competition at home. In October 2003, Postabank (the second-largest retail bank) was sold to Erste Bank (of Austria), already present in Hungary (Condon, 2004). As of end-2003, foreign ownership of Hungarian banks exceeded 80% of total banking capital (table 1).

Supported by the introduction of generous state interest subsidies (in 2001) and by other budgetary enticements of various kinds, mortgage lending has ballooned in recent years (+130% in 2002, +70% in 2003), albeit from a very modest point of departure. The market has so far been rather noncompetitive, administered by a limited number of service providers, and has witnessed high spreads (OECD, 2004a, 100–102). Thus, partly subsidized credit expanded at an annual average of over a fifth from 1999 to 2003. But banks' penetration into riskier fields has entailed a decline of the overall capital adequacy ratio in recent years; the ratio still exceeds the regulatory minimum by a comfortable margin, though. The sustained presence of foreign strategic investors mostly from Western European countries has featured instances of "lender-of-last-resort assistance" from parent banks to their Hungarian subsidiaries or branches.

Table 1

Hungary						
Macroeconomic and Banking Sector-Related Indicators (1999–2004)						
	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	4.2	5.2	3.8	3.5	3.0	4.2
CPI inflation (year-end, %)	11.2	10.1	6.8	5.3	5.7	5.5
Exchange rate (HUF/EUR, annual average)	252.8	260.0	256.7	243.0	253.5	251.7
Number of banks (of which foreign-owned, year-end)	43(29)	42(33)	41(31)	37(27)	36(29)	35(0)
Degree of financial intermediation (bank assets/GDP, %)	68.1	68.5	71.2	71.4	78.2	75.8
Share of foreign-owned banks in total banking capital (%)	65.3	66.7	63.0	78.3	81.9	..
Credit (credit volume/GDP, %)	25.1	29.3	29.8	31.5	37.2	..
Share of nonperforming loans in total loans (%)	4.4	3.2	2.9	3.3	3.1	3.2
Deposits (volume of deposits/GDP, %)	68.1	68.5	68.4	69.3	78.1	..
Return on equity (ROE, %)	6.6	16.8	22.0	20.0	23.5	29.0
Capital adequacy (capital/risk-weighted assets, %)	15.0	15.2	15.6	13.0	11.8	11.2

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiw, OeNB.

¹⁾ Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 27.6, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

2.2 Poland

Following major upheavals in the 1990s, the Polish banking sector appears to have entered a path of steady and successful expansion and catching-up with competing markets. Its size may have contributed to the particular dynamism and vigor of the Polish market. While exposing weaknesses, the intermittent slowdown of economic growth in 2001 and 2002 may have helped to trigger efficiency improvements in the sector. Majority foreign-owned banks, which came to dominate the market toward the end of the 1990s, intensified competition, stimulating the consolidation process. The total number of credit institutions shrank from 77 at end-1999 to 57 at end-2004.

Notwithstanding the expansion of the number of their branches, Polish banks have witnessed a sizeable drop of employment over recent years. At end-September 2003, the sector's workforce came to 126,000, approximately 25,000 fewer persons than in 1999. Head office staff cuts have been associated with operational restructuring measures, a new approach to branch staffing, the introduction of modern technology and the increasing use of electronic banking. The country's good economic performance contributed to banks' rising profitability and helped them build up an appropriate capital base.

Despite robust average growth in the last ten years, Poland went through a weak patch in 2001 and 2002, which was overcome in 2003, as table 2 indicates. The share of credit institutions' nonperforming loans in total loans, which was already rather high in Poland, rose from 14% in 1999 to 22% in 2002, before somewhat receding in the following two years.² Nonbank financial institutions began to compete more directly with banks, putting pressure on traditional banking practices. Investment and pension funds, for example, proved successful in luring away some depositors by offering more attractive conditions. Credit institutions reacted by more aggressively including investment bank activities in their service portfolios. But banks also increased purchases of low-risk government bonds and stepped up cost-cutting and rationalization measures in this period (Gardó, 2004b, 38). Despite the slowdown, the capital adequacy ratio of Polish banks remained largely unchanged at around 13% from 1999 through 2003 (table 2). Provisions remained substantial (National Bank of Poland, 2004, 5).

Economic recovery in 2003 and 2004 restored profitability. Mortgage loans have witnessed particularly rapid increases lately. As of end-2003, the largest Polish bank was the former state savings bank Powszechna Kasa Oszczędności Bank Państwowy (PKO BP, 100% state-owned), with a share of 16% of total banking assets, followed by Bank Polska Kasa Opieki (Bank Pekao, 53% owned by Italy's UniCredito) and Bank Przemysłowo-Handlowy (BPH, main shareholder: Bank Austria-Creditanstalt, part of HypoVereinsbank Group). Majority foreign-owned credit institutions accounted for over two-thirds of total assets, majority state-owned banks for a quarter.

The financial situation of the last two big publicly owned credit institutions – PKO BP and Bank Gospodarki Żywnościowej (BGZ), the central institution of rural cooperative banks – remained fragile, necessitating further restructuring

² However, the classification of bad loans in Poland has reportedly been more stringent than in many other countries, at least until adjustments were introduced on January 1, 2004 (OECD, 2001, 168–169; National Bank of Poland, 2004, 5–6, 40).

measures and capital injections prior to their privatization. As part of the recovery program for PKO BP, the finance ministry transferred to the bank at the end of 2000 shares of five listed companies and credit institutions. Narodowy Bank Polski (NBP) temporarily waived reserve obligations, and parliament passed an act authorizing the finance ministry to underwrite 90% of old housing loans, the deterioration of which had negatively influenced the banks' earnings.

In November 2004, the government sold a 39% stake of PKO BP in an initial public offering on the Warsaw stock exchange. The bulk of the stake was reserved for domestic investors. In late 2004, half of BGZ was sold to the Dutch Rabobank (35%) and the European Bank for Reconstruction and Development, the EBRD (15%). Notwithstanding impressive successes in recent years, a general weakness still hampering financial intermediation and economic expansion is the often arbitrary and inefficient application of new regulations in Poland; it also reflects lingering deficiencies of the court system.

Table 2

Poland						
Macroeconomic and Banking Sector-Related Indicators (1999–2004)						
	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	4.1	4.0	1.0	1.4	3.8	5.4
CPI inflation (year-end, %)	9.8	8.6	3.4	0.7	1.7	4.5
Exchange rate (PLN/EUR, annual average)	4.23	4.01	3.67	3.86	4.40	4.53
Number of banks (of which foreign-owned, year-end)	77(39)	73(46)	69(46)	59(45)	58(46)	57(44)
Degree of financial intermediation (bank assets/GDP, %)	61.9	65.8	66.4	64.3	64.7	65.3
Share of foreign-owned banks in total banking assets (%)	49.3	72.5	72.0	70.9	71.6	75.0
Credit (credit volume/GDP, %)	27.1	28.3	29.0	27.9	28.6	27.3
Share of nonperforming loans in total loans (%)	13.7	15.5	18.6	22.0	21.8	15.5
Deposits (volume of deposits/GDP, %)	36.2	37.6	38.5	36.0	35.7	34.6
Return on equity (ROE, %)	12.9	14.5	12.8	5.2	5.9	..
Capital adequacy (capital/risk-weighted assets, %)	13.2	12.9	15.1	13.8	13.6	15.6 ¹⁾

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiw, OeNB.

¹⁾ Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

2.3 Czech Republic

Foreign strategic investors had practically “taken over” the largest part of the Czech banking sector in 1998–2001. This contributed to overcoming the lingering financial crisis that had plagued the country since the mid-1990s. Much sounder credit institutions started to steadily expand their activities (Neue Zürcher Zeitung, 2004). The “takeover” had essentially consisted in the purchase of majority stakes in the three largest banks (in terms of assets): in Československá obchodní banka (ČSOB) by KBC Bank (of Belgium), in Česká spořitelna (the Savings Bank) by Erste Bank (Austria), and in Komerční banka by Société Générale.

While this change brought the injection of urgently needed capital as well as know-how, corporate governance and competition, the structural recovery has yet to fully run its course. Considering that investors received substantial state guarantees against future losses related to inherited loans (ringfencing), the total direct cost to the state of resolving the banking problems of the 1990s is not yet definitely known (Bonin and Wachtel, 2004, 15). It could eventually reach up to 20% of annual GDP (Tüma, 2003, 71). This raises concern at a time when budget shortfalls continue to be large. Apart from fiscal and macroeconomic costs, the protracted period of distorted allocation of capital also entailed sizeable structural costs of the banking crisis.

Restructuring measures coupled with the growing importance of alternative distribution channels (like e-banking) caused the number of branch offices to contract by almost half from 1995 to 2003. The number of bank employees plunged in the same period – from 60,800 to 39,000. This reduction was partly connected to efficiency adjustments and staff slashing in the head offices of the largest banks, partly caused by the concentration of strategic activities in parent institutions abroad. As table 3 shows, at the end of 2003 no less than 96% of total banking assets belonged to nonresidents. The traditionally high degree of financial intermediation in the Czech Republic has declined somewhat in recent years, owing to structural reform and the stagnation of lending. Overall lending has stagnated because of tighter prudential regulations and because credit institutions have become cautious in the wake of the crisis, given the lingering difficulties in part of the enterprise sector and given that enforcement of creditor rights has remained insufficient. Furthermore, the sudden widening of the budget deficit triggered an increase in government financing.

Investments in low-risk, highly liquid “quick assets” such as T-bills, Česká národní banka (ČNB) bills and deposits at other banks have featured prominently in recent years. Czech banks are well capitalized. Thanks to the recent robust growth of loans to households (+32% in 2003, of which mortgage credits: +55%), it seems that the weakness of overall lending to the real sector may have come to an end. Credits to SMEs have shown some life, too. The EU accession process and the alignment of legislation and regulations to EU standards, including the recent “harmonization amendment” to the Banking Act, have constituted key elements in improving and stabilizing the environment for banks. This amendment became effective in 2002 and inter alia brought the establishment of a Central Credit Register in November 2002 and the inception of consolidated supervision of financial groups or conglomerates as of the beginning of 2003.

But a breakthrough in lending will probably only materialize once the rule of law improves and courts work more effectively. Transparency of the judiciary may also need some polishing. On a macroeconomic level, limited lending has so far been offset by high inflows of FDI. As of end-2002, Česká konsolidační agentura (the successor to the “hospital bank,” Konsolidační banka) administered assets with a book value of EUR 9.5 billion. Attempting to phase out the legacy of the past crisis, the authorities – hesitantly – decided to sell off the agency’s claims to private investors on the market. The first auctions of loans were held in 2001 and 2002 and delivered proceeds of 7% and 9% of

the respective nominal values. The state was thus forced to accept huge discounts, but plans are to finish the sales and wind up the agency by 2007 (Anderson, 2004).

Table 3

Czech Republic						
Macroeconomic and Banking Sector-Related Indicators (1999–2004)						
	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	1.2	3.9	2.6	1.5	3.2	4.4
CPI inflation (year-end, %)	2.6	4.1	4.2	0.6	1.1	2.8
Exchange rate (CZK/EUR, annual average)	36.88	35.61	34.08	30.81	31.84	31.90
Number of banks (of which foreign-owned, year-end)	42(27)	40(26)	38(26)	37(26)	35(26)	35(26)
Degree of financial intermediation (bank assets/GDP, %)	141.7	144.8	130.2	112.8	101.0	97.1
Share of foreign-owned banks in total banking assets (%)	27.1	75.4	93.3	94.2	95.9	96.0
Credit (credit volume/GDP, %)	45.7	43.6	37.9	35.2	35.8	..
Share of nonperforming loans in total loans (%)	21.5	19.1	13.4	8.1	4.9	4.1
Deposits (volume of deposits/GDP, %)	53.8	53.1	57.1	64.5	62.3	..
Return on equity (ROE, %)	-4.3	13.1	14.4	27.4	23.7	23.4
Capital adequacy (capital/risk-weighted assets, %)	13.6	14.9	15.4	14.3	14.5	12.7

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiw, OeNB.

¹⁾ Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

2.4 Slovakia

Following the deterioration of the economic situation in the second half of the 1990s, the new government tightened policies and relaunched ambitious banking reforms in 1999: The package of measures consisted in the recapitalization, restructuring and privatization of distressed large, systemically important banks, the resolution of troubled small and medium-sized credit institutions and the shaping-up of regulation and supervision. The reform drive continued in the following years and brought about a major change of incentives under which banks operated. Slovakia thus caught up with and, on some indicators, may have overtaken some of its peers.

A major breakthrough was the privatization of the country's two largest banks. After expensive rehabilitation measures, majority ownership of 67% in Slovenská sporiteľňa went to Erste Bank (of Austria) and a 95% share in Všeobecná úverová banka (VUB) was sold to Banca Intesa in 2001. Given the dominating market shares of the two credit institutions and some other privatization transactions, including the acquisition of Investičná a rozvojová banka (IRB) by Hungary's Országos Takarékpénztár és Kereskedelmi Bank Rt (OTP Bank) in 2002, the share of majority foreign-owned banks in total banking assets increased to around 96% at end-2002. Moreover, quickly expanding Tatra banka, majority-owned by Austria's Raiffeisen Zentralbank, featured as the third-largest credit institution in terms of assets in 2003. As of the end of 2004, foreign capital reportedly controlled about 98% of Slovak banking assets – probably a record position among transition economies, and in Europe (table 4) (Economist Intelligence Unit, 2004, 2).

The revenue from the sales of the three formerly state-owned banks amounted to more than half of the respective cost of recapitalization and of the carve-out of nonperforming loans (14% of GDP) (OECD, 2002, 118). The foreign strategic investors, by injecting know-how and technology, made pivotal contributions to improving corporate governance, enhancing risk management techniques, encouraging competition and modernizing Slovak banking. Rising competitive pressure has prompted increased bank consolidation and a narrowing of interest rate margins.

After its reserves had been depleted by the reimbursement of insured accounts at four failed medium-sized entities, the Deposit Insurance Fund carried out some adjustments: The insurance premium was raised to reestablish financial viability of the fund, the scope of deposit guarantees was somewhat lowered to curb elements of moral hazard and to incite depositors to monitor their bank more closely. Amendments to the Banking Act, which came into force in 2002, moved the legal framework of Slovak banking closer to EU standards; among the key improvements were the introduction of consolidated supervision to forestall any schemes to spin off riskier activities to affiliated nonbanks subject to less oversight. Accounting rules have been upgraded substantially.

Table 4

Slovakia

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	1.5	2.0	3.8	4.6	4.5	5.5
CPI inflation (year-end, %)	14.2	8.3	6.2	3.3	9.3	5.9
Exchange rate (SKK/EUR, annual average)	44.12	42.59	43.31	42.70	41.49	40.05
Number of banks (of which foreign-owned, year-end)	25(11)	23(14)	21(13)	20(15)	21(16)	21(. .) ²⁾
Degree of financial intermediation (bank assets/GDP, %)	91.2	90.7	92.0	92.5	82.0	87.4
Share of foreign-owned banks in total banking assets (%)	37.8	40.6	90.5	95.6	96.3	98.0
Credit (credit volume/GDP, %)	48.6	43.6	33.5	32.1	33.6	..
Share of nonperforming loans in total loans (%)	32.9	26.2	24.3	11.2	9.1	7.8 ²⁾
Deposits (volume of deposits/GDP, %)	60.6	65.3	67.2	70.4	66.6	..
Return on equity (ROE, %)	–36.5	25.2	22.7	29.4	27.1	..
Capital adequacy (capital/risk-weighted assets, %)	12.6	12.5	19.8	21.3	21.6	18.7

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiw, OeNB.

¹⁾ Preliminary data.

²⁾ End-September 2004.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

Some important problems remain: Like banks in other countries that experienced the economic shock of bank restructuring and that are moving toward hard budget constraints in the sector, Slovak credit institutions reacted by becoming (very) cautious lenders. Given the banking sector's lead in reforms, the enforcement of hard budget constraints has not yet fully spread to the real sector. Nonperforming loans, while having declined considerably, have remained relatively high (about 8% of total loans at end-September 2004, table 4). So banks adjusted their intermediation role and reshuffled their portfolios toward lower-risk investments, e.g. government securities and Národná

banka Slovenska (NBS) bills. Such placements are not highly profitable, though. Most credit institutions also hiked their fees for diverse transactions, triggering an investigation by the competition authority. Most recently, lending to the private sector seems to have regained some dynamics, albeit from a low base: Household loans (particularly mortgages) have vigorously expanded since 2002, and enterprise credits have also shown some signs of recovery (OECD, 2004b, 111–112). Still, the judicial infrastructure would need an overhaul.

3 Southeastern European Countries

The Southeastern European countries dealt with in this study (Bulgaria, Romania, Croatia and Serbia) were initially slower to push forward with reforms than their Central European peers. Serbia is a special case, since serious transition only started after the regime change in 2000. However, Southeastern Europe did catch up at least to some degree later on, as described below.

3.1 Bulgaria

Bulgaria's impressive economic and banking recovery after the deep crisis of 1996–97 can be taken as an example of what can be achieved if root causes of problems are attacked and fundamental incentives “put right.” Of course, the country is still struggling with major challenges (e.g. unemployment, poverty, weak government services and an ineffective judiciary). We can observe a steady overall catching-up process that in some areas has even turned stormy of late. The scars of the crisis of 1996–97 were still visible in the early years of the new millennium, as banks remained very conservative and risk-averse in lending: As of end-2000, loans to the economy still came to only about 11% of GDP (table 5). Credit institutions at that time focused on transforming short-term deposits into relatively liquid and safe assets (like government securities and deposits at foreign banks). This resulted in a very high level of capital adequacy of 36% in 2000.

Regulation and supervisory oversight have much improved since the crisis. The authorities have taken a number of steps to eliminate obstacles to financial intermediation. In early 2000, the Central Credit Registry accessible to banks was made operational (Barisitz, 2002, 49). Bank monitoring was enhanced by the adoption of consolidated supervision in July 2000. In January 2003 International Accounting Standards (IAS) were introduced for banks and other financial institutions. Lending was on the rise and soon accelerated. Driven by the sustained economic recovery, further substantial FDI flows into the banking sector, increased competition and rising confidence, credits grew to 19% of GDP at end-2002, 26% at end-2003 and to around 35% at end-2004 (table 5). Based on 1999 figures, annual real growth rates of credit volumes came to a quarter in 2000 and to a half in 2003 and in 2004, which corresponds to a full-fledged credit boom, albeit from a low point of departure. At their level of 2003 (in relation to GDP), credit volumes in Bulgaria remained rather low, compared to Hungary or Slovakia, but have moved near Polish levels. Amendments to the insolvency section of the commercial code in mid-2003 also made it easier for banks to lend.

Apart from the divestiture of the largest bank (in terms of assets), Bulbank, in 2000, a number of deals served to increase foreign strategic investors' presence in the country. These included the purchase of United Bulgarian Bank (the third-largest credit institution) by the National Bank of Greece in 2000, the sale of Bank Biokhim to Bank Austria Creditanstalt in 2002, and the takeover of Derzhavna spestovna kassa (DSK, the former State Savings Bank and second-largest bank) by Hungary's OTP in 2003, which practically completed the privatization of the sector (European Commission, 2003, 38–39). DSK had been the first major credit institution active in the housing loan market, which expanded particularly fast. As of end-2004, 83% of banking assets were in majority foreign ownership.

The swift and accelerating growth of credit gave rise to concern on the part of the Bulgarian National Bank (Bǎlgarska narodna banka, BNB) and the IMF: While increased financial intermediation is welcome from a structural perspective, it swells already strong demand and puts pressure on inflation and the current account. With monetary policy operations, particularly interest rate changes, circumscribed because of the currency board arrangement, the authorities had to resort to other measures. They launched a credit growth containment policy in mid-2003. The BNB initially focused on intensifying supervisory activity: The frequency of on-site inspections was stepped up, and provisioning requirements on various types of loans were tightened.

Table 5

Bulgaria

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	2.3	5.4	4.1	4.9	4.5	5.6
CPI inflation (year-end, %)	6.2	11.4	4.8	3.9	5.6	4.0
Exchange rate (BGN/EUR, annual average)	1.956	1.956	1.956	1.956	1.956	1.956
Number of banks (of which foreign-owned, year-end)	34(22)	35(25)	35(26)	34(26)	35(25)	35(. .)
Degree of financial intermediation (bank assets/GDP, %)	34.6	36.5	41.1	45.0	50.3	65.1
Share of foreign-owned banks in total banking assets (%)	28.4	71.5	70.6	72.4	82.2	82.5
Credit (credit volume/GDP, %)	10.1	11.3	14.0	18.7	26.2	35.4
Share of nonperforming loans in total loans (%)	11.7	8.2	7.0	5.5	4.2	3.5
Deposits (volume of deposits/GDP %)	25.7	26.6	32.2	34.9	39.5	..
Return on equity (ROE, %)	20.9	21.9	20.5	15.6	22.8	20.6
Capital adequacy (capital/risk-weighted assets in %)	41.3	35.5	31.1	25.2	22.2	17.1

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiv, OeNB.

¹⁾ Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 27.6, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

In view of the persisting sharp rise in bank credit in 2004, the authorities supplemented their strategy with liquidity drainage operations: Minimum reserve requirements were adjusted on three occasions over the year (even doubled in December 2004). In May and June 2004, the government withdrew fiscal reserves, which had been held with commercial banks, and deposited them with the BNB. In July, the BNB broadened the coverage of reserve requirements. While the sector has so far remained generally solid, the quality

of loans somewhat weakened and the capital position declined in late 2004. In an apparent effort at moral suasion, central bankers in early 2005 launched talks with individual banks whose lending practices were regarded as aggressive.

3.2 Romania

After the financial crisis and recession of 1997–99, Romania experienced a breakthrough to economic growth and banking recovery in 2000. While a number of important factors underpinned this turnaround, some fragilities have subsisted. The new banking legislation of 1998 strengthened the independence and supervisory powers of the Banca Națională a României (BNR). The failure and winding up of Bancorex in 1999³ showed that even large banks were not necessarily “too big to fail.” This change of environment was complemented by the first privatizations of major Romanian credit institutions to foreign strategic investors: Banca Română pentru Dezvoltare (BRD) and Banca Agricolă were sold in 1999 and 2001, respectively (Barisitz, 2004b, 90). In 2000, the authorities embarked on prudent macrostabilization efforts. The decade-long conflict in neighboring former Yugoslavia drew to an end. With the strengthening of the economic upswing in 2001 and the following years, market participants gained more confidence and credit institutions started to expand their activities. Still, progress with the restructuring of large and often loss-making state-owned enterprises (SOEs) remained slow.

The assets of the banking sector grew from a low of 29% of GDP in 2000 to 33% at end-2003 (and, according to preliminary data, 39% at end-2004; see table 6). Total loans witnessed a rapid expansion from 9% of GDP to 16% in the corresponding period. But levels are still quite modest. Lower returns on government debt paper, on deposits with the BNR and on forex transactions contributed to the enhanced attractiveness of lending. The increase in loans focused on private and privatized firms, SMEs and households. Consumer credits, particularly mortgage loans and loans for the purchase of durables, have grown extremely fast and have even multiplied, albeit from a basis of almost zero.

The rapidity of the credit expansion, while welcome in the context of a catching-up process, triggered concern on the part of the monetary authorities, given the structural weaknesses of the economy. Banks’ risk management capacities still seem to be insufficient. Furthermore, lower interest rates on foreign currency credits and the most recent tendency toward appreciation of the Romanian leu have made particularly euro loans more attractive, boosting foreign currency lending to more than half of total lending at present. Since it is doubtful that most borrowers have substantial hard currency proceeds, the exchange rate risk could turn into a credit risk for banks. Starting in 2002, the BNR has attempted to rein in the growth of credit, particularly forex loans.

As of end-2004, 30 banks (including 7 branches) or 62% of banking assets were majority-owned by foreigners (table 6). Among these were seven of the top ten credit institutions, including BRD (the second-largest bank, owned by Société Générale), Raiffeisen Bank (former Banca Agricolă), ABN Amro

³ This largely explains the sharp increase of nonperforming loans in 2003.

Bank Romania and the Bucharest branch of ING Bank. The state held majority stakes in two institutions comprising 7% of total assets. Seven banks accounting for 31% of total assets were in domestic private ownership.

The largest bank, BCR (Banca Comercială Română, accounting for about 30% of assets) continues to hold an important state minority participation (37%). In the wake of two previously failed attempts to privatize the bank, the authorities in October 2003 sold a quarter of BCR's share capital, 12.5% to the EBRD and 12.5% to the International Finance Corporation (IFC). The bank's employees acquired 8%, and five domestic investment funds together took 30%. The two international institutions are expected to stimulate modernization of the bank prior to the planned sale of a majority stake to a foreign strategic investor by 2006. The third-largest bank, CEC (Casa de Economii și Consemnațiuni, Savings Bank), is currently undergoing a restructuring program and is to be privatized by 2005 or 2006. In early 2003, the BNR tightened loan classification and loss provisioning rules.⁴ The new Banking Act passed in December 2003 constituted a move toward full compatibility with EU norms (National Bank of Romania, 2004, 19). But the environment still features weak corporate governance, limited contract enforcement capacities and insufficient rule of law.

Table 6

Romania

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	-1.2	2.1	5.7	5.0	5.2	8.3
CPI inflation (year-end, %)	54.8	40.7	30.2	17.9	14.1	9.3
Exchange rate (ROL/EUR, annual average)	16296	19956	26027	31255	37556	40532
Number of banks (of which foreign-owned, year-end)	41(26)	41(29)	41(32)	39(32)	38(29)	39(30)
Degree of financial intermediation (bank assets/GDP, %)	34.9	29.2	30.5	31.6	32.7	39.5
Share of foreign-owned banks in total banking assets (%)	47.8	50.9	55.2	56.4	58.3	62.0
Credit (credit volume/GDP, %)	11.1	9.4	10.2	11.8	16.0	17.9
Share of nonperforming loans in total loans (%)	35.4	3.8	3.4	2.3	8.3	8.1
Deposits (volume of deposits/GDP, %)	22.4	20.0	20.4	21.7	21.3	..
Return on equity (ROE, %)	-15.3	12.5	21.8	18.3	15.8	17.0
Capital adequacy (capital/risk-weighted assets, %)	17.9	23.8	28.8	25.0	21.1	18.8

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiw, OeNB.

¹⁾ Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 27.6, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

3.3 Croatia

The banking crisis of 1998–99 and the exit of a number of smaller and medium-sized credit institutions, the hardening of budget constraints, the withdrawal of the state from the sector and the infusion of foreign financial and human capital have contributed to the robust recovery and expansion of Croatian banking activity since the turn of the millennium. Following their privatization at the end of 1999, the two largest banks changed owners again: A consortium of

⁰ This is also dubbed “roundtripping of loans to shareholders” (Odling-Smee and Thomson, 2003).

UniCredito and Allianz AG purchased market leader Zagrebačka banka in March 2002. As a condition for this transaction, Hrvatska narodna banka (HNB) required UniCredito to relinquish its stake in Splitska banka (the third-largest Croatian bank), as the Italian institution would otherwise have acquired a dominating competitive position. Splitska banka was taken over by Bank Austria Creditanstalt (HypoVereinsbank Group). Banca Intesa became the majority owner of Privredna banka Zagreb (the second-largest bank).

The authorities swiftly handled a crisis that had broken out in March 2002 at Riječka banka, which had been saddled with hidden losses of around EUR 100 million by a rogue trader. Upon discovery of the losses, the HNB quickly came up with liquidity to calm the markets, and the government purchased a 60% stake of Riječka for USD 1 from its owner, Bayerische Landesbank. Following Riječka's recapitalization, the authorities sold a majority stake in the institution to Erste Bank (Austria). The market share of foreign-owned credit institutions, essentially consisting of six large banks or banking groups, climbed from 40% of total assets at end-1999 to 91% at end-2004. Today Croatia is in the vanguard of transition economies with respect to the level of financial intermediation achieved: Total banking assets grew from an already high 66% of GDP in 1999 to about 109% at end-2004. Credits expanded in the corresponding period from 39% to 61% of GDP (table 7). This happened despite the still tenuous rule of law and slow-working, overburdened courts. The HNB has been strengthening supervision by moving from the formal verification of regulations to a more substantive risk-based approach.

Notwithstanding the authorities' impressive low inflation record – now sustained for over a decade – Croatians continue to maintain about two-thirds of their bank deposits in euro, complemented by sizeable euro cash holdings outside the sector. This is one of the highest levels of currency substitution and informal euroization recorded in Europe. It partly owes to lingering memories of high inflation or hyperinflation during the 1970s and 1980s in former Yugoslavia and the burst of inflation in the early 1990s. It also stems from the fact that the bulk of tourism revenues as well as guest workers' remittances are held in foreign currency (Gardó, 2004a, 31–32). The total value of household bank accounts almost doubled from 1999 to 2001, which can be explained by the impact of the euro area's "cash changeover" from the Deutsche mark (and other legacy currencies) to the euro at the beginning of 2002. In order to carry out the conversion, people had to pay their Deutsche mark cash into bank accounts, which were then converted. On the whole, EUR 2.5 billion were exchanged, the lion's share of which (EUR 2.1 billion) stayed in the accounts, which documented the population's enhanced trust in the banking sector.

While credit growth doubtlessly stimulated economic recovery and the catching-up process, it contributed to a surge in imports and to forex loans from abroad, which further widened the current account deficit and heightened the country's vulnerability to external shocks. In early 2003, the monetary authorities adopted a decision on the compulsory purchase of HNB bills, under which banks whose credit growth exceeded an annual rate of 16% were required to subscribe to low-yield HNB bills in an amount equal to 200% of the exceeded growth (Croatian National Bank, 2004, 115). This strict measure effectively slowed down the credit boom in 2003 and somewhat dampened

credit institutions' profitability. The measure was repealed in early 2004 and was replaced by tighter prudential requirements and more market-based instruments.

Table 7

Croatia

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	2.5	−0.9	4.4	5.2	4.3	3.8
CPI inflation (year-end, %)	4.4	7.4	2.6	2.3	1.7	2.7
Exchange rate (HRK/EUR, annual average)	7.58	7.63	7.47	7.41	7.56	7.50
Number of banks (of which foreign-owned, year-end)	53(13)	43(21)	43(24)	46(23)	41(19)	40(18)
Degree of financial intermediation (bank assets/GDP, %)	66.1	73.3	91.1	98.7	101.1	109.0
Share of foreign-owned banks in total banking assets (%)	39.9	84.1	89.3	90.2	91.0	91.3
Credit (credit volume/GDP, %)	39.1	39.6	45.6	54.5	58.1	61.0
Share of nonperforming loans in total loans (%)	10.3	9.5	7.3	5.8	5.1	4.5
Deposits (volume of deposits/GDP, %)	39.6	47.6	63.1	63.7	64.8	..
Return on equity (ROE, %)	4.8	10.7	6.6	15.3	14.5	16.6
Capital adequacy (capital/risk-weighted assets, %)	20.6	21.3	18.5	17.2	16.2	14.1

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiv, OeNB.

¹⁾ Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

3.4 Serbia

After the regime change in late 2000, the Federal Republic of Yugoslavia (FRY) broke with the past and embarked on an ambitious catching-up strategy. While initial results have been impressive, the speed of transformation appears to have slowed down recently. After liberalizing prices and the exchange rate, which produced a jump in the price level and a sharp depreciation of the dinar, the authorities tightened monetary policy, established a managed float for the Yugoslav currency (nominal anchor: Deutsche mark/euro) and brought inflation down. The catastrophic situation of the banking sector in 2000 is illustrated by Yugoslav banks' own (optimistic) assessment of their capital adequacy of 0.7% (which is far below the 8% minimum level corresponding to the Basel Accord of 1988, compare also table 8). Loans granted to shareholders and persons connected to them comprised almost 90% of the total value of large credits. 30 credit institutions (including the 6 largest, out of a total of 80), which together comprised about 70% of the sector's assets, were insolvent or featured negative capital.

Furthermore, the FRY – like Croatia – was saddled with a historic legacy originating in the communist era. But while Zagreb had addressed the problem in the 1990s, not much had happened in Belgrade: Most “old” banks (founded before the collapse of socialist Yugoslavia and predominantly socially-owned) were saddled with large blocks of “frozen liabilities” and “frozen assets.” Frozen liabilities referred to citizens' foreign currency accounts that had been transferred to Narodna banka Jugoslavije (NBJ, National Bank of Yugoslavia) and then in fact confiscated and spent by the authorities, and to forex loans received from

commercial or official creditors abroad for onlending to domestic enterprises that then defaulted. Frozen assets referred to banks' corresponding claims on the NBJ for transferred forex accounts and on domestic delinquent firms for onlent forex credits. "New" banks (mostly private) did not have this problem, but they were initially relatively small. With regard to citizens' frozen accounts, the Serbian authorities in the summer of 2002 launched the issue of EUR 4.2 billion of state bonds in exchange for such deposits.

In the first half of 2001 the NBJ carried out a comprehensive assessment of the banking sector and elaborated a restructuring strategy (endorsed by the International Financial Institutions, the IFIs). After enactment of a bankruptcy law in October 2001, 19 relatively small, undercapitalized and inefficient credit institutions were closed. In early 2002, the authorities decided to shut down and liquidate four of the five largest banks (all of them old ones: Beobanka, Beogradska banka, Investbanka and Jugobanka). These four banks accounted for almost 60% of the book value of the sector's assets and for about two-thirds of outstanding commercial credit to the nonfinancial sector.

The intervention certainly constituted one of the boldest bank restructuring measures yet undertaken in transition economies. Far from provoking significant negative repercussions, this step actually improved public confidence and stimulated hope that the sector had finally reached a turning point (Barisitz, 2003, 199). Owing to the huge carve-out, some other structural adjustments and economic expansion, the total book value of the sector shrank drastically from 126% of GDP at end-2001 to 36% a year later (table 8). Following the closures, the NBJ's regulatory and supervisory powers were strengthened by the enactment of a new Banking Act in mid-2002. The central bank has since been focusing on enforcement.

Launching a new restructuring initiative, in late 2002 the authorities converted state claims (related to guarantees for forex liabilities to the Paris and London Clubs) into shares and thus "nationalized" 12 medium-sized socially-owned banks in order to facilitate their privatization or resolution. But subsequent restructuring efforts of these entities, which together accounted for over half of total bank assets, were drawn out due to intermittent political instability. In February 2003, a new, loose confederation – Serbia and Montenegro – replaced the FRY. The NBJ became the NBS (Narodna banka Srbije); Montenegro, which had unilaterally euroized in 1999–2000, features its own independent fiscal, monetary and banking policies, and will not be treated here. Given the very small size of the banking sector in the wake of the carve-out, foreign-owned credit institutions swiftly gained terrain. Their share in total assets grew from 13% (excluding the four large insolvent banks) at end-2001 to over a third in late 2004. According to preliminary data, as of end-2004, four of the five largest Serbian credit institutions (including Raiffeisenbank, Delta banka and HVB banka) were foreign-owned (Financial Times, 2004). Foreign-owned banks played a particularly prominent role in restoring confidence in the sector and gathered the lion's share of new deposits. The seventh-largest credit institution, Jubanka, was sold to Alpha Bank (Greece) in January 2005.

Table 8

Serbia

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	-21.0	5.2	5.1	4.5	2.4	8.6
CPI inflation (year-end, %)	36.5	113.5	40.7	14.8	8.1	12.5
Exchange rate (YUD/EUR, annual average)	11.70	15.30	59.44	60.79	65.26	73.00
Number of banks (of which foreign-owned, year-end)	75(3)	81(3)	54(8)	50(12)	47(16)	43(13)
Degree of financial intermediation (bank assets/GDP, %)	79.8	185.0	127.0	36.4	31.5	38.8
Share of foreign-owned banks in total banking assets (%)	..	0.3	2.1	12.8	22.9	37.0
Private sector credit (credit volume/GDP, %)	29.6	56.6	31.7	17.2	16.0	21.5
Share of nonperforming assets in total assets (%)	..	30.9	12.6	24.3	22.5	23.0
Private sector deposits (volume of deposits/GDP, %)	9.7	14.7	13.4	15.5	17.7	20.7
Return on equity (ROE, %)	..	-78.5	-26.0	-34.5	-1.2	-5.0
Capital adequacy (capital/risk-weighted assets, %)	..	0.6	21.9	30.6	31.3	27.9

Source: NCB, BA-CA, RZB, IMF, EBRD, ECB, wiiw, OeNB.

¹⁾ Preliminary data.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 276, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

4 Russia and Ukraine

As members of the Commonwealth of Independent States, Russia and Ukraine have been bound together by a common legacy and various similarities in economic policies and banking evolution since independence. More recently, they seem to have increasingly chosen their own paths of reform and development.

4.1 Russia

The impressive Russian recovery that followed the severe crisis of 1998 enabled banks to begin anew, although initially they hardly contributed to the recovery. The expansion was supported by the significant easing of monetary conditions, as the ruble had strongly devalued in real-effective terms, which boosted competitiveness of domestic manufacturing and kick-started import substitution. Then, importantly, oil and raw material prices recovered again and rose strongly. Political stability was gained and retained under the Putin presidency (since January 2000), prudent macroeconomic policies were carried out and some positive effects of structural reforms, e.g. tax reforms, made themselves felt. As from 2000, an uninterrupted string of federal budgets featured surpluses.

Rising earnings and wealth of raw material extractors, exporters and linked industries attracted banks and provided a new financial base for the banking business. This was later complemented by the steady recovery of wages and salaries and pronounced adjustments of pensions. Sberbank was the first to react by expanding its credit portfolio (already in mid-1999), other banks followed suit (in 2000). According to the monetary authorities, by the end of 2001, the Russian banking sector had more than offset the losses caused by the crisis, and its profitability had been restored. As of end-2004, total banking assets in real terms were 75% to 80% higher than in July 1998 (just before the crisis) and reached 41% of GDP (EUR 185 billion to EUR 190 billion). The total volume of

loans more than doubled from July 1998 to end-2003 and attained 22% of GDP (table 9). Household deposits climbed 60% during that period. Yet these data are based on official Russian accounting standards (RAS), which tend to put greater emphasis on formal reporting requirements than on material elements and economic meaning. A (still) not infrequent way of dressing up the books appears to be that banks lend to their owners, who then use the funds to “boost” capital.⁵

When the dust of the crisis had settled, it was clear that state-owned credit institutions had – once again – become the dominant players in Russia. Coming to 1,299 as of end-December 2004, the total number of Russian banks is still very high, even for a country of 144 million with an immense territory. However, the majority of credit institutions have only very few branches. Today, Russian banks can be subdivided into four basic groups: First, there are the big state-owned institutions Sberbank and Vneshtorgbank. Sberbank remains by far the biggest player in the market. It still has about 190,000 employees and entertains around 20,000 branches and service posts across the land, which is more than all other banks taken together. In October 2004, Sberbank held about 62% of all household deposits, thus retaining a quasi-monopoly in the area. Over recent years, Sberbank as well as Vneshtorgbank, the former foreign trade bank of the Russian Federation and second-largest bank (measured by assets), have strongly expanded their exposure to the corporate sector, particularly the oil and gas industries. At end-2003, majority state-owned banks together accounted for 38% of loans to the real sector.

The second group contains the next 15 to 20 mostly privately owned institutions, currently dominated by banks owned by big raw material producers. Among the largest “RawMat banks” are Gazprombank (the third bank, associated with the majority state-owned natural gas monopolist Gazprom), Rosbank (attached to the Interros financial-industrial group, including the huge Norilsk Nickel Corporation) and Bank Petrokommerts (linked to Lukoil). The largest privately owned credit institution (ranking fourth) is Alfabank, connected to Alfacgroup, a diversified financial-industrial group. Most private banks function as “pocket banks” or “agent banks,” i.e. extended treasuries or financial departments of owner firms or conglomerates. The third group of banks is numerically overwhelming, consisting of over 1,200 small or even tiny institutions. Many of these are undercapitalized regional outfits or providers of niche services. Despite reform progress, the insufficient protection of creditors, the problems in securing collateral and the generally weak or selective rule of law make it difficult for Russian banks to lend on the free market.

FDI and foreign ownership account for the fourth group of banks. This group only plays a minor role in Russian banking. At end-2003, 41 majority foreign-owned credit institutions accounted for 7% of total banking assets in Russia (table 9). Citibank, Raiffeisenbank and Hypo-Vereinsbank (which participates in Mezhdunarodny moskovsky bank) feature among the top 15 Russian banks. The relatively weak presence of foreign capital in the Russian sector is certainly in part due to the still lingering impact of the crisis of 1998,

⁵ This is also dubbed “roundtripping of loans to shareholders” (Odling-Smee and Thomson, 2003).

when many foreigners lost a lot of money. Although many restrictions for FDI in banking have been abolished, some still exist, like a (de facto) ban on the opening of branches of foreign banks. There also seems to be an underlying resistance to allowing foreigners to buy significant stakes in large local institutions (Trofimova et al., 2004, 64).

Since late 2003, the authorities have passed a number of important banking reforms, thereby stepping up the pace of change. The Central Bank of the Russian Federation (Bank Rossii, Bank of Russia) radically revised its general instruction “On banks’ mandatory norms,” which entered into force in April 2004. The new rule exemplifies efforts to shift from form to substance in regulation and, according to experts, may bring about a real improvement in the quality of Bank of Russia supervision in that it reduces opportunities for banks to manipulate their accounts in order to meet prudential ratios. But implementation promises to be difficult. After long discussions and hesitations, household deposit insurance legislation was finally signed into law in December 2003. To counter moral hazard, the Bank of Russia has limited deposit coverage and made access to insurance subject to stringent inspections and conditions. Banks that do not meet the admission criteria will no longer be allowed to accept deposits. Around 1,140 credit institutions applied to take part in the deposit insurance scheme. The Bank of Russia engaged in what was bound to be the first serious review for the overwhelming majority of Russian banks in years (Barisitz, 2004a, 147, 149).

Table 9

Russian Federation

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	6.4	10.0	5.1	4.7	7.3	7.2
CPI inflation (year-end, %)	36.8	20.1	18.6	15.1	12.0	11.7
Exchange rate (RUB/EUR, annual average)	26.24	26.03	26.13	29.65	34.55	35.81
Number of banks (of which foreign-owned, year-end)	1,349(32)	1,311(33)	1,319(35)	1,329(37)	1,329(41)	1,299(42)
Degree of financial intermediation (bank assets/GDP, %)	35.4	33.4	34.9	37.8	39.3	40.6
Share of foreign-owned banks in total banking assets (%)	10.6	9.5	8.8	8.1	7.4	..
Credit (credit volume/GDP, %)	13.1	13.5	16.2	18.5	21.7	23.0 ²⁾
Share of nonperforming loans in total loans (%)	13.4	7.7	6.2	5.6	5.0	..
Deposits (volume of deposits/GDP, %)	10.2	9.9	10.7	12.4	14.4	16.0 ²⁾
Return on equity (ROE, %)	−4.0	8.0	19.4	18.0	17.8	..
Capital adequacy (capital/risk-weighted assets, %)	26.7	24.9	24.3	22.2	19.1	17.0 ²⁾

Source: NCB, IMF, RZB, EBRD, ECB, wiiw, OeNB.

¹⁾ Preliminary data.

²⁾ June 30, 2004.

³⁾ March 31, 2004.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 27.6, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

It was in this particular environment of examinations and nervousness that two smaller banks' licenses were revoked in connection with money laundering charges in May 2004. This triggered turbulences that culminated in the illiquidity or insolvency of a medium-sized bank, Gutabank, and sizeable withdrawals even from Alfabank in July 2004. The central bank reacted by repealing the licenses of ten smaller banks, halving its reserve requirements, and supporting the takeover of Gutabank by Vneshtorgbank with a low-interest loan. Gutabank was thus effectively nationalized. In mid-July, parliament passed a special law providing for a limited interim guarantee for all existing – but not for any new – bank deposits of private individuals. These measures calmed the situation. In the fall of 2004, banking activities resumed their – fragile – expansion. The Bank of Russia took action against about 190 banks found to have artificially inflated their capital. In mid-March 2005, the central bank published a list of around 820 banks, accounting for 98% of all private deposits, which had passed the inspections and will be admitted to the scheme.

4.2 Ukraine

After a decade of uninterrupted and deep economic contraction, 1999 marked a turning point, and 2000 was the first year of a steep and sustained recovery. While the depression had been even more pronounced than in Russia, so was the rebound, which accelerated to provide double-digit annual growth in 2004 (table 10). Apart from the base effect, some of the driving forces of Ukrainian economic expansion are the following: After the financial crisis of 1998, the hryvnia continued to decline throughout the following year, which favored import substitution. Strong rises in world market prices for some of Ukraine's prime exports (steel, chemical products) served to ignite export-led growth in 2000. Later on, domestic demand gathered momentum, and an impressive credit boom contributed to financing the expansion. Moreover, a reform-oriented, if short-lived, government came to power in Kiev in early 2000 and initiated important adjustments: Macrostabilization was strengthened, subsidies were cut, tax rules simplified and enforced. The authorities stepped up privatization and enacted a new banking law.

Notwithstanding the undercapitalized and precarious state of large parts of the sector, banking activity started to expand strongly in 1999. The new Law on Banks and Banking Activity became effective in January 2001 and strengthened the powers of the National Bank of Ukraine (Natsionalny bank Ukraini, NBU) as supervisor and improved the regulatory environment for banks. After years of difficulties in trying to ensure greater compliance of the former state-owned Bank Ukraina (focusing on agriculture) with prudential regulations, the central bank finally overcame political barriers and decided to liquidate the bank in July 2001 (Loehmus, 2002, 18). Buoyed by the favorable economic environment, a credible exchange rate anchor, which stabilized expectations,⁶ the quick decline of inflation, which bolstered confidence, and strong money demand growth, which paved the way for rapid remonetization, Ukraine experienced a credit boom.

⁶ In 2000, the U.S. dollar was chosen as a *de facto* nominal anchor for the hryvnia within the framework of a managed float.

From 1999 to mid-2004, average annual commercial bank credit growth to the economy exceeded 50% in real terms. The loans-to-GDP ratio more than tripled from 9% at end-1999 to 30% in June 2004, which corresponds to one of the most rapid such expansions in transition economies (table 10). Deposit growth financed the lion's share of the expansion. Most recently, inflation has been on the rise again (to 12.3% at end-2004), and the credit boom has raised serious concerns about credit risk in the banking sector. Ukraine's loans-to-GDP ratio has reached a level well within the average range of the more advanced transition countries (like Poland) and above average for transition countries with a similar institutional quality in the sector.

Increasing competition has brought about losses of market shares for the two large remaining state-owned banks – Oshchadny bank (Savings Bank, the fourth-largest measured by assets) and Ukreximbank – as well as for former state-owned banks saddled with nonperforming claims, e.g. Prominvestbank (the third-largest) and Ukrsotsbank. The two big private banks unburdened by the past, Avalbank and Privatbank, became the largest credit institutions in Ukraine. As of end-2004, there were still 160 banks in the country. Particularly the smaller ones functioned as pocket banks of enterprise groups whose ownership structures have often been difficult to trace, notably where ownership has been “layered” or “packaged” through several companies (IMF, 2003, 7).

Table 10

Ukraine

Macroeconomic and Banking Sector-Related Indicators (1999–2004)

	1999	2000	2001	2002	2003	2004 ¹⁾
GDP growth (real, %)	−0.2	5.9	9.2	5.2	9.6	12.1
CPI inflation (year-end, %)	19.2	25.8	6.1	−0.6	8.2	12.3
Exchange rate (UAH/EUR, annual average)	4.393	5.029	4.814	5.030	6.024	6.609
Number of banks (of which foreign-owned, year-end)	161(15)	154(14)	152(16)	157(15)	157(19)	160(19)
Degree of financial intermediation (bank assets/GDP, %)	19.6	21.8	23.3	28.3	37.9	43.5
Share of foreign-owned banks in total banking assets (%)	..	..	..	16.0	17.0	..
Credit (credit volume/GDP, %)	9.0	12.4	14.5	19.4	27.0	27.1
Share of nonperforming loans in total loans (%) ²⁾	35.8	29.6	25.1	21.9	28.3	30.0
Deposits (volume of deposits/GDP, %)	9.6	11.4	12.8	16.9	23.4	26.2 ³⁾
Return on equity (ROE, %)	8.7	−0.5	7.5	8.0	7.6	8.4
Capital adequacy (capital/risk-weighted assets, %)	19.6	15.5	20.7	18.0	15.2	16.8

Source: NCB, IMF, EBRD, ECB, wiw, OeNB.

¹⁾ Preliminary data.

²⁾ IMF estimate.

³⁾ Mid-2004.

Memorandum item: EU-15 (average 2002–03, %): banking assets/GDP: 27.6, foreign-owned banks/total banking assets: 22.1, nonperforming loans/total loans: 3.1, ROE: 9.4, capital adequacy: 12.2.

Notwithstanding the new banking law, insider lending practices went on, and according to IMF estimates, more than a quarter of total loans were nonperforming in mid-2004 (Schaechter, 2004, 14, 23).⁷ To counter weak-

⁷ This is the highest level observed in all analyzed countries. The Ukrainian indicator is reported to have risen further to 30% at end-2004.

nesses in capitalization and stimulate consolidation, the NBU raised the minimum capital adequacy ratio from 8% to 10%, effective March 2004. Various areas need further strengthening: banks' risk management capacities, creditor rights, the court system, transparency and banking supervision. Given this environment and the ban on opening foreign bank branches (similar to that in Russia), it is not surprising that – despite the boom – foreign banks' presence is modest. As of end-2004, there were 19 majority foreign-owned credit institutions in Ukraine (many of them Russian), which accounted for about a sixth of total banking assets. Raiffeisenbank was the only foreign-owned bank among the ten largest credit institutions of the country.

5 Conclusions

After the collapse of the communist system, most of the ten analyzed countries (Hungary, Poland, the Czech Republic, Slovakia, Bulgaria, Romania, Croatia, Serbia, Russia and Ukraine) experienced the 1990s as a volatile decade featuring major banking crises and partly painful structural transformation. Around the turn of the millennium, the environment stabilized and banking activities entered a path of sustained expansion, boosted by the resumption of robust economic growth and the anchor of EU integration or proximity.

Some of the findings of this study can be summarized as follows:

Foreign-owned banks have acquired dominating competitive positions in all analyzed countries except slower or late reformers (Russia, Ukraine, Serbia). In some countries, like Slovakia and the Czech Republic, foreign-owned banks' positions are overwhelming. Foreign investors had often entered the markets during or immediately after a major sector clean-up (preceded by a crisis) and as soon as a reasonable degree of rule of law had been established. Foreign-owned banks' average share in total assets is much higher in Central and Eastern Europe than in the euro area (where it comes to about a quarter). Bank privatization is all but finished in most countries. The strongest foreign presence (in terms of assets) is that of Austrian, Italian, Belgian, German and French banks. The share of state-owned banks is still relatively high (over 30% of assets) in Russia and Serbia. The state retains important minority stakes in Romanian and Ukrainian credit institutions.

Selling banks to foreign strategic investors has generally paid off, because it has contributed to enhancing the sector's competitiveness and efficiency. Foreign strategic investors have injected know-how, technology, corporate governance and money, thus boosting competitiveness, stimulating competition and bolstering fragile confidence in the sector. In some instances, foreign parent banks have also acted as *de facto* lenders of last resort to their subsidiaries in the region, although this cannot be taken for granted (see the case of Riječka banka). This does not mean that foreign takeovers are the only feasible route for establishing viable and competitive credit institutions in the region (or other emerging markets). But if development is to be essentially homegrown, the necessary accumulation and transfer of human and financial capital will probably take longer. There are only few examples of successful large domestically owned banks in Central and Eastern Europe. Perhaps the most prominent, OTP, appears to owe its strong position in the Hungarian market and its relatively

efficient structure to the impact of the relentless competition from foreign-owned institutions, which compelled it to drastically streamline and modernize its operations.

Practically every analyzed country seems to be overbanked and underbanked at the same time – overbanked in that it harbors too many, particularly small, credit institutions and underbanked in that access to and use of banking services is far below the EU average. But the tightening of minimum capital requirements and intensifying competition are contributing to ongoing consolidation processes, which in some countries include sizeable cuts of banking employment. Modernization and rationalization of banking structures and networks, notably in Central European countries, comprise the swift dissemination of IT (greater use of credit cards, telebanking, e-banking) and may reconcile the above-mentioned apparent contradictory tendencies through enhanced productivity and efficiency.

In recent years, a genuine credit boom has unfolded in most countries. However, the boom was preceded by a sharp curtailment or collapse of the traditionally lax credit policies inherited from the past. The bank restructuring programs of the 1990s, the concomitant tightening of regulations and supervision as well as the improvement of bookkeeping rules essentially established hard budget constraints for credit institutions. Due to delays in the implementation of creditor rights in the real sector, banks initially became more cautious in lending and partly reshuffled their portfolios toward low-risk investments, like government securities and central bank bills.

Based on strong growth and improved macroeconomic and structural conditions, rising confidence, jumps in deposit levels as a result of the euro cash changeover 2001–02 as well as, in most countries, substantial FDI inflows into the banking sector, lending subsequently recovered, eventually leading into a credit boom. The authorities concerned perceive the boom as a welcome advance on the path of structural catching-up and convergence. Although the boom is accompanied by a decline of capital adequacy ratios, the latter remain relatively high, and bad loans do not seem to be a serious problem. Pushed by competition, credits spread to hitherto less covered areas, like retail – particularly mortgage – lending, where they have multiplied from a base of almost zero. Notwithstanding the establishment of credit information bureaux in most countries, SME lending has not yet taken off, except in Hungary.

But the credit boom does give rise to concern at least in some countries (e.g. Bulgaria, Romania, Croatia, Ukraine). Owing to the sheer speed of the expansion, careful screening of individual loans may not be possible. This heightens the danger that some loans could turn nonperforming in the next economic downturn. Moreover, the credit boom has swelled already strong aggregate demand, which can fan inflation; with loans often being used to purchase imported consumer goods, pressure is put on the trade and current accounts and on external liabilities. Authorities have tended to react somewhat hesitantly to the boom. In many instances, regulatory and supervisory rules were further

tightened, notably minimum reserve requirements. Croatia resorted to temporary administrative restrictions, which proved effective, but at a cost. Apart from Croatia, the effectiveness of the tightening measures is not yet clear.⁸

“Agent banks” or “pocket banks,” i.e. extended treasuries or financial departments of owner firms or enterprise groups whose ownership structures tend to be opaque, still play an appreciable role in some countries, especially in Russia and Ukraine, where they prevail. The “agent bank – principal firm” structure and relationship may at least partly reflect an approach to protect business interests in a continually distorted environment; on the other hand, extensive insider lending, excessive portfolio concentrations and bank captivity to owners entail high risks.

Banking supervision has generally been moving forward from the formal verification of regulations to substantive risk-based approaches, including the overhaul of accounting methods toward IAS or EU-compatible standards. The EU accession process and legal harmonization with the *acquis communautaire* has contributed to improving and stabilizing the environment for banks. However, lingering deficiencies of the courts (e.g. weak enforcement of contracts, difficult access to collateral) are still felt in a number of countries. Due to intensifying competition, there is a general tendency for interest rate spreads to decline, even if they clearly exceed margins in the euro area because risks are higher. Higher margins also correspond to higher average profitability of transition economies’ banking sectors.

Notwithstanding important progress in banking transformation and persisting high growth rates of income and financial intermediation, the banking markets in Central and Eastern Europe retain generous expansion potential, as witnessed by the still much lower per capita income and access to banking services than in the euro area or in Western Europe. Even in relation to income levels, consumption of banking products is lower in Central and Eastern Europe. Thus, while the gap is shrinking, it is still wide.

All in all, after adopting the *acquis communautaire* in connection with entering the EU, Central European countries are most advanced in terms of legal and institutional reforms and convergence. They feature the smallest shares of the state and the highest shares of foreign investors in total banking assets. They boast, on average, the highest degree of financial intermediation. Southeastern European countries are EU candidate or potential candidate countries. While Croatia is clearly most developed with respect to financial intermediation in Southeastern Europe, the banking sector on average is at an earlier stage of development than in Central Europe. Although foreign-owned banks dominate the sector (apart from Serbia), state-owned banks are still important in some countries (Romania, Serbia). Russia and Ukraine are particularly large countries and markets; given their stage of development, they possess the highest potential for further banking expansion. However, despite improvements, the rule of law remains weakest (or most selective) in these two countries. Sectors are still

⁸ For detailed information on the determinants, impact and monetary policy implications of credit expansion in Central and Eastern European EU Member States, see Backé and Zumer (2005) in this publication.

marked by an abundance of small undercapitalized outfits, transparency of ownership leaves a lot to be desired, and pocket banks and insider lending hold sway.

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Developments in Credit to the Private Sector in Central and Eastern European EU Member States: Emerging from Financial Repression – A Comparative Overview

This article provides an overview of developments in credit to the private sector in Central and Eastern European EU Member States in the period from 1999 to 2004. It discusses the main determinants of credit expansion, explores its impact on economic developments and examines policy implications. The paper also reviews how the issue of credit growth has featured in the monetary integration process of new Member States so far. The analysis shows that (i) lending to the private sector has grown dynamically in most but not all countries under review, (ii) loans to households have risen dynamically in all countries and (iii) foreign currency lending has been sizeable, in particular in countries with pegged exchange rates. Credit growth has been promoted by macroeconomic stabilization, comprehensive reforms and privatization in the financial sector and by the introduction of market institutions and legal reforms. Financial depth in most new Member States continues to be comparatively low, which suggests that credit growth will tend to be high, especially over the medium term. In those countries that have recorded fast and persistent private sector credit growth in recent years, current account deficits have moved above levels that can be deemed sustainable over a longer period of time. Our analysis thus corroborates the case for keeping macroeconomic vulnerabilities in check by containing domestic demand growth and current account deficits to sustainable levels over the medium term in the countries concerned.

Peter Backé,
Tina Zumer¹

1 Introduction

In many of the new Member States of the European Union, domestic credit to the private sector has been growing at high rates in recent years. This development has attracted considerable attention, highlighting the need to better understand the underlying factors driving credit dynamics in the new EU Member States and to explore their effects on macroeconomic and financial stability at a stage in which these countries are preparing for their prospective integration into the euro area. Against this background, this article provides a succinct overview of developments in domestic credit to the private sector in Central and Eastern European (CEE) EU Member States.² It identifies the main determinants of domestic credit expansion and briefly discusses the latter's impact on economic developments and some policy implications that arise at the present juncture.³ The paper also provides a concise account of how the issue of credit growth has featured in the monetary integration process of new Member States so far.

Specifically, the article reviews the developments in credit to the private sector on the aggregate level in these countries for the period from 1999 to 2004.⁴ In doing so, we use data that are based on the ECB definition of credit to the private sector, which is a broad measure of the financing that the MFI

¹ Oesterreichische Nationalbank (OeNB), Foreign Research Division, peter.backe@oenb.at and European Central Bank (ECB), EU Countries Division, tina.zumer@ecb.int. The standard disclaimer applies. The authors gratefully acknowledge comments by Stephan Barisitz, Balázs Égert, Jarko Fidrmuc, Antje Hildebrandt, Doris Ritzberger-Grünwald, Zoltan Walko and two anonymous referees. A previous version of this paper benefited from comments by Reiner Martin and Ad van Riet. We would like to thank Ingeborg Schuch for language advice.

² In this paper we focus on lending by domestic monetary financial institutions (MFIs). While lending from foreign MFIs has been an important source of financing for the private sector in several countries, this article does not cover the latter aspect as regards direct borrowing from abroad by nonfinancial corporations and households. However, in dealing with the sources of lending by domestic MFIs, it does include the intermediation of foreign funds to domestic nonfinancial corporations and households.

³ The article does not cover the two new Member States from Southern Europe, Cyprus and Malta, both of which have a long-standing history of being financial centers in which a large share of services is extended to nonresidents. This particular feature has strongly determined financial sector development in these two countries and clearly sets them apart from the Central and Eastern European new Member States.

⁴ For the Czech Republic and Slovakia, comparable data on credit to the private sector are available from the beginning of 2002 and 2000, respectively.

sector provides to the non-MFI sector, excluding general government.⁵ Further on, the analysis is selectively extended to the sectoral level as well to the currency structure of loans to the private sector, using nonharmonized data from national sources (as no disaggregated ECB data are available yet). Consequently, these segments of the analysis should be treated with particular caution and understood as a tentative illustration of interesting aspects that need further examination in the future.

The main motivation of the paper is to give an up-to-date account of the topic and thus provide a comparative perspective across the new Member States from Central and Eastern Europe. To our knowledge, the only study with a similar focus is Cottarelli et al. (2003). However, we use a new dataset (ECB data) and cover two additional years, namely 2003 and 2004, which display very interesting lending dynamics in a number of countries under review.⁶ In this article, we discuss the subject mostly informally. Undoubtedly, it would be desirable to examine the factors that drive credit dynamics in the new Member States with econometric estimation methods. Yet limited data availability, short time series and the comprehensive transformation process the new Member States have undergone in the recent past severely constrain such an analysis, and consequently any serious modeling and estimation effort would certainly exceed the bounds of this survey article. Moreover, there is already some empirical work on selected issues which can be examined more straightforwardly with econometric techniques, such as the estimation of expected long-term levels of private sector credit in CEE countries, and the results of these estimations are duly reported in the literature survey (section 2) of this article.

2 A Brief Literature Overview

Several strands of literature are of relevance to the topic at hand. Naturally, this includes studies on the determinants of credit demand and supply. As credit growth can be a manifestation of financial development, the literature on the finance-growth nexus also has a bearing. Within the literature on credit growth, finally, work on lending booms and busts is of importance, together with those parts of the financial crisis literature that explore the role of credit growth in and for periods of high financial volatility.

A look at the *theoretical literature* in these areas yields four main findings. First, there is a variety of theoretical models on credit demand, typically featuring real GDP, price indices or interest rates as explanatory variables. Yet there appears to be no widely used “standard” credit demand model which would readily offer itself for an examination (estimable specification) of credit dynamics and their macroeconomic implications in new EU Member States. Similarly, a variety of credit channel models consider how changes in the financial positions of banks (bank lending channel) and borrowers (balance sheet channel) affect the supply of credit in an economy (see Hall, 2001, for a succinct overview). Second, as regards the finance-growth nexus, some theoretical

⁵ Credit includes MFI loans to residents and MFI holdings of securities issued by residents.

⁶ Their study covers private-sector credit developments in Central and Eastern Europe and in the Balkans until 2002 using data from national sources; at the time, ECB data on credit developments in CEE countries were not yet available.

arguments have been made that would underpin a positive link between financial sector development and GDP growth (see Terrones and Mendoza, 2004, box 4.1, for a concise overview; compare also Mooslechner, 2003, for a survey of relevant economic theory on this issue across history). Third, on lending booms, leading theories highlight several triggers, in particular (i) real business cycles caused by technological or terms-of-trade shocks (with highly procyclical output elasticity of credit demand), (ii) financial liberalization of an initially repressed financial system, (iii) capital inflows triggered by external factors, and (iv) wealth shocks originating e.g. from comprehensive structural reforms (see Gourinchas et al., 2001, for a concise survey). In addition, less-than-fully credible policies (notably exchange rate-based stabilizations) can also play a role in spurring credit booms by setting off an unsustainable consumption boom (see Calvo and Vegh, 1999, for a review).

Moreover, one can find some theoretical insights into the mechanisms that drive or amplify credit dynamics. In this context, the financial accelerator literature is of particular relevance (which argues that positive real shocks, by raising asset prices, impact on the net worth of agents holding these assets, in turn affecting their ability to borrow).⁷ Yet if changes in asset valuations become based on overly high expectations about future earnings (or if the initial positive shock reverts), lending expansions will turn out to be unsustainable and thus ultimately involve a correction.

Empirical work on credit growth provides evidence on the following key aspects. First, studies investigating credit demand are mostly on high-income industrialized countries. Their common finding is that income and interest rates can satisfactorily explain credit demand, although supply factors, if important, may reduce the reliability of the estimation results, due to difficulties in distinguishing demand and supply for credit in econometric estimation.⁸ More generally, there are strong indications that the demand for credit is positively related to output, usually with elasticity higher than one in the long run. This implies that credit-to-GDP levels rise as per capita GDP increases, a process which is denoted as financial deepening. As regards the empirical literature on credit supply, there is a large body of studies that have investigated the existence and the importance of the credit channel for a range of countries, using both macro and micro data. While results are diverse, a number of studies – including some initial papers on CEE countries – find evidence in support of the credit channel.⁹

⁷ *The financial accelerator literature intersects with the literature on the role of credit in monetary transmission, in particular the balance sheet channel, which rests on the inverse relationship between a borrower's net worth and the external finance premium he or she faces.*

⁸ *It should be noted that most of the empirical studies estimating the demand for credit distinguish between households and nonfinancial corporations. Only a limited number of studies investigate demand of aggregate credit to the private sector (see for example a study on the euro area by Calza et al., 2001).*

⁹ *The Eurosystem Monetary Transmission Network undertook comprehensive empirical work on monetary transmission in the euro area, which also covers the credit channel (see ECB Working Papers Nos. 91–114 and Angeloni et al., 2003). Empirical work on the credit channel in new Member States has been e.g. done by Juks (2004) on Estonia; by Hurlin and Kierzenkowski (2002) as well as Wróbel and Pawłowska (2002) on Poland; by Pruteanu (2004) on the Czech Republic; furthermore, by Schmitz (2004) on all eight new Member States from CEE. Research on the credit channel in Hungary by Horváth et al. (2005) is currently ongoing. Compare also OeNB (2001) reporting on an East Jour Fixe seminar in the fall of 2001 dealing with "The Monetary Transmission Mechanism in Austria, the Eurosystem and in Central and Eastern Europe."*

Second, on the positive interaction between finance and growth, empirical studies have examined the direction of causality, with most results suggesting that it is financial deepening which spurs economic development (see e.g. Beck et al., 2000). These studies usually focus on the size of the banking sector as a proxy for the degree of financial sector development, measured as credit to the private sector extended by banks and as banks' liabilities. While the results of this literature are appealing, it goes without saying that establishing genuine causality is intricate – with nonlinearities in the relationship between financial development and growth as well as country heterogeneity adding to the analytical problems in this area (see discussion in Favara, 2003). This, in turn, suggests that the impact of private sector credit expansion on economic growth is difficult to estimate and even more so to predict, as it is likely to be different across countries, and this also holds for countries with similar levels of economic and financial development.

Third, in the empirical literature on financial crises and, in particular, in the strand of papers that explore their predictability, rapid credit growth has emerged as a main leading indicator for financial crises. However, one cannot conclude from this literature that lending booms typically lead to financial crises. As Gourinchas et al. (2001) point out, while the conditional probability of a lending boom occurring before a financial crisis may be quite high, this does not tell much about the converse, i.e. the conditional probability that a financial crisis will follow a lending boom.

Within the empirical literature on credit growth, several studies have dealt with lending booms, in particular in non-European emerging market economies, exploring their stylized features, driving forces, macroeconomic effects as well as possible policy implications. It is noteworthy that the concept of credit/lending booms has been used in different ways in this literature. Some studies have defined lending booms in broad terms, capturing periods of rapid and sustained credit expansions as well as episodes in which credit expansions were followed by reversals. Other research has focused more narrowly on excessive cyclical expansions of credit that eventually collapse of their own accord. As one could expect, the way credit booms are defined has a strong bearing on results, i.e. on the macroeconomic and financial conditions that are found to be associated with such episodes. This relates above all to the degree of output volatility and financial vulnerability related to lending booms. Apart from these differences, a fairly uniform finding of these empirical studies is worth being reported: Credit booms in non-European emerging market economies have typically not had a major impact on inflation (compare Terrones and Mendoza, 2004; Gourinchas et al., 2001).

The empirical literature on credit growth in CEE countries is fairly limited. The main study in this area is Cottarelli et al. (2003), who examine bank credit growth to the private sector in 15 countries of Central and Eastern Europe and the Balkans. Looking at credit-to-GDP developments since the mid-1990s, the authors discern three country groupings (early birds, late risers and sleeping beauties). Based on econometric estimates of the expected long-term credit-to-GDP ratios they conclude that bank credit levels in 2002 were

not inconsistent with the structural characteristics of the economies under examination.¹⁰ While credit growth to the private sector should thus be seen as a welcome structural development, the authors call on policymakers to evaluate its macroeconomic and financial stability implications carefully. A few other studies also deal with the finance-growth relationship in CEE transition economies. Coricelli and Masten (2004) present tentative empirical evidence which suggests that financial market development in CEE countries, including rising credit-to-GDP ratios, can have a positive impact on GDP growth, while also helping reduce output volatility.¹¹ Drakos (2002) reports empirical evidence for a positive link between the degree of competition in the banking sector and economic growth based on data from 21 transition economies. Koivu (2002) also finds that financial development in qualitative terms (captured by changes in interest rate margins) is positively associated with GDP growth, while quantitative indicators of financial development, namely bank credit to the private sector, did not help output growth in 25 transition economies in the period from 1993 to 2000. A possible explanation for this result is, in her view, that credit developments in that period (which, for the most part, precedes the period under examination in this article) had not always been sustainable and in some cases may have led to a decline in growth rates.

Furthermore, echoing actual developments, credit growth has become an increasingly important issue in the regular publications of central banks in the region on financial stability issues, with much of the analysis focusing on loans to households (see financial stability reports or report series of Magyar Nemzeti Bank, Narodowy Bank Polski, Česká národní banka, Eesti Pank, Banka Slovenije, Národná banka Slovenska as well as special studies in these reports or separate publications, in particular Bethlendi and Nagy Vas (2004), Czinege et al. (2004), Kask (2003); compare also Jankov and Kraft (2005) for the EU candidate country Croatia; furthermore, see as well the financial stability reports of the Oesterreichische Nationalbank, which cover Central and Eastern Europe quite extensively, given the strong involvement of Austrian banks in that region).¹² Likewise, credit growth has received added attention in the regular IMF surveillance of Central and Eastern European countries in the recent past.¹³

3 Key Features of Credit Growth

To place credit developments in the new Member States (MS) into context, it is useful to recall that financial systems in the countries under review are bank-based – about 85% of financial sector assets are bank assets – and that capital markets (in particular corporate bond and stock market segments) are generally

¹⁰ The authors estimate a model of the long-term relationship between the private sector credit-to-GDP ratio and a set of variables (per capita GDP, public debt-to-GDP, inflation, financial liberalization, legal origin) for a panel of nontransition economies. Subsequently, they produce out-of-sample estimates for private sector credit-to-GDP ratios of CEE and Balkan countries.

¹¹ While this paper provides some provisional indications, further work would be highly useful to underpin the robustness of the results.

¹² Further useful information can be found in the Senior Loan Officer Surveys that are regularly published by some NCBs of new Member States (Narodowy Bank Polski, Magyar Nemzeti Bank).

¹³ Actually, the IMF has a long-standing focus on domestic credit dynamics, the main argument being that credit developments can provide a more appropriate picture of monetary conditions than changes in money supply, in particular for economies with an external payments deficit. Consequently, limits on domestic credit expansion have played and continue to play an important role in adjustment programs supported by the IMF.

not very developed. This implies that bank credit is the main source of external financing in these countries, although also foreign direct investment (FDI) has been important in some countries. Banking sectors in the new Member States from CEE have undergone a comprehensive transformation in the past one-and-a-half decades, including a complete overhaul of the regulatory framework, bank consolidation schemes and – in almost all countries – sweeping privatization, mainly to foreign strategic owners (mostly financial institutions based in “old” EU Member States). Consequently, the governance of banks has greatly improved, and the performance and the health of banking sectors have advanced substantially, as standard prudential indicators on capitalization, asset quality, profitability and liquidity show (see ECB, 2005; Barisitz, 2005; EBRD, 2004; Bruckbauer et al., 2004; or also IMF, 2005).

The key facts about the developments in credit to the private sector in the new MS, which will be analyzed in more detail in subsequent sections, can be summarized in three main points. First, in most countries one can observe dynamic growth in credit to the private sector, well above the pace seen in the euro area (see charts 1a and 1b). Nominal growth rates of credit to the private sector (displayed in chart 1a) have been especially high in the Baltic countries and Hungary, and also high, though to a somewhat lesser extent, in Slovenia. It is noteworthy that the Baltic countries recorded very high nominal credit growth rates in an environment of rather low inflation, while in Hungary and Slovenia credit dynamics have to be seen to some extent in the context of higher and only gradually falling inflation, implying less rapid growth rates of credit in real terms (see chart 1b). In some other countries growth in credit to the private sector has picked up recently (Czech Republic and Slovakia). In Poland, on the other hand, growth in credit to the private sector has moderated in recent years from relatively high levels recorded previously. Although growth in credit to the private sector has varied across countries, lending to households, especially for home purchases, has been dynamic in all new Member States of Central and Eastern Europe.

Charts 1a and 1b

Growth of Credit to the Private Sector, 1999–2004

Average annual changes in nominal terms, %



Average annual changes in real (CPI-deflated) terms, %

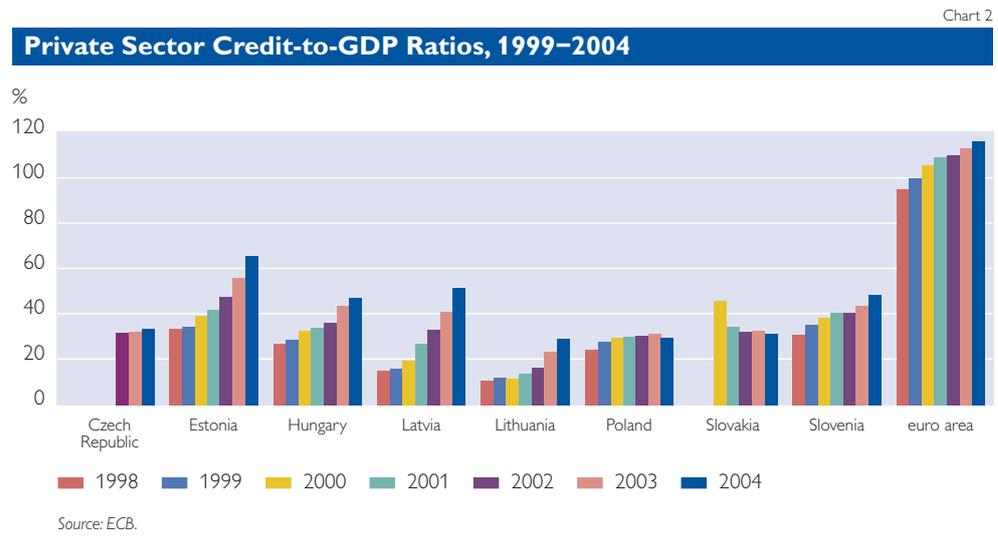


Source: ECB.

Note: The contraction in 2001 and 2002 in Slovakia is due to bank rehabilitation measures (see section 4).

Second, credit-to-GDP ratios have increased (or are beginning to increase) in most new Member States of CEE, while still remaining well below those of the euro area (chart 2). The rise was particularly pronounced in the Baltic countries. In Central Europe, the expansion of credit relative to GDP was noticeable in Hungary and Slovenia, while it was much more moderate in the

Czech Republic and in Poland. Slovakia, in turn, has recorded marginal falls in its credit-to-GDP ratios, though starting from levels that were above those of the other countries under review.

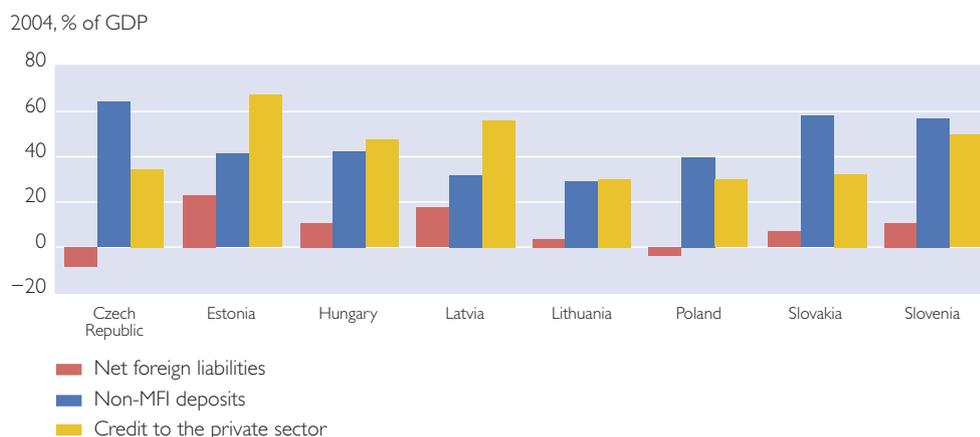
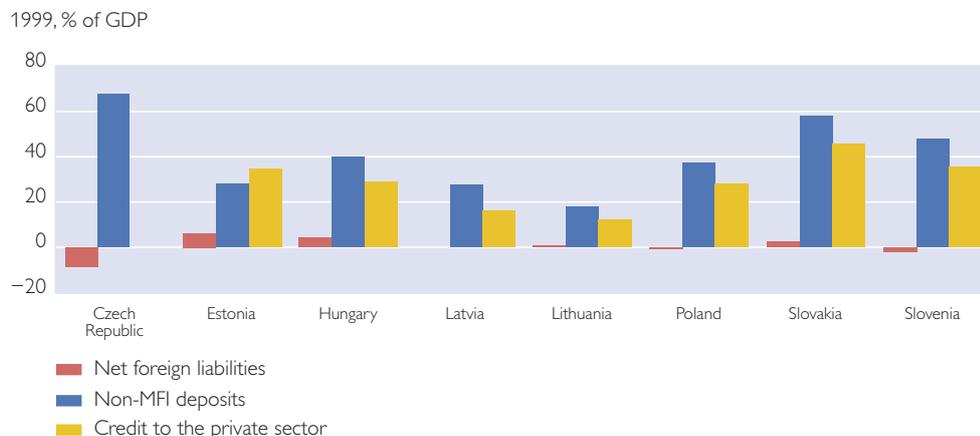


Third, credit expansion in the most of the new Member States in CEE has been financed by both domestic and foreign sources (see charts 3a and 3b). While deposits of domestic residents played the main role in funding credit growth until 2001–02 and are still the largest item on the liability side of banks, foreign borrowing has become an increasingly important source of financing the expansion of domestic credit in these countries, particularly in those new MS which have recorded rapid credit dynamics.¹⁴ Whereas the banking systems of most new Member States were net lenders to the rest of the world at the beginning of this decade, the net foreign position of banks in those countries that have recorded high and rising credit growth has deteriorated noticeably more recently (as net foreign liabilities increased or net foreign assets turned into net foreign liabilities). Still, net foreign liability positions of CEE banking sectors continue to be moderate; only in Estonia and Latvia have they reached more sizeable levels (of about 23% and 17% of GDP, respectively, at the end of 2004), in part driven by borrowing from foreign parent banks. In Poland and the Czech Republic, where aggregate credit growth has remained moderate, banking systems continue to be net creditors to the rest of the world.

¹⁴ In Hungary in recent years banks have also financed the credit expansion by issuing domestic debt securities, thus taking less recourse to net foreign borrowing than other new Member States recording high credit growth.

Charts 3a and 3b

Selected Banking Sector Assets and Liabilities



Source: National central banks.

4 Developments across Countries, Sectoral Allocation and Currency Structure

Since 1999, credit growth has been most dynamic in the Baltic countries, Hungary and Slovenia, accelerating particularly in Latvia (especially until 2001) and in Lithuania (throughout the sample period), i.e. the two countries where credit growth started from the lowest base (relative to GDP). Estonia, Hungary and Slovenia, in turn, displayed steadier growth rates. The annual growth rates of credit to the private sector differ substantially within these five countries, ranging – in 2004 – from around 20% in Slovenia to just above 50% in Lithuania.

In the Czech Republic and Slovakia, growth in credit to the private sector picked up more recently after a period of rather moderate or, at times, negative growth before 2004 (Czech Republic) and 2003 (Slovakia). In 2004, credit growth in these two countries amounted to around 10%, picking up dynamically especially in the Czech Republic. It should be noted that in the Czech Republic and Slovakia the interpretation of credit data before 2002 is difficult due to the consolidation of the banking sector and the cleaning of the credit

portfolios of selected banks at the time. In any case, banking sector “rehabilitation” facilitated the subsequent acceleration of banks’ lending activity in these countries since 2002. In addition, the fact that more dynamic credit expansion took place only recently can be attributed to the cautiousness of banks to finance longer-term capital projects in the business sector and, in the Czech Republic, also to relatively moderate real GDP growth in past years. Moreover, FDI (which also includes credit transactions between affiliated enterprises) has been a particularly important source of financing in these two countries and has thus substituted for bank credit.

In Poland, lending to the private sector decelerated from relatively high rates recorded in the period up to the end of 2000, to average annual growth rates of around 5% in 2004. This was related to the economic slowdown and, in particular, the severe contraction of gross fixed capital formation during the earlier years of this decade. In the more recent economic upswing since 2003, the ample profit situation of the enterprise sector has promoted internal financing of corporate sector activities and thus curbed overall credit demand in the economy. Household borrowing in contrast expanded dynamically.

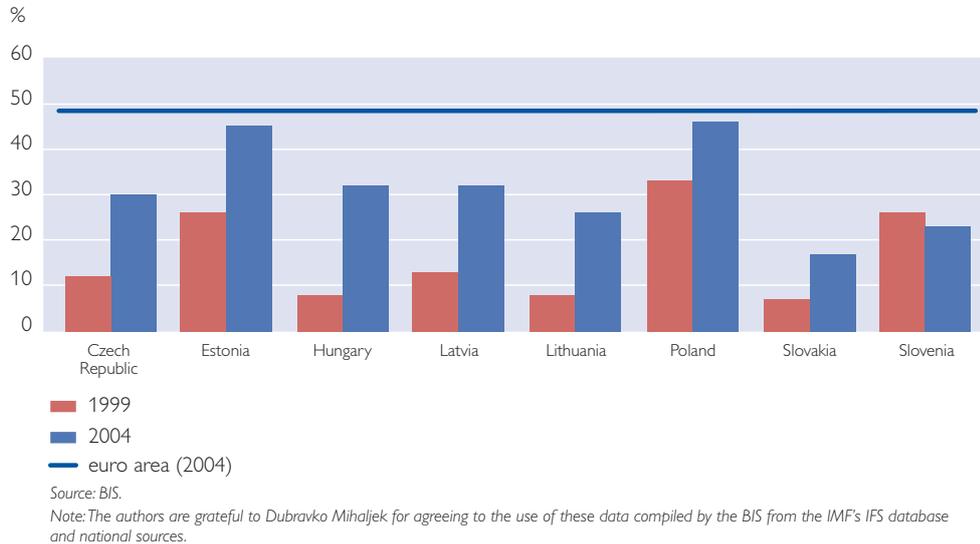
With regard to sectoral allocation, the trend of strong growth of loans to households, primarily mortgage-based housing loans, in general continued in most of the countries throughout the period from 1999 to 2004.¹⁵ However, housing loan dynamics have recently started to decelerate in a few countries, reflecting the tightening of mortgage scheme subsidies (Hungary) and base effects after prior spikes in lending (e.g. in Latvia). In Slovakia, by contrast, commercial banks adjusted their interest rate policies to offset lower subsidies, which led to a further strengthening of mortgage loan dynamics. In Slovenia, where the expansion of credit to the private sector has not been based on housing loans, such loans have also begun to pick up considerably more recently. Furthermore, in some countries, consumer loans have also grown dynamically, underpinning buoyant private consumption.

Overall, loans to nonfinancial corporations have grown at a more measured pace than loans to households, so that the share of household lending in total domestic lending increased considerably in most countries during the period under review (see chart 4). However, it should be noted that the available data seem to overstate the difference in the dynamics of lending to these two sectors, mainly for two reasons. First, developments in credit to corporations have been affected by bank restructuring programs, as mentioned earlier. Second, loans to nonincorporated businesses are usually recorded as lending to households. Nevertheless, with the notable exception of Poland, the growth of credit to the corporate sector has tended to accelerate in recent years, benefiting from reduced levels of interest rates, as well as from an improved economic outlook. Based on information by NCBs from new Member States, the variation in the dynamics of lending to the corporate sector across countries can be largely explained by differences in the reliance on foreign sources, including credits from nonresidential banks and FDI, and in the companies’ own internal funds and savings.

¹⁵ The subsequent analysis is based on national sources and uses (more narrowly defined) data on loans to households and nonfinancial corporations.

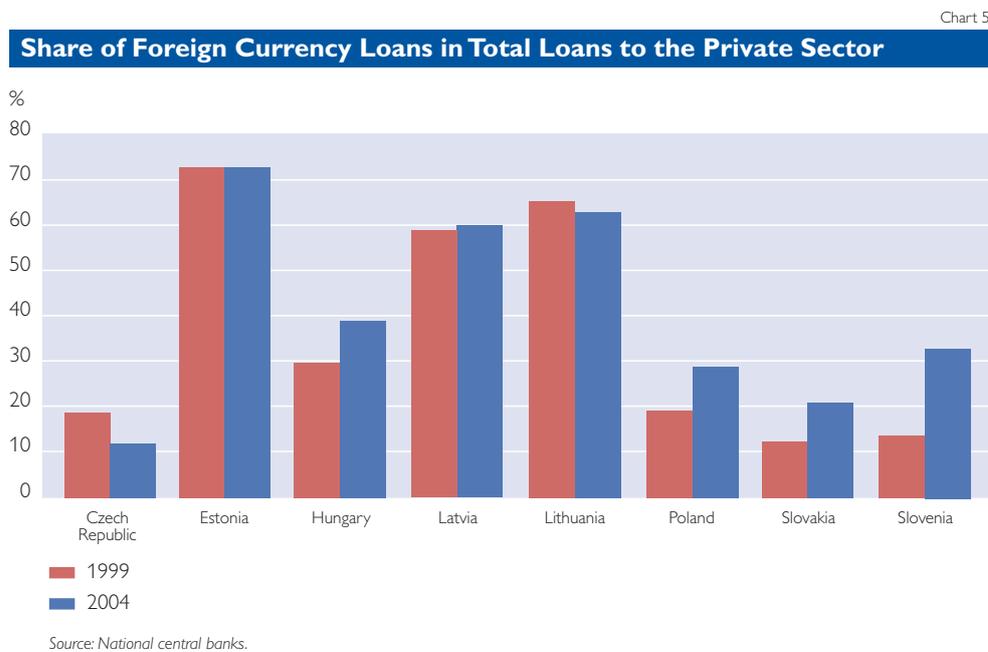
Chart 4

Share of Household Lending in Total Domestic Lending, 1999 and 2004



In terms of the currency structure of lending to the private sector, foreign currency-denominated or foreign currency-indexed loans have had an important share in total private sector loans in most of the Central and Eastern European new Member States, with their shares in 2004 ranging from 12% in the Czech Republic to 72% in Estonia (see chart 5). It is worth noting that in three of these countries, namely in the Baltic countries, the share of foreign currency-denominated loans was at or above 60% of total loans to the private sector. Furthermore, these shares remained relatively steady between 1999 and 2004, which implies that foreign currency-denominated borrowing had already built up in the Baltics before 1999. Long-standing exchange rate stability and a high degree of foreign ownership in the banking sector may have played a role in these developments. In the other countries, with the exception of the Czech Republic, the share of foreign currency-denominated borrowing increased over the same period, most notably in Slovenia and in Slovakia, where it more than doubled and almost doubled, respectively. The growing importance of foreign currency-denominated borrowing may be attributable to an increased linkage of the currency toward the euro (Slovenia) or emerging appreciation expectations (Slovakia), and, moreover, to interest rate differentials and thus lower borrowing costs. In Slovakia, the strongly increased role of foreign-owned companies may also have played a role. The Czech Republic, by contrast, which has pursued a managed float and enjoyed low domestic-currency interest rates in recent years, was the only country where foreign currency-denominated borrowing contracted compared to 1999. Looking at most recent developments, it is noteworthy that during the course of 2004, foreign currency-denominated loans to the private sector increased considerably in most of the CEE Member States (by between 40% and 50% annually, measured in domestic currency) except in Lithuania and the Czech Republic, where foreign currency-denominated loans

remained broadly unchanged, and in Poland, where they declined by 18%, partially due to valuation changes of foreign currency loans in domestic currency because of exchange rate changes.



Foreign currency-denominated loans in CEE Member States are mainly granted to the nonfinancial corporate sector, and in some countries, in considerable magnitudes also to households. Such loans are mostly euro-denominated. In most countries under review, the euro and its legacy currencies have played a leading role in foreign currency lending from the outset. In the remaining countries, where the U.S. dollar was preeminent, the euro has gained ground, to different degrees, with the reorientation of exchange rate policy to the single currency. However, in some countries, other currencies, in particular the Swiss franc, have begun to gain importance most recently, also in household borrowing. Foreign currency loans to nonfinancial corporations represent an important share in total loans outstanding to this sector in all CEE EU countries, ranging from around 20% in the Czech Republic to 80% in Estonia, whereas for the household sector four of these countries, namely the Baltic countries and Poland, stand out with shares ranging from 25% in Poland to 66% in Estonia.

Overall, borrowing in foreign currency has been more extensive in countries with fixed exchange rate regimes, particularly currency board arrangements, as the perceived exchange rate risk is smaller. In addition, in most of the countries, borrowing in foreign currency has been associated with lower borrowing costs and supported by progressing financial liberalization. Besides that, a sizeable share of borrowing in foreign currency is generally undertaken by larger multinational firms, for which information asymmetries are lower. Furthermore, foreign-currency borrowing by the corporate sector is frequently used for hedging purposes. Large multinational firms play a prominent role in this respect as well, as the greater part of their revenues is in

foreign currency.¹⁶ By contrast, the rationale for household borrowing in foreign currency is much less clear cut, even when and as long as sizeable interest rate differentials to key currencies prevail, as it substantially increases their exposure to exchange rate risk, especially for loans denominated in other foreign currencies than the euro.

5 The Main Driving Forces of the Credit Expansion

Lending growth in the new Member States has been promoted by a combination of macro- and microeconomic factors, which have affected both the supply of, and the demand for, private sector credit.

Credit expansion was promoted by macroeconomic stabilization and, in particular, a build-up of confidence in policy frameworks that ensured an environment of moderate or low inflation, which allowed interest rates to decline. For the period under review, interest rates have been at low levels in several new Member States (the Baltic countries and the Czech Republic), while they have come down – in some cases substantially – in the others (Hungary, Poland, Slovakia and Slovenia). Thus, financing conditions have been favorable or improving.

Privatization and restructuring of the banking sector as well as regulatory reforms of financial markets have improved confidence and promoted domestic private sector savings, a particularly important source of banks' financing of the credit expansion in many countries. Banking sector reforms have also led to substantially higher competition and increased the supply of new products (e.g. mortgage loans). The business strategies of the revamped banks have aimed at raising market share and profitability. The banks thus began to focus on those market segments that had been grossly underserved in the earlier stages of the transformation process, notably lending to small and medium-sized enterprises and to households. Sizeable positive margin spreads against the euro area have been an important incentive for banks in this respect (on this particular aspect, see Walko and Reininger, 2004). Raising the previously relatively low level of bank loans in total assets has been one of the strategies of banks to improve profitability.

As a consequence of banking sector reforms and, more generally, advancing economic transformation as well as financial liberalization and integration, the access of banks to foreign funds has greatly eased. Alongside, the cost of foreign borrowing has fallen, as risk premia declined and global interest rates were low. This has allowed banks in a number of new Member States to finance sustained credit expansion increasingly from abroad (see section 3).

It is noteworthy that public sector credit-to-GDP ratios were broadly stable or, in some cases, slightly rising, in the new Member States from 1999 to 2004. Thus, there is no evidence for a crowding-in of private sector credit as a consequence of contracting public borrowing over the period under review.

Improvements of the domestic legal system have reduced uncertainty and credit risk, thereby promoting credit supply. This is particularly true for reforms that have facilitated contract enforcement and the seizure of collateral.

¹⁶ For an empirical investigation of why firms borrow in foreign currency, see for example Keloharju and Niksanen (2001) for Finland and Kedia and Mozumdar (2003) for the United States.

Alongside, robust growth in output and incomes in most new Member States have underpinned credit demand in recent years. This favorable performance also boosted income and profit expectations, thus promoting intertemporal substitution (i.e. borrowing against expected future incomes and profits), which further increased credit demand.

In some country cases, generous subsidy or guarantee schemes for housing loans have spurred credit demand in this segment. At the same time, increasing property prices in the new Member States have also promoted credit demand. As property has become more expensive, the size of individual housing loans has risen. Moreover, in some countries, these price increases have been perceived as the beginning of a price level convergence process in this sector, thus creating expectations of further price increases and encouraging agents to frontload property purchases early in the process. Furthermore, these price increases have raised wealth, in particular household wealth. So far, there is some but overall limited evidence that households indeed borrow against these increases in their net worth.

Looking ahead, Cottarelli et al. (2003) argue that there are two main macroeconomic forces that are likely to support private sector credit dynamics, namely (i) crowding-in, as countries consolidate their fiscal accounts in preparation for a future entry into the euro area, and (ii) capital inflows in the context of nominal convergence and catching-up. Due to the favorable net foreign asset positions of banks in most countries under review, there appears to be further room for financing credit expansion from abroad.

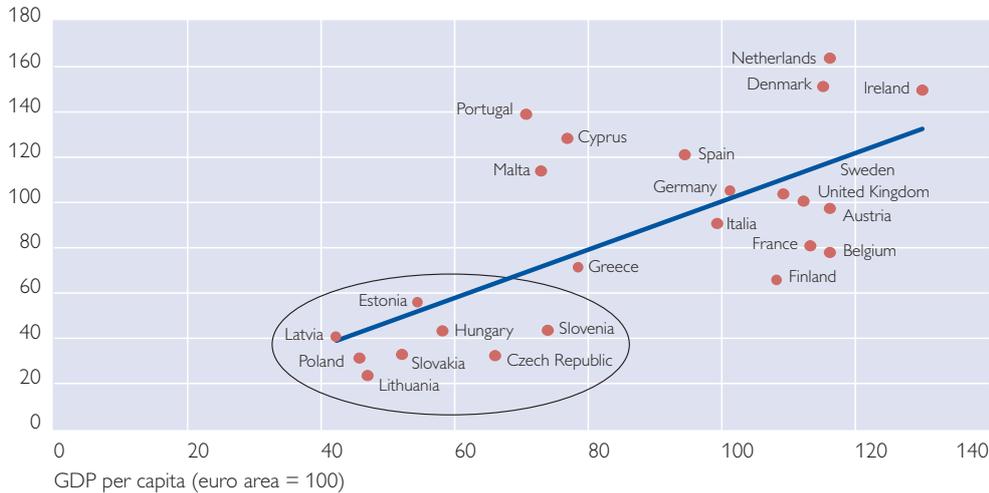
Moreover, despite credit developments in recent years, financial depth and, more specifically, private sector credit-to-GDP levels in most new Member States still remain below average levels in other countries that are at a similar stage of development. While credit to previously underdeveloped market segments has risen rapidly, both driven by demand- and supply-side factors, it seems that this process is still incomplete, in particular in the countries where credit growth has gained momentum only more recently. On the other hand, in those countries which have already experienced a longer period of fast credit growth and low interest rates, saturation effects may kick in earlier, thus dampening credit growth dynamics.

Chart 6

Private Sector Credit-to-GDP Ratios and Per Capita GDP

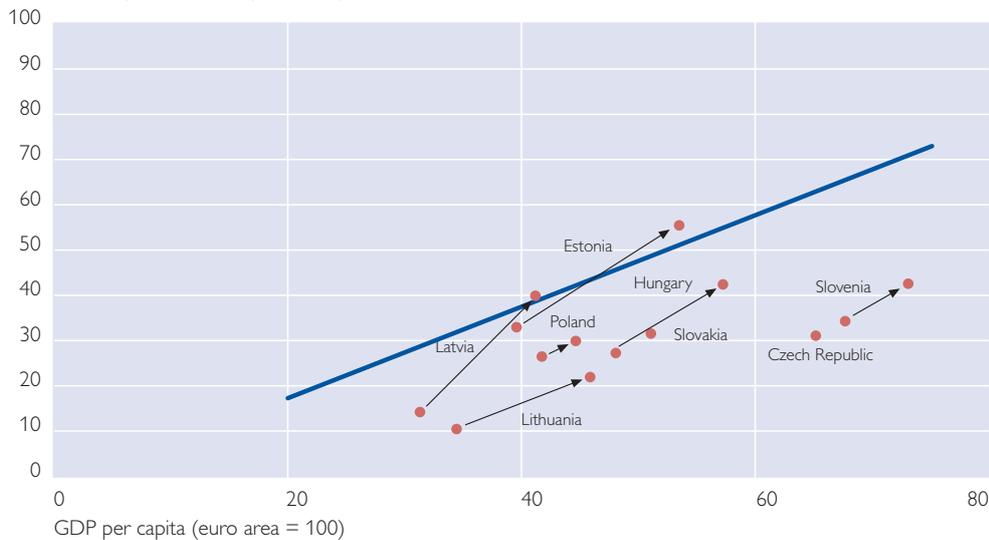
EU-25, 2004

Credit to the private sector (% of GDP)



New MS, 2004 versus 1999

Credit to the private sector (% of GDP)



Source: ECB.
Note: Regression line estimated on EU-24 (EU excluding Luxembourg). Based on ECB data, this regression line illustrates for the EU countries the positive correlation between credit-to-GDP ratios and per capita GDP that emerges as a statistically significant empirical regularity in larger samples (estimated on the basis of data from the IMF's IFS database and Penn World Tables); compare e.g. Cottarelli et al. (2003), figure 3, or Terrones and Mendoza (2004), figure 4.1.

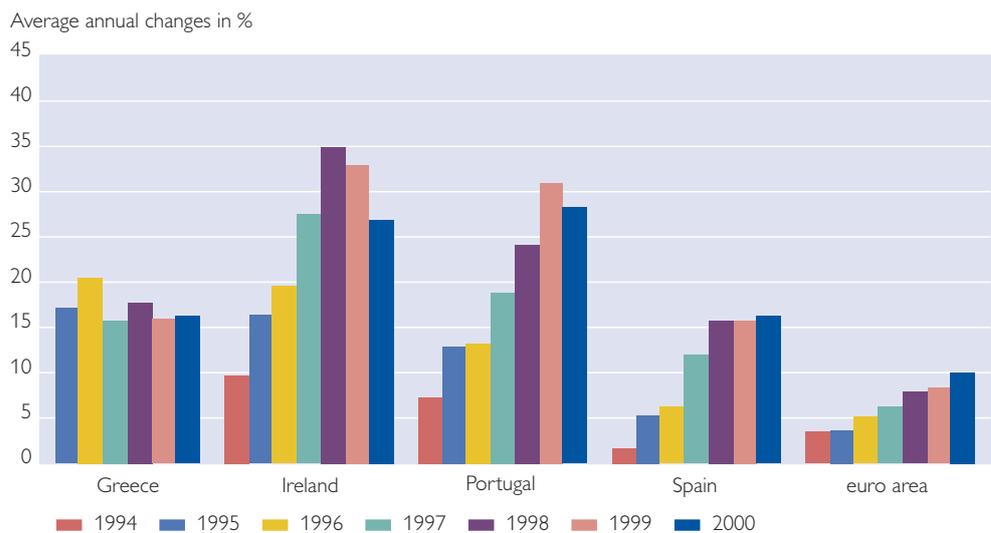
One could therefore argue that the financial deepening process in the new Member States has two main dimensions. Over the medium term, one can see a move from a state in which the economy is (or some of its sectors are) financially underserved, to a state in which the depth of financial services corresponds to the structural characteristics of the economies and their level of economic development (move toward an equilibrium level of financial depth). At the same time, the equilibrium level of financial depth itself will rise

and thus spur credit growth as the Central and Eastern European economies are growing richer. In addition, cyclical movements may temporarily lend further momentum to credit growth dynamics in some periods.

Finally, the experience of the “old” Member States, particularly former catching-up economies like Greece, Ireland, Portugal and Spain, is also supportive of expectations of dynamic credit growth in the new Member States, especially over the medium term. In the run-up to the euro, Greece, Ireland, Portugal and Spain faced low (and, at times, negative) real interest rates, strong income and private consumption growth, rising house prices and, concomitantly, a fast expansion of credit to the private sector (see chart 7). The experience of these countries also suggests that the macroeconomic and financial conditions associated with episodes of fast credit expansion may differ considerably, even if lending dynamics are similar during the boom period.

Chart 7

Loans to the Private Sector in Selected Euro Area Countries



Source: ECB.

Note: The chart displays loan data, as data on credit to the private sector in these countries are not available on a harmonized basis for the respective period.

6 Implications of Fast Credit Growth: Economic Effects and Policy Responses

Episodes of fast credit growth can have potentially substantial effects on macroeconomic developments and financial stability. To a large extent, the economic and financial impact of a lending boom depends on its characteristics, namely whether such a boom reflects a sustained financial deepening process or whether it is the first stage of an “excessive” credit cycle that has no fundamental underpinnings and will eventually collapse in a lending bust. Of course, distinguishing between different kinds of lending booms in real time is notoriously difficult.

Moreover, even a credit boom that is in principle consistent with financial deepening may get out of hand if the process toward a higher degree of financial depth occurs too fast. This could lead to financial fragility and macroeconomic vulnerability. Financial stability could become endangered if the limits of credit risk assessment and monitoring capabilities of financial institutions are overstretched and, consequently, asset quality worsens. Macroeconomic risks, in turn, could emerge if fast credit growth spurs domestic demand to a point at which sizeable positive output gaps arise. Even though the empirical evidence from non-European emerging economies suggests that the relation between credit and inflation developments is not very strong (see section 2), such a situation could still pose risks to achieving or maintaining price stability. While such inflation pressures may be mitigated for countries that display high or very high trade openness, like the new Member States do, small open economies are particularly prone to building up large external imbalances when domestic demand surges. However, if these risks are successfully contained, the effects of a lending boom that brings about financial deepening will be essentially benign, especially in as much as increased financial intermediation promotes output growth.

The discussion in section 5 suggests that there are good reasons to interpret credit developments in the new Member States to date as a manifestation of financial deepening. At the same time, credit expansion in some countries under review has indeed been rapid and persistent. This raises the question of whether the adjustment to the expected longer-term levels of financial depth takes place at an appropriate or possibly at an overly fast pace.

A short review of financial and macroeconomic trends in the new Member States offers some insights on this issue. First, the overall financial stability picture in the new Member States from Central and Eastern Europe is positive and improving (see section 3). Strong credit growth has helped maintain bank profitability amidst narrowing interest rate margins. Nonperforming loan ratios have declined in the past few years (which, of course, is to some extent a consequence of rapid credit growth itself, as a large part of credits has been extended only recently and the denominator of such loan ratios rises fast¹⁷).

There are, however, three qualifications to this generally positive situation. One relates to foreign currency lending. While the direct foreign exchange risk of banks is small (see OeNB, 2004), there certainly is an indirect credit risk for banks in as much as borrowers are not hedged against exchange rate risk (see section 4). Second, as data on indebtedness, debt-to-income ratios and debt servicing costs at a sectoral level are not or not fully available, there is some uncertainty as to what extent a potential reversal in interest rate convergence or a cyclical downswing could affect the debt servicing ability of the nonfinancial private sector. At the same time, there are some indications that private sector debt levels and debt servicing costs in most new Member States are comparatively low. Yet the relatively large proportion of basic costs of living (such as food) compared to income levels limits households' room for servicing

¹⁷ Moreover, as mentioned above, the removal of nonperforming loans from banks' balance sheets has also played a role in some of the countries under review.

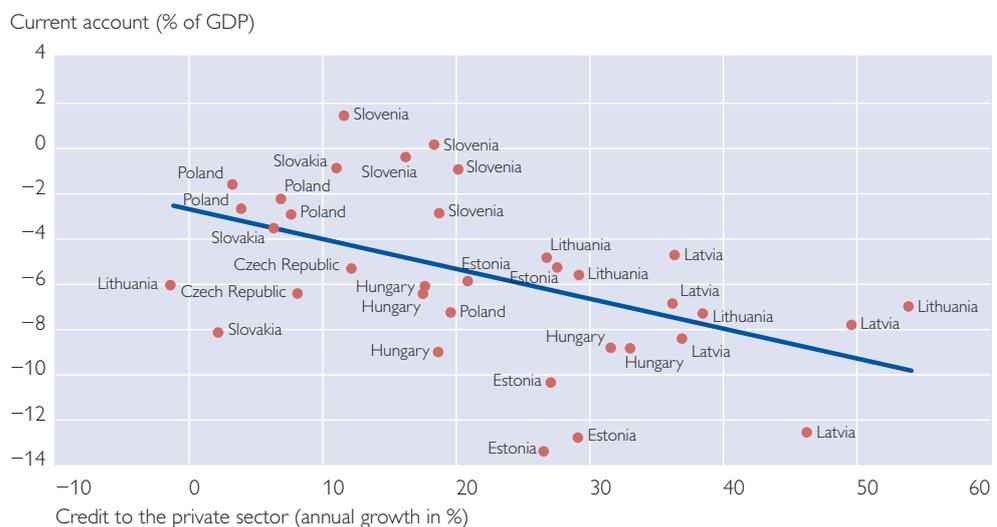
debt in these countries. The third qualification, finally, concerns the rise in mortgage lending, which implies an increasing exposure of banks and households to real estate market developments.

In the macroeconomic realm, it is plausible that the recent output growth record indeed benefited from progressing financial sector development, even though it is not easy to quantify this effect.¹⁸ Furthermore, there is no evidence that credit growth has added substantially to inflation pressures so far, as one cannot find significant comovements between domestic credit growth and inflation (compare also Xiao, 2004, for Latvia, based on data up to end-2003). However, one may conjecture that the persistent buoyant demand and credit growth in the Baltic countries may have contributed somewhat to price dynamics in the most recent past. Nevertheless, other factors, in particular supply-side shocks (increases in indirect taxes, upward adjustment in regulated prices, oil price developments and in some countries food price increases), have been much more important drivers of inflation in these country cases.

At the same time, the link between strong demand dynamics, underpinned by fast credit growth, and external imbalances appears to be more significant. In this context, it seems suggestive that the countries with the most dynamic credit expansion (the Baltic countries and Hungary) have also recorded the largest current account deficits (see chart 8).

Chart 8

Credit to the Private Sector and Current Account Positions, 2000–2004



Source: ECB.

Note: The chart displays five annual data points each for the Baltic countries, Hungary, Poland and Slovenia (2000–2004), two annual data points for the Czech Republic (2003–2004) and three annual data points for Slovakia (2002–2004).

While current account deficits may well be justified in catching-up economies when viewed from an intertemporal perspective (allowing countries to finance higher investments in a setting of high expected returns on these investments or to smooth consumption), current account deficits in some of these

¹⁸ Compare discussion of this issue in section 2.

countries have moved beyond levels that are sustainable in the medium to longer term (see table 1). This assessment is robust to alternative methods of estimating or calculating sustainable current account positions.¹⁹ External imbalances that exceed sustainable levels for a prolonged period of time may pose risks to macroeconomic stability, especially if they contribute to shifts in market sentiment (e.g. due to rapid debt dynamics). Such changes in perceptions and expectations could be particularly detrimental in a setting in which countries are getting ready to meet the criteria for a future entry into the euro area (section 7 below has a more detailed discussion on this aspect of monetary integration).

Table 1

Current Account Positions								
Actual Outcomes and Estimates of Sustainable Longer-Term Positions								
	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Slovakia	Slovenia
	% of GDP							
Estimates								
Minimum	-7.1	-12.1	-6.2	-9.8	-11.9	-7.1	-10.2	-3.3
Maximum	-2.1	-4.4	-1.4	-0.4	-4.8	2.0	1.9	1.7
Mean	-4.8	-8.0	-4.2	-6.7	-7.8	-3.3	-6.5	-0.5
Actual outcomes								
2000-2004 average	-5.5	-9.4	-7.9	-7.9	-6.0	-3.0	-5.2	-0.5
2004	-5.2	-12.6	-8.8	-12.3	-7.2	-1.6	-3.5	-0.9

Source: Bussière et al., 2004 (estimates of sustainable positions); ECB (actual outcomes).

Turning to the issue of policy implications now, the evidence and argumentation laid out in section 5 seems to indicate that credit growth will very likely remain fast in the new Member States or accelerate further in those countries where it is still comparatively moderate. There are only few, if any, reasons which would point to a substantial “endogenous” moderation of credit dynamics over the medium term. Thus, a policy response may be needed to decelerate credit growth and contain vulnerabilities, in particular with respect to external positions.

A set of policy tools can be used to influence credit developments, above all interest rate policy, prudential action, other regulatory measures, moral suasion and fiscal policy. Before discussing these instruments, it is worth recalling that credit developments play a more or less important role in the conduct of monetary policy, depending on the policy framework in place. Central banks with monetary targets or with reference values for monetary aggregates

¹⁹ The various issues that arise in the context of estimating or simulating sustainable current account positions cannot be explored within the confines of this article. The estimates displayed in table 1 are based on an intertemporal current account model that considers the current account from a savings-investment perspective with consumption smoothing over time by lending and borrowing abroad. Two modifications to the standard intertemporal current account model are introduced, namely heterogeneity of agents and habit formation, to capture the persistence of current account deficits and the impact of fiscal policy on the current account. The authors maintain that such a model is particularly well suited to analyze current account balances of catching-up economies (Bussière et al., 2004). For alternative but somewhat outdated estimates of sustainable current account positions see Doisy and Hervé (2001). Compare also various simulations of sustainable current account positions in various IMF country reports (e.g. Burgess et al., 2003, for the Baltic countries).

typically monitor domestic credit and, in particular, credit to the private sector closely, given that it usually is a main counterpart of broad money. In the case of the ECB, “the developments of credit to the private sector and of the most liquid components of M3 [...] are followed with particular attention. This broader analysis is necessary to put developments into perspective to obtain a better understanding of M3 developments and, more generally, to develop a broader insight into monetary conditions and their implications for monetary policy decisions aimed at maintaining price stability” (Issing, 2001). More generally, most central banks, irrespective of their monetary strategies, find it useful to watch credit developments and the indebtedness of the nonfinancial sectors in their overall assessment of economic and financial conditions. Moreover, developments in credit aggregates are important for understanding the monetary policy transmission mechanism, especially since the interest rate and credit channels are likely to strengthen as financial deepening proceeds.

Monetary policy options to curb credit growth depend on the monetary policy and exchange rate strategy in place. However, in the CEE Member States the scope of monetary policy options to deal with rapid credit growth appears to be limited. Apart from the constraints that are posed by explicit or implicit exchange rate targets, a tightening of the policy stance may just lead to a crowding-out of domestic lenders and a shift to borrowing abroad. Likewise, such a policy move may lead to a substitution of domestic currency borrowing for foreign currency borrowing.

Similar limitations possibly emerge with respect to prudential action. Measures to improve banking supervision can help moderate credit growth and are actually often the first best response, as long as regulation and application practice in this area is not yet fully in line with international standards. However, by now, harmonization in the field of prudential supervision is far advanced and, in fact, regulations in the new Member States are even stricter than in the “old” Member States in a few respects. Tightening prudential rules further would have two potential downsides. First, domestic banks would be put at a disadvantage vis-à-vis nonbank intermediaries (if tightening measures pertain only to the banking sector) or foreign intermediaries could gain an undue competitive edge in serving the domestic market (if the whole financial sector is covered). Second, very tight prudential regulations could constitute an incentive for foreign parent banks to transform their subsidiaries in the domestic market into branches, thus “escaping” from the constraining regulatory context and effectively withdrawing these entities from the supervision of the host country. Despite these limitations, there may still be some room for selected prudential measures, in particular dynamic provisioning and capital requirements that are designed to dampen cyclical fluctuations of lending activity. Likewise, temporary changes in liquidity ratios and loan-to-value ratios could be of use in some cases.

Administrative measures such as capital controls and credit ceilings may be temporary stop-gap measures that could help gain a bit of time in critical situations. However, they are not in line with an integrated financial market in the EU, nor would they most likely be effective beyond the very short term.

Moral suasion and communication on the risks related to high lending growth are further tools that are at the disposal of the authorities, in particular the central bank and the financial supervisory agency in countries where such an authority has been established to oversee the financial sector. How effective these instruments are appears to be case- and time-dependent.

Fiscal policy can play a central role in controlling aggregate demand pressures and could thus be used to contain positive output gaps and rapid domestic credit growth. Time lags in policy formulation and implementation may, however, make it difficult to use this instrument in practice. Moreover, the political will to use fiscal policy to contain risks to the external position of an economy may be limited. Apart from its impact on overall demand and credit developments, specific fiscal measures may have significant impact on credit demand in some segments. This pertains especially to the tax regime and to subsidy and guarantee schemes, which can strongly affect incentives to borrow (e.g. mortgage-based housing loans).

Some new Member States have in fact taken measures in recent years to contain credit growth. Apart from changes in tax and subsidy rules (see section 4), moral suasion has been applied by the Baltic countries and Hungary. Furthermore, Latvia tightened its monetary policy stance in the course of 2004, with the explicit motivation to slow lending dynamics. Improvements in prudential regulation and supervision have been taken for prudential reasons in some countries, while the authorities' hope that such measures would also help address the macroeconomic aspects of lending booms were occasionally evident. There was no noticeable recourse to administrative measures to cope with credit dynamics in the new Member States. Fiscal policy has generally not been used very actively to deal with demand and credit booms. In fact, in some instances, fiscal laxity has prevailed, thus aggravating macroeconomic stability problems and the effects of private sector credit growth on external positions.

7 Credit Growth and Monetary Integration

According to their stated policy intentions, the new Member States plan to be ready for the introduction of the single currency between 2007 and 2010. Against this background, macroeconomic and structural policies in the new Member States are increasingly geared toward the prospective adoption of the euro. A number of new Member States have already entered ERM II, which is an important step and stage in the process of monetary integration.

A smooth functioning of ERM II is of common interest to all parties involved in the mechanism. In order to minimize risks during participation in ERM II, policy consistency is of key importance, even though there are no formal criteria and preconditions for joining the exchange rate mechanism (see ECB, 2003). Policy consistency is ensured on three planes. First, major policy adjustments – for example with regard to price liberalization and fiscal policy – are to be undertaken prior to participation in the mechanism, while fiscal policy is to embark on a credible consolidation path (necessary policy corrections at this stage are sometimes referred to as “prior action”). Second, when joining the mechanism, new entrants may undertake jointly defined

commitments that underscore and reinforce the compatibility of their overall policy frameworks. Finally, during participation in ERM II, policy consistency is monitored on a regular basis by the European System of Central Banks.

In all this, credit developments are one of those aspects that are of relevance for policy consistency. A case in point are the policy commitments with respect to credit growth into which Estonia, Lithuania, Slovenia and Latvia entered when joining ERM II.²⁰ Furthermore, current account imbalances need to be reduced to sustainable levels over the medium term (Estonia, Latvia) or kept at sustainable levels (Lithuania) so as to ensure macroeconomic stability and keep external vulnerabilities in check during the ERM II stage. Latvia faces a twin challenge, as it needs to achieve a sustainable reduction of inflation – which has hovered in the higher single digits since the second half of 2004 – while bringing down the current account deficit to sustainable levels. While fiscal policy represents the key policy instrument to achieve these objectives, other policy tools should also help restrain domestic demand and thus external imbalances, namely effective financial supervision, which should assist in containing domestic credit growth (Estonia and Lithuania). In Latvia, in turn, the authorities should remain vigilant concerning risks of excessive credit growth, while financial supervision will assist in promoting prudent credit policies and in limiting risk in the banking sector. Moreover, in the cases of Estonia and Latvia, also measures promoting wage moderation feature in the policy commitments. In the case of Slovenia, the authorities committed to continue taking the necessary measures to lower inflation in a sustainable way. In this context, fiscal policy is assigned a central role in controlling demand-induced inflationary pressures, while financial supervision will assist in containing domestic credit growth.

Moreover, in a forward-looking perspective, credit growth developments matter in the achievement of a high degree of sustainable convergence, which is required for the prospective adoption of the euro. The ECB 2004 Convergence Report, in which the performance of the new Member States with respect to the Maastricht convergence criteria was examined for the first time (in parallel with a Convergence Report produced by the European Commission), is a useful reference point.

The ECB Convergence Report discusses the issue of credit growth from the angle of both price stability and exchange rate stability. More specifically, it relates the rebound of inflation in some new Member States in 2003–04 to a combination of factors, in particular EU entry-related increases in indirect taxes and administered prices, rising oil prices and, to some extent, also to rapid domestic demand growth, reflected in high wage and credit growth. The report also states that in a setting of strong domestic demand and an expected pick-up in external demand and thus in capacity utilization, there are risks to price stability in the respective countries over the medium term. At the same time, the report points out that in the new MS from CEE the starting level of domestic credit was low, reflecting the relatively low level of financial intermediation.

In its country-specific forward-looking analysis, the report contains references to strong credit growth as one of the factors that implies upside risks to future inflation in the cases of Latvia and Lithuania. For both countries, a

²⁰ Estonia, Lithuania and Slovenia joined ERM II in June 2004, and Latvia in April 2005, together with Cyprus and Malta.

determination to contain strong credit growth is also perceived as necessary to ensure the sustainability of the sizeable current account deficit (Lithuania) or its orderly reduction to sustainable levels (Latvia). In a similar vein, the containment of credit growth is flagged as one of the key requirements for Estonia to achieve a high degree of sustainable convergence, while it would also contribute to ensuring an orderly reduction of the current account deficit to sustainable levels. Finally, in the case of Slovenia, the report identifies a continued need to control demand-induced inflationary pressures and sees a role for financial supervision in this context to assist by containing domestic credit growth.

The 2004 Convergence Report by the European Commission also refers to credit developments in the new Member States. However, the Commission Report does not explicitly discuss macroeconomic effects of credit dynamics or possible policy implications, as it deals with credit developments when examining the result of financial market integration. It states that in the eight new Member States of Central and Eastern Europe, the level of financial intermediation remains comparatively low and refers in this context to total loan-to-GDP ratios. The Commission Report also presents evidence on foreign currency loans in the countries under review and draws attention to the exchange rate risks involved.

8 Conclusions

This article has given an overview on domestic private sector credit developments in Central and Eastern European EU Member States in the period from 1999 to 2004 and has examined their determinants as well as their economic and financial implications. The main findings of the analysis can be summarized as follows:

Lending to the private sector has grown dynamically in most but not in all new Member States from Central and Eastern Europe. Aggregate credit growth to the private sector has been fast in the Baltic countries, in Hungary and, to a somewhat lesser extent, in Slovenia, while having been much more moderate in the Czech Republic, Slovakia and Poland. Lending to households has expanded strongly in all countries under review, rising significantly faster than total lending to the private sector (with the exception of Slovenia), but from a very modest point of departure. Foreign currency lending plays an important role, in particular in countries with explicit exchange rate regime commitments. Banks have financed credit growth by both domestic and foreign sources, with an increasing reliance on the latter in countries recording a rapid expansion of lending to the private sector.

Credit growth has been promoted by macroeconomic stabilization, comprehensive reforms and privatization in the financial sector and the introduction of market institutions and legal reforms (especially contract enforcement and seizure of collateral) throughout the economies of the countries under review. As a consequence, the new Member States have experienced a move from repressed to liberalized financial systems. Robust GDP growth has underpinned credit growth, while rising income and profit expectations have encouraged intertemporal substitution, thus further boosting domestic lending.

Given that this process is still underway and, in some countries, still at a relatively early stage, credit growth will most likely remain fast in the new Member States or accelerate further in those countries where it is still comparatively moderate. Lending dynamics will presumably be especially high over the medium term, as liquidity constraints on segments that were financially underserved in the past (small and medium-sized enterprises, households) are being removed and these sectors shift to debt levels that are rational from an intertemporal perspective. In the longer run, lending growth will be mainly driven by the convergence process in per capita GDP terms.

Against this background, credit developments in the new Member States to date can presumably be interpreted, by and large, as a manifestation of financial deepening. At the same time, the rapid pace of credit expansion and its persistence in a number of countries does pose risks.

The financial stability picture in the new Member States is generally positive, but the pace of lending growth calls for heightened vigilance so as to ensure that asset quality remains sound. Moreover, specific attention needs to be given to risk elements, in particular as regards foreign currency lending.

On the macroeconomic side, the rapid process toward higher levels of financial depth in some countries and the concomitant credit expansion has fueled demand booms. As a consequence, in some countries recording high and persistent credit growth, current account deficits have moved above levels that can be sustained over a longer period of time.

These macroeconomic risks have been pinpointed in the policy debate. They have also featured in the monetary integration process on which the new Member States have embarked, both in the context of the first entries of new Member States into ERM II and in the latest Convergence Report of the ECB. Our analysis corroborates that there is a case for keeping macroeconomic vulnerabilities in check by containing domestic demand growth and current account deficits to sustainable levels over the medium term in the countries concerned. In doing so, (additional) policy action to decelerate credit expansion may be needed. Designing the appropriate policy response is not an easy task, as the instruments the authorities can use to cope with rapid lending growth may be of limited effectiveness or involve intricate tradeoffs, rendering the attainment of other policy objectives more difficult. At the same time, mitigating risks and stabilizing expectations may be particularly rewarding in a setting in which countries are getting ready to meet the criteria for a future entry into the euro area.

Overall, the issue of credit growth is likely to remain high on the agenda of economic policymakers and financial supervisors in Central and Eastern European EU Member States for quite some time to come.

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Can Banking Intermediation in the Central and Eastern European Countries Ever Catch up with the Euro Area?

Markus Arpa,
Thomas Reiningger,
Zoltan Walko¹

This paper focuses on the private credit flow-to-GDP ratio for measuring and comparing the degree of banking intermediation, which complements the widely used stock-flow measure. The authors find that, on the basis of this flow-flow measure, the current degree of banking intermediation in most Central and Eastern European countries (CEECs) is significantly closer to the euro area average than suggested by the traditional stock-flow measure. Nevertheless, the longer-term average of annual figures of the recent past indicates that most CEECs still have some way to go to catch up with intermediation in the euro area in a persistent manner, even on the basis of the flow-flow measure. Furthermore, the authors analyze the implications of the different concepts of convergence in the degree of banking intermediation. According to simulations, maintaining a flow-flow ratio in the CEECs equal to the euro area average of the past ten years (i.e. given full convergence in the flow-flow ratio) will also lead to convergent stock-flow ratios. However, this will only be the case at a rather late point in time, i.e. not before the end of this century, and will thus come considerably later than convergence in GDP per capita at purchasing power parity (PPP). On the other hand, for the CEECs to simultaneously achieve convergence in the stock-flow ratio and in per capita income levels, the flow-flow ratios would have to significantly and persistently exceed the euro area average of the period from 1994 to 2003 for a period of between 15 and 50 years, depending on the respective country. Drawing on the experience of major catching-up economies in the past 50 years worldwide, the authors do not completely exclude, but take a rather skeptical view on, the possibility of realizing in a sustainable manner the high level of the flow-flow ratio that would be required for the simultaneous convergence in the stock-flow ratio and in per capita income levels.

1 Introduction

Using the ratio of the stock of domestic claims on the private sector² or banking sector assets as a percentage of GDP is a widespread approach in financial literature when it comes to comparing the degree of banking intermediation. Institutions, such as the European Bank for Reconstruction and Development (EBRD), the European Commission (EC), the Bank for International Settlements (BIS) or the European Central Bank (ECB), regularly refer to credit-to-GDP ratios or similar stock-flow measures in their publications. They generally demonstrate the relative underdevelopment of the Central and Eastern European countries (CEECs) in terms of banking intermediation by comparing these ratios with that observed for a developed-economy benchmark (e.g. the euro area). Likewise, academic literature frequently refers to such stock-flow GDP ratios. For example, Levine et al. (1999) address the issue of causality between financial development and economic growth and identify the determinants of financial development. They measure financial development levels by means of two stock-flow ratios (i.e. liquid liabilities of the financial system and private credit, each divided by GDP), and the ratio of commercial bank assets divided by the sum of commercial bank and central bank assets. Khan et al. (2001) illustrate the detrimental, nonlinear effect of inflation on financial depth, using different stock-flow indicators of financial depth as dependent variables. Cottarelli et al. (2003) estimate an econometric model of credit-to-GDP ratios and identify the major determinants of their long-term

¹ Oesterreichische Nationalbank (OeNB), Foreign Research Division, markus.arpa@oenb.at, thomas.reiningger@oenb.at, zoltan.walko@oenb.at. The opinions expressed in this paper are those of the authors and do not necessarily represent the views of the OeNB or the European System of Central Banks (ESCB). The authors would like to thank two anonymous referees for valuable comments and Ingrid Haussteiner for language advice.

² The term “claims” refers to loans, securities and repurchase agreements. In this paper we focus on claims of domestic banks on households and nonmonetary corporations (i.e. nonmonetary financial institutions and nonfinancial corporations). The term “credit” is used synonymously to claims.

development (per capita income, public debt-to-GDP ratio, inflation, financial liberalization as well as legal, regulatory and corporate culture). They find that credit-to-GDP ratios in Central and Eastern Europe (CEE) are still significantly undersized compared with the equilibrium suggested by the model.

Other authors investigate the dynamics of credit-to-GDP ratios over time. For example, Klein and Olivei (1999) observe a positive relationship between capital account liberalization and financial deepening in OECD countries. In their econometric models, they partly use changes in stock-flow measures of financial depth as dependent variables. Kaminsky and Reinhart (1999) find that growth in the domestic credit-to-GDP ratio accelerates markedly in the run-up to banking and currency crises. Demirgüç-Kunt and Detragiache (1997) report some, yet not very strong, evidence that a boom in credit to the private sector (measured by the change of the credit-to-GDP ratio) precedes banking crises. Gourinchas et al. (1999, 2001) and Cottarelli et al. (2003) investigate the dynamics of credit-to-GDP ratios over time based on the deviation of the ratio from a retrospective country-specific stochastic trend. Gourinchas et al. find that the probability of a banking or currency crisis increases significantly after a lending boom, which they define as a relative or an absolute deviation of the credit-to-GDP ratio from its stochastic trend in excess of a given threshold. Using the same methodology, Cottarelli et al. identify no signs of excessive lending booms or a looming banking crisis in the CEECs on the basis of developments up to 2002.

Pilková and Pátoprstý (2004) develop “effective” measures of financial intermediation that reflect the economic potential of transition economies and discard what they call the “cost of transition.” They derive an “effective asset intermediation level” by relating a narrower definition of the total assets-to-GDP ratio. In a farther-reaching effort, they infer “effective” loans and deposit intermediation levels by relating the level of total gross loans and deposits to some kind of measure of the debtors’/depositors’ income (with different methods of calculation applying to the retail and the corporate sector, and to deposits and loans). Comparing traditional and effective measures of intermediation delivers mixed results in the different segments, with regard to both absolute gaps between the CEECs and the euro area and the development of gaps over time.

Overall, existing research gives a comprehensive overview about banking intermediation in CEE on the basis of either the stock-flow measure of banking intermediation or the dynamics of this indicator. In our paper, we propose to extend the measures of banking intermediation by also focusing on a flow-flow measure, i.e. on the ratio of private credit flows³ to GDP. We think that this measure provides further insights into banking intermediation, because compared with the private credit stock-to-GDP ratio it better reflects the banking sector’s capability to mobilize new savings and inject fresh capital into the productive sectors of the economy.

³ Annual credit flows are approximated by differences in credit stocks, both unadjusted and exchange rate-adjusted, at the end of the given year and at the end of the previous year.

Another argument for taking a closer look at the flow-flow ratio is the need to correct the stock-flow measure for the inherent “time bias” or “accumulation bias,” as shown in our paper. Some research papers have already touched upon this issue by focusing on the dynamics of the stock-flow measures, and we believe that this approach deserves to be further developed. Moreover, whereas numerical values of the flow-flow measure may sometimes be similar to the values of the change in the stock-flow indicator, the two measures differ conceptually, as any change in the stock-flow measure can be affected by (1) a change in the numerator (e.g. in the nominal stock of loans) and (2) a change in the denominator (i.e. in nominal GDP). By contrast, the flow-flow measure relates the change in the nominal value of the stock in a given year to that year’s GDP. Hence, this measure better captures the relationship between the volume of new capital injected into the economy and economic output in a given year, whereas the difference between the two measures increases the greater the change in the denominator is. Moreover, the excessiveness of changes in the credit stock-to-GDP ratio has so far been assessed mostly on the basis of this indicator’s past development. However, given their transitory character, past credit developments may not be a suitable yardstick for the CEECs, and thus an alternative benchmark may be called for. Finally, the flow-flow ratio can be related to a complementary concept of convergence in banking intermediation, which in turn may provide additional insights into the time horizon of convergence in financial wealth as measured by the stock-flow ratio.

For these reasons, we believe that the flow-flow measure represents an important complementary indicator of the level of banking intermediation. In a comprehensive exercise, i.e. when the level of banking intermediation is compared on the basis of both the flow-flow and the stock-flow measure, it should be borne in mind that the former more flexibly reflects short-term developments in banking intermediation, the economic cycle or the financing structure of households and enterprises. However, the flow-flow measure does not take into account banking intermediation in the form of relending (partially) matured claims, which in macroeconomic terms is linked to the financing of (probably more productive) replacement investment. Moreover, assuming that there may have been market imperfections in the past implying that capital was not allocated in a totally efficient way, efficiency gains might be realized in current periods owing to capital reallocation (e.g. interindustry reallocation). Obviously, this type of intermediation activity is of economic importance even if the flow-flow measure indicates that no fresh capital has been channeled into the economy.

This paper is structured as follows. In section 2, we analyze the stock-flow ratio and compare the concepts of measuring banking intermediation by credit stock and credit flow, taking into account the situation in the CEECs. Section 3 explains how we derived flow-flow ratios for the CEECs. Section 4 gives a comprehensive assessment of the current degree of banking intermediation in the CEECs, including both stock-flow and flow-flow ratios. Section 5 takes a close look at the issue of convergence in banking intermediation. Finally, section 6 concludes, touching also briefly on possible policy implications.

2 Analysis of the Stock-Flow Measure of Banking Intermediation

The development of the stock of financial assets over time can be stylized in the following way. Let Q_t^s be the saving ratio defined as the stock of savings as a percentage of GDP in period t , S_t the stock of (domestic currency) savings in period t , Y_t nominal GDP in period t , π_t inflation from period $t-1$ to t , r_t the realized real interest rate level from period t to $t+1$, α the fraction of interest income that is redeposited (taking values between zero and one), S_t^T transaction savings (i.e. net new savings) in period t , R_t revaluation adjustments (e.g. price revaluations of marketable instruments) and y_t the growth rate of real GDP from period $t-1$ to t .

It follows from

$$Q_1^S = \frac{S_1}{Y_1} = \frac{S_0 + S_0 \times \alpha[(1 + r_0) \times (1 + \pi_1) - 1] + S_1^T + R_1}{Y_0 \times (1 + y_1) \times (1 + \pi_1)} \quad (1)$$

and under the simplifying assumption that $\alpha = 1$

$$Q_1^S = \frac{S_0 \times (1 + r_0)}{Y_0 \times (1 + y_1)} + \frac{S_1^T}{Y_0 \times (1 + y_1) \times (1 + \pi_1)} + \frac{R_1}{Y_0 \times (1 + y_1) \times (1 + \pi_1)} \quad (2)$$

that $Q_1^S > Q_0^S$ if – ceteris paribus – the realized real interest rate from period $t-1$ to t is greater than the growth rate of real GDP in the same period, or transaction savings are made in period t , or the deposit volume is positively affected by revaluations. If $\alpha \leq 1$, then the increase in Q_1^S will be smaller. However, more importantly for the purpose of our analysis, equation (2) implies that Q_t^S increases over time by the annual volume of transaction savings (in percent of GDP). Thus, the longer the savings accumulation lasts, the higher the saving ratio becomes.

In analogy to (1) and (2), a similar relationship can be defined for the stock of domestic (local currency) claims, i.e. loans, securities and repurchase agreements.⁴

In the case of foreign currency deposits or claims, similar relationships hold true for the deposit and claim ratios.⁵ In these cases, the increase in the deposit and claim ratios over time depends on the volume of transactions, on the portion of “recycled” interest income and on revaluation adjustments in addition to the domestic nominal growth rate of GDP. Moreover, the increase in these ratios depends on nominal exchange rate changes (expressed in terms of a relative change in the volume of domestic currency per unit of foreign currency, denoted D) and, in the case of a positive “interest recycling” ratio, also on the foreign nominal interest rate level.⁶

⁴ See annex 1 for details.

⁵ See annex 2 for details.

⁶ If the foreign currency appreciates in nominal domestic currency terms at a positive rate of D (i.e. domestic currency per unit of foreign currency increases at a rate of D), the domestic currency changes in nominal foreign currency terms at a rate of $(1/(1+D) - 1)$, thus depreciates (i.e. foreign currency per unit of domestic currency changes at a rate of $(1/(1+D) - 1)$, thus decreases). If D is deflated by the inflation differential between domestic and foreign inflation, the real change of the foreign currency at a rate of d results. If this real change has a positive value, it means a real appreciation of the foreign currency, which implies a real depreciation of the domestic currency at a rate of $(1/(1+d) - 1)$.

Against the background of the above equations and if we take into account that the latest bout of accumulation in the euro area started around 60 years ago (following World War II), while little more than a decade ago in the CEECs, it is not surprising that the deposit and claim ratios are significantly smaller in the CEECs than in the euro area. The financial suppression in the command economy implied that any real capital accumulation that took place was not reflected in financial capital accumulation to the same degree as in the countries that today make up the euro area. More importantly, the size of real capital accumulation itself was by far lower than in the current euro area, precluding the increase of financial wealth.

In contrast to financial market literature, public finance statistics differentiates between flow-flow and stock-flow measures. Flow-flow measures refer to budget balance, budget revenues and expenditures in percent of GDP, while stock-flow ratios express public debt as a percentage of GDP. In most cases, a flow-flow ratio, namely budget expenditures as a percentage of GDP, serves to measure the state's redistribution role in the economy. Moreover, a public finance assessment also takes explicit note of the relationship between the flow-flow measure, i.e. the budget balance in percent of GDP, and the stock-flow measure: In the absence of revaluations (e.g. net acquisition/sale of financial assets, valuation changes of the government debt stock), the stability of the debt ratio requires that the primary budget balance be matched by the differential between the realized nominal (or real) interest rate and nominal (or real) GDP growth. In other words, if the realized nominal (or real) interest rate is equal to the nominal (or real) GDP growth rate, the public debt ratio increases over time by the annual primary budget deficit.

The bias in the stock-flow ratio in measuring the degree of banking intermediation can be shown by the following example. Assume that in a particular year the banking sector is completely idle and no new deposits are taken in and no new loans are extended to the economy (e.g. long-term deposits were taken in the previous years and subsequently lent in the form of long-term loans). In this year, the stock-flow measure of banking intermediation may be changed only on the back of interest accrual or revaluation (e.g. of foreign currency claims and deposits). In this example, does the stock-flow ratio accurately reflect the financial system's intermediation activity in this particular year?

We argue that it fails to do so, as we believe that stock-flow ratios are significantly biased due to the time factor, i.e. the length of the accumulation process or the maturity of outstanding claims and deposits. Obviously, large volumes of outstanding savings and claims require sufficient capacities to handle these large volumes and to bridge lenders and borrowers across time and preferred maturities. However, the capability to handle large *existing* volumes differs from the capability to channel *fresh* capital from domestic savers to agents that need additional financial resources. A stock-flow measure of banking intermediation gives an impression of the past development of the financial sector's intermediation activity over time – and the ratio is probably the higher, the longer this history is. By contrast, a flow-flow measure gives a more accurate impression of contemporaneous processes of intermediation between new

savings and new capital formation. Setting, for example, new domestic claims (net) of a particular year in relation to that year's GDP would produce such a flow-flow indicator.⁷

As shown by the equations above, the degree of banking intermediation in the CEECs can approach that in the euro area (EU-12) as measured by the traditional stock-flow ratio *only if* (ceteris paribus, and in particular apart from any potential price revaluation effects of marketable instruments and reclassifications, which will probably not make any significant difference) over a longer period of time

- the CEECs show sufficiently high net volumes of annual transaction deposits and claims in relative terms (i.e. as a percentage of nominal GDP in the years of the transactions)⁸; or
- in the case of local currency deposits and claims
 - with regard to stocks and interest income: the realized real (domestic) interest rate exceeds the real (domestic) GDP growth rate in the CEECs by a greater margin than in the euro area (assuming the same fraction of interest income recycling); or
- in the case of foreign currency deposits and claims
 - with regard to stocks: the nominal appreciation of the foreign currency (in domestic currency terms) exceeds the nominal domestic GDP growth rate in the CEECs by a wider margin than in the euro area; or
 - with regard to interest income (assuming the same interest income recycling fraction): the combination of the nominal appreciation of the foreign currency (in domestic currency terms) and the foreign nominal interest rate exceeds the nominal domestic GDP growth rate in the CEECs by a wider margin than in the euro area.⁹

Nominal or real exchange rate changes can hardly be expected to contribute to an increase in the stock-flow intermediation ratio in the CEECs over the long run. This becomes evident when we take the equation for the foreign currency credit stock-to-GDP ratio (annex 2) into account and consider that the CEECs tend to experience an equilibrium real appreciation of their currencies (implying a real depreciation of the foreign currency vis-à-vis these currencies) due to the catching-up process (Égert, 2003), while their real GDP growth rates can be expected to exceed euro area real interest rates.

Moreover, there are ways of achieving a higher stock-flow intermediation ratio – e.g. in particular via a real interest rate level above the real GDP growth rate – that can hardly be regarded as conducive to real catching-up in the long run. Provided a higher contribution to real catching-up is the ultimate goal of

⁷ Theoretically, a stock-stock measure (e.g. the ratio between the stock of claims and the value of accumulated outstanding goods and services – or wealth – in an economy) would be an adequate solution as well.

⁸ The issue what “sufficiently high” may mean will be further explored by means of simulations in section 5. Given the fact that the deposit or credit stock-to-GDP ratios are significantly lower in the CEECs than in the euro area, an equal net volume of annual deposit flow or credit flow as a percentage of nominal GDP in the CEECs and in the euro area suffices that the stock-flow ratios in the CEECs approach those in the euro area. However, in such a case, full convergence will only be achieved in the very long run (i.e. not before the turn of this century). Earlier full convergence in the stock-flow ratios would require the flow-to-GDP ratios in the CEECs to be higher than that in the euro area.

⁹ In the case of a recycling ratio of 1, the real appreciation of the foreign currency – in domestic currency terms – exceeds the difference between real domestic GDP growth and the foreign real interest rate in the CEECs by a greater margin than in the euro area.

deepening banking intermediation, such an increase in the stock-flow indicator would constitute a financial deepening, which would run against the underlying goal of deeper financial intermediation.

Consequently, given the CEECs' handicap of lacking around 50 years of banking intermediation history, one may expect the traditional stock-flow measure of banking intermediation in the CEECs to approach the EU-12 level only in the very long run. Here, the time horizon critically depends on the comparative size of the flow-flow ratio, as will be shown in section 5.

3 Deriving a Flow-Flow Measure of Banking Intermediation

A flow-flow measure of domestic banking intermediation is difficult to derive for all CEECs given the lack of statistical data on banks' net lending and net deposit-taking activity. Traditional monetary statistics are based on stock data, and the harmonized monetary financial institution (MFI) interest rate statistics recently introduced capture new deposit and lending volumes on a gross basis, i.e. without netting them against deposit withdrawals and loan repayments. Data on credit and deposit transactions have been published by the ECB for the euro area and since 2002 by Česká národní banka for the Czech Republic. Data for the other countries (and for the Czech Republic prior to 2002) must be approximated. Thus, to ensure comparability across countries, we calculated flow data from stock data for the euro area and the Czech Republic. For illustrative purposes, we limited the following calculations to "MFI claims on other domestic residents," i.e. on domestic nonbanks outside the general government.

The ECB methodology to derive transaction data from stock data is based on the following formula:

$$F_t = (L_t - L_{t-1}) - C_t - E_t - V_t \quad (3)$$

whereby F_t denotes transactions in period t , L_t the stock in period t , C_t the reclassification adjustment in period t , E_t the exchange rate adjustment in period t and V_t other revaluation adjustments in period t .

For the purpose of our analysis, however, a different adjustment procedure seemed to be more adequate.

First, owing to the lack of data, it was impossible to adjust for reclassifications. However, reclassifications are altogether unlikely to have significantly affected the aggregate indicator of "MFI claims on other domestic residents." For the same reason, we also had to omit a certain type of revaluation adjustment, namely for price changes of marketable instruments. Nevertheless, since domestic claims on the private sector in the CEECs almost exclusively comprise loans, such price adjustments are likely to play but an insignificant role.

Second, we did not adjust for claim write-offs, which might be seen as part of either reclassifications or revaluations that had negative values and lowered L_t . The reason is that we treated claim write-offs as a cleaning process which corrects for overlending in previous periods, i.e. a high degree of past banking intermediation, which was, however, partly unsound. This is particularly true for countries where imprudent lending practices in the past led to an

accumulation of nonperforming claims. Were claim write-offs to be adjusted, this would favor such countries in our comparison, since strong (and partially imprudent) lending would boost the flow-flow measure of intermediation, whereas the subsequent correction of this unfavorable trend would be eliminated from the calculation. In order to best capture these dynamics, we decided to base the flow-flow measure of intermediation on a value averaged out over a longer period (instead of over just one year) which ideally includes both the (partially unsound) initial lending boom periods and the later correction periods. Alternatively, we also calculated the average for the period since the last write-off.

Third, we would have preferred to separate the relending of interest income into the economy (which the ECB methodology leaves fully to the series of transactions). However, significant uncertainty about the portion of “recycled” interest income rendered such an adjustment impossible.

Finally, for the exchange rate adjustment, we estimated the stock of foreign currency claims, using the share of foreign currency loans in total loans to domestic nonbanks outside the general government. Then we calculated the exchange rate adjustment by multiplying the estimated stock of foreign currency claims at the end of the previous year by the change in the bilateral exchange rate against the euro. Given the euro’s dominating role in total foreign currency loans,¹⁰ this seems to be an acceptable approximation of the actual currency distribution of claims.

4 A Comprehensive Assessment of the Current Degree of Banking Intermediation in the CEECs

Table 1 summarizes different measures of the degree of banking intermediation in selected CEECs and the euro area. It includes the traditional measure of banking intermediation based on the stock of domestic claims (i.e. loans, securities and repurchase agreements) on nonbank sectors outside the general government, and two measures of banking intermediation based on “flows” (proxied by differences in stocks, both unadjusted and exchange rate-adjusted) for the euro area and several CEECs.

It should be noted that for the multi-year averages the measures based on “flows” are not calculated as the average annual change in the stock-to-GDP ratio. Rather, they represent the ratio of the average annual “flows” (proxied by the annual changes in outstanding claims) to average annual nominal GDP.

¹⁰ For example, the euro currently accounts for around 85% of foreign currency loans to domestic nonbanks in Bulgaria, the Czech Republic and Slovakia. In Hungary, its share stands at nearly 60%, with the Swiss franc accounting for another 27% of total foreign currency loans.

CAN BANKING INTERMEDIATION IN THE CENTRAL AND EASTERN EUROPEAN COUNTRIES EVER CATCH UP WITH THE EURO AREA?

Table 1

Domestic Credit to the Private Sector							
% of GDP	Stock-flow measure		Flow-flow measures				
	Credit stock in % of GDP		Annual difference in credit stock in % of GDP			Annual difference in credit stock (adjusted for exchange rate changes) in % of GDP	
	Average 1993–2003	Average 1999–2003	Average 1993–2003	Average 1999–2003	Average 2002–2003	Average 1999–2003	Average 2002–2003
Euro area	96.3	107.7	6.7	7.4	5.1	7.5	5.8
Czech Republic	47.1	38.1	0.8	-2.0	0.9	-1.9	0.9
Hungary	31.9	35.5	6.2	7.1	8.4	7.0	8.0
Poland	26.6	29.8	3.8	3.0	1.5	2.6	0.3
Slovenia	35.1	39.8	5.8	6.0	5.1	5.7	4.8
Slovakia	43.5	37.8	1.6	0.0	2.0	0.1	2.0
Bulgaria	16.9	18.1	4.8	4.8	7.6	4.8	7.5
Romania	11.9	10.7	3.6	3.0	4.1	1.7	2.8

Source: Eurostat, national central banks, authors' calculations.

Notes: Credit includes funds extended by domestic banks (i.e. MFIs) to households and nonmonetary corporations (i.e. nongovernmental nonbanks or "other domestic sectors") in the form of loans, securities and repurchase agreements.

The values represent arithmetic averages of the annual figures during the respective periods in both the numerator and the denominator. For the stock-flow measure, this means that the average value of credit stock is divided by the average value of GDP. For the flow-flow measures, the average values for annual changes in credit stock are divided by the average value of GDP.

Euro area: stock from end-1993 to end-2003; difference in stock from 1993 to 2003 (difference in stock in 1993 = change from end-1992 to end-1993).

Czech Republic: stock from 1993 to 2003; difference in stock from 1994 to 2003.

Hungary: stock from 1993 to 2003; difference in stock from 1993 to 2003.

Poland: stock from 1993 to 2003; difference in stock from 1994 to 2003.

Slovenia: stock from 1994 to 2003; difference in stock from 1995 to 2003.

Slovakia: stock from 1994 to 2003; difference in stock from 1995 to 2003.

Bulgaria: stock from 1995 to 2003; difference in stock from 1996 to 2003.

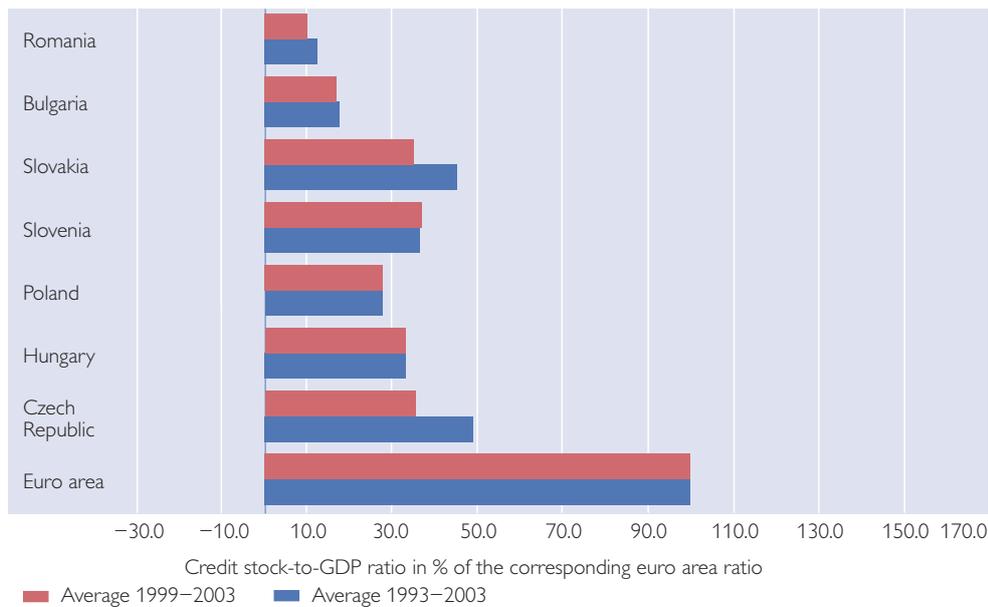
Romania: stock from 1993 to 2002; difference in stock from 1994 to 2002; baseline period and alternative short period are 1999 to 2002 and 2002, respectively.

Chart 1 shows the relative size of stock-flow and flow-flow measures compared with the euro area.

Chart 1a

Relative Position of the Ratio of Domestic Credit to the Private Sector to GDP

Stock-Flow Measure: Credit Stock-to-GDP Ratio (euro area = 100)

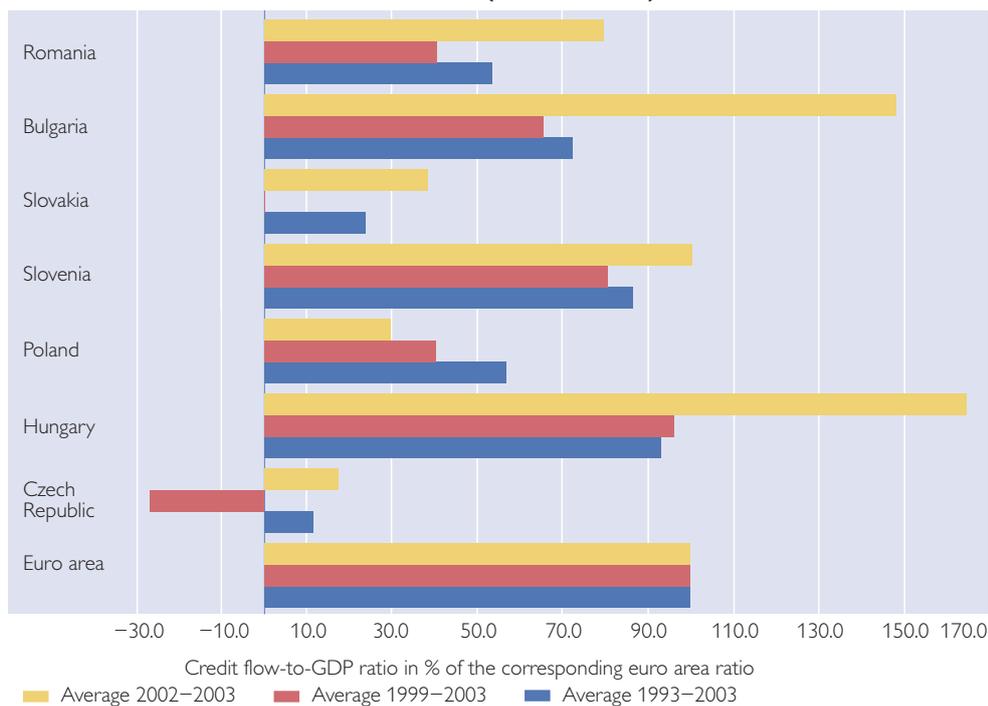


Source: Eurostat, national central banks, authors' calculations.
Note: The same notes apply as for table 1.

Chart 1b

Relative Position of the Ratio of Domestic Credit to the Private Sector to GDP

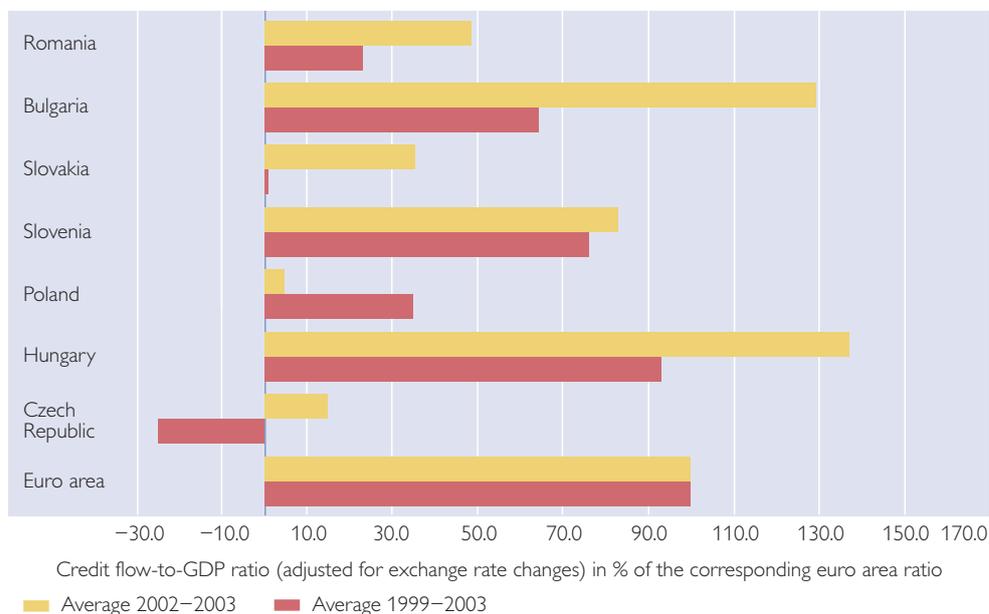
Flow-Flow Measure: Credit Flow-to-GDP Ratio (euro area = 100)



Source: Eurostat, national central banks, authors' calculations.
Note: The same notes apply as for table 1.

Relative Position of the Ratio of Domestic Credit to the Private Sector to GDP

Credit Flow-to-GDP Ratio (Adjusted for Exchange Rate Changes) (euro area = 100)



Source: Eurostat, national central banks, authors' calculations.

Note: The same notes apply as for table 1.

In both table 1 and chart 1, the baseline is the period from 1999 to 2003, since all three intermediation measures can be calculated for this period. To reflect the impact of debt write-offs in the Czech Republic and Slovakia, we also present an alternative longer period starting in 1993 (unless otherwise indicated) in order to include the development of lending prior to the debt write-off, and an alternative shorter period starting in 2002 in order to account for the development of lending after the debt write-off only.

It should be noted that the flow-flow measure of banking intermediation exhibits significantly larger cross-country and cross-period differences than the stock-flow measure. The dynamics of credit to the private sector over time seem to be particularly strong in the catching-up CEE economies. To smooth out excessive volatility over time, we therefore focus on multi-year average values in the flow-flow ratio. However, as table 1 and chart 1 show, the differences remain relatively large (compared with the differences in the stock-flow ratio) even after this adjustment. This phenomenon is attributable to the higher sensitivity of the flow-flow measure to short-term changes in the degree of banking intermediation, to the economic cycle or to changes in the financing structure of households and enterprises. By contrast, the stock-flow measure reflects these changes only much more sluggishly. Overall, we believe that the higher volatility of the flow-flow ratio compared with the stock-flow ratio better mirrors these cross-country and cross-period differences and helps better understand the process that takes place in the stock-flow measure between two points in time. It also seems that the persistence of these cross-country

differences in the CEECs is clearly reflected in the persistence of the cross-country dispersion of the flow-flow measure over the past few years (measured by the annual standard deviation of flow-flow ratio values in the selected CEECs). It is noteworthy, though, that the cross-country dispersion in the CEECs over the past few years (average for the period from 1997 to 2003: 3.8%) was modestly lower than the cross-country dispersion within the euro area excluding Luxembourg (1998 to 2003: 6.9%; by 2003, the standard deviation had declined to 4.9%).

The left-hand-side blocks in table 1 and chart 1a show that, based on the traditional measure of banking intermediation, the CEECs lag behind the euro area by a wide margin. Moreover, a comparison of the baseline period (1999–2003) with the longer period (1993–2003) showed that the gap between the CEECs and the euro area did not narrow over time (with the exception of Slovenia). In two countries, the Czech Republic and Slovakia, the gap widened sharply, which is ascribable to the significant debt write-offs in both countries in the early 2000s.

A somewhat different picture emerges, however, from the flow-flow measure.

On the basis of unadjusted stock changes, as shown in the middle block in table 1 and chart 1b, banking intermediation in Hungary and Slovenia reaches levels close to or even above those recorded in the euro area. Also Bulgaria and Romania have lately shown a relatively large ratio of annual changes in the stock of domestic claims to annual GDP. All countries but two record a relative position to the euro area that is significantly better based on the flow-flow measure than on the stock-flow measure.

The two exceptions are the Czech Republic and Slovakia, where debt write-offs in the early 2000s affected the flow-flow measure more negatively than the stock-flow measure. The performance of both countries in terms of the flow-flow measure was somewhat better over the alternative longer period, but still worse than in any other of the countries under study. To some extent this might be explained by the fact that the debt write-off is likely to have affected debt accumulated prior to 1993, so that the average annual difference in stock between 1993 and 2003 possibly captures the preceding overlending period in an insufficient manner and is therefore dominated by the write-off transaction.¹¹ Nevertheless, given that the value for the alternative shorter period (i.e. following the debt write-off) is only insignificantly larger than the value for the longer period and looks relatively poor in comparison with most other CEECs, banking intermediation in the Czech Republic and Slovakia seems to remain comparatively less pronounced.

¹¹ This is probably particularly true for the Czech Republic, where the stock-flow ratio was as high as 65.6% already at end-1993 and has not exceeded this level afterwards, which implies that the lending boom is not captured when calculating the differences in the stock from end-1993 onward. In Slovakia, the ratio stood at 53.7% at end-1993 and increased to 56.4% by end-1996 before starting to decline owing to cleaning steps.

When comparing the flow-flow measure in the CEECs and the euro area, one should bear in mind the CEECs' significant financial openness. In particular, foreign direct investment inflows (in the form of both equity financing and intercompany loans) play a significant role in most CEECs and are often worth several percentage points of GDP per year. Over the past few years, these inflows were particularly large in the Czech Republic and Slovakia, i.e. in the two countries with relatively low flow-flow measures of domestic financial intermediation. Moreover, cross-border loans and – to a lesser extent – international bond issues constitute further important funding sources for the private nonbank sector in the CEECs, partly substituting for domestic bank intermediation (Reininger et al., 2002).

As no sufficient data were available on the currency structure of domestic claims, it was only possible to calculate the flow-flow measure adjusted for exchange rate valuations for the periods from 1999 to 2003 and from 2002 to 2003, and not for the alternative longer period (see the right-hand-side block in table 1 and chart 1c). Nevertheless, since the comparison with the unadjusted change in stocks shows no significant differences between the unadjusted and adjusted values, the unadjusted measure seems to be a good proxy for the degree of banking intermediation. Somewhat larger differences between the two values were observed only for Poland, Slovenia and Romania, where the exchange rate-adjusted values in the period from 1999 to 2003 as well as in the period from 2002 to 2003 showed a lower degree of banking intermediation than the unadjusted values. These were the countries which experienced the smallest real appreciation (Slovenia and Romania) or even a depreciation (Poland) during the period from 1999 to 2003. On the basis of exchange rate-adjusted stock changes, the degree of banking intermediation in Hungary, Slovenia and Bulgaria came closest to that in the euro area in the period from 1999 to 2003.

Based on flow-flow measures, banking intermediation in the CEECs compares significantly better with the euro area than on the basis of the traditional stock-flow measure. In the most recent past (2002–03), banking intermediation of new capital was even more pronounced in Hungary and Bulgaria than in the euro area, both in unadjusted and exchange rate-adjusted terms. Intermediation in Slovenia matched the euro area level in unadjusted terms during these two years. Nevertheless, for the other CEECs, the flow-flow measure also suggests that banking intermediation still has some way to go to reach euro area levels, albeit – with the exception of the Czech Republic and Slovakia – a significantly shorter way than implied by the stock-flow measure. However, as long as intermediation on the basis of the flow-flow measure continues to lag behind the euro area (even if to a diminishing extent), the gap based on the stock-flow measure is unlikely to narrow at all.

5 Convergence in Banking Intermediation

It is quite common to show by graph the correlation of lower levels of GDP per capita (at PPP) with lower ratios of private credit stock-to-GDP (see e.g. Backé and Zumer, 2005). From our point of view, such a graph demonstrates that countries that post lower per capita income levels at a certain point in time usually have had a later start, or a longer interruption, of the real capital

accumulation process and, hence, of the increase in financial wealth. Clearly, the process of accumulation tends to lift both the income level and the stock-flow ratio.

As soon as a (low-income) catching-up country has achieved and maintains convergence in the flow-flow ratio with a (high-income) benchmark country, the implied credit growth in the catching-up country will be higher than in the benchmark country. On the basis of some simplifying assumptions, it can be shown¹² that given convergence according to the flow-flow-measure, i.e. at

$$\left(\frac{C_A^T}{Y_A} = \frac{C_B^T}{Y_B} \right) \quad (4)$$

the following relation holds true:

$$\frac{C_A^T = C_B^T}{C_A < C_B} \text{ or } \left(\frac{C_A^T}{C_A} \right) > \left(\frac{C_B^T}{C_B} \right) \quad (5)$$

which means that in the catching-up country *A* the same volume of transaction claims (credits) as in the benchmark country *B* is divided by a smaller volume of claim (credit) stock. This automatically leads to a higher ratio, which is the credit growth rate. Thus, a lower level of the stock-flow measure of banking intermediation in a catching-up country implies higher credit growth given full convergence according to the flow-flow measure. This explains the strong negative correlation between annual credit growth and the level of the stock-flow measure of intermediation.

Moreover, by means of simulation we calculated paths of future stock-flow ratio (credit stock-to-GDP ratio) and flow-flow ratio (credit flow-to-GDP ratio) development under two different assumptions, which lead to two scenarios (“scenario 1” and “scenario 2”).¹³ Table 2a summarizes the results of these simulations, which represent a “mechanistic” approach under reasonable assumptions. For a more comprehensive overview of the simulation results, see annex 4.

Scenario 1 in table 2a shows the level the private credit stock-to-GDP ratio would reach in the CEECs at the time of convergence in GDP per capita (at PPP) levels with the euro area (EU-12), assuming (until the year of income convergence) the persistence of an annual flow-flow ratio in the CEECs (and the euro area) equal to the euro area average observed during the period from 1994 to 2003 (6.8% of GDP). We find that given full convergence in the flow-flow ratio, the private credit stock-to-GDP measure in the CEECs will be considerably larger than at the currently expected point of convergence in their per capita income levels.

¹² See annex 3 for details.

¹³ The simulation is based on actual values for 2003 and the following basic assumptions for the parameters of future economic development: (1) a real growth rate of 2% and an inflation rate (GDP deflator) of 2% in the euro area; (2) a real growth rate of 4.5% (a growth differential of 2.5 percentage points) and an inflation rate (GDP deflator) of 3.5% (an inflation differential of 1.5 percentage points, as a proxy for real appreciation with constant nominal exchange rates) in the CEECs. In scenario 1, for both the euro area and the CEECs a private credit flow (net)-to-GDP ratio of 6.8% is assumed to prevail. Scenario 2 shows the implied annual private credit flow (net)-to-GDP ratios that would be necessary in the CEECs to simultaneously achieve convergence in income levels and in the private credit stock-to-GDP ratio, while for the euro area a private credit flow (net)-to-GDP ratio of 6.8% is assumed to prevail throughout the entire period, as in scenario 1.

Scenario 1 implies rather high annual average nominal and real credit growth rates over the next ten years (and also until the year of income convergence), as can be seen in annex 4. In fact, these credit growth rates will by far outpace the increments resulting for the euro area. This assumption is in line with the above reasoning that, given full convergence according to the flow-flow measure, the implied credit growth in the catching-up country will be higher than in the benchmark country (see also annex 3).

While the private credit stock-to-GDP ratio will be considerably higher in the CEECs in the year of income convergence than at the starting point (2003), it will nevertheless remain significantly below the private credit stock-to-GDP ratio currently recorded for the euro area (EU-12) in all CEECs. Moreover, it will trail the future private credit stock-to-GDP ratios in the euro area (EU-12) in the respective years of convergence by a wide margin. This result stands in clear contrast to what may be taken as suggested by a graph that correlates levels of GDP per capita (at PPP) with ratios of private credit stock to GDP, as mentioned above.

This leads to the question whether in this scenario, i.e. given full convergence in the flow-flow ratio, the stock-flow ratio in the CEECs will not only rise, but also catch up with the euro area (EU-12). Put differently, will banking intermediation in the CEECs ever be able to catch up with the euro area in stock-flow terms? Our simulation shows that this scenario would lead to convergence in the stock-flow ratio, but only at a rather late point in time, namely not before the end of this century, and thus considerably later than convergence in GDP per capita at PPP. In other words, based on an equal annual private credit flow-to-GDP ratio, the gap in per capita income will be overcome much earlier than the gap in the economy's accumulated capital and financial wealth (as proxied by private credit stock to GDP).

Scenario 2 reverses the simulation, allowing us to answer the question at which level the annual flow-flow ratio has to be maintained until the year of convergence in per capita income so that convergence in the stock-flow ratio will be achieved at the same time.¹⁴ Table 2a presents the corresponding simulation results under the "scenario 2" heading. Obviously, for the assumption that convergence in the private credit stock-to-GDP ratio and in GDP per capita (at PPP) levels will be attained simultaneously to hold, a significantly higher annual private credit flow-to-GDP ratio than the euro area average of the past ten years, namely roughly double that level, would be necessary. Clearly, scenario 2 implies even higher annual average nominal and real credit growth rates over the next ten years (and also until the year of income convergence and simultaneous convergence in the private credit stock-to-GDP ratio), as shown in annex 4.

One may raise the question why this should not be the case in catching-up economies like the CEECs. Even if the flow-flow ratio converged to that in the benchmark economy at least in the long run, why should the ratio not be higher for several years of intense catching-up in per capita income and thus also imply faster catching-up in the CEECs' financial wealth? Indeed, one argument that speaks in favor of a temporarily higher private credit flow-to-GDP ratio is

¹⁴ For the euro area, a private credit flow (net)-to-GDP ratio of 6.8% is assumed to prevail throughout the entire period, as in scenario 1.

the need to finance higher investment ratios in order to ensure catching-up in income levels. By contrast, one may point out that the private sector in the CEECs will probably further increase its integration into the global financial system, which implies that it will tap financing sources other than domestic credits (i.e. loans from, or securities issued to, domestic banks). While such alternative forms of financing, e.g. foreign direct equity investments, intercompany loans or foreign cross-border credits, have already played an important role for CEECs in recent years, they may to some extent dampen the expansion of domestic credit to the private sector also in the future.

Table 2a

Simulation Results for the Future Development of the Private Credit Stock-to-GDP Ratio

and the Private Credit Flow-to-GDP Ratio in the CEECs

Two scenarios for the stock-flow ratio in, and the flow-flow ratio until, the year of convergence in GDP per capita (at PPP)

	2003 Stock-flow ratio	Year of income convergence (GDP p.c., PPP)	Scenario 1:		Scenario 2:	
			Flow-flow ratio until year of	Stock-flow ratio in year of	Flow-flow ratio until year of	Stock-flow ratio in year of
			income convergence		income convergence	
Euro area	112%	2017–2055	6.8%	139%–167%	6.8%	139%–167%
Czech Republic	32%	2021	6.8%	76%	13.7%	144%
Hungary	42%	2026	6.8%	82%	13.0%	150%
Poland	29%	2038	6.8%	87%	12.5%	159%
Slovenia	43%	2017	6.8%	75%	14.0%	139%
Slovakia	33%	2033	6.8%	86%	12.6%	156%
Bulgaria	27%	2055	6.8%	89%	12.9%	167%
Romania	14%	2055	6.8%	88%	12.9%	167%

Source: Eurostat, national central banks, wiiv, authors' calculations.

Notes: The simulation is based on actual values for 2003 and the following basic assumptions for the parameters of future economic development: (1) a real growth rate of 2% and an inflation rate (GDP deflator) of 2% in the euro area; (2) a real growth rate of 4.5% (a growth differential of 2.5 percentage points) and an inflation rate (GDP deflator) of 3.5% (an inflation differential of 1.5 percentage points, as a proxy for real appreciation with constant nominal exchange rates) in the CEECs. In scenario 1, for both the euro area and the CEECs an annual private credit flow (net)-to-GDP ratio of 6.8% is assumed to prevail until the year of income convergence (i.e. convergence in GDP per capita at PPP). Scenario 1 shows for each country and for the euro area the private credit stock-to-GDP ratio that will be attained in the year of convergence in GDP per capita (at PPP) under this assumption. In scenario 2, only for the euro area an annual private credit flow (net)-to-GDP ratio of 6.8% is assumed to prevail. Scenario 2 shows for each country the implied private credit flow-to-GDP ratio that would be necessary in the CEECs to simultaneously achieve convergence in GDP per capita (at PPP) level and in the private credit stock-to-GDP ratio. The stock-flow ratio for each CEEC in scenario 2 is equal to the stock-flow ratio in the euro area in the year of income (GDP per capita at PPP) convergence of the respective country with the euro area.

Table 2b

Private Sector Credit Flow-to-GDP Ratios in Economies Undergoing

Catching-up Processes since the Early 1950s

% of GDP

	Annual ratios	20-year rolling average ratios		
	Available since	Average value	Year of maximum value	Maximum value
Austria	1954	6.1	1990	7.1
Finland	1951	5.5	1990	8.0
Greece	1954	5.5	1991	6.7
Italy	1964	7.0	1984	8.8
Portugal	1954	12.2	1984	14.5
Spain	1954	10.0	1982	11.9
Ireland	1951	6.0	2004	11.0
Japan	1954	8.8	1979	11.9
Korea	1953	7.7	2003	8.9
Philippines	1951	3.5	1997	5.0
Thailand	1951	5.5	1997	10.6
South Africa	1966	7.7	2003	8.6
Argentina	1961	11.4	1990	15.1
Brazil	1965	19.3	1994	25.5
Mexico	1951	4.4	1994	5.7
Cross-country average				
Total		8.0		10.3
Excluding Austria, Finland, Italy and Japan		8.5		11.2

Source: IMF (International Financial Statistics), authors' calculations.

Note: The annual flows used to calculate the flow-to-GDP ratios are derived as changes in the year-end stock of outstanding private sector credit.

For deriving an assessment of the (net) private credit flow-to-GDP ratio that may be appropriate for catching-up economies, we turned to the past experience of major economies that had undergone a catching-up process at least for one or more decades since the early 1950s. Some of these economies have accomplished their catching-up process and have become well-established industrialized countries.

As reflected by table 2b, the evaluation of these experiences does not lead us to be very optimistic with respect to the possibility of realizing in a *sustainable manner* the high flow-flow ratio level that would be required for simultaneous convergence in the stock-flow ratio and the per capita income level. For the economies under investigation, the average value of 20-year rolling windows of the credit flow-to-GDP ratio was not higher than 8%. Even when we exclude those economies that have matured in the meantime, e.g. Austria, Finland, Italy and Japan, and, hence, posted lower values of their 20-year rolling windows in the later phase, the average value does not reach more than 8.5%. Both values are closer to the ten-year euro area average in the period from 1994 to 2003 (6.8%) than to the levels required for simultaneous convergence in the stock-flow ratio and in the per capita income level.

Granted, some countries registered higher average values of their 20-year rolling windows that are close to or even exceed the required credit flow-to-GDP ratio, as can be seen in table 2b. Naturally, the number of countries with such ratios increases if we do not look at the average, but at the maximum value of their 20-year rolling windows. However, in several of these cases, the

higher average values were not coupled with a successful catching-up process, as for instance in Argentina or to a lesser extent in Brazil, where the periods that were more successful in terms of per capita GDP growth witnessed annual flow-flow ratios closer to the 6.8% value.¹⁵

In some cases, relatively high maximum values were achieved in periods when the annual private credit flow-to-GDP ratio was at excessively high levels, around times of economic instability, soaring inflation and ensuing economic crisis (with Thailand in 1997 a case in point). Nevertheless, there are also exceptions: the average values in Portugal and Spain as well as the maximum values in Ireland and Japan. For Portugal, Spain and Ireland, it should be noted that these high values were influenced in particular by the relatively high annual private credit flow-to-GDP ratios that were linked to (preparations for) EU accession, the full liberalization of capital flows and, most notably, the adoption of the euro. Since the introduction of the euro, the average annual private credit flow-to-GDP ratios of these three countries have come to between 14.2% and 18.5%. In all three countries, this average ratio was higher than in the preceding five years. However, it remains to be seen whether such high credit flow-to-GDP ratios can be maintained over an extended period of time, say, for 20 years.

Against the background of this evidence, the possibility of realizing in a sustainable manner the high level of the flow-flow ratio that would be required for simultaneous convergence in the stock-flow ratio and in the per capita income level should not be completely excluded. Even more so, as the institutional setting in which new EU Member States in CEE operate is similar to that in which Portugal, Spain and Ireland operated in the past.

6 Conclusions

The banking intermediation activities required from the financial sector in an economy comprise both the management of the existing stock of outstanding claims and the channeling of new funding/saving into new net investment.

Managing the existing stock consists, first of all, in the relending of (partially) matured claims, which in macroeconomic terms is linked to the financing of (probably more productive) replacement investment. Moreover, assuming possible market imperfections in the past that imply that capital was not allocated in a totally efficient manner, efficiency gains might be realized in current periods by capital reallocation (e.g. interindustry reallocation). Obviously, this type of intermediation activity is of economic importance even if the flow-flow measure indicates that no fresh capital has been channeled into the economy. At the same time, the potential size of this management activity is closely related to the size of the ratio of the outstanding stock of claims to GDP. As the outstanding stock of claims is to a significant extent dependent on the length of time of the preceding accumulation process, economies with com-

¹⁵ It should also be noted that the relatively high average values of 20-year rolling windows of the credit flow-to-GDP ratio in Brazil resulted primarily from the very high ratios recorded during the period from 1988 to 1994, which were then followed by ratios of between 0.9% and 5.5% of GDP. Hyperinflation (1988–94) as well as inflation differences across sectors and weak GDP growth (1988–92) probably had an asymmetric impact on the nominal volume of credits (high positive real interest rates measured by consumer prices, e.g. 421% in 1990) and GDP (inflated by the GDP deflator), bringing about excessively high and clearly unsustainable credit flow-to-GDP ratios in this period.

pletely different starting points of capital accumulation can be expected to converge with respect to the traditional stock-flow measure of banking intermediation only in the very long run. It follows that the size of this type of intermediation activity will very probably continue to differ significantly between such economies for a very long time, as will the volume of financial wealth.

Banking intermediation between new funding/saving and new net investment does not depend on the length of time of past accumulation. Thus, economies with completely different starting points of capital accumulation can converge with respect to this type of banking intermediation in a significantly shorter period of time by comparison. The proposed flow-flow measure lends itself to measuring the degree of this type of banking intermediation (i.e. the channeling of new funding/saving into new claims to finance net investment and thus new capital stock). Therefore, the flow-flow measure should receive much more attention when comparing the degree of banking intermediation between different economies than is currently the case.

It follows that to measure catching-up in banking intermediation it is necessary to take a close look at the flow-flow measure proposed in this paper. Specifically, the flow-flow measure can serve as an additional tool to assess the sustainability of high credit dynamics, beside the traditional analysis of annual credit growth rates or changes in the private credit stock-to-GDP ratio. Not only private credit flow-to-GDP ratios in the CEECs that are far above the usual level of private credit-flow-to-GDP ratios in the euro area, but also private credit flow-to-GDP ratios in the CEECs equal to the usual level of euro area private credit-flow-to-GDP ratios (i.e. given full convergence in the flow-flow ratio) imply already relatively high nominal and real private credit growth rates. This observation should lead monetary policymakers to be wary of assessing private credit growth as being too high and requiring restrictive responses. However, central bankers clearly have to remain vigilant, in particular when private credit growth rates approach very high levels, such as those that would be required for simultaneous convergence in the stock-flow ratio and in the per capita income level.

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Annexes

Annex 1

The time bias in the (local currency) credit stock-to-GDP ratio:

$$Q_1^C = \frac{C_1}{Y_1} = \frac{C_0 + C_0 \times \beta[(1 + r_0) \times (1 + \pi_1) - 1] + C_1^T + R_1}{Y_0 \times (1 + y_1) \times (1 + \pi_1)}$$

and under the simplifying assumption that $\beta = 0$

$$Q_1^C = \frac{C_0}{Y_0 \times (1 + y_1) \times (1 + \pi_1)} + \frac{C_1^T}{Y_0 \times (1 + y_1) \times (1 + \pi_1)} + \frac{R_1}{Y_0 \times (1 + y_1) \times (1 + \pi_1)}$$

whereby Q_t^C denotes the domestic claims ratio, defined as the stock of domestic claims as a percentage of GDP in period t , C_t the stock of domestic claims in period t , β the fraction of interest income which is relent (taking values between zero and one), C_t^T transaction claims (i.e. net new claims on domestic sectors) in period t , R_t revaluation adjustments (e.g. price revaluations of marketable instruments or claim write-offs). Similar to the saving ratio, the domestic claims ratio increases over time (ceteris paribus) on the back of the annual volume of net new claims (as a percentage of GDP). Again, the longer the accumulation period, the higher the domestic claims ratio tends to be. A positive recycling factor β has a positive impact on the claims ratio, which is amplified by a positive differential between the realized real interest rate and the real GDP growth rate.

Annex 2

The time bias in the foreign currency credit stock-to-GDP ratio:

$$Q_1^{C,FX} = \frac{C_0^{FX} \times (1 + D)}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)} + \frac{C_0^{FX} \times \chi[(1 + r_0^f) \times (1 + \pi_1^f) \times (1 + D) - 1]}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)} + \frac{C_1^{FX,T}}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)} + \frac{R_1^{FX}}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)}$$

and assuming $\chi = 1$

$$Q_1^{C,FX} = \frac{C_0^{FX} \times (1 + D)}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)} + \frac{C_0^{FX} \times (1 + r_0^f) \times (1 + \pi_1^f) \times (1 + D)}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)} - \frac{C_0^{FX}}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)} + \frac{C_1^{FX,T}}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)} + \frac{R_1^{FX}}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)}$$

results in

$$Q_1^{C,FX} = \frac{C_0^{FX} \times D}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)} + \frac{C_0^{FX} \times (1 + d)}{Y_0 \times \frac{(1 + y_1^d)}{(1 + r_0^f)}} + \frac{C_1^{FX,T}}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)} + \frac{R_1^{FX}}{Y_0 \times (1 + y_1^d) \times (1 + \pi_1^d)}$$

Annex 3

Convergence in the credit flow-to-GDP ratio and the credit growth rate:

Recall that the annual credit growth rate can be written as the ratio of transaction claims (or credits) to the stock of claims (credits) in the previous period:

$$c_1 = \frac{C_1^T}{C_0}$$

Expanding both the numerator and the denominator by GDP (for the reason of simplicity assuming no change in nominal GDP between the two periods, $Y_0 = Y_1$) leads us to

$$c_1 = \frac{C_1^T}{C_0} = \frac{\frac{C_1^T}{Y_1}}{\frac{C_0}{Y_0}}$$

Thereby, the expanded numerator corresponds to our flow-flow measure of banking intermediation, while the denominator represents the traditional stock-flow measure.

Combining

- our postulation that catching-up in terms of banking intermediation between two countries (country A being the catching-up country and country B being the benchmark country) should be measured by the flow-flow measure

$$\left(\frac{C_A^T}{Y_A} \right) \text{ and } \left(\frac{C_B^T}{Y_B} \right)$$

and

- the observation that catching-up countries show a lower level of the stock-flow measure (mostly due to the time effect)

$$\left(\frac{C_A}{Y_A} \right) < \left(\frac{C_B}{Y_B} \right)$$

with

- the assumption of equality in total nominal GDP between the two countries (for the reason of simplicity, let us compare a large catching-up economy like Poland with a small benchmark economy like Belgium, assuming their nominal GDP is equal) $Y_A = Y_B$

implies that

when *full convergence* according to the flow-flow-measure is *achieved*, i.e. at

$$\left(\frac{C_A^T}{Y_A} = \frac{C_B^T}{Y_B} \right)$$

the following relation holds true:

$$\frac{C_A^T}{Y_A} = \frac{C_B^T}{Y_B}$$

$$\frac{C_A}{Y_A} < \frac{C_B}{Y_B}$$

and thus – after multiplication with nominal GDP –

$$\frac{C_A^T = C_B^T}{C_A < C_B} \text{ or } \left(\frac{C_A^T}{C_A} \right) > \left(\frac{C_B^T}{C_B} \right)$$

This finding may be extended to the situation *before* full convergence in terms of the flow-flow measure, as the catching-up country will usually be closer to full convergence in terms of the flow-flow measure than in terms of the traditional stock-flow measure. The latter can be expressed by the following combination of two inequalities:

$$\left(\frac{C_A^T}{Y_A} < \frac{C_B^T}{Y_B} \right) \text{ and } \left(\frac{C_A}{Y_A} \ll \frac{C_B}{Y_B} \right)$$

This, in turn, implies:

$$\frac{\frac{C_A^T}{Y_A} < \frac{C_B^T}{Y_B}}{\frac{C_A^T}{Y_A} \ll \frac{C_B^T}{Y_B}} \text{ or } \frac{C_A^T < C_B^T}{C_A \ll C_B} \text{ or } \left(\frac{C_A^T}{C_A} \right) > \left(\frac{C_B^T}{C_B} \right)$$

Annex 4

Simulation Results for the Future Development of the Private Credit Stock-to-GDP Ratio and the Private Credit Flow-to-GDP Ratio in the CEECs

	2003	Scenario 1:	Scenario 2:
Czech Republic			
GDP per capita (at PPP), % of euro area	64%	100%	100%
Year of convergence in GDP per capita (at PPP)		2021	2021
Private credit flow (net)-to-GDP ratio, annual figures (up to convergence year)		6.8%	13.7%
Average private credit growth, real, year on year (in the next ten years)		12.1%	18.7%
Private credit stock-to-GDP ratio	32%	76%	144%
compare: private credit stock-to-GDP ratio in the euro area (EU-12)	112%	144%	144%
Hungary			
GDP per capita (at PPP), % of euro area	57%	100%	100%
Year of convergence in GDP per capita (at PPP)		2026	2026
Private credit flow (net)-to-GDP ratio, annual figures (up to convergence year)		6.8%	13.0%
Average private credit growth, real, year on year (in the next ten years)		9.8%	15.4%
Private credit stock-to-GDP ratio	42%	82%	150%
compare: private credit stock-to-GDP ratio in the euro area (EU-12)	112%	150%	150%
Poland			
GDP per capita (at PPP), % of euro area	43%	100%	100%
Year of convergence in GDP per capita (at PPP)		2038	2038
Private credit flow (net)-to-GDP ratio, annual figures (up to convergence year)		6.8%	12.5%
Average private credit growth, real, year on year (in the next ten years)		12.8%	18.7%
Private credit stock-to-GDP ratio	29%	87%	159%
compare: private credit stock-to-GDP ratio in the euro area (EU-12)	112%	159%	159%
Slovenia			
GDP per capita (at PPP), % of euro area	72%	100%	100%
Year of convergence in GDP per capita (at PPP)		2017	2017
Private credit flow (net)-to-GDP ratio, annual figures (up to convergence year)		6.8%	14.0%
Average private credit growth, real, year on year (in the next ten years)		9.6%	15.9%
Private credit stock-to-GDP ratio	43%	75%	139%
compare: private credit stock-to-GDP ratio in the euro area (EU-12)	112%	139%	139%
Slovakia			
GDP per capita (at PPP), % of euro area	49%	100%	100%
Year of convergence in GDP per capita (at PPP)		2033	2033
Private credit flow (net)-to-GDP ratio, annual figures (up to convergence year)		6.8%	12.6%
Average private credit growth, real, year on year (in the next ten years)		11.7%	17.4%
Private credit stock-to-GDP ratio	33%	86%	156%
compare: private credit stock-to-GDP ratio in the euro area (EU-12)	112%	156%	156%
Bulgaria			
GDP per capita (at PPP), % of euro area	28%	100%	100%
Year of convergence in GDP per capita (at PPP)		2055	2055
Private credit flow (net)-to-GDP ratio, annual figures (up to convergence year)		6.8%	12.9%
Average private credit growth, real, year on year (in the next ten years)		13.3%	19.5%
Private credit stock-to-GDP ratio	27%	89%	167%
compare: private credit stock-to-GDP ratio in the euro area (EU-12)	112%	167%	167%
Romania			
GDP per capita (at PPP), % of euro area	28%	100%	100%
Year of convergence in GDP per capita (at PPP)		2055	2055
Private credit flow (net)-to-GDP ratio, annual figures (up to convergence year)		6.8%	12.9%
Average private credit growth, real, year on year (in the next ten years)		20.3%	27.6%
Private credit stock-to-GDP ratio	14%	88%	167%
compare: private credit stock-to-GDP ratio in the euro area (EU-12)	112%	167%	167%

Source: Eurostat, national central banks, wiiv, authors' calculations.

Notes: The simulation is based on actual values for 2003 and the following basic assumptions for the parameters of future economic development: (1) a real growth rate of 2% and an inflation rate (GDP deflator) of 2% in the euro area; (2) a real growth rate of 4.5% (a growth differential of 2.5 percentage points) and an inflation rate (GDP deflator) of 3.5% (an inflation differential of 1.5 percentage points, as a proxy for real appreciation with constant nominal exchange rates) in the CEECs. In scenario 1, for both the euro area and the CEECs an annual private credit flow (net)-to-GDP ratio of 6.8% is assumed to prevail until the year of income convergence (i.e. convergence in GDP per capita at PPP). The column "scenario 1" shows for each country and for the euro area the private credit stock-to-GDP ratio that will be attained in the year of convergence in GDP per capita (at PPP) under this assumption as well as the implied annual credit growth in the next ten years. In scenario 2, only for the euro area an annual private credit flow (net)-to-GDP ratio of 6.8% is assumed to prevail. The column "scenario 2" shows for each country the implied private credit flow-to-GDP ratio which would be necessary in the CEECs to simultaneously achieve convergence in GDP per capita (at PPP) levels and in the private credit stock-to-GDP ratio as well as the implied annual credit growth in the next ten years.

The Banking Sector of Bosnia and Herzegovina: The Dominant Role of Austrian Banks

Tamás Mágel¹

This study analyzes the development of the banking sector of Bosnia and Herzegovina until the end of 2004. After a brief description of the institutional and macroeconomic background, it covers the ownership structure and concentration in the banking sector, the degree of financial intermediation, the structure of the aggregated balance sheet and the role of foreign exchange in the banking sector's balance sheet. Finally, this paper investigates the development of capital adequacy and profitability. The author finds that macroeconomic stabilization (on the back of a currency board arrangement) and the market entry of foreign banks supported the reform process in the banking sector and helped deepen financial intermediation, while leading to a relatively high concentration of banking sector assets. The author argues that the main challenges for the banking sector in Bosnia and Herzegovina are first, to increase (longer-term) lending to nonfinancial corporations; second, to keep its overall net foreign currency position under control amidst the domestic household lending boom; third, to closely monitor the development of asset quality; and fourth, to further improve the banking sector's operational efficiency.

1 Introduction: Institutional and Economic Background

This study² focuses on the banking sector of Bosnia and Herzegovina, analyzing in particular the developments from 1997 until the end of 2004.

From 1992 to 1995, Bosnia and Herzegovina was severely affected by the war in Former Yugoslavia. In addition to the serious humanitarian and social consequences of the war, destruction, loss of trade and other economic links, and the forced dispersal of the labor force led to a near-total breakdown of the country's economic system. The huge population displacement, both within the country and abroad (with refugees making up 50% of the total pre-war population), resulted in a fragile and dislocated social situation and a reduced internal market. The collapse of traditional markets and the degree of physical damage to the existing infrastructure led to an estimated fall in GDP per capita to 30% of pre-war levels (European Commission and The World Bank, 2003).

In response to the ethnic and territorial conflicts that arose during the war, the parties participating in the peace negotiations of Dayton in 1995 aimed at formulating a compromise that ensured political stability and a balance of power in the country. Thus, according to the Dayton Peace Agreement (DPA), Bosnia and Herzegovina (BiH) consists of a central authority, an autonomous district (Brčko District) and two autonomous entities, namely the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS), which were formed as international protectorates under the supervision of the United Nations (Annex II of the DPA, 1995). Both entities and the district have established and operate their separate legislation and administration authorities and institutions based on the defined conditions of the DPA. In fiscal terms, these entities are autonomous. The state of Bosnia and Herzegovina is the central authority, but has only limited and specific powers like monetary policy (common currency and common central bank), external trade and customs, regulatory competence on telecommunications, the transport system and traffic control,

¹ *MagelTamas@gmx.net. The author prepared this study during his six-month internship at the Foreign Research Division, Oesterreichische Nationalbank (OeNB). Thomas Reiningger and Zoltan Walko (OeNB) supervised the preparation of this paper and provided methodological support and valuable comments. The author would also like to thank Jarko Fidrmuc for his comments and Susanne Steinacher for language advice. The standard disclaimer applies.*

² *Concerning the reliability of statistical data used in this paper, it should be noted that the high number of statistical offices (at the canton, entity and state levels) and the low level of coordination between them (resulting from the complicated constitutional partition of the country) are highly problematic when it comes to applying a statistical methodology, and therefore require caution on the part of the reader (Pöschl, 2004, 6).*

foreign relations, interentity criminal laws and immigration policies. The entities – which each have their own constitutions – exert all functions not expressly assigned to the central state by the constitution of BiH (European Commission Delegation to BiH, 2003, 10).

Against the background of this formal separation, the entities try to create conditions for social and economic unification in order to support a sustainable social and economic development. Moreover, there are some efforts in progress to enhance economic cooperation not only between the entities within the state, but also with the neighboring countries. At the beginning of July 2003, the governments of both entities agreed on the basic principles for a common economic strategy. The main objectives set in this agreement were to strengthen the private sector, reduce dependence on imports, increase exports, and join the World Trade Organization in 2004 and the EU by 2010. In the course of the Trade Initiative of the Stability Pact for South Eastern Europe, all countries of the region have been setting up bilateral trade agreements. As all the countries in this region form a geographic and strategic unit in the perception of foreign investors, the liberalization of trade should attract further FDI. In this regard, country-specific competitiveness will play an important role as well (Marinovic, 2004, 3).

Regarding its main economic developments, Bosnia and Herzegovina experienced high GDP growth rates during the first years after the war (1996–99), albeit starting from a very low base level. After a slowdown from 10% in 1999 to 5.5% in 2000, real GDP growth in BiH settled down to an average of around 5% per annum in the period from 2000 to 2004 – this figure was not inflationary, but combined with a significant external imbalance.

Excluding the estimate for the unobserved economy, GDP per capita in BiH remained below the weighted average GDP per capita in the Western Balkans³ (excluding Croatia), both calculated on the basis of the exchange rate and at purchasing power parity (PPP), throughout the period from 2000 to 2004. GDP per capita was far lower than in Bulgaria, Romania and Croatia (see table 1).

By contrast, in 2004, the average monthly gross wage level in BiH amounted to more than EUR 380, thus considerably exceeding average levels in Bulgaria (EUR 149) and Romania (EUR 204) (Pöschl, 2005, 89).

³ *Western Balkans as defined by the European Commission: Albania, Bosnia and Herzegovina, Croatia, FYR of Macedonia, Serbia and Montenegro with Kosovo.*

Table 1

Gross Domestic Product: Real Growth and Per Capita Income Level in Comparison								
	1997	1998	1999	2000	2001	2002	2003 (c)	2004 (d)
Real GDP growth (year on year, %) (a)	10.0	5.5	4.5	5.5	3.0	5.0
GDP per capita (EUR at exchange rate), excluding estimate for the unobserved economy (b)	1,234	1,359	1,476	1,556	1,642	1,732
GDP per capita (EUR at exchange rate), including estimate for the unobserved economy (b)	2,262	2,387
For comparison: GDP per capita (EUR at exchange rate) in								
Western Balkan countries (excluding Croatia), average (b)	2,136	1,566	1,830	1,966	2,121
Croatia (b)	4,505	4,998	5,449	5,749	6,224
Bulgaria and Romania, average (b)	1,764	1,982	2,191	2,300	2,604
GDP per capita (EUR at PPP), excluding estimate for the unobserved economy (b)	3,270	3,507	3,719	3,978	4,133	4,439
GDP per capita (EUR at PPP), including estimate for the unobserved economy (b)	5,694	6,118
For comparison: GDP per capita (EUR at PPP) in								
Western Balkan countries (excluding Croatia), average (b)	3,940	4,264	4,580	4,760	5,122
Croatia (b)	8,107	8,642	9,303	9,723	10,396
Bulgaria and Romania, average (b)	5,095	5,567	6,073	6,326	6,943
EU-15, average (b)	21,639	22,419	23,172	23,321	24,251

Source: (a) CBBH (2005a); (b) OeNB calculation based on CBBH (2005a) and Pöschl (2005) (Western Balkan average excludes estimate for the unobserved economy in BiH); (c) revised data; (d) preliminary data.

The registered unemployment rate was above 40% in 2003 and 2004. Taking into consideration employment in the shadow economy, the Central Bank of Bosnia and Herzegovina (Centralna banka Bosne i Hercegovine – CBBH) estimated the unemployment rate at around 20% in 2003 (Bergkvist, 2004, 52).

In 2004, the current account deficit amounted to 23.3% of GDP, after it had risen significantly in the period from 2000 to 2003. At least the deficit did not deteriorate further in 2004. The source of the high current account deficit was the very high trade deficit, which amounted to 55.4% of GDP in 2004. This means that exports covered less than one-third of imports. While the trade deficit-to-GDP ratio remained stable from 2000 to 2003 and improved in 2004, the surplus on both the income balance and the current transfers balance declined significantly, which implied a considerable increase in the current account deficit (see table 2).

The main sources of financing the current account deficit in the period from 2001 to 2004 were other investment net inflows, followed by the surplus in the capital account and gradually increasing net FDI inflows. Together with a positive net errors and omissions position, these items have even caused a significant buildup of gross official reserves in recent years.

Table 2

Balance of Payments Items								
	1997	1998	1999	2000	2001	2002	2003	2004
	BAM million							
Trade balance	..	-5,482	-6,052	-5,868	-6,470	-6,892	-7,180	-7,192
Trade balance as a percentage of GDP	..	-72.5	-67.3	-58.4	-59.0	-59.2	-58.4	-55.4
Services balance	..	309	298	323	432	386	460	584
Income balance	..	1,424	1,309	1,225	1,177	1,057	921	703
Current transfers balance	..	3,097	3,441	3,338	3,095	2,869	2,788	2,884
Current account balance	..	-653	-1,004	-983	-1,766	-2,579	-3,011	-3,021
Current account balance as a percentage of GDP	..	-8.6	-11.2	-9.8	-16.1	-22.1	-24.5	-23.3
Capital account balance	..	871	1,148	1,160	866	849	799	775
Financial account balance (excluding change in reserve assets)	..	-314	363	-289	2,314	1,372	1,973	2,047
of which: direct investment, net	..	117	325	310	260	551	660	783
portfolio investment, net	..	0	0	0	0	0	0	0
other investment, net	..	-431	38	-599	2,054	821	1,313	1,264
Net errors and omissions	..	243	81	276	251	114	555	876
Reserve assets (+ = decrease of gross official reserves excluding gold)	..	-148	-588	-165	-1,665	245	-316	-677

Source: CBBH (2005a), OeNB calculations.

Annual inflation has been at very low levels since 1998 in the FBiH and since 2001 in the RS, where a pronounced deflation took place in 1997. Since 2002, annual average inflation in BiH has been below 1% (see table 3).

Table 3

Retail Price Index								
	1997	1998	1999	2000	2001	2002	2003	2004
	Year-on-year change in %							
Federation of Bosnia and Herzegovina, December (a)	13.6	1.8	-1.0	4.0	2.4	0.7	-0.3	-0.3 (d)
Republika Srpska, December (a)	-10.0	5.6	14.0	16.0	2.5	2.4	0.2	2.2 (d)
Bosnia and Herzegovina, December (b)	7.6	2.8	3.3	7.5	2.4	1.2	-0.2	0.5 (d)
Federation of Bosnia and Herzegovina, annual average (a)	..	..	-0.9	1.2	1.7	-0.2	0.1	-0.3
Republika Srpska, annual average (a)	..	..	15.1	13.6	6.5	1.7	1.8	1.9
Bosnia and Herzegovina, annual average (c)	..	13.3	3.7	4.8	3.1	0.4	0.6	0.4

Source: (a) EBRD (2004); (b) OeNB calculation based on EBRD data; (c) CBBH (2005a); preliminary weighted data for 2004. Weights used represent FBiH and RS shares in BiH GDP for 2003. (d) CBBH (2005b).

This impressive disinflation process came on the back of the efforts initiated by the institutional monetary policy arrangement. The CBBH was established under the DPA and commenced its operations on August 11, 1997. As mentioned before, the CBBH is a federal-level institution, which means it is the only monetary authority in BiH. It operates throughout the country with five offices (Chamber of Economy of Federation of Bosnia and Herzegovina, 2004). The most important aim of the CBBH is to formulate, adopt and control the monetary policy of BiH. Monetary policy is conducted through strict adherence to the currency board arrangement (CBA), as stipulated in the CBBH law and in the DPA (Kovačević, 2004, 59).

The choice of a currency board had two main motivations. First, the currency board should provide a firm nominal anchor in the form of a fixed exchange rate, which was considered crucial in the economically very uncertain post-war situation. Second, a strictly rule-based approach to monetary policy was seen as the most appropriate, taking into account the difficulty in making political decisions in the country's complex institutional and political environment (Kovačević, 2004, 59).

There are three essential features of the CBA in BiH, all of which are specified in the CBBH law:

First, the exchange rate of the national currency, i.e. the Bosnian convertible mark (BAM), was pegged to the Deutsche mark (DEM) at a fixed rate of 1:1. This exchange rate made the parallel use of the two currencies easier during the period in which citizens were building up their trust in the new national currency. When the euro was introduced in January 1999, the convertible mark was tied to the euro at the same parity as the Deutsche mark (1.95583 BAM per EUR). Second, the domestic currency liabilities of the CBBH have to be fully backed with convertible foreign assets (Kovačević, 2004, 59). According to the CBBH balance sheet, BAM liabilities came to 3,284 million and foreign assets to BAM 3,458 million at the end of 2004, so there was more than 100% coverage (Centralna banka Bosne i Hercegovine, 2005a). Third, full convertibility of the currency was implemented, which means that the CBBH had to be prepared to exchange BAM for DEM (EUR) at any time and in any amount (Kovačević, 2004, 60).

The main discretionary monetary policy tool available in the CBA is the minimum reserve requirement rate. In BiH this rate was reduced from 10% to 5% in mid-2003 and raised again to 10% in 2004. In mid-2003, the base for the required reserve was expanded to include foreign exchange deposits in addition to BAM deposits (Ljubiša, 2003). The reserve requirement rate had been introduced in 1998 with a minimum of 10% and a statutory maximum of 15%, with both rates applying for commercial banks' total BAM deposits (Centralna banka Bosne i Hercegovine, 1999, 14). Later in September 2002, the upper limit had been raised to 20% (Centralna banka Bosne i Hercegovine, 2003, 22).

Against this institutional and economic background, this paper analyzes the development of the banking sector in Bosnia and Herzegovina. The structure of the paper is as follows: Section 2 provides a description of the general situation in the Bosnian and Herzegovinian banking sector, including the privatization process, the banking capital and ownership structure, the distribution of market shares and the degree of financial intermediation. Section 3 analyzes commercial banks' balance sheets on an aggregated level, split up into the assets and liabilities sides. Section 4 comments on the role of foreign exchange in banking activity. Section 5 shows the capital adequacy and liquidity indicators of the banking sector in BiH, section 6 analyzes the profitability of banks and section 7 concludes.

2 The Banking Sector: Current Situation and Main Features

After the implementation of the new monetary policy by the CBBH in 1997 and the market entry of foreign banks, the financial sector – in which the banking sector dominates – experienced a stabilization and consolidation process.

On behalf of the Council of Ministers and the Ministry of Foreign Trade and Economic Relations, the Office of the BiH Coordinator for Poverty Reduction Strategies released its mid-term development and poverty reduction strategy paper in March 2004. The strategy paper analyzes the current situation in the banking sector and concludes that the banking system has achieved the most evident progress among all the sectors in BiH. In addition, banking sector results in the FBiH have been notably better than in the RS. Listing up all the important achievements, the paper describes the privatization process of the banking system as almost fully completed and the regulatory framework as having successfully been put in place. Furthermore, it states that the number of banks has been reduced, that foreign banks are present and that interest rates are falling. It highlights that confidence in banks has strengthened, that a deposit insurance system has been established and that the level of savings has increased. Last but not least, sufficient banking supervision instruments have been developed and are continuously being improved (Council of Ministers et al., 2004, 92).

In its Information on the Banking System 2003, the Banking Agency of the Federation of Bosnia and Herzegovina reported that the first phase of reform of the BiH banking system had come to an end. Concerning the current situation, the Banking Agency described the system as being stable, transparent and profitable (Banking Agency of the Federation of Bosnia and Herzegovina, 2004, 4).

In its report on the banking sector the Chamber of Economy states, “Bosnia Herzegovina has an improving commercial banking sector. The reform in the banking sector has gone further and faster than reform in any other sector of the economy. Confidence is coming back and depositors are now prepared to put their savings in the banks rather than keep them at home in foreign cash” (Chamber of Economy of Federation of Bosnia and Herzegovina, 2004, 1).

The EBRD has developed a transition indicator for banking sector reform as an important international source of assessment. This indicator ranges from 1 to 4+, with 1 defined as little progress in financial sector reform and 4+ representing full convergence of banking laws and regulations with BIS standards and a full set of banking services. According to this indicator, BiH was rated 2+ in 2003, which is interpreted as being a typical value for this region (SEE⁴ average: 2.75) (Falcetti et al., 2004, 23).

2.1 Bank Privatization

In both legal entities of BiH, bank privatization was conducted in accordance with special laws. Thus, banks could not be privatized against certificates or vouchers, but only against cash investment that was selected via international tenders.

⁴ Southeastern Europe (SEE) as defined in the EBRD Transition report: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR of Macedonia, Moldova, Romania, Serbia and Montenegro with Kosovo.

In the Republika Srpska, the capital of 11 banks that were majority state-owned was offered for sale during the privatization period. By 2003, nine banks had been sold or merged with other banks and two had been closed. Given the poor situation in the banking sector, total realized income came to no more than BAM 7.4 million.

In the FBiH, there were separate processes for the privatization of those banks that were majority state-owned and those banks in which the FBiH held minor stakes. Most state-owned banks have been successfully privatized by now, and the remaining ones have already been offered for sale (Council of Ministers et al., 2004, 81).

However, it has to be highlighted that the consolidation process of the banking sector came mainly on the back of foreign direct investment through the acquisition of private – or already privatized – banks. Therefore, while significant foreign direct investment in the banking sector was made, state revenues from bank privatization were less than BAM 20 million by end-2003 (Council of Ministers et al., 2004, 81). In addition to the acquisition of existing banks, foreign strategic investors undertook sizeable greenfield investments in the banking sector.

2.2 Banking Capital and Ownership Structure

At the end of 2004, private banking institutions accounted for 86% of total banking capital in BiH, with the share of foreign private capital in total capital coming to 67%. Thus, the share of foreign capital in private capital was 78% (see table 4). The share of state capital in total banking capital increased somewhat in 2004 as a result of the recapitalization of the Investment Bank of the FBiH by the government of the FBiH (Centralna banka Bosne i Hercegovine, 2005c).

The total banking capital-to-GDP ratio came to 8.5% at end-2004 compared with 7.1% at end-2002, while it was 5.1% in SEE and 5.3% in the NMS-5⁵ (Falcetti et al., 2004, 23), respectively.

Table 4

Structure of Banking Capital								
	1997	1998	1999	2000	2001	2002	2003	2004
<i>End of period</i>								
Total banking capital (BAM million)	684	700	831	933	1,102
Private capital as a percentage of total capital	90	90	86
State capital as a percentage of total capital	10	10	14
Foreign private capital as a percentage of total capital	66	70	67
Banking capital as a percentage of GDP (BiH average)	6.8	6.4	7.1	7.6	8.5

Source: CBBH (2005c, data for 2004), Banking Agency of the FBiH (2004), Banking Agency of the RS (2004), OeNB calculations.

⁵ NMS-5: Czech Republic, Hungary, Slovakia, Slovenia, Poland.

2.3 Market Leadership and Concentration

At end-2004, 33 banks were operating in Bosnia and Herzegovina. Due to privatization and consolidation, this figure had gone down significantly since end-1999 (see table 5).

At end-2002, when 42 banks were operating in the country, the number of banks per 100,000 inhabitants was 1.05, which was higher than the corresponding average figure in SEE (0.45), in the NMS-8⁶ (0.30) or in the euro area (0.54) (Falcetti et al., 2004, 23).⁷

Table 5

Number of Banks Operating in Bosnia and Herzegovina

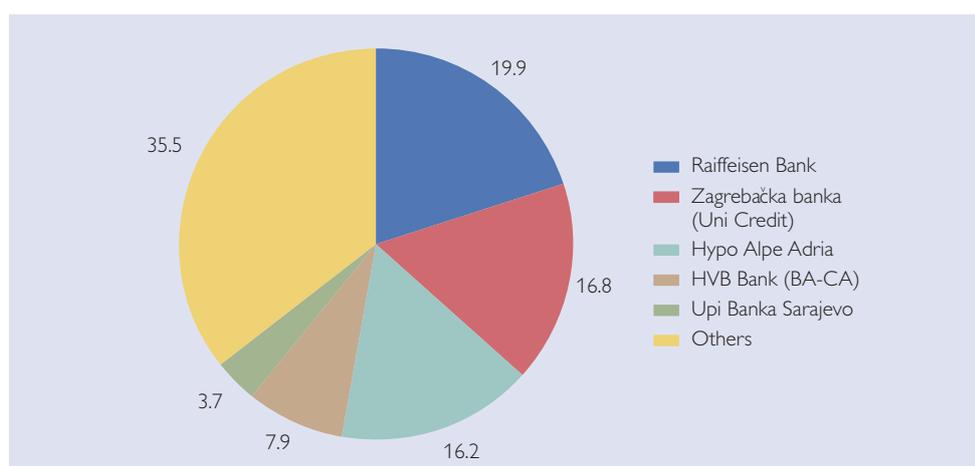
	1997	1998	1999	2000	2001	2002	2003	2004
Federation of Bosnia and Herzegovina	44	37	32	31	27	24
Republika Srpska	17	18	16	11	10	9
Bosnia and Herzegovina	61	55	48	42	37	33

Source: CBBH (2005c), Banking Agency of the FBiH (2004), Banking Agency of the RS (2004).

The five largest banks in BiH accounted for more than 64% of total banking assets at end-2003. Three of these five banks were direct subsidiaries of Austrian banks. The banking assets of the biggest bank in BiH, the Austrian Raiffeisen banka dd Bosna i Hercegovina, accounted for nearly 20% of total banking assets and the two largest banks, Raiffeisen banka dd Bosna i Hercegovina and Zagrebačka banka BH (both in foreign ownership), together accounted for about 36% of total banking assets in BiH at end-2003. These ratios point to a high degree of concentration in the banking sector (see chart 1).

Chart 1

Market Share as a Percentage of Total Assets



Source: RZB Group Research (2004).

⁶ NMS-8: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.

⁷ It should be noted, however, that this indicator is based not on the number of branches but on the number of banking institutions operating in the market.

Moreover, according to the same calculation, concentration in the banking sector in BiH was even slightly stronger than the average banking concentration in the SEE countries, where the five largest banks accounted for less than 60% of total assets at the end of 2002 (Falcetti et al., 2004, 23).

2.4 Degree of Financial Intermediation

Financial intermediation in BiH is almost entirely conducted through the banking system, while insurances and nonmonetary financial institutions play a minor role in the financial sector (Council of Ministers et al., 2004, 92). Financial intermediation – measured by the ratio of domestic claims to GDP, both for the whole economy and for the private sector, as well as by the ratio of total banking assets to GDP – decreased until 2000, but then went up significantly until the end of 2004, to a level considerably above that of end-1997 (see table 6).

The degree of financial intermediation as measured by total assets to GDP was higher in BiH than in SEE on average at end-2002 (46.5%) (Falcetti et al., 2004, 23), but lower than the NMS-10⁸ average at the end of 2003 (81.0%) (Oesterreichische Nationalbank, 2004).

Table 6

Domestic Credit and Total Banking Assets as Indicators of Financial Intermediation								
	1997	1998	1999	2000	2001	2002	2003	2004
	% of GDP							
Domestic claims on the private sector	37.7	37.1	30.5	29.7	30.2	36.2	41.3	45.3
Domestic claims	39.9	38.6	30.9	30.0	30.5	36.7	41.6	45.7
Total banking assets (BiH)	54.6	49.4	43.4	42.4	50.9	54.5	62.5	72.4

Source: CBBH (2005a), OeNB calculations.

⁸ NMS-10: NMS-8 plus Malta and Cyprus.

3 Structure of Commercial Banks' Aggregated Balance Sheets

3.1 Asset Side

3.1.1 Amount of Assets

The amount of the banking sector's total assets⁹ almost doubled in the period between end-2000 and end-2003. At the end of 2003, total banking sector assets amounted to BAM 7.8 billion and grew further to BAM 9.4 billion by end-2004. In 2003, FBiH banks accounted for 82.6% and RS banks for 17.4% of total banking assets in BiH.

Total domestic claims¹⁰ made up 63.1% of total banking assets at the end of 2004. In 2001, the share of domestic claims in total banking assets declined sharply, although domestic claims continued to grow strongly in real terms. This development resulted from the jump in the total reserves and foreign assets positions in 2001, which, in turn, was mainly attributable to an increase in the volume of domestic deposits, in particular foreign currency-denominated deposits. The larger volume of domestic funding did not immediately lead to increased lending activity. Rather, in a first instance, these funds were partly redeposited abroad and partly held as additional liquid assets. However, in 2002, the high level of liquidity provided the basis for an expansion of domestic lending, which implied a corrective change in the shares of the three components of banking assets. From end-2002 to end-2004, all three components of banking assets increased significantly, implying rising ratios to GDP. However, the growth of reserves outpaced that of domestic claims and foreign assets, implying declining shares of those two components in total banking assets. At the end of 2004, the relatively high share of reserves, coupled with a credit-to-deposit ratio of 106%, indicated a favorable liquidity situation of the banking sector.

In addition to higher funding volumes, the improving financial solvency and liquidity of debtors may be considered a supporting factor that drove the strong growth of domestic claims, as it improved the opportunities to place the additional funds (see table 7).

⁹ In this paper the banking sector is defined as "other monetary financial institutions" (i.e. excluding the central bank). Total banking sector assets also comprise claims of the banking sector (i.e. excluding the central bank) on the central bank. In principle, total banking sector liabilities also comprise – inter alia – liabilities of the banking sector (i.e. excluding the central bank) to the central bank. However, as a result of the currency board arrangement, the central bank does not perform any refinancing function for the banking sector. It should be noted that domestic interbank claims/liabilities are included neither on the asset side nor on the liability side.

¹⁰ Please note that in this paper domestic claims do not include domestic claims on other monetary financial institutions (including the central bank).

Table 7

Structure of Banking Assets in Bosnia and Herzegovina

	1997	1998	1999	2000	2001	2002	2003	2004
<i>End of period</i>								
Banking assets (BAM million)								
Domestic claims	2,440	2,921	2,781	3,017	3,339	4,281	5,122	5,927
Foreign assets	659	605	848	961	1,364	1,469	1,562	1,906
Reserves	240	208	275	287	872	595	1,005	1,567
Total banking assets (on balance)	3,337	3,733	3,904	4,265	5,575	6,345	7,688	9,400
Structure as a percentage of total banking assets (on balance)								
Domestic claims	73.1	78.2	71.2	70.7	59.9	67.5	66.6	63.1
Foreign assets	19.7	16.2	21.7	22.5	24.5	23.2	20.3	20.3
Reserves	7.2	5.6	7.0	6.7	15.6	9.4	13.1	16.7
Total banking assets (on balance)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CBBH (2005a), OeNB calculations.

Note: Domestic claims do not include domestic claims on other monetary financial institutions (including the central bank).

3.1.2 Structure of Claims against Domestic Sectors

Total domestic claims are dominated by two components – claims on households (and others) and claims on nonfinancial corporations – while claims on the general government play a negligible role. Claims on households have continuously gained in weight since end-1997, while the share of claims on nonfinancial corporations in total domestic claims has fallen considerably. However, at end-2004, nonfinancial corporations were still the most important group of debtors to the banking sector. Within the claims on nonfinancial corporations, the share of claims on private companies has risen significantly since the end of 2000. It is unclear whether this uptrend resulted exclusively from the regrouping of companies as a result of privatization (see table 8).

The lack of appropriate insolvency regulations and well-functioning real estate markets that enable banks to provide collateral-backed credits may help explain the low expansion of credit to nonfinancial corporations (Pöschl, 2005, 91).

In BiH, domestic claims of the banking sector nearly exclusively consist of domestic credits (loans), while other claims like securities and repurchase agreements still play a negligible role.

Table 8

Structure of Domestic Claims

	1997	1998	1999	2000	2001	2002	2003	2004
<i>BAM million</i>								
Domestic claims								
Domestic claims on the general government	134	113	37	34	33	61	46	46
Domestic claims on nonmonetary financial institutions	8	5	6	11	20	28	40	60
Domestic claims on households and others	164	388	285	424	713	1,496	2,009	2,651
Domestic claims on nonfinancial corporations	2,134	2,414	2,453	2,548	2,574	2,697	3,026	3,170
<i>of which: domestic claims on public nonfinancial corporations</i>	<i>1,099</i>	<i>1,100</i>	<i>1,003</i>	<i>1,673</i>	<i>1,431</i>	<i>1,255</i>	<i>1,167</i>	<i>692</i>
<i>domestic claims on private nonfinancial corporations</i>	<i>1,035</i>	<i>1,314</i>	<i>1,449</i>	<i>875</i>	<i>1,143</i>	<i>1,442</i>	<i>1,860</i>	<i>2,478</i>
Total domestic claims	2,440	2,921	2,781	3,017	3,339	4,281	5,122	5,927
<i>As a percentage of total domestic claims</i>								
Structure								
Domestic claims on the general government	5.5	3.9	1.3	1.1	1.0	1.4	0.9	0.8
Domestic claims on nonmonetary financial institutions	0.3	0.2	0.2	0.4	0.6	0.6	0.8	1.0
Domestic claims on households and others	6.7	13.3	10.3	14.1	21.3	34.9	39.2	44.7
Domestic claims on nonfinancial corporations	87.5	82.7	88.2	84.5	77.1	63.0	59.1	53.5
<i>of which: domestic claims on public nonfinancial corporations</i>	<i>45.0</i>	<i>37.7</i>	<i>36.1</i>	<i>55.5</i>	<i>42.9</i>	<i>29.3</i>	<i>22.8</i>	<i>11.7</i>
<i>domestic claims on private nonfinancial corporations</i>	<i>42.4</i>	<i>45.0</i>	<i>52.1</i>	<i>29.0</i>	<i>34.2</i>	<i>33.7</i>	<i>36.3</i>	<i>41.8</i>
Total domestic claims	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Domestic claims as a percentage of total banking assets	73.1	78.2	71.2	70.7	59.9	67.5	66.6	63.1
Domestic claims as a percentage of GDP	39.9	38.6	30.9	30.0	30.5	36.7	41.6	45.7

Source: CBBH (2005a), OeNB calculations.

Note: Domestic claims do not include domestic claims on other monetary financial institutions (including the central bank).

3.1.3 Asset Quality

From end-2001 to end-2004, the share of classified assets, i.e. the sum of watch assets and nonperforming assets, in total assets under classification went down, primarily owing to the decreasing share of nonperforming assets. The share of watch assets, by contrast, declined only marginally. Within nonperforming assets, the shares of all three subcomponents (substandard, doubtful and loss assets) decreased.

At end-2004, the share of nonperforming assets in total assets under classification amounted to 3.5%, compared with 8.7% at the end of 2001.

Although the ratio of reserves and provisions to total assets under classification declined from 2001 to 2004, the ratio of reserves and provisions to nonperforming loans climbed to 96.1% at the end of 2004 from 62.0% at end-2001 (see table 9).

All these trends indicate that asset quality improved in the three years from end-2001 to end-2004 despite the strong increase in total domestic claims in this period and the resulting deepening of financial intermediation as measured by the ratio of total domestic claims to GDP. However, the sharply rising share of household credit in total domestic credit could lead to a weakening of asset quality in the future.

Table 9

Asset Quality in Bosnia and Herzegovina								
	1997	1998	1999	2000	2001	2002	2003	2004
<i>End of period, BAM million</i>								
Asset positions and reserves and provisions								
Total assets under classification (on and off balance)	4,987	6,341	7,743	10,234
Standard assets	4,115	5,401	6,737	9,004
Watch assets	438	555	631	871
Nonperforming assets	434	385	376	359
of which: substandard assets	206	190	188	165
doubtful assets	218	183	180	188
loss assets	10	12	8	5
Classified assets	872	940	1,007	1,229
Reserves and provisions	269	289	299	345
<i>End of period, % (unless otherwise indicated)</i>								
Share in total assets under classification								
Total assets under classification (on and off balance)	100.0	100.0	100.0	100.0
Standard assets	82.5	85.2	87.0	88.0
Watch assets	8.8	8.8	8.1	8.5
Nonperforming assets	8.7	6.1	4.9	3.5
of which: substandard assets	4.1	3.0	2.4	1.6
doubtful assets	4.4	2.9	2.3	1.8
loss assets	0.2	0.2	0.1	0.0
Classified assets	17.5	14.8	13.0	12.0
Reserves and provisions	5.4	4.6	3.9	3.4
Reserves and provisions as a percentage of nonperforming assets	62.0	75.1	79.4	96.1
Reserves and provisions as a percentage of doubtful and loss assets	118.0	148.2	158.5	178.2

Source: CBBH (2003), CBBH (2004), OeNB calculations.

3.2 Liability Side

3.2.1 Amount of Liabilities

Foreign liabilities were the main component of total liabilities in 1997. However, their share in total liabilities declined continuously until the end of 2000. In 2001, it fell markedly as a result of the sharp increase in domestic (foreign currency-denominated) deposits. Thereafter, it increased moderately, but dropped again in 2004 and remained far below the level registered in 2000.

The share of total domestic deposits in total banking liabilities increased moderately from 41% in 1997 to 46% in 2000. In 2001, it jumped to 59%, which is mainly attributable to the depositing of constituent currencies of the euro in the run-up to the cash changeover at the end of 2001.¹¹ Importantly, the share of domestic deposits in total liabilities remained relatively stable from then on until the end of 2004. The fact that a substantial part of the foreign currency deposits that were converted into euro continued to be kept with banks may be seen as a signal of increased confidence in the banking sector.

The share of capital and reserves showed a downtrend up to the end of 2004 (see table 10). Debt securities issued by banks and restricted deposits were unimportant components of banks' liabilities.

¹¹ See Reininger and Walko (2005) for a similar finding on the development of the Croatian banking sector.

Table 10

Structure of Banking Liabilities in Bosnia and Herzegovina

	1997	1998	1999	2000	2001	2002	2003	2004
<i>End of period, BAM million</i>								
Banking liabilities								
Domestic deposits	1,194	1,482	1,820	1,954	3,271	3,724	4,366	5,578
Foreign liabilities	1,514	1,606	1,519	1,577	1,527	1,794	2,437	2,651
Capital and reserves	1,043	1,311	1,257	1,096	1,119	1,214	1,305	1,472
Other liabilities	-414	-666	-692	-362	-341	-386	-420	-302
Total banking liabilities (on balance)	3,337	3,733	3,904	4,265	5,575	6,345	7,688	9,400
<i>End of period, %</i>								
Percentage structure of total banking liabilities (on balance)								
Domestic deposits	35.8	39.7	46.6	45.8	58.7	58.7	56.8	59.3
Foreign liabilities	45.4	43.0	38.9	37.0	27.4	28.3	31.7	28.2
Capital reserves	31.3	35.1	32.2	25.7	20.1	19.1	17.0	15.7
Other liabilities	-12.4	-17.8	-17.7	-8.5	-6.1	-6.1	-5.5	-3.2
Total banking liabilities (on balance)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CBBH (2005a), OeNB calculations.

3.2.2 Structure of Domestic Deposits

The share of nonfinancial corporations' deposits in total domestic deposits declined from 48.5% at end-1999 to 33.1% at the end of 2001, while the share of household deposits in total domestic deposits surpassed this figure, increasing from end-1997 until end-2001. At that point in time, household deposits began to dominate the structure of domestic deposits, making up 48.6% of total deposits. From end-2001 to end-2004, the relative importance of corporate deposits and household deposits did not change significantly. The share of general government deposits has remained rather stable at about 15% since the end of 1999 (see table 11).

Table 11

Structure of Domestic Deposits

	1997	1998	1999	2000	2001	2002	2003	2004
<i>BAM million</i>								
Domestic deposits								
Deposits by the general government	394	330	274	278	506	619	784	876
Deposits by nonmonetary financial institutions	29	37	63	65	92	160	189	213
Deposits by households and others	364	544	599	752	1,589	1,761	2,063	2,654
Deposits by nonfinancial corporations	596	751	884	858	1,084	1,183	1,331	1,836
<i>of which: domestic deposits by public nonfinancial corporations</i>	245	274	329	377	393	456	629	843
<i>domestic deposits by private nonfinancial corporations</i>	350	477	554	481	691	727	702	993
Total domestic deposits	1,382	1,662	1,820	1,954	3,271	3,724	4,366	5,579
<i>End of period, %</i>								
Percentage structure of total domestic deposits								
Deposits by the general government	28.5	19.9	15.1	14.2	15.5	16.6	18.0	15.7
Deposits by nonmonetary financial institutions	2.1	2.2	3.5	3.3	2.8	4.3	4.3	3.8
Deposits by households and others	26.3	32.7	32.9	38.5	48.6	47.3	47.2	47.6
Deposits by nonfinancial corporations	43.1	45.2	48.5	43.9	33.1	31.8	30.5	32.9
<i>of which: domestic deposits by public nonfinancial corporations</i>	17.8	16.5	18.1	19.3	12.0	12.2	14.4	15.1
<i>domestic deposits by private nonfinancial corporations</i>	25.3	28.7	30.5	24.6	21.1	19.5	16.1	17.8
Total domestic deposits	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CBBH (2005a), OeNB calculations.

Note: At end-1997 and end-1998, the absolute sum of domestic deposits disaggregated by sectors, as shown in this table, was not fully consistent with the sum total of domestic deposits according to the analytical accounts of the banking sector, which is given in the previous table.

3.3 Net Positions of the Banking Sector

Within the net position the banking sector holds against domestic sectors (defined as domestic claims less domestic deposits), the net position against the general government and that against households have continuously been negative since 1997. The negative net position against the general government (relative to total liabilities) has been rather stable since the end of 2001. By contrast, the negative net position against households increased significantly up to end-2001 (as a result of strong deposit growth), but had nearly vanished by the end of 2004. The latter development reflects the very dynamic growth of lending to households, which exceeded further deposit growth.

The net position against nonfinancial corporations remained positive throughout the period from 1997 to 2004. However, relative to total assets, the net position against nonfinancial corporations significantly decreased in this period, as new bank lending to nonfinancial corporations was roughly covered by new deposits of this sector. In particular, the relatively stable share in total domestic deposits and the further declining share in total domestic claims since the end of 2001 caused the net position to further decrease relative to total assets.

The overall net position of the banking sector against all domestic sectors has been positive since 1997. However, a sharp drop occurred in 2001, when the net position against households became most negative within the period between 1997 and 2004 as euro constituent currencies were deposited with banks in the run-up to the cash changeover at the end of 2001, as mentioned above. These developments created the basis for strong lending growth. The ensuing higher lending activity was directed in particular at households, with household lending growth far outpacing further household deposit growth and thus requiring additional funding. From end-2002 to end-2004, the intensifying domestic lending activity was funded by larger government deposits and higher foreign liabilities. In 2004, this development was complemented by the fact that corporate deposit growth outpaced the growth of corporate borrowing. Thus, the negative net position against households improved, coming close to zero by end-2004.

The net foreign asset position of the banking sector has been negative since 1997. As a result of the upward jump in deposits and the ensuing redepositing abroad of (foreign currency-denominated) deposits, the net foreign asset position showed the least negative value by far of the entire observation period at the end of 2001. After that, however, it widened substantially in absolute terms until end-2003, as this position served to finance the further expansion of domestic credit, in particular to households.

Relative to total liabilities, the decline in the negative net position against households from end-2001 to end-2004 was facilitated by the decline in the positive net position against nonfinancial corporations, which helped contain the increase in the ratio of net foreign liabilities to total liabilities so that this ratio did not reach or surpass the levels of the period from 1997 to 2000 (see table 12).

Table 12

Net Positions against Domestic Sectors and Nonresidents

	1997	1998	1999	2000	2001	2002	2003	2004
	<i>BAM million</i>							
Net positions								
Net position against the general government	-261	-217	-237	-244	-473	-559	-738	-830
Net position against nonmonetary financial institutions	-20	-32	-57	-54	-72	-132	-149	-152
Net position against households and others	-200	-156	-313	-328	-876	-266	-53	-3
Net position against nonfinancial corporations	1,538	1,663	1,569	1,690	1,490	1,513	1,696	1,334
<i>of which: net position against public nonfinancial corporations</i>	854	826	674	1,296	1,037	799	538	-151
<i>net position against private nonfinancial corporations</i>	685	837	895	394	452	715	1,158	1,485
Total net position against domestic sectors excluding MFIs	1,077	1,290	1,018	1,118	140	689	904	501
Net foreign assets	-855	-1,001	-671	-616	-163	-325	-875	-745
	%							
Net positions (as a percentage of total assets/liabilities)								
Net position against the general government	-7.8	-5.8	-6.1	-5.7	-8.5	-8.8	-9.6	-8.8
Net position against nonmonetary financial institutions	-0.6	-0.9	-1.5	-1.3	-1.3	-2.1	-1.9	-1.6
Net position against households and others	-6.0	-4.2	-8.0	-7.7	-15.7	-4.2	-0.7	0.0
Net position against nonfinancial corporations	46.1	44.6	40.2	39.6	26.7	23.9	22.1	14.2
<i>of which: net position against public nonfinancial corporations</i>	25.6	22.1	17.3	30.4	18.6	12.6	7.0	-1.6
<i>net position against private nonfinancial corporations</i>	20.5	22.4	22.9	9.2	8.1	11.3	15.1	15.8
Net position against domestic sectors excluding MFIs	32.3	34.6	26.1	26.2	2.5	10.9	11.8	5.3
Net foreign assets	-25.6	-26.8	-17.2	-14.4	-2.9	-5.1	-11.4	-7.9

Source: CBBH (2005a), OeNB calculations.

4 The Role of Foreign Exchange

The share of foreign currency-denominated credit (including foreign currency-indexed loans denominated in domestic currency) in total domestic credit went down spectacularly from end-1999 (80.3%) to end-2003 (28.2%). At the end of 2004, the share of foreign currency-denominated credit excluding foreign currency-indexed loans amounted to 15.4%.

The development of the share of foreign currency-denominated credit in total banking assets between 1997 and 2004 mirrored that of the share of foreign exchange credit in total domestic credit.

As the share of foreign assets did not change to a similar degree, total foreign assets and domestic foreign currency credit held a decreasing share in total assets from end-1999 to end-2004 (see table 13).

Table 13

Foreign Currency-Denominated Positions and Ratios on the Asset Side

	1997	1998	1999	2000	2001	2002	2003	2004
<i>BAM million</i>								
Total domestic credit	2,440	2,921	2,781	3,017	3,339	4,281	5,122	5,927
Domestic local currency credit	197	207	549	993	1,612	2,775	3,685	5,015
Domestic foreign currency credit	1,636	1,756	2,232	2,024	1,727	1,506	1,436	912
<i>Domestic foreign currency credit as a percentage of total domestic credit</i>	67.1	60.1	80.3	67.1	51.7	35.2	28.2	15.4
Difference (RS data that is not broken down by currency)	607	958	0	0	0	0	0	0
Foreign assets	659	605	848	961	1,364	1,469	1,562	1,906
Sum of foreign assets and domestic foreign currency credit	2,295	2,361	3,080	2,985	3,091	2,975	2,998	2,819
<i>As a percentage of total banking assets</i>								
Domestic foreign currency credit	49.0	47.0	57.2	47.4	31.0	23.7	18.7	9.7
Foreign assets	19.7	16.2	21.7	22.5	24.5	23.2	20.3	20.3
Sum of foreign assets and domestic foreign currency credit	68.8	63.3	78.9	70.0	55.4	46.9	39.0	30.0

Source: CBBH (2005a), OeNB calculations.

Note: BAM-denominated credits which include a currency clause (tied to the euro) are not available separately. Previously, banks reported these foreign currency-indexed loans as part of foreign currency-denominated credit. As from September 2004, these loans are reported as part of credits denominated in local currency (CBBH, 2005d).

On the liability side, the share of foreign currency-denominated deposits in total domestic deposits decreased from end-1997 to end-2000.¹² In 2001, this trend was interrupted as euro constituent currencies were deposited with banks in the run-up to the cash changeover at end-2001. However, the previous trend continued after 2001. The share of domestic foreign currency-denominated deposits in total banking liabilities showed a similar pattern.

The decreasing share of domestic foreign currency liabilities in total liabilities probably indicates growing confidence in the national currency, which, in turn, most likely reflects the growing credibility of the commitment to the currency board arrangement and thus also achievements in settling inflation expectations.

Although the share of foreign liabilities increased from end-2001 to end-2003 (after having fallen between 1997 and 2001), the share of the sum of foreign liabilities and domestic foreign currency deposits in total liabilities declined continuously until the end of 2004. However, the resulting decline was considerably less pronounced than that of the foreign currency-denominated position on the asset side (see table 14).

¹¹ See Reiningger and Walko (2005) for a similar finding on the development of the Croatian banking sector.

Table 14

Foreign Currency-Denominated Positions and Ratios on the Liability Side

	1997	1998	1999	2000	2001	2002	2003	2004
<i>BAM million</i>								
Total domestic deposits	1,382	1,662	1,820	1,954	3,271	3,724	4,366	5,578
Domestic local currency deposits	189	194	659	904	1,264	1,759	2,274	2,897
Domestic foreign currency deposits	1,028	1,062	1,161	1,050	2,006	1,966	2,092	2,681
<i>Domestic foreign currency deposits as a percentage of total domestic deposits</i>	74.4	63.9	63.8	53.7	61.3	52.8	47.9	48.1
Difference (RS data that is not broken down by currency)	165	406	0	0	0	0	0	0
Foreign liabilities	1,514	1,606	1,519	1,577	1,527	1,794	2,437	2,651
Sum of foreign liabilities and domestic foreign currency deposits	2,542	2,668	2,681	2,627	3,533	3,759	4,529	5,332
<i>% of total banking liabilities</i>								
Domestic foreign currency deposits	30.8	28.4	29.7	24.6	36.0	31.0	27.2	28.5
Foreign liabilities	45.4	43.0	38.9	37.0	27.4	28.3	31.7	28.2
Sum of foreign liabilities and domestic foreign currency deposits	76.2	71.5	68.7	61.6	63.4	59.2	58.9	56.7

Source: CBBH (2005a), OeNB calculations.

Note: BAM-denominated deposits which include a currency clause (tied to the euro) are not available separately. However, their amount is estimated to be negligible (CBBH 2005d).

The net domestic foreign currency position (representing the difference of domestic foreign currency credit and domestic foreign currency deposits), which had been positive between end-1997 and end-2000, became negative by the end of 2001 due to the above-mentioned jump in deposits. Moreover, it deteriorated further until end-2003, as the share of domestic foreign currency deposits in total liabilities declined by less than that of domestic foreign currency credit in total assets. The further deterioration in 2004 resulted, at least partly, from the shifting of foreign currency-indexed loans to loans denominated in domestic currency.

Net foreign assets were always negative between the end of 1997 and 2004. The sharp decrease in the ratio of net foreign liabilities to total banking liabilities in 2001 resulted from the combined effect of the jump in foreign currency domestic deposits on the liability side (which reduced the share of foreign liabilities) and the redepositing of these additional funds on the asset side (which drove up the share of foreign assets). From end-2001 to end-2003, the net foreign liabilities position widened again.

The parallel widening of the negative net domestic foreign currency position and the negative net foreign asset position led to a significantly negative total net foreign currency position of -26.7% of total assets on balance at the end of 2004 (see table 15).

Table 15

Net Foreign Currency-Denominated Positions								
	1997	1998	1999	2000	2001	2002	2003	2004
<i>BAM million</i>								
Net domestic foreign currency position	608	694	1,071	974	-279	-460	-656	-1,769
Net foreign assets	-855	-1,001	-671	-616	-163	-325	-875	-745
Sum of net domestic foreign currency position and net foreign assets	-247	-306	400	358	-442	-784	-1,531	-2,514
<i>% of total banking assets/liabilities</i>								
Net domestic foreign currency position	18.2	18.6	27.4	22.8	-5.0	-7.2	-8.5	-18.8
Net foreign assets	-25.6	-26.8	-17.2	-14.4	-2.9	-5.1	-11.4	-7.9
Sum of net domestic foreign currency position and net foreign assets	-7.4	-8.2	10.2	8.4	-7.9	-12.4	-19.9	-26.7

Source: CBBH (2005a), OeNB calculations.

5 Profitability and Capital Adequacy

It was not until 2003 that the banking sector in BiH registered positive profitability ratios. In 2004, return on equity (ROE) amounted to 6.5% in nominal terms and – given the low inflation rate – 6.1% in real terms (see table 18).

Net interest income (as a percentage of average total assets) declined in the period from 2001 to 2004 as a result of the narrowing overall interest rate margin (see table 16), which, in turn, may be partly related to the liquidity injection from increased funding by domestic deposits. However, at the same time, the share of net interest income in total operating income increased from 40% in 2001 to 50% in 2004 (see table 18).

Table 16

Interest Rates								
	1997	1998	1999	2000	2001	2002	2003	2004
<i>Annual average, %</i>								
Average interest rate on loans (new contracts)	30.5	16.6	12.7	10.9	10.3
Average interest rate on deposits (new contracts)	14.7	6.1	4.5	4.0	3.7
Average overall interest rate margin (new contracts)	15.8	10.5	8.2	6.9	6.6

Source: CBBH (2004, 2005b), OeNB calculations.

Thus, the ratio of noninterest income to average total assets deteriorated even more markedly, resulting in a lower ratio of operating income to average total assets (see table 18). According to the CBBH, the main sources of non-interest revenues were service fees, followed by foreign exchange income.

However, the ratio of operating costs to average total assets declined in tandem. Thereby, the cost-to-income ratio fell slightly, indicating increasing efficiency on the cost side (see table 18). At the same time, the total number of employees in the banking sector went up. As annual employment growth in employment was weaker than total asset growth, one may assume that staff efficiency improved (see table 17). The rise in both nominal and real operating profits per employee from 2001 to 2004 also supports this assumption.

Table 17

Number of Persons Employed in the Banking Sector

	1997	1998	1999	2000	2001	2002	2003	2004
<i>End of period</i>								
Federation of Bosnia and Herzegovina	4,289	4,610	5,101	5,394	5,686
Republika Srpska	2,697	2,705	2,418	2,229	2,153
Bosnia and Herzegovina	6,986	7,315	7,519	7,623	7,839
Annual change in employment (% BiH)	3.0	4.7	2.8	1.4	2.8
Annual change in banking assets (% BiH)	..	11.9	4.6	9.2	30.7	13.8	21.2	22.3
Annual change in operating profits (% BiH)	3.5	20.3	8.5	7.9

Source: Banking Agency of the FBiH (2004, 2005), Banking Agency of the RS (2004, 2005), OeNB calculations.

Despite the decrease in operating profits (as a percentage of total assets) registered from 2001 to 2004, a continuous improvement of the pretax result could be achieved, as the costs of loan loss provisioning fell significantly over the same period. In addition, the decline in the tax burden further enhanced after-tax profitability (see table 18).

Table 18

Profitability and Structure of Income and Costs

	1997	1998	1999	2000	2001	2002	2003	2004
<i>BAM 1,000</i>								
Total assets, average ¹⁾	3,808,884	4,975,909	6,230,403	8,153,384
Equity, average	692,440	759,896	857,432	1,001,637
Operating income	460,122	483,342	581,329	625,399	660,772
Operating income as a percentage of total assets, average	12.7	11.7	10.0	8.1
Net interest income	184,892	192,734	230,301	282,785	327,751
Net interest income as a percentage of total assets, average	5.1	4.6	4.5	4.0
Net interest income as a percentage of operating income	40.2	39.9	39.6	45.2	49.6
Noninterest income	275,230	290,608	351,028	342,614	333,021
Noninterest income as a percentage of total assets, average	7.6	7.1	5.5	4.1
Noninterest income as a percentage of operating income	59.8	60.1	60.4	54.8	50.4
Operating costs	299,459	317,058	381,319	408,361	426,642
Operating costs as a percentage of total assets, average	8.3	7.7	6.6	5.2
Cost-to-income ratio	65.1	65.6	65.6	65.3	64.6
Operating profit	160,663	166,284	200,010	217,038	234,130
Operating profit as a percentage of total assets, average	4.4	4.0	3.5	2.9
Net costs of loan loss provisioning	210,713	198,835	211,062	186,845	167,730
Net costs of loan loss provisioning as a percentage of total assets, average	5.2	4.2	3.0	2.1
Pretax profit	-50,050	-32,551	-11,052	30,193	66,400
Tax	3,248	4,045	2,752	2,923	1,100
Net aftertax profit	-53,298	-36,596	-13,804	27,270	65,300
Tax burden as a percentage of pretax profit	-6.5	-12.4	-24.9	9.7	1.7
ROA, %	-1.0	-0.3	0.4	0.8
ROA deflated by CPI (year-on-year average)	-3.9	-0.7	-0.2	0.4
ROE, %	-5.3	-1.8	3.2	6.5
ROE deflated by CPI (year-on-year average)	-8.1	-2.2	2.6	6.1

Source: Banking agency of the FBiH (2004, 2005), Banking Agency of the RS (2004, 2005), OeNB calculations.

Note: Figures for the entire banking sector of BiH derived by own calculation from the figures published separately for the FBiH and the RS. As available information is limited, it was not possible to consolidate the figures for the two separate entities; therefore, the figures in this table are merely aggregated.

¹⁾ Total banking assets excluding off-balance sheet items and after deduction of loan loss provisions and reserves on assets.

The coefficient of capital adequacy (representing the relation between the capital base and risk-weighted assets) of the BiH banking sector fell from 28.4% at end-2000 to 18.6% at end-2004.

From 2001 to 2004, the year-on-year growth of the total risk component outpaced that of the net capital base. Thus, not a decrease of capital, but strong asset growth and the subsequently higher total risk component led to a lower, albeit still not low, capital adequacy ratio (see table 19).

Table 19

Capital Adequacy								
	1997	1998	1999	2000	2001	2002	2003	2004
Net capital base (BAM million)	687	731	884	1,051	1,242
Total risk component (BAM million)	2,422	2,911	4,312	5,177	6,665
Net capital base (year on year)	6.4	20.9	18.8	18.3
Total risk component (year on year)	20.2	48.1	20.1	28.8
Capital adequacy ratio	28.4	25.1	20.5	20.3	18.6

Source: Banking Agency of the FBiH (2004, 2005), Banking Agency of the RS (2004, 2005), OeNB calculations.

6 Conclusions

The banking sector in Bosnia and Herzegovina operates in a stable macroeconomic environment, with inflation below 1% (on the back of a currency board arrangement) and real GDP growth coming to around 5% on average in recent years. However, the current account deficit widened sharply until 2003 and remained at a very high level in 2004.

The market entry of foreign banks, which currently control more than two-thirds of total banking capital, supported the reform process in the banking sector and helped deepen financial intermediation. In recent years, the number of banks has considerably declined. By the end of 2003, the banking sector was already rather concentrated, with the five largest banks controlling 64% of total banking assets. Three out of the five largest banks in BiH were owned by Austrian banks and together held a market share of more than 45%. The degree of financial intermediation as measured by the ratio of total banking assets to GDP is higher than the average degree in SEE, but lower than that in the NMS.

In 2001, financial intermediation received an important boost by the euro cash changeover, as this led to an upward jump in households' foreign currency deposits with the banking sector. A substantial part of those foreign currency deposits that were converted into euro continued to be kept with the banks in the following years. This phenomenon reflected a higher confidence in the banking sector and provided the basis for strong lending growth, in particular of lending to households. In parallel, confidence in the national currency increased as well, as can be seen from the fact that the share of domestic foreign currency-denominated liabilities in total liabilities declined continuously (with the exception being the year 2001, given the impact of the euro cash changeover). From end-2001 to end-2004, household lending growth outpaced further household deposit growth by far. The resulting decline in the negative net position against households relative to total liabilities was facilitated by the

drop in the positive net position against nonfinancial corporations, which helped contain the rise in the ratio of net foreign liabilities to total liabilities. Still, combined with the fact that the share of foreign currency deposits in total domestic deposits declined at a slower pace than the share of foreign currency credits in total domestic credit, the total on-balance net foreign currency position turned from being positive at end-2000 (8.4% of total assets/liabilities) to being significantly negative at end-2004 (26.7% of total assets/liabilities).

It is worth noting that asset quality improved significantly from end-2001 to end-2004 despite the strong increase in total domestic claims. However, the clearly higher share of household credit to total domestic credit could weaken future asset quality. Despite having deteriorated in recent years, the capital adequacy ratio stood at close to 20% at the end of 2004.

The visible progress in banking sector consolidation in general and the improvement in asset quality in particular made the banking sector more efficient and profitable. The smaller volume of loan loss provisioning due to the improved asset quality decisively supported the 2003 turnaround in banking sector profitability.

The main challenges for the banking sector in Bosnia and Herzegovina are first, to step up (longer-term) lending to nonfinancial corporations; second, to keep its overall net foreign currency position under control during the domestic household lending boom; third, to closely monitor the development of asset quality; and fourth, to further improve its operational efficiency as measured for instance by the cost-to-income ratio.

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The Implementation of the Basel Core Principles in Selected Countries from the Perspective of the International Monetary Fund

This study examines the implementation of the Basel Core Principles (BCPs) based on the Financial System Stability Assessments (FSSAs) carried out by the International Monetary Fund (IMF) in Bulgaria, the Czech Republic, Germany, Croatia, Hungary, Austria, Poland, Romania, Russia, Slovenia, Slovakia and Ukraine. From the perspective of Austria's financial sector, these countries are of particular interest owing to Austrian banks' investment focus on Central and Eastern European countries (CEECs). The 25 Core Principles, which were developed by the Basel Committee on Banking Supervision in 1997, in collaboration with international bank supervisors, the IMF and the World Bank, represent minimum requirements for good banking governance and an efficient supervisory system. The seven supervisory areas examined, to which the BCPs relate, are: preconditions for effective banking supervision, licensing and structure of banks, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking. By comparing BCP implementation in the relevant countries, the strengths and weaknesses of financial regulation and banking supervision can be identified and a need for action to strengthen the supervisory regime can be inferred.

Ingrid Ettl,
Alexandra Schober-
Rhombert¹

1 Introduction

Apart from other economic effects, globalization has led to the integration of financial markets, making it possible for crises to spread more quickly and further afield. In the communiqué issued at the Lyon G7 Summit in 1996, the global risks arising from the complex financial sector were highlighted under the heading “Better prudential safeguards in international financial markets” (G7, 1996).

In many cases, weak banking systems lay at the core of these financial crises (Fischer, 1999). One countermeasure is to strengthen both central banking and financial systems. This is why effective and internationally standardized prudential regulations and norms are considered necessary for banks.

2 The Basel Core Principles

In September 1997, the Basel Committee on Banking Supervision (Basel Committee)², in collaboration with international banking supervisory authorities³, prepared a comprehensive set of “core principles for effective banking supervision” (Basel Committee on Banking Supervision, 1997). The International Monetary Fund (IMF) and the World Bank were also involved in developing the Basel Core Principles (BCPs) with the aim of applying them within the framework of their surveillance mandate. In formulating the BCPs, care was taken to ensure that they are applicable not only to industrialized countries but also to transitional and developing countries.

The 25 BCPs are minimum requirements for good banking governance and an efficient supervisory system. They were adopted by the international community at the IMF's annual meeting in October 1997. Although BCP implemen-

¹ Oesterreichische Nationalbank (OeNB), European Affairs and International Financial Organizations Division, ingrid.ettl@oenb.at, alexandra.schober-rhombert@oenb.at. Translation from German. The authors gratefully acknowledge language advice by Jennifer Gredler. The standard disclaimer applies.

² The Basel Committee, which is based at the Bank for International Settlements (BIS), was established by the G-10 in 1974. It comprises the following members: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The countries are represented by their respective banking supervisory authorities (central bank or other authority).

³ In addition to the Basel Committee member countries, the following countries were directly involved in developing BCPs: Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. Furthermore, Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore were also associated.

tation is voluntary, international pressure to comply is significant given the integration of financial markets. Since BCPs are defined as minimum standards, it is a matter for individual countries to stipulate individually tailored requirements – in addition to the BCPs – for the purpose of covering specific risks and to incorporate sufficient flexibility into their legislative framework in order to satisfy ever-changing market conditions.

The Basel Core Principles are summarized in table 1.

Table 1

Basel Core Principles	
BCP 1	Preconditions of effective banking supervision
BCPs 2–5	Licensing and structure
BCPs 6–15	Prudential regulations and requirements
BCPs 16–20	Methods of ongoing banking supervision
BCP 21	Information requirements
BCP 22	Formal powers of supervisors
BCPs 23–25	Cross-border banking

Source: Basel Committee.

The definition of the BCPs includes the following principles (Basel Committee on Banking Supervision, 1997):

1. The key objective of banking supervision is to maintain stability and confidence in the financial system, thereby minimizing the risk of loss to depositors and other creditors.
2. Bank supervisors should support market discipline and enhance market transparency by highlighting and promoting sound corporate governance structures.
3. In order to carry out its tasks effectively, a supervisory authority must have operational independence, the means and powers to gather information both on and off site, and the authority to enforce its decisions.
4. Supervisory authorities must understand the nature of the business undertaken by banks and ensure to the extent possible that the risks incurred by banks are being adequately managed. Banking supervision cannot, and should not, provide an assurance that banks will not fail.
5. Effective banking supervision requires that the risk profile of individual banks be analyzed and supervisory resources allocated accordingly.
6. Supervisors must ensure that banks have appropriate resources to undertake risks, including adequate capital, sound management, and accounting records in compliance with international standards.
7. Close cooperation and the exchange of information with international supervisory agencies are essential.

3 The Application of BCPs by the IMF

The role of international financial institutions such as the IMF is, inter alia, to provide support to member countries and to strengthen their economic and financial systems. Owing to their integration of economic and financial policies and to their surveillance expertise, the IMF and the World Bank are actively involved in the implementation process, as the Basel Committee has neither the competence nor the staff to monitor BCP implementation.

The Financial Sector Assessment Program (FSAP) was jointly created by the IMF and the World Bank in May 1999 in order to enhance the effectiveness of member countries' financial systems, i.e. to reduce the financial sector's vulnerability while promoting its development and contributing to improving economic growth. Participation in the program is on a voluntary basis.

Under the FSAP, IMF and World Bank experts, supported by supervisory authorities and central banks⁴, perform Financial System Stability Assessments (FSSAs) to evaluate the stability of the financial sector by monitoring the relevant standards in the banking, insurance and securities sectors.

Using the methodology of the Basel Committee, they assess BCP compliance in the banking sector, analyze weaknesses in the financial system and develop relevant remedial measures and recommendations. This study will focus solely on the banking sector and its implementation of BCPs.

Originally planned as a pilot project with 12 countries, the FSAP was extended to cover more than 80 countries by the end of 2004 (see annex 1). This was not only due to the wave of international approval but, above all, to the fact that FSSAs were directly helping to uncover emerging problems in some countries and to develop a raft of national reforms. More generally, they also raised the IMF's surveillance work and the World Bank's development activities in the financial sector to a new level. Despite the huge response elicited by the FSAP from the IMF's 185 member countries, a survey of global financial stability was not forthcoming owing to, among other factors, the lack of FSAPs for systemically important countries such as the U.S.A. and China.

Under the FSAP, the IMF's general procedure for assessing BCPs commences with the relevant country performing a self-assessment based on several questionnaires sent by the IMF and with the production of all relevant documentation. Subsequently, a small group of experts, consisting of IMF representatives and selected supervisory authorities, confers on site with the home country banking supervisor to discuss any difficulties encountered in implementing the BCPs. Finally, the group of experts prepares an assessment report, which should also include a trouble-shooting plan. If the country assessed gives green light, its assessment report is published on the IMF's website.

This study examines BCP implementation based on the FSSAs carried out in selected countries. From the perspective of Austria's financial sector, countries in which Austrian banks have invested heavily are of particular interest. This study therefore presents an overview of the IMF's assessment results on BCP compliance for Bulgaria, the Czech Republic, Germany, Croatia, Hungary, Austria, Poland, Romania, Russia, Slovenia, Slovakia and Ukraine.

The sources used were the FSSAs of selected countries, which were published by the IMF until June 2005. It must be said that these FSSAs lack the necessary degree of detail for an accurate analysis due to the IMF's practice of confidentiality. Moreover, FSSAs are supposed to avoid any description that is damaging to the relevant financial market. Since FSSAs are not conducted every year and as there are no recent updates for certain countries, Article IV Consultations, which are carried out annually by the IMF, and/or the latest

⁴ Including the OeNB.

Reports on the Observance of Standards and Codes (ROSCs) of certain countries are used to obtain a more up-to-date overview of the progress of BCP implementation.

4 General Findings Regarding BCP Compliance

The methodology of the Basel Committee establishes five assessment categories: compliant, largely compliant, materially non-compliant, non-compliant and not applicable.

The assessment criteria of individual BCPs consist of criteria that are absolutely essential for full compliance as well as additional criteria. Despite this specified categorization, the IMF still has relatively wide-ranging discretionary powers as regards the assessment of BCP compliance.

The IMF's most recent general survey to date on BCP compliance dates from 2002. It presents a summary of BCP compliance in 60 countries that had undergone assessment by December 2001 (International Monetary Fund and World Bank, 2002). The findings of this IMF study show that 32 of the 60 countries were fully compliant with 10 or fewer of the 25 BCPs. Only 10 countries were compliant with 20 or more BCPs. Developing countries generally showed lower levels of compliance than industrialized countries, although this was due to, inter alia, adverse macroeconomic conditions, an inadequate legal and judicial system, poor credit control and inaccurate accounting systems. Although some of these weaknesses relate to areas outside the jurisdiction of banking supervision, remedying them is an essential precondition for effective banking supervision. Stable macroeconomic conditions support the resilience of the financial sector. Although banking supervision has been relatively well established and organized, it still fails to promptly bring supervisory requirements in line with the dynamic developments of the financial market. The key requirements were consolidated supervision, adequate risk evaluation by oversight and cross-border cooperation between supervisory authorities. Banking supervision in industrialized countries also faced challenges. In particular, the rise of international financial conglomerates and the development of new financial instruments and derivative products require constant fine-tuning of supervisory methods relating to both sector-wide and cross-border risk management.

5 The Results of FSSAs in Selected Countries

5.1 BCP 1: Preconditions for Effective Banking Supervision

The preconditions for effective banking supervision cited by the Basel Committee are sound and stable economic policies, a well-developed public infrastructure, effective market discipline, procedures for efficient troubleshooting in banks and mechanisms for providing an appropriate level of systemic protection (or a public safety net). This means that clear responsibilities and standards are required for banking supervision. The supervisor should be provided with the necessary independence, the appropriate powers and adequate resources to exercise its mandate and should be embedded in an appropriate legal framework. Banking supervision should enjoy protection from both personal and institutional liability, provided its supervisory function is performed in good faith. A system of cooperation and information exchange

between the various domestic and foreign supervisory authorities, as well as precautionary measures against the exchange of confidential information, should be in place.

Almost half of the 60 countries assessed by the IMF by the end of 2001 for BCP implementation and compliance had fulfilled most BCP 1 criteria and had created a framework for effective banking supervision. It is worth highlighting that some 40% of countries found it hard to comply with the principle of supervisory independence (BCP 1.2). A further weakness was the legal protection of supervisors (BCP 1.5), and the exchange of information between banking authorities and other supervisory agencies both domestically and internationally (BCP 1.6) (see annex 2).

In the ROSC updated in 2004, the IMF noted that *Croatia* was the only one of the countries examined in this study to have complied with every recommendation of the FSSA of 2002. Accession to the EU in 2004 meant that *Poland*, *Slovakia*, *Slovenia*, the *Czech Republic* and *Hungary* had to bring their banking supervision's legislative and regulatory frameworks into line with EU norms. This resulted in a higher BCP implementation and compliance rate. However, the IMF points out – not least in view of the financial sector's ever-increasing complexity, growing competition and narrowing bank margins – that the implementation and application of banking supervisory norms is not a matter of mere statistics but requires ongoing efforts to meet these additional demands.

In *Germany*, *Austria*, *Poland* and *Hungary*, political influence exerted on the relevant supervisory authority is currently being examined by the IMF. In *Austria*, moreover, the IMF is examining the problem of liability faced by financial market supervision in the event of a bank insolvency. According to the IMF, the role of banking supervision is to ensure the orderly liquidation of weak banks but not to prevent all losses and insolvencies. In *Poland* and *Slovenia*, clear conditions are also necessary as regards the legal protection of employees. In *Romania*, although bank supervisors are legally protected in exercising their mandate, there is no legal protection against costs incurred by proceedings. In *Ukraine*, legal protection should be introduced for external staff insured for assessments.

In *Poland*, *Slovakia* and in *Slovenia*, banking supervision needs to be provided with better financial and staff resources in order to meet assessment requirements.

In *Hungary*, although the Hungarian Financial Supervision Authority (HFSA) is responsible for issuing and withdrawing banking licenses, it is obliged to consult the country's central bank prior to withdrawing a license. Although the HFSA can issue only nonbinding guidelines and recommendations for the country's financial sector, individual bank assessment decisions are binding.

In the *Czech Republic*, insolvency law relating to the liquidation of banks is inadequate. The Czech judiciary is considered to be unsatisfactorily short-staffed and slow.

In *Bulgaria*, although the Bank Insolvency Act was adapted under the FSAP in the fall of 2002 on the advice of the IMF, its implementation has so far been slow and still awaits assessment.

Reform of the banking sector is of the highest priority in *Russia*. The IMF's general conclusion is that the practical implementation of largely sufficiently current statutory provisions is inadequate. Many laws overlap with each other and subsequent secondary legislation is often absent. As a supervisory authority, the Russian central bank therefore needs to adopt a broad-based strategy designed to strengthen the supervisory environment, to ensure greater transparency of the ownership structure in banks, to improve the reporting system, to consolidate the fragmented private banking sector and to standardize conditions for both private and state-owned banks.

5.2 BCPs 2–5: Licensing and Structure

BCPs 2–5 stipulate that, in addition to the definition of the term “bank” by the supervisory authority, the ownership structure, directors and senior management (assessment of competence, integrity and expertise, i.e. fit and proper criteria), operating plan, internal control systems and capital base must be presented to the supervisory authority as a minimum requirement for the licensing of banks. Where a foreign bank is involved, the consent of its home country supervisor should be obtained before licensing. The supervisory authority should be notified if any changes to the original licensing are made in terms of the ownership structure. Similarly, the supervisory authority must have the power to specify criteria for acquisitions and investments in order to prevent unnecessary risks from being incurred.

As regards a bank's licensed activities, the Banking Act of *Slovakia* does not provide for the intervention of banking supervision where an institution is carrying out banking transactions without a banking license. New banks should therefore be monitored more frequently. In addition to banks, credit associations in *Romania* should be subject to appropriate surveillance by the country's central bank. To date, Banca Națională a României, the Romanian central bank, does not consult the home country authority before licensing foreign subsidiaries or before the acquisition of Romanian banks by foreigners. The planned amendment to the law will be confined to EU countries. In the *Czech Republic*, the licensing procedure for identifying the lawful owner of a bank should be improved.

Russia should have more stringent measures as regards “fit and proper” provisions for banking management.

In *Russia* and *Ukraine* the Banking Act should contain provisions that give banking supervision sufficient powers to ensure the disclosure of the ownership structures of banks. In *Ukraine*, the power of banking supervision to reject owners should also be introduced.

According to the IMF, *Germany*, *Austria* and *Romania* should have more stringent provisions regarding the prenotification of major or risky acquisitions by banks. This applies particularly to investments in entities other than credit institutions. The supervisory authorities in these countries should also be involved in the decision-making process at an earlier stage.

5.3 BCPs 6–15: Prudential Regulations and Requirements

According to the Basel Committee, supervisory authorities play a key role in monitoring the risks inherent in the banking system. The development and control of qualitative and quantitative criteria for managing appropriate capital adequacy, credit risk, the assessment of asset quality and loan loss provisions and reserves, portfolio diversification, connected lending, country and transfer risks, market risk and all other risks (interest rate risk, liquidity risk, operational risk) are indispensable. Banking supervision must also ensure that adequate internal control systems are in place and that stringent “know-your-customer” rules are applied so that high professional standards in the financial sector are promoted and protection is guaranteed against the abuse of the banking system by criminal elements. In particular, supervisory authorities should support the implementation of recommendations made by the Financial Action Task Force on Money Laundering (FATF), where these apply to financial institutions.

Some 40% of the 60 countries analyzed by the IMF until 2001 reveal shortcomings in their compliance with BCPs 7 (credit policies) and 10 (connected lending), and 30% in their compliance with BCP 8 (loan evaluation). Credit risk, particularly as a result of connected lending, poor risk management, lax credit classification and the generous acceptance of collateral, represented some of the threats to a sound banking system. Almost half of the countries found it hard to comply with BCPs 11–13, which relate to risk management. In many countries where foreign investment by banks is not a common phenomenon, country risk is considered to be insignificant for this very reason. Nevertheless, banking supervision should acquire the competence to assess country risk, market risk, operational risk and, above all, liquidity risk. About half the countries assessed revealed shortcomings in complying with BCP 15 (the “know-your-customer” rule). According to the IMF, this gives cause for alarm as regards anti-money laundering measures. A further weakness in some 30% of the countries was the inaccurate calculation of the appropriate level of capital adequacy. At times, this calculation included only credit risk (see annex 2).

In *Austria*, *Germany*, *Poland*, *Slovakia*, *Slovenia*, *Russia*, *Ukraine* and *Hungary*⁵, the guidelines on the extension and management of loans to related companies or individuals should be more precisely defined, according to the IMF. *Česká národní banka*, the central bank of the *Czech Republic*, should be given greater discretionary powers to interpret the definition of “related companies and individuals.” In *Russia*, the definition of “insider” should include at the very least companies that belong to the “insider” or are controlled by said party.

The IMF recommended *Slovenia* to improve loan evaluation in respect of its banking groups’ significant level of outstanding loans. The IMF urged *Germany* to define and report both bad loans and those to be restructured more precisely. In *Ukraine*, lending, in respect of total lending and risk assessment, should be legally defined in detail and implemented.

⁵ The HFSA bases itself on consistency with EU Directives and therefore refuses to adapt the guidelines on connected lending.

The *Czech Republic* is characterized by poor legal definition and inadequate supervisory support for banks in terms of the application of the “know-your-customer” rule. According to the IMF, this could give rise to stringent lending conditions that will adversely affect the legal enforceability of loan agreements and undermine anti-money laundering measures. In *Russia*, the central bank should monitor banks’ hitherto patchy compliance with money laundering guidelines more strictly and penalize any violations thereof.

According to the IMF, *Bulgarian* and *Romanian* banking supervision should also provide support to individual institutions in managing country risk and monitoring related management practices. Bulgarian banking supervision should include in its plans staff for monitoring interest rate risk, market risk, risk management systems and IT systems. In *Ukraine*, by contrast, the central bank has yet to formulate guidelines on country risk, market risk and interest rate risk. In *Poland*, banks should pay closer attention to both country and market risk, and banking supervision should improve guidelines. Likewise, both *Germany* and *Austria* need to prepare clearer guidelines on the correct management of liquidity risk, interest rate risk and operational risk. As regards operational risk, the IMF thinks that the *Czech Republic* should make further adjustments to its Banking Act.

The IMF also criticizes *Bulgaria*, *Romania*, *Russia*, *Slovakia* and *Ukraine* for failing to include market risk in capital adequacy and to calculate capital adequacy on a consolidated basis.^{6,7} In view of both macroeconomic and internal bank risks (poor credit management and loan portfolio), the IMF recommends *Ukraine* to increase minimum capital adequacy to at least 10%.

According to the IMF, *Russia* should improve its accounting standards so that capital ratios can be calculated more accurately. Guidelines on lending and investment criteria remain to be drafted.

In *Bulgaria*, *Poland*, *Russia*, *Slovenia* and *Hungary*, the responsibility and liability of bank management should be clearly defined (corporate governance). The IMF urges banking supervisors in *Hungary* to pay greater attention to internal control systems in banks and not only monitor compliance with formal guidelines. In *Russia*, furthermore, companies’ internal audit reports should be submitted to the supervisory board at least twice a year.

5.4 BCPs 16–21: Methods of Ongoing Banking Supervision and Information Requirements

An effective system of banking supervision should consist of both on-site inspections and off-site analyses. Bank supervisors should maintain contact with the directors and senior management of banks at regular intervals, as well as collect and analyze (consolidated supervision) information on the activities of these banks (in particular, non-core activities) and their domestic and foreign branches. On-site inspections test, inter alia, validated information for plausibility. Bank supervisors must ensure that accounting records are in line with general accounting principles and rules. Banks must regularly file up-to-date financial statements and balance sheets. If a bank knowingly or through

⁶ Planned for 2004 in *Bulgaria*.

⁷ In *Slovakia* this should have been taken into account in the implementation of the capital adequacy guideline, which was planned for 2004.

want of care provides bank supervisors with incorrect data, the banking supervisor must take appropriate supervisory steps and/or initiate criminal proceedings forthwith.

More than half of the 60 countries assessed by the IMF until 2001 revealed shortcomings in consolidated supervision (BCP 20). Similar weaknesses were to be found in global supervision in most countries (BCP 23). In view of the rise of financial conglomerates with cross-border operational activities, both the legal and operational implementation of global consolidated supervision is indispensable, according to the IMF (see annex 2).

In *Germany* and *Austria*, the current frequency of on-site inspections could be increased. In *Austria* this would require greater resources. In *Germany*, off-site analysis should also be systematized. In *Slovenia* as well, the requisite frequency of inspection cannot be complied with due to staff shortages. This is why it should fully exploit synergies with external auditors. In *Ukraine*, moreover, the frequency of inspections should be increased and the quality of the work by external auditors enhanced. *Russia* should rethink its supervisory methods to enhance the quality of examination. Its current focus consists in fulfilling the formal conditions rather than in evaluating underlying risks. Likewise, an approach that is more risk-aware is required for bank supervision in *Ukraine*.

As for consolidated supervision, *Bulgaria* has a special regulation, according to which subsidiaries in countries where the transfer of information is impeded by legal obstacles are exempted from reporting on a consolidated basis. This regulation should be revised.⁸ *Germany* should extend consolidated supervision to both nonconsolidated and holding companies. In *Russia*, legislation governing the exchange of consolidated information should be enacted to facilitate risk management within a corporate group. In *Slovenia*, provision should be made for the systematic risk evaluation of activities constituting non-core business. In *Poland*⁹ and *Ukraine*¹⁰, supervision on a consolidated basis is nonexistent, according to the IMF.

The layout of the annual report based on international accounting standards (IAS) has yet to be developed in *Ukraine*. In *Russia*, banking supervision should request that reports be based on IAS. The filing of information by non-exchange listed banks should be expedited in *Hungary*.

5.5 BCP 22: Formal Powers of Supervisors

Supervisory authorities must have at their disposal adequate supervisory instruments to bring about timely corrective action when banks fail to meet prudential requirements or where depositors are at risk in any other way. Assessing whether a bank can be restructured is also important, as is the proposal of appropriate remedial measures. In the worst-case scenario, it should be possible to withdraw the banking license.

⁷ In *Slovakia* this should have been taken into account in the implementation of the capital adequacy guideline, which was planned for 2004.

⁹ Assessment on a consolidated basis is current supervisory practice.

In somewhat more than 40% of the countries assessed by the IMF by the end of 2001, bank supervisors lacked independence¹¹ or legal protection, and supervisory measures were not protected under law (see annex 2).

In *Austria*, the IMF sees the burden of proof placed on the banking supervisor as problematic, as an (excessively) lengthy period of time could elapse before steps are taken to prevent bank supervisors from facing legal action¹² (claim for compensation).

In *Russia*, supervisory authorities should have the power to make bank managers liable. The explicit and increased enforceability of remedial measures should be enshrined within *Czech* law. Generally, supervisory measures and compliance therewith should be monitored and improved in *Poland*.

5.6 BCPs 23–25: Cross-Border Banking

As part of their mandate of consolidated supervision, home country bank supervisors have a twofold obligation. First, they must monitor internationally active banks' compliance with prudential regulations, a key component of which is establishing regular contact and information exchange with host country supervisory authorities. Second, they must ensure that the same prudential regulations apply to foreign banks as they would to domestic banks.

In concert with *Germany*, *Slovakia*, *Slovenia*, the *Czech Republic* and *Hungary*, *Austria* has signed a Memorandum of Understanding (MoU) on cooperation between supervisory authorities.¹³ The MoU with *Croatia* was concluded in June 2005. Further MoUs are currently being negotiated with *Poland* and *Romania*.

In *Germany*, the Federal Financial Supervisory Authority (BaFin) should prohibit the licensing of foreign branches where cooperation with the competent home country supervisory authority is not guaranteed.

Information exchange with foreign supervisory authorities should be stepped up in *Poland*. Currently, the transfer of information from foreign subsidiaries and Polish bank branches is only on a voluntary basis. Although the supervisory authority may prohibit the opening of branches, it may not make them close down.

Although, in *Romania*, the results of foreign branches are included in Romanian banks' financial statements, the results of foreign subsidiaries and joint ventures should be consolidated. Although Banca Națională a României can close down the foreign branches of Romanian banks, it cannot keep the latter from pursuing their various international activities. Financial statements filed by foreign branches in Romania should not be confined to including merely the balance sheet, income statement and outstanding foreign currency loans.

In *Slovenia*, further specialist training for bank supervisory staff would be recommendable for comprehensive global consolidated supervision.

¹¹ Although the independence of bank supervisors only relates to BCP 1, FSSAs frequently deal with BCP 1 and BCP 22 jointly, as these principles are closely associated.

¹² However, no such case is known to date.

¹³ In addition to the above-mentioned countries, *Austria* has concluded MoUs with *France*, *Italy*, the *United Kingdom* and the *Netherlands*. It is currently negotiating an MoU with *Bulgaria*. However, this has yet to be concluded, contrary to the representation in the IMF's 2002 FSSA (*International Monetary Fund*, 2002a, 40).

In *Russia*, the central bank should have the right to exchange customer information with domestic and foreign authorities in respect of their outstanding debts.

In *Hungary*, consolidated supervision should also focus on Hungarian banks with foreign representative offices.

Ukraine should generally step up information exchange with foreign supervisory authorities. Ukrainian banks require their central bank's written permission in order to open a foreign branch. A further restriction is the fact that this applies only to countries with which Ukraine has an MoU. As for foreign banks, they can only open subsidiaries – and not branches – in Ukraine.

6 Key BCP Assessment Results of Selected Regional Groups

The common problems shared by certain regional groups considered in this study – old EU Member States, new EU Member States and nonmember states – are summarized here, taking into account the diversity of the results and the different times at which individual FSSAs and their updates were prepared (see annex 3). It should be remembered that BCP implementation is the minimum requirement for effective banking supervision; the expectation in industrialized countries, in particular, is that the process of improving implementation will maintain its momentum, with banking supervision constantly bringing itself in line with market requirements.

The FSSAs for Austria and Germany show that banking supervision in these two countries is embedded in a well-developed legal framework of long standing. This guarantees not only close cooperation between individual supervisory authorities but also ensures their independence. Although compliance with BCPs is generally high, improvements can be made in the domains of financial conglomerate supervision and risk management by banks. The banking sector's market discipline could definitely benefit from increased transparency and disclosure. Although the supervisory authorities are relatively small and rather poorly staffed, the high quality of their on-site inspections is conspicuous. Their staff shortages are only partly offset by their focus on systemically important institutions and by their inclusion of external auditors. According to the IMF, banking supervision in Austria and Germany is equal to facing the challenges posed by the sector-wide and cross-border integration of financial markets and the rapid development of new financial instruments.

Despite general adjustments to legislation in the areas of banking, the law and insolvency as a result of EU accession by Poland, Slovakia, Slovenia, the Czech Republic and Hungary, these countries' shared shortcomings have to do with their compliance with the requirements for covering credit risks and global consolidated supervision, according to the IMF.

The remaining countries considered in this study can be classified into two groups. According to the IMF, Croatia has complied with every BCP. In Bulgaria, Romania, Russia and Ukraine, by contrast, the need for reform is to be found primarily in contract law and creditor protection. On the operational front, these countries need to catch up in terms of ongoing supervision – particularly, in the identification of potential weaknesses. Above all, criticism is directed at the qualitative assessment of banks, their managerial practices and

their risk management. Also evident are the authorities' partial shortcomings in enforcing the law. Although both consolidated and cross-border supervision reveal weaknesses (generally on staffing grounds), they are currently in the process of being developed in all the countries under review.

7 Conclusions

By assessing the implementation of the Basel Core Principles within the framework of the FSAP, the IMF can make two valuable contributions. First, it can take stock of the efficiency with which banking supervision is conducted in individual countries and, second, it can ensure global financial stability. By comparing the implementation of BCPs in the countries concerned, the strengths and weaknesses of both financial regulation and banking supervision can be identified and the need for action to strengthen the supervisory regime can be inferred. Adherence to and convergence with international standards, together with technical assistance provided by the IMF, should promote the certainty of law and confidence in the banking sector. This can be clearly seen in Croatia's case. Its banking supervision problems, identified by the IMF in the FSSA of 2002, were remedied by the Croatian authorities' measures recommended by the IMF. As a result, the ROSC in 2004 did not contain any criticism of BCP implementation.

The FSAP findings showed that efficient bank supervision and full BCP implementation are possible only if economic policies are stable and the legal system is well developed. It can also be noted that BCP implementation could be improved in many domains. This primarily relates to BCPs governing general credit policies and connected lending, as inadequate credit management is by far the greatest danger for the sector's stability. In this respect, there is frequently a discrepancy between current formal guidelines on loan evaluation and lending, and the practical implementation thereof. The potential significance of country risk, market risk and all other risks (interest rate risk, liquidity risk and operational risk) as well as the ability of bank supervisors to identify these is often underestimated, as these types of risk currently still lack any real meaning for many countries. A further challenge for banking supervision is the assessment of increasingly larger and more complex financial conglomerates on a consolidated basis.

However, this study has also shown that the various IMF assessment teams still have relative discretionary powers in interpreting BCP compliance. If the FSSA report results were clearly and uniformly assigned to the Basel Committee's assessment categories, this would facilitate the comparison of BCP compliance in individual countries. The assessment reports should be prepared in a way such that comparability and transparency are guaranteed. However, a certain qualification needs to be made. Owing to the confidentiality of the detailed FSAP reports, some of the FSSAs published are only in a cursory summary form, which could make comparison difficult. In addition, it is even more difficult to make direct comparisons, as critical appraisals in FSSAs are often problematic country-specific issues proposed by supervisory authorities, some of which go beyond BCP compliance in the strict sense of the word.

Reports prepared within the FSAP framework are at times very complex and are seldom used as a decision-making basis by market players in practice. However, the assessment categories in the methodology of the Basel Committee need to be worded more precisely. The question also arises as to the differentiated assessment of industrialized countries and developing countries.

Follow-up by the IMF at regular intervals would also be desirable in order to monitor the implementation of recommended measures in certain countries and the banking sector's further progress. At present, there is no provision for FSSA updates. Irregular and fairly infrequent FSSA updates are often attributable to inadequate resources at the IMF. Although BCP assessments can also be performed under Article IV Consultations and/or ROSCs, they are not performed to the same degree of detail as FSSAs.

The accession of Poland, Slovakia, Slovenia, the Czech Republic and Hungary to the EU as well as the preparations made by Bulgaria, Croatia and Romania in the run-up to accession have accelerated the implementation of BCPs in these countries. However, as the IMF repeatedly points out, BCPs are only minimum standards and it is the responsibility of individual countries to specify and fine-tune individually tailored conditions for sound effective banking supervision.

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THE IMPLEMENTATION OF THE BASEL CORE PRINCIPLES
IN SELECTED COUNTRIES FROM THE PERSPECTIVE
OF THE INTERNATIONAL MONETARY FUND

Annex 1

Status of FSAP Projects¹⁾

2000	2001	2002	2003	2004	2005
Columbia	Ghana	Gabon	Kirghiz Republic	Macedonia	<i>Belarus</i>
Lebanon	Guatemala	Switzerland	Japan	Jordan	<i>Sudan</i>
Canada	Poland	Lithuania	Bangladesh	Kuwait	<i>Norway</i>
South Africa	Armenia	Luxembourg	Hong Kong	New Zealand	<i>Belgium</i>
El Salvador	Israel	Sweden	Honduras	<i>Kenya</i>	<i>Italy</i>
Hungary	Peru	Philippines	Malta	ECCU ²⁾)	<i>Paraguay</i>
Iran	Yemen	Korea	Mauritius	<i>Ecuador</i>	<i>Rwanda</i>
Kazakhstan	Senegal	Costa Rica	Singapore	Azerbaijan	<i>Serbia</i>
Ireland	Slovenia	Bulgaria	Oman	Austria	<i>Albania</i>
Cameroon	Iceland	Sri Lanka	Germany	Netherlands	<i>Jamaica</i>
Estonia	Czech Republic	Morocco	Mozambique	<i>Nicaragua</i>	<i>Trinidad, Tobago</i>
India	Uganda	Nigeria	Tanzania	Chile	<i>Bahrain</i>
	Dominican Republic	United Kingdom	Romania	Saudi Arabia	<i>Spain</i>
	United Arab Emirates	Slovakia	Algeria	France	
	Latvia	Barbados	Bolivia	<i>Pakistan</i>	
	Tunisia	Brazil		<i>Moldova</i>	
	Finland	Ukraine			
	Mexico	Russia			
	Croatia	Egypt			
	Georgia	Zambia			
FSAP Updates					
	Lebanon South Africa	Hungary	Iceland	Ghana Slovenia Kazakhstan El Salvador	Senegal Hungary Columbia Uganda Nigeria

Source: IMF.

¹⁾ Current and planned FSAPs in italics.

²⁾ Eastern Caribbean Currency Union.

THE IMPLEMENTATION OF THE BASEL CORE PRINCIPLES
IN SELECTED COUNTRIES FROM THE PERSPECTIVE
OF THE INTERNATIONAL MONETARY FUND

Annex 2

Compliance with BCPs

% of all countries assessed by the IMF, where applicable

Basel Core Principles for Effective Banking Supervision	Compliant or largely compliant	Non-compliant or insufficiently compliant	Assignment of compliance problems recorded in section 5 to countries assessed ¹⁾	Problems identified by the IMF
1. Framework for supervisory authority				
1.1 Objectives	89	11		Shared responsibility; unclear role of external auditors
1.2 Independence	61	39	AT, DE, HU, PL, SK, SI	Political influence; insufficiently enshrined in law; not enough qualified personnel
1.3 Legal framework	90	10	BG, CZ, RU	Poor information exchange; inadequate cooperation (also with foreign authorities); insolvency law; inadequate compliance
1.4 Enforcement powers	80	19		Inadequate legal framework
1.5 Legal protection	71	29	PL, RO, SI, UA	Inadequate legal protection of supervisors; outstanding liability issues
1.6 Information sharing	71	29		Lack of formal basis
2. Permissible activities	94	6	CZ, RO, SK	Unclear licensing criteria
3. Licensing criteria	84	16	RU	Political influence; lack of bank management requirements
4. Ownership	82	18	RO, RU, UA	Too little transparency of ownership structure
5. Investment criteria	75	25	AT, DE, RO	Lack of restrictions on investments
6. Capital adequacy	67	33	BG, RU, RO, SK, UA	No risk-weighted calculation of capital adequacy
7. Credit policies	66	34	RU	Unclear specifications
8. Loan evaluation	68	32	DE, RU	Unclear rules
9. Large exposures	74	26	PL, RU, SI, UA	No monitoring on a consolidated basis
10. Connected lending	59	41	AT, DE, CZ, PL, RU, SI, SK, HU	Inadequate legal framework
11. Country risk	38	48	BG, PL, UA	Lack of rules
12. Market risk	46	51	BG, PL, RO, UA	Lack of rules
13. Other risks	51	49	AT, CZ, BG, DE, UA	Lack of rules; insufficient supervisory staff numbers
14. Internal control	66	34	BG, HU, PL, RU, SI	Lack of standards; no corporate governance rules
15. Money laundering	55	45	AT, CZ	Lack of legal framework
16. Framework for on-site and off-site supervision	73	27	AT, SI, UA, RU	Low frequency of supervision; small, poorly educated staff; unclear specifications
17. Bank management	83	17		Poor contact management
18. Requirements for off-site supervision	74	26		No consolidated supervision
19. Validation of information	77	23		No steps taken to remedy poor external audit
20. Consolidated supervision	39	45	AT, BG, DE, PL, RU, SI, UA	Lack of specifications
21. Accounting	73	27	HU, UA	No compliance with IAS; lack of enforceability
22. Remedial measures	65	35	CZ, HU, PL, RU	Inadequate legal framework; ineffective compliance
23. Global consolidation	47	25	HU, PL, RU, RO, SI, UA	Lack of consolidated supervision; insufficient competence to monitor foreign institutions; poor information exchange
24. Host country supervision	58	23	DE	Lack of formal agreement with home country authorities
25. Supervision of foreign establishments	77	20	RO	Inadequate information exchange; no supervision permission for foreign authorities

Source: IMF.

¹⁾ See Legend, Abbreviations and Definitions for a list of country codes.

BCP Implementation Problems and Areas of Improvement in Selected Countries

Basel Core Principles for Effective Banking Supervision	AT ¹⁾	BG	HR	CZ	DE	HU	PL	RO	RU	SI	SK	UA
1. Framework for supervisory authority												
1.1 Objectives												
1.2 Independence	●				●	●	●			●	●	
1.3 Legal framework		●		●					●			
1.4 Enforcement powers												
1.5 Legal protection							●	●		●		●
1.6 Information sharing												
2. Permissible activities				●				●			●	
3. Licensing criteria						●		●				
4. Ownership								●	●			●
5. Investment criteria	●				●			●				
6. Capital adequacy		●						●	●		●	●
7. Credit policies									●			
8. Loan evaluation					●				●			
9. Large exposures							●		●	●		●
10. Connected lending	●			●	●	●	●		●	●	●	
11. Country risk		●					●					●
12. Market risk		●					●	●				●
13. Other risks	●	●		●	●							●
14. Internal control		●				●	●		●	●		
15. Money laundering	●			●								
16. Framework for on-site and off-site supervision	●								●	●		●
17. Bank management												
18. Requirements for off-site supervision												
19. Validation of information												
20. Consolidated supervision	●	●			●		●		●	●		●
21. Accounting						●						●
22. Remedial measures				●		●	●		●			
23. Global consolidation						●	●	●	●	●		●
24. Host country supervision					●							
25. Supervision of foreign establishments												

Source: IMF.

¹⁾ See Legend, Abbreviations and Definitions for a list of country codes.

HIGHLIGHTS

The CEEC Website

Silvia Kirova

We hope that you will find this website useful and that you will stay in touch with us: Click on <http://ceec.oenb.at> or visit the OeNB's website at www.oenb.at, where you may click on the quick link Central and Eastern Europe. The CEEC website is available in German and English. Please send your inquiries or proposals directly to the CEEC team at ceec@oenb.at.

The screenshot shows the OeNB website with a navigation menu at the top. The main content area is titled "Central and Eastern Europe" and features several sections: "CEEC Research Platform (ceec.oenb.at)", "Focus on European Economic Integration", "Financial Stability Report", and "Olga Radzyner Award". A large red watermark "http://ceec.oenb.at" is overlaid diagonally across the page. The left sidebar contains a menu with categories like "About the OeNB", "Monetary Policy and Economics", and "Financial Market and Stability".

The selected abstracts below alert readers to studies on CEEC topics published in other OeNB publications. For further details see www.oenb.at.

An Overview of European Economic Indicators: Great Variety of Data on the Euro Area, Need for More Extensive Coverage of the New EU Member States

This contribution provides an overview of the most common short-term indicators of economic development in the euro area. These indicators are useful when official data are released with long time lags or if they are subject to major revisions. Indicators based on surveys among businesses, households, financial market analysts or forecasters have the advantage of providing detailed and timely information on individual sectors on a monthly basis and largely without later revision. As an additional instrument, composite indicators, which are calculated by combining a variety of measures into a single indicator with the help of regression and factor analysis, offer an attractive tool for drawing conclusions from different, often divergent signals. Even the most reliable economic indicators, however, can only be interpreted as constituent elements of comprehensive economic analyses. With regard to the new EU Member States, coverage is found to be limited as yet. This study also shows that the forecasting quality of the European Commission's business and consumer surveys for the new Member States is not as high as for the other EU Member States. As the quality of economic indicators increases as forecasting institutions and respondents gain more experience, coverage of established indicators should be extended early on to this group of countries, in particular as some of the new Member States may soon join the euro area.

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Maria Antoinette
Silgoner

Real Estate Markets and Capital Flows in the Context of EU Accession

Lecture Presented by Dubravko Mihaljek, Senior Economist at the Bank for International Settlements

On June 16, 2005, Dubravko Mihaljek, Senior Economist at the Bank for International Settlements (BIS) in Basel, gave a lecture at the OeNB on real estate markets and capital flows in the context of EU accession. Before focusing on a country study on Croatia¹, he addressed some wider implications for Central and Eastern Europe (CEE).

To start with, Mihaljek analyzed the current situation of foreign investment in real estate within the enlarged EU. He discussed the right of EU citizens to buy property in other EU countries without being residents of those countries, recalling the permanent exceptions of Denmark and Malta in this area and providing further details on the transitional arrangements that are in place for the new Member States.

Mihaljek continued by pointing out some general characteristics of CEE real estate markets. In general, these markets are still fairly small: together with the construction sector, they account for 10% to 15% of GDP, compared to 20% to 25% in industrialized countries. As the public sector retreated from housing construction in the 1990s and private construction firms have started off only slowly, the supply of housing in the primary market has been very limited. The secondary market is characterized by high owner occupancy ratios; moreover, as a result of privatization many people own houses they would not be able to afford under normal market conditions. In general, the housing stock itself is in relatively poor condition and maintenance costs are often very high.

Dubravko Mihaljek subsequently discussed the impact of the increased demand for secondary residences by foreigners on property prices in specific regions – such as tourist areas – and examined the potential future effects of foreign property investment on housing markets. Combined with a strong demand by nonresidents, supply constraints may push prices further up and thus create a situation in which local residents may find it difficult to afford housing. Antispeculative regulations (e.g. tax regulations) may partly mitigate price rises, while still existing legal uncertainties should be solved to remove disincentives to supply housing in the secondary market. In view of likely supply constraints in the short run, Mihaljek argued that a gradual opening of real estate markets to nonresidents would allow for a more orderly adjustment than a rapid removal of restrictions would.

Turning to the macroeconomic effects of foreign investment in the property sector, Mihaljek highlighted various macroeconomic challenges for the new EU Member States. Given that real estate prices have risen considerably in the past few years, the wealth of property-owning households has grown, too. This situation may spur domestic demand. In some countries, property sales to nonresidents may generate considerable capital inflows, which may – *ceteris paribus* – exert appreciation pressure on the respective currency. In a first

¹ Mihaljek, D. 2005. *Free movement of capital, the real estate market and tourism*. In: Ott, K. (ed.). *Croatian Accession to the European Union*. Vol. 3. Zagreb: Institute of Public Finance and Friedrich-Ebert-Stiftung. www.ijf.hr.

round, state budgets will benefit from the positive effect of property sales on tax revenues while, after that, the overall fiscal effect depends on how this extra revenue is going to be spent.

Finally, Dubravko Mihaljek stressed the case of Croatia, where restrictions on property sales to nonresidents are currently in place. Under its Stabilisation and Association Agreement, Croatia has committed itself to removing the restrictions on property sales to nonresidents by 2009. However, Croatia may seek an extension of this transitional arrangement, or a permanent exemption, during accession negotiations. On the one hand, both Croatian tourism and the national economy will benefit from foreign investment in property, but on the other hand there is the risk of excessive housing and infrastructural development in the coastal region. It will be the responsibility of the Croatian government to prevent overbuilding by ensuring the strict enforcement of existing building regulations and further appropriate adjustment of all relevant legislation.

All in all, the new Member States may have the chance to benefit from allowing EU residents unrestricted access to their property markets, as housing stock will be renewed, the regions in question will become more attractive for other tourists, local communities will be revitalized and, as a consequence, local residents will have the possibility to create wealth. However, without proper longer-term management, this process also bears potentially high risks such as environmental damage and skyrocketing prices.

The “East Jour Fixe” of the Oesterreichische Nationalbank

55th East Jour Fixe

Monetary and Exchange Rate Policy in South-Eastern Europe

The East Jour Fixe of the Oesterreichische Nationalbank (OeNB), a series of meetings initiated in 1991 as a forum in which economists, members of academia, government officials and other experts on Eastern Europe meet to discuss specific transition issues, looks back on a long tradition. The 55th East Jour Fixe on May 30, 2005, was a special event. It served to underline the OeNB’s dedication to its newly added focus of research: Southeastern Europe. While not much research has been devoted to this region so far, Southeastern Europe is already among the fastest-growing regions on the continent, and has large potential to be tapped for further output expansion. Austria is tightly linked to Southeastern Europe by geography and by centuries of close historical connections. Today, economic links play a prime role, with trade on a dynamic trajectory and Austrian investors from the enterprise and banking sectors in the forefront of the region’s process of microeconomic reintegration with the rest of Europe.

The 55th East Jour Fixe dealt with “Monetary and Exchange Rate Policy in South-Eastern Europe,” a domain exhibiting a surprising variety of approaches and strategies. High-ranking central bank representatives from eight countries or territories exchanged views under the chairmanship of the OeNB. The event was organized in three sessions. In her introductory statement, Doris Ritzberger-Grünwald, Head of the OeNB’s Foreign Research Division, stressed the important progress a number of countries in the region have achieved in their EU integration process. Although economic growth has been strong across Southeastern Europe in recent years (about 4% to 5% per annum on average), most countries remain burdened by external disequilibria, particularly current account deficits, and some strongly depend on workers’ remittances and foreign financial assistance. Most countries have been remarkably successful in bringing down inflation, be it with the help of the euro as a nominal anchor (as in the majority of cases) or with other policies. Growing confidence has contributed to remonetization and credit booms, which, however, are not without risks.

The first session, presided by Doris Ritzberger-Grünwald, was entitled “Monetary Policy Frameworks: Experiences and Challenges.” Aneta Krstevska, Director of the Research Department of the National Bank of the Republic of Macedonia, presented the case of the monetary policy strategy of her country, which is a small and open economy and thus a price taker. Output and exports are not much diversified. The share of foreign currency deposits in total deposits (unofficial euroization) is very high (around 65%). Therefore, Macedonia has been running a de facto peg first to the Deutsche mark and then to the euro (exchange rate targeting) for the last ten years, which has the advantage of constituting a clear commitment for the public. During this period, the Macedonian denar was devalued only once – in July 1997. Prices and the real effective exchange rate have been stable in recent years. Aneta Krstevska cited potential swings in market expectations, the necessity to main-

tain high foreign currency reserves to defend the denar, if needed, and possible effects of capital account liberalization (impossible trinity) as challenges to the strategy.

Amir Hadziomeragic, Head of Economic Research and Statistics Department of Centralna banka Bosne i Hercegovine, highlighted major traits of his country’s currency board regime. In a post-war situation of fragile statehood like Bosnia’s, the conduct of rule-based monetary policy is the only realistic option, he argued. The currency board and the new Bosnian currency, the Bosnian convertible mark, both established in 1997–98 in line with the Dayton agreement, turned out to be very successful in reducing inflation, replacing the previously existing multicurrency system and creating a stable pillar of Bosnian statehood and identity. The arrangement was so successful that, after the expiration of the initial period of six years, the authorities decided to extend it indefinitely (i.e. until the eventually expected adoption of the euro). The only major deviation from strict currency board rules and the only available monetary policy instrument are reserve requirements for commercial banks. According to Hadziomeragic, the country’s persistent and very high current account deficits are the consequence of incomplete structural adjustment, but also of large international aid flows, remittances and growing FDI inflows in recent years.

The focus of Gramoz Kolasi’s presentation was the evolution of the Bank of Albania’s monetary policy. Kolasi, Head of the Monetary Policy Department of Banka e Shqipërisë (Bank of Albania), pointed out that his institution had already adopted a monetary targeting regime in 1992. Since 1998, the publicly stated monetary policy objective of Banka e Shqipërisë has been to keep the annual inflation rate within a band of between 2% and 4% at year-end. This is to be achieved by exercising monetary control. Most recently, inflation in Albania has declined to below the bottom limit of the band. Although the Albanian lek floats loosely, there is no doubt that the euro is the most important foreign currency for the country (80% of trade is conducted with the EU.) Even though the signaling power of monetary aggregates targeted by Banka e Shqipërisë may start to fade, Gramoz Kolasi cautioned that the central bank’s goal of adopting an explicit inflation targeting regime in the medium term would require more macroeconomic stability, stronger economic growth, more new jobs, greater price stability, a speedier implementation of structural reforms, etc.

The next session dealt with implications of currency substitution for monetary policy and was chaired by Thomas Reininger, Senior Expert with the OeNB’s Foreign Research Division, who gave a brief overview of the various types of currency substitution that can be observed in the region, ranging from the complementary (unofficial) use of a foreign currency (mostly the euro) to the official adoption of a foreign currency (the euro) as sole legal tender. Nicola Fabris, Chief Economist of Centralna banka Crne Gore, explained why and how the Montenegrin authorities decided to unilaterally introduce the Deutsche mark/the euro in the period from 1999 to 2001, and what the results were. Monetary policy misuse by the Milošević regime in Belgrade, a very high level of inflation and a dramatic decline of GDP compelled the authorities in Podgorica to euroize, Fabris argued. In a first step, the hitherto usual practice of using the Deutsche mark was legalized in November 1999, when the

Deutsche mark was given the status of legal tender in parallel to the Yugoslav dinar. In January 2001, the Deutsche mark became sole legal tender in the republic. In March 2001, Centralna banka Crne Gore, the central bank of Montenegro, was established. With the cash changeover in early 2002, euro cash was officially introduced. According to Nicola Fabris, euroization helped create stability in Montenegro, with inflation rates coming down swiftly, but it cannot be treated as a substitute for economic reform.

A case of very high – unofficial – euroization is Croatia, as emphasized by Ljubinko Jankov. In his presentation, the Executive Director of the Research and Statistics Area of Hrvatska narodna banka emphasized the low inflation rate and the stability of the exchange rate of the Croatian kuna to the Deutsche mark/euro (without commitment) since late 1993. Despite this record, the share of foreign currency deposits in total bank deposits continues to surpass 75%. Given this situation and the fact that Hrvatska narodna banka’s foreign exchange reserves exceed base money by about 50%, the country’s monetary policy has long been characterized by the authorities as that of a “quasi currency board.” With this regime, as Jankov put it, the monetary authorities strive to get the best of both worlds: first, credibility associated with exchange rate stability and low inflation; and second, discouragement of speculative capital flows through upholding two-way residual risk. But, of course, under these circumstances freedom of monetary policy is severely circumscribed. To improve the country’s competitiveness and reduce its external disequilibrium, Hrvatska narodna banka attempts to persuade the government to trim the fiscal deficit and step up structural reforms.

Real exchange rate dynamics in the run-up to EU accession was the topic of the third session, chaired by Peter Backé, Head of Unit – Central and Eastern European Analysis, Foreign Research Division (OeNB). Backé raised the question of what to think of real appreciation pressures, as witnessed in some Southeastern European countries, in the context of sizeable current account imbalances and possible future shifts in capital flow dynamics. Rossen Rozenov, Head of the Monetary and Financial Research Division in the Bulgarian National Bank’s Economic Research and Projections Directorate, discussed Bulgaria’s recent experience with real exchange rate developments. The Bulgarian National Bank has been running a currency board linked to the Deutsche mark (and later the euro) since mid-1997. In the period from 1998 to 2004, the weighted real exchange rate of the Bulgarian lev appreciated by about 20% (CPI-deflated) or by 7% (ULC-deflated), respectively. Given sizeable FDI and industrial restructuring, real exchange rate appreciation (so far) does not seem to have adversely impacted on Bulgarian export performance; as Rozenov stressed, Bulgarian firms have recently gained market shares in the EU.

Cezar Botel, Director of the Macroeconomic Modeling and Forecasting Department at Banca Națională a României, focused on real exchange rate dynamics in his country. The Romanian leu’s exchange rate regime over the last decade has been a managed float, featuring the gradual removal of current and capital account restrictions and lately showing higher flexibility. The real exchange rate, based on the CPI as a deflator, has been relatively stable over the past five years; taking ULC in industry as a deflator, the real exchange rate has even decreased. Yet since 2004, there has been a substantial real apprecia-

tion. According to Botel, this most recent turnaround is attributable to strong capital inflows that were triggered by a high interest rate differential to the euro area, by the rising attractiveness of the Romanian economy owing to the country’s good macroeconomic performance and improved prospects for joining the EU in 2007, and by anticipated capital account liberalization. Moreover, in preparation for the planned switch to inflation targeting in 2005, Banca Națională a României decided in November 2004 to allow more exchange rate flexibility and, if applicable, some appreciation of the leu.

An overview analysis of real exchange rate dynamics in Southeastern Europe was offered by Gunther Schnabl, Adviser with the Division EU Neighbouring Regions, DG International and European Relations at the ECB. Despite quite heterogeneous exchange rate regimes in the region, most countries – except Serbia, Bosnia and Herzegovina, and the FYR of Macedonia – witness real appreciation pressures. Schnabl reviewed the determinants of real exchange rate dynamics, arguing that in this context factors other than the standard Balassa-Samuelson framework can be important for the Southeastern European region. Finally, Darko Bohnc, Vice Governor of Banka Slovenije, shared his country’s experience with real exchange rate developments prior to EU accession and ERM II entry. Based on the case of Slovenia, he aptly illustrated his main proposition, namely that exchange rate dynamics are shaped by the dual nature of the exchange rate, which constitutes an asset price while also reflecting macroeconomic fundamentals.

Summing up, while real appreciation tendencies have been rather limited in most Southeastern European countries in recent years, a number of factors – including growing capital flows – indicate mounting appreciation pressures in the future. Given the traditionally large external imbalances in the region, this fact promises to become a major challenge for economic policies in Southeastern Europe.

In all three sessions, the discussion was very lively and focused on a number of issues, ranging from statistics to the design of economic policy, including possible equilibrium exchange rates, which are gaining interest.

Please note that all speakers’ presentations can be downloaded from the OeNB’s Central and Eastern Europe Research Platform at ceec.oenb.at.

STATISTICAL ANNEX

Table A1

Gross Domestic Product

Annual real change in %

	2002	2003	2004	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2
Albania	3.4	6.0	6.0	x	x	x	x	x	x
Bosnia and Herzegovina	5.5	3.0	5.0	x	x	x	x	x	x
Bulgaria	4.9	4.5	5.6	4.5	5.5	5.8	6.2	6.0	..
Croatia	5.2	4.3	3.8	4.2	3.8	3.6	3.6	1.8	..
FYR of Macedonia ¹⁾	0.9	2.8	2.9	x	x	x	x	x	x
Romania	5.1	5.3	8.4	6.1	6.7	9.8	9.7	5.9	..
Russia	4.7	7.3	7.2	7.6	7.7	7.1	6.4	5.2	..
Serbia and Montenegro	3.0	2.0	7.0	x	x	x	x	x	x
Turkey	7.9	5.8	8.1	10.1	13.4	4.5	6.3	4.8	..
Ukraine	5.2	9.4	12.1	12.3	13.3	14.6	8.2	5.4	2.4

Source: Eurostat, wiiw, national sources.

¹⁾ Former Yugoslav Republic of Macedonia.

Table A2

Industrial Production

Annual real change in %

	2002	2003	2004	Feb. 05	Mar. 05	Apr. 05	May 05	June 05	July 05
Albania	1.8	2.7	3.1	x	x	x	x	x	x
Bosnia and Herzegovina	13.9	-7.8	9.0	4.3	5.0	6.6	3.8	3.7	3.3
Bulgaria	4.7	14.1	17.7	7.9	14.2	13.9	..	..	..
Croatia	5.5	4.1	3.7	-1.5	-2.9	6.3	8.3	12.3	5.4
FYR of Macedonia	-5.3	4.7	-2.2	x	x	x	x	x	x
Romania	4.4	3.2	5.4	3.6	4.0	7.8	..	..	..
Russia	3.7	7.0	7.4	5.1	4.0	5.0	1.4	..	..
Serbia and Montenegro	1.7	-2.7	7.5	x	x	x	x	x	x
Turkey	9.5	8.8	10.0	10.7	3.4	5.1	2.2	1.6	..
Ukraine	7.0	15.8	12.5	x	x	x	x	x	x

Source: wiiw, EBRD, national sources.

Table A3

Average Gross Wages

Annual nominal change in %

	2002	2003	2004	Jan. 05	Feb. 05	Mar. 05	Apr. 05	May 05	June 05
Albania ¹⁾	22.7	8.5	14.4	x	x	x	x	x	x
Bosnia and Herzegovina ²⁾	1.4	8.4	8.6	8.6	6.1	6.6	8.8	8.9	8.5
Bulgaria ³⁾	6.6	6.2	7.0	9.4	9.0	9.9	8.9	9.2	9.8
Croatia ⁴⁾	5.0	5.9	5.9	4.1	4.7	5.7	3.8	6.4	4.9
FYR of Macedonia ⁴⁾	6.9	4.8	4.0	x	x	x	x	x	x
Romania ⁴⁾	27.1	25.4	22.5	25.3	23.1	20.9	24.5	24.2	23.8
Russia ⁵⁾	34.5	24.8	24.0	23.8	21.6	25.9	24.1	24.0	23.4
Serbia and Montenegro ⁴⁾	65.8	24.9	28.5	x	x	x	x	x	x
Turkey ⁵⁾	32.1	17.2	10.3	11.5	5.7	13.7	..	..	..
Ukraine ⁵⁾	20.7	23.0	27.7	28.3	30.7	32.5	33.9	..	..

Source: wiiw, national sources.

¹⁾ Monthly earnings in the state sector.²⁾ Excludes Brcko district wages.³⁾ Total economy, gross.⁴⁾ Total economy, net.⁵⁾ Monthly manufacturing earnings.

Table A4

Unemployment Rate

End of period, %	2002	2003	2004	Jan. 05	Feb. 05	Mar. 05	Apr. 05	May 05	June 05
Albania	15.8	15.0	14.4	x	x	x	x	x	x
Bosnia and Herzegovina	40.9	42.0	43.2	x	x	x	x	x	x
Bulgaria ¹⁾	17.4	14.3	12.7	13.1	13.1	12.7	12.1	11.5	11.1
Croatia ¹⁾	22.3	19.5	18.2	19.1	19.3	19.2	18.7	18.0	17.4
FYR of Macedonia ²⁾	31.9	36.7	37.2	x	x	x	x	x	x
Romania ¹⁾	10.2	7.6	6.8	6.3	6.2	6.0	5.7	5.5	5.5
Russia ²⁾	8.0	8.6	8.2	8.3	8.3	8.1	7.9	7.7	7.6
Serbia and Montenegro ¹⁾	13.8	15.2	15.0	x	x	x	x	x	x
Turkey ²⁾	10.4	10.5	10.3	x	x	x	x	x	x
Ukraine ²⁾	9.6	9.1	8.6	x	x	x	x	x	x

Source: *wiiv, national sources.*¹⁾ Registered, period average.²⁾ LFS, period average.

Table A5

Industrial Producer Price Index

Period average, annual change in %	2002	2003	2004	Feb. 05	Mar. 05	Apr. 05	May 05	June 05	July 05
Albania	x	x	x	x	x	x	x	x	x
Bosnia and Herzegovina	-0.3	-0.1	2.3	1.1	4.7	-0.8	-1.0	-1.6	-2.2
Bulgaria	1.4	5.0	5.9	6.4	7.5	7.7	5.9	7.1	6.6
Croatia	-0.5	1.9	3.6	5.1	5.1	4.5	2.3	2.4	2.3
FYR of Macedonia	-0.9	-0.3	0.9	x	x	x	x	x	x
Romania	23.2	19.6	19.1	12.8	13.6	14.7	14.4	12.8	..
Russia	11.7	15.6	24.0	22.0	23.5	24.0	24.7	..	..
Serbia and Montenegro	-41.3	-3.8	4.0	x	x	x	x	x	x
Turkey	50.1	25.6	14.6	10.6	11.3	10.2	5.6	4.3	4.3
Ukraine	3.1	7.8	20.4	22.4	22.0	21.1	20.5	..	..

Source: *wiiv, national sources.*

Table A6

Consumer Price Index

Period average, annual change in %	2002	2003	2004	Feb. 05	Mar. 05	Apr. 05	May 05	June 05	July 05
Albania	5.2	2.3	2.9	1.8	1.7	1.6	2.0	2.9	1.8
Bosnia and Herzegovina ¹⁾	0.6	0.7	0.3	1.8	2.3	2.6	2.4	2.6	3.4
Bulgaria	5.8	2.3	6.1	3.9	4.3	5.1	4.6	5.1	3.9
Croatia ²⁾	1.7	1.8	2.1	3.3	3.9	3.5	2.8	2.9	3.1
FYR of Macedonia ¹⁾	1.4	2.4	0.9	x	x	x	x	x	x
Romania	22.5	15.3	11.9	8.9	8.7	10.0	10.1	9.7	9.3
Russia	16.0	13.6	11.0	12.8	13.3	13.4	13.6	13.4	12.9
Serbia and Montenegro	16.5	9.4	10.8	17.0	17.5	17.4	17.5	16.8	17.5
Turkey	45.0	25.5	8.6	8.7	7.9	8.2	8.7	9.0	7.8
Ukraine	0.8	5.2	9.0	13.3	14.7	14.7	14.6	..	..

Source: *Eurostat, wiiv, national sources.*¹⁾ Retail prices.²⁾ Retail prices until 2001.

Table A7

Trade Balance

% of annual GDP

	2002	2003	2004	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1
Albania	x	x	x	x	x	x	x	x	x
Bosnia and Herzegovina	x	x	x	x	x	x	x	x	x
Bulgaria	-10.2	-12.4	-14.0	-16.5	-12.4	-17.5	-8.4	-17.8	-14.7
Croatia	-24.6	-27.3	-24.3	-29.3	-23.2	-28.3	-21.2	-24.9	-23.5
FYR of Macedonia	x	x	x	x	x	x	x	x	x
Romania	-5.7	-7.9	-9.0	-9.9	-6.0	-11.3	-7.1	-10.8	..
Russia	13.5	14.0	15.0	13.1	14.5	15.1	14.9	15.2	17.2
Serbia and Montenegro	x	x	x	x	x	x	x	x	x
Turkey	-4.0	-5.7	-8.0	-6.3	-8.5	-9.2	-7.1	-7.7	..
Ukraine	1.7	-0.4	5.8	-2.5	7.9	10.4	4.0	2.4	7.1

Source: National central banks.

Table A8

Current Account Balance

% of annual GDP

	2002	2003	2004	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1
Albania	-9.7	-8.2	-7.0	x	x	x	x	x	x
Bosnia and Herzegovina	-18.4	-18.9	-19.1	x	x	x	x	x	x
Bulgaria	-5.6	-9.2	-7.4	-15.8	-12.2	-10.2	7.4	-16.5	-15.9
Croatia	-8.7	-6.9	-4.6	-19.8	-19.2	-14.2	25.9	-15.6	-19.8
FYR of Macedonia	-9.5	-6.0	-6.8	x	x	x	x	x	x
Romania	-3.4	-5.7	-7.3	-7.8	-2.7	-10.6	-5.1	-9.4	..
Russia	8.5	8.3	10.3	7.1	10.5	10.0	9.6	11.1	14.0
Serbia and Montenegro	-8.9	-9.4	-10.5	x	x	x	x	x	x
Turkey	-0.9	-3.3	-5.2	-5.0	-9.0	-6.9	-0.7	-5.9	..
Ukraine	7.3	5.8	10.5	2.7	13.9	15.4	8.8	5.9	11.5

Source: National central banks.

Table A9

Net Foreign Direct Investment

% of annual GDP

	2002	2003	2004	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1
Albania	x	x	x	x	x	x	x	x	x
Bosnia and Herzegovina	x	x	x	x	x	x	x	x	x
Bulgaria	5.7	10.3	8.4	10.3	8.6	14.6	-11.0	22.8	6.0
Croatia	2.5	6.6	2.5	11.3	3.8	3.3	1.7	1.6	2.2
FYR of Macedonia	x	x	x	x	x	x	x	x	x
Romania	2.5	3.2	6.7	3.0	4.0	5.9	3.1	11.6	..
Russia	0.0	-0.4	0.3	-2.2	0.6	0.4	-1.4	1.9	1.4
Serbia and Montenegro	x	x	x	x	x	x	x	x	x
Turkey	0.5	0.5	0.6	0.7	0.8	0.7	0.6	0.5	..
Ukraine	1.6	2.8	2.6	2.1	2.8	4.1	2.2	1.7	1.6

Source: National central banks.

Table A10

Reserve Assets Excluding Gold

End of period, % of annual GDP

	2002	2003	2004	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1
Albania	x	x	x	x	x	x	x	x	x
Bosnia and Herzegovina	23.6	25.6	..	x	x	x	x	x	x
Bulgaria ¹⁾	25.6	28.1	33.1	28.1	27.9	31.3	31.0	33.1	31.9
Croatia ¹⁾	23.3	25.7	23.3	25.7	23.8	24.1	23.8	23.3	23.9
FYR of Macedonia	19.0	..	..	x	x	x	x	x	x
Romania ¹⁾	12.3	12.7	18.4	12.7	13.2	14.7	17.5	18.4	20.1
Russia ¹⁾	11.6	15.3	19.0	15.3	16.5	16.6	16.7	19.0	21.1
Serbia and Montenegro	x	x	x	x	x	x	x	x	x
Turkey ¹⁾	13.4	12.4	11.0	12.4	12.1	12.0	12.0	11.0	..
Ukraine	9.2	12.3	13.1	12.3	14.3	16.6	19.5	13.1	16.8

Source: wiw, IMF.

¹⁾ Quarterly data on the basis of rolling four-quarter GDP.

Table A11

Gross External Debt

End of period, % of annual GDP

	1998	1999	2000	2001	2002	2003	2004
Albania	36.9	32.3	31.8	29.2	26.5	24.8	20.3
Bosnia and Herzegovina	69.2	66.2	59.4	47.5	45.0	36.6	30.5
Bulgaria	x	89.2	86.7	78.3	64.9	60.0	62.9
Croatia	47.5	54.1	60.6	60.7	62.2	77.6	82.0
FYR of Macedonia	40.1	40.6	41.5	43.9	43.1	38.8	38.6
Romania ¹⁾	21.7	26.6	27.9	30.4	30.8	31.2	30.0
Russia	x	x	56.8	46.9	39.5	38.9	34.1
Serbia and Montenegro	67.3	61.8	164.0	103.5	76.4	69.7	56.8
Turkey	47.0	60.1	59.1	81.3	65.1	53.7	49.5
Ukraine	x	x	60.2	54.4	46.4	43.1	43.2

Source: National central banks, EBRD.

¹⁾ Medium- and long-term debt.

Table A12

General Government Balance

% of GDP

	2002	2003	2004	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1
Albania	-7.2	-4.8	-5.3	x	x	x	x	x	x
Bosnia and Herzegovina	-2.4	-0.2	-0.9	x	x	x	x	x	x
Bulgaria	-0.6	0.0	1.7	-8.9	2.9	7.4	4.0	-6.1	5.5
Croatia ¹⁾	-2.0	-1.1	..	4.0	-5.3	..	..	..	..
FYR of Macedonia	-5.6	-1.6	0.1	x	x	x	x	x	x
Romania ¹⁾	-3.1	-1.5	-0.8	-2.8	-1.5	-1.6	1.0	-1.4	-1.4
Russia ¹⁾	1.4	1.7	4.4	-0.3	3.9	5.6	5.0	3.0	12.0
Serbia and Montenegro	-4.6	-3.4	-2.0	x	x	x	x	x	x
Turkey	-14.1	-11.1	-7.1	-10.2	-8.7	-8.0	-4.9	-7.7	..
Ukraine	0.7	-0.2	-3.4	-5.8	1.9	-0.8	-2.4	-9.8	3.7

Source: wiw, EBRD, national sources.

¹⁾ Central government balance.

Table A13

Gross General Government Debt

% of annual GDP

	1998	1999	2000	2001	2002	2003	2004
Albania	75.9	72.7	71.3	66.8	64.8	60.7	55.3
Bosnia and Herzegovina	x	x	x	x	x	x	x
Bulgaria	x	79.3	73.6	66.2	54.0	46.3	38.8
Croatia ¹⁾	x	x	x	x	x	51.6	53.8
FYR of Macedonia	x	x	x	x	x	x	x
Romania	x		23.9	23.2	23.3	21.3	18.5
Russia	81.9	90.0	62.5	48.2	41.4	32.4	25.9
Serbia and Montenegro	x	x	x	x	x	x	x
Turkey	50.2	65.9	57.5	105.2	94.3	87.2	80.8
Ukraine	37.6	51.0	45.9	36.9	33.5	29.3	24.7

Source: Eurostat, EBRD.

¹⁾ Central government debt.

Table A14

Broad Money

End of period, annual nominal change in %

	2002	2003	2004	Feb. 05	Mar. 05	Apr. 05	May 05	June 05	July 05
Albania (M3)	5.7	7.6	13.1	15.1	14.4	15.2	15.7	18.3	..
Bosnia and Herzegovina (M2)	8.6	8.4	24.3	21.4	19.3	18.1	19.0	18.4	..
Bulgaria (M3)	11.7	19.6	23.1	23.9	38.1	28.0	29.0	25.4	26.3
Croatia (M4)	9.5	11.0	8.6	8.6	9.7	7.8	10.3	10.1	9.4
FYR of Macedonia	-9.3	18.0	22.5	x	x	x	x	x	x
Romania (M2)	38.2	23.3	39.9	42.2	41.1	43.9	46.7	46.5	41.1
Russia ¹⁾	33.8	38.5	33.7	30.6	30.8	31.7	33.0	33.6	37.2
Serbia and Montenegro	52.7	27.9	32.1	x	x	x	x	x	x
Turkey ¹⁾	29.1	14.6	22.1	17.5	20.5	19.8	19.5	19.3	23.0
Ukraine	41.8	46.5	32.4	36.3	38.5	39.4	..	..	..

Source: wiw, national sources.

¹⁾ Monetary survey definition.

Table A15

Official Key Interest Rate

End of period, %

	2002	2003	2004	Mar. 05	Apr. 05	May 05	June 05	July 05	Aug. 05
Albania (repo rate) ¹⁾	8.5	7.0	5.3	5.0	5.0	5.0	5.0	5.0	5.0
Bosnia and Herzegovina	x	x	x	x	x	x	x	x	x
Bulgaria (official refinancing rate) ²⁾	3.31	2.83	2.37	1.91	1.95	2.03	2.10	2.10	2.00
Croatia (official discount rate) ³⁾	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
FYR of Macedonia (basic central bank rate)	10.70	6.50	6.50	x	x	x	x	x	x
Romania (official refinancing rate) ⁴⁾	20.40	20.41	17.00	10.75	8.45	7.96	7.96	7.96	7.96
Russia (official refinancing rate) ⁵⁾	21.00	16.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00
Serbia and Montenegro (discount rate)	9.50	9.00	8.50	x	x	x	x	x	x
Turkey (overnight deposit rate) ⁶⁾	44.00	26.00	18.00	15.50	15.00	14.50	14.25	14.30	14.30
Ukraine (refinancing rate)	7.00	7.00	9.00	9.00	9.00	9.00	9.00	..	..

Source: Eurostat, Bloomberg, wiw, IMF.

¹⁾ The Bank of Albania's basic interest rate.

²⁾ The Bulgarian National Bank's basic interest rate.

³⁾ Hrvatska narodna banka's basic rate for lending to commercial banks.

⁴⁾ From February 1, 2002, reference rate of Banca Națională a României.

⁵⁾ Charged by the Bank of Russia on three-month loans to commercial banks.

⁶⁾ Interest rate paid by Türkiye Cumhuriyet Merkez Bankası on overnight deposits.

Table A16

Three-Month Interbank Rate¹⁾

End of period, %

	2002	2003	2004	Jan. 05	Feb. 05	Mar. 05	Apr. 05	May 05	June 05
Albania	x	x	x	x	x	x	x	x	x
Bosnia and Herzegovina	x	x	x	x	x	x	x	x	x
Bulgaria	x	3.50	3.64	3.67	3.65	3.63	3.62	3.62	3.62
Croatia	3.93	8.33	6.65	6.45	6.46	6.25	5.20	5.63	6.00
FYR of Macedonia	x	x	x	x	x	x	x	x	x
Romania	20.47	22.31	17.19	15.80	12.69	0.00	9.78	9.81	9.75
Russia	13.35	6.20	6.16	6.30	5.43	5.45	5.43	6.66	7.06
Serbia and Montenegro	x	x	x	x	x	x	x	x	x
Turkey	49.00	26.00	23.00	19.00	19.00	18.00	16.50	16.50	15.75
Ukraine	x	4.75	10.50	10.50	10.50	10.50	10.50	10.50	10.50

Source: Bloomberg, Thomson Financial.

¹⁾ Ask rate.

Table A17

Exchange Rate

Period average, national currency per EUR (ECU)

	2002	2003	2004	Feb. 05	Mar. 05	Apr. 05	May 05	June 05	July 05
Albania	132.46	137.58	127.61	126.70	126.38	125.85	124.82	123.71	122.00
Bosnia and Herzegovina	1.96	1.96	1.96	x	x	x	x	x	x
Bulgaria	1.95	1.95	1.95	1.96	1.96	1.96	1.96	1.96	..
Croatia	7.41	7.57	7.50	7.52	7.46	7.39	7.33	7.32	..
FYR of Macedonia	60.98	61.26	61.34	x	x	x	x	x	x
Romania	31,234.75	37,543.00	40,511.75	36,733.00	36,292.00	36,277.00	36,175.00	36,136.00	..
Russia	29.65	34.69	35.81	36.38	36.47	35.99	35.49	34.68	..
Serbia and Montenegro	60.68	65.05	73.00	80.40	80.79	81.27	81.77	82.41	..
Turkey	1.44	1.70	1.78	1.71	1.73	1.76	1.74	1.66	..
Ukraine	5.03	6.02	6.61	6.89	6.98	6.17	..	..	..

Source: Eurostat, wiw, national sources, Thomson Financial.

NOTES

Legend, Abbreviations and Definitions

Legend

× = No data can be indicated for technical reasons

.. = Data not available at the reporting date

0 = The numerical value is zero or smaller than half of the unit indicated

Discrepancies may arise from rounding.

Abbreviations

BA-CA	Bank Austria Creditanstalt
BaFin	Federal Financial Supervisory Authority
BAM	Bosnian convertible mark
BCP	Basel Core Principle
BGN	Bulgarian lev
BGZ	Bank Gospodarki Żywnościowej
BiH	Bosnia and Herzegovina
BIS	Bank for International Settlements
BNB	Bulgarian National Bank (Bălgarska Narodna Banka)
BNR	Banca Națională a României
BRD	Banca Română pentru Dezvoltare
CBA	currency board arrangement
CBBH	Centralna banka Bosne i Hercegovine
CBR	Central Bank of Russia
CEE	Central and Eastern Europe(ean)
CEECs	Central and Eastern European countries
CEEI	Conference on European Economic Integration (OeNB)
CIS	Community of Independent States
ČNB	Česka národní banka
CPI	consumer price index
CZK	Czech koruna
DEM	Deutsche mark
DPA	Dayton Peace Agreement
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
ECCU	Eastern Caribbean Currency Union
Ecofin	Council of Economic and Finance Ministers
ECU	European Currency Unit
EEA	European Economic Area
EEC	European Economic Community
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	exchange rate mechanism
ERM II	exchange rate mechanism II
ESA	European System of Accounts
ESCB	European System of Central Banks
EU	European Union
EUR	euro

FATF	Financial Action Task Force on Money Laundering
FBiH	Federation of Bosnia and Herzegovina
FDI	foreign direct investment
FRY	Federal Republic of Yugoslavia
FSAP	Financial Services Action Plan
FSSA	Financial System Stability Assessment
FYROM	Former Yugoslav Republic of Macedonia
GDP	gross domestic product
GFCF	gross fixed capital formation
HFSA	Hungarian Financial Supervision Authority
HICP	Harmonised Index of Consumer Prices
HNB	Hrvatska narodna banka
HRK	Croatian kuna
HUF	Hungarian forint
IAS	International Accounting Standards
IFC	International Finance Corporation
IFI	international financial institution
ILO	International Labor Organization
IMF	International Monetary Fund
LFS	Labor Force Survey
MFI	monetary financial institution
MNB	Magyar Nemzeti Bank
MoU	Memorandum of Understanding
MS	Member State(s) (EU)
NACE	statistical classification of economic activities (EU)
NBJ	Narodna banka Jugoslavije
NBP	Narodowy Bank Polski
NBS	Národná banka Slovenska
NBS	Narodna banka Srbije
NBU	Natsionalny bank Ukraini
NCB	national central bank
NMS	new Member State(s) (EU)
NMS-5	Czech Republic, Hungary, Slovakia, Slovenia, Poland
NMS-8	Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia
NMS-10	NMS-8 plus Malta and Cyprus
OECD	Organisation for Economic Co-operation and Development
OeNB	Oesterreichische Nationalbank
OTP	Országos Takarékpénztár és Kereskedelmi Bank
PEP	Pre-Accession Economic Programme (EU)
PKO BP	Powszechna Kasa Oszczędności Bank Państwowy
PLN	Polish złoty
PPI	producer price index
PPP	purchasing power parity
ROA	return on assets
ROE	return on equity
RON	Romanian leu
RS	Republika Srpska

RUB	Russian ruble
SAA	Stabilisation and Association Agreement (EU)
SAP	Stabilisation and Association Process (EU)
SDR	Special Drawing Right
SEE	Southeastern Europe
SEECs	Southeastern European countries
SGP	Stability and Growth Pact
SIT	Slovenian tolar
SKK	Slovak koruna
SMEs	small and medium-sized enterprises
SOE	state-owned enterprise
Treaty	Treaty on European Union
ULC	unit labor costs
UN	United Nations
USD	U.S. dollar
VAT	value-added tax
WIFO	Österreichisches Institut für Wirtschaftsforschung – Austrian Institute of Economic Research
wiiw	Wiener Institut für internationale Wirtschaftsvergleiche – The Vienna Institute for International Economic Studies
WTO	World Trade Organization

Country Codes

AT	Austria	LT	Lithuania
BG	Bulgaria	LU	Luxembourg
BE	Belgium	LV	Latvia
CY	Cyprus	MT	Malta
CZ	Czech Republic	NL	Netherlands
DE	Germany	PL	Poland
DK	Denmark	PT	Portugal
EE	Estonia	RO	Romania
EL	Greece	RU	Russia
ES	Spain	SE	Sweden
FI	Finland	SI	Slovenia
FR	France	SK	Slovakia
HR	Croatia	TR	Turkey
HU	Hungary	UA	Ukraine
IE	Ireland	UK	United Kingdom

Definitions

Bulgaria is a candidate country within the EU enlargement process. A candidate country is a country that has formally applied to the European Union for membership and has been officially recognized by the European Council as a candidate for membership. As the Accession Treaty was signed on April 25, 2005, Bulgaria may be termed an acceding country.

Bulgaria applied for EU membership on December 15, 1995, and was formally recognized as a candidate country at the Helsinki European Council meeting on December 10 and 11, 1999. Accession negotiations were opened on February 15, 2000. Negotiations were provisionally closed in December 2004, and the Accession Treaty was signed on April 25, 2005. The Accession Treaty will have to be ratified by the national parliaments of the 25 EU Member States and those of Bulgaria and Romania in order to enter into legal force.

Romania is a candidate country within the EU enlargement process. A candidate country is a country that has formally applied to the European Union for membership and has been officially recognized by the European Council as a candidate for membership. As the Accession Treaty was signed on April 25, 2005, Romania may be termed an acceding country.

Romania applied for EU membership on June 22, 1995, and was formally recognized as a candidate country at the Helsinki European Council meeting on December 10 and 11, 1999. Negotiations were provisionally closed in December 2004, and the Accession Treaty was signed on April 25, 2005. The Accession Treaty will have to be ratified by the national parliaments of the 25 EU Member States and those of Bulgaria and Romania in order to enter into legal force.

Croatia is a candidate country within the EU enlargement process. A candidate country is a country that has formally applied to the European Union for membership and has been officially recognized by the European Council as a candidate for membership.

Croatia applied for EU membership on February 21, 2003, and was formally recognized as a candidate country at the Brussels European Council meeting on June 17 and 18, 2004. The European Council of December 2004 had scheduled the start of accession negotiations for March 17, 2005, provided that Croatia fully cooperated with the International Criminal Tribunal for the former Yugoslavia (ICTY). On March 16, 2005, the General Affairs and External Relations Council (GAERC) of the EU concluded that “In that regard, after deliberations by the Council and in the absence of a common agreement, the opening of accession negotiations has been postponed” and that “The bilateral intergovernmental conference will be convened by common agreement as soon as the Council has established that Croatia is cooperating fully with the ICTY.” The European Council of March 22 and 23, 2005, supported the creation of a task force to report on Croatia’s progress in meeting the conditions for opening accession negotiations with the EU. The task force would consult both with the Croatian authorities and with the ICTY and report to the GAERC.

Turkey is a candidate country within the EU enlargement process. A candidate country is a country that has formally applied to the European Union for membership and has been officially recognized by the European Council as a candidate for membership.

Turkey applied for EU membership on April 14, 1987, and was formally recognized as a candidate country at the Helsinki European Council meeting on December 10 and 11, 1999. On the basis of a report and recommendation by the European Commission, the European Council of December 2004 decided that Turkey fulfills the Copenhagen political criteria (provided that it brings into force six specified pieces of legislation) and that accession negotiations should be opened on October 3, 2005.

The *Former Yugoslav Republic of Macedonia* is an applicant country within the EU enlargement process. An applicant country is a country that has formally applied to the European Union for membership.

The Former Yugoslav Republic of Macedonia applied for EU membership on March 22, 2004.

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¹ Focus on Transition was published up to issue 2/2003 and has been replaced by Focus on European Economic Integration since issue 1/04.

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Addresses of the Oesterreichische Nationalbank

	Postal address	Telephone	Telex
Head Office			
Otto-Wagner-Platz 3	PO Box 61	(+43-1) 404 20-0	(1) 114669 natbk
AT 1090 Vienna	AT 1011 Vienna	Fax: (+43-1) 404 20-2398	(1) 114778 natbk
Internet: www.oenb.at			

Branch Offices

Western Austria Branch Office

Innsbruck

Adamgasse 2	Adamgasse 2	(+43-512) 594 73-0	
AT 6020 Innsbruck	AT 6020 Innsbruck	Fax: (+43-512) 594 73-99	

Southern Austria Branch Office

Graz

Brockmanngasse 84	PO Box 8	(+43-316) 81 81 81-0	
AT 8018 Graz	AT 8018 Graz	Fax: (+43-316) 81 81 81-99	

Klagenfurt

10.-Oktober-Straße 13	PO Box 526	(+43-463) 576 88-0	
AT 9010 Klagenfurt	AT 9010 Klagenfurt	Fax: (+43-463) 576 88-99	

Northern Austria Branch Office

Linz

Coulinstraße 28	PO Box 346	(+43-732) 65 26 11-0	
AT 4021 Linz	AT 4021 Linz	Fax: (+43-732) 65 26 11-99	

Salzburg

Franz-Josef-Straße 18	PO Box 18	(+43-662) 87 12 01-0	
AT 5027 Salzburg	AT 5027 Salzburg	Fax: (+43-662) 87 12 01-99	

Representative Offices

Oesterreichische Nationalbank	(+44-20) 7623-6446	
London Representative Office	Fax: (+44-20) 7623-6447	

Gracechurch Street 48, 5th floor

GB EC3V 0EJ London

Oesterreichische Nationalbank	(+1-212) 888-2334	(212) 422509 natb ny
New York Representative Office	(+1-212) 888-2335	
745 Fifth Avenue, Suite 2005	Fax: (+1-212) 888-2515	

US 10151 New York

Permanent Representation of Austria to the EU	(+32-2) 285 48-41, 42, 43	
Avenue de Cortenberg 30	Fax: (+32-2) 285 48-48	

BE 1040 Bruxelles

Permanent Representation of Austria to the OECD	(+33-1) 53 92 23-39	
Rue Albéric-Magnard 3	(+33-1) 53 92 23-44	
FR 75116 Paris	Fax: (+33-1) 45 24 42-49	