Stability and Structure of Financial Systems in CEC5

Background document for the CEC5 Governors meeting in mid-May 2002

This paper is prepared for the Basle meeting of the Governors of the Czech National Bank, National Bank of Hungary, National Bank of Poland, National Bank of Slovakia and Bank of Slovenia. The country chapters were written by experts from the national central banks, while the editorial work was completed by experts from the National Bank of Poland. Authors tried to fit to the general outline allowing for cross-country comparisons, emphasizing, at the same time, issues that are the most relevant for their countries specific situation.

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1. Introduction

There are close linkages between the monetary stability of a country and the stability of its financial system. These two issues go hand in hand and cannot be treated as opposing goals for central banks. Even though, in some countries, the central bank's responsibility for maintaining financial stability is not directly stated in the law, it usually accepts a moral obligation to look after the stability of banking sector.

A sound banking sector allows for effective transmission of monetary policy signals to a real economy. On the other hand, the monetary policy itself may influence the condition of banks. Weak banks tend to be less responsive to market signals and central bank instruments in adjusting their balance sheets than sound banks do. A bank, struggling for survival, might react to monetary policy decisions in the opposite way to what the monetary authority intends. If there are a number of such banks, their actions may jeopardize the ultimate goal of a central bank which is the stabilization of the price level. Conversely, monetary policy makers might be limited in their decision making process by the stance of a banking sector. The poor or unstable financial conditions of banks may be fairly easily worsened by a sudden and significant increase in a level of interest rates, which otherwise might be desired from the perspective of monetary stability. The importance of the soundness of a banking sector leads us therefore to draw the reader's attention to the structure and stability of financial systems in candidate countries (CEC5), with special respect to their banking sectors.

The financial and currency crises around the world have proved that their causes might be either of a macro (e.g. crisis in Mexico 1995, or in Brazil 1999) or micro nature (e.g. South Korea 1997, Indonesia 1997). Thus, a credible economic policy and the promotion of prudent operation of financial entities by supervisory agencies and central banks are equally important for a sustainable growth of a country. In this paper we focus on the micro side of financial stability while the sum-ups of economic developments are presented in the appendix together with numerical data.

The contents of this paper are as follows: the second section comprises the a summary of stability issues of the financial systems in the Central European Countries: the Czech Republic, Hungary, Poland, Slovakia and Slovenia. It is followed by detailed country sections that briefly introduce the structure of the financial systems and subsequently give a picture of the main features shaping the stability of the core of the financial system, i.e. the banking sector. These sections touch upon such issues as the ownership of banks, endowment in capital, risk management and profitability. Some vital challenges to the banking sector, which are related to joining the European Union, are the topic of the closing part of each country chapter. The statistical appendix, at the end of the paper, allow broad comparisons across CEC5 members.

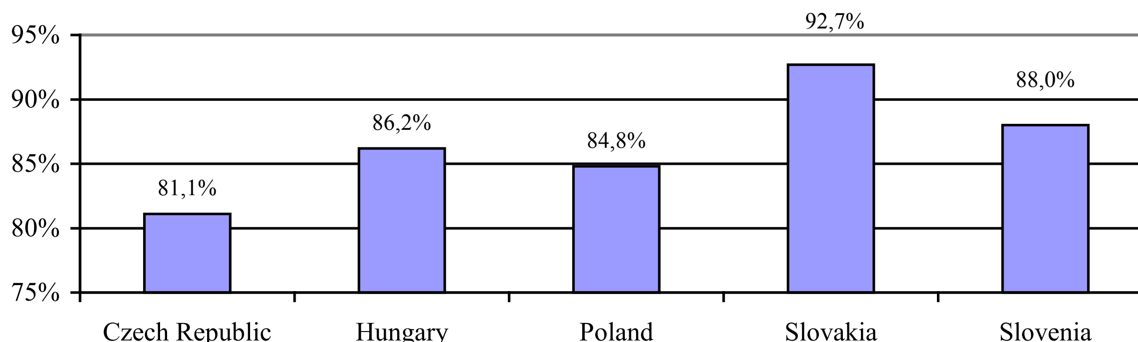
2. Common features of financial systems and stability issues in CEC5 (Summary of country chapters)

All five analyzed countries belong to the group of transition economies which have evolved from command economies to the market ones. They are also treated as "emerging markets". Similarities in their economic histories and experiences, as well as comparable methods applied to build the market economies, lead to creation of not very divergent structures and institutions. It also involves the development of the financial sector.

Comparative structure of the financial sector is as follows:

- Visible domination of banks as financial intermediaries (in terms of asset size); their share in total assets of financial institutions exceeds eighty percent (in Slovakia even ninety percent).

Bank assets as percent of the financial system assets

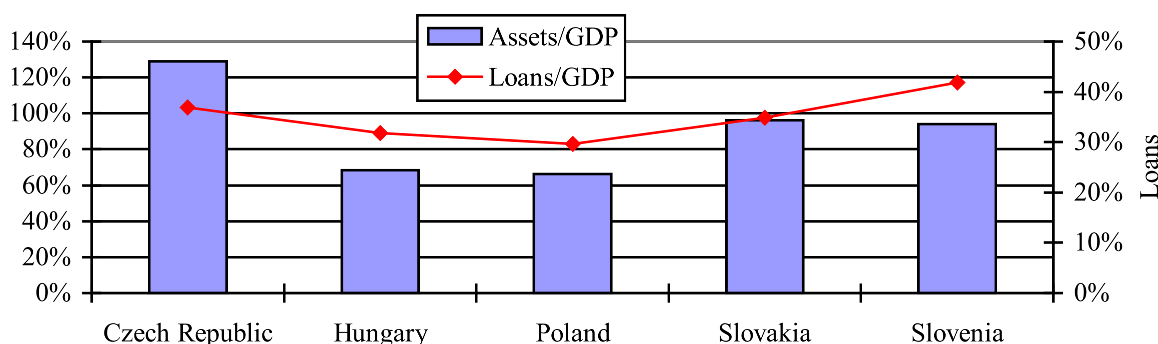


- Insurance companies are the second largest type of financial institutions, with growing importance; their share, however, is still below ten percent of the total assets.
- The depth of the financial markets is highly diversified across the countries, as measured by total assets to GDP ratio. It ranges from as low as 66 percent (Poland, Hungary), to well above 100 percent, which is comparable to the level in developed countries (the Czech Republic).
- Penetration of the economy by loans is much more limited; it ranges from 30 to 40 percent in the analyzed countries.

Basic ratios describing development of the financial system

	Czech Republic	Hungary	Poland	Slovakia	Slovenia
Bank assets/ttl assets	81,1%	86,2%	84,8%	92,7%	88,0%
Insurance co./ttl assets	9,5%	7,2%	8,4%	6,6%	8,0%
Assets/GDP	129,0%	68,3%	66,3%	96,3%	94,2%
Loans/GDP	36,9%	31,8%	29,6%	34,8%	41,9%

Bank intermediation



- In most countries banking sector is relatively strongly concentrated, as a result of traditionally dominant role of savings banks in planned economies, as well as due to the recent mergers and acquisitions within banking sectors (partly stemming from mergers of strategic investors abroad).
- Pension funds are relatively most important in Poland, while in other countries these are much weaker; it is a consequence of only recently taken steps toward a pension system reform.
- Role and size of the stock exchange in most countries is relatively low as a source of capital, that is shown by the low ratio of stock market capitalization to GDP.

In consequence, the banking sector plays the most important role in financial intermediation. Thus, robustness and stability of banks seem to be crucial for the further growth of the countries in question, in mobilizing savings and utilizing them for financing the investment projects.

Sources of funding of corporations and households

Banks are the main providers of funds to the economic agents, not only to large corporations but also they expand in the areas of household and SME lending.

- In financing of households one observes fast growth -- especially, in housing loans in some countries (Hungary, Poland), in consumer loans, as well as car loans (in Poland and the Czech Republic provided also by specialist banking institutions).
- Nevertheless, the level of households' indebtedness is low in comparison to the EU average but it is rapidly growing. It illustrates the tendency of households to catch up in consumption standards to the highly developed countries' levels.
- Business loans certainly prevail in banks' loan portfolios; e.g. the share of household loans ranges from approximately 7 percent in Hungary, 10 in Czech Republic, 15 in Slovakia to 27 in Poland.
- In most countries new types of banking outlets and ATMs grow at a fast pace, as well as the number of Internet and electronic banking, and different types of bankcard users. But still, the market seems not to be saturated with banking services and the appropriate financial depth has not been achieved.

Financial stability

Financial stability is determined, among others, by the role played by private owners (including foreign strategic investors), banks' performance and soundness, capital and reserves being buffers for risks, as well as by proper regulation and supervision framework.

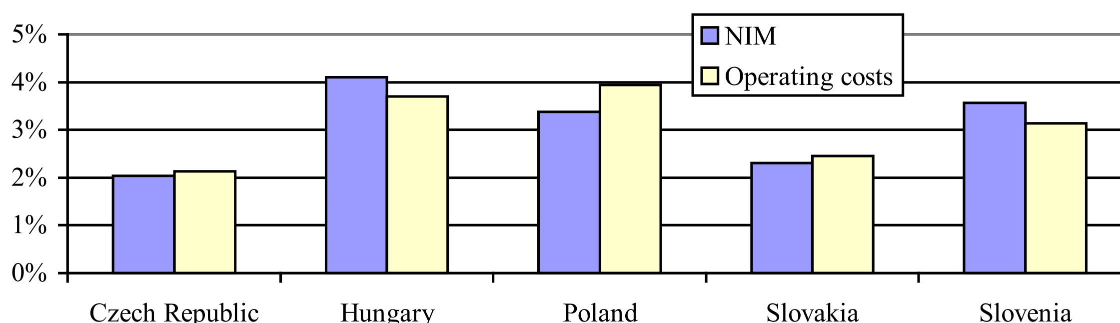
- Level of private ownership in the analyzed countries is basically different, since there were various strategies of bank privatization adopted. In countries where the decisive privatization was perceived as a remedy to constant recapitalization of state-owned institutions, privatization was achieved earlier than in other countries. In this respect Hungary remains a leader.
- Foreign participation in banking sector in most CEC5 is high; the highest proportion is in the Czech Republic, Hungary and in Poland. Foreign ownership is very low in Slovenia but it is expected to soar; similar strategy of greater openness to foreign capital in banking is also implemented in Slovakia.

Selected bank rations

	Czech Republic	Hungary	Poland	Slovakia	Slovenia
Non-performing loans	13,8%	3,4%	17,8%	21,9%	5,4%
NIM	2,04%	4,1%	3,38%	2,3%	3,56%
Operating costs	2,13%	3,7%	3,94%	2,45%	3,14%
Loans / deposits	66,1%	90,9%	76,0%	41,5%	68,9%
ROA (profit before tax)	0,45%	1,8%	1,36%	1,15%	0,4%

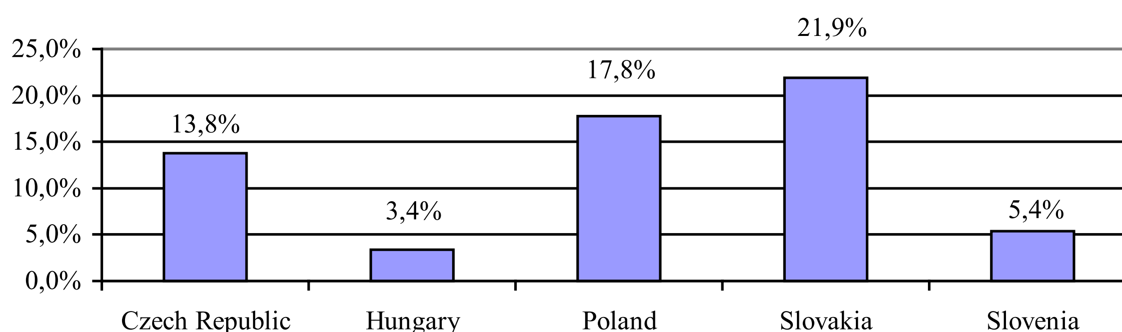
- Recent financial performance of banks has been positive in all countries but, at the same time, highly diversified. In Hungary, Slovenia and Poland Net Interest Margins was the highest ranging from 3,4 to 4,1 percent. Visibly lower ratios was obtained by banks in the Czech Republic and Slovakia, which could be attributed to very low interest level and consequently narrow spreads.
- There are large differences across countries in the ratio of operating costs to assets. In Poland, Hungary and Slovenia it is higher than in other countries, which implies a greater effort needed to cut them down in the future, to meet western standards and remain competitive.

Main source of net income (NIM) and main expenses direction (operating costs/assets)



- Lowest ratios of classified loans to total portfolios were observed in Slovenia and Hungary. That was a result of an effective restructuring in Hungary and favorable macroeconomic environment. The ratios in Poland, Slovakia, the Czech Republic were still of double digit, although reasons of this fact differ across the countries. Country studies point to credit boom in the past as one of the causes of high NPL ratios. In some countries (the Czech Republic and Poland) there are fiscal disincentives to write-off lost loans which additionally create the feeling for noticeably higher non-performing (impaired) loans.
- Differences in assets quality entailed very strong disparities in the ratios of provisions against classified assets. In countries with high non-performing loans share, provisioning substantially affect profits.

Non-performing loans as percentage of total loan portfolios



<u>Note:</u>
Figures shown on the above chart are hardly comparable, since there are no broadly accepted standards for classification of loans as non-performing. Additionally, some countries excluded from the sample banks under conservatorship (e.g. the Czech Republic) and some others did not (e.g. Poland).

- Return over average assets (before tax) is also highly diversified, from as low as 0,4 percent in Slovenia and Czech Republic to 1,8 percent in Hungary (mainly resulting from very low ratio of classified assets and ratio of provisions created against).

Major risk areas

- In most countries studied, the major area of risks to bank profits is <u>credit risk,</u> as illustrated by the share of non-performing loans and their coverage by specific reserves, as well as cost of provisions.
- <u>Currency risk</u> is seen as important, but not in all analyzed countries; it results from foreign currency lending to residents and open FX position of banks themselves and their customers. The propensity of bank clients to apply for loans in foreign currency ranges from very strong in Poland to rather moderate in Hungary (negative growth rate in 2001). This behavior affects the FX risk level in respective banking sectors.
- <u>Interest rate risk</u> is not perceived in CEC5 as posing a significant threat, since banks in those countries tend to give loans applying floating interest rates. This stance will probably change, along with the convergence of interest rates to EU levels and depressing inflation expectations.
- <u>Liquidity</u> position of banking sectors in the five countries seems to be good, given the proportion of loans to deposits.

In all analyzed countries there are well-organized *supervisory institutions*.

- In some countries there exists very close and formal cooperation of supervisory and regulatory institutions, e.g. in Hungary supervisors are formally integrated into unified agency, in the Czech Republic and in Poland a formal agreement has been concluded among various agencies.
- Supervision is performed on the consolidated basis in some countries (the Czech Republic, Poland, Hungary) that minimizes the risk, which bank subsidiaries might pass on to their parents.

- A credit information agency exists in some countries. In the Czech Republic the Central Bank established the Central Credit Register. In Poland Credit Information Bureau is a separate entity, established by banks and the Polish Banks Association.

Accession to the EU

Countries responded that they do not see imminent threats resulting from the accession to the EU. There exists, however, some possibility of reduction of domestic interbank operations, mainly foreign exchange operations, and it seems especially likely after the introduction of the euro as a national currency. The challenge, that the domestic banking sectors will have to face, is the possible increase in growth of lending to households after closing down the interest differential vis a vis EU.

Macroeconomic stability

In most countries one may observe some sings of external imbalances, high current account deficit and growing foreign indebtedness. In some countries also large inflows of capital produce the side effect of the appreciation of the domestic currency (real and nominal). There are also large differences of the overall financial safety indicators -- coverage of debt by foreign exchange reserves, ratio of short-term debt to total debt. As far as internal imbalances are concerned, in some countries inflation prevails, but with the tendency to decrease in time.

Conclusions

The country studies show the existence of many similarities in the shape of the financial markets. In all countries, banks dominate the financial systems. At the same time, however, other financial institutions grow fast, mainly insurance companies and investment funds. Privatization is also a common pattern, with an outcome of a growing role of foreign investors, which should add to the risk management capacities and hence to stability.

A limited role of the equity market and great importance of public debt financing needs undermine the role of intermediaries active on the market, mainly investment funds and brokerage houses. In some countries, there is a large number of institutions licensed, but assets under their management are disproportionally low. The role of pension funds largely differs across the countries depending on the stage of the system reform undertaken.

There are also large differences in loan portfolios' quality, tendencies in lending and taking deposits, role of the stock market as a source of financing, level of private ownership. In most countries there are in place strict regulations concerning the asset classification, but the effective coverage is diverse. In most countries banks were responsible for the bad loans resolution (restructuring). In the Czech Republic and Slovakia a different method was applied in banks prior to their privatization -- the State Treasury decided to remove the bad assets from banks' balance sheets and to transfer them to a specialist financial agency.

We may observe a very strong influence of the macroeconomic environment on the financial sector soundness -- the differences in the phase of the business cycle are evident to dynamics of lending, asset quality developments and bank profitability.

3. Country studies

Czech Republic

3.1. Structure of the financial system

The financial sector of the Czech Republic, as in other economies in transition in Central and Eastern Europe, has changed dramatically since 1990. A relatively advanced financial sector has been established and competition is growing. The financial market has been liberalised and there are an increasing number of foreign financial institutions now operating on it.

The Czech financial sector is relatively large and consists of banks, insurance companies, pension funds, investment companies, investment funds and brokerage houses, credit unions and leasing companies (see Table 3 in the Statistical appendix). The banking sector dominates the financial sector structure, accounting for 81.1% of total assets. Although the dominance of the banking sector has been declining over recent years, the role of the other entities, e.g. insurance companies, investment companies, investment funds and pension funds, is still underdeveloped by international comparison. The banking sector is the most important domestic financial intermediary.

All segments of the financial sector have undergone a process of consolidation, and just a few companies now control most of the total assets. The number of banks has declined considerably since 1995. Up until 1999, their number was decreasing mainly because of their poor financial situation, but more recently the decline has been due primarily to mergers. As at 31 December 2001 there were 38 banks and branches of foreign banks licensed to operate within the territory of the Czech Republic. The biggest groups are medium-sized banks (10 institutions) and foreign bank branches (also 10). There are 6 building societies and 8 small banks. One bank is under conservatorship. Three large banks play the dominant role in the market, although their share of the banking sector's assets has steadily declined from 66% at the end of 1998 to 58% (2001).

The entire financial sector has undergone concentration. The three biggest investment funds control the market. As of 31 December 2001 a total of 19 pension funds operated on the market; after concentration just three of them govern the market, with a market share of around 35%. The biggest domestic insurance company, which has been operating on the market for the longest period, has nearly 41% of the life insurance market and 37% of the non-life insurance market. The insurance market is strongly competitive. Two foreign insurance companies belonging to financial groups have gained a significant position. Under the law (harmonised with EU principles), life and non-life insurance will have been separated by 2010. All universal insurance companies will be transformed into life or non-life insurance companies. Credit unions do not play an important role on the financial market, managing less than 1% of total deposits.

The Czech capital market is still small compared with developed countries. As at 31 December 2001, the market capitalisation of the Prague Stock Exchange was USD 18.2 billion (consisting of shares, units and bonds; main, secondary and free market combined). This represents 30.7% of GDP (or 15.8% excluding bonds). Only a few financial institutions

(large banks and an insurance company) are traded on the Prague Stock Exchange. As at 31 December 2001, the market capitalisation of these entities was 4.6% of GDP.

The process of privatising the Czech banking sector was completed in mid-2001, with the state stakes in the large banks having been sold to strategic investors. This constituted a substantial change in the ownership structure of the sector. Roughly 95% of the banking sector's assets are now under foreign control.

The Czech banking sector consists almost solely of banks having the form of joint-stock companies.

As at 31 December 2001, the total assets of the banking sector amounted to CZK 2,784.7 billion (USD 76.8 billion, exchange rate as at 31 December 2001). The growth rate in the period from 1996 to 2001 was between 5% and 17% a year. All groups of banks contributed to the growth in assets. The most rapid growth was recorded by the medium-sized banks, whereas at the end of the period the lowest growth rate was recorded by the large banks owing to the process of privatisation and ongoing transformation. The Czech state transferred a major part of the bad loans in the credit portfolios of the large partly state-owned banks to a special non-banking institution. This was an important step prior to their privatisation.

The banking sector is still oriented predominantly towards classic banking; i.e. accepting deposits and providing credits. This situation is reflected in its total asset and liability structure. As at 31 December 2001, net credit accounted for 33% of total assets and client deposits for 49% of total liabilities.

The economic recession in recent years has affected the asset structure, reducing lending activity because of a shortage of creditworthy projects and leading to a decrease in credits as a percentage of total assets and in nominal terms in 1999 and 2000. Against this background, the volume of credits in the domestic economy has remained flat. Domestic corporations instead make use of foreign direct investment and their own funds. Credit is only available to clients of good standing. Small and medium-sized firms are suffering most from a lack of credit. Foreign companies are financed mainly by their domestic backers.

The growth rate of net credit was 15% in 1996; since 1999 it has slowed substantially (when net credit reached only 92% of the previous year's total). The first signs of economic recovery emerged in the second quarter of 1999, and the lending process is recovering, although not dramatically. This slow expansion is chiefly attributable to a lack of profitable investment projects.

On the other hand, retail banking is expanding apace. Demand for consumer loans, mortgage loans and building saving loans is growing particularly fast. Given that their total volume (CZK 117.1 billion as at 31 December 2001) is not a dominant factor on the market, the growth rate is significant.

The credit market caters primarily to the corporate sector. The share of credits to businesses is stable at just below 90% of total credits and that of credits to households at about 10%.

The credit portfolio is divided into domestic currency loans and foreign currency loans. The CZK portfolio has declined from 84% of total net credit in 1996 to 79% at the end of 2001. Nevertheless, it remains dominant.

3.2. Stability issues of the banking system

The banking sector has gone through a process of consolidation and stabilisation. This process has involved:

- resolving the problems of small and medium-sized banks in the mid-1990s,
- transferring a major part of bad loans from the large partly state-owned banks to a special transformation agency and preparing those banks for privatisation,
- completing the process of privatising the state-owned stakes in the large banks,
- stabilising the banking system by issuing rules harmonising the legislation and regulations with the laws and practices of the European Community; in this respect identifying all the risk areas in the banking business and limiting the potential problems,
- forging closer international co-operation, bilateral co-operation and co-operation of the regulators on the domestic financial market.

The development of financial banking groups led in 1998 to the signing of a tripartite co-operation agreement between the regulators on the Czech financial market: the Czech National Bank (banking supervision), the Securities Commission (oversight of the capital market and its participants) and the Ministry of Finance (supervision of insurance companies and pension funds). This agreement laid the groundwork for systematic co-operation. In practical terms, this co-operation primarily involves sharing information on regulated entities in the areas of licensing procedures, new shareholders in financial institutions, remedial measures and on-site examinations.

3.2.1. Factors determining financial stability

The Czech banking sector has undergone considerable qualitative changes over the last two years. These changes have strengthened and stabilised the sector.

The process of privatising the state-owned stakes in the large Czech banks was completed in the middle of 2001. This has been the primary factor influencing the ownership structure of the banking sector. All the large banks now have strategic partners. As at 31 December 2001 there were 16 banks and 10 foreign branches in foreign ownership, e.g. 71.1% of the total number of licensed entities on the market. The main strategic investors come from the EU. The state's holdings have decreased considerably. State ownership is concentrated in specialised banks that provide support for government programmes in the areas of export and assistance for small business. The foreign capital is already having a significant effect and is making an important contribution to fostering financial stability.

Capital adequacy is a very important indicator of financial stability. Until March 2000, capital adequacy – a basic and internationally applied standard for setting capital requirements in relation to the extent of banking activities and their degree of risk – covered credit risk only. Since April 2000, under a new "provision" (regulation) of the Czech National Bank, banks have also been required to include market risk when calculating capital adequacy. The calculation of capital adequacy in the Czech Republic is harmonised with the methodology applied in developed countries. As capital is a very important item and the measurement thereof in terms of capital adequacy is highly regarded, other institutions on the financial market, e.g. brokerage houses, also use this indicator of stability. As at 31 December 2001, the capital adequacy of the banking sector stood at 15.52% (for all 38 active banks). This is

almost twice the prescribed minimum limit of 8%. But capital adequacy also depends on the risk of the environment in which the banks operate. For the Czech Republic, capital adequacy should ideally be between 10% and 12%. Most of the Czech banks attain this level, and all of them comply with the 8% minimum.

As at 31 December 2001 overall capital amounted to CZK 132.3 billion (USD 3.65 billion, exchange rate at 31 December 2001), an increase of 6.5% on a year earlier. The dominant component is Tier 1.

In the course of their activities banks are confronted with a whole range of risks arising from both the external and internal conditions. Some of the primary risks associated with banking activities are credit risk, interest rate risk, liquidity risk, market risk and country risk. In accordance with international practices, the banking supervisory regulator issues fundamental rules and limits intended to limit the risks undertaken and to ensure sufficient funds to cover potential losses. The decisive factor in limiting bank risks, however, is a bank's ability to identify, monitor and manage specific risk. Prudent internal procedures for the overall management of the bank and for specific transactions are an essential precondition for its successful functioning.

The Czech banking sector is characterised by stable growth in primary resources, high liquidity and good capitalisation. Credit risk, on the other hand, poses the greatest threat. The main problem has been a relatively high burden of non-performing loans. Since 1999 the share of these loans in the total volume of loans has been falling thanks to the transfer of bad assets from the large banks prior to their privatisation. This situation has led to a reduction in the volume of newly granted credits.

As at 31 December 2001, coverage of the total volume of non-performing loans with reserves and provisions was 75.23%. The large volume of non-performing loans is due to relatively high credit exposure to the troubled part of the corporate sector, limits on tax-deductible loan loss provisions (motivating banks to postpone write-offs), and the generally protracted nature of legal proceedings. Nevertheless, this large volume does not pose a threat to the stability of the banking sector. The banks have created provisions and reserves covering just over 80% of the risky part of the loan portfolio (see Table 4 in the Statistical appendix).

In this respect the banking sector is showing ongoing stability. The process of enhancing the legal environment is continuing; the economic situation of the corporate sector is at last improving; the state as a former owner has transferred a large portion of non-performing loans to a state agency and cleaned up loan portfolios of the large banks; and the new owners of the large banks are expected to implement efficient and effective credit processes. One of the ways of reducing credit risk is to raise the bank's awareness of the credit exposure of potential clients and their record of payment discipline, financial situation and so on. The Czech National Bank has decided to get involved in this area by operating a central register of credits, which will be launched this year.

Market risk covers interest rate risk, foreign exchange risk, equity risk and commodity risk. In line with the new capital adequacy framework, banks have to hold a minimum volume of capital in respect of all these risks. The relevant requirement for the banks resulting from Czech National Bank provisions relates to capital adequacy. Whereas exposure to foreign exchange risk can be assessed from angles other than capital requirements (as detailed

statistics are available for this area), other sources of data are limited in the case of interest rate risk.

With regard to interest rate risk, interest rates declined steadily during 2001. The Czech National Bank's banking supervisors address this issue during on-site examinations. Banks generally assess their interest rate risk exposure using knowledge of the distribution of their assets and liabilities into time bands using the gap or duration method.

The foreign exchange risk to which Czech banks are exposed is currently linked primarily with the development of the US dollar and the euro. The Czech banking sector is principally oriented towards meeting the needs of the domestic economy and population. As a result, most banking operations are conducted in koruna and the exchange rates of the Czech koruna are the determinant of exchange rate risk.

Not all banks are exposed to the same degree of foreign exchange risk; large differences exist between the different groups of banks. Branches of foreign banks conduct the largest amount of foreign exchange transactions owing to their close ties with their home country. This applies both to sources of funds (e.g. credits and the interbank market) and to the use of such funds.

The foreign exchange risk of the banking sector as a whole is very low, thanks to maintenance of equilibrium of the foreign exchange position, including in the off-balance sheet.

The stability of banks and the banking sector as a whole is also determined by the ability to generate a satisfactory profit from banking activities. In 2001, the banks operated in a highly competitive environment characterised by low interest rates. Its parameters were close to those in the eurozone. Banks' margins were also very narrow. Interest profit and profit from fees and commissions are the core components of the profit.

Profit from banking activities reached CZK 92.4 billion in 2001, the highest level of profitability in three years. The main reasons for this good result are increased profits from securities and derivatives transactions, which were loss-making in the previous year in the banking sector as a whole. Profit from banking activities was positively influenced by increasing profit from fees and commissions and a moderate improvement in net interest income. The increased profit from clients' fees and commissions reflects the changing profit structure of banking activities.

The dominant large banks accounted for nearly two-thirds of the profit from banking activities in 2001; this corresponds to the size of their assets. Unlike in 2000, break-even was achieved in 2001 in the process of creating provisions and reserves. In 2000, the impact on profit had been positive. In 2001, reserves and provisions of CZK 5.1 billion were created; this had a negative impact on profit.

The growth rate of general operating expenses of banks decreased for several years up to 2000. In 2001 this item rose by 6.9% owing to growth in the operating expenses of the large banks.

Banks are striving to increase their efficiency and productivity by developing new ways of serving customers, especially electronic banking, which facilitates fast access to banking services without the need to visit the bank. Clients are gradually ceasing to communicate

face-to-face with staff in branches and are starting to get used to the new information and communication environment provided by new technology. Direct banking is on the increase. Growth in the number of payment cards continued to rise in 2001, especially in the retail sector. The use of payment cards still does not correspond with their primary intended role as a means of payment for goods and services. Such cards are used chiefly for withdrawing money from ATMs. As at 31 December 2001 there were 1,923 ATMs, representing an annual growth rate of more than 20%. The number of ATMs has been steadily rising in the Czech Republic since 1996. As at 31 December 2001, a total of 4,516,300 debit cards were in use. There were only 53,200 credit cards, but in 2001 these recorded their highest-ever annual growth rate of 37.5%. Electronic banking is used mainly for payment services. A full 20.3% of the total volume of payments was delivered to banks by new technology. Telephone banking has a strong position, while PCs are less widely used. As mobile telephone use has spread rapidly throughout the country over the last two years, mobile banking is not gaining a strong position.

The stability of the Czech banking sector is affected by its liquidity. Financial intermediation is based on domestic deposits. Client deposits have increased steadily, standing at CZK 1,477.8 billion as at 31 December 2001. In the Czech Republic people deposit their money mostly at the bank, even though there are other possibilities, e.g. pension funds, life insurance, mutual funds and so on. Financial intermediation is still underdeveloped.

3.2.2. Challenges related to accession to the EU

- Accession to the EU will certainly influence the banking sector in the Czech Republic. The banks will operate on a free market, with free movement of goods, services, capital and labour. Banking here will converge towards the parameters of the banking sector in the EU member states.

- In accordance with the accession process, financial services will have been fully harmonised by 2003.

- Owing to the completion of privatisation, the ownership structure of the banking sector has changed. Most banking assets are controlled by foreign investors. The sector is becoming integrated into the European banking structure.

- The owners of the large banks operating on the domestic market and their strategy will influence the further development of the sector.

- It can be expected that the strong strategic partners will strengthen competition so as to gain market share, as well as improving performance by supplying know-how, introducing new products and services, transferring new technology and optimising branch networks.

- The future structure of the banking sector will depend most of all on the strategy of the large banks and market potential. There are opportunities to be exploited, e.g. retail banking, underdeveloped insurance banking, investment banking and so on.

- The further development of the banking sector will be closely linked with that of the domestic economy; there is still growth potential.

- The dominant role will be played by the large banks, whereas small banks will specialise in particular banking products, services and segments.

- Overall trends will be seen towards mergers and acquisitions, integration, increasing competition, growing strength of banks, rising profitability and use of new technology.

- Mergers and acquisitions in the euro area are expected to influence the ownership structure of the Czech banking sector.

- Since 1998, inflow of FDI has started to be an important substitute for domestic credits. A large proportion of the FDI inflow has been attributable to massive privatisation of state-owned stakes in the large banks and other major enterprises. Only a few companies remain to be sold to a strategic investor. The future inflow of FDI will be based on a sound entrepreneurial environment and a strong and healthy economy.

- Inflow of capital from structural funds will be neutral from the financial stability standpoint. There are no exceptions in this area for the Czech Republic in its process of accession to the EU.

The fundamental principles of banking sector regulation are set forth in the Act on Banks. These principles are specified in more detail in a series of Czech National Bank (CNB) provisions (regulations). The current CNB Provision on Capital Adequacy Incorporating Credit and Market Risk entered into force on 1 April 2000. For banks, this regulation meant above all a further qualitative shift in risk measurement and management. It also sets credit exposure limits and limits for open foreign exchange positions. There are no problems within the banks as regards capital coverage of credit and market risk.

The current CNB Provision on Banking Supervision on a Consolidated Basis entered into force on 19 July 1999. This provision for the time being relates to capital adequacy incorporating credit risk only. A provision on capital adequacy incorporating the credit and market risk of consolidated groups will enter into force on 1 January 2003.

Hungary[1]

3.1. Structure of the financial system

The structure of the Hungarian financial sector has undergone a dramatic change in the past decade, and new types of institutions have appeared on the market. Nowadays, the financial system consists of almost all kinds of institutions which usually form an integral part of a developed market. The vast bulk of financial intermediation (nearly three-quarters, measured by balance sheet total) is performed by credit institutions in Hungary. Non-bank financial intermediaries are rapidly gaining ground, however, they are still small in size compared to Western standards.

There are 41 credit institutions operating in the form of companies limited by shares, of which 33 are licensed as banks and 8 as specialised credit institutions. The number of banks has decreased slightly over recent years in Hungary due to liquidations and acquisitions, although the extent of these was rather limited. In addition to commercial banks, there are also a large number of mostly small co-operative credit institutions. At the end of 2001, their number amounted to 184 savings co-operatives and 7 credit co-operatives, 7 less than a year earlier. This decrease was primarily due to regulatory factors, as several savings co-operatives had to merge in order to comply with the minimum capital requirement set by the Banking Act. Despite the large number of co-operative credit institutions, their aggregated market share is currently around 6%.

The balance sheet total for the sector of credit institutions (including banks, specialised credit institutions and co-operative credit institutions) amounted to HUF 10,145 billion (USD 36.4 billion) at the end of 2001, exceeding the figure for the previous year by 13.2%, or 5.8% in real terms.[2] Both banks and co-operative credit institutions grew above the inflation rate. However, due to the relatively rapid growth of the economy, the banking sector's average balance sheet total as a percent of GDP declined slightly to 60.5% by year-end, which is quite low in an international comparison (see Chart 1 in the Statistical appendix).

The driving force behind business expansion is robust lending activity, so that traditional banking intermediation deepened significantly, following the pause in 1999. The stock of outstanding lending to the corporate and household sectors was 25.7% of GDP at end-2001 (see Chart 2 in the Statistical appendix).

The year 2001 witnessed only minor changes in the ownership structure of the banking system. Foreign ownership decreased by 3.6 percentage points to 63% at the year-end, while the share of state ownership within residents' domestic equity holdings rose at the expense of credit institutions, enterprises and individuals. (Excluding the Hungarian Development Bank, a special-purpose state development institution from the statistics, and focusing only on commercial banks, the foreign ownership amounted to 76%.)

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[1] This study is based on a paper prepared by Balazs Zsamboki for the ECB workshop on "Financial Sector Structure and Functioning in Accession Countries". Special thanks to Erzsebet Nagyne Vas, Eva Fischer, Csaba More and Zoltan Gyenes for the valuable comments and written contributions.
[2] Official HUF/USD exchange rates for 2001: annual average: 286.54, end-of-year: 279.03.

The number of employees working in the banking sector has been steadily decreasing for years now, while branch density has remained relatively stable. Between 1996 and 2001 the number of employees decreased by more than 20% to 26,198. The branch network consists of around 1,200 units (i.e. 8,400 inhabitants / branch).

The non-bank financial sector includes investment funds, insurance companies, pension funds and investment firms. In recent years, vigorous growth has characterised non-banking financial intermediation in Hungary, however its depth is still low by international standards. While the number of participants in the market of the non-bank financial intermediary system is relatively high (exceeding 500), in respect of insurers, investment funds and private pension funds the degree of concentration is very high. In 2000 and 2001, the development of the non-bank financial intermediation again showed the dynamic growth which has characterised the past few years. Owing to the low base, however, the combined share of investment units, life insurance premium reserves and claims against pension funds in the financial assets of households was only around 20%, even at the end of 2001. The comparable figure was only 9% in 1996.

Looking at the asset side of the balance sheets of these institutions, however, it becomes clear that they invest their funds largely in government securities well above the required level. Moreover, the share of risk-free investments has increased considerably over the past three and half years, attributable mainly to the unfavourable capital market trends on the heels of the Russian crisis which still characterise certain parts of the Hungarian capital market.

Non-bank financial intermediation is not independent of banks' activities. The growth registered by financial intermediaries linked to banking groups has outpaced the performance of the entire sector. This appears to buttress the view that banks, particularly large banks, can provide a better background as regards the provision of finance and services, and that investor confidence in such institutions is higher.

Investment funds can boast of dynamic development over the past few years, with the exception of last year, which was characterised by a more modest increase in the net value of assets. At the end of 2001, 106 investment funds were operating in Hungary. At present, investors may choose between equity, bond, mixed, hedging, money market, foreign equity, foreign bond funds and real estate funds. Because of the stagnating equity market, in the last one and half year only bond funds and mixed funds were able to achieve significant growth. The market is dominated by fund managers with direct or indirect bank ownership backing - their market share is 96-98% with respect to assets managed.

The annual gross premium revenue/GDP ratio has been continuously rising since 1995. With respect to the distribution of insurance premium revenue between the branches of insurance, life insurance represents a greater weight in OECD and European Union member states, accounting for more than 60 percent of gross premium revenue, while the comparable figure for Hungary was around 40 percent in 2001. The number of insurers operating as companies limited by shares decreased by one, to 22 in 2001. Bank assurance has been gaining more and more ground in Hungary. In addition to contractual co-operation agreements, an increasing number of insurance companies are backed by banks as owners.

The legislation package, which is regarded as the foundation of the new three-pillar pension system, was adopted in the summer of 1997. The actual start-up of the system, that is, the beginning of the financial processes of the flows of membership fees, took place from

February 1998. The opportunity to establish voluntary pension funds was created earlier than private pension funds, namely in 1994. In respect of non-bank financial intermediaries, pension funds have performed the most saliently over the last few years. This was due mainly to the low base and to the mandatory nature of the second pillar. Indicating the growth potential of pension funds, their total assets can amount to some 30–40% of GDP in developed countries. The total wealth of Hungarian funds accounted for around 5% of Hungary's GDP at the end of 2001. At the end of 2001, 138 pension funds were operating in Hungary.

A number of negative influences have affected the economic environment of investment firms recently. The uncertain business outlook, the worsening performance of listed companies and the slowdown in the increase in profits of a few blue chip firms all pointed in the direction of a withdrawal by international institutional investors who mobilise large amounts of capital. As a result of passive market behaviour on the side of the largest investors, turnover volumes and prices both fell at the Budapest Stock Exchange. As a result of the grim capital market outlook, more and more banks are taking the opportunity to integrate their investment services affiliates and become universal service providers. Also, the significance of non-bank owned independent investment firms has decreased seriously in the past few years. Therefore, the significant narrowing of opportunities, the intensification of competition and, simultaneously, a period of strong restructuring and consolidation characterised the market of investment service providers in 2000-2001.

Financing requirement of businesses

In 2001, the net financing requirement of corporate sector decreased in comparison with previous year. This can be largely explained by the slowing rate of growth of investment. Although the financial assets of businesses increased at the same rate as in the previous year, liabilities rose only modestly.

Last year the structure of financing changed significantly. As the FX credit risk has increased as a consequence of the intervention band widening, the share of FX credit taking went down from 75% to 61% within the total finance requirement. Beside this process, the weight of intercompany loans multiplied. The diminishing growth rate of the import demand of investment may also have contributed to the falling share of FX credit in the financing of the businesses.

The level of leverage of non-monetary companies rose from 71% to 80% during 2000.

3.2. Stability issues of the banking system

3.2.1. Factors determining financial stability

Financially committed owners, endowment in capital

Privatisation of the Hungarian banking sector, which took place in the wake of the bank restructuring programmes between 1993 and 1994, was completed by the second half of the decade. Privatisation was carried out in the form of open tenders, and one of the new responsibilities undertaken by the new owners was to further reinforce bank capital. As a result, today some two-thirds of the Hungarian banking sector is held by foreign strategic owners. A great number of new banks have been set up, operating invariably in the form of

subsidiaries, which also contributed to the high proportion of foreign ownership. Even though allowed under Hungarian law, up to now no foreign bank has opened a branch in Hungary. In addition to the non-resident owners, with a strong capital base, there are some institutions engaged in special activities which remain predominantly state-owned.

The banking sector has adequate capital, and its reserves are in proportion to the risks taken. This has been reflected in the development of the capital adequacy ratio over the past few years. The capital adequacy ratio of the banking sector has been hovering somewhat above 14% for years now, providing an adequate level of cover against the increasing exposure to credit and market risks. At the end of 2001 the ratio stood at 14.2%. With regard to the capital structure of the banking system as a whole, the own funds of credit institutions mainly consist of Tier 1 capital, and the stock of Tier 2 elements - mainly subordinated loans - runs only to 15% of Tier 1 capital. Although from January 2000 the calculation of the banks' own funds can include the subordinated loan capital only to the extent of 50% of Tier 1 capital, (previously the limit was 100%), even this lower limit has remained unutilised by banks. Risk-weighted assets are growing at a similar rate as regulatory capital, therefore as far as capital adequacy is concerned no problems are expected in this field over the near term.

Risk management

Credit risk

Of the risks taken by the banking sector, lending risk is being affected to a great extent by the lending boom seen over the past two or three years. This is reflected in an upsurge in the proportion of loans within the banking system's balance sheet.

As credit institutions are not able to fully cover their sharply increasing lending by funds from customers, nowadays they are implementing a major on-balance-sheet restructuring of assets basically at the expense of advances to the central bank. Within the term structure of the balance sheet, the share of long-term lending is growing. As a positive change, the proportion of long-term liabilities within bank liabilities are also rising, thanks primarily to increases in internal funds and long-term foreign liabilities.

Corporate business line

Corporate lending of the banking sector grew by 10% in 2001, lagging somewhat behind the growth rate of total assets. After exceptionally high growth rates in 1999 and 2000, co-operative credit institutions increased corporate lending by 24% last year, accounting for 7.4% of total corporate lending by credit institutions. Annual lending growth stemmed entirely from forint-denominated loans, and in contrast to the year 2000, which witnessed a robust expansion in foreign exchange lending, FX loans shrank even in nominal terms last year. Lending to small, medium and micro-sized enterprises expanded at a faster rate (14.6% in 2001) than did corporate lending as a whole. At the end of 2001, credit to such enterprises slightly exceeded 30% of the total stock of corporate lending.

An analysis by economic sectors reveals that banks are increasingly reluctant to finance agriculture and food industry enterprises, which has resulted in a significant fall in total lending to these sectors in the past two years. These firms are viewed as involving the greatest risk, mainly due to a shortage of capital and slow technological progress.

The five banks holding the largest market share accounted for 58% of total corporate lending by the banking system, which reflects some increase in concentration relative to 2000.

Household business line

Household lending represents the fastest growing area of the banking system's operations, although households were previously treated only as a source of deposits. Households' motivation to borrow is based on the ever-wider range of products and services available, higher incomes held by certain sections of the population as well as favourable macroeconomic conditions. This trend is expected to continue over the coming years. Nevertheless, Hungarian households' level of indebtedness (i.e. the ratio of household financial liabilities to disposable income) – currently at around 7% – falls far short of the above 50% rate seen in EU member countries.

The stock of household lending by credit institutions was up by nearly 50% in 2001. Credits extended by savings co-operatives rose at a rate of 29%. This raised the share of household lending within total credit institution assets from 5.9% in 2000 to 7.4%. This figure is still very low in an international comparison and a further increase is expected in this field. Loans with a maturity over one year are predominant in this market segment, accounting for nearly 90% of total lending. The five commercial banks most active in the household market accounted for 51% of lending, reflecting a gradual decline in concentration compared with the previous years.

Currently, consumer credit represents the largest share of household lending by credit institutions. In this field a rise of 46.6% was recorded in 2001. Of consumer credits, auto financing, offered largely by specialised institutions, is worth mentioning. The year 2000, and even more so, 2001 witnessed a breakthrough in lending by credit institutions for housing purposes. After a steady decline over the previous few years, housing credit started to pick up pace. Accordingly, mortgage-type household credit rose by HUF 136 billion (ca. USD 475 million) in 2001, amounting to HUF 324 billion (USD 1.2 billion) at the end of the year, a growth rate of 70%.

Portfolio of the banking system

The proportion of classified assets within the total portfolio increased in 2001, reflecting a moderate deterioration in portfolio quality. Although classified assets rose slightly, the increase mostly affected the category "special watch", while the other categories involving higher risk (substandard, doubtful and bad) hardly changed. The proportion of non-performing assets declined at a steady pace in the years after the Russian crisis, sinking below its pre-crisis level (4%) by end-2001 (3.6%). Nevertheless, the improving trend in respect of this category also seems to have lost considerable momentum in 2001. As a combined result, the proportion of weighted classified assets within on-balance-sheet items fell slightly from 2.3% to 2.2%, reflecting a moderation in aggregate risk.

All in all, the evolution of portfolio quality seems to pose no short-term threat to the stability of the banking system, and the degree of the recorded revaluation loss also appears to be acceptable, which reflects banks' prudent ratings policy. The extent of medium- and long-term risks is regarded as dependent primarily on the position of the economic cycle, with special regard to that of the lending cycle.

Exchange rate risk

In May 2001, the National Bank of Hungary lifted the constraints of the crawling peg system, adopted in 1995, and a widening of the forint's exchange rate band against the euro (from 4.5% to 30%) enabled the exchange rate to appreciate in nominal terms. In the course of June 2001, a number of remaining foreign exchange restrictions were scrapped, bringing about full convertibility of the forint for residents and non-residents alike.

As the widening of the fluctuation band increased exchange rate risk, economic agents felt motivated to curb their foreign exchange exposure. This was reflected in the composition of the banking system's balance sheet in terms of denomination, with both the assets and liabilities side seeing a reduction in the weight of foreign exchange items, although the former to a much lesser extent. At end-2001, foreign exchange assets and foreign exchange liabilities accounted for 34.2% and 33.6% of the balance sheet total, respectively. In other words, by the end of the year, the earlier short position in foreign exchange changed signs on the balance sheet of the banking system.

It should be noted that the open positions of certain banks have increased in volatility since the widening of the band. The factor at work here is that as a logical consequence of the significant widening of the fluctuation band, market participants' expectations of the direction and size of exchange rate movements have become more heterogeneous, in comparison with those under the narrow-band crawling peg.

Interest rate risk

The first nine months of 2001[3] saw a continuation of the trend experienced in 2000, as the banking system narrowed the repricing gap of the forint[4]. The cumulated 90-day repricing gap of the forint shrank by 0.8 percentage points as a proportion of the balance sheet total, relative to end-2000. By contrast, the same period witnessed an increase of 1.3 percentage points as a proportion of the balance sheet total in the cumulated 90-day foreign exchange repricing gap.

For the banking system as a whole, exposure to interest rate risk measured in terms of the repricing gap appears to be low both on the forint and foreign exchange sides. Even though the domestic market of interest rate derivatives is not yet very advanced, the management of interest rate risk within the balance sheet is significantly facilitated by the fact that the great majority of interest-bearing assets and liabilities (77% and 89% respectively) have floating interest rates.

Profitability

Pre-tax profits for 2001 amounted to HUF 164 billion (ca USD 570 million), 1.5 times the figure for 2000. Favourable tendencies in earnings have been experienced for two years now. Factors behind this marked improvement in profitability includes a rise in interest earnings

[3] With no reliable data available on December 2001, changes in the repricing gap can only be assessed over the first nine months of the year.
[4] The repricing gap is defined as the difference between interest-bearing assets and interest-bearing liabilities that have been repriced within the period under review. Reference to the direction of a shift in the gap applies to the absolute value of this difference. Thus, the narrowing of the negative gap, typical of forint items, reflects a drop in the open interest rate position and consequently in exposure to risk.

arising from stronger lending activity; a considerable increase in income from fees and commissions; moderately rising costs and improved cost-efficiency.

Return on equity (ROE) figures also reflected a significant improvement in the profitability of credit institutions. Banks experienced the most spectacular change, with their ROE up from 4.1% in 1999 to 11.6% and 16.6% in 2000 and 2001, respectively. The market share of loss-making banks and the size of the losses are also declining. Interest earnings are improving mainly because interest-bearing assets are expanding faster than interest-bearing liabilities. This is also reflected in the development of the spread, which, after narrowing somewhat until September 2000, rose to a slightly higher level.

An analysis of interest receipts reveals that interest income realised on loans increased sharply both in nominal terms and in terms of proportion in the two years under review (from 44% of interest income to 54% in 2000 and 61% in 2001). At the same time, interest expenditure on customer deposits decreased within total interest expenditure.

Contrary to earlier experience, operating costs rose at roughly the same pace as inflation in 2000 and 2001.

Liquidity

Due to the expansion of credit, the (annual average) loan/deposit ratio[3] of the banking sector as a whole has increased substantially over the past two years, with the market share of banks with an (annual average) customer credit/customer deposit ratio of over 100% rising from 34.2% in 2000 to 46.4% in 2001, as a proportion of the balance sheet total. Nevertheless, a decisive tightening in banks' liquidity position occurred in 2000. In 2001, the liquidity reducing effect of the expansion of credit to households was offset by a slowdown in the growth of lending to enterprises, accounting for a higher portion of total lending, and the pick-up in the pace of lending to households, accounting for a higher share of deposits. (As a result, the loan/deposit ratio was confined basically to the range of 81-82.5% in that year.)

The banking sector continues to project a reassuring picture in terms of liquidity on both the assets and liabilities sides. In 2001, following a two-year downward trend, banks' liquid assets remained virtually unchanged as a proportion of the balance sheet total, and the ratio is sufficiently high (at 31%), while the share of money market liabilities within external liabilities, viewed as the most volatile, has been on a decline for several years now, and is sufficiently low (at 6.7%).

The maturity transformation implemented by the banking sector gained considerable momentum in 2001, mainly because the funds furnishing the increase in long-term household and corporate loans came predominantly from short-term deposits by customers.

[3] Lending to non-financial corporations, auxiliary companies and households/deposits and securities held by non-financial corporations, auxiliary companies and households.

3.2.2. Challenges related to the accession to the EU

Channeling foreign currency inflows stemming from FDIs and structural funds

In Hungary, government transactions involving foreign currency (e.g. conversion of the revenue from a forex bond issuance into domestic currency) are usually done via the NBH. Thus, the interbank forex market is not affected by these potentially large transactions. Transfers, such as those from EU structural funds are supposed to be handled the same way, i.e. they are not likely to influence exchange rates or market conditions on the forex market, no matter how large these inflows are.

As to the impact of FDIs or, more specifically, privatisation inflows, the use of these revenues is not determined by strict legislation and is largely at the discretion of the government. However, for a long time, the practice has been that these inflows are used to repay sovereign debt and currently there are no signs of changing this policy.

Competition with EU banks

The possible effects of EU accession on the Hungarian financial market is analysed by a study recently published in the NBH's Report on Financial Stability.[4] The study, which has the banking system in its focus, reveals that the economic strength of Central and Eastern European countries would imply larger and more developed banking sectors, and that the banks in accession countries have considerable growth potential. This is underlined by the low balance sheet total-to-GDP ratio, which is at least two or three times higher in European states than in Hungary.

With regard to the current level of balance sheet total, there appear to be too many banks, implying that the average size of banks is below the optimum level. In other words, the Hungarian market is generally considered as overbanked. However, looking at the density of branches, Hungary's is not overbanked, although technological development will certainly make some branches redundant.

Liberalisation of establishing branches

Provisions, which apply to the single market, will come into force upon Hungary's accession to the EU. Of these, the implementation of the 'Single European Passport' may cause significant changes, which will allow European banks to provide services in Hungary as well, either directly or via branches, without the need to apply for an additional licence. In Hungary, regulations on branch opening continue to include some restraints, the most important of which is the endowment capital requirement, which should be terminated upon accession. However, some of the Hungarian subsidiaries of foreign banks are already operating like branches, which is perceptible in many areas ranging from decision-making mechanism to risk management activities. Therefore, strategic decisions to be taken by parent banks will be crucial for the future of Hungarian banks. The transformation into branches from subsidiaries currently operating in Hungary is not expected to have a significant influence on the banking market, as the transformation will likely affect banks operating as quasi-branches, and the operations of these will have a limited impact on the retail market.

[4] Zsámboki, Balázs (2001): Probable Impact of Hungary's Accession to the EU on the Hungarian Banking Sector, Report on Financial Stability, National Bank of Hungary, May

Transformation of market structures

European experience shows that growth potentials related to traditional banking activities (deposit collection, lending, and payment transactions) have become very low by now. Moreover, Hungarian banks' lending activities are not so much concentrated on the entire corporate sector, but primarily on large companies, which will have much easier access to international sources of finance following accession. The shift in large companies' focus towards the capital market will very likely impede the development of domestic banks. However, large-scale restructuring is expected in the corporate sector as a result of accession. The related waves of acquisitions and mergers may facilitate the expansion of bank lending. Generally, it can be expected that the Hungarian economy, becoming increasingly stable as a result of the convergence criteria will grow at a high rate, which may also contribute to the expansion of bank lending.

Lending will likely shift towards small and medium-sized enterprises as well as households in Hungary. The borrowing capacity of these market segments will improve due to robust economic growth and the increase in real incomes, which will reduce banks' risks. Moreover, experience has shown that the pick-up in lending not only accompanies economic growth, but even outperforms it.

The Hungarian financial market is much more bank-oriented than the European average, with banks playing the dominant role in corporate finance. The underdevelopment of the Hungarian non-bank (equities and bond markets) intermediary system is even more striking relative to EU member states, which makes it likely that growth will concentrate on this sector. This process will be further reinforced by the ageing of the population, increasing the importance of long-term forms of saving. These factors, in turn, will impede banks' growth, and so the expansion of market activities will affect mostly the non-bank sector.

Estimating the future growth potential of the banking sector is not an easy task, since the effects of accession may strengthen or offset each other. Growth in the banking sector will more likely reach or slightly exceed GDP growth. But this process probably will not be spectacular. Rather, it may be realised gradually, over several years (or decades).

In countries the size of Hungary, in most cases there is a much higher degree of market concentration, and where the situation is different, for example, in Austria, there the reason can be found in the strong co-operative banking sector and the massive regional segmentation of the financial sector. None of these factors plays an important role in Hungary, so market forces will likely enforce a higher degree of concentration, or they will drive smaller banks either towards closing-down or force them to focus on a particular market segment.

Joining the single European market will likely further strengthen competition in Hungary. As a consequence of intense market competition, interest margins and fee charges are expected to fall, in line with the general trend, although income from fees could even increase due to the expansion of universal banking. It is also expected that non-bank entities will take an increasingly higher share of profit making within banking groups.

Joining EMU will certainly confront Hungarian banks with new challenges also in the field of monetary policy. Institutions may struggle to acquire access to ECB funding when not disposing over the quantity and quality of collateral. However, obtaining foreign interbank

finance will probably not cause problems for the majority of Hungarian banks, but for banks that do not have the backing from a foreign parent bank.

Generally, it can be expected that the parents of Hungarian banks will concentrate treasury operations in their own headquarters, which will narrow the room of Hungarian branches and subsidiaries for manoeuvre.

Impact of the CAD II directive implementation

The CAD I. and CAD II. directives of the EU have already been implemented in Hungary. The introduction of the new regulations did not cause any major problems and no significant impacts are expected in the coming years. We believe that the accession to the European Union will be a smooth process and the Hungarian financial system is strong enough to withstand the challenges posed by the accession. More likely than Hungary's accession to the EU, joining the euro area will induce perceptible changes in the Hungarian banking sector.

Poland[5]

3.1. Structure of the financial system

Polish financial system has undergone dramatic changes and has become more diversified over the last decade. It has been privatized both by selling to private entities and opening the market to generic private institutions, many of which are foreign-owned, reputable institutions. Foreign ownership, thus, has increased substantially in all segments contributing to the overall stability. The presence of foreign partners has led to the larger competition and subsequently to the enrichment of the range and quality of services, as well as implementation of modern risk management techniques.

Despite the emergence of new types of institutions and significant growth of their size in the 1990s, combined assets of the financial system in Poland still account to less than eighty percent of GDP. The financial system is somewhat dominated by banks, which overtake other institutions by the size of assets and capital, but also are leaders of larger financial groups/conglomerates. The other segments of financial system, especially pension funds, grow comparatively fast and in the future may compete more severely with banks for household funds/deposits.

The second largest segment of the financial system in Poland is the insurance sector. The number of insurance companies almost doubled over the last six years, from 39 in 1995 to 71 in 2001. In 2001 the combined assets of life and non-life insurance companies amounted to $11.9 bn, or seven percent of GDP. There is a potential for development of the sector in the future, since in the previous economic system the life insurance sector was virtually non-existent and household saturation with life policies is still low.

Pension and mutual investment funds are becoming more important players on the financial market. The pension system in Poland was reformed in 1999 when 21 pension funds were originally registered. At the end of 2001, due to M&As, the number of pension funds decreased to 17 while their total assets increased to $4.9 bn, or 2.7 percent of GDP. At the same time there were 94 mutual funds in operation run by 17 investment funds corporations. The total value of assets managed by investment funds amounted to $1.8 bn, or 2.4 percent of GDP. The other participants of capital market are brokerage houses. There were 6 entities belonging to banks and 36 independent ones. The amount in their management stood at the level of $1.2 bn (shown as the off-balance sheet item in the footnote to Table 3 in the Statistical appendix).

The smallest piece of the financial market is the credit union sector. In 2001 there were 140 credit unions and their total assets amounted to $445.8 mln. Although small in size, they grow very dynamically, being strong competitors for co-operative banks, which target similar clientele.

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[5] The Polish chapter was written by employees of the Research Department of the NBP, led by Paweł Wyczański. The other team members were Michał Brzoza-Brzezina, Marta Gołajewska, Ewa Sadowska-Cieślak and Marzena Zaremba. The authors would like to express their special thanks to Grażyna Domańska and Wojciech Kozłowski for language and technical support.

The size of Polish capital market is still relatively small in comparison to developed countries. At the end of 2001, capitalization of the Warsaw Stock Exchange reached $26 bn or 14.4 percent of the GDP (down from 20 percent in 2000). The number of listed companies at the end of the last year was 230 but only 10 new participants were floated in that year. Low capitalization of the WSE, limited number of newcomers to the market coupled with a low share of free float (30 percent) make the equity market in Poland not being recognized as an important source of capital for enterprises.

The core of the financial system in Poland is banking sector with over 84.8 percent of financial system assets in 2001. Therefore in the further part of this chapter we focus on banks.

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All the mentioned segments face some challenges resulting form the slowdown in the economic growth, rising unemployment rate, as well as lower income of households and lower profits of enterprises. These cyclical difficulties do not pose, however, any threat to the stability of the system as such.

Structure of the banking sector in Poland

In December 2001 there were 71 commercial banks, of which 23 banks with majority Polish-held equity and 48 with majority foreign-held equity. As of end of 2001 foreign investors controlled about 70 percent of banking assets. The government has a majority holding in three commercial banks, which together account for about 22.3 percent of total bank assets. Apart from commercial banks, co-operative banks are the important element of the banking sector, however small in asset terms.

The total assets of the banking sector (commercial and co-operative banks) amounted to $120.2 bn, or 66.3 percent of GDP in 2001 and loans and deposits for 42.3 and 52.5 percent of GDP, respectively. The above figures indicate that the level of financial intermediation and monetization in Poland is still low compared to EU countries but also to some Central and Eastern European ones as well.

An average Polish bank is relatively small in terms of asset size. That is why many banks see consolidation as a good way of further development. In the last years M&As have been often initiated by foreign owners that merge in-a-country banking businesses in the aftermath of mergers of their parent companies abroad. Also the cooperative banking sector has experienced significant consolidation. It has been triggered by minimum capital requirements set for these banks by the law. The number of cooperative banks has decreased from 1510 in 1995 to 642 in 2001.

Banking sector in Poland is highly concentrated. At the end of 2001 the top five banks held 51 percent of the total banking assets, 47.9 percent of total loans and 55.5 percent of total deposits. At the same time the banking sector is fragmented, since 60 commercial banks (with assets lower than $1 bn, or less than 1 percent of sectors' assets) together with all co-operative banks account for only 18 percent of total assets. These smaller institutions tend to concentrate on the local markets or specialize in specific niches, like car-loans.

Source of funding large companies, SME and households

External financing of Polish corporations is limited and largely takes the form of bank loans. Approximately 33 percent of enterprises use retain earnings as a sole source of financing. The other source of funds is commercial paper or bonds' issues. In 2001 commercial paper amounted to about 25 percent of short-term business loans[6] extended by banks. Even though banks buy a significant part of CP issues (less than 1/5), they are still an alternative for bank credit. There is not a case for financing investment projects however. In 2001 corporate loans as a share of GDP stood at 19.3 percent and debt securities issued by the Polish corporations at 2.5 percent. In absolute terms, total corporate bank loans amounted to $34.9 bn and debt $4.4 bn in 2001.

There is no precise data on SME financing. Anecdotal evidence proves that due to short life and records, and insufficient collateral, the availability of bank loans is difficult. The SME clients get more attention from banks, however, since corporate market seems to be already divided among big players. Smaller enterprises and household may be a chance for gearing income.

The share of loans to households has been steadily increasing since the beginning of 1990s, form less than 4 percent of total loan portfolios in 1992 to 27 percent in 2001.

*

Market saturation with banking services might be measured by percentage of households holding bank accounts. In 2001, approximately 65 percent of Poles over 18 years old have a personal bank account. Of those with bank accounts 53 percent use payment cards. In December 2001 banks possessed 6476 ATMs what gives a ratio of 5967 adults per machine. Above figures indicate that banking products and services, as well as electronic payment systems have not fully matured yet.

Structure of supervision over the financial market

Supervision over the financial institutions in Poland is performed by independent agencies. The Commission for Banking Supervision (CBS) oversees the banking sector (both commercial and co-operative banks). Supervision of banks is closely connected to the central bank since the Governor of the NBP chairs the CBS, and its operating arm is a department of the Bank. There is a separate agency regulating and supervising the capital market and its institutions (Securities and Exchange Commission); the another supervises the insurance companies and pension funds sector (Insurance and Pension Funds Supervision Commission), and still another credit unions (National Associations of Cooperative Savings and Credit Unions). Supervision, although not integrated into one institution, demonstrates some features of such a solution. The aforementioned agencies (theirs boards) work on a cross-representation basis which allows heads of a particular supervisory institution to be aware of important issues in other segments of the financial market. Since 2002 banking groups have been supervised on a consolidated basis. The risk exposure residing in subsidiaries and the consolidated capital position of banks is under scrutiny of the CBS.

[6] Loans to farmers and individual entrepreneurs excluded.

3.2. Stability issues of the banking system

3.2.1. Factors determining financial stability

Most of the banking system in Poland has been already privatized, mainly through sale to foreign financial institutions. The main advantages adding up to the stability of banks are an enhanced ability of risk management, unlimited access to modern banking technology, as well as access to liquidity and subordinate debt sources. The privatization agenda has not been completed however, with the largest retail bank still remaining state-owned. The state holds shares directly in three banks: two banks from the top eleven in respect to asset size[7] and in one minor bank[8]. According to the government's stated intend, the two large banks will be introduced to the stock exchange in the future but the state will not give up full control of them. The monetary authority in Poland, and also the international organizations assessing stability of the financial system, deem that the suspension of the real and meaningful privatization process poses a potential threat to the particular institutions and the system as such. The concern is especially expressed in the case of the bank that covers a quarter of the system's deposits and provides liquidity (funds) to the interbank market. Namely, the question could be raised whether the lack of a financially committed owner does not stand in the way of that bank's further sustained development and does not bring about negative implications for managerial ability and corporate governance issues.

Apart from the three aforementioned banks the rest of the top banks managed to find owners of well known brands and solid reputation. Thanks to previous governments' efforts, investors are diversified in respect to the country of origin. The shares of different countries are fairly equal with slight domination of American and German banks (22 and 20 percent of foreign capital, respectively). That variety of investors should protect the Polish market against excessive exposure to a given country's problems. The important feature of a presence of foreign capital in Poland is the legal status of banks. Contrary to the situation in the Czech Republic, all the foreign-owned banks (45) but one are subsidiaries. This fact leads to the capital being invested within the country and renders the bank subject to supervision by the Polish agency. Thus it gives some degree of reassurance to the supervisory agency in the case of financial distress. The recent behavior of foreign owners of banks in Argentina, however, makes this reassurance less certain.

Banks in Poland are relatively well capitalized: the average solvency ratio in December 2001 stood at 14.9 percent. There were a few institutions with ratios lower than eight percent (three commercial and ten co-operative banks) but all of them are under close monitoring by the Commission for Banking Supervision and/or Bank Guarantee Fund. Capital in banks is adequate to cover risks stemming from the present scope of activity. From the point of view of financial needs of potential corporate borrowers however, the level of bank capital should be higher.[9] The largest companies are not able to get a sufficiently high loan with one bank, so banking syndicates have to be formed to meet their funding needs (debts of one borrower or a group of connected borrowers cannot exceed 25 percent of bank capital). Therefore in

[7] I.e. the retail bank and the bank for agriculture - former apex bank for co-operative banks.

[8] This bank serves as a state agent performing special tasks, e.g. distribution of funds.

[9] The literature gives arguments for the necessity of maintaining higher solvency ratio by the *de novo* banks (see: Juha-Pekka Niinimaki "Should new or rapidly growing banks have more equity?", *Bank of Finland Discussion Paper,* No 16/2001). Being new to the market they are exposed to all kinds of risks to manage which they are not necessarily prepared. Such banks are recognized to be more fragile than established banks. The gradual implementation of CAD I and II, however, lessen the pressure for higher equity ratio.

this respect banks are visibly constrained by capital. One of the remedies to this shortage is M&As, widely present in the Polish banking sector. In the last two years several commercial banks as well as small local co-operative banks merged.

In 2001 the supervisory agency implemented a new regulation on bank capital. Since then banks have had to put aside additional amounts of capital to cover not only credit risk (as indicated by the solvency ratio) but also risks originating from open positions in foreign currencies. In 2002 this regulation was widened to cover other types of market risks (interest rate, price and commodity risks) in order to further implement capital adequacy directives (CAD I and II).

Currently the most important risk in the Polish banking system is the credit risk. Since 1998 it has influenced the financial results of banks in a rather significant way. According to the accounting rules in Poland, interest "earned" on classified loans is not recognized as income, regardless of a bad loan category[10]. In 2001 interest on non-performing loans amounted to some 20 percent of total income revenues (excluding from the denominator interest on securities and interbank loans). The other way in which bank profits are hit by bad loans is provisions. In 2001 net charges for specific reserves consumed 18 percent of bank gross income.[11] The ratio of non-performing loans to total loan portfolios stood at 17.8 percent at the end of 2001, which was 5 percent of GDP.

For several reasons the actual importance of non-performing loans is much lower than the above figures suggest. First of all, Polish regulations are rather strict in respect to classification of loans and setting provisions. They also employ conservative evaluation rules on collateral. Furthermore, due to fiscal disincentives, banks tend to keep fully covered loss loans in their books instead of writing them off. The modified NPL ratio (excluding loss loans -- 100 percent covered by reserves and collateral -- which stay in bank books longer then two years) would be 9.8 percent, or 2.8 percent of GDP.

Deterioration of loan portfolio has speeded up since 1998 -- in the aftermath of the Russian crisis. Especially high growth of NPLs has been observed in loans granted to individual clients. It could be attributed to the general economic slowdown but also to the misjudgment of households' abilities to repay loans. Banks have probably paid too little attention to loan applications and rejecting potentially weaker borrowers. The underdevelopment of rich databases and good scoring systems seem to add to the lowering of the quality of bank loans and lower profits. Building further experience in these fields is one of the important challenges for the future.

The currency risk seems to be potentially the second major type of risks for banks. As a matter of fact, banks keep their own open positions very tight (open positions rarely go beyond 2 percent of capital). The Monte Carlo simulation shows that under the most pessimistic assumptions, the largest loss in bank tier 1 capital would not exceed 5.5 percent. The low foreign currency exposure in banks does not fully determine the exchange rate risk however. It stems mainly from non-hedged loans of banks' clients. Approximately 10

[10] There are three categories of non-performing loans: (1) substandard (arrears longer than one month or the economic situation of a borrower might put in question the loan repayment), (2) doubtful (arrears longer than three months or the financial situation of a borrower has deteriorated significantly) and (3) loss (arrears longer than six months or the economic situation of a borrower worsens in a way that makes the repayment impossible).

[11] We define gross income as a sum of net interest income and net non-interest income.

percent of corporate loans are naturally covered by FX receipts from exports and a majority of loans extended to households is not hedged at all. The high interest rate differential has recently made taking loans in foreign currency very attractive. In 2001 almost all mortgage loans extended to households were denominated in currencies other than the zloty, mainly in euros. The share of FX loans has been increasing steadily since the second half of the 1990s. At the end of 2001 it accounted for roughly 27 percent of corporate loans and 19 percent of household loans; the overall ratio of FX loans in total portfolios stood at 25 percent (30 percent when counted with FX linked loans in zloties). The growing share of foreign currency loans makes the banking system sensitive to exchange rate volatility. A sudden depreciation of the domestic currency may result in solvency problems for borrowers and subsequently translate into a credit risk for banks. Many banks offer currency swap options for individual clients to mitigate such a scenario but in the case of a substantial exchange rate drop these could not work. Therefore maintaining macroeconomic stability itself is important as a factor stabilizing the banking sector in Poland.

The interest rate risk has been of minor importance. Until the end of the first half of the 1990s almost all assets and liabilities were related to floating interest rates. Together with lowering the inflation rate and, following that, cuts in interest rates, fixed rate instruments gained some popularity among clients. It is still not yet reasonable for clients to apply for a zloty loan with fixed interest rate. Because of the domination of floating rate items in the balance sheets of banks, interest rate risk is considered moderate. The rough estimates say that maximum loss from interest rates may result in 5 percent drop in a bank tier 1 capital.

Even facing the severe burden of making provision for non-performing loans, the Polish banking sector has remained relatively profitable and showed good potential for adding to the value of bank capital. In 2001, the return on asset and tier 1 equity ratio amounted to 1.36 and 18.5 percent, respectively.[12] The main source of net income was still net interest margin (NIM) although non-interest income has been gradually growing in relative importance. Banks actively seek new kinds of services and thus alternatives to interest-based sources of income. In December 2001 the NIM ratio stood at the level of 3.38 percent and the non-interest income to asset ratio at 3.05 percent. Five years earlier, in 1996, the proportions between these ratios were visibly different depicting the shift towards non-interest income (5.98 and 1.87 percent, respectively).

The weak point of an average Polish bank is relatively low operating efficiency understood as operating costs in relation to assets. Salaries, other employee benefits, depreciation and related expenses are altogether roughly twice as much as in the EU, e.g. 3.94 percent in 2001. Conversely, average assets and income per employee are much lower in comparison with EU banks, e.g. $821 and 9.7 thousand per employee, respectively. The quoted figures suggest a potential source of threat since the good profits so far have been maintained, to some extent, thanks to a high interest rate level. The average minimal (OMO rate) and maximal (Lombard) real interest rates of the National Bank of Poland were 9.5 and 13.3 percent, respectively during 2001. In the last fourteen months, starting from December 2000, the NBP has cut its primary rates by 950 basis points. Banks have adjusted interest policies in a way that allows for protecting profits against high provisioning: interest rates on deposits have been cut by some 773 basis points, and interest rates on business loans and consumer loans by 657 and 369 basis points respectively.

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[12] The average CPI in 2001 was 5.5 percent.

Another important indicator of bank stability, namely liquidity, has changed over the last decade. The system as a whole is still considered to be excessively liquid – with, in 2001, the NBP absorbing $5.2 billion per day, or 4.8 percent of bank assets. The situation of particular banks is rather diverse, with many banks being "dried out". As mentioned earlier, the vast majority of funds in the interbank market are provided by one bank. If that bank's financial condition suddenly deteriorates, it could impair the overall system. The loans to deposits indicator waves along with changes in the monetary policy stance but the general trend is upward, pointing out the tightening of liquidity. Banks have improved management, by following banking supervision guidelines or by applying procedures derived from foreign parent banks. Additionally, in December 2001, the NBP introduced a new instrument, intra-day credit (with no charges if repaid at the end of the day), to help banks manage their liquidity and smooth settlements.

3.2.2. Challenges related to the accession to the EU

Polish privatized banks have made significant progress in coming closer to western standards. There is still much to be done however, since in many cases implementation of necessary changes has been constrained by availability of funds.

The range of traditional products and services, as well as their quality are fairly close to what is offered by foreign-owned banks, set up as greenfield investments in Poland in the early 1990s. There is, however, a constant challenge to keep pace with changes on the global market: the decline of traditional banking business and the blurring of borders between banks and other financial intermediaries. The closer the EU accession, the stronger the pressure for narrowing interest spreads and hence narrowing the net interest margin. This tendency, combined with the still pressing issue of up-grading technology and introducing more automation in bank operations, could dangerously squeeze profits, unless banks manage to significantly cut costs before interest rates come down further. For a few years banks in Poland have tried to reorganize themselves, to reduce back-office staffing and move the remainder to more direct money-making activities. The trend of increasing bank networks does not go together with a growing number of employees. On the contrary, employment in banks has been slowly diminishing over two years. As various operating ratios suggest, these efforts have not yet brought significant improvements in the whole banking sector. Individual banks seem to be more diverse in this respect than at the outset of transition.

The other challenge connected with achieving the convergence criteria is an expected growth rate of loans, especially household loans. With a one digit interest rate on loans in the future, the growth rate of indebtedness can skyrocket -- as it did in Portugal just before and just after joining the EMU. This scenario could possibly happen in Poland, since the easy availability of different kinds of goods after decades of "the economy of shortages" has created strong incentives to go into debt. Therefore, there is a need to develop advanced scoring systems in banks and work further on monitoring procedures, as well as building a market for collateral. It should allow banks to avoid deterioration in loan portfolios in the event of a higher loan growth rate. There is also a role for the education of the general public in respect to the awareness of the risks connected to taking loans and avoiding misjudgments of pay-back abilities. The recent economic slowdown, with a growing unemployment rate resulting in difficulties with repayment of loans by some borrowers, will certainly be a lesson for the future.

In the medium-run the Polish banks have to face the challenge related to the implementation of the Basle New Capital Accord. The change in classification rules of the credit risk of a country -- from the membership to the OECD to credit agency ratings -- will initially elevate risk weights for securities issued by the Polish government. This will in turn cause higher capital requirements for banks to adequately cover risks. Moreover, Polish banks (like the country itself) will be treated as bearing a higher risk, which will imply, for them, higher costs of financing. At the same time, however, individual banks may have lower risk ratings than the country they are licensed in. Thus foreign-owned banks located in Poland may have lower risk ratings than generic Polish banks have, and even Poland itself, and may enjoy lower cost of capital and financing. Summarizing, there is the threat that the rules of the New Capital Accord will substantially worsen or change the competitive position of the Polish banks and trigger legal arbitrage or even massive change of the foreign-owned banks' status, from subsidiaries to branches.

The expected improvement in the economic situation on international markets and the EU accession will cause larger foreign exchange inflows. The increased FX inflows will be channeled -- as they currently are -- through the banking sector, affecting banks' balance sheet structure and calling for more advanced and precise risk management. Polish banks will have to participate more actively in the international foreign exchange markets as well as in the domestic market. The other dimension of increased FX inflows is that transfers from the EU can increase the monetary base -- if the government decides to exchange them in the central bank -- and fuel credit expansion in the Polish banking sector. In this way the issue of risk management, especially credit risk, appears on the agenda once more.

Slovak Republic[13]

3.1. Structure of the financial system

The most important event in the Slovak banking sector in 2001 was the accomplishment of restructuring and privatization of the banks with major share of assets. 2001 was a crucial breakpoint in the development of the banking sector and set a solid ground for sound and safe development of the banks and the financial sector in Slovakia. Positive results of restructuring were shown particularly in significantly cheaper funds, which fact represents a basic pre-condition for both the banking and economic growth. Recovering of the banking sector is reflected in the significant improvement of the assets structure, growth in the capital adequacy of the sector and decrease of the classified loans ratio. Decrease of the cost funds is reflected in lowering of the average interests rates level on deposits and loans.

The transfer of non-performing loans and their replacement by government bonds had an impact on further relative decrease in total loans. This fact, together with cheap funds and strengthened capital power of banks, creates a favorite precondition for financing the economic growth.

Among others, one of the goals in privatization of the banks with major share of the state ownership was to minimize non-market interference in the banks' activities, to transfer know-how and to open one of the key channels for the inflow of investments. The foreign capital share in banks and in the volume assets of controlled by foreign banking entities were dominating at the end 2001.

The transformation of the Konsolidačná banka, š.p.ú, to which the classified claims of the restructured banks were transferred is also linked with the restucturalisaton process. The MoF of the Slovak Republic as the founder of the Konsolidačná banka, š.p.ú issued a decision on revoking the banking license without liquidation effective of 31 January 2002. The Slovenská konsolidačná, a.s. Bratislava, became its legal successor. The sound portion of the portfolio was transferred to the Slovenská záručná a rozvojová, š.p.ú., and the remaining portion to the special agency Slovenská konsolidačná, a.s.

According to the Banking Act No. 21/1992 Zb., banks were defined as legal entities with its registered office in the territory of the Slovak Republic, founded as joint stock companies or founded as state financial institutions conducting banking services on the basis of a banking license.

Since 1 January 2002 the new Act No. 483/2001 Z. z. on Banks came into force, which includes in Art. 121 transformation of state financial institutions into joint stock companies. Deadline for such transformation is set up to six months after the new Act entered into force.

[13] The Slovak chapter was written by the team led by Peter Baláz from Department of Banking Supervision Strategy and International Cooperation and Renata Konecná from Monetary Policy Department. The other contributors were Anna Bruchácová (Research Department), Mariana Lisá and Jana Jirsáková (Monatray Policy Department) and Zuzana Wallová (Banking Supervision Division).

Relative size of the banks following assets (on 31 December 2001)

Groups of banks	Number of banks
1 Group – assets (220 bn – 100 bn SKK)	3
2 Group – assets (99 bn – 50 bn SKK)	1
3 Group – assets (49 bn – 10 bn SKK)	13
4 Group – assets (9 bn SKK – and less)	4
Total number of banks */	21

**/including branches of foreign banks*
FX rate USD/SKK as of 14 Apr. 2002: 46.86

Number of banks by the ownership structure

Groups of ownership	Number of banks
State ownership */	4
Private ownership:	17
of which foreign ownership	14
Total number of banks **/	21

**/ National Property Fund, Restitution Investment Fund, Ministries and state enterprises*
***/including branches of foreign banks*

Funding of enterprises and households

In the years 2000 and 2001 there were several factors, that significantly affected the credit development in Slovakia. Adjustments had to be done due to the restructuring of specified banks in pre-privatization process in 2000. Classified loans in portfolio of privatized banks were moved to the special agency and were replaced by state bonds. In 2000 and 2001 three banks lost its banking licenses and their balance sheets ceased to be operative. Mentioned adjustments caused the decrease in the volume of credits. NBS used in its credit development analyses adjusted, continuous time series.

NBS monitors the development of banking sector's assets and liabilities via Monetary Survey table. The breakdown by clients' type includes government sector, enterprises and households.

As for client's structure, commercial banks prefer to grant credits to enterprises in comparison to the small individual clients. Banks haven't heavily focused on households. Appeared gap has been covered by the building savings banks that dynamically multiplied the volume of deposits as well as credits to households.

The economic subjects did not show significant sensitivity on interest rates movements in the middle 90-ties when deciding whether to spend or save or invest.

In that period the dynamics of credits in foreign currency reached the two digit rates. At the same time there has been also reported dynamic development in the SKK credits growth. Simultaneously, the volume of classified loans has increased.

To moderate the trade balance deterioration in 1997, the NBS had tight its monetary policy. The new policy mix included:

- increase of minimum reserves requirements
- implementation of foreign currency position of commercial banks for monetary purposes
- limiting refinancing of banks.

Implementation of these measures resulted in the interest rates increase, as well as in the credit growth reduction.

The credit deceleration seems to continue in 2000 and 2001. There were several factors, which significantly affected the credit development. Adjustments had to be done due to the restructuring of specified banks in pre-privatization process in 2000. Classified loans in portfolio of privatized banks were moved to the special agency and were replaced by state bonds. In 2000 and 2001 three banks lost their banking licenses and their balance sheets ceased to be operative. NBS used in its credit development analyses adjusted, continuous time series. Mentioned adjustments caused the decrease in the volume of credits. Other aspects of current development have their origin in imperfect legal framework connected with low law requisition. As the influence of these factors will weaken, NBS expects credits development recovery in the next period.

On the liability side of the banks' balance sheets the deposits transactions played the important role. Despite the advance of term deposits in comparison to demand ones, the short-term maturity prevails. Long-term deposits are collected mostly in the building savings banks. In the 1997, after the new policy mix implementation, while interest rates had increased, the term deposits were concentrated in the 1-week maturity. Nowadays are deposits spread into wider maturity range.

Indebtedness of corporate sector and households

Loans and deposits in relation to GDP									
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Domestic credits	67.72%	57.21%	56.14%	59.76%	53.93%	52.12%	50.18%	46.25%	34.81%
- to households	4.76%	3.54%	2.80%	2.94%	2.97%	3.53%	4.40%	4.94%	5.38%
- to enterprises	62.95%	53.67%	53.33%	56.82%	50.95%	48.59%	45.77%	41.31%	29.43%
adjusted								43.25%	41.30%
Deposits	58.40%	57.10%	59.10%	61.61%	59.00%	56.33%	57.55%	60.97%	62.10%
- of households	35.20%	34.71%	36.36%	38.03%	39.15%	40.33%	40.56%	40.71%	40.51%
- of enterprises	19.25%	18.88%	19.60%	20.36%	17.26%	14.09%	14.78%	17.75%	19.01%
Corporate sector indebtedness									
in. bn. SKK	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
- banks' loans	245.9	250.2	291.2	344.4	349.6	364.8	373.2	366.5	283.9
adjusted								383.7	398.4
- commercial paper	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6.5	5.3
- loans from abroad	n.a.	n.a.	n.a.	66.2	98.4	160.2	201.3	204.6	261.9

Households indebtedness in banks									
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
- in bn. SKK	18.6	16.5	15.3	17.8	20.4	26.5	35.9	43.8	51.9
- relation to GDP	4.76%	3.54%	2.80%	2.94%	2.97%	3.53%	4.40%	4.94%	5.38%
- relation to total banks loans	7.03%	6.19%	4.99%	4.91%	5.51%	6.77%	8.78%	10.68%	15.46%
adjusted								10.25%	11.53%
Growth rates of loans									
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Total	-	0.83%	14.92%	18.17%	2.15%	5.76%	4.55%	0.29%	-18.16%
adjusted								4.50%	5.33%
- to households	-	-11.29%	-7.27%	16.34%	14.61%	29.90%	35.47%	22.01%	18.49%
- to enterprises	-	1.75%	16.39%	18.27%	1.51%	4.35%	2.30%	-1.80%	-22.54%
adjusted								2.81%	3.83%
- in SKK	-	-1.60%	12.49%	16.77%	0.97%	3.68%	2.88%	0.81%	-21.54%
adjusted								5.63%	5.20%
- in foreign currency	-	77.78%	57.64%	35.68%	14.94%	25.42%	17.57%	-3.26%	5.94%

** the decline in the growth rates of loans in 2000 and 2001 is affected by account adjustments in connection with the restructuring of specific banks in 2000, conversion of loans into bonds (the adjustment concern loans to households and enterprises in SKK), and by the balance sheet items of banks that ceased to be operative in 2000 and 2001.*

3.2. Stability issues of the banking system

In 2002 Slovakia adopted a new banking law and banking regulations have been brought closer into line with EU directives. One of the most important changes is the supervision provided on consolidated basis. There was also an amendment of the existing National Bank Act in 2001, which increased the central bank's supervision power over the banking system. In addition, a corporate bankruptcy law was passed in 2000, which should make it easier to declare a company bankrupt and enforce creditor rights then previously.

Supervision over the financial institution in Slovakia is performed by:

The National bank of Slovakia (Banking supervision Department)
The banking supervision cooperates closely with IMF and World Bank. "The program of strategic development of the banking supervision" was introduced in 2001 and has to be finished in 2002.

Financial Markets Authority (UFT)
It is responsible for regulating the capital markets, insurance companies and pension funds (formally the responsibility of the MoF) and in conjunction with the MoF is responsible for developing policy and laws for the capital market and insurance industries.

Ministry of Finance (MoF)
The NBS submits banking and foreign exchange legislation to the government jointly with the MoF. The MoF is also responsible for taxation and, hence, has to agree any tax incentives for

banks. The MoF has been also involved in the privatization process, but its involvement in the financial sector is now limited to co-operation on new legislation which each regulator.

Deposit Insurance Fund (DIF)
All banks operating in Slovakia that hold the deposits of private individuals are obliged to contribute to the DIF. Amendment of the Deposit Guaranteed Scheme Act terminates the deposit protection to 90 percent. Since December 2001 to the end of June 2002, 30-times the average monthly wage is protected and since June 2002 this level is increased to 40-times the average monthly wage.

Consolidation Agency.
The Slovak Consolidation Agency (JSC) was set up in 1999 as a specialized financial agency administering the portfolio of non-performing loans. The proceeds from sales of assets to third parties are to be used to reduce the fiscal costs of restructuring the banking and corporate sectors.

According to the ”Staff Monitored Program” the Government approved conception of financial market integrated supervision in 2002. The main idea is to create only one central regulator of the financial market and it is stated in the act of supervision of the financial market which entered in to the force as of April 1, 2002.

3.2.1. Factors determining financial stability

Results over the year of 2001 have proved that the Slovak banking sector was stabilized. In December of 2001, total assets grew again, certain financial indicators and economic results were improved, and prudential ratios of banking activities performed well.

As of December 31, 2001, the Slovak banking sector comprised of 21 banking entities (19 banks and 2 branches of foreign banks) and 10 representative offices of foreign banks. Thereof - 19 active banks - two state financial institutions, three specialized banks - home saving banks and six banks are authorized to conduct mortgage business.

Total of subscribed share capital of banks (without the National Bank of Slovakia) totaled SKK 53,2 bn on December 2001. Permanently available funding provided by foreign banks to their branches represented SKK 4,9 bn.

The process of bank privatization, performed with financial consulting participation of legal advisories services was completed. Austrian investor acquired 87.2 percent interest in Slovenska sporitelna, a.s. The state sold 94,5 % shares of Všeobecná úverová banka. The Government of the Slovak Republic approved selling share of the equity capital of Investičná a rozvojová banka, a.s. After transferring shares of the equity capital of Investičná a rozvojová banka, a.s. to Hungarian investor it will be 72,75%. Banka Slovakia, a.s. is currently in the process of the third tender of selection suitable financial institutions for privatization. Also the Poštova banka is now in process of tender of privatization. The government approved selling share of the equity capital totaled to 100 % of ISTROBANKA, a.s. to an Austrian investor. The Government of the Slovak Republic made a decision about the privatization of Konsolidačná banka Bratislava, š. p. ú. (state owned institution) in November 2001. On the ground of this, Ministry of Finance of the Slovak Republic, as a

founder of this bank decided to dissolve Konsolidačná banka Bratislava, š.p.ú. (KOBL) without liquidation on 31 January 2002.

The share of foreign investors in the total of subscribed share capital of banks is 83,6 percent as of 31 March 2002, the share of domestic owners was 17,4 percent (without Investičná a rozvojová banka, a.s. and ISTROBANKA, a.s.).

Positive results of banking sector reform of Slovakia, which has started to be implemented at the end of the year 1999 and started to show up during the year 2000 and are confirmed by the 2001 development (excluding KOBL, it's assets were taking out from the banking sector).

Non-performing loans and capital adequacy ratios, %

Year	Non- performing loans	Capital adequacy
1998	31,7	6,7
1999	23,7	12,6
2000	15,3	12,5
2001*)	13,1	19,6

**) Preliminary data*

A further step in economy is the reform of capital market and public sector restructuring. As a result of banking sector restructuring, lending policy can be eased, however this does not mean less prudent loan granting.

Total assets of banks in the Slovak Republic started to increase during the year 2001, after the decrease in the year 2000. This trend continued during the last quarter in 2001, bank assets rose moderately by SKK 84,4 bn (to SKK 931,3 bn as of December 31, 2001). The share of state in the total of assets of banks is 5.0 per cent. The share of foreign investors in the total of assets of banks is 79,6 percent. (Investičná a rozvojová banka, a.s. and ISTROBANKA, a.s. are not included, KOBL is included). After entering of foreign investors to the sector it is expected to be 85,1 percent (without KOBL).

The asset structure of the banking sector improved. Earning assets to banking sector assets ratio was 91,3 present as of December 31, 2001 (with KOBL). In comparison to the end 2000, the ratio of earning assets increased, by 2,85 percentage point. The classified loans to total loans ratio decreased from almost 15,32 % in December 2000 to 13,08 percent in December 2001 (without KOBL).

The Slovak banking sector was in profit of SKK 10,3 bl, as of December 31, 2001, which means an year-to-year increase by SKK 5,9 bn.

The Slovak banking sector total capital adequacy as of December 31, 2001, less the ratio of Konsolidačná banka, s.p.u reached 19,62 % in comparison with December 31, 2000 (an increase by 7,14 percentage point).

The uncovered estimated loss (the UEL) of the Slovak banking sector excluding KOBL increased from SKK 0,01 bn as of December 31, 2000 to SKK 0,13 bn as of December 31, 2001.

Improvement in meeting prudential limits: the number of banks that did not comply with the set limits decreased. As of December 31, 2001 (excluding KOBL):

- 8% capital adequacy ratio was met by all banks,
- 3 banks breached credit exposure limit set for operations with non-banks, a limit for operations with banks was fulfilled by all banks, and a limit for persons with a special relationships to the banks by 1 bank. All banks fulfilled a limit on aggregated net credit exposure,
- all banks met limits on total open foreign exchange positions,
- all banks as of December 31, 2001 met a limit set on monthly liquidity (i.e., a ratio of assets to liabilities due in a month $\geq$ 0,9); 2 banks did not meet a limit on fixed and illiquid (non-performing) assets over own funds and reserves, which cannot exceed 1.

The Slovak banking system is tolerant against most major shocks to important risk factors. Simple credit risk, represented by existing loans turning bad, is likely to be relatively less of a focus of vulnerability going forward for a number of reasons. First, Slovak banks are now well-capitalized and capable of taking a big hit. Second, borrowers are in improved financial condition. Furthermore, after restructuring and privatization of the system, conservative credit management will slow the pace of generating any new NPLs. Indirect credit risk arising from shocks to market risk factors -- especially exchange rates -- is more of a concern. In assessing indirect credit risk, there are some positive indicators. For example, non-financial enterprises have substantially improved their ratio of cash flow to liabilities to 37.3 percent in 2001 from just 6.1 percent in 1998.

The system is relatively resilient to direct interest rate shocks but more exposed to both credit and exchange rate risk. With the focus of bank management concentrated on the control of credit risk, supervisory attention should turn as a needed complement to the important concern of managing and limiting foreign exchange risk exposure.

Slovakia has at present a highly capitalized, highly liquid banking market with low operating profitability populated by strategic investors that have made long-term commitments to the country. This is a recipe for increasing competition that will lead banks to assume new risks in order to generate products such as derivatives and reaching for yield in more market risk-intensive structured investments.

The NBS issued six new or revised decrees in the year2000, coming into effect March 31, 2000,to enforce prudent behavior and which cover most of the risks, except the market risk (see: The legal framework, at the end of this sub-chapter).

Decree in preparation (revised version according to the Act No. 483/2001 Z.z. on banks) is Decree of the National Bank of Slovakia on adequacy of own funds of banks, bank's position and trading book of banks. Purpose: it replaces the old decree with amendment of market risks calculation and specification of trading book, new structure of capital adequacy ratio.

3.2.2. Challenges related to the accession to the EU

Channeling foreign currency inflows stemming from FDIs and structural funds

For Slovak Republic the inflow of FX sources from abroad is essential for covering the Current Account deficit. It is directly associated with the fact of Slovak economy being small, open and strongly dependent on raw materials import, as well as Slovak production being dependent on import in general. Creating appropriate conditions for inflow of primarily non-debt forms of capital represents certain challenge for the future.

Despite significant increase of Current Account deficit, its financing in 2001 has not caused any serious difficulties. Capital and Financial Account resulted in surplus SKK 78,9 bn after adjusting it for activities affecting the change of NBS' reserves position (associated with privatization processes). For financing of Current Account, the sources inflowing mainly in the form of direct investment (62%-including part of privatization activities, which remained on accounts of commercial banks and other capital within FDI) and portfolio investment (23.5%) were used. It means majority of FX inflow connected with privatization was not used for financing of current account as those resources are realized through the NBS.

Foreign direct investment in net terms (difference between FDI by non-residents in Slovakia and by Slovak residents abroad) amounted to SKK 70.6 bn and resulted from an inflow of capital into Slovakia from abroad in the amount of SKK 71.3 bn and an outflow of capital through the activities of Slovak economic entities abroad in the amount of SKK 0.7 bn.

Foreign direct investments

(bn Sk)	2000	2001
Foreign direct investment (FDI)	95,9	71,3
from which equity capital	91,3	57,0
from which: - privatization FDI	42,0	33,9
- other equity capital	49,3	23,1
other capital	4,6	14,3

Competition with the EU banks

In relation to the accession to the EU, development of the Slovak banking sector is expected in the following directions:

- The growth of the banking sector will be, as it has been, connected with the domestic economy. Strong expansion abroad is not expected owing to the intense competition in the banking sector of EU countries. However, it is possible to participate in the EU market through cooperation with strategic partners.
- When the liberalization process of the foreign exchange regime started, strong and solvent clients acquired access to less expensive, external, resources of financing. Therefore, the competitiveness of the Slovak banking sector has been conditioned by the economic position of the domestic businesses which are burdened by their loans and currently exhibit a higher rate of credit risk than businesses in EU countries. The

termination of the corporate restructuring process is a precondition for the growth of Slovak banking sector competitiveness.

- The Slovak banking sector is gradually being cleared of small and non-performing banks. The market is, nevertheless, small and does not offer sufficient space for the current number of universal banking institutions and for the effective long-term allocation of external resources. Considering the capital strength of the local banks, their competitiveness vis-a-vis EU banks is low; thus it is expected that the process of concentration will continue.

The situation in the Slovak banking sector is very similar to that in Poland Republic. In spite of the privatization of the most commercial banks in the near past, there is still space for improving and modernization of their systems (mainly information system) this fact could be one of the competition factor of EU banks. Also, due to the slow restructuring of the economy, banks are very prudent in the loan activities. Their financial operations are concentrated on trading with state bonds and treasury bills mostly.

Impact of the CAD II directive implementation

Decree No. 2 of the NBS concerning capital adequacy takes into account only credit risk and does not include tools eliminating market risk. This is not in accordance with the CAD II. Market risk should be covered by new decrees on adequacy of own funds of banks which is now being prepared by NBS.

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THE LEGAL FRAMEWORK

- Reinforcement of regulation and banking supervision conduct
- Secondary Legislation – the NBS Decrees

Reinforcement of regulation and banking supervision conduct

In the year 2000 the preparations for amendments to existing legislation started to take place, leading to the adoption of, or proposals for, brand – new legislation or revision to existing laws in the year 2001.

- The National Bank of Slovakia Act No.566/1992, as amended May 2001
- Banking Act no. 483/2001 dated October 5, 2001, effective January 1, 2002
  The new Banking Act aims at harmonizing the Slovak banking legislation with relevant EU directives, at implementing the World Bank and the IMF recommendations and at increasing the NBS's banking supervisory authority.
- The Act on Bankruptcy and Composition was amended by Act No.238/2000, effective August 1, 2000.
- The Act on the Financial Market Authority, amending certain other laws (No. 329/2000, effective November 1, 2000.
- The Act on Protection Against the Legalization of Proceeds from Criminal Activities No.367/2000, effective January1, 2001.
- The Act No. 492/ 2001 on amendments of Act No. 118/1996 on protection of bank deposits.

Secondary Legislation- the NBS Decrees

- The NBS issued six new or revised decrees in the year 2000, coming into effect March 31, 2000, to enforce prudent banking behavior.
- In December 2000, the NBS Bank Board adopted a decree specifying the criteria and details of applications for prior approval under Article 16, paragraph 1, of the Banking Act.

Capital Adequacy
- **Decree No.2** of the NBS concerning capital adequacy lays down the minimum ratio of capital to risk weighted assets. Banks were to achieve a minimum ratio of 6.75% by the end of 1994, to be raised to 7.25% by the end of 1995 and 8% by the end of 1996.

Large Credit exposures
- The NBS adopted **Decree No.4** to limit the magnitude of a bank's potential losses as a result of failure on the part of one more debtors to meet their commitments. The amount of credit extended to a single borrower and to the ten largest borrowers or group of economically connected borrowers may not exceed a prescribed percentage of a bank's capital reserves.

Liquidity Ratio
- Under **Decree No. 3**, in order to ensure that they can meet their payment obligations, banks must maintain a minimum level of liquid assets in relation to their total assets or liabilities.

Open Foreign Exchange Position
- **Decree No. 5** implements the statutory requirement to limit open foreign exchange positions (Article 14 of the Act on Banks). Under this Decree the total open overnight foreign exchange position may not exceed 25% of bank's capital.

Additional Decrees and Decrees in the Process of Preparation

1. **Decree No. 12** of the National bank of Slovakia **dated December 21, 2001** stipulating the requisites of an application for authorization to operate as a bank.
2. **Decree No. 13** of the National bank of Slovakia **dated December 21, 2001** stipulating the requisites of an application for a banking license by a foreign bank wishing to undertake banking activities as a branch in the Slovak Republic.
3. **Decree No. 14** of the National bank of Slovakia **dated December 21, 2001** stipulating the requisites of an application for the registration of a representative office of a foreign bank or a similar foreign financial institution that performs banking activities.
4. **Decree No. 15** of the National Bank of Slovakia **dated December 21, 2001** stipulating the requisites of an application for prior approval to establish a foreign branch by a bank.

5. **Decree No. 16** of the National bank of Slovakia **dated December 21, 2001** stipulating the requisites of an application for prior approval, and the conditions for granting prior approval, pursuant to Article 28, paragraph 1, of Banking Act, No. 483/2001 Coll., and on changes and amendments to certain laws
6. **Decree No. 17** of the National Bank of Slovakia **dated December 21, 2001** on required disclosures in reports in order to identify other persons having a special relationship to a bank or a branch of a foreign bank due to their relationship with the reporting person.
7. **Decree No. 18** of the National bank of Slovakia **dated December 21, 2001** specifying the prescribed contents of a detailed audit – report for banks and branches of foreign banks.
8. **Decree of NBS** on liquidity of banks and foreign banks´ branches. **To be presented to Directorium: 7th of March 2002.**
9. **Decree of NBS** on prudential banking rules in connection with selected large exposures**. To be presented to Directorium: 7th of March 2002.**
10. **Decree of NBS** on credits granting safe operational rules of banks and foreign banks' branches. **To be presented to Directorium: 7th of March 2002.**
11. **Decree of NBS** on safe operational rules of banks and foreign banks' branches in connection with the dealing of foreign currency, gold and financial instruments. **To be presented to Directorium: 7th of March 2002.**
12. **Decree of NBS** on public disclosure of annual reports by the banks and foreign banks' branches active on territory of Slovak Republic. **Decree has been already presented to Directorium: 15th of November 2002 and will be presented in Bank Board 30th of June 2002.**
13. **Decree of NBS** on classification of assets and liabilities, on adjustment of valuation of assets and liabilities and on creating and canceling reserves**. Will be presented to Directorium till: 30th of April 2002.**
14. **Decree of NBS** on adequacy of own funds of banks. **Will be presented to Directorium till: 30th of September 2002.**
15. **Decree of NBS** on large exposures of banks. **Will be presented to Directorium till: 30th of September 2002.**
16. **Decree of NBS** on stipulating the details of management and using of credit register and guarantees, scope and method of input and output data and technical security of announced and provided resources. **Will be presented to Directorium together with decree on classifications of assets and liabilities (…) till 30th of April 2002**.
17. **Decree of NBS** on unsecured foreign exchange position is still valid and its contents will be the part of adequacy of own funds decree.
18. **Decree of NBS** on reporting data by banks is still valid and its contents will be the parts of now preparing decrees.

Slovenia[14]

3.1. Structure of the financial system

Monetary financial intermediaries are holding and preserving a leading position in the Slovenian financial market. The most important part of Slovenian financial system is banking sector. The share of banking sector assets in total assets was 61 percent at the end of 2000.

Structure of Slovenian financial system at the end of 2000 (in EUR million)

End of Year 2000	Total Assets	Share	% GDP
Central bank	3,636	14.4%	18.5%
Banking sector	15,449	61.0%	78.5%
Other financial intermediaries	6,241	24.6%	31.7%
Authorised investment companies	2,712	10.7%	13.8%
Insurance companies	1,522	6.0%	7.7%
Others	2,008	7.9%	10.2%
Total	25,326	100.0%	128.7%

Source: Bank of Slovenia

In terms of total assets, non-monetary financial intermediaries do not reach half of total assets held by monetary financial intermediaries. At the end of 2001, the composition of non-monetary financial intermediaries was as follows: 35 authorized investment companies, 18 mutual funds, 15 insurance companies, 7 (mutual) pension funds and 6 pension companies, as well 31 authorized participants on securities market (banks and brokerage companies).

Slovenia maintains efforts to develop financial markets as well as interest rate transmission mechanism. On the money market there is a significant trend of development. The Bank of Slovenia and the Ministry of Finance have become more active in supporting treasury bills market. Market makers were introduced and their quotations are publicly presented. For the further development the Bank of Slovenia will stimulate banks in using repo transactions. The Bank of Slovenia is preparing a master agreement for repos of short-term securities which is expected to be accepted by banks until June 2002. In the last two years currency swaps are becoming more used among banks. In 2001 their average outstanding amount has nearly tripled comparing with year 2000 and it represents 64 percent of the total turnover on the cash market. At the beginning of 2002 banks started to quote the interbank deposit rates with different maturities and in the future those rates could be used as a reference in determining other rates. The Ministry of Finance is expected to operate on domestic money market with more instruments and in to contribute to further development of the market. The Bank of Slovenia will try to stimulate banks in using derivatives (interest rate swaps, futures rate agreements, etc.) for the purpose of hedging.

Primary securities market in Slovenia remains relatively undeveloped. The issuers of debt securities are mostly banks, which raise long-term funds that they lend over to companies. In

[14] This chapter has been prepared by the group of authors: Uroš Čufer and Matjaž Noč (Analysis & Research Department), Janez Fabijan and Tomo Narat (Financial Statistics Department), Gordana Ilc Križaj and Mojca Majič (Supervision Department), Cilka Ferjančič and Danica Prelovšek (Central Banking Operations Department).

the area of equity securities a number of problems have contained a rapid development: most shares stem from the privatization process, the majority of companies display only low profitability and shares on the secondary market are trading for many companies below book values.

Central Securities Clearing Corporation (KDD) was founded in 1994 and it offers services of issuing, transfer, payment and record keeping. The system of KDD is compatible to that of the electronic trading system at the Ljubljana Stock Exchange. Most of the existing securities and all of the privatization shares are already in a book entry form. At the end of December 2001 the Central Securities Clearing Corporation had on its books 1033 securities issued by 885 issuers, including 915 shares and 118 bonds.

The value of shares registered with the Central Securities Clearing Corporation at the end of December 2001 carried at market value amounted to EUR 13.4 billion (64.8 % of GDP), while the value of bonds was EUR 2.6 billion (12.7 percent of GDP). Non-financial companies are the most important issuers of shares (78 percent of total shares value), they are followed by banks (15 percent) and other financial intermediaries (6 percent). Among shareholders the Government is on the top (26 percent), followed by households (20 percent), non-financial companies (20 percent), other financial intermediaries (19 percent), foreign investors (10 percent) and banks (4 percent). The major issuer of bonds is the Government (77 percent of total bonds value), followed by banks (13 percent) and non-financial companies (9 percent). Among bond holders banks are on the first place (47 percent), followed by insurance companies (20 percent), households (14 percent), the Government (7 percent), non-financial companies (6 percent), other financial intermediaries (4 percent) and foreign investors (2 percent).

The Ljubljana Stock Exchange (LSE) represents organized part of secondary securities market. Trades on each of the market segment are conducted only through the electronic trading system (BTS). On the Ljubljana Stock Exchange 270 securities issued by 220 issuers were traded as at the end of December 2001. Trading on the LSE in 2000 and 2001 was coined by take-overs and acquisitions, which resulted in consolidation of the ownership of companies.

In the term of foreign investments on the securities market non-residents may purchase or sell securities on the capital and money market since January 2002 without any limitations.

The investments in securities abroad by residents are free of any restrictions. Before September 1999 only banks were allowed to purchase securities abroad.

3.2. Stability issues of the banking sector

3.2.1. Factors determining financial stability

The most important segment of Slovenia's financial system is the banking sector. Within the banking sector banks are the most important credit institutions. Aggregate total assets of all credit institutions (banks, savings banks and savings and loan undertakings) accounted for 89 percent of GDP at the end of 2001. The market share of banks was 98 percent of the entire banking sector. The market share of savings banks and savings and loan undertakings (in terms of total assets) is extremely low in comparison with banks - only 2 percent.

The number of banks has gradually fallen since 1994 from 33 to 21 today. The sharpest drop was in 1998 after three mergers and one liquidation. In 1999 there was one more merger, but the Bank of Slovenia also licensed the first new bank in five years, Hypo Alpe-Adria-Bank, a subsidiary of Hypo Alpe-Adria-Bank AG based in Austria. As branches of foreign banks are authorized to operate in Slovenia under the 1999 Banking Act, the first branch of a foreign bank, Kaerntner Sparkasse AG, Celovec, Podružnica v Sloveniji, began operations in 1999. This has remained the only branch of a foreign bank operating in Slovenia so far.

In 1999 and 2000 consolidation was slower than predicted. However, in October 2001 the largest Slovenian bank, Nova Ljubljanska banka (hereinafter referred to as NLB), acquired three banks that were members of its banking group. In 2002 NLB hopes to acquire three other banks within its banking group. Should these acquisitions be approved and successful, the dominant role of the largest Slovenian bank will be even greater with the market share of around 39 percent.

It is also expected that the fourth largest Slovenian bank Abanka will merge with a smaller Slovenian bank Banka Vipa, which currently has 1.8 percent market share, effective on 1 January 2003.

In addition, the number of savings banks was cut in half at the end of the year 2000 in comparison to the end of 1999 due to two mergers and one regular (voluntary) liquidation. We saw the same downward trend in the case of savings and loan undertakings. Their number fell from 64 at the end of 2000 to 43 at the end of March 2002 due to aligning their operating activities to the Banking Act.

The savings and loan undertakings are to gradually reach the required level of compliance with the provisions applying to credit institutions, so as to be fully compliant at the end of the five-year transitional period in 2004. The savings and loan undertakings, which intended to comply with the capital requirements had to increase »capital« by 31 December 2001 to 110 million tolars (EUR 496.817 as at 31 December 2001) and then must step up capital in order to reach from 31 December 2003 onward at least the level of mandatory minimum initial capital 220 million tolars. As from that date, the savings and loan undertakings must also comply with the statutory capital adequacy ratio and observe the limits on exposures to a single client or a group of connected clients, as well as the limits set with respect to the sum of all large exposures.

Since many savings and loan undertakings did not meet the requirement of the Bank of Slovenia to achieve at least half of the required nominal capital i.e. 110 million SIT by 31 December 2001, they joined the Association of Savings and Loan Undertakings (14) or transferred receivables and liabilities to another credit institution (3). In addition, one savings and loan undertaking went bankrupt and one commenced voluntary liquidation. The majority of the rest of them are still to join the Association of Savings and Loan Undertakings or the banks by the end of 2003. Savings and loan undertakings failing to achieve full compliance by February 2004 will be remanded to compulsory (forced) liquidation.

The main features of Slovenia's banking system over the past few years have been a stable market share of the largest banks, and relative concentration of banks. The number one bank in Slovenia had almost a 29 percent share of the market in terms of unconsolidated total assets at the end of 2000. After acquisition of three banks in 2001, which were members of NLB banking group, its share increased to almost 35 percent.

Three largest banks used to control approximately half of the market (now 56 percent), the five largest banks had approximately 60 percent market share (currently 69 percent), the top seven banks control almost three-quarters of the market (currently 80 percent). The share of the ten largest banks was approximately 82 percent, now it is 87 percent.

Out of 21 banks in Slovenia, four are subsidiaries of foreign banks and one is a branch of a foreign bank. 7 banks are fully controlled by domestic shareholders and 5 are wholly owned or controlled by foreign shareholders. The remaining 9 banks are controlled by domestic owners. Foreign shareholders are mostly from Austria, France and Italy.

The Slovenian banking system can be considered as stable and sound. This is also reflected in a significant increase in deposits (especially long-term deposits) over 2001, which shows the increasing confidence of the general public in the banking system.

Total assets and market shares of largest banks

Bank	Total assets in EUR million		Nominal growth in %		Market share in %	
	31 Dec. 2000	31 Dec. 2001	2000 / 1999	2001 / 2000	31 Dec. 2000	31 Dec. 2001
NLB *	4,344	6,179	22.1	48.9	28.8	34.6
NKBM	1,740	2,092	14.4	25.8	11.5	11.7
SKB banka	1,529	1,757	5.1	20.3	10.1	9.9
Abanka	889	1,153	26.0	35.7	5.9	6.5
Banka Koper	938	1,102	18.1	23.0	6.2	6.2
Banka Celje	876	1,023	18.9	22.3	5.8	5.7
Gorenjska banka	752	934	22.1	30.0	5.0	5.2
Aggregate total assets - top 7	11,068	14,240	17.9	34.7	73.3	79.9
Aggregate total assets - all banks	15,096	17,832	18.8	23.7	100.0	100.0

* *Figures as at 31 December 2001 excluding the Italian branch of NLB.*
Figures as at 31 December 2001 are not audited.
Source: Bank of Slovenia

As of 31 December 2001, aggregate total assets of Slovenian banks amounted to EUR 18 billion, 23.7 percent higher that one year earlier. On the liabilities side, deposits by the non-banking sector still dominate with 68.4 percent of average liabilities (the largest portion represented by deposits from households – citizens and sole entrepreneurs – with 41.7 percent share).

There was some moderate growth of the share of liabilities arising from securities, but it remained small at 2.6 percent. The share of deposits by the banking sector remains stable at 11.3 percent of the average liabilities. On the asset side, the share of lending to the non-banking sector was broadly stable at about 50 percent of average assets.

The banks' earnings in the year 2001 totaled EUR 69 million in profit before taxes. Nominal growth in the banks' gross income to EUR 773 million in 2001 reached 0.7 percent. Return on average assets fell from 1.1 percent to 0.4 percent and return on average equity fell from 11.3 percent to 4.8 percent (as of result of the loss incurred by one of the largest banks). Net interest margin decreased from 4.5 percent to 3.6 percent in the year 2001.

Total assets of three savings banks at the end of 2001 stood at EUR 69 million, implying that their share in Slovenia's banking environment remains small at 0.4 percent of assets.

3.2.2. Challenges related to the accession to the EU

Although the ratification of the Europe Agreement between the Republic of Slovenia and the European Union and the promulgation of the Banking Act have opened up the domestic banking environment, the number of foreign banking institutions has not significantly increased. The possibility of establishing branches of foreign banks in Slovenia was seen by many as a threat to the domestic banking industry. In fact, only one foreign bank decided to open a branch in Slovenia resulting in little impact on the banking system.

By joining forces, Slovenian banks may be better prepared to face foreign competition when Slovenia becomes a member state of the European Union. However, the mergers and acquisitions to date have not yet had a major impact on lowering operating costs in the banking sector.

The stake of foreign shareholders in the Slovenian banking sector rose from 12 percent as at 31 December 2000 to 15.4 percent as at 31 December 2001 after the acquisition of a 15-percent holding in the fifth largest Slovenian bank Banka Koper by the Italian bank. Currently the Italian bank has 62.1-percent holding in the fifth largest Slovenian bank, therefore the percentage of foreign ownership increased. The percentage of foreign ownership is bound to rise once a 34 percent of the largest Slovenian bank has been sold to a key investor (in accordance with the privatization program of the Government).

Ownership structure of the banking sector (equity holding in %)

	31 Dec. 2000	31 Dec. 2001
Non-residents	12.0	15.4
Central government	36.8	37.3
Other domestic persons	51.2	47.3

Source: Bank of Slovenia

The market share of majority foreign-owned banks is increasing. At the end of 1999 it was under 5 percent, but it rose when the third largest bank became majority foreign owned bank in 2000. Currently the market share of foreign-owned banks is almost 16 percent.

Private ownership of the banks incorporated in Slovenia prevails. The list of state-controlled banks includes Slovenia's top two banks - NLB and Nova Kreditna banka Maribor (hereinafter referred to as NKBM) both taken-over by the Republic of Slovenia upon the completion of the rehabilitation process, as well as Slovenska investicijska banka, d.d. where the state has a 14.4 percent stake in equity capital. Poštna banka Slovenije d.d. (Post Office Bank of Slovenia) is indirectly controlled by the state.

Progress in bank privatization in Slovenia was relatively limited in 2000 due to the pre-election period. More progress will be achieved in 2002.

In May 2001, the Government of the Republic of Slovenia endorsed a framework program for privatization of NLB and NKBM, whose combined market share is 46 percent. The Government agenda is to use the privatization of both banks to enhance corporate governance, contribute to greater effectiveness of both banks and consequently contribute to greater effectiveness of all Slovenian banks. At the same time, it is keen to optimize privatization proceeds.

The privatization process has been steered and supervised by an independent, 7-member Privatization Committee.

The Government of the Republic of Slovenia decided to sell 34 percent of NLB to the Belgian KBC Bank as the offer complies with the privatization program adopted in May 2001 and amended in December 2001. The Government also decided to proceed with the second stage of privatization as foreseen in the privatization program.

Following the closure of the project, KBC will be acquiring 2,611,885 ordinary shares of NLB, representing 34 percent of the share capital.

The second stage of privatization will be a combination of a private placement of up to 14 percent of the shares still held by the Government, and a capital increase of up to 15 percent. The initial 5 percent of private placement will be offered to the European Bank for Reconstruction and Development (EBRD).

The final ownership structure of NLB following the second phase of the privatization will be: 33 percent held by the Republic of Slovenia (including two state-owned Funds), 34 percent by KBC and 33 percent by other institutional shareholders.

The proceeds of the privatization will be used for public debt reduction, and it is estimated that a total 1.8 percent GDP of public debt will be reduced following the first phase of privatization.

The Government of the Republic of Slovenia decided not to sell 65 percent of NKBM to any of the three bidders (Bank Austria HVB Group, UniCredito Italiano, Aktiva Consortium) as their offers did not match the expectations of the Government as laid out in the privatization program adopted in May 2001. The Government instructed the Management and Supervisory Board of NKBM to draft a program for implementation of the Bank’s Development Strategy. Regard should be given to the necessary capital increase and possible sale of the state’s share.

The privatization process lasted from June 2001 when the Privatization Committee was appointed until March 2002 when it was decided on the level of the Committee that none of the offers follow the principal goals from the privatization program. These are:

1. To enhance the efficiency and competitive ability of the bank and the banking system through improved business operation and a more appropriate ownership structure, and in particular:
   - To improve the corporate management of the Bank;
   - To enable access to new knowledge and the development of new financial products;
   - To secure additional capital for the implementation of the Development Strategy of the Bank (especially a breakthrough to the markets of South-Eastern Europe),
2. To achieve the highest possible purchase price with a view to reducing the national debt.

The legal framework governing regulation and supervision of the banking sector has undergone significant changes in the last three years. The objective has been to make the Banking Act and regulations, as well as supervisory practices, consistent with international best practice and compatible with EU directives. The Financial Sector Assessment Program (FSAP), conducted in November 2000 by the International Monetary Fund (IMF) in collaboration with the World Bank, proved that Slovenia complies with most of the Basel Committee's Core Principles for Effective Banking Supervision. In September 2001 team of experts – supervisors from the Member States continue the work of the Financial Sector Assessment Program Mission. On the basis of the findings of the of Financial Sector Assessment Program Team, the IMF prepared the Financial System Stability Assessment (FSSA) with the summary assessment of compliance with standards. This report also served as the groundwork for the P*eer Review* in Slovenia, which is an examination if adequate administrative capacities of financial services supervisory authorities are in place.

Despite a strong supervisory framework, some weaknesses exist in some areas concerning connected lending, implementation of consolidated supervision and capital requirements for market risks.

The modifications and amendments to the Banking Act 1999, which entered into force in July 2001 have introduced a number of changes designed to enhance alignment with the legislative framework of the European Union and international standards.

In accordance with the recommendations made by the members of the FSAP Mission the requirement calling for a more stringent treatment of exposure of banks to shareholders and other persons in a special relationship with the bank (connected persons) has become enforceable. A three-year transitional period has been provided for a 10% bank exposure to a person in a special relationship with a bank (for instance member of the bank's management board, member of the bank's supervisory board etc) and a 100% of all bank exposures to persons in a special relationship with a bank. The provisions allowing granting of credits to connected persons under more favorable terms and conditions have been deleted. In addition, new obligation was imposed upon the management board to notify the supervisory board of the exposure to any persons referred to above in excess of 1% of the bank's capital.

Implementation of consolidated supervision and capital requirements for market risks are complex issues and huge efforts will be necessary to implement these requirements at a high quality level. We transposed the Directive on the Supervision of Credit Institutions on a Consolidated Basis into Slovenian regulation by issuing the Decree on the Supervision of Banks and Savings Banks on a Consolidated Basis. The Decree was issued in December 1999, but the implementation started in 2001 due to the complexity of new requirements. Additional hands-on experience will be needed for carrying out on-site examinations in this field.

Another area where additional effort is needed is implementation of capital requirements for market risks and their supervision. The Regulation (Decree) on the Capital Adequacy of Banks and Savings Banks, transposing the CAD Directive and Netting Directive, was issued in February 2001. Besides the capital requirements for credit and foreign exchange risk Slovenian banks will be obliged to cover capital requirements for position, counterparty, settlement and commodities risk after the Decree comes into full effect.

In March 2002, the Bank of Slovenia passed the new Regulation on Capital Adequacy of Banks and Savings Banks. The provisions from the "old" Regulation (Decree) on Capital Adequacy adopted in February 2001, which define the method for the calculation of capital requirements, had to be reviewed for a number of reasons. Some of most important considerations taken into account are listed below:

1. The amendments and modifications to the Banking Act have given to the Bank of Slovenia discretionary power to require on a case-by-case basis a capital ratio higher than the minimum one.
2. The need to incorporate the provisions of the Directive referred to as the CAD II (98/31/EEC) has resulted in adding a new chapter to the regulation that addresses the use of internal models for the calculation of capital charges required to absorb currency and market risks. For the time being, banks may opt for internal models to measure risk and determine capital charges if they get a prior approval of the Bank of Slovenia, and only as far as currency risks are concerned. In addition to the conditions to be taken into account when using models to calculate capital charges arising from the market risks, the Regulation lays down a number of criteria that the bank wishing to use internal models for capital purposes must fulfil in order to convince supervisors and qualify for the approval.
3. Since capital requirements calculated on the basis of an internal model depend on the results obtained by applying the relevant model (value at risk - VaR or a risk of incurring a loss), the supervisory authority must be satisfied that input data and assumptions, as well as the obtained results are accurate in measuring risk before the bank is permitted to use the proposed model.
4. The new Regulation addresses the computation of capital charges for market risks on a consolidated basis.

The banks are not required to observe the provisions of the section referring to market risks by 31 December 2002.

Within the framework of negotiations with the European Union with regard to freedom to provide services, the Slovenian negotiation team requested and received approval for transitional period for two issues related to the banking industry. The first one is the Deposit Guarantee Scheme. By 31 December 2005 credit institutions from other Member States taking deposits on the Slovenian market would not be in a position to offer higher guarantee levels, above the EU minimum, than Slovenian credit institutions. Second transitional period was approved for the savings and loan undertakings established prior to the implementation of the Banking Act. They are granted additional time to comply with capital requirements and to meet other requirements related to safe and sound banking operations.

There are also two more issues addressed in the Europe Agreement that still have to be fully aligned with EU directives. These are the principle of single banking license and the issue of home country control. It was agreed that these two principles will be implemented as of the date of Slovenia’s full-fledged membership.

The Single Market for financial services has been formed for almost 28 years. During this period the EU Member States participated in the legislation process regarding financial services. On the contrary, the Candidate Countries started with the approximation of their legislation to the *acquis communautaire* in the second half of the 90s. This means that the Candidate Countries have to do the similar burden of work in a much shorter period. In the

future the Candidate Countries will have to catch up with the EU at the same time and to be up-to-date with all the changes going on in the Financial Services Action Plan.

From a moment of joining the EU, the banks, investment firms and insurance companies from the new Member States will have the European Passport, allowing them to operate in the entire EU. They will establish branches and offer cross-border services freely while remaining under home country control. It is important that by then they will have fully adopted all the EU financial services legislation. But it is clear that the formal adoption of the *acquis communautaire* into a national law is not all that is required. The EU provisions have to be implemented in daily practice as well.

The process of analytical examination of the *acquis*, carried out by the European Commission with each Candidate Country, is done on the basis of screening exercise and transposition tables.

At the time when first multilateral and bilateral screening for the chapter freedom to provide services took place in 1999, there were a huge number of directives in all regulated financial services. It was perhaps difficult to get a clear and transparent picture on banking from all 26 directives or their amendments.

The Transposition Tables is an essential instrument for the monitoring of formal implementation of the *acquis* into national laws. Both the Candidate Country and the European Commission are enabled to get a detailed view of the status and to follow the continuous process of the transposition of the EU legislation.

But the structure and methodology of assessing the compatibility of national legislation with certain directives in the year of 1999 through detailed tables of concordance required a large amount of work of that staff, which is, at the same time, working at the necessary legislative process. The text of the directives was split into separate articles, paragraphs, sentences and numbers according to the requirements. The Candidate Country than filled in the right side the national legislation which constitutes the transposition of the EU requirements. The Candidate Country had to indicate whether a provision has been fully, partly, or not yet transposed.

The main objective to adopt a more systematic approach was not achieved. Hundreds or thousands of such completed pages paid attention to details and did not contribute to transparency. Therefore we support the decision to simplify the tables.

A single EU Market for financial services has been under construction since 1973 and according to the European Commission's Action Plan it should be completed by 2005. Comparing the time needed for constructing it in the EU and the available period for the Candidate Countries to transpose and implement the acquis communautaire *in this field it can easily be concluded that the Candidate Countries have less time available.*

Another problem that the Candidate Countries face concerning transposing the *acquis* in the field of financial services is that it is difficult for the Candidate Countries to catch up with the EU and existing *acquis* and to be up-to-date with all the changes going on in this field at the same time. The number of the new directives or regulations in the Financial Service Action Plan is not so huge, but the complexity of some of them shows us that the enormous job has to be done in this period. Attention will be focused on further education and specialization of employees on both sides (in industry and supervisory authorities), especially on certain

segments (IT, e-money and e-commerce, derivatives, market risks, accounting on the principle of fair value, internal ratings and models, supervision of conglomerates...).

It can be argued if the Candidate Countries really need the same level of regulation as the developed EU economies.

The new Basel Capital Accord is under discussion in countries all over the world. The Candidate Countries can participate in the consultation process on Capital Accord in Basel. The solutions of the future EU directive will be probably very similar as both documents are in a parallel process. Some Candidate Countries already took part in some Basel working groups. Therefore, also in Slovenia the implementation of the new Capital Accord will involve massive work in the regulatory field (drafting amendments and modifications to the effective regulations), and will highlight the importance of the supervisory review process carried out by the inspectors of the Bank of Slovenia. New responsibilities and competence entrusted to the Bank of Slovenia on the basis of the new Capital Accord will undoubtedly require further enhancing of human resources and above all professional qualifications of banking supervisors to meet these challenges.

Statistical appendix

Comments on macroeconomic developments (Table 1)

Czech Republic

The banking sector is strongly affected by the economic environment in which it operates. The economy began to recover in 2000, and this positive trend was confirmed in 2001 with a second consecutive year of growth in gross domestic product (3.6 percent). Total GDP was CZK 1,499.2 billion (USD 41.35 billion; exchange rate 31 December 2001) as at 31 December 2001 at constant prices, compared with CZK 1,433.8 billion as at 31 December 2000 (USD 37.92 billion; exchange rate 31 December 2000).

Inflation in 2001 was moderate. The inflation rate was 4.1 percent as at 31 December 2001, fluctuating between 4 percent and 6 percent during the course of the year. Net inflation was 2.4 percent, meaning that the CNB's net inflation target (of 2 percent –4 percent) for end-2001 was fulfilled. Inflation targeting has been successfully used for four years now.

The koruna's exchange rate against the euro strengthened significantly at the end of the year because of inflow of foreign capital into the Czech economy. From its year-2000 average of CZK 35.61 to the euro the koruna strengthened to CZK 34.08 to the euro in 2001. Against the US currency the koruna's exchange rate (full-year average) strengthened from CZK 38.59 to CZK 38.04 to the dollar in the same period.

In 2000 the unemployment rate increased by 0.1 percent to 8.9 percent as at 31 December 2001. The recovery of the economy did not lead to a decreasing rate of unemployment. The excess supply of labor led to relatively low labor costs. Total year-on-year growth in average nominal wages was 8.5 percent and real wage growth 3.6 percent at the end of 2001.

The development of Czech foreign trade was affected by the slowdown in economic growth abroad. The annual growth rate of exports and imports fell, and import growth exceeded export growth on average. The trade balance showed a deficit of CZK 119 billion as at 31 December 2001. The current account deficit ended the year at CZK 101 billion; it was covered by a financial account surplus of CZK 153.3 billion.

Reports of unfavorable inflation generated a rise in short-term interest rates in July 2001, followed by the other interest rates. Domestic interest rates then followed the declining trend in interest rates in the USA and the eurozone. Towards the end of 2001 the discount rate was lowered to 3.75 percent and the Lombard rate to 5.75 percent.

Poland

Macroprudential indicators for the Polish economy show a mixed picture of economic performance. On the one hand, internal as well as external stability has improved significantly over the last 2 years, on the other, the economy has moved into a business cycle trough in 2001, which dampened growth and increased unemployment. However, from the point of view of macroeconomic stability, it can be stated that the situation is much better now than in recent years.

The situation looked gloomiest in late 1999 and early 2000, when both inflation and the current account deficit expanded dramatically. Several causes can be mentioned:

- The economy started to overheat already in 1996, when the growth rate of domestic demand exceeded GDP growth by over 3 percentage points. In view of loose fiscal policy the National Bank of Poland sharply increased interest rates in 1997.
- When the situation started to return under control in early 1998, the economy was hit by the Russian crisis and subsequently by increased oil prices. The current account deficit increased rapidly to 7.5 percent of GDP in 1999, inflation, after a sudden drop, started to accelerate and increased from 5.6 percent in early 1999 to over 10 percent in mid 2000.

It is only then that restrictive monetary policy was able to bring the situation back under control. Since mid 2000 both inflation and current account deficit dropped dramatically (to 3.6 percent and 4,1 percent in 2001 respectively) and the growth rate of domestic demand remained well below GDP growth rates. Lower inflation led to more stable inflationary expectations and less variability in the inflation rate itself.

On the other hand, high real interest rates, supported by increasing oil prices and the subsequent slowdown of the world economy, induced a sharp decrease of growth rates in Poland. GDP growth decelerated from 4 percent in 2000 to just 1.1 percent in 2001. Weak growth and unfavorable demographic conditions were the main reasons for unemployment to soar. In 2001 over 17 percent of the labor force remained unemployed.

However, other economic indicators, like the constantly high level of foreign reserves (over USD 26 bn), which covers almost threefold short term external debt, relatively low and falling external debt to GDP ratio (39.9 percent) and the very high coverage of current account imbalance by foreign direct investment (96,7 percent), show that from the point of view of macroeconomic stability the picture looks positive.

Moreover, it has to be borne in mind that the Polish economy is partially protected against a currency crisis, as the zloty is floating and the NBP does not create expectations whether and when it would intervene at the Forex market against depreciation. Thus, as indicators point at a weak recovery already in Q1 2002, the economic environment looks at the moment relatively friendly from the point of view of macroeconomic stability.

Hungary

Economic growth

As a consequence of the global economic recession and slackening domestic demand, the economic growth slowed down considerably in 2001. Industrial output was lower in December 2001 than the level of a year earlier. Unlike the trends of the preceding periods, this slowdown in output growth was mainly attributable to a drop in exports. Compared with an annual average rate of nearly 30 percent in the period 1997–2000, exports grew by only 8.9 percent in 2001. The total volume of domestic sales remained broadly unchanged at the previous year's level. The December volume of fresh orders to the export and domestic sectors failed to reach the levels recorded in the same period of 2000. In contrast with manufacturing, the upturn in construction industry activity continued in 2001: construction sector output was 9.9 percent higher in 2001 than in the previous year.

Employment

Developments in the Hungarian labor market were characterized by conflicting trends in 2001 Q4 – unemployment continued to fall, while the number and proportion of people in employment stopped rising further. According to the indicators derived from quarterly data of the CSO's Labor Force Survey, adjusted for seasonal and random effects, the whole-economy activity ratio, at 50 percent, was 0.2 of a percentage point and 0.4 of a percentage point lower respectively in 2001 Q4 than in the previous quarter and the same period a year before. Examining developments in unemployment by gender, male unemployment, at 6.2 percent, continued to be higher. This compared with 4.9 percent female unemployment in 2001.

Prices

According to the data released by the CSO, consumer price index fell to 6.8% in December 2001, showing a drop of 0.3 of a percentage point relative to November. Annual average consumer price inflation was 9.2 percent in 2001, 0.6 of a percentage point lower than in 2000. Domestic producer prices excluding energy characterize changes in producer prices the best. Seasonally adjusted by the Bank, they fell by 0.1 percent in December relative to the preceding month. Industrial firms' domestic selling prices, released by the CSO, fell by 0.5 percent in December, the twelve-month increase amounting to 3.6 percent. The annual average change in domestic selling prices was an increase of 9.4 percent in 2001.

Exchange rate

Movements in the market rate of the forint was confined to the upper region of the intervention band in 2001. On the last business day of the year, the currency stood 10.78 percent away from the central parity, into the upper region of the intervention band. Its rate closed at 246.33 vis-à-vis the euro in December 2001. With effect from 1 October 2001, the National Bank of Hungary abandoned the crawling-peg exchange rate regime, and fixed the currency's central rate at 276.1 HUF/EUR.

Balance of payments

According to the not seasonally adjusted data, Hungary's current account registered a EUR 1,248 million (ca. USD 1,120 million) deficit in 2001. The EUR 186 million change in the current account deficit relative to the EUR 1,434 million deficit recorded for the previous year was accompanied by higher net expenditures for trade in goods. The goods deficit was EUR 349 million higher in 2001, accompanied by rising export and import levels. However, the

surplus on services increased by EUR 486 million, the tourism surplus explaining more than 80% of the change.

The balance of non-debt capital transactions showed a total inward flow of EUR 813 million (ca. USD 730 million) in 2001. This was EUR 599 million more than in the previous year. Net inflows of direct investments in equity capital were the balance of direct investment transactions by non-residents in Hungary, at EUR 1,083 million, and those by Hungarian residents abroad, at EUR 358 million. Portfolio investment transactions in equity securities showed net inflows of EUR 88 million.

Hungary's external accounts
Whole-economy gross foreign debt was EUR 37.8 billion (USD 33.4 billion) at the end of December 2001. The combined gross debt of general government and the National Bank of Hungary outstanding to non-residents amounted to EUR 17 billion (USD 15 billion). The gross debt of other monetary financial institutions and the other sectors was EUR 20.9 billion (USD 18,4 billion). Here, inter-company loans amounted to EUR 5.2 billion (USD 4.6 billion). Inter-company loans, i.e. debt liabilities of subsidiary companies to their parents, had a share of 36% within the other sectors' gross foreign debt. Whole-economy net debt amounted to EUR 11.8 billion (USD 10.4 billion) at end-December.

The total stock of direct investments by non-residents in Hungary amounted to EUR 25.9 billion (USD 22.9 billion) at the end of December, of which the value of holdings of corporate shares and other classes of equity capital was EUR 20.7 billion (USD 18.3 billion).

Government budget deficit
The cumulative general government deficit amounted to HUF 607.3 billion (ca. USD 2.1 billion) in 2001, in comparison with HUF 451.6 billion (ca. USD 1.6 billion) in the previous year.

Slovak Republic

Monetary development in the Slovak Republic in 1996 was the further strengthening of the Slovak koruna internal and external stability. The basic objectives set by the National Bank of Slovakia were fulfilled. The annual rate of consumer-price inflation was at the level of 5,4%, lower than projected in the monetary program for 1996. Falling inflation had a stabilizing effect on exchange-rate policy.

The year 1996 was already the third year of economic growth for the Slovak Republic. When compared with the figure for 1995, real gross domestic product (expressed at constant 1993 prices) increased by 6,9 percent, reaching SKK 443,3 bn at the end of 1996. The share of the private sector in GDP generation increased to 76,8 percent, from 62,6 percent in 1995.

The average rate of inflation, expressed in terms of consumer-prices, fell in 1996 to 5,8% (from 9,9% in 1995).

One of the main problems of the Slovak economy, which delimited and restricted the operating space of the central bank, was the process of economic transformation and restructuring. The low inflow of long-term foreign capital in the form of foreign direct investment and the growth in domestic demand, supported by the state budget deficit and the development of infrastructural projects, represented further problems for the financing of the trade deficit and servicing of the country's foreign obligation.

According the Statistical Office of the SR, the country's gross domestic product, expressed at constant 1995 prices, increased year-on-year by 6.2 percent at the end of 1997. A key role in GDP creation was played by services. With regard to demand, the development of GDP was influenced by domestic as well as foreign demand, the growth of the latter exceeding that of domestic demand.

The average annual rate of inflation, expressed in terms of the consumer price index, reached 6.1 percent. The average monthly rise in the level of consumer prices increased from 0.44 percent in 1996, to 0.52 percent in 1997.

With regard to external relations, the year 1997 was marked by a partial change in the trend that started at the end of 1995, which consisted in a steep increase in domestic demand and decline in foreign demand. By the combined use of stricter monetary policy and import-restricting administrative measures, the development of domestic demand and the rate of growth in imports moderated during the 2nd half of the year, following a period of increased current account deficit during the first six months. Due to faster growth in the export of goods and services than in import, the current account deficit fell year-on-year by SKK 19.2 billion and its share of GDP decreased to 6.9 percent.

The slow process of transformation in the Slovak economy, especially the delayed restructuring of resource-generating sectors, was also responsible for the slowdown in the output of the domestic economy in 1998, which recorded a 4.4 percent rate of year-on-year growth. The structure of domestic demand, which was along with foreign demand - the engine of growth in gross domestic product, remained unsatisfactory. The dynamics of domestic demand were stimulated by the growth of final consumption in the household sector and the developing activities of the public sector in the area of investment, both directly and indirectly, through the provision of government guarantees for loans.

The fiscal deficit of the Government reached its highest level since 1993, both in absolute value and in terms of dynamics of growth. The expansive fiscal policy absorbed a large part of the country's limited domestic resources, and had a restrictive effect on the economic activities of entrepreneurial entities. With regard to the growth in investment demand and consumption, the resources generated on the domestic market in 1998 were not large enough, leading to increased borrowing from abroad. The persistence and strengthening of negative trends, particularly the deficit in public finance and the shortfall in the current account of the balance of payments, combined with the absence of systemic measures in economic policy, led to reassessment of the country 's credit rating and inclusion in the non-investment grade by international rating agencies. As a result, the access of companies to foreign resources was limited in 1998:loans from abroad could only be obtained at higher rates of interest and with shorter maturities. Apart from domestic factors, the inflow of capital from abroad was negatively affected by the external environment, particularly the financial crisis in Russia. The whole macroeconomic stance together with crisis in Russia and elections in Slovakia caused the pressures on exchange rate with effect on leaving fixed exchange rate regime and introducing the floating followed by exchange rate depreciation.

Macroeconomic and monetary development recorded a change in 1999 towards mitigation of macroeconomic imbalances from previous years, particularly the fiscal deficit and the shortfall in the current account of the balance of payments. To solve the problem of economic instability, the Government of the SR adopted a strategy for the acceleration of economic reforms in May 1999. Based on a complex of measures, the strategy was designed to improve budgetary performance in public finances and to reduce the dynamics of domestic demand by freezing the level of wages in public administration, adjusting the lower rate of value-added tax, and raising excise duties. At the same time, price anomalies gradually began to be straightened out through increases in regulated prices. In addition to measures taken in the area of domestic demand, the solution of the problem of the increased current account deficit was supported by an increase in the import surcharge. The aforementioned measures began to produce results in the second half of 1999.

The National Bank of Slovakia and the economy as a whole gradually learnt to live with the conditions of a floating exchange rate, which was stabilized successfully with the help of the economy policy of the Government. Over the course of the year, further steps were taken towards liberalization, with a positive effect on monetary development. As a result of the measures taken by the Government, particularly in the area of domestic demand, the trend of development began to change in both deficits – the fiscal deficit and that of the current account – in the second half of the year.

The development of the Slovak economy in the year 2000 was characterized by continued macroeconomic stabilization, which was reflected in the favorable course of inflation, accompanied by a decrease in the current account deficit of the balance of payments and the fiscal deficit in relation to GDP, whilst the exchange rate of the Slovak crown remained relatively stable. The positive economic results and the gradual introduction of liberalization measures contributed to Slovakia's admission to OECD. At the same time, conditions were created for further development of financial markets and the banking sector, which were connected with loan portfolio restructuring at selected commercial banks and the ongoing privatization process.

The improvement in economic development during the year made a gradual reduction in key NBS rates possible, and a consequent fall in primary interest rates for both deposits and loans. The level of interest rates on new loans fell by more than 5 percentage points and gradually approached the overnight refinancing rate of the NBS.

Until December 2001, the effects of internal as well as external factors had determined the development of consumer prices. The effect of domestic factors was connected mainly with the continued process of deregulation and an increase in input prices in the production sector. In addition to administrative and cost factors, the development of consumer prices was affected by demand-based factors, but only to a negligible extent, which was indicated by the moderate dynamics of prices for tradable goods and the stabilized rise in the price of market services.

The impact of external factors was connected with the fluctuation in the world prices of strategic raw materials and the exchange rate of the Slovak crown to the US dollar. In the second half of the year, the world price of oil fell below the lower limit of the reference zone of OPEC countries, with a subsequent downward effect on the level of fuel prices. This factor, together with the favorable trend in food prices and the absence of pre-enounced demand-based pressure, was responsible for the fall in inflation in the second half of the year. The year-end rate of overall and core inflation was below the lower limit of the interval set in the Revised Monetary Program of the NBS for 2001. Overall (year-on-year) inflation reached 6.5 percent, of which the core inflation was 2.39 percentage points at the end of 2001. The core inflation dynamics on a year-on-year basis was 3,2 percent.

Compared with the previous year, the rate of economic growth accelerated in 2001, with gross domestic product increasing by 3.3 percent. In comparison with 2000, the year 2001 saw a change in the structure of economic growth, which was stimulated by domestic, for the most part investment demand. This was connected with the ongoing restructuring in specific sectors, mainly corporate entities, which were the targets of foreign investors. Part of domestic demand is final household consumption, the growth of which was stimulated by an increase in real wages and additional funds received from the redemption of NPF bonds.

The development of domestic demand and the slowdown in the rate of economic growth in the countries of Slovakia’s major trading partners, led to dynamic growth in the trade deficit and a shortfall in the balance of payments on current account. The growth in imports was due mainly to the development of investment demand, stimulated by an inflow of foreign capital in the form of direct investment. The dynamic growth in imports was, however, connected with the persistent high material intensity of the Slovak economy and the resulting import of semi-finished goods and raw materials. Imports intended for final consumption were dominated by car imports.

The balance of payments on current account for the year 2001 was characterized by a gradual increase in the deficit, which reached SKK 84.9bn (SKK 52.5bn more than in the same period in 2000). This development was affected significantly by a further increase in the trade deficit. The other items in the current account (balance of services, balance of income, and that of current transfers) showed an improvement. The share of the current account deficit in GDP reached 8.8 percent in 2001.

The conduct of monetary policy in 2001 was determined by both the actual and predicted courses of macroeconomic and monetary development. The fall in inflation over the first

months of the year and the forecast for its further development, made it possible for the NBS to cut its key interest rates by 0.25 percentage points in March 2001. With regard to the relatively dynamic growth in domestic demand, imports, and the size of the trade deficit, the NBS applied a more prudent monetary policy during the following period, despite the relatively favorable trend in consumer prices, with the aim of dampening domestic demand and so avoiding the occurrence of undue macroeconomic imbalances. The moderate reduction in the official rates of the NBS in the first quarter led to a fall in interest rates for primary customers.

The Monetary Program of the NBS for the Year 2002 is based on the forecast of macroeconomic development for the period until the end of 2001. The key assumptions of the Monetary Program are the size of the fiscal deficit, which should not exceed 3.6 percent of GDP, The Monetary Program is based on the scope of adjustments to regulated prices approved for 2002. If additional price adjustments are approved, the projected inflation figures will have to be modified.

With effect from 1 January 2002, the Statistical Office of the SR revised the consumer basket of goods and services used for the calculation of the Consumer Price Index (CPI). The change in the weights of individual components of the consumer basket may affect the statistically determined rate of inflation; therefore, it will probably be necessary to correct the figures in the Monetary Program, with respect to inflation.

As for the latest developments in 2002, the level of consumer prices in March remained in average unchanged. Prices of the core inflation items did not recorded change on month-to-month basis, too. Overall inflation achieved 3,6 percent, of which the core inflation was 2,1 percentage points. The core inflation dynamics on a year-on-year basis was 2,7 percent.

The balance of payments current account for January 2002 ended in a deficit equaling SKK 4bn, mainly due to the deficit in the trade balance equaling SKK 5,8bn. According to the preliminary data, the capital and financial account of the balance of payments for the same period ended with a deficit of SKK 0,4bn.

Slovenia

In 2001, macroeconomic aggregates have been under different influences from the international environment than in 2000. Foreign demand began to decline this year because of the slowdown in the international economic environment, which was reflected in the gradual deceleration of export growth rates. In spite of this, export dynamics retained a strong pace especially in the first half of the year. On one hand, this was due to the usual six-months delay from the moment export market growth starts to decelerate to the fall in export orders. On the other hand, the relatively strong export growth was sustained by higher exports to the markets of former Yugoslavia and Russia. Domestic demand was weak after 1999 and has increased in real terms by 1.1 percent in 2000 and by 0.5 percent in 2001. As a consequence of mentioned developments real GDP growth was 4.6 percent in 2000 and 3.0 percent in 2001.

Export flows in 2000 were affected by the positive economic developments in the international environment, while import flows were influenced by low domestic consumption. Total exports rose by 11.3 percent and imports by 3.6 percent in real terms. However, current account deficit narrowed only from 3.9 percent of GDP in 1999 to 3.4 percent of GDP in 2000 because the terms of trade worsened by 5.2 percent at the same time. The two factors that contributed most to a distinctive improvements of the current account in 2001, which dropped to the level of 0.4 percent of GDP, were still strong foreign demand in the first half of the year and low domestic demand. The growth of exports was 5.1 percent and the growth of imports only 0.4 percent in real terms. Terms of trade improved for 0.9 percent and also contribute to better current account outcome.

In last two years current account deficit was entirely covered by capital inflows, which counted 5.9 percent of GDP in 2000 and 8.8 percent of GDP in 2001. As a result, official reserve assets increased from 3.2 billion USD at the end of 1999 to 4.4 billion USD at the end of 2001. Inflows from loans from abroad were relatively high in last years. Foreign direct investments increased from 1.0 percent of GDP in 2000 to 2.4 percent of GDP in 2001. Decrease of holdings of foreign currencies by households (conversion to EUR) in last quarter of 2001 was important source of inflow in 2001.

In 2001, total general government revenues counted 43.3 percent of GDP and general government expenditure 44.7 percent of GDP.

After a protracted period of dynamic development in activities designed to lower inflation, the inflation trend changed direction in the middle of 1999. Even though that turnaround coincided with putting into effect the tax reform, it was predominately triggered by the developments in the external environment. Marked growth in price of oil in the world markets that practically tripled prices compared to the level recorded year and a half before accounted for a lion's share of around 20% rise in import prices in 2000. In 2000, administered prices jumped by 19.9 percent pushed by oil derivatives prices soaring by 32.7 percent and some other administered prices.

In 2001 the inflation dropped to 7.0 percent. The prices rise in 2001 exceeded our expectations from the beginning of 2001 as variables that were assessed as unstable actually deviated in the direction of increasing inflation. First of all, the positive effect of the reduction of price pressures from abroad was delayed quite unexpectedly. The government policy, from the point of lowering prices, was rather tolerant in the area of administered prices

and its closely connected financing of the budget through excise duties. The exchange rate policy allowed relatively fast depreciation in the early months of the year and through impact of import prices influenced the setting of consumer prices and inflationary expectations.