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Division of Research & Forecasting

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Commentary

The countries of New Europe continue to grow at a robust rate with low inflation. The latest economic data reveal a strong real GDP growth for 2006, ranging from 5.2% (Poland) to 7.8% (Romania). This growth is driven primarily by private consumption and gross fixed capital formation. On the inflation front, the news is equally good. Despite the rapid expansion of aggregate demand, inflation has either remained subdued (Poland) or declined (Bulgaria, Romania, Serbia). Only Turkey and Ukraine have faced a resurgence of inflationary expectations, but both cases were instigated primarily by external developments.

The risks to those upbeat prospects are not very high, yet they exist. They emanate from the rapid expansion of borrowing, especially in foreign currency, and the large internal and external imbalances. New Europe's economies are under-banked, so credit expands at a spectacular pace and, in most cases, is either indexed or denominated outright in foreign currency. Thus, in case of an abrupt economic slowdown or an episode of currency volatility, both carrying a small probability, a significant number of unhedged borrowers could face difficulties servicing their debts. Domestic borrowing also increases household consumption and business investment, leading to large current account deficits. The latter have not yet become a major constraint on economic development, as they are partly financed via net FDI inflows.

Political developments represent another source of risk. Poland operates with an unstable political coalition, Serbia announced early elections and Turkey is facing elections in the forthcoming months. These developments raise the likelihood of fiscal policy relaxation and a substantial procyclical stimulus, exacerbating the internal and external imbalances. Some Central Banks have, in fact, indicated that they might be forced to tighten monetary policy in order to counterbalance potential increases in public expenditure.

In this issue of **New Europe** we also present two special research reports for the countries of New Europe. In the first report, we explore the connection between banks' ownership structure and their performance. Our results indicate that in countries which were quick to liberalise their banking systems, foreign banks are more efficient, more profitable and better capitalised compared to state and domestic privately-owned banks. In the second research report, we assess the relative competitive advantage of Central and Eastern European countries relative to EU-25 based on unit labour costs and find that a low unit labour cost advantage does not always suffice to attract a significant amount of FDI.

Prof. Gikas A. Hardouvelis
Chief Economist and Director of Research

1. Bulgaria

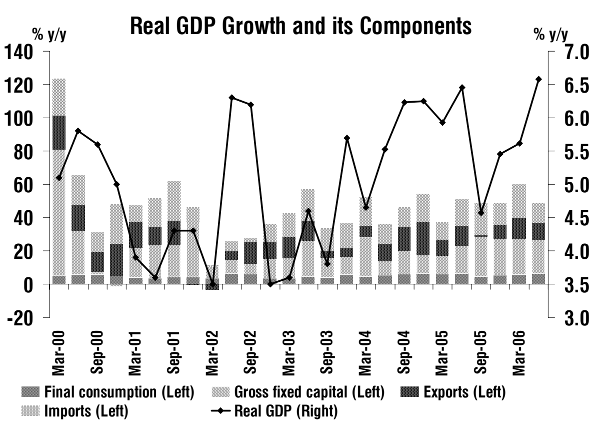
- **On the verge of EU accession, the Bulgarian economy expanded by 6.6% in Q2-2006.**
- **For the entire 2006, we expect real GDP to grow by 6%.**
- **Strong consumption and investment growth has contributed to a further increase in the current account deficit. In Q2-2006, it reached 14.5% of GDP, on an annualised basis.**
- **The fiscal surplus is projected to reach 3.3% of GDP by year-end, compared to the 3% target.**
- **Despite regulatory constraints, credit growth to both households (33.8% yoy in Q3-2006) and enterprises (17.3% yoy in Q3-2006) has been robust.**
- **Given the mounting evidence that credit constraints are loosing their effectiveness, BNB is planning their gradual removal.**

1.1 Economic Outlook

During the second quarter of 2006, the Bulgarian economy raced ahead, buoyed by the impending accession to the EU. The European Committee's monitoring report confirmed that Bulgaria, along with Romania, will be fully fledged members of the European Union, as of January 1, 2007. In parallel, the report of the European Committee urges Bulgaria to take immediate action in order to address a number of outstanding issues, the most important of which are tackling organized crime and reforming the public sector.

In real terms, the Bulgarian economy expanded by 6.6%, in Q2-2006, up from both Q1-2006 (5.6% in Q1-2006) and the same period a year ago (6.5% in Q2-2005) (Figure 1.1). Given the growth rates the economy has registered for the first two quarters of the year, total growth during 2006 is expected to exceed 6%. The main contributors to this robust growth are final consumption (mainly household consumer expenditure) and gross fixed capital formation.

Figure 1.1



Final consumption expanded by 6.7% in Q2-2006 and is anticipated to contribute approximately 4.7 percentage points to GDP growth rate by year-end. The main driver of final consumption has been household expenditure, which was boosted by positive developments in both unemployment and consumer credit. On the unemployment front, the Bulgarian economy recorded a single digit level of unemployment (9% in Q2-2006), for the first time since 1990 (Figure 1.2). At the same time, employment accelerated by 4.3%, yoy. In this direction, the reduction of payroll taxes had a positive effect, since it contributed to the integration of the informal economic activities to the labour statistics. A further cut of payroll taxes has also been announced for 2007. Finally, as we elaborate in the next section, household consumption has also been stocked up by rapid mortgage and consumer credit growth.

Extension of credit, in one form or another, has also contributed to the robust growth of gross fixed capital formation, which expanded by 20.3% yoy, while it is projected to average 17.5% contributing 4.2 percentage points to GDP growth in 2006. As we discuss below, companies in Bulgaria have found a variety of alternative financing sources, other than bank loans, such as direct borrowing from abroad and leasing agreements.

The increase in direct foreign borrowing is reflected in the dramatic change of the composition, rather than the level, of external debt. In August 2006, total external debt stood at 70.1% of GDP, up from 64.2% of GDP in the end of 2003. Nevertheless, the private sector's contribution to that debt has increased from 33% to 73%, over the same period (Figure 1.3). Furthermore, claims under financing leasing contracts grew by 51.7% from September 2005 to June 2006, while the banks' transfer of newly extended loans to banks abroad has led to a substantial increase in banks' net foreign assets.

Against this background of robust household consumption and investment expenditure, the sound fiscal performance is helping to address some of the macroeconomic imbalances. The budget surplus reached 4.5% of GDP in September, versus a 3% target agreed with the IMF for the entire 2006 (Figure 1.4). According to the Ministry of Finance, the budget surplus is projected to be 3.3% of GDP. This comes as a result of increased revenues stemming from VAT taxation. Tax revenues have been growing at 11.3% in the Jan-Sep period, while total expenditures have been contained close to inflation levels, at 5.9%. Strong primary balances have led to a rapid decrease of the government debt from 41% in 2004 to 26.3% in September 2006. As a result, Standard and Poor's has upgraded Bulgaria's sovereign credit rating to BBB+, a total of a three notches upgrade over the last three years (from BB+ in 2003, to BBB+ in 2006).

Figure 1.2

Labour Market

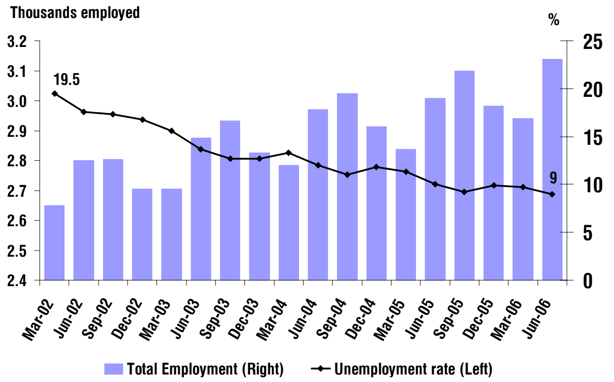


Figure 1.3

Decomposition of Gross External Debt

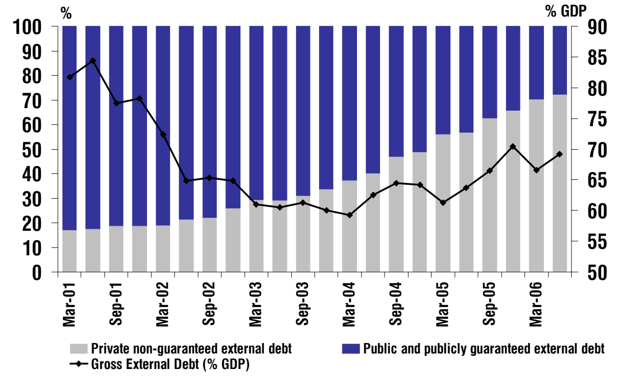
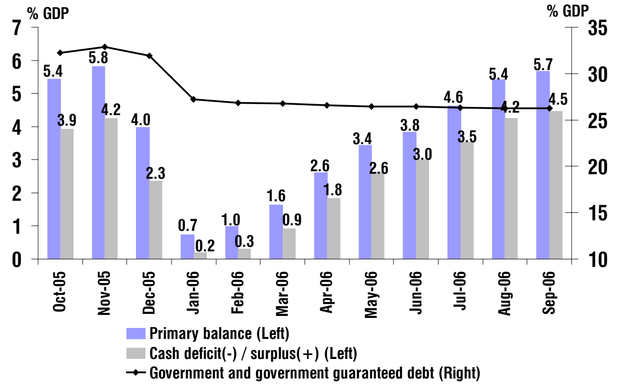


Figure 1.4

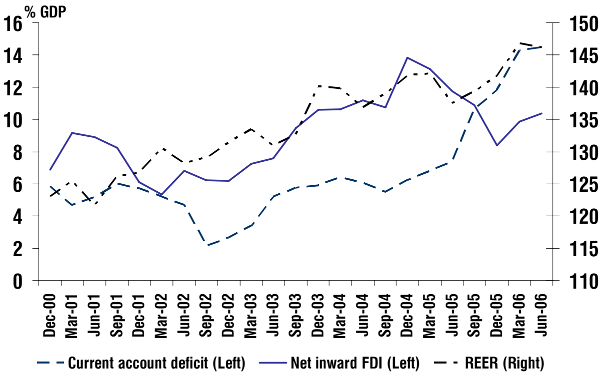
Public Finances



On the other hand, the National Bank of Bulgaria reported that the current account deficit widened to €1.8bn (7.6% of GDP) in the January-July period, up from €1.1bn (5% of GDP) over the same period in 2005. On an annualized basis, the current account deficit stood at 14.5% of GDP (Figure 1.5). The trade balance deteriorated over the same period by 19.3% yoy, reaching 20.5% of GDP (on an annualized basis), despite the deceleration of the imports growth rate. The decomposition though of the imports volume reveals that while the imports of capital investment oriented goods have remained broadly unchanged at 17.9%, energy and related imports were the main culprits for the widening of the trade deficit, since they grew by 61.7%.

Figure 1.5

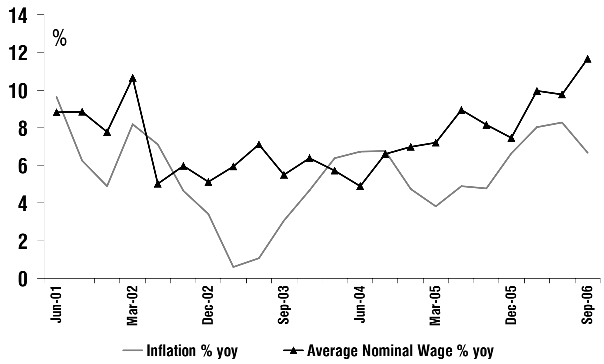
Current Account Deficit and its Financing



On the bright side, the economy is not expanding at the expense of incurring external financing requirements. FDI inflows are financing 77% of the current account deficit, according to the Q2-2006 data. FDI inflows are expected to increase further as a result of impending EU membership, the announced corporate tax rate cut to 10% in 2007 and the overall attractiveness of Bulgaria as a FDI investment destination. According to our analysis on the competitive advantage of the Central and Eastern European countries, based on their unit labour cost (presented as a special issue in this report), Bulgaria tops our rankings as the country that combines the lowest unit labour cost, relative to EU-25 average, and the highest FDI inflows as a percentage of GDP. Our results are corroborated by UNCTAD's World Investment Report, according to which the Bulgarian economy is classified as an economy of high potential and high growth in terms of FDI.

Figure 1.6

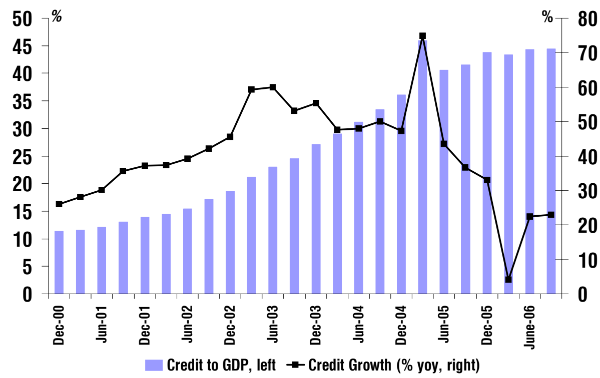
Inflation & Nominal Wages



As we had anticipated in the previous issue of our quarterly review, the main bulk of inflationary pressures for 2006 materialized during the first 3 months of the year, mainly because of hikes in excise duties on alcohol and tobacco and increases in the price of sugar. From April onwards though, administered prices had a negligible contribution to inflation. This, combined with lower than expected food prices, resulted in a disinflationary period from May to October. As a result, inflation declined in October to 5.6%, yoy, while average inflation reached 6.7% Q3-2006 compared with a 6.5% BNB forecast for the entire 2006 (Figure 1.6).

Figure 1.7

Financial Intermediation & Credit Expansion



1.2 Credit Developments

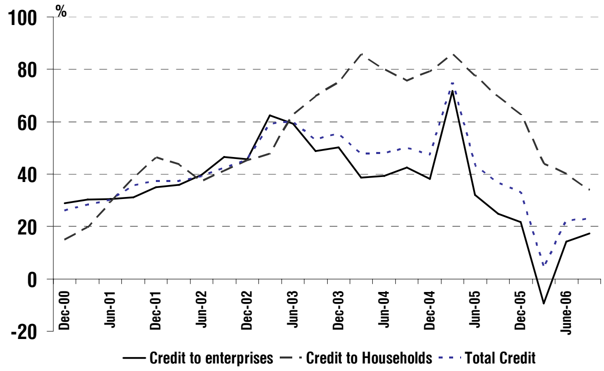
Despite a number of prudential and regulatory measures introduced by BNB, in order to restrict credit growth, total credit grew by 22.9% yoy in Q3 2006, mortgage lending by 68.9%, consumer credit by 17.85%, and total household lending grew by 33.8%. As a result, total household lending currently stands at 15.8% of GDP and accounts for 35% of total credit in the economy (Figures 1.7, 1.8).

Credit to non-financial enterprises grew by 17.32%, yoy, in Q3-2006, resulting in a dramatic reduction of the total credit growth (household and business lending) to 22.8%, yoy, in September 2006, down from 41% in August 2005. While this is very close to the BNB's target of 20%, there exist several indications that both banks and enterprises have found ways to circumvent BNB's restrictions. As mentioned above, the most popular alternatives to bank lending that have emerged are direct borrowing from abroad, leasing agreements and transfer of bank loans from foreign-owned Bulgarian banking institutions to their parent banks abroad.

These developments for both consumer and business credit indicate that prudential and regulatory measures, imposed by BNB, are loosing their effectiveness in curbing credit expansion. Furthermore, the danger is that after EU accession, these regulatory measures would put Bulgarian banks at a disadvantage compared with banks conducting banking business in Bulgaria but regulated by the supervisory authorities of other EU members. For these reasons, BNB has indicated that while it does not plan to lower the level of prudential supervision, it is considering a gradual removal of some of its administrative restrictions.

Figure 1.8

Credit Growth Rates



Bulgaria: MacroEconomic Indicators	2001	2002	2003	2004	2005	2006Q1	2006Q2	2006Q3
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	4.0	4.8	4.5	5.6	5.5	5.6	6.6	-
Final Consumption	4.4	3.6	6.6	5.1	6.8	4.8	6.7	-
Gross fixed capital formation	19.9	9.3	13.9	12.0	19.0	21.4	20.3	-
Exports of goods and services	8.5	6.2	8.0	13.1	7.2	12.9	10.2	-
Imports of goods and services	13.0	4.7	15.3	14.1	14.6	20.0	11.4	-
Industrial production (in nominal terms)	-4.8	4.0	18.3	21.5	5.8	7.3	5.9	-
Labour Market								
Employment	-3.4	1.5	3.5	3.1	2.0	3.6	4.3	-
Unemployment (in per cent of labor force)	19.8	17.8	13.7	12.0	10.1	9.7	9.0	-
Prices	*(Percentage Change)*							
Consumer prices (annual average)	7.4	5.9	2.3	6.1	5.0	8.0	8.3	6.7
Producer prices (annual average)	3.6	1.3	4.9	6.0	6.9	7.8	8.2	9.9
Average monthly wage in economy	6.9	7.3	6.1	7.0	9.3	10.0	9.8	11.6
Government sector	*(In per Cent of GDP)*							
General government balance	1.9	-0.2	0.3	2.7	2.4	1.0	3.3	-
General government debt	66.2	53.7	46.0	40.9	32.2	30.2	29.1	-
Monetary and Financial Indicators	*(Percentage Change)*							
M3	27.6	17.7	16.6	22.5	27.3	16.8	18.8	-
Domestic credit	37.2	45.5	55.4	47.3	33.1	4.1	22.4	22.9
	(End of Period)							
Base interest rate	4.5	4.0	2.7	2.6	2.0	2.3	2.5	2.8
Exchange rate BGN/USD	2.2	1.9	1.5	1.4	1.7	1.6	1.5	-
Exchange rate BGN/EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	-
Real Effective Exhange Rate (Index)	126.8	131.4	140.1	141.9	141.8	146.8	146.1	-
International Position	*(In per Cent of GDP)*							
Current account balance	-5.6	-2.4	-5.5	-5.8	-11.3	-13.7	-13.9	-
Trade balance	-11.7	-11.4	-13.7	-15.1	-20.2	-21.3	-20.5	-
Exports of Goods & Services	55.6	53.1	53.6	58.0	60.8	61.9	63.1	-
Imports of Goods & Services	63.1	59.8	63.0	68.2	77.4	80.4	81.2	-
Foreign direct investment, net	5.9	5.8	10.3	11.5	11.2	12.6	13.2	-
External debt	78.4	72.7	67.7	70.8	67.2	66.3	67.9	-
Memorandum items	*(Denominations as Indicated)*							
Population (end-year, million)	7.9	7.8	7.8	7.8	7.8	-	-	-
GDP (in millions of leva)	29,618	32,324	34,410	38,008	41,948	-	-	-
GDP per capita (in US dollar)	1,718	1,984	2,546	3,109	3,434	-	-	-

Source: National Statistics, BNB, European Commission

Bulgaria: Banking Indicators								
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006
Percentage of GDP (%)								
Assets	41.1	45.0	50.1	65.1	78.3	79.1	80.5	82.6
Total Credit	14.0	18.7	27.1	36.1	43.8	43.3	44.3	44.5
Credit to Enterprises	11.1	14.9	20.9	26.1	29.0	28.3	28.4	28.5
Credit to Households	2.8	3.7	6.1	9.9	14.7	14.9	15.8	15.8
Deposits	32.2	34.9	39.3	51.0	60.6	60.4	62.2	64.5
Percentage Change (%, yoy)								
Assets	25.0	19.1	19.0	43.8	31.8	17.0	28.9	30.4
Total Credit	37.2	45.5	55.4	47.3	33.1	4.1	22.4	22.9
Credit to Enterprises	35.0	45.6	50.2	38.1	21.7	-9.3	14.2	17.3
Credit to Households	46.3	45.3	75.0	79.3	63.0	43.8	39.9	33.8
Deposits	34.3	18.1	20.5	43.7	30.1	12.0	27.7	33.7
Percent (%)								
Capital Adequacy Ratio	31.3	25.2	22.2	16.1	15.2	16.0	-	-
Capital to Assets	13.5	13.3	13.1	11.0	10.5	-	-	-
NPLs to Total Loans	3.3	2.4	2.5	1.9	1.7	-	-	-
Provisions to NPLs	61.6	59.6	50.0	48.5	45.3	45.3	-	-
Return on Assets	2.9	2.1	2.4	2.1	2.1	2.6	-	-
Return on Equity	21.9	17.9	22.7	20.6	22.1	25.8	-	-

Sources: BNB, IMF

2. Romania

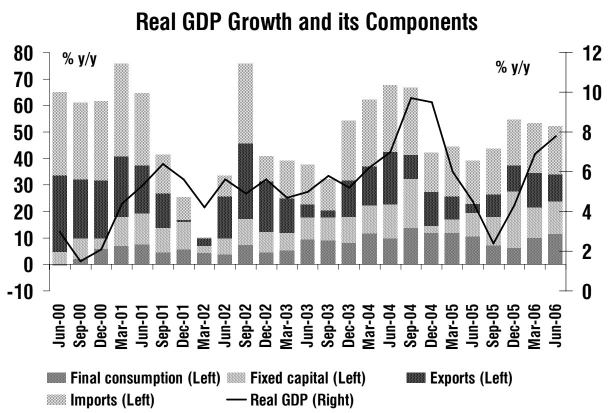
- **Real GDP has accelerated to 7.8% yoy in Q2-2006.**
- **Our forecast is for 7.5% growth for the whole of 2006 driven by the anticipation of EU membership, the high real wage growth and a robust credit expansion.**
- **Government's spending plan to swing from a budget surplus of 1.1% of GDP in September to 2.5% deficit by year-end. The extent of public spending would determine the short and medium term evolution of both inflation and monetary policy.**
- **Total credit grew by 51% yoy in the first 9 months of 2006.**
- **Above potential economic growth is contributing to the widening of the current account deficit (9.4% of GDP in Q2-2006).**
- **Despite robust economic growth, inflation has decelerated to 4.8% in October, within NBR's target band.**

2.1 Economic Outlook

The Romanian economy is accelerating in light of the prospective EU membership. The European Commission announced that Romania will join the EU on January 1st 2007, but at the same time urged the Romanian government to take all necessary steps in order to curb corruption and improve the EU funds administrative mechanisms.

Romania's GDP grew by 7.8 percentage points yoy in the Q2-2006, compared with 4.5 percentage points during the same period a year ago. Based on these developments, we now expect GDP to grow by 7.5% for the entire 2006. The main driver of this growth is private consumption, which increased by 12.7% in Q2-2006, up from 11.6% in Q2-2005 (Figure 2.1). Private consumption is expected to grow by 7.5% in 2006, contributing 6.2 percentage points to GDP growth. The continued growth in consumption is also reflected in the growth of retail sales. Retail sales, a proxy of private consumption, grew by

Figure 2.1



12.2%, compared to 8.9% in Q2-2005, and is projected to average 11% for 2006.

Domestic demand is fuelled by increasing credit expansion and real wage growth. Despite monetary tightening during 2006, credit growth has not slowed down. In September 2006, total lending continued to grow at around 51%, yoy. As a result, credit reached 25.2% of GDP (Figure 2.2). While this is well below EU-12 or even EU-25 levels, the rapid credit expansion has been a cause for concern for the authorities in terms of prudential oversight. Nominal and real wages have been rising quickly. Average net nominal wages have increased by 14.3%, yoy, in Jan-Sep 2006, a rate that is equivalent to an 8.8%, yoy, real wage rise. In turn, based on the historical relationship between real wage growth and real private consumption growth (see Figure 2.4) we expect this real wage growth to be translated into a robust private consumption growth in Q3-2006. In addition, falling unemployment and rising disposable income have been fuelling private consumption. In that direction, unemployment has dropped to 5.0% in September, a record low since July 1992, while employment growth has been modest at 1.4% in Q3-2006, compared with 2.4% in Q3-2005 (Figure 2.3).

Fiscal policy, and especially the government's spending plans for the last quarter of 2006 are receiving increasing attention. For the first 9 months of 2006, Romania was running a surplus of 1.1% of GDP. Total revenues increased by 26%, boosted by VAT revenues, rising incomes and the waning of the adverse effect of the implementation of the 16% flat tax rate. At the same time, government spending increased only by 23.9%. However, public spending in Romania traditionally picks up during the last quarter of the year (Figure 2.5). In addition, the government has announced that it has revised the targeted year-end deficit from 0.9% to 2.5% of GDP and plans to channel the additional expenditure to infrastructure projects. If these plans are to materialize, then the risk is that this excess spending will provide a substantial pro-cyclical stimulus to the economy and exacerbate both inflationary pressures and the current account deficit.

The liberalization of the capital account has led to massive capital inflows in Romania and a real appreciation of the local currency. Following a real appreciation of the RON by 8% during last year, the trade deficit is widening. As a result, the current account reached 9.4% of GDP on an annual basis in Q2-2006, compared with a 9.2%

Figure 2.2

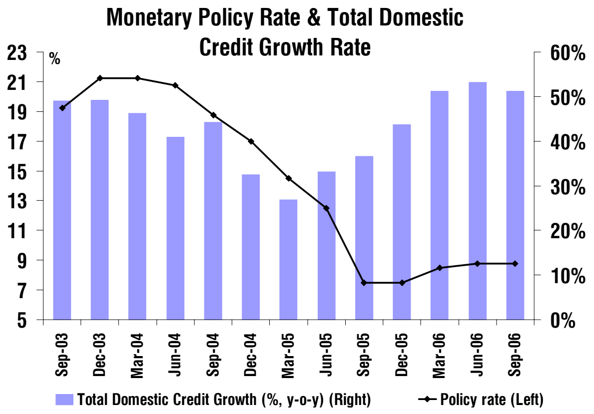


Figure 2.3

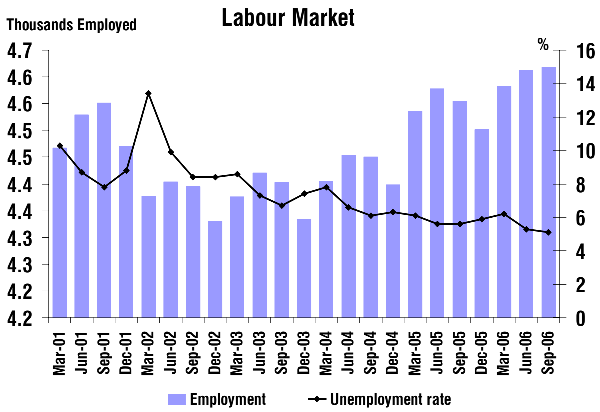
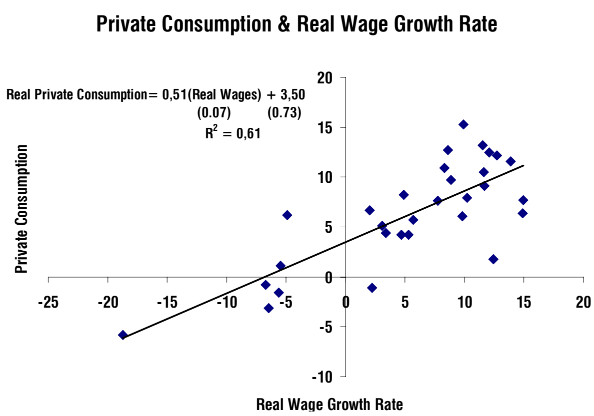


Figure 2.4



deficit in Q1-2006 and an 8.6% deficit in H1-2005 (Figure 2.6). According to IMF's projections, the current account deficit is expected to reach 10.5% of GDP by year-end.

From a financing perspective, the current account deficit is covered primarily by FDI flows. In Q2-2006, approximately 85% of the current account deficit has been financed by FDI inflows. Amongst other factors, the decline in corporate tax rate and further privatization efforts of the banking sector has resulted in an increase in FDI investment. As a result, the World Bank's "Doing Business 2007" report has ranked Romania as the second most active reformer in the ease of doing business rankings among 175 countries (see also special issue in this Review). The reforms targeted areas such as simplifying business licensing and trading, easing access to credit, increasing labour market flexibility, and strengthening investor protection. Due to these positive developments, Romania has also received an upgrade for its foreign-currency denominated sovereign debt from international rating organizations such as Fitch (to BBB from BBB-) and Moody's (to Baa3 from Ba1).

Up to now, NBR had faced a challenging trade-off. It has pursued a tight monetary policy, in an attempt to maintain price stability but at the same time higher interest rate differentials attracted a speculative capital inflow, which led to RON appreciation. In June 2006, NBR raised the policy interest rate for the second time to 8.75% and in late June it increased the minimum reserve requirements for lei-denominated liabilities from 16% to 20%. On the other hand, inflation in August dropped for the first time since 1990 to 6%, yoy, and in October it declined even further to 4.8%, below the 5% target of the central bank, and well within the +/-1% band around the target. In our view NBR's future actions will depend on the evolution of the government's spending plans. If the government goes ahead (either in Q4-2006 or during 2007) with its spending plans then NBR will have to continue its tight monetary policy in order to counterbalance the economic stimulus that will be provided by the fiscal outlays. If, on the other hand, the fiscal stimulus is not as substantial as originally planned, then we forecast a gradual relaxation of monetary policy, which will help reverse RON's recent appreciation and alleviate the external imbalances of the Romanian economy.

Figure 2.5

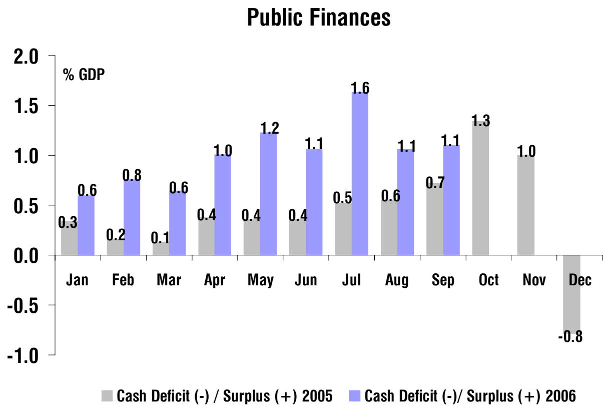
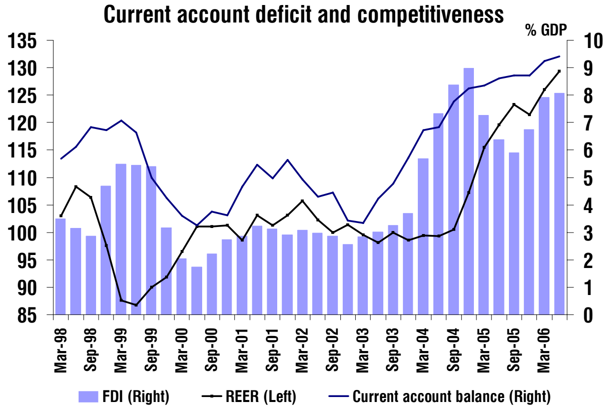


Figure 2.6

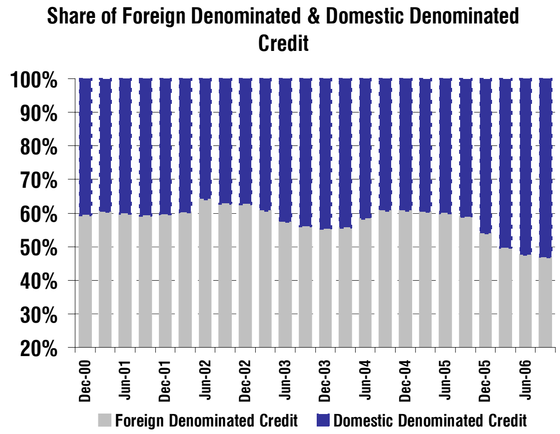


2.2 Credit Developments

Credit expansion is continuing its upward trend, with total lending growing at 51%, yoy, as of 9/2006. This is mainly attributed to non-government credit growing at 55%, yoy. Credit expansion has been substantial for all sectors of the economy, especially so for the household sector. Loans extended to households increased by 84.8%, twice as much as loans to the private corporate sector (47% yoy, in September 2006). Observing the structure of household credit, we detect the prevalence of consumer credit over mortgage loans. Eighty percent of total household credit is consumer credit , which is growing by 95.8%, yoy, as of September 2005. Contrary to long - term mortgage loans, consumer credit is mainly denominated in domestic currency. For that reason, the share of foreign currency loans to households declined to 40%, in September 2006, down from 51% a year ago.

The decline of foreign currency denominated loans is not limited to household credit; instead it constitutes a wider trend. The share of foreign-currency denominated loans was reduced to less than 50% for the first time in Q1-2006 (Figure 2.7). Indicative of the reversal of this trend is the fact that as of 9/2006 loans in RON increased by almost 101%, whereas loans in foreign currency by only 23%.

Figure 2.7



Romania: Macroeconomic Indicators	2001	2002	2003	2004	2005	2006Q1	2006Q2	2006Q3
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	5.7	5.1	5.2	8.4	4.1	6.9	7.8	-
Private consumption	6.9	5.3	8.5	14.1	9.7	10.9	12.7	-
Public consumption	3.6	3.0	7.5	5.0	4.5	4.3	0.9	-
Gross fixed capital formation	10.1	8.2	8.6	10.8	13.0	11.4	12.2	-
Exports of goods and services	12.9	15.3	6.4	21.3	17.5	22.0	18.7	-
Imports of goods and services	22.1	8.6	12.3	24.0	23.9	28.6	22.7	-
Industrial production (in nominal terms)	8.2	6.0	3.1	5.3	2.0	4.5	6.7	-
Labour Market								
Employment	1.4	-2.8	0.1	1.0	2.6	1.6	0.9	-
Unemployment (in per cent of labor force)	8.8	8.4	7.4	6.3	5.9	6.2	5.6	-
Prices	*(Percentage Change)*							
Consumer prices (annual average)	34.5	22.5	15.3	11.9	9.1	8.7	7.2	-
Producer prices (annual average)	42.0	24.8	19.7	18.6	12.5	11.6	12.1	-
Average monthly wage in economy	40.9	26.8	25.4	22.5	23.7	15.0	14.7	-
Government sector	*(In per Cent of GDP)*							
General government balance	-3.5	-2.0	-1.5	-1.5	-1.5	0.7	1.5	-
General government debt	23.2	25.0	21.5	18.8	15.9	-	-	-
Monetary and Financial Indicators	*(Percentage Change)*							
M2	42.9	40.6	30.5	32.3	41.5	31.9	27.7	-
Domestic credit	46.4	42.4	49.2	32.5	43.7	51.1	53.3	51.2
	(End of Period)							
Reference rate	35.0	20.4	18.9	20.2	9.7	8.5	8.5	8.75
Exchange rate RON/USD (end-period)	3.2	3.4	3.3	2.9	3.1	2.9	2.8	-
Exchange rate RON/EUR (end-period)	2.8	3.5	4.1	4.0	3.7	3.5	3.6	-
Real Effective Exhange Rate (Index)	101.5	102.3	99.1	101.6	119.9	126.1	129.3	-
International Position	*(In per Cent of GDP)*							
Current account balance	-5.5	-3.3	-5.8	-8.4	-8.8	-9.5	-9.8	-
Trade balance	-7.4	-5.7	-7.5	-8.8	-9.8	-10.6	-10.9	-
Exports of Goods & Services	33.3	35.4	34.7	35.9	33.0	33.4	33.5	-
Imports of Goods & Services	41.1	41.1	42.2	45.0	43.4	43.9	44.1	-
Foreign direct investment, net	2.9	2.5	3.6	8.4	7.1	8.2	8.4	-
External debt	30.9	35.0	34.7	35.1	33.0	-	-	-
Memorandum items	*(Denominations as Indicated)*							
Population (end-year, million)	22.4	21.8	21.7	21.7	21.7	-	-	-
GDP (in billions of Lei)	116.8	151.5	197.6	246.4	287.2	-	-	-
GDP per capita (in US dollar)	1,793	2,103	2,738	3,483	4,535	-	-	-

Source: National Statistics, NBR, European Commission

Romania: Banking Indicators								
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006
Percentage of GDP (%)								
Assets	30.2	31.6	31.3	37.1	45.4	45.5	47.4	-
Total Credit	13.4	14.7	16.8	17.9	22.0	22.8	25.2	-
Credit to Enterprises	9.2	9.9	10.6	10.9	12.4	12.5	13.5	-
Credit to Households	0.7	1.4	3.8	4.8	7.4	7.6	9.2	-
Deposits	21.2	22.6	21.3	24.1	27.7	27.2	27.9	-
Percentage Change (%, yoy)								
Assets	51.3	35.8	29.1	48.0	42.5	35.4	36.8	31.3
Total Credit	46.4	42.4	49.2	32.5	43.7	51.1	53.3	51.2
Credit to Enterprises	53.2	41.1	25.1	4.7	0.0	6.1	12.5	6.4
Credit to Households	87.6	161.5	258.9	58.3	80.0	73.3	76.4	84.8
Deposits	49.0	38.3	23.0	40.8	34.1	30.0	25.8	15.2
Percent (%)								
Capital Adequacy Ratio	28.8	25.0	20.0	18.8	20.2	20.0	-	-
Capital to Assets	12.1	11.6	10.9	8.5	8.8	9.2	-	-
NPLs to Total Loans	3.3	2.3	8.3	8.1	8.3	8.3	-	-
Provisions to NPLs	76.8	52.6	33.5	34.3	31.4	34.1	-	-
Return on Assets	2.5	2.7	2.7	2.5	1.9	1.9	-	-
Return on Equity	15.8	18.8	20.0	19.3	15.4	15.0	-	-

Sources: NBR, IMF

3. Serbia

- **Political risk creates a challenging environment in Serbia, especially when considering the forthcoming elections and the adoption of a new constitution.**
- **Real GDP growth in Serbia remains robust at 6.6% in Q2-2006.**
- **Inflation has been decelerating aggressively to 9.3% (October 2006) down from 18.0% (October 2005).**
- **Total credit grew by 58%, yoy, in Q2-2006, while total credit outstanding amounts to 26.6% of GDP.**
- **Strong economic growth and rapid credit expansion have contributed to a widening of the current account deficit to 10.4% of GDP in Q1-2006, up from 8.3% of GDP in 2005.**
- **The current government's intention to implement its National Investment Plan will result in extra spending reducing the budget surplus from 2.1% of GDP, down to 0.8% of GDP.**

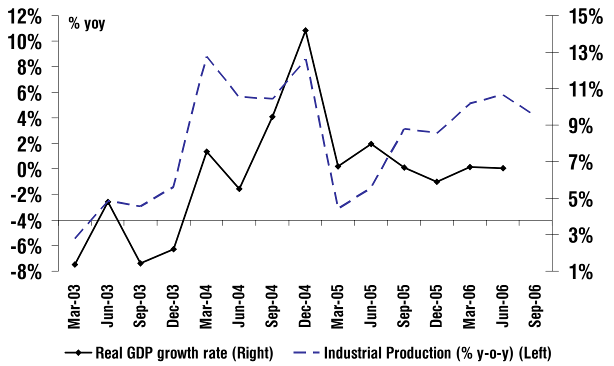
3.1 Economic Outlook

While economic indicators in Serbia provide a positive outlook in the short-run, political risk and geopolitical outstanding issues create a challenging economic environment. The country is undergoing a transition which entails huge institutional and legal framework changes. The results of this restructuring process have begun to show up in the economic activity, though the legacies of the past still have not been fully overturned.

The new constitution, which will recognise Kosovo as an integral part of the country, and the break-up of the state-union with Montenegro, are the driving political developments. These are pointing towards early parliamentary elections in January, but it remains uncertain whether these will produce a stable government and be able to put an end to political volatility in the country. Issues such as the unresolved Kosovo dispute and the co-operation with the International Criminal Tribune for Former Yugoslavia (ICTY), which led to the suspension of negotiations with the European Union for a

Figure 3.1

Real GDP Growth and Industrial Production



stability and association agreement in May 2006, constitute challenges that the next government will eventually have to deal with. While all these outstanding issues have been discounted by international markets they can still create unfavourable conditions and hurt the investment climate.

Economic growth in Serbia has remained robust in Q2-2006. Preliminary data for GDP - estimated according to the production approach - show that economic growth in Q2-2006 reached 6.6%, yoy, compared with 8% growth in Q2-2005. Based on this data, real GDP growth rate is now expected to exceed 6% for the entire 2006 (Figure 3.1). The key factor behind this growth is the recovery of industrial production, mainly due to the manufacturing sector which accounts for about 20% of the GDP produced. Strong demand growth has also been reflected in the buoyant credit growth. Total credit growth has reached 58%, yoy, in Q2-2006, which represents 26.6% of GDP.

On the fiscal front, the budget finances are being favourably influenced by privatization revenues. The budget surplus in September reached 1.95% of GDP, compared to a budget surplus of 1.5% of GDP at end-2005 (Figure 3.2). Total budget revenues grew by 24% in September, yoy, boosted by privatizations that took place in the telecoms sector during August.

On the other hand, the current government's intention to implement the National Investment Plan (which envisages that privatization proceeds be channelled to infrastructure projects) has led to a revision of the budget surplus from 2.1% down to 0.8% of GDP.

In our view the upcoming parliamentary elections are expected to hold back the privatization program. As a result, major privatization projects, such as the privatization of NIS (Oil and Gas state-owned Company), will be held back until a new government is elected. Finally, in an effort to improve the domestic business environment and reduce the high unemployment, the government has reduced both the corporate tax rate and the social security contributions.

The current account deficit has deteriorated from 8.3% of GDP, at end-2005, to 10.4% in Q1-2006, being driven by the deterioration of the trade deficit which widened by 23%, yoy, in the January-August period. The value of imports has gone up by 23.9%, 15.4% of which is due to capital investment oriented goods. Despite REER appreciation, exports growth remains robust and has increased to 24% compared to 20% in the beginning of the year (Figure 3.3). From a financing perspective, FDI covered 60% of the current account deficit, despite the political uncertainties. The main reason behind these FDI flows has been the privatization of these FDI flows

Figure 3.2

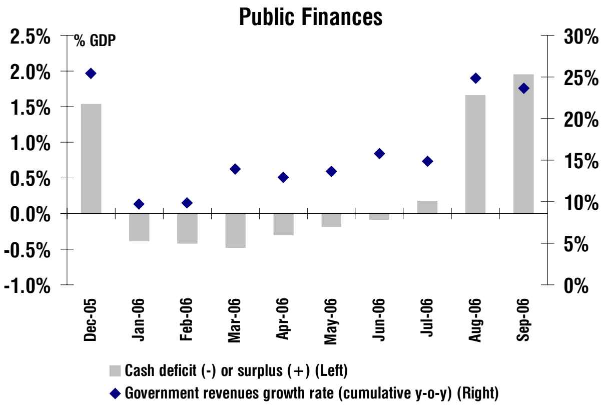


Figure 3.3

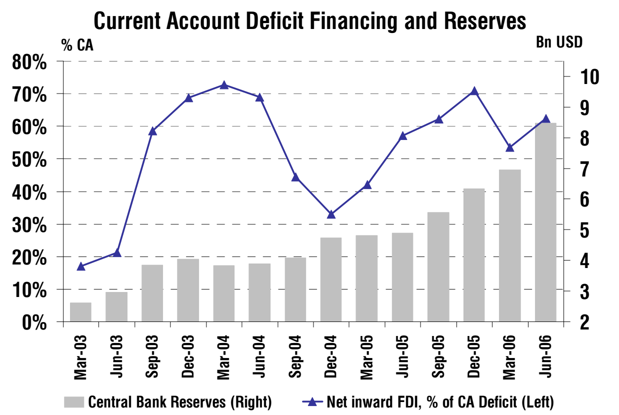
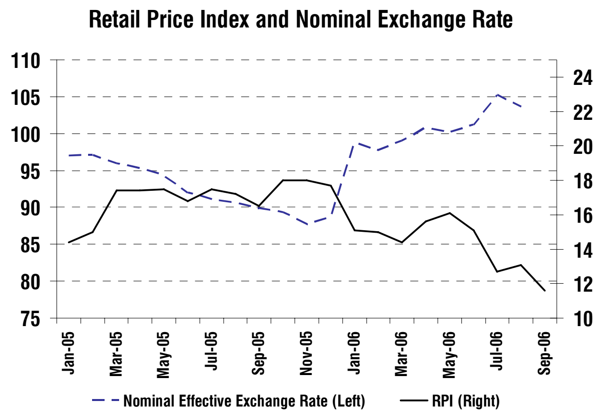


Figure 3.4



has been the privatization of state-owned enterprises.

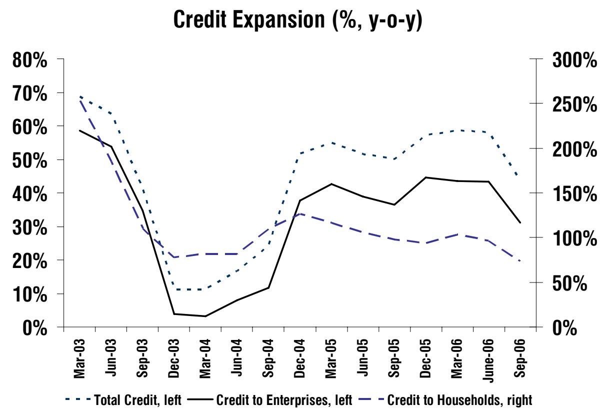
Finally, despite the robust economic growth and significant credit expansion, inflation has been slowing down in Serbia. After reaching levels of 17%-18% in 2005, inflation slowed down to 9.3% in October, yoy, down from 18.0% in August 2005 (Figure 3.4). Inflationary pressures are being restrained mainly by the local currency appreciation against the main currencies, the Euro and the US dollar.

3.2 Credit Developments

Financial intermediation in Serbia remains at a particularly low level (credit to GDP stood at 27.3%, as of September 2006). However, total credit growth surged to 43.8%, yoy, as of September 2006, loans to households grew by 73.7% and loans to enterprises by 31.2% (Figure 3.5). The largest share of credit is extended to private enterprises (63.7% of total credit outstanding in Q3-2006) while approximately a third of total credit is given to households. Mortgage loans account for approximately 20% of credit to households, while consumer lending accounts for the rest of households borrowing.

Finally, two are the main risk factors for the financial stability of the Serbian banking sector. More than 80% of total loans are either FX-denominated or FX-indexed, leaving unhedged borrowers exposed to currency volatility. In addition, non-performing loans stand at very high levels constituting almost a fifth of banks' loan portfolio (20.7% in Q1-2006).

Figure 3.5



Serbia: MacroEconomic Indicators	2001	2002	2003	2004	2005	2006Q1	2006Q2	2006Q3
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	5.1	4.5	2.4	9.3	6.8	6.7	6.6	-
Industrial production (in nominal terms)	-	-5.2	-3.0	7.1	0.4	5.2	6.2	-
Labour Market								
Employment	-	-	-1.2	0.2	0.4	1.1	0.0	-2.0
Unemployment (in per cent of labor force)	12.2	13.3	14.6	18.5	20.8	-	-	-
Prices	*(Percentage Change)*							
Retail Price Index (annual average)	94.3	21.4	11.7	9.8	17.3	14.7	15.4	13.6
Producer prices (annual average)	-	10.7	5.9	9.5	13.0	-	-	-
Government sector	*(In per Cent of GDP)*							
General government balance	-0.5	-3.3	-2.8	-0.1	1.6	-0.5	-0.1	1.9
General government debt	-	85.4	79.2	67.3	52.1	-	-	-
Monetary and Financial Indicators	*(Percentage Change)*							
M3	-	-	29.1	31.3	39.1	43.8	40.3	-
Domestic credit	13.4	-35.3	11.2	51.7	57.1	58.5	58.0	43.8
	(End of Period)							
Exchange rate CSD/USD (end-period)	67.7	59.0	54.6	57.9	72.2	71.9	68.6	64.5
Exchange rate CSD/EUR (end-period)	-	60.7	65.3	73.1	83.3	87.5	86.5	83.0
Real Effective Exhange Rate (Index)	130.0	116.8	101.9	98.9	101.6	100.3	104.7	110.7
International Position	*(In per Cent of GDP)*							
Current account balance	-5.9	-12.0	-10.1	-13.1	-8.3	-8.9	-10.4	-
Trade balance	-26.6	-27.1	-25.3	-31.5	-22.1	-23.7	-24.6	-
Foreign direct investment, net	1.6	3.3	6.9	4.3	5.9	6.2	5.5	-
Memorandum items	*(Denominations as Indicated)*							
Population (end-year, million)	8.3	8.3	8.3	8.3	8.3	-	-	-
GDP (in millions of CSD)	771.8	998.0	1,189.0	1,421.0	1,745.0	-	-	-
GDP per capita (in US CSD)	1,386.0	1,866.9	2,484.5	2,906.9	3,117.0	-	-	-

Source: National Statistics, NBS , European Commission

Serbia: Banking Indicators	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006
Percentage of GDP (%)								
Assets	125.9	32.4	29.3	33.8	43.4	-	-	-
Total Credit	34.1	15.3	14.8	18.4	23.6	-	-	-
Credit to Enterprises	29.4	13.4	12.1	13.6	16.1	-	-	-
Credit to Households	0.7	1.6	2.4	4.5	7.1	-	-	-
Deposits	14.1	14.5	17.1	18.9	22.8	-	-	-
Percentage Change (%, yoy)								
Assets	39.6	-62.9	3.7	41.2	56.4	61.0	67.6	58.9
Total Credit	13.4	-35.3	11.2	51.7	57.1	58.5	58.0	43.8
Credit to Enterprises	11.4	-34.5	4.0	37.6	44.7	43.6	43.3	31.2
Credit to Households	86.6	219.9	77.5	126.0	93.9	102.6	96.5	73.7
Deposits	84.8	47.6	35.4	36.0	46.6	3.9	9.6	11.1
Percent (%)								
Capital Adequacy Ratio*	-	25.6	31.1	27.9	25.2	-	-	-
Capital to Assets*	-	18.3	22.5	18.8	17.2	-	-	-
NPLs to Total Loans*	-	21.6	24.1	22.3	19.8	-	-	-
Provisions to NPLs*	-	-	54.0	58.9	47.8	-	-	-
Return on Assets*	-	-8.4	-0.3	-1.2	0.9	-	-	-
Return on Equity*	-	-60.6	-1.2	-5.3	5.4	-	-	-

* For 2005 the latest figure available is provided

Sources: NBS, IMF

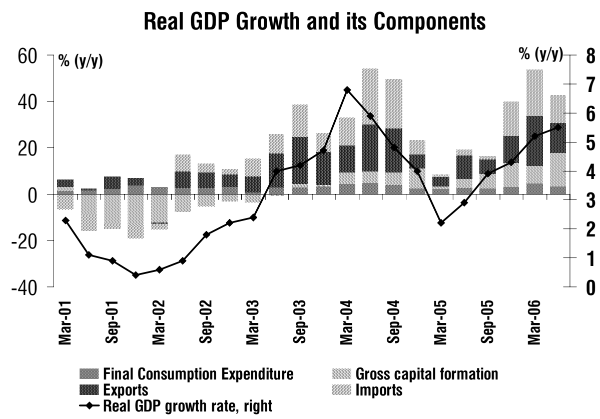
4. Poland

- **Political instability raises concerns about maintaining a positive climate in the economy.**
- **Strong investment and private consumption growth (14.4% and 4.9% of GDP respectively, in Q2-2006) contributed to a real GDP growth rate of 5.5% in Q2-2006 (2.9% in Q2-2005).**
- **Real GDP growth for the entire 2006 is forecasted in the region of 5.2% - 5.5%.**
- **Inflation data released in October (1.2% yoy, 1.6% in September) confirms that inflation has entered an upward path, but is still below the 2.5% target set by the NBP.**
- **Public sector's reform is deemed necessary in order to avoid future deterioration of the public finances.**

4.1 Economic Outlook

Recent political events, such as the collapse and the subsequent restoration of the government coalition, were a strong reminder of the fragility of the political climate in Poland. Political risk is also being stoked up by the prospect that in potential elections, the smaller parties could further increase their parliamentary and thus their bargaining power in a coalition government. This political turbulence may eventually endanger the economic climate and performance of the Polish economy. The coalition government faces many challenges ahead and it will be difficult to push for structural reforms, further privatizations and fiscal consolidation.

Figure 4.1



Driven by gross fixed capital formation and private consumption, economic growth in Poland picked-up further during Q2-2006. Real GDP growth reached 5.5%, yoy, in the second quarter of 2006, compared with 2.9% over the same period a year ago (Figure 4.1). Based on the most recent data we now expect the economy to grow by 5.2% - 5.5% for the entire 2006. For 2007, the European Commission estimates a slight deceleration of economic growth to 4.7%. The main source of growth in Poland for the first two quarters of 2006 has been the strong growth in investment. Due to high levels of capacity utilization and very favourable financial conditions, gross fixed capital formation accelerated by 14.4% in Q2-2006, compared with 7.4% in Q1-2006, a growth rate that is the highest since 1998. Furthermore, investment growth is expected to maintain its momentum, supported by structural and regional EU funds (Figure 4.2).

In Q2-2006, private consumption rose by 4.9%, compared with 5.2% in Q1-2006. The main factors driving private consumption growth were increases in the real disposable income and the rapid growth of household credit. Real disposable income increased by 8.6% in Q2-2006, versus a 5% increase in Q1-2006, mainly due to higher growth in social benefits and real wages. In addition, in August 2006, household credit grew by 30.2%, yoy.

Recent data also point towards an improvement in the labour market. Unemployment recorded a decline of 2.5 percentage points, from 17.7% in 2005, down to 15.2% in September 2006, while employment also grew by 3.5% (Figure 4.3). Despite these positive developments, it has to be mentioned that unemployment in Poland is still the highest in the EU and that part of the unemployment decrease was due to technical factors such as early retirements and emigration.

With respect to the fiscal outlook, the budget deficit seems to be under control. The central government budget deficit reached 1.4% of GDP in September, much lower than the deficit of 2.9% recorded for 2005 (estimates according to national definitions and excluding transfers to pension funds). This represents 48% of the budget deficit target for 2006, a nominal anchor of PLN 30bn. This came as a result of a revenue increase by 12.1%, yoy, in Q3-2006. Strong revenue growth was underpinned by the increase of direct taxes as labour market conditions and corporate profits improved, while indirect taxes, mainly from retail sales, and were also above last year's levels. On the other hand, expenditures increased only by 6.3%, yoy, marginally up from 5.8% in Q2-2006.

The general government deficit (including pension reform costs) has dropped to 3.9% of GDP in 2005, down from 5.9% in 2004 and is projected to reach 4.2% of GDP in 2006, provided that there will be no significant deterioration due to political developments (Figure 4.5). On the other hand, the 2007 budget outlook looks worrisome. According to the draft budget of Poland for 2007, the deficit is expected to reach 3.7%, taking into account the costs of pension reform, while the European Commission warns that it may turn out to be above 4.0%.

The main risk stems from off-budget financing which leads indirectly to increases in government debt. In August 2006, Government debt

Figure 4.2

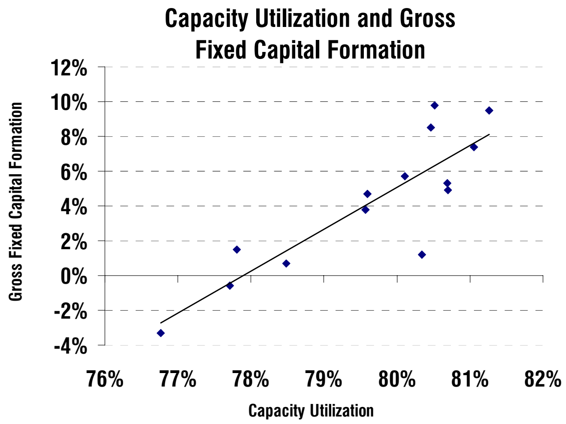


Figure 4.3

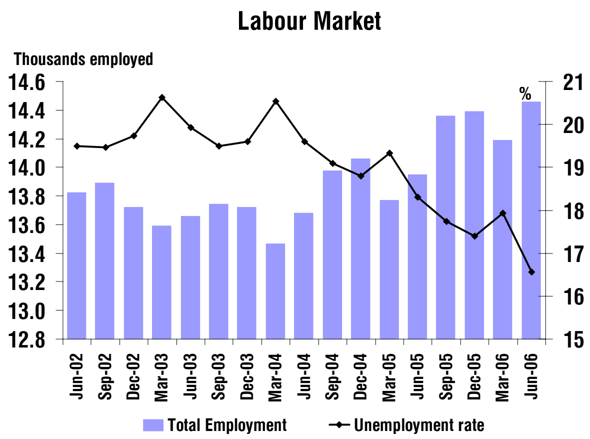
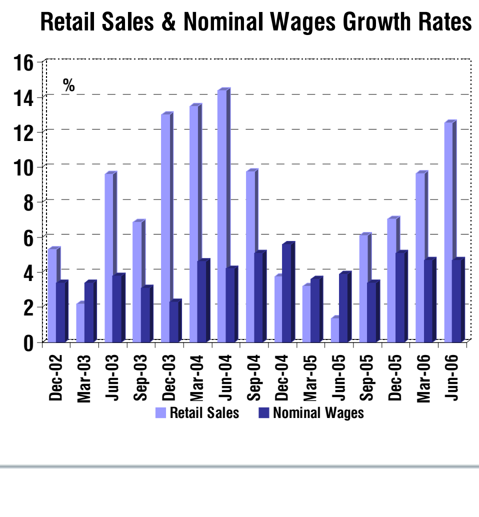


Figure 4.4



was 46% of GDP, up from 44.5% at the end of 2005.

These benign figures for public sector's debt and deficit, mask a more challenging long-term outlook. Simulations by the IMF and the NBP have shown that under the assumption of no-policy reforms, public sector's deficit will exceed 5% of GDP and government debt will reach 55% of GDP during the next five years.

The current account deficit remains at comparatively low levels standing at 2.0% of GDP in Q2-2006, compared with 2.2% of GDP in Q2-2005. The current account deficit was comfortably financed by FDI inflows, which, in Q2-2006, amounted to 133% of the current account deficit. The trade deficit has declined from 1.3% of GDP in Q2-2005 to 0.9% in Q2-2006. Going forward though, the trade deficit is expected to deteriorate if the projected increase in EU capital inflows is translated into a commensurate increase of imported goods (Figure 4.6).

Finally, during the third quarter we have witnessed a reversal of the inflation trend. In October, inflation slightly declined to 1.20% after having hiked to 1.60%, yoy in September, compared to only 0.8% yoy in June. While a part of this increase can be attributed to temporary factors, such as increases in the prices of food and non-alcoholic beverages, the most worrying aspect of the recent inflation pick-up is that core inflation is also accelerating mainly due to wage pressures and the closing of the output gap. As a result, the consensus is that, despite short-term fluctuations, inflation will continue its upward trend and will approach NBP's inflation target of 2.5% during the first half of 2007.

4.2 Credit Developments

Financial deepening in Poland remained subdued with total credit to GDP standing at the low level of 30.9%, in Q2-2006. Credit growth has been particularly slow since 2001 due to slow economic growth and weak economic activity. However, lending has started growing again in double-digit figures since September 2005, increasing at a rate of 19.9%, as of September 2005 (Figure 4.7). The surge in credit growth was primarily driven by loans to households which grew by 32.3%, yoy, as of September 2006. Consumer loans continued to grow rapidly, having increased by PLN 11.5bn in Q2-2006, relatively to a year ago. The amount of mortgage loans outstanding has increased by 56%, yoy, as of September 2006, so that their share to total household lending has reached 41.1% (5.5 percentage points higher than a year ago). Loans to enterprises grew by 9.5%, yoy, in Q3-2006, with credit to private sector being its most dynamic component (12.2% yoy as of September 2006).

Figure 4.5

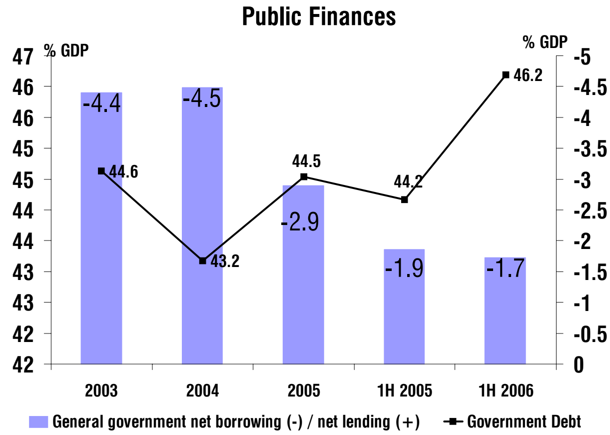


Figure 4.6

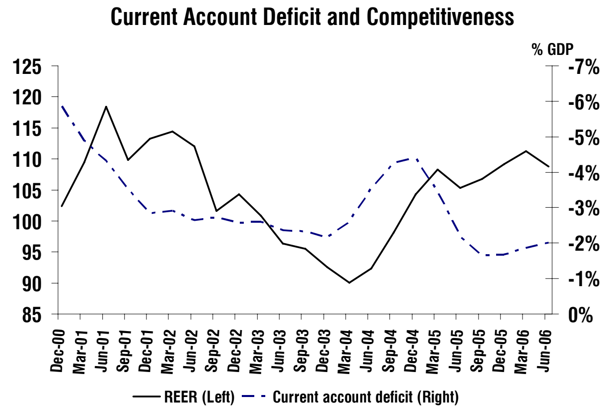
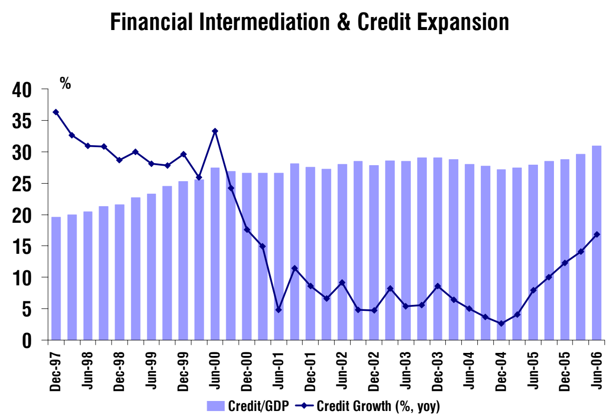


Figure 4.7



One of the major concerns about financial stability is the rapid growth of foreign-denominated mortgage loans. Despite the prudential measures taken and the strengthening of risk management practices, housing loans in foreign currency grew by 70% in Q3-2006, constituting 66.5% of total mortgage loans' portfolio. Since households are essentially unhedged, they are vulnerable to potential volatility in the FX market.

Poland: MacroEconomic Indicators	2001	2002	2003	2004	2005	2006Q1	2006Q2	2006Q3
Output and expenditure				*(Percentage Change in Real Terms)*				
GDP	1.1	1.4	3.8	5.3	3.4	5.2	5.5	-
Private consumption	2.2	3.3	1.9	4.0	1.8	5.2	4.9	-
Public consumption	2.5	1.5	4.7	3.9	5.3	3.1	-0.9	-
Gross fixed capital formation	-9.7	-6.3	-0.1	6.4	6.5	7.4	14.4	-
Exports of goods and services	3.1	4.8	14.2	14.2	14.0	21.7	13.0	-
Imports of goods and services	-5.3	2.7	9.3	15.2	4.2	19.9	11.7	-
Industrial production (in nominal terms)	0.0	1.5	8.7	12.3	3.8	12.4	12.1	-
Labour Market								
Employment	-2.2	-3.0	-1.1	1.3	2.4	3.1	3.7	-
Unemployment (in per cent of labor force)	15.1	17.5	20.0	20.0	19.0	17.9	16.6	-
Prices				*(Percentage Change)*				
Consumer prices (annual average)	5.5	1.9	0.8	3.5	2.1	0.6	0.8	-
Producer prices (annual average)	1.7	1.2	2.7	7.1	0.8	0.6	2.3	-
Average monthly wage in economy	7.2	3.5	3.2	4.0	3.5	4.7	4.7	-
Government sector				*(In per Cent of GDP)*				
General government balance (ESA95)	-3.7	-3.2	-4.7	-3.9	-2.5	-	-	-
General gross government debt (ESA95)	35.9	39.8	43.9	41.8	42.0	-	-	-
Monetary and Financial Indicators				*(Percentage Change)*				
M2	15.0	-2.8	5.7	6.9	12.2	9.8	12.5	-
Domestic credit	8.6	4.8	8.6	2.7	12.3	14.1	16.9	19.9
				(End of Period)				
Exchange rate Zloty/USD (end-period)	4.0	3.8	3.7	3.0	3.3	3.3	3.2	-
Exchange rate Zloty/EUR (end-period)	3.5	4.0	4.7	4.1	3.9	3.9	4.0	-
Real Effective Exhange Rate (Index)	114.1	104.4	89.0	84.5	93.2	-	-	-
International Position				*(In per Cent of GDP)*				
Current account balance	-2.8	-2.5	-2.1	-4.2	-2.2	-1.9	-2.0	-
Trade balance	-4.0	-3.7	-2.6	-2.2	-0.9	-0.9	-0.9	-
Exports of Goods & Services	27.1	28.7	33.4	37.5	37.0	-	-	-
Imports of Goods & Services	30.7	32.1	35.9	39.5	37.3	-	-	-
Foreign direct investment, net	3.0	2.1	2.1	5.1	2.7	-	-	-
Memorandum items				*(Denominations as Indicated)*				
Population (end-year, million)	38.6	38.2	38.2	38.2	38.1	-	-	-
GDP (in millions of Zloty)	779	808	842	922	968	-	-	-
GDP per capita (in US dollar)	4,928	5,181	5,670	6,609	7,849	-	-	-

Source: National Statistics, NBP, European Commission

Poland: Banking Indicators								
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006
Percentage of GDP (%)								
Assets	70.1	69.0	71.9	68.4	70.2	71.7	73.7	-
Total Credit	27.6	27.8	29.0	27.2	28.7	29.9	30.9	-
Credit to Enterprises	15.1	14.6	14.3	12.6	12.1	12.4	15.6	-
Credit to Households	10.3	10.7	11.7	11.9	13.9	14.4	15.6	-
Deposits	38.9	36.1	36.0	34.9	36.3	36.3	37.2	-
Percentage Change (%, yoy)								
Assets	9.7	2.1	8.5	4.4	9.0	8.4	9.5	12.2
Total Credit	8.6	4.8	8.6	2.7	12.3	14.1	16.9	19.9
Credit to Enterprises	3.2	0.4	2.1	-3.7	2.6	3.8	5.1	9.5
Credit to Households	14.7	7.9	13.9	11.7	24.0	26.6	30.0	32.3
Deposits	13.1	-3.8	3.9	6.4	10.4	9.2	11.3	11.6
Percent (%)								
Capital Adequacy Ratio	13.5	14.2	13.8	15.4	14.5	14.7	-	-
Capital to Assets	8.0	8.7	8.3	8.0	7.8	7.9	-	-
NPLs to Total Loans	-	-	10.4	9.2	7.7	-	-	-
Provisions to NPLs	42.6	46.7	47.3	58.0	59.4	-	-	-
Return on Assets	0.9	0.5	0.5	1.4	1.6	1.5	-	-
Return on Equity	12.4	6.1	5.8	17.1	20.7	19.3	-	-

Sources: NBP, IMF

5. Ukraine

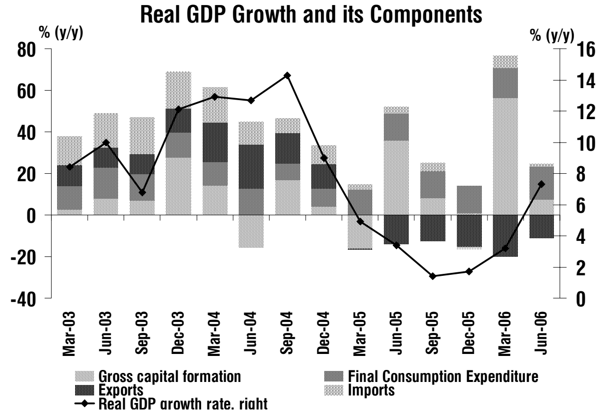
- **Real GDP growth rate continues its strong rebound (7.3% in Q2-2006 compared to 3.4% in Q2-2005), after decelerating in 2005.**
- **For the entire 2006, we expect real GDP to grow above 6%.**
- **The consolidated budget recorded a budget surplus of 0.7% of GDP, in the period from January to September.**
- **Current account swings from surplus (3% of GDP in 2005) to deficit (0.5% of GDP on an annual basis) in Q2-2006.**
- **Total credit growth reached 66%, yoy, in September 2006.**

5.1 Economic Outlook

The Ukrainian economy has recorded an impressive economic rebound during the first three quarters of 2006, after a sharp deceleration in 2005. Despite the recovery of the economy, the economic outlook remains highly vulnerable to economic policy shifts - given the unstable and politically divided government coalition - and to metal prices volatility which could affect the net exports balance of the country.

Figure 5.1

Real GDP Growth and its Components



In the first half of 2006, economic activity in Ukraine has rebounded strongly. Real GDP growth accelerated to 7.3% in Q2-2006, yoy, up from 3.4% in Q2-2005. Based on data up to August 2006, we expect real GDP for the entire 2006 to grow by 6%. The main driver of Ukrainian economic rebound is the strong final consumption growth (mostly private consumption), which increased by 16.2% in Q2-2006, yoy, compared with 12.8% in Q2-2005 (Figure 5.1). The consumption boom was fuelled by real wage growth (22%, yoy, in August 2006) which has also resulted in strong retail sales, which grew by 25.6%, in constant, prices over the same period.

Inflation has also picked up in the last months, recording an annualised growth rate of 11% in October, up from 6.8% in June. On the other hand, the average inflation in the period from January to October has remained stable at 8.5% (Figure 5.2).

One of the main factors supporting consumer spending has been the acceleration of credit growth. In Q3-2006, credit has continued rising dramatically at 66%, yoy, despite monetary policy restrictions. As a result, credit as a percentage of GDP stood at 38.4% in Q2-2006, 50% of which is either FX-denominated or FX-indexed. On the other hand, the gross external debt in Ukraine has reached 46.7% in H1-2006 compared to 46.5% in H1-2005 (Figure 5.3).

That has led Fitch, a ratings agency, to place Ukraine amongst the countries that display a high level of vulnerability to potential systemic stress and give the most cause for concern. According to Fitch, the fast credit growth rate, coupled with the real exchange rate appreciation and strong real equity prices, has intensified the systemic risk of the banking sector.

The fiscal policy stance in Ukraine had been loosening, as a result of the resent elections. After reaching a historical high level in April (35.6% of GDP), the consolidated budget expenditure has now stabilized at 33.3% of GDP in September (cumulative 9 month data). On the other hand, revenues increased mainly because of VAT collections, leading to a consolidated budget surplus of 0.8% of GDP in September 2006, compared with a budget deficit of 0.5% of GDP in the H1-2006. These developments point to the conclusion that, the targeted budgeted expenditure for 2006, originally projected at 2.6% of GDP could be broadly achievable. Moreover, the draft 2007 budget presented in September envisages also a deficit of around 2.5%.

The current account has swung from a surplus in 2005 to a deficit in Q2-2006. From a current account surplus of around 3% of GDP at end-2005, Ukrainian statistics recorded a current account deficit of 4% in Q2-2006 (equivalent to 0.5% of GDP on a yearly basis) (Figure 5.4). This was due to the deterioration of the trade balance deficit, stemming from a surge in imports (21.7%, yoy, growth in July 2006), while exports have been rising only modestly (4.8%, yoy, in July 2006). This reflects mainly the vulnerability of Ukraine to volatility in the global mineral prices and the increased Russian gas prices, compared to the gas prices a year ago. On the other hand, Ukraine's ability to attract foreign investment has been steadily improving despite the difficult investment climate. Privatization proceeds resulted in FDI inflows at levels of approximately 9% of GDP in 2005. This trend has continued in 2006, with FDI inflows representing 5.8% of GDP, in Q2-2006.

Figure 5.2

Monetary Policy Stance in Ukraine

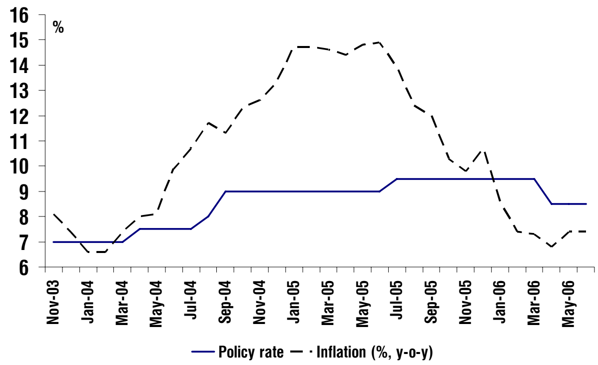


Figure 5.3

Credit Expansion in Ukraine

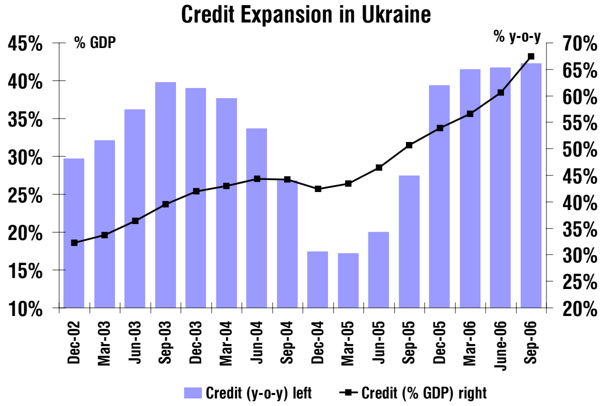
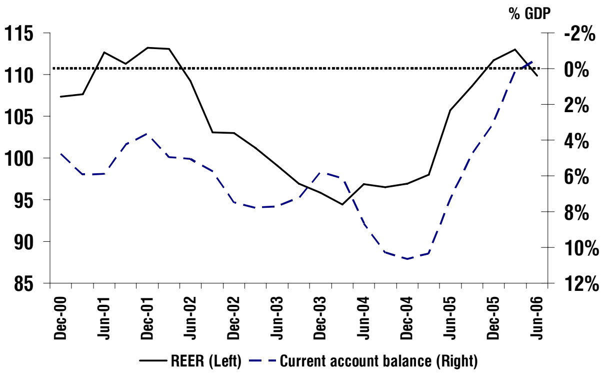


Figure 5.4

Current Account Deficit and Competitiveness



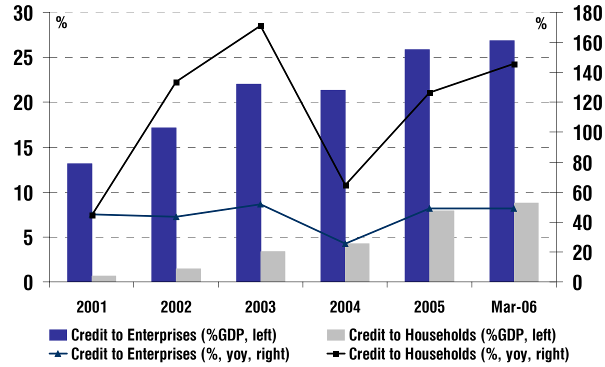
5.2 Credit Developments

As we have already mentioned, financial deepening is expanding rapidly in Ukraine with credit growing by 66%, yoy, as of September 2006. However, this unprecedented credit activity poses a major risk to Ukraine's financial stability, due to the high levels of impaired loans to total loans' portfolio. Although at a declining trend non-performing loans still comprise approximately a fifth of banks' loan portfolios.

Credit expansion has been driven mainly by lending to households (natural persons according to the classification by NBU), with loans extended to them increasing by 145%, yoy, in Q1-2006. Loans to economic entities grew by 48.9%, as of Q1-2006 (Figure 5.5). The rapid opening up of banks towards the household sector poses a new risk for Ukraine's banking system, especially when considering that a large part of this lending is foreign currency denominated (57.7% as of September 2006). Thus, the typically unhedged households are susceptible to foreign-exchange risk. Currently few banks offer mortgage loans but some of the bigger banks are currently entering the mortgage market. To that point, construction lending (5.9% of total credit in May 2005), is considered to be strongly related to real estate loans.

Figure 5.5

Credit to Enterprises and to Households



Ukraine: Macroeconomic Indicators	2001	2002	2003	2004	2005	2006Q1	2006Q2	2006Q3
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	9.2	5.2	9.4	12.1	2.6	3.2	7.3	-
Industrial production (in nominal terms)	14.2	7.0	15.8	12.5	3.1	0.2	3.6	-
Labour Market								
Unemployment (in per cent of labor force)	3.6	3.7	3.5	3.5	3.1	3.2	3.2	2.9
Prices	*(Percentage Change)*							
Consumer prices (annual average)	12.0	0.8	5.2	9.0	13.5	9.7	7.2	8.0
Producer prices (annual average)	8.7	3.0	7.6	20.4	16.8	-	-	-
Average monthly wage in economy	35.2	21.0	22.8	27.6	36.7	36.7	29.2	26.9
Government sector	*(In per Cent of GDP)*							
General government balance	0.3	0.7	0.2	3.2	1.8	0.4	0.5	0.7
General government debt	36.3	33.4	29.1	22.3	17.0	-	-	-
Monetary and Financial Indicators	*(Percentage Change)*							
M2	42.9	42.3	46.9	32.8	53.9	39.2	36.5	36.7
Domestic credit	48.4	48.2	61.4	30.6	61.9	64.9	65.3	66.1
	(End of Period)							
Exchange rate UAH/USD (end-period)	5.3	5.3	5.4	5.3	5.0	5.1	5.0	-
Exchange rate UAH/EUR (end-period)	4.7	5.5	6.6	7.1	6.0	6.1	6.3	-
Real Effective Exhange Rate (Index)	114.2	102.6	95.3	95.8	112.8	113.1	109.3	-
International Position	*(In per Cent of GDP)*							
Current account balance	3.7	7.5	5.8	10.6	3.0	0.2	-0.5	-
Trade balance	0.5	1.7	1.0	5.8	-1.4	-1.8	-1.1	-
Exports of Goods & Services	55.4	55.1	57.8	63.6	53.4	56.3	-	-
Imports of Goods & Services	53.8	50.7	55.2	56.0	52.6	62.3	-	-
Foreign direct investment, net	2.1	1.6	2.8	2.6	9.4	3.3	5.8	-
Gross External debt	53.6	51.1	47.5	47.2	46.7	46.7	-	-
Memorandum items	*(Denominations as indicated)*							
Population (end-year, million)	48.5	48.0	47.6	47.3	47.1	-	-	-
GDP (in millions of UAH)	204.2	225.8	267.3	345.9	424.0	-	-	-

Source: National Statistics, NBU, European Commission

Ukraine: Banking Indicators								
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006
Percentage of GDP (%)								
Total Credit	13.9	18.6	25.4	25.7	33.8	35.7	38.4	43.2
Credit to Economic Entities	13.2	17.1	22.0	21.4	25.9	26.8	-	-
Credit to Natural Persons	0.7	1.5	3.4	4.3	7.9	8.8	-	-
Deposits	12.6	16.7	22.9	24.0	31.3	30.7	31.8	33.9
Percentage Change (%, yoy)								
Total Credit	48.4	48.2	61.4	30.6	61.9	64.9	65.3	66.1
Credit to Economic Entities	44.9	43.7	51.9	25.4	48.9	48.9	-	-
Credit to Natural Persons	44.7	133.6	171.2	64.6	126.6	145.5	-	-
Deposits	38.1	46.9	62.7	35.2	60.0	40.5	41.9	43.0
Percent (%)								
Capital Adequacy Ratio	20.7	18.0	15.2	16.8	15.0	14.9	-	-
Capital to Assets	15.6	14.7	12.3	13.1	11.5	11.5	-	-
NPLs to Total Loans	25.1	21.9	28.3	30.0	19.6	18.3	-	-
Provisions to NPLs	39.2	37.0	22.3	21.1	25.0	25.9	-	-
Return on Assets	1.2	1.2	1.0	1.1	1.3	1.4	-	-
Return on Equity	7.5	8.0	7.6	8.4	10.4	11.8	-	-

Sources: NBU, IMF

6. Turkey

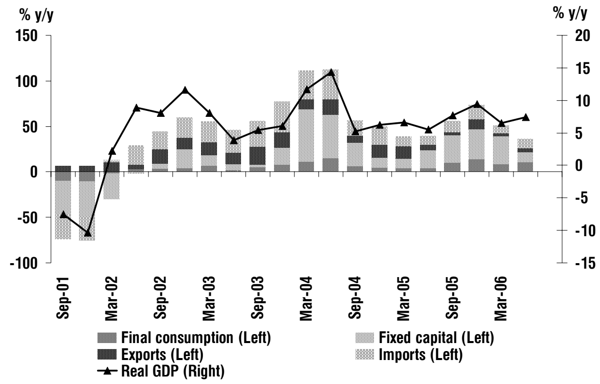
- **The Turkish economy expanded by 7.5% in Q2-2006, up from 5.5% in Q1-2006.**
- **We expect real GDP growth of 5.5% to 6.5% for the entire 2006.**
- **EU Commission's monitoring report shifts the burden of a decision for Turkish accession negotiations with the European Union to the EU Council in December.**
- **Turkish Lira has appreciated by 17% against the USD since last May's sell-off.**
- **The recent monetary policy tightening has not yet affected credit expansion (total credit growth stood at 60%, yoy, in Q2-2006).**
- **The current account deficit has widened in Q3-2006 to 7.8% of GDP, but the decomposition of financing has improved, due to increasing FDI inflows.**

6.1 Economic Outlook

Macroeconomic fundamentals in Turkey continue to display a positive trend, but political risk, stemming from the forthcoming elections as well as worries that the European Union accession negotiations are going to be postponed, may undermine investors' confidence and subsequently derail macroeconomic performance. On the political front, the EU Commission's enlargement strategy report recorded that no progress has been made on behalf of Turkey with respect to implementing the customs union with Cyprus but at the same time transferred the burden of a decision with regards to the Turkish negotiations with the EU to the European Council summit that will take place in December.

Figure 6.1

Real GDP Growth and its Components



One of the main developments in the third quarter that dominated the economy is the rebound of the Turkish Lira, since last May's sell-off, by 15%. The recent currency volatility has yet to affect the real economy, as GDP grew by 7.5% in Q2-2006, up from 5.5% in Q1-2006. Private consumption grew by 10.8% in Q2-2006, up from 3.9% in Q2-2005 and although we expect demand to decelerate in the second half of 2006, we have few indications of a substantial economic slowdown (Figure 6.1). It is indicative that despite the recent monetary policy tightening, bank lending grew by 60%, yoy, In June and 51%, yoy, in August. Based on these forward indicators, we expect real GDP to grow by 5.5%-6.5% in 2006, above the consensus estimate of 5%.

The tightening of the fiscal policy in Turkey, after the crisis of 2001, has helped to reduce fiscal vulnerability. In that direction, the implementation of this year's budget seems to be largely on track, having been boosted by favourable GDP dynamics. The consolidated government sector primary budget balance (fiscal balance excluding interest payments) recorded a surplus of 4.7% of GNP (or YTL 25.1bn - excluding state owned enterprises) in H1-2006. At the same time, the overall consolidated government sector surplus reached YTL 7.3bn (1.3% of GNP) versus a targeted interim deficit of YTL 4.0bn. IMF projects that the primary consolidated government sector surplus would turn out at 6.7% of GNP marginally higher than the target of 6.5% of GNP, while the overall consolidated government sector deficit would reach 0.9% by year-end (Figure 6.2).

Nevertheless, the government has been trying to strike a balance between achieving the IMF agreed targets and the challenges stemming from entering an election year. The corporate tax rate cut to 20%, effective from the fiscal year of 2006, coupled with increased expenditures in the budget due to the forthcoming elections, make the implementation of next year's budget a challenging case. In that direction, both the latest OECD report and the IMF country report on Turkey, highlighted the risk of fiscal policy loosening against the political cycle.

The current account deficit is the main vulnerability of the Turkish economy. The increased trade deficit, due to faster growth of imports than exports and high fuel prices, led to the widening of the current account deficit to 7.8% of GDP in Q2-2006, up from 7% in Q1-2006 and also higher compared with the deficit during the same period a year ago (5.8% in Q2-2005). The composition of the current account financing has improved though, due to the sharp increase in net FDI funds. In Q2-2006, FDI flows reached 4.6% of GDP (on an annual basis, compared to 0.6% in Q2-2005), financing over 50% of the current account deficit (Figure 6.3). Yet, this improvement might turn out to be only temporary, given that the Turkish State Planning Agency has indicated that the privatization proceeds could halve in 2007. This is going to exacerbate the dependence of the current account deficit financing on portfolio flows and magnify the Turkish economy's vulnerability to emerging markets volatility and sudden changes in international investors risk aversion and liquidity constraints. To that point, the JP Morgan EMBI+ Turkey spreads index, a measure of investors' risk premium perception, stood at 230

Figure 6.2

Fiscal Balance in Turkey

(IMF definitions)

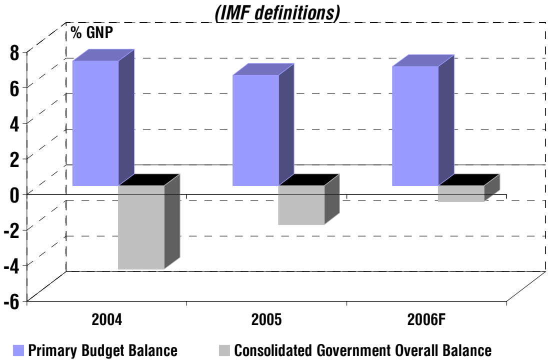


Figure 6.3

Current Account Deficit and FDI Investment

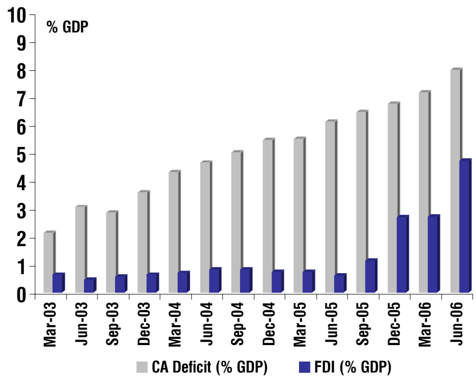
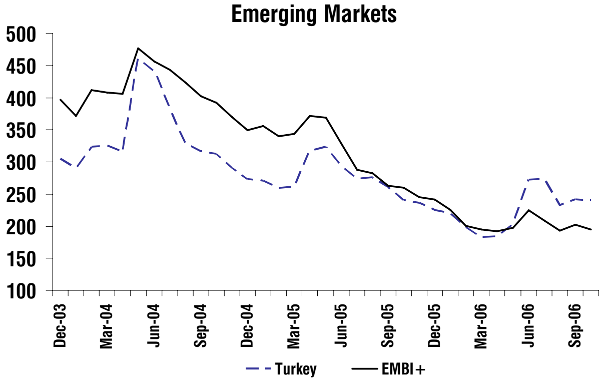


Figure 6.4

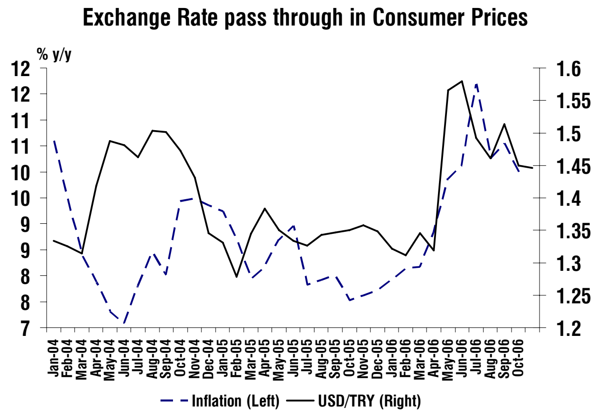
Country Risk Premium in Turkey versus other Emerging Markets



basis points 30 bps lower compared with its level during the crisis period (Figure 6.4).

The financial markets turmoil during May and June, that was accompanied by a significant increase in emerging markets' risk premia and the depreciation of the Lira, put significant upward pressure on inflation and forced CBRT to raise its policy rate by 425bps. As a result, in October, inflation stood at 10%, significantly higher than during the same period last year (7.5% in October 2005), but 1.7 percentage points lower than July's inflation rate (Figure 6.5). Given the current turn of events, it is certain that inflation at year-end will turn out around 9%-10%, significantly above this year's inflation target of 5%.

Figure 6.5

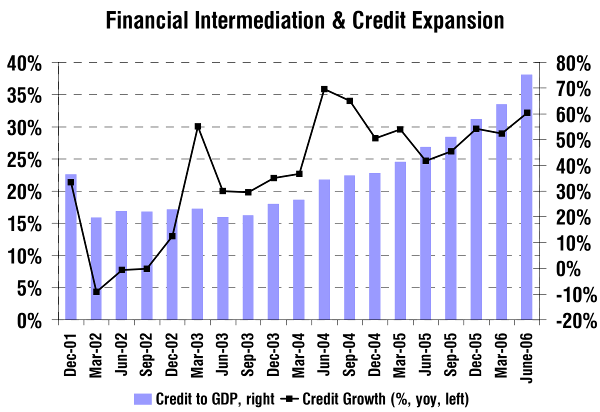


Looking forward, we see two main factors pulling inflation into opposite directions. On one hand we expect inflation to moderate even further on the back of lower domestic demand and the current strengthening of the Lira, although we will have to wait until the middle of 2007 until the adverse base effect of the May/June FX depreciation disappears from the inflation data. On the other hand, a wildcard factor that can push inflation to the opposite direction is government spending, in view of the forthcoming government elections. Our assessment is that the balance between these two opposing forces will also determine monetary policy actions by CBRT in the short to medium term.

6.2 Credit developments

The Turkish banking system is characterized by intensive credit expansion (60% in Q2-2006), which is expected to be further boosted by the dynamic entrance of foreign banks in the Turkish market (Figure 6.6). A thriving market segment is that of mortgage lending, growing by 234.3%, yoy, as of June 2006. This can be well explained by the low level of financial intermediation in this loan category (4% of GDP as of Q2-2006) along with demographic reasons, such as increasing urban population density, house improvements and natural disasters. Rapid credit expansion in the household sector has unavoidably resulted in a steep increase in households' indebtedness from 7.5% (household debt to disposable income) in 2003 to 20.6% in 2005.

Figure 6.6



Despite surging lending activity, the asset quality of the banking sector is improving. The ratio of non-performing loans to total loans is following a declining trend (3.8% in Q2-2006, down from 17.6% in December 2002). In addition, foreign exchange risk, although one of the major risk factors of the banking system, is mitigated by the fact that the share of foreign-denominated loans was reduced to 31% of total loans, down from 60.4% in December 2002. However, the ability of foreign banks to circumvent certain prudential regulations relevant to lending in foreign currency creates serious worries about the banking sectors' stability.

Turkey: MacroEconomic Indicators	2001	2002	2003	2004	2005	2006Q1	2006Q2	2006Q3
Output and expenditure				*(Percentage Change in Real Terms)*				
GNP	-9.5	7.9	5.9	9.9	7.6	-	-	-
GDP	-7.5	7.9	5.8	9.0	7.4	6.5	7.5	-
Private consumption	-9.2	2.1	6.6	10.1	8.8	8.6	10.6	-
Public consumption	-8.5	5.4	-2.4	0.5	2.4	8.1	18.1	-
Gross fixed capital formation	-31.5	-1.1	10.0	32.4	24.0	30.7	10.9	-
Exports of goods and services	7.4	11.1	16.0	12.5	8.5	3.5	4.3	-
Imports of goods and services	-24.8	15.8	27.1	24.7	11.5	8.2	10.0	-
Industrial production (in nominal terms)	-8.7	9.4	8.7	9.8	5.4	3.4	9.3	-
Labour Market								
Employment	0.0	-0.3	-0.8	2.0	1.7	-1.1	0.6	-
Unemployment (in per cent of labor force)	8.4	10.4	10.5	10.3	10.2	11.9	8.8	-
Prices				*(Percentage Change)*				
Consumer prices (annual average)	54.4	45.0	21.6	8.6	8.2	7.6	8.1	9.6
Producer prices (annual average)	61.6	50.1	22.7	14.6	5.9	2.3	4.9	8.4
Average monthly wage in economy	31.8	37.2	23.0	13.4	12.2	11.4	10.6	11.5
Government sector				*(In per Cent of GNP)*				
Consolidated Government Overall balance*	-17.1	-13.6	-9.0	-4.7	-2.2	-	-	-
Net public sector debt*	90.5	78.5	70.4	63.5	55.8	-	-	-
Monetary and Financial Indicators				*(Percentage Change)*				
M4	56.0	36.5	31.9	40.9	30.9	42.2	41.1	-
Domestic credit	33.4	12.4	35.2	50.6	54.2	52.4	60.5	-
				(End of Period)				
Reference rate	-	44.0	26.0	18.0	13.5	13.5	17.3	-
Exchange rate YTL/USD (end-period)	1.5	1.7	1.4	1.3	1.3	-	-	-
Exchange rate YTL/EUR (end-period)	1.1	1.4	1.7	1.8	1.7	-	-	-
Real Effective Exhange Rate (Index)	116.3	125.4	140.6	143.2	171.3	172.9	142.0	155.5
International Position				*(In per Cent of GDP)*				
Current account balance	2.4	-0.8	-3.3	-5.2	-6.4	-6.8	-7.5	-
Trade balance	-2.6	-4.0	-5.8	-7.9	-9.1	-9.5	-10.0	-
Exports of Goods & Services	33.7	29.2	27.4	28.9	27.4	27.1	27.2	-
Imports of Goods & Services	31.3	30.7	30.7	34.7	34.0	34.2	35.2	-
Foreign direct investment, net	2.0	0.5	0.5	0.7	2.4	2.5	4.4	-
Memorandum items				*(Denominations as Indicated)*				
Population (end-year, million)	68.5	69.6	70.7	71.8	72.1	-	-	-
GDP (in milliards of YTL)	178.4	277.6	359.8	430.5	487.2	-	-	-
GNP (in milliards of YTL)	176.5	275.0	356.7	428.9	486.4	-	-	-

Source: National Statistics, CBRT, European Commission, *IMF Statistics

Turkey: Banking Indicators								
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006
Percentage of GDP (%)								
Assets	89.8	76.4	69.6	71.8	85.5	83.9	88.8	-
Total Credit	22.6	17.2	18.0	22.8	31.2	33.4	38.1	-
Credit to Enterprises	17.5	12.3	14.4	18.6	25.5	27.0	30.5	-
Deposits	58.6	49.6	43.3	44.7	50.6	51.8	54.9	-
Percentage Change (%, yoy)								
Assets	62.0	25.9	17.4	22.7	29.5	31.5	34.9	-
Total Credit	33.4	12.4	35.2	50.6	54.2	52.4	60.5	-
Credit to Enterprises	-	3.8	50.5	54.5	53.9	51.6	57.7	-
Deposits	87.3	25.1	12.6	23.0	27.2	32.3	27.7	-
Percent (%)								
Capital Adequacy Ratio	15.3	25.3	30.9	28.8	24.2	23.5	-	-
Capital to Assets	7.9	11.9	14.2	15.0	13.5	13.5	-	-
NPLs to Total Loans	29.3	17.6	11.5	6.0	4.8	4.5	-	-
Provisions to NPLs	47.1	64.2	88.5	88.1	89.8	89.6	-	-
Return on Assets	-5.5	1.1	2.3	2.3	1.7	0.7	-	-
Return on Equity	-69.4	9.3	16.0	16.4	11.8	5.3	-	-

Sources: CBRT, IMF

Part B: Special Issues

Banks' ownership structure and banking sector's performance

Assessment of the relative competitive advantage of Central and Eastern European countries based on Unit Labour Cost

Banks' ownership structure and banking sector's performance

Introduction

In the previous issue of this Review, we discussed at length the beneficial influence that the liberalisation of the banking sectors of the "New Europe" countries had in terms of promoting economic growth and solidifying financial stability in the area.

Given the importance of the banking sector for these countries, in the present issue of the Review, we analyse the effect that the opening up of the banking sectors to new entrants (both foreign and domestic) had on the balance-sheet structure and performance of banks when classified according to their ownership structure. By recording all major acquisition of banking institutions in these countries, from 1998 onwards, we are able to track changes in the balance-sheets of state-owned, foreign-owned and domestic privately-owned banks, across time and across countries.

As anticipated, the main unifying feature of the banking systems in these countries is the (deliberate) reduction of the significance of the role of the state-owned banks. On the other hand, the relationship between foreign and domestic-privately owned banks turned out to be far more complex as it depends upon the time that has elapsed since the introduction of foreign capital in the banking sector of each country. In countries such as Poland and Bulgaria, which were the first to liberalise their banking sectors, foreign banks have come to dominate the banking system, being more efficiently run (lower cost to income ratio), more profitable (higher RoE, RoA) and better capitalised (higher capital to assets ratio) than domestic privately-owned banks. In Romania, which opened up to foreign financial institutions more recently, foreign banks do control the majority of the banking sector's assets but domestic-private banks have been expanding more aggressively, trying to increase their market share both in terms of lending and in terms of deposits. Finally, Turkey has been the last to attract the attention of foreign institutions and as a result domestic-private banks have the dominant role in the banking system. This situation though is subject to change, should the planned privatisation program goes ahead.

Finally, Serbia and Ukraine are special cases, each on each own right. Serbia had a massive wave of privatisation in 2005, making it too soon to assess the strategy of the privatised banks. Ukraine on the other hand is dominated by domestic privately-owned banks which do not always have a retail focus, but serve the needs of specific industrial groups.

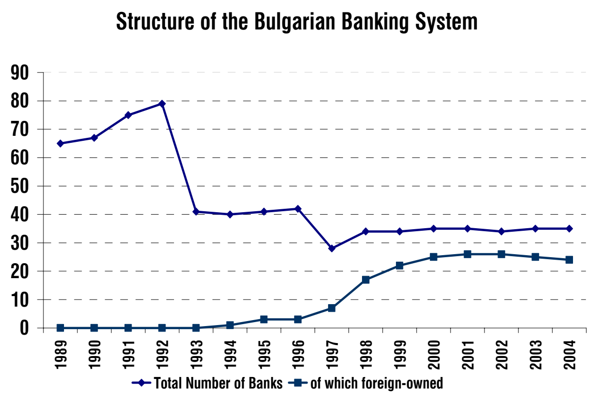
1. Bulgaria

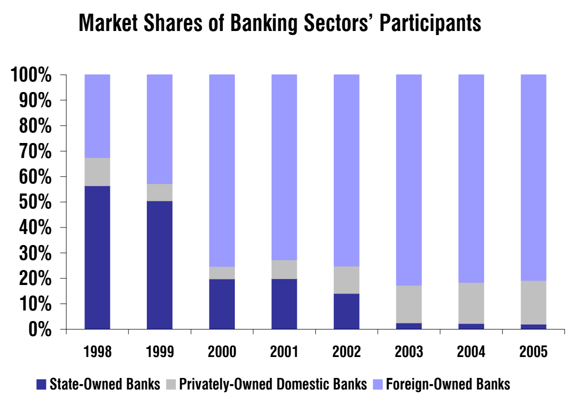
Structure of the Banking System

In Bulgaria, the process of banking sector liberalisation and of opening up to foreign capital started in 1997, in the aftermath of the economic and banking sector crisis and the subsequent introduction of the currency board. A series of bank privatizations took place, initiated with the sale of United Bulgarian Bank in 1997. Post Bank was sold in 1998, Expressbank in 1999, Bulbank, the country's largest bank, Hebros Commercial Bank and Corporate Commercial Bank in 2000, and finally Bank Biochim in 2002. DSK bank was transformed into a commercial bank in 2003 and deprived of its 100% state guarantee on deposits. These banks, privatized in the period 1997-2003, had a total market share of 70%, as of 1999. Indeed, it has to be stressed that the Bulgarian banking sector was privatized earlier compared to other banking systems in the region. Its restructuring efforts started about three years prior to Romania's and much earlier than the recent efforts to reform the Turkish and Serbian banking systems.

Most of the privatized banks were sold to foreign participants, contributing to the openness and liberalization of the banking sector. Until 1994, no foreign bank existed in the country due to the restrictive policy imposed by BNB. Since 2000, however, the Bulgarian banking system is dominated by foreign investors, who possess almost 80 percent of the sector's assets. Since the completion of the privatization process, some foreign banks have managed to successfully enter the market through start-up operations. Currently, state-owned banks control less than 2% of the total assets, while the rest belongs to privately-owned domestic banks. However, the banking system allows for further consolidation which can be accomplished by mergers and acquisitions between foreign and domestic privately-owned banks. This process began with the acquisition by Bank Austria Creditanstalt of Hebros Bank in 2004, its later integration with HVB Biochim and more recently by the acquisition of DZI by Eurobank EFG, which already owns Postbank.

Figure 1.1

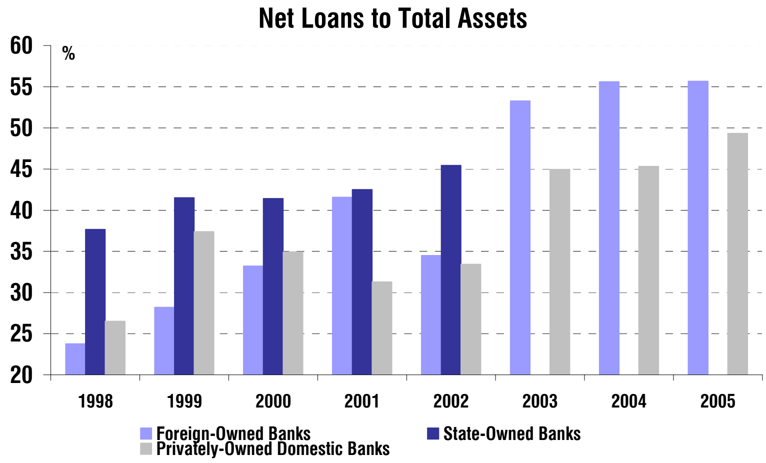




Structure of Assets

The crisis of the banking sector and its subsequent recovery was not immediately followed by a rapid credit expansion, mainly due to the conservative approach of banks with respect to lending. However, as the restructuring of the sector progressed and the share of bad loans declined by 6.6 percentage points in 2000, compared to one year earlier, to 10.9% of total loans, and then to 4.4% of total loans in 2003, a credit boom emerged. Thus the share of loans to total assets increased from 27% as of 2000 to about 56% as of 2005, for the entire sector.

Figure 1.2



Financial deepening was intense in all bank categories, a natural effect of banks' assets reallocation in a period of credit expansion. However, the loans to assets ratio is higher for foreign banks (56% as of 2005) compared to the domestic privately-owned banks (49% as of 2005). This can be well attributed to the fact that domestic privately-owned banks need to have more liquid assets in their balance sheets than foreign participants, given that they lack support from other sources. Consequently, in case of a shock, foreign banks will turn to their parent institutions, while domestic banks need to be sufficiently prepared to absorb it based solely on their internal liquidity sources. Government securities, a main category of liquid assets, account for a larger proportion of the domestic privately-owned banks portfolio (13% as of 2005) compared to foreign-owned banks (10% as of 2005).

As we have mentioned above, the restructuring of the banking sector resulted in a sharp reduction of state-owned banks market share which was completed, to a large extent, by 2002. State-owned banks today control less than two percent of the banking sector's assets and the two small state-owned banks remaining do not operate fully on a commercial basis. Data available till 2002 reveal that less than half of the state banks' balance-sheet consisted of loans, and a further fifth of their assets consisted of government securities. In what follows, we do not intend to focus on the performance of state-owned banks not only because of insufficient data but also because of their limited significance.

Structure of Liabilities

The restructuring of the banking sector resulted in regaining depositors' confidence. This effort was aided by the introduction of the Euro, instead of the Deutsch Mark, creating the need to deposit Deutsch Mark "mattress" savings into bank accounts in order to convert them into the new currency. This recovery of the depositors' confidence resulted in the accumulation of deposits which were used to fund the subsequent credit boom. This process was more intense for domestic privately-owned banks since this banking group is mainly dependent on deposits to fund credit expansion, lacking the support from parent institutions that foreign banks enjoy.

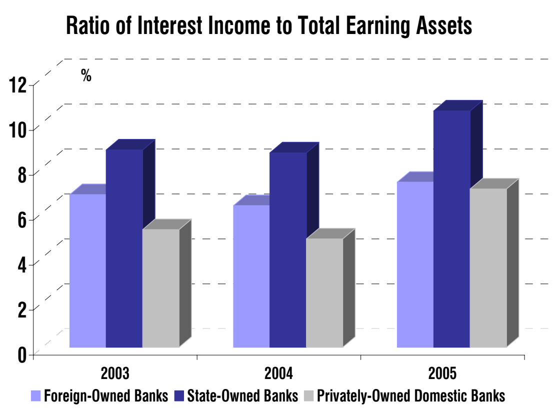
While, at the onset, credit boom was entirely financed by deposits, subsequently banks started seeking for alternative sources of financing. Thus, after 2003, an increase of money market operations is observed in both foreign and domestic privately-owned participants.

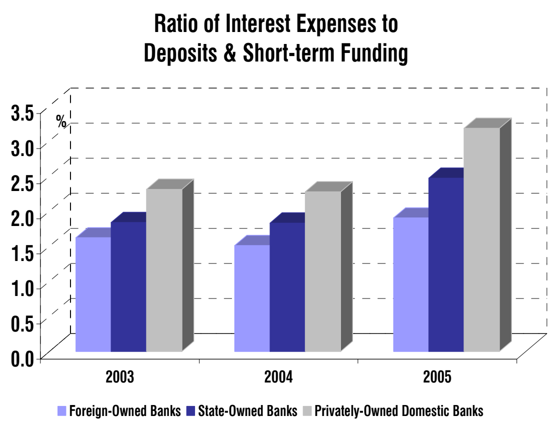
Return on Assets and Cost of Funds

We devise two metrics to assess the district strategies adopted by the different banking groups in order to expand their loan books and attract new deposits. The ratio of interest income to total earning assets provides a proxy for the total lending rates the banks charge to their customers and the return they earn from their bond portfolios. The higher the ratio the better the ability of banks to earn a higher return by taking advantage of their dominant position in the lending market, introducing innovative products or by better managing their bond holdings. Conversely, the ratio of interest expense to deposits and short-term funding provides a proxy for the cost of funding, either from depositors or from the interbank market.

As mentioned before, the Bulgarian banking landscape is highly liberalized and dominated by foreign participants, since they consist of approximately 80% of the banking sector. Thus, domestic privately-owned banks have to follow intense growth strategies in order to gain market shares and compete with the highly efficient foreign-owned banks. This struggle of domestic privately-owned banks to maintain or even increase their market share is well reflected in the return of banks' assets, which consist mainly of loans. Domestic privately-owned banks earn lower returns compared with foreign participants, offering cheaper and thus more appealing loans to their investors.

Figure 1.3





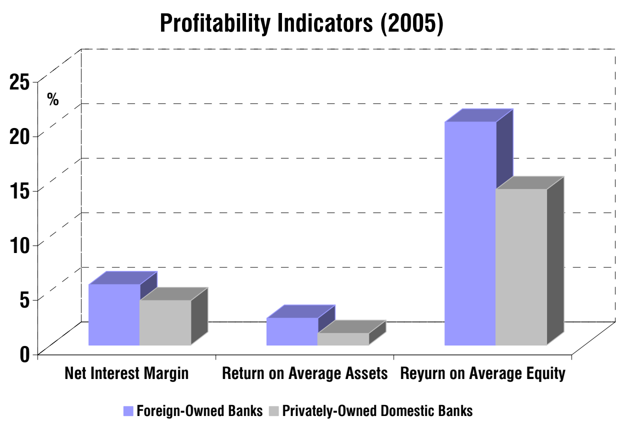
The cost of funds for the different banking groups follows the reverse pattern. Domestic privately-owned banks, unlike their foreign counterparts, are lacking alternative sources of funding and are thus dependent on deposits to fund their activities. Being forced to attract more deposits locally, they offer higher returns to their customers.

Profitability & Efficiency

The domination of the banking system by foreign banks and the pressure exerted on the privately-owned domestic banks seriously affect the profitability of the banking groups. The pressure exerted on privately-owned domestic banks to become more competitive has a direct impact on their net interest margin, which is gradually declining, remaining constantly at a lower level compared with the net interest margin of the foreign participants of the sector. The same conclusion is reached once observing the structure of banks' operating income. Net interest revenue accounts for approximately 70% of foreign banks' operating income, as of 2005, compared with the much lower 57% share of net interest income for the private domestically-owned banks.

The lower net interest margin of the locally-owned banks resulting from their more aggressive pricing policy, characterized by lower charges to their customers and higher rates to their depositors, is reflected both in the profitability and in the efficiency of this banking group. As a result, foreign-owned banks enjoy higher profitability and higher efficiency than their local counterparts. Overall, however, the increased competition for both new customers and new depositors has contributed to the general decline of the banking sector's profitability and margins.

Figure 1.4



Capital Adequacy & Liquidity

Despite rapid credit expansion which intensified particularly after 2003, the system's solvency ratio, although constantly declining, remains at the adequate level of 15.2%, still higher than the 12% regulatory threshold. Locally-owned banks have generally been confronted with a greater solvency risk than the remaining participants of the sector. Their constant efforts to gain market share and the pressure these efforts exert on their profits do not allow them to increase the ratio of bank capital to total assets. This, along, with the absence of any support from parent institutions, makes them more vulnerable in case of a crisis. On the other hand, foreign participants enjoy both higher profits and capital adequacy compared with locally-owned banks.

The banking system is also characterized by adequate liquidity levels. According to BNB stress tests, the sector can withstand a liquidity crisis of up to 30% of total borrowings. The ratio of liquid assets to deposits & short-term funding is 25%, as of 2005, for locally-owned banks, compared with 23.5% for foreign-owned banks.

Appendix 1: Key Acquisitions

Key Acquisitions in the Bulgarian Banking System	
Target Name	**Acquiror Name**
2006	
DZI Bank	Eurobank EFG
West-East Bank	Nova Ljubljanska Banka dd
2005	
Unionbank	Magyar Kulkereskedelmi Bank
First Investment Bank	Investor Group
Eurobank	Bank of Piraeus SA
Hebrosbank	HVB Bank Biochim
2003	
DSK Bank EAD	Orszagos Takarekpenztar
2002	
Central Co-operative Bank	Armeets Insurance Company
Biochim AD	Bank Austria AG
Dobrudjanska Banka	Central Cooperative Bank
Unionbank	EBRD
2001	
Central Cooperative Bank	Bulchimex GmbH(Chimimport)
Central Cooperative Bank	Othornio Investments
Central Co-operative Bank	Bank Consolidation(Bulgaria)
BNP-Dresdner Bank(Bulgaria)	BNP Paribas SA
Bulbank AD	IFC
Mineralbank	Roseximbank
2000	
Bulbank AD	Investor Group
United Bulgarian Bank	National Bank of Greece
First Private Bank(Bulgaria)	Yorset Holdings
Agrobusinessbank	Bulgaria
TSBank	Bulgaria
Corporate Commercial Bank AD	Undisclosed Acquiror
Hebrosbank	Regent Pacific Group
1999	
Corporate Bank	Bulbank AD
Expressbank(Bank Consolidat)	Societe Generale SA
Central Co-operative Bank	State Fund Zemedelie(Bulgaria)
1998	
Post Bank(Bank Consolidation)	Investor Group

Source: Thomson Financial, BNB

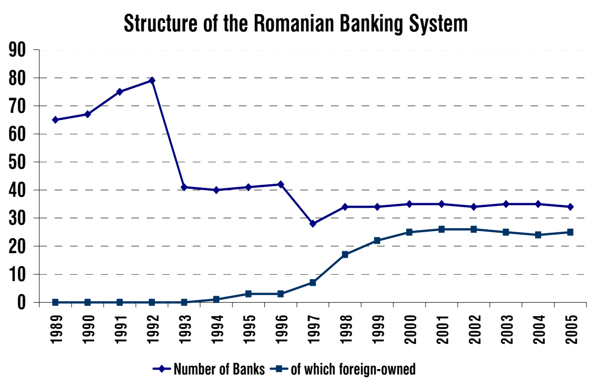
2. Romania

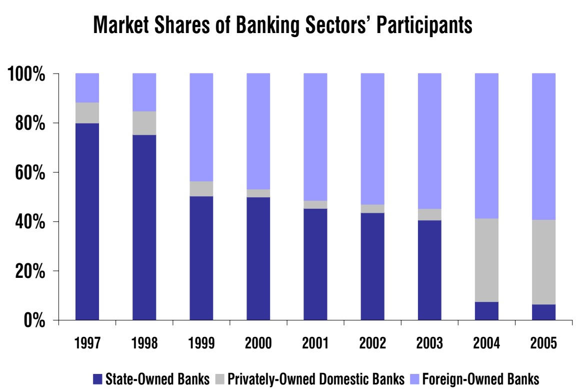
Structure of the Banking System

The reforming process of the Romanian Banking Sector started at the beginning of the last decade with the establishment of Banca Comerciala Romana, which was supposed to perform retail operations previously conducted by the NBR, as well as with the integration of newly-established privately-owned and foreign-owned banks to the banking system. This was an important step in the transition from the communist mono-bank system to a market oriented two-tier banking structure. However, the unstable macroeconomic environment, the inefficient supervisory and regulatory conditions, the lax accounting standards and the mismanagement of banks led to a severely undercapitalized sector characterized by a credit portfolio of particularly poor quality. It is noteworthy that at end-1998 impaired loans constituted 58% of total banks' loans. Following the crisis, an intense restructuring and privatization program began which resulted in the cleaning-up of the state-owned banks' balance sheet and the increase in the share of foreign shareholders.

Bank privatization was initiated in 1998 with the sale of the state's holding of the Romanian Development Bank (BRD) to Societe Generale. This was followed by the sale of the state's share in BancPost (1999) and in Banca Agricola (2001). The second-largest bank at the time, Bancorex was placed under administration in 1999 and was subsequently absorbed by Banca Comerciala Romana (BCR). As a result, BCR emerged as the largest commercial bank in Romania with a market share of 25.7%, as of 2005. The privatization of BCR was a condition of the stand-by agreement with the IMF (2001) but was accomplished much later with the sale of 61.9% stake to the Austrian Erste Bank. As a consequence of the closure and privatization of state-owned banks, their market share shrank from 80% in 1997 to 6% in 2005, which will go down further to 1.6%, once the pending privatization of CEC is completed. As a result, the state will hold a majority stake only in Eximbank, which is being converted into an export-guarantee institution.

Figure 2.1





The restructuring of the banking sector following the crisis along with the improvement of the regulatory and prudencial supervisory framework governing banks and the recapitalization of the sector resulted in the creation of a highly competitive, market-oriented banking sector, with improved asset quality (impaired loans to total have gone down to approximately 1.7%). Overall, the financial costs of the banking sector's restructuring assumed by the government, accounted for 10% of GDP between 1990 and 2003.

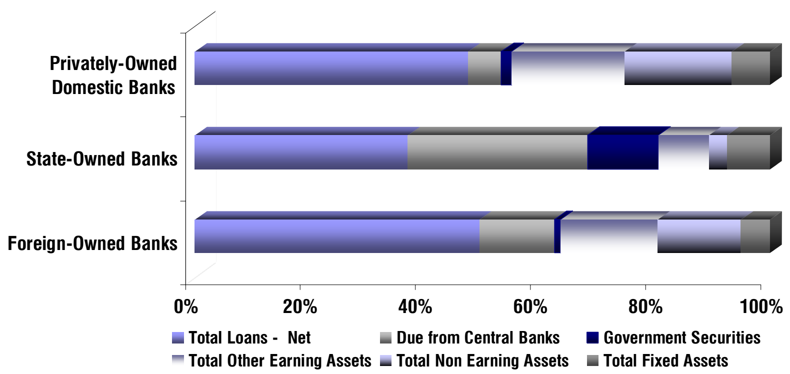
Currently, the Romanian banking system is dominated by foreign investors, who have increased their shares from 12% in 1997 to 55% in 2005. Austrian banks control approximately a fifth of the foreign capital invested in the sector, while Greek banks follow in the second place with 14.7% share in total capital.

Structure of Assets

The reform of the banking system provided the underpinning to the rapid increase of financial monetization and the expansion of banks to non-government lending. The structural analysis of the dynamics of the aggregate balance sheet for each of the three banking groups reflects banks' turn to intensive lending activity. The domestic privately-owned banks were the banks who entered most aggressively into the financial deepening process, with their share of loans to total assets almost doubling since 1998, reaching 57%, as of 2005. Foreign banks followed, with loans constituting almost 50% of their assets. This opening up of domestic private banks to lending activities may be a consequence of their efforts to compete with foreign-banks, maintaining or expanding their market shares in a growing market. Both domestic privately-owned and foreign banks are obliged to maintain reserves with the Central Bank and they have also invested in government securities. However, the proportion of these components to total assets is very small and constantly decreasing.

Figure 2.2

Structure of Banking Groups' Assets



Contrary to the highly competitive, active, privately-owned domestic and foreign banks, state-owned banks' asset structure reveals that they have not managed to transform themselves into modern, dynamic and efficient credit institutions. Thus, state-owned credit institutions lag behind their counterparts in the financial deepening process with loans corresponding to only about two fifths of their aggregate balance sheet. Being unable to access the interbank market, they are obliged to maintain reserves with the Central Bank which consist almost a third of their assets. Compared with the other bank categories, a large share of state-owned banks' assets are invested into government securities and fixed assets (12% and 7% respectively). However, the volume of government securities dropped due to a steady decline in the government debt and the narrowing of the primary market for government securities.

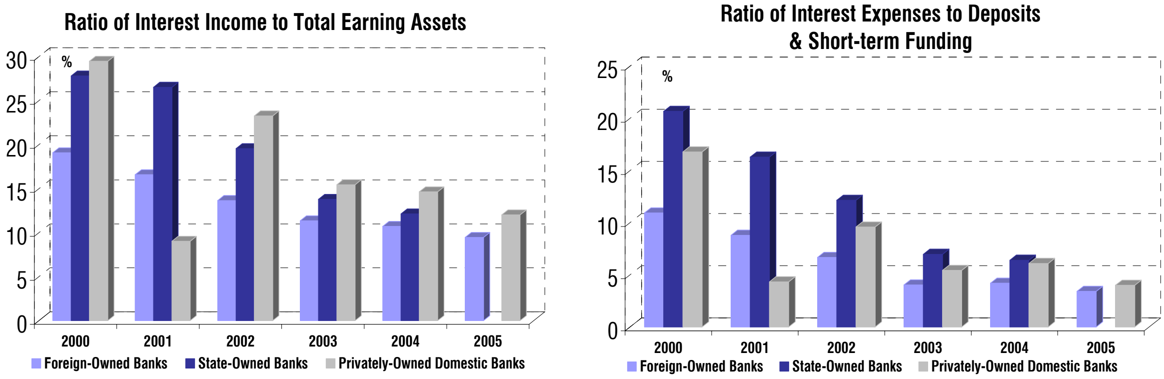
Structure of Liabilities

The financial deepening process characterizing the banking sector has also had an effect on banks' liabilities structure. The steadily increasing lending activities which became more obvious after 2001, created the need for banks to find adequate funding resources. Until recently, banks' liabilities side consisted almost entirely of deposits. This continues to be the case for state-owned banks, the least aggressive category of banks in the lending process. On the contrary, domestic privately-owned and foreign banks, which pursue a dynamic, highly competitive lending policy, have turned themselves to the interbank market in order to establish new sources of funding. However, lending from the interbank market is still in a primitive stage and deposits still consist the main component of the liabilities side of the banks' balance sheets

Return on Assets and Cost of Funds

The conclusions from examining and comparing banks' returns from their lending activities (ratio of interest income to total earning assets) as well as their costs of funding (interest expense to deposits and short-term funding) for the different bank categories are striking. Domestic privately-owned banks earn constantly the highest return from their earning assets and thus from their credit portfolio, since loans constitute their main asset class, compared with the rest of the market participants. On the other hand, foreign banks in their effort to establish themselves and attract new clientele offer more competitive lending rates from both domestic private and state banks.

Figure 2.3



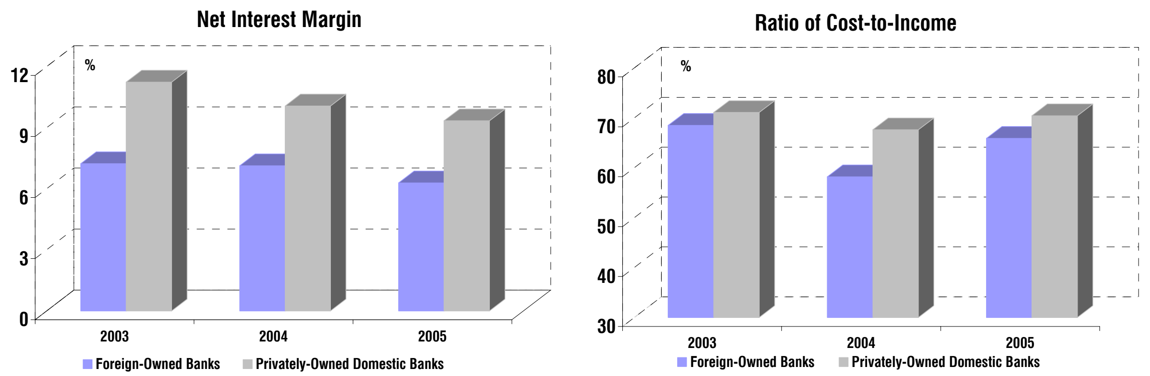
The cost of funding for the three participants of the sector is the flip side of the coin. Domestic privately–owned banks' aggressive lending policy creates an urgent need for them to find adequate sources of funding. Unlike foreign banks, which enjoy the support of their parent banks, domestic privately-owned banks have to rely solely on their own balance-sheet to fund their activities. They are obliged therefore to offer better deposit rates to attract more depositors, despite the costs that such a strategy entails. Finally, the higher cost of funds characterizing the state-owned banks is due to their traditional policy to offer the highest rates to their depositors.

Profitability & Efficiency

The Romanian banking system, including all its participants independently of the type of ownership, is characterized by a high level of profitability. Net interest income constitutes the main source of income for all three categories of credit institutions (almost 60% of operating income). The second largest contribution comes from commissions, (around 20% of operating income) which again is almost identical for all participants.

The decreasing share of net interest income in banks' operating income since 2003, results from the downward trend in the differential between average lending and deposit rates applied to non-bank customers. This downward trend in the interest margin, resulting mainly from fiercer competition, is more pronounced for domestic privately-owned banks (1.9% decline since 2003, compared with a 0.9% decline for foreign-owned banks). However, domestic privately-owned banks are characterized by a higher interest margin (9.3% as of 2005), compared with foreign-owned banks (6.3% as of 2005).

Figure 2.4



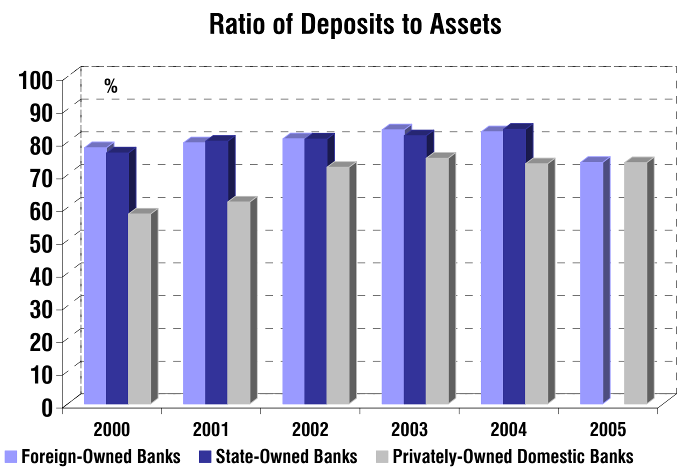
Looking at the cost to income ratio foreign banks are able to operate more efficiently compared with domestic private banks, but due to their ability to earn a higher return on their loan books private domestic banks achieve a higher return for their shareholders.

Capital Adequacy & Liquidity

Despite the rapid credit expansion, the sector's capital adequacy remains at high levels. According to NBR, in 2005, state-owned banks had the highest solvency ratio of 40.3%. This can be largely attributed to the smaller credit intermediation by state-owned banks as well as to the large share of government – zero-risk-weighted securities in their portfolios. In the past, foreign banks were able to operate with a smaller amount of capital compared with domestic private banks, mainly due to the implicit support they received from the foreign banking groups they were part of. Recently though the capital levels of the two banking groups have converged and both domestic private and foreign banks have solvency ratios around 20%, well above the minimum level of 12%.

In terms of liquidity, the banking system is negatively affected by the intensive financial deepening characterizing the sector. Privately-owned domestic banks, lacking support from parent institutions and following aggressive lending policies, mainly turn to deposits to fund their activities. Following attractive pricing policies for their customers as aforementioned, they have been able to attract more deposits and improve the ratio of deposits to assets in their balance sheet. On the contrary, the deposit to assets ratio is stable for foreign and state-owned banks.

Figure 2.5



Appendix 2: Key Acquisitions

Key Acquisitions in the Romanian Banking System	
Target Name	**Acquiror Name**
2006	
Mindbank	Agricultural Bank of Greece
2005	
BCR	Erste Bank
Daewoo Bank (Romania) Ltd	Banca CR Firenze
Banca Comercial Ion Tiriac SA	HVB Bank Romania SA
2004	
Volksbank Romania	Investor Group
Banca Romana pentru Dezvoltare	Societe Generale SA
Banca Comerciala Robank	Orszagos Takarekpenztar
Robank	OTP
2003	
Bank Romanesca	National Bank of Greece
Banca Comerciala West Bank SA	Cardine Banca SpA
2002	
Demirbank Romania SA	Unicredito Italiano SpA
Demirbank TAS-Foreign Branches	Investor Group
Daewoo Bank (Romania) Ltd	Conef SA(Marco International)
2001	
Bankcoop	YUCO Banka(YUCO Business)
Banca Comerciala West Bank SA	Cardine Banca SpA
Banca Agricola SA(Romania)	Raiffeisen Zentralbank
2000	
BNP-Dresdner Bank(Romania)	Egnatia Bank SA
Banc Post(Romania)	Investor Group
Banca de Credit Industrial	Finansbank AS
Pater Bank of Romania	Bank of Piraeus SA
1999	
Banca Romana pentru Dezvoltare	EBRD
Banc Post(Romania)	Investor Group (GE Capital, Banco Portugues do Investimento)
Chase Manhattan-Bucharest Bch	National Bank of Greece
Romanian Bank for Development	Societe Generale SA
1998	
Banca Romana pentru Dezvoltare	Societe Generale SA

Source: Thomson Financial, NBR

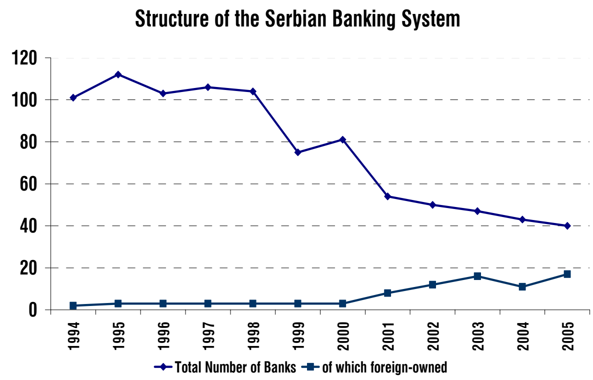
3. Serbia

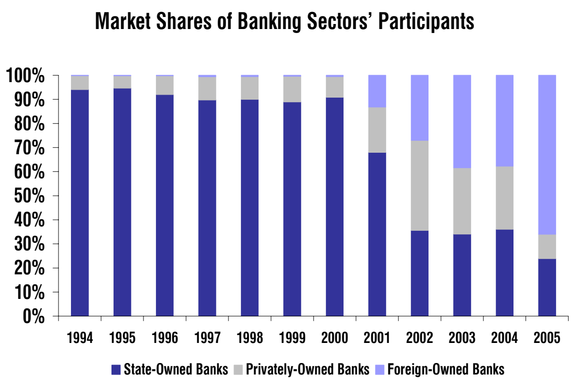
Structure of the Banking System

The military conflict and the turmoil that prevailed during the previous decade devastated the Serbian banking sector. In 2000, a turnaround in the political thinking in the form of a new government and the country's gradual opening up to the outside world fostered the beginning of banking reform. Initially, the restructuring of the banking sector has been slow and has accelerated only during the last few years.

In an attempt to clean up the sector several banks were closed down after 2000. The number of banks was reduced to 47 in 2003 down from 81 three years earlier, with the state acquiring significant interests in the banking system. In essence, the restructuring process resulted in the re-nationalisation of the Serbian banking system, with the state possessing approximately 68% of banking sectors assets. The presence of the state has been gradually declining and was limited to 36% in 2004 and to 24% in 2005.

Figure 3.1





The beginning of bank reform attracted the interest of foreign investors, interested in gaining exposure to the Serbian banking sector. Foreign banks' penetration has been aided by the government's decision to promote the direct sales to foreign investors as its preferred privatisation method. Admittedly, the privatization process has been particularly slow and has only accelerated in the last couple of years. In 2005, privatizations accelerated with the sales of Jubanka, Novosadska Banka and Kontinental Banka to Alpha Bank, Erste and Nova Ljubljanska Banka respectively. In 2006 further privatizations took place with the acquisition of Niska Banka by Hungary's OTP, of Vojvodjanska Banka by Greece's NBG and the sale of Panonska Banka to Italy's San Paolo IMI. Yet, the privatization process is far from being completed, since 11 banks still remain in state hands, consisting one quarter of total banks' assets. In addition, the delays recorded in the state's privatization process, led foreign banks to strengthen their presence via mergers and acquisitions of domestic privately-owned banks. As a result, foreign banks' market share increased from 13% in 2001 to 66% in 2005, becoming the dominant group of banks in the sector.

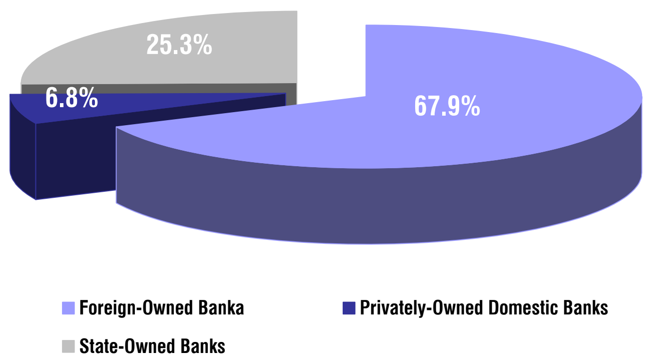
Structure of Assets

The closure of several banks along with prudential measures to deal with the bad debt problem (in 2001, NPLs amounted to 25% of total loans) resulted in a precipitous shrinkage of lending to the private sector. However, the change in the banking landscape in 2001, in conjunction with the entrance of foreign banks in the country, resulted in banks' increasing their lending activity.

Foreign banks led the credit boom that took place in recent years (57% y-o-y credit growth as of 2005) possessing a share of almost 70% of total credit. On the other hand, only a fifth of total credit is granted by state-owned banks, while the rest is granted by domestic privately-owned banks, which now consist a minority in Serbian banking sector (10% of total assets as of 2005).

Figure 3.2

Share of Credit Given by Serbian Banking Groups



The increase in the levels of financial intermediation is apparent when observing the structure of banks' balance sheets. Since 2001, the share of loans to total assets has been rapidly increasing in all banking groups, constituting on average about 57% of banks' assets, as of 2005, up from approximately 22%, four years earlier. More spectacular has been the increase of the loan portfolio of foreign-owned banks from roughly 6% of the total assets, in 2001, to 58%, in 2005. Finally, it has to be stressed that the attempts by the National Bank of Serbia to curb credit growth may have strengthen foreign banks' position even further, given their ability to circumvent NBS restriction by transferring part of their loan portfolios to their parent institutions abroad.

Structure of Liabilities

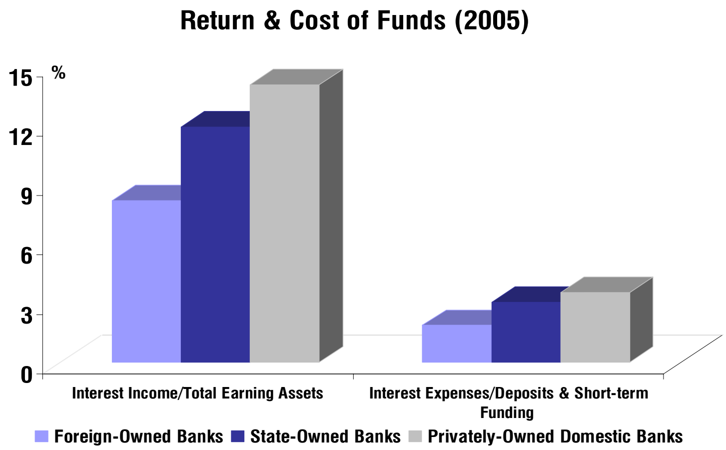
During the turmoil of the 90s depositors' confidence was severely shaken due to the freezing and virtual confiscation of foreign currency deposits of households by the state. Depositors trust was not immediately restored once banking restructuring began and until 2005, the population still kept an estimated $4 bn in foreign exchange "under the mattress''.

However, deposits have grown substantially motivated by the withdrawal of the Deutsch Mark and the introduction of the Euro at the beginning of 2001, as well as by the penetration of foreign banks in the sector. Hence, deposits' share in banks' balance sheets increased from a 32%, in 2001, to 63% in 2005. Deposits thus constitute the main source of financing the lending activities for all bank categories. However, foreign participants, being the most aggressive, have turned to supplementary sources of funding such as the interbank market.

Return on Assets and Cost of Funds

Based on the ratios of interest income to earning assets and interest expense to deposits and short-term funds, we observe that the domestic privately-owned banks are in a position to earn a higher lending rate from the loan portfolio but at the same time they face the highest funding costs for their pool of deposits. On the contrary, foreign banks competition and their attempts to gain market share forces them to offer more attractive terms to their clients.

Figure 3.3



Profitability & Efficiency

The structure of banking groups' operating performance in Serbia is particularly awkward with the component 'Other Operating Income' consisting a major part of banks' net operating income. This particular component has been bloated by elements such as revaluation results, provisions and reverse provisions and it is prominent in all banking groups, but particularly in domestically-owned banks.

As we have already stressed the banking landscape has vastly changed in the last couple of years and it would be premature to form an opinion on the profitability of foreign banks, given that they had a limited amount of time to turn the privatised banks around. Indeed, in 2005 almost the entire amount of interest revenues were absorbed by provisions for non-performing loans (the ratio of loan loss provisions to net interest revenues was 99% for foreign banks compared with 89% and 70% for state-owned and domestic private banks respectively). Observing thus the participants' profitability in 2004-2005, domestically-owned private banks enjoy higher profitability levels compared to their counterparts.

Table 3.1

Profitability Indicators				
	Return on Assets		Return on Equity	
Banking Groups*	2004	2005	2004	2005
State-Owned Banks	-4.8	0.2	-27.6	1.2
Privately-Owned Domestic Banks	6.1	6.9	14.4	18.6
Foreign-Owned Banks	-0.3	0.4	-2.2	3.4

** Ownership Structure as of Q1 2006*

Source: IMF

However, foreign banks are more efficient than the domestic banks as indicated by the cost-to-income ratio. The cost to income ratio stands at 79% and 67% for privately-owned domestic and state-owned banks respectively, while it is much lower for foreign-owned banks (48% as of 2005).

Capital Adequacy & Liquidity

The single most important issue in the Serbian banking sector is the growing amounts of non-performing loans. The ratio of NPLs for foreign-owned banks increased by 6 percentage points in only one year, reaching 16% of total loans as of 2005. However, this may well reflect the tightening of the loan classification criteria and the incorporation of the loans of privatized or acquired privately-owned domestic banks to the foreign banks' loan portfolio. NPLs are even higher in both state-owned and domestically-owned private banks (38% and 52% respectively as of 2005). One comforting factor though is the high levels of capital adequacy, with the overall solvency ratio being equal to 26%, in 2005.

The ability of banks to attract new deposits will be the key factor in their attempts to further expand their activities. Liquidity risk could also be further aggravated by euroization of liabilities, since attempts to promote dinar-denominated term deposits have been largely unsuccessful. However, foreign-owned banks are in a better position since they rely for support on their parent institutions. Thus, the increasing share of foreign-owned banks in the banking system is improving the ability of the sector to absorb a liquidity shock.

Appendix 3: Key Acquisitions

Key Acquisitions in the Serbian Banking System	
Target Name	**Acquiror Name**
2006	
Panonska banka AD Novi Sad	Sao Paolo IMI
Vojvodjanska Banka	NBG
Komercijalna Banka	EBRD
Niska Banka AD	OTP
Nova Banka	Findomestic Banca SpA
2005	
Centrobanka	Laiki Bank
National Savings Bank JSC	EFG Eurobank Ergasias SA
Novosadska Banka	Erste Bank der
Meridian Bank AD	Credit Agricole SA
Euromarket Banka	Nova Ljubljanska Banka dd
Atlas Bank	Piraeus Bank
Delta Bank	Banca Intesa SpA
Jubanka AD	Alpha Bank AE
Continental Banka	Nova Ljubljanska Banka dd
2004	
Eskimbanka	Bank Austria
2003	
Montenegrobanka	Nova Ljubljanska Banka dd

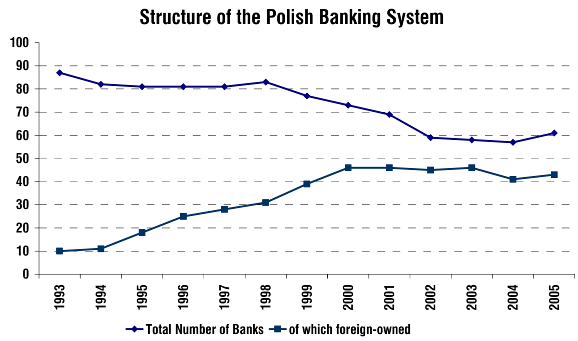
Source: Thomson Financial, NBS

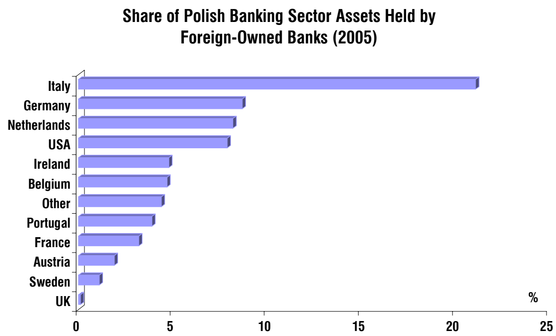
4. Poland

Structure of the Banking System

The Polish banking sector is one of the few banking sectors in Central and Eastern Europe that did not undergo a severe financial crisis. Polish banks met with some difficulties in 2000-01, but they survived without any great problems. Polish banks are mostly in private hands with a strong presence of foreign investors. This is the result of a series of privatizations, mergers and acquisitions the majority of which were completed by 2001. In 2001, 46 out of 69 banks were in foreign hands, which controlled 70% of total banks' assets. Foreign presence in Poland is well-diversified with investors from 18 countries operating in the sector. Italian banks prevail with a market share of 21% as of 2005, followed by German (8.7% of total assets as of 2005), and Dutch (8.2% of total assets as of 2005) banks. Many foreign institutions set foot in Poland's banking system during the last decade through their involvement in the restructuring of distressed banks during the former decade. Currently, many foreign investors enter into the Polish banking sector by buying stakes in locally-owned private banks.

Figure 4.1





According to NBP, the market share of banks established by foreign entities does not exceed 8% of total sector's assets. The presence of the state is limited to 4 out of 61 banks, one of which PKO BP is currently the largest Polish bank. The government has committed not to privatize PKO, since it wants to maintain control over a major financial institution. Finally, domestic privately-owned banks, having seen their market share shrinking from 26% in 1999 to a mere 3.5% in 2000, they currently possess approximately one tenth of the banking sectors' assets.

Structure of Assets

Credit expansion has been particularly slow in Poland compared to the rest of New Europe with credit to the private sector increasing by single digit figures for the whole of 2001-2004. In 2004, credit growth even moved to a negative territory, but it has picked up again in 2005. As a result of this slow pace of financial deepening, the ratio of loans to assets for all banks is relatively low and currently stands at 45% of total assets. Instead, banks have invested a large proportion of their assets in government bonds. Even in foreign banks, government bonds account for 19% of their total assets.

Structure of Liabilities

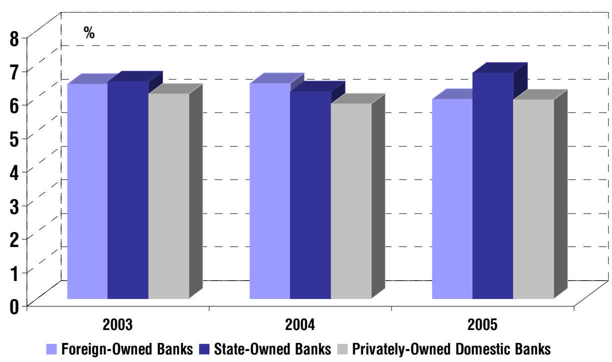
Deposits prevail on the liabilities side of banks' balance sheet, consisting more than 80% of their total liabilities. Admittedly, this is more pronounced for domestic – state-owned and privately owned – banks, since these bank categories lack support from other sources such as the parent institutions of the foreign-owned banks' subsidiaries. Considering the slow pace of lending activities, banks can adequately fund their activities relying on their deposits. Besides, financing through market instruments is usually of a short-term nature, and comes at a higher cost.

Return on Assets and Cost of Funds

As we have already mentioned, the Polish banking sector has undergone substantial ownership restructuring as early as the beginning of the decade. Apart from that, credit expansion in Poland has been too slow and can be adequately financed by the current pool of deposits. These features of the Polish banking system have led to a convergence of both the lending rates and the cost of funding amongst the three banking groups. Since there is no pressure for variation, all bank categories follow similar policies and are characterized by approximately the same levels of returns on loans and cost of funding. Competitive pressures have resulted in the easing of loans' terms and conditions and lending to lower income customers.

Figure 4.2

Ratio of Interest Income to Total Earning Assets

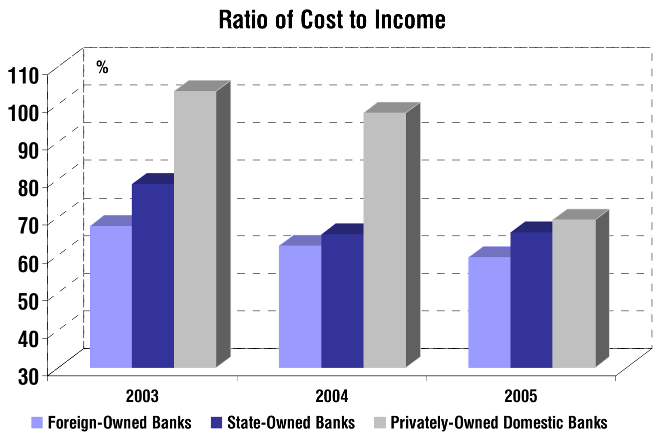


Profitability & Efficiency

The slow credit expansion has affected the structure of the operating income of Polish banks. Specifically, the contribution of interest income to total income is much smaller than what we observe elsewhere. Net interest income contributes 50% of banks' operating income while net commission revenue accounts for 30% of their total operating income. The high contribution of commission revenue is explained by the fact that all banks - foreign-owned banks in particular - have counterbalanced slow credit expansion by making profits from commissions.

Overall, the Polish banking sector is characterized by good levels of profitability. Foreign-owned banks enjoy levels of profitability which are similar to the profitability levels of state-owned banks. On the contrary, the profitability of domestic privately-owned domestic banks is much lower owing to their smaller size and their lower efficiency. This lack of efficiency is reflected in their having a higher cost to income ratio (69% in 2005), compared to both state-owned (65%) and foreign (59%) banks.

Figure 4.3

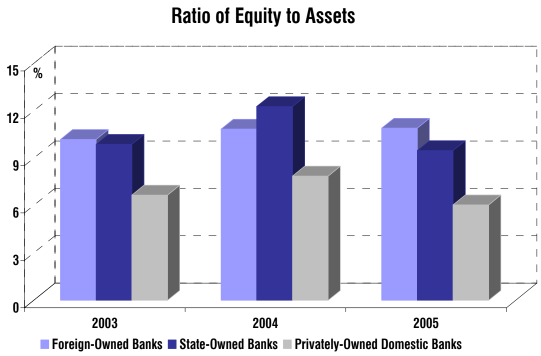


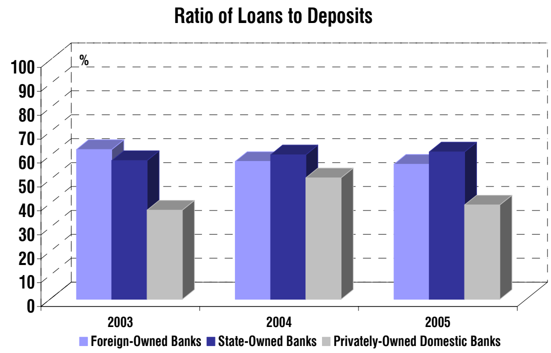
Capital Adequacy & Liquidity

Despite its decline to 14.5% in 2005 from 15.4% in 2004, capital adequacy is high enough to guarantee the soundness of the banking system. Privately-owned domestic banks are less well-capitalized compared to the two other banking groups. This is related to their lower profitability, higher cost and less efficient operating performance compared to the other two banking groups. Being the minority of the banking system they bear the burden of competitive pressure, which also affects their level of equity capital.

In terms of liquidity, as we have already stated, the banking system overall does not face particular problems. All bank categories maintain a high proportion of liquid assets in their balance sheets (26.2% as of 2005), while their deposits can adequately finance their lending activities. Finally, given that around two thirds of the banking sector are foreign-owned banks, they can easily find support from their parent banks in the event of a liquidity squeeze in the banking sector.

Figure 4.4


Ratio of Equity to Assets
%
15
12
9
6
3
0
2003
2004
2005
Foreign-Owned Banks
State-Owned Banks
Privately-Owned Domestic Banks


Ratio of Loans to Deposits
%
100
90
80
70
60
50
40
30
20
10
0
2003
2004
2005
Foreign-Owned Banks
State-Owned Banks
Privately-Owned Domestic Banks

Appendix 4: Key Acquisitions

Key Acquisitions in the Polish Banking System	
Target Name	**Acquiror Name**
2006	
Dominet Bank	Fortis
Kredyt Bank SA	Sofina SA
2005	
Wschodni Bank Cukrownictwa SA	Getin Holding SA
Euro Bank SA	Societe Generale SA
2004	
Bank Pocztowy SA	Powszechna Kasa Oszczednosci
Bre Bank Hipoteczny SA	BRE Bank SA
Kredyt-Pension Fund Bus	Powszechne Towarzystwo
Gornoslaski Bank Gospodarczy	Getin Holding SA
2003	
TBM Sp zoo	Millennium Bank(Big Bank)
2002	
Inteligo Financial Services	Powszechna Kasa Oszczednosci
Kredyt Bank SA	KBC Bancassurance Holding NV
Petrobank(LG Group)	Nordea AB
Inteligo Financial Services	Bankgesellschaft Berlin AG
Cuprum Bank(Bank Handlowy SA)	Dominet
Powszechny Bank Kredytowy SA	Bank Przemyslowo-Handlowy PBK
2001	
Bank Powierniczo-Gwarancyjny	Dresdner Bank AG(Allianz AG)
Kredyt Bank PBI SA	KBC Bancassurance Holding NV
Wielkopolski Bank Rolniczy	ING BSK
ING BSK	ING Groep NV
Bank Ochrony Srodowiska	Skandinaviska Enskilda Banken
Polski Kredyt Bank SA	Kredyt Bank PBI SA
Bank Czestochowa	BRE Bank SA
BWP-Unibank SA	Bank Komunalny w Gdyni SA
Bank Slaski w Katowicach	ING Groep NV
Wielkopolski Bank Kredytowy	Bank Zachodni SA
2000	
Millennium Bank	BIG Bank Gdanski SA
Polsko-Kanadyjski Bank Sw	Danske Bank A/S
Invest Bank SA	Investor Group
Bank Rozwoju Eksportu	Commerzbank AG
BIG Bank Gdanski SA	Eureko BV
Cukrobank	Bank Inicjatyw Spoleczno
Bank Inicjatyw Spoleczno	Caisse Centrale de Credit
Bank Komunalny w Gdyni SA	MeritaNordbanken
Bank Handlowy SA	Citigroup Inc
BIG Bank Gdanski SA	Banco Comercial Portugues SA
Kredyt Bank PBI SA	Banco Espirito Santo SA
Bank Handlowy SA	Citigroup Inc

Bank Wspolpracy Regionalnej SA	Deutsche Bank AG
Bank Handlowy SA	PZU Zycie
Bank Handlowy SA	Bank Rozwoju Eksportu
BIG Bank Gdanski SA	Deutsche Bank AG
Invest Bank SA	Polska Telewizja Satelitarna
Bank Przemyslowo-Handlowy PBK	Bayerische Hypo- und Vereins
Powszechny Bank Kredytowy SA	BA/CA Poland SA(Bank Austria)
BA/CA Poland SA(Bank Austria)	Powszechny Bank Kredytowy SA
Bank Wspolpracy Regionalnej SA	Deutsche Bank AG
1999	
Bank Handlowy SA	Investor Group
Bank Komunalny w Gdyni SA	MeritaNordbanken
Bank Handlowy SA	Commerzbank AG
Bank Ochrony Srodowiska	Narodowy Fundusz Ochrony
Bank Przemyslowo-Handlowy PBK	Bayerische Hypo- und Vereins
BIG Bank Gdanski SA	Banco Comercial Portugues SA
BIG Bank Gdanski SA	Eureko BV
Bank Przemyslowo-Handlowy PBK	Bayerische Hypo- und Vereins
Powszechny Bank Kredytowy SA	Bank Austria AG
BIG Bank Gdanski SA	RZB Central European
Bank Zachodni SA	AIB European Investment Ltd
Bank Polska Kasa Opieki SA	Investor Group
Bank Ochrony Srodowiska	Kredyt Bank PBI SA
Kredyt Bank PBI SA	KBC Bancassurance Holding NV
Bank Amerykanski w Polsce SA	DG Bank
BIG Bank Gdanski SA	Deutsche Bank AG
BIG Bank Gdanski SA	Bank Rozwoju Eksportu
Bank Budownictwa(Poland)	Bank Gospodarstwa Krajowego
Pierwszy Polko-Amerykanski Bk	Fortis AG
BWR Bank Secesyjny SA	DaimlerChrysler Services AG
Agrobank SA	Kredyt Bank PBI SA
Pierwszy Komercyjny Bank w Lub	Powszechny Bank Kredytowy SA
Bank Przemyslowo-Handlowy SA	Bayerische Vereinsbank AG
Kredyt Bank PBI SA	Kredietbank NV
Bank Przemyslowo-Handlowy SA	Allied Irish Banks PLC
Prosper Bank	Kredyt Bank SA
Powszechny Bank Kredytowy SA	Kulczyk Holding SA
1998	
Bank Amerykanski w Polsce SA	DG Bank
Bank Przemyslowo-Handlowy SA	Bayerische Vereinsbank AG
Bank Polska Kasa Opieki SA	EBRD
Banku Podlaskiego	AIG Consumer Finance Group Inc
Bank Amerykanski w Polsce SA	Bayerische Landesbank
Credit Lyonnais Bank Polska SA	Credit Lyonnais Global Banking
Powszechny Bank Kredytowy SA	Investor Group
Wlasnosci Pracowniczej SA	Unidanmark A/S
Bank Polska Kasa Opieki SA	Investors

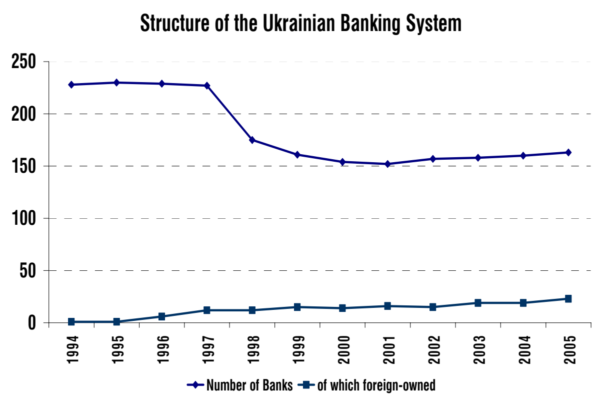
Source: Thomson Financial, NBP

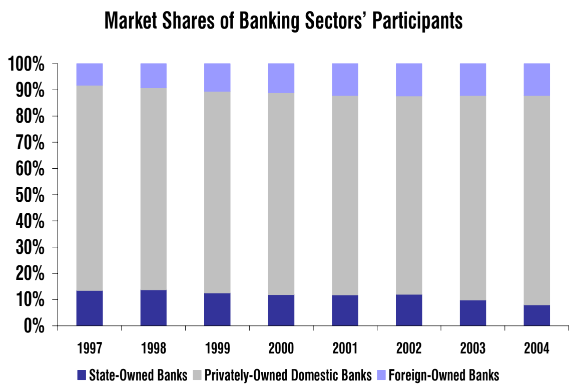
5. Ukraine

Structure of the Banking System

The Ukrainian banking sector is the least liberalised and the most underdeveloped amongst the "New Europe" group of countries. Its banking system is characterized by structural weaknesses and is highly fragmented. This is clearly reflected in the large number of banks operating in Ukraine, 163 as of 2005, the majority of which are small, pocket-banks, intended to provide services to their owners. Indicative of the latter is the fact that more than 80% of the banks operating hold assets less than $150mn. The 30 largest banks account for approximately 75% of banking sectors' assets, many of which are part of large corporate and industrial conglomerates. Furthermore, according to its own admission Ukraine's National Bank has no clear evidence about the real owners of two-thirds of the country's banks.

Figure 5.1





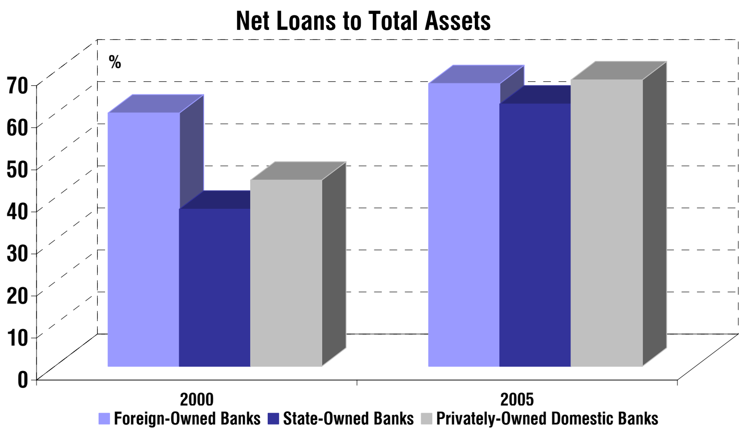
The majority of the banking sector belongs to private domestic investors, who possessed almost 80% of the sector, as of 2004. The state owns only 2 of the 165 banks permitted to perform banking transactions in Ukraine (8% of banking sector's assets as of 2004). Until recently, foreign banks had limited presence in the Ukrainian banking sector. As of 2004, 19 foreign banks were operating, the majority of which originated in, or were doing business with Russia. During the last two years however this picture has been changing quickly, since foreign banks realised the large potential for expansion to the under-serviced Ukrainian banking sector. Thus a number of big deals took place in the last couple of years, initiating a consolidation process that is expected to proceed further. In 2005, Raiffeisen International acquired Aval bank, the second largest bank in Ukraine, BNP Paribas acquired Ukrsibbank (the fifth largest bank) and Banca Intensa took over Ukrsotsbank (the fourth largest bank). Moreover, Erste Bank, Eurobank EFG and OTP gained exposure to Ukrainian banking system, acquiring smaller banks. According to the Financial Times, many bankers expect half of Ukraine's banking industry to fall into pan-European hands by 2008, while the other half is expected to remain under ownership of domestic and Russian groups.

The landscape in the banking system is changing but as we stressed above the disclosure of information regarding the sector has been limited. Consequently, it would be an exaggeration to claim that it is possible to have a clear picture of the performance of the banking sector in general, and of specific banking groups in particular.

Structure of Assets

Ukraine is already familiar with a booming credit market. Credit growth has been intense since 2000, while credit as a percentage of GDP has increased by 19 percentage points in the last five years. The effect of this credit boom has become more than obvious to the asset structure of banks' balance sheets. Since 2000, the ratio of loans to assets increased by 7 percentage points (67% as of 2005) for foreign-owned banks, while the increase was more obvious for state-owned and privately-owned domestic banks. State-owned banks' ratio of loans to assets increased to 62.4% in 2005, up from 37.4% in the period 2000-2005, while for the domestically-owned private banks' the ratio increased to 68% in 2005, up from 44% in 2000.

Figure 5.2



The expanding loan market was vastly supported by sound policies adopted by the central bank along with improvements in the legislation of the financial sector. The latter combined with the imposition of currency controls in the late 1990s, resulted in banks switching away from their previous emphasis on trading in the FX and government bond markets towards more traditional banking activities.

Structure of Liabilities

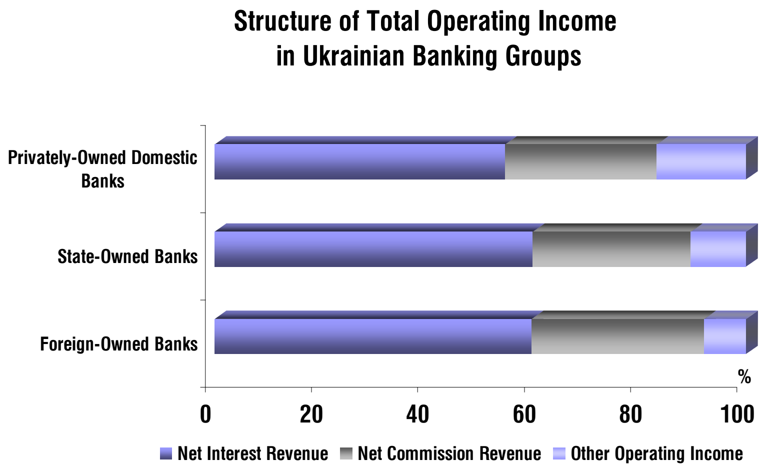
The rapid credit expansion requires a large funding basis. Due to the lack of a developed interbank market in Ukraine, deposits are of increasingly importance as they constitute the main source of financing banks' activities. The political crisis which broke out in 2004 resulted in a deterioration of consumers' confidence in the banking sector and subsequently in a massive withdrawal of deposits.

However, stability in the system was soon restored thanks to the NBU effective measures that circumscribed the withdrawal of current deposits.

Profitability & Efficiency

The profitability of the banking sector is considered particularly low, with banks suffering from high overhead costs and high inefficiency. As expected, our results suggest that foreign-owned banks enjoy higher profitability and display higher efficiency compared with both domestic privately-owned and state-owned banks. However, we need to stress again that the effect of the recent privatisations of major domestic Ukrainian banks is not yet depicted in the data.

Figure 5.3



The interest income is the main source of operating income for all bank categories. Overall, the average net interest margins of the banking sector are particularly high standing at 4.9%. However, the foreign participants have lower margins compared to the prevailing privately-owned domestic banks. This might be attributed to the fact that foreign participants are more cost efficient compared to their counterparts and their having a smaller presence in retail banking.

Capital Adequacy & Liquidity

Undisputedly, the quality of the credit portfolio of Ukrainian banks constitutes the most important risk factor for the stability of the Ukrainian banking sector. In 2005 non-performing loans accounted for a fifth of their total loan portfolio. These figures are difficult to compare with international standards, because the National Bank of Ukraine employs much stricter criteria for the classification of loans as substandard, but still they are indicative of the overall credit quality of the banks' loan book. Exchange rate risk can also have an indirect impact on credit quality, given that a large part of lending was granted in the form of long-term foreign currency denominated loans.

In the backdrop of these issues, Ukrainian banks' capitalization, although above regulatory limits, is also beginning to look stretched. The significant expansion of the credit portfolio coupled with the low profitability of the banking sector (see previous section), has resulted in a capital adequacy ratio (CAR) that has been declining steadily since 2001.

In addition, banking sector's ability to expand further seems limited, given that in 2005 the ratio of total loans to deposits was 116% and the ratio of loans to deposits in foreign currency was even higher at 136.5%. While this imbalance poses no threat to foreign-owned banks that can rely on funding from their parent institutions, local banks have been forced to cover their funding gap with short-term borrowing from abroad.

Appendix 5: Key Acquisitions

Key Acquisitions in the Ukrainian Banking System	
Target Name	**Acquiror Name**
2006	
Bank Prestige	Erste Bank
RBUA	OTP
Credit Agricole	JSC Index Bank
Ukrotsbank	Banca Intensa
Universal Bank of Ukraine	Eurobank EFG
Mria Bank	Vneshtorgbank
JSIB UkrSibbank	BNP Paribas SA
2005	
VA bank	TBIH
JSPPB Aval	Raiffeisen International Bank-
First Ukrainian Intl Bank	System Capital Management Ltd
Aval Bank	Raiffeisen International Bank-
2004	
Kredyt Bank(Ukraine)	Powszechna Kasa Oszczednosci
2003	
Commercial Bank PrivatBank	Highlanders Alloys LLC
Micro Finance Bank	Investor Group
2002	
VAbank	Truecrown Limited
Aviatekhbank	Petrocommerzbank
2000	
Slobozhanschyna Bank	Nadra Bank JSC
Kyivsky Mizhnarodny Bank	Rabobank
Kievinvestbank	Alfa-Bank (Moscow)(Alfa-Group)
KyivInvestBank	Alfa Group
Western Ukrainian Credit Bank	EBRD
Western Ukrainian Credit Bank	Group Credit Bank CA
1999	
Zakhidno-Ukrainsky Komertsiyny	Polish Credit Bank SA(Poland)

Source: Thomson Financial, NBU

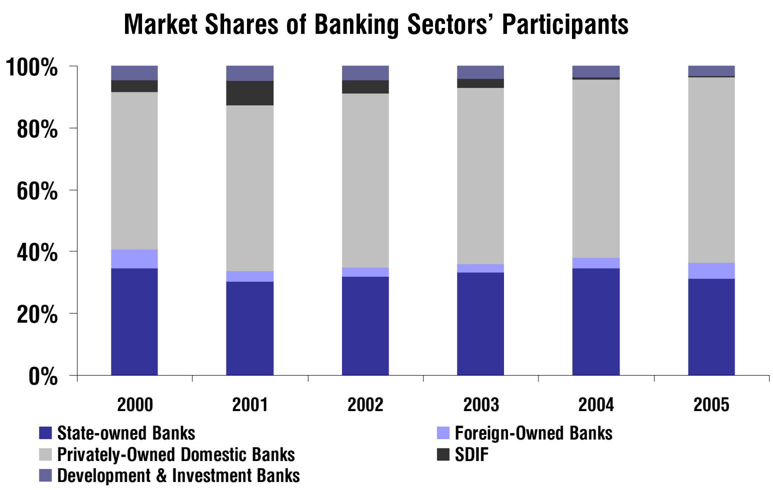
6. Turkey

Structure of the Banking System

Banking sector's consolidation was an important part of the post 2000/01 crisis restructuring process. The number of banks was curtailed by almost a third, from 85 in 2000 to 51 in 2005. Still, the Turkish banking sector remains in domestic private hands. In 2005, 7 out of the 10 largest banks in Turkey were domestic privately-owned, controlling almost 60% of total banking sector's assets.

Foreign-owned banks accounted for only 5.2% of banking sector's assets, as of 2005, according to the Central Bank of the Republic of Turkey. It should be stressed however that this figure unavoidably underestimates foreign presence in Turkey because it takes into account only banks where the foreign shareholders have a controlling stake. Yet, many foreign investors currently hold minority stakes in several Turkish banks and these are not taken into account in CBRT's calculations of foreign-owned assets. Technicalities aside, the fact is that during the last couple of years foreign interest has increased sharply. Over the last two years, a third of total FDI ($ 10.5bn) was related to foreign investment in commercial banks. In 2006, several takeovers took place changing the landscape of the Turkish banking sector. Akbank (3rd largest bank in Turkey), Finansbank (9th largest bank in Turkey), Denizbank (10th largest bank in Turkey) were acquired by Citibank, NBG, and Dexia respectively.

Figure 6.1



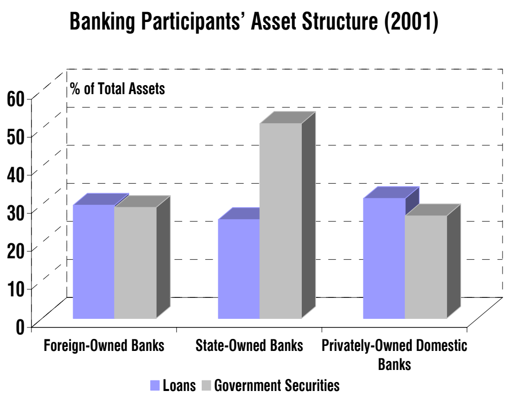
Next in the privatization agenda are three state-banks, Ziraat bank (the largest bank in Turkey with a market share of 16.4% as of 2005), Halk bank (6th bank with 6.8% of total sectors' assets) and Vakif bank (7th largest bank with 6% of total assets as of 2005). All three banks enjoy special relationships with specific sectors of economic activity. For instance, Ziraat bank lends primarily to farmers, Halk bank to small businesses and Vakif bank is a special public bank owned by foundations. An additional characteristic of state-owned banks in Turkey is their special relationship with state-owned enterprises.

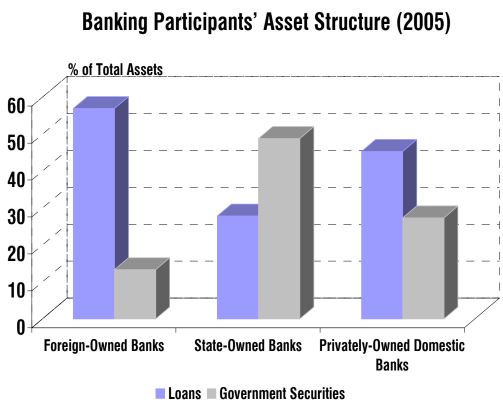
The latter can only bank with state-owned banks, which have therefore attained complete control of state-owned enterprises. Thus state banks' privatization should take place in conjunction with a plan to deprive them of their privileges over state-owned enterprises' deposits.

Structure of Assets

Privately-owned domestic banks as well as the dynamic foreign-owned banks followed aggressive lending policies increasing their share of credit from around 30% of total assets as of 2001 to 45% and 57% of total assets respectively. However, the highest share of credit volume is provided by private banks due to their dominating role in the sector. At the other end of the spectrum, loans account for only a third of the state-owned banks' balance-sheet.

Figure 6.2





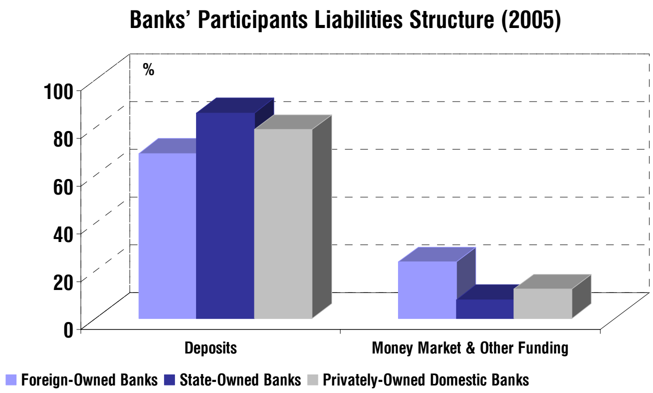
The restructuring process left Turkish banks with a large amount of government bond holdings. Despite their following a declining trend owing to the more rapid increase in the loan portfolio, they still constitute a substantial part of total assets. This is more pronounced in state-owned banks where they consist almost half of total assets. This is considered to be the most serious impediment to those banks' privatization. The reduction of government securities in favour of loans is considered to be important in terms of stable growth and efficient performance of their intermediary functions. The abolition of the liquidity requirement according to which banks were obliged to hold government securities with the CBRT was a positive step towards this direction.

Structure of Liabilities

The liabilities side of banks' balance sheet consists mainly of deposits. The share of deposits is higher for the state-owned banking group being around 85% of their portfolio. In Turkey, other sources of funding are more important compared to the other New Europe countries we examined. The financing of banks' activities through the money market and other funding is substantial for foreign participants, accounting for approximately 24% of their liabilities as of 2005.

Rapid credit expansion creates the need for a similar increasing trend in deposits. This need is obvious if we consider that liquidity shortage was one of the main causes of the banking crisis of 2001. Fortunately, banking sector's restructuring along with the entrance of foreign banks in the sector provides an indication that financing conditions are improving.

Figure 6.3



Return on Assets and Cost of Funds

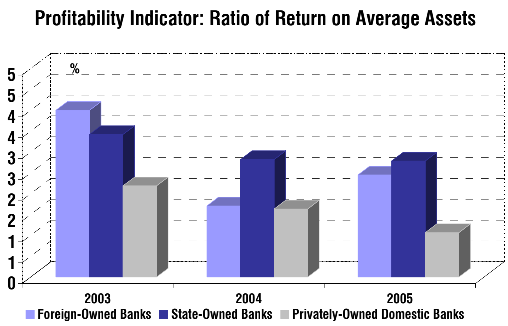
Analysing the return on assets and the cost of funding for the different participants of the banking sector, we do not detect any difference of great interest. The ratio of interest income to total earning assets ranges between 10.4% and 13.4%, as of 2005. On the other hand, interest expenses to deposits & short-term funds vary between 6% and 8.8%, as of 2005, amongst banking groups.

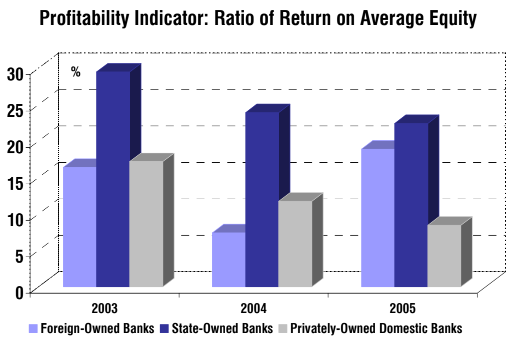
Profitability & Efficiency

Although high interest rates, inflation, and low financial leverage hinder the growth of traditional banking activities, such as lending to households and enterprises, the banking system's profitability remains overall at good levels. Interest income is the main source of revenue, accounting for approximately 60% of total operating income. The intensive lending activity followed by foreign-owned banks and the large government bond portfolio held by state-owned banks account for a large share of interest income in total operating income for these two banking groups (61% and 69% respectively).

Foreign participants along with state-owned banks are the two most profitable groups of the sector. Foreign-banks are characterised by a higher net interest margin (6.4%) compared with 5.2% for privately-owned domestic banks and for 4.9% for state-owned banks. In 2005, profitability declined in the domestic banking groups. The main reasons behind this decline in profitability of state-owned banks are the declining interest rates along with the decrease of state banks' securities portfolio. As far as domestic privately-owned banks are concerned, the decrease in profitability can mainly be attributed to the decline in net interest income, as well as their high cost to income ratio, which stood at 79%. On the contrary, foreign-owned banks were the only banking group that increased its profitability in 2005. The rising market share of foreign banks, along with their expansionary lending policies were the key factors for this improvement.

Figure 6.4



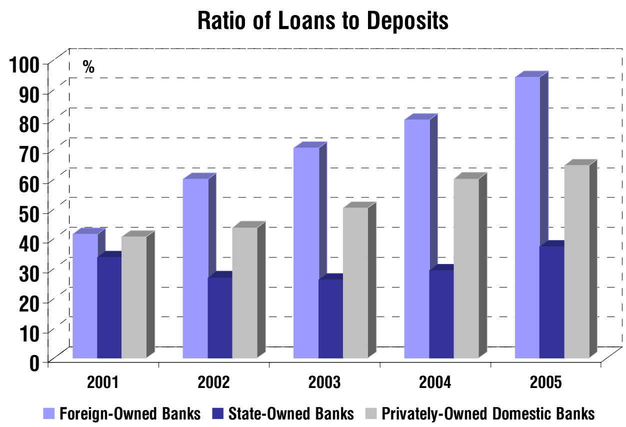


Capital Adequacy & Liquidity

Despite its rapid expansion, the Turkish banking sector remains well capitalised with an overall capital adequacy ratio of 24.2%. State-owned banks appear to be the best capitalised banking group. In 2005, their equity to assets ratio stood at 13.2%, compared with 12.4% for foreign participants and 11% for domestic privately-owned banks.

In terms of liquidity, the banking groups that are more vulnerable to a liquidity squeeze are those pursuing the most aggressive lending strategies. This is clearly depicted by the higher loan-to-deposit ratio for foreign and domestic private banks. Although foreign banks appear to be the less liquid group of banks, the situation is mitigated by support they receive from their parent institutions.

Figure 6.4


Ratio of Loans to Deposits
%
100
90
80
70
60
50
40
30
20
10
0
2001
2002
2003
2004
2005
Foreign-Owned Banks
State-Owned Banks
Privately-Owned Domestic Banks

Appendix 6: Key Acquisitions

Key Acquisitions in the Turkish Banking System	
Target Name	**Acquiror Name**
2006	
Akbank	CitiBank
Denizbank	Dexia
Tekfenbank	Eurobank EFG
Finansbank AS	NBG
Yapi Ve Kredi Bankasi AS	Koc Finansal Hizmetler
2005	
Turkiye Garanti Bankasi AS	GE Consumer Finance
Turk dis Ticaret Bankasi	Fortis Group
Yapi Ve Kredi Bankasi AS	Unicredito
2004	
TBC Bank	Soros Investment Capital Ltd
2002	
Toprak Bank-Branches(9)	Finansbank AS
Toprak Bank-Branches(26)	Investor Group
Toprak Bank	Bayindir Bank(SDIF)
Sinai Yatirim Bankas(Is Bank)	TSKB
Tekstilbankasi AS	GSD Holding AS
Sinai Yatirim Bankas(Is Bank)	Sinai Kalkinma Bank
Sitebank AS	Novabank SA
2001	
Toprak Bankasi	Savings Deposit & Ins Fund
Finansbank AS	Fiba Holding AS
Osmanli Bankasi AS	Turkiye Garanti Bankasi AS
Alternatifbank AS	Anadolu Endustri Holding AS
DemirBank TAS	HSBC Bank PLC
Bank Ekspres	Tekfen Holding Co Inc
Finansbank AS	BNP Paribas SA
Faisal Finans Kurumu AS	Sabri Ulker
Turkiye Garanti Bankasi AS	Dogus Insaat ve Ticaret AS
Osmanli Bankasi AS	Korfezbank
Turk dis Ticaret Bankasi	Dogan Finansal Kiralama
Esbank Eskisehir Bankasi TAS	Etibank AS(Turkey)
Interbank AS	Etibank AS(Turkey)
1999	
Egebank AS	Central Bank of Turkey
Yasar Bankasi	Central Bank of Turkey
Sumerbank AS	Central Bank of Turkey
Yurt Ticaret Ve Kredi Bankasi	Central Bank of Turkey
Esbank Eskisehir Bankasi TAS	Central Bank of Turkey
Turk Sakura Bank AS	Fiba Holding AS
Interbank AS(Nergis Tekstil)	Central Bank of Turkey
1998	
Bank Ekspres	Central Bank of Turkey
Otomobilcilik AS	Sevket Demirel Holding Group

Source: Thomson Financial, CBRT

Assessment of the relative competitive advantage of Central and Eastern European countries based on Unit Labour Cost

- Bulgaria has the lowest unit labour cost compared with the rest of the Central and Eastern European countries we examine (having a ULC 29.4% of the average ULC in EU-25), followed by Slovakia and Latvia. At the other end of the spectrum, Turkey, Hungary and Slovenia are the countries with the highest ULC.
- We document a negative relationship between the two components of ULC, namely productivity and wages. Higher productivity is counterbalanced by higher labour cost.
- The main reason for the low ULC estimated in countries such as Bulgaria, Slovakia and Latvia, is that low wages overcompensate for the low labour force productivity. On the contrary, productivity in Slovenia is not sufficiently high to reduce unit labour cost, since higher productivity is combined with higher wages relative to the other countries considered.
- Low unit labour cost countries attract a significant amount of foreign direct investment (FDI), but low ULC is not automatically translated to high FDI flows.

1. Introduction

In May 2004, Europe witnessed the biggest enlargement of European Union (EU) since its inception. Ten countries (Hungary, Poland, Cyprus, Czech Republic, Slovakia, Slovenia, Estonia, Lithuania, Malta and Latvia) joined the existing fifteen members and formed EU-25. Furthermore, the European Commission has recently endorsed the accession of Bulgaria and Romania to the EU on January 1st 2007. Finally, on October 3rd 2005, membership negotiations were symbolically opened with Turkey and on June 12th 2006 the examination and assessment of the *acquis communautaire* began.

The significant progress new EU-members and acceded countries made in fighting corruption, creating an entrepreneurial friendly environment and enhancing price-trade liberalization encouraged firms already based in the EU-15, the United States to curtail their production capacity in their home country and transfer their production facilities to Central and Eastern European countries. As a recent newspaper article in Sunday Times (Ray Hutton (2006), "Eastern Europe: the New Detroit") accurately put it, eastern Europe is becoming Europe's new Detroit, recalling the era when American carmakers and car parts' suppliers moved their businesses to the state of Michigan early in the 20th century.

The international competitiveness of a country, and thus its ability to attract foreign investments and expand its industrial production, is determined by both the cost of labour and the labour productivity. Hence, low labour cost countries attract companies from countries where labour cost is higher. Additionally, high labour productivity implies that the same output can be produced with the use of a smaller number of workers. As a result, prices of final goods are lower compared to competition. Labour productivity and labour cost along with the level of prices determine the profit margin every firm aims to maximize. The higher productivity and prices are, the higher the profit margin will be. By the same token, lower cost has also a positive impact on corporate profits.

The purpose of this note is to rank the new EU member countries in Central and Eastern Europe relative to the EU-25 in terms of cost competitiveness. The study compares new EU member countries to the EU-25 average, in an attempt to identify the most cost efficient country in the production process. To that end, labour cost and labour productivity of each country are measured relative to EU-25, after accounting for exchange rate and purchasing power differences. Relative labour cost and productivity are combined in order to estimate the unit labour cost, defined as the wage per employee paid for every unit of output produced by each worker.

2. Unit Labour Cost: Definition and Estimation

One of the major indicators used to evaluate the international competitiveness of a country is its unit labour cost, defined as the ratio of labour compensation per worker over labour productivity. Labour compensation per worker is approximated by the wage per employed person, while productivity is defined as the output per employed person. Unit labour cost depicts the ability of the economy to accommodate an increase or decrease of labour compensation relatively to output creation. The lower unit labour cost is, the more cost competitive the country is, since each worker can produce more at a lower wage rate. Thus, it is implied that a country is more competitive when the labour cost is low and productivity is high.

Loosely speaking, unit labour cost can be thought-off as an aggregate indicator which reflects the international competitive advantage of an economy. As such it is affected by the same factors that define both labour cost and productivity. On one hand, an increase in labour cost can result from a domestic currency appreciation that increases both inflationary expectations in the economy. Elevated expected inflation reduces real wages and, in anticipation, workers demand higher negotiated wages in order to overcome the reduction to their purchasing power due to imported inflation. Alternatively, a higher wage rate might me attributed to a shortage of labour supply necessary to reduce leisure. On the other hand, lower productivity might be the consequence of weak technological progress, inadequate or slow structural reforms in the labour market, or reforms that affect primarily the services sector where productivity response is more sluggish.

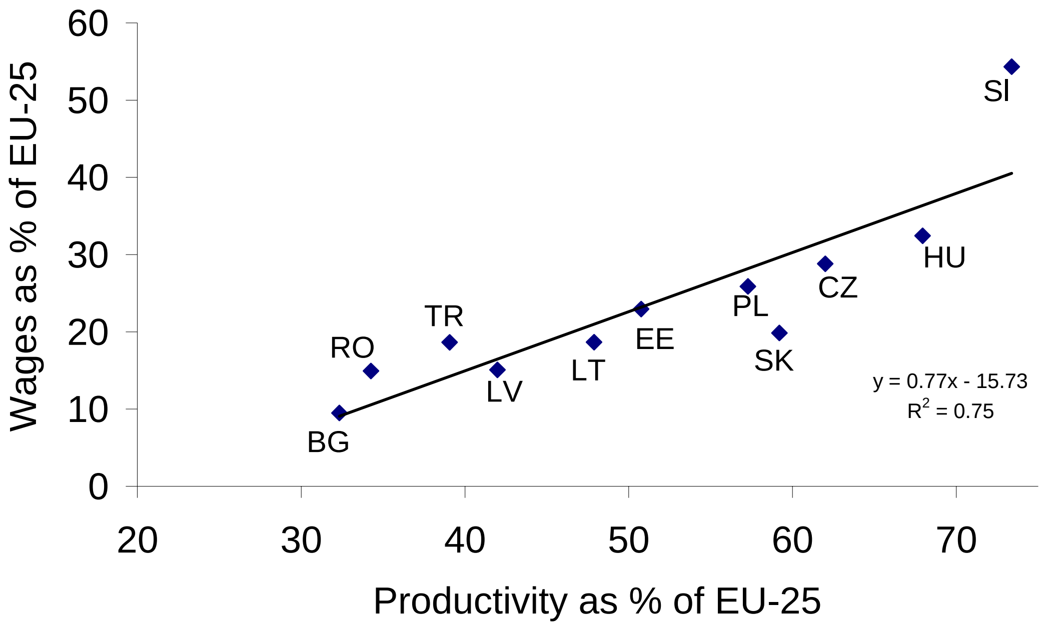
A particular feature of unit labour cost is that the numerator of the ratio (labour cost) is expressed in nominal terms, while the denominator (labour productivity) is expressed in volume terms. As a result, labour productivity needs to be converted into a common currency using purchasing power parity exchange rates in order to account for differences in relative prices across countries. This step is essential, since not only consumer price indices vary from country to country, but also different components of these consumer price indices vary more, relative to other components. Additionally, it is important to compare price indices that refer to the same consumption bundle across countries and adjust for differences in the quality of goods, services and consumption patterns. Use of nominal exchange rates could lead to a misleading picture, since purchase power parity exchange rates correspond to traded goods instead of non-traded goods, while nominal exchange rates are used to buy goods other than goods and services e.g. capital assets.

In order to deal with the volume-nature of labour productivity and account for the weaknesses of the nominal exchange rates for the currency conversion of data in volumes, Purchasing Power Standards (PPS) are used instead. Specifically, labour productivity at each country is defined as GDP in PPS per person employed relative to the EU-25 average, in order to eliminate price differences between countries allowing meaningful volume comparisons of relative GDP. Relative labour cost between each country and EU-25 is defined as the ratio of wages per employee at each country to those at the EU-25 after converting labour costs in common currency, using the annual average of the corresponding bilateral exchange rate. The ratio of relative labour cost and labour productivity define a modified measure of the unit labour cost according to which every country is ranked.

3. Relationship between Wages and Productivity

As a prelude to our assessment of the countries' competitiveness based on their relative labour costs, we first examine the relationship between the two components that define ULC, namely wages and productivity. In Figure 1, average relative wages per employed are reported against average labour productivity for each country, relative to the EU-25, over the period 2001-2005. According to the chart, there exists a strong positive relationship between relative wages and productivity, suggesting that higher labour productivity is accompanied by higher relative wages. Hence, countries that have labour cost lower relative to EU-25 have also lower productivity implying that low production cost countries need to enhance their productivity, as well, in order to build a sustainable competitive advantage.

Figure 1. Wages per employee and labour productivity of each country considered relative to EU-25 (averages of period 2001-2005)



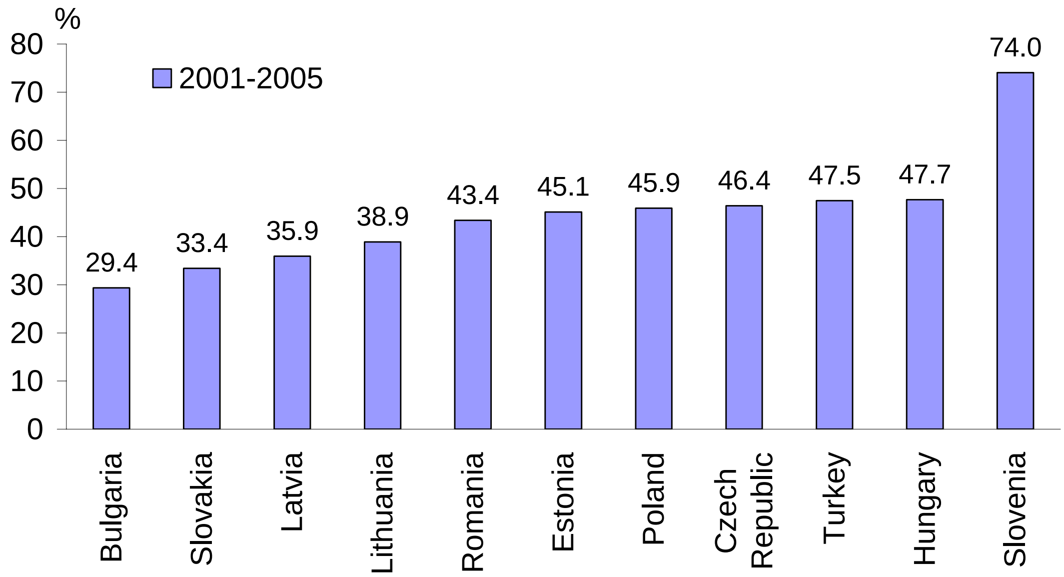
Abbreviations: BG Bulgaria, CZ Czech Republic, EE Estonia, HU Hungary, LV Latvia, LT Lithuania, PL Poland, RO Romania, SK Slovakia, SI Slovenia, TR Turkey
Source: AMECO and Eurostat

Low labour cost is a temporary advantage that will help to attract multinational enterprises. However, the advantage will cease to exist in an environment where unemployment rate is declining and labour market is tightening. Moreover, imported inflation in the form of appreciated domestic currency will increase expected inflation and reduce real wages. Consequently, workers will demand higher wages and labour cost will increase.

4. Country Rankings based on ULC

Figure 2, schematically summarises the key results of our study. In this chart, every country considered is ranked in terms of its relative unit labour cost, relative to the ULC in EU-25. Evidently, unit labour cost in Bulgaria is the lowest, standing at 29.4% of the unit labour cost in EU-25. Unit labour cost in Latvia, Lithuania, Bulgaria and Slovakia is on average one third of EU-25. In Romania, Estonia, Poland, Czech Republic, Turkey and Hungary unit labour cost is approximately half the unit labour cost in EU-25, while in Slovenia it is 74% of the EU-25 average.

Figure 2. Unit labour cost of each country relative to EU-25, average of period 2001-2005

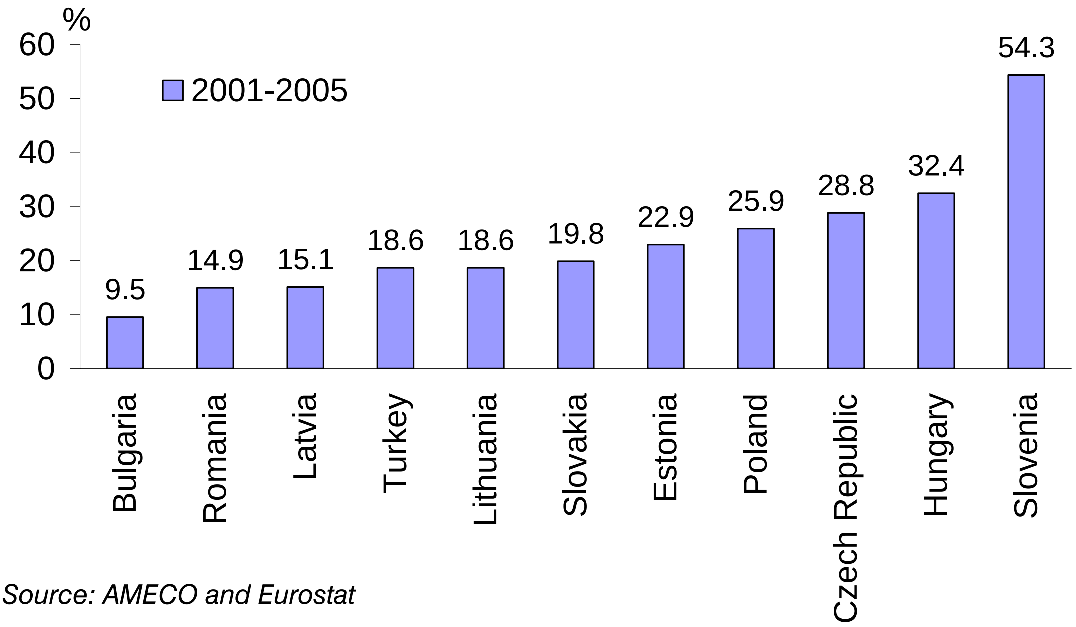


Source: AMECO and Eurostat

Determinants of the rankings

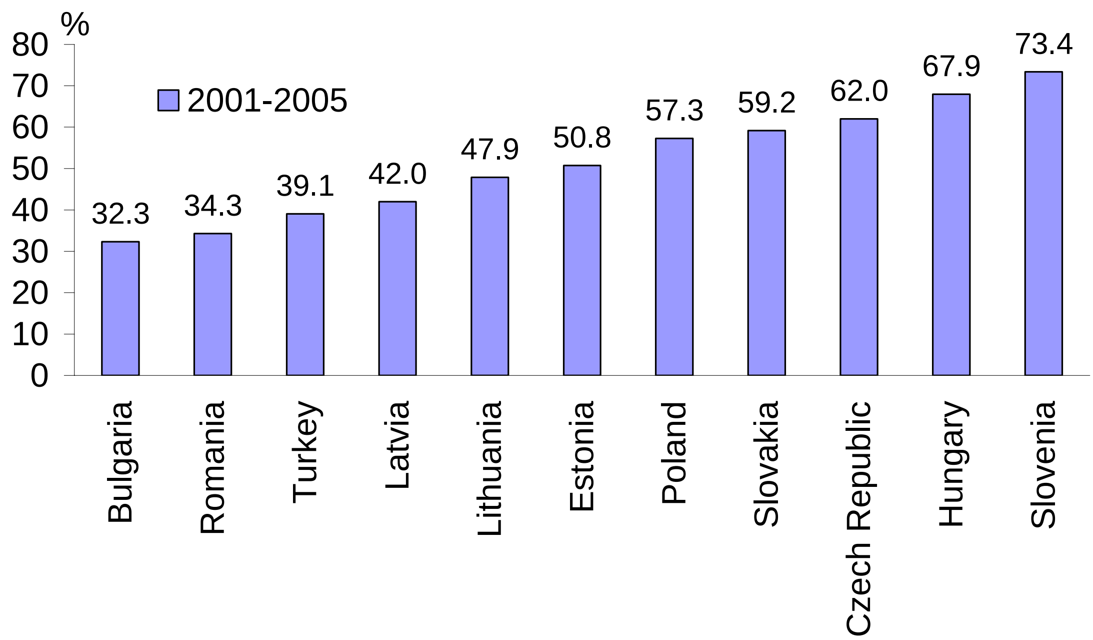
As discussed above, there exists a negative relationship between wages and productivity and their relative magnitude ultimately determines the level of ULC. Thus, it would be of interest to examine the relationship between these two components of ULC and determine whether the level of unit labour cost of the countries considered is affected by their relevant ranking in terms of either wages or labour productivity. An examination of Figures 3 and 4**,** suggests that low relative labour cost coexists with low labour productivity.

Figure 3. Wages per employee at each country relative to EU-25, average of period 2001-2005



Source: AMECO and Eurostat

Figure 4. Labour productivity at each country relative to EU-25, average of period 2001-2005



Source: AMECO and Eurostat

Labour cost in Bulgaria relative to EU is the lowest among the countries considered. In fact, a worker in Bulgaria earns one tenth of what an EU-25 worker earns. However, relative labour productivity in Bulgaria is the lowest, since a Bulgarian worker produces one third of what the average EU-25 worker produces. Figures 3 and 4 indicate that Slovakia's second place in terms of relative unit labour cost can be attributed to high relative labour productivity, since relative labour productivity in Slovakia is the fourth largest compared to the countries considered.

The performance of Latvia and Lithuania relative to labour cost and productivity suggests that the position of those countries with regard to unit labour cost is primarily attributed to low labour cost and not high labour productivity. In Figure 3, Latvia and Lithuania are ranked third and fifth, respectively with regards to wages while they achieve very low rankings regarding labour productivity in Figure 4.

Although labour cost in Romania is the second lowest (see Figure 3), productivity is not high enough to reduce unit labour cost relative to competition (recorded in Figure 4). A worker in Romania produces one third of the output his European colleagues produce, while he is earning 15% of the average European wage.

The rankings of Estonia and Poland, in terms of relative unit labour cost, are in line with their rankings in terms of relative productivity. Thus, their unit labour cost performance is aligned to their performance in terms of labour productivity. A worker in Estonia (Poland) produces 51% (57%) of output the average EU-25 worker produces, while earning 23% (26%) of the average EU-25 wage.

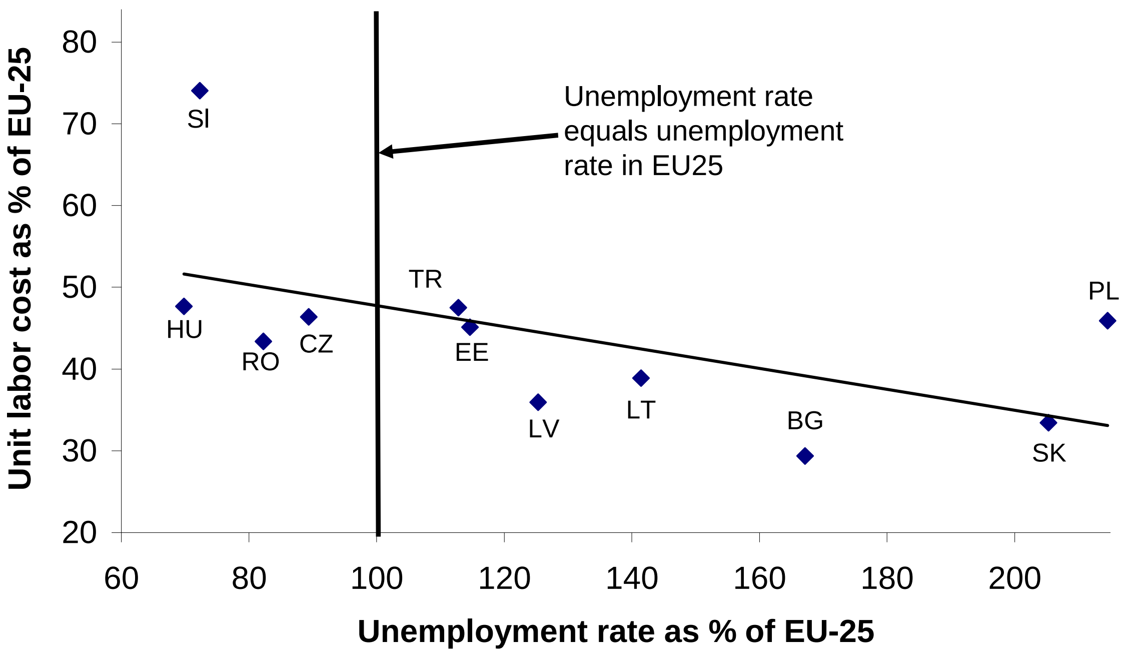
According to Figure 3, low labour productivity in Turkey is the main driver of the country's ranking with regards to unit labour cost. A Turkish worker produces 39% percent of the output average European worker produces, while he is paid 19% of the average European wage. Low wages in Turkey are not combined with higher labour productivity that could reduce the overall unit labour cost and result in a higher ranking for Turkey.

Unit labour cost in Slovenia is the closest to the European average. Labour productivity in Slovenia is very close to labour productivity of the average European worker. Labour productivity in Slovenia is not sufficient to reduce unit labour cost, since high labour productivity is combined with high wages relative to the countries considered.

5. Unit Labour Cost and Unemployment

One likely determinant of wage levels and ultimately of ULC in these countries is their unemployment rates, relative to EU-25 average. Economic theory suggests that higher unemployment exerts downward pressures on wages. On the contrary, a tightening of the labour market increases the bargaining power of workers and results in higher wages. Indeed, in Figure 5, a negative relationship is found between relative unemployment rate in each country and relative unit labour cost. As the unemployment rate relative to EU-25 increases, unit labour cost advantage relative to EU-25 strengthens. This is particularly true when the unemployment rate for the countries considered is above the unemployment rate of EU-25 at the right of the thick vertical line in Figure 5. As a matter of fact, the six countries with the lowest unit labour cost relative to EU are all at that region. Unit labour cost advantage is weaker for countries where

Figure 5. Unit labour cost and unemployment rate of each country considered relative to EU-25, averages of period 2001-2005



Abbreviations: BG Bulgaria, CZ Czech Republic, EE Estonia, HU Hungary, LV Latvia, LT Lithuania, PL Poland, RO Romania, SK Slovakia, SI Slovenia, TR Turkey
Source: AMECO and Eurostat

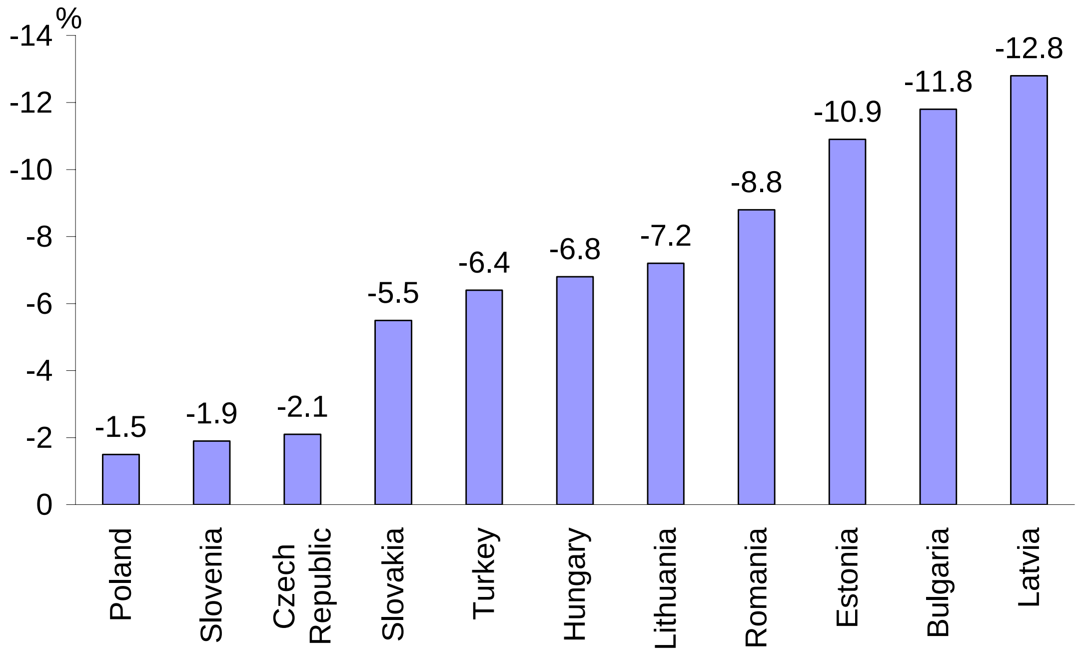
the unemployment rate is lower compared to the EU-25. This set of countries includes Hungary, Slovenia and Czech Republic.

6. Unit Labour Cost and inward FDI flows

Finally it is interesting to investigate the extent to which the countries under consideration do take advantage of their lower unit labour cost in order to attract foreign direct investment inflows (FDI). FDI is part of the financial account of the balance of payment and is used to finance the current account deficit. The countries considered in this study have significant current account deficits with most prominent that of Latvia's and Bulgaria's hovering at 12.8% and 11.8% of GDP, respectively (Figure 6, data for 2005). Increasing current account deficit intensifies the need of financing the deficit with FDIs that are considered to be longer term investments and less volatile sources of funding compared to portfolio investments. Low labour cost boosts international competitiveness and attracts more FDIs.

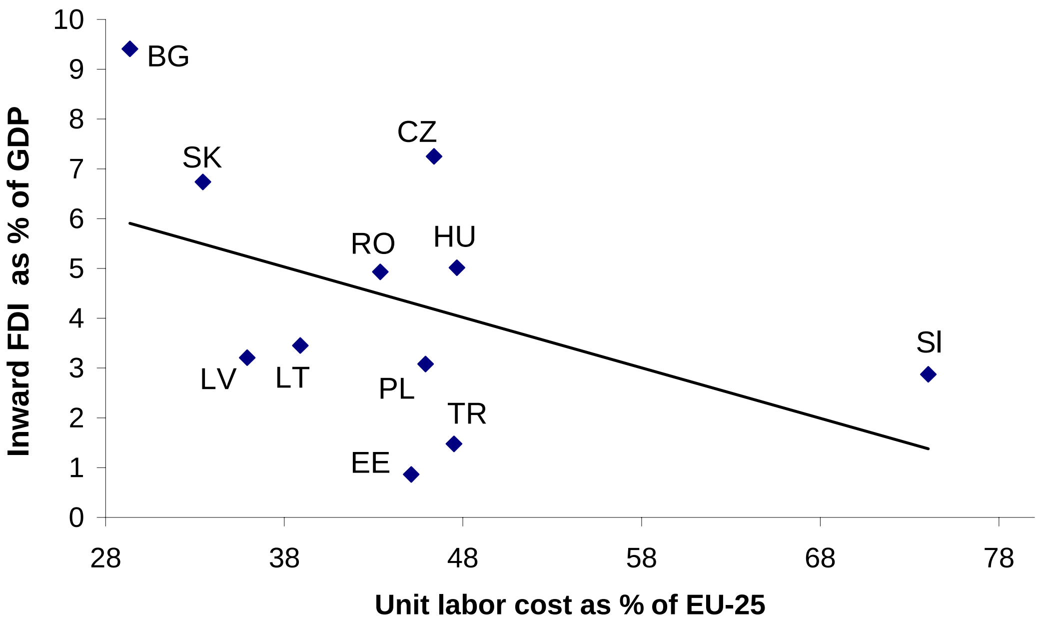
Indeed, in Figure 7, a negative relationship is recorded between (inward) FDI and relative unit labour cost. In fact, countries where unit labour cost is less than half that of the EU-25 average, perform better in attracting FDIs, while countries with unit labour cost more than half the EU-25 average do poorly in attracting FDIs. Nevertheless, the ULC gives only a partial account of the FDI flows. By comparing the rankings reported in Figure 2 and the results of Figure 7, we observe that the relationship between ULC

Figure 6. Balance of current account as percent of GDP, 2005



Source: AMECO and Eurostat

Figure 7. Inward FDI as percent of GDP versus unit labour cost relative to EU-25, average of period 2001-2005.



Abbreviations: BG Bulgaria, CZ Czech Republic, EE Estonia, HU Hungary, LV Latvia, LT Lithuania, PL Poland, RO Romania, SK Slovakia, SI Slovenia, TR Turkey
Source: AMECO, ECOWIN and Eurostat

and FDI (as % of GDP) is far from perfect. Bulgaria, for instance, has the lowest ULC and is also attracting the highest FDI (as % of its GDP). On the other hand the Czech Republic ranks 8th in terms of ULC, but has the second highest FDI flows. Hence, the conclusion from this rudimentary analysis of the linkages between ULC and FDI is that while ULC does play a role in FDI determination, this relationship is only tentative and can be overridden by other cultural or economic factors.

7. Concluding remarks

The present study attempted to rank the new EU members in Central and South Eastern Europe (Hungary, Poland, Czech Republic, Slovakia, Slovenia, Estonia, Lithuania and Latvia), the two acceded countries (Bulgaria and Romania), and Turkey in terms of their unit labour cost relative to EU average. The differences recorded are decomposed to differences in relative wages and relative labour productivity. The study records a strong positive relationship between relative wages and labour productivity implying that higher productivity is accompanied by higher labour cost. Thus, low cost countries should advance productivity of their labour force in order to enhance their international competitiveness.

In terms of relative unit labour cost, Bulgaria outperforms the countries considered since unit labour cost is 29% of the average EU unit labour cost due to low wages in Bulgaria where workers earn one tenth of what their EU colleagues earn. However, labour productivity is the lowest too implying that low labour cost countries suffer low labour productivity. This finding is common to all countries with low wages. In contrast, in Slovenia, unit labour cost is 74% of the EU-25 average, due to high wages per employee despite high labour productivity.

The study suggests that the comparative advantage of the low unit labour cost countries is primarily attributed to the high unemployment in those countries relative to the EU. High unemployment reduces wages which is the most important determinant of unit labour cost for the countries where the relative unit labour cost is the lowest e.g. Bulgaria, Slovakia, Latvia and Lithuania. Finally, it is argued that low unit labour cost countries attract a significant amount of FDI. Nevertheless, we presented evidence that low ULC is not automatically translated to high FDI flows, which implies that other economic forces can also affect foreign investment decisions.