# I
# EXTERNAL ENVIRONMENT

## International Financial Markets

Owing to the recovery of world economy and improved outlook **the stock markets** started to rise in March 2003 and such movement lasted until mid-October (see Figure 1.1). Of major economic areas Japan and the United States showed the fastest revival with major stock indices rising by 27 and 19%, respectively. Meanwhile, the rise in the stock markets of the euro area remained slower (10%) due to weaker economic growth. In the Nordic stock markets Sweden outpaced Finland with indices rising by 25 and 5%, respectively, from the start of 2003 to mid-October.

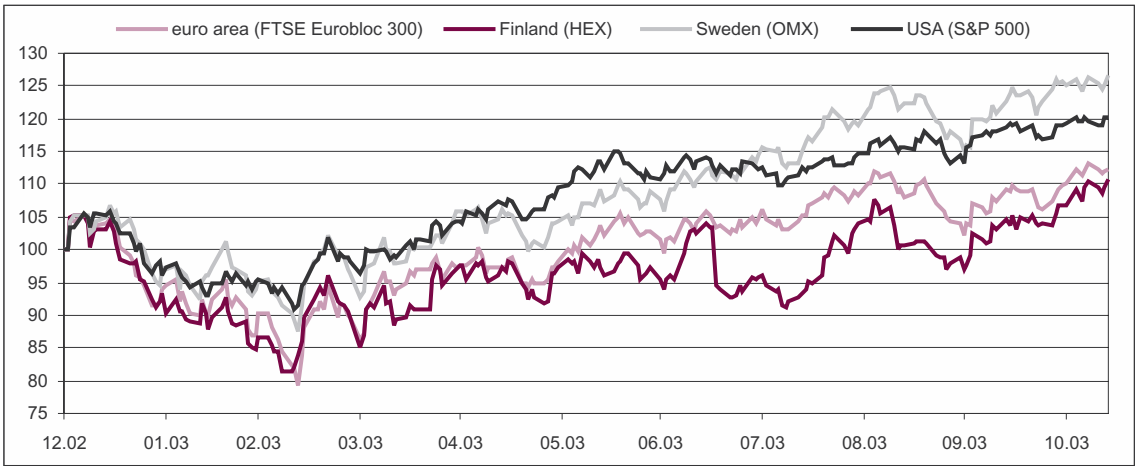


***Figure 1.1. Stock indices in the United States, euro area, Sweden and Finland (31 December 2002 = 100)***

*Source: EcoWin*

The continued growth of equity indices reflects investors' belief that global economic growth is going to pick up towards the end of 2003 and strengthen further in 2004. At the same time, a prerequisite for improved economic growth is continued investment growth along with improvements in the labour market. However, some important risks to the growth still remain, of which the issue of sustainable private consumption is the most intense, calling for stronger employment.

Changes in economic activity are also reflected in the dynamics of the **bond market**. In the first half of 2003, the actions of central banks were still clearly dominated by the trend of easing the monetary policy in order to boost economic growth. Another reason was consistent decline in the inflation rate along with the fear that such a downslide might lead to an undesirably low level of inflation; in the US there were even discussions about the threat of deflation.

Therefore, the central banks of the United States, the euro area and Sweden alike lowered key interest rates (by 25, 75 and 100 basis points, respectively), which led to lower short-term interest rates (see Figure 1.2). The latest decline in the key interest rates in the US and the euro area happened in June (to 1 and 2%, respectively), while in Sweden it occurred in July (to 2.75%).

Starting from the second quarter of 2003, the signs of increased economic activity appeared in the leading economic areas (the euro area was still an exception) accompanied by rising long-term interest rates: by

mid-October, 10-year interest rates had risen by 58 basis points in the United States from the start of the year, while in the euro area the increase was 15 basis points and in Sweden 21 basis points (see Figure 1.3).

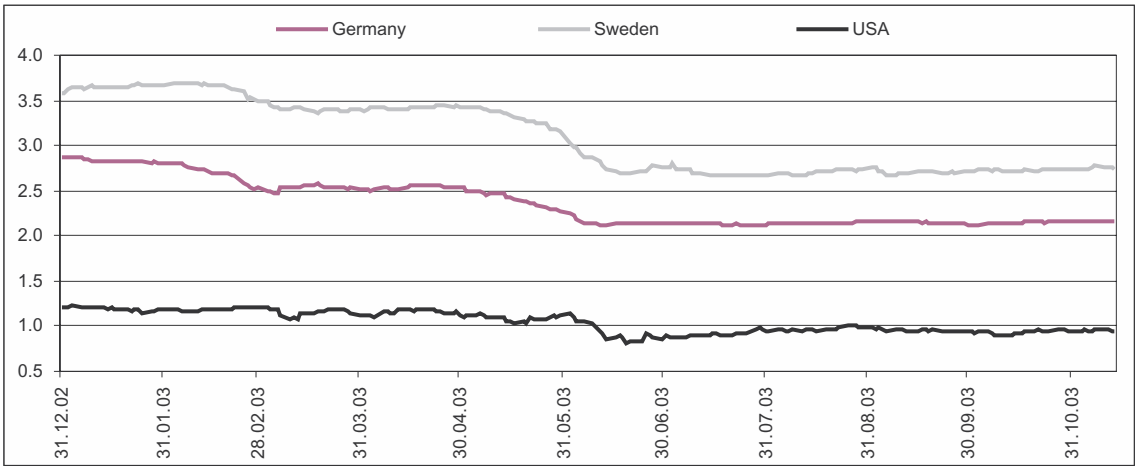


***Figure 1.2. 3-month interest rates in the United States, Germany and Sweden***

*Source: EcoWin*

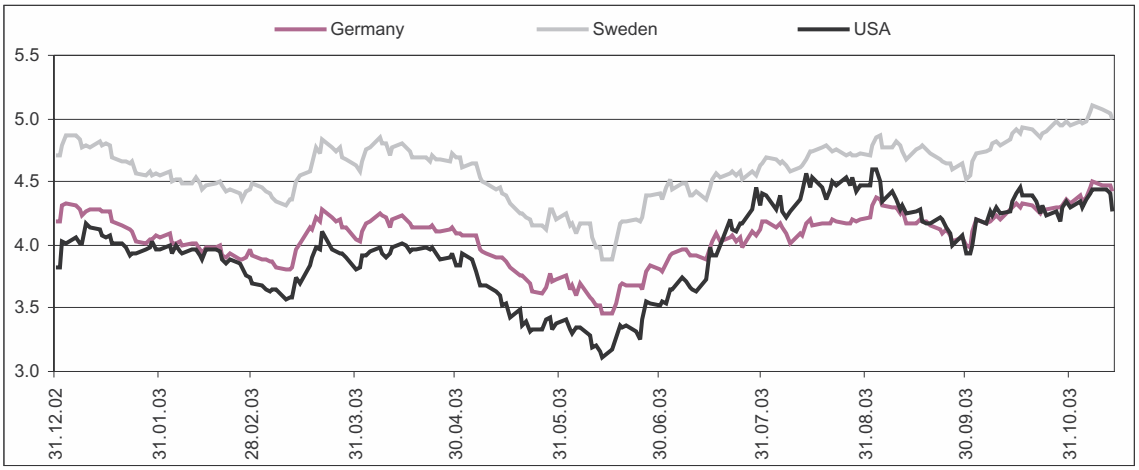


***Figure 1.3. 10-year interest rates in the United States, Germany and Sweden***

*Source: EcoWin*

However, economic recovery did not bring about significant changes in the monetary policy of central banks and key interest rates will probably not be raised in 2003. But the markets expect this to happen in 2004 – a rise of 25 basis points by the end of the second quarter of the next year has been predicted for the United States and the euro area alike. Such an expectation might seem a little too optimistic for the euro area, since economic growth remains sluggish and financial conditions have started to restrain growth due to the appreciating euro.

**In the currency markets** the main trend in 2003 has been the decline in the dollar exchange rate against other leading currencies (see Figure 1.4). It has been particularly significant against the euro (exchange rate has soared by 11.2% from the start of the year), as well as against the yen (exchange rate has increased by 7.7%). The current account deficit of the United States might soar to 600 billion dollars in 2003, which is why the country finds it increasingly difficult to finance the deficit through capital inflow from other countries.

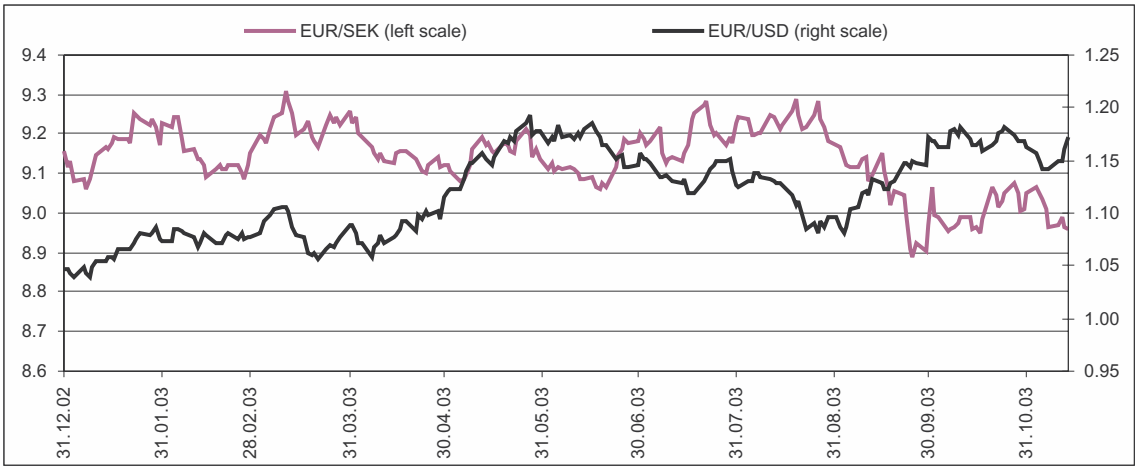


***Figure 1.4. Exchange rate of the euro against the Swedish krona and United States dollar***

*Source: EcoWin*

In order to reduce the imbalance, economic growth in the United States has to outpace that of the other countries significantly, or the US dollar has to weaken. Meanwhile, the United States are not interested in a plummeting dollar since this might lead to extensive sales of dollar assets, particularly shares and bonds held by foreign investors, which in turn might curb a boost in economic activity.

Regarding further dynamics in the exchange rate of the euro, it is getting increasingly difficult to predict a rise in the shorter term since economic growth in the euro area is currently lower than in the United States (the respective 2003 growth rate predictions stand at 0.5 and 2.6%). In longer term one cannot exclude further strengthening of the euro.

## Development of the European Banking Sector[1]

European banking sector has been operating in an environment of slow economic growth both in 2002 and 2003. Although profitability has been affected, the sector has so far been capable of managing quite well with the impacts of unfavourable environment. To maintain profitability and adequate solvency banks have been cutting costs, reorganising businesses and improving risk management. The deterioration in banks' asset quality has been relatively modest.

The decline in the **profitability** of EU banks continued in 2002 and banks' aggregate return on equity after tax and extraordinary items (ROE) decreased from 10.1% in 2001 to 8.6% in 2002. Regionally, the profitability of banks still remained diverse. While in 2002 the deterioration in profitability was affected by decline in non-interest income and deterioration in asset quality, the data on major banks indicates improvement in profitability in the first half of 2003 supported by cost cutting and reduction in loan loss provisions. Still, there is no full certainty yet whether these improvements in profitability indicate a beginning of a longer trend.

In 2002 the share of net interest income in total operating income of EU banks increased to 61.5%. Even though sluggish pace of economic activity has led to restrained **loan growth**, the growth in housing loans has helped the banks to compensate for the more modest growth in corporate lending. At the end of the first half of 2003, the annual growth rate of lending for house purchase was 7.0% and of lending to non-financial corporations 3.6% (at the end of 2002 these growth rates were 7.6% and 3.4% respectively). As for new housing loans, European lowest interest rates still tend to be those in Finland (see Figure 1.5).

[1] Source: EU Banking Sector Stability: Autumn 2003 Report.

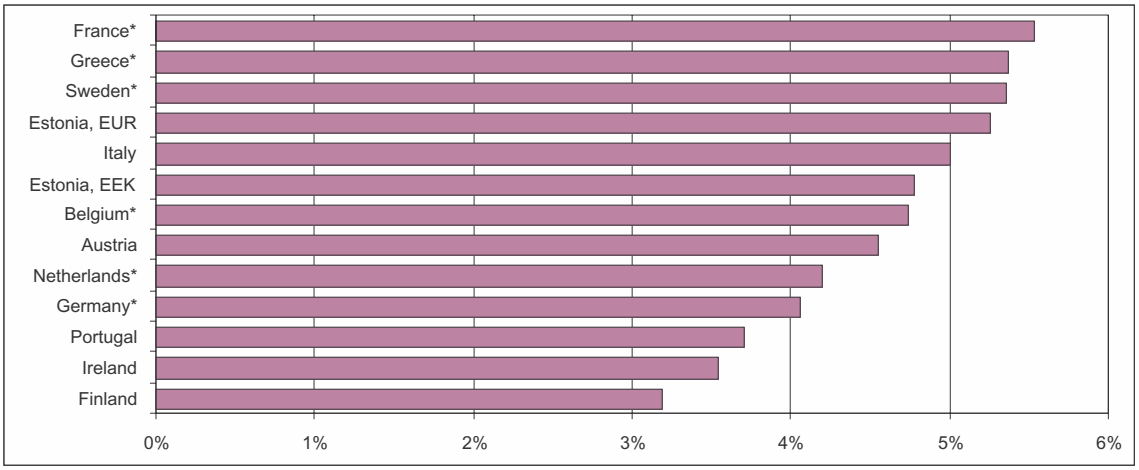


***Figure 1.5. Interest rates of new housing loans in Estonia and in several EU countries, June 2003 (unharmonised national statistics)***

** fixed interest rate*
*Sources: ECB and Eesti Pank*

In 2002 the aggregate cost-to-income ratio of banks decreased to 66.0%. The major banks' data reveal improved efficiency in the first half of 2003. As total expenses decreased in 2002, the share of staff expenses increased – staff expenses accounted for 53.8% of total expenses in 2002.

Regardless of the unfavourable economic environment, banks' **asset quality** remained in general still quite satisfactory in 2002. Non-performing and doubtful loans increased from an average 2.9% of total loans and advances in 2001 to 3.1% in 2002. Majority of problem loans originated from corporate sector; still, in some regions also slight decline in household loan quality was noted. If so far favourable interest environment has assisted clients at servicing their debt, from credit risk perspective it is important how possible growth in interest rates may affect clients' debt servicing capabilities.

Even though lending growth to the non-bank private sector has been decelerating (year-on-year growth has slowed from 5.7% at the end of 2002 to 4.5% at the end of the first half of 2003), corporate and household debt ratios have continued to increase. Stronger growth in housing loans has increased their share in banks' loan portfolios. Regarding the risks related to housing loans, it can be considered that in majority of EU countries loan-to-value ratios usually do not exceed 60–80%, and even though the possibility of problems in some regions cannot be fully excluded, it is still deemed unlikely that risks related to housing loans might currently threaten the overall stability of EU banking sector. However, banks' asset quality may be affected, should interest rates rise or households become more affected by corporate sector difficulties.

EU banks' aggregated **regulatory capital ratio** increased by 0.1 percentage points in 2002 – to 12.3%. The total capital ratio of large banks declined to 11.8%, the ratio of medium-sized banks increased to 12.5% and that of small banks to 15.9%.

Further developments in banking sector depend on future developments in European as well as global economy.