# *International Environment Fraught with Increased Downside Risks*

## Oil Price Dampens Economic Growth and Speeds up Inflation in Many Industrialized Economies

OECD economic growth came to 3.4% in 2004, a fairly robust rate compared to the long-term average. Since mid-2004, growth has slowed to a more moderate pace. The prime cause of the slowdown is the rise in the price of crude oil and crude oil products, whereas continued favorable financing conditions and relatively high budget deficits supported growth. The price of oil has roughly doubled since the beginning of 2004, repeatedly surpassing experts' forecasts. Most up-to-date forecasts see the oil price remaining high in the upcoming years; Consensus Forecasts predict a range of USD 45 to USD 75 at the end of 2006. On account of the elevated price of oil, inflation has risen in many countries; core inflation, though, has remained moderate so far. Obviously, various factors – such as more intense international competition on the labor and goods markets, existing excess capacity and high profit margins – have partly buffered the price pressure emanating from oil so far. In its most recent World Economic Outlook for 2005 and 2006, the International Monetary Fund (IMF) is optimistic about the world economic development, envisaging growth rates close to the long-term average and moderate inflation. According to the IMF, the global financial system will be quite resilient to shocks in the near future given the recent high profitability of financial intermediaries and of the corporate sector.

However, the continued positive outlook for growth is fraught mainly with downside risks, whereas the risks to inflation are mainly upside considering possible second-round effects of the high oil price. Apart from the effects of expensive oil, downside risks were caused by the disorderly adjustment of the U.S. current account deficit, which is generally regarded as too high, and a sharp, rapid rise in the maturity and inflation risk premia inherent in long-term bond yields; the latter could have a negative impact on real estate prices, which have spiraled upward in many countries.

Table 1 provides an overview of the changes in the economic outlook for the U.S.A., the euro area and Japan.

Table 1

**IMF World Economic Outlook of April and September 2005**

%

| | GDP growth | | | | Inflation rate | | | |
|---|---|---|---|---|---|---|---|---|
| | Apr. 2005 | Sep. 2005 | Apr. 2005 | Sep. 2005 | Apr. 2005 | Sep. 2005 | Apr. 2005 | Sep. 2005 |
| | 2005 | | 2006 | | 2005 | | 2006 | |
| U.S.A. | 3.6 | 3.5 | 3.6 | 3.3 | 2.7 | 3.1 | 2.4 | 2.8 |
| EU-12 | 1.6 | 1.2 | 2.3 | 1.8 | 1.9 | 2.1 | 1.7 | 1.8 |
| Japan | 0.8 | 2.0 | 1.9 | 2.0 | –0.2 | –0.4 | . . | –0.1 |

*Source: World Economic Outlook, IMF.*

### Stable Bond Markets, Gains in European and Japanese Stock Prices, Robust U.S. Dollar

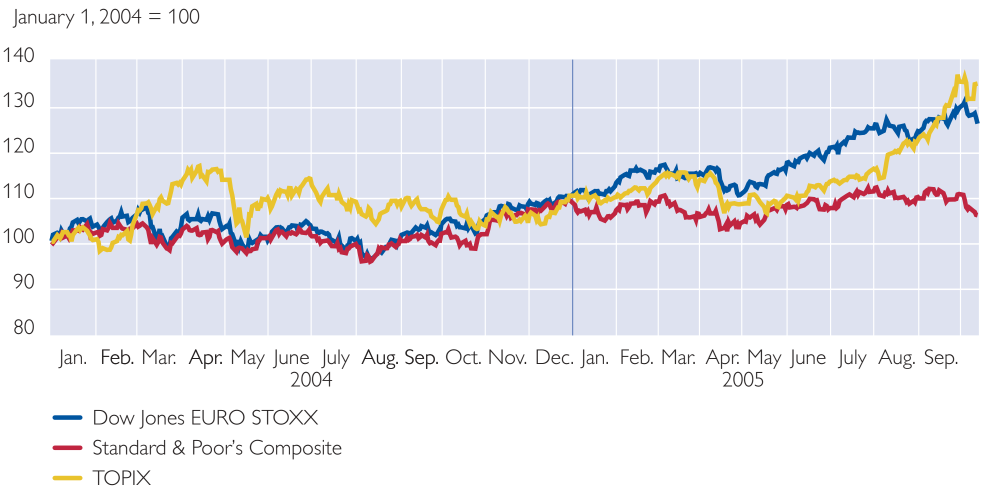
In the *money markets,* the U.S. Federal Open Market Committee lifted policy rates three times by a total of 75 basis points to 3.75% from May 2005, whereas comparable euro area rates remained unchanged at 2% and Japanese key interest rates were left at 0%. The U.S. Federal Reserve held out the prospect of further moderate rate increases given the need to preserve price stability and the continued supportive nature of the monetary policy stance. An increasingly debated topic on Japanese markets was the possibility that monetary policy would be tightened in view of a higher probability of a permanent return to positive core inflation figures. In the period from May through October 2005, the Governing Council of the ECB emphasized the need for strong vigilance with regard to the upside risks to price stability in the euro area. In the U.S.A., the 12-month money market rate continued to rise in tandem with policy rates; temporary reductions followed the natural disasters in the U.S. South. With euro area markets expecting policymakers to postpone key interest rate hikes or even to cut rates again, money market rates in the region declined until June 2005. From June to October 2005, money market rates augmented by some 20 basis points. In Japan, 12-month money market rates began to rise in June 2005, possibly reflecting the expectation that key interest rates would be raised in the future. The implied volatilities of options on euro- and U.S. dollar-denominated money market futures decreased further from May through June 2005 and stabilized at a low level from then on, signaling that markets were fairly confident about the development of key interest rates. Fairly precise market expectations about future short-term interest rates tend to contribute to lower long-term interest rates.

The yield curve in U.S. *government bond markets* flattened further from May through October 2005 in the U.S.A. because of the more pronounced rise in short-term interest rates. In the euro area, the yield curve shifted slightly with short-term rates going up and long-term rates falling, but continued to exhibit a slightly rising profile. Long-term interest rates in both regions remain low in a historical comparison. In particular in the euro area, these developments are partly based on the downward revision of market expectations about long-term growth. In Japan, yields on medium- and long-term maturity bonds rose, which resulted in a steeper yield curve and the elimination of its negative convexity. This development is likely to be linked to greater expectations that the Bank of Japan would end its policy of quantitative easing. Inflation risk premia derived from ten-year inflation-indexed bonds have climbed somewhat since July 2005 in the U.S.A. and in the euro area, apparently on account of the further rise in the price of oil, which has at least a temporary effect on inflation rates. Overall, it looks like inflation expectations on U.S. and euro area bond markets are firmly anchored at levels consistent with price stability. Long-term real interest rates, which are measured in terms of the yields on these bonds, have declined further in the euro area, whereas they have edged up in the U.S.A. Risk premia on corporate bonds sank marginally after having increased powerfully from March through May 2005 and are currently low compared to their long-run averages. Companies' good profit performance along with their lower propensity to invest and thus improved debt ratios are probably at the heart of this development. An increased willingness to assume credit risk to reach high rates of return in the hunt for yields may also have played a role.

In the *stock markets,* investors in European and Japanese equities saw powerful price gains of about 12% and 20%, respectively, from May through mid-October 2005; U.S. stock prices went up by only about 3%. Oil and gas sector stocks posted above-average gains. The positive development of Japanese stock price indices is attributable, among other things, to the improved economic outlook and perhaps also to the outcome of the elections to Parliament. Conversely, in the euro area, stock price gains were triggered more by good profitability figures and prospects. U.S. stock markets are likely to have suffered from the natural disasters affecting the South and from surging oil prices and prices for processed petroleum products, which weighed on investor sentiment and hence on prices.

Chart 1

**Stock Indices in the U.S.A., the Euro Area and Japan**




Source: Thomson Financial.

In the *foreign exchange markets,* the euro slipped against the U.S. currency and the Japanese yen from May to June, whereas it stayed fairly stable against the Swiss franc. The euro recovered fully against the yen, but only temporarily against the U.S. dollar. It then lost ground again vis-á-vis the U.S. currency and stabilized at a bit over 1.20 USD/EUR in mid-October. A key reason for the dollar's growing strength since May 2005 is probably the edge that U.S. dollar-denominated securities have over lower-yield financial instruments. The rejection of the EU constitutional treaty by referendum in France and in the Netherlands seems to have caused a temporary dip in the euro. The partial liberalization of the Chinese currency regime in July 2005 had no noticeable impact on the currency relations among the euro, the U.S. dollar, the Japanese yen and the Swiss franc.

## Net Capital Inflows to the Emerging Markets in 2005 Decline Substantially

### Economic Growth to Stay Robust though Weaker in 2005 and 2006

Economic growth in the *emerging market economies (EMEs)* is expected to average 6½ % in 2005, falling short of the record rate of 7.3% in 2004. However, the largely unchanged aggregated growth forecast for the region masks considerable changes in regional and individual forecasts that reflect the change in the price of oil and other commodities, the risks involved in manufacturing and trade globalization and country-specific factors. The cyclical outlook for the EMEs remains upbeat for 2006; the IMF has adjusted its forecast for real GDP growth upward slightly to 6.1% at a perceptibly higher rate of inflation. The key risks to economic developments in the EMEs lie in a high and volatile oil price, a rapid and marked rise in historically low interest rates in the industrialized countries and these countries' growing protectionism in the face of e.g. textile imports from China. The IMF called on the EMEs to roll back their debt ratios of currently 60% of GDP and to improve their debt structure. *Asia's* economies kept up their fast pace of growth in the first half of 2005, remaining the global engines of economic growth alongside the U.S.A. Exports have recently maintained a steady growth rate, and domestic demand has continued to show fairly strong growth momentum in most major economies in the region. At the same time, inflationary pressures remain moderate, as some of these countries had already started to tighten monetary policy in 2004. In China and in India, the authorities had chosen to do this by lifting interest rates and minimum reserve requirements for banks. Most recently, inflationary pressures intensified in some countries in the wake of the reduction in fuel subsidies. China's economic growth rate is expected to be only a bit lower in 2005 than in 2004 (9.5%) in spite of efforts to dampen growth (revaluation, expenditure limits) but should ease gradually in 2006 as exports and investment lose momentum. China's latest annual inflation figure came to just 1.3% (August 2005). Growth prospects remain bright in *India* as well. With domestic demand – in particular consumer spending – on the rise, the economic outlook for the region remains favorable, although high oil prices represent a considerable risk. Most countries incur great expenses to sterilize strong inflows from abroad – the IMF predicts that reserves will augment by almost USD 300 billion to nearly USD 1,200 billion in 2005 on account of continued strong current account surpluses and speculative capital inflows, covering more than four-fifths of annual imports – and are additionally threatened by the specter of capital losses in the event that the dollar slides further against the national currencies. In *Latin America,* powerful growth is set to continue, albeit at a more moderate pace, with exports and domestic demand as the main engines of growth. Because its external debt is comparatively high, the above-mentioned risk of a rise in long-term interest rates in industrialized countries applies particularly. In the *Middle East,* rising oil production and oil prices alongside substantial improvements in current accounts and budgets have bolstered economic growth. The development of infrastructure to support sectors other than oil manufacturing is making progress, but prudent fiscal and structural policies are required to efficiently absorb higher oil revenue. In the *CIS*

*(Community of Independent States)* real GDP growth has been slowing so far in 2005. While Russia's economy has benefited from the high price of oil, the investment climate deteriorated in conjunction with increased interventions by the authorities (one example is the Yukos affair) and because taxes in the oil sector were raised sharply, so that real GDP growth is expected to lose further momentum in 2006. Growth in the EMEs in *Europe* has remained robust, but has slowed down since mid-2004. Whereas economic growth in *Turkey* is set to ease to a more sustainable rate (5% in both 2005 and 2006) in parallel to ongoing disinflation, the current account deficit will expand further to over 5½ % of GDP. The IMF is supporting the country with massive financial aid to promote structural reform, above all of the banking and the social security systems. The opening of EU accession negotiations on October 3, 2005, may be considered a further stability anchor. According to the IMF, institutions and governance are being strengthened in several countries in *Africa*. Nevertheless, cautions the IMF, the international community must lend its support, above all by reducing subsidies in agricultural trade, and by providing additional financial aid. Risks specific to the region are the drop in cotton prices and the weak competitive position.

Table 2

**Private Capital Flows into Emerging Markets and Developing Countries according to the IMF[1])**

USD billion

| | 2002 | 2003 | 2004 | 2005[2]) | 2006[2]) |
|---|---|---|---|---|---|
| **Net capital flows according to the IMF** | 68.2 | 158.2 | 232.0 | 132.9 | 53.8 |
| **By instruments** | | | | | |
| Direct investment | 142.7 | 153.4 | 189.1 | 209.2 | 206.1 |
| Portfolio investment | –87.6 | –7.3 | 64.0 | –28.6 | –19.0 |
| Other flows | 13.0 | 12.1 | –21.1 | –47.7 | –133.3 |
| **By regions (countries)** | | | | | |
| Latin America (31) | 0.4 | 18.5 | 9.9 | 15.2 | 8.5 |
| Europe (13) | 55.8 | 48.1 | 58.0 | 72.3 | 58.6 |
| CIS (12) | –9.5 | 16.5 | 9.4 | –10.3 | 0.4 |
| Middle East (14) | –2.8 | 2.4 | 7.5 | –51.7 | –66.2 |
| Africa (46) | 3.4 | 10.7 | 14.2 | 22.7 | 18.3 |
| Asia (15) | 21.0 | 62.0 | 132.9 | 84.6 | 34.1 |
| **Memorandum item** | | | | | |
| Current account balance | 143.8 | 229.9 | 319.4 | 490.2 | 570.9 |
| Reserve assets[3]) | –185.7 | –364.6 | –517.4 | –510.5 | –506.8 |
| of which China | –75.7 | –117.2 | –206.3 | –210.0 | –160.0 |

*Source: World Economic Outlook, IMF.*

*[1]) This table shows aggregated balance-of-payments data sets of 131 nonindustrialized countries, including the major 44 EMEs. Given repeated revisions of the national balances of payments, which also affect the data sets of previous years, the capital flows may differ substantially afterwards.*

*[2]) Forecast.*

*[3]) – = increase.*

Whereas according to the IMF dynamic worldwide growth fostered *net capital inflows of the private sector* to the EMEs in 2004, these inflows are likely to decelerate sharply overall in 2005. Among these capital inflows, *net inflows of FDI* (foreign direct investment) have risen in nearly all regions,

Table 3

**Claims of BIS Reporting Banks on Central and Eastern Europe and on Turkey [1])**

| % of GDP of the recipient country | Austria | Germany | Italy | France | Nether-lands | Sweden | Belgium | United King-dom | Europe[2]) | U.S.A. | Japan |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **CEE plus Turkey** | 2.1 | 9.8 | 3.9 | 2.8 | 2.4 | 1.6 | 1.9 | 1.3 | 29.7 | 1.9 | 0.5 |
| **Central European EU Member States** | | | | | | | | | | | |
| Poland | 1.6 | 13.8 | 7.1 | 1.3 | 5.0 | 0.8 | 3.7 | 0.4 | 40.5 | 3.3 | 0.9 |
| Slovakia | 7.6 | 12.6 | 21.3 | 1.4 | 7.7 | 0.1 | 8.3 | 0.2 | 60.7 | 2.5 | 0.2 |
| Slovenia | 5.5 | 13.4 | 2.2 | 5.7 | 0.4 | 0.0 | 4.5 | 0.2 | 32.8 | 0.1 | 0.5 |
| Czech Republic | 4.5 | 11.6 | 1.9 | 18.4 | 3.4 | 0.0 | 2.8 | . . | 45.3 | 2.4 | 0.3 |
| Hungary | 5.6 | 27.3 | 8.4 | 2.8 | 2.7 | 0.1 | 9.3 | 0.7 | 59.1 | 2.5 | 0.8 |
| **Other CEECs** | | | | | | | | | | | |
| Bulgaria | 2.0 | 10.6 | 6.4 | 2.3 | 2.0 | 0.1 | 0.3 | 0.5 | 33.6 | 1.6 | 0.2 |
| Croatia | 10.2 | 20.5 | 45.1 | 0.7 | 0.6 | 0.0 | 0.6 | 0.8 | 79.7 | 0.8 | 1.0 |
| Romania | 1.4 | 5.3 | 1.9 | 4.3 | 4.4 | 0.3 | 0.1 | 0.3 | 22.4 | 1.3 | 0.1 |
| Russia | 0.4 | 4.0 | 0.2 | 0.8 | 0.9 | 0.1 | 0.1 | . . | 8.5 | 1.0 | 0.3 |
| **Turkey** | 0.1 | 4.6 | . . | 1.5 | 1.3 | 0.1 | 0.5 | . . | 12.4 | 1.9 | 0.6 |

*Source: BIS, IMF and OeNB calculations.*

*Note: The claims shown here correspond to the "Consolidated international claims of BIS reporting banks" released by the BIS (BIS Quarterly Review September 2005, Table 9B). The BIS statistics cover direct cross-border claims, i.e. they do not include guarantees that parent banks have assumed for their subsidaries abroad.*

*[1]) As at end-March 2005.*

*[2]) The column "Europe" comprises the countries of origin listed here as well as Denmark, Greece, Ireland, Portugal, Finland, Spain, Switzerland and Norway.*

not least because economic agents see good profitability in EME mergers and acquisitions and in holdings of privatized enterprises. FDI inflows concentrated on the oil and gas sector, telecommunications and the banking sector. The increase in net FDI inflows conceals the fact that FDI outflows – in particular from Asia – are also growing rapidly; these investments are targeted at the development of new markets and are supposed to ensure the supply of intermediate goods. According to the IMF, considerable outflows are on the horizon for the volatile item *portfolio investment* and *other flows,* such as *bank loans, trade credits and derivatives,* which will reduce overall net private inflows. These outflows stem from the fact that some regions increasingly resort to local capital markets to close financing gaps. The investment of high revenues by oil-exporting countries, stepped-up investment in external markets by Asian countries (above all China) and the accelerated repayment of debt by Russia and Poland within a Paris Club rescheduling agreement reinforce the rise in outflows. Despite markedly lower inflows, *Asia* remains the region which receives the main share of net capital inflows to EMEs. In addition to the *Middle East, CIS* countries range among the net exporters of capital in the wake of higher income from oil and gas exports and in connection with Russia's accelerated repayment of debt. Capital inflows into the other regions have risen.

## Claims of Austrian Banks on Central and Eastern Europe Exceed the International Average

At the end of March 2005, 58% of the Austrian banking sector's total claims on EMEs and developing countries were on the ten new Member States, four-fifths on the new EU Member States, the Central and Eastern European Countries (CEECs) and the CIS.

At the end of March 2005, Austrian banks ranked fifth among international banks with claims on the CEECs and Turkey as based on the Bank for International Settlements' (BIS) most recent data,[1] which do not include Austrian banks' subsidiaries claims and the guarantees Austrian parent banks have assumed for their subsidiaries in these countries.

### Spreads between Eurobonds and Benchmark Bonds Narrow Further

Buoyed by investors' ongoing low risk aversion vis-á-vis EMEs and the continued hunt for higher yields in view of low long-term interest rates in the U.S.A. and Europe, the mood in international eurobond markets remained very bullish in the first nine months of 2005. Other positive factors were improved fundamentals and debt profiles (declining interest burdens, extensions of maturities and the early refinancing of debts due in the future) of issuer countries, which resulted in rating upgrades and in turn in a broadening of the investor base. Strategic reallocation by institutional investors such as mutual and pension funds following changes in legal provisions and in view of the above-average profitability of eurobonds in recent years also had a positive impact.

According to the IMF's forecast, the overall volume of net portfolio investment in the EMEs will shrink in 2005. This decrease, however, is attributable to the reinvestment of oil revenue by the oil-exporting countries (including Russia); holdings of eurobond issues of EMEs continue to expand. The average yield differential between *U.S. dollar-denominated government bonds* issued by EMEs and U.S. benchmark bonds (measured by J.P. Morgan's EMBI Global Index) narrowed from roughly 350 basis points at the beginning of the year to 235 basis points at the end of September 2005. This contraction occurred mainly in the wake of developments since mid-2005 following market turbulences between the beginning of March and early June 2005. Spreads declined most for bonds of Latin American issuers, a consequence of the sharp reduction of differentials on the bonds of Argentina and the Dominican Republic after successful conclusion of rescheduling efforts. Moreover, the spreads on CEE issuers' bonds sank considerably from their already low level at the beginning of 2005. Russian and Ukrainian government bonds topped the list, with spreads falling by 121 basis points and 98 basis points to 90 basis points and 157 basis points, respectively, from the end of 2004 to end-September 2005. A notable occurrence was the issue of U.S. dollar-denominated bonds by Serbia and Montenegro in April 2005 (as part of the conversion of the country's "old debt" to the London Club of commercial creditors into eurobonds). These bonds featured a yield spread of 230 basis points at end-September 2005, much like that of Turkish bonds. The narrowing of spreads helped boost the profitability of U.S. dollar-denominated eurobonds. The overall index shot up by 8.7% (not annualized) in the first nine months of 2005 following a surge by 11.7% in 2004. Total returns were highest for CEE issuers' bonds at 10.4% (2004: 10.6%) followed by Latin American bonds at 8.7%. Russia was first

[1] *The consolidated BIS statistics on international banking transactions are the most comprehensive source of aggregated data on banks' cross-border claims and provide internationally comparable measures of the country risk assumed by individual countries' banking sectors. Recent improvements of these statistics include the provision of more detailed information about risk transfers.*

Tabelle 4

**Eurobonds: Spreads to Reference Bonds and Development of Returns by Regions**

| | EMBI Global (in USD) | | | | | | Euro EMBI Global (in EUR) | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Share of total index in % | Yield differential in basis points | | Total return in % | Rating | Duration | Share of total index in % | Yield differential in basis points | | Total return in % | Rating | Duration |
| | Sep. 30, 2005 | Sep. 30, 2005 | Change since the beginning of the year | Since the beginning of the year | Sep. 30, 2005 | Sep. 30, 2005 | Sep. 30, 2005 | Sep. 30, 2005 | Change since the beginning of the year | Since the beginning of the year | Sep. 30, 2005 | Sep. 30, 2005 |
| Overall index | 100.0 | 235 | –112 | 8.7 | BB+ | 6.62 | 100.0 | 70 | –34 | 7.3 | BBB– | 5.54 |
| Africa | 3.7 | 247 | –38 | 5.5 | BBB | 3.94 | 2.9 | 64 | –22 | 6.4 | BBB+ | 5.06 |
| Asia | 12.1 | 253 | –13 | 6.9 | BBB– | 6.07 | 4.9 | 42 | –84 | 6.8 | BBB | 4.22 |
| Europe | 24.3 | 136 | –81 | 10.4 | BB+ | 6.81 | 63.3 | 38 | –14 | 7.0 | BBB | 5.90 |
| Latin America | 58.4 | 267 | –148 | 8.7 | BB | 6.90 | 28.9 | 92 | –148 | 8.3 | BB+ | 5.02 |
| Middle East | 1.6 | 304 | –30 | 5.1 | B– | 3.50 | 0.0 | × | × | × | × | × |

*Source: Bloomberg, J.P. Morgan, OeNB calculations.*

*Note: Spread and return levels and developments, as well as other index features differ between the EMBI Global und Euro EMBI Global indices because they cover different currencies, instruments, countries, maturities, etc. and are based on different investor structures. The rating is calculated as the average of Moody's, Standard & Poor's and Fitch's ratings for long-term government foreign currency liabilities and are given in the rating categories Standard & Poor's uses.*

among CEE issuers, with total returns on its bonds at 14.1%. Ukrainian and Turkish eurobonds posted total returns of 7.8% and 6.6%, respectively.

Positive investor sentiment on the eurobond market is also reflected in *euro-denominated government bonds* (measured by J.P. Morgan's Euro EMBI Global index). However, spread and return levels and developments differ between the two indices because the indices cover different currencies, instruments, countries and maturities and are based on different investor structures. For example, the average spread of the Euro EMBI Global index decreased from 104 basis points from end-2004 to 70 basis points at end-September 2005, much less than in the case of the EMBI Global index, largely because it started from a far lower level. Nevertheless, the dynamics of both indices' developments were similar during the first nine months of 2005, as the contraction of spreads for euro-denominated bonds also occurred mainly from mid-2005 onward after a temporary expansion in the second quarter. Latin American bonds experienced the strongest narrowing of spreads (–148 basis points) followed by Asian eurobonds (–84 basis points). A closer look reveals that among Latin American bonds, Brazilian bonds exhibited the most pronounced spread reduction; among Asian bonds, it was Philippine bonds. The yield spreads of CEE issuers' bonds, which represent the core of the Euro EMBI Global index, fell least, dropping by just 14 basis points to 38 basis points at the end of September 2005. Spread reductions of Turkish (–46 basis points), Croatian (–25 basis points) and Romanian (–22 basis points) bonds surpassed the CEE average. Nevertheless, with returns of +7.0% (not annualized) in the first nine months of 2005 (2004: +10.8%), CEE eurobonds posted a performance that was only marginally below the Euro EMBI Global index average of +7.3% (2004: +11.8%). By comparison to their Asian counterparts, CEE eurobonds achieved higher returns despite the significantly smaller decline in spreads, as they had higher durations. Only Latin American eurobonds posted above-average returns.

In the upcoming months, the development of bond yields in the U.S.A. and in the euro area represents the greatest source of uncertainty for the eurobond market. A rise in long-term interest rates could act as a damper on the quest for higher-yield, higher-risk investment options. Apart from rising long-term interest rates, a (further) sharp increase in short-term interest rates could prompt investors to square eurobond positions financed with credits, as they did to a limited extent in the second quarter of 2005. The currently historically low spreads would also support a downward price correction. However, improved fundamentals and market structures along with the experience of the recent past would seem to suggest that the risk of a chaotic price correction is fairly limited.

## Appreciation Pressure in Central and Eastern Europe Eases

### Development of Exchange Rates Mixed across CEE

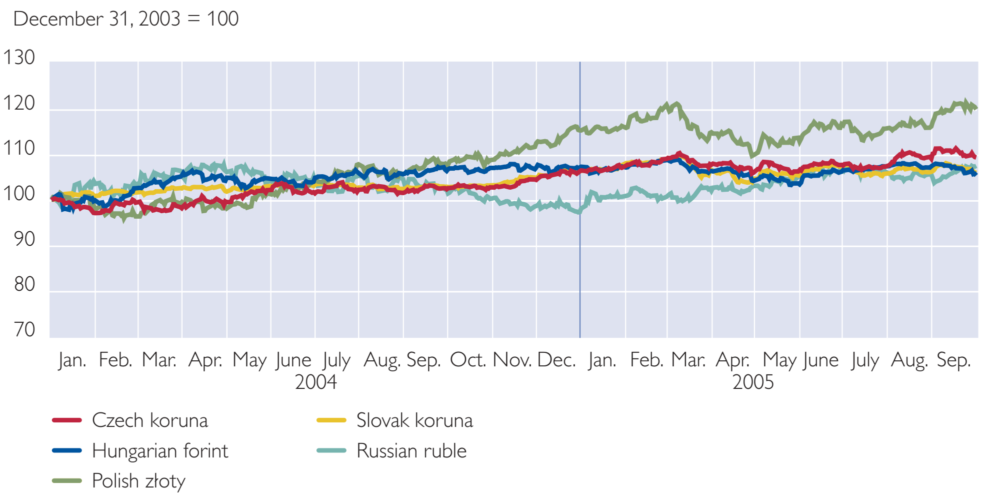
After the Czech koruna, the Hungarian forint, the Polish złoty and the Slovak koruna had appreciated quite substantially against the euro in 2004, the exchange rate movements of these currencies were far smaller from the end of 2004 until end-September 2005. The *Polish złoty,* which had climbed by 15.2% against the euro in 2004,[2] advanced by 4.0% in the nine-month period. The *Czech koruna,* which had risen by 6.6% against the euro in 2004, strengthened by a further 2.7%. The *Hungarian forint* and the *Slovak koruna,* which had gone up by 7.2% and 6.3%, respectively, against the euro in 2004, experienced a slight turnaround, with the forint weakening by 1.8% and the koruna by 0.4% against the euro in the first nine months of 2005. Still, all four currencies followed roughly the same pattern: a relatively powerful appreciation between the end of 2004 and the beginning of March 2005 was followed by weakness as long-term U.S. dollar-denominated government bond yields temporarily peaked; this languid phase lasted until the end of April 2005 for the Czech koruna, the Slovak koruna and the Polish złoty and until the end of May 2005 for the Hungarian forint. All four currencies recovered during the summer months of 2005. Since the beginning of September 2005, the Czech, Slovak and Hungarian currencies lost some ground, whereas the Polish złoty stabilized at a relatively high level. The appreciation of the *Romanian leu,* which had commenced at the beginning of November 2004, continued until the beginning of March 2005. Interest rate cuts and numerous central bank interventions provided a phase of stability until the currency resumed its fast-paced appreciation between mid-July and mid-August 2005. The central bank moved in to contain the rise, but the resulting correction did not fully break the appreciation trend and the leu's re-newed appreciation thereafter implied a saw-tooth pattern. The *Croatian kuna* also gained 2.8% on the euro from end-2004 to end-September 2005. The uptrend lasted until about mid-May 2005 and was followed by a broadly stable exchange rate during the summer and a slight weakening from the beginning of August and the end of September 2005. The *Russian rubel* firmed markedly against the euro between end-

[2] *Exchange rate developments are stated in euro per local currency unit.*

2004 and end-September 2005 (+9.6%). With the exception of corrections during July and August 2005, this trend was more or less continuous. The rubel's movement against the U.S. dollar was a mirror image of its development against the euro, albeit less pronounced overall, as the rubel's decline against the U.S. currency only came to around 2.7%. The reason for this mirroring of trends is that the Russian central bank has oriented its exchange rate policy on a currency basket containing the U.S. dollar and the euro since the beginning of February 2005. The euro's weight in this currency basket was raised in several steps from 10% originally to 35% most recently. Since the beginning of February 2005, the rubel has remained broadly stable against the currency basket. The *Slovenian tolar* has remained largely stable against the euro ever since Slovenia entered exchange rate mechanism II (ERM II) in June 2004. The slight but continuous upward trend which had emerged at the beginning of October 2004 lasted until the end of June 2005. Since then, the currency has stabilized at about 0.05% to 0.10% from the central rate in the strong part of the fluctuation band of ±15%. There were no changes to the peg of the *Bulgarian lev* to the euro within the framework of a Currency Board Arrangement during the period under review.

Chart 2

**Exchange Rate: Euro per Unit of National Currency**




*Source: Bloomberg.*

The development of the *combined current and capital account balance* relative to GDP supported the exchange rate of the Czech, Hungarian, Polish and Slovenian currencies. During the first half of 2005, deficits on the combined account decreased in all four countries, in some cases markedly, primarily because net goods and services improved despite the rise in import prices fueled by the high price of oil. Only in Poland did the income and transfer balances also improve noticeably. As a result, the need for external financing was close to zero in all these countries except Hungary in the first half of 2005; Slovenia even posted a marginal surplus on its combined current and capital account. However, Hungary's deficit on the combined account remained very high at 7.1% of GDP and continues to feed into a rise in external debt, as FDI inflows are not high enough to offset the deficit. In Slovakia, the combined current account and capital account balance deteriorated perceptibly in the first half of 2005; the resulting net deficit ratio to GDP augmented from 2.5% in the first half of 2004 to 6.9% in the first half of 2005. Roughly half of this worsening can be pinpointed to the goods and services balances, the other half to the income and transfers balances. At least part of the deterioration of the income balance is attributable to a change in the compilation method that allows for an improved representation of reinvested profits as an outflow in the income balance and an inflow under direct investment. Foreign direct investment covered approximately two-thirds of financing requirements in the first half of 2005. The external balances of Bulgaria, Romania and Croatia also deteriorated compared to the first-half result for 2004; the half-yearly deficits in Bulgaria and Croatia are traditionally especially high due to seasonal influences. In parallel to the deterioration of the current account, the inflow of FDI to Bulgaria and Romania also weakened.

Given the decline in interest rates in recent years, the interest rate differential puts less and less appreciation pressure on most CEECs' currencies, but has remained a factor in currency appreciation. In Romania, where the high spread has entailed higher capital inflows and a sharp currency appreciation since October 2004, key interest rates were cut several times in 2005. As a result, the interest rate differential to the three-month euro area interest rate dropped from some 15.0% at the beginning of the year to 4.5% at end-September 2005. In tandem with the central bank's intervention in the foreign exchange market, this decline helped alleviate the appreciation pressure on the leu, an appreciation being undesirable in view of Romania's external imbalances. But the central bank is not likely to want the currency to lose too much strength, either, as this would make it harder to reach the inflation target of 5% for the end of 2006. The shrinking interest rate differentials, which were reinforced in some countries by central banks' operations to dampen credit demand, may also explain the moderation of foreign currency lending to domestic companies and households in recent months. Though the pace of lending has remained robust in several countries, the conversion of foreign currency loans into local currency is likely to cause less and less appreciation pressure.

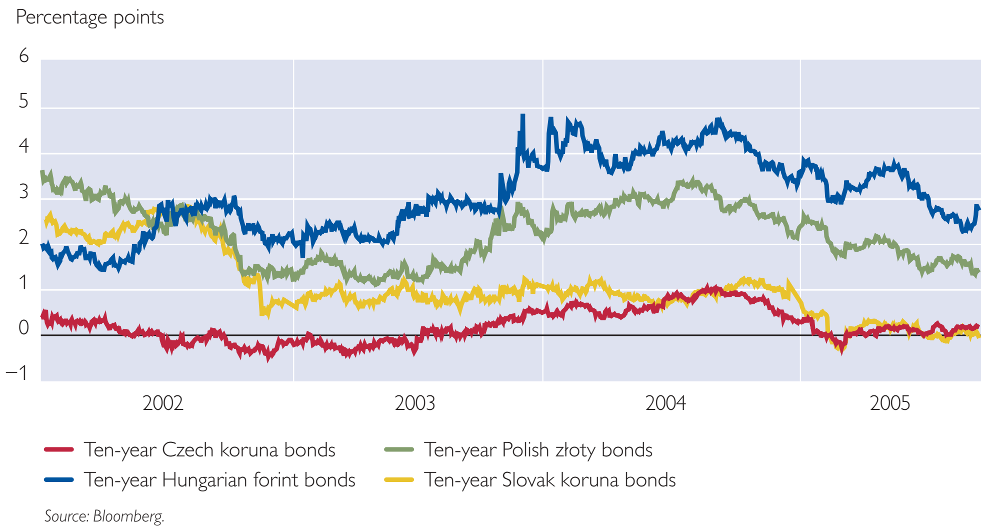
Overall, the improvement of the external position in several countries and the slight correction of the appreciation which took place in 2004 in some countries should markedly reduce the probability of most CEE currencies to depreciate massively. Currently low international interest rates foster capital inflows into the EMEs despite the narrowing of interest rate differentials. However, it cannot be ruled out that a gain in U.S. and euro area (long-term) interest rates dampens capital flows to the region, causing a shift in the equilibrium between the interest rate spread and the exchange rate level, much as had already been the case temporarily in the second quarter of 2005. Above all the currencies of countries which depend on net inflows of portfolio investment or other investment to cover high current account deficits that are only insufficiently offset by FDI inflows could be affected if the present favorable capital market environment deteriorates. For this reason, the reduction of external debt to a sustainable path remains a key economic policy concern in individual countries. For the new EU Member States, exchange rate stability is a fundamentally important issue, also in view of their eventual adoption of the euro in the future. Three new EU Member States (Estonia, Lithuania, and Slovenia) joined ERM II in mid-2004, three other countries (Latvia, Malta, Cyprus) have been participating in ERM II since May 2005.

### Yield Differentials of Government Bonds Denominated in National Currencies Fall Further against Euro Area Benchmark Bonds

The spreads of ten-year local currency-denominated government bonds against euro area benchmark bonds were lower at the end of September 2005 than at the beginning of the year in the *Czech Republic, Hungary, Poland* and *Slovakia,* although all four markets experienced a temporary rise from March through May 2005 largely in parallel with the weakening of their currencies and turbulence on the euro-bond markets in the wake of the interim increase in long-term U.S. government bond yields. The yield gap contracted in the first weeks of 2005 in the Czech Republic and in Slovakia: the yield differential to the euro area as measured by the harmonized long-term interest rate statistics for convergence assessment purposes plunged from about 25 basis points and 70 basis points, respectively, at the beginning of the year, even turning negative mid-March 2005. After the slight upward correction which followed, Czech and Slovak ten-year bond yields moved roughly on a par with those of the euro area. The yield differential on Polish government bonds fell by and large continuously from around 230 basis points at the beginning of 2005 to roughly 140 basis points at end-September 2005. The yield spread of Hungarian government bonds sank by a total of some 90 basis points, but at 270 basis points at end-September 2005 it was far higher than its Polish counterpart. During the last days of this period, the spread had widened by about 50 basis points.

Chart 3

**Yield Spreads against Euro Area Benchmark Bonds**




*Source: Bloomberg.*

The reduction of the yield differentials to the euro area and the stabilization of Czech and Slovak yields at the euro area level were fostered by the drop in *inflation* in all four countries. In contrast to earlier fears, after inflation had quickened in the first half of 2004, there were no inflationary second-round effects of the oil price rise and of the increases in indirect taxes linked to EU membership. On account of the reduction of real wage growth and the resulting weakening of consumer demand in all these countries except Slovakia as well as favorable base effects as a consequence of EU entry in 2004, the decrease in inflation which started in the second half of 2004 continued in 2005. In August, the Czech Republic, Poland and Slovakia posted lower inflation figures than the euro area. Only in Hungary did the 3.5% rate of inflation exceed the euro area average by 1.3 percentage points. But the persistent rise in energy prices was reflected in these countries' inflation rates in September 2005, especially as energy represents a noticeably higher share of the consumer price basket there than in the euro area. The inflation risk is upward, above all because inflation has already reached quite a low level. First, the lastingly high oil price levels and especially the further rise in prices of oil and processed petroleum products in the third quarter may well have an impact on the general price level and on inflation expectations. Second, in the second quarter of 2005, consumer spending began to recover in the Czech Republic and in Hungary, and it may accelerate further despite the dampening effect of high energy prices not least because of fiscal stimuli in the forefront of the parliamentary elections in 2006. Moreover, investment shot up in Hungary, partly on account of animated public investment growth. In Slovakia, growth was already powered by domestic demand, and especially by fixed capital formation, in the second quarter of 2005. The dynamic growth of lending to the private sector reinforces the assumption that domestic demand will accelerate in the Czech Republic and Slovakia and to a smaller degree also in Hungary. Third, annual wage growth in industry in Slovakia was fairly high at almost 9% in the first half of 2005, above all considering that labor productivity in industry did not increase year on year. On the other hand, however, industrial unit labor costs in the Czech Republic, Hungary and Poland have been stagnating or sinking. In all four countries, favorable inflation developments have created room for a reduction of key interest rates. In response to inflation and exchange rate developments, Česká národní banka cut its key interest rate by 25 basis points each at the end of January, at the beginning of April and at the end of April, bringing it to 1.75%. At the end of October 2005, however, the central bank raised the rate to 2%, the same level as in the euro area. In Slovakia, the key policy rate has stood at 3.0% since March 2005. Since the beginning of 2005, the Polish central bank has successively lowered the official rate by a total of 200 basis points to 4.5% most recently, whereas Magyar Nemzeti Bank cut the key rate by a total of 350 basis points to 6.0% until the end of October 2005.

In the Czech Republic, Poland and Slovakia, *budget developments* during the period to end-September 2005 had a neutral to positive effect on the bond market. Deficit data for 2004 were partly revised downward (between the fiscal notifications of March and September 2005), and some deficit forecasts for 2005 were also revised downward slightly. In the Czech Republic, though, the expansion of the budget deficit from 3.0% of GDP in 2004 to 4.8% of GDP in 2005 is still being expected; this expansion is in line with the updated Czech Convergence Programme of November 2004. All three countries envisage reducing their debt in 2006, but the deficits in the Czech Republic are likely to remain above the 3% mark and only slightly below in Slovakia despite robust economic growth. In Poland, the new government's steps after the parliamentary elections of end-September 2005 will be decisive in determining the budget balance targeted for 2006. Unlike in the three other countries, budget prospects for Hungary worsened continuously in the course of 2005. Not only was the deficit for 2004 revised upward sharply from 4.5% in the March 2005 fiscal notification to 5.4% in the September 2005 notification (exclusive of the cost of the pension reform of 0.9% of GDP before revision and 1.1% of GDP after revision). Moreover, the forecast for 2005 was heavily adjusted from 3.6% of GDP to 6.1% of GDP (exclusive of 1.3% of GDP attributable to the cost of the pension reform) due to the inclusion of expenditure items following Eurostat's decision of mid-September 2005 and due to revenue shortfalls and expenditure overruns. For 2006, a deficit reduction to 4.7% of GDP (excluding 1.4% for pension reform costs) is targeted. Hungary's Convergence Programme of December 2004 had scheduled a gradual deficit reduction of 0.7 percentage point each in 2005 and 2006 to 3.1% of GDP,[3] but the figures currently available show a deficit rise of 0.7 percentage point in 2005. Even if Hungary succeeds in bringing the deficit down by 1.4 percentage points as planned in the election year 2006, the deficit would still be 1.6 percentage points higher than the originally envisaged target. The budget developments prompted the Hungarian government to question the date for the adoption of the euro – 2010 – at the end of September 2005. A decision is to be taken by the end of 2005; the market is speculating on a delay to 2012 or 2013. The bad news about the budget and the prospect of a delay in the adoption of the euro weighed more and more on the Hungarian currency and bonds in the second half of September 2005. Conversely, Czech bonds remained unaffected by the government's announcement of the beginning of September 2005 to envisage euro adoption not in 2009 to 2010, as originally scheduled, but in 2010. Slovakia has stuck by its plan to introduce the euro in 2009, whereas in Poland, the new government has yet to decide this issue.

[3] *In spring 2005 the deficit target for 2005 was lowered from 3.8% to 3.6% of GDP, that for 2006 from 3.1% to 2.9% of GDP.*