International Environment Increasingly Fraught with Risk

Low Interest Rates Favor Robust Growth, but Risks Increase

While Global Economic Growth Is Robust, Growth Weakens in the Euro Area and Japan

Coming to some 5% in 2004, the global economy posted the highest growth rate since the 1970s according to the IMF, even though the second half of the year was slightly less dynamic. The higher oil price seems to have been the main reason for this slowdown. In the course of 2004, the oil price in U.S. dollars climbed by up to 50% against the previous year, thus exceeding the development expected in most economic forecasts. In the first quarter of 2005, the oil price remained high and price volatility went up noticeably. Most forecasts expect oil prices to remain at a high level over the next few years. According to forecasts for 2005 and 2006 by the IMF, the OECD and the European Commission, economic growth will continue to be robust, with growth rates hovering around the long-term average and inflation remaining moderate. The risks for this favorable growth outlook, however, point mostly downward. In this context, the U.S. current account deficit, which is generally estimated to be too high, continues to give cause for concern. The IMF e.g. argues that the U.S. dollar might depreciate substantially and long-term interest rates might rise, especially in the U.S.A., if international investors were no longer willing to accumulate or hold U.S. dollar-denominated financial instruments. The oil price represents another risk factor: Should the oil price remain high or rise even further, it would dampen growth more considerably than currently expected. This could trigger a buildup of inflationary pressure, which might cause long-term interest rates to surge. This, in turn, would entail certain risks with regard to possible corrections of the relatively high real estate prices in several countries as well as to widening spreads.

In the *U.S.A.,* two factors played a key role in maintaining robust economic growth rates despite the higher oil price: solid (though recently slightly slower) productivity growth and a continued commitment to supportive fiscal and monetary policies. On the back of solid income growth, positive wealth effects, growing employment and high consumer confidence, consumer spending was dynamic, as was corporate investment, which benefited from positive turnover expectations as well as from favorable financing conditions and temporary tax advantages. The high oil prices drove up the inflation rate, whereas the relatively modest growth of labor unit costs and the continued availability of production capacities have so far kept domestic inflationary pressures low. Since June 2004, key interest rates have been raised to 2.75% in seven moves (by a total of 175 basis points) in light of the robust economic upswing, stable inflation expectations, the limited upward pressure on inflation as well as the balanced risks for future inflation and future economic growth as assessed by the Federal Open Market Committe (FOMC).

After a strong start in 2004, growth in *Japan* slowed down considerably and was slightly negative for three quarters in a row. In particular exports of IT goods and consumer spending declined. Given the favorable international environment, the IMF expects a renewed upswing; as demand in relation to aggregate supply is relatively low, however, persistently positive inflation rates will probably not be achieved in the short term, which suggests

that the Bank of Japan will continue its accommodative monetary policy.

In *non-Japan Asia*, the strong economic growth observed in the first half of 2004 continued as inflation remained largely moderate. China again posted tremendous growth rates although economic policy measures were taken to slow down this rapid growth. In 2004, the build-up of substantial (mostly U.S. dollar-denominated) foreign reserves in the region continued owing to financial account and current account surpluses, with China accounting for the largest share of that increase. This trend seems to have contributed to the low yields of U.S. government bonds as well.

Growth in the *United Kingdom* slowed down slightly in recent quarters, thus approaching trend growth. Consumer spending and investment lost some momentum in the process. As expected, the higher short-term interest rates helped stabilize real estate prices after years of heavy growth. Even though capacity utilization continued to rise and unemployment remained low, wages have not triggered any significant upward pressure on inflation so far. Between May 2003 and August 2004, key interest rates were raised by a total of 125 basis points to counter the upward pressure on inflation expected to result from high capacity utilization.

Since mid-2004, growth in the *Swiss* economy slowed down at a faster pace than expected, which has affected investment as well as exports and consumer spending. The inflation rate remained low. In 2005, the Swiss economy should pick up again as exports are improving and financing conditions are favorable. In June 2004, key interest rates were raised by 25 basis points; slower economic activity, among other factors, has kept them steady since then. The *Schweizerische Nationalbank* announced that it would take appropriate measures in case unexpected developments caused the Swiss franc to appreciate.

In the second half of 2004, growth in the *euro area* slowed down noticeably, with Germany and Italy, inter alia, experiencing the strongest impact. Given the high and volatile oil prices, domestic demand in the euro area was generally subdued, whereas the slower pace of global growth and the appreciation of the euro caused the growth in export demand – which had contributed significantly to the economic upturn in the first half of 2004 – to decline. Corporate profits recovered, but this development has not yet led to a significant increase in corporate investment, as enterprises tend to prioritized restructuring their balance sheets. Wage moderation as well as currently low employment growth have dampened consumer demand. Higher oil prices temporarily drove up HICP inflation, whereas domestic price pressures remained low as wages went up only moderately and the higher oil prices have not triggered any second-round effects so far. Given the low domestic price pressure, the key interest rates have been left at 2%. Growth, and especially domestic demand, is expected to accelerate gradually in 2005 and 2006.

Weak Dollar and Unusually Low Long-Term Interest Rates

In the second quarter of 2004, interest rates started to rise in the U.S. *money markets*. Market expectations were considerably influenced by the Federal Reserve's announcement to raise key interest rates at a measured pace in the future. In March 2005, growing inflation concerns gave rise to expectations of a faster key interest rate hike. After a

series of unfavorable economic data was published in early April, these expectations receded again. In the euro area, money market interest rates remained mostly unchanged owing to stable long-term inflation expectations and slackening economic activity. The implied volatilities in the U.S. and euro area money markets decreased further.

Yields in the U.S. *bond markets* remained largely unchanged after having declined between the third quarter of 2004 and February 2005. Given the favorable economic outlook and the Fed's substantial rise of key interest rate, this came as a surprise to many observers, as yields have tended to go up markedly in such conditions. In February, a speech by the FOMC chairman as well as speculations about accelerated key interest rate hikes sparked a rapid rise in bond yields, which, however, receded when these speculations were dispelled. Long-term inflation risk premiums, measured against indexed bonds, continued to trend upward in recent quarters. In the euro area, yields continued to fall between September 2004 and the beginning of January 2005, as bond prices have gone up, apparently as a result of unexpectedly low economic activity and the weak U.S. dollar. By long-term comparison, inflation risk premiums fluctuated at a somewhat higher level.

In February, the risk premiums for *corporate bonds* in the U.S.A. and the euro area reached a very low level by long-term comparison and have clearly increased since then, following the release of negative data on the creditworthiness of large U.S. car manufacturers. By long-term comparison, the level of risk premiums is relatively low, which suggests that investors continue to be willing to take high risks; the favorable overall profit situation seems to have had a positive impact on corporate balance sheets, thus reducing the risk of future defaults.

Chart 1

Interest Rate Profile in the Euro Area and the U.S.A.

Source: Thomson Financial.

Stock market prices in the U.S.A. remained mostly stable; however, the effects of the sound profit situation were partly offset by high oil prices and the recently somewhat increased long-term interest rates as well as by the fact that risk aversion increased slightly from a previously low level. In the euro area, stock prices continued their upward trend until March 2005, mainly on the back of high corporate profits and long-term interest rates, which had dropped more sharply in the euro area than in the U.S.A.

The pronounced dollar weakness on the *foreign exchange markets* in the fourth quarter of 2004 appeared to be related to the high current account deficit and the prolonged period of low long-term interest rates in the U.S.A. The extent of the nominal effective appreciation of the euro was smaller, however, than in past periods of dollar weakness. Speculation about a future appreciation of the Chinese yuan put some additional upward pressure on the Japanese yen, which nonetheless depreciated against both the U.S. dollar and the euro owing to slow economic activity. The Swiss franc remained fairly stable against the euro. In the reporting period, the foreign exchange markets were very sensitive to information suggesting portfolio shifts from U.S. dollar-denominated official foreign exchange reserves to other currencies. The euro and the Swiss franc responded with partly noticeable gains. As of mid-March, the U.S. dollar rebounded amid growing expectations that the Fed would raise key interest rates quickly which also caused some upward pressure on U.S. bond yields.

Financial Flows into Emerging Markets at a High Level in 2004

Robust Economic Prospects for 2005

In 2004, the *emerging market economies (EMEs)* posted average economic growth of more than 7%, thus exceeding expectations in nearly all regions. This was partly attributable to robust domestic demand, stepped-up export activities and higher commodity prices. According to the IMF, economic prospects for 2005 remain robust. The IMF has revised its forecast for 2005 GDP growth in the EMEs from 5.7% to 6.3% and envisages a slightly less vibrant growth for 2006 amid a continued slowdown in inflation. Most of the risks applying to EMEs stem from the international economic environment and are identical with those relevant in industrialized countries, including the oil price risk, a possible increase in the currently low long-term interest rate level, sluggish labor market recovery, decreasing asset prices and a high exchange rate volatility.

Together with the United States, *Asian EMEs* remain the main engine of global growth. The favorable development in this region is supported by the prolonged investment boom, even though corrections occurred in the information technology markets. The consolidation of the financial sector and structural reforms of the corporate sector are still top priorities in Asian EMEs. Although selective economic policy measures were initiated a year ago in order to dampen strong economic growth in *China*, it will probably not be significantly lower in 2005 than the previous year's value of 9.5%. While interest rates have been liberalized, the exchange rate is still pegged to the U.S. dollar despite mounting international pressure – a fact that enhances the country's com-

petitiveness. Although robust economic growth is again expected for *India*, the budget deficit is likely to remain close to 10% of GDP, while the *Reserve Bank of India* will need to closely monitor the surge in short-term trade credits.

Despite the appreciation of the local currencies, average debt ratios in *Latin America* continue to be high and may be considered a potential source of risk. However, sustained high growth rates boosted by domestic demand are expected to improve the debt situation and support a better investment climate, thus improving job prospects for the rapidly growing labor potential. In the *Middle East*, progress is being made in establishing an infrastructure that helps strengthen the non-oil industries. According to the IMF, several *African countries* place emphasis on strengthening institutions and improving governance in order to reduce their vulnerability to shocks and to promote their integration in liberalized global trade.

The *Russian* economy still benefits from high oil prices; the investment climate, however, has recently deteriorated especially owing to stronger state intervention, which caused growth to subside as of the second half of 2004. As a consequence of this development, real GDP growth is expected to slow down again this year. The high level of risk in the Russian financial sector (bad loans account for 15% of total loans) contrasts with a favorable fiscal situation and high foreign reserves. In parallel to a strongly increasing current account deficit, economic growth in *Turkey* has been surprisingly pronounced at 8% in 2004 and may come to 5% in 2005, with inflation declining further. The IMF has extended considerable financial assistance to Turkey on condition that structural reforms be promoted; owing to a lack of corporate governance and insufficient investor protection, private capital inflows are still a mere trickle.

Net Capital Inflows 2005: Slight Decline Expected After Record Level 2004

According to the IMF, *private net capital inflows* in the EMEs benefited from the global economy's dynamic growth in 2004. While *net FDI inflows* and volatile *portfolio investment* increased, the position *"Other capital flows" (bank loans, trade credits and derivatives)* recorded outflows. Several EMEs managed to partly finance their fiscal deficit via local capital markets. The IMF forecasts net FDI inflows to grow again in 2005, not least owing to market participants' favorable expectations of profitability in the EMEs. This year's lower net inflows in portfolio investment and the outflows recorded under "Other capital flows", which will weaken total private net capital inflows, seem to be driven by two main factors: first, the investment of the high revenues gained by oil-exporting countries, and second, the expectation that Russia will repay foreign debt ahead of schedule pursuant to an agreement with the Paris Club.

Table 1

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

USD billion

	2002	2003	2004	2005f	2006f
Net capital flows according to the IMF	75.8	149.5	196.6	175.1	193.9
By instrument					
Direct investment	144.4	151.9	186.4	217.4	222.3
Portfolio investment	–90.0	–9.9	28.8	2.3	16.0
Other capital flows	21.4	7.5	–18.6	–44.6	–44.4
By region (number of countries)					
Latin America (31)	3.3	15.2	12.7	22.4	30.3
Europe (13)	55.3	52.0	60.6	65.8	57.7
CIS (12)	–9.5	16.4	2.9	–6.4	2.7
Middle East (14)	–4.0	–2.4	–21.0	–31.2	–25.1
Africa (47)	6.9	12.3	11.4	15.6	13.5
Asia (15)	23.9	56.1	130.1	108.9	115.0
Memorandum items					
Current account balance	142.4	233.8	336.3	395.4	345.8
Foreign reserve assets (– = increase)	–194.4	–369.3	–518.9	–523.4	–515.7
of which China	–75.7	–117.2	–206.6	–210.0	–210.0

Source: IMF (WEO).
Note: f = forecast.
[1]) This table shows aggregated balance-of-payments data sets of 131 nonindustrialized countries, including the major 44 EMEs. Given repeated revisions of the balances of payments. which also affect the data sets of previous years. capital flows may differ substantially afterwards.

The *Asian EMEs*, most notably China, have continued to attract the bulk of net capital inflows. A key objective and major challenge of many Asian central banks in this context is to keep inflation low while at the same time stabilizing the nominal exchange rate against the U.S. dollar. According to the IMF, reserves will further augment by more than USD 300 billion to almost USD 1,200 billion in 2005 owing to persistently large current account surpluses and speculative capital inflows and will thus cover more than 85% of annual imports. Substantial shares of these strong external inflows will be sterilized in most of these countries, thus creating costs of sterilization; in addition, a depreciation of the U.S. dollar against these currencies would result in capital losses. Even though the current account surpluses of the Asian EMEs are anticipated to shrink in 2005, China's measures to cool the economy (e.g. specifying quotas for foreign capital financing for foreign banks doing business on the Chinese credit market) are likely to reduce the inflows of foreign capital into the region altogether. By contrast, *European EMEs* might record growing FDI inflows in 2005, as foreign corporations choose to step up their investment in production industries with high value added given the highly qualified workforce in many of these countries. Alongside the *Middle Eastern* economies, the economies of the *Commonwealth of Independent States (CIS)* are also becoming net capital exporters, since revenues from exporting hydrocarbons are up and Russia is expected to buy back debt ahead of schedule.

Austrian Banks' Cross-Border Claims on Central and Eastern Europe – An International Comparison

At end-September 2004, the ten new EU Member States accounted for over 58% of the Austrian banking sector's total cross-border claims on EMEs

Table 2

Claims of BIS Reporting Banks on Central and Eastern Europe and Turkey as at End-September 2004

Countries of origin of the BIS reporting banks posting the highest external positions vis-à-vis the respective region

% of GDP of the recipient country

	AT	DE	IT	FR	NL	SE	BE	UK	Europe[1])	U.S.A.	Japan
CEE plus Turkey	1.9	6.5	1.3	1.1	1.0	0.8	0.8	0.7	16.1	0.7	0.4
Central European EU Member States											
Poland	1.8	×	1.5	0.7	0.8	0.3	0.5	0.3	14.4	0.3	0.6
Slovakia	5.1	×	3.4	0.9	0.4	0.0	1.9	0.1	19.9	0.5	0.3
Slovenia	5.0	×	1.7	2.0	0.4	0.0	1.1	0.3	22.8	0.1	0.5
Czech Republic	4.2	×	0.4	0.6	0.5	0.0	2.6	0.0	14.9	0.3	0.2
Hungary	4.8	×	3.2	1.9	1.0	0.0	3.6	0.9	34.6	0.4	0.7
Other CEECs											
Bulgaria	1.3	×	2.7	0.8	1.6	0.1	0.2	0.6	18.8	1.5	0.2
Croatia	8.5	×	15.5	0.7	0.4	0.0	0.4	0.8	43.9	0.7	1.2
Romania	1.1	×	1.1	1.6	1.9	0.1	0.1	0.3	13.1	0.6	0.0
Russia	0.4	×	0.2	0.7	0.9	0.0	0.1	0.0	7.2	0.5	0.3
Turkey	0.1	×	0.6	1.4	1.2	0.1	0.4	0.0	10.4	1.0	0.5

Source: BIS. Eurostat. IMF. national sources 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 March 2005. Table 9C). The BIS statistics cover crossborder claims denominated in all currencies as well as the claims denominated in a currency other than that of the recipient country and held by subsidiaries in the recipient country (with the exception of Austria and the U.S.A.).
[1]) The column „Europe" comprises the countries of origin listed here as well as DK, GR, IE, PT, FI, ES, CH and NO.

and developing countries; Central and Eastern European countries including the CIS accounted for almost four fifths.

Leaving the German banking sector, for which no disaggregated data are available, aside, the Austrian banking sector had the highest foreign currency-denominated claims on the new Member States in CEE at end-September 2004 by international comparison, even if the foreign currency-denominated claims of Austrian banks' subsidiaries in these countries are not included.

Central and Eastern European Financial Markets Fairly Stable

Central and Eastern European Eurobonds Stand Their Ground despite Rising U.S. Interest Rates

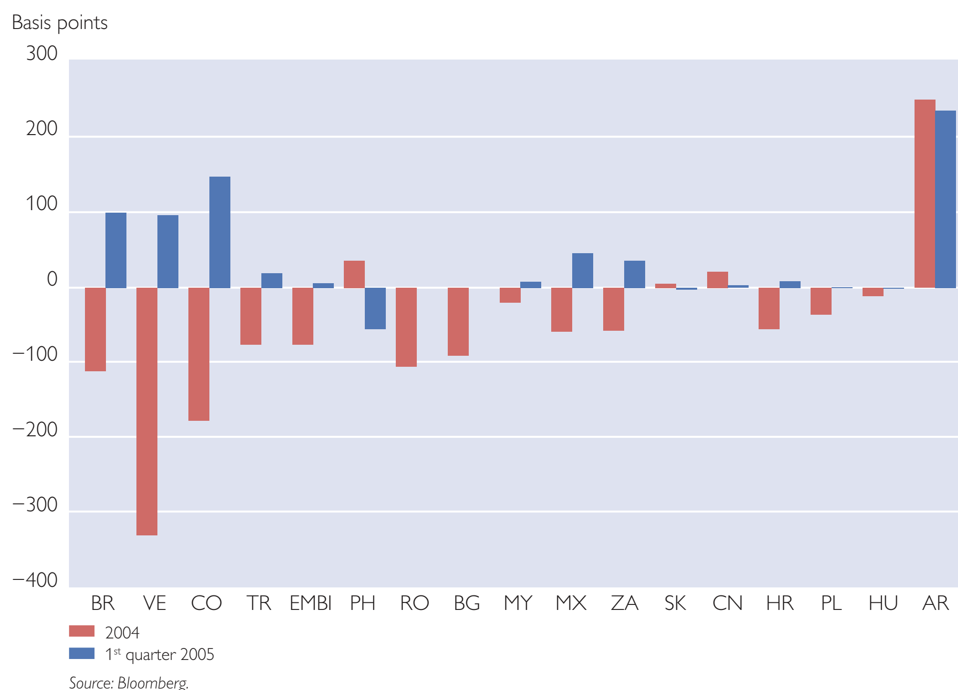
In 2004, demand for foreign currency-denominated government bonds issued by emerging market issuers remained strong despite the higher level of U.S. interest rates. Between end-2003 and end-2004, the yield spreads beween government bonds denominated in U.S. dollar and euro against U.S. and euro area benchmark bonds (measured by JP Morgan's EMBI Global index and Euro EMBI Global index, respectively) narrowed substantially by 56 and 74 basis points on average, which translated into total returns of almost 12% in both cases.

Key factors in the decline in yield spreads in 2004 were improved fundamentals in the emerging markets, which were also reflected in ratings upgrades, investors' continued low degree of risk aversion and the ongoing quest for higher yields in view of the relatively low U.S. and euro area interest rates.

In March 2005, yield spreads widened to an extent that exceeded the

Chart 2

Change in Euro EMBI Global Spreads (2004 and First Quarter 2005)



continued narrowing that was observed over the first two months of the year. A catch-up reaction to previous U.S. interest rate hikes and a change in the assessment of future U.S. interest rate increases seem to have been responsible for this setback, which coincided with an increase in yields on ten-year U.S. government bonds. Latin American issuers recorded a particularly pronounced widening of yield spreads.

Among the Central and Eastern European issuers, only *Romania* and *Bulgaria* posted an above-average contraction of spreads in 2004 compared to the Euro EMBI Global index, whereas in Hungary, Poland and Slovakia a contraction of this dimension was simply not possible given the low initial levels. The yield spreads of *Romanian* eurobonds shrank by 103 to 58 basis points, while those of *Bulgarian* eurobonds contracted by 89 to 44 basis points. The yield spreads of *Croatian* eurobonds narrowed by 54 to 42 basis points. Rating upgrades, declining deficits in the combined current and capital accounts of Bulgaria and Croatia, improved fiscal positions, the approaching EU accession date for Bulgaria and Romania and the fact that Croatia was granted the status of an EU candidate country seem to have had a positive impact on eurobonds. Spreads kept narrowing until early March 2005, when they came to 30 to 40 basis points. Owing to a global reversal of emerging market eurobond spreads, however, the yield spreads in Bulgaria, Romania and Croatia climbed by 12 to 18 basis points until end-March. This upward movement was still lower, however, than that of the Euro EMBI Global average (25 basis points) and significantly lower than that of the yield spreads of bonds issued by Latin American issuers (up to 130 basis points). Given the fact that eurobond spreads in the new EU Member States

Czech Republic, Hungary, Poland and *Slovakia* came to between 13 and 29 basis points in late March 2005, there seems to be relatively little leeway for further spread contractions. Investors are therefore likely to consider investing in foreign currency bonds of other Eastern European issuers if they want to continue to achieve noticeably higher nominal yields than in the euro area.

At the end of March 2005, the *Russian Federation*'s eurobonds recorded a yield spread of 207 basis points (EMBI Global), whereas *Turkey's* eurobonds offered a spread of 309 basis points (EMBI Global) and 192 basis points (Euro EMBI Global), respectively, with liquidity being sufficient at the same time: Russia accounts for 13% of the EMBI Global (third-largest share), Turkey for 7.5% (fourth-largest share). Both countries look back on a relatively long, albeit sometimes rather turbulent history in the international financial markets. Since early 2004, their spreads have contracted considerably, not least owing to successful measures aimed to stabilize their economies in the past few years, which were also reflected in an upgrade of ratings. In addition, Russia's excellent foreign currency liquidity seems to support the country's government bonds. Moreover, enterprises and central, regional and local authorities both in Russia and in Turkey issue eurobonds on a regular basis, which increases the number of possible risk/return combinations for investors. Turkey's EU candidate status to some extent acts as an anchor for future economic stability. Next to the risks that affect the entire eurobond market and are related in part to the yield development of U.S. government bonds, there are considerable country-specific risks. In Russia, these are first and foremost connected with the oil price development, whereas in Turkey, they result from the recent heavy expansion of the current account deficit.

At the end of March 2005, *Ukrainian* eurobonds had a yield spread of some 209 basis points (EMBI Global). Now that the political situation has calmed down, the medium- to long-term perspectives seem to have improved. In early May, Standard & Poor's upgraded its rating for Ukrainian sovereign long-term foreign currency-debt to BB– from B+. In early April 2005, *Serbia* returned to the international capital market when it converted its "old debt" to the London Club group of commercial creditors into eurobonds. Prior to that, in 2004, the country had entered into a debt relief agreement with its creditors in the Paris Club and the London Club and had received a (B+) rating from Standard & Poor's in November 2004.

Table 3

Changes in Ratings of Sovereign Long-Term Foreign Currency Debt

	Moody's			Standard & Poor's			Fitch		
	Rating	Since	Change	Rating	Since	Change	Rating	Since	Change
Country									
Bulgaria	Ba1	17.11.04	⇑	BBB–	24.06.04	⇑	BBB–	04.08.04	⇑
Croatia	Baa3	27.01.97		BBB	22.12.04	⇑	BBB–	28.06.01	⇑
Romania	Ba1	02.03.05	⇑	BB+	14.09.04	⇑	BBB–	17.11.04	⇑
Russia	Baa3	08.10.03	⇑	BBB–	31.01.05	⇑	BBB–	18.11.04	⇑
Turkey	B1	21.12.00		BB–	17.08.04	⇑	BB–	13.01.05	⇑
Ukraine	B1	10.11.03	⇑	BB–	11.05.05	⇑	BB–	21.01.05	⇑

Source: Bloomberg.

Currency Appreciation Remains an Issue in Most CEECs

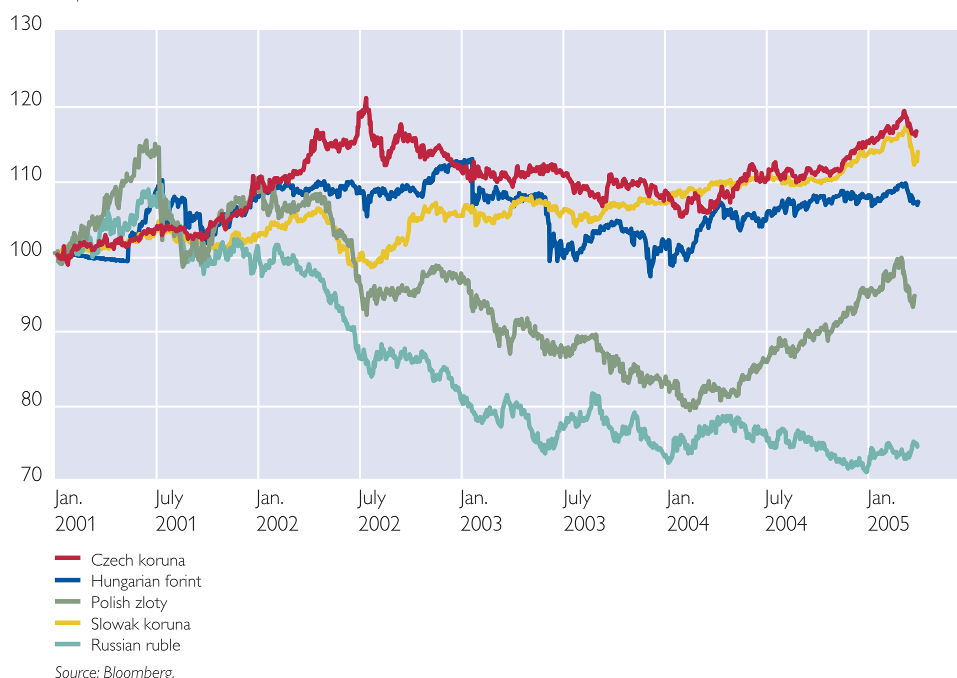
Following a depreciation of the regions' currencies against the euro in 2003 the currencies of most CEECs firmed up against the euro in 2004, with the exception of the *Slovak koruna*, which had been subject to upward pressure already in 2003, and the *Bulgarian lev*, whose exchange rate was fixed through a currency board arrangement in mid-1997. The *Polish zloty* posted the largest gain in 2004 (+15.2%), thus almost completely compensating its depreciation of 2003, which had been the strongest in the region. Similarly, the *Hungarian forint* made up about three fourths of the 2003 dip (+7.2%). The *Czech koruna* appreciated against the euro by approximately 6.5% in 2004, thus clearly rebounding from its slide in 2003, and the *Slovak koruna* continued to firm up against the euro.

These four currencies appreciated further against the euro from end-2004 onward; they came under pressure in March 2005, however, as a consequence of international investors' heightened risk aversion and of a drop in prices for higher-risk financial assets (e.g. eurobonds, corporate bonds). Still, in late March 2005, the Czech koruna's value against the euro was slightly higher than at end-2004, while the value of the Slovak koruna, the Hungarian forint and the Polish zloty remained almost unchanged.

Since Slovenia's entry into the Exchange Rate Mechanism II (ERM II), the *Slovenian tolar* has remained fairly stable against the euro and close to the central rate. As the Romanian central bank began to tolerate a greater exchange rate flexibility, the nominal depreciation trend of the *Romanian leu* came to an end in October 2004; by the end of March 2005, the Roma-

Chart 3

Exchange Rate Euro per Unit of National Currency



Source: Bloomberg.

nian currency had appreciated against the euro by roughly 12% in nominal terms. The *Croatian kuna*'s exchange rate remained fairly stable, aside from the usual seasonal appreciation in summer.

Between end-April and end-December 2004, the *Russian ruble* depreciated continuously against the euro in nominal terms (but significantly less so than its reference currency, the U.S. dollar) while at the same time appreciating in real terms. In line with the U.S. dollar's appreciation against the euro in the first quarter of 2005, the ruble strengthened against the euro by about 4%. Since the beginning of February 2005, the Russian central bank's exchange rate policy has no longer been solely based on the ruble's exchange rate against the U.S. dollar but on a EUR/USD currency basket. From the beginning of February to mid-March 2005, the euro had a weight of around 13% in the basket; since then, its weight has been almost 25%.

In most cases, currency appreciations took place on the back of one of the following current account balance scenarios: the current account balance (in percent of GDP) was either negative at relatively low (or in Russia even positive) levels or negative at relatively high but declining (Bulgaria, Croatia) or broadly stable (Hungary) levels. Considerable parts of these deficits were financed through net FDI inflows; in Poland and in Bulgaria these inflows even exceeded the countries' deficits. The development in Romania was quite different, as the marked currency appreciation in the fourth quarter of 2004 and the first quarter of 2005 and the simultaneous further expansion of the trade and current account deficits at relatively high levels in 2004 (from –7.8% and –6.0% of GDP in 2003 to –9.0% and –7.5% of GDP in 2004, respectively) pose an economic policy challenge.

In *Hungary* and *Romania* in particular, the high interest rate and yield levels in local currencies supported a currency appreciation. Capital inflows to Romania were driven up by the expected deregulation of financial account transactions effected in mid-April 2005, which permitted foreigners to hold short-term leu deposits. Part of the speculative capital seems to have reached the foreign exchange market even before the implementation of the deregulation. *Banca Naţională a României* announced that it had prepared measures in coordination with the European Commission to counteract an undesirable additional currency appreciation after the deregulation. Between late 2003 and August/September 2004, yield spreads widened over the euro area in the Czech Republic and Poland as well, thus stimulating portfolio capital inflows into these countries. Thereafter, the yield spreads narrowed rapidly again and had even dropped below the level of end-2003 by end-2004.

The upward pressure on domestic currencies is in part also attributable to the increasing volume of foreign currency loans extended to domestic companies and households in several countries (Bulgaria, Hungary, Romania, Slovakia and Slovenia), as borrowers exchange the proceeds from these foreign currency loans for national currency.

In 2004 and also in early 2005, *Národná banka Slovenska* and *Banca Naţională a României* intervened on the foreign exchange market by purchasing large volumes of foreign currencies to counter the appreciation pressure. The Romanian central bank's massive intervention in mid-February 2005 seems to have contributed to the stabi-

lization of the leu which had been appreciating strongly before. Since the beginning of 2004, *Hrvatska narodna banka* has purchased euro from commercial banks as well. *Česká národní banka* sold smaller euro amounts in the Czech foreign exchange market every month despite the koruna's appreciation tendency. After entering ERM II, *Banka Slovenije* intervened with small amounts in the foreign exchange market in order to signal to market participants that the policy of gradual currency depreciation had stopped.

In addition, *Národná banka Slovenska* and *Banca Naţională a României* focused their interest rate policies on easing the upward pressure on their currencies: *Národná banka Slovenska* cut its key interest rate in several steps by a total of 200 basis points in 2004 and by another 100 basis points in February 2005 to the current level of 3.0%. The Romanian central bank also trimmed its key interest rate from 21.25% in mid-2004 to 14.5% in March 2005. In both countries, interest rate cuts coincided with a sharp decline in inflation, which dropped from 9.3% in December 2003 to 2.6% in February 2005 in Slovakia and from 14.1% in December 2003 to 8.9% in February 2005 in Romania. In *Hungary,* the central bank's decision to cut interest rates by a total of 425 basis points between February 2004 and March 2005 was above all based on the unexpectedly pronounced reduction in inflation (from 5.6% in December 2003 and 7.8% in May 2004 to 3.4% in February 2005). Moreover, this interest rate reduction was in line with the exchange rate policy, in particular as the exchange rate has continuously firmed up since mid-2004 and has approached the strong end of the +/–15% currency band since early 2005. Considerations of currency strength also played a role in the interest rate cuts by *Česká národní banka* in January and March 2005 and by the Monetary Policy Council in *Poland* at the end of March 2005.

All in all, the present currency strength has a favorable effect on the decline in inflation in the countries under review. However, currency appreciation in real terms might have a negative impact on competitiveness, current accounts and, consequently, on economic growth. Whenever currency appreciations coincided with a rise in foreign debt (e.g. portfolio net investment in local currency-denominated debt securities), the sustainability of such a development remains questionable. In this context, the risk of a rapid reversal of portfolio capital accumulated over an extended period of time is a critical issue, particularly when interest rates are increasing more strongly in the U.S.A. or in the euro area. The rising proportion of foreign currency loans to domestic borrowers, and the consequent increase in banks' indirect foreign exchange risk, needs to be monitored continuously as well.

Yield Spreads of Local Currency-Denominated Government Bonds Drop against Euro Area Benchmark Bonds

In the *Czech Republic*, *Hungary* and *Poland*, the yield spreads of ten-year government bonds denominated in national currencies widened against euro area benchmark bonds up until the third quarter of 2004. According to the harmonized long-term interest rate statistics for the convergence assessment, yield spreads expanded by up to 80 basis points between December 2003 and August/September 2004, coming to 90 basis points in the Czech Republic, to 320 in Hungary and to 450 in Poland. In contrast, the spreads

of *Slovakian* government bonds remained largely unchanged over the same period at between 70 to 100 basis points. Thereafter, bond spreads started to clearly drop in all four markets and continued to fall until early March 2005, when international investors withdrew from higher-risk financial assets and bond spreads again widened moderately.

Since the end of 2003, the development of yield spreads in the *Czech Republic*, *Poland* and *Hungary* has been closely linked to the development of the countries' inflation differentials vis-à-vis the euro area. In the Czech Republic and in Poland, the inflation differential went up until August/September 2004, reaching 0.8 and 2.6 percentage points, respectively, whereas Hungary recorded a peak level of 5.4 percentage points as early as May 2004. Hence, the country had recorded a further substantial widening of yield spreads already in the first quarter of 2004, which was reversed until mid-April. The increase in the inflation differential in these countries was attributable to rising international energy prices, whose impact was stronger in the new EU Member States than in the euro area, and to adjustments of indirect taxes and of regulated prices in the course of EU accession.

Although the inflation differential in Hungary had already begun to decrease in June 2004, the yield spread of Hungarian government bonds widened again, in parallel to yield spreads of Czech and Polish government bonds, until August/September 2004. Since September 2004, inflation differentials against the euro area have decreased considerably in all three countries. In the Czech Republic and in Poland, the inflation differential contracted by 1 to 1.5 percentage points until February 2005 and yield spreads narrowed by approximately 100 basis points to 0 and 210 basis points, respectively. In Hungary, the inflation differential had fallen by 3 percentage points by February 2005. However, the yield spread narrowed only by 120 basis points, possibly owing to the different market perceptions of fiscal policy in these countries. In January and February 2005, the inflation rate in the Czech Republic was again below the euro area level, whereas in February 2005 it was approximately 1.5 percentage points above the euro area level in Hungary and Poland. Since end-2003, the Slovak inflation differential has continually decreased from a very high level (approximately 7.5 percentage points) to only 0.6 percentage points in February 2005.

In response to the (expected) rise in inflation, Czech and Polish yield spreads had already augmented in the first half of 2004, even before *Česká národní banka* and *Narodowy Bank Polski* reacted to the rise in inflation by raising key interest rates in the summer of 2004 – a move which, in turn, was followed by a further widening of yield spreads. Analogously, narrowing spreads anticipated the contraction of inflation differentials and the central banks' subsequent key interest rate cuts.

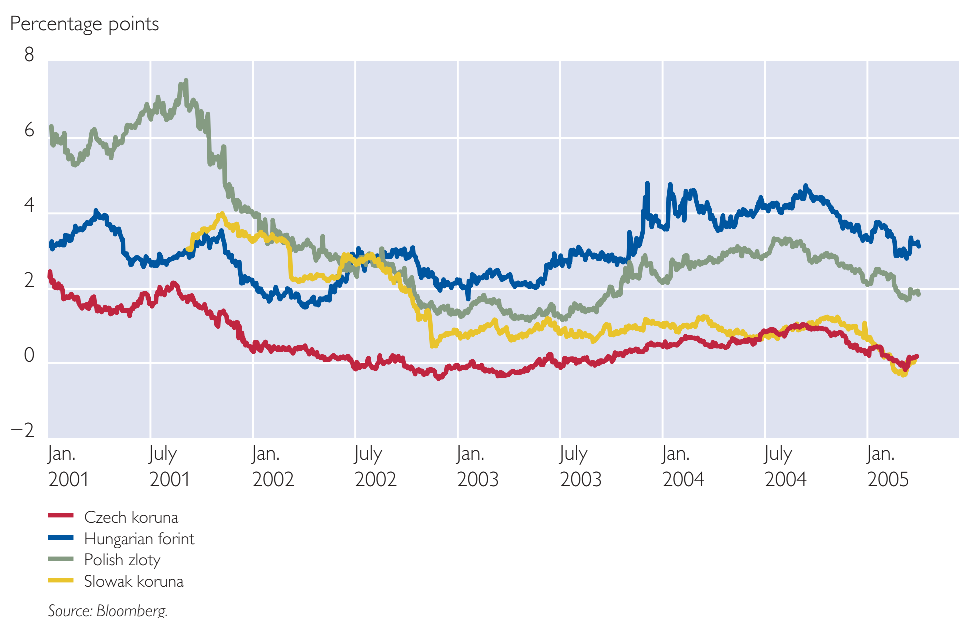
In 2004, budgetary developments in the Czech Republic, Poland and Slovakia were favorable for bond markets. The Czech Republic and Slovakia managed to reduce their deficits to 3.0% and 3.3% of GDP year on year, respectively, while Poland's deficit went up from 6.2% of GDP in 2003 to 6.8% in 2004 (including pension reform costs for both years), primarily as a result of EU accession. In all three countries, however, the deficit was clearly lower than announced in the conver-

gence programs of May and December 2004 or expected by the European Commission's Autumn Forecast for 2004. In contrast, the budget outturn in Hungary was again disappointing: While the budget deficit came down from 7.1% of GDP (after data revision) in 2003 to 5.4% in 2004 (again including pension reform costs), deficit data for 2003 had to be revised upward by almost one percentage point even against the December 2004 convergence program. Moreover, even though the deficit for 2004 corresponded to the target value laid down in the December 2004 convergence program, it was clearly above the target value of 4.6% specified in the convergence program of May 2004. In addition, in January 2005 the Ecofin Council found that Hungary had taken no effective action in response to the Council recommendation of July 2004 to reduce its excessive deficit. In March 2005, the Council issued another recommendation, inviting Hungary to take measures with a view to reducing the deficit by July 2005. In their updated convergence programs of December 2004, all four countries provided for a continuous reduction of their budget deficits over the next few years. In the Czech Republic and Slovakia, the results for 2004 were not only below the initial levels originally assumed for 2004 but also below the (even lower) target values for 2005. It is still unclear whether the deficit targets for 2005 to 2008 will be revised downward in view of the unexpectedly low deficits recorded in 2004 (with the exception of Hungary).

Between May 2004 and February 2005, market anticipations of the date for the introduction of the euro in Hungary moved from 2009 to 2010, thus drawing level with the dates expected for Poland and the Czech Re-

Chart 4

Yield Spreads against Euro Area Benchmark Bonds



Source: Bloomberg.

public. The EU decision to increasingly – over the next five years – include the net budgetary costs resulting from pension reforms already under way in calculating the deficit used in the excessive deficit procedure might lead to a more rapid launch of fiscal consolidation measures and thus change expectations of the date of euro introduction.