Robust International Economy in a More Volatile Financial Environment

Continued Robust GDP Growth despite Oil Price Shock

GDP growth in *industrialized countries* stabilized following the global economy's dynamic recovery until 2004 and, in early 2006, was at a good level by historical standards of around 2.75%. In other words, the economies of industrialized countries have so far been fairly resilient to the growth-dampening effects of crude oil prices, which have soared since early 2004. In view of expected growth in demand, political risks and ongoing capacity constraints in the mineral oil sector, high prices and elevated levels of price volatility may be anticipated for both crude oil and mineral oil products also in the future. The range of oil price forecasts for mid-2007 is USD 42 to USD 79 per barrel (Consensus Forecasts). The overall positive performance of the global economy may be connected not least with historically favorable financing conditions. Since mid-2004, however, key interest rates in the U.S.A. have been raised substantially, and monetary policy in the euro area and in Japan has also been tightened to some extent in recent quarters. Although inflation rates increased on the back of rising oil prices, contagious effects on other goods and second-round effects in wage setting remained limited to date. Clearly, various factors have so far cushioned a significant portion of the inflationary pressure induced by the high price of oil. These are, for example, the diminished importance of oil in industrialized economies, fiercer international competition in labor and goods markets, current overcapacity and the level of unemployment, high profit margins as well as the credibility of central banks in ensuring price stability.

As for the three biggest economic areas, the *U.S.A.*, which is further advanced in the economic cycle, particularly saw growth momentum gradually slow somewhat from an initially high level. In the *euro area*, the economy, following a more sluggish first half of 2005, recovered primarily thanks to growing exports and somewhat more dynamic investment. In *Japan*, by contrast, economic recovery has been gathering momentum since 2004. In recent quarters, unemployment fell in these three economic areas, whereas capacity utilization increased. Core inflation trended slightly upwards from a low level in the euro area and the U.S.A., whereas in Japan an end to the current deflationary period is beginning to emerge. For 2006 and 2007, the European Commission currently expects the economy to continue to develop favorably, with growth rates hovering around the long-term average and inflation remaining modest. Compared with fall 2005, this means the forecasts for the following two years have not changed in essence. In the euro area, growth should be driven first and foremost by corporate investment and the favorable international environment, whereas inflation should remain low owing to continued wage moderation. Growth in the U.S.A. is likely to slow a little due to key interest rate hikes, higher long-term interest rates and, consequently, less dynamic real estate markets and weaker private consumption growth.

The majority of risks to this positive growth outlook point to the downside, whereas the risks to infla-

Table 1

European Commission Economic Forecasts of November 2005 and April 2006

	GDP growth (% on previous year)				Inflation rate (% on previous year)			
	2006		2007		2006		2007	
	Nov. 05	Apr. 06	Nov. 05	Apr. 06	Nov. 05	Apr. 06	Nov. 05	Apr. 06
U.S.A.	3.2	3.2	2.7	2.7	2.9	2.9	2.2	1.6
EU-12	1.9	2.1	2.1	1.8	2.2	2.2	1.8	2.2
Japan	2.2	2.8	1.8	2.4	0.3	0.7	2.0	1.0

Source: European Commission.

tion point to the upside due to possible second-round effects arising from the high price of oil. The downside risks to growth include, apart from the effects of the higher oil price, a disorderly correction of the high U.S. current account deficit as well as a rapid and dramatic rise in long-term bond yields with negative consequences for real estate prices, which have rocketed in many countries. According to the IMF, the global financial system's resilience to shocks is high, above all thanks to the robust profitability and sound balance sheets of financial intermediaries and enterprises in the recent past.

Globally Rising Interest Rates, Volatile Stock Prices

From September 2005 to May 2006, the U.S. Federal Reserve raised *key money market* rates five times in succession to 5.0% (by a total of 125 basis points). In the euro area, key interest rates were raised to 2.5% (by 25 basis points each in December and March). By contrast, the Bank of Japan (BoJ) announced in March that it would phase out its policy of quantitative easing [1] and maintain its zero interest rate policy for the time being. In May, the Federal Reserve indicated that, in light of high commodity prices, the possibility of further expansion in already high levels of capacity utilization and the ensuing inflation risk further interest rate hikes could be necessary. In early May, the ECB Governing Council noted that its monetary policy was accommodative and that the risks for price stability still pointed to the upside. In the U.S.A., interest rates for maturities of up to two years continued to rise in tandem with key interest rates, with rates for longer maturities increasing by a smaller extent. The U.S. money market's yield curve now signals a tightening of monetary policy that is well advanced according to market opinion. In the euro area, the slope of the money market yield curve became markedly steeper during 2006, indicating expectations that key interest rates would be further raised in the coming quarters. In Japan, the money market yield curve

[1] *The policy of quantitative easing consists in conducting open market operations to manage financial institutions' demand deposits held at the BoJ, with the aim of ensuring a liquidity position that significantly exceeds the reserve requirements.*

also became steeper, indicating greater expectations that the BoJ may abandon its zero interest rate policy at an earlier stage. Long-term interest rates in the U.S., euro area and Japanese *government bond markets* exhibited a gradually rising trend and noticeably increased by some 100 basis points in the past few months. Since September 2005, inflation risk premia derived from inflation-indexed bonds with a ten-year maturity have risen only slightly in both the U.S.A. and the euro area despite the high price of oil. This is likely to be connected with continued low, albeit slightly increasing core inflation rates and central banks' sustained credibility in guaranteeing price stability. In the euro area long-term real interest rates measured by the yields on these bonds have risen from a historical low of about 1% since September, while in the U.S.A. the previously existing trend of gradually rising long-term real interest rates has continued. These increases reflect expectations of a sustained economic upturn, a correction of very low maturity premia and monetary policy tightening measures in both economic areas that have already been implemented and that are anticipated for the future. Although risk premia on corporate bonds in the U.S.A. and the euro area edged up slightly in the past few months, they remain low on a long-term basis. This is likely to be attributable not least to the robust profitability and improved debt ratios of enterprises in the recent past. Moreover, high levels of institutional investors' willingness to assume credit risk in order to meet yield targets ("hunt for yield") are also likely to play a part.

Global stock market uncertainty, as measured by implied volatility, increased notably – from very low levels – in May, triggered most likely by inflation and interest rate concerns, which, consequently, did not result in a further rise in benchmark bond yields, but – first and foremost – in a revaluation of high-risk portfolio investments.

Before the corrections in the *stock markets* starting in mid-May 2006, the broad indices DJ EURO STOXX (euro area) and TOPIX (Japan) posted substantial further gains of some 17% and 36%, respectively, between Sep-

Chart 1

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

Source: Thomson Financial.

tember 2005 and April 2006, while in the U.S.A., gains based on the S&P 500 were considerably smaller, coming to around 5% like in previous quarters. Despite stock price decreases, at end-May 2006, all three stock markets posted gains compared with September. U.S. monetary policy tightening, which is further advanced, is likely to have contributed to this quite different performance. In the past few quarters, price/earning ratios increased slightly in the euro area and decreased somewhat in the U.S.A.; they are currently hovering around their historical averages since 1990. In Japan, despite the previous quarters' very high gains, price/earning ratios continue to remain below their long-term average since 1990. In all three economic areas, robust corporate profitability has underpinned stock prices.

In the *foreign exchange markets*, the euro first continued to slide against the U.S. dollar compared with its exchange rate of mid-2005 and, in November 2005, reached around USD 1.18, its lowest level since November 2003. It then appreciated and by end-May attained a level of over USD 1.28 per euro. In the recent past, the USD/EUR exchange rate correlated relatively closely with the interest rate differential between both economic areas, which was basically determined by their respective monetary policies. In addition, the U.S. current account deficit has increasingly been seen as a potential risk by the markets which could harm the U.S. dollar in future. Despite growing expectations of an early end to the BoJ's zero interest rate policy, dynamic economic recovery and the reform of China's exchange rate regime, the Japanese yen appreciated against the U.S. dollar to a lesser extent than the euro, thus depreciating somewhat against the euro. The JPY/EUR exchange rate is currently hovering around its historical highs. The G-7 statement of April 21, 2006, which urged greater exchange rate flexibility on emerging market economies with high current account surpluses, inter alia sparked a temporary appreciation of the Japanese yen against the U.S. dollar and the euro. By contrast, the Chinese yuan remains very strongly oriented to the U.S. dollar and did not gain much ground against the latter currency. The Swiss franc remained stable against the euro in the past few months.

Commodity and precious metal markets saw – in part substantial – price increases over reporting period. The gold price, for instance, climbed to USD 725 per fine ounce. Inflation concerns, which have surfaced more clearly recently, and increased uncertainty in higher-risk segments of the capital market have led to higher volatility also in these markets.

Emerging Markets: Smaller Net Capital Inflows after Peak in 2005

Robust, Only Slightly Weaker GDP Growth in 2006

The IMF expects that emerging market economies (EMEs) will experience continued economic momentum in 2006, fueled by robust demand from industrialized countries, and accordingly revised its growth forecast sharply upward for these countries. At almost 7%, the real GDP growth of EMEs in 2006 is expected to fall only slightly short of the previous year (2005: 7.2%). The IMF anticipates that EMEs will witness continued momentum also in 2007 and accordingly upgraded its growth forecast (with weaker inflation) sharply to 6.6%. However, this outlook conceals substantial changes in regional and individual forecasts, in which the influence of commodity price changes and country-specific factors are reflected. A significant risk to EMEs is a possible energy crisis due to geopolitical uncertainties. A further risk factor is a rapid and sizeable rise in the still low long-term interest rates of industrialized countries, to which EMEs contribute, as they are major net savers. Recent volatility in higher-risk segments of the capital market highlights many EMEs' vulnerability. The stable macroeconomic environment and high liquidity in the international financial markets had resulted in notably less risk diversification, e.g. measured by bond spreads. The critical question for EMEs is whether the recent rise in volatility only leads to increased diversification between investments in different risk categories or to a general decline in venture capital investment.

In 2005, *Asian economies (excluding Japan)* continued to expand. In addition to the U.S.A. and, latterly, Japan, Asian economies remained the most important engine of global growth. This expansion was primarily attributable to exports, which more than offset the general sluggishness of domestic investment (except for China). Inflationary pressures remained moderate although divergences between individual countries increased owing to the different size of the pass-through of oil prices to consumer prices. In China, the expansion of surplus capacity (particularly, in the steel and automotive industries) represents a potential risk to the economy. The upward revision of China's average annual real GDP growth by 0.5 percentage point to 9.9% between 1993 and 2004 saw the country become the world's fourth-largest economy after Germany in nominal terms. Following GDP growth of again 9.9% in 2005, China's rate of expansion is likely to further continue in 2006, according to the IMF. Growth prospects also look favorable in India. In 2006, the IMF anticipates that current account surpluses and external net inflows in the region as a whole will further boost foreign exchange reserves by more than USD 250 billion. To a large extent, these inflows are sterilized at considerable costs. Capital losses will also loom on the horizon if the U.S. dollar continues to soften against these currencies.

In *Latin America*, rapid economic growth continued apace. Growth continues to be driven by exports, increasingly supported by strengthening domestic demand, which, in certain key countries, is also fueled by a less restrictive monetary policy. After their external position had improved for several years, Brazil and Argentina used a part of their rapidly growing currency reserves to make an early repayment of their IMF loans totaling more than USD 25 billion at end-2005. However, continued elevated levels of foreign debt mean that this region remains vulnerable in the event of global interest rates rising sharply.

In the *Middle East*, buoyant oil prices are currently stoking GDP growth, accompanied by clear improvements in the current account and fiscal situation. Implementing a prudent structural policy geared at channeling high liquidity into productive investments (also within the non-oil sector) constitutes the biggest challenge in the region. In *Africa*, institutions should be strengthened and governance improved, according to the IMF. At the same time, a cut in agricultural subsidies (including cotton) as well as additional financial support are urgently required.

Despite the appreciation of several regional currencies[2], growth in *European EMEs* is also likely to remain robust in 2006 thanks to generally vibrant domestic demand. In 2005, GDP growth in Turkey, in particular, accelerated dramatically to more than 7%, driven by strong credit growth. However, Turkey's high current account deficit continued to deepen at the same time. With the IMF's assistance, structural reforms (particularly as regards banks and social insurance) will be further pursued.

High Private Net Capital Inflows Dominated by Direct Investment

In 2005, *private net capital inflows* to EMEs accelerated, reaching a historical high. The IMF attributes this to EMEs' greater resilience to shock, which also feeds through to improved ratings (improvements in both fiscal and monetary policies, external positions and financial systems). In 2006, the IMF expects that net inflows will be lower on account of investments brought forward to 2005 and the announcement of early foreign debt repayments.

FDI net inflows have continued to grow in all EME regions (except for the Commonwealth of Independent States – CIS), owing to lower risk assessments as well as improved business and investment conditions. Enterprises in both developed economies and EMEs have also stepped up their diversification efforts (securing supply with primary products). In addition, cross-border mergers and acquisitions are still considered to generate substantial earnings. Inflows into EMEs remain concentrated in the oil and gas, telecoms and banking sectors. According to the IMF, net inflows have also continued to be positive for "portfolio investment" and "other flows" (trade credits, bank credits, derivatives), which both are more volatile items. However, the latter suffered a visible decline, as financing gaps have been increasingly plugged via local capital markets and foreign debt has been repaid early. In view of these early repayments and oil-exporting countries' investment of high levels of revenue in foreign markets, the overall increased net capital inflow is particularly worth highlighting. From a regional perspective, Asia has ceded its leading position in terms of net capital inflows to European EMEs. The economies of the Middle East and the CIS are likely to be net capital exporters in 2006 as a result of higher revenue from the export of oil and gas as well as other commodities, and the early repayment of foreign debt.

Claims of Austrian Banking Sector Lead in Some CEECs

At end-September 2005, the ten new EU Member States accounted for almost two-thirds of the Austrian banking sector's total claims on EMEs and developing countries. Including Central and Eastern Europe (CEE) and the CIS, this share rises to almost 94%. According to data compiled by

[2] *For further details about developments in Central and Eastern Europe (including Russia), please consult the next chapter.*

Table 2

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

USD billion

	2002	2003	2004	2005	2006[2]	2007[2]
Net capital flows according to the IMF	97.3	160.4	230.6	254.0	178.8	153.8
By instruments						
Direct investment	149.5	157.5	184.3	213.3	220.6	217.5
Portfolio investment	−78.6	−3.7	34.5	38.5	−4.7	−3.2
Other flows	26.5	6.6	11.8	3.2	−37.1	−60.5
By regions (countries)						
Latin America and the Caribbean	−2.1	15.5	6.0	25.2	34.6	28.1
Europe	53.5	52.3	71.0	108.2	94.7	84.4
CIS	16.1	16.7	8.0	24.9	−13.7	−21.3
Middle East	4.1	7.9	12.2	11.4	−8.7	−10.1
Africa	4.9	4.6	13.0	30.4	16.6	21.1
Asia	20.8	63.5	120.3	53.8	55.2	51.6
Memorandum item						
Current account balance	138.5	229.4	310.5	511.2	576.5	569.8
Reserve assets[3]	−194.7	−351.6	−515.4	−580.2	−584.2	−562.3
of which China	−75.7	−117.2	−206.3	−208.5	−220.0	−220.0

Source: IMF (World Economic Outlook).

[1] *This table shows aggregate 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.*

the Bank for International Settlements (BIS), Austrian banks moved up from fifth to second place (behind Germany) in terms of claims on this region (including Turkey) within the space of six months. In some countries, the Austrian banking sector even took the lead. This is not only due to the Austrian banking sector's further expanded business operations in this region, but also to new, harmonized reporting and survey methods. Reporting is now carried out on a consolidated basis depending on the location of the group's headquarters, which is why both cross-border claims and claims of Austrian banking subsidiaries within the host countries which are denominated in another currency than that of the host country are now included. This provides a better reflection of both the creditor's perspective and the actual distribution of risk.

Below-Average Income Growth of European Foreign Currency Bonds

The mood in international Eurobond markets remained upbeat during most of the reporting period under review, i.e. from September 2005 to end-March 2006[3]. By end-February 2006, the average yield differential of EME issuers' government bonds denominated in U.S. dollars against U.S. benchmark bonds (measured by J.P. Morgan's EMBI Global index) had narrowed from 235 basis points to some 180 basis points. By end-March, this spread had widened by a slight margin to 190 basis points and after a temporary narrowing in the course

[3] *The period under review chosen refers to the detailed analysis of the development of primarily Central and Eastern European foreign currency bonds. The turbulence in the international financial markets in May 2006 can be analyzed only in part.*

Table 3

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

% of GDP of the recipient country	AT	DE	IT	FR	NL	SE	BE	UK	Europe[2]	US	JP
CEE plus Turkey	6.6	9.0	3.3	2.8	2.1	1.6	3.2	1.2	33.7	1.5	0.6
Central and Eastern European EU Member States											
Poland	3.2	12.3	6.0	1.2	4.5	0.9	2.9	0.4	38.5	2.3	1.1
Slovakia	37.5	9.9	19.2	1.5	5.7	0.1	8.2	1.4	83.8	2.3	0.2
Slovenia	20.2	15.9	2.4	5.2	0.5	0.1	3.7	0.2	49.0	0.2	0.7
Czech Republic	21.8	10.3	1.5	18.3	2.7	0.0	21.6	1.4	78.6	2.5	0.4
Hungary	16.8	25.6	8.6	3.1	3.0	0.1	9.5	0.9	70.9	2.0	1.1
Other CEECs											
Bulgaria	6.8	10.7	5.8	2.3	1.4	0.0	0.4	0.1	42.3	1.2	0.2
Croatia	49.4	19.4	44.9	1.5	0.8	0.0	0.5	0.6	118.3	0.7	0.9
Romania	5.6	4.9	1.7	4.2	4.1	0.1	0.1	0.2	27.0	1.2	0.2
Russia	0.8	4.4	0.2	0.6	0.9	0.1	0.1	0.3	9.0	0.8	0.4
Turkey	0.2	3.8	. .	2.1	1.2	0.1	2.1	2.7	14.3	1.8	0.5

Source: BIS, Eurostat, Thomson Financial, national sources and own calculations.

Note: The claims shown here correspond to the „Consolidated international claims of BIS reporting banks" released by the BIS (BIS Quarterly Review March 2006, Table 9B). For every bank, these include the claims and off-balance sheet guarantees as well as the acceptances of liabilities by both parent and subsidiary companies on the borrowers and/or parties to whom the guarantees are made outside the group in the relevant countries. In the case of subsidiary companies in these host countries, only claims denominated in another currency than that of the host country are included.

[1] *As at end-September 2005.*

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

of April came to 200 basis points in mid-May 2006. Between end-September 2005 and early March 2006, the yield differentials of Eurobonds denominated in euro (measured by J.P. Morgan's Euro EMBI Global index) narrowed from 70 to 54 basis points. By end-March, however, they had widened by a margin bigger than that for bonds denominated in U.S. dollars. As a result, the average yield spread at end-March 2006 was back at its level of end-September 2005. After a period of stability in the ensuing weeks, the yield spread expanded to some 80 basis points until mid-May 2006.

In regional terms, U.S. dollar-denominated bonds of Asian issuers and euro-denominated bonds of Latin American issuers posted the biggest declines in spreads between the end of September 2005 and end-March 2006. However, and unlike in earlier periods, European issuers' bonds denominated in both U.S. dollars and euro underperformed overall, although Turkish and (in the case of U.S. dollar-denominated bonds) Serbian bonds, which – after Ukrainian bonds – currently offer the highest yield spreads, ranked among global outperformers. In the reporting period, European bonds generated the lowest total return. For bonds denominated in euro, this implied a higher loss than for other regions. For bonds denominated in U.S. dollars, by contrast, this signified a paltry loss (as a single region), compared with a profit of more than 3% for the index as a whole.

Investors' worldwide sustained low risk aversion and risk perception vis-à-vis emerging markets and the ongoing quest for yield given low long-term interest rates in the U.S.A. and in Europe continued to remain key factors for a positive index development until end-February 2006. Furthermore, improved fundamental data and debt profiles (extension of maturities, early repayment of outstanding foreign debt, early refinancing of future financing requirements) were also reflected in many countries' upgraded ratings. This, in turn, attracted more investors and fanned Eurobond prices. Overall, these factors led to a sharp increase in capital inflows to emerging market bonds during 2005 and early 2006.

A striking parallel trend between yield spreads and average ratings was observable at the level of the broad indices. However, closer analysis raises the question as to whether investors in recent months (actually since early 2003) have differentiated sufficiently between individual issuers and their fundamental data, when making their portfolio decisions. While the steady narrowing of yield spreads was accompanied by a further decrease in the distribution of individual countries' yield spreads, no such uniformity was observable for ratings (and, in the case of the Euro EMBI global index, not to the same degree).

With the record lows reached by yield spreads and a possible inadequate differentiation according to issuer credit rating in the allocation of portfolios, there is a risk that the Eurobond market will react relatively sensitively to a further increase in U.S., euro area and Japanese interest rates. First, this would increase the refinancing costs of investments in emerging markets and thus render carry trades less attractive. This investment strategy involves borrowing in a low interest rate currency and then taking a long position in a higher interest rate currency or in a currency with perceived potential for appreciation. While the former include primarily the Japanese yen and Western European currencies at present, EMEs and also highly developed and mostly booming economies are the destinations of such capital flows. Second, increased interest rates in industrialized countries would probably temper the quest for higher profit opportunities (especially when adjusted for risk). In contrast to the correction episodes in the spring of 2004 and 2005, which were followed by new

Table 4

Eurobonds: Spreads to Reference Bonds and 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
	March 31, 2006	March 31, 2006	Change since Sept. 30, 2005	Since Sept. 30, 2005	March 31, 2006	March 31, 2006	March 31, 2006	March 31, 2006	Change since Sept. 30, 2005	Since Sept. 30, 2005	March 31, 2006	March 31, 2006
Overall index	100.0	191	−44	3.4	BB+	6.93	100.0	69	−1	−1.6	BBB	5.52
Africa	3.4	250	3	0.5	BBB	3.71	3.6	65	1	−1.6	BBB+	4.51
Asia	14.0	181	−72	5.4	BB+	6.42	4.6	97	5	0.5	BBB	4.97
Europe	23.6	132	−4	−0.1	BBB−	6.76	66.6	49	11	−2.5	BBB	5.81
Latin America	56.8	208	−59	4.5	BB	7.39	25.2	127	−25	0.3	BB+	4.97
Middle East	2.2	338	34	6.2	B−	4.89	0.0	×	×	×	×	×

Source: Bloomberg, JP Morgan, OeNB calculations.

Note: Spread levels and changes, total returns, as well as other index features differ between the EMBI Global and 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 and Poor's and Fitch's ratings for long-term government foreign currency liabilities and are given in the rating categories Standard and Poor's uses.

record lows in Eurobond spreads, the current situation is marked by (even) smaller yield spreads with higher interest rates in the U.S.A., the euro area and in Japan. It is also notable that Eurobond spreads have tended to decline over the last few months in contrast to the rise in risk premia of other risk categories such as swap spreads or yield spreads of U.S. and euro area corporate bonds.

The slight increase in spreads in March 2006 is likely to have been connected with a higher increase in yields on long-term U.S. government bonds following breach of a technical mark.

Eurobonds of Central and Eastern European issuers remained largely unaffected by the most recent turmoil in EMEs in the second half of May. Only the yield spreads of issuers with comparatively low ratings (Ukraine and Serbia) widened notably (by 40 to 50 basis points).

Central and Eastern Europe: Cool Breeze for Currencies in March 2006

During the reporting period from end-September 2005 to end-March 2006, most Central and Eastern European currencies under review managed to build on their appreciation in the first nine months of 2005. The Czech and Slovak koruna gained most in value, appreciating by 3.4% and by 3.1%, respectively, against the euro during this period. Whereas high direct investment inflows were the key determinant for the Czech currency, for its Slovak counterpart, joining the exchange rate mechanism (ERM) II with effect from November 28, 2005, was a key factor for its appreciation. ERM II entry came as a surprise to many market players and triggered the currency's appreciation by 1.5% on the very day of its joining. In the weeks thereafter, the Slovak koruna continued to firm against the euro. In addition, the Russian ruble, the Croatian kuna and the Romanian leu also firmed during the reporting period (by some 1% to 2%). The appreciation of the ruble relative to the euro should be seen against the backdrop of the ruble's orientation to a basket of currencies consisting of euro and U.S. dollars at a ratio of some 45% to 55%, respectively, against which the currency rose by 2.5%. Exceptions were the Hungarian forint and the Polish zloty, which from end-September 2005 to end-March 2006 softened against the euro by 6.1% and 0.6%, respectively, although by end-February the forint had initially depreciated by 1.4% and the zloty had appreciated by 3.5%. Finally, the Slovenian tolar maintained its high level of stability within ERM II, and the pegging of the Bulgarian lev to the euro in the framework of a currency board arrangement did not change during the entire period under observation.

Every currency under review, except for the Slovenian tolar and the Bulgarian lev, depreciated – some even markedly – against the euro in March 2006. The forint and zloty lost the most in value, while the ruble and kuna were the least affected. As with Eurobonds, these losses are likely to have been sparked by the further steep rise in long-term interest rates in the U.S.A. and the euro area, along with greater expectations that interest rates would rise in both these regions and in Japan, which triggered losses not only in many emerging markets but also in small open economies such as Iceland and New Zealand. These developments were exacerbated by carry trade liquidation and

Chart 2

Exchange Rates against the Euro (Euro per Unit of National Currency)

Source: Thomson Financial.

country-specific risk factors such as – in the case of New Zealand or Iceland – high current account deficits and substantial exposure to volatile (commodity) markets. Also the forint and the zloty were particularly exposed to this unfavorable international development owing to country-specific factors (high, albeit declining external financing requirements and lax fiscal policies in Hungary, political uncertainty in Poland). However, these exchange rate losses were not accompanied by a general loss in the value of Central and Eastern European assets. The currencies of most CEECs were hardly affected by renewed turmoil in EMEs in May 2006; only the Polish zloty and the Romanian leu suffered to some extent, but even these exchange rate losses were comparatively modest (some 2% to 3%).

The currencies under observation performed in an overall favorable *macroeconomic environment*. In the Czech Republic, Slovakia and Bulgaria, GDP growth came to 5.5% to 6.0% in 2005, while the growth rate in Hungary, Slovenia and Croatia was around 4.0%. Only the Romanian and Polish economy cooled noticeably compared with 2004. At 4.1%, however, growth in Romania was relatively robust and in both countries reaccelerated in the second half of 2005. The pattern of growth varied widely between these countries. Whereas in the Czech Republic and in Slovenia growth was primarily led by (net) exports, domestic demand represented the sole or clearly predominant positive contribution to growth in Slovakia, Croatia, Bulgaria and Romania. In Bulgaria and Romania, the contribution to growth by net exports was markedly negative. In Hungary and Poland, both domestic demand and net exports were key components of growth.

In the Czech Republic, Poland and Slovenia, the *performance of the combined current and capital account* relative to GDP was a strengthening factor for the exchange rate. In 2005, all three countries posted a decline in their need for external financing, with their deficits being reduced to a very small size (1% to 2% of GDP). In addition, net direct investment inflows more than offset the remaining deficits both in the Czech Republic and in Poland. In Hungary, although the external deficit was smaller than in 2004, it also remained relatively high at 6.5% of GDP. In addition, only about three-fourths of Hungary's deficit was financed by direct investment (and this only thanks to revenue generated by a one-off major privatization in the fourth quarter), which resulted in the further deepening of net external debt. In 2005, Slovakia saw a dramatic deterioration in its combined current and capital account, the deficit of which climbed to 8.8% of GDP (from 3.2% in 2004). The deterioration was primarily caused by the income and current transfers accounts, although, unlike in the above mentioned countries, the goods and services balance also deteriorated in Slovakia. The deterioration in the income balance is partly attributable to an adjustment in the statistical compilation method (improved accounting of reinvested profits as outflows in the income balance and inflows under direct investment). However, net direct investment inflows in Slovakia were only marginally higher in 2005 than in the previous year, meeting only less than 50% of the country's need for external financing. Among the other countries under review, this development was very negatively marked especially in Bulgaria, where the deficit deepened from 5.8% of GDP in 2004 to 11.8% in 2005. In contrast to the period from 2002 to 2004, net direct investment inflows did not completely meet the increased need for external financing. Romania's external position also deteriorated, albeit to a far lesser extent, resulting in an increase in foreign debt for the first time in three years. Foreign debt continued to climb also in Croatia, although growth in direct investment inflows more than offset the increase of the current account deficit. Russia, by contrast, continued to post high surpluses in its combined current and capital account, primarily due to the positive effect of high oil prices.

Notable *interest rate differentials*, together with the existence of liquid investment opportunities, are likely to prop up the relevant currencies primarily in Hungary, Poland and Romania. In Hungary, in particular, portfolio capital inflows induced by the high interest rate differential are likely to have helped meet the need for external financing and thus to have prevented a sharper depreciation in the reporting period than actually occurred. In Slovakia, the short-term interest rate differential gradually widened relative to the euro area before the central bank raised rates at end-February 2006 out of concern that inflation would rise. This factor could prop up the Slovak koruna. In early February 2006, the Romanian central bank also deemed it necessary to raise interest rates owing to the unfavorable inflation development. The interest differential which has thus increased, together with the opening of the government bond auctions to foreign investors from mid-March 2006, could also fuel inflows of capital. In view of Romania's deepening current account deficit, it remains to be seen to what extent the central bank will tolerate the policy of allowing the leu to firm, which should help to meet the inflation target. In Russia, only partly sterilized foreign exchange market interventions by the central bank helped vigorously boost both foreign exchange reserves and money supply in 2005. Possibly out of concern for the associated inflation risks, the central bank allowed the ruble to firm considerably relative to its basket of currencies in the first three months of 2006. However, the volume of capital inflows seems to have been sizeable, as the accumulation of foreign currency reserves nonetheless continued in this period.

In many CEECs, *foreign currency lending by domestic banks to domestic customers* represents another aspect of the interest rate differential relative to the foreign market. At 35% to 80%, the share of foreign currency loans to domestic businesses and households is particularly high in Croatia (including local currency loans indexed to the euro), Romania, Bulgaria, Hungary and Slovenia. In all these countries, the volume (and, in Croatia, Hungary and Slovenia, also the share) of these loans expanded vigorously in 2005. This is likely to have propped up the currencies concerned on account of borrowers converting amounts into local currency.

Overall, the firming of currencies in several countries during the last six months is likely to be in step with the improvement in these countries' external position. In certain countries, however, a correction of high external deficits or the reversion of unfavorable developments in 2005 appears necessary in order to reliably ensure exchange rate stability in the medium term and to limit the increase in foreign debt. Furthermore, countries with a high need for external financing after allowing for net direct investment inflows (Slovakia, Bulgaria) or with relatively high foreign debt (Bulgaria, Croatia, Hungary) will remain vulnerable to further deterioration in the international capital market climate. The continued rise in both short-term and long-term interest rates in industrialized countries would most probably curb capital inflows into the region or could even spark capital outflows in its wake.

From the perspective of the new EU Member States, exchange rate stability is also essential in relation to their future adoption of the euro. Currently, seven new EU Member States (Estonia, Latvia, Lithuania, Malta, Slovakia, Slovenia and Cyprus) participate in ERM II. The convergence test of these and other EU Member States which are not part of the euro area is scheduled to take place in two rounds in 2006: Lithuania and Slovenia in May 2006, the remaining countries most probably in October. In May, the European Commission released a positive recommendation for Slovenia to adopt the euro; in July 2006, the Ecofin Council will take a final decision upon whether Slovenia will join the euro area in 2007.

Yield Differentials of Local Currency Government Bonds hardly affected by Currency Weakness

In the Czech Republic and in Poland, the yield differentials of ten-year local currency government bonds against euro area benchmark bonds were some 20 basis points and 40 basis points lower, respectively, at end-March 2006 than at the beginning of the reporting period at end-September 2005. In the Czech Republic, this meant slightly lower yields than in the euro area. By contrast, Polish bonds offered a yield spread of some 115 basis points. In Hungary and Slovakia, however, yield differentials widened by some 30 to 40 basis points, albeit from very different initial levels. In Slovakia, the yield differential increased from 3 to some 40 basis points, whereas the differential in Hungary grew from 300 to some 330 basis points. Apart from this, currency weakness in March 2006 did not greatly rub off onto the bond markets. Yield differentials in Hungary and Poland, whose currencies were the most affected, climbed by only 3 to 10 basis points, and the volume of Hungarian government bonds in foreign ownership has grown steadily since early February. In response to turmoil in EMEs in May, the yield differential between local currency bonds and euro area benchmark bonds widened temporarily by some 15 to 40 basis points in these four countries. However, only in Poland and Slovakia was the spread at the end of May higher than at the end of April (increase by about 15 basis points).

Various factors were responsible for the widening and narrowing of yield differentials in individual countries. *Inflation (HICP)* developed favorably for the bond market in Hungary and Poland. In Poland, the inflation rate fell from almost 2% in September 2005 to 0.9% in March 2006; in Hungary, by contrast, it declined from 3.6% to 2.4% over the same period. In March 2006, furthermore, these two countries' core inflation rates (excluding unprocessed foodstuffs and energy prices) were only 0.4% and 1.1%, respectively. However, the drop in Hungary's inflation in early 2006 was strongly influenced by a temporary factor – the cut in the highest VAT rate. In 2007, inflation is expected to climb back to some 3%. In the Czech Republic and particularly in Slovakia, however, inflation rose by 0.4 percentage point and by 2.0 percentage points, respectively, between September 2005 and March 2006. In part, this was due to the rise in energy prices, but inflation excluding energy and unprocessed foodstuffs also went up (by 0.3 and 0.6 percentage point, respectively). Although the inflation outlook in these four countries is basically positive, certain risks should not be ignored. In view of the relatively high share of energy prices in these countries' baskets of goods, it first remains to be seen to what extent the continued rise in energy prices will have an effect on core inflation in the medium term. Second, the growth in domestic demand in all four countries (and above all in Slovakia) has been fueled by more robust lending growth in the last few months. Third, the reduction or the plugging of the negative output gap in these four countries is currently countering persistent disinflation. Furthermore, in 2005, Hungary and Slovakia also posted relatively high growth in unit labor costs, which could increase inflationary pressure on the costs front if the trend continues. Passing on the pressure on costs to consumers could be favored by the latest acceleration in domestic consumer demand.

In 2005, *budgetary developments* in the Czech Republic, in Poland and Slovakia were a favorable factor for the bond market. All three countries posted budget shortfalls of less than 3% of GDP.[4] These were smaller than in 2004 (above all, in Poland) and lower than predicted in fall 2005 (particularly so in the Czech Republic

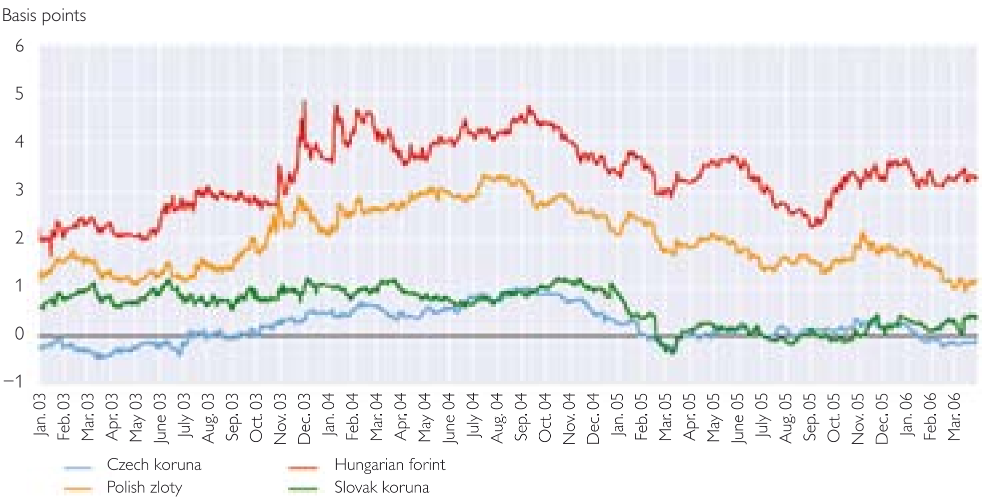
[4] *The shortfall amounted to 2.6% of GDP in the Czech Republic, 2.5% (4.4% including pension reform costs) in Poland and 2.9% (3.5% including pension reform costs) in Slovakia.*

and in Poland). According to official sources in the Czech Republic, however, the shortfall is expected to deepen substantially this year. By contrast, Poland's deficit should deteriorate by only a slight margin compared with 2005, and Slovakia's should prove stable. Hungary's budget deficit, however, deepened from 5.4% of GDP in 2004 to 6.1% in 2005 (and from 6.6% to 7.5% including pension reform costs). The plan to reduce the shortfall in the 2006 budget by around 1 percentage point appears ambitious. Moreover, Hungary needs to present a revised convergence program by September 1, 2006, at the latest, as the Ecofin Council did not find the program submitted at end-2005 to include sufficiently conclusive information.

For these four markets, the *international investment climate* remained favorable during most of the reporting period. As also with the Eurobond and currency markets, potential future shifts in the portfolios of international investors in response to a further rise in industrialized countries' short-term and long-term interest rates represent a risk for local currency bond markets. This applies particularly to Poland and Hungary, where foreign investors hold a larger share of the outstanding volume of government bonds.

Chart 3

Yield Spreads of 10-year Government Bonds against Euro Benchmark Bonds



Source: Bloomberg.