

Global Growth Continues until Mid-2007, but Downside Risks Increase

Industrialized Countries: Markedly Higher Volatility in Financial Markets Dampens Outlook for Growth

Pace of Second-Quarter Growth Varies across Regions

Economic growth stayed robust in the *highly advanced economies* in the first half of 2007. According to the International Monetary Fund (IMF), second-half and 2008 developments in the U.S.A. and in the euro area will be somewhat weaker than forecast in the summer of 2007 as a result of the financial market turmoil. In November 2007, the price of Brent crude oil reached an all-time high of over USD 95 per barrel. Futures markets expect the price of crude oil to diminish gradually to around USD 80 until the end of 2009.

In the *U.S.A.*, the higher growth contribution of net exports and public spending speeded up real GDP growth in the second quarter of 2007 following a very weak first quarter. By contrast, consumer spending augmented only moderately. The downturn in private residential construction slowed, but continued to dampen GDP growth. Consumer price inflation excluding food and energy climbed by 2.2% year on year in October 2007, roughly the same rate

as in the two preceding quarters. However, including food and energy, inflation accelerated sharply from an annual low of 2.0% in August to 3.5% in October.

The long period of rising real estate prices in the U.S.A. came to a halt, which, along with rising borrowing costs, precipitated defaults and caused forced sales, particularly among subprime households. The subprime crisis also hit individual financial institutions. Yet the substantial outstanding volume of mortgage credit-based derivatives coupled with uncertainty about which institutions had problem assets backed by securitized mortgage loans in their portfolio, and to what extent, resulted in a general loss of confidence and thus to a spillover of the U.S. subprime crisis to financial markets worldwide from mid-July onwards.

In view of weaker consumer spending and the decline in residential investment in the wake of tighter borrowing conditions, U.S. economic growth is likely to slow to 1.9% in 2007 and to remain subdued at that rate in 2008, according to IMF forecasts (table 1). The main downside risk is considered to be continued financial market turmoil.

Table 1

IMF Economic Forecasts of April and October 2007

	GDP growth (% , year on year)				Consumer price inflation (% , year on year)			
	2007		2008		2007		2008	
	Apr. 07	Oct. 07	Apr. 07	Oct. 07	Apr. 07	Oct. 07	Apr. 07	Oct. 07
Industrialized countries	2.5	2.5	2.7	2.2	1.8	2.1	2.1	2.0
U.S.A.	2.2	1.9	2.8	1.9	1.9	2.7	2.5	2.3
Euro area	2.3	2.5	2.3	2.1	2.0	2.0	2.0	2.0
Japan	2.3	2.0	1.9	1.7	0.3	0.0	0.8	0.5

Source: IMF (World Economic Outlook).

In the *euro area*, economic growth slackened in the second quarter of 2007, with private consumption resuming its role as the motor of growth after having stalled in the first quarter. Whereas a rising saving rate is acting as a damper on the extent of future consumer spending on the one hand, climbing employment and falling unemployment signal an expansion of consumer spending. After having stayed below 2% for one year, the rate of inflation rose above the 2% mark again in September 2007 and went up further to 2.6% in October. The IMF anticipates more sluggish economic activity until 2008, but the inflation rate is likely to stay at around 2%. In June 2007, the Governing Council of the ECB decided to raise key interest rates, a decision it justified on two counts: the favorable economic climate, and potential risks to price stability. At the beginning of October 2007, the Governing Council dropped its assessment that its monetary policy was still accommodative.

In *Japan*, second-quarter real GDP growth shrank for the first time in three quarters, declining by 0.3% quarter on quarter on account of a marked slowdown in export growth. Growth stimuli came from corporate investment; private consumption was also up. The Bank of Japan still considers the economy to be on track to modest growth that is driven by domestic demand. The IMF sees growth at 1.7% in 2008, marking the eighth year in a row of real GDP growth. Inflation is projected to keep rising marginally in the medium term. As downside risks, forecasters cite a sharp slowdown in the U.S. economy and a detrimental impact of the turmoil in the U.S. mortgage market on

the profitability of the Japanese banking system.

Central Banks Inject Liquidity into Turbulent Financial Markets; Key Interest Rates Cut in the U.S.A., and Kept Unchanged in the Euro Area and the U.K.

Responding to the financial market turbulences, major central banks provided *money markets* with liquidity at several instances from August, which helped calm markets to some extent. The U.S. central bank's policy board, the Federal Open Market Committee (FOMC), cut the discount rate by 0.5 percentage point to 5.75% in August 2007. On September 18, 2007, the FOMC lowered both the discount rate and target for the federal funds rate by 50 basis points each to 5.25% and 4.75%, respectively. These steps marked the first reductions in key interest rates in four years, and were followed on October 31, 2007, by a further 25 basis point cut in the federal funds target rate to 4.50%. The ECB has kept the key interest rate unchanged since June 2007, when it raised the rate on main refinancing operations by 25 basis points to 4.0% – double the rate it had been in December 2005, when the ECB had started to increase interest rates. After raising its Bank Rate by 25 basis points to 5.75% at the beginning of July 2007, the Bank of England held the rate unchanged.

In the U.S. *government bond market*, investors flocked to government bonds as a safe haven in the wake of the U.S. mortgage market crisis, bringing yields on 10-year bonds down from 5.1% at the beginning of July 2007 to 4.3% mid-September. Not until the days immediately preceding the FOMC's decision to raise

key rates on September 18, 2007, did yields recover to reach 4.7% mid-October. Grippled by a further wave of financial market turbulence linked above all to large banks' announcements that they would have to take loan loss provisions, yields slipped back to 4.15% in mid-November. Despite the key interest rate reductions, the yield curve on U.S. bonds with maturities of up to ten years remained inverted. In the euro area, interest rates rose by approximately 25 basis points across all maturity bands, more or less mirroring the rise in key interest rates. Hence, term spreads were virtually unchanged at first, but after the financial market turbulence, they declined markedly especially mid-September and mid-November 2007 and were then considerably below the long-term average. In mid-November 2007, the yield on ten-year euro area government bonds outpaced the corresponding U.S. yield for the first time since April 2004. The results of the Consensus Forecasts indicate that long-term inflation expectations have stayed stable in the euro area and in the U.S.A.

Risk premia on corporate bonds of top-rated debtors (AAA rating) and less highly rated issuers (BBB rating) in the euro area were up by 10 and 40 basis points, respectively, in mid-November on early July 2007 figures. Risk premia have thus remained low in a long-term comparison, which is likely to be a result of excellent corporate profits. *Ten-year swap spreads* in the euro area widened from 23 basis points in early July 2007 to 34 basis points at mid-August, declined somewhat, and then resumed their rise to reach 32 basis points mid-November 2007, about 10 basis points above the level of early July 2007. Hence, the

development of swap spreads paralleled that of AAA corporate bond spreads. However, in the U.S.A., ten-year swap spreads fluctuated even more sharply, enlarging from 59 basis points in early July 2007 to 84 basis points mid-August, narrowing slightly and then rising marginally to 79 basis points in mid-November 2007. This brought U.S. swap spreads 20 basis points higher in November 2007 than in early July 2007, and to a level that remained considerably above the comparable euro area level.

Prices on U.S. *stock markets* plummeted from mid-July, but started to recover a few days before the key rate cut on September 18, 2007; by mid-October, prices had reached a new all-time high. This was followed by a renewed drop in prices to a mid-November level just barely above the lows of mid-August. In the euro area, the Euro STOXX 50 paralleled the fluctuations of the U.S. market. However, both euro area and U.S. earnings yields, which are calculated on the basis of broad stock indices, remain close to their historical average since 1990.

The most recent financial market turbulence also encompassed *foreign exchange market* fluctuations. When the most recent turmoil broke out, the U.S. dollar still managed to gain against the euro, but soon began to lose ground to a level well below the initial one. At the beginning of November 2007, the euro hit an all-time high of USD 1.47 per euro, marking a 15% increase in its value against the U.S. currency within a year. The Japanese yen exhibited especially strong fluctuation on account of the turbulent financial market conditions, which may be attributed above all to carry

trades.¹ Gains against the U.S. dollar and the euro from mid-July 2007 to mid-August 2007 resulting from the unwinding of carry trades were partly reversed until mid-October. Until mid-November 2007, a second wave of gains against the U.S. dollar, but also against the euro, followed. The Japanese currency reached a rate of JPY 110 per U.S. dollar mid-November, a level last seen in fall 2005.

Emerging Markets: Boom Continues, Net Capital Inflows from Abroad to the Private Sector Reach Record Level in 2007

Economic Activity Remains Robust; Current Account Sur- pluses Decline

For the *emerging market economies*,² the IMF forecasts real GDP growth at a strong 8.1% in 2007, the same as in 2006, and an easing to 7.4% growth in 2008, still above the long-term average of 6.5% growth for this country group. Only Africa is expected to exhibit upward momentum in growth compared to 2006 (from 5.6% to 6.5% in 2008), whereas the CESEE countries (excluding Ukraine and Russia) and Latin America are anticipated to post slower growth from 2007, and the CIS countries as well as developing Asia will experience slower growth from 2008. Only developing Asian economies are projected to post current account improvements in 2007 and 2008. The IMF sees inflation in emerging mar-

ket economies quickening from 5.0% to 5.9% in 2007 and subsequently declining to 5.3% in 2008. On the whole, the protracted financial market turmoil emanating from the U.S.A. since July 2007 has barely damaged economic prospects in the region as a whole. At the country level, Mexico and a few Asian countries appear to have suffered most from the fallout of the turbulence. However, caution is in order – especially emerging market economies such as the economies of Central and Southeastern Europe are vulnerable, as their high current account deficits are financed largely by foreign bank loans.

The IMF expects *developing Asia* to keep growing at a torrid pace of 9.8% on the back of growth in the domestic economy and the external sector in 2007 and to lose only some momentum at 8.8% growth in 2008. For China, the IMF raised its forecast for 2007 growth to 11.5%. Chinese consumer price inflation rose from 1% in July 2006 to 6.5% in August 2007. This is the highest rate of inflation in more than a decade, and is markedly higher than the 3% inflation target. The elevated rate has attracted great political attention, as phases of high inflation have historically frequently led to political turbulence. The IMF expects economic growth to come to 10.2% in 2008, reflecting partial success of the authorities' efforts to reduce growth to 9% by tightening monetary and fiscal policy. For India, the IMF sees

¹ In a carry trade, an investor makes use of an arbitrage opportunity by taking out a loan in a country with low short-term interest rates and investing the amount in longer-term financial instruments in countries with higher interest rates. Such transactions exert depreciation pressure on the borrowing currency and appreciation pressure on the investment currency.

² This group does not include the newly industrialized Asian economies (South Korea, Taiwan, Hong Kong and Singapore); the IMF anticipates that growth there will ease from 5.3% in 2006 to 4.9% in 2007 and further to 4.4% in 2008.

growth slowing from 9.7% in 2006 to 8.9% in 2007 and further to 8.4% in 2008.

In *Latin America*, marked regional differences in growth should narrow in 2007, with growth accelerating in Brazil to 4.4% and in Chile to 5.9% and decelerating to between 6% and 8% in Argentina, Colombia, Peru, Venezuela and the Caribbean. However, with the U.S. economy weakening, Mexico is also set to suffer a slowdown from 4.8% to just 2.9%. For the region as a whole, the IMF thus sees real growth receding from 5.5% in 2006 to 5.0% in 2007 and further to 4.3% in 2008 as a result of the ongoing loss of momentum in the rapidly expanding economies; moreover, the IMF sees the current account slipping into deficit in 2008.

The IMF expects growth in *Africa*³ (in particular in *Sub-Saharan Africa*) to climb from 5.6% (5.7%) in 2006 to 6.5% (6.8%) 2008, fueled by the oil-exporting countries Angola and Nigeria. However, even oil-importing countries appear set to grow by about 5% in 2007 and in 2008, like in 2006. Inflation will stay moderate, except in Zimbabwe. As most of the countries in this group have large current account deficits and as the oil-exporting countries will post smaller current account surpluses, the overall current account deficit of the Sub-Saharan countries will widen from 0.3% of GDP in 2006 to 3.0% in 2007 and decline to 1.6% in 2008.

For the *Middle East*, the IMF expects stable growth of 5.9% in 2007 and 2008 to follow growth of 5.6% in 2006; Egypt, an oil importer, is likely to continue growing at a rate substantially above average, about

7%, and to post a slight current account surplus. Despite elevated crude oil prices, the budget and current account surpluses of the oil exporters will decline because of infrastructure and social spending as well as investment in the oil industry.

In *Turkey*, the IMF expects real GDP growth to decelerate further from 6.1% in 2006 to 5.0% in 2007 and to quicken again to 5.3% in 2008. Exports, which have recovered, are the mainstay of growth, whereas the country's restrictive monetary policy course steered since mid-2006 to combat inflation (after depreciation) and weaker credit growth dampens domestic demand. According to the IMF, the current account deficit, which rose to almost 8% of GDP in 2006 despite the weaker lira, will diminish only moderately until 2008.

Boom in FDI Inflows to Private Sector, but Public Sector Net Capital Outflows Remain High

Net capital inflows to the private sector have been at historically high levels in recent years in many emerging market economies and developing countries. The IMF sees net private inflows doubling in 2007. As usual, the bulk of net inflows were related to FDI activities. Additionally, net lending inflows continued to rise sharply as in 2006, whereas total net inflows from portfolio investment are expected to be relatively low, because the private sector in emerging Asia was a net investor in foreign securities. In 2008, total net capital inflows to the private sector in the emerging market economies is likely to decline, given a projected decrease in net credit inflows and net outflows from portfolio investment.

³ This group does not include Libya and Egypt, which are subsumed under the Middle East.

Table 2

**Net Capital Inflows to Emerging Market Economies
and Developing Countries¹**

USD billion

	2003	2004	2005	2006	2007 ²	2008 ²
Net capital inflows to the private sector	168.3	239.4	271.1	220.9	495.4	291.3
By instrument						
Direct investment	164.4	191.5	262.7	258.3	302.2	293.9
Portfolio investment	-11.7	21.1	23.3	-111.9	20.6	-93.1
Other flows (esp. loans)	14.5	25.1	-17.0	73.6	171.0	88.8
By region (country)						
Europe	53.7	75.3	116.1	122.4	140.5	145.5
CIS	18.3	7.6	34.4	58.8	82.4	42.8
Middle East	1.7	-22.1	-24.5	-28.1	-10.6	4.5
Africa	7.0	17.2	26.5	17.3	42.1	45.9
Asia	65.3	146.8	83.3	40.5	157.2	5.1
Latin America and the Caribbean	22.2	14.5	35.3	9.9	83.7	47.5
Net capital inflows to the public sector³	-48.7	-67.2	-146.4	-165.8	-132.1	-141.2
Memorandum item						
Current account balance	227.7	298.3	522.4	691.7	689.9	715.8
Reserve assets ⁴	-359.7	-509.2	-595.3	-754.2	-1085.3	-887.1
of which: held by China	-117.2	-206.3	-207.0	-247.0	-490.0	-410.0

Source: IMF (World Economic Outlook).

¹ This table shows aggregated balance of payments data sets of 131 nonindustrialized countries, including 44 major emerging market economies. Europe = Central, Eastern and Southeastern Europe excluding European CIS countries and including Turkey. Asia = including Hong Kong, Korea, Singapore and Taiwan.

² Forecast.

³ A minus sign indicates net outflows of capital from developing countries to industrialized countries.

⁴ A minus sign indicates an increase.

In all geographic regions except the CIS, *direct investment* remains the dominant type of net inflow to the private sector in emerging market economies in 2007 and 2008. *Net credit inflows* will probably be the most important source of external finance by far in the CIS, and almost on a par with direct investment in CESEE and in emerging Asia. All net credit inflows are to these three regions, whereas the Middle East and Latin America will experience continued net credit outflows. Net inflows of *portfolio investment* are anticipated to be significant only for Africa, as in 2006, and for Latin America; however, each of these inflows are much smaller than net portfolio outflows from Asia.

The only one of these regions with a persistently high *current account deficit*, namely CESEE, is estimated to attract the largest share of net capital inflows to the private sector in 2007

(together with emerging Asia) and 2008, just like in the two previous years. The Middle East is the only region to have posted *net capital outflows* from the private sector for years (investment of petrodollars); it is projected to post net capital inflows to the private sector in 2008. All other regions have been characterized by a combination of *current account surpluses* and net capital inflows to the private sector since 2005, a trend that appears set to continue in 2007 and 2008, with the exception that Africa will slip into a current account deficit.

In all geographic regions, *public sectors* (excluding central banks) recorded *net capital outflows* in 2006 (repayment of foreign debt, investment); the same should hold for 2007 and 2008, except in Africa. Moreover, all regions – especially emerging Asia, which posted the largest current account surplus in absolute figures –

are expected to *increase official reserves* in 2007 and 2008, like they did in 2006.

High Level of Austrian Bank Claims on CESEE Expanded Further

At the end of March 2007, Austrian⁴ banks' claims accounted for nearly 9% of CESEE countries' and Turkey's nominal GDP, putting Austrian banks ahead of all other countries' banks in terms of claims on the region. Austrian banks account for nearly one-fifth of the loan receivables of all banks in the region that report to the BIS.

Austrian banks had the highest claims of all countries' banks on the Czech Republic, Slovakia, Hungary, Romania, Croatia and Ukraine and the second-highest claims on Bulgaria

(after Italy) and Russia (after Germany). More than 30% of the claims of all banks reporting to the BIS in Slovakia, Romania, Croatia and Ukraine are held by Austrian banks; Austrian banks also account for the same high share of loan receivables in the euro area country Slovenia.

Global Nervousness in Financial Markets Affects Eurobonds

Following the turbulence in May and June 2006, Eurobonds recovered and developments on the Eurobond market stayed positive *until June 2007*. The average *yield differential* of emerging market issuers' government bonds denominated in euro and U.S. dollars against benchmark bonds (based on J.P. Morgan's (Euro) EMBI Global) narrowed by about 20 (U.S. dollar) and 10 (euro) basis points,

Table 3

Claims of BIS Reporting Banks on Central, Eastern and Southeastern Europe and Turkey¹

% of GDP of the recipient country

	AT	DE	IT	FR	NL	SE	BE	UK	Europe ²	US	JP
CESEE plus Turkey	8.8	7.0	6.6	4.2	2.7	3.1	3.5	1.6	43.9	2.2	0.7
CESEE EU Member States (excluding the Baltic countries)											
Bulgaria	11.2	4.4	14.5	3.6	1.3	0.0	0.4	0.4	59.9	1.2	0.2
Czech Republic	25.9	5.0	8.5	17.1	2.9	0.0	20.6	2.1	83.6	2.2	0.5
Hungary	22.7	22.2	16.4	4.6	3.8	0.2	11.1	1.3	87.5	2.4	1.0
Poland	3.1	8.5	11.3	2.5	6.0	0.6	3.5	0.5	45.3	2.9	1.1
Romania	24.2	14.3	6.3	10.5	3.9	0.1	0.3	0.3	69.5	1.2	0.1
Slovakia	39.8	4.5	26.2	2.6	6.2	0.1	14.6	0.8	95.3	2.5	0.1
Slovenia	25.4	12.9	7.9	5.6	1.7	0.0	5.8	0.6	61.9	0.9	0.7
Other CESEE countries											
Croatia	60.5	9.3	55.1	16.7	0.4	0.0	0.6	0.9	145.1	0.3	1.0
Ukraine	7.7	2.7	1.1	5.7	2.1	0.3	0.2	0.1	23.3	0.7	0.3
Russia	1.3	3.5	1.3	0.9	1.3	0.3	0.1	0.9	11.3	1.3	0.6
Turkey	0.2	4.0	..	2.9	1.7	0.1	3.3	3.1	22.9	3.6	0.6

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

Note: The claims shown here correspond to the "Consolidated foreign claims of reporting banks" published by the BIS (BIS Quarterly Review September 2007, table 9B). For every bank, these include the claims (in all currencies) of both parent and subsidiary companies on borrowers outside the group in the relevant countries. In this consolidated overview, claims of Austrian banks do not include claims of the BA-CA group.

¹ As of end-March 2007.

² In addition to the countries of origin listed individually, "Europe" comprises Denmark, Greece, Ireland, Portugal, Finland, Spain, Switzerland and Norway.

⁴ The BIS consolidated banking statistics does not subsume BA-CA group among Austrian banks, as it is not majority-owned by Austrians.

Table 4

Eurobonds: Spreads to Reference Bonds and Returns by Region

	EMBI Global (USD)						Euro EMBI Global (EUR)					
	Weight in total index in %	Yield spreads in basis points		Total return in %	Rating	Duration	Weight in total index in %	Yield spreads in basis points		Total return in %	Rating	Duration
	Sep. 28, 2007	Sep. 28, 2007	Change since March 31, 2007	Since March 31, 2007	Sep. 28, 2007	Sep. 28, 2007	Sep. 28, 2007	Sep. 28, 2007	Change since March 31, 2007	Since March 31, 2007	Sep. 28, 2007	Sep. 28, 2007
Overall index	100.0	214	44	1.1	BB+	7.13	99.2	72	12	0.2	BBB+	4.92
Africa	2.0	279	-15	3.2	BBB	4.61	3.7	91	25	-0.6	BBB+	5.25
Asia	16.7	178	36	1.9	BB+	6.55	4.6	89	28	0.1	BBB	3.84
Europe	25.1	167	20	2.4	BBB-	6.66	71.7	59	10	0.3	BBB+	5.48
Latin America	53.3	227	54	0.3	BB+	7.76	19.2	117	21	0.0	BBB-	4.76
Middle East	2.9	541	117	-0.7	B-	4.82

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

Note: The EMBI Global and Euro EMBI Global indices differ in composition (in terms of currencies, countries covered, instruments, maturities, etc.). Differences in the level and development of yield spreads and returns as well as in other index features can be attributed in part to this different composition and in part to 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 sovereign debt and is expressed in the rating categories of Standard & Poor's.

respectively, in the second quarter. In particular, the crisis on the U.S. mortgage market triggered a reversal, causing the average yield differential to widen by a total of 44 (U.S. dollar) and 12 (euro) basis points, respectively, from end-March to end-September.

From June to mid-August, the average yield differential of euro-denominated government bonds increased by 40 basis points to the highest level in 12 months, and that of dollar-denominated bonds climbed by 105 basis points to a two-year high. By end-September, spreads had contracted again by 43 (U.S. dollar) and 16 (euro) basis points.

From end-September to mid-October 2007, average yield spreads declined further (by 20 basis points for U.S. dollar government bonds, by 8 basis points for euro government bonds). The differential then rebounded by 47 basis points (U.S. dollar) and 16 basis points (euro) up to mid-November 2007; this up-and-down movement in asset prices was in line with the movements in other segments of the financial market.

The fact that *total* returns were positive for both indices from end-March to mid-September even though yield differentials had widened indicates that the crisis had only limited impact on the emerging markets. The U.S. dollar EMBI Global index showed total returns (not annualized) of 1%, compared to just 0.2% for the Euro EMBI Global. The different development of returns in these two indices may, among other things, be explained by the different development of the benchmark bonds underlying each index.

Unlike in the last reporting periods, the current period showed a discrepancy between the rise in yield differentials and the *development of economic fundamentals* (as measured by *average ratings*) at the overall index level. Even though the number of rating upgrades by the three largest rating agencies for the countries contained in both indices (EMBI Global and Euro EMBI Global) was noticeably lower in the first and second quarters of 2007 than in the same period of 2006, it was nevertheless

higher than the number of rating downgrades. (Among the CESEE countries in the indices, only Poland underwent a rating change, namely an upgrade by Standard & Poor's from BBB+ to A-.) Nonetheless, after the outbreak of the U.S. mortgage crisis, demand for Eurobonds issued by emerging market sovereign debtors ebbed. Assuming that ratings are appropriate, the divergent development of fundamentals and yield differentials may either be interpreted as a contagion-related temporary negative overshooting of market expectation or as a sustained correction of investors' previous excessive risk appetite. (In the third quarter of 2007, upgrades of emerging markets continued, including especially Brazil, China and Peru).

Just like Eurobonds issued by *European emerging markets* (e.g. CESEE EU Member States and candidate countries) typically lag the overall index developments in times of falling yield differentials (meaning that the yield differential declines less and the overall return is lower because these Eurobonds start from a much lower initial level), this negative development had only a limited impact on such European government bonds. The hardest-hit European Eurobonds were those issued by the lowest-rated countries in the group, e.g. Serbia, Ukraine and Russia.

CESEE Markets: International Financial Market Turmoil Triggers Correction of Romanian Leu after a Sharp Rise in the First Half of 2007

Most of the currencies analyzed in this report managed to escape the turmoil fairly unscathed *from end-March to end-September 2007*; some

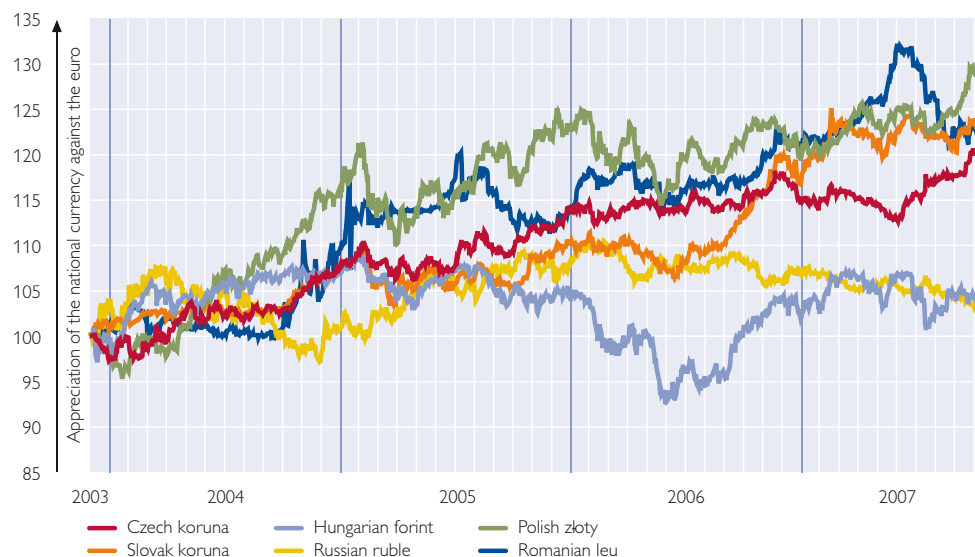
even firmed against the euro. The Polish zloty chalked up the highest gains during this period (+2.5% against the euro). While this currency rose almost as much as in the last reporting period (from end-September 2006 to end-March 2007), the Czech koruna's appreciation quickened from 1.1% to 1.7%. The Croatian kuna, barely hit by the market unrest, advanced by 1.8% from April until end-September 2007 thanks to vibrant tourism; this rise followed a depreciation in the fall and winter months. The Romanian leu managed to firm marginally (+0.3%) overall, but was subject to marked fluctuations during the period. Currencies that lost against the euro during the review period were the Slovak koruna (-1.6%), the Hungarian forint (-1.2%) and the Russian ruble (-2%). The depreciation of the ruble against the euro reflects the underlying basket of reference currencies (USD/EUR), which compels the ruble to partly follow the U.S. dollar's losses against the euro. The Bulgarian lev, which is under a currency board system, remained unperturbed during the turmoil in the financial markets.

In the first half of the review period *from end-March 2007 until the outbreak of global financial market turbulence in July*, the Slovak koruna, the Polish zloty, the Hungarian forint and the Romanian leu resumed their long-term uptrend. The appreciation was particularly marked in the case of the Romanian leu, which surged by 7% between end-March and the beginning of July 2007, and which thus reached the highest level since 2002. In all countries, this appreciation trend was interrupted between early May 2007 (in the case of Slovakia, the beginning of April) and early June

Chart 1

National Exchange Rates against the Euro

Dec. 31, 2003 = 100



Source: Thomson Financial.

Note: Index based on euro per unit of national currency.

2007, when political uncertainty about Turkey and Poland as well as rising interest rates in the U.S.A. and in the euro area caused investors to resort to temporary portfolio shifts.

The U.S. mortgage market crisis affected the analyzed currencies most heavily *between mid-July and mid-August 2007*. The Polish zloty and the Slovak koruna plummeted about 2% against the euro from July 24 to August 17, 2007. However, the Hungarian forint and the Romanian leu were hardest hit – during the same period, they slipped by around 5.4% and 4.2%, respectively. In Hungary, the currency slippage may be pinpointed to the still relatively early stage of economic stabilization – a policy which, while showing initial success, is also hotly debated; in Romania, it may be attributed to the high and still sharply rising current account deficit. Moreover, both countries' foreign exchange markets had a fairly elevated share of short-term

capital. The Hungarian forint and the Polish zloty recovered *from mid-August*, with the gains partly (forint) or even wholly (zloty) offsetting earlier losses, whereas the leu continued to depreciate substantially, as did the Slovak koruna, though to a lesser degree. Overall, the Romanian leu and the Slovak koruna depreciated by over 7% and 2.5%, respectively, against the euro *from mid-July to end-September 2007*. Nevertheless, the exchange rate losses of the currencies analyzed above were clearly smaller than the losses of many other emerging economies' or industrialized countries' currencies. The Brazilian real decreased by 9%, the Thai baht by 7%, and the New Zealand dollar as well as the Icelandic króna lost about 12% against the euro. One currency represented a remarkable exception among the currencies described: The Czech koruna, after depreciating from the beginning of 2007, gained roughly 4% against the euro from

mid-July to end-September 2007 because it had been in great demand as a refinancing currency for carry trades. Investors chose the Czech koruna both for the comparatively low level of interest rates currently prevailing in the Czech Republic (sustained negative differential to the euro area) and the perceived limited exchange rate and interest rate risks. Once investors' propensity to run risks had fallen from mid-July, carry trades were unwound, and the Czech currency posted marked gains.

From the end of September until mid-November 2007, the Czech koruna and the Polish złoty strengthened further against the euro (+3.4% and +2.9%, respectively); the Slovak koruna also began to resume its rise (+2.4%), whereas the Hungarian forint dipped marginally (-1.5%) and the Romanian leu kept declining markedly (-3.3%).

Fundamental Factors with an Impact on Exchange Rate Developments

Economic activity remained vigorous in most CESEE countries in the first half of 2007, partly even accelerating from whole-year 2006 results (in Poland, Slovenia, Slovakia, Bulgaria and Croatia). Growth was especially strong in the first quarter of 2007 (among other things because the mild winter was a boon to construction activity), but lost some momentum in the entire region, except in Bulgaria and Slovakia – in the second quarter. The first-quarter rise in economic growth was especially pronounced in Slovenia, which had introduced the euro on January 1, 2007. Throughout the region, GDP expanded by between almost 6% to over 9% in the first half of 2007. As before, Hungary represented an exception, with

growth slowing further to just 1.9% as a consequence of the government's reform measures.

In all countries but Hungary, *domestic demand* made a substantial contribution to economic growth, as in 2006. In Bulgaria and Romania, the contribution of domestic demand to growth exceeded that of exports to a particularly large extent. In most countries of the region, investment growth outweighed consumer spending as a domestic demand component of growth in the first six months of 2007. At the same time, private consumption augmented more quickly than GDP in the Czech Republic, Bulgaria, and especially Romania. Disregarding developments in Hungary, domestic demand in the region drew primarily on faster real wage growth (Croatia being the exception), on continued powerful and in some countries even stepped-up credit growth, on higher FDI (Czech Republic, Croatia and Slovenia) and on country-specific one-off effects (such as tax policy in Slovenia).

The *contribution of net exports to growth* was negative across the CESEE region in the first half of 2007 except in Slovakia and Hungary, and generally less favorable than in the first half and in the full year of 2006 except in Croatia (lower negative contribution to growth than last year) and Slovakia (larger positive contribution to growth). The reason for the latter was that export growth remained stable in Slovakia and diminished only slightly in Croatia, whereas import growth decreased in both countries. In combination with a less rapid slowdown in import growth or even faster import growth (Hungary), the drop in export growth in most other countries (except Slovenia) paralleling the slowdown of import growth in the

euro area reduced the contribution of net exports to growth. In particular, the large negative contribution of net exports GDP mounted further in Bulgaria and Romania. In Slovenia, export growth mounted, but so did import growth. As a result, the contribution of net exports to growth worsened in this country as well.

In conformity with the positive growth contribution of net exports in Slovakia, the deficit on the *goods and services balance* shrank from just under 5% to 1% of GDP in Slovakia compared to the first half of 2006. The Hungarian goods and services balance switched to a surplus of 2% of GDP. Even though net exports made a small negative contribution to growth, the surplus of goods and services more than doubled to 4.9% of GDP in the Czech Republic. In Bulgaria and Romania, however, the very high deficits on goods and services were the main reason for the current account gap in the first half of 2007. The partly high and rising external deficits must be seen in the context of the booming economy and strong investment demand. Especially in Bulgaria and Romania, though, vigorous consumer demand is likely to have contributed to boost import growth.

As a percentage of GDP, the deficit on the *combined current and capital accounts* was lower year on year in the first half of 2007 in the Czech Republic (1.1%), Slovakia (4.1%, just over half the comparable 2006 figure), Hungary (5.8%) and Croatia (18.9%). With a near-doubling of its deficit to 2.9% of GDP, Poland, long the country with the lowest deficit among the countries analyzed, lost this position. In Slovenia, the combined deficit expanded to 3.4% of GDP, and it augmented even more in Bulgaria and Romania, where the deficits climbed

from high levels in the first half of 2006 (16% and nearly 11% of GDP, respectively) to 22.4% and 16.2% of GDP, respectively. Although net FDI inflows (including intracompany loans) declined from the first half of 2006, they remained the key source of finance for the current account gap in most of the countries analyzed. In the first half of 2007, the remaining gap was not insignificant in the three countries with exceptionally high current account deficits, namely Bulgaria, Croatia and Romania. Moreover, in Slovenia, this gap was still large, and in Hungary, it had grown large. In the latter two countries, the extensive gap may be explained by net FDI outflows mainly due to direct investment of these countries abroad.

The Hungarian forint and the Romanian leu continued to exhibit large *short-term interest rate differentials relative to the euro area*. However, the differential remained on a marginal downtrend in Hungary and a pronounced downtrend in Romania. The downtrend in both countries is attributable to the central banks' key interest rate cuts, in addition to rising interest rates in the euro area. The key rate cuts represented presumably a reaction to falling inflation, to strong appreciation pressure and, in Hungary, to a weakening of credit growth. Whereas the moderate rise in the short-term interest rate differential appears to have somewhat supported the appreciation of the Polish zloty, the differential generally remained stable at a low level in Slovakia, apart from a brief interlude in August 2007, when it reversed in the wake of the rise in euro area interbank interest rates.

Slovakia and, above all, Croatia executed large-scale *foreign exchange intervention operations* to influence

exchange rate dynamics during the review period. In April 2007, Národná banka Slovenska intervened with a purchase of over EUR 700 million after the Slovak koruna had traded 6% higher than the center of the parity. As a reaction to the appreciation of the Croatian kuna since the beginning of April 2007 and continued appreciation pressure, Hrvatska narodna banka intervened three times, most recently on October 1, 2007, with its most sizeable intervention ever. The currency had come under pressure in the course of the unexpectedly animated demand for stocks of the telecommunications company T-HT (purchases totaling over EUR 350 million).

Banks' net external asset position deteriorated in Poland, Slovakia, Romania and Bulgaria in the first half of 2007. In Poland and Bulgaria, the positive net external asset position contracted, and the negative position in Slovakia and Romania widened, developments which are likely to have contributed to the firming of the Polish, Slovak and Romanian currencies in the first half of 2007.

The main *risk factors* for the CESEE countries lie in a slowdown in GDP growth in the euro area and in a worsening of external financing conditions. If capital becomes more expensive in the longer run, and if foreign investors assess the risks of individual countries in the region as permanently higher, inflows of foreign capital could be dampened or even a (sudden) capital outflow could set in, which would have a negative impact on exchange rates. That would affect above all countries which have elevated current account deficits and where FDI inflows are insufficient to cover external financing needs, compelling them to depend on possibly

volatile portfolio investment and rising loan liabilities. Though foreign parent companies (of banks or non-financial corporations) have extended the bulk of credit outstanding, noticeable reductions in inflows (or even net outflows) of portfolio and cross-border loans represent a risk factor for these countries' currencies. Therefore, to support the economic catching-up of these countries, it is crucial to limit or to roll back deficits caused by disproportionately high domestic demand and in particular consumer spending growth. Moreover, ensuring that the economic climate is fundamentally attractive for direct investment inflows represents an important economic policy task.

Yield Spreads of National Currency-Denominated Government Bonds Widen Marginally

The yield spreads of ten-year local currency-denominated government bonds against euro area benchmark bonds in the four CESEE countries analyzed here (Poland, Slovakia, the Czech Republic and Hungary) had reached a 12-month low in the last period (end-September 2006 to end-March 2007) and continued to sink for some time in Hungary and Poland. Spreads contracted from 260 basis points *from the end of March 2007* to about 200 basis points *mid-July 2007* in Hungary and from 115 basis points to 85 basis points at the beginning of June 2007 in Poland, followed by a rise to 105 basis points in mid-July. Conversely, in Slovakia, spreads lost another 10 basis points until mid-April 2007, but then increased from nearly zero to 20 basis points mid-July. In the Czech Republic, the uptrend of yield differentials

started as early as mid-February, with markets anticipating the tightening of monetary policy. Until the end of March, spreads reversed from –35 to +5 basis points and continued to widen to 15 basis points mid-July 2007.

In the third quarter, investors' risk appetite declined as a result of the U.S. mortgage market crisis, which was reflected in a widening (albeit to a limited extent) of the spreads of the government bonds analyzed here. During the period of strongest turbulence *from mid-July through mid-September 2007*, spreads enlarged in all four countries (Hungary: +70, Poland: +60, Slovakia and Czech Republic: +30 to +40 basis points). Only in Hungary was the broadening of yield spreads, and – given the relatively strong depreciation of the forint against the euro – the loss in euro terms larger during the two-month period than the emerging market average (in terms of J.P. Morgan's Government Bond Index – Emerging Markets Broad, GBI-EM Broad). *Mid-September 2007*, yield spreads in the Czech Republic were at the same level as in early 2006, and in Slovakia and Poland at the level of fall 2006; in Hungary they were at the March 2007 level. Subsequently, *until end-September* yield spreads decreased in all four countries and on the emerging markets average (Hungary: –40, Poland: –30, Slovakia and the Czech Republic: –20, GBI-EM Broad: –25 basis points).

Thus, compared with the beginning of the review period, until end-September 2007, spreads rose moderately in Poland, Slovakia and the Czech Republic (by about 15 to 20 basis points). Although Hungary temporarily reacted most intensely to

the U.S. subprime mortgage crisis, at end-September 2007, its yield spread was about 30 basis points below the end-March level, so that Hungary still exhibited the largest differential to the euro area (roughly 230 basis points). Poland, Slovakia and the Czech Republic followed, with spreads of 135, 40, and 25 basis points, respectively.

Yield spreads contracted by 5 to 10 basis points in all four countries *from end-September to mid-October 2007*, but rose by 20 to 30 basis points (and thus less than the emerging market average) until mid-November. This fluctuation echoed the movements in the international financial markets.

Fundamental Factors with an Impact on Yield Developments

Apart from the summer months, in which the yield gap was substantially influenced by negative market reactions to the situation in the U.S.A., the development of the yield differential corresponded to the *inflation differential against the euro area* (as measured by the HICP) in the Czech Republic, Poland and Hungary. The Czech and Polish inflation differential to the euro area became positive at +0.9 percentage points and +0.4 percentage points, respectively, after having stood at –0.8 percentage points and –0.5 percentage points in November and December, 2006, respectively. In Hungary, the positive inflation differential to the euro area sank from 7.1 percentage points in March 2007 to 5.4 percentage points in August 2007, whereas in Slovakia, the differential switched from +0.2 percentage points in March 2007 to –0.5 percentage points in August 2007. In parallel, euro area inflation eased from 1.9% to 1.7% during the same period. In the

Czech Republic, private consumption growth has already come to be slightly higher than GDP growth, unlike in all other countries analyzed, where private consumption does not appear to be exerting strong demand-side inflationary pressure yet. However, the development of the output gap and pressure on the labor market in Poland, the Czech Republic and Slovakia could have an inflationary impact (in the medium term).

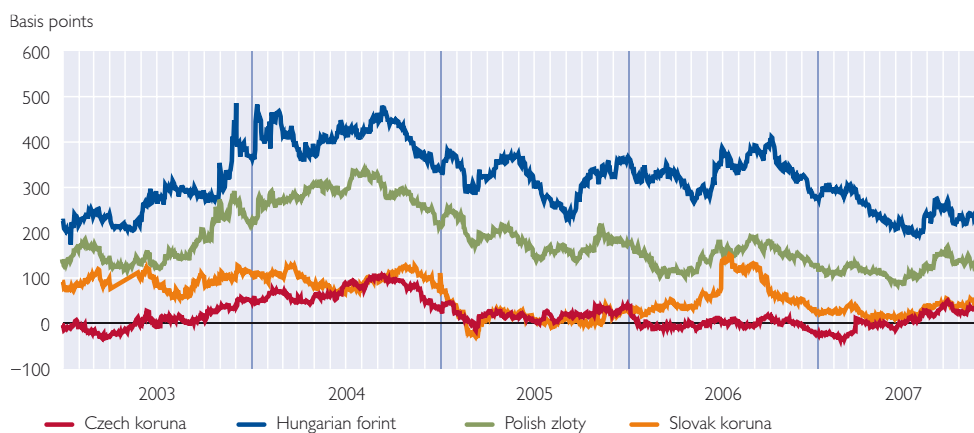
With the exception of the first three weeks of August, in which euro area money market rates skyrocketed as a result of general caution on the interbank market, the development of *differentials between short-term money market rates in the four countries under review and those in the euro area* largely corresponded to the development of long-term yield spreads from March to September 2007 (lower negative differential in the Czech Republic, larger positive differential in Poland and continued decline in the positive differential in Hungary).

In Hungary, *budget developments* continued to support the reduction in long-term yield differentials. In Poland, the Czech Republic and Slovakia, the development of the budget outturn and budget plans for 2008 are unlikely to have considerably influenced yield differentials either positively or negatively.

Even if the impact of the recent financial turmoil on these four countries was limited and even if the largely stability-oriented economic policies helped to shield them from unfavorable external developments, the as yet fragile global financial environment – which involves as yet uncertainty about the effects of the recent turbulence and requires risks to be reassessed – represents the biggest *risks to yield developments*. Additionally, yield developments will depend on how strictly the countries adhere to their fiscal consolidation plans (or take additional measures, if necessary) and whether public sector wage policy is differentiated and prudent.

Chart 2

Spreads of Ten-Year Government Bonds against Euro Area Benchmark Bonds



Source: Bloomberg.