

Robust International Economy Fuels Recovery of Financial Markets Following Corrections in Spring

Industrialized Countries: Positive Growth Outlook but Downside Risks

Continued Robust Economic Expansion

Although *global economic* prospects remain bright on the whole, there will be downside risks in 2007. According to the World Economic Outlook of the International Monetary Fund (IMF), the global economy will grow by 5.1% in 2006 and by 4.9% in 2007. This means that the IMF's current growth outlook exceeds its spring outlook by 0.25 percentage point. Inflation should rise only temporarily in both industrialized and emerging economies just to fall to 2.3% and 5% in 2007, respectively. In other words, the positive trends of the past few years should continue with relatively low inflation and robust growth.

In *industrialized countries*, economic growth in the first half of 2006 remained buoyant on the whole, even though oil prices during this period soared to as high as USD 78 in the wake of military action in the Middle East. Oil prices have since fallen notably to below USD 60. Oil price forecasts for mid-2007 range from USD 50 to USD 78 per barrel (Consensus Forecast). Long-term interest rates remained low whereas short-term rates – particularly in the U.S.A. and in other industrialized countries – rose on the back of monetary policy tightening which was initiated and, in some cases, continued in recent quarters. As regards the three largest economic areas, growth momentum in the *U.S.A.*, above all, has continued to slow gradually from

a high level. This trend is likely to continue in the second half of 2006 due to the visible cooling of the real-estate market and to weaker private consumption. In the *euro area*, growth in the first half of 2006 continued to accelerate and broaden owing to, *inter alia*, a positive development in fixed capital formation. Germany and Italy, which had exhibited lower growth rates than the euro area on average in the past, also registered far stronger economic momentum. For the remainder of 2006, the European Commission predicts a somewhat slower continuation of the healthy growth performance.

In *Japan*, the economy continued to recover. In the three largest economic areas, unemployment fell in the past few quarters while capacity utilization continued to increase and, in some cases, is already at an elevated level.

At the same time, inflation rose on the back of higher energy prices, in particular. If oil prices, which have recently fallen significantly, remain at a relatively low level, energy price inflation rates can be anticipated to slow down. However, the U.S.A., in particular, experienced a marked rise in core inflation while the euro area saw producer prices come under greater upward pressure but core inflation in this region has so far remained low. In Japan, the period of deflation now appears to be over. For 2007, the IMF's current outlook assumes continued buoyant, albeit somewhat slower, economic momentum, with growth rates hovering around the long-term average, as well as somewhat higher inflation. This

Table 1

IMF World Economic Outlooks of April and September 2006

	GDP growth (% on previous year)				Consumer price inflation (% on previous year)			
	2006		2007		2006		2007	
	Apr. 06	Sep. 06	Apr. 06	Sep. 06	Apr. 06	Sep. 06	Apr. 06	Sep. 06
U.S.A.	3.4	3.4	3.3	2.9	3.2	3.6	2.5	2.9
EU-12	2.0	2.4	1.9	2.0	2.1	2.3	2.2	2.4
Japan	2.8	2.7	2.0	2.1	0.3	0.3	0.6	0.7

Source: IMF (World Economic Outlook).

means that, in particular, its current growth outlook for the U.S.A. was revised downward relative to the spring outlook.

The *risks* to this continued positive outlook for economic growth largely point to the downside though inflationary pressures could turn out to be stronger. Robust global growth and growing capacity utilization mean that the price-dampening impact of globalization on import prices has become less significant. Apart from supply-side induced high oil prices, downside risks to growth include a disorderly correction of the U.S. current account deficit and an inflation-induced rise in interest rates, with potential negative consequences on real estate prices that have rocketed in many countries.

Declining Long-Term Interest Rates, Stabilization of Stock Markets

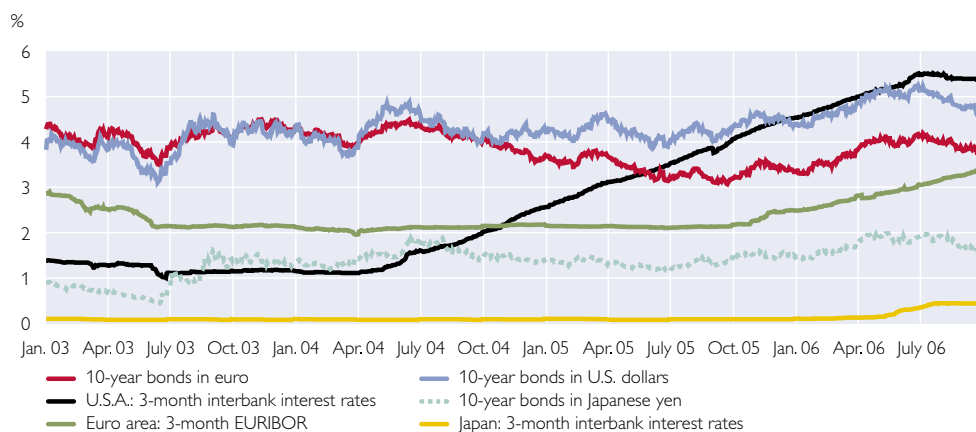
At end-June 2006, the U.S. Federal Reserve raised key *money market* rates by a further 25 basis points to 5¼%. Since then, U.S. key interest rates have remained stable, after having been increased by 150 basis points in total over the past 12 months. In the euro area, key interest rates were raised by 25 basis points each in June,

August and October 2006 (and by a total of 125 basis points in the last 12 months) to 3.25% while the Bank of Japan (BoJ) increased key interest rates in July 2006 by 25 basis points to 0.25%. The central banks in a number of other industrialized countries also increased their key interest rates. The Open Market Committee of the Federal Reserve System announced in September 2006 that further monetary policy tightening could be necessary in view of still existing inflation risks. The Governing Council of the European Central Bank (ECB) noted in October 2006 that key interest rates had continued low and that it would be warranted to further withdraw monetary accommodation if the assumptions about future economic growth will be confirmed. The U.S. money market's yield curve signaled in early October that the money markets considered a lowering in key interest rates next year to be a possibility. In the euro area, the money market yield curve indicates that there are expectations of a further hike in key rates before the end of 2006. In Japan, forward rates suggest that key interest rates will continue to climb slowly.

Long-term interest rates in the U.S., euro area and Japanese *govern-*

Chart 1

**Interest Rate Developments in the U.S.A., the Euro Area and Japan
from January 1, 2003, to October 4, 2006**



Source: Thomson Financial.

ment bond markets underwent a trend reversal to the downside in July 2006. This may be attributable to increased market expectations of a slowdown in the world economy starting in the U.S.A. In both the U.S.A. and the euro area, inflation risk premia derived from inflation-indexed bonds with a residual maturity of ten years have since declined slightly, which is due to the notably falling oil prices. Long-term real interest rates measured by the yields on these bonds were also a tad lower.

Risk premia on corporate bonds in the U.S.A. and the euro area exhibited an uptrend in the past four quarters, which strengthened for a short while in May 2006 owing to the markets' increased risk aversion. In early October 2006, spreads for issuers with a lower credit rating (BBB) were 120 basis points in the U.S.A. and 130 basis points in the euro area. Since the prospects for the probability of loan defaults have not changed in essence, this indicates that investors are somewhat less willing to assume credit risks.

As for stock markets in the U.S.A., the euro area and in Japan, stock in-

dices have rallied since the steep losses of May/June 2006 triggered by increased investor risk aversion. In the euro area and the U.S.A., stock price levels have now returned to their levels of May 2006, leading to prices firming by some 11% and 7% since the beginning of 2006, respectively. Healthy corporate profitability and declining long-term interest rates have fueled the recovery. In addition, implied stock price volatility decreased following increases in May/June, although the decrease in the U.S.A. was less marked. This suggests reduced investor uncertainty. Price/earnings ratios in recent quarters 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, price/earnings ratios, despite very strong price gains in the past few quarters, are below their historical, albeit relatively high, average since 1990.

In the foreign exchange markets, the euro remained relatively steady against the U.S. dollar in the past few months (around USD 1.27 per euro). Despite the end of the BoJ's policy of

quantitative easing and the country's dynamic economic recovery, the Japanese yen depreciated in value, latterly stabilizing at the historically low level of around JPY 150 per euro. The Swiss franc depreciated in the past few months, softening to almost CHF 1.59 per euro. This is likely to be in connection with the interest rate advantage enjoyed by euro area investments, which has been growing in the last few months.

Emerging Markets: Dynamic Growth – Private Capital Inflows

Continued Robust Growth

The IMF expects that *emerging market economies* (EMEs) will experience sustained economic momentum in 2006 and has accordingly revised its growth forecast for these countries sharply upward. Real GDP growth of EMEs is expected to be 7.3% in 2006 and 7.2% in 2007. Inflation is anticipated to fall slightly to 5.0% by 2007. Turmoil in the world financial markets in May/June 2006 did not adversely affect the outlook significantly primarily because the increases in emerging market spreads remained a temporary phenomenon only and these spreads are still historically low. However, EMEs remain susceptible to changes in international investors' willingness to take risks and sensitive to a rise in interest rate levels in industrialized countries. For oil importing countries, adjustments to terms-of-trade losses, a good portion of which may be long lasting, represent an economic challenge that has so far been met remarkably well.

Non-Japan Asia (NJA) in the first half of 2006 sustained the economic momentum commencing in mid-2005 on the back of exports and robust domestic demand. The IMF ex-

pects NJA to experience an uninterrupted economic upturn in 2006 and 2007, for which further developments in the U.S. economy will represent the main risk, in addition to high energy prices. In China, real GDP growth in the first half of 2006 accelerated to 10.9% year on year. Beginning in April 2006, the People's Bank of China raised its key interest rates to curb the high levels of lending growth.

In *Latin America*, rapid economic momentum accelerated in the first half of 2006, and the IMF anticipates exports and domestic demand to fuel real GDP growth of almost 5% for the year as a whole. The fact that both stock price and exchange rate losses owing to turmoil in global financial markets in May/June 2006 were relatively quickly offset reflects Latin America's decreased vulnerability thanks to its current account surpluses, higher currency reserves, more flexible currency regimes and stronger fiscal positions.

According to the IMF, the fact that also oil-importing countries in *Sub-Saharan Africa* are posting robust growth is primarily explicable by improved economic policies, stronger institutions and a better investment climate. The continuation of these developments should be supported by the market liberalization of both industrialized and emerging economies, debt cancellations and increases in development cooperation funds, which is particularly important if the Doha round fails.

In the *Middle East*, oil revenue has been increasingly used to build infrastructure and to consolidate the non-oil sector. In this region, loan growth, as well as asset prices (stocks, real estate) and their volatility, have soared in the past three years, resulting in

the financial sector becoming more vulnerable due to a possible deterioration in credit quality or to asset price corrections.

In *Turkey*, the coincidence of higher than expected inflation from April 2006 with increased worldwide risk aversion triggered a sharp depreciation in the national currency and a substantial retreat in stock prices. Surmounting these difficulties lasted longer than in other emerging markets – a sign of Turkey’s greater vulnerability in the eyes of investors. The Turkish central bank reacted to the turmoil in the financial markets and to the rise in inflation by increasing key interest rates by 425 basis points in total. Although the central bank will fail to meet its inflation target set in early 2006, it stood by its explicit mid-term inflation target of 4%. The current account deficit, which deepened significantly in 2005, is not set to shrink in 2006 despite the Turkish lira’s sharp depreciation, as revenue from tourism is expected to take a knock owing to political uncertainties. The financing of this deficit has recently been facilitated by the rapid growth of FDI inflows driven, first and foremost, by Turkey’s EU accession process.

High Private Net Capital Inflows with Growing Current Account Surpluses

Private net capital inflows to EMEs accelerated in 2005, reaching a historical high. The first half of 2006 saw further net inflows despite the turmoil in global financial markets. The IMF expects sustained high, albeit moderately lower private net inflows for the full years 2006 and 2007. These will arise exclusively from net direct investment whereas, for port-

folio investment and other flows (especially credits), net outflows are anticipated. In all individual regions, direct investment constitutes the key net inflow measure. For Africa, Latin America as well as for Central and Eastern Europe (CEE), net inflows are also expected for portfolio investment. For CEE, net inflows are also anticipated for other flows.

From a regional perspective, EMEs in Europe received the lion’s share of private net inflows in 2005. This region was also the only one with a current account deficit in aggregate terms in recent years. In the Middle East, higher crude oil prices generated considerably higher current account surpluses coupled with an *increase in official currency reserves* while the investment of oil export revenue gave rise to private net capital outflows. In the other regions, the combination of current account surpluses and private net capital inflows is reflected in the continued build-up of currency reserves. Since 1998, the ratio of currency reserves to imports has increased from 45% to 69%, having a positive impact on EMEs’ resilience to shocks. Some observers see this huge increase in EMEs’ currency reserves as one of the reasons for industrialized countries’ historically low level of long-term interest rates.

In addition to changes to official currency reserves, *public sector net capital outflows* were observed in all regions in 2005 due to repayments of foreign debt and investment by oil exporting countries, in particular. The IMF also expects the same for 2006 and 2007. Overall, public sector net outflows will in fact exceed private net inflows in 2006 and be roughly as high as the latter in 2007.

Table 2

**Net Capital Flows to Emerging Market Economies and
Developing Countries according to the IMF¹**

USD billion

	2002	2003	2004	2005	2006 ²	2007 ²
Private net capital inflows	77.3	165.6	205.9	238.5	211.4	182.2
By instrument						
Direct investment	150.6	159.1	176.9	255.9	263.3	246.1
Portfolio investment	-91.7	-10.9	13.9	3.2	-31.1	-4.6
Other flows	18.4	17.3	15.1	-20.6	-20.8	-59.2
By region (country)						
Latin America and Caribbean	3.8	17.3	1.1	14.0	12.7	18.5
Europe	53.2	51.4	70.4	113.5	88.8	84.8
CIS	15.7	17.7	7.5	37.6	18.8	5.4
Middle East	-20.0	4.4	-19.6	-20.0	-31.8	-17.3
Africa	4.1	6.8	16.1	29.4	24.9	21.7
Asia	20.6	68.1	130.4	64.0	97.9	69.0
Memorandum						
Public sector net capital inflows ³	-4.3	-53.1	-64.7	-151.8	-238.7	-174.1
Current account balance	133.3	229.6	303.8	514.7	666.8	720.4
Reserve assets ⁴	-200.6	-362.7	-513.5	-592.5	-666.3	-747.9

Source: IMF (World Economic Outlook).

¹ The table shows aggregated balance of payments data sets of 131 nonindustrialized countries, including the major 44 EMEs. Europe = Central and Eastern Europe, excluding European CIS countries and including Turkey.

² Forecast.

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

⁴ A minus sign indicates an increase.

**Claims of Austrian Banking
Sector Lead in CEE**

In the international arena, Austrian banks have great importance as lenders and financial intermediaries in CEE. At end-March 2006, claims came to around 7% of recipient countries' GDP (see table 3).

**Continued Below-Average Growth
of Return of Emerging Europe's
Foreign Currency Bonds**

Setbacks and recovery phases marked international eurobond market trends between end-March 2006 and end-September 2006. After the average *yield differential* of EME issuers' government bonds denominated in euro and U.S. dollars against benchmark bonds (based on J.P. Morgan's (Euro) EMBI Global index) had reached a low of about 50 (euro) and 180 (U.S. dollar) basis points in early March (euro) and early May (U.S. dollar), this spread widened in the wake of the turmoil in the financial markets

from May to end-June 2006 to some 105 and 230 basis points, respectively. July and the first half of August 2006 saw an almost complete correction before yield differentials began to widen again, standing at some 80 (Euro) and 210 (U.S. dollar) basis points at end-September.

Although yield differentials in the entire period under review showed a slight increase, from end-March to end-September 2006 eurobonds denominated in U.S. dollars and euro generated a (non-annualized) *overall yield* of more than 4% and around 2%, respectively. In regional terms, European issuers' eurobonds posted a below-average performance in both market segments. This was attributable primarily to the rather modest performance posted by eurobonds with relatively low ratings (on the EMBI Global index, especially Serbia and Turkey; on the Euro EMBI Global index, Turkey, Bulgaria, Croatia and Romania).

Table 3

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

	% of GDP of the receiving country											
	AT	DE	IT	FR	NL	SE	BE	UK	Europe ²	US	JP	
Central and Eastern Europe plus Turkey	7.2	6.6	3.5	3.1	2.3	2.4	3.2	1.4	34.3	1.9	0.6	
Central European EU Member States												
Poland	3.1	6.9	6.2	1.6	4.5	0.8	2.8	0.5	33.9	2.6	1.1	
Slovakia	36.3	5.3	19.2	4.5	7.4	0.1	12.3	0.9	87.2	2.3	0.1	
Slovenia	22.2	11.3	2.2	5.4	0.7	0.0	4.4	0.2	47.3	0.4	0.5	
Czech Republic	22.9	5.3	1.5	14.7	2.3	0.1	20.8	1.6	70.0	2.6	1.6	
Hungary	17.7	19.3	7.5	3.2	2.5	0.1	9.3	1.7	78.4	2.9	0.5	
Rest of Central and Eastern Europe												
Bulgaria	8.0	3.8	6.0	3.1	1.1	0.0	0.3	0.2	40.0	0.7	0.2	
Croatia	53.5	9.1	48.9	1.6	0.4	0.0	0.6	0.6	116.1	0.6	1.1	
Romania	6.7	2.1	2.3	5.3	4.6	0.1	0.1	0.2	29.2	1.2	0.1	
Russia	0.9	4.7	0.2	0.9	1.0	0.2	0.1	0.7	10.2	1.1	0.5	
Turkey	0.2	3.8	..	2.7	1.4	0.1	2.2	2.9	15.9	2.6	0.6	

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

Note: The claims shown here correspond to the "Consolidated Foreign Claims of BIS Reporting Banks" published by the BIS (BIS Quarterly Review September 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 although, in the case of subsidiaries in host countries, only claims existing in a currency other than that of the host country are included.

¹ As of end-March 2006.

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

The sharp correction in spreads in May and June 2006 from previously attained record lows was induced less by country-specific factors than by a general reduction in investors' risk appetite and by the rise in both short- and long-term interest rates in the major industrialized countries until early July 2006. During the first eight months of 2006, the number of rating upgrades exceeded the number of rating downgrades by a wide margin, resulting in a further improvement of both indices' average ratings as well. The increase in investors' risk aversion is due to the volatility of energy prices (primarily oil) and geopolitical uncertainties (war in Lebanon, tension with Iran). Likewise, capital market rates, which have fallen since early July, and the stabilization of U.S. short-term interest rates are likely to have played a major part in the recovery of eurobonds since early

July. It should also be underlined that the selling surge in various asset classes in May and June 2006 concerned first and foremost, stocks, foreign currencies and local currency bonds rather than eurobonds. There are two reasons for eurobonds' resilience. First, fundamental data improved. Second, market-related factors, such as growing institutional demand (for eurobonds as an addition to the traditional portfolios mix for risk diversification purposes) at the same time as easing supply (pre-financing in 2005, bond buybacks, mounting preference for issuing local currency bonds) may have also played a part. Whereas market average yield spreads are likely to be in line with fundamental data (based on the average rating) at the level of broad indices, the dispersion of yield spreads across countries included in the relevant indices was still far smaller than

Table 4

Eurobonds: Spreads to Reference Bonds and Returns by Region

	EMBI Global (in USD)						Euro EMBI Global (in EUR)					
	Share of total index in %	Yield differential in basis points		Total return in %	Rating	Duration	Share of total index in %	Yield differential in basis points		Total return in %	Rating	Duration
		Sep. 29, 2006	Sep. 29, 2006					Change since March 31, 2006	Since March 31, 2006			
Overall index	100.0	208	17	4.3	BB+	7.01	100.0	76	7	2.1	BBB	5.58
Africa	3.4	288	38	3.2	BBB	3.45	4.7	92	27	1.5	BBB+	5.20
Asia	15.4	182	1	5.2	BB+	6.53	4.8	102	5	2.2	BBB	4.58
Europe	23.4	165	33	2.8	BBB-	6.76	67.6	59	10	1.8	BBB+	5.85
Latin America	54.7	218	10	4.8	BB+	7.57	22.9	126	-1	3.0	BBB-	5.07
Middle East	3.0	420	82	0.0	B-	5.38	x	x	x	x	x	x

Source: Bloomberg, JP 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 growth of yield differentials and returns as well as differences in other index features can be attributed in part to this different composition. The rating is calculated as the average of Moody's, Standard & Poor's and Fitch's ratings for long-term government foreign currency liabilities and are given in the rating categories of Standard & Poor's.

the dispersion of their ratings, which might be considered to mark a relatively small differentiation by investors. Similarly, the difference between the yield spreads on eurobonds of sovereign debtors and corporate bonds of the same rating grade (not adjusted for maturity structure) fell short of their historical level. This difference was less positive or more negative depending on the rating grade. Apart from these rather *technical risk factors*, higher inflation rates and a sharper increase in major industrialized countries' key interest rates than currently expected, a significant cooling of the world economy (especially in the U.S.A.), a disorderly correction of global imbalances and an increase in geopolitical risks are all likely to be key risk factors for the eurobond market. Above all, countries with high external financing requirements, deep budget deficits and inadequate economic policy sustainability are likely to be particularly affected by another increase in investors' risk aversion and by the ensuing capital outflows.

Central and Eastern Europe: Currencies Stronger, Except for Hungarian Forint

Most CEE currencies under review had an *exchange rate* at end-September 2006 that was either unchanged or firmer against the euro than at end-March 2006 even if some had fluctuated sharply in the interim. The Hungarian forint was the main exception: By end-September, it had softened by some 2.7% against the euro, compared with end-March. In the period under review, the Russian ruble depreciated by some 1.2% against the euro. However, this was attributable to the performance of the USD/EUR exchange rate. The ruble appreciated by some 1.5% against its basket of currencies consisting of euro and U.S. dollars at a ratio of 45% and 55%, respectively. The Slovak koruna, which also depreciated during the summer, more than made up for lost ground. In addition, the Polish zloty, which had come under pressure, has since end-June firmed around end-March levels, albeit with setbacks. The Czech koruna, the Ro-

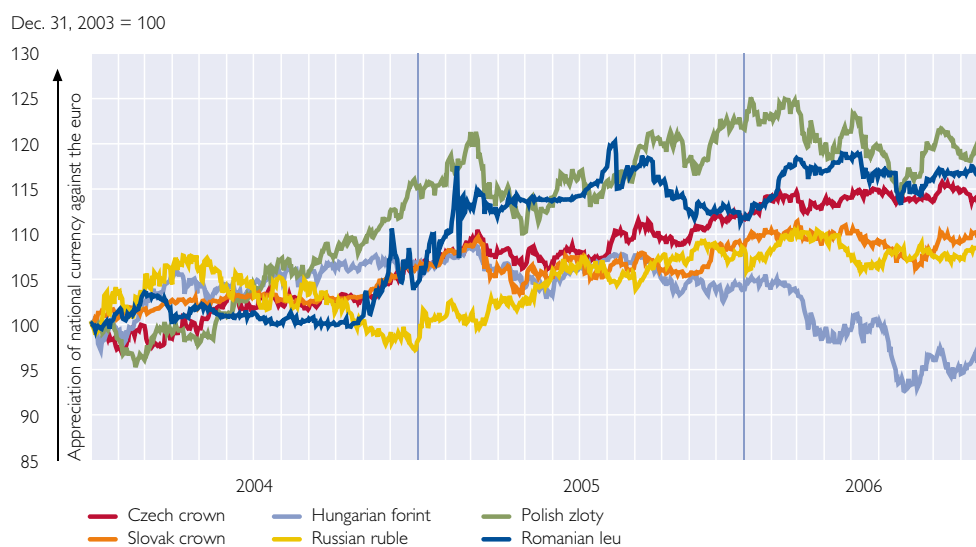
manian leu and the Croatian kuna were subject to by far smaller fluctuations. At end-September 2006, the Czech koruna was firmer by some 0.9%, and the latter two currencies were around 0.5% softer against the euro than at end-March. On a year-on-year basis, only the Hungarian forint posted a substantial depreciation whereas, of the currencies under review, the Czech koruna registered the biggest nominal appreciation (+5%) against the euro. The Slovenian tolar's exchange rate remained almost unchanged at the ERM II central rate, which was fixed as an irrevocable conversion rate for entry to the euro area at the beginning of 2007.

The performance of CEE exchange rates was partly overshadowed by negative *external factors*. These factors are roughly classifiable into two groups. The first group comprises factors the impact of which has accumulated over a fairly long period – such as rises in short-term interest

rates, capital market rates and interest expectations in major industrialized countries – thus gradually dampening the incentive for seeking higher yield prospects in riskier market segments (stocks, corporate bonds, EME assets). From early July 2006, however, the stabilization of U.S. short-term interest rates, the moderation of expectations of interest rates hikes and the sharp decline in long-term yields in the U.S.A. and the euro area had a favorable impact on the global sentiment of financial investors and thus also on the performance of CEE currencies. The second group of external risk factors includes “shocks” in certain market segments (such as the U.S. stock market's nosedive in mid-May and early June 2006) and certain countries (e.g. Iceland and New Zealand in March 2006 due to compelling current account problems or in Turkey in May 2006 owing to both current account and inflation problems). These shocks emerged without much warning (albeit not completely

Chart 2

Exchange Rates of National Currencies against the Euro



Source: Thomson Financial.

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

unrelated to the aforementioned group of external factors) and spread relatively rapidly in an environment characterized by the aforementioned factors. As a result, considerable amounts of capital flowed out of both the stock markets and local currency bond markets of some CEECs exhibiting a high current account deficit and thus a similar risk profile (e.g. Hungary), a deep fiscal deficit (e.g. Hungary) or domestic political uncertainties (e.g. Slovakia, Hungary). These *country-specific factors* played a greater role in CEECs particularly in June and July 2006.

In Hungary, the government was forced to admit in mid-June 2006 that the budget deficit had got out of hand: it threatened to reach some 12% of GDP in 2006. Market players took skeptical note of correction measures announced at the same time and totaling some 1.5% of GDP; it is likely that this sentiment was very much influenced by the fact that the government's fiscal policy had lacked credibility for some time. In addition, the major rating agencies delivered a more unfavorable assessment of the country's risk outlook. However, the Hungarian forint has largely remained unaffected by the country's domestic political turmoil since mid-September 2006. In Slovakia, markets responded negatively to the formation of a coalition government including national populist parties that had announced a partial retreat from market reforms, which exacerbated the impact of external factors on the currency. In Poland, by contrast, the dismissal of the reform-friendly finance minister at end-June 2006, the resignation of the moderate prime minister in early July and the collapse of the three-party coalition at end-September each provoked a negative re-

sponse from the markets for a short while only. In the Czech Republic, the stalemate situation following the parliamentary elections, which has thwarted the formation of a majority government even after four months of talks, did not have any significant negative impact on the national currency either.

The CEE currencies continued to perform in a macroeconomic environment marked by robust growth. In the first half of 2006, GDP growth in most of the countries under review attained rates of between 5.0% and 7.5%. Hungary, which posted growth of 4.2%, was the sole exception. Of the countries under review, Hungary was the only one where net exports continued to make a higher contribution to GDP growth than domestic demand as a whole. Unlike the scenario in Bulgaria, Croatia and Romania, however, the contribution of net exports to growth also remained positive in the other four Central European countries. With the exception of Hungary, investment accelerated at a faster pace than consumption, which continued to increase at a slower rate than GDP as a whole in all the countries (except for Romania), thereby tending to reduce inflationary pressures.

In the first half of 2006, the deficit on the combined current and capital accounts relative to GDP further increased on a year on year basis from an already high level (to between 7% and 20% of GDP) in Hungary, Slovakia, Bulgaria, Croatia and Romania. The Czech Republic also registered a widening of its deficit, albeit at a much lower level (3% of GDP). In Hungary and the Czech Republic, the deficit was induced by the negative balance of the income and current transfers accounts whereas the goods

and services balance was positive. By contrast, the deficit in Slovakia and, especially, in Bulgaria, Croatia and Romania was induced by significant (and on a year-on-year basis, increased) reductions in the goods and services balance. In all four countries, however, this may have been partly connected with imports attributable to brisk investment demand, although, in Romania, consumer goods imports are also likely to have played a fairly significant role. Equally, the fact that the net inflow of direct investment (including intra-company loans) increased and limited the widening of the remaining external financing gap should also be seen in a positive light. The remaining external financing needs were large in scale in Croatia only (almost 14% of GDP). In Hungary, Bulgaria and Romania, the external deficit after the deduction of (on a year-on-year basis, increased) direct investment inflows amounted to 2% to 4% of GDP. Although capital inflows plugged this financing gap (thereby also permitting the build-up of currency reserves), the shortfall also led to a further increase in foreign debt. Financing requirements in the first half of 2006 are also attributable to seasonal factors particularly in Croatia and Bulgaria.

In conjunction with existing liquid investment opportunities, the increase of *short-term interest rate differentials relative to the euro area* in response to central bank rate hikes propped up the national currencies of Hungary and Slovakia. In Poland, however, the interest rate differential narrowed as a result of stable Polish interest rates relative to rising euro area rates while the negative interest rate gap between short-term rates remained largely stable in the Czech Republic.

Whereas the central bank rate hikes were primarily traceable to inflation developments, several central banks deemed it appropriate *to intervene in the foreign currency market* in response to exchange rate fluctuations. The Slovak central bank intervened with relatively small sums in favor of the Slovak koruna in April and May 2006, but also sold foreign currency totaling EUR 3.1 billion in June and July 2006 to counter the depreciation of the Slovak koruna. By contrast, the Croatian central bank repeatedly purchased foreign currency from banks between May and July 2006 in a bid to check upward exchange rate pressure on the Croatian kuna. Following a relatively rapid depreciation of the kuna between early August and mid-September 2006 in response to the tightening up of provisions relating to commercial banks' short-term foreign currency liquidity requirements (which coincided with the end of the tourism season), the Croatian central bank both purchased and sold foreign currency in the second half of September to stabilize the exchange rate. In Slovenia, banks almost completely ran down their foreign currency swap portfolio with the Slovene central bank in June and July 2006. This is likely to be connected with Slovenia's forthcoming entry to the euro area on January 1, 2007. Pursuant to the decision of the European Council of June 11, 2006, the conversion rate will be SIT 239.64 per euro, which is equivalent to the Slovene tolar's central rate in ERM II.

Apart from the negative consequences of high exchange rate volatility for the real economy and financial investors, exchange rate stability is also important from the perspective of financial stability in countries with

a large share of foreign currency loans¹ as a percentage of total domestic credit to enterprises and households. The high current account deficit, which is partly a result of high domestic loan growth and/or relatively deep fiscal deficits, still looks to be the biggest risk factor for exchange rate stability in many CEECs, provided the deficit does not arise directly from imports attributable to direct investment.

An economic climate that promotes the inflow of direct investment (both for new investment and the re-investment of profit shares earned by foreign investors) can help ensure exchange rate stability. An external financing need that is not met by direct investment augments dependency on portfolio capital and credit liabilities as sources of finance. This, in turn, exposes the countries concerned to a greater extent to international financial market fluctuations and therefore necessitates that a significant degree of economic credibility is ensured. In the first half of 2006, the possibility of increased exchange rate volatility in the event of disruptions in these areas became evident in the case of several countries (Iceland, New Zealand, Hungary and Turkey). In this connection, it should not go unmentioned that there are increased political (and economic) risks in some CEECs, which could have a negative impact on market confidence in the medium term. A slowing in domestic loan growth financed by foreign capital inflows (and the net repayment of foreign currency liabilities as a result of restructuring both the credit and refinancing structure of banks) could temporarily trigger increased ex-

change rate volatility even if this is likely to reduce the external financing need in future.

Yield Spreads of Local Currency Government Bonds Affected by International Developments

After a period of moderate stability from end-March 2006 to mid-May 2006 (coupled with a slight narrowing in Hungary), yield differentials of 10-year local currency government bonds against euro area benchmark bonds increased by a wide margin in Poland, Slovakia and Hungary. Although the yield spread in the Czech Republic widened marginally, it remained very close to euro area levels. The main reason for this development in all four bond markets was the deterioration of the international climate for emerging markets, which was exacerbated by country-specific factors. The increase in yield differentials was most evident in Slovakia and Hungary (by some 110 basis points), followed by Poland (+ 80 basis points) and, to a much lesser extent, by the Czech Republic (+25 basis points). Conversely, easing in the U.S. and euro area bond markets from the second half of June 2006 (from mid-July in Slovakia) induced yield spreads to narrow. While this process persisted in Slovakia until the end of the period under review, a renewed increase in spreads has been evident in Hungary and Poland since the second half of July. It has led to levels above the high recorded at end-June 2006.

In the period from March 2006 to September 2006, inflation as measured by the Harmonized Index of Consumer Prices (HICP) rose in

¹ For more on this subject, also see also the box "Foreign Currency Lending Risks of Austrian Banks are Basically Domestic Risks" in the section "Austria's Financial Intermediaries Are on A Dynamic Growth Path."

Poland, Slovakia and Hungary while continuing to remain largely stable in the Czech Republic. As a result, the positive inflation gap in Hungary and Slovakia widened while inflation in Poland and the Czech Republic approached the euro area rate from below and remained close to euro area levels, respectively. In terms of core inflation (overall inflation excluding energy and unprocessed food prices), inflationary pressures rose above all in Hungary and Slovakia. Inflation risks are currently pointing up in all four countries. In Hungary, inflation is expected to accelerate noticeably to around 8% in the first half of 2007 as a result of government fiscal consolidation measures (increase in regulated prices and indirect taxes). In Slovakia, the government is thinking of introducing a lower rate of value-added tax on specific goods and services, which could have a directly favorable impact on inflation. However, the long-term impact could prove detrimental owing to demand effects and in view of sustained robust consumer demand and rising unit labor costs. In the Czech Republic, the increase in indirect taxes and regulated prices is likely to trigger a rise in inflation in 2007 whereas, in Poland, the agricultural drought could fan inflation in early 2007 to above the target band average (2.5%). In addition, robust growth in Poland, Slovakia and the Czech Republic is narrowing negative output gaps and widening positive output gaps, which might stoke inflation in the medium term. In these three countries, a fiscal policy which under the given economic conditions seems too unambitious represents another risk factor for future inflationary trends.

In the past few months, the central bank of the Czech Republic and, especially, those of Slovakia and Hungary have already responded to burgeoning inflationary pressures, raising their respective key interest rates by 50, 125 and 175 basis points between March 2006 and September 2006. In all three countries, both the inflation momentum and the inflation outlook prompted the market to anticipate further interest hikes, which is also mirrored in Hungarian and Czech forward interest rates. In Poland the forward rates also reflect the expectation of a steeper increase in short-term interest rates within the next six months.

Budgetary trends in the past few months played a signal role in the Hungarian bond market, in particular. The fact that the Hungarian government once again failed to meet its deficit target in 2006 (by an amount that surpassed all previous expectations) was received by the market with great disappointment. The erosion of Hungary's fiscal policy credibility over the past few years may also be the reason why yield differentials have remained at high levels, despite the announcement of government plans for the long-term restructuring of public finances in the period from 2007 to 2009. In Poland and Slovakia, a change in the leadership of both countries cast doubts about the course fiscal policy will take in the coming years. So far, however, the leaders of both countries have affirmed that they are seeking to maintain a stability-oriented fiscal policy. The updated convergence programs in early 2007 will contain further details on medium-term fiscal plans. In the Czech Republic, the unstable political situation (possible fresh elections in early

2007) makes longer-term fiscal policy objectives continue to look equally uncertain.

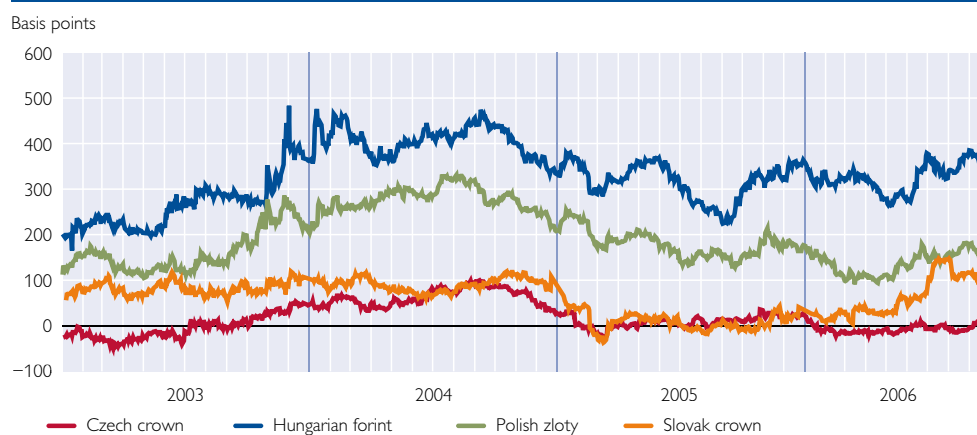
In view of the increased fiscal policy uncertainties and inflation risks, it is not surprising that market players expect that Hungary's and Slovakia's *date of joining the euro area* will be further deferred: The dates given in quarterly surveys changed by one year in each case between February 2006 and August (to 2013 in the case of Hungary and 2010 in Slovakia). For Hungary, moreover, the earliest expected date of entry was postponed by two years to 2012.

Rising inflation rates, central bank interest rate hikes (except for Poland) and fiscal policy risks represent *uncertainty factors for the capital market outlook* in all four countries. In Hungary, it remains to be seen whether measures already adopted or in the pipeline can really put public

finances on a sustainable footing in the longer term. In the three other countries, the respective governments will have to provide proof that their fiscal policy credibility of the past few years will be maintained. Furthermore, the matter about whether the mild inflationary climate in the Czech Republic and in Poland can be sustained in the medium term despite the aforementioned risks or whether currently high inflation in Hungary and Slovakia can be reduced again to a lower level is of crucial importance. In Hungary and Poland, the two countries with a particularly large share of foreign investors holding the outstanding volume of government bonds, local currency bond markets ultimately remain dependent on the international investment climate and potential future shifts in the portfolios of international investors.

Chart 3

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



Source: Eurostat.