International Environment Continues to be Favorable in General, but Risk Factors Remain

Industrialized Countries: Robust Growth, Temporarily Higher Volatility on Financial Markets

Robust Growth and Greater Balance across Regions

In the *industrialized countries* economic growth has remained robust. In the euro area economic growth continued to strengthen, while it weakened in the United States. The crude oil market experienced higher price volatility: As of August 2006, the price of crude oil dropped significantly, hovering around 50 USD on some days in January. By mid-April 2007 it had recovered to over 65 USD. At any rate, the futures markets for crude oil suggest that crude oil prices will stay high. Short- and long-term interest rates rose slightly during the period under review, with long-term forward rates remaining historically low.

In the *United States,* real GDP growth, which had already been much less dynamic in the preceding quarters, continued to weaken during the first quarter of 2007. So far, the economic slowdown has mainly affected the real estate sector and certain industrial subsectors. Thanks to the job market situation and to significantly lower crude oil prices, consumer spending remained robust. However, declining real estate investment and weak business spending dampened economic growth. During the period under review banks tightened their credit terms for mortgage loans to borrowers with low creditworthiness. Core inflation remained at a slightly higher level. While the Federal Reserve System expects inflation to slow down, there is the risk that the full resource utilization in the U.S. economy could prolong the upward pressure on inflation. Economic growth in the United States is likely to slow down more significantly than anticipated in the fall. However, most forecasts currently predict an early recovery. The IMF expects economic growth to reach 2.8% in 2008.

Euro area growth continued to be dynamic in the last quarter of 2006 and also in the first quarter of 2007, which means that most growth forecasts were outperformed. During this period, the employment market saw increasing employment and shrinking unemployment rates. HICP inflation declined, mainly owing to base effects in energy prices. Between the beginning of October 2006 and the end of March 2007, the Governing

Table 1

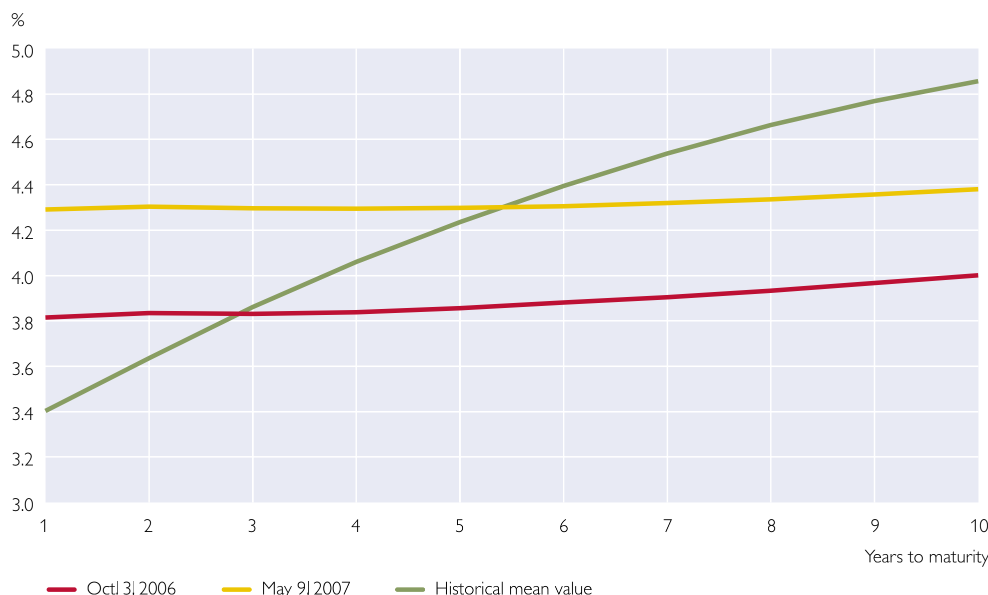
IMF Economic Forecasts of September 2006 and April 2007

	GDP growth (%, year on year)			Consumer price inflation (%)		
	2007		2008	2007		2008
	Sep. 06	Apr. 07	Apr. 07	Sep. 06	Apr. 07	Apr. 07
Industrialized countries	2.7	2.5	2.7	2.3	1.8	2.1
U.S.A.	2.9	2.2	2.8	2.9	1.9	2.5
Euro area	2.0	2.3	2.3	2.4	2.0	2.0
Japan	2.1	2.3	1.9	0.7	0.3	0.8

Source: IMF (World Economic Outlook).

Chart 1

Yield Curve Remains Flat but Shifts Upward



Source: Thomson Financial| OeNB| based on interest rate swaps.

Council of the ECB raised the ECB's key interest rate by another 75 basis points; the Governing Council continued to see upward risks to price stability at the beginning of April. The IMF expects the favorable economic developments to continue until 2008 and inflation to stay at 2%.

In *Japan,* the economy continued to grow in the last few quarters, while core inflation remained near zero (mostly because a new calculation method was used). Both the Bank of Japan and the IMF expect economic growth to remain moderate and medium-term inflation to continue its slight upward trend.

Temporary Turmoil in the Financial Markets, Interest Rates Rise in the Euro Area and in Switzerland

On the U.S. *money markets,* the Federal Reserve System held its key interest rate at a steady 5¼% from the beginning of October 2006 until mid-May 2007. Over the same period, the ECB and the Bank of Japan raised their key interest rates by 75 and 25 basis points to 3.75% and 0.5%, respectively. The Swiss central bank increased its key interest rate by 50 basis points. In mid-May its target range for the three-month Libor for the Swiss franc was between 1.75% and 2.75%. The central banks of a number of other industrialized countries also continued to raise their key interest rates. While key interest rate hikes in the euro area and in Japan had been anticipated in the money markets, the expectations some market participants had of falling key interest rates in the United States did not materialize. In mid-April, money market forward rates suggested that market participants did not agree on whether the U.S. key interest rate would be lowered by the end of September. For the euro area, Japan and Switzerland, by contrast, market participants expected short-term interest rates to go up.

The U.S. *capital market yield curve* remained largely unchanged and maintained its inverted shape for maturities of up to three years. In the euro area, interest rates across the entire maturity spectrum went up by about 50 basis points, presumably because of the ECB key interest rate hikes and the stronger than expected economic activity. In Switzerland, interest rates rose for all maturities as well albeit at a more moderate rate than in the euro area. In all three currencies, term premia were considerably below the long-term average in mid-April. Measured against the results of Consensus Forecasts, long-term inflation expectations remained stable in the euro area and slightly decreased in the U.S.A. and in Switzerland.

In the period under review *risk premia on corporate bonds* of highly creditworthy borrowers in the euro area remained broadly unchanged. Risk premia for less creditworthy issuers continued to decrease considerably until end-February, when they rebounded quickly during turmoils in the financial markets. Subsequently, they maintained their higher level until mid-April. However, in a long-term comparison, risk spreads remained low, mainly because companies made excellent profits and improved their balance sheets. Swap spreads in the euro area increased slightly as well at the end of February.

The upward trend on U.S. *stock markets* slowed down as of fall 2006, while euro area stock markets continued to record price gains. One of the reasons for these unequal trends lies in the different economic developments in these two economic areas. At the end of February 2007, a broad market correction caused stock prices to decrease rapidly and substantially. Uncertainty, as measured by the implied volatility of options, rose significantly, both on the stock and on the money and foreign exchange markets. The slump in prices was attributed to higher risk aversion caused by concerns about (1) developments in the U.S. economy and the U.S. mortgage market, (2) the high volume of carry trades (i.e. borrowing in low-interest currencies for speculative purposes, in particular for investment in higher-yielding currencies) and (3) the further development of the Japanese yen, as well as to the pronounced stock price decline in the Chinese stock market. Markets stabilized again after a few days. Stock prices rebounded and implied volatility receded and, in mid-April, reached more or less the level it had recorded in the preceding months, which was low in a long-term comparison. The price-to-earnings ratios in the United States and in the euro area went up slightly in the past quarters and are now close to their historical mean values.

In the *foreign exchange markets,* the euro appreciated markedly against the U.S. dollar, reaching the highest level since its introduction in January 1999 at a rate of USD 1.3649 per euro on April 25, 2007. The common currency appreciated even more strongly against the Japanese yen and the Swiss franc, reaching historical highs at JPY 161.91 and CHF 1.6467 per euro, respectively. These gains were partly caused by the relatively stronger rise of euro area interest rates across the entire maturity spectrum. In the course of the financial market turmoil at the end of February, during which the U.S. dollar came under pressure, the exchange rates of the euro against the Japanese yen and the Swiss franc were consid-

erably volatile, which caused a temporary, significant appreciation of these two currencies against the euro. This temporary strengthening of the Swiss franc and the Japanese yen was generally considered to be attributable to stronger risk aversion, which had prompted some investors to discontinue carry trade investments.

Emerging Markets: Dynamic Growth, Inflows to the Private Sector

Continued Strong Growth and Predominantly High Current Account Surpluses

According to the IMF, dynamic economic developments in the *emerging market economies (EMEs)* will continue. The IMF once again significantly upgraded its growth projections for several EMEs, in particular for the CIS countries (except Russia), for Brazil, India and for sub-Saharan Africa. For 2007 and 2008, the IMF predicts an annual real GDP growth of 7% for the EMEs, after almost 8% in 2006. Inflation, which has been slightly decreasing, is expected to fall below 5% by 2008. The turmoils in the global financial markets in late spring 2006 and in February 2007 had no permanent impact on growth prospects. This can above all be attributed to sound fundamentals in the EMEs: Most EMEs hold large current account surpluses and have stabilized their public finances, reduced their debt burden ratios and stepped up their currency reserves. For these countries, further interest rate hikes in the developed economies are considered a risk, as this might prompt international investors to reconsider risk-taking.

In *non-Japan Asia (NJA),* real GDP growth accelerated slightly to 8.9% in 2006, although some of the large economies experienced a minor slowdown in the second half of the year. Both the domestic economy and the external sector continued to be major pillars of growth. While India's economy kept booming at a rate of 9.2%, the rate of economic growth in China went up slightly to 10.7%, driven by dynamic capital investments and exports. The People's Bank of China raised its key interest rates three times within a year, tightened administrative controls and repeatedly stepped up the minimum reserve requirements for deposits to dampen credit growth. According to the IMF, economic perspectives in NJA remain bright, even if growth rates will presumably ease down to 8.0% until 2008. A stronger economic downturn in the U.S.A. might pose a risk to exports in the region.

In *Latin America,* the economy grew by 5.5% in 2006, with significant differences between the individual countries. The IMF expects broadly based growth to moderately slow down to 4.2% in 2008 in the entire region, while growth in Brazil is expected to accelerate to this value. According to the IMF, structural reforms in several countries within the region have reduced their vulnerability to external shocks. Supportive financing conditions and continually high commodity prices enhance the positive outlook, although Latin America would be affected more severely by a slowdown in the U.S. economy than other regions.

In *sub-Saharan Africa,* economic growth was dynamic at 5.7% in 2006, with oil importing countries growing by 5.3%. After an acceleration to 6.8% in 2007, the IMF expects economic growth to slow down slightly to 6.1% in 2008. The frequency of military conflicts and the extent of

political instability in the region clearly declined over the last ten years. Therefore, a prolongation of economic growth now depends mainly on economic policies: structural reforms, a strengthening of institutions and a better investment climate may help reduce the strong dependence on commodities. According to the IMF, expenditures for infrastructure, education and health (based on oil profits and debt reliefs) need to be stepped up, but with a view to maintaining economic stability as a whole. The IMF calls on the developed economies to live up to their (financial) commitments in the area of development cooperation and to open up their markets to African exports to support economic growth in Africa.

In the *Middle East,* the IMF expects growth rates to remain stable around 5.5% until 2008. According to the IMF, the oil exporting countries have managed to improve their infrastructure, with a particular focus on further developing the non-oil sector. The IMF believes that careful management of the high oil revenues accrued during the current commodity boom has reduced the vulnerability to price drops. Although the stability of financial institutions is improving because of continued financial market reforms, financial institutions in several countries are left with a large number of problem loans.

In *Turkey,* growth slowed down further to 6.1% in 2006, as domestic demand declined in the second half of the year, partly owing to a restrictive monetary policy stance following the depreciation in spring 2006 and weaker credit growth. With inflation hovering at 9.7% in December, the central bank failed to meet the target rate set at the beginning of 2006. Nevertheless, Türkiye Cumhuriyet Merkez Bankası stands by its medium-term inflation target of 4% (+/–2%). In spite of the depreciation, the current account deficit, which climbed to 8% of GDP in 2006, is expected to decrease only moderately. Most recently, the deficit was financed through soaring net inflows of direct investment, which were primarily driven by the EU accession process.

High Capital Inflows to the Private Sector and Capital Outflows from the Public Sector in the EMEs

In 2006, *net capital inflows to the private sector*[1] in the EMEs maintained record levels reached in 2005. Following the turmoil in the global financial markets in late spring 2006, capital inflows started to increase again by mid-year in the face of robust economic growth expectations and decreasing inflation expectations. The IMF expects net capital inflows in 2007 and 2008 to attain previous levels and fully stem from net inflows of direct investment (as in previous years), while the much lower and receding net inflows under "other flows" (mainly loans) will not suffice to offset continuous net outflows under portfolio investment. *Direct investment* constitutes the most important net inflows in all regions. As in the previous year, *portfolio investment* will generate net inflows only in CEE, in the CIS countries and, to a significant degree, in Africa. In Asia, by contrast, the strong net outflows that started in 2006 will continue. As for *"other flows",* net inflows will again concentrate on CEE, the CIS and, this year, Asia. Latin America and Africa will again post net outflows. CEE, as the only of these regions to

Table 2

Net Capital Inflows to Emerging Market Economies and Developing Countries[1]

USD billion

	2003	2004	2005	2006	2007[2]	2008[2]
Net capital inflows to the private sector	173.3	238.6	257.2	255.8	252.7	259.3
By instrument						
Direct investment	165.3	190.0	266.3	266.9	283.7	288.9
Portfolio investment	–12.1	25.0	29.4	–76.3	–62.0	–52.2
Other flows	20.1	23.5	–38.5	65.2	30.9	22.6
By region (country)						
Europe	52.5	74.7	117.5	121.1	109.0	117.7
CIS	17.9	7.7	37.6	65.7	38.0	28.6
Middle East	4.7	–12.0	–19.9	–15.5	14.4	34.8
Africa	2.7	12.3	18.3	20.2	28.6	39.9
Asia	69.2	142.5	69.7	53.9	30.7	–5.8
Latin America and the Carribean	26.2	13.3	33.9	10.4	32.0	44.2
Net capital inflows to the public sector[3]	–44.5	–57.8	–122.6	–143.8	–96.4	–116.6
Memorandum items						
Current account balance	*229.4*	*299.7*	*511.6*	*638.5*	*548.6*	*567.1*
Reserve assets[4]	*–358.9*	*–508.2*	*–590.1*	*–738.4*	*–715.5*	*–716.4*
of which held by China	*–117.2*	*–206.3*	*–207.0*	*–240.0*	*–290.0*	*–320.0*

Source: IMF (World Economic Outlook).

[1] This table shows aggregated balance of payments data sets of 131 nonindustrialized countries, including 44 major EMEs. Europe = CEE excluding European CIS countries and including Turkey. Asia = Asia including Hong Kong, Korea, Singapore and Taiwan.

[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.

continuously post a high *current account deficit,* will presumably continue to attract the largest share of net capital inflows to the private sector in 2007 and 2008. The only region that posted *net capital outflows* from the private sector in 2006 (petrodollar investments) was the Middle East, which is also expected, however, to record net inflows in 2007 and 2008. All other regions posted high *current account surpluses combined with net capital inflows* to the private sector in 2006. The same is expected for 2007 and 2008.

In all regions, *public sectors* recorded *net capital outflows* (repayment of foreign debt and investments) accompanied by a further *increase of gross official reserves* in 2006. The IMF forecasts similar results for 2007 and 2008, with the exception that net inflows to the public sector are expected for Africa.

Claims of Austrian Banking Sector Lead in CEE

At the end of September 2006, claims of Austrian banks (excluding Bank Austria Creditanstalt) in CEE and Turkey made up more than 7% of recipient countries' nominal GDP. Austrian banks thus had a higher share in claims on this region than the banks of any other country. Compared to other lending countries' banks, Austrian banks held the highest stock of claims on any EU Member State in CEE (except for the Baltic countries and Poland), sharing first place with Belgian banks in the Czech Republic and with German banks in Hungary. The claims of all BIS reporting banks on Slovakia, Slovenia and Croatia were concentrated on Austrian banks to a particularly high degree.

Table 3

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

% of GDP of the recipient country

	AT	DE	IT	FR	NL	SE	BE	UK	Europe[2]	US	JP
CEE plus Turkey	**7.3**	**5.9**	**3.3**	**3.4**	**2.2**	**2.5**	**3.1**	**1.5**	**34.0**	**1.8**	**0.6**
EU Member States in CEE (excluding the Baltic countries)											
Bulgaria	8.9	3.3	6.0	3.0	1.0	0.0	0.3	0.5	42.2	1.3	0.1
Czech Republic	21.8	5.3	1.7	16.2	2.9	0.1	21.8	1.8	73.1	2.5	0.5
Hungary	20.0	20.3	8.8	3.8	2.6	0.2	10.2	0.7	71.2	2.3	0.9
Poland	3.0	7.1	5.9	1.4	4.4	0.8	3.0	0.7	34.0	2.6	1.0
Romania	8.4	1.7	2.3	7.0	3.6	0.1	0.1	0.2	31.8	1.0	0.1
Slovakia	34.9	4.2	17.2	2.3	4.2	0.1	7.5	1.1	72.1	2.0	0.1
Slovenia	22.3	12.9	1.2	4.8	0.7	0.0	4.6	0.8	48.8	0.3	0.7
Other CEECs											
Croatia	54.8	7.3	48.3	16.3	0.5	0.0	0.7	0.6	129.5	0.4	1.0
Russia	1.1	3.2	0.2	0.7	1.1	0.1	0.1	0.6	8.6	0.9	0.6
Turkey	0.2	4.2	..	2.6	1.7	0.1	2.2	3.0	16.6	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 reporting banks" published by the BIS (BIS Quarterly Review March 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 Bank Austria Creditanstalt group.

[1] As of end-September 2006.

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

Eurobonds Resilient against Investors' Reduced Risk Appetite

After the financial market turmoils between May and June 2006 and the ensuing recovery, developments on the international eurobond market remained basically positive from end-September 2006 to end-March 2007. The average yield spread on U.S. dollar- or euro-denominated government bonds of emerging market issuers against benchmark bonds as measured by J. P. Morgan's (Euro) EMBI Global index narrowed by a total of 38 basis points (USD) and 16 basis points (EUR), respectively, during this period.

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
	March 30, 2007	March 30, 2007	Change since Sep. 30, 2006	Since Sep. 30, 2006	March 30, 2007	March 30, 2007	March 30, 2007	March 30, 2007	Change since Sep. 30, 2006	Since Sep. 30, 2006	March 30, 2007	March 30, 2007
Overall index	100.0	170	−38	6.3	BB+	7.38	100.0	60	−16	1.1	BBB	5.43
Africa	2.4	294	6	4.1	..	3.29	4.9	66	−26	1.6	BBB+	5.56
Asia	16.3	142	−40	6.1	BB+	6.88	4.8	61	−41	2.3	BBB	4.29
Europe	24.5	147	−18	5.1	BBB−	6.92	69.7	49	−10	0.6	BBB+	5.54
Latin America	53.7	173	−45	7.2	BB+	8.07	20.6	96	−30	2.1	BBB−	5.29
Middle East	3.1	424	4	4.1	B−	5.09	..	..	..	..	..	..

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 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.

The general downward trend in yield spreads was interrupted by two temporary setbacks at the beginning of December 2006 and the end of February 2007. Compared to stock markets, to high-yield bond markets and individual currencies, the eurobond market proved to be largely resilient to increasing risk aversion at the end of February 2007.

Although yield spreads of U.S. dollar- and euro-denominated eurobonds moved in the same direction, differences in the yield levels (which were higher for bonds denominated in U.S. dollars) and in yield trends (decline for U.S. dollar-denominated bonds, increase for euro-denominated bonds) led to differences in *total returns*. In the period under review, eurobonds denominated in U.S. dollars generated non-annualized total returns of more than 6%, while bonds denominated in euro only generated returns of about 1%. In both market segments, eurobonds of European issuers again underperformed the overall index. This relatively poor performance can be attributed to the comparatively low initial spread levels of eurobonds of European issuers and the (partly related) small extent to which yields declined further.

At the level of the overall indices, narrowing average yield spreads continued to be in line with developments in *economic fundamentals* (as measured by the average ratings). For the countries included in the EMBI Global and Euro EMBI Global indices the number of rating upgrades by the three leading rating agencies clearly exceeded the number of downgrades, even if the ratio of upgrades to downgrades somewhat deteriorated in the first quarter of 2007. Out of all the CEECs included in the indices, five countries (Bulgaria, Poland, Romania, Slovakia and Lithuania) were upgraded and only one country (Hungary) was downgraded.

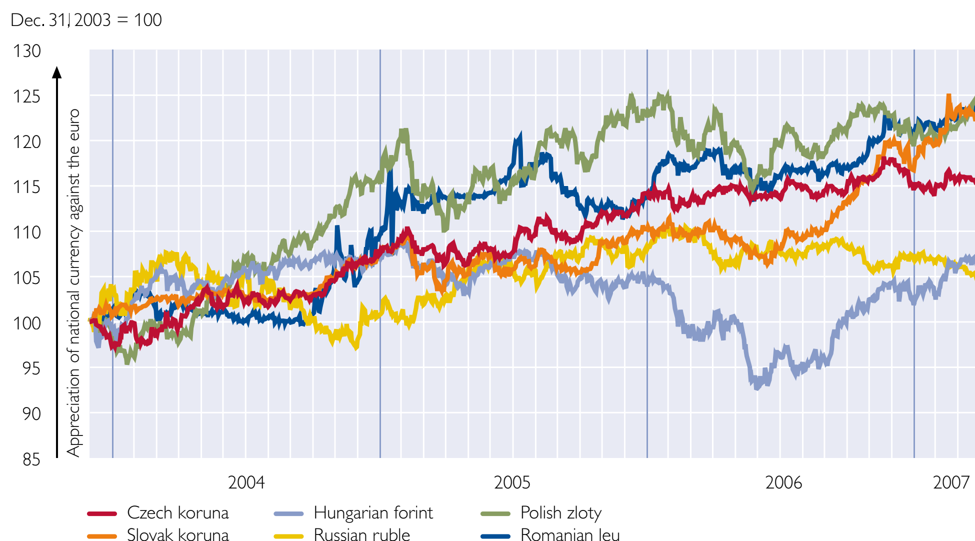
The *risk factors* for eurobond markets mentioned in the OeNB's previous Financial Stability Report persist. First of all, the low extent by which investors differentiate between individual issuers (measured by the dispersion of yield spreads across the countries included in the relevant indices) is still not fully in line with the dispersion of their ratings, although the dispersion of ratings across countries included in the EMBI Global index declined in the course of 2006. Second, the difference between the yield spreads on eurobonds of sovereign debtors and on corporate bonds of the same rating class (not adjusted for maturity) remains negative, sometimes even to a greater extent, for most rating classes. Third, currently low yield spread levels also depend on global liquidity conditions and investors' willingness to assume risk. In this context the major risk factors for the eurobond market are a serious economic slowdown, higher than currently anticipated key interest rates or an unexpected sharp increase of long-term interest rates in the industrialized countries, a disorderly correction of global imbalances and an increase in geopolitical risks.

Central and Eastern Europe: Significant Exchange Rate Gains for Hungarian Forint and Slovak Koruna

Between end-September 2006 and end-March 2007 most CEE currencies under review strengthened against the euro – some of them significantly. The Slovak koruna and the Hungarian forint underwent the largest appreciation, gaining 12.1% and 10.2%, respectively. The Hungarian

Chart 2

Exchange Rates of National Currencies against the Euro



Source: Thomson Financial.

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

forint thus more than made up for ground lost in June 2006 and the Slovak koruna even appreciated by 16% against its low in mid-July 2006.

Upon request of the Slovak authorities, the ERM II central rate of the Slovak koruna was revalued by +8.5% against the euro with effect of March 19, 2007. The accompanying communique stated that this revaluation was justified by current developments in the underlying economic fundamentals. Furthermore, the decision to revalue the Slovak koruna was based on the firm commitment by the Slovak authorities to pursue an economic policy aimed at achieving price stability and maintaining competitiveness. According to the communique, this approach includes strengthening the fiscal adjustment path in line with the Council opinion on Slovakia's convergence program, the promotion of a wage policy which reflects labor productivity growth, the continuous pursuit of structural reforms so as to raise productivity growth and improve the functioning of markets, and vigilance concerning risks of strong credit growth.

At 5.4%, the Romanian leu also strengthened substantially against the euro, while the Czech koruna and the Polish zloty appreciated to a much smaller degree.[1] These currencies mostly gained in the fourth quarter of 2006. The exchange rate of the Croatian kuna remained largely unchanged during the period under review, while the Russian ruble depreciated by some 2% against the euro. The Russian ruble gained almost 1% against its currency basket, which is composed of euro (45%) and U.S. dollars (55%). Until end-2006, the Slovenian tolar fluctuated against the euro within a very narrow margin, remaining close

[1] *However, the Polish zloty gained strongly in the weeks before and after the interest rate hike of end-April.*

to its ERM II central rate. At the beginning of 2007, Slovenia joined the euro area and adopted the common currency at the central rate of SIT/EUR 239.640.

During most of the period under review, the CEE currencies experienced a favorable *international environment* marked by high liquidity, a pronounced tolerance for risk and a continuing quest for higher returns in higher-risk market segments. However, these currencies also proved to be resilient to the increased volatility and falling prices that were seen in other segments of the international capital market (e.g. stocks, high-yielding bonds and some currencies) from end-February to early March 2007, even though stock prices were exposed to some pressure also in CEE.

The exchange rate of the Hungarian forint had depreciated markedly because of an increasing risk aversion in the international capital markets between May and June 2006, which coincided with severe external imbalances and the government's lacking economic policy credibility. However, during the reporting period, investors' confidence in Hungary improved markedly, even if one rating of foreign currency bonds was downgraded. Stronger investor confidence can be attributed to the announcement of a comprehensive fiscal consolidation plan and initial steps that were taken to reduce the excessive fiscal deficit, which had reached almost 10% of GDP in 2006. Furthermore, the government started with the introduction of structural reforms, and domestic policy turmoil abated. In Slovakia as well, the new government, which has been in office since July 2006, was able to overcome initial skepticism and gain market confidence. Its stance to stick to the projected date for the introduction of the euro at the beginning of 2009, the adoption of a sound budget for 2007 and the presentation of a convergence program focusing on deficit reduction were probably the key factors for this success. In Poland, domestic politics, which had caused short-term negative reactions on the markets around end-June and the beginning of July 2006 as well as at end-September 2006, calmed down as well, while in Romania the country's upcoming EU accession may have contributed to positive market sentiment and fueled exchange rate gains in November and December 2006.

Most CEE currencies appreciated in an *environment of strong economic growth*. In 2006, GDP growth came to between 5% and 8% and accelerated – or remained at a constantly high level – in most of the countries analyzed in this report. The only exception was Hungary, where growth rates decreased owing to austerity measures introduced by the government. In the second half of the year, growth was generally more dynamic than in the first half, except for the Czech Republic and Hungary, which experienced slowdowns, and Croatia, which posted constant growth levels. In contrast to 2005, growth in 2006 was primarily based on domestic demand (with the exception of Hungary), which accelerated in the second half of the year (except in Hungary and Croatia). Among the components of domestic demand, investment growth was stronger than consumption growth (except for Hungary), which remained below GDP growth rates (with the exception of Bulgaria and Romania). The contribution of net exports to growth was positive in Slovakia, the Czech Republic and Hungary and negative

in the other countries; it was particularly negative in Bulgaria and Romania. This phenomenon can be attributed to the fact that imports accelerated a lot more strongly than exports in most cases (with the exception of Hungary and Slovakia). However, the exports of most of the countries under review were able to increase or hold their shares in world imports and EU-27 imports in 2006 – despite the fact that their terms of trade deteriorated in most cases.

In the second half of 2006, the *combined current and capital account balances* developed differently in the countries under review. In Slovakia and Hungary, the deficit was lower than in the second half of 2005. It was still high in Slovakia, however, coming to 8.7% of GDP. In Poland, the deficit remained unchanged at 1.7% of GDP, once again reaching the lowest level of the countries under review. Deficits increased in the Czech Republic and in Slovenia, and went up to a significantly stronger degree in Bulgaria and Romania, where deficit levels reached 14.6% and 9.6% of GDP, respectively (up from already high levels in the second half of 2005). In Croatia, the traditional tourism-related surplus in the second half of the year was lower than in the comparable period in 2005. In line with the positive contribution of net exports, the goods and services balance improved in Slovakia, where the deficit went down from 5% to 4% of GDP, and in the Czech Republic and Hungary, which posted surpluses of a little over 1% of GDP. In Bulgaria and Romania the continuously high deficits in the goods and services balance were mostly responsible for the current account gap in the second half of 2006. The partly high or increasing external deficits can be explained by strong economic growth and high investment demand, although investment growth to some extent also reflects vigorous residential construction activity. In Bulgaria and Romania, strong consumer demand is likely to have contributed to import demand as well. Net inflows of direct investment (including intracompany loans) helped reduce the financing gap significantly in most of the countries under review, which is a positive development. In the second half of 2006 (and also over the entire year 2006), large financing requirements existed only in Slovenia, as there was a net outflow of direct investment (low inflows, continued outflows) and the current account deficit increased. Croatia's sum of the current account balance and net direct investment was positive, as usual, during the season, and near zero for the entire year.

The Hungarian forint and the Romanian leu continued to be exposed to appreciation pressures from high *short-term interest rate differentials against the euro area.* However, interest rate differentials decreased slightly in Hungary and significantly in Romania. Reasons for the strong decrease in Romania lay in rising interest rates in the euro area but also in interest rate cuts Banca Națională a României had introduced in the wake of decreasing inflation and slightly weakening loan growth with a view to reducing appreciation pressures. For both countries, market participants expect short-term interest rates to decline in the course of the next few months, which is likely to further reduce the interest rate differential against the euro area. The Slovak koruna appreciated at a time when short-term interest rate differentials were decreasing from the already sig-

nificantly lower levels they had reached before. At end-March 2007, market participants expected the interest rate differential to be negative relative to the euro area for the following months as interest rates were expected to fall in Slovakia and to rise in the euro area. In Poland, the short-term interest rate differential for the reporting period decreased from an already low level as well, while in the Czech Republic the negative interest rate differential widened further. Market participants expect short-term interest rates to rise more strongly in these two markets than in the euro area in the upcoming months.

During the period under review, Slovakia in particular conducted major *foreign exchange interventions* to influence exchange rate dynamics. After the Slovak koruna had started to appreciate strongly in mid-July 2006, Národná banka Slovenska reacted at end-December 2006, when the exchange rate stood at close to 11% on the strong side of the ERM II fluctuation band, by intervening on the foreign exchange market purchasing around EUR 500 million and followed up with further interventions in March 2007. In addition, Národná banka Slovenska tried to reduce the koruna's attractiveness by increasing money market liquidity. It did so by rejecting large bids at several reverse repo auctions. During the period under observation, Hrvatska narodna banka was also active in the foreign exchange market on several occasions in order to prevent extreme exchange rate fluctuations. These interventions exclusively consisted of foreign currency purchases from commercial banks during the tourist season.

In the reporting period, domestic loans expanded at a faster rate than domestic deposits particularly in Slovenia, and to a lesser extent in the Czech Republic and Poland. This development made banks more reliant on *foreign capital as a source of finance* and may thus have helped firm the respective currencies. In Bulgaria, Croatia and Russia, rising direct borrowing abroad by nonfinancial corporations exerted some appreciation pressure.

The continuous expansion of current account deficits in several countries still constitutes a *risk factor for the development of CEE currencies, even if most countries* so far have been able to finance these deficits mostly through net inflows of direct investment. Preventing deficits caused by excessively growing domestic and, in particular, consumer demand is a key challenge during the economic catching-up process. In addition, countries must create an attractive economic climate for direct investment inflows. If net inflows from direct investment do not suffice to meet external financing requirements, countries depend on net inflows of portfolio investment and on higher borrowing in the form of foreign loans. Even though foreign parent companies (of banks or nonfinancial corporations) have granted a large part of outstanding cross-border loans so far, the sudden absence or net outflow of portfolio capital and cross-border loans represent a risk factor for exchange rates. In this context, rising long-term interest rate levels in the U.S.A. and the euro area and the subsequent reduction of the interest rate differential are relevant primarily for financial investors and possibly also for foreign direct investors. Shrinking interest rate differentials relative to Switzerland and Japan contribute to rendering the region less attractive

for financial investors via carry trades and might at the same time dampen the trend toward borrowing in Swiss francs that has been gaining popularity in several countries over the last few years. These factors may lead to higher exchange rate volatility and currency depreciation. Temporarily, such a development may also result from a slowdown in credit growth which has been financed by foreign capital inflows, or from net repayments of banks' foreign currency liabilities in the wake of a reorganization of their asset and liability structures, even if this might eventually reduce external financing requirements and the depreciation risk in the longer term.

Yield Differentials of Local Currency-Denominated Government Bonds on the Decrease

After a rise in the previous reporting period (end-March to end-September 2006), the *yield differentials of ten-year local currency-denominated government bonds* against euro area benchmark bonds narrowed in all four countries under review (Czech Republic, Hungary, Poland and Slovakia) between end-September 2006 and end-March 2007. As a result, yield spreads were below March 2006 levels in all these countries at end-March 2007. Hungary still recorded the highest spread against the euro area (260 basis points), followed by Poland and Slovakia (105 and 10 basis points, respectively). The yield of Czech ten-year bonds was close to 30 basis points below the euro area level. In terms of yield spread developments, Hungary saw the strongest decrease during the reporting period (–130 basis points), followed by Poland (–70 basis points), Slovakia (–50 basis points) and the Czech Republic (–40 basis points). The temporarily decreasing risk tolerance on the international capital markets caused yield spreads in these four markets to widen only preliminarily between end-February and mid-March 2007. By the end of March, spreads returned to the low levels recorded previously or (in Hungary) to even significantly lower levels.[2]

The *inflation differential against the euro area* (as measured by the HICP) corresponded to yield spread developments only in Slovakia, where the positive inflation differential narrowed from 2.7 percentage points in September 2006 to 0.2 percentage points in March 2007. The favorable inflation development can partly be attributed to energy prices but also to a decrease in core inflation (excluding prices for energy and unprocessed food) during that period. While inflation in the Czech Republic had been close to euro area levels in the previous reporting period, between October 2006 and February 2007 the country posted much lower (by up to 0.8 percentage points) inflation rates than the euro area. However, as inflation gained momentum, this negative spread gradually decreased and turned slightly positive in March 2007 (0.2 percentage points). In Poland, inflation also accelerated more strongly than in the euro area during the reporting period, primarily owing to developments in the "unprocessed food" segment. In March 2007, Poland posted the first positive inflation differential (0.5 percentage points) to the euro area since May

[2] *Moreover, this trend continued in April.*

2005. In Hungary, yield spreads narrowed against the background of a strongly widening positive inflation differential against the euro area. Higher inflation was primarily caused by a hike in indirect taxes and administered prices in the wake of fiscal consolidation efforts and a surge in the prices for unprocessed food. In all four countries domestic consumption currently does not seem to give rise to immediate inflationary pressures from the demand side, as consumption growth rates are below GDP growth rates. However, output gap developments might involve some medium-term inflationary risks, especially in Poland, the Czech Republic and Slovakia.

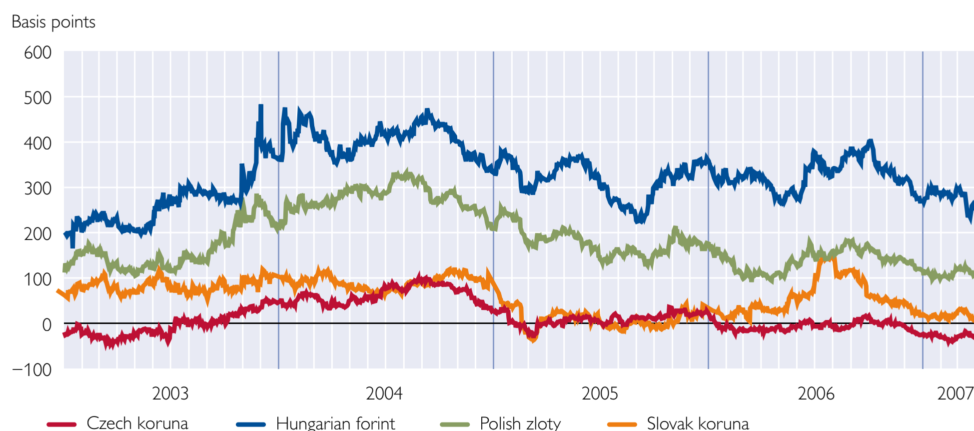
Declining positive *differentials* (or, as in the case of the Czech Republic, widening negative differentials) *between short-term money market rates in the four countries under review and those in the euro area* also supported the narrowing of long-term yield spreads in the period under review.

Particularly in Hungary, *budgetary developments* underpinned the decrease of long-term yield spreads during the past months (see section "Central and Eastern Europe: Significant Exchange Rate Gains for Hungarian Forint and Czech Koruna"). The Czech Republic and Poland also successfully reduced their fiscal deficits (including the net costs of reforming the pension system by partially switching to a funded system) to 2.9% and 3.9% of GDP, respectively, in 2006, while the Slovak deficit expanded to 3.4% due to an increase in pension reform costs. According to the April 2007 fiscal notifications, the deficits in Hungary, Poland and Slovakia are projected to narrow in 2007 (to 6.7%, 3.4% and 2.9%, respectively), while the Czech Republic is expected to see a significant increase in the deficit ratio to 4% caused by higher social security expenditure.

In Slovakia and Hungary, yield developments will mainly depend on how strictly governments adhere to their fiscal consolidation plans but also on how significantly and sustainably inflation decreases. In the Czech Republic, by contrast, it is mainly the degree to which inflation is expected to accelerate (and the potential reaction of the central bank) that causes

Chart 3

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



Source: Eurostat.

uncertainties in yield developments (aside from the implementation of fiscal plans), while uncertainties in Poland are related to a possible interest rate hike aimed at preventing a potential acceleration of inflation. An increase in volatility and contingent price corrections in other segments of the international capital market also constitute risk factors. However, the expected correction of economic imbalances in Hungary and the largely stability-oriented economic policies in all four countries should provide some cushion against such unfavorable external developments.