

Financial Crisis Increases Risk of Recession

Industrialized Countries: Government Measures for Containing the Financial Crisis and its Repercussions on the Real Economy

Dismal Growth Outlook Owing to Financial Crisis

In *industrialized countries*, economic growth in recent quarters slowed on the back of higher commodity prices and the impact of the U.S. subprime crisis. At the same time, inflation in many countries rose primarily because of an increase in commodity prices to historical highs. The price of crude oil (Brent) was very volatile: from April to mid-July 2008, it rose from around USD 100 to as much as USD 145. By mid-November, however, crude oil prices fell to about USD 50 as the outlook for all industrialized countries had worsened. In its November outlook for all industrialized countries for the second half of 2008 and for 2009, the IMF expects GDP to decline by 0.3%, owing, in particular, to the deterioration in financing conditions induced by the financial crisis.

Global financial turmoil stemming from the U.S.A. since summer 2007 escalated seriously from September 2008 onwards. In the U.S.A., the government took over Freddie Mac and Fannie Mae, two of the country's leading mortgage banks, before Lehman Brothers, the fourth-largest U.S. investment bank, filed for bankruptcy, on September 15. As a result of this bank failure, American International Group (AIG), the largest U.S. insurance company, was saved from collapse only by government intervention, and the U.S. financial sector underwent extensive restructuring via (partly government-assisted) corporate takeovers. Lehman's bankruptcy also triggered the withdrawal of high volumes from money market funds – an important

source of funds for rolling-over commercial papers that are used to finance major corporations' working capital – and induced a massive loss of confidence between banks. As a result, trading in money markets partially dried up. Central banks took coordinated action to make available additional liquidity – especially, USD liquidity. On September 19, 2008, the U.S. Treasury announced a proposal for a comprehensive program to stabilize the country's financial sector. However, this package was approved only two weeks later together with further tax cuts and an increase in deposit guarantees. In Europe too, individual financial institutions where refinancing difficulties had emerged were provided government support or were nationalized. Starting from end-September, a number of initiatives designed to restore confidence between banks as well as between banks and their customers were launched in the EU, first at national levels and subsequently also as part of coordinated action at EU level. These measures consisted, in particular, in government guarantees, the provision of government funds for potential bank capital increases and a rise in deposit guarantees (to a minimum of EUR 50,000 and up to an unlimited amount). In a concerted action on October 8, 2008, the U.S. Federal Reserve, the ECB, the Bank of England, the Bank of Canada as well as both the Swedish and Swiss central banks announced a cut of 50 basis points in their key interest rates. This measure was taken on account of there being downside risks to the economy, which had increased as result of the financial crisis, and – in connection with this – significantly reduced upside risks to price stability. This assessment was based primarily on the IMF's revised projections released in October 2008.

Table 1

IMF Outlook: Industrialized Countries

	GDP (real growth)							Consumer price inflation					Current account				
	Oct. 08		Apr. 08		Oct. 08		Nov. 08		Oct. 08		Apr. 08		Oct. 08		Oct. 08		
	2007	2008 ¹	2009 ¹	2008 ¹	2009 ¹	2008 ¹	2009 ¹	2007	2008 ¹	2009 ¹	2008 ¹	2009 ¹	2007	2008 ¹	2009 ¹		
	%							%					% of GDP				
Industrialized countries	2.6	1.3	1.3	1.5	0.5	1.4	-0.3	2.2	2.6	2.0	3.6	2.0	-0.9	-1.0	-0.6		
U.S.A.	2.0	0.5	0.6	1.6	0.1	1.4	-0.7	2.9	3.0	2.0	4.2	1.8	-5.3	-4.6	-3.3		
Euro area	2.6	1.4	1.2	1.3	0.2	1.2	-0.5	2.1	2.8	1.9	3.5	1.9	0.2	-0.5	-0.4		
Germany	2.5	1.4	1.0	1.8	0.0	1.7	-0.8	2.3	2.5	1.6	2.9	1.4	7.6	7.3	6.8		
France	2.2	1.4	1.2	0.8	0.2	0.8	-0.5	1.6	2.5	1.7	3.4	1.6	-1.2	-2.8	-2.7		
Italy	1.5	0.3	0.3	-0.1	-0.2	-0.2	-0.6	2.0	2.5	1.9	3.4	1.9	-2.5	-2.8	-2.4		
United Kingdom	3.0	1.6	1.6	1.0	-0.1	0.8	-1.3	2.3	2.5	2.1	3.8	2.9	-3.8	-3.6	-3.4		
Japan	2.1	1.4	1.5	0.7	0.5	0.5	-0.2	0.0	0.6	1.3	1.6	0.9	4.8	4.0	3.7		

Source: IMF (World Economic Outlook) April 2008 and October 2008; IMF (World Economic Outlook Update) November 2008.

¹ Forecast.

In the U.S.A., the preliminary annualized quarterly growth of (seasonally adjusted) real GDP was negative in the third quarter of 2008 (-0.3%), down from a clearly positive +2.8% a quarter earlier. Year on year, growth dropped to 0.8% (after 2.1% in the second quarter of 2008). The positive contributions of net exports and the general government to quarterly growth did not suffice to offset the slump in private consumption and the continuing decline in private investment. The labor market situation has deteriorated in recent months (joblessness grew, employment declined). The correction in the U.S. real estate market continued with house prices falling nationwide and a still high and expanding inventory of unsold houses. In its November outlook, the IMF expected the GDP to shrink in 2009 (-0.7%). In September 2008, core inflation was 2.5 % year on year. By contrast, the consumer price index (CPI) rose by 4.9 % (August 2008: +5.4 %). The IMF projects a drop in inflation to 1.8 % in 2009.

In the *euro area*, seasonally adjusted real GDP in the second quarter of 2008

shrank by 0.2 % on a (non-annualized) quarterly basis. Year on year, GDP growth fell to 1.4 % (first quarter of 2008: 2.1 %). A growth correction had been expected following dynamic growth induced by special factors in the first quarter of 2008 (+0.7 % on a quarterly basis). In *Germany*, *France* and *Italy*, GDP fell in the second quarter of 2008, compared with the previous quarter. The IMF's November outlook expects a 0.5% to 0.8% contraction of GDP for the euro area as a whole and for these three economies, which are the largest in the euro area. HICP inflation peaked in summer 2008, reaching 4% in both June and July 2008 (year on year), and dropped to 3.6% year on year in September 2008. The IMF projects a further drop in inflation to 1.9 % for 2009 as a whole.

In *Japan*, real GDP in the second quarter of 2008 fell by 0.7 % on a quarterly basis. In its November outlook, the IMF expected GDP to stagnate in 2009 (-0.2 %). Inflation was 2.1% in September, breaching the upper limit of the Bank of Japan's definition of price stability. The decline in commodity

prices should dampen inflation, however.

Liquidity Constraints, Rising Risk Premiums and High Volatility in the Financial Markets

In the *money markets*, there were only minor interest rate changes prior to the intensification of the financial crisis in September 2008. On April 30, 2008, the U.S. Fed's Open Market Committee, decided to cut key interest rates by 25 basis points to 2% in order to counter any risks to the economy. In the euro area, the Governing Council of the ECB, on July 3, 2008, decided to raise the key interest rate by 25 basis points to 4.25% on account of increased upside risks to price stability and the absence of significant lending restrictions. However, the strains existing in the interbank money markets since August 2007 started to intensify in mid-September 2008 as the bankruptcy of Lehman Brothers gave rise to an enhanced perception of risk and an increased preference for liquidity on the part of financial institutions. Interbank dealings in the money market were partly limited to overnight business only. In addition to their coordinated cut in interest rates on October 8, 2008, central banks also cooperated constantly in their efforts to replace the money market temporarily by providing liquidity to one another (via foreign exchange swaps) as well as to banks (via auctions). The Fed and the ECB Governing Council cut their respective key interest rates by another 50 basis points as of October, 29, and November, 12, 2008, to 1% and 3.25% respectively. Owing to the very tight conditions in the interbank money markets, the three-month EURIBOR had climbed from 5.0% at end-August to 5.3% at end-September 2008 while the U.S. dollar three-month LIBOR had

increased from 2.8% to 4.1%. After the interest rate cuts and the additional liquidity-providing measures, the three-month EURIBOR dropped to 4.3% and the U.S. dollar three-month LIBOR to 2.2% by mid-November.

In euro area and U.S. *long-term government bond markets*, yields widened from April to June 2008 (by 0.5 percentage points to 4.8% and by 0.4 percentage points to 4.1% respectively), as investors' risk aversion decreased slightly and concerns about inflation spiraled with rising oil and commodity prices. At the same time, economic prospects were considered to be less downbeat and projected key interest rates were revised upward. From July and June, respectively, to mid-November 2008, in the wake of the financial crisis, yields decreased to the level seen in April, as the macroeconomic outlook worsened and investors preferred reliable government bonds. Break-even inflation rates derived from inflation-indexed bonds rose until July 2008 on the back of growing inflation expectations and increasing inflation risk premiums in the euro area and then dropped owing to the ECB's key interest rate hike, lower oil prices and, last but not least, to the worsening financial crisis.

As the financial crisis escalated, *risk premiums on corporate bonds* for borrowers with the best credit rating (AAA) and for issuers with poorer credit ratings (BBB) climbed steeply from September onwards on the back of increased risk aversion, a greater preference for liquidity and heightened concerns about the economy, reaching new historical highs after only a gradual rise had been evident previously. In the euro area and the U.S.A., BBB risk spreads increased by some 310 to 600 basis points and by 330 to 660 basis points respectively between April and mid-

November 2008. AAA risk spreads, by contrast, rose by 60 basis points in the euro area between April and October and by 180 basis points in the U.S.A.; by mid-November, decreases by 20 to 90 basis points and by 30 to 310 basis points were recorded.

In euro area and U.S. *stock markets*, the recovery that commenced in mid-March 2008 came to a halt in May, and stock prices continued to fall in the third quarter of 2008. This development was primarily due to uncertainty about future financial and economic developments and is attributable to slowing corporate profit momentum. Both in the euro area and the U.S.A., the overall market index was driven downward by falling prices of commodity- and energy-related stocks. Since bank shares fared worse, the stock index dropped more sharply in the euro area than in the U.S.A. From end-September to mid-November 2008, both regions saw an even steeper fall in stock prices than in the third quarter of 2008. Especially financial shares slumped disproportionately owing to three factors: first, increased doubt about the profitability, or even solvency, of (U.S.) financial institutions, second, short selling¹ and, third, the liquidity needs of mutual funds from which risk-averse investors have increasingly withdrawn money. Many countries took regulatory measures to limit short selling. A dramatic increase in implicit volatilities between end-August and mid-November also reflected higher uncertainty in the stock markets.

In *foreign exchange markets*, the USD/EUR exchange rate, on July 15, 2008, reached a new high of USD/EUR 1.5990. In the weeks that followed, the exchange rate tumbled sharply on the

back of gloomier growth prospects in the euro area. In addition, the Japanese yen and the Swiss franc firmed against the euro during this period, albeit to a smaller extent. With the escalation of the financial crisis in mid-September 2008, volatility in the foreign exchange markets shot up, and the USD/EUR exchange rate responded to the bad news by fluctuating sharply, with the U.S. dollar appreciating overall – which may be related to high levels of investment in short-term U.S. government papers. The Swiss franc continued its uptrend, which may be attributable to its role as both a “safe haven” currency and one for financing carry trades. The Japanese yen came under appreciation pressure in the wake of the financial turmoil. In mid-November 2008, the exchange rate of the euro against the U.S. dollar and the Japanese yen was 22% and 29% respectively below the highs of July 2008; against the Swiss franc, the euro traded 9% below the rate of July 2008.

Emerging Economies: Slowing Economic Momentum; Net Capital Inflows to the Private Sector Declining after Record Level in 2007

Buoyant, Albeit Flagging, Economic Momentum with Decreasing Inflation Risks

In its November outlook the IMF expects real GDP growth for the emerging market economies (EMEs) and the developing countries (DCs) as a whole to slow to 6.7% in 2008 and to 5.1% in 2009.

Growth in *Asia* and the *Commonwealth of Independent States (CIS)* is likely to be the strongest worldwide in 2008 (as it has consistently been since 2003).

¹ *Selling stocks short is the selling of borrowed stocks that must be repurchased at a later date and then returned to their owner.*

Table 2

IMF Outlook: Emerging Market Economies and Developing Countries

	GDP (real change)						Inflation			Current account		
	Nov. 08	Apr. 08	Oct. 08		Nov. 08		Oct. 08			Oct. 08		
	2007	2008 ¹	2008 ¹	2009 ¹	2008 ¹	2009 ¹	2007	2008 ¹	2009 ¹	2007	2008 ¹	2009 ¹
	%						%			% of GDP		
All EMEs & DCs	8.0	6.7	6.9	6.1	6.7	5.1	6.4	9.4	7.8	4.1	4.1	2.9
CESEE²	5.7	4.4	4.5	3.4	4.2	2.5	5.7	7.8	5.7	-6.6	-7.1	-7.2
Czech Republic	6.6	4.2	4.0	3.4	..	..	2.8	6.7	3.4	-1.8	-2.2	-2.5
Hungary	1.3	1.8	1.9	2.3	..	..	7.9	6.3	4.1	-5.0	-5.5	-6.1
Poland	6.6	4.9	5.2	3.8	..	..	2.5	4.0	3.3	-3.8	-4.7	-5.7
Slovakia	10.4	6.6	7.4	5.6	..	..	1.9	3.9	3.6	-5.4	-5.1	-4.7
Romania	6.0	5.4	8.6	4.8	..	..	4.8	8.2	6.6	-14.8	-13.8	-13.3
Croatia	5.6	4.3	3.8	3.7	..	..	2.9	7.0	4.9	-8.6	-10.1	-10.2
CIS	8.6	7.0	7.2	5.7	6.9	3.2	9.7	15.6	12.6	4.4	5.5	3.0
Russia	8.1	6.8	7.0	5.5	6.8	3.5	9.0	14.0	12.0	5.9	6.5	3.4
Ukraine	7.6	5.6	6.4	2.5	..	..	12.8	25.3	18.8	-3.7	-7.2	-9.2
Middle East	6.0	6.1	6.4	5.9	6.1	5.3	10.6	15.8	14.4	18.4	22.9	17.1
Egypt	7.1	7.0	7.2	6.0	..	..	11.0	11.7	16.1	1.5	0.6	-0.9
Iran	6.4	5.8	5.5	5.0	..	..	18.4	26.0	22.0	10.1	11.2	6.7
Africa	6.1	6.3	5.9	6.0	5.2	4.7	6.2	10.2	8.3	0.4	3.0	0.2
Nigeria	5.9	9.1	6.2	8.1	..	..	5.5	11.0	11.1	2.1	6.2	0.6
South Africa	5.1	3.8	3.8	3.3	..	..	7.1	11.8	8.0	-7.3	-8.0	-8.1
Asia	10.0	8.2	8.4	7.7	8.3	7.1	4.9	7.3	5.8	6.8	5.2	5.0
China	11.9	9.3	9.7	9.3	9.7	8.5	4.8	6.4	4.3	11.3	9.5	9.2
India	9.3	7.9	7.9	6.9	7.8	6.3	6.4	7.9	6.7	-1.4	-2.8	-3.1
Indonesia	6.3	6.1	6.1	5.5	..	..	6.2	9.8	8.8	2.5	0.1	-0.1
Latin America²	5.6	4.4	4.6	3.2	4.5	2.5	5.4	7.9	7.3	0.4	-0.8	-1.6
Argentina	8.7	7.0	6.5	3.6	..	..	8.8	9.1	9.1	1.7	0.8	-0.6
Brazil	5.4	4.8	5.2	3.5	5.2	3.0	3.6	5.7	5.1	0.1	-1.8	-2.0
Mexico	3.2	2.0	2.1	1.8	2.0	0.9	4.0	4.9	4.2	-0.6	-1.4	-2.2

Source: IMF (World Economic Outlook) April 2008 and October 2008; IMF (World Economic Outlook Update) November 2008.

¹ Forecast.

² CESEE here excluding European CIS countries; Latin America including the Caribbean.

According to the IMF, *Asia*, followed by the *Middle East* and *Africa*, will post the highest growth rates in 2009.

In *Asia*, industrialized countries' weak demand should largely be offset by domestic demand components and regional momentum. Although growth will slacken, these countries are likely to maintain their economic stability owing to low debt ratios. While growth in China slowed on the back of weaker export growth in the first half of 2008, in India flagging growth was attributable to sluggish investment. In *Latin*

America too, growth in the entire year of 2008 will be largely driven by domestic demand (despite worsened financing conditions), as the positive terms-of-trade effects, which had resulted from the high commodity prices in some countries until the third quarter of 2008, have been fading. Also, in *Africa*,² growth up to the third quarter of 2008 was supported by high energy and commodity prices (especially prices of metals, coffee, cocoa and cotton). The price slump of these goods seen afterwards put a sharp brake on growth.

² *Libya and Egypt, which belong to the regional group of the Middle East, are not included here.*

At the same time, risks to growth in this region increased in conjunction with the risk of a sharper decline in global demand. In the *Middle East*, oil-importing Egypt's sustained (exceptionally) high growth, which is also supported by tourism, is worth highlighting. In *Turkey*, growth is hit by weaker demand from the EU (the automotive industry, in particular, is adversely affected) and by sluggish investment. In addition, restrictive monetary policies for combating inflation as well as fiscal consolidation measures are dampening the economy. According to the IMF, the credit markets' current drying up poses a particular threat to the Turkish economy.

The IMF revised its November 2008 growth outlook for 2008 for the EMEs and the DCs as a whole slightly down to the level of the April 2008 outlook. The regional projection for 2008 revised most pronouncedly in the November 2008 outlook was the projection for *Africa*, which was revised downward. For 2009, the November outlook for the EMEs and the DCs as a whole put growth 1 percentage point lower than the October outlook. The IMF's downward revisions were significantly above-average for the CIS. This is traceable to the problems seen in the Russian banking sector, which are closely linked with the international financial crisis and the slump in commodity and energy prices (see the section on the CESEE of this Report).

Overall, EMEs and DCs will generate a continued high *current account surplus* in 2008, which will probably decrease in 2009. However, large differences exist between, as well as within, individual regions, depending above all on the availability of commodities. Europe is the only region with a higher deficit, which – according to the IMF – is set to further increase in 2009. But

also in Latin America, the small deficit anticipated for 2008 will widen in 2009. In addition to Ukraine, other EMEs with larger current account deficits (including Turkey, South Africa) could have financing problems owing to enhanced investor risk aversion and tighter external lending conditions, according to the IMF.

The slowdown in growth in most EMEs and DCs has meant that inflationary pressures, which emerged primarily from markedly higher energy and – as a result – food prices, but also from robust domestic demand, are now easing. In a number of countries, inflation had been falling notably already before the escalation of the international financial crisis in 2008 and the resulting dramatic deterioration in growth outlooks, in particular owing to the decline in energy and food prices.

Net Capital Inflows to the Private Sector Expected to Fall Sharply in 2009 while Net Capital Outflows from the Public Sector Persist

Many EMEs and DCs saw historically high *net capital inflows to the private sector* in 2007. Traditionally, net inflows are dominated by foreign direct investment (FDI). However, 2007 also saw net portfolio investment inflows and sharp rises in net credit inflows. The IMF expects total net inflows to the private sector will weaken slightly in 2008 and markedly in 2009. The reasons anticipated for this are (increasingly stronger) net outflows of volatile portfolio investment (increased foreign investment by Asia's private sector), smaller net credit inflows in 2008 (turnaround of previously strong net inflows into net outflows in the CIS), and net credit outflows in 2009 (similar turnaround in Asia).

Table 3

Net Capital Inflows to Emerging Market Economies and Developing Countries¹

	2004	2005	2006	2007	2008 ²	2009 ²
	<i>USD billion</i>					
Net capital inflows to the private sector	236.5	248.7	223.0	632.8	528.6	286.6
By instrument						
Direct investment	189.0	261.8	246.0	379.0	443.6	414.6
Portfolio investment	12.7	-20.4	-107.3	54.5	-6.6	-89.1
Other flows (especially loans)	34.8	7.3	84.4	199.5	91.8	-38.7
By region (country)						
Europe	74.3	119.2	119.9	173.8	179.9	181.7
CIS	3.1	31.7	56.8	125.3	19.8	26.0
Middle East	-16.9	-57.5	-47.5	33.7	-99.6	-86.2
Africa	13.1	26.3	36.0	39.6	43.7	62.3
Asia	147.8	90.9	48.3	163.0	291.6	22.0
Latin America and the Caribbean	15.2	38.1	9.5	97.4	93.2	80.8
Net capital inflows to the public sector³	-71.1	-109.9	-158.0	-140.7	-158.6	-135.4
Memorandum item						
Current account balance	300.0	525.1	709.9	745.5	869.6	695.6
Reserve assets ⁴	-508.4	-595.8	-754.3	-1256.1	-1270.1	-920.2
of which: held by China	-206.3	-207.0	-247.0	-461.8	-670.0	-500.0

Source: IMF (World Economic Outlook), October 2008.

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

² Forecast.

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

⁴ A minus sign indicates an increase.

Both, in 2008 and 2009, FDI will continue to be the most important form of net capital inflows to the private sector in all EME regions – except for Europe, where *net credit inflows* are likely to remain the key external source of financing in this period.

Central, Eastern and Southeastern Europe (CESEE), the only region with a traditionally high *current account deficit*, has been attracting the highest *net capital inflows to the private sector* since the mid-1990s. In 2008, CESEE is likely to temporarily cede this leading position to Asia, as 2008 is currently witnessing extraordinarily high net lending to Asia. Like CESEE, Latin America will have a(n) (albeit small) current account deficit in combination with net capital inflows to the private sector in 2008 and 2009. In Asia, Africa and the CIS, the combination in existence since 2004 of *current account*

surpluses and *net capital inflows to the private sector* will continue in 2008 and 2009 as well. Only the Middle East will see *net capital outflows from the private sector* (investment of *current account surpluses* in the form of petrodollars) in both years.

In 2008 and 2009, *net capital outflows from the public sector excluding the central bank* (foreign debt repayments as well as investment, of which some via sovereign wealth funds) are anticipated for every region (apart from Africa and Latin America), with by far the largest in the Middle East. Moreover, according to the IMF, the *buildup of foreign currency reserves* is likely to continue in every region in 2008 and 2009, although growth in 2009 may lag behind the record levels of 2008. The reason for this is a smaller buildup of reserves in Asia, where absolute growth will nonetheless remain the highest world-

wide since the largest absolute current account surplus will be generated in this region.

Claims of Austrian Banking Sector Lead in CESEE

As at end-March 2008, the claims of the Austrian banking sector³ on CESEE residents came to 8.5% of the nominal GDP of recipient countries in the region, thus still exceeding the claims of other countries on this region (see table 4). The Austrian banking sector accounts for almost a fifth of the claims of all BIS reporting banks on this region.

Compared with other countries' banks, Austrian banks held the highest level of claims on Slovenia, the Czech Republic, Slovakia, Romania, Croatia and Ukraine and the second-highest on Hungary (after Germany) and Bulgaria (after Italy). In terms of its level of

claims on Russia, Austria, together with Italy in fourth place, ranks after Germany, France and the Netherlands. In the case of Slovenia (a euro area country), Slovakia, the Czech Republic and Croatia, the claims of all BIS reporting banks are concentrated on Austrian banks to a particularly large extent, with the latter holding a share of 30% or more.

Eurobonds Severely Affected by the International Financial Crisis

The performance of the international Eurobond market was impacted by the global financial turmoil as early as from summer 2007. After the average *yield spread* of EME issuers' U.S. dollar and euro-denominated government bonds relative to U.S. and euro-area government bonds – measured by J.P. Morgan's (Euro) EMBI (Emerging Market

Table 4

Claims of BIS Reporting Banks on Central, Eastern and Southeastern Europe¹

	AT	DE	IT	FR	NL	SE	BE	U.K.	Europe ²	U.S.A.	Japan
	% of GDP (2007) of the recipient country										
CESEE	8.5	6.2	6.0	4.9	2.9	2.8	3.6	1.2	42.2	1.6	0.7
EU Member States of CESEE (excluding the Baltic countries)											
Bulgaria	12.4	5.3	15.5	6.3	1.3	0.0	4.5	0.6	78.9	0.9	0.2
Czech Republic	31.0	5.4	8.3	18.6	3.3	0.1	24.2	..	95.4	1.8	0.6
Hungary	22.8	23.1	17.3	6.8	3.7	0.2	11.1	..	91.3	1.9	1.5
Poland	3.3	10.3	11.4	4.8	6.0	1.4	4.7	0.3	52.8	2.5	1.4
Romania	22.8	1.9	6.1	11.2	4.5	0.1	0.6	0.1	61.1	0.8	0.1
Slovakia	37.5	4.5	22.6	7.0	6.8	0.1	11.7	..	92.7	1.5	0.1
Slovenia	29.9	25.8	14.7	5.5	1.6	0.0	5.7	0.6	86.3	0.7	0.9
Other countries of CESEE											
Croatia	64.5	31.6	56.5	14.9	0.3	0.0	0.7	0.7	171.6	0.5	0.9
Ukraine	8.9	3.3	3.3	7.2	2.5	3.5	0.5	0.5	36.1	1.2	0.6
Russia	1.5	3.1	1.5	2.5	1.6	0.5	0.6	..	14.1	1.1	0.7
Turkey	0.4	2.4	..	2.0	2.7	0.1	2.1	..	17.6	2.0	0.5

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 2008, 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 (BA) group.

¹ As of end-March 2008.

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

³ The consolidated BIS statistics do not include the BA group among Austrian banks.

Bond Index) Global – had reached a historic low of 150 (USD) and 50 (EUR) basis points in June 2007, it moved in parallel with the ups and downs of the international financial market's other segments.

Until JPMorgan Chase acquired U.S. investment bank Bear Stearns with government assistance in mid-March 2008, the average bond yield spread had widened by 190 (USD) and 95 (EUR) basis points. This widening arose primarily because Eurobond yields did not replicate the decline in benchmark bond yields, as the yields on 10-year U.S. government bonds in this period narrowed by 165 basis points and the yields on 10-year euro-area government bonds declined by 75 basis points. Following the bailout of Bear Stearns, these spreads narrowed by almost 80 and 40 basis points respectively until end-May 2008 but then widened until mid-September by just under 100 and 30 basis points respectively. After widening, hence, between the start of the financial turmoil in mid-2007 and mid-September 2008 by 210 basis

points and 85 basis points respectively, during the escalation of the crisis following Lehman Brothers' filing for bankruptcy on September 15, 2008, they jumped by 350 and 240 basis points to 710 and 380 basis points respectively until mid-November 2008, while yields on USD benchmark bonds (10-year U.S. government bonds) on balance hardly changed at all (increasing slightly until mid-October and falling afterwards) and yields on EUR benchmark bonds (10-year government bonds of euro area countries) narrowed by 50 basis points.

After the *average total return on Euro-bond investment* was close to zero for both indices from March to mid-September 2008, both index portfolios suffered (non-annualized) total losses of 19% (USD portfolio) and 8% (EUR portfolio) between mid-September and mid-November 2008. For investors from the euro area, these USD portfolio losses were partially offset by the parallel appreciation of the U.S. dollar by 12%.

Table 5

Eurobonds: Spreads to Reference Bonds and Returns by Region

	EMBI Global (USD)						Euro EMBI Global (EUR)					
	Weight in over-all index in %	Yield spreads in basis points		Total return in %	Rating	Duration	Weight in over-all index in %	Yield spreads in basis points		Total return in %	Rating	Duration
	Nov. 13, 2008	Nov. 13, 2008	Change since March 31, 2008	Change since March 31, 2008	Nov. 13, 2008	Oct. 31, 2008	Nov. 13, 2008	Nov. 13, 2008	Change since March 31, 2008	Change since March 31, 2008	Nov. 13, 2008	Oct. 31, 2008
Overall index	100.0	711	387	-19.4	BB+	5.95	100.0	381	252	-7.9	BBB+	4.72
Africa	2.3	797	369	-19.8	BB+	4.21	3.9	715	461	-13.6	BBB+	4.03
Asia	17.4	610	338	-17.7	BB+	5.79	3.4	342	227	-3.9	BBB	3.76
Europe	27.6	708	436	-20.8	BBB-	5.47	76.6	336	233	-7.5	BBB+	4.99
Latin America	49.1	740	393	-20.3	BBB-	6.47	16.1	590	366	-9.0	BBB	3.67
Middle East	3.6	741	164	-4.1	B-	4.35	..	..	..	..	..	..

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

Note: The EMBI Global and the 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 foreign currency sovereign debt and is expressed in the rating categories of Standard & Poor's.

Clearly, the decline in demand for Eurobonds issued by EME sovereign borrowers and the resulting widening of yield spreads were not in line with the positive *development in fundamental data* measured by the number of rating upgrades (by the three largest rating agencies) for countries included in both these indices between end-March and end-September 2008. This number continued to exceed by a wide margin the number of rating downgrades, albeit to a smaller extent than previously. In fact, the key factor was the steep increase in global risk aversion, which also infected this segment of the international financial market.

European USD and EUR-denominated government bonds were hit by the financial upheaval in very different ways. From mid-2007 to mid-September 2008, the spreads of Ukraine, Romania and Bulgaria and, to a lesser extent, those of Croatia and Hungary widened more sharply than the average spreads for the broad index. Also from mid-September to mid-November 2008, this was the case in these countries as well as in Turkey and Russia. By contrast, the spreads of Slovakia as well as those of the Czech Republic and Poland widened in both these periods to a much smaller extent than for the broad index.

CESEE: Countries with External Imbalances Worse Hit by the International Financial Crisis

Both the financial upheaval from mid-2007 and the escalation of the financial crisis from mid-September 2008 primarily hit the financial assets of countries that were exposed and vulnerable

owing to their external position (balance of payments, foreign debt) or to their share of domestic foreign currency loans. This applies particularly to Eurobonds issued by sovereign borrowers (see above) and – with qualifications – to government bonds denominated in national currency and to national currencies themselves (see below). These differences are also to a lesser extent mirrored in the performance of stock markets. In addition to Ukraine, where political uncertainties also played a decisive role, the countries concerned included, above all, those in Southeastern Europe and Hungary. The repercussions of the international financial crisis and the change in risk aversion came about via several different channels. For instance, both banks and their customers backed out of mutual funds, which for their part had to liquidate positions rated with a relatively high risk in order to disburse their shares. Furthermore, banks in EMEs were also hit by the general crisis of confidence in the inter-bank market – in both the money market and foreign exchange swap⁴ markets. Problematic financial developments in these CESEE countries were therefore not only triggered as a result of a jittery market reacting very sensitively to deteriorating fundamentals. Indeed, Hungary's example, in particular, highlights the fact that increased risk worldwide can lead to "contagions" by giving rise to problems in countries where the fundamentals have appreciably improved in recent years, but the residual risks are considered as too high now – this after far worse fundamentals and more substantial risks had previously not caused a negative reaction.

⁴ Foreign exchange swaps are foreign exchange transactions that are executed for a specified period of time and based on the interest rate spreads between two currencies.

Effects of the Financial Crisis in Central and Southeastern Europe

In *Hungary*, the demand for forint-denominated government bonds slumped in early October 2008. This resulted in forint-denominated government bond yield spreads widening sharply relative to benchmark bonds in the euro area to a level last seen in September 2004. After narrowing by 110 basis points to 360 basis points from mid-March to mid-September 2008 and then widening to 420 basis points until end-September, they jumped to 670 basis points by October 10, 2008. The backdrop to this collapse in demand is likely to have been the fact that the foreign exchange swaps, on the basis of which foreign swap partners had invested the received forint-denominated liquidity in government securities, had largely dried-up. There was also speculation about financial difficulties besetting OTP, the country's largest and Hungarian majority-owned bank, whose stock price lost 40% in value in the week to October 10, 2008, adversely affecting the index (-21%) in which OTP has a large share. Indeed, OTP Bank, too was hit by the slump in international foreign exchange swap markets, since it needed such deals to close otherwise open foreign currency positions owing to, in particular, the (domestic) foreign currency loans it had issued. It was therefore constrained to switch to the foreign currency cash market, triggering depreciation pressures on the currency. Fears about government intervention that may be required, which could increase government debt, were intermixed with associations with the problems currently faced by Iceland and its banks. Owing to foreign portfolio investors selling their stocks and bonds, the demand for foreign currency grew further and the forint depreciated by 7% against the euro from end-Septem-

ber to October 10, 2008. In response to this fall in financial asset prices, immediate measures were taken:

- The Hungarian central bank (supported by a refinancing line from the ECB) began to act as a foreign exchange swap partner to improve (foreign currency) liquidity in the interbank market.
- To restore equilibrium in the bond market, the ceiling for Hungarian pension funds' investment in government bonds was skipped, the budget deficit target of 3.8% for 2008 was reduced to 3.4% of GDP and the volume of new issuance in 2008 was lowered to the amount required for the roll-over of existing debt. For 2009, tax-cutting plans were postponed and the deficit target was lowered to 2.9%. Last but not least, bond repurchase auctions were held.
- Moreover, the Hungarian government immediately implemented the EU-wide decision stipulating a minimum deposit guarantee of EUR 50,000, also establishing government guarantees in the event of bank failures.

Still, the spread of forint-denominated government bonds continued to widen until October 23, 2008 (by another 160 to 830 basis points), and the forint depreciated against the euro by another 8% (i.e. the Hungarian currency had lost almost 15% of its value against the euro since September 2008).

On October 22, 2008, the Hungarian central bank increased its key interest rate by 300 basis points to 11.5%. At end-October, the IMF, the EU and the World Bank agreed with the Hungarian government on a loan package totaling EUR 20 billion, of which the IMF and the EU provided EUR 12.5 billion and EUR 6.5 billion respectively. Under this agreement, the gov-

ernment committed itself to using this means also for stabilizing the banking sector (by establishing a refinancing guarantee fund and a capital increase fund) and to reduce the budget deficit to 2.5% in 2009 by making, above all, savings in public sector salaries and pensions. This loan agreement also came with the expectation that foreign banks will continue to remain active in Hungary to the extent they have to date. News about the preparation and adoption of this package triggered a positive market response: the forint appreciated strongly against the euro until early November (+9.5%), and the bond spread narrowed notably (–210 basis points). Afterwards, until mid-November, the currency saw a gradual depreciation and the forint-bond spread a gradual widening.

The events in Hungary had spillover effects in *Poland* and in the *Czech Republic*. From end-September to October 23, 2008, the yield spread of national currency-denominated government bonds widened by 180 to 320 basis points and by 110 to 80 basis points respectively, after having narrowed by 50 and 80 basis points respectively between March and mid-September 2008. The Polish zloty and the Czech koruna depreciated against the euro by 13% and 5% respectively between end-September and October 23, 2008; before that, from March to August 2008, the two currencies had appreciated by 9% and 6% respectively and depreciated only slightly afterwards. As a countermeasure, the Polish central bank embarked on improving liquidity by introducing foreign exchange swaps and by stepping up the supply of refinancing credit while the government approved as a precautionary measure a bill for state assistance facilities (guar-

antees, loans and participating interests) for fragile financial institutions. In the Czech Republic, the government cancelled government bond auctions, and the central bank began to offer liquidity-injecting repo deals (with government bonds as loan collateral). News about the preparation and announcement of the IMF's and the EU's credit arrangement with Hungary triggered positive contagion effects for both countries. In a first response, the currencies and the national currency-denominated government bonds recouped a considerable part of the losses suffered previously due to contagion; after that, both currencies depreciated gradually until mid-November 2008.

In *Bulgaria*, the government stood guarantor for interbank loans, introduced a government bond repurchase scheme for domestic financial institutions and announced as a precautionary measure the possible provision of government deposits at banks.

As in Hungary, the EU-wide decision to increase the deposit guarantee to a minimum amount of EUR 50,000 was implemented in all the other EU countries of the region. Besides Hungary and Lithuania, which stipulated a minimum amount of EUR 100,000, only *Slovakia* went beyond the minimum amount of EUR 50,000 set by the EU, introducing an unrestricted deposit guarantee. *Croatia*, which is currently in EU accession talks, followed suit by increasing its deposit guarantee from EUR 14,000 to EUR 56,000. To boost foreign currency liquidity in the interbank market, the Croatian central bank also suspended its special reserves requirement (applicable to commercial banks), under which 55% of newly raised foreign loans must be deposited as reserves with the central bank.

Effects of the Financial Crisis in Ukraine

In *Ukraine*, the overheating of the economy, in tandem with a credit boom and strong consumption growth, as well as the fall in steel prices in the first half of 2008, resulted in the current account deficit deepening to 7.7% of GDP (first half of 2007: 3.3%), which was only partly covered by FDI inflows (6.2% of GDP). However, the Ukrainian currency, the hryvnia, came under considerable appreciation pressure owing to high capital inflows and, at end-May 2008, the central bank revalued its U.S. dollar-pegged currency band by +4%. In mid-September 2008, the international financial crisis hit Ukraine in manifold ways: First, the outlook for the economy and, thus, for steel exports and FDI inflows deteriorated considerably (while price rises for Russian gas imports in 2009 are waiting in the wings); second, greater risk aversion led to the increase in the external deficit being revalued; and third, many Western and Russian portfolio investors required liquidity. In addition, the government coalition collapsed, followed by uncertainty about fresh elections. This led to a marked widening of the Eurobond spreads, a slump in stock prices and the depreciation of the hryvnia from end-August to end-September 2008 by 8% against the U.S. dollar (implying a shift from the strong towards the weak end of the currency band), which equaled a 5% depreciation against the euro. When the weak end of the currency band was penetrated, the central bank in early October 2008 responded by devaluing and expanding the currency band as well as by making massive foreign exchange interventions. After the central bank had to rescue a medium-sized bank by granting loans in early October, emergency measures were taken to ensure

the stability of the banking sector (including a ban on early withdrawals, an increase in the deposit guarantee and restrictions on new foreign exchange-denominated lending). In mid-October 2008, Fitch and Standard & Poor's downgraded the rating for long-term sovereign foreign currency debt. Finally, on October 26, 2008, the IMF arranged with the Ukrainian government a 2-year stand-by loan of USD 16.5 billion. From end-September to October 26, 2008, the hryvnia depreciated by another 14% against the U.S. dollar but remained almost stable against the euro (because the euro also depreciated). Despite the announcement of the credit arrangement, the currency continued to depreciate by a hefty 17% against the U.S. dollar and 18% against the euro within three trading days. This depreciation was successfully reversed until mid-November 2008, only after the Ukrainian parliament had given its definitive consent to the loan agreement on October 31, 2008, and after the central bank's continued massive interventions in the foreign exchange market. From end-September to end-October 2008, Ukraine's foreign currency reserves declined by 5% (measured in euro) to EUR 25 billion. As a result of the euro's depreciation against the U.S. dollar within the same period, however, the loss in reserves came to 15% measured in U.S. dollars. The arrangement with the IMF stipulates the requirement of a restrictive monetary and fiscal policy as well as that of wide-ranging structural reforms (including stabilizing the banking sector).

Effects of the Financial Crisis in Russia

But the adverse effects of the international financial crisis were not confined to countries with (relatively) high cur-

rent account deficits or foreign debt (both measured in GDP terms). *Russia* too has serious problems to overcome in its domestic financial sector even if its problems here are embedded somewhat differently. As early as from August 2008, international security policy tensions in the wake of the Georgian crisis, as well as the drop in energy and commodity prices, triggered both net outflows of portfolio capital and capital flight. This was yet further exacerbated by the escalation of the international financial crisis, not least also because the crisis reinforced expectations of a continued fall in energy prices. The thus induced stock market slump, accompanied by the suspension of trading for entire days on several occasions, gave rise to challenging liquidity problems, particularly, for around 1,150 small and medium-sized Russian banks, as stocks had frequently been provided as loan collateral and their slump in value hugely increased margin requirements (in the form of liquid funds). The Russian central bank reacted rapidly by intervening massively in foreign exchange markets to prop up the ruble and by injecting liquidity via short-term loans. This action was then followed by the introduction of several comprehensive packages of measures. In mid-September 2008, the minimum reserve requirement ratios were lowered by 4 percentage points, and the government announced several measures: (1) financial assistance for 28 large and medium-sized banks as well as for major exchange-listed enterprises in the form of longer-term deposits, loans and stock purchases; (2) the reduction of export taxes on oil; (3) the setting-aside of part of the official foreign exchange reserves to ensure the servicing of private-sector foreign debt; and (4) the increase of the deposit guarantee by 75% to around the equivalent of

EUR 19,400. At end-September 2008, a major private bank, which had fallen into difficulties, was taken over by state-owned Vneshekonombank (VEB). In early October, further measures of assistance – particularly, for major banks – were announced, including the granting of long-term (5-year) loans. On October 10, 2008, the Russian parliament approved a number of previously announced measures. Overall, the total amount of disbursements and assumptions of liability came to some EUR 150 billion or around 17% of GDP. From early August to end-October 2008, Russia's foreign currency reserves (which are held partly in U.S. dollars, partly in euro) declined by 4% (measured in euro) to EUR 380 billion. Due to the euro's depreciation against the U.S. dollar within the same period, however, the loss in reserves came to 19% measured in U.S. dollars. In the first half of November, the Russian central bank embarked on a policy of a controlled depreciation of the ruble: on the one hand, it replaced the ruble's close peg to a currency basket consisting of 55% U.S. dollars and 45% euro, with a $\pm 1\%$ currency band – the ruble immediately moved towards the weak end of the currency band –, while on the other hand it raised the refinancing rate by 100 basis points to 12% on November 11, 2008. Apart from political uncertainties and institutional weaknesses, Russia was hit by the international financial crisis via the simultaneous deterioration in the outlook for its current account surplus (decline in energy prices) and the negative impact on its external financial account. The latter was especially large, as Russia's financing flows were closely connected to stock market performance and foreign parent banks only contribute a small share of the total external financing of the Russian banking sec-

tor, in which they hold only a relatively small market share. Nevertheless, Russia managed to adopt wide-ranging countermeasures thanks to its official foreign exchange reserves and state reserve funds, which were built up on the bedrock of high energy and commodity prices.

Against the backdrop of the international financial crisis, the key *medium-term risk factors for the CESEE countries* include, above all, the negative economic outlook for the euro area as well as the accompanying weakening of the export market for countries in this region and the decline of FDI inflows to these countries. At the same time, the financial crisis has also exacerbated the conditions for, and possibly the scale of, external financing by borrowing. This is likely to hit primarily countries with high current account deficits.

The following presentation and analysis of currency trends show how strong CESEE countries – with some significant differences in their fundamentals – are ultimately all influenced by the international financial market situation and by the appetite for risk.

Regional Currencies under Depreciation Pressure owing to the Global Financial Crisis

Whereas the Bulgarian lev in the framework of the currency board regime remained firm also during the financial turmoil, the trend relative to the euro for currencies under review here with a nonpegged foreign exchange rate (Slovak koruna, Czech koruna, Polish zloty, Hungarian forint, Romanian leu, Croatian kuna, Russian ruble) showed a similar picture to some degree.

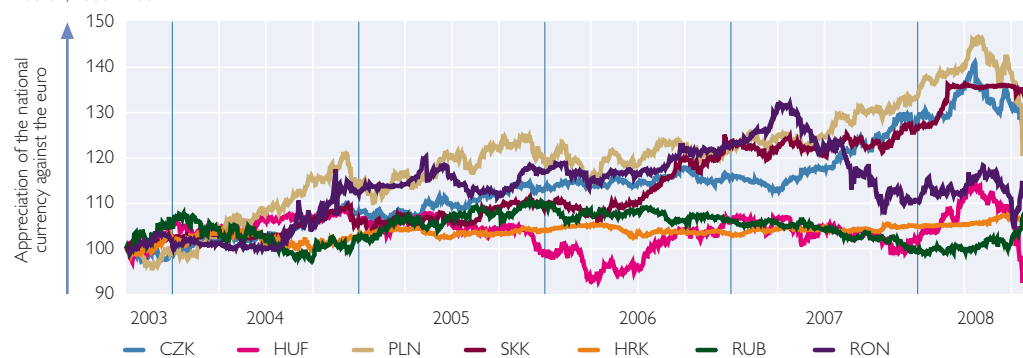
All these currencies firmed against the euro *from March to end-July/early August 2008* – particularly strongly in the case of the Romanian leu (+5%) and the Hungarian forint (+11%), which had previously depreciated by 17% and 6% respectively from mid-2007 to March 2008, and the Slovak (+7%), Czech (+6%) and Polish currencies (+9%), which had previously already appreciated by 4%, 15% and 6% respectively (see chart 1).

The appreciation of the Slovak koruna resulted in a market exchange rate within the $\pm 15\%$ band, which was 12.2% below the SKK/EUR central rate (or, in euro terms, 13.9% above

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.

the central rate) on May 27, 2008. At Slovakia's request, it was unanimously agreed on May 28, 2008 (effective as of May 29) to reduce the SKK/EUR central rate to the 15% lower hitherto strong end of the currency band, i.e. to revalue the central rate of the Slovak koruna (measured in euro) within ERM II by 17.6%. In the EU's statement, this appreciation was described as justified owing to the development in economic fundamentals. No further appreciations were seen subsequently within this new band, as the market rate continued to stay close to the central rate, which was subsequently fixed also as the conversion rate for the euro changeover on January 1, 2009.

Slovakia's successful path toward euro changeover and the appreciation of its national currency might also have had a tonic effect on other flexible currencies of the region. Moreover, the strong uptrend of these flexible currencies was supported by the generally positive (albeit, in some cases, uniformly so) perception of the region by investors. In the final analysis, in view of the steep rise in inflation in some of these countries such as Romania, the

(in certain cases) already occurred tightening of interest rate policy, or the anticipation thereof, may have had a major impact. Interest rate differentials are always likely to gain quickly in importance when risk aversion subsides to some extent worldwide.

From end-July/early August to mid-September 2008, the currencies of the Czech Republic (−3%), Poland (−4%), Hungary (−3%) and Romania (−2%) underwent a modest corrective depreciation against the euro while the (strongly managed) Croatian kuna continued to firm slightly on the back of summer tourism (+1.5%).

After the collapse of Lehman Brothers in mid-September 2008, the following currencies depreciated sharply against the euro until mid-November: the forint (−11%), the zloty (−10%), the leu (−5%) and the Czech koruna (−3.5%).

The ruble, which is tied to a currency basket (55% U.S. dollar, 45% euro), firmed against the basket from mid-March to end-July 2008, thereby appreciating somewhat more strongly against the euro (+1.5%) than would correspond to the mere partial

Table 6

Fundamental Factors Influencing Exchange Rate Developments

	GDP growth (%)		Contribution of net exports to GDP growth (percentage points)		Balance of trade and services (% of GDP)		Income balance (% of GDP)		Demand for external financing (% of GDP) ¹		Demand for external financing plus net FDI inflows (% of GDP)	
	H1 07	H1 08	H1 07	H1 08	H1 07	H1 08	H1 07	H1 08	H1 07	H1 08	H1 07	H1 08
Slovakia	8.8	8.1	6.1	−0.3	0.0	−1.1	−3.0	−4.2	−3.2	−5.0	−0.5	−3.8
Czech Republic	6.6	4.9	0.3	3.4	5.9	7.2	−6.3	−8.9	−0.6	0.0	3.2	3.1
Poland	6.8	6.1	−1.4	−0.3	−2.9	−3.5	−3.4	−3.4	−3.5	−3.7	0.3	−1.8
Hungary	1.9	1.9	3.2	2.5	1.2	2.0	−7.9	−7.6	−6.7	−5.0	−7.9	−0.7
Bulgaria	6.5	7.1	−8.9	−5.2	−23.6	−27.1	−0.7	−1.2	−22.6	−23.8	−3.0	−12.9
Romania	5.9	8.8	−16.4	−14.3	−16.4	−15.2	−5.3	−4.8	−16.1	−14.4	−8.7	−5.3
Croatia	6.8	3.8	−0.6	−3.0	−17.2	−19.0	−4.8	−5.4	−19.0	−21.7	−6.5	−12.5
Russia	7.7	8.0	−7.6	−6.0	9.4	11.4	−2.7	−3.3	6.5	8.0	6.8	9.4

Source: Eurostat, national central banks, OeNB.

¹ Demand for external financing = sum of current account balance and capital account balance, hence demand for financing in addition to demand for financing due to the financial account (e.g. via borrowing in order to roll over existing external liabilities, flight of capital).

replication of the appreciation of the U.S. dollar against the euro in this period. From end-July to mid-November 2008, however, the ruble steadily softened against this basket. At +6%, it appreciated against the euro significantly more weakly than by the proportional appreciation of the U.S. dollar against the euro, which would have been +14%. The ruble's weakness was the result of the repercussions of the financial crisis on Russia (see above), which were only partly offset by the Russian central bank's massive interventions in the foreign exchange market.

Economic growth was robust in almost all CESEE countries in the first half of 2008, ranging between 4.3% in Croatia and 8.8% in Romania. Hungary was an outlier yet again, with growth amounting to a mere 1.9% owing to the effects of fiscal consolidation measures as well as to structural weaknesses (low investment and employment rates). Compared with the previous period a year ago, growth slowed in most countries of the region, except in Romania, Bulgaria and Russia. Among domestic demand components, investment growth was (considerably) more vigorous than private consumption growth in the first half of 2008 in all the countries under review (except for Slovakia). Private consumption growth in Hungary remained negative. Only in Romania and Russia did private consumption grow far more sharply than GDP. Leading indicators for the third quarter of 2008 show a notable slowdown in growth, but – contrary to the euro area – no recession in the CESEE region.

The *contribution of growth to net exports* was significantly negative in Romania and – to a lesser extent – in Russia, Bulgaria and Croatia. In Romania and Russia, this is explicable by, above

all, very buoyant private consumption growth in addition to brisk investment activity.

The *combined current and capital account balance* remained in the red (i.e. a need for external financing exists) in all countries of the region with the exception of Russia and – most recently – the Czech Republic, with the level and structure in the individual countries differing very widely. In Central European countries (except for the Czech Republic), the external financing requirement did not exceed 5% of GDP, and the negative income balance was the main reason and (in Poland) a main joint reason for the external financing deficit. In Southeastern European countries, the (in some cases) huge external financing deficits stem from the performance of the trade and services balance, with additionally the income balance being significantly negative in Romania and Croatia. Moreover, in Bulgaria and Croatia, the current account deficit increased while net FDI inflows declined, resulting in a marked increase in the remaining external financing requirement. However, for Croatia, in particular, it should be highlighted that its current account deficit is always far lower in the year as a whole owing to a tourism-induced surplus in the second half of the year in GDP terms. In 2008, moreover, Croatia will also see net FDI inflows rise significantly owing to large-scale privatization in the oil industry.

At almost 12 percentage points in mid-November 2008, the Romanian leu registered by far the widest *short-term interest rate spreads relative to the euro area*. Only in Romania had the short-term interest rate differential relative to the euro area widened considerably from March to mid-September 2008 (+240 basis points to 8.6%), in part owing to interest rate hikes

(+125 basis points), in part owing to the increase in risk premiums. The differential continued to widen afterwards, reaching a very high level (up to 45%) for a few days in mid-October, which were ascribed – in part – to the approaching end of payment periods and foreign currency interventions to support the leu. In Croatia, the short-term interest rate spread narrowed from March to mid-September 2008 (–65 basis points) only to then widen substantially until mid-November (+360 basis points to 5%). In Bulgaria, the short-term interest rate spread widened somewhat from March to mid-September 2008 (+30 basis points) and likewise widened substantially until mid-November (+140 basis points to 3.7 %). In Hungary and Poland, short-term interest rate spreads remained fairly stable from March to mid-September 2008. In Slovakia and the Czech Republic, the short-term interest rate spread relative to the euro area was still negative, widening even further, above all, owing to the increase in interbank interest rates in the euro area. With the exception of Slovakia, these Central European countries saw a significant increase in short-term interest differentials between mid-September and mid-November 2008: Hungary (+380 basis points to 7.5%), Poland (+90 basis points to 2.5%) and Czech Republic (+120 basis points to 0%).

These increases are in part attributable to different key interest rate changes: while the euro area saw interest rate cuts by a total of 100 basis points, interest rates were raised by 300 basis points in Hungary, remained unchanged in Poland and were cut by 75 basis points in the Czech Republic.

Major *interventions in the foreign exchange markets* to influence the exchange rate momentum were made during the reporting period in Romania and, above all, in Russia.

In mid-2008, *gross foreign debt* was especially high in Hungary, Bulgaria and Croatia. Their foreign debt burden remains high also after the amount of their official foreign currency reserves is taken into account. In Hungary, the public and banking sectors account for most of the foreign debt. In Bulgaria and Croatia, by contrast, particularly private nonbanks and the banking sector have raised the largest amounts of foreign loans. To a fairly large extent, the foreign debt of these countries' banking sectors consists of liabilities to foreign parent banks. Apart from the foreign debt, there exists also a relatively high share of domestic foreign currency debt of private nonbanks in some countries, like in particular in Hungary, Romania and Croatia. This could adversely affect the financial sector in the event of a sharper exchange rate correction.