THE ROCKY PATH TO THE EURO

HELMUT KAISER OF DEUTSCHE BANK LOOKS AT THE IMPLICATIONS OF RECENT DEVELOPMENTS FOR LOCAL BOND MARKETS IN CENTRAL AND EASTERN EUROPEAN ACCESSION COUNTRIES.

Over recent years the local bond markets of the European Union (EU) accession countries from central and eastern Europe have been driven by convergence. Gradual adjustment of inflation and interest rates to Euroland rates and capital inflows have temporarily led major bond rallies in these markets. However, as things stand, instead of the convergence process becoming more predictable and straightforward in its final stage, it has brought a number of problems to the fore.

The initial intention of taking on the euro as early as two years after EU accession (ie by 2006) has become unrealistic. Two developments account for this: the problem of high current account and fiscal deficits, and the volatility of local currencies. The problems surrounding the stabilisation of currencies have increased since spring, as the criteria for joining the euro have been recently interpreted in a more stringent way than initially assumed.

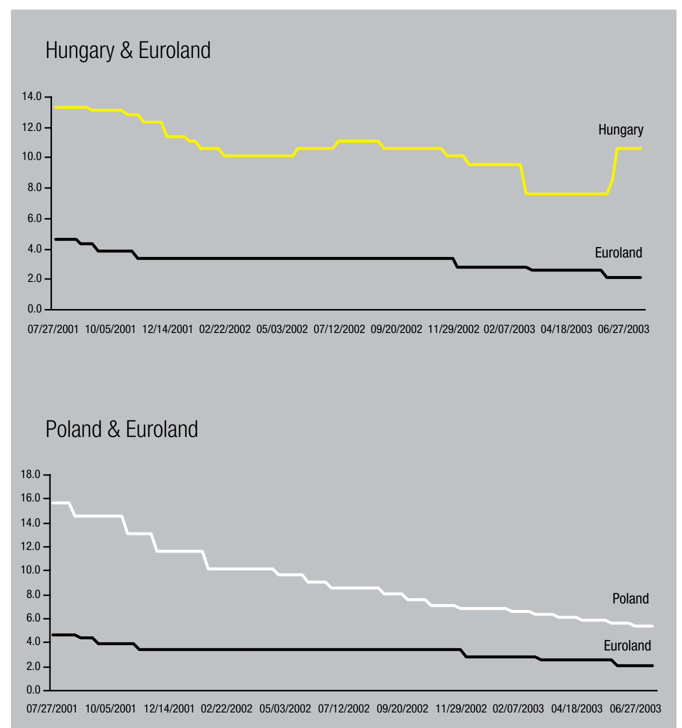
According to the agenda of the EU accession treaty, the new EU Member States have to peg their currency relatively closely to the euro before joining the monetary system. For the founding members of the euro, this band of fluctuation was +/-15%.

According to EU Commissioner Pedro Solbes's remarks in spring 2003, the local currencies of the new members shall only be allowed to fluctuate within a band of +/-2.25%. This has come as a complete surprise to eastern central Europe. This condition is not only harsher than originally assumed, but also raises a couple of fresh problems. Such a tight band will undoubtedly bring speculators to the market, making it more difficult to defend the exchange rate band. The stabilisation of the exchange rate will be made even harder by the demanded liberalisation of capital movements.

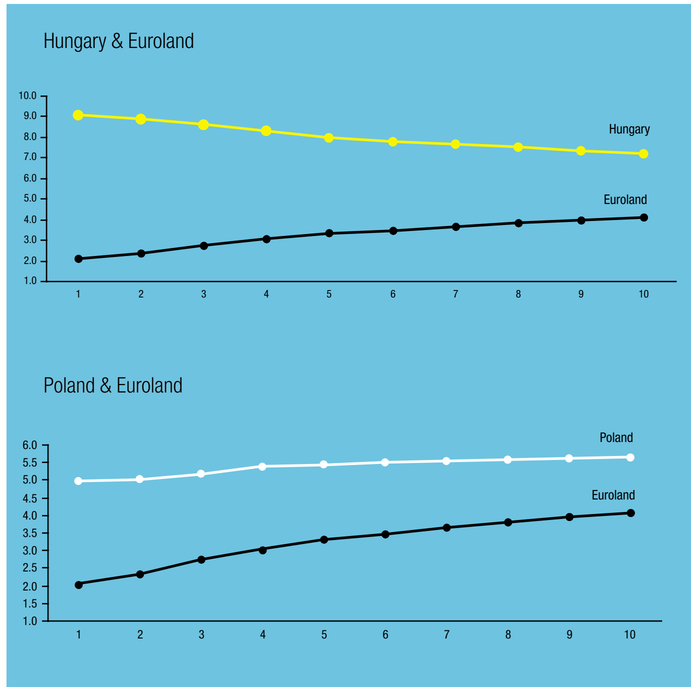
Apart from the problems surrounding the stabilisation of exchange rates, the hurdles on the course to the euro have become even higher as a result of the recent worsening of macroeconomic fundamentals. A classical problem for these countries is the real appreciation of the exchange rate caused by high capital inflows. Productivity in the sector of tradeable goods (export) increases quickly, leading to higher wages. But wages in the sector of non-tradeable goods also rise, leading to price increases – for productivity growth is slower in this sector (Balassa-Samuelson effect). This results either in a generally higher inflation rate or a higher exchange rate. This will inevitably lead to clashes, with the euro accession terms stipulating a reduction of inflation to a maximum rate of 3% and a stable exchange rate.

SOLVING THE ISSUES. It is also doubtful whether the twin deficits can be drastically reduced over the next two years. In Hungary and the Czech Republic, current account deficits have increased significantly. In Hungary, direct investments are far from sufficient. To finance the current account deficit, portfolio capital flows must >>

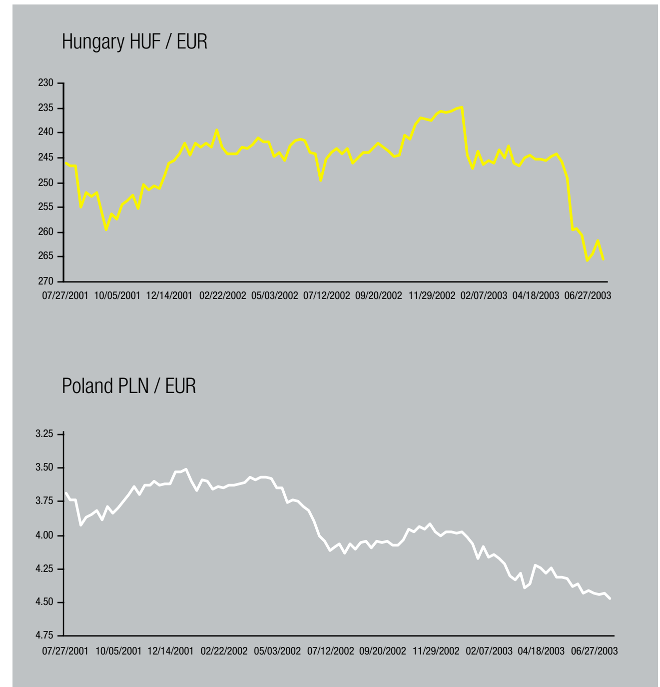
■ Figure 1
Key interest rates



▪ Figure 2
Yield curve



▪ Figure 3
Exchange rate development



▪ Table 1
Accession countries: central and eastern Europe

Emu convergence					Nominal exchange rates		
	Inflation *% yoy 2002*	Interest rates *10yr last*	Fiscal deficit[1] *% of GDP 2002*	Public debt[1] *% of GDP 2002*	Exchange rate *Against parity[2] Max 12yr*		
Reference value	***3.0***	***5.5***	***-3.0***	***60.0***	***+/-15%***	last	Currency reg
Czech Republic	1.8	3.8	-4.6	22.4	-5.0	31.9	Managed float (EUR)
Estonia	3.65.3	2.9	1.2	5.4	-1.5	15.6	Currency board (EUR)
Hungary	1.8	6.5	-9.6	50.4	-6.0	262.1	Target zone (EUR)
Latvia	0.3	7.8	-2.7	13.9	-14.4	0.64	Peg (SDR)
Lithuania	1.9	6.4	-2.8	25.0	-5.8	3.45	Currency board (EUR)
Poland	3.3	5.4	-5.4	48.0	-15.5	4.45	Float
Slovakia[1]	7.6	5.0	-1.9	32.0	-5.0	41.7	Managed float (EUR)
Slovenia[2]	7.6	7.2	-1.1	32.2	-5.6	234.6	Managed float (EUR)
Bulgaria[3]	5.8	6.4	0.2	60.9	-0.4	1.96	Currency board (EUR)
Romania[4]	22.5	29.7	-1.7	25.7	-32.7	36546	Managed float (EUR)

[1]If available, shorter maturities; Bulgaria, Estonia, Latvia, Lithuania, Romania, Slovenia. [2]Parity here: average rate of exchange of the past three years against the euro. [3]Definitions could differ from those of the European Union and of the accession countries. [4]Budget deficit includes privatisation revenues.

Source: Deutsche Bank AG

<< also be relied upon now; a previously unpopular option because of their volatility.

Another possibility to solve the problem of the high current account deficit – a devaluation of the currency – is not a serious option, as it endangers the achievement of the inflation target. On the contrary, the Hungarian central bank had to counter a devaluation of the currency in mid-June by increasing the official interest rate by 300bp (to 9.5%). This was only a short while after it had attempted to weaken the forint by a rate cut because it threatened to break the upper band. This action led to a weakness of the currency which spiralled out of control and had to be counterbalanced by the counter-measures mentioned before (a sharp rate hike). This zigzag course confusing foreign investors illustrates the conflict between the economic targets of boosting growth (weaker exchange rate desired) and curbing inflation (stronger exchange rate required), and reducing the twin deficits.

Apart from the increasing current account deficit, the high fiscal deficit is a big problem for Hungary. Last >>

<< year, the budget deficit still amounted to almost 10% of GDP. Reducing this financing gap to 3% of GDP within two years should prove to be difficult. Although the government recently paid lip-service to complying with the tight timetable for the introduction of the euro, it did not announce any concrete actions to contain the fiscal deficit.

In the first half of 2003, the fiscal deficit is already far above the target figure so that the expected 4.5% to 5% of GDP is hardly within reach. Nor is it foreseeable that the 2004 budget plans will bring about a tangible relief. With a planned increase of expenses of 8% to 9%, and higher revenues not yet secured, the target of reducing the deficit to 3.5% of GDP is not credible. The lack of fiscal restrictive measures heightens the risk of future exchange rate volatility and limits the scope for rate cuts in the months to come. Although the political situation stabilised in Poland recently, the situation of the minority government remains fragile. The economic focus should be slightly shifted to economic growth with corresponding implications for the fiscal deficit in 2004. The current account deficit of roughly 3.5% of GDP is lower in Poland than in Hungary (5.5%), and is largely financed by foreign direct investment.

The main problem in Poland is its fiscal deficit of roughly 5% of GDP, which might even increase towards 6% in 2004. The government has announced its intention to manage down its budget deficit to fall within the Stability and Growth Pact (SGP) limits (3%) by 2007. This would imply joining the euro in 2009.

What are the implications of these most recent developments for the local bond markets of these countries? First, the expected date for joining the euro will have to be further postponed. Until recently, Hungary, Poland and Slovakia planned to join the euro between 2006 and 2008. The Czech Republic was the only country already planning to join later. In Hungary and Poland, it should be assumed that the euro will be introduced, at best, two years later. Foreign investors in the local bond markets will also have to live with stronger ups and downs of bond prices in the foreseeable future.

GOING FOR GROWTH. All in all, this implies that risks in these markets have substantially increased. The risk premium has meanwhile shot up again. The yield spread in the intermediate Hungarian bond market sector is, for example, 450bp over German government bonds – in May, it was just 300bp. The risk premium has therefore again reached its record high of 2000. With a spread of 250bp, the risk premium has increased significantly in Poland, too.

Summarising, we believe that the market's simple equation that 'EU = Emu = currency strength' has had to be revised. Membership fees equal to 1.3% of GDP in 2004 are a heavy burden for fiscal policy, and with inflation low and growth weak in many of the 10 countries – unemployment in Poland is 17% – competitive depreciation and going for growth are the themes for eastern Europe in 2004 and the following years. Joining ERM2 on a two-year view, with full Emu membership towards the end of the decade, is a realistic prospect. Meanwhile, interest rate convergence should continue, notwithstanding the odd hiccup, such as Hungary's recent rate hike following a rather mishandled devaluation. Overall, eastern Europe will be more a place for stock investors than for bondholders in the coming year.

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