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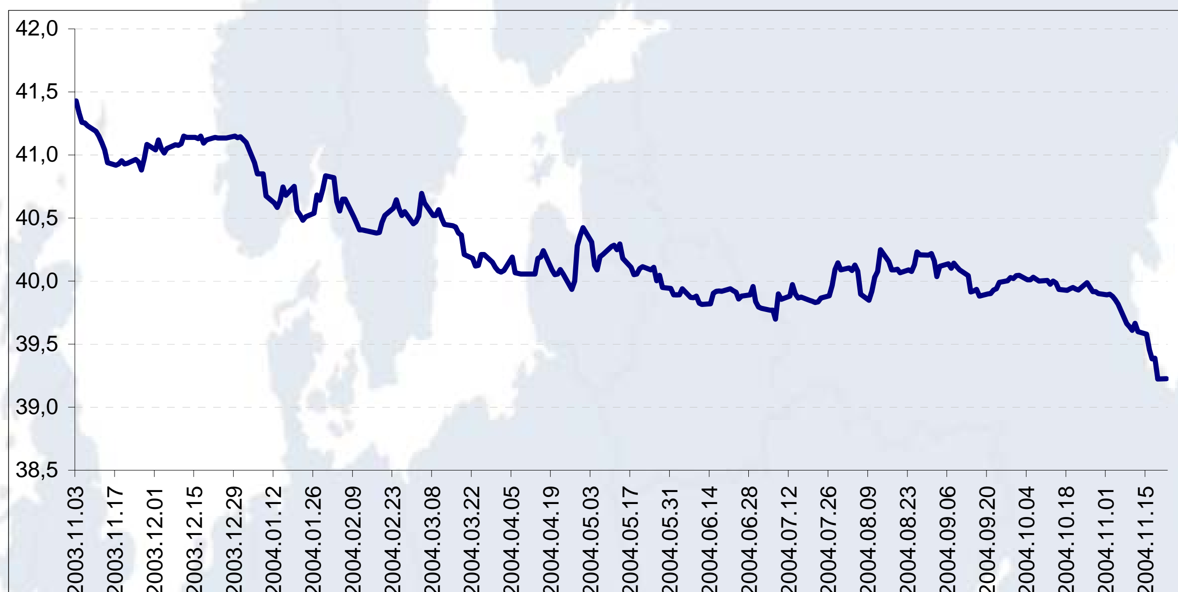
SHARP CROWN APPRECIATION, DOES IT TRIGGER FURTHER MONETARY EASING?

Following a long period of uneventful trading, the Slovak crown started to firm significantly in the middle of November. The currency broke through levels, which earlier triggered the Central Bank to intervene. The National Bank of Slovakia (NBS) has already cut the base rate by 150 basis points this year to 4.50%, in order to curb the „excessive" strengthening of the currency. The recent firming of the Slovak unit raises the question of further monetary easing. Another rate cut however could endanger the disinflation process of the country. In its latest report IMF called for the danger of the inflation pressure, but Central Bank Governor Marian Jusko said he still saw some room for the rate cuts.

Chart 1. The evolution of the SKK exchange rate against the Euro



The Slovak crown was traded in its well established band of 39.950-40.050 for weeks. The unit was always testing, but could not break through permanently the psychological level of 40.00 EUR/SKK. Exchange rate developments simply ignored the release of the favourable macroeconomic data. The Slovak currency also failed to react to the upgrade of the country's credit ratings. Foreign investment banks tried to strengthen the currency, but local corporate clients always started profit taking around the level of 40 EUR/SKK. The impacts seemed to be balanced, the crown hovered in a tight range, but traders said that the currency should strengthen in the longer run.

Around the middle of November the Slovak unit finally gained momentum and broke through the psychological level of 40 per euro. Since than the crown has started a gradual firming, and EUR/SKK reached a record high at 39.250 on November19. Central bank remained silent for a while, did not even use verbal

intervention. However based on the track record of the NBS another rate cut can not be ruled out.

The benign inflation developments could support the idea of the monetary easing. Year on year inflation dropped to 6.6% in October from September's 6.7%. CPI peaked in July at 8.5% and started to fall significantly in the autumn months due to the favourable base effect. October data proved to better than the market consensus, mainly because of the favourable food price developments. Food prices were expected to rise following the seasonal fall in the previous month, but prices still went down by 0.5% m-o-m.

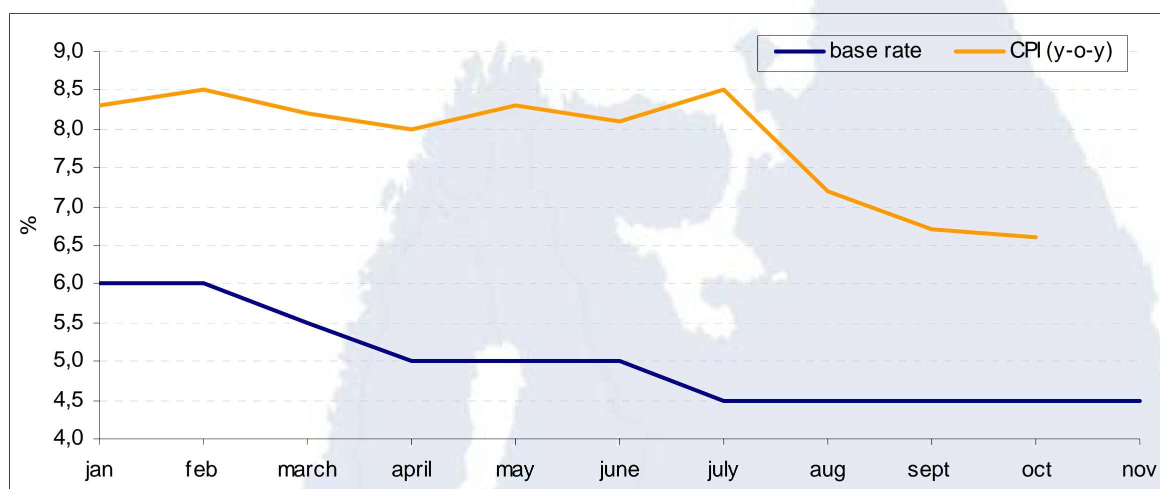
The data reflected the good harvest and the increasing competition in the retail sector. The show up of some bigger discount chains contributed to the slower growth of the price level. CPI should decline further towards the end of the year, the end-2004 rate should be around 6.5%, well in the 5.5-7.0% target range of the central bank.

Despite the actual inflation developments as well as the favourable outlook on the medium term (CPI is likely to fall to 4% by end-2005), there are significant upside risks. IMF called for the danger of the accelerating wage and price growth in the non tradable sector, and the closing output gap. The Fund also mentioned that although the impact of the high global oil prices on the CPI has not been significant, there had been some pass through, an there was a risk of second round inflationary pressures from oil and administered prices.

The IMF estimated the end-2005 CPI to exceed 3.3%, the upper limit of the central bank's target range. According to the Fund the central bank's strategy of slowing the nominal appreciation of the crown could risk missing the inflation criterion for adopting the euro. The IMF however did not suggest any appropriate pace of the strengthening of the crown, but emphasised that NBS should not resist a gradual appreciation, that would lead to the tightening of the monetary conditions.

Most of the analysts agree with the IMF, and claim that there is no need for further rate cut because domestic demand is already rising. GDP growth is expected to be around 5% this year and about the same rate in 2005. The growing domestic consumption contributes to the acceleration of the growth rate. Retail sales figures reflect this trend, the September data showed a 8.9% y-o-y rise. The recent data indicate a significant recovery of people's effective demand after a couple of years of subdued demand.

Chart 2. Consumer prices and the base rate of the central bank in 2004



Budget developments on the other hand did not prove to be expansive, Slovakia is definitely the frontrunner in the region concerning the fiscal reforms. The accumulative deficit had reached only 39% of the 78.5 bln. crown full year plan in October. The government forecasts a 3.8% deficit to GDP ratio for this year, which is expected to decline further to 3.4% in 2005. Despite having the lowest deficit among the CE4 countries, the IMF argued that budget deficit targets for 2005-2007 were not ambitious enough to ensure that the 3% Maastricht criteria was achieved in the event of an adverse economic shock.

According the central bank the economy is not overheated, and there are no signs of any demand side inflation pressure. Following the recent sharp firming of the crown NBS has remained silent for a while, but finally Central Bank Governor Marian Jusko stated, that he saw further room for monetary easing in order to curb the speculative inflow. Mr. Jusko admitted that the room to manoeuvre was smaller this time compared to the beginning of the year. Central bank governor said that NBS was monitoring the surge of the crown, and added that the bank would not tolerate any unjustified appreciation. Governor Jusko said that strengthening driven by the economic fundamentals and productivity gains would be accepted. Mr. Jusko added that the level above which the NBS would not want to see the crown was dynamic, dependent on the economic developments.

A couple of weeks ago Monetary Policy Board member Karl Mrva claimed that a 2-3% annual nominal appreciation of the Slovak crown would be in line with the economic developments. Slovak crown has already firmed by 1.6% since the beginning of November, and a cumulative 4-5% since the beginning of the year. According to the Finance Minister Ivan Miklos the strong crown does not threat the competitiveness of the economy because of the structural reforms, that have been undertaken in the past few years. The Finance Ministry also said that a 25bp rate cut by the end of the year might be possible, depending mainly on the exchange rate developments.

Current account and trade figures do not provide any clear indication about the appropriate level of the exchange rate. The current account gap is expected to rise to 3% of the GDP this year from last year’s record low of 0.8%. Deterioration is driven by the higher import, which is due to the investment goods related to the investments of the big car manufacturers. Export is expected to pick up from 2006 when the newly arrived companies will start their production.

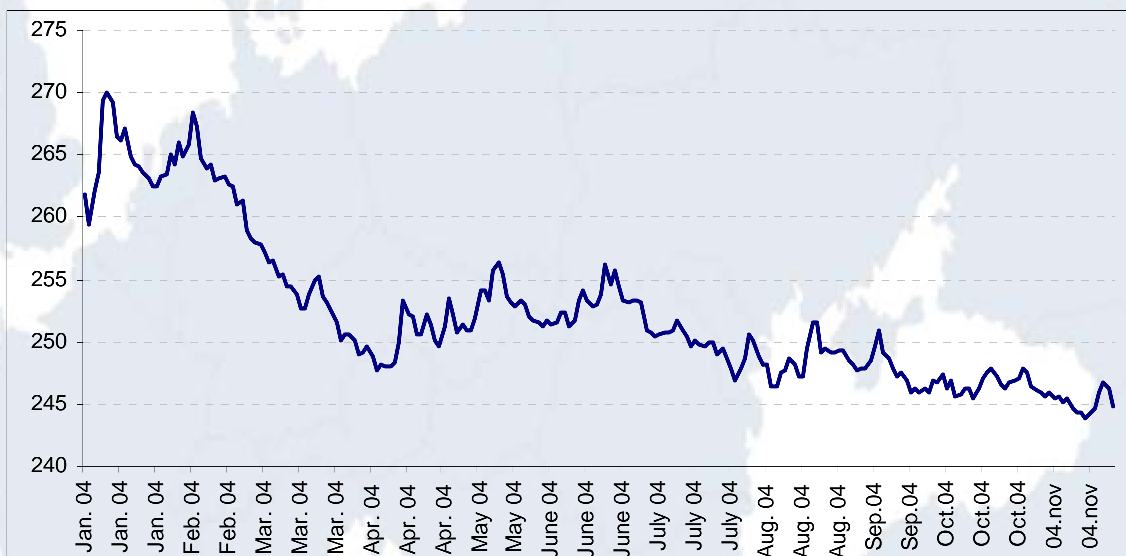
Based on the exchange rate developments it is getting more likely that the NBS will cut the base to prevent the crow from the excessive firming. The monetary easing is likely even though the central bank might tolerate the firming of the crown a bit more because the change of the monetary council members is approaching. (Marian Jusko Central Bank Governor, known as the main opponent of the appreciation is about to leave his post by the end of the year.) The inflation developments do not really allow a bigger cut, and this point to 25 b.p. rate slash, however the possibility of a more radical rate cut is also priced in the curve.

FORINT APPRECIATION: THE FACTORS BEHIND IT AND ITS SUSTAINABILITY

After the turbulent and volatile exchange rate developments in 2003, in the last months one could observe a steady and almost uninterrupted appreciation of the Hungarian currency. The appreciation of the Forint has been especially strong in the first quarter of the year and in recent weeks, which brought it against to the edge of the exchange rate band, which in early January led already to speculative capital inflows and pressure on the central bank to appreciate the band. The domestic currency was traded against the Euro in mid November at the exchange rate around 245 and further short term appreciation was foreseen by traders and market analysts.

The appreciation of the Forint came to many as a surprise due to the relatively bad macroeconomic fundamentals of the country. Similar to 2003 fiscal policy remains altogether rather loose leading to 5,5% general government deficit, which exceeds the twice revised original deficit figures. High fiscal deficit and growing public debt is accompanied by persistent current account deficit, which is in the range of 7-8% of GDP. At the same time inflation has increased in 2004: though due mainly to temporary factors, but it is still one of the highest among the new member states. All these factors would have pointed to the weakening of the currency: however since early 2004 there has been an almost 10 percent appreciation against the Euro.

Chart 3. The evolution of the HUF/€ exchange rate in 2004



THE FACTORS LEADING TO THE OBSERVED APPRECIATION OF THE HUF

The most important factor explaining appreciation of the domestic currency is related to the applied fiscal-monetary policy mix. In Hungary fiscal policy has been very expansive since late 2001, reflected in the average general government deficit of

6% for 2001-2004 and increase of gross public debt from 52,5% in 2001 to almost 60% by the end of 2004. At the same time monetary policy remained tight to meet the inflation targets within the inflation targeting framework introduced in 2001 and to send signals for the expansive fiscal policy. The loose fiscal and tight monetary policy mix is the worst in a financially open small economy and it led to a significant increase of short-term capital flows, which remained quite volatile, reflecting the concerns with the fiscal stance and sustainability of fiscal policies.

Besides high public sector borrowing requirements capital inflows were also stimulated by the composition of debt finance. In Hungary almost third of domestic public debt is financed by foreign lenders since the level of net domestic savings is very low (the net saving of the household sector declined to almost 1% in 2003, and the corporate sector with the exception of 2003 showed constantly negative net saving position). Due to the low level of net domestic savings the financing requirement is increasingly covered by foreign borrowers who are attracted by high returns on Hungarian government bonds. Besides interest rate gap the appreciation of domestic currency results in capital returns for foreign investors stimulating further inflows and lending to government.

There have been two vicious circles related to the fiscal-monetary policy mix. First, high PSBR and low domestic savings required high foreign lending to the government, which forced monetary and fiscal authorities to maintain high returns on domestic currency contributing to capital inflows and currency appreciation. On the other hand loose fiscal and tight monetary policies resulted in high and volatile capital flows, the direction of which depended on the strength of the interest premium versus concerns with fiscal sustainability: if the former dominated than inflows led to appreciation, if the latter than sustainability concerns resulted in increasing yields and currency depreciation.

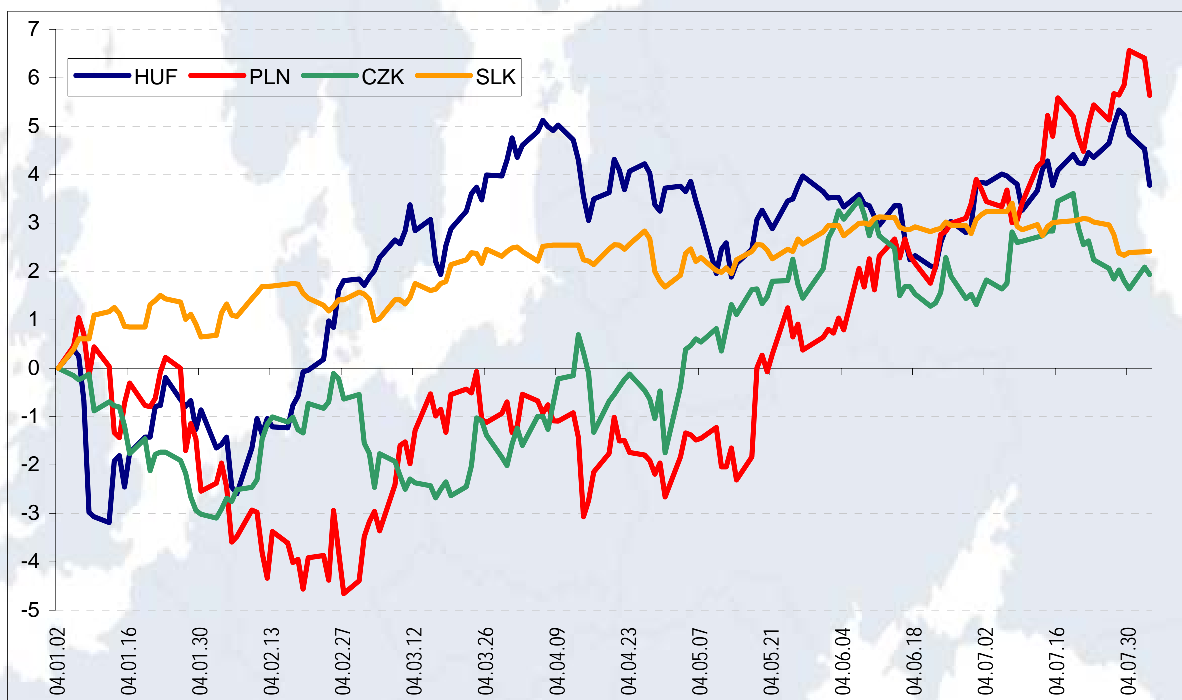
There is another factor, which has been increasingly contributing to the observed appreciation and long-term strength of the Hungarian currency. In recent years there has been a fast increase in foreign currency denominated borrowing and debt position of the household and corporate sectors. The reasons behind this phenomenon are manifold but quite similar to other Central European countries. First, increased foreign currency borrowing and debt has been stimulated by the well-known original sin problem, which manifests itself in the special borrowing pattern of middle income countries reflected in longer-term foreign currency and short-term, domestic currency denominated debt.

In Hungary the household and corporate sectors have been constrained to increase their net debtor position with borrowing in domestic currency due to maturity mismatch and gaps between domestic and foreign nominal returns. In recent 18 months there was an average 7-9 percentage point differences between the returns on domestic currency and Euro denominated debt. This has led to increased foreign

borrowing of the two sectors and to growing domestic borrowing in foreign currencies. In 2004 almost 60% of the new credits extended to the corporate and household sectors were denominated in foreign currencies with the corporate sector representing higher and households still lower levels. This increasing indebtedness created a constant conversion pressure on Forint and contributed to its appreciation.

Finally, the appreciation of the Forint has to be put in a regional context. After the Central European countries joined the European Union in May 2004 one could observe a general appreciation of their currencies, which in some cases continued the trend seen prior accession. Enlargement could have contributed to appreciation by increasing capital inflows due to lower risks for investors, while all countries experience an increase of non interest sensitive capital flows too. This has contributed to the general appreciation of local currencies, which had an indirect influence on the Hungarian currency.

Chart 4. The appreciation of NMS currencies against the Euro since early 2004



The Sustainability of Current Exchange Rate Level

While there has been intensive discussion on the costs and benefits of the strong national currency, a more important question is related to the sustainability of the current level of the exchange rate. It is very likely that the current level of domestic currency is not sustainable at least not in the short term.

First, there are increasing concerns related to the evolution of the general government balance and the feasibility of fiscal plans for 2005 and 2006. The initial deficit figure for 2004 was 3,7%, which first was modified at the beginning of the year

to 4,6% and later to 5,3% due to the lower than expected level of revenues and rising expenditures. On the other hand markets expect that the deficit of the general government will be closer to 5,5%, which means that there has been no improvement compared to 2003 and only a minor 1 percentage point improvement compared to the adjusted figure of 2002 (when the cash flow deficit was 9,2%, out of which 2,7% were exceptional expenditures and the comparable deficit figure was 6,5% of GDP). The deficit target for 2005 is 4,7% but there are concerns whether it can be met concerning the worse than expected outcome for 2004, the likely increase of debt service expenditures in 2005.

Further concerns are related to medium term targets as the deficit target for 2006 is currently.4,1 % of GDP, which means that there has to be a further 0,6 percentage point improvement in 2006, which is an election year and in Hungary the deficit in the last three election years (1994,1998,2002) exceeded the level of the previous year on average by almost 2 percentage points. So the sustainability of fiscal policy as well as the willingness of foreign lenders to finance public sector borrowing requirement is a concern which may lead to capital outflows and currency depreciation.

The second concern is the coincidence of high fiscal deficit with persistently high current account deficit: its level has been on average around 8-8,5% of GDP in 2002-2004. This is the natural outcome of the net dissaving by both the public and private sectors, as foreign net savings were required to finance domestic spending. Simultaneously with high current account deficit the structure of deficit finance changed in recent years and compared with the 1997-2001 period when it was mainly financed by FDI and other non-debt creating capital inflows, now it is covered by short-term borrowing and other debt creating inflows. This results in an increase of gross and also net foreign currency debt. High current account deficit and less stable financing questions the sustainability of the current exchange rate level and may require weaker national currency.

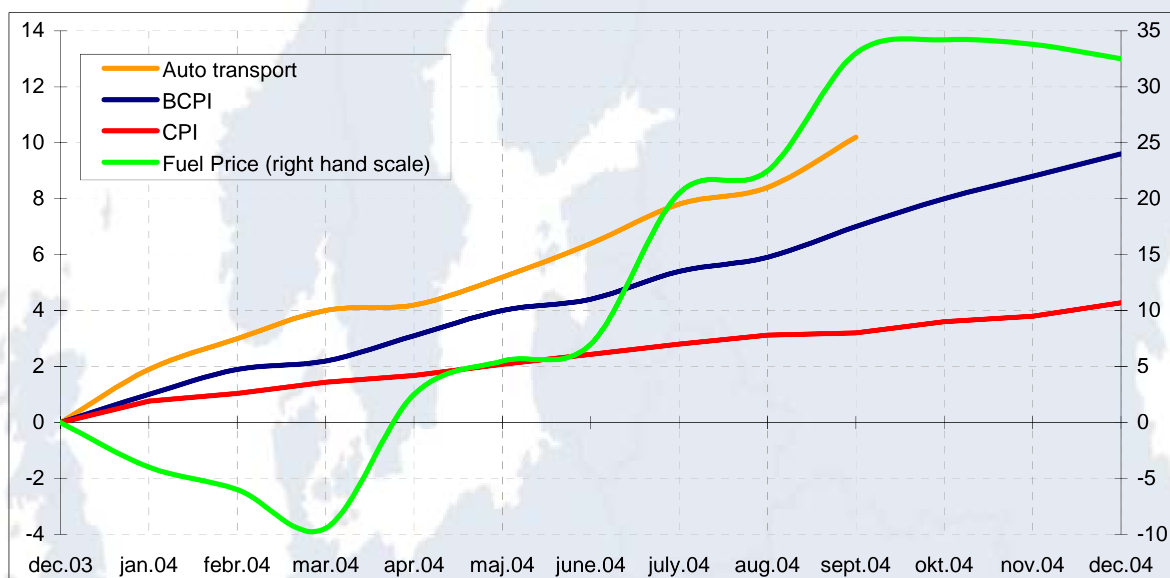
Finally, foreign currency borrowing may also slow down when households and the corporate sector recognize the costs and dangers of increasing their net foreign debt position. The current gradual decline of the growth rate of household consumption may lead towards its declining foreign currency borrowing, while corporate sector may be faced by growing debt service expenditures.

Considering the factors that have created the current exchange rate level and the likely concerns, the evolution of the HUF exchange rate depends on the timing of fiscal adjustment and the evolving fiscal-monetary policy mix. If fiscal adjustment is realistic and proceeds according to the budget rules, than the current exchange rate level may be sustained even if monetary policy is loosened. On the other hand if fiscal adjustment is delayed than the growing concerns with the sustainability of fiscal policy may result in capital outflows even if the high domestic interest rate level remains, as seen in late 2003 and early 2004.

MONETARY AND FISCAL DEVELOPMENTS AND SHORT-TERM PROSPECTS IN RUSSIA

Inflation in Russia for the last 12 months has been 11,5%, which is approximately 1,5% higher than it was expected earlier. The consumer price index (CPI) increased until September by 8% and is expected to go up in the rest of the year, which is stipulated by the considerable increase in producer prices. The most significant increase in Russian producer prices took place in the first half year: by 35% in the fuel industry, by 54% in ferrous metallurgy, by 10% in the engineering industry and by 12% in construction.

Chart 5. The changes in the major producer price items



The research of the Institute of Open Economy shows that producers' prices determine the future behavior of consumers' prices. In particular an increase in producers' prices is reflected in the postponed inflation. Estimations show that consumer prices react to producers' price change with 9 months lag. So it is reasonable that October and November turns out to be the most problematic for inflation developments in 2004.

But there is one more factor, budget surplus, which affects inflation due to reserve inflows and associated increase in money supply growth affect inflation. During the previous four years the problem of budget deficit gradually turned into the difficulties with the surplus. Between 2000-2003 the surplus of the federal budget on average was 2% of GDP and was used mostly for paying off the external debts. Now as GDP is growing fast and there is a preference for fiscal policy that would cut public sector, some "excess" money appears. So by September the surplus was 6,7% of GDP, which means that it has almost become equal to the repayment of external debt but there are also borrowings and repayments from lower public sector organs.

It was the reason why in 2003 the Russian government took a decision to create the Stabilization Fund (SF) for forming financial reserves in years of favorable external situation and financing spending in unfavorable years. According to the legislation the money of SF can be used if oil prices are lower than base ones in case of the SF volume exceeds 500 billion RUR. The sources of filling the SF are extra incomes from export duties as well as the balances of the federal budget at the beginning of a financial year regardless of the formation reasons. Extra incomes come from an excess of oil price over basic one – 20 USD/ barrel.

The government defined the average oil price in 2005 as 28 USD/barrel, according to which the Ministry of Finance (MF) forecasts assignments to SF of 388 billion RUR and budget surplus of 278 billion RUR. However, there can be much more incomes since they directly depend on oil prices. On the average a 1% increase in oil price leads to 0.24% GDP or each extra dollar in oil price gives 2 billion USD. Thus if average oil prices in 2005 are 32 USD/barrel then extra incomes will exceed planned by 6 billion USD. This will lead to 32 instead of 26 billion USD (government's plan) volume of SF by the end of 2005.

In general by MF's estimates16 billion USD will be received in 2004 and 13 - in 2005. The decrease is connected with the prediction of an average oil price of 28 USD/barrel, while the average price of the current year will be at least 31 USD/barrel. So it is going to be this year when the threshold will be crossed and an opportunity to spend money will appear. These spending are going to be directed to the external debt (3.1 billion USD) and the deficit of the Pension Fund (2.5 billion USD). The Russian gold and foreign currency reserves have increased by 29,4 billion USD and reached the level of 107.4 billion USD.

Table 1. The dynamics of money supply and reserves.

Date	Foreign reserves	Foreign reserves in currency	money supply	growth of money supply
01.01.04	76.938	63.134	3 212,7	—
01.02.04	83.990	66.364	3 214,1	0,0
01.03.04	86.318	68.987	3 335,5	3,8
01.04.04	83.398	68.723	3 421,2	6,5
01.05.04	82.664	69.211	3 483,5	8,4
01.06.04	85.612	71.225	3 526,5	9,8
01.07.04	88.226	69.460	3 687,2	14,8
01.08.04	88.610	68.169	3 634,9	13,1
01.09.04	88.702	66.976	3 657,9	13,9
01.10.04	95.082	75.127	3 727,5	16,0
01.11.04	107.338	86.668		

The data are in billion USD

In the next year it is likely that CB will pursue unchanged monetary policy. CB is still going to increase reserves, regulate money supply and restrain inflation. But with restraining inflation the government hopes to cut down the year growth of consumer

prices to 6,5%. Money demand depending on the mentioned oil price developments, will increase by 20-35% compared with 2004. But CB cannot estimate the expectation of currency inflows: therefore CB doesn't treat the parameters of money demand as strictly determined limits of money supply growth rate.

The target inflation in 2005 is 6,5–8,5% (CB), but taking into account the above the figures are hardly achievable. It is a very tough challenge to restrain the growth of consumer prices and to stimulate the economy. Due to high oil prices there is a high inflow of foreign currency and it is necessary to sterilize money emission as otherwise inflation increases.

In order to keep inflation below the announced 10% level the government will have to make all the efforts. The meeting of the goal became in recent months has become more uncertain due to the substantial growth of producer prices.

Kirill Tremasov of Moscow Bank considers that the only way to decrease inflation is tough credit-policy, which is however able to cause one more banking crisis. Besides it is hardly reasonable to decrease the inflation at the expense of much slower growth.

Nevertheless keeping inflation under 10% is one of the most important steps, which are to bring Russia to the club of countries with low inflation. That is why CB has cut down the appetite on reserves.

Due to high oil prices a lot of foreign currency flows in to Russia and it is necessary to sterilize money emission otherwise inflation increases. Even if CB acts more intensively against money supply growth, then the annual inflation will be between 11 and 12%. In August it became public that CB was planning for the autumn to take some extra measures to reduce extra liquidity. So the September auction of CB's bonds (total amount of 50 billion RUR) was announced. Such auctions have not been held for several years.

If money supply grows with the rate of about 2% per month (which corresponds to "Main directions of CB's monetary-credit policy for 2004") then for the last four months of this year the year inflation is going to reach 13.1%.