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UNEXPECTED 25 BP RATE CUT, THE WAY FORWARD IS UNCERTAIN

The Monetary Council (MC) of the NBH surprised the market with a 25 basis point (bp) rate cut at its latest meeting on March 22. The two new members of the council attended the meeting for the first time since their appointment. Market analysts did not expect any monetary easing before Q3, however fixed income rates already reflected the possibility of the rate slash. The move to 12.25% has little direct economic impact, (especially after the latest 300 bp rate hike), it is rather a demonstrative step.

The move indicates that NBH has changed its earlier strategy that still regarded further rate hikes possible. The statement released after the meeting mentioned the improving fundaments and the declining risk premium as the two main factors that accounted for the rate cut. Both FI and FX market benefited from the move, EUR/HUF reached levels not seen for a long time. The crucial question right now is NBH's strategy for the near future.

EUR/HUF already started firming significantly on the week before the MC meeting, especially following the surprisingly optimistic announcements of the NBH Governor. FI market already priced in a 50-70 bp rate cut before the MC decision, and another 100 bp rate slash got priced in the curve following the move. The strong demand at the GDMA auctions supported the Hungarian unit. HUF had tried to breakthrough the level of 250, but failed several times because the level proved to be strongly resistant for a while. Following several attempts, Forint finally dropped below 250 on March 30 and kept on firming gradually. EUR/HUF stood around 249 on the last day of the month. Yields showed a significant decline following the rate cut decision, that was followed by a slight correction temporarily, but further strengthening took place after that. The 1Y, 3Y, 5Y, 10Y and 15Y benchmark papers were traded at 10.48%, 9.45%, 8.69%, 7.71% and at 7.38% respectively on the last day of the month. A 75 bp rate cut till May is priced in the curve currently.

Market analysts did not expect monetary easing before Q3, especially following the outcome of NBH's February Inflation Report, that projected a 4.3% end-2005 CPI with upward risks, exceeding the 4% official target. Information trickling out of the MC meeting indicated that a part of the members were strongly arguing for rate hike following the outcome of the Inflation Report. Another reason for the analysts not to project any rate cut was the inflation trajectory, which is expected to reach its peak in May.

At the moment the effect of one off measures like the changes of the tax rates and the administrative prices on the expectations is still not foreseeable. The wage inflation developments are uncertain and the promising pledges of the fiscal policy have not been definitely confirmed yet either. MC's rate cut decision came as a surprise though Mr. Járai's statements on the previous week already drew the attention to the positive economic developments. These trends were confirmed in the statement released after the MC meeting.

According to that, the improving cyclical international conditions and the slowdown of household's consumption both contributed to the rate slash decision. Other positive developments were also mentioned, like the pick-up of the Hungarian export, the rise of industrial output and corporate investment. The statement mentioned that the declining consumption and the increasing savings were going to result in a more favourable financing structure for the public sector. According to the NBH, the improving confidence in the economic policy made the rate cut possible.

Following the decision some of the experts criticized the extent of the measure and different opinions emerged regarding the desirable strategy of the NBH for the near future. Current situation proved again the impossibility of an independent monetary policy in case of a small and open country. It is hard to set the interest rate to support the internal and external balance at the same time. The overwhelming capital inflow has proved to be a tough challenge for the monetary policy for several times during the past decade. At the end of 2001 NBH was forced to cut rates by 250 bp within a four months period.

A similar problem emerged at the end of 2002, when the significant capital inflow resulted in a speculative attack on the strong end of the fluctuation band in January. This time the situation looks a bit different, market has supposedly gained some experience from the past. Last year big investment banks launched their speculative attack because they expected the NBH to shift the fluctuation band independently from the government in order to defend their 2004 inflation target. Reaching the 2005 inflation target also seems more realistic now, than meeting the 2004 target was in January 2003. Though the February Inflation Report projected a higher end-2005 CPI than the target, calculations were based on a much weaker Forint than the current EUR/HUF. Speculation against the strong end of the band is not likely at all, but NBH could still get in difficult situations.

The overwhelming rate cut expectations, and the market tracking attitude of the NBH could lead to dangerous rate cut spiral that might endanger the internal balance according to some analysts. Even though some foreign analysts already regarded the 25 bp rate cut as a proactive step by the NBH, according to others Central Bank is only tracking dangerously the market developments. Certain experts expect the NBH to cut rates cautiously, only gradually by 25-50 bp, in order to avoid overshooting. However, this strategy might prove to be market tracking and could easily fail to cool the expectations.

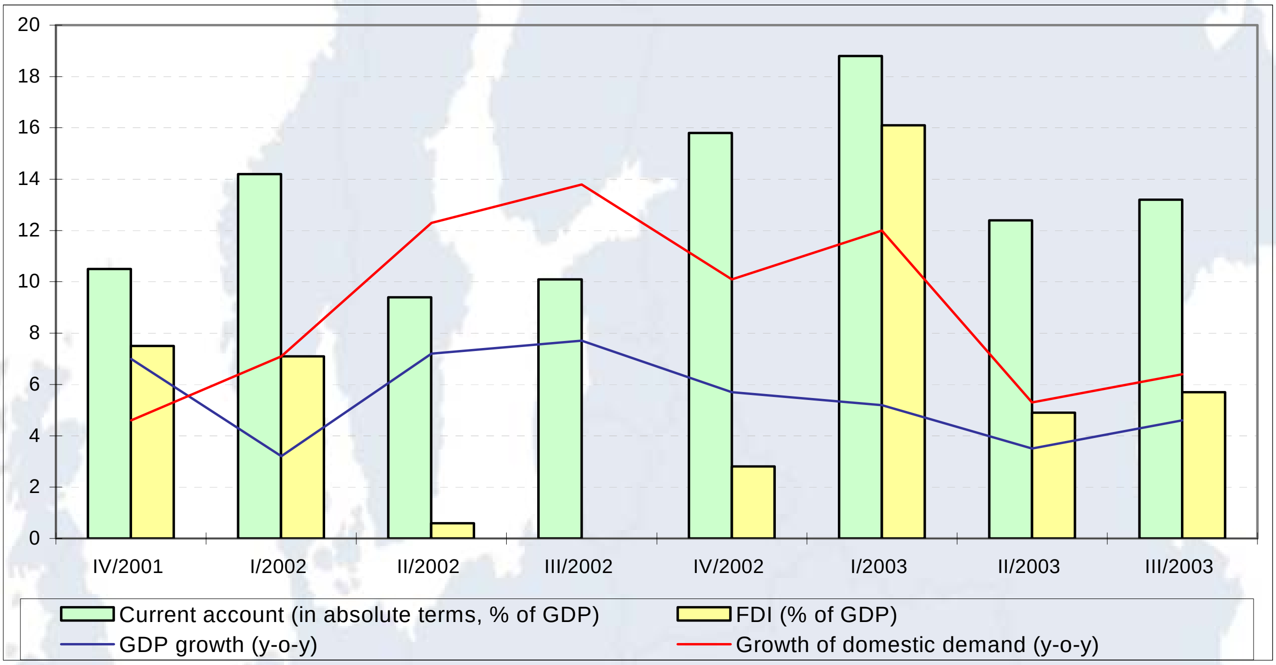
A bigger rate cut might be more helpful, that could calm down the market sentiment for a while. Forint is likely to remain strong in the short run, especially following the breakthrough of the 250 level, where many stop-losses were activated. The publication of the revised C/A deficit figures could not hinder the firming. While big investment banks projected a EUR/HUF around 270-280 in their January-February macro outlooks, now they liquidated their short HUF positions. Such a weak Forint was already unrealistic in January taking into account the recent rise of the industrial output and the pick up of the export, but a EUR/HUF stronger than 250 could also prove to be unrealistic and could raise the problems of the strong Forint policy again.

Nevertheless, the strong HUF cannot be taken for granted in the longer run. The significant part of the inflowing capital is aiming for the carry trade, so rate cuts could easily reverse the capital flows. However, speculation for rate cuts might replace the carry speculation, the outcome is uncertain. Volatile Forint still remains a problem for the Hungarian economy, the return of the real investors is still needed.

SOARING CURRENT ACCOUNT DEFICIT IN ESTONIA

In November 2003 Bank of Estonia (BoE) forecasted the annual current account deficit for 14,4% of GDP. After the release of the figures for November and December, the deficit can be estimated even higher, around 15%. Even in the case of the better scenario the country will post an all-time high current account deficit, which causes serious concerns in the country and abroad. In nominal terms the deficit is €1140 millions.

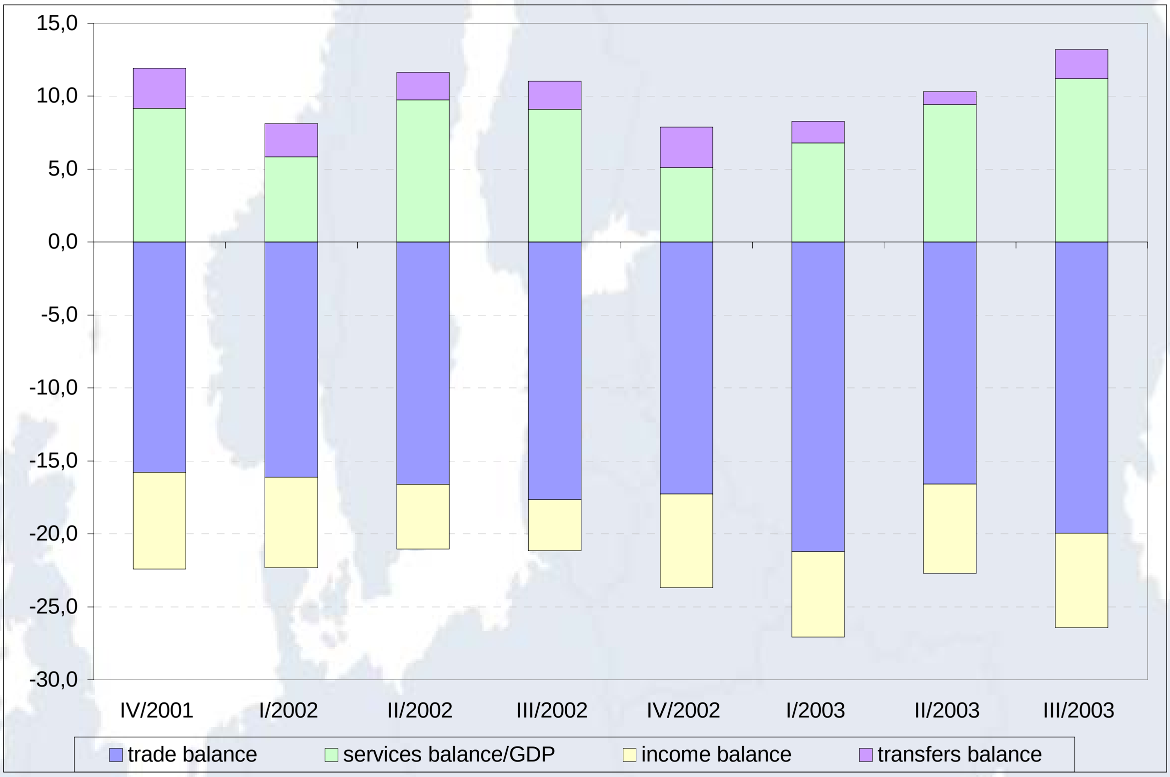
Chart 1. Current account and GDP growth



In 2002 the CA deficit accounted for 12,3% of GDP. Thus in two consecutive years Estonia reported an unrivalled high deficit among EU acceding countries, which had significant negative impact on economic growth. While in 2002 Estonia grew at a similar pace than its Baltic counterparts, last year Latvia and Lithuania were likely to widen the growth gap *vis-à-vis* Estonia. In the first three quarters the Estonian economy grew by 4,4%, while in the same period of 2002 by 6%. According to the forecast of BoE, the growth rate will not change in the last quarter, thus the decrease of average annual growth rate stuck at 1,6 percentage point. The slowdown itself is not a bad sign, because it is a common characteristic of the candidate countries for 2003. The real problem is the current account deficit , because it has still been soaring in spite of the slower growth.

Among the components of current account mostly the deterioration of trade balance has contributed to the disappointing CA figure. It accounted for €1430 millions. The imports of goods grew by 13% over the last year, while the exports by 9%. Thus the trade balance deficit increased by €267 million or by 23%. It is noteworthy that in 2002 the deficit of trade balance increased even faster, by 32%. Contrarily, the services balance showed a surplus of €658 million, which is higher by 27% than a year before. It derives mainly from the low basis, because the surplus is almost equal to the 2001 figure. The deficit of income balance worsened remarkably and reached 460 million euro. Net transfer is a smaller item. Its surplus accounts for €94 million, by 58 million smaller than a year ago.

Chart 2. Sub-balances of current account (% of GDP)



A positive sign for the potential growth of the economy is that in 2003 the financing structure of CA deficit was more favorable than a year before. Foreign direct investments (€580 million) covered one-half of the deficit, while in 2002 this covering ratio accounted for only 20%. Portfolio investments declined both in nominal terms (to 170 million euros) and regarding their share. Other investment inflows (mainly liabilities of credit institutions) were about equal to the 2002 figure, as accounted for 460 million euro or 40% of CA deficit. Reserve assets of Bank of Estonia declined by 147 million euro.

Bank of Estonia released a comment on economic policy in December, in which it warns that unless CA deficit decreases, the economic growth in the following years could sink to the level of 2,5 – 3,5%. Current account deficit is accompanied by the growing debt burden of private persons. Bank of Estonia expressed its commitment to apply adequate measures together with the government in order to slow down loan growth.

Last year the initial measures had proved to be insufficient and weak, as the loan boom did not slow down in the second half of the year. Until the structure of expenditure side of GDP does not change, the CA deficit will likely to remain at a high level. In the first three quarters of 2003 domestic demand increased by 7,9% (10,8% in the whole 2002 year) of which consumption expenditure of households was up by 6,2% (9,3% in 2002), and general government final consumption expenditure grew by 5,5% (5% in 2002).

Similarly to previous years, gross fixed capital formation (of which about 90% is investment) has been soaring. Its growth accounted for 15,4% in the mentioned period (16,1% in 2002). Consequently, the structure of expenditures was more favorable than in 2002, as growth of consumption slowed down but investment boom continued. Nonetheless, investment ratio in % of GDP exceeded domestic savings by more than 10 percentage-points.

The parallel boom of consumption and investment led to, of course, a huge increase in import. Real import growth generated by strong domestic demand outpaced remarkably the real export growth in the first nine months. Between 2002 and 2003 the gap (between real import and export growth) widened from 4,8 percentage-point to 6,5 percentage-point. Not the sluggish export, but the soaring import is responsible for the disappointing figure, because real export growth accelerated compared to 2002.

What forces stood behind the widening current account deficit? First of all, the low interest rates, which encouraged both investment and borrowing. Currently, interest rates in Estonia are among the lowest ones in the European Union. It derives from the extremely fixed exchange rate regime, which obliged the interest rate to follow closely that of the ECB. In the euro area the inflation pressure is eliminated and the growth is deteriorating, consequently the monetary policy is rather expansionary, the interest rate is low.

Annual growth of real sector loans in Estonia exceeded even the high 2002 figure, and accounted for 28%, of which service sector and households have the biggest share. Loans for the latter went up by 32%. The banks are obliged to use more and more external resources to meet the demand. Meanwhile, deposits of households increased only by 10%. The narrowing interest spread (3,23 percentage-point in October) played a major role in these tendencies. The borrowing boom had not led to instability in banking sector. The capitalization of banks is still high, loan quality is good, profits increased and capital adequacy remained rather high.

Secondly, raising employment and fast-growing wages (which exceeded the increase of productivity) made private persons optimistic and encourage them to consume and borrow more. In the third quarter of 2003, the number of employed persons was the largest in the last five years. It meant 609 thousand persons, by 30 thousand more than in the first quarter. In the fourth quarter it slightly decreased to 603 thousand. In addition, unemployment rate dropped remarkably, from 11,3% to 9,3% between the end of 2002 and 2003.

During the last year average gross wages increased ca. by 10%, a little slower than a year before, but in real terms (owing to the low inflation) the wage growth exceeded the 2002 figure and accounted for about 8,5%. Contrarily, productivity was up by only 3,5% (according to BoE estimation), which is the worst figure in recent years. As a result of the factors mentioned, both component of domestic demand, investment and consumption increased last year at a high pace, although slower than a year before altogether.

Thirdly, the Currency Board Arrangement (which played a vital role in the success story of Estonia) hinders the exchange rate depreciation, which would have helped to balance the current account. In fact, following the euro, the Estonian Kroon has appreciated against the national currency of Estonia’s foreign trade partners and the US dollar. Similarly, the all-time low inflation rate (1,3% annually, 3,6% in 2002) contributed to the all-time high CA deficit.

Due to the low inflation rate the domestic supply of goods and services was not able to meet the strong domestic demand. Thus the excess demand resulted in high deficit of trade. Although in other circumstances the low inflation rate can be considered as a sign of stable and balanced economy, in the case of Estonia due to other imbalances it increased CA deficit.

Bank of Estonia drew up some suggestions addressed to banks and government in order to restore the stability of the economy. The central bank together with the Financial Supervision Authority sends letters to banks, in which draws attention to loan standards and warns the banks against the dangers of widening loan portfolio with risky customers. In the future, the Bank of Estonia will have to change the banks' reserve requirements in order to bring them in line with that of the euro area.

Furthermore, according to a new amendment, the vault cash of banks will be removed from reserve requirement calculation base, consequently banks have to increase their reserves. BoE suggests that the government should maintain the balanced budget. Although in January 2003 the parliament approved the budget with a planned deficit of 0,3% of GDP, the figures showed a surplus of 1,2% last year. Thus, the government satisfied the requirements of International Monetary Fund.

The IMF released its opinion in the summer that the government should seek to achieve a budgetary surplus to the tune of two percent of GDP. Another proposal drafted by the Bank of Estonia deals with the elimination of housing loan facilitation. According to BoE’s suggestions, the share of self-financing should be lifted from 10%

and the availability to deduct housing loan interests from taxable income should be revoked.

The most important consequence of the huge CA deficit is the increasing debt burden of households and growing external liabilities of banks. The total of loan and leasing liabilities of private persons has exceeded 23 billion Kroons. At the end of September 2003, Estonia's gross external debt was estimated at 69% of the GDP. A good point is that the debt of general government is low (ca. equal to 5% of the expected GDP).

Under unfavorable economic circumstances (higher interest rates, slowly growing wages etc) the households will likely be unable to repay the loans or the repayment will significantly hurt the consumption and living standard, which could lead to social tensions. Similar problems are unlikely to arise in the banking sector because it is stable enough and the introduction of the Euro will radically decrease the share of foreign currency denominated liabilities.

It has to be mentioned briefly, that the government took a decision on 16 January foreseeing joining the exchange rate mechanism, ERM2, as fast as possible after 1 May 2004. The government would like to be reach the readiness to adopt the Euro cash in the middle of 2006.

Prepared by: Gergely Baksay

GENERAL ELECTIONS IN CROATIA - INTERVENTIONS ON BOTH SIDES WITHIN TWO WEEKS BY THE CROATIAN NATIONAL BANK

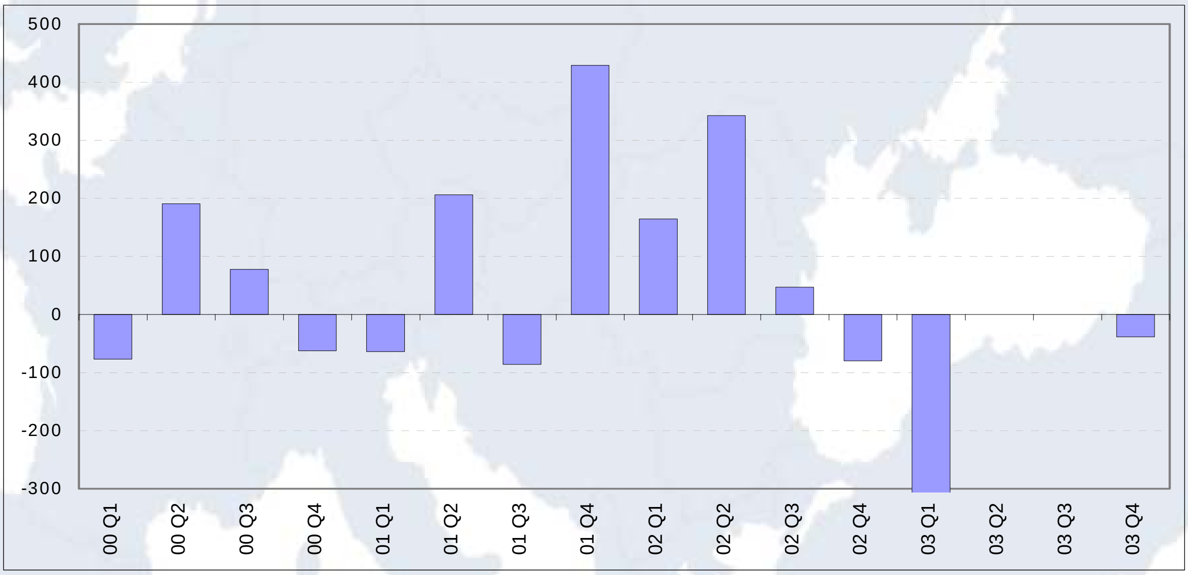
In December the Croatian National Bank (CNB) held two interventions. First on 9 December it sold 63.1 million euros to banks and then on 22 December it purchased back 84.5 million.

Before trying to reveal its relevance, a brief explanation should be given about the Croatian monetary policy. The national bank has been using a managed float system for about 9 years, trying to keep the local currency's Euro rate stable. This works quite successfully, although there is extremely high trade and serious budget deficit, the rate of inflation has been under 3% since the end of 2001, growth was more than 5% in 2002 and the foreign currency market seems to be stable.

To keep the currency market steady, the national bank holds discretionary interventions and uses other techniques, like foreign currency swaps, to maintain liquidity. Precisely, interventions are one side multiple-price auctions, where the banks in their bids state the exchange rate and the amounts they offer.

Since the enormous trade deficit is partly financed by the country's sizable incomes from tourism, massive seasonal effects were brought into the system. This appears in the disposition direction of interventions, as the chart shows. In summer months CNB purchases foreign currency from banks and it sells in winter. The other factor which finances the trade deficit is the foreign capital inflow. Sometimes, like from the end of 2001 the rapid inflow deranges the above mentioned seasonality.

Chart 3. Foreign exchange interventions of CNB
(M EUR)



In this chart CNB's foreign currency purchases are represented by positive value and its sales by negative.

Reverting to the starting point of this article, the adverse interventions within short terms are not particular because of capital flows. For example on 14 January 2000 CNB sold 91.2 million euros and 11 days later it purchased back 14.5 million, or on 29 January 2002 it sold 22.6 million and after 16 days it purchased back 67.1 million.

Moreover, the question whether the Kuna is under depreciation pressure is more defensible, considering that at the beginning of the last year all-time high interventions were required to keep the rate stable and then the usual summer foreign currency purchases were cancelled. It is well emphasized that CNB has other techniques to regulate the foreign currency demand and supply and the trend of interventions clearly shows depreciation pressure.

If it is true, there is good reason for that. The first could be the country's biggest problem besides unemployment, the serious budget deficit. The Croatian general government's deficit to the GDP was 8.2%, 6.5%, 6.8%, 4.8% in the period of 1999-2002 respectively, according to the IMF. The other cause might come from the political uncertainty. Although the elections were held at the end of last year, it was doubted whether the former governing parties and their coalition could stay in position till the end of their period.

Although the leader parties did not change as a result of the elections, it is hard to measure what the new governing coalition's stance on reducing deficit is. According to international experiences,[1] coalition governments generally have less success in reducing deficits.

Returning to the original starting point, the result of the election and the hardship of forming the new coalition could have an effect of higher volatility on the foreign currency market. Nevertheless, the conclusion is that these adverse interventions are not particular, they could be caused both by abrupt foreign capital flows or by emergent raised uncertainty.

Consequently, the new government's first steps in the next few months will be essential for the foreign investors, the foreign exchange market and for Croatia.

Prepared by: Péter Sulán

[1] Good summary about what and how determinates budget deficits could be found in Economic, political, and institutional determinants of public deficits by Jaejoon Woo in Journal Public Economics 2003 p. 387-426.