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NEWS OF THE MONTH

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Table of Contents

I. LAST YEAR WAS A ROLLER-COASTER RIDE FOR THE SLOVAK CROWN

In 2002, the Slovak crown hit not only all-time highs but three-year lows. The reasons for the volatility can be found in political and foreign circumstances and Slovakia's economic performance. In the summer, the Slovak crown weakened 6-7% against Euro (from SKK41.30 to above SKK44). Political uncertainty and loose fiscal policy led investors to sell the crown, and fears over Mečiar's possible return to power had caused hesitance. The election results were favorable and the uncertainty about crown was eliminated and it started to strengthen, which continued after right-wing parties created the government coalition. Immediately after the election results were announced, the crown strengthened below SKK43 per Euro.

In October, the Moody's revised outlook on Slovakia (from stable to positive) resulted in further strengthening of the Slovak crown. Slovakia's long-term outlook also improved after the enlargement report by the European Commission (and the favorable Irish referendum) suggested that Slovakia (and nine other states) will be invited to join the EU in 2004. In November, NATO representatives were set to decide at a Prague expansion summit on Slovakia's bid to join the military alliance. Slovakia was accepted that gave a feeling of safety and security to industrial investors. A growth in the number of investors and the amount of investments could follow the acceptance, meaning an inflow of foreign currency and a growth in demand for domestic currency, further strengthening the crown.

The Slovak crown hit all-time highs in early November and threatened to surpass SKK41 per Euro, prompting intervention by the central bank. The National Bank of Slovakia (NBS) decided to intervene directly on 12 November (for the first time in 2002) by purchasing Euro for Slovak crowns from domestic and foreign banks, with the aim of preventing the exchange rate from further disproportionate appreciation. The first purchases took place at the level of SKK41.19 per Euro.

The NBS purchased foreign exchange in the equivalent of EUR364 million. Interventions continued on the following two days, but with decreasing intensity: the NBS purchased a further EUR 101 and 63 million. In total, the NBS purchased EUR 583 million from domestic and foreign banks in November. By midday November 14, NBS action on exchange markets had pushed the Crown down to SKK41.8 per Euro. The central bank had been threatening intervention for much of the previous week as the currency gained strength against its Euro benchmark.

In mid-November, the central bank decreased three key interest rates by 1.5 per cent each, finishing the three-day battle against the surging Slovak crown on which the bank spent more than 500 million Euro to weaken the currency. The two-week repo rate dropped to 6.5 per cent, the one-day sterilization rate to 5 per cent and the one-day refinancing rate to 6.5 per cent. The bank expected this measure would reduce the interest differential which had prompted mainly European investors to buy crowns and deposit them with the NBS. The differential, along with positive political and economic news coming from Slovakia, had pushed the crown to strengths not seen since 1999, and had led to fears of a worsening trade balance deficit.

According to experts, the attention on the Slovak crown of speculative investors increased. Speculative capital takes into account higher earnings in comparison to Western currencies, the indicators showing GDP growth in Slovakia at significantly higher levels than in surrounding countries. In the future, these factors could bring more influence on Slovak crown. The question of further strengthening depends on whether such a positive outlook will remain, whether the government will continue with the policies it has started.

Before corrective measures, the head of the NBS treasury department said that NBS had reiterated several times that the current exchange rate of the Slovak crown does not reflect economic fundamentals. Moreover, an overly strong crown could have a negative impact on Slovakia's foreign trade balance. The biggest danger could be the impact on foreign trade: stronger crown would support imports and would put Slovak exporters at a competitive disadvantage. Analysts' point that the strengthening of the crown is inevitable, and the only question is the pace and extent of its rise.

However, several analysts say that the decision by NBS to lower interest rates in response to the appreciating Slovak crown has not had much effect on the exchange rate. Several interventions on foreign currency markets pulled the crown's value back slightly. NBS officials said continued growth had forced the bank to lower interest rates by 1.5 percentage points. Following news of the rate cut on November 15, the crown weakened by only SKK0.05 against its Euro benchmark, falling to SKK41.8 before firming back up to SKK41.67. The NBS was not successful in reversing the trend and weakening the crown. In the following days, the Slovak currency continued strengthening, repeatedly hitting SKK41.4.

NBS is ready to use all its available tools to make the Slovak crown exchange rate proportionate to economic fundamentals, said NBS governor. However, the NBS would have had to implement a much more significant interest rate cut in order to stop the crown's strengthening, which they say is an unrealistic step. It looked like NBS was the only player who considered exchange rates alarming, the Finance Minister's statement included that the exchange rate would be either stable or slightly up in current year.

The last geopolitical event affecting the exchange rate was Slovakia's invitations to join the EU. The exchange rate did not change significantly, it was priced in the expectations. In the second half of December, the exchange rate was between SKK41.80 and SKK41.70 per Euro. Shortly before the end of the year, the NBS intervened against the strength of the crown when it broke 41.2 to Euro.

Another factor pushing the crown higher at the turn of the new year, especially against the Euro was the interest rate differential between Eurozone and Slovak currency deposits. With the European Central Bank offering interest rates below 3 per cent, compared to the 6.5 per cent two-week repo rate offered by the NBS, portfolio investors had been motivated to buy crowns, which on a fairly illiquid market pushed the crown higher in the first week of January. Macroeconomic results helped the crown these days: November trade results, showing a SKK9.7 billion deficit, were some SKK3 billion better than analysts had expected, largely because of the weak US dollar, and pushed the crown up immediately against the Euro.

The Slovak crown strengthened to 41.17 against its Euro reference currency when it was announced the Peugeot had chosen Slovakia as the site of a 700 million Euro factory investment. This level was only 10 basis points from the crown's record strength against the Euro. Money market dealers say they expect the currency to break the 41 level in the near future. It is expected to keep strengthening in 2003, and break another psychological barrier of SKK40 per Euro in the first half of next year.

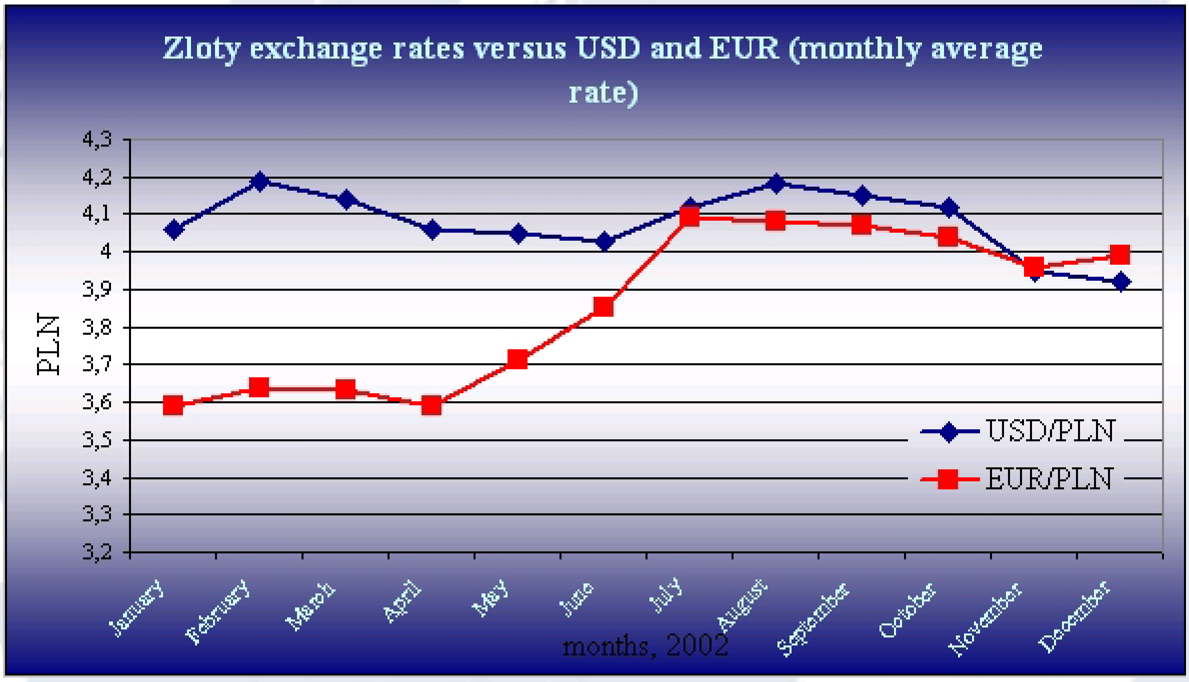
Prepared by: Péter Bilek

II. EXCHANGE RATE TRENDS OF THE ZLOTY IN 2002

The Polish national currency, the Zloty has been loosing ground to the Euro from the beginning of 2002, especially in the second quarter, but from July onwards the EUR/PLN exchange rate remained on the same level (around 4.08 on average) and has slightly appreciated in October and November (compared to the exchange rate in July). Overall the Zloty has depreciated with respect to the common European currency both in nominal and real terms in 2002.

At the end of 2002 the Zloty has become the strongest compared to the USD since its liberalization in April 2000. This resulted from the continued strengthening trend of the Euro to the dollar in the world market from the second quarter of 2002. From February until June the Zloty has been appreciating against the dollar, but from June until August weakening again, and from August until the end of the year strengthening again, reaching the historically low 3.92 USD/PLN level in December.

Chart 1



Source: National Bank of Poland

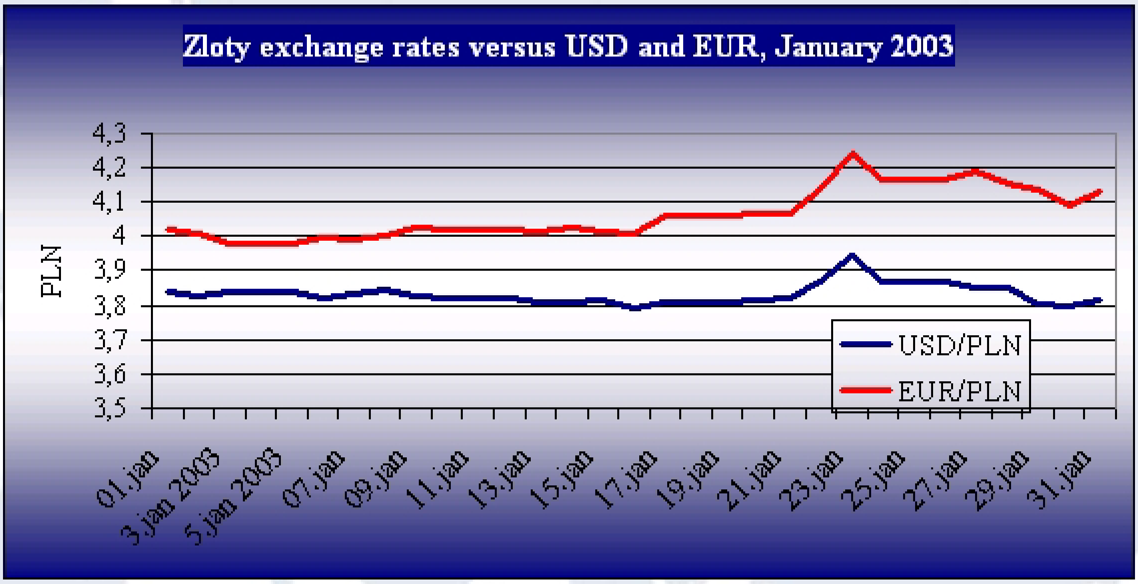
In the second quarter of 2002 the Zloty exchange rate movements against the dollar and the Euro were reversed. The Zloty appreciated 2.1% vis-a-vis the dollar in the given time period, while depreciated 2.6% on average against the Euro. The Zloty exchange rate was relatively stable in Q2 2002, its relative volatility was about 2.4%, compared to 3.2% in Q1 2002.

In the third quarter of 2002 the Zloty has depreciated in nominal and in real terms against both the Euro and the dollar. In July, August and September the monthly average Zloty-dollar exchange rates were 4.12, 4.18, 4.15 USD/PLN respectively. The Zloty-Euro average exchange rates for the same months were 4.09, 4.09, 4.07 EUR/PLN. July 9th, 2002 was the Zloty's weakest point against the dollar since February 2002, and weakest against the Euro since June 2000. This was the result of the global economic uncertainty and the appointment of the new finance minister, Grzegorz Kolodko in the beginning of July, as his new economic program caused controversy. In Q3 2002, particularly in July, the volatility of the Zloty rate increased.

The factors influencing the weakening of the Zloty were similar in the second and the third quarter of 2002:

- further strengthening of the Euro/dollar rate in the world market (especially pronounced in July);
- temporary rise in domestic (the appointment of Grzegorz Kolodko as the new minister of finance, statements of politicians on Poland's exchange rate strategy in the run-up to EU accession and membership) and foreign (the situation in Brazil, and its effects on other emerging economies) political risk;
- decrease in Polish and foreign interest rate disparities causing a relative lessening in the appeal of Polish securities;
- relative (compared to the situation in 2001) weakening of the market expectations of further Monetary Policy Council interest rate cuts;
- market expectations regarding an uncertain outcome of the referendum in Ireland (at the end of Q3).

Chart 2.



Source: National Bank of Poland

During January 2003 the Zloty exchange rate against the Euro and the dollar has shown a similar pattern. The USD/PLN rate stayed close to 3.8 all month, up until the 23rd of January, when the Zloty suddenly depreciated vis-a-vis the dollar. The same can be said about the EUR/PLN rate, staying around 4 in the first half of the month, but the Zloty's depreciation started earlier vis-a-vis the Euro, on the 17th of January, and it was stronger then the Zloty depreciation against the dollar. After the 23rd of January the Zloty began to gain strength again against both the dollar and the Euro. In the case of the dollar, it moved back to the 3.8 level at the end of the month. As for the Euro the EUR/PLN rate settled around 4.1 at the end of January

The idea of abandoning the current exchange regime (the free floating of the Zloty) has been a controversial question between the government and the National Bank of Poland at the end of 2002. According to the government and the Ministry of Finance the current exchange regime should be replaced by the managed float system before joining the ERM-2. The reason for this is that the free floating Zloty is overvalued, negatively effecting the economic performance of Poland, and causing serious problems especially for the exporters. The managed float system would be a useful tool to make the Zloty weaker, or in other words less overvalued. It would therefore enhance economic activity, and avoid excessive exchange rate volatility.

The exchange regime can only be changed if both the government and the central bank decide that the change should be made. At the moment the National Bank of Poland does not want to change the exchange regime. The Monetary Policy Council (which current members are considered conservative) is on the opinion that the direct inflation-targeting regime of the central bank should be applied with the free floating Zloty. The new Monetary Policy Council will be elected in 2003 and the term of the new members is going to begin at the beginning of 2004. The new Monetary Policy Council is expected to include more members who are considered to be radical. Therefore in 2004 the government might succeed in introducing the managed float, with the agreement of the new Monetary Policy Council.

Prepared by: Veronika Czakó

III. Calculability and stability - The Croatian foreign exchange system

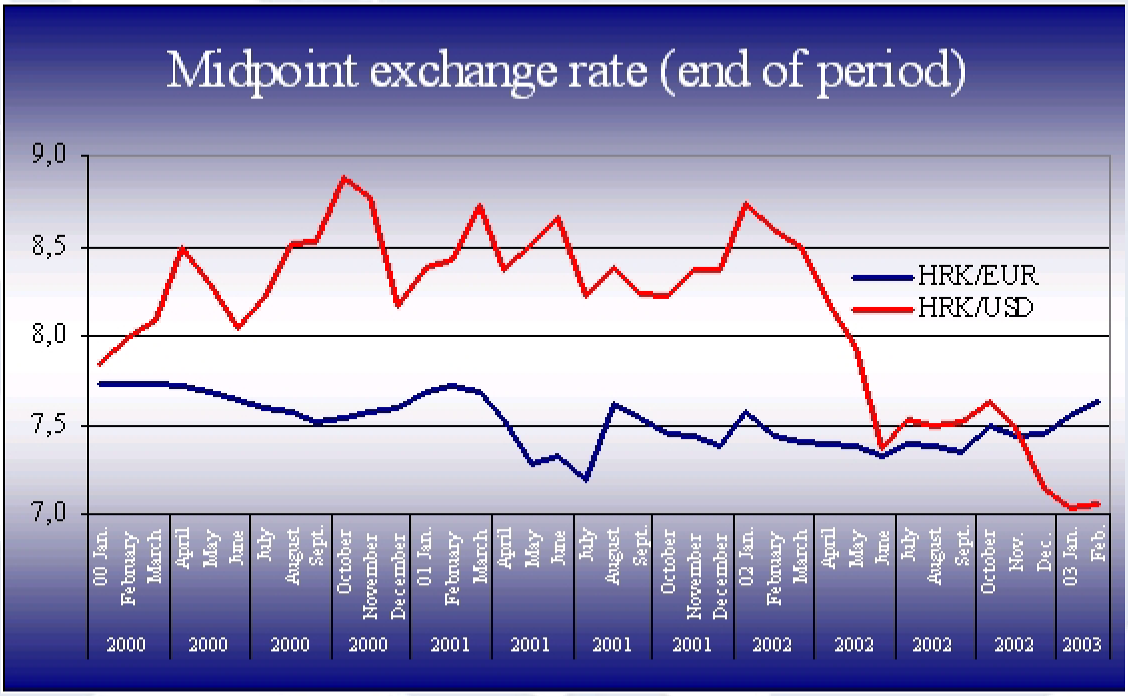
The objectives of the Croatian National Bank (CNB) according to the Low on the CNB are the following:

"(1) The primary objective of the Croatian National Bank, within the powers granted, shall be to achieve and to maintain price stability.

(2) Without prejudice to its primary objective, the Croatian National Bank shall support the economic policy of the Republic of Croatia, thereby acting in accordance with the principles of the open market economy and free competition."

To fulfill the requirement of price stability, the central bank attach great importance to exchange rate stability, above all the kuna/Euro rate of exchange. The chief reasons why against the Euro are that 55% of the Croatian export goes to the European Union, most of the tourists visit from European countries, and 56% of total import comes from the EU. A stable kuna/Euro exchange rate helps to reduce the foreign exchange risk, and to keep the inflation pressures low by the imported inflation. To maintain the exchange rate stability, the central bank uses a managed floating system, holds foreign currency auctions in the Interbank foreign exchange market based on discretionary decisions, and occasionally sells foreign currency to the government.

Chart 3.



The kuna and Euro demand and supply are mainly determined by seasonal factors like incomes from tourism in summer or paying out the bills of imported energy in winter. A simple table of the Balance of Payments shows the character of the Croatian economy that the high level of trade balance deficit is financed both by the incomes from services, which mainly means tourism and by foreign capital inflows. (In addition the share of services in the Croatian GDP is about 60%, which is quite high from the perspective of a developing economy 10 years after the war was ended.)

Table 1. The Croatian balance of payments in million HKR

Balance of Payments (in million USD)	**2000.**	**2001.**	**2002.**		
			Q1	**Q2**	**Q3**
Trade balance	-3203.8	-4101.3	-1011.6	-1381.4	-1410.9
Services	2267.9	2926.4	113.2	561.7	2183.4
Capital and financial account excluding reserve assets	1785.4	2521.7	1428.9	1519.4	267.9
International reserves of the CNB*	3524.8	4704.2	4885.5	5601.8	5705.2

** End of the period*

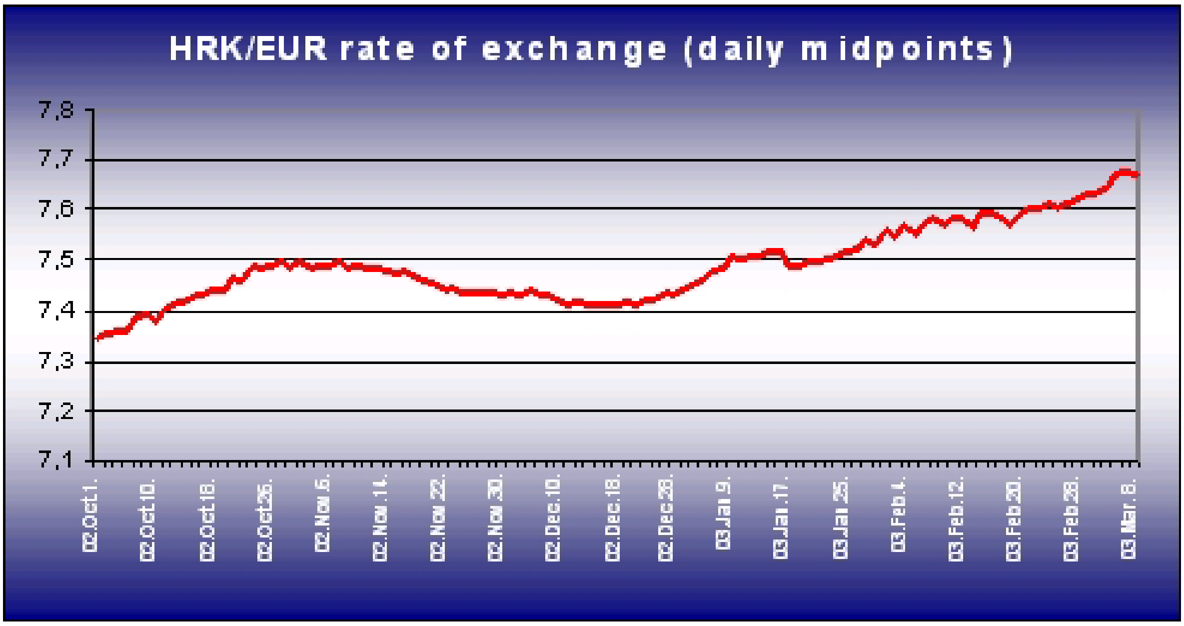
These figures considered it is obvious that in an ordinary year in the winter months there is depreciation pressure on the local currency, and in summer months appreciation pressure arises. These have to be eased by the interventions of the Croatian National Bank in order to keep the exchange rate stable. This structure could be disturbed by an unequal foreign capital flows, privatization revenues, speculative behavior or administrative measurements as it happened in the third quarter of 2001. At that time the CNB purchased foreign currency from banks, in order to ease the appreciation pressure on Kuna.

In August 2001 the CNB enacted the decision on reducing the permitted exposure of the total foreign exchange position to currency risk from 25% to 20% of authorized bank and savings bank regulatory capital, and the possibility of making exceptions in implementing this decision was eliminated. As for the first and second quarter of 2002 there was a large amount of foreign capital inflow. These could be the explanations for the irregularity of the interventions held by CNB in this period.

In the recent few months the Kuna/Euro exchange rate fluctuated within a relatively narrow band, while the Kuna slightly but continuously depreciated. The CNB held six foreign currency auctions from the beginning of October 2002 and each time sold Euro to banks. In October the CNB sold 79,8 million Euro, in January 115,7 million, on 21st February 49,4 million, and on 5th March 82,7 million, which process is suitable to this season.

In accordance with the Hungarian incident, as it well known, there was a speculative attack on the Hungarian currency in order to enforce the further appreciation, (the National Bank of Hungary had to intervene about 5 billion Euro on 16th and 17th January) the Kuna had not react so much. On 17th January the Kuna appreciated from 7.5139 to 7.4892 Euro by 0.4%, than started to depreciate again.

Chart 4.



In the next few months the depreciation could continue along lesser pressure as the tourist season begins. As for the long-term prospects there is not much possibility of a similar to the Hungarian case speculative attack to appreciate the Kuna. First, in Hungary the foreign exchange regime is a banded float and not a managed float. Second, there is much uncertainty with the Croatian connection to the EU and later to EMU (Croatia has just handed in her accession application to the EU on 21st February in Greece.) Third, the central bank doesn't have to maintain higher interest rates because of the serious budget deficit in order to prevent inflation pressures. (The CNB's discount rate is currently 4.5%.)

But there are some impacts that will make the central bank to allow more room for appreciation of Kuna. When Croatia's EU entry becomes more certain, it will generate more foreign investment inflow. Since the CNB's international reserves are constantly on the rise (table 1), this might mean that the Kuna has already became somewhat undervalued. And finally if the inflation remains at this level (from September 2001 the year on year retail price index is under 4% and in December 2002 it was 2.3%) the real appreciation pressures from the shrinking productivity gap between the EU and Croatia will not find other path to achieve the real convergence among the economies than the nominal appreciation of Kuna against foreign currencies.

Prepared by: Péter Sulán

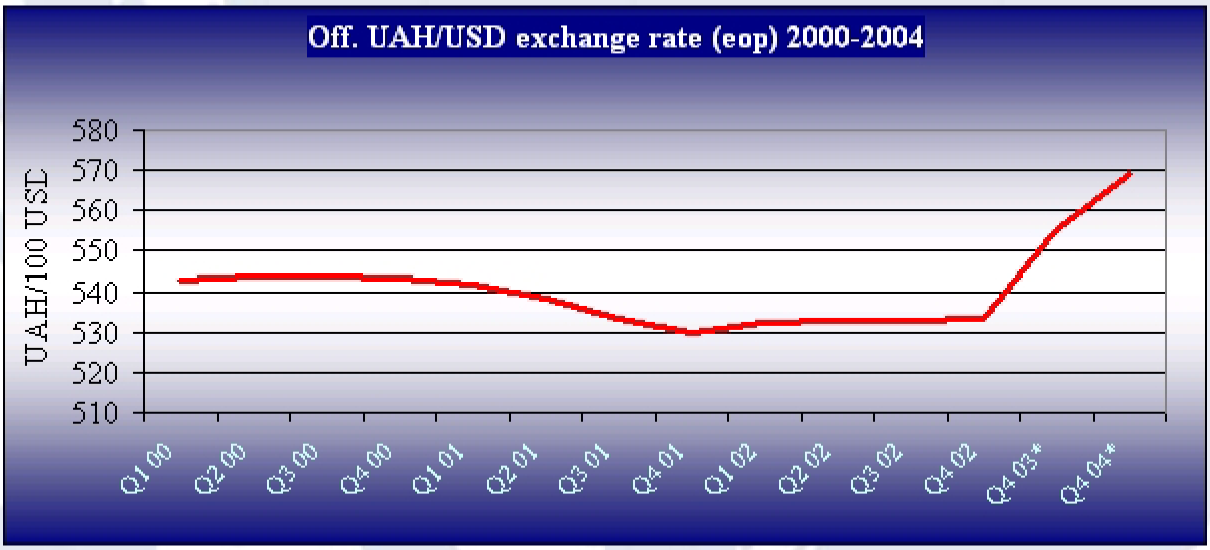
IV. Stable Ukrainian Currency

Main task of the monetary policy of the National Bank of Ukraine is the maintenance of the stability of national monetary unit (Hryvnia), with gradual and permissible (insignificant) revaluation of home currency. Such policy helps to keep positive influence of the exchange rate on financial stability, contributes to disinflation, reduces critical import prices and establishes favorable conditions for foreign economic activity.

In the foreign exchange market, the National Bank of Ukraine performed operations mainly with purchase of foreign currency using this instrument to ensure a stable Hryvnia exchange rate. The mechanism of exchange rate determination in Ukraine's currency market has traditionally centered on the US dollar, which account for almost four-fifths of transaction volumes. Correspondingly the dollar is the key currency of the NBU's interventions. In 2002 the NBU focused on maintaining stability and smoothing the fluctuations of the nominal UAH/USD exchange rate. The fact that the dollar has been depreciating in international currency markets meant a depreciation of the effective exchange rate in Ukraine.

The UAH/USD exchange rate remained at a steady level till the end of 2002. Simultaneously the Ukrainian currency ceased to depreciate against Euro, since the Euro's position stabilized in international markets. A record high positive current account balance in 2002 ensure the 5,34 UAH/USD exchange rate by the year end, which is 0,9% annual nominal Hryvnia depreciation.

Chart 5.



Under a stable nominal exchange rate the 2002 real effective UAH/USD exchange rate have depreciated, because of deflation in Ukraine in 2002. (See: News of the month Nr.7 ICEG European Center January, 2003)

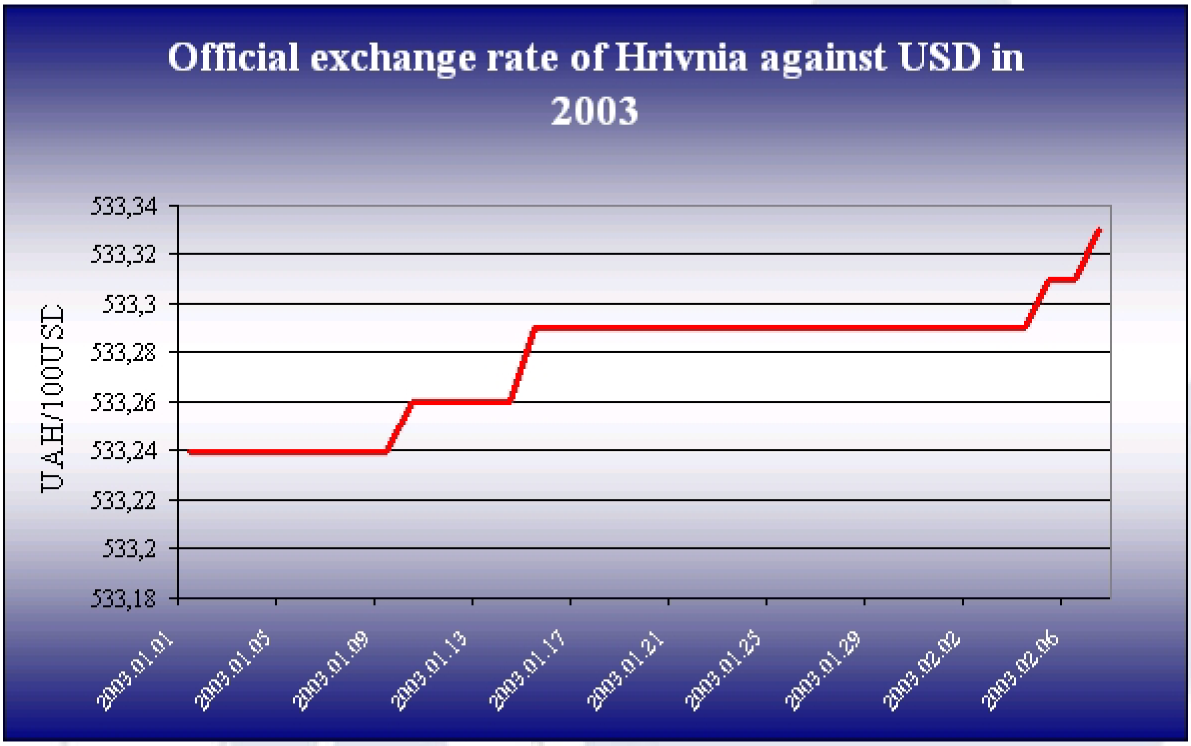
The national currency was stable in 2002, thanks to the policy of central bank, which tried to use nominal exchange rate stability to promote disinflation. From the other side it allowed further build up of foreign currency reserves. The key indicator was the slightly high current account surplus, which was the result of favorable outcome of increased price competitiveness following the currency depreciation in 1998 and of the growth of external demand. This led to the significant accumulation of foreign exchange reserves, which is an important condition for increasing macroeconomic stability.

In January (2003) the official exchange rate of Hryvnia against US dollar has decreased by 0,05 kopiykas (0,09%) and has amounted to 533.29 UAH./100 USD. UAH/EUR exchange rate by 19.89 kopiykas (3.6 %) to 573.1801 UAH./100 EUR, because of the depreciation of USD against EUR Finally against Russian Ruble has increased by 0.0019 kopiykas (0.11 %) to 1.6758 UAH /10 RUR. Volume of transactions at the interbank foreign exchange market of Ukraine (purchase and sale in dollar equivalent) was 3552.8 USD million. NBU interventions (balance) has equaled 116.7 USD million (in dollar equivalent). NBU international reserves as of 31.01.2003 have amounted to 4557.1 USD million; increase of international reserves - 140.1 USD million (3.17 %).

Fortunately the political wrangling in December about the changing of National Bank's head didn't lead to insignificant moving of monetary indicators. Vladimir Stelmakh was dismissed from this position and Serhiy Tihipko was appointed his successor.

Very important, in January several measures loosening the foreign exchange market regulations were adopted by the NBU. Among others, the NBU permitted forward operations with hard currency on international foreign exchange markets. Although the changes in the regulations are minor, they might be treated as the first step towards the long-awaited liberalization of the foreign exchange market. However the 50% obligatory sale of foreign exchange receipts remains an unresolved problem.

Chart 6.



By the forecast of ICPS, the decline in the nominal UAH/USD exchange rate will speed up in the next two years, due to a sizable decrease in foreign currency inflows, triggered by the curtained current account balance (the NBU estimates, that the annual current account balance will fall back to USD 1,7 billion due to import intensification) and due to NBU foreign currency reserves accumulation. Accordingly, the year-end exchange rate of the Hryvnia against dollar will amount to 5.55 UAH/USD in 2003 and 5,69 UAH/USD in 2004.

Excepted a steady real exchange rate, because the nominal depreciation of exchange rate will equal the difference in inflation rates between Ukraine and it's major trading partners. In 2003 CPI inflation is forecasted at 5,2% according to the scenario of the Ministry of Economy. So for stable real exchange rate the NBU needs an 5% annual nominal depreciation of Hryvnia.

Prepared by: Tamás Borkó