Introduction

Financial liberalization has important benefits:

- Lowers the cost of capital and improves its allocation, thereby promoting growth
- Promotes trade flows
- Promotes the development of sound institutions (e.g. better information and legal systems, better financial supervision)

However, it can lead to financial instability and crises if not managed properly
„The issue is not whether financial globalization is inherently good or bad, but whether it can be done right”,


Main Themes

• The presentation evolves around three main themes:
  • Managing expectations
  • The exchange rate and monetary regimes adopted matter
  • Risks of credit booms
Capital account liberalization has a direct effect on the investment strategy of market participants.

Sharp increase in the fiscal deficit in Hungary.
Weak fiscal credibility in Hungary

High budget deficit is associated with large debt financed external deficit in Hungary
Chart 5 – Hungary – Changes in foreign investors’ net position against HUF and stock of government securities held by non-resident, 2001-2005

Liberalization makes countries vulnerable to speculation

Chart 6 – Historical volatility of the Polish zloty (PLN) and the HUF exchange rates*

The exchange rate regime matters
Chart 7 – Historical yield volatility of the PLN and the HUF (standard deviation of yields during a moving 90-day period, yields are based on CEBI bond indexes*)

*CEBI, the DrKW's Central European Bond Index, incorporates the CEE4 local currency denominated government bonds of various maturities

More focus on exchange rate stability can lead to more volatile interest rate

Chart 8 – Exchange rate movements of the Czech, Polish and Greek currencies, 1998-2000

A framework of commitment to stability helps
Chart 9 – Polish, Czech, Slovak and Hungarian implied forward rate differentials vis-à-vis euro rates in 5 years time (for 5-year maturity bonds)

Credibility and fundamentals are essential

Chart 10 – Hungary - Non-residents’ share in the outstanding amount and in the secondary market turnover of government bond

When expectations worsen, short-term speculative investments become important
Chart 11 – 3-month interest rates in the Eurozone and the new EU member states (1996-2005)

Strong yield convergence in the new EU members

Table 1 – Long term average yields and standard deviation, and overall performance of CEE bonds*

<table>
<thead>
<tr>
<th>Index</th>
<th>Average yield (1) 1999-2005</th>
<th>Standard deviation of average yield (2) 1999-2005</th>
<th>Performance indicator (3) 1999-2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual yield in euro (A)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech</td>
<td>11,6%</td>
<td>6,8%</td>
<td>1,70</td>
</tr>
<tr>
<td>Slovak</td>
<td>10,0%</td>
<td>6,0%</td>
<td>1,66</td>
</tr>
<tr>
<td>Hungarian</td>
<td>10,8%</td>
<td>9,0%</td>
<td>1,19</td>
</tr>
<tr>
<td>Polish</td>
<td>12,8%</td>
<td>11,2%</td>
<td>1,15</td>
</tr>
<tr>
<td>Reference index</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CEBIComposite</td>
<td>11,9%</td>
<td>7,9%</td>
<td>1,50</td>
</tr>
<tr>
<td>iBoxx (euro)</td>
<td>5,3%</td>
<td>3,1%</td>
<td>1,71</td>
</tr>
<tr>
<td>Annual yield in local currency (B)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech</td>
<td>8,4%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovak</td>
<td>6,7%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hungarian</td>
<td>10,6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Polish</td>
<td>11,3%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Appreciation of the exchange rate (A-B)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech</td>
<td>3,1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovak</td>
<td>3,2%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hungarian</td>
<td>0,2%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Polish</td>
<td>1,0%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*CEBI, the Central European Bond Index (CEBI) of Dresdner Kleinwort Wasserstein (DrKW), incorporates the Czech, Polish, Hungarian and Slovak local currency denominated government bonds. The iBoxx is the euro-region sovereign euro denominated bond index of the International Index Company.

Different performance
Unexpected policy moves have long-term impact

Anchoring expectations is important
Vulnerability increases when the fundamentals and credibility are weak

Table 2: Selected macroeconomic indicators in Emerging European countries

<table>
<thead>
<tr>
<th></th>
<th>Czech Republic</th>
<th>Slovakia</th>
<th>Poland</th>
<th>Hungary</th>
<th>Turkey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal balance*</td>
<td>-2.9 -2.6 -3.2</td>
<td>-3.0 -2.9 -2.7</td>
<td>-3.9 -2.5 -3.0</td>
<td>-6.5 -7.6 -9.4</td>
<td>-8.3 -8.4 -9.4</td>
</tr>
<tr>
<td>C/A deficit*</td>
<td>-6.0 -2.3 -3.4</td>
<td>-3.4 -5.7 -4.2</td>
<td>-1.5 -2.0 -8.4</td>
<td>-7.4 -9.3 -5.2</td>
<td>-6.3 -6.5</td>
</tr>
<tr>
<td>Inflation</td>
<td>2.6 1.6 2.5 7.5</td>
<td>2.8 4.4 5.6 2.2 1.0</td>
<td>8.7 3.5 6.6 8.2</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*percent of GDP
Source: Eurostat and European Commission, 2006 Spring Forecast

Turkey and Hungary have the worst fundamentals
Chart 15 - Average Growth Rate of Domestic Credit to the Private Sector, 2003-2004

Dangers of credit booms

Chart 16 – Credit growth in Estonia and Latvia

Note: min, max and median values correspond to the estimated equilibrium credit/GDP range

Dangers of credit booms
The fast credit growth has lead to high current account deficits in Estonia and Latvia despite strong budgeted positions.

An additional sign of overheating in Estonia and Latvia is the acceleration of inflation.
Dangers of currency mismatch

Conclusions

Capital account liberalization has important benefits, but also carries dangers:

– Makes countries vulnerable to speculation
– Can fuel credit booms
– Can lead to currency mismatch

all of which can destabilize the banking system and the economy if not managed properly
Conclusions (cont.)

• With open capital accounts, managing expectations is key to success, sound macroeconomic management is a must because markets will penalize misbehavior:
  – Follow sound fiscal policy, enforce transparent accounting
  – Anchor inflation expectations by transparent monetary policy (e.g. inflation targeting), ensure central bank independence
  – Strengthen financial supervision, give sufficient independence to supervisory agencies so that they can withstand political pressure
  – Strengthen information and legal systems