wiiw Spring Seminar 2015

Welcome Address

Challenges for monetary and exchange rate policy in CESEE

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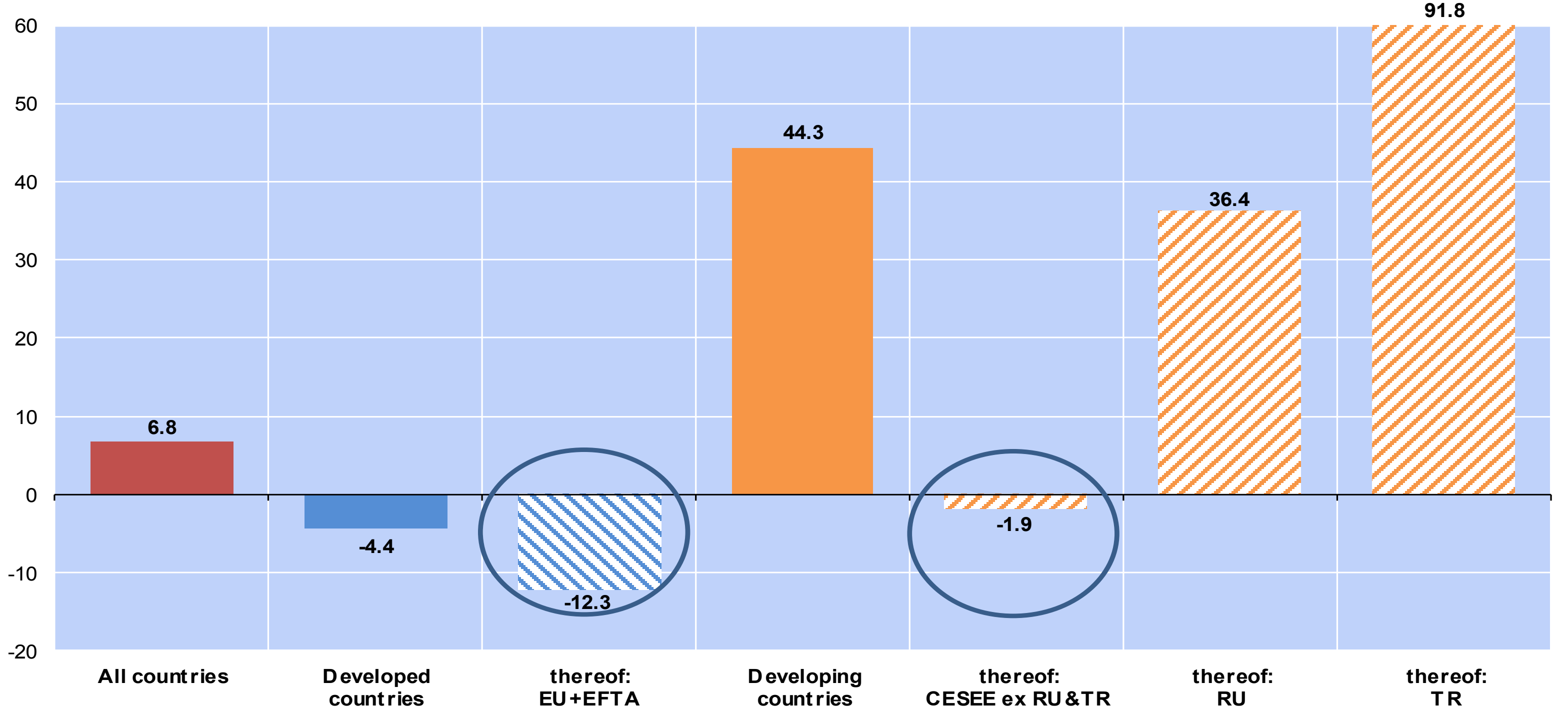
External factors set the stage for economic and financial developments and policy responses in CESEE

Bank credit to CESEE (except for Russia and Turkey) developed more in line with credit to the euro area aggregate than with credit to other emerging markets from 2010 to 2014

Consolidated foreign claims against all sectors of the recipient countries' economies

Change from end-2010q2 to end-2014q3, in %, all reporting banks of all BIS reporting countries, after adjustment for ER changes



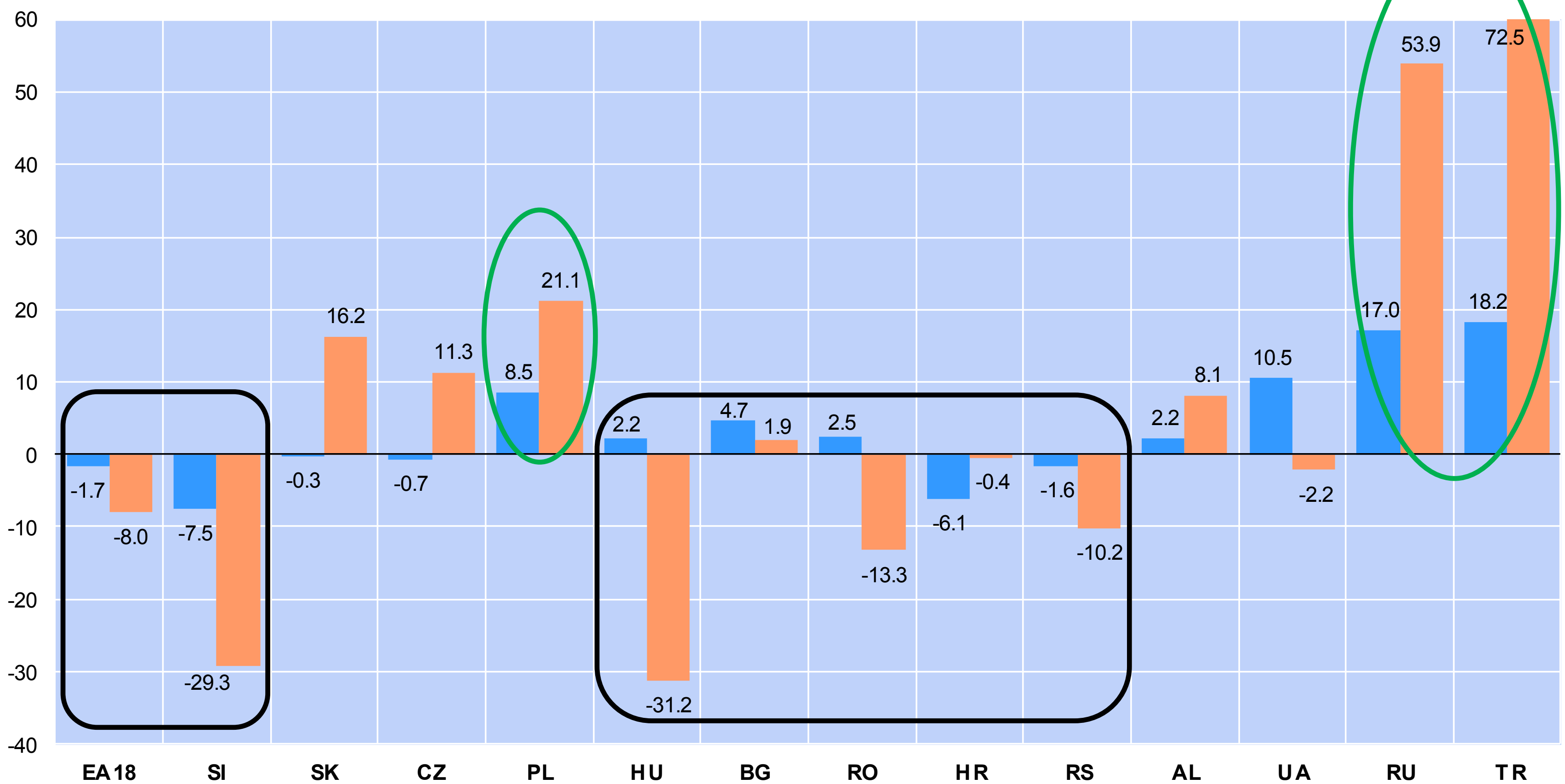
Source: BIS, IMF, OeNB. Note: Claims are partly net claims, i.e. gross claims minus corresponding loan loss provisions, as some BIS reporting countries report claims of their banks only after deduction of loan loss provisions.

- This reflects both close EA–CESEE linkages and the CESEE financial cycle where the past (FX) credit boom, followed by tight lending standards, raised NPL ratios that hamper credit growth.
- Globally, banks shifted positions, while containing total exposure at a low nominal growth rate.

Like in the euro area, several CESEE countries show a combination of weak or negative economic and credit growth, while Poland, Russia and Turkey had the opposite combination

Real domestic demand growth and real domestic credit growth from 2010 to 2014

cumulated change in % (domestic credit to private nonbanks after adjustment for exchange rate changes)



Source: Eurostat, National Central Banks, National Statistical Offices, Thomson Reuters.

Weak EA demand, fiscal tightening and weak credit growth imply a negative output gap that is forecast to prevail until 2016 in most CESEE countries, like in the euro area on aggregate

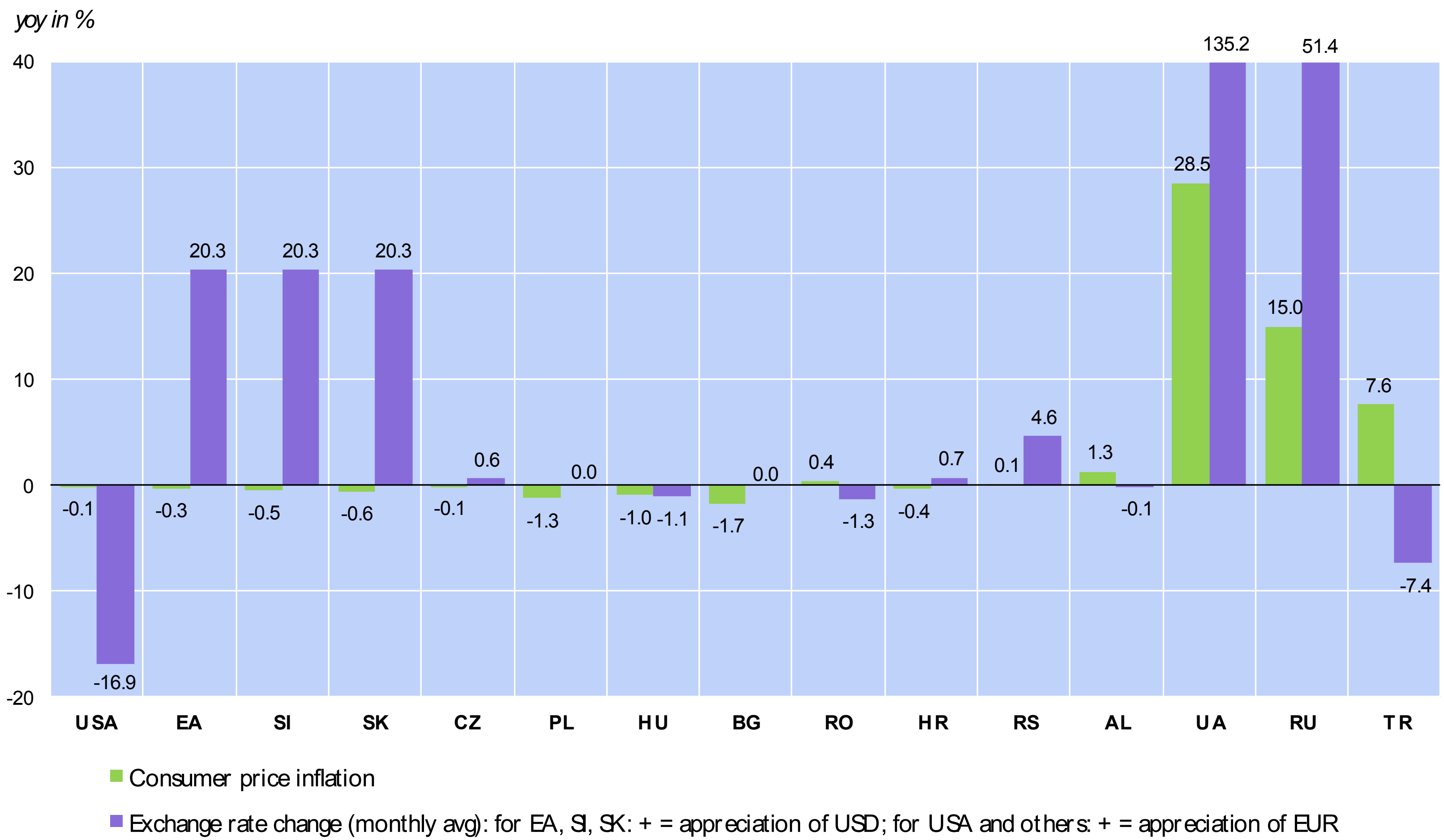
Output gap relative to potential GDP

Deviation of actual output from potential output as % of potential GDP

Source: European Commission.

Like in the euro area, in most CESEE countries inflation is low or negative, given the negative output gap and small annual exchange rate changes against the euro, with Ukraine, Russia and Turkey as exceptions.

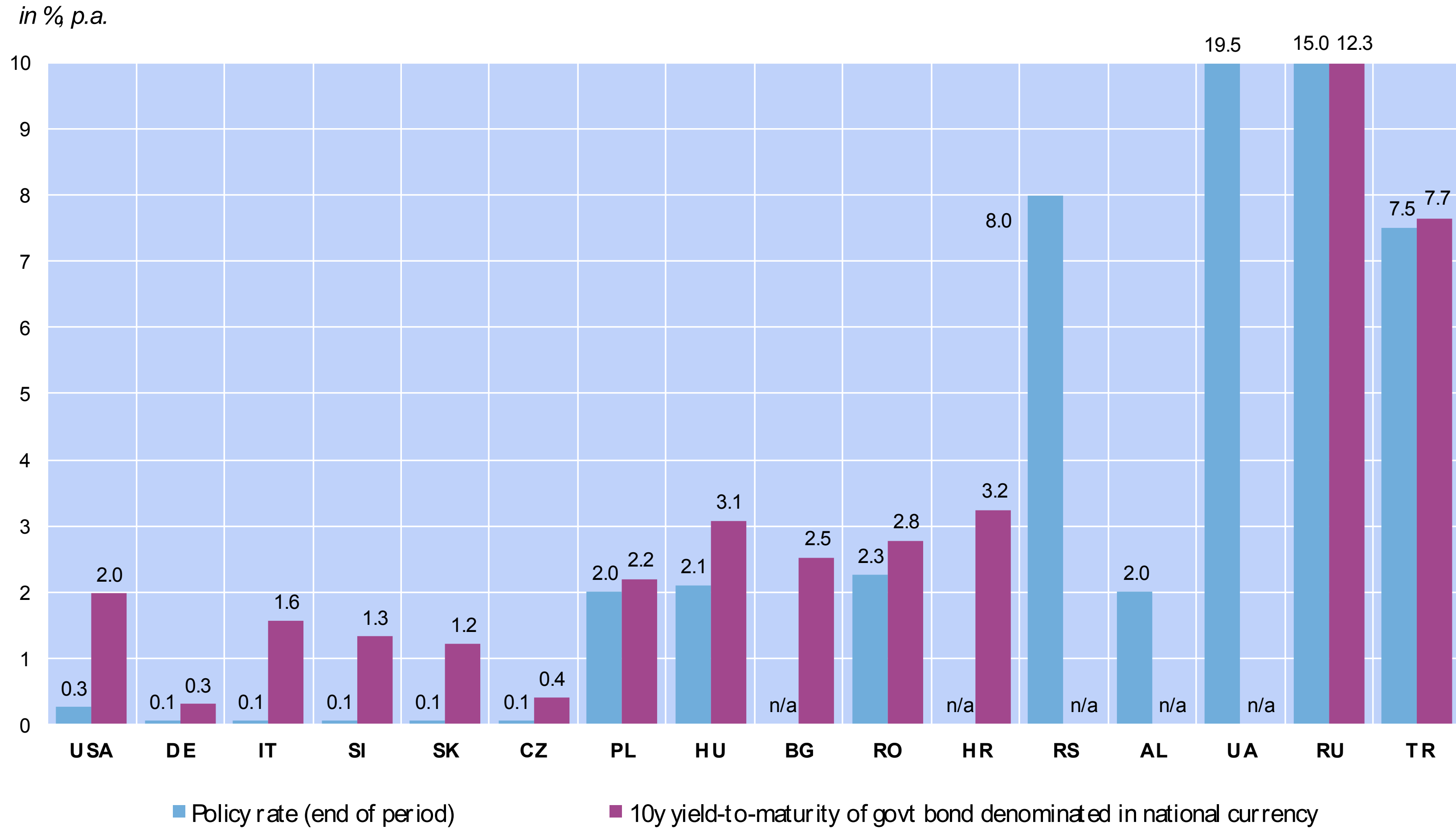
Inflation and exchange rate changes in February 2015



Source: Eurostat, wiiw, Bloomberg.

However, in some CESEE countries policy rates are still substantially higher than in the euro area, while sovereign bond yields are not much higher than for Italy

Policy rate and government bond yields in February 2015

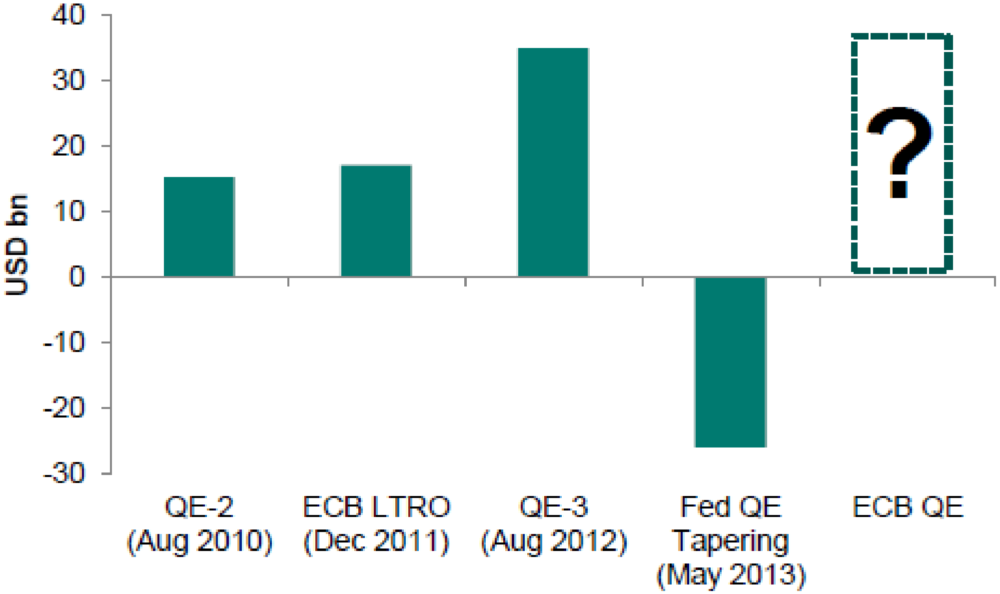


Source: Eurostat, Thomson Reuters, Bloomberg.

In this context, US and euro area monetary policy responses will decisively shape the challenges for CESEE monetary and exchange rate policy, with their central banks' policy actions depending on the exchange rate regime in place.

US and EA monetary policy heading for opposite direction

6M cumulative flows into EM bond funds following QE announcements



Source: EPFR Global, Barclays Capital

- Fed is preparing to hike in 2015
- But no hurry as long as inflation low and labor market slack

- Previous rounds of ultra-loose monetary policy have resulted in considerable portfolio capital inflows into EM bonds, albeit to a lesser extent to CESEE.

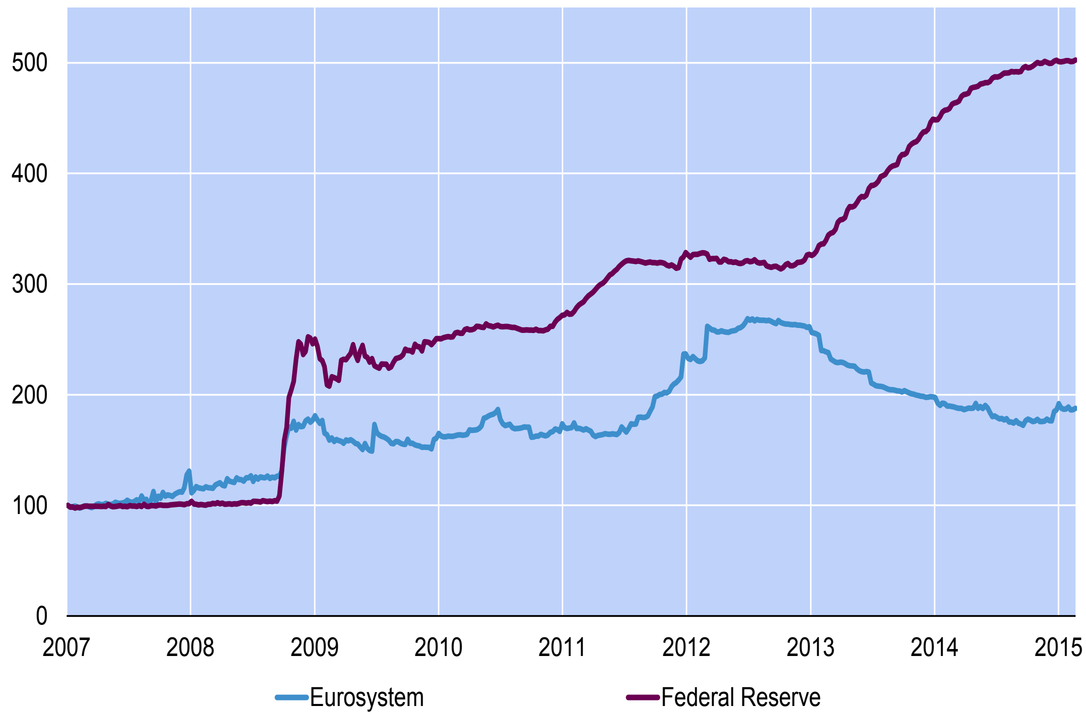
- Capital outflows from EM bonds in response to Fed tapering announcement – and probably further outflows when Fed tightening starts.
- But ECB QE may provide a cushion, especially for CESEE.

 Source: Naradowy Bank Polski (NBP).

Reversal of divergence between US and EA central bank balance sheets has started, but will happen only very gradually

Central Bank Balance Sheets

January 2007 = 100



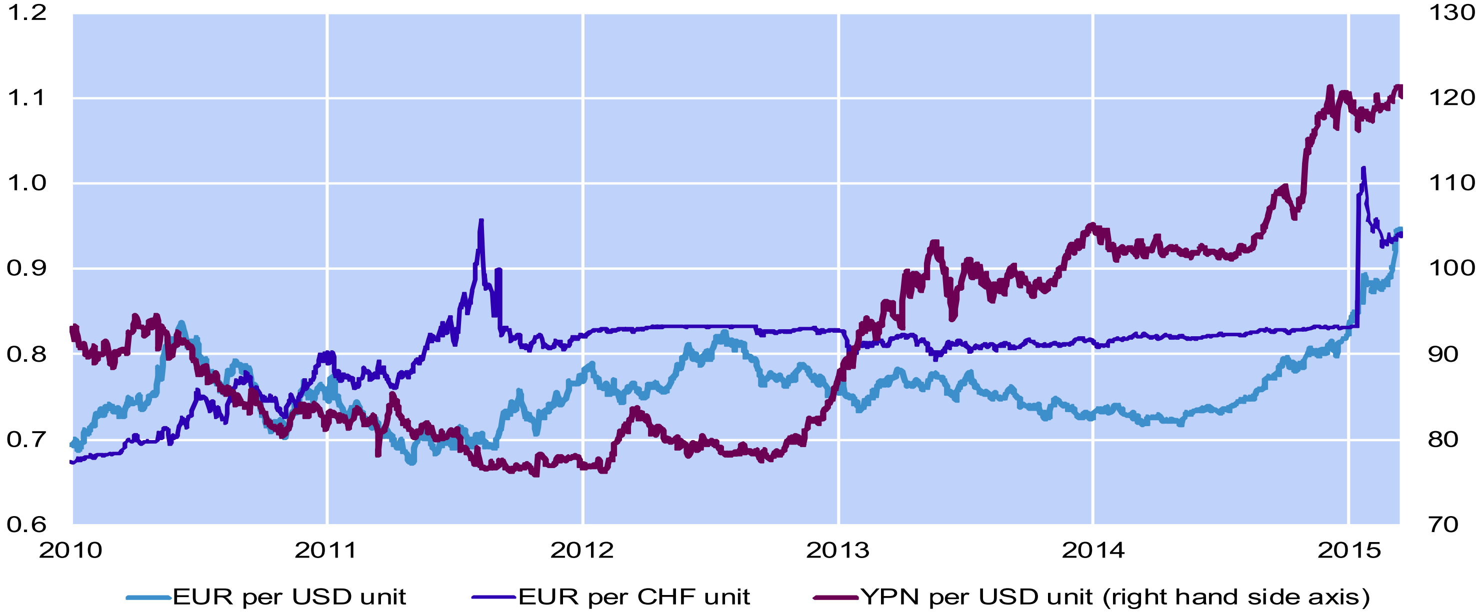
Source: Thomson Reuters.

Eurosystem's version of QE:

- Inflation outlook below mandate
- Expanded Asset Purchase Programme as of March 2015
  - Extension of existing programs for ABS and covered bonds to sovereign bonds to EUR 60 bn per month.
  - At least until September 2016; in any case until inflation rate below but close 2% in the mid-term.
  - Risk-sharing for 20% of purchases (ECB's share 8%, securities of European Institutions 12%).
- Reduction of interest rate for targeted longer-term refinancing operations (TLTROs) by 10 bp to the MRO rate

Opposite monetary policy outlook impacts on exchange rates: Appreciation of USD and CHF against EUR and JPY 2014/2015

Exchange rates of EUR and JPY to the USD and the CHF



Source: Thomson Reuters.

- Expectations of Fed tightening and EA QE strengthened the USD and led the SNB to scrap its cap on the CHF. → CHF appreciation challenges CESEE countries with substantial share of CHF loans to households (Poland, Croatia, Romania).
- The stronger USD contributed to the lower oil price, conform to its inverse relation of the past. Lower energy and metal prices have already had an impact on the euro area and on CESEE economies, also by reinforcing deflationary pressures.

Conclusions: Most CESEE countries will face challenging times for monetary and exchange rate policy

- For most CESEE countries, Eurosystem‘s QE may well induce more capital inflows than the capital outflows resulting from Fed tightening.

- Thus, yields (and spreads) are likely to decline even further and currency appreciation pressures are likely to emerge
  - implying risks for the currency peg or cap, or else
  - implying risks for price developments, as deflationary pressures will rise.

- Fixed-peggers will have to respond with FX interventions, expanding the central bank balance sheet
- Floaters may respond by a mixture of interest rate cuts (to negative levels) and FX interventions.

→ *Euro area policy spillovers further enhance the similarity of challenges for monetary and exchange rate policy in the CESEE region with those in the euro area.*