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CEE bond markets - the new "AAA“?

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Downside risks inside the (whole!) Eurozone: The "core" Eurozone not AAA anymore

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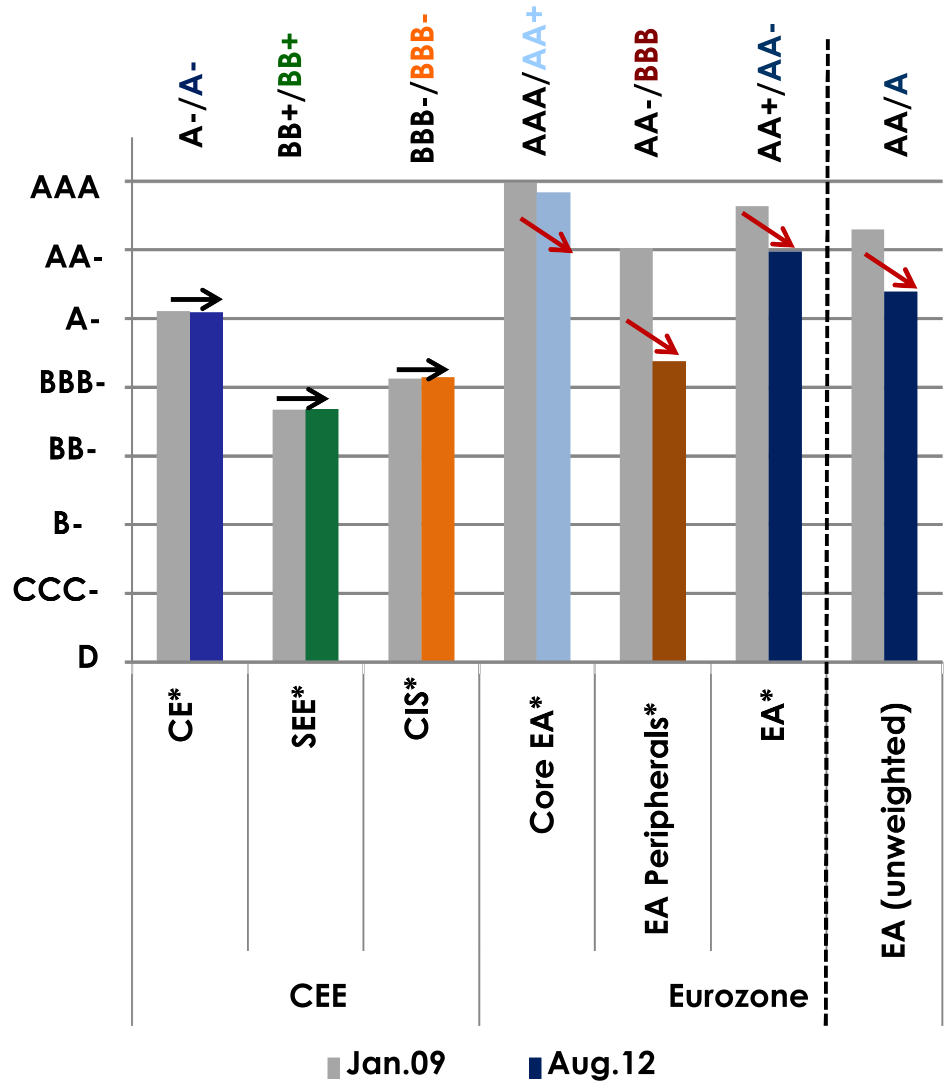
- Major downside surprises on the rating front in the Eurozone Peripherals (EA Peripherals) …

… and up to a certain extent also in the core Eurozone countries, which are no "AAA" anymore



CE: PL, CZ, SK, HU, SI, SEE: BG, RO, HR, CIS; RU, UA, BY

Core EA: DE, FR, AT, BE, NL; EA Peripherals: ES, IT, PT, IE

Source: S&P, Raiffeisen RESEARCH

** GDP weighted regional S&P ratings, Source: S&P, Raiffeisen RESEARCH*

Risk repricing in Europe: Upward trend for all – Peripherals on the top

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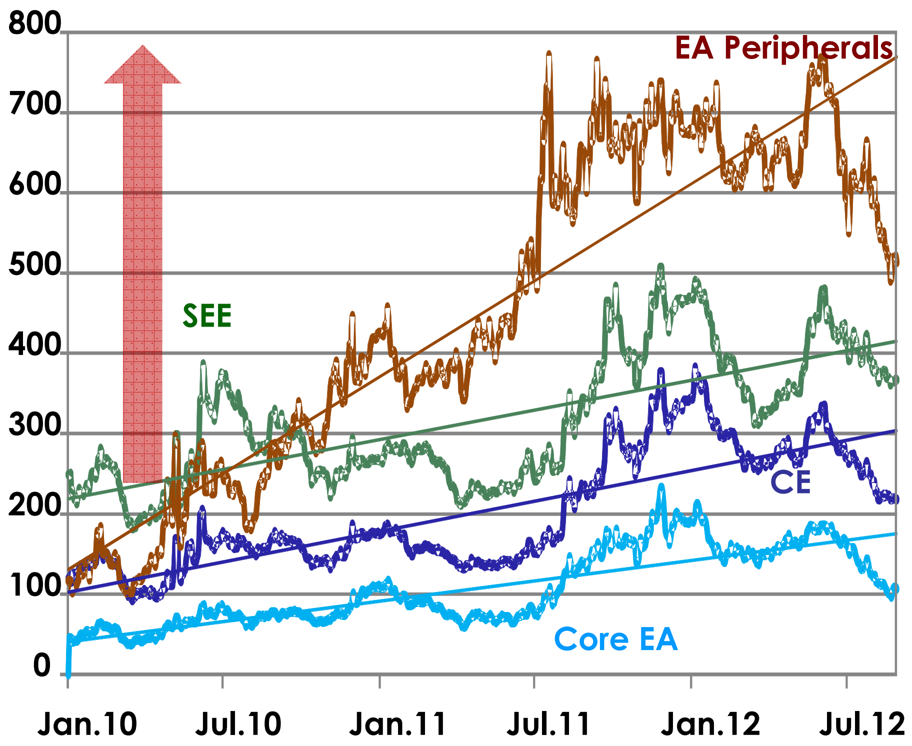
5-year sovereign CDS premia (bp)



CE: PL, CZ, SK, HU, SI

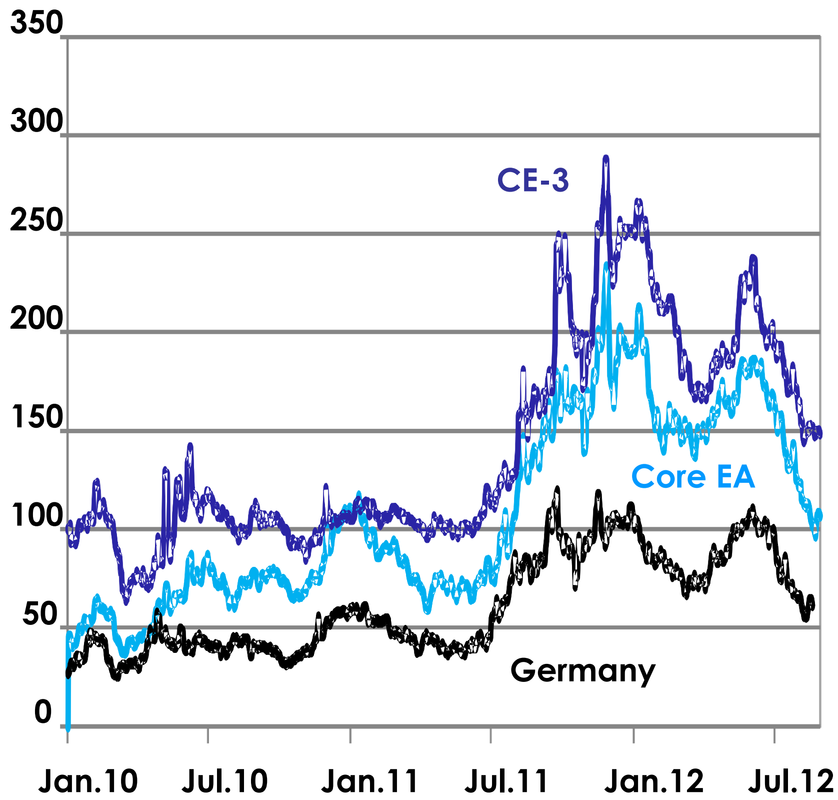
SEE: BG, RO, HR

Core EA: DE, FR, AT, BE, NL

EA Peripherals: ES, IT, PT, IE

Source: Bloomberg, Raiffeisen RESEARCH

5-year sovereign CDS premia (bp)



Core EA: DE, FR, BE, AT, NL

CE-3: PL, CZ, SK

Source: Bloomberg, Raiffeisen RESEARCH

What risk is currently repriced in Europe?
Is it the FISCAL? Yes and No!

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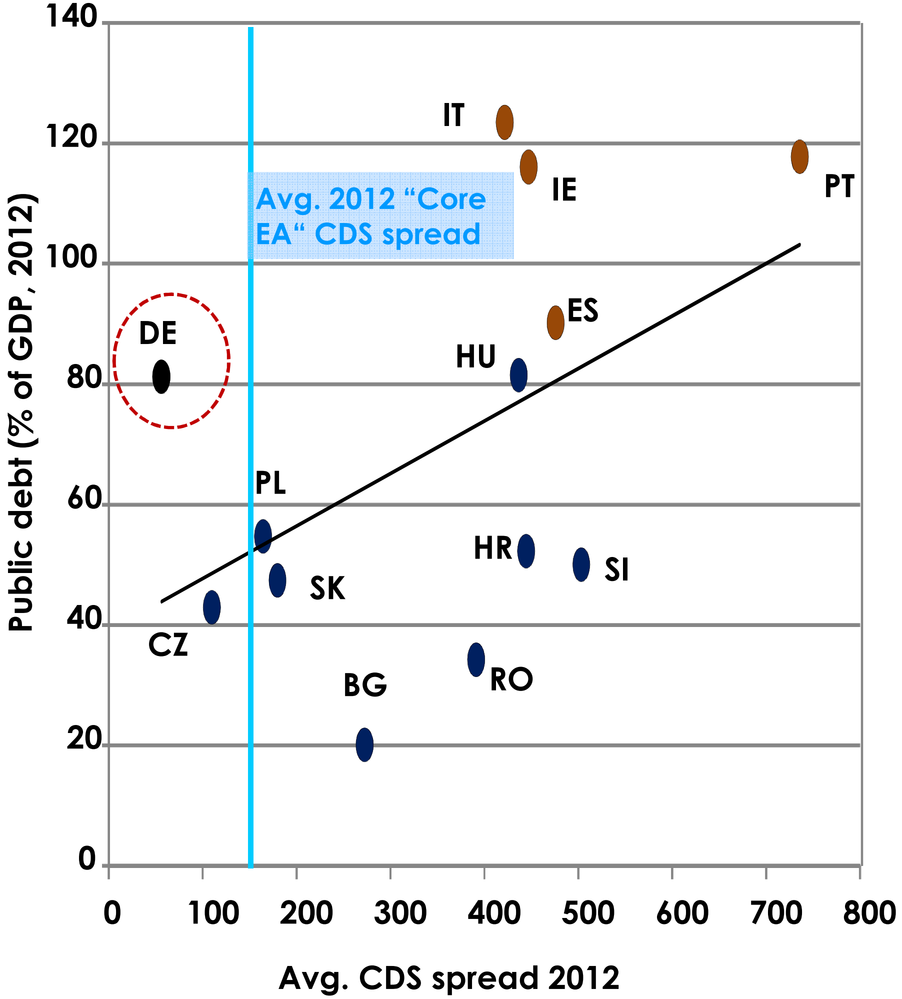
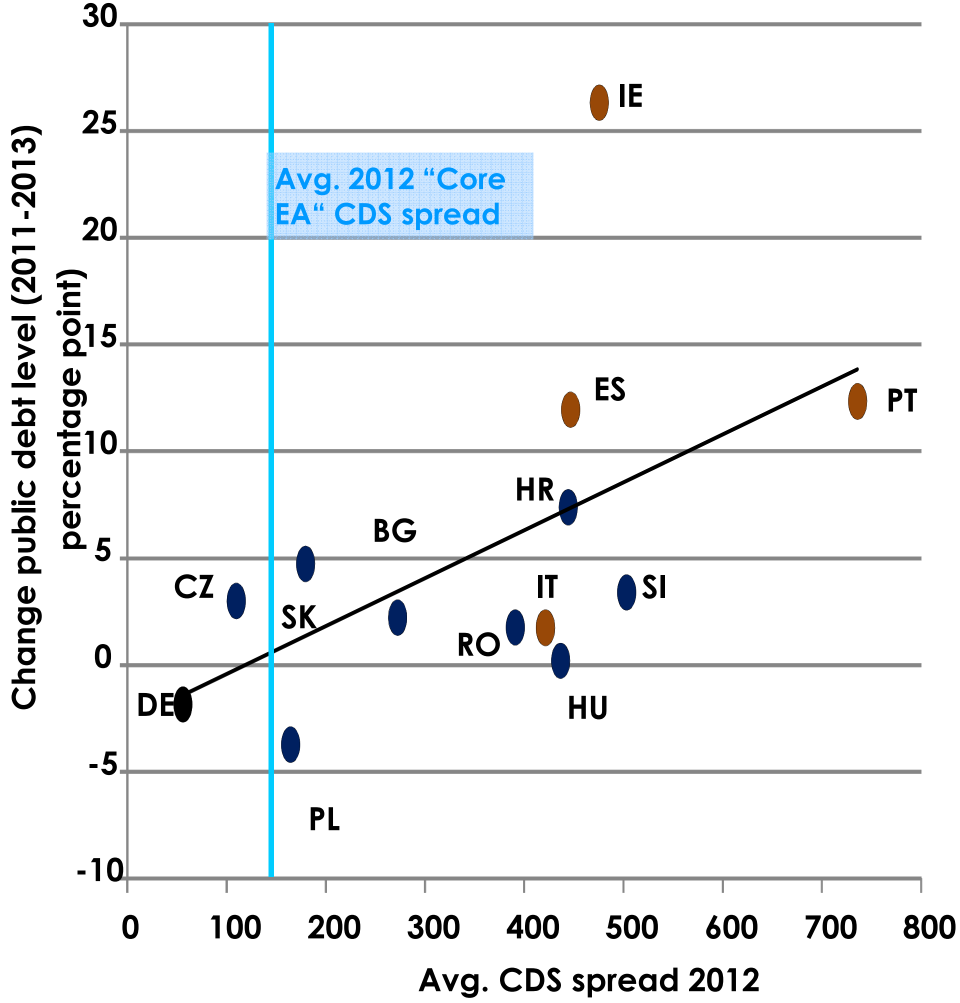
Public debt level vs. CDS premia



Change public debt level vs. CDS premia



Source: national sources, Eurostat, Bloomberg, Raiffeisen RESEARCH

What risk is currently repriced in Europe?
Is it the (external) FINANCING? Possibly yes

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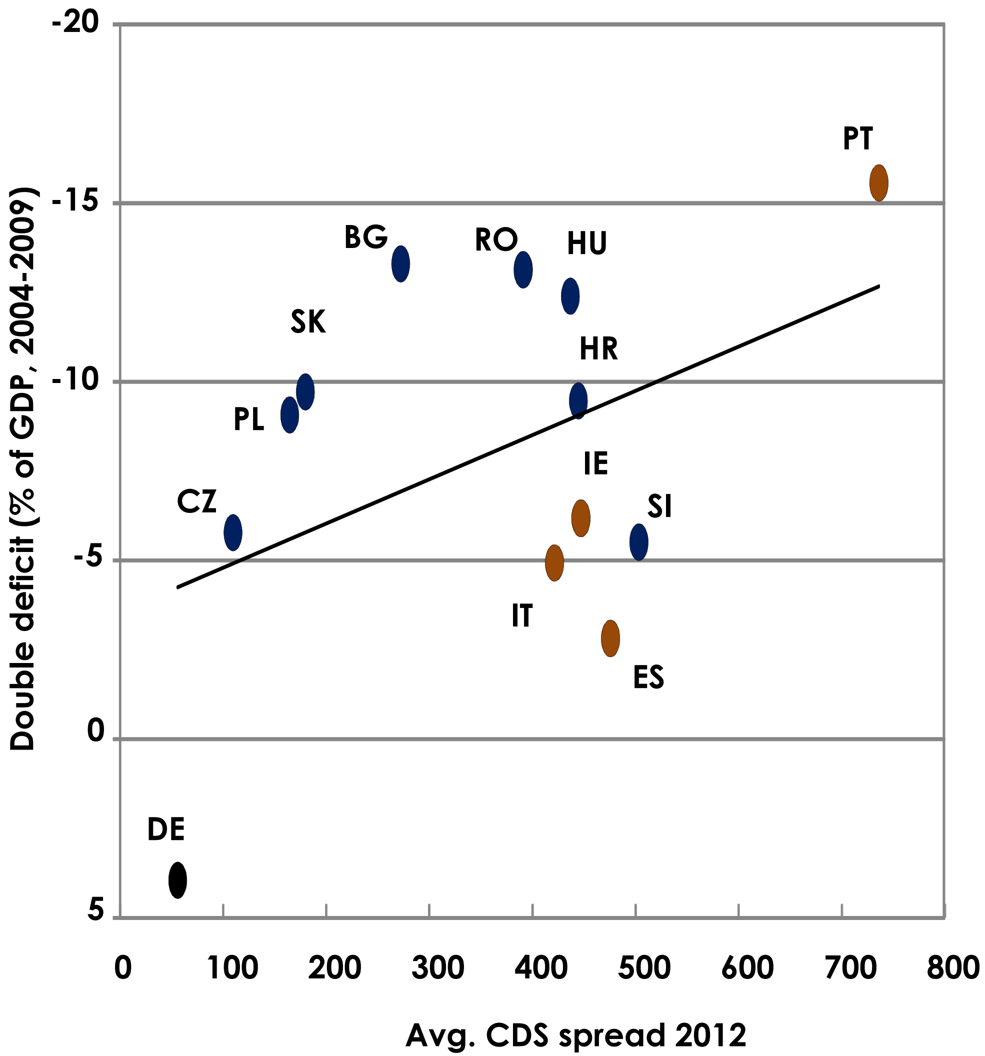
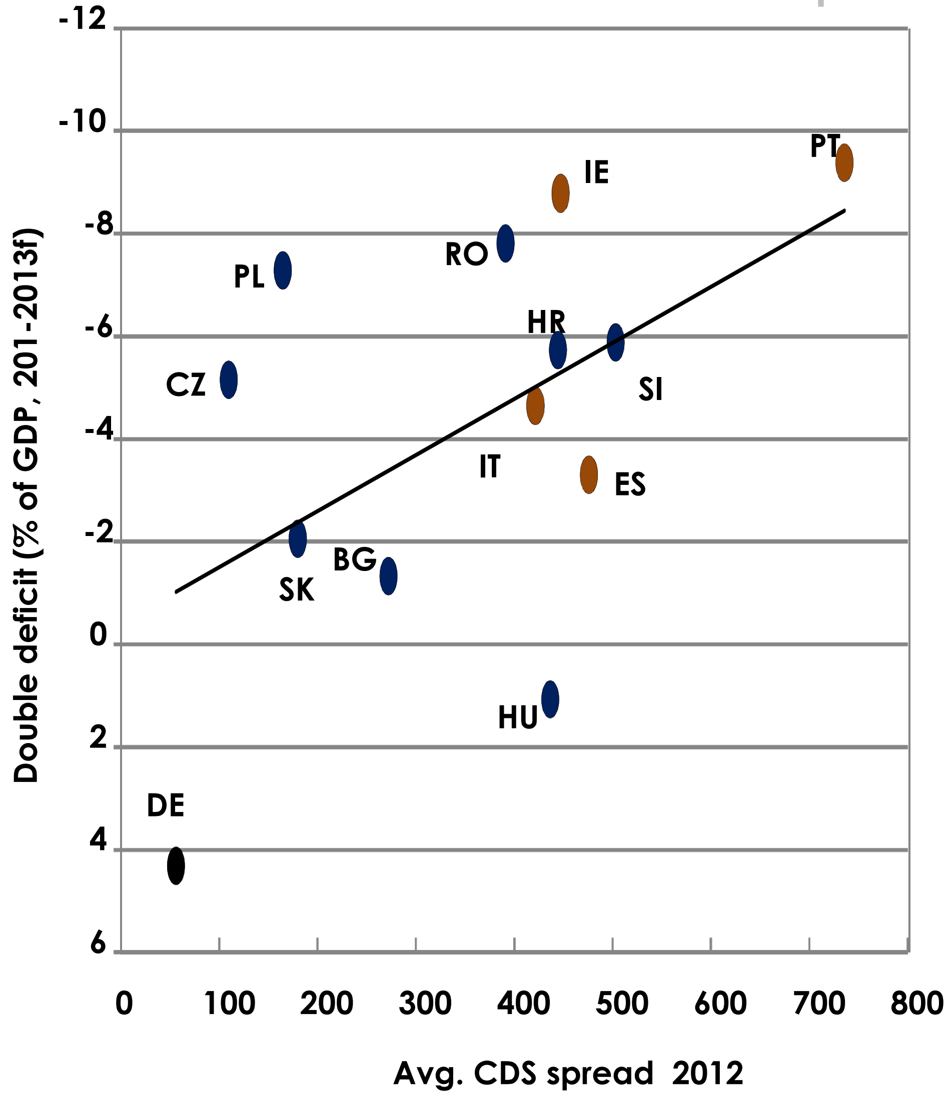
Pre-crisis double deficits vs. CDS premia



Post-crisis double deficits vs. CDS premia



Source: national sources, Eurostat, Bloomberg, Raiffeisen RESEARCH

What risk is currently repriced in Europe?
Is it the longer-term GROWTH? Possibly yes

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- **"Eurozone-Peripherals"** as **"ill-prepared" members** in a therefore **"suboptimal" currency area**

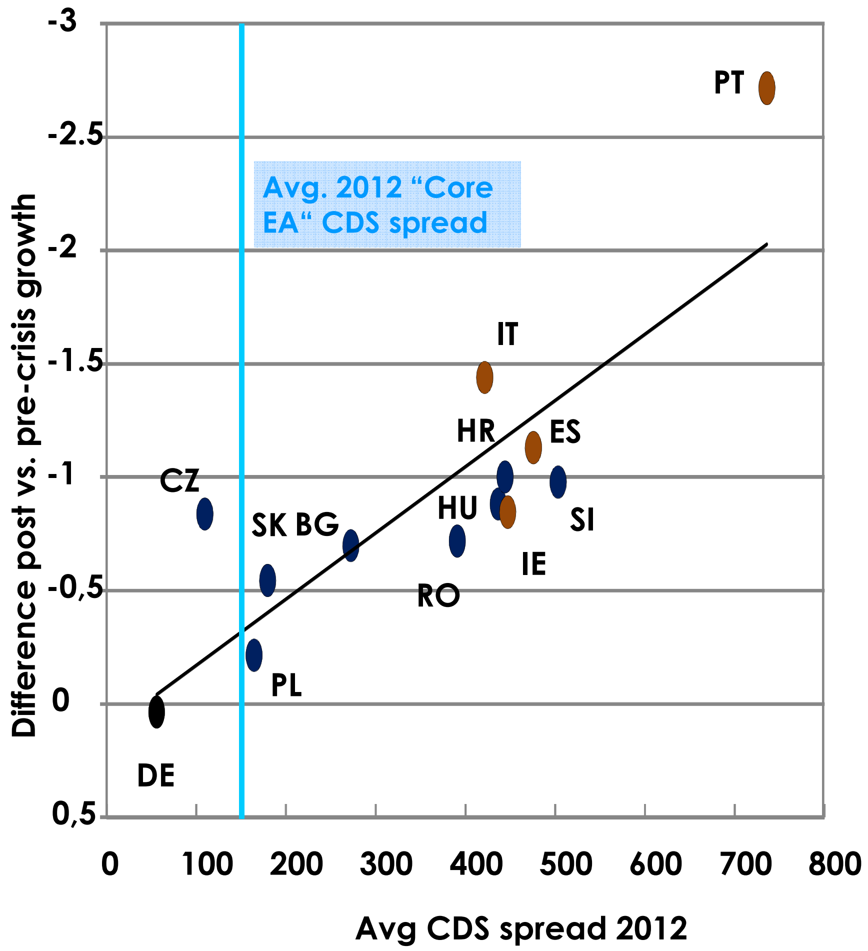
- **"Suboptimal currency area trap"** major driver of **current risk repricing** in Europe **(for the "Core" and "Periphery"!) ….**

… so think twice whether you are willing and able to enter the club and do not enter prematurely !!!

→ **Entering Eurozone is about joining a monetary union with Germany!** (at least up to now)

→ **Markets are pricing a few CEE sovereign credits fairly close to the "Core EA" countries** ("AA+" rated currently, "AAA" pre-crisis)

Pre- & post-crisis growth vs. CDS premia



Source: national sources, Eurostat, Bloomberg, Raiffeisen RESEARCH

CEE markets - the new AAAs?
But do not enter EMU too early!

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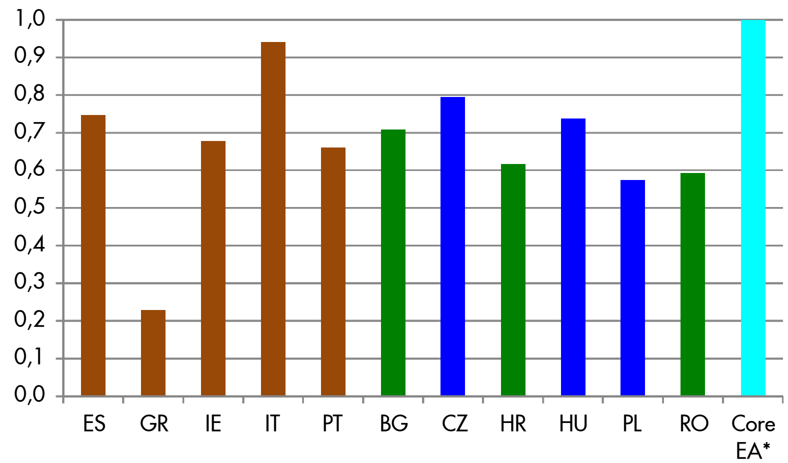
- "Economic Distance" scores based on GDP data (2000-2012) vis-à-vis the "core" EA only in the CE-3 countries below the levels in the "Peripherals"

- Most other CEE countries (although current EMU members SI and SK) at least as distant to the "core" EA than "Peripherals"

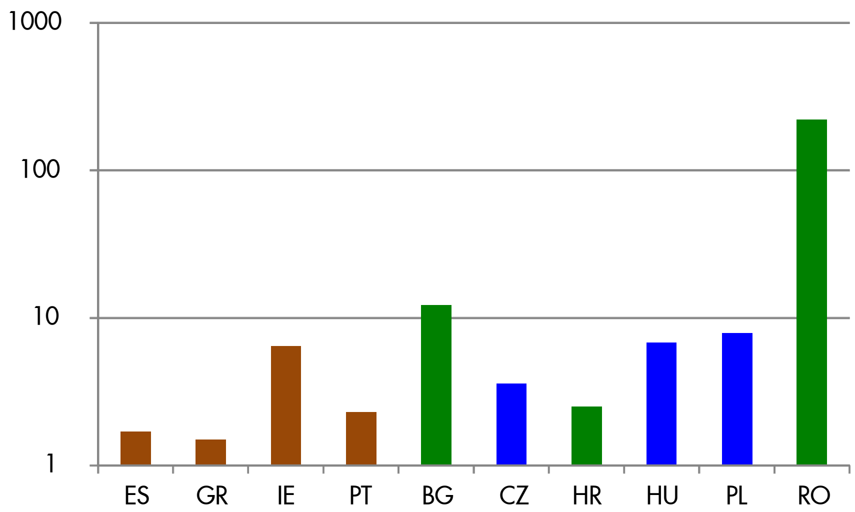
$$EconD_{GDP} = \left(\left(\frac{stdGDP_c}{stdGDP_{coreEMU}} \right)^2 + \left(1 - corr_{GDP_c \,\&\, GDP_{coreEMU}} \right)^2 \right)^{1/2}$$

$EconD_{GDP}$ = Economic $Distance_{GDP}$, $stdGDP_c$ = standard deviation of GDP growth in a country, $stdGDP_{coreEMU}$ = average standard deviation of GDP growth in the core EMU countries, $corr_{GDPc\&GDPcoreEMU}$ = coefficient of correlation between GDP growth in a country and average GDP growth in the core EMU countries

Correlation GDP growth vs. „core" EA



"Economic Distance" GDP growth (log. scale)



Source: Raiffeisen RESEARCH

CEE markets - the new AAAs? But do not enter EMU too early!

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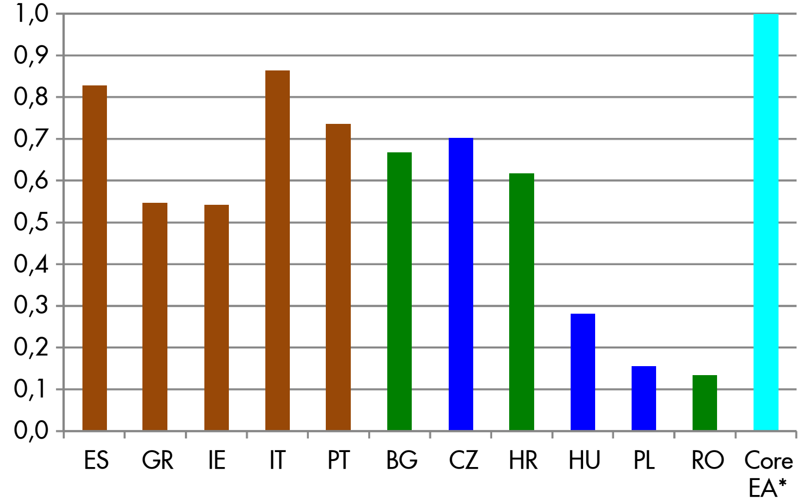
- "Economic Distance" scores based on CPI data (2000-2012) vis-à-vis the "core" EMU above the levels in the "EMU-Peripherals" in nearly all CEE countries

- Current EMU members SI and SK even more distant to the "core" EMU than the "EMU-Peripherals"

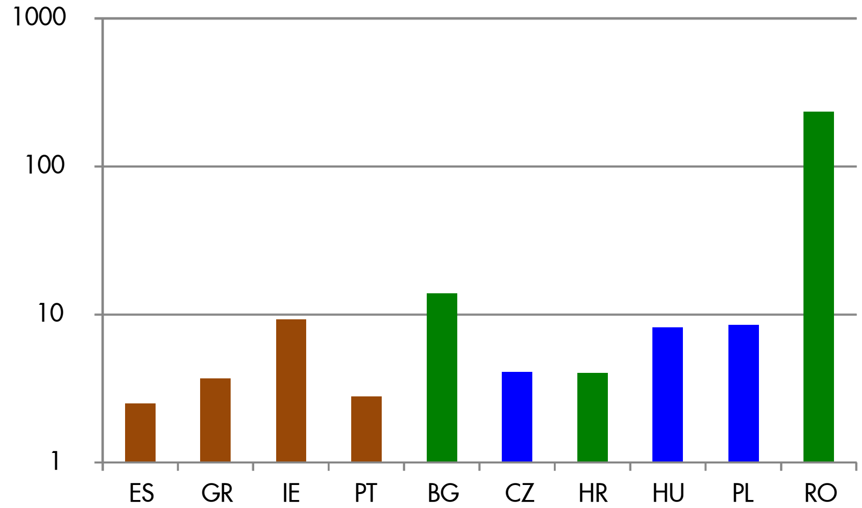
$$EconD_{CPI} = \left(\left(\frac{stdCPI_c}{stdCPI_{coreEMU}} \right)^2 + \left(1 - corr_{CPI_c \,\&\, CPI_{coreEMU}} \right)^2 \right)^{1/2}$$

$EconD_{CPI}$ = Economic $Distance_{CPI}$, $stdCPI_c$ = standard deviation of CPI in a country, $stdCPI_{coreEMU}$ = average CPI standard deviation in the core EMU countries, $corr_{CPI_c \& CPI_{coreEMU}}$ = coefficient of correlation between CPI in a country and the average CPI in the core EMU countries

Correlation inflation vs. „core" EA



"Economic Distance" inflation (log. scale)



Source: Raiffeisen RESEARCH

CEE markets - the new AAAs? CEE markets needs flexibility!

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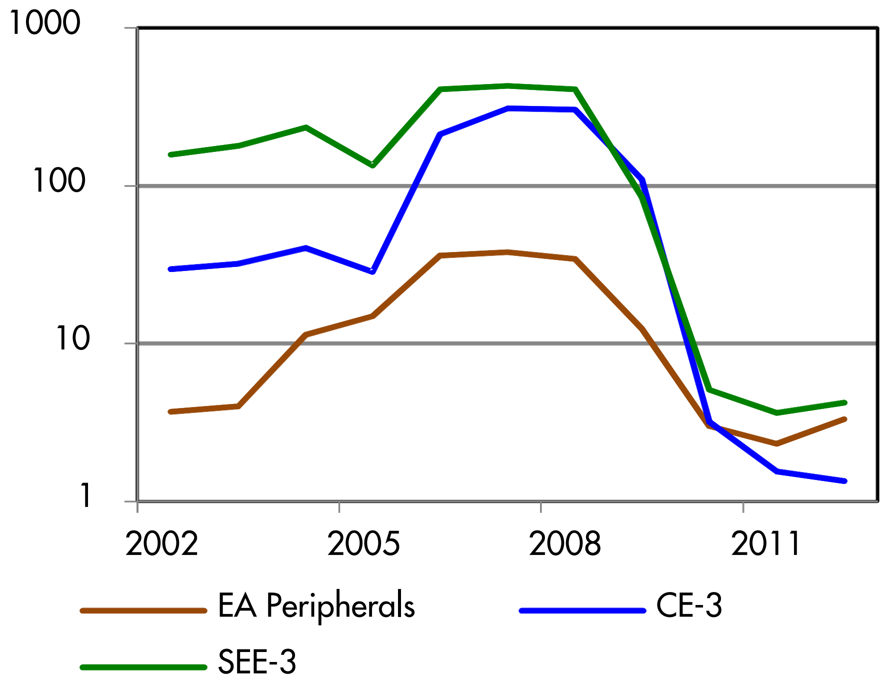
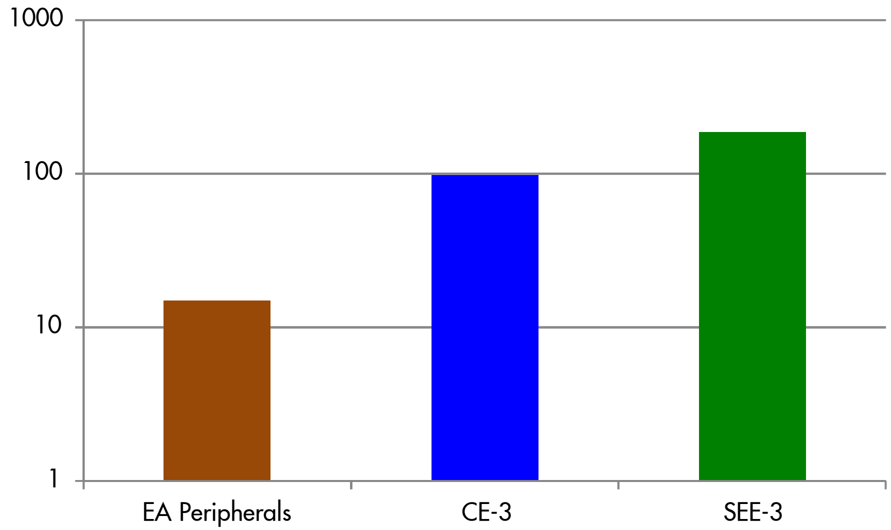
“Economic Distance“ GDP+inflation (log. scale)



Source: Raiffeisen RESEARCH

“Economic Distance“ GDP+inflation 2002-12 (log. scale)



$$CEconD = \left(\left(\frac{stdGDP_c}{stdGDP_{coreEMU}} \right)^2 + \left(1 - corr_{GDP_c \,\&\, GDP_{coreEMU}} \right)^2 \right)^{1/2} + \left(\left(\frac{stdCPI_c}{stdCPI_{coreEMU}} \right)^2 + \left(1 - corr_{CPI_c \,\&\, CPI_{coreEMU}} \right)^2 \right)^{1/2}$$

CEconD = Combined Economic Distance, $stdGDP_c$ = standard deviation of GDP growth in a country, $stdGDP_{coreEMU}$ = average standard deviation of GDP growth in the core EMU countries, $corr_{GDPc\&GDPcoreEMU}$ = coefficient of correlation between GDP growth in a country and average GDP growth in the core EMU countries, $stdCPI_c$ = standard deviation CPI in a country, $stdCPI_{coreEMU}$ = average CPI standard deviation in the core EMU countries, $corr_{CPIc\&CPIcoreEMU}$ = coefficient of correlation between CPI in a country and the average CPI in the core EMU countries

- **Overall “Economic Distance” to the “core” EMU only in the CE-3 countries (CZ, PL, HU) more or less at the levels of the “EMU-Peripherals”**

CEE markets - new AAAs the "Swedish way"? Local currencies to stay for longer time!

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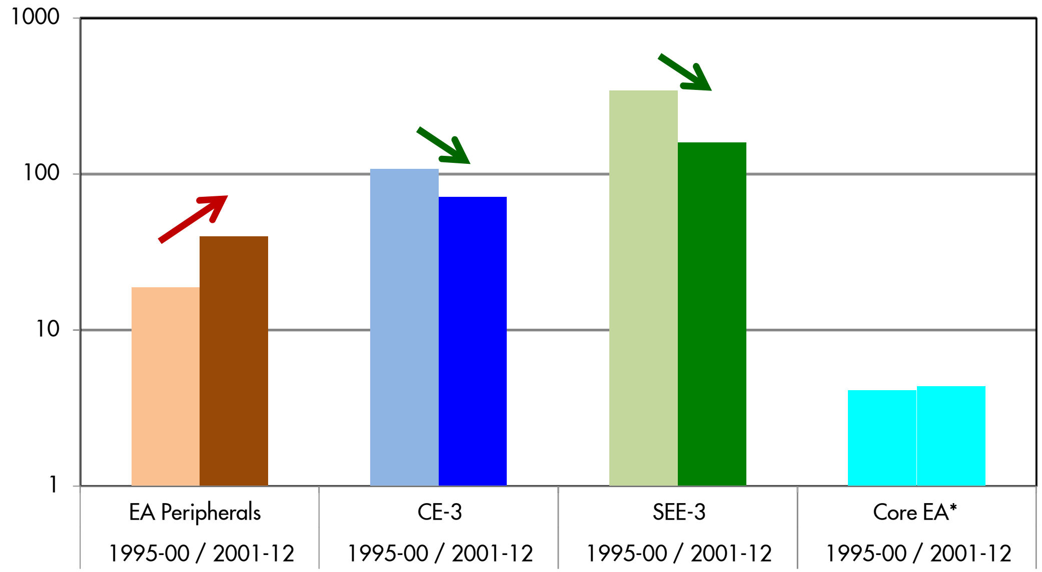
- Structural divergence to the "core" EMU (taking GDP growth, CPI trends, current account position and wealth level into account) even in the CE-3 countries above the levels in the "EMU-Peripherals"

- Increase of structural divergence in Eurozone "Peripherals" inside the Eurozone, vs. trend development in CE-3!

Structural divergence (GDP+inflation+C/A+GDP p.c.)



Source: Raiffeisen RESEARCH

$$StD_{II} = \left(1/4*(GDP_c - GDP_{coreEMU})^2\right) + \left(1/4*(CPI_c - CPI_{coreEMU})^2\right) + \left(1/4*(CA_c - CA_{coreEMU})^2\right) + \left(1/4*(GDPpc_c - GDPpc_{coreEMU})^2\right)$$

StD_{II} = Structural Divergence score II, GDP_c = GDP growth in a country, $GDP_{coreEMU}$ = average GDP growth in the core EMU countries, CPI_c = CPI in a country, $CPI_{coreEMU}$ = average CPI in the core EMU countries, CA_c = current account balance in a country, $CA_{coreEMU}$ = average current account balance of the core EMU countries, $GDPpc_c$ = GDP per capita at PPP of a country, $GDPpc_{coreEMU}$ = average GDP per capita at PPP in the core EMU countries

CEE markets – No front-loaded EMU enlargement

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Eurozone enlargement outlook: Expected ERM-II and EMU entry dates*

Likelihood of entering ERM-II in a specific year	2012	2013	2014	2015	2016	2017	2018	2019	2020	*Other outcomes*
Poland	0%	0%	**5%**	**30%**	**25%**	**20%**	**10%**	**5%**	0%	**5%**
Hungary	0%	0%	**5%**	**5%**	**5%**	**10%**	**15%**	**20%**	**20%**	**20%**
Czech Republic	0%	0%	**3%**	**15%**	**6%**	**2%**	**3%**	**25%**	**6%**	**40%**
Bulgaria	0%	15%	**45%**	20%	10%	5%	5%	0%	0%	0%
Romania	0%	0%	5%	35%	**45%**	10%	0%	0%	0%	**5%**
Croatia	0%	0%	0%	10%	**50%**	25%	5%	5%	5%	0%

Likelihood of entering EMU in a specific year	2012	2013	2014	2015	2016	2017	2018	2019	2020	*Other outcomes*
Poland	0%	0%	0%	0%	5%	30%	**35%**	15%	10%	5%
Hungary	0%	0%	0%	0%	5%	5%	5%	10%	**15%**	**60%**
Czech Republic	0%	0%	0%	0%	0%	3%	**15%**	**15%**	0%	**67%**
Bulgaria	0%	0%	0%	15%	**35%**	35%	5%	5%	5%	0%
Romania	0%	0%	0%	0%	10%	25%	**40%**	15%	5%	5%
Croatia	0%	0%	0%	0%	0%	5%	30%	**40%**	20%	5%

** Dates with the highest likelihood marked in* ***red***

Source: Raiffeisen RESEARCH

CEE markets - Local currencies to stay for longer time!

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→ Business implications:

- FX markets, FX business/risks and LCY bond markets will stay for longer
- Developing LCY bond markets gains in attractiveness for sovereigns, banks, investors
- Investors can at least ride on 1-2 more monetary policy cycles
- Some “high quality” CE currencies with potential to strengthen their role as “niche currencies”

Contacts

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Many thanks for your attention!

Any questions? Happy to discuss!

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References

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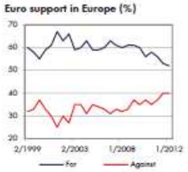
If you like it more practical-oriented …

Special
EMU entry monitoring
11 September 2012
Raiffeisen RESEARCH

Source: evlen001/sxc.hu

Euro support in Europe (%)



* Support for EMU in the EU (not EMU)
Source: Eurostat, Eurobarometer

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Eurozone membership revisited in CEE

- **Entering European Monetary Union (EMU) out of fashion in CEE, no EMU entry may take place in the next 3-5 years**
- **Cautious EMU entry strategies warranted from fundamental point of view and taking recent setbacks inside the EMU into account**
- **Most EMU candidates from CEE at least as distant from/close to "core" Eurozone than current EMU Peripherals based on several indicators**
- **Postponed EMU entry with important implications for financial markets**

Sustainable degree of nominal and real convergence indispensable

Even if a candidate is able to fulfil the nominal Maastricht entry criteria at one point in time, entering the European Monetary Union (EMU) or Euro Area (EA) is not always an optimal strategy at every point in time. There is sufficient evidence that both a sustainable degree of nominal and real convergence vis-á-vis the so called "core" Eurozone countries (e.g. Germany, Netherlands, Austria, France) are indispensable before joining EMU. This aspect is in the mutual interest of every current and future EMU member. The basic understanding that both nominal and real convergence do matter is crucial for CEE. Recent crisis years put an end to the credit- and demand-driven boom-bust cycles in many CEE countries. Hence, some CEE countries came closer to the EMU in terms of fulfilling the hard but unsophisticated nominal Maastricht entry criteria – at least at one point in time.
However, if a candidate country does not come up with a sustainable level of real convergence, joining the EMU could become a costly enterprise. ECB's monetary policy stance in particular – for the most part determined by the "core" EMU members – may turn out as inappropriate. Moreover, in the absence of basic tools (i.e.

Likelihood of entering ERM-II in a specific year*

	2012	2013	2014	2015	2016	2017	2018	2019	2020	Other outcomes
Poland	0%	0%	5%	**30%**	25%	20%	10%	5%	0%	5%
Hungary	0%	0%	5%	5%	5%	10%	15%	**20%**	**20%**	**20%**
Czech Republic	0%	0%	3%	15%	6%	2%	3%	**25%**	6%	**40%**
Bulgaria	0%	15%	**45%**	20%	10%	5%	5%	0%	0%	0%
Romania	0%	0%	5%	20%	**30%**	25%	10%	0%	0%	10%
Croatia	0%	0%	0%	10%	**50%**	25%	5%	5%	5%	0%

Likelihood of entering EMU in a specific year*

	2012	2013	2014	2015	2016	2017	2018	2019	2020	Other outcomes
Poland	0%	0%	0%	0%	5%	25%	**40%**	15%	10%	5%
Hungary	0%	0%	0%	0%	5%	5%	5%	10%	**15%**	**60%**
Czech Republic	0%	0%	0%	0%	0%	3%	**15%**	**15%**	0%	**67%**
Bulgaria	0%	0%	0%	15%	**35%**	**35%**	5%	5%	5%	0%
Romania	0%	0%	0%	0%	10%	20%	**25%**	**25%**	10%	10%
Croatia	0%	0%	0%	0%	0%	5%	30%	**40%**	20%	5%

* most likely outcome bold
Source: Raiffeisen RESEARCH

If you like it more academic …

Economic Distance and Divergence in Europe – When Central and Eastern Europe (CEE) will be able to join EMU?

Gunter Deuber and *Stephan Csaba Imre**

I. Introduction

Recent adverse developments inside the European Monetary Union (EMU) have shown the imperative need of a sufficient degree of real economic convergence in order to secure the sustainability of nominal convergence in EMU member countries. It also became evident that a sustainable degree of nominal and real convergence before joining EMU is in the mutual interest of every current and future EMU member state. Otherwise the centralised monetary policy of the European Central Bank (ECB) may turn out as inappropriate. The absence of monetary and nominal exchange rate flexibility as tools to stabilise the domestic economy in case of economic shocks can cause a challenging situation in EMU members without a sufficient degree of nominal and real convergence. These lessons learned are of importance for all remaining EMU candidates, most of them being current or future EU members located in Central and Eastern Europe (CEE).

From a conceptual point of view EMU membership represents a complex trade-off between several costs and benefits, while a distinction should be made between the initial conditions. This holds especially true with regards to the monetary and exchange rate regimes before EMU accession – i.e. whether an EMU candidate runs a currency board or floating exchange rate regime – but also to the degree of indebtedness in foreign currency (FCY). Moreover, an EMU entry is associated with more complex opportunity costs apart from one-time logistical costs or the risk of an improper fixing of the conversion rate to the EUR. Firstly, entering EMU entry automatically asks for a decreasing room

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