Highlights

Selected Abstracts

The selected abstracts below alert readers to studies on CEE topics in other OeNB publications. You may find the full-length contributions at *www.oenb.at*.

Price Level Convergence in Europe: Did the Introduction of the Euro Matter?

Jesús Crespo Cuaresma, Balázs Égert, Maria Antoinette Silgoner

Several theoretical arguments suggest that price level divergence across EU countries has diminished in the course of the European integration process as a result of both product market integration and the introduction of the common currency. In this paper, we empirically assess this hypothesis for the euro area countries and a group of control countries since 1990, using price level data on over 160 products and services in 27 European cities. Our conclusions confirm that price convergence took place at the beginning of the 1990s. There is, however, not much evidence that the introduction of the single currency has led to a further narrowing of price differentials. In fact, price dispersion has remained remarkably stable in recent years, whereas it has increased slightly since 2003 in the control group.

Published in Monetary Policy & the Economy 1/07.

The Euro on the Road East: Cash, Savings and Loans

Peter Backé, Doris Ritzberger-Grünwald, Helmut Stix

The euro is already present throughout Central, Eastern and Southeastern Europe today. Against this backdrop, the OeNB has been regularly conducting household opinion polls for years in the countries that make up this economic space. The survey questions place special emphasis on euro cash holdings. The results show that the choice to hold euro cash is based on a wide variety of motives, above all geographic proximity, coupled with increasing economic interlinkages, the desire to minimize risk, and tradition. Decisions to have savings in euro or to take out euro-denominated loans can be attributed to similar considerations. In addition, macroeconomic factors such as inflation and exchange rate expectations may also play a role. What clearly emerges is that the extent of currency substitution varies considerably from country to country. In terms of cash, Slovenia, which was about to adopt the euro at the time of the most recent poll, is the frontrunner (approximately 40% of the population reported euro cash holdings in the second half of 2006). Hungary is last, with only a 7% rate. In terms of savings and loans, Croatia posts the highest percentage according to both the OeNB survey and the aggregated bank balance sheet data (approximately 80% of all savings deposits and/or borrowings of households and enterprises are denominated in foreign currency). At the opposite end of the spectrum is the Czech Republic, a country with approximately 10% in both areas.

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Booming, but Risky: The Ukrainian Banking Sector – Hot Spot for Foreign Strategic Investors

Stephan Barisitz

This paper gives an overview and assessment of the evolution of the Ukrainian banking sector since the outset of transition, focusing on the most recent developments. While the 1990s saw turbulent changes against the backdrop of continuous economic contraction, the Ukrainian banking sector has been on a strong expansion path ever since the turn of the millennium, a path which appears to have been only briefly interrupted by the minor crisis of late 2004 and early 2005. Although the National Bank of Ukraine has certainly improved banking regulations and supervision, the country's credit boom (sevenfold real increase of credit volume between 2000 and 2005, albeit from a modest base) has raised serious concerns about credit risks. Financial fragility continues to loom large in an environment where the practice of "pocket banking" (credit institutions acting as extended financial departments of owner firms) is still widespread. Over the past months, foreign strategic investors have started to move in: Led by Raiffeisen, which purchased the second-largest Ukrainian bank in October 2005, takeovers and business expansions have raised foreigners' share in total banking assets from 13% to 26% within a year. Austrians account for somewhat less than half of all foreign-owned banking assets in Ukraine.

Published in Financial Stability Report 12.

Stress Testing the Exposure of Austrian Banks in Central and Eastern Europe

Michael Boss,
Gerald Krenn,
Claus Puhr,
Markus Schwaiger

Austrian banks are heavily engaged in Central and Eastern European (CEE) markets primarily by running local subsidiaries but also by extending cross-border loans. We give an account of the historical development and the status quo of these exposures and conduct a stress test for the Austrian banking system with respect to its credit exposure vis-à-vis the CEE region. Our test is based on an analysis of the current state of the local banking systems from a risk perspective, inter alia drawing on stress testing experiences gained by the national central banks and the International Monetary Fund. We use a stress scenario that (i) takes account of the differences in host country risks and (ii) represents a worst case that deliberately exceeds historical shocks. It turns out that, despite the dramatic worsening of the economic environment implied by the scenario, the Austrian banking system is not put at risk by the hypothesized crisis. The possible repercussions of a crisis in a single country via solvency problems of the Austrian parent institution turn out to be limited.

Published in Financial Stability Report 13.

Banking Efficiency and Foreign Ownership in Transition: Is There Evidence of a Cream-Skimming Effect?

Jaroslav Borovička

This paper revisits the issue of cost efficiency in the banking sector and the role of foreign ownership in European transition economies. The novelty of our approach is that we instrument for the decision of foreign investors to acquire domestic banks. This analysis allows us to evaluate the endogeneity bias that results from the so-called cream-skimming effect. Using a sample of 282 banks in 19 transition countries, we employ a two-stage instrumental variable approach. In the first stage, we estimate the probability of foreign acquisitions of domestic banks by implementing a panel probit model. In the second stage, the estimated propensity scores are used in the Battese and Coelli (1995) stochastic efficiency frontier specification. Although cost differences may also be caused by different product characteristics, our main finding is that the instrumental variable approach reveals that foreign ownership has a negative impact on cost efficiency. This observation indicates that in the transition countries studied the cream-skimming effect is significant, which implies that foreign investors tend to acquire the most cost efficient banks in the first place.

Published in Financial Stability Report 13.

The Changing Landscape of FDI in Europe

The OeNB's Conference on European Economic Integration 2006

Compiled by Maria Antoinette Silgoner[1]

The OeNB's third Conference on European Economic Integration (CEEI, the successor of the East-West Conference) took place from November 20 to 21, 2006, in Vienna. The OeNB organized the CEEI 2006 together with the European Bank for Reconstruction and Development (EBRD). The conference was entitled "The Changing Landscape of FDI in Europe" and covered a broad range of topics, such as global foreign direct investment trends, the effects of foreign direct investment (FDI) on home and host countries, policies to attract FDI and corporate FDI experiences, all with a special focus on the countries of Central, Eastern and Southeastern Europe (CESEE).

As in recent years, the conference met with an impressive response, with around 250 – partly high-ranking – participants coming from 30 countries, including balance of payments experts from international institutions, national central banks and ministries as well as researchers from renowned universities. The program featured keynote lectures, panel discussions and the presentation of academic research.

The conference was opened by OeNB Governor Klaus Liebscher, who highlighted the European perspective of FDI. At the very origin of the European integration project stood the hypothesis that economic – and later monetary – integration would boost trade and FDI flows, thus enhancing growth and the catching-up process. Indeed, empirical evidence and the most recent data support this hypothesis: In 2005, the European Union (EU) attracted almost half of all funds invested worldwide. The same year, FDI inflows into all ten new EU Member States (NMS) rose by 19%, reaching new record levels. Austria has for decades profited from outward and inward FDI flows, first as a typical FDI host country, but in recent years also as an increasingly active investor CESEE countries. Today Austria is the top investor in several countries in this region, but is facing more and more competition from what used to be typical FDI host economies, Governor Liebscher concluded.

In his opening remarks, Manfred Schepers, Vice President of the EBRD, focused on the importance of FDI for promoting transition. FDI brings innovation, new skills and risk management techniques; it promotes competition, forces domestic incumbents to become more productive, and provides forward and backward linkages. The EBRD continues to be the biggest investor/financier in Central and Eastern Europe (CEE). The bank invests about USD 4 billion in the region every year. The new EU Member States are expected to graduate from EBRD assistance within the next five years – which is an indication of the success of the strategy, Shepers underlined.

In his keynote lecture, Robert Lipsey, Director of the New York Office of the National Bureau of Economic Research (NBER), provided a comprehensive overview of the international literature on the effects of FDI, both on home

[1] *On the basis of notes taken by Stephan Barisitz, Balázs Égert, Gabriel Moser, Wolfgang Pointner, Thomas Reininger, Thomas Scheiber, Josef Schreiner, Tomas Slacik and Zoltan Walko.*

and host countries, and using balance of payments as well as micro data. According to Lipsey, the success of countries like Ireland and China, which have achieved strong growth through strategic foreign investment, has motivated many economies to follow the example and open up to FDI. In his opinion, the most efficient policy measures to attract FDI are removing impediments, improving governance and creating reliable and predictable legal systems. FDI in CEE led to improvements at all levels of governance in the years before EU entry, but reform fatigue has set in since. While there is unequivocal evidence of productivity gains by foreign producers, evidence on crowding out of domestic players or on productivity spillovers to domestic firms is far less clear. In the ensuing lively and fruitful discussion, Lipsey stressed that fears of adverse home country effects of FDI may be exaggerated, but that structural adjustment was necessary to move the investor country up the skills ladder.

The first session of the day, chaired by Peter Mooslechner (OeNB), dealt with trends, patterns and determinants of FDI, both at a global level and from the Austrian perspective. Blanka Kalinova of the Organisation for Economic Co-operation and Development (OECD) elaborated on policy barriers to FDI, differentiating between restrictive product and labor market regulations and FDI-specific restrictions. According to OECD estimates, the alignment of product market regulations and FDI restrictions with the level of the most liberal OECD country would increase the total OECD inward FDI position by as much as 20%. Kalinova appealed to policymakers to reduce FDI protectionism, to enhance policy transparency, and to extend and encourage the acceptance of international investment policy standards.

Laura Resmini of Università Bocconi, Milano, provided an overview of the major determinants of FDI, focusing on locational advantages of individual countries. She noted that the impact of policy variables on FDI was less clear and less important than that of economic variables. Resmini emphasized that FDI in European transition countries has remained highly concentrated, both at a sectoral and at a geographical level. Competition for FDI funds is a phenomenon that takes place primarily between regions rather than across national borders. Especially in high-tech sectors this can be attributed to agglomeration effects.

René Dell'mour from the OeNB focused on the Austrian perspective of the changing landscape of FDI. Austrian FDI flows started to skyrocket following the fall of the Iron Curtain and Austria's application for EU membership in 1989. While inward FDI comes primarily from the EU-15 countries, outward FDI goes mostly to Central, Eastern and Southeastern Europe. In this context, Dell'mour highlighted Austria's role as a "bridgehead" for multinational enterprises, which can explain the simultaneous development of Austrian inward and outward FDI.

In the last presentation of this session, Arjan Lejour of Netherlands Bureau of Economic Policy Analysis focused on the specific patterns of FDI in the services sector, which account for 60% of total FDI flows. He attributed the large and growing weight of the service sector in total European FDI to the capital market and services liberalization, the increased services intensity of manufacturing and the trend toward outsourcing. Turning specifically to CEE, Lejour stressed that services FDI in the region was below its potential. Its stock could be raised by 50% to 80% if regulatory reforms, anti-corruption efforts and improvements in tax administration were stepped up. At the EU level, Lejour expressed some disappointment about the potential benefits of the European Services Directive in its approved form. A complete elimination of barriers to services trade and investment in the EU may potentially increase FDI stock by as much as 200%.

The second session, chaired by Manfred Schekulin, Director at the Austrian Federal Ministry of Economics and Labour, investigated the question of "How to attract sustainable investment." The emphasis in the session's title is on the term sustainable, as measures to attract FDI need to be supplemented by efforts to maximize the beneficial effects of FDI also for the domestic economy.

As an introduction to the session, EU Commissioner László Kovács, Directorate Taxation and Customs Union, gave a keynote speech on "Tax Harmonization for Growth, Jobs and Competitiveness." He pointed out that many of the remaining barriers to the Single Market relate to the differences in tax systems across the EU countries, which impair transparency and thus competition in the Single Market and may harm the global competitiveness of European companies. The European Commission therefore strongly advocates as broad and simple as possible a harmonization of the tax base. What is not intended, however, is the harmonization of tax rates. The Commissioner did not exclude proceeding with his proposal with only a subgroup of EU countries if no broad consensus could be found.

In the first presentation of the session, Christian Bellak of the Vienna University of Economics and Business Administration elaborated on policies to attract FDI in Central and Eastern European countries (CEECs). He saw two strategies for countries in more mature phases of transition: a "low-wage, low-tech" and a "high-wage, high-tech" specialization strategy. Bellak argued that the attraction of sustainable FDI requires a match between the location factors of a host country and the particular value-added stages of foreign firms. He concluded that the CEECs should shift their focus from the provision of incentives and general location factors to more specific bundles of location factors for closely defined activities.

Summarizing evidence from the past two decades, Theodore H. Moran from Georgetown University reported that FDI as a means of import substitution in often protected domestic markets has failed to achieve sustainability as it does not promote the emergence of autonomous, mature industries. By contrast, export market-oriented FDI, typically an integral part of the parent companies' global supply chain, seems to have more beneficial effects on the home economy and is, moreover, not restricted to simple assembly operations with little value added. Moran praised the active FDI promotion strategy of CzechInvest, the Czech investment agency. The provision of one-stop shops to facilitate FDI approvals and give support for initial problems is a far more promising approach than the imposition of strict performance requirements on foreign investors.

A representative of CzechInvest, Jakub Mikulasek, described how the focus has shifted over the years from only attracting FDI to increasingly also improving business conditions for the local enterprises. CzechInvest sees its tasks and challenges for the future in targeting the right potential clients, in supporting existing clients, in continuously adjusting its strategies and tools and in sustainably integrating FDI into the local economy. Mikulasek was skeptical about a proposal from the audience to create an FDI promotion agency at the European level. Competition for FDI funds today no longer takes place between large regions but rather between single cities or narrow regions in different countries.

In his keynote address, Ivan Pilip, Vice President of the European Investment Bank (EIB), stressed that cross-border investment in less familiar territory is – in addition to the usual credit risks – often associated with real or perceived political risks, such as currency risks, expropriation or civil unrest. The EIB mitigates these risks by providing loan finance for foreign investments on similar terms and conditions as within the EU and by reducing political risks through the conclusion of "framework agreements" with the host countries. These framework agreements provide for equal treatment, currency convertibility and transferability and no withholding tax on interest payments. Among the many positive effects of FDI for host countries, Pilip emphasized the partial local reinvestment of earnings.

The third session, chaired by Doris Ritzberger-Grünwald (OeNB), was devoted entirely to the implications of outward investment for investors' home countries. For decades, this topic has ranked high on the agenda in Western European countries and the United States but is now also gaining importance in classical FDI host countries in CEE, which are increasingly emerging as active investors in their neighboring countries.

Karolina Ekholm of the Stockholm School of Economics addressed public concerns about layoffs caused by outsourcing or offshoring domestic production to low-wage countries. According to these concerns, vertical FDI decreases labor demand in the investor's home country. This causes an increase in unemployment and puts downward pressure on wages, especially on those of less skilled workers. But studies on German and Swedish companies find that the effects of outsourcing to CEECs on domestic wages and employment are relatively small: A 10% increase in wages in CEECs actually boosts labor demand at parent firms by about 0.5% to 1%. The reason is that affiliate workers in low-wage countries are only a weak substitute for parent firms' workers in high-wage countries. The international division of labor may even increase the demand for high-skilled workers.

Marjan Svetlicic of the University of Ljubljana focused on the role of the new Member States as active investors. Currently, FDI outflows from these countries are still low, but they have experienced high growth in recent years. The major destinations of FDI from the NMS are locations in other NMS, given the narrow technological and cultural gap. Nevertheless, the net investment position of the NMS will remain negative over the medium term. Svetlicic pointed out that in the Slovenian case, outward FDI by domestic firms does not crowd out local investment. Firms that actively invest abroad clearly outperform firms that did not.

Priit Vahter of the University of Nottingham presented his research on the effects of both inward and outward FDI in the Estonian manufacturing sector.

He also explicitly tested for productivity spillovers of outward FDI on the Estonian service sector. Like productivity spillovers in host countries, such spillovers are caused by worker mobility or demonstration effects. Based on enterprise-level panel data of Estonian firms, Vahter finds positive direct effects of both inward and outward FDI on productivity, but only mixed evidence of externalities to the Estonian service sector.

The dinner speech on the first conference day was delivered by Jürgen Stark, Member of the Executive Board of the ECB. Stark focused on the challenges of euro area enlargement for the NMS, but also for the current euro area countries. He emphasized the importance of achieving a high degree of nominal, real and legal convergence before euro adoption. A major challenge for the new and old EU Member States is that fiscal and structural policies are under national responsibility but have to be treated as a matter of common concern, as omitted reforms in one country can have negative implications also for other countries. Structural reforms in labor markets should be targeted at facilitating wage adjustments that better reflect regional and sectoral productivity differences, while product market reforms should enhance innovation, ensure the efficient allocation of resources and contribute to creating a business-friendly environment.

In his opening remarks on the second day of the conference, OeNB Executive Director Josef Christl stressed the importance of FDI for economic growth and the catching-up process in the CESEE countries. Christl named three channels through which FDI can influence the economic performance of a country: First, FDI increases the capital stock of an economy, which, according to the standard neoclassical growth theory, should by itself lead to higher levels of per capita output. Second, FDI contributes to productivity growth, as foreign firms tend to have better technological know-how and managing skills. Third, FDI potentially entails a row of spillover effects also to local enterprises through labor mobility, imitation or training of suppliers. All these effects seem to be at work in CESEE and are likely to have contributed to the economic convergence process with Western Europe.

EBRD Chief Economist Erik Berglöf used the conference as an opportunity to present the main results of the EBRD Transition Report 2006. The overall picture drawn by the report is rather bright: Growth in 2006 is picking up in the CESEE and CIS countries. Convergence with Western Europe as well as within the region is actually taking place. The latest transition indicators point to a sustained reform momentum in 2006. A total of 24 transition score upgrades were awarded, almost half of them in the fields relating to financial institutions, and with most progress noted in Southeastern European (SEE) countries. Berglöf attributed the recently observed delay of euro adoption plans to a mixture of reform fatigue in the NMS and enlargement fatigue in the old EU Member States. The resulting uncertainty may be an obstacle for the formation of economic agents' expectations. Referring to the special topic of the 2006 report, "Finance in Transition," Berglöf considered the financial sector improvements in terms of size and complexity the most striking feature of transition. Foreign banks have contributed substantially to enhancing the stability and the efficiency of financial systems. Nevertheless, financial sectors remain underdeveloped by Western standards and further institutional reforms are needed.

Erik Berglöf chaired a session that was entirely devoted to the effects of foreign direct investment on FDI host economies. The discussant of the session was Libor Krkoska from the EBRD. Jan Svejnar from the University of Michigan presented the results of a study on vertical and horizontal FDI spillovers in transition economies. The authors find a significantly positive impact of the presence of transnational corporations on total factor productivity only for large firms. This impact is stronger for firms with a larger share of workers with university education and thus a higher absorptive capacity. When it comes to vertical spillovers, foreign-owned firms provide backward productivity spillovers to domestic firms when they buy from them and forward spillovers when they sell to them. Svejnar finds evidence of backward spillovers both for smaller and larger firms. By contrast, there is no significant evidence of positive forward spillovers. Overall, the spillover effects seem to be independent of business environment factors such as corruption or bureaucracy.

Julia Wörz from The Vienna Institute for International Economic Studies (wiiw) investigated the impact of FDI on productivity growth on the basis of a sample of 35 OECD countries and emerging economies in CEE and East Asia. For catching-up economies, she finds a positive impact of FDI on productivity growth. This result matches well with the finding that the effect is stronger in labor- and resource-intensive industries (e.g. food or textile and wood sectors), which are more important at earlier stages of economic development. In these cases, FDI inflows are an important contributor to growth, in particular if combined with high domestic investment.

Based on these findings, Maria Silgoner from the OeNB investigated the nexus between FDI and wage growth in manufacturing industries in CEECs. Both domestic and foreign direct investment are found to be positively linked with wage growth. This appears to be in line with Wörz's evidence of the productivity-enhancing effects of FDI. But Silgoner also shows that foreign-owned companies tend to pay a wage premium to their employees to reduce work turnover. This factor is strongly limited by exposure to external competition, so that in very open sectors wage growth can at times even fall short of labor productivity growth.

Ksenia Yudaeva from the Centre for Strategic Research in Moscow investigated channels of spillover effects of FDI in Poland, Romania, Russia and Ukraine. She finds positive spillovers only in the case of export-oriented FDI. Spillovers are not limited to knowledge transfers – the exposure to foreign technologies alters the production function of domestic firms. This leads to higher capital intensity in more developed countries, such as Poland, and higher labor intensity in less developed countries, such as Russia. Both types of spillovers are stronger in regions with higher human capital endowment and less corruption.

The afternoon of the second conference day dealt with practical corporate FDI experiences in CEE. It started off with two introductory statements with a specific regional focus that may serve as a benchmark for CEECs. Frank Barry from the University College Dublin emphasized Ireland's success in attracting

FDI inflows over the last two decades as a key factor for its high growth performance. Today, Ireland's FDI per capita is as much as six times higher than the European average. Half of employment in manufacturing and a quarter of employment in services are in multinational firms. The language and the large Irish community in the U.S.A. are only two causes – several other factors are equally or even more important: the favorable investment climate after fiscal imbalances and labor market shortages had been sorted out in the 1980s; low corporate taxes; institutions that provided young people with the necessary science and engineering training; the growing influence of the Industrial Development Agency on government decisions; and the meritocratic orientation of public services. As a result, Ireland used EU regional aid more efficiently than Greece, Portugal or Spain.

The second regional focus was on Asia. Hui Tong from the Research Department of the IMF presented a paper coauthored with Barry Eichengreen in which he asked whether recent and increasing FDI flows to China were complementary to FDI in other countries or were rather crowding them out. The empirical results covering 29 source and 60 destination countries over the period between 1988 and 2003 suggest that FDI flows to China did not significantly influence FDI to other countries. There is evidence of some crowding out in OECD countries – largely because China is viewed as a large consumer market – but not in Latin America or in the CEECs. Asian countries that are part of China's production chain (e.g. Japan) experience beneficial effects on FDI, whereas countries that compete with China on the production of consumer goods (e.g. India or Pakistan) suffer from crowding-out effects.

The final panel discussion, chaired by OeNB Executive Director Peter Zöllner, was composed of leading representatives of multinational companies that are active investors in CESEE and are either headquartered in Austria or organize their expansion strategies in the region from an Austrian base. Austrian companies were among the first movers investing in the CEECs in the mid-1990s. As markets and investments in the NMS mature, Austrian companies are increasingly investing in countries in SEE and in the CIS.

The speakers agreed that the countries of Central, Eastern and Southeastern Europe are important markets at their doorstep, as they provide excellent opportunities to expand companies' market share. This argument often dominates even the common offshoring objective of cost reduction. Bigger market share in turn strengthens companies' competitiveness within Austria. In some cases, companies also follow their major customers or business partners, who are already active in that region. Overall, FDI is seen as a win-win situation for home and host countries, as Austrian firms and multinational enterprises contribute significantly to the economic development of the whole region. All speakers cited the diligent management of cultural differences and sufficiently skilled and trained employees as crucial for successful FDI.

The massive expansion of Siemens Austria AG into the region was achieved mainly through acquisition of newly privatized companies rather than greenfield investments, explained the company's CEO Brigitte Ederer. These FDIs were aimed partly at complementing the Siemens portfolio (i.e. manufacturing and software development centers) and partly at building up regional subsidiaries. The region's assets are low unit labor costs and a well-educated workforce.

Oliver Dillenz explained that OMV AG needed to grow in order to stay independent. As this cannot be ensured by the mature Austrian home market with its limited growth perspectives, OMV has invested EUR 1 billion to EUR 2 billion a year since 2003 in CESEE, and this trend will continue at least until 2010. The company's FDI policy pursues two strategies of vertical integration: utilizing the proximity to the growing markets for the downstream business, and securing future supply through a strong upstream position in six core regions around the world.

According to the representative of Zumtobel Lighting GmbH, Christian Schröder, the Eastern European luminaire market will stay small compared with that of Western Europe, but it offers significant growth potential both in terms of market share and increasingly sophisticated lighting solutions. Apart from its market share objective, Zumtobel strives to reduce its cost base by relocating one of its manufacturing units to Romania. Schröder stressed that training of future employees and continuing on-site support as well as a diligent involvement of local Romanian decision-makers will be a key factor for offshoring to succeed.

This is an insight around which DLA Piper, a global law firm, has built up its core competence. Stefan Eder, Regional Managing Partner of the CESEE arm of DLA Piper, is convinced that clients are best served through local offices and lawyers who are familiar with the cultural and legal environment. Therefore, DLA Piper has embarked on a strategy of being present in the market even before the customer arrives, thus anticipating the need of future clients to minimize (legal) risk.

Overall, the contributions to the panel discussion underpinned many findings of the theoretical literature. In some cases, however, the practitioners' view provided new insights that may shape future research.

5th Emerging Markets Workshop[1]

Emerging Markets: Any Lessons for Southeastern Europe?

Suomen Pankki – Finlands Bank initiated a series of workshops dedicated to emerging market economies, the first of which was organized in Lapland in 2003. The 5th Emerging Markets Workshop was held at the OeNB on March 5 and 6, 2007. It attracted around 60 participants and concentrated on "Emerging Markets: Any Lessons for Southeastern Europe?" – a topic in line with the OeNB's research focus. Moreover, the two-day event was also dedicated to the memory of Olga Radzyner, former Head of the OeNB's Foreign Research Division, who would have celebrated her 50th birthday in 2007.

In his opening statement on the first day of the workshop, Peter Mooslechner (OeNB) pointed out that emerging Europe was of particular importance for Austria: In 2005, Austrian banks' assets in Central, Eastern and Southeastern Europe (CESEE) amounted to 16.1% of their total assets and to 35% of their pre-tax profits. The Austrian economy has benefited from Central and Eastern European (CEE) integration by a growth bonus of about 3½ percentage points in total since 1990. According to Mooslechner, some South Eastern European economies have not yet fully turned into emerging markets (Albania, Montenegro, Serbia), while others certainly qualify (Croatia, Bulgaria, Romania) and one has probably even passed beyond that stage (Slovenia). The main difference between European and non-European emerging markets is that European integration provides an economic and political anchor for most European emerging market economies (EMEs).

The first workshop session dealt with corporate sector issues including industrial restructuring and the role of foreign direct investment (FDI). Peter Havlik (Vienna Institute for International Economic Studies – wiiw) documented the rapid productivity growth in the New Member States (NMS) of the EU and in the Commonwealth of Independent States (CIS) arguing that this was largely a jobless growth as employment elasticity to GDP growth was very low. In the same session, Adam Geršl (Česká národní banka) reported mixed and thus somewhat disappointing evidence of productivity spillovers from FDI in the Central and Eastern European Countries (CEECs) during the last six to seven years. Evgeni Peev (University of Vienna) presented the main features of corporate financing in the NMS.

The second session focused on central bank and asset prices, in particular on central bank interventions and sterilization. Darko Bohnec (Banka Slovenije) and Marko Košak (University of Ljubljana) pointed out that some central banks had been relatively successful in opting for a managed floating exchange rate regime and had implemented adequate sterilization policies. In this respect, Banka Slovenije serves as a good example as it combines market-based instruments and capital controls with new instruments developed to compensate for underdeveloped financial markets and the lack of securities. Balázs Égert (OeNB) presented results based on the event study approach according to which – for a sample including Croatia, the Czech Republic, Hungary, Romania, Slovakia and Turkey – foreign exchange interventions

[1] *The proceedings will be published in the OeNB's workshop series later in 2007.*

alone were only effective in the short run but were more successful if coordinated with verbal interventions and interest news.

In his keynote speech Dimitri Demekas (IMF) illustrated that European emerging markets differed from other emerging markets for various reasons: They have undergone strong unconditional convergence, they have recorded important capital flows and current account deficits associated with growth. These developments, which can mainly be attributed to financial integration, to the prospect of EU accession and/or euro area membership and to threshold effects, mitigate the traditional risks of capital flow volatility and sudden stops. Although superficial international comparisons, by and large, miss the point, overvaluation and balance sheet risks are still present.

The third session on indebtedness and vulnerability dealt with public debt structure and foreign exchange exposure in emerging markets. Aitor Erce Dominguez (Banco de España) argued that looser international conditions would favor domestic debt restructuring. Similarly, domestic financial market deepening and issuance clustering would facilitate the financing of domestic debt on international markets. In her survey-based presentation Katalin Bodnár (Magyar Nemzeti Bank) illustrated that although the weakening of the Hungarian forint would have a negative impact on small and medium-sized enterprises (SMEs), many of these SMEs were not even aware of this fact. Moreover, they often lacked foreign exchange risk management tools, and two-thirds of domestic foreign exchange-denominated loans were not naturally hedged. Enrique Alberola (Banco de España) focused on the evolution of the public debt-to-GDP ratio and the share of foreign exchange debt, both of which have declined in emerging markets as a result of favorable financial conditions and authorities' proactive debt management strategies.

On the second day, the fourth workshop session examined banking sector issues such as banking sector restructuring and the ensuing credit expansion. Dubravko Mihaljek (Bank for International Settlements) presented a number of challenges connected to the presence of foreign banks. According to a survey, the quality of banking supervision in emerging markets increases with the presence of foreign banks. In this respect Mihaljek raised the following questions: What would happen if a foreign-owned bank that was important for the domestic banking system but of marginal interest for the parent company ran into difficulties? Who would rescue it? And how to deal with the effects of mergers of parent institutions on the domestic market? How should banking supervision react if domestic banks merged as a result of their foreign activities? Peter Backé (OeNB) compared today's CESEE with East Asia in 1997. By contrasting obvious similarities with striking differences, he illustrated that, overall, differences outweighed similarities, suggesting that CESEE has advantages over East Asia for the following reasons: First, CESEE's financing structures of current account deficits are more favorable. Second, the region's foreign debt is often financed by foreign parent companies. Third, CESEE's corporate sector leverage is lower, the maturity of its external debt is longer and its reserve coverage higher. Finally, its financial sectors are generally sound.

Reiner Martin (ECB) talked about the results of an event study examining 23 countries that had experienced boom-bust episodes. The findings for CEE indicated that a boom was likely but that it was not clear what was to follow. Therefore, increased awareness of the associated policy challenges is needed and close monitoring will be necessary in some areas, such as external balances and balance sheet risks.

In the fifth session on exchange rates, Tuuli Juurikkala (Suomen Pankki – Finlands Bank) analyzed the real exchange rates of oil producing countries, showing that the Balassa-Samuelson effect was not a relevant factor for these countries. Furthermore, the elasticity of the real exchange rate with respect to real oil prices is usually quite close to 0.5. The oil price has a direct effect on the equilibrium exchange rates in oil-producing countries, over and above the possible effect stemming from higher per capita GDP.

Markus Pramor (Center for Financial Studies) examined co-movements of CEE and euro area exchange rate volatility against the dollar. According to his results, the Slovak koruna's long-term volatility is closest to that of the euro, whereas the Polish złoty is the least correlated currency. This study also highlighted the fact that the correlation of volatility developments between the euro area and the CEECs has increased over time.

Finally, Gunther Schnabl (University of Leipzig) elaborated on the effect of foreign exchange rate volatility on economic growth in Eastern Europe and East Asia, concluding that countries with fixed exchange rate regimes had grown faster than countries with flexible exchange rate regimes, which might be explained by the fact that fixed regimes promote trade and macroeconomic stability.

2nd Conference of the South East Europe Monetary History Network[1]

The Experience of Exchange Rate Regimes in Southeastern Europe in a Historical and Comparative Perspective

The main objective of the South East Europe Monetary History Network (SEEMHN) is to spread the knowledge of Southeastern Europe's (SEE) economic history as an integral part of the European experience; the network focuses particularly on monetary and banking history and brings together economists and historians. As its first general meeting in Sofia in 2006 had been a great success and as participants and members had expressed their willingness to further advance the initiative, the OeNB decided to support the SEEMHN by hosting its second conference in Vienna on April 13, 2007. The meeting analyzed the exchange rate regimes in SEE from a historical and a comparative perspective.

Peter Mooslechner, Director of the OeNB's Economic Analysis and Research, opened the event by underlining the undiminished importance attached to choosing exchange rate regimes with regard to economic policy. This issue is particularly pertinent for small open economies (SMOPECs) such as (almost all) the SEE economies. Despite the fact that in Europe the overall perception regarding monetary policy has shifted to the notion of monetary union, it is still necessary to review and reflect different approaches. Luca Einaudi (Italian Prime Minister's Office) held the first keynote speech entitled "Early Monetary History, Mainly 1860s to 1920s: Efforts of Balkan States to Leave the Monetary Areas of the Ottoman Empire and the Austro-Hungarian Empire and to Move to Sovereign Currencies." Although these efforts to break away from the former empires were successful, the desire to rapidly modernize and catch up with the most advanced European nations unfortunately could not offset bleak economic and financial realities.

Chaired by Peter Mooslechner, the first session consisted of two presentations: Matthias Morys (University of Oxford) spoke about "Adjustment under the Classical Gold Standard (1870s–1914): How Costly did the External Constraint Come to the European Periphery and to South-Eastern Europe in Particular?" He contended that under the gold standard there might have been more room for economic policy maneuvers (also for peripheral economies) than scientists had previously thought. "Exchange Rate Control in Italy and Bulgaria in the Thirties. History and Perspectives" was the topic of a joint paper by Kalina Dimitrova and Nikolay Nenovsky (both from the Bulgarian National Bank) and Giovanni Pavanelli (University of Torino).

In the second session, which was chaired by Roumen Avramov (Centre for Liberal Strategies, Sofia), Erik Buyst (Katholieke Universiteit Leuven) and Ivo Maes (Nationale Bank van België/Banque Nationale de Belgique – NBB) talked about "Central Banking in 19th-Century Belgium: Was the NBB a Lender of Last Resort?" While they discovered that the NBB had rendered the Belgian financial system more crisis resistant, especially by restricting banking sector leverage, Buyst and Maes concluded that the NBB had not really functioned

[1] *The proceedings of the conference will be published in the OeNB's workshop series later in 2007.*

as a lender of last resort, as most rescue operations had taken place upon the explicit request of the finance minister. Martin Pontzen and Franziska Schobert (both from the Deutsche Bundesbank) discussed "Episodes in German Monetary History – Lessons for Transition Economies?" A dramatic episode of recent SEE monetary history was the subject of the presentation of Zorica Mladenović and Pavle Petrović (both from the University of Belgrade), who lectured on "Modelling Exchange Rate and Money Demand in Extreme Conditions: Econometric Analysis of the Daily Data from the Serbian Hyperinflation of 1992–1993." The authors explained this hyperinflation, which, at an average monthly rate of 10,900%, was 34 times higher than the inflation rate recorded during the famous German hyperinflation of 1923 (322%), by forward-looking behavior combined with a need for seignorage.

Doris Ritzberger-Grünwald, Head of the OeNB's Foreign Research Division, presided over the second keynote speech delivered by Peter Bernholz (University of Basel) on "General Patterns in the Monetary History of Balkan Countries in the 20th Century." Bernholz focused on four episodes of hyperinflation SEE had seen since 1945, namely in Greece in the aftermath of World War II, in Yugoslavia between 1989 and 1990, in Serbia and Montenegro between 1992 and 1994, and in Bulgaria in 1997. These episodes share a number of qualitative characteristics that have been confirmed in other cases: At the beginning of the inflation, the real stock of money increases at a faster rate than the price level and the exchange rate. Later, the dynamics reverse, leading to undervaluation, which is only overcome once monetary stabilization has been undertaken.

The third session was chaired by Sophia Lazaretou (Bank of Greece). Kalina Dimitrova (Bulgarian National Bank), Martin Ivanov (Bulgarian Academy of Sciences) and Ralitsa Simeonova-Ganeva (St. Kliment Ohridski University, Sofia) analyzed the impact of "Effective Exchange Rates in Bulgaria 1897–1939." Their lecture was followed by Biljana Stojanović (Megatrend University, Belgrade), who discussed "Exchange Rate Regimes of the Dinar 1945–90. Assessment of Appropriateness and Efficiency." Given that in former socialist Yugoslavia ideological and legal frameworks were conducive to persistent monetary expansion, the weakening of the Yugoslav currency was inevitable whatever the officially applied exchange rate regime. Elisabeta Blejan (Banca Națională a României) analyzed "The Foreign Exchange Regime in Romania 1929–1939," followed by Yury Goland (Russian Academy of Sciences) who presented "Discussions over the Exchange Rate in the Period of NEP (1921–1928)."

The fourth and final session was chaired by Nikolay Nenovsky (Bulgarian National Bank) and featured Yüksel Görmez (Türkiye Cumhuriyet Merkez Bankası) lecturing on "The Evolution of Exchange Rate Regime Choice in Turkey." Turkey appears to have tried various kinds of exchange rate regimes, ranging from strictly fixed to free float regimes. In the past – contrary to the current situation – experimental regime choice was common practice against the background of structural imbalances, ever increasing dollarization and the lack of fiscal discipline coupled with central bank financing of public deficits through short-term advances. Ljiljana Đurđević and Milan Šojić (both from Narodna banka Srbije) focused on "Dinar Exchange Rate in the Kingdom of Serbia 1882–1914." Finally, Dragana Gnjatović (Megatrend University, Belgrade) expounded her analysis of "Foreign Exchange Policy in the Kingdom of Yugoslavia during and after Great Depression."

The conference was wrapped up by Sophia Lazaretou, Peter Mooslechner and Nikolay Nenovsky. Lazaretou announced that the next SEEMHN conference would focus on "Commercial and Central Banking in the Southeastern European Periphery: Lessons of Historical Experience" and would be held at the Bank of Greece in Athens in about a year. Nenovsky thanked Mooslechner for organizing the Vienna conference, which the latter concluded by pointing to many further interesting research issues and by stressing that in this respect it was important to continue collecting more historical data.