The Euro's Contribution to Economic Stability in CESEE

Conference on European Economic Integration

Compiled by Andreas Breitenfellner[1]

This year's *Conference on European Economic Integration* (CEEI) of the *Oesterreichische Nationalbank (OeNB)* was dedicated to the theme "The Euro's Contribution to Economic Stability in CESEE" and took place in Vienna on November 16 and 17, 2009.[2] The central issue was whether the euro has become an attractive anchor of financial and economic stability in the countries of Central, Eastern and Southeastern Europe (CESEE), in particular for those countries that have not yet introduced the euro. More than 300 participants from over 30 countries followed the lively discussions of high-profile representatives of central banks, international organizations and academia.

In his opening speech, *Ewald Nowotny,* Governor of the *OeNB* and Member of the Governing Council of the *ECB,* recalled the stabilizing effects of the euro. While failing to prevent the build-up of internal and external imbalances, the common currency had indeed cushioned the effects of global shocks in the euro area. Especially in times of crisis these stabilizing effects had to be counterweighted adequately to offset risks, though. One such risk, namely an additional risk of foreign exchange fluctuation, had been created by the high volumes of foreign currency loans granted in some CESEE countries. Banks would therefore have to adapt their business models accordingly.

According to Nowotny, the optimal timing for introducing the euro differs from country to country. The positive stability effects for the respective economy had to be balanced against the risk of giving up the exchange rate too early as an economic policy instrument, which makes getting the timing of euro introduction right a challenge. To this end, the so-called Maastricht criteria as well as sufficient flexibility of labor and product markets would offer a suitable framework for decision-taking.

In referring to the euro's place as one of the leading world currencies, Nowotny recalled the fact that the European Union – the potential future monetary union – exceeded the U.S.A. even today in terms of GDP. At the same time, the common currency had been constantly gaining in importance outside the euro area, in particular in Southeastern Europe, where the euro is high in demand for transactions and as a store of value.

Finally, Nowotny paid tribute to the anniversary of two important milestones in the process of European integration, namely the fall of the Iron Curtain 20 years ago and the beginning of European Economic and Monetary Union (EMU) 10 years ago. The fact that Europe had mastered the deepest financial and economic crisis of post-war history relatively well might in no small part be attributed to the preparedness of European policymakers to meet the challenges together.

[1] *On the basis of notes taken by Markus Eller, Martin Feldkircher, Jarko Fidrmuc, Sándor Gardó, Mathias Lahnsteiner, Thomas Reininger, Thomas Scheiber, Tomáš Slačík and Julia Wörz.*

[2] *The conference proceedings will be published by Edward Elgar Publishing Ltd. in the course of the year 2010. Presentations and papers as well as information about speakers and the program are available at www.oenb.at under Services and Events.*

The Euro's Role on the World Stage

Joaquín Almunia, Member of the *European Commission* responsible for Economic and Monetary Affairs, held the first keynote lecture, in which he addressed above all developments in the new EU Member States (NMS) and the EU candidate and potential candidate countries in CESEE: While all these countries had been badly hit by the crisis (following a sharp decline in global demand and retrenchment of capital inflows), the recession and financial strains had been stronger in those countries that had been suffering from major imbalances or policy weaknesses already at the onset of the crisis. However, the EU had rapidly shown its solidarity with its members in difficulty, activating the EU's medium-term assistance facility for the first time in 15 years and raising the ceiling of this facility fourfold to EUR 50 billion. Since October 2008, support programs (in cooperation with international institutions and in combination with bilateral support) had been launched for Hungary, Latvia and Romania, bringing total commitments under the facility to EUR 14.6 billion. In conjunction with the accompanying policy programs, the international assistance had contributed to stabilizing market expectations, restoring access to private external financing and preventing an even larger recession (by providing budget financing to allow greater operation of automatic stabilizers than would have been possible otherwise). This had helped limit the social effects of the crisis. The private sector had been involved in the crisis resolution efforts as well. Parent banks had so far provided the necessary funding to their affiliates in the new EU Member States, and in the context of the European banking coordination initiative – the so-called *Vienna Initiative* – parent banks had pledged to maintain exposure to these countries and recapitalize their affiliates if necessary.

Almunia stressed the heighted attractiveness of the euro: Among countries with pegged exchange rate regimes, the crisis had reinforced the prevailing euro adoption strategies. Euro adoption was perceived as a credible exit strategy propping up confidence (residents and nonresidents alike) in the pegs and as offering a relief to liquidity constraints and eliminating exchange rate mismatches while not imposing additional challenges on economic policies.

For countries with floating exchange rates, the crisis had highlighted the vulnerabilities coming from large fiscal deficits. However, euro adoption should not be seen as a quick fix to economic vulnerabilities, but rather as part of a broader long-term policy strategy. Membership in the euro area was enhancing resilience, but it had not eliminated the need to work out underlying imbalances. New entrants needed to prepare thoroughly to cope with life under an irrevocably fixed exchange rate. This might involve the need to improve the state of public finances, in some cases changes to the exchange rate regime, and structural reforms to strengthen domestic adjustment capacity. In this respect, the crisis might serve to galvanize public and political support for the necessary measures. Euro adoption remained a key anchor for medium-term policies and expectations. However, an accelerated euro area enlargement that would require a loosening of the entry criteria was not an option. Without sustainable convergence, euro adoption might turn out to be a suboptimal strategy for the country concerned, and it would make the management of EMU more difficult by heightening economic divergences. Compliance with the convergence criteria in a sustainable manner was in the interest of both the prospective and existing members of the euro area.

Living with or without the Euro in Times of Crisis

The first session, chaired by OeNB Governor *Nowotny*, discussed the euro's role as an anchor for stability as illustrated by the contrasting experiences of Portugal (a euro area member since its existence), Sweden (an EU Member State that has postponed its euro adoption after a negative referendum) and Serbia (a potential candidate country with a high degree of euroization). Representatives of those three countries shared their views on the single currency against the backdrop of the current crisis.

Pedro Duarte Neves (Governor of *Banco de Portugal)* summarized Portugal's macroeconomic developments since adopting the euro. A strong synchronization of the business cycle and quick inflation convergence on the one hand and a substantial increase in the indebtedness of the private sector and a loss in export market shares on the other hand illustrated the costs and benefits of giving up the domestic currency. Duarte Neves concluded that enhancing banking supervision and the implementation of structural reforms to ensure competitiveness were the main challenges that some countries within the euro area – in particular Portugal – had to manage.

Karolina Ekholm (Deputy Governor of *Sveriges Riksbank)* noted that while the crisis had hit all economies, the consequences for the countries had varied quite strongly. As a case in point, Sweden's real economy had been affected by the recent downturn more severely (high export dependency) than its financial markets, which had remained resilient. The measures to counter the crisis taken by the Riksbank were in line with those implemented by the ECB: strong liquidity provisioning for financial markets and gradual cuts of interest rates. In the current environment – with (real) interest rates standing at record low levels – securing bank funding, lowering future policy rates and raising inflation expectations were the key measures to further provide stimuli to the economy. The Riksbank had lowered expected future policy rates by offering fixed rate loans and had recently started publishing policy rate forecasts. Moreover, the central bank had been able to provide foreign currency under swap agreements with the Federal Reserve and the ECB. Ekholm concluded that the current environment was exactly the time when an own currency was most beneficial since the crisis constituted an external shock with asymmetric consequences for the economies. At the same time, the (likely) limited ability of foreign currency provisioning to the Swedish banking sector in the event of a local crisis constituted a downside of being outside the euro area.

Radovan Jelašić (Governor of *Narodna banka Srbije)* pointed to the unique position of the Serbian economy, which was practically living with the euro while having officially retained its own currency. Serbia had traditionally reported high amounts of savings and loans in foreign currency, partly for historical reasons. Local banks simply had to lend in foreign currency since the level of deposits denominated in domestic currency was small. Jelašić stressed that the banking system had been remarkably resilient, although the Serbian dinar had witnessed a sizeable depreciation during the crisis despite the economy'y high level of euroization. For economies with a floating exchange rate regime, it was of particular importance to have a sound supervisory policy framework and stable capital adequacy ratios in the banking system. The limits of floating would be reached when the banking system was endangered. In his concluding remarks Jelašić mentioned the stabilizing effect of coordinated policy measures undertaken by the IMF and the *Vienna Initiative*

and the need for the central bank in Serbia as a lender of last resort to provide support not only in local but also in foreign currency.

A Case for Rapid Euro Adoption?

The first panel discussion brought together central bank governors of the Czech Republic, Hungary and Poland, who shared their take on how their respective country had fared during the crisis and indicated how this experience was influencing their plans and time tables for euro adoption.

The framework for this discussion was provided by an introductory statement delivered by *Gertrude Tumpel-Gugerell,* Member of the *ECB's* Executive Board. She pointed out that while national authorities in CESEE had adopted various measures to alleviate the impact of the crisis on their respective economies, the entire region had benefited from the stabilizing assistance provided by the ECB, particularly through its support to parent banks in EMU. Moreover, she emphasized that the crisis had unveiled the necessity to embark on a sustainable growth and convergence path, not only in CESEE. Alluding to often heard opinions suggesting a quick short-cut into the euro area for some countries, she explained that it was important to distinguish between necessary stabilizing measures and EMU membership. She unmistakably declared that the euro was no panacea and that the fulfillment of the Maastricht criteria was essential for EMU membership as well as in the interest of the countries in question. Hence, according to Tumpel-Gugerell the crisis has neither changed the ECB's policy on euro adoption nor its view on unilateral euroization, which is considered not in line with the Treaty.

András Simor (Governor of *Magyar Nemzeti Bank)* started off by assuring that the Hungarian central bank had always favored early euro adoption despite a number of risks. However, prior to the crisis an unhealthy macroeconomic policy mix by former governments had provided wrong incentives and had eventually led to serious structural imbalances. These imbalances, which the monetary regime had been unable to mitigate, had started to unwind in the wake of the crisis. To find a long-term solution to these challenges required a policy mix, possibly tough in the short run, but setting strong fundamentals for steady long-term growth. Hence, according to Simor, the lesson that Hungary has learned is that it should enter the euro area as soon as possible to minimize vulnerabilities, however, not before structural problems are fixed and convergence is well on track.

In a similar vein, *Sławomir Skrzypek* (Governor of *Narodowy Bank Polski)* recalled that the experience of euro area countries suggested that a positive net balance of euro adoption was not certain at every point in time and hinged on structural reforms enhancing a country's competitiveness. Moreover, he stressed that while it was very important to be part of the EU and the euro area, which had, particularly during the crisis, functioned as an umbrella and institutional anchor, EU and euro area membership would not fix every problem. Against this background, Skrzypek concluded that, like Hungary, Poland was aiming at adopting the euro as fast as possible but in line with fundamentals.

The presentation of *Zdeněk Tůma* (Governor of *Česká národní banka)* added a different perspective. He began by saying that he had accepted that the debate on the meaningfulness of the Maastricht criteria was over although the criteria had been designed in a very different environment than they were being applied now. Tůma proceeded to doubt that the euro had had any significant impact on the

economic performance of EMU countries. Subsequently he presented simulation results of a dynamic general equilibrium (DGE) model for the Czech Republic, suggesting that the euro would not significantly reduce, but partially even increase volatility. Tůma then backed up his case by arguing that whereas inflation, consumption and GDP volatility had increased substantially in Finland in the decade after euro adoption, in Sweden this increase had been much less pronounced or even negative. He thus concluded that the effects of the euro were time- and country-specific and that it was in principle possible to fare well or even better without the euro.

The Euro Area: A Shelter?

The second panel, chaired by *Peter Mooslechner,* Director of the *OeNB's* Economic Analysis and Research Department, addressed the question whether the euro area had acted (or, respectively, could have acted) as a shelter in the course of the 2008–09 global economic crisis. The panel brought together high-level central bank representatives from three CESEE EU Member States that are at quite different stages in this respect: Romania, which follows an inflation targeting strategy with a flexible exchange rate vis-à-vis the euro; Estonia, which has pegged the kroon to the euro within the framework of a currency board arrangement and has participated in the exchange rate mechanism II (ERM II) since June 2004; and Slovakia, which adopted the euro in January 2009 after entering ERM II in November 2005.

Cristian Popa, Deputy Governor of *Banca Naţională a României,* stressed that the position of the Romanian central bank (euro adoption at the earliest in January 2015) had not changed in the course of the crisis, pointing to a still low degree of business cycle synchronization of Romania with the most important euro area countries, a low degree of flexibility if the euro were adopted too early, nonnegligible *Balassa-Samuelson* effects, a potential pick-up in inflation after euro adoption, and also the difficulty to fix central parities given considerable crisis-related distortions for the accurate estimation of equilibrium exchange rates.

Märten Ross, Deputy Governor of *Eesti Pank,* concluded that Estonia had definitely benefited during the crisis from the euro area being a shelter, namely in terms of foreign stability or the pass-through of low euro area interest rates. However, macroeconomic costs could have been even lower if Estonia had already been inside the euro area. This held especially for pronounced foreign exchange positions (e.g. the very high share of euro-denominated credits) that were under special scrutiny throughout the crisis.

Ivan Šramko, Governor of *Národná banka Slovenska,* emphasized that the euro changeover in Slovakia had passed very smoothly (high public support played an important role) and that the successful euro adoption had brought several immediate benefits, such as higher price stability, increased investors' confidence together with sound public ratings and no liquidity shortages. Nonetheless, Slovakia had experienced a temporary deterioration of its price competitiveness and the euro had not been able to shield the Slovak economy from adverse effects of the global recession. But a relatively quick economic recovery was expected – partly supported by the benefits of the euro.

Euro Assets: A Safe Haven?

The second session, chaired by *Doris Ritzberger-Grünwald,* Head of the *OeNB's* Foreign Research Division, focused on the role of foreign currencies in household portfolios.

Helmut Stix (OeNB) investigated the question whether the euro has been a safe haven for households' assets in CESEE countries before and during the economic and financial crisis and whether it will be a safe haven in the near future. The answer to all three questions is yes, in particular for SEE countries. Although the SEE economies stabilized and prospered over the last decade, the extent of euroization of households' total financial assets (i.e. savings deposits and cash holdings irrespective of the currency denomination) still ranged from 31% to 88% in SEE. In particular, foreign currency cash holdings were an important component in households' portfolios. Econometric analysis of micro data provided by the *OeNB's Euro Survey* attributed this persistence of euroization and the preference for cash to respondents' memories of past periods of instabilities and bad economic governance, hysteresis (biased formation of expectations, which ignores changes in fundamentals), network externalities, low trust in banks, and expectations of higher inflation as well as the expected depreciation of the local currency. During the crisis people had re-activated former patterns of behavior, growing mistrust in banks and in the local currency resulted in, partly temporary, deposit withdrawals in all SEE countries and in a change of the overall degree of euroization in some countries. Given the high sensitivity and the severe extent of shock, the reactions of households had not been overly strong. This subdued impact was likely to signal that pre-crisis and crisis stabilization policies had paid off. Analyzing the plans of the households surveyed, Stix concluded that the euro would continue to have an important role in the portfolios of CESEE households.

Asel Isaková (EBRD) presented a paper about the costs of currency substitution in Central Asia. Kazakhstan, the Kyrgyz Republic and Tajikistan had faced a severe and prolonged period of macroeconomic and political instability in the 1990s after the collapse of the Soviet Union. Private agents in these countries had reacted by substituting local currency cash and savings deposits for foreign currency cash and savings deposits in order to safeguard the value of their savings and to establish a more reliable medium of exchange and unit of account. Isaková's empirical model succeeded in replicating the high extent of dollarization in the three countries and proved that the foreign currency was indeed efficient in terms of providing liquidity services. Although the monetary authorities lost seigniorage revenues due to the substitution of domestic currency by foreign currency, the Central Asian economies still incurred an overall welfare gain through an optimal extent of currency substitution.

Current EMU Divergence: Lessons for an Enlarged EMU

Chairing also the third session, *Doris Ritzberger-Grünwald* explained the motivation of the session, which addressed a controversial topic: While all EMU countries had to fulfill the convergence criteria before adopting the euro, significant differences had evidently prevailed within monetary union. This raises important questions, including whether divergence matters and what implication it can have for the functioning of monetary union.

The first speaker, *Zsolt Darvas (BRUEGEL,* Brussels) started with an analysis of convergence and divergence in monetary union so far. There were many examples

of both convergent and divergent economic developments. From a theoretical point of view, divergence was not necessarily disadvantageous for the functioning of a monetary union. However, the member states had to avoid extended periods of low growth and external deficits. He backed up these points with numerous country studies and analyses of selected economic developments in the current Member States. In general, he showed that an increasing number of EU members were failing to fulfill the Maastricht criteria once they had made it into the euro area. Finally, he addressed the lessons for future entrants to the euro area, advocating a flexible application and possible reform of the entry criteria.

Agnès Bénassy-Quéré (CEPII, Paris) picked up the arguments introduced in Darvas' presentation, starting with a discussion of the euro's effects on trade as analyzed in several CEPII studies. On the one hand, the aggregate trade impact had remained limited so far. On the other hand, however, the single currency had already had important microeconomic effects, as illustrated by the case of France, including higher competition and increased product variety for the benefit of consumers. However, prices had converged only moderately within the euro area so far, which could be attributed to a certain "reform fatigue" among member states. Euro area member states shared a high degree of product market regulation with little improvement over the last decade. Conversely, there was already important convergence of tax rates in the euro area. The financial crisis of 2008 introduced new challenges given its differing impact within the euro area. These new challenges would have to be addressed with adequate tools, including fiscal policy, structural reforms and financial regulations. Bénassy-Quéré stressed that widening current accounts within the euro area had been overlooked so far since the risk of a balance of payments crisis was contained. She questioned the common perception of imbalances as a unilateral challenge and instead suggested a coordinated approach by all parties involved, including surplus countries, namely Germany. In concluding, she proposed that some countries should be allowed to have higher inflation rates with a view to facilitating price convergence, and she highlighted the importance of sound policy surveillance in general.

20 Years of East-West Integration – Hopes and Achievements

The menu for the conference dinner included a special course, so to speak, namely a brief celebration of the 20th anniversary of the fall of the Iron Curtain and the opening-up of Eastern Europe. The OeNB commemorated this historic event by publishing a special issue of its Focus on European Economic Integration. Since 1996 this publication series has served to disseminate research related to economic and financial developments in CESEE. The special issue, entitled "1989–2009: Twenty Years of East-West Integration: Hopes and Achievements" was presented with a panel discussion among renowned experts and contributors to the special issue: *Elena Kohútiková,* management board member of *VÚB Banka* and former Deputy Governor of the Slovak central bank, *Marianne Kager,* managing director of *MK CEBA* and former chief economist of BA-CA for 20 years, and *Michael Landesmann,* Scientific Director of The Vienna Institute for International Economic Studies *(wiiw)*. The discussion was chaired by OeNB Governor *Ewald Nowotny.* Drawing on their very personal experiences, all three panelists emphasized the great success of the transformation in CESSE. Kager referred to the importance of the EU accession perspective and a clearly defined roadmap for the catching-up process. Kohutikova

pointed out that the process had indeed been successful, but also painful and that it had lasted considerably longer than initially expected. She concluded that 1989 had not only taken Eastern Europe by surprise, but that Western Europe had not been fully ready for the changes to come, either. Landesmann supported this view and highlighted a number of research fields that either arose newly from the process of transition and catching-up or that were challenged by this process. When asked about their views on future challenges for the region, the panelists referred to various aspects relevant for resuming sustainable growth in the region once the current crisis has been digested. Mention was made, in particular, of developments in FDI flows, current and trade accounts, exit strategies from expansionary fiscal policies, regional income disparities and migration pressure.

A Macro Perspective on Crisis Lessons

Paul De Grauwe, professor at the *University of Leuven,* opened the second conference day with a keynote lecture pointing out the discrepancy between the causes of the current crisis on the one hand and mainstream macroeconomic modeling on the other: Whereas the crisis had come about as a result of inefficiencies in the financial market and economic agents' poor understanding of risk, standard macroeconomic models, which have become popular in recent years, were based on the unrealistic assumption that agents are capable of using and processing all available complex information. Hence, these rational expectations *top-down* models, as De Grauwe referred to them, needed to be replaced by what he dubbed *bottom-up* systems, in which individuals understand only small bits of total information and apply simple decision rules. De Grauwe then presented such a bottom-up model, in which agents have cognitive limitations and use simple rules to guide their behavior. As a simplified example, he introduced two types of hypothetical agents forming output and inflation forecasts either as weighted averages of extrapolated past values (chartists) or of their own fundamentals-based estimation in the case of output or the announced target in the case of inflation (fundamentalists). Since agents learn in a "trial and error" manner they continuously adjust the weights assigned to each component depending on how each particular rule performed in the past. The calibrated model generates endogenous unpredictable waves of pessimism and optimism. Hence, while in rational expectations top-down models, business cycles are exogenous shock phenomena that central banks can do nothing about, the slow bottom-up process based on backward evaluation in this new model type generates an endogenous inertia and business cycle.

The immediate implication is that whereas in a top-down setting the present economic downturn is the result of an exogenous increase in risk premiums in August 2007, in De Grauwe's bottom-up model it results from the excessive boom prior to 2007. Moreover, model-based simulations suggest that central banks can reduce both output and inflation variability when they move away from strict inflation targeting and assign a certain weight also to the minimization of the output gap in the Taylor rule. The reason for this result is that when the central bank leaves output unattended, its fluctuations lead to stronger waves in optimism and pessimism, which in turn bring about higher inflation variability. Overall, De Grauwe thus concluded that inflation targeting was necessary but not sufficient and that central banks must also explicitly care for output stabilization. This is in

sharp contrast with the implications of top-down models that have assigned only a minimalist role to central banks, which failed to act when bubbles occurred.

Regaining Financial Market Stability in CESEE

The forth session, chaired by *OeNB* Governor *Ewald Nowotny,* dealt with the highly topical issue of financial market stability.

Diana Dragutinović, Minister of Finance of the *Republic of Serbia,* focused her presentation on the strengths and weaknesses of the Serbian economy prior to the global crisis, on the impact of the crisis as well as on the global and domestic policy responses to the crisis. In particular, she stressed the quick reaction of the central bank of Serbia and the importance of the IMF support package for the Serbian economy. Finally Dragutinović pointed to the current challenges related to the financial system and the need for fiscal adjustment.

Thereafter *Vladimir Dubrovskiy (CASE,* Ukraine), highlighted various factors that may have caused the severe impact of the global crisis on Ukraine. Inter alia, he mentioned the lack of effective reforms, the unsustainably rapid growth of real incomes, the real appreciation of the hryvnia, skyrocketing inflation and the deteriorating trade balance. On a positive note he said that Ukraine's labor market had reacted quite flexibly to the crisis as evidenced by the immediate adjustment of real wages.

Last but not least, *Christoph B. Rosenberg,* Advisor at the *IMF,* outlined the stabilization tendencies on financial markets, which were almost entirely driven by the rebound of global risk appetite. Rosenberg argued that short-term market stabilization had been achieved through the various global policy response measures to the crisis. In this respect he also pinpointed the importance of the Vienna Initiative in coordinating public and private sector agents (foreign parent banks). Moreover, Rosenberg highlighted that financial markets were now differentiating more strongly between individual CESEE countries. In concluding he addressed long-term issues in securing financial market stability, including the need for establishing macroprudential policy frameworks and improving cross-border cooperation and coordination.

Post-Crisis Business Models of Banks in CESEE

The final panel of the 2009 CEEI, chaired by *OeNB* Executive Director *Andreas Ittner,* brought together high-profile bank managers and experts.

The first speaker, *Erik Berglöf,* chief economist of the *EBRD,* stressed that although CESEE had been hit hard by the global economic and financial crisis, the impact of the crisis on CESEE could have been worse. On a positive note, there had been no uncontrolled currency collapses, system-wide bank runs, populist or coercive policy responses and reform reversals in the region, all characteristic elements of previous emerging market crises. In his view, this can be first and foremost attributed to the forceful crisis response, which ranged from mature support measures in Western Europe and CESEE over large international support packages (IMF, EU, G-20, ECB) to the *Vienna Initiative* as an important tool for public-private coordination. According to Berglöf, financial integration, which was the key driver of the growth and convergence process in CESEE alongside capital inflows, was a double-edged sword. While foreign financing contributed to credit booms, excess leverage and increased foreign exchange risks in CESEE,

foreign banks were a crucial stabilizing factor for the region during the crisis. Finally, Berglöf called for a "Vienna Plus" initiative, which would address the issue of foreign exchange exposures in CESEE.

The second speaker, *Natalia Orlova,* chief economist of the Russian *Alfa-Bank,* shared her views on financial market developments in Russia since the start of the crisis, while highlighting the initial resilience of the country to the crisis given the global commodity price boom and the relatively small size of the Russian mortgage market. According to Orlova, the strong decline in commodity prices had triggered strong capital outflows in the second half of 2008, however. At the same time, downward pressures on the exchange rate had led to sharply falling foreign exchange reserves and had made banks more vulnerable. Although financial markets and the real economy seemed to have stabilized, the current macro trends had triggered a slowdown in credit growth and a pick-up in nonperforming loans, in both the corporate and retail segments. Thus, in Orlova's view the current difficult economic environment has to be used to consolidate the banking sector and to reduce the number of banks.

Next, *Herbert Stepic,* CEO of *Raiffeisen International,* identified the transition process as a "unique window of opportunity" for Austrian banks, which have exported the traditional banking model based on universal banking to the region. Stepic stressed that commercial banks had initially above all feared bank runs, prompting them to stock up cash vaults to be prepared for the worst-case scenario of system-wide bank runs. The worst-case scenario had, however, not materialized; on the contrary, the situation had quickly changed from under- to overliquidity. Concerning future banking models, he stressed that in order to cope with the present "risk tsunami" banks would have to change their internal organizational procedures. Also, capital and liquidity (in particular long-term) would get more expensive in the future, so that banks would have to find ways to balance these increases in costs. Nevertheless, as in his view the transition process has been completed only to one-third, the CESEE region still promises "juicy" banking business in the future.

Finally, *György Surányi,* Regional Head of CEE at *Intesa Sanpaolo,* first sketched the stylized facts of the growth and convergence process in CESEE, which had been largely export- and investment-driven and had been actively supported by capital inflows. The flipside of the coin was, however, the widening external imbalances throughout the region. In this context, Surányi stressed the need for differentiation across countries in CESEE with a view to their pre-crisis vulnerability levels. Surányi sees the prevalent foreign exchange risks as a natural consequence of the permanent external deficits of the region, so that, in his view, banking sector balance sheets (micro level) purely mirror the prevalent macro imbalances. He called the request of international financial institutions for restrictions on credits in foreign currency as cynical, since these lending practices had only become feasible after the same institutions had pressured the countries to fully liberalize capital flows. In this context, he underscored that limiting foreign currency lending was acceptable only if medium- and long-term local currency-based financing was available at a reasonable price. Put differently, restricting foreign currency lending while not providing local currency-based financing would only result in a prolonged economic stagnation of the region. He also added that the region would not be able

to return to the growth levels seen before the crisis, but would have to adjust to a lower growth path.

In addition to the official debates, the two conference days provided welcome room for informal talks and networking among central bankers, government officials, finance sector managers, journalists and researchers. The conference received a lot of press coverage and positive feedback from participants, which confirmed its status as one of the leading discussion events on regional economic and monetary integration.