

Taking Stock of Twenty Years of Analysis and Research on CESEE at the OeNB

1 Building a New Europe

For Austria and its central bank, the Oesterreichische Nationalbank (OeNB), the last 20 years have been marked by fundamental change. From a monetary policy perspective, the period started in an era characterized by the Austrian schilling's informal peg to the Deutsche mark, commonly referred to as the "hard currency policy," which has proved a success for Austria, a small open economy, for a number of reasons. From an analytical point of view, maintaining the peg did not seem to be a very demanding task, considering that the anchor was clearly defined and observable on a daily basis. In economic policy terms, however, it was obviously much harder to stick to the hard peg option: The problems it involved ranged from mastering political difficulties to market turbulences and permanent real economy adjustment needs. Things changed significantly when Austria – together with Sweden and Finland – joined the EU in 1995. Though hardly debated in public, it was quite clear that Austria would participate in monetary union, if it were ever to be realized. After all, the peg to the Deutsche mark constituted a kind of monetary union already. The common currency, this long-term European project, became a reality as early as in 1999 and 2002, when the national currencies of 11 EU countries – including Austria – were replaced by the euro. In monetary policy, the "one member, one vote" principle in the Governing Council of the newly established European Central Bank (ECB) gave the OeNB much more responsibility and, as a result, required it to step up economic and monetary analysis.

The opening up of Central and Eastern Europe (CEE) happened more or less in parallel with these fundamental changes in the EU. Without a doubt, the fall of the Iron Curtain was a historic event for all Europeans, but it was of special importance for Austria. Not only did Austria find itself close to the heart of these politically and economically extraordinary developments, but its citizens were also reminded of their country's historical ties with the region, which, in many cases, had survived at the personal level. Austrian enterprises managed to be part of this transformation process and to profit from it right from the beginning. Their investment activities were mainly driven by three different motives: Some investors simply wanted to revive "the good old days," when Central Europe was one of the most innovative and developed regions in Europe; others, whose business opportunities were restricted by a very narrow home market, were looking to develop new markets and others again wanted to take advantage of the comparatively low labor costs in the region. Very often, all three motives seemed to play a role, but the objective of widening one's market was clearly the most important factor from the point of view of a small country. In addition, many multinational companies considering "going east" established their CEE headquarters in Vienna. As a result, the Austrian capital, a city with sound business infrastructures and a high standard of living, became a hub not only for air connections to the east but also for investment activities in CEE.

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For the OeNB, these institutional and economic dynamics, which to a large extent characterized European history in the 1990s, involved substantial challenges: On the one hand, Austria was in the process of integration into the EU and monetary union, on the other hand, the transformation of CEE as well as the growing number of EU members and monetary union applicants created an increasing demand for policy advice, knowledge transfer and technical assistance. Another newly evolving task was cross-border banking supervision. Not surprisingly, Austrian banks were among the first ones to participate in the restructuring and privatization of the CEE financial markets. In fact, Austrian banks established themselves as major players in many CEE countries, defending their market shares until today, as the conditions in the region have turned difficult in the wake of the global financial crisis. Especially since January 2008, when the OeNB was assigned additional key tasks in banking supervision, the stability of the CEE financial market has become a major issue for the OeNB.

2 “Going East” – The Obvious Strategic Choice from a Viennese Perspective

After the fall of the Iron Curtain, the OeNB decided to systematically use and increase its expertise in CEE issues and to share this know-how not only at home (e.g. with the social partners or commercial banks) but also with its counterparts in the ESCB. Admittedly, this strategy was half pushed and half pulled; as it turned out, Austrian members of any ESCB committee were immediately expected to be fully-fledged experts on CEE. As a result, the OeNB was one of the first central banks in the ESCB to specialize on a particular analytical topic. Consequently, apart from fulfilling its responsibilities to the Austrian economy, the OeNB had to develop a very clear focus on CEE issues. Suomen Pankki, the Finnish central bank, was in a very similar position, as the Finnish economy had a long-standing tradition of trade with Russia and the Baltic countries. In order to reap the greatest benefit from their expertise, the OeNB and the Bank of Finland Institute for Economies in Transition (BOFIT) agreed on a close cooperation in analyzing CEE economies, which turned out to be very fruitful and has remained relevant until today.

Moreover, the OeNB enhanced its already existing contacts in the region and established a kind of network between Austrian and CEE institutions, including not only central banks but many other organizations as well, from research and academic institutions to banking and commercial business organizations.² These network activities have never been a one-way street, as all participants have profited from a free flow of information in both directions. The challenges of preparing for EU membership first and participation in monetary union a few years later as well as the experience of living outside or inside the EU and living without or with the euro were just a few core topics among a broad range of issues discussed. A fairly regular and frequent exchange of experts was established, which, in the end, constitutes the backbone of institutional and personal relationships throughout the region.

² *It should also be emphasized that many other business areas of the OeNB – from accounting and cash logistics to controlling, financial markets analysis and supervision, payment systems and statistics – have contributed considerably to the OeNB’s cooperation and technical assistance activities in CEE.*

Much has happened since 1989: Many CEE countries have become members of the EU – Slovenia and Slovakia have even entered monetary union – which gave the new EU Member States a say in the Eurosystem/ESCB committees. Despite these major developments, the topics of transition, catching-up and convergence have not lost their importance. Quite on the contrary, the financial crisis has shown the urgent need for even more and deeper analyses of CEE economies and for including a larger number of countries in these analyses. When the Iron Curtain came down, our main focus was on the CEE-5 (Poland, the Czech Republic, Hungary, Slovakia and Slovenia). In the meantime, the regional focus has shifted south, in particular to the Western Balkan countries. In the OeNB's communication, this shift has been highlighted also by the use of the acronym CESEE – Central, Eastern and Southeastern Europe – rather than CEE. More recently, we have added some CIS countries to our portfolio, as Austrian banks have spread their activities to the region. At the same time, we did not give up or significantly reduce the analysis of the CEE-5 as originally planned, but, on the contrary, we had to take on board some urgent elements of economic developments in the Baltic countries in our analyses. Of course, this has been largely due to the financial crisis, which erased at least some of the progress in catching-up and harshly highlighted most, if not all, CESEE countries' position as emerging markets.

3 A Wide and Changing Range of Topics³

Analyzing CESEE requires a lot of flexibility, as the topics of interest change frequently. Three main areas of research can be identified: (1) transition: the fundamental change from centrally planned to market economies; (2) catching-up: the closing of the gap between the EU average GDP per capita and GDP per capita in CEE; and, finally, (3) integration: institutional change, mainly in an EU context.

With respect to transition, the case of East Germany and its unification with West Germany, of a few Asian and Latin American countries as well as, more recently, economic and institutional developments in China can to some extent be compared with CESEE. The latter, however, has been through a unique process in so far as it had been a fairly prosperous region before World War II and because of its medium-term prospects in the European integration context. One of the most visible parts of transition was the change from state to private ownership of many firms. Privatization took place in various ways: through voucher privatization, initial public offerings on the stock exchange or through direct sales to national and international investors. Another important issue was how to attract FDI in general, as modernizing the infrastructure and increasing production capacities required foreign expertise and capital.

Besides these practical issues, very general questions arose in the transformation process, mainly discussed in behavioral economics, such as how to deal with the lack of incentive mechanisms and how to install new ones; how to make economic entities more self-reliant so that they do not wait for decisions made by others; how to get rid of highly subsidized prices and how to find true equilibrium prices, including exchange rates. At the same time, the CESEE countries' heritage also contained some positive features, like low or even nonexistent public debts, which

³ For an encompassing overview of the topics and issues we have addressed since the very beginning, see "CESEE-Related Activities of the OeNB's Economic Analysis and Research Department" in this issue.

provided room for fiscal action, albeit lacking the required instruments and decision-making bodies.

Catching-up remains a crucial issue. Most countries started from a very low level of GDP per capita, which decreased further at the beginning of the transformation process and, in some cases, even today continues to stand at levels half of those of the euro area. Therefore, adjustment speed is one of the major issues: An economy that is growing too quickly runs the risk of overheating, while an economy that is growing too slowly runs the risk of missing opportunities, triggering unemployment and a brain drain. In general, catching-up drives the convergence of several economic areas and leads to the adjustment of all kinds of prices and wages. The Balassa-Samuelson effect is a special phenomenon of this process and received widespread attention in the literature of the 1990s.

Finally, transformation has also implied integration and, hence, necessitated institutional change, which was a prerequisite for the first and the second round of EU eastern enlargement and is a crucial component of the negotiating processes with prospective EU members (such as Croatia) and of EU neighborhood policies in general. The most advanced CESEE countries have already qualified for monetary union. Slovenia and Slovakia introduced the euro recently.

The institutional changes on the path to EU and euro area membership also affected trade and capital agreements. In general, they led to an increase in trade, competition and competitiveness; in many cases, however, they also caused balance of payments deficits. Borders were opened – at least to some extent – also for workers, enhancing migration in one direction and the flow of remittances in the opposite one. In addition, there have been substantial institutional changes at the micro level, for instance to ensure central bank independence, which is an important precondition for EU membership.

4 From General to Specific Issues

The character of the issues that had to be addressed also changed over time. At the beginning of the transition process, evaluations of first reform steps and of first experiences were at the center of interest. These ranged from the evaluation of outcomes (e.g. distributional effects) to the search for a new, adequate policy mix, as novel challenges were emerging. The appropriate wage level, the “right” exchange rate policy and the right speed of financial deepening, for instance the dynamics of credit growth, were among the issues discussed. The overall aim was to find a sustainable growth path, or, put differently, to avoid overheating without dampening growth prospects. This sounds very much like the key question of sustainable development in any economy, but as CESEE started from a very low income level, people were eager to catch up and to increase their living standards to Western levels quickly. In some cases, this led to the appearance of bubbles, mainly in the real estate or housing sectors, but also in lending. These bubbles were driven by various factors, sometimes by foreign investors, sometimes by domestic demand fuelled by (mostly foreign-owned) banks’ expansive lending practices.

In some countries, including the Baltics, the bursting of these domestic bubbles coincided with the – unrelated – arrival of the global financial and economic crisis, which triggered the worst downturn we have seen since the Great Depression of the 1930s. This crisis reached the CESEE region in late autumn 2008. It hit most

countries hard, as financial markets, which did not differentiate between the individual countries of the region, identified huge risks hidden in current account and other imbalances. The growth differentials between the EU-15 and CESEE melted and the catching-up process came to a halt. 2008 and 2009 were devoted to analyzing the financial crisis, its impact on the Western European banking system and the IMF's, the EU's and national support and stimulus measures. In the medium term, the focus will shift to a more thorough economic analysis that investigates the causes of the crisis and identifying measures to safeguard economic catching-up in the long run.

5 Research, Technical Assistance and Cooperation – The Main Pillars of the OeNB's Focus on CESEE

A range of OeNB publications reflects the bank's extensive analysis of and research on CESEE-related topics.⁴ "Focus on European Economic Integration" (the successor to "Focus on Transition") is the OeNB's flagship publication on transition and integration issues. Studies on CESEE topics are also published in "Monetary Policy & the Economy" and "Financial Stability Report." In view of the continuous demand for analyses of developments in CESEE, "Focus on European Economic Integration" has been published on a quarterly instead of a semiannual basis since 2009 and is indexed in EconLit.

Furthermore, the OeNB organizes regular events as a platform for discussion and an exchange of views, including, in particular, the one-day workshop series called East Jour Fixe and the internationally renowned two-day Conference on European Economic Integration (the successor to the East-West Conference). One feature of the annual conference is the presentation of the Olga Radzyner Award for Scientific Work on European Economic Integration bestowed on young economists from CESEE, which had been established to commemorate the former Head of the OeNB's Foreign Research Division, who died in a tragic accident in 1999. Olga Radzyner had been one of the key initiators and promoters of the OeNB's CESEE-related activities.

One of the most memorable events was the Conference on European Economic Integration that took place in 2004, the year the first CESEE countries joined the EU. A festive atmosphere prevailed at this event, where all CESEE national central banks presented the distinctive features of their home economies. Another highlight was the conference of 2005, which was organized together with the ECB and its financial integration research network. This event's much more academic character was reflected by a call for papers and by parallel sessions on an unusually wide range of financial and capital market issues. On the whole, all conferences featured topics of immediate relevance as well as outstanding speakers and always attracted a large audience – people from east and west, from policymaking, academia and banking – that showed great interest.

One of the main objectives of our events was and still is to share our knowledge and experience. Also, we aim to promote the catching-up process not only by analyzing it but also by providing active support. This idea was the basis for the

⁴ See "CESEE-Related Activities of the OeNB's Economic Analysis and Research Department" in this issue.

Austrian Bankers' College International.⁵ The first of these ABCi seminars in Weißenbach in Upper Austria was held in 1989, right after the fall of the Iron Curtain, and was a premiere for both speakers and participants, who learned a lot from each other. In the following six years, more than 4,000 bankers from 24 CESEE and CIS countries participated in knowledge exchange and received training in Austria. In fact, many long-lasting working relationships and close personal contacts started or were intensified at the ABCi seminars.

The Joint Vienna Institute (JVI), founded in 1992, is based on a much broader institutional and professional footing. A cooperative venture of six international organizations (including the IMF) as well as the OeNB and the Austrian Ministry of Finance, it provides training for officials and managers from former centrally planned economies to assist them in the transition process. Between 1992 and 2008, no less than 23,305 participants attended courses at the JVI, of which 8,915 were central bankers, 6,529 came from government ministries, and 7,861 from other institutions. We are proud to say that some of them are now in leading positions in politics or at eminent institutions, for example Dalia Grybauskaitė, President of Lithuania, Sergey Ignatiev, Chairman of the Central Bank of the Russian Federation, or Ilmārs Rimšēvičs, Governor of Latvijas Banka.

As a member of the ESCB and the Eurosystem, the OeNB has been providing its expertise on CESEE to the discussions of the Governing Council and the General Council of the ECB. Apart from contributing to the general debates on economic and monetary policy issues, the OeNB played a particular role in Slovenia's and Slovakia's efforts to enter the euro area. Moreover, the OeNB was actively involved in the discussions on ERM II topics at the Eurosystem/ESCB level and regularly provides its analyses on CESEE-related issues to the International Relations Committee as well as to the Monetary Policy Committee of the Eurosystem/ESCB. In addition, OeNB staff members have been invited to participate in numerous activities over the past decades, organized by the ECB and many other international organizations.

Apart from hosting high-profile events like the Eurosystem's high-level seminar with the Central Bank of the Russian Federation in March 2009, the OeNB maintains informal bilateral dialogues with a number of CESEE central banks. In March 2007, the Governor of the OeNB invited his counterparts from the central banks of the Czech Republic, Hungary, Slovakia and Slovenia to Vienna to discuss topical issues of mutual interest. In 2008, the Governor of Česká národní banka hosted the follow-up meeting in Prague. In 2009, this circle of governors was extended to include the Governor of Narodowy Bank Polski. The 2009 meeting was held in Budapest.

The OeNB has traditionally sustained close relations with BOFIT and Suomen Pankki. Apart from maintaining a regular exchange of researchers, the OeNB and the Finnish central bank share their expertise on CESEE for instance by contributing to each other's forecast. These combined results are used as an input to the external assumptions of the regular Eurosystem forecasting exercises. The OeNB also regularly hosts the Emerging Europe Seminar, an event originally designed by

⁵ As early as in 1975, the OeNB created the Central Bankers Club, which brought together representatives of small and medium-sized European central banks for the discussion of and an exchange of views on topics of common interest.

Suomen Pankki and now organized on a rotating basis by several European central banks with a special expertise in emerging markets.

At the national level, the OeNB maintains an excellent working relationship with the Vienna Institute for International Economic Studies (wiiw), the leading Austrian think tank for CESEE-related issues. Co-authored papers, jointly organized events like the Global Economy Lecture as well as joint seminars at the JVI are elements of this fruitful cooperation.

6 Mission Accomplished? More Needs to Be Done!

The OeNB's focus on CESEE has always been and will continue to be under permanent review. Over the years, there have been discussions in particular about which countries to include in our "country focus;" after all, some CESEE countries have become EU members, some are very small and far away and do not belong to the countries where Austrian businesses and banks are active. Both the current crisis and Austrian banks' strategy to enter the markets of the Western Balkans and the CIS, however, have shown that we were right not to exclude any CESEE country completely and to aim for the almost impossible goal of covering them all, albeit with different nuances and different intensity. Although CESEE research and analysis is certainly one of the most fascinating fields for economists today, we do hope that in the long run, our research will not be needed any more, when catching-up has been completed and a truly integrated Europe has become a reality not only in economic and currency terms, but also in the lives of the people.