

Research Update

Economic Analysis and Research Department

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Editorial



by Doris Ritzberger-Grünwald

Director of the Economic Analysis and Research Department

Wishful thinking

Under normal circumstances, central bankers are concerned about too large an increase in prices. They are the watchdogs that keep warning about inflation getting too high, eroding the value of money, endangering price competitiveness, and punishing creditors.

These days, things are the other way round: Analysts are following price data releases of euro area countries even more anxiously, but not because they are afraid of too high an increase. Each increase which is higher than previously expected is actually highly welcomed and seen as a relief.

Some warning signs were evident already at the beginning of this year, but the true wake-up call came when annual inflation in the euro area dropped to 0.5% in March. What startled observers was not so much the very low level but the fact that the drop to 0.5% came as a surprise. Tax increases in some countries, for instance in Italy, should have resulted in a cost push, and the predicted increase in euro area private consumption should have led to a demand pull. But the opposite happened.

As regards the price stability aim of the Eurosystem, an inflation rate of 0.5% does certainly not qualify as "below, but close to, 2%." At the same time, we should keep in mind that a) this aim has to be reached in the long run, b) the Eurosystem did not jump to action when the inflation rate was above the 2% threshold for quite a long time, and c) what is much more relevant in this respect is inflation expectations, and which ones to single out – a subject that is far too broad for an editorial, though.

Our real problem is the lack of growth. Without growth, bank balance sheet repair, Europe's homework #1, will become even more difficult, as nonperforming loans will increase further rather than decline. Spurring investment, Europe's homework #2, will not vanish from our agenda, either. And without growth there is not much chance that we will see new jobs, Europe's homework #3, for the unemployed, the many migrants, or simply for the next generation.

Hence the current relevance of the Banking Union and its completion (see the article on our latest Economics Conference). Another issue that has made it onto the warning list is house price bubbles. Whereas central bankers used to monitor the development of assets prices mainly from an investor point of view, the crisis has increased our awareness in this respect, and a macroprudential framework has given us at least the possibility to warn in time (see the publications on the OeNB's fundamental house price indicator). Entering uncharted waters seems to become everyday business for central bankers. Those who thought (or maybe hoped) that our workload would decrease have to realize that this was wishful thinking. Instead, the agenda is getting fuller day by day.

Doris Ritzberger-Grünwald



Toward a European Banking Union: Taking Stock

42nd OeNB Economics Conference, Vienna, May 12 and 13, 2014

On May 12 and 13, 2014 the 42nd Economics Conference of the Oesterreichische Nationalbank (OeNB) took place in Vienna. Reflecting the recent finalization of the legal framework for the EU banking union, this year's conference discussed the move "Toward a European Banking Union." The creation of a European banking union has been initiated to decouple any potential future banking crises from sovereign debt crises. One of the building blocks for the banking union is the joint European banking supervision as embodied by the Single Supervisory Mechanism (SSM), which will become operational in late 2014 under ECB leadership.



Another fundamental pillar is the planned Single Resolution Mechanism (SRM), an instrument to deal with distressed banks in the future. The conference intended to weigh the potential costs and benefits of this bold institutional reform, which aims to enhance financial stability in Europe. It brought together a diverse international audience of 420 leading policy, business and finance experts as well as renowned members of the global academic community. The following summarizes a few highlights of the key findings presented at the conference.

In his opening remarks, *Ewald Nowotny*, the OeNB's Governor, addressed the impact of the EU's banking union on economic policymaking, the banking industry and the economy at large. *Axel Weber*, Chairman of the Board of Directors at UBS and former President of the Deutsche Bundesbank, talked about the role of the banking union for the European integration process. He denoted capital as a significant competitive advantage of banks in the future and stressed that banks should address any capital needs in the currently benign environment. *Vitor Constância*, Vice-President of the European Central Bank (ECB), discussed the consequences of the banking union for the European integration. In his view, banking union represents a paradigm change, ending the culture of bail-out and ushering in a culture of bail-in. Additionally, it implies a considerable shedding of sovereign power by participant countries, and at the same time the strength of banks will no longer be influenced by the ability of governments to provide domestic banks with the implicit subsidy of public support. Issues

relating to the transition and the new supervisory regime were discussed by *Elke König*, President of Germany's Federal Financial Supervisory Authority BaFin, and *Danièle Nouy*, Chair of the Supervisory Board of the Single Supervisory Mechanism.

Sigríður Benediktsdóttir, Central Bank of Iceland looked at the question if and how outsiders will be affected by the European banking union. One lesson she drew from the Icelandic experience with a financial crisis is that the credibility of supervision is essential. For the world financial system as a whole it would be important if the move toward a banking union ended up in a "race to the top". *Giovanni Dell'Ariccia*, International Monetary Fund, discussed tradeoffs associated with a banking union. The "net benefits" of a banking union depend on the degree of financial and economic integration, the exchange rate regime, the financial structures and the relative size of the countries taking part.

Thierry Philipponnat, Secretary General of Finance Watch, and *Thomas Wieser*, President of the Eurogroup Working Group, pointed out that the Internal Market within the European Union did not lead to "One Market" in the financial sector as it was hoped for. Supervisory and regulatory nationalism prevailed. For both of them a banking union has the potential to resolve the problem. *Martin Hellwig*, Director of the Max Planck Institute for Research on Collective Goods, agreed with the above diagnosis. Not surprisingly, he was less convinced of the therapy.



During the conference the Klaus Liebscher Award for 2014 was presented by Claus Raidl and Ewald Nowotny. This year's two prize-winning papers, which were selected from numerous excellent submissions, address particularly topical economic policy issues and display outstanding academic quality: "Systemic Sovereign Risk: Macroeconomic Implications in the Euro Area" by Saleem Abubakr Bahaj and "Information Frictions and the Law of One Price: 'When the States and the Kingdom became United'" by Claudia Steinwender.

Summary of the conference on “Bretton Woods at 70 – Regaining Control of the International Monetary System,” 27-28 February 2014, Vienna

This conference was organized to commemorate the 70th anniversary of the Bretton Woods institutions and was hosted jointly by the Reinventing Bretton Woods Committee, the Austrian Federal Ministry of Finance and by the Oesterreichische Nationalbank.

The conference provided an opportunity to reflect on the motivations of the Bretton Woods international monetary system, its drawbacks and its potential implications for further developments on the international agenda. It was organised in six sessions. Session I started out with a historical account of the role of the Bretton Woods system, including the Bretton Woods institutions, namely the International Monetary Fund (IMF) and the World Bank. Participants inter alia discussed the objectives driving the main protagonists, the US and UK, back in July 1944, when the Bretton Woods monetary system was launched. Subsequently, Session II was devoted to the euro area's role in the international monetary system. Speakers outlined the challenges of the euro area in recent years and the remedial measures that have been taken to overcome these challenges, such as the strengthened economic governance within the euro area and the creation of a banking union. Session III took up

the issue of global adjustment in an increasingly multi-polar world. It was shown that the advanced economies and the emerging markets are closely inter-dependent and that the relative importance of the latter will even more increase over the coming decades. Session IV dealt with the management of capital flows, reserves and exchange rate volatility, which is a topical issue given the current problems in some emerging economies. Session V covered the topic of preventing the middle income trap. It was highlighted that real income convergence between emerging markets and advanced economies has grown in the past decades, but that this catching-up process may have its limits. Session VI provided an outlook on the possible future role of the international monetary system. In general, the IMF was seen as remaining an important global institution also in future years but that a greater weight in the IMF's decision-making will have to be shifted to emerging markets.

The proceedings of this conference will be published shortly in the OeNB Workshop Series.

East Jour Fixe: 10 Years of Eastern Enlargement

On the occasion of the 10th anniversary of eight CESEE countries joining the European Union, the OeNB hosted the 75th East Jour Fixe “Ten Years After the 2004 EU Enlargement: Achievements and Next Steps” on its premises on Friday, April 25, 2014. The Anniversary East Jour Fixe was part of a two-day event on April 24 and 25, 2014, organized jointly by the OeNB, the Austrian Federal Ministry for Europe, Integration and Foreign Affairs (BMEIA), the Austrian Federation of Industries (IV), the Institute for Human Sciences (IWM) and The Vienna Institute for International Economic Studies (wiiw). The event covered a broad range of topics associated with EU enlargement and the European integration process, such as: lessons learned from past EU enlargement rounds; prospects for the future; multi-speed Europe; reviving convergence after the crisis; monetary and exchange rate strategies; European integration and nationalism; and 1914–2014: a century of European disintegration and re-integration.

The focus of the East Jour Fixe was on monetary and exchange rate aspects and was organized in two moderated panel discussion rounds of central bank heads of research from Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia, followed by concluding remarks by former ECB Executive Board member Gertrude Tumpel-Gugerell.

The detailed program of the conference can be found under

<http://www.oenb.at/Termine/Terminarchiv/2014/Konferenz-24-04-2014.html>

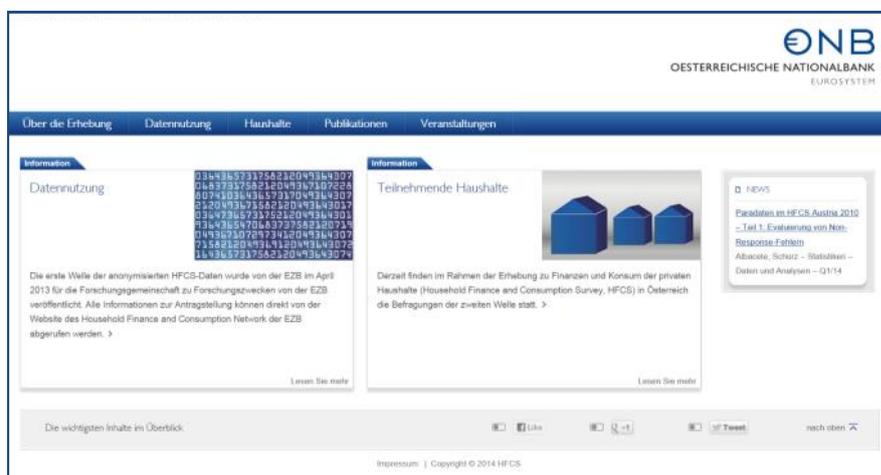
Under <http://wiiw.ac.at/ten-years-after-the-2004-eu-enlargement-achievements-and-next-steps-e-211.html>, there is also a video documentation of all sessions. The workshop proceedings will be published in Focus on European Economic Integration Q2/14.

Re-Launch HFCS Website

The project website of the Eurosystem's Household Finance and Consumption Survey (HFCS) in Austria was re-launched with a new web design and updated content in time before the start of the second wave of this survey. All essential information about the HFCS can be found in this user friendly web presence. Thus, both the users of the HFCS data (the research community) and the households that are invited to take part in the survey find on this website information about the content and scope of the HFCS. Furthermore, methodological details can also be found. Additionally, published research papers as well as presentations in connection with the HFCS in Austria are provided and can be downloaded as well. Contact details, links to other websites such as

the HFCS website of the ECB and a catalogue of workshops (including videostream for selected lectures) complement the information.

For further details see www.hfcs.at



Call for Applications – Visiting Research Program

The Oesterreichische Nationalbank (OeNB) invites applications from external researchers for participation in a Visiting Research Program established by the OeNB's Economic Analysis and Research Department. The purpose of this program is to enhance cooperation with members of academic and research institutions (preferably postdoc) who work in the fields of macroeconomics, international economics or financial economics and/or with a regional focus on Central, Eastern and Southeastern Europe.

The OeNB offers a stimulating and professional research environment in close proximity to the policymaking process. Visiting researchers are expected to collaborate with the OeNB's research staff on a prespecified topic and to participate actively in the department's internal seminars and other research activities. They will be provided with accommodation on demand and will, as a rule, have access to the department's computer resources. Their research output may be published in one of the department's publication outlets or as an OeNB Working Paper. Research visits should ideally last between 3 and 6 months, but timing is flexible.

Applications (in English) should include

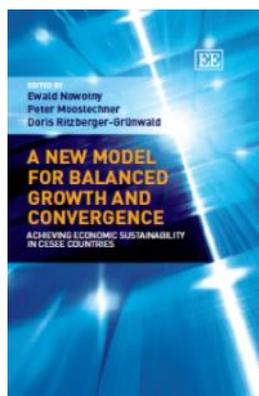
- a curriculum vitae,
- a research proposal that motivates and clearly describes the envisaged research project,
- an indication of the period envisaged for the research visit, and
- information on previous scientific work.

Applications for 2014 should be e-mailed to eva.gehringer-wasserbauer@oenb.at by May 1, 2014.

Applicants will be notified of the jury's decision by mid-June 2014. The following round of applications will close on November 1, 2014.

See also: <http://www.oenb.at/en/About-Us/Research-Promotion/Grants/Visiting-Research-Program.html>





A new Model for Balanced Growth and Convergence

Achieving Economic Sustainability in CESEE Countries

Nowotny, E., Mooslechner, P. and Ritzberger-Grünwald, D.

Edward Elgar Publishing

This topical book addresses the need for emerging economies in Central, Eastern and South-Eastern Europe to find a new, sustainable growth model that fosters continued convergence with the EU without leading to the build-up of new vulnerabilities.

The expert contributions frame the discussion on balanced growth in Europe, deal with the legacy of the old growth model (such as managing disrupted capital flows and deleveraging), and provide insights from the growth strategies of Russia and Turkey as well as the adjustment process of successful small CESEE countries. They focus on providing a multi-disciplinary assessment, combining the views of policy-makers and academics with those of central and commercial bankers.

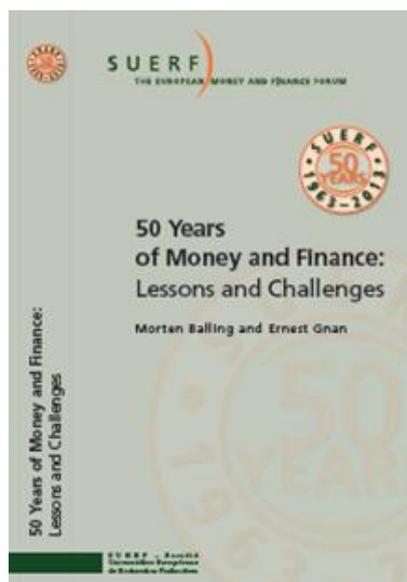
This book will prove a thought-provoking read for academics, researchers and students in the fields of economics – particularly international economics – and finance, money and banking. Policy-makers and economists interested in European integration and emerging European economies will also find this book to be an invaluable resource.

See also:

http://www.eelgar.co.uk/bookentry_main.lasso?id=15470&breadcrumblink=&breadcrumb=&sub_values

50 Years of Money and Finance - Lessons and Challenges

Edited by Morten Balling and Ernest Gnan, with a foreword by Christian Noyer, preface by Urs Birchler and an introduction by the editors



SUERF commemorates its 50th anniversary with the publication of a special volume entitled "50 years of Money and Finance: Lessons and Challenges", published to coincide with its 50th Anniversary celebration in Paris. The volume is published by Larcier for SUERF. The researchers who have contributed to the volume were asked to look at the monetary and financial history of the last 50 years, and to summarise the most important trends and experiences and to then draw conclusions for the future. They were asked to identify the main trends in international

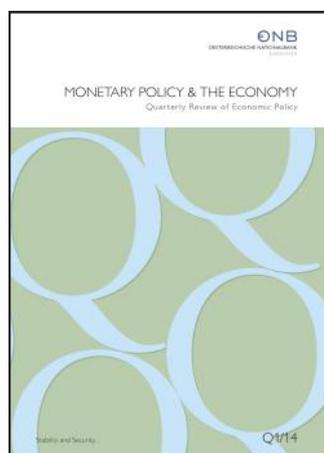
financial markets, in global and European macroeconomic (im)balances, in European financial integration, in central banking, in banking and securities markets, in financial innovation and in the origins and handling of financial crises. Path-breaking events, political decisions and relevant outstanding research contributions in the field since the early 1960s all feature significantly

http://www.suerf.org/index.php?option=com_k2&view=item&layout=item&id=463&Itemid=139

OeNB Periodical Publications

<http://www.oenb.at/en/Publications/Economics.html>

List of all Publications since 2001 (by staff of the Economic Analysis and Research Section)



Monetary Policy & the Economy Q1/14

Austria: Economic Activity Picks Up at the Turn of the Year (Ragacs)

The EU's Reformed Institutional Framework and the Way Forward (Kment, Lindner)

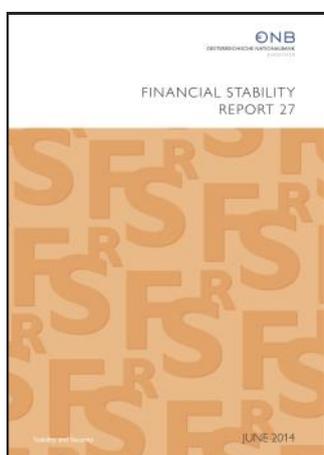


Focus on European Economic Integration Q1/14

Do the Drivers of Loan Dollarization Differ between CESEE and Latin America? A Meta-Analysis (Mariya Hake, Fernando Lopez-Vicente, Luis Molina)

Can Trade Partners Help Better FORCEE the Future? Impact of Trade Linkages on Economic Growth Forecasts in Selected CESEE Countries (Tomáš Slačák, Katharina Steiner, Julia Wörz)

The Cyclical Character of Fiscal Policy in Transition Countries (Rilind Kabashi)



Financial Stability Report 27 (forthcoming)

Risk Bearing Capacity of Households - Linking microlevel data to the macro-prudential toolkit (Albacete, Eidenberger, Krenn, Lindner, Sigmund)

Capital market development in CESEE countries (Jäger-Gyovai)

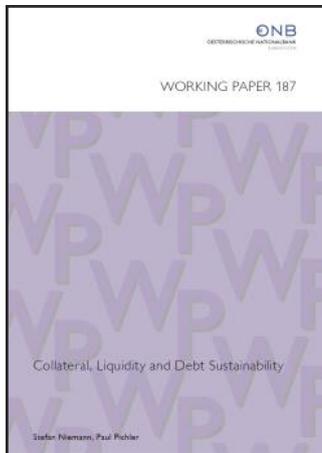
Recent developments in Russia and Turkey from the viewpoint of Austrian banks (Ebner, Wittenberger, Widhalm) (working title)

Different perspectives of deleveraging (working title)

Macroprudential supervision in Austria (working title)

OeNB Working Papers

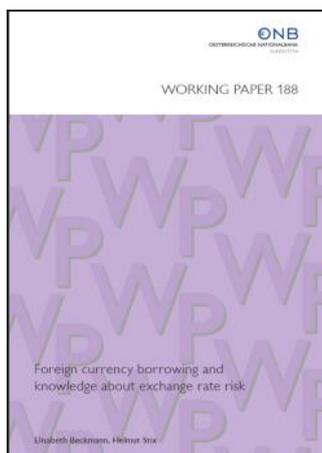
<http://www.oenb.at/en/Publications/Economics/Working-Papers.html>



Collateral, Liquidity and Debt Sustainability

Stefan Niemann and Paul Pichler (Working Paper 187)

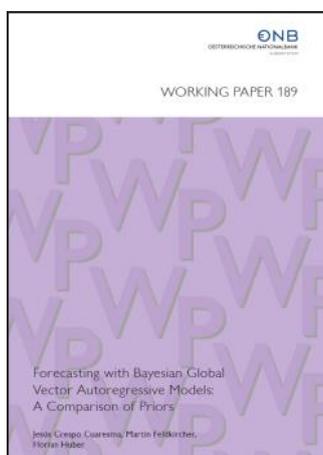
We study the sustainability of public debt in a closed production economy where a benevolent government chooses fiscal policies, including haircuts on its outstanding debt, in a discretionary manner. Government bonds are held by domestic agents to smooth consumption over time and because they provide collateral and liquidity services. We characterize a recursive equilibrium where public debt amounts to a sizeable fraction of output in steady state and is nevertheless fully serviced by the government. In a calibrated economy, steady state debt amounts to around 84% of output, the government's default threshold is at around 94% of output, and the haircut on outstanding debt at this threshold is around 40%. Both reputational costs of default and contemporaneous costs due to lost collateral and liquidity are essential to generate these empirically plausible predictions.



Foreign currency borrowing and knowledge about exchange rate risk

Elisabeth Beckmann, Helmut Stix (Working Paper 188)

Foreign currency borrowing is widespread in many regions of the world. This raises the question whether unhedged borrowers do not understand the exchange rate risk emanating from such loans. Employing household level micro-data from eight Central and Eastern European countries we study how agents' knowledge about exchange rate risk affects the currency denomination of loans. Results show, first, that a majority of respondents is aware that depreciations increase loan installments. Second, we find that knowledge about the exchange rate risk lowers the demand for foreign currency borrowing. To assess the causal effect of literacy on loan demand we utilize information on agents' exchange rate expectations. Overall, results suggest that financial literacy exerts a strong impact on the choice of the loan currency. However, from an aggregate perspective, a misunderstanding of the underlying risks is not the main cause of foreign currency borrowing.



Forecasting with Bayesian Global Vector Autoregressive Models: A Comparison of Priors

Jesús Crespo Cuaresma, Martin Feldkircher, Florian Huber (Working Paper 189)

This paper puts forward a Bayesian version of the global vector autoregressive model (B-GVAR) that accommodates international linkages across countries in a system of vector autoregressions. We compare the predictive performance of B-GVAR models for the one - and four-quarter ahead forecast horizon for standard macroeconomic variables (real GDP, inflation, the real exchange rate and interest rates). Our results show that taking international linkages into account improves forecasts of inflation, real GDP and the real exchange rate, while for interest rates forecasts of univariate benchmark models remain difficult to beat. Our Bayesian version of the GVAR model outperforms forecasts of the standard cointegrated VAR for practically all variables and at both forecast horizons. The comparison of prior elicitation strategies indicates that the use of the stochastic search

variable selection (SSVS) prior tends to improve out-of-sample predictions systematically. This finding is confirmed by density forecast measures, for which the predictive ability of the SSVS prior is the best among all priors entertained for all variables at all forecasting horizons.

External Publications by Staff Members

Efficiency wages, staggered wages, and union wage-setting

Markus Knell (2014). *Oxford Economic Papers*, first published online: March 24, 2014, doi:10.1093/oenb/gpu016

This article studies the role of staggered efficiency wages in a small-scale DSGE model. The simple structure of the model allows for closed-form solutions. The set-up differs from the related literature in that I assume wages are sticky and unions are responsible for wage-setting. The model has the potential to explain why wages depend strongly on past wage levels as it is suggested by empirical data. The presence of efficiency wages increases persistence, however, only for certain parameter constellations. In particular, the elasticity of effort with respect to the wage has to be large. In an extension of the model I show that this is more likely to be the case if wages are the outcome of a bargaining process between unions and firms.

Net Wealth across the Euro Area - Why household structure matters and how to control for it.

Pirmin Fessler, Peter Lindner, Esther Segalla (2014). *ECB Working Paper 1663*, March 2014

We study the link between household structure and cross country differences in the wealth distribution using a recently compiled data set for the euro area (HFCS). We estimate counterfactual distributions using non-parametric re-weighting to examine the extent to which differences in the unconditional distributions of wealth across euro area countries can be explained by differences in household structure. We find that imposing a common household structure has strong effects on both the full unconditional distributions as well as its mappings to different inequality measures. For the median 50% of the differences are explained for Austria, 15% for Germany, 25% for Italy, 14% for Spain and 38% for Malta. For others as Belgium, France, Greece, Luxembourg, Portugal, Slovenia and Slovakia household structure masks the differences to the euro area median and Finland and the Netherlands change their position from below to above the euro area median. The impact on the mean and percentile ratios is similarly strong and varies with regard to direction and level across countries and their distributions. We can confirm the finding of Bover (2010) that the effect on the Gini is somewhat less pronounced, but might mask relevant information by being a net effect of different accumulated effects along the distribution. Country rankings based on almost all of these measures are severely affected alluding to the need for cautious interpretation when dealing with such rankings. Furthermore, the explanatory power of household structure changes along the net wealth distribution. Therefore we argue for more flexible controls for household structure. We provide such a set of controls to account for household type fixed effects which are based on the number of household members as well as possible combinations of age categories and gender.

Upcoming and Recent Events

The following events are organized by the OeNB. Please note that attendance is by invitation only. If you are interested in participating in one or more of the events, please send an e-mail to OeNB.ResearchUpdate@oenb.at

Upcoming

May 23, 2014	Friday Seminar: Christophe Chamley (Boston University) - TBA
June 12, 2014	A Way to a new price index for Austrian commercial properties (Workshop held in German language)
June 17, 2014	Professor Martin Feldstein (Harvard University and National Bureau of Economic Research); The US Economy and the Federal Reserve
August 25 – 29, 2014	OeNB Summer School: Applications of multilevel models
September 12, 2014	Using Survey Data For Economic Policy Research - A Focus On CESEE (Working Title)
September 18 – 19, 2014	Using Microdata for Macroprudential Policy Data, Methods, Applications
September 25 – 26, 2014	Second CEPR Economic History Symposium
November 24 – 25, 2014	Conference on European Economic Integration (CEEI): The Rebalancing Challenge in Europe – Perspectives for CESEE

Recent

May 12 – 13, 2014	42 nd Economics Conference of the OeNB
May 9, 2014	Friday Seminar: Marco Spaltro (Morgan Stanley) - QE and capital requirements: impact on bank lending
April 24 – 25, 2014	East Jour Fixe: 10 Years of Eastern Enlargement
April 11, 2014	Friday Seminar: Loukas Balafoutas (Universität Innsbruck) - Don't expect any help: Direct and indirect punishment among strangers

OeNB Courses at the Joint Vienna Institute (JVI)

For further details see: www.jvi.org

August 25-29, 2014	OeNB Summer School
September 15-17, 2014	Cash Circulation and Payment Systems in Austria
October 13-17, 2014	Macro-Financial Stability in Central, Eastern and Southeastern Europe
October 20-24, 2014	Economic and Monetary Integration in Europe
November 17-21, 2014	Monetary and Financial Statistics Collected and Compiled by the ESCB
December 1-2, 2014	Financial Education in Central Banks: Initiatives and Activities