

Research Update

Economic Analysis and Research Department

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OeNB's Economic Outlook (October 2008) (see page 3)

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From the Governor's Office

An interview with Ewald Nowotny
Governor of Oesterreichische Nationalbank

With you taking over as Governor of the Oesterreichische Nationalbank on September 1, the Economic Analysis and Research Department changed directorate and is now directly assigned to the Governor. What was the motivation for this?

It was important for me to make economic analysis part of my "portfolio" as Governor, because it is the prime task of a central bank. At the same time, the recent financial market turbulence, which is now starting to cause severe problems in the real economy, has a deep impact on economic policymaking.

Without doubt, the current crisis has taught us a lesson about the importance of pursuing a broad analytical approach in order to detect potential vulnerabilities in the financial system; macroeconomic analysis and banking analysis have to interact very closely to achieve this objective. We have to make sure that supervisory and economic research staff exchange assessments and feed back on each other to fit both perspectives together. Otherwise we would be ill prepared to detect the next crisis early on.

Apart from that, I think it will be important to ensure that quality research and analysis are maintained at the OeNB. While we have done a lot in recent years to keep up with the state of the art – with our researchers publishing in high-profile scientific journals and our own publications continuously improving in quality – I consider it crucial that similarly, the academic world is more attuned to current policy issues. The current crisis is also a crisis for the academic mainstream in economics, which has played its part in the build-up of the crisis by reassuring everyone in recent years that efficient financial markets know best. Therefore, I consider it important to engage in more frequent dialogue with universities: It is vital to stimulate applied research in academia by communicating questions and problems arising in day-to-day policymaking.

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From the perspective of an economist, this is a challenging and a fascinating time. How do you assess the current state of the financial crisis: Have we seen the worst of it yet?

I think that the right measures have been taken to tackle the crisis. But there is no doubt that we are facing tough times and it will be some time before we reach the end of the tunnel. There may also be temporary setbacks in the meantime. For central banks it means testing new territories in many areas. First, policy instruments and the role of central banks: as an emergency measure, central banks have accepted a broader range of collateral, and they have de facto taken over the role of the interbank market by acting as a kind of clearing house. Second, central banks' understanding of stability-oriented policies: The global downturn necessitates active fiscal policy in order to prevent the worst, and this needs to be implemented in a coordinated way at the European level if not worldwide. There is one key issue: the financing of the real economy! To avoid a breakdown of the banking system and to secure a stable supply of credit to investors is the overriding objective at the moment.



Editorial

by Peter Mooslechner
Director of the Economic Analysis and Research
Department

Financial Crisis: What to expect under the Christmas tree?

Since the beginning of the financial turbulence almost one and a half years ago, the crisis has worsened and deepened at an increasing speed. Downward revisions to international forecasts are already outdated when they are published, and data and information usually used in forecasting do not tell us much about the present situation once they are published with their usual one-, two- or three-month lag.

However, economic policy is expected to react immediately, and it has in fact reacted worldwide in a very flexible and timely manner. But the situation we are facing is, without doubt, the most severe challenge of this type seen since the end of World War II, and history cannot tell us how to deal with it. The situation is outstanding in many respects, including its causation and the way it spread first from the U.S.A. to the rest of the world and then from the financial markets to the real economy. As it turns out now, at the turn of the year, no part of the world seems to be able to escape the consequences of the crisis – not even

How do you assess the situation of the Austrian banking system?

So far the Austrian banking system has weathered the crisis rather well. But the downturn in Eastern Europe surely will pose some additional challenges for banks with substantial investments in the region. Therefore I expect all the main banks in Austria to accept the recapitalization offer under the Financial Market Stability Act, which is part of a package of government measures launched in October to support the financial sector. Overall, the Austrian banks are in a sound position and they were hardly hit directly by the crisis. At the same time it has become clear now that no part of the world will be able to escape the consequences of the crisis. We all have to implement the necessary measures to dampen its negative impact on the real economy. We have to make sure that banks keep on lending to the private sector. This is the main rationale of the measures taken in Austria – even if we do not have to deal with systemic failures in the financial system at the moment.

the fastest-growing economies like China or India. And the forecasts are telling us: there is more to come in 2009.

Obviously, this is the time for policy action. Also, it has become clear that there is a lot to do for the economics profession, academic and applied, in the future. No doubt, there were several warning signs regarding many of the adverse effects of financial developments we have seen over the last decades. But in the end, the mainstream of economic analysis and economic policymaking seemed to be completely taken by surprise by the scale and the intensity of events. I think it is fair to conclude that we really do not understand many of the dynamics we observe at the moment.

One thing is for sure, the world will definitely not look the same once we have mastered the current situation. It will be different in many respects, from the regulatory framework of financial markets to the overall role of governments in the economy – and our approach to economics and economic policy will be quite different, too.

Despite this unfavorable outlook, let's hope for a quiet turn of the year and let's be optimistic that the turmoil will calm down a little bit under a blanket of snow.

Merry Christmas and a considerably less turbulent New Year to all of us!

Economic Outlook for Austria from 2008 to 2010 (December 2008)

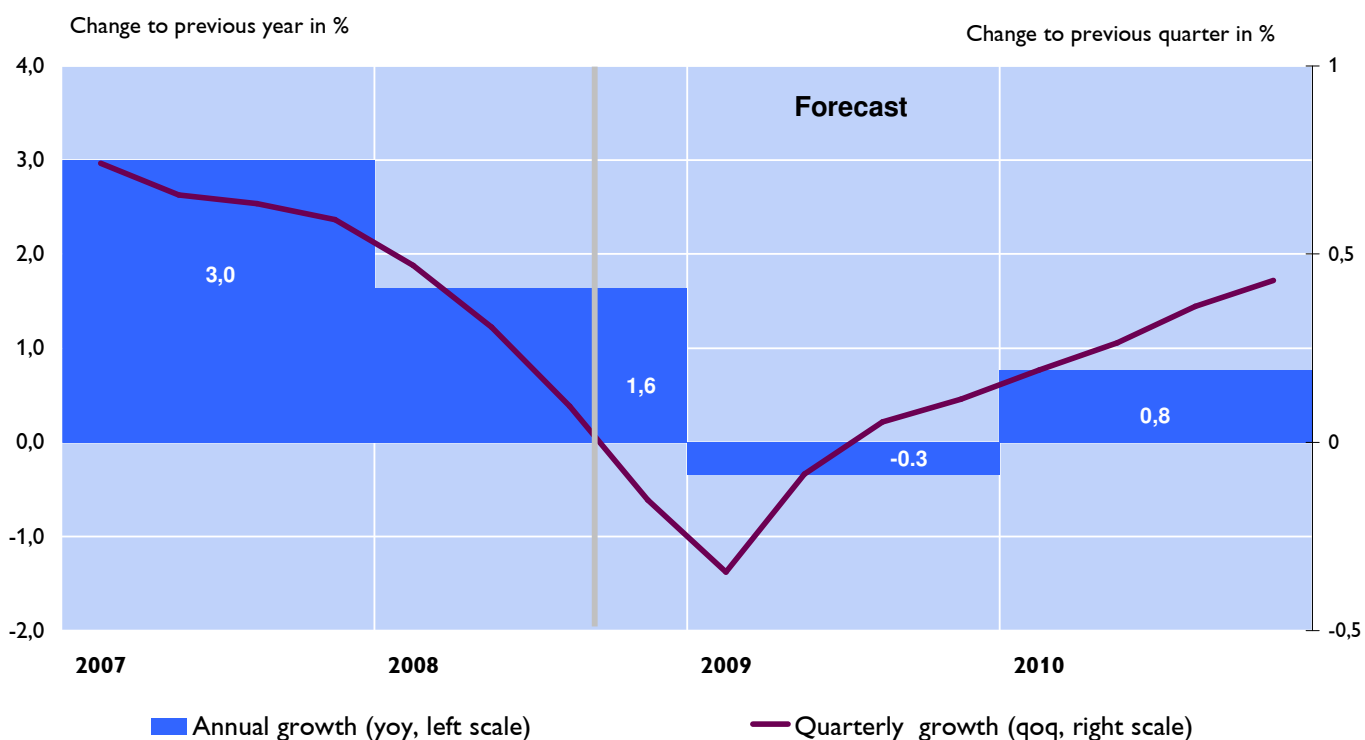
OeNB expects a recession for 2009 in Austria. After strong real GDP growth in the first two quarters of 2008, real GDP growth for the whole year 2008 is forecast at 1.6%. In 2009, however, GDP will shrink by -0.3%. A mild recovery can be expected for 2010, when growth is projected to be 0.8%. Compared to the June forecast growth expectations for 2009 and 2010 have been cut by 2.0 and 1.6 percentage points respectively. At 3.3%, HICP inflation in 2008 is expected to reach its highest whole-year level since. It is projected to come down to 1.4% and 1.6% in 2009 and 2010 respectively.

The effects of the worldwide crisis, triggered by the financing problems in the U.S. real estate sector, are becoming increasingly evident in the real economy. With a delay of about a year after the outbreak in the U.S., Western Europe and Japan are now being hit by the crisis. Recently Central, Eastern and South Eastern European countries and emerging markets in Asia and Latin America are also hit by a moderation of real GDP growth.

The projected downturn in Austria is mirrored by a strong decline both in exports and domestic

demand. While exports in recent years have played a strong role in sustaining growth, they will recede by 2.7% in 2009. The last year that Austria saw shrinking exports was in 2007. Despite negative import growth (-2.5%) in 2009, the contribution of net exports to GDP growth will be negative (-0.3%). In spite of a strong decline in gross fixed capital formation (-1.6%) and lower-than-expected growth of private consumption (+0.5%), domestic demand (excluding changes in inventories) contributes positively (+0.1%) to growth in 2009. As real disposable household income is expected to rise by 1.3% (mainly because of high wage settlements in 2009), a rise in the savings ratio to 13.6% is projected for 2009. This is mainly due to two reasons: first we assume that the trend of a rising savings ratio of recent years is set to continue; second we expect households to react to the crisis by increasing precautionary saving.

Real GDP Growth (seasonal and workingday adjusted)



Source: Eurostat, OeNB.

Employment growth will recede to 0.2% in 2009. About 45,000 additional people will become unemployed in the next two years. According to Eurostat definitions (seasonally adjusted), the unemployment rate will rise to 4.2% (2009) and 4.8% (2010). This would be an extraordinary strong rise after the low rate seen in October 2008 (3.0%).

Driven by the price hike in energy and raw materials, HCPI inflation reached a climax of 4.0% during the summer. It is expected to fall close to the 2% benchmark until the end of the year. This will result in an HICP inflation rate of 3.3% for the

whole year. Until the second quarter of 2009 HICP inflation will gradually recede, mainly due to falling energy and raw material prices, reaching an average of 1.4% in 2009. After that, the OeNB expects a slight increase to 1.6% in 2010.

The general government budget deficit will deteriorate slightly to -0.7% of GDP in 2008, but will widen to -1.9% in 2009 and -2.5% in 2010. In this context, it has to be mentioned that the OeNB projection takes into account only measures that were decided before November 20, 2008.

Conference “Integration of European Labor Markets”

The OeNB's annual Conference on European Economic Integration (CEEI) with the title “The Integration of European Labor Markets” took place on November 17 and 18 in Vienna. Enlargement of the European Union towards Central and Eastern Europe and economic integration in general reduced the importance of national borders and allow for more migration. Mobility of people can change the size and the composition of labor supply in the countries involved, which will in turn have an impact on wage structure. Furthermore, growing international trade may also have significant effects on wage setting and on employment. These aspects were the key themes of this year's CEEI, with migration standing out as a particularly topical issue, given the decisions to be taken by spring 2009 with regard to the full opening of labor markets for workers from Central, Eastern and Southeastern European EU Member States in a row of countries (among them Austria) that still restrict free access to their labor markets.

Despite the ongoing financial crisis binding substantial resources, more than 280 participants from more than 30 countries took the opportunity and joined for interesting discussions and networking activities. The conference also welcomed a range of distinguished speakers such

as Božidar Djelić, Deputy Prime Minister of Serbia, and high ranking representatives of the European Commission, the European Social Partners and the International Labour Organization. In his key note lecture on the first day, Klaus Zimmermann, President of the German Institute for Economic Research and Director of the Institute for the Study of Labor, stressed the importance of a better integration of immigrants and opted for an auction mechanism combined with a point system to manage future migration streams. The second day was opened by key note lectures by Giuseppe Bertola from the University of Turin and by Henryk Kierzkowski of the Graduate Institute Geneva. While Bertola elaborated on increasing costs of labor market policies in the context of liberalized markets and its consequences, Kierzkowski focused his talk on the rising importance of purchases of goods and services from abroad for domestic production.

Papers and presentations from the conference can be found on the OeNB's website www.oenb.at. The conference proceedings are going to be published by Edward Elgar.

Difficult Environment Poses Test for Austrian Financial System

In view of the international financial crisis and the economic slowdown in Austria and Central and Eastern Europe, the Austrian financial system is facing serious challenges, according to the 16th issue of the OeNB's Financial Stability Report released on December 15, 2008. The anticipated significant rise in loan loss provisions, which had been at a historical low, as well as increased capital requirements in the markets compel the major Austrian banks to strengthen their capital positions. Thanks to the comprehensive set of measures launched by the Austrian government and the fact that Austrian banks employ a business model that relies on a broad basis of deposits, Austrian banks will, however, continue to be able to support the economy by maintaining lending to businesses, the OeNB expects.

Financial Turbulence Triggers Slowdown in Growth

Since the beginning of 2008, sustained financial turmoil worldwide has led to a gradual downward revision of the economic outlook for both industrialized countries and emerging market economies. Similarly, the growth outlook for the economies of Central, Eastern and Southeastern Europe (CESEE) has deteriorated notably although forecasts for the CESEE countries mostly still exceed those for the euro area by a wide margin. In some countries of the region, high external imbalances and the significant role of foreign currency loans increased interest rate and exchange rate risks, which have already materialized in part.

In response to the intensification of the financial turmoil, a number of countries, including Austria, have put together packages to strengthen both the liquidity and capital base of their banking sectors. These measures aimed at increasing confidence among financial market participants and ensuring the availability of loans to strengthen demand in the real economy. In fact, they helped alleviate to some extent the crisis of confidence in stock, bond and interbank markets.

Deteriorating Financing Conditions for Austrian Economy

The growth prospects for the Austrian economy have continued to worsen. While corporate profits remained healthy until mid-2008, financing conditions for businesses deteriorated in the course of the year. At the same time, external corporate financing started to be affected by the turbulence in the financial markets. Financing through quoted shares almost dried up, and growth in bond-based financing slowed from a high level. Loan growth remained buoyant until the third quarter of 2008, but the figures for October already reflected first signs of weakening.

The household sector also felt the impact of the international financial turbulence, facing, in particular, valuation losses in capital market products. In the first three quarters of 2008, households shifted their financial assets from capital market instruments to bank deposits. The continued volatility in foreign exchange and capital markets confirms the critical stance maintained by the Austrian Financial Market Authority (FMA) and the OeNB toward foreign currency loans; the increased volatility of the Swiss franc against the euro and the valuation losses in repayment vehicles clearly highlight the risk potential of foreign currency loans.

Indirect Effects of Financial Turmoil Hit Austrian Banks

While the Austrian financial sector was relatively mildly hit by the direct effects of the turmoil stemming from the U.S. subprime market, it cannot escape the impact of its worldwide repercussions. Earnings are down for the first time after years of growing profits, mainly due to a negative trading result and a sharp decline in fee income in the first three quarters of 2008. All in all, however, banks expect to still post comparatively high profits for the whole of 2008.

Austrian banks have so far been able to avoid a sharper deterioration in profitability not least thanks to continued strong business in CESEE. In view of significant external imbalances in some countries of the region, however, the further increase in the importance of CESEE business represents also a risk

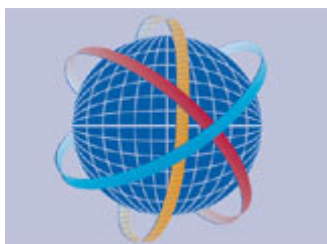
that should not be overlooked as regards the future profitability of banks active in this region.

In light of the marked deterioration in the business environment over the past few months, trading and fee income must be expected to decrease further and loan loss provisions are set to rise. Since the latter are at historical lows in both Austria and CESEE, a notable and longer-lasting increase should be assumed. Maintaining bank profitability will become more and more difficult in the months to come, supporting the case for capital-strengthening action in time.

The OeNB's biannual *Financial Stability Report* provides regular analyses of Austrian and international developments with an impact on financial stability. In addition, it includes studies offering in-depth insights into specific topics related to financial stability. The current issue features analyses of household debt, corporate governance at credit institutions, the implementation of the ICAAP in Austrian banks and the refinancing structure of banks in Central, Eastern and Southeastern Europe. The *Financial Stability Report* can be downloaded from the OeNB's website at www.oenb.at.

OeNB Economics Conference 2008:

Toward the First Decade of Economic and Monetary Union: Experiences and Perspectives



The conference held on April 28-29, 2008 included speeches by Jean-Claude Trichet, Chales Wyplosz, Charles Goodhart, Hans Tietmeyer and others. The Papers are now available at

http://www.oenb.at/en/img/vowitag_2008_tcm16-92678.pdf

OeNB Conference of Eastern European Integration 2007:

Currency and Competitiveness in Europe



Edward Elgar, Cheltenham (UK) and Northampton, MA (USA), 2008

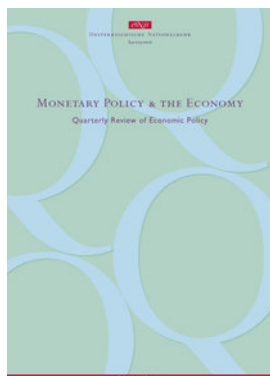
This book raises the understanding of exchange rate dynamics and analyses the role of exchange rates in reinforcing economic competitiveness. The overall focus is on the link between currency developments and the real side of the economy. From a regional perspective, the contributions highlight developments in Central, Eastern and South-eastern Europe and thus put a special emphasis on aspects of transition and convergence. Combining contributions from academics, professionals and central bankers, the book addresses key issues of global imbalances, the role of fundamentals in exchange rate economics as well as the significance of qualitative and quantitative aspects of competitiveness, and related policy challenges.

http://www.e-elgar.co.uk/bookentry_main.lasso?id=13224

OeNB Periodical Publications

http://www.oenb.at/en/presse_pub/period_pub/publications_.jsp

Monetary Policy & the Economy, Q3/08



Tax and Economic Growth in Austria (Konrad Pesendorfer)

Economic Country Risks Emanating from Austria's International Exposure (Matthias Fuchs)

Four Monetary Policy Strategies in Comparison: How to Deal with Financial Instability? (Jesús Crespo Cuaresma, Ernest Gnan)

The Economics of Financial Stability: Research Workshop at the OeNB (Martin Summer)

Global Market Disruptions – Will Global Imbalances Unwind? (Peter Backé, Franz Nauschnigg)

Financial Stability Report 16 (December 2008)



The refinancing structure of banks in selected countries in Central Eastern and Southeastern Europe (Zoltan Walko)

Implementing ICAAP in big Austrian banks (Elisabeth Woschnagg)

Austrian Carry-Trade: Which households take on foreign currency credits? (Christian Beer, Steven Ongena, Marcel Peter)

Development of credit to the household sector in Austria (Friedrich Fritzer, Lukas Reiss)

Corporate Governance and credit institutions (Birgit Sauerzopf)

Other recent periodical publications:

Focus on European Economic Integration 1/2008

Workshop Series No. 13 (2008): “The Experience of Exchange Rate Regimes in Southeastern Europe in a Historical and Comparative Perspective”

OeNB Working Papers

http://www.oenb.at/en/presse_pub/research/020_workingpapers/working_papers_2008.jsp

Working Paper 146

“The Optimal Mix Between Funded and Unfunded Pensions Systems When People Care About Relative Consumption” (September 1, 2008) by Markus Knell

In this paper I derive the optimal portfolio mix between a funded and an unfunded pension system when people care about their consumption relative to a reference group. Pay-as-you-go systems with fixed contribution rates have the property that pension benefits are tied to labor income. This lowers the uncertainty of individuals' future relative position and thus increases the attractiveness of unfunded systems. The paper shows analytically that in an OLG model the optimal share of funding decreases with the strength of individuals' concern for relative standing. A calibrated version of the model that uses data for various countries and time periods suggests that the sensitivity of the optimal share of funding to the concern of relative standing is also quantitatively important. For reasonable assumptions about reference standards it is typically around 20%.

Working Paper 147

“Inequality and growth: Goal conflict or necessary prerequisite?” (September 8, 2008) by Cecilia García-Peñalosa

In this paper I discuss recent theories on the relationship between growth and inequality, and ask whether the two move together or not. Output growth can be due to increases in either physical capital, human capital, the labour supply or the level of technology, and I argue that each of these represents a mechanism that relates our two variables of interest. The literature indicates that there are two difficulties in answering the question. The first concerns causation, since inequality affects

growth, growth impacts distribution, and third factors have an effect on both. The second is the fact that, depending on the source of growth, inequality and growth may be positively or negatively related. This means that we have to be much more precise in the way in which we ask the question. On the one hand, we need to identify the particular source of growth before we can assess how it relates to inequality. On the other, different dimensions of inequality have different impacts. Both the theory and the empirical evidence indicate that inequality at the top of the distribution does not have the same effect as inequality at the bottom.

Working Paper 148

“Comparing the New Keynesian Phillips Curve with Time Series Models to Forecast Inflation” (September 30, 2008) by Fabio Rumler and Maria Teresa Valderrama

The New Keynesian Phillips Curve, as a structural model of inflation dynamics, has mostly been used to explain past inflation developments, but has hardly been used for forecasting purposes. We propose a method of forecasting inflation based on the present-value formulation of the hybrid New Keynesian Phillips Curve. To evaluate the forecasting performance of this model we compare it with forecasts generated from time series models at different forecast horizons. As state-of-the-art time series models used in inflation forecasting we employ a Bayesian VAR, a traditional VAR and a simple autoregressive model. We find that the New Keynesian Phillips Curve delivers relatively more accurate forecasts compared to the other models for longer forecast horizons (more than 3 months) while they are outperformed by the time series models only for the very short forecast horizon. This is consistent with the finding in the literature that structural models are able to outperform time series models only for longer horizons.

External Publications by Staff Members

The Small Open-Economy New Keynesian Phillips Curve: Empirical Evidence and Implied Inflation Dynamics

Alexander Mihailov, Fabio Rumler, Johann Scharler

University of Linz Economics Working Paper No. 0817.

This paper applies GMM estimation to assess empirically the small open-economy New Keynesian Phillips Curve derived in Galí and Monacelli (2005). We obtain a testable specification where fluctuations in the terms of trade enter explicitly, thus allowing a comparison of the relevance of domestic versus external determinants of CPI inflation dynamics. For most countries in our sample the expected relative change in the terms of trade emerges as a more relevant inflation driver than the contemporaneous domestic output gap. Overall, our results indicate some, albeit moderate, support based on data from ten OECD countries typically classified as open economies.

Foreign Banks in Central Europe: Do They Contribute to Economic Development?

Peter Haiss, Katharina Steiner, Markus Eller

in: Petr Chadraba and Reiner Springer (eds.): Business Strategies for Economies in Transition: Book of Readings on CEE Countries, Cambridge Scholars Publishing, December 2008, 342-363.

Central, Eastern, and Southeastern Europe (CESEE) has experienced far-reaching structural changes since the beginning of transition in the early 90s. The liberalization of financial markets, privatization policies, and the strong growth potential in financial intermediation pulled in massive financial sector FDI (FSFDI). This contribution discusses managerial

implications and questions whether host economies benefit from FSFDI. A crossover from the business administration literature to the macroeconomic oriented finance-growth nexus is given. We delineate foreign bank strategies and identify the main competitive advantages that foreign-owned banks may have in transition economies. We then discuss how this higher efficiency of foreign banks may contribute to host country economic development and provide stylized facts for 11 CESEE countries from 1996 to 2007. We find that the level and quality of foreign investment influences the financial sectors' contribution to economic development in the region and provide directions for future research.

(How) Will the Euro Affect Inflation in the Czech Republic? A contribution to the current debate

Tomas Slacik

FIW Working Paper N°18

We analyse relevant macro- and microeconomic forces driving inflation in the Czech Republic with a particular focus on how these channels are likely to change in the wake of euro adoption. We employ an ARDL model combined with the Bayesian Model Averaging technique. In order to carry out this analysis, we also estimate the time-varying natural rate of interest purged from the risk premium. Our results suggest that the costs arising from the discontinuation of nominal trend appreciation of the koruna after euro adoption are likely to be rather low. In contrast, a low inflation environment and a harmonization of the business cycles between the Czech Republic and the euro area are essential for ensuring that inflation hikes will remain limited after the euro adoption. The fulfilment of the Maastricht inflation criterion should not be enforced by policy measures that would artificially reduce inflation temporarily. The potential inflationary effect of the changeover cannot be eliminated altogether but it may well be substantially reduced by applying best practices based on the experience of current euro area participants.

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 econ.newsletter@oenb.at

In week 3, 2009	Presentation of the EBRD Transition Report 2008 (Simon Commander)
January 23, 2009	SUERF - Special East Jour Fixe on Russia Current trends in the Russian Financial System
January 23, 2009	“Wage Setting Patterns and Monetary Policy: International Evidence” Friday seminar with Silvana Tenreyro (LSE)
March 23, 2009	Recent Developments in the Baltic Countries – what lessons for South Eastern Europe?
May 7, 2009	Global Economy Lecture held by Tony Atkinson
May 14-15 , 2009	OeNB Economics Conference
November 16-17, 2009	OeNB Conference on Eastern European Integration
<i>Recent Events:</i> Nov. 17-18, 2008	“The Integration of European Labor Markets” Conference on European Economic Integration
November 28, 2008	“Assessing the risk, return and efficiency of banks’ loans portfolios” Friday seminar with Javier Mencia (Banco de Espana)
December 12, 2008	“Banking integration, synchronization and volatility” Friday seminar with Jose-Luis Peydro-Alcalde (ECB)

OeNB Courses at the Joint Vienna Institute (JVI)

March 9 - 13, 2009	Stress Testing for Banking Systems: An Introduction
April 27 - 30, 2009	Institutional Challenges for SEE Countries on the Road to the EU and EMU
May 25 - July 31, 2009	Applied Economic Policy (AEP) Course The segment “Financial Sector Issues” is taught by the OeNB
August 31 - September 4, 2009	OeNB Summer School "The current financial crisis - what can structural models tell us?"
September 21 - 25, 2009	Inflation, Exchange Rate Stability and Credit Growth: Challenges for EMU
October 5- 8, 2009	Cash Circulation and Payment Systems in Austria
November 9 - 13, 2009	Monetary and Financial Statistics Collected and Compiled by the ESCB
November 23 - 26, 2009	Economic and Monetary Integration in Europe
November 30 - December 2, 2009	Translation in a Central Bank Setting

For further details see: http://www.jvi.org/fileadmin/jvi_files/JVI_Program2009.pdf

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Oesterreichische Nationalbank, Economic Analysis and Research Section

Postal address: P.O. Box 61, A 1011 Vienna, Austria; econ.newsletter@oenb.at

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