

Research Update

Economic Analysis and Research Department

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Upcoming Highlights

Conference on European Economic Integration „The Integration of European Labor Markets“

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Editorial

by Peter Mooslechner,
Director of the Economic Analysis and Research Department

If somebody has ever held the perception that banking and financial markets are a boring business, recent months demonstrate that it is much more challenging than we all like it to be. While all over the world the financial industry prays for a return of calmer days, central banks right from the beginning have been on the forefront of efforts to tame the storm – and it looks like if this will have to continue for some time.

Definitely, these are not the perfect framework conditions for a change in leadership at the top as in the case of Oesterreichische Nationalbank: Ewald Nowotny has taken over the post of Governor from Klaus Liebscher on September 1. But with almost 30 years of experience as a professor of economics as well as high level positions at the EIB and in commercial banking, he is certainly more than well prepared to steer our institution through rough weather. And we will do our best to support him in this challenging task, as with the incoming of Ewald Nowotny the Economic Analysis and Research Department has changed directorate and is now directly assigned to the Governor. We are sure that this will lead to even more engaging debates about economic issues and analyses than ever before – and probably to intensified work as well. Here is an overview of topical issues just addressed by our researchers we have assembled for this newsletter:

First, we present our recent update of the short-term economic outlook, which shows a considerable slow-down of the Austrian economy.

Second, we report on a number of discussions we had on very timely topics related to the recent financial turmoil, like financial stability, risk and liquidity, global imbalances and economics of real estate. All these were very recently dealt with in a number of interesting events organized by Oesterreichische Nationalbank.

Third, a symposium on dimensions of inequality in the EU a few weeks ago reminded us of an issue too often neglected in the day to day business of monetary policy making. The event received widespread attention and was characterized by stimulating discussions.

Let us hope that the forthcoming weeks will spare us from too much additional storm and that new insights on the art of policymaking will help us to solve the crisis quickly and to dampen as much as possible its impact on the real economy!

Global Economic Developments Overshadow Outlook for Austria

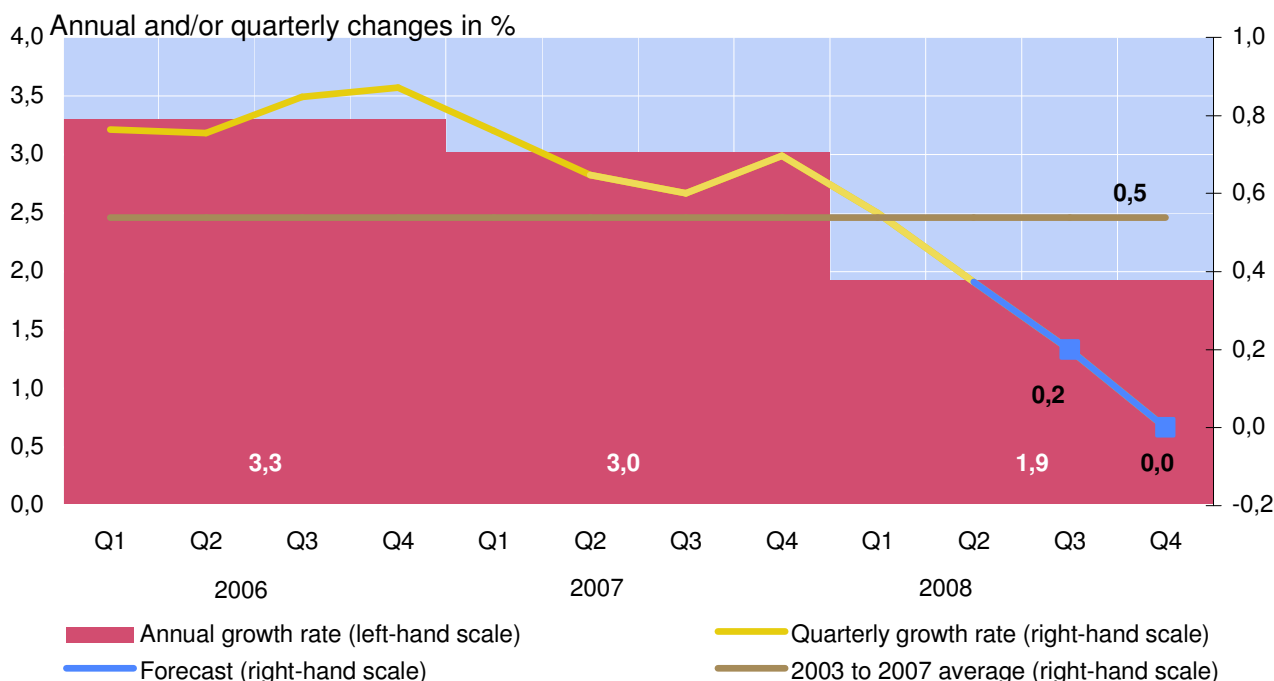
Results of the OeNB Short-Term Indicator of October 2008

Most recently, the global economic outlook has continued to deteriorate sharply as a result of financial market turmoil. The Austrian economy does not remain unaffected by these developments, given its strong reliance on exports. Moreover, private consumption – usually the key pillar of economic activity in mature phases of the economic cycle – does not provide any significant impulses, which may be attributed, attributed to both a high propensity to save and to high inflation. In light of these facts, the Austrian economy will almost stagnate in the second half of 2008. The OeNB economic indicator predicts real GDP growth to come to 0.2% in the third quarter of 2008 (seasonally and working day adjusted, change to previous quarter) and to stagnate (+0.0%) in the fourth quarter of 2008. Still,

real GDP growth for full-year 2008 will reach 1.9% owing to vigorous activity in early 2008.

This estimate is, however, subject to exceptionally high uncertainty. While the direct effects of financial turmoil on Austria's financial system are small compared with other countries, it is impossible at this point to assess the actual proportions of the crisis and its impact on the world economy and on Austria's main trading partners. Under the current circumstances, it should be highlighted that the OeNB economic indicator of October 2008 reflects developments only up to the end of September 2008 and thus does not cover the developments of the last few weeks.

Short-Term Outlook for Real GDP Growth in Austria for Q3 and Q4 2008 (seasonally and working-day adjusted)



Source: OeNB.

Global Market Disruptions – Will Global Imbalances unwind?

On June 12-14, OeNB together with the Reinventing Bretton Woods Committee organized a roundtable discussion on “Global Market Disruptions – Will Global Imbalances unwind?” near Salzburg. The discussion brought together speakers from the public sector, market participants and academics.

Among other speakers, Kristin Forbes (MIT) questioned the sustainability of capital inflows to the US at current levels. Low returns, recent financial turbulences and reluctance towards some foreign investments in the US could lower the willingness of foreigners to invest in the US.

Concerning the path of current account adjustments, Sophia Drossos (Morgan Stanley) highlighted the importance of capital flows from public sector investors abroad to the US. Miranda Xafa (IMF) pointed towards domestic causes of the recent Dollar weakness, among them recent developments in housing and credit markets and interest rates.

In Michael Dooley’s (Cabezon Capital) assessment, “Bretton Woods II” (i.e. the Dollar peg of many emerging markets) could be a viable arrangement for the longer term. Inevitably, some members would graduate from the system, but new countries would replace them.

According to Richard Portes (CEPR), the current international monetary system is rather a “non-system”. The role of the US Dollar as an international currency would gradually erode, but the question must be asked whether the rise of the euro might lead to more instability. The international monetary system, according to Portes, suffers from the weakness of the IMF which still has not found a new role. Apart from that, the world lacks a lender of last resort and an international court for sovereign debt restructuring.

Participants also debated whether the IMF could manage reserves on behalf of Sovereign Wealth Funds, therefore depoliticizing the use of their funds and developing the anticyclical potential of the latter.

Risk, Liquidity and Financial Stability

In July the OeNB research department organized two events on financial stability issues: On the 4th and 5th of July the OeNB Guest Professor 2008 Hyun Song Shin gave a series of three lectures on the topic “Risk and Liquidity”. On July 7th and 8th an international group of researchers met in the premises of OeNB for the research workshop “The Economics of Financial Stability” jointly organized by Hyun Song Shin, Princeton University, and Martin Summer from OeNB’s research department. In his first lecture Shin analyzed in depth the nature of risks that typically occur in financial markets. He emphasized that these risks are a result of collective behaviour of market participants. This fact is typically ignored by many popular quantitative risk management models. The feedback effects between risk and behaviour are key to the understanding of financial crisis. He discussed these effects in a series of examples and criticized standard risk management approaches as well as regulatory paradigms founded in assumptions about exogenous risk. In the second lecture he gave an in depth analysis of the US subprime crises and shed particular light on deeper

structural problems stemming from the business model of investment banks. Active risk management and strict leverage targeting create boom and bust cycles. The pressure on banks to enter the subprime business as well as the surging demand for new asset classes in the boom is intimately linked to this deeper structural problem. In the last lecture Shin discussed policy implications for banking regulation, for accounting rules as well as for monetary policy.

In the workshop “The Economics of Financial Stability”, leading researchers from universities and central bank research departments discussed various theoretical approaches to improve the understanding of financial instability and financial crises at an analytical level. The presenters were Nobuhiro Kyotaki, Guido Lorenzoni, Wolf Wagner, Viral Acharya, Tobias Adrian, Hans Gersbach and Jan Werner. The papers were broadly organized around the problem of obtaining a genuinely economic perspective on financial stability problems in contrast to a pure risk management viewpoint. A detailed write-up of the workshop can be found in issue 3/08 of “Monetary Policy and the Economy”.

Workshop “Housing Market Challenges in Europe and the United States - any solutions available?”

In light of the current financial turmoil around 90 participants from several European countries followed the invitation to the one-day workshop organized by the Oesterreichische Nationalbank (OeNB) on September 29, 2008 in Vienna.

In his keynote speech Mr Elias Karakitsos (University of Cambridge) recommended that all institutions confronted with the unforeseen major crisis, including central banks, should critically reassess their instruments for detecting an uprising crisis. The origin of the current crisis in the housing bubble could only occur through a corresponding increase in credit. The excessive liquidity which led to the bubble was mainly driven by financial innovation and loose monetary policy. He argued that this liquidity financed in the first instance the internet bubble, but because there was no de-leverage following the burst of this bubble the liquidity went on to finance other bubbles, including housing, private equity and commodities. Thus, the housing bubble is a transformation of the previous internet bubble. Karakitsos revealed the shortcomings of an inflation target alone by central banks and pointed to the need to target also the output gap in an asset-led business cycle.

In session 2 – “European Housing Market Developments and their Macroeconomic Implications” Elisabeth Springler (University of Economics, Vienna) and Karin Wagner (OeNB) tried to explain differentials in homeownership rates across Europe by analyzing both housing finance systems and the role of the state in housing via its impact on the cost of financing for homeowners. Christophe Andre (OECD) analyzed the rising house prices and the increasing housing wealth and household debt and discussed implications for economic policies. In Session 3 – “Wealth Position of Households - Do Microdata help to understand Housing Markets better?”, Karin Wagner (OeNB) gave some information on the 2008 Survey on Housing wealth of private households. After lunch session 4 – “Housing Policies in Europe” touched upon the topics of rented markets and regulation issues. Montserrat Pareja-Eastaway (University of Barcelona, Spain) gave an overview on the dynamics in the rented sector in Europe and explained the

regulatory steps taken in the Spanish housing market. Guido Wolswijk (ECB) thereafter discussed fiscal aspects of Housing in Europe. Afterwards, Wolfgang Amann (Institute for Real Estate, Construction and Housing) discussed the development of sound legal regulations and the establishment of business structures for PPP housing. He highlighted the new Housing Law for Romania. József Hegedüs (Metropolitan Research Institute) analyzed whether there is a divergence or convergence in new housing policies in CEE. The following Session 5 questioned “Statistics – how to measure House Prices in a Proper Way?” Anthony Murphy (University of Oxford) gave a user’s perspective on house price and housing market data. All available UK and US house price indices display the same medium and long run trends, therefore the choice of index is not that important. Adrian Page (ECB) gave an overview of residential property price statistics available. The workshop was concluded by a panel discussion on “What lessons have we learned from the Spanish/Italian/British/US case? What can be done in Europe to make housing markets more stable?” Elias Karakitsos, Montserrat Pareja-Eastaway and Leonardo Gambacorta (Banca d’Italia) discussed possible ways out of the house price crisis/bubble. The panelists proposed to rethink regulation for financial economies and stated that regulation rules have to be found that do not repress financial innovation but lead from “financial deepening” to economic growth. Gambacorta told that the Italian experience shows that some rules (a limit to the loan-to-value ratio, the usury law) have reduced (at least so far) the effects of the financial turmoil. Furthermore, the role of housing policies and, in particular, of social housing is crucial in dampening overheated markets.

The workshops program and the papers/presentation slides can be found at the OeNB homepage at http://www.oenb.at/de/geldp_volksw/Volkswirtschaftliche_Veranstaltungen/workshop_housing_market_challenges_in_europe_and_the_united_states_any_solutions_available.jsp. And there is a publication planned with Palgrave Macmillan.

Dimensions of Inequality

Together with the Austrian chamber of labor, the OeNB hosted a conference on „Dimensions of Inequality in the EU“ on September 8. The economics of inequality recently seems to be experiencing a boom as a field of research, due to growing inequality of wealth and its implications for growth, financial stability as well as democracy.

In his introduction, Peter Mooslechner (OeNB) highlighted the need for better data on inequality to ensure a better foundation for policy advice.

Cecilla Garcia Penalosa (CNRS) presented her work on the relationship between inequality and growth. In a framework of endogenous growth, both positive and negative relationships among the two variables are possible. In her conclusions, Garcia Penalosa stressed the importance of policy for inequality.

Michael Foerster (OECD) and Karl Pichelmann (EC) both presented empirical data and indicators for growing inequality in advanced industrialised countries. Foerster stressed the role of the state (taxes, public health institutions etc.) in determining outcomes.

In his analysis of income concentration in the 20th century, Giacomo Comeo (Free University Berlin)

showed how changes over time followed a U-shaped pattern. The upper income brackets have held a very high proportion of income at the beginning of the 20th century. Their share sank until the 1970s. Since the 1980s it has started to rise again. This development is most pronounced in Anglo-American societies and has reached continental Europe with some delay. The dangerous implication for democracy and its legitimacy is growing power of elites within the political system.

Elites and their reproduction were the topic of Michael Hartmann's (Technical University Darmstadt) presentation. Hartmann reported on growing permeability between formerly more separated elite groups, for instance in economics and politics.

There was a consensus among speakers that there is currently a frustrating lack of data on inequality. On the other hand, this leaves ample room for academic work to improve on this situation.

Forthcoming:

Conference on European Integration

“The integration of European Labor Markets”

November 17 and 18, 2008 (Vienna)

With the importance of national borders having declined following EU enlargement and economic integration in general, migration is on the rise in Europe. This development is changing the size and composition of labor supply in the countries involved. Furthermore, increasing FDI and growing trade may also have significant effects on wage setting and employment. These aspects will be dealt with in this year's conference, in sessions dealing with labor mobility within the EU, labor market effects of migration, international experiences, integration by trade, and policy implications of labor mobility. Prominent speakers like Ewald Nowotny, Joaquin Almunia, John Monks and Klaus Zimmermann will be joined by academics and policy makers in an interesting debate about how to deal with the reality of migration in European economic policy making.

OeNB Summer School 2008: Econometric Analysis of Real-Time Data (1-5 September 2008)

The purpose of this year's course was to bring participants up to date with a variety of developments related to the real-time econometric analysis of macroeconomic data. The aim was to introduce a variety of new tools for working with data subject to revisions as well as to put these tools into the context of recent applied work in macroeconomic policy analysis. The main topics that were covered included the characterization of data revisions, forecasting with data subject to revision and real-time analysis of trends and cycles. The five-day course was held by Professor Simon van Norden

(HEC Montreal), an internationally acknowledged expert working at the current research frontier in the econometric analysis of real-time data. The course took place at the Joint Vienna Institute and consisted of lectures in the mornings, followed by applications to real-time data for the Euro area and countries of course participants. Economists of OeNB and 11 central banks of other European countries participated in the course. The OeNB offers the summer school training since 2003 on an annual basis.

OeNB EURO SURVEY

The Euro in Central, Eastern
and Southeastern Europe



In Central, Eastern and Southeastern Europe (CESEE), the use of foreign currencies in general and the euro in particular is a widespread phenomenon. Despite its sensitive implications on economic policy little is known about the extent and determinants of euroization. To overcome this, the OeNB has commissioned a new survey, the OeNB EuroSurvey, which has been conducted twice in a total of 11 CESEE countries. First results show that the euro dominates foreign currency cash and deposits holdings. Euro cash holdings are more important in the SEE where about 26% of respondents hold about EUR 470 (median) in cash. In CEE some 17% hold around EUR 190. The main motive for holding euro cash in SEE is to safeguard the value of their savings, whereas CEE countries hold euro cash to pay for travelling and shopping abroad.

More details about the OeNB EuroSurvey and selected results can be found at our website <http://ceec.oenb.at>.

OeNB Annual Report 2007

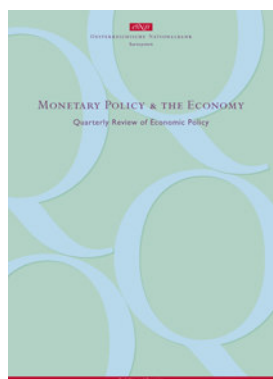


The OeNB's Annual Report 2007 was released in May 2008. It provides a broad review of Austrian monetary and economic conditions, new developments in financial markets in general and in financial market supervision in particular as well as of the OeNB's responsibilities and its role as an international partner in cooperation and dialogue.

http://www.oenb.at/en/img/ar_2007_tcm16-85363.pdf

OeNB Periodical Publications

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



Monetary Policy & the Economy, Q2/08

Financial Crisis and Spike in Commodity Prices Dampen Growth and Fuel Inflation (Gerhard Fenz, Martin Schneider)

Supply-Side Triggers for Inflation in Austria (Juergen Janger)

Do Aggregate Demand Factors Influence Current Inflation Developments? (Fabio Rumler, Maria Teresa Valderrama)

Stock Holdings in Austria (Pirmin Fessler, Martin Schuerz)

The Impact of EU Enlargement in 2004 and 2007 on FDI and Migration Flows. Gravity Analysis of Factor Mobility (Andreas Breitenfellner, Jesus Cuaresma, Peter Mooslechner, Doris Ritzberger-Gruenwald)

Toward the First Decade of Economic and Monetary Union – Summary of the 36th Economics Conference (Ernest Gnan, Martin Summer)

Other recent periodical publications:

Financial Stability Report 15 (June 2008)

Focus on European Economic Integration 1/2008

OeNB Working Papers

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

Working Paper 143

“Risk-Premia, Carry-Trade Dynamics, and Speculative Efficiency of Currency Markets” (May 15, 2008) by Christian Wagner

Foreign exchange market efficiency is commonly investigated by Fama-regression tests of uncovered interest parity (UIP). In this paper, we conjecture a speculative UIP relationship which implies that exchange rate changes comprise a time-varying risk component in addition to the forward premium. This suggests that the forward premium anomaly reported in previous research potentially stems from omitting this component in UIP tests and that the popular carry-trade strategy can be rationalized to some extent. Moreover, while related work focuses on the Fama-regression slope coefficient, we show that also the intercept is important for judging the economic significance of currency speculation. Empirically, we find support for speculative UIP and the existence of a risk-premium. Furthermore, although carry-traders are able to collect some risk-premia, currency speculation does not yield economically significant excess returns, which suggests that foreign exchange markets are speculatively efficient. Disregarding the Fama-regression constant, however, leads to distortions in the assessment of economic significance and induces spurious rejection of speculative efficiency.

Working Paper 144

“Dating and forecasting turning points by Bayesian clustering with dynamic structure: A suggestion with an application to Austrian data” (June 19, 2008) by Sylvia Kaufmann

The information contained in a large panel data set is used to date historical turning points of the Austrian business cycle and to forecast future ones. We estimate groups of series with similar time series dynamics and link the groups with a dynamic structure. The dynamic structure identifies a group of leading and a group of coincident series. Robust results across data vintages are obtained when series specific information is incorporated in the design of the prior group probability distribution. The results are consistent with common expectations, in particular the group of leading series includes Austrian confidence indicators and survey data, German survey indicators, some trade data, and, interestingly, the Austrian and the German stock market indices. The forecast evaluation confirms that the Markov switching panel with dynamic structure performs well when compared to other specifications.

Working Paper 145

“Transmission of business cycle shocks between the US and the euro area” (July 21, 2008) by Martin Schneider and Gerhard Fenz

We analyze the transmission of structural shocks between the US and the euro area within a two-country VAR framework. For that purpose, we simultaneously identify cost-push, demand and monetary policy shocks for both countries using sign restrictions. Our results show that domestic shocks explain the largest share of the forecast error variances for GDP, consumer prices and the interest rate in both countries in the short run, whilst spillovers from the other country and global factors gain importance in the medium run. The strength of the shock transmission between the two countries is quite symmetric. Our approach to the identification of structural shocks allows us to construct confidence bands that account both for estimation and identification uncertainty. We find impulse responses to domestic shocks to be significant while spillovers across countries are insignificant.

External Publications by Staff Members

Crude Oil Prices and the Euro-Dollar Exchange Rate: A Forecasting Exercise?

Jesus Crespo Cuaresma, Andreas Breitenfellner

University of Innsbruck Working Papers in Economics and Statistics 2008-8

If oil exporters stabilize the purchasing power of their export revenues in terms of imports, exchange rate developments (and particularly, developments in the US dollar/euro exchange rate) may contain information about oil price changes. This hypothesis depends on three conditions: (a) OPEC has price setting capacity, (b) a high share of OPEC imports comes from the euro area and (c) alternatives to oil invoicing in US dollar are costly. We give evidence that using information on the US dollar/euro exchange rate (and its determinants) improves oil price forecasts significantly. We discuss possible implications that these results might suggest with regard to the stabilization of oil prices or the adjustment of global imbalances.

Growth, convergence and EU membership

Jesús Crespo-Cuaresma, Doris Ritzberger-Grünwald and Maria Antoinette Silgoner

Applied Economics 40 (2008), 643-656.

The effect of European integration on long-term growth of the EU-15 member states is studied by means of panel data methods. The length of EU membership is found to have a significant positive effect on economic growth, which is relatively higher for poorer countries. While previous empirical studies tend not to find positive growth effects of regional integration, the present study suggests an asymmetric, convergence stimulating impact of EU membership on long-term growth.

Fundamentals, the exchange rate and prospects for the current and future EU enlargements: evidence from Bulgaria, Croatia, Romania and Turkey

Jesús Crespo-Cuaresma, Jarko Fidrmuc and Maria Antoinette Silgoner

Empirica 35 (2008), 195-211.

We analyze the link between macroeconomic fundamentals and exchange rate dynamics in two new and two potential EU member states: Bulgaria, Romania, Croatia, and Turkey. Given the different institutional settings of the exchange rate market in the countries of interest, we follow two different modelling strategies. For Romania and Turkey, we evaluate possible exchange rate misalignments based on a monetary model of exchange rate determination. In the case of Bulgaria and Croatia, with currency board and narrow-band peg arrangements against the euro, we discuss possible exit strategies and quantitatively assess the effects of the peg arrangements by means of simulation.

The Economic Sentiment Indicator: Leading Indicator Properties in Old and New EU Member States

Maria Antoinette Silgoner

Journal of Business Cycle Measurement and Analysis 3/2(2007), 199-216.

This paper assesses the leading indicator properties of the Economic Sentiment Indicator (ESI) of the European Commission, as well as two of its subcomponents, for industrial production growth. For this purpose we perform correlation analysis, Granger causality tests, an assessment on the ability to predict turning points and an out-of-sample forecasting exercise. Within a panel setting we compare the characteristics of these indicators for two subgroups of EU countries: the EU-15 and the new EU member states. We show that the forecasting quality and the leading indicator properties are still slightly lagging behind in the group of new EU member states. This may be related to the general problem of data quality and the undergone history of structural change in these countries that makes the assessment of future economic prospects particularly difficult.

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

October 17, 2008	“EMU: tensions and diagnosis” Friday seminar with Mike Wickens (University of York)
October 24, 2008	Workshop “Saving in Austria - too Little and too Late?”
October 31, 2008	“Distance, Lending Technologies and Interest Rates” Friday seminar with Paolo Mistrulli (Banca d'Italia)
November 14, 2008	“Understanding Bank Runs: The Importance of Depositor-Bank Relationships and Networks” Friday seminar with Rajkamal Iyer (University of Amsterdam)
November 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 portfolio” Friday seminar with Javier Mencia (Banco de Espana)
December 12, 2008	“Governance Issues in Central Banking” 4th Vienna Dialogue on Institutional Central Banking Issues. Speakers include Ewald Nowotny (OeNB), Gertrude Tumpel-Gugerell (ECB), David Archer (BIS), Franco Bruni (Bocconi University)
January 23, 2009	SUERF/East Jour Fixe “Russian Financial System”
<i>Recent Events:</i> July 2 - 4, 2008	Public Lecture “Risk and Liquidity” by Hyun Song Shin (Princeton University)
October 3, 2008	“Monetary Persistence and the Labor Market: A New Perspective” Friday seminar with Christian Merkl (Kiel Institute for the World Economy)
October, 13, 2008	“Financial Deepening and Macro-Financial Stability in South-Eastern Europe” East Jour Fixe in cooperation with the central Bank of Greece and the National Bank of Greece

OeNB Courses at the Joint Vienna Institute (JVI)

November 10-14, 2008	Monetary and Financial Statistics Collected and Compiled by the ESCB
December 3-5, 2008	Translation in a Central Bank Setting

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