

Reden und Präsentationen

Crisis Management

General Reflections and the Austrian Experience

Univ.-Prof. Dr. Ewald Nowotny, Gouverneur
Athen, 27. 5. 2009

Es gilt das gesprochene Wort.

Ladies and Gentlemen,

Let me begin by thanking the organizers for giving me the chance to present some thoughts on the current financial and economic crisis from an Austrian perspective. It is a great pleasure for me to be here in Athens, that vibrant metropolis with its history of more than 4,500 years. During that time, the inhabitants of Athens certainly had to cope with many crises, which often jeopardized their livelihood. I am far from sugar-coating the current crisis, but I think it is important to stress that today the conditions for coping with a crisis of this dimension are much better than in most episodes of the past.

Since my previous speakers have already emphasized many important issues, I will focus my presentation on some selected issues on the management of the crisis from an Austrian point of view.

Slide 2 – Outline

I have structured my speech into four parts. First, I want to highlight some aspects of the crisis that are relevant for designing the proper policy response. Then, I will talk about the reaction of economic policy in Austria. Having done that, I will turn to the effects of the crisis on Central, Eastern and Southeastern Europe (CESEE), which is of particular interest from an Austrian perspective due to the strong ties of Austria with that region. Finally, I will talk about the crisis in this region from the perspective of Austrian banks.

1. The Crisis in a Nutshell

Slide 4 – Initial Conditions and Trigger of the Crisis

Let me start my talk with a short overview of how the crisis developed. Although I assume you are familiar with the basic causes and consequences of the crisis, a brief look on the history of the crisis – with a special focus on the policy measures needed to manage the crisis – might be worthwhile.

As you all know, the crisis originated in the market for subprime loans in the United States. But how can a crisis on such a small market spill over to the world financial system and to the real economy?

To understand this, let us take a brief look at the time before the crisis, when the initial conditions for the crisis were set. After the 2001 recession, huge worldwide savings and low interest rates led to a "**search for yield**" of investors. The U.S.A. was regarded as an attractive place for investments. The emergence of securitized assets rendered the distribution of yield (and risks) across borders possible. **Loopholes in the regulation** made it possible that such assets were issued by special purpose vehicles that were mainly founded on a short-term basis. The **risks** of these complex and hard-to-value assets were **underestimated**. As a consequence, the global financial system became strongly **interconnected**. At the same time, the **leverage** of the financial system as a whole increased sharply, making the system **more vulnerable**. The spark that ignited this mixture was the U.S. subprime market.

Slide 5– Amplification and Contagion

One major **amplification mechanism** was a steep decline in confidence, which caused massive financing problems of monetary and financial institutions in **short-term money markets**. This led to "fire sales" of assets, causing asset prices to fall. This applied especially to complex and hard-to-value assets such as mortgage-backed securities. This reduction in prices further reduced capital. Another amplification mechanism was the need of MFIs to improve their capital ratio and the resulting deleveraging process. As a consequence, the supply of loans was negatively affected. Feedback loops between the financial and the real sectors of the economy further amplified the negative impact. Deleveraging also took place on a global scale, leading to capital outflows from emerging economies.

Slide 6 – Needs for Policy Action

The crisis calls for policy action in different areas. The most urgent topic on the agenda is to **remedy the malfunction of the financial system**. The decline in the value of equity of many financial institutions makes it necessary to **recapitalize** them in order to restore capital ratios. The decline in confidence contained the risk of bank runs. Although substantial guarantees for household deposits were in place in most countries before the crisis, **these guarantees were extended** to strengthen public confidence. The collapse of the interbank market called for action to restore liquidity. These points are covered by banking support packages and they already prove to be effective. One crucial point which remains to be solved is the problem of toxic assets. Policymakers need to agree on a framework on how to value and dispose of such toxic assets and thus contribute to sound balance sheets of financial institutions. The contagion of the real economy calls for coordinated fiscal and monetary policy action to dampen the economic downturn.

The crisis hits **emerging economies** from different sides. In addition to the steep decline in demand for their products due to the slump in world trade, capital outflows exert pressure on emerging economies' capital accounts, triggering the need for massive financial support.

2. The Reaction of Austrian Economic Policy

Slide 8 – The Austrian Banking Support Package

The Austrian bank stabilization package was passed by the Austrian parliament in October 2008 and primarily encompasses two new laws, the Interbank Market Support Act (Interbankmarktstärkungsg), and the Financial Market Stability Act (Finanzmarktstabilitätsg).

The Austrian measures were designed in accordance with the common principles highlighted at the ECOFIN meeting on October 7, 2008, and the Declaration on a concerted European action plan by the heads of state of the euro area on October 12, 2008. This declaration, which defines specific cornerstones regarding national measures for supporting the financial markets, shows that the European Union is in a position to act quickly and in a coordinated manner in the case of a financial crisis.

With the Interbank Market Support Act, an "**Austrian clearing bank**" (Oesterreichische Clearingbank AG) was established as a special purpose entity to strengthen the interbank market and to guarantee bank bonds. The Austrian clearing bank serves as an intermediary on the interbank market by borrowing funds from credit institutions and lending them on to other credit institutions and insurance undertakings. Measures under this law may not exceed EUR 75 billion. The Interbank Market Support Act expires on December 31, 2009. Up to now, bank bonds to the amount of EUR 11.1 billion have been guaranteed by the Austrian government, while guarantees given in the interbank market amount to EUR 5.3 billion.

Under the Financial Market Stability Act, the Minister of Finance may take **measures to recapitalize credit institutions and insurance undertakings** by way of assuming liabilities, guaranteeing loans and providing equity capital, acquiring company shares or convertible bonds, taking over company assets and – as a measure of last resort – taking over property rights (i.e. nationalization). Fees and interest for these instruments must be set at market rates. Measures under this law may not exceed EUR 15 billion. The law also provides for (re)privatization after stabilization has been achieved. Up to now, agreed capital measures amount to EUR 6.35 billion, leaving a buffer of EUR 8.65 billion for further recapitalization measures in the future.

Another measure taken by the Austrian authorities concerns the **safeguarding of bank deposits** and the prevention of bank runs. For bank deposits of retail customers, a 100% state guarantee was put in place retroactively from October 1, 2008; this guarantee will be valid until the end of 2009. As of January 1, 2010, protection for retail customers' deposits will be limited to EUR 100.000 (previously EUR 20.000 per account holder/per bank). The deposit protection for small and medium-size enterprises was raised to EUR 50.000. Overall, a maximum of EUR 10 billion has been allotted to this measure.

All these measures, adopted in a swift and comprehensive way, contributed successfully to reestablishing confidence in the Austrian financial market and to securing financial stability.

Slide 9 – The Austrian Bank Stabilization Package – International Comparison

When **comparing the Austrian bank stabilization package** with those of other countries, the Austrian package was initially criticized as being oversized. But in fact, the dimension of the package was already taking the new risk development in the CESEE countries (where Austrian banks have a high exposure) into account and proved to be the result of prudent foresight. Moreover, compared with the banking systems in other countries (U.S.A., Germany, U.K. etc.), where public rescue packages play a key role in guaranteeing the survival of the banking system, it is particularly worth noting that the **Austrian banking system is still generating profits**. The Austrian banking support package can be described as a vaccination against potential future problems.

Slide 10 – The Role of Fiscal Policy in Times of Crisis

The financial crisis has become a global economic crisis. Given the scope of the current crises, several arguments in favor of **discretionary fiscal policy** have been put forward. First, since the output gap is expected to remain negative for a longer period of time, the **well-known implementation lag of discretionary fiscal policy is currently less problematic**. Second, in "normal" times, fiscal policy supports monetary policy in smoothing the business cycle via automatic stabilizers. This has worked quite well over the last 25 years. Yet, these are not "normal" times. Although automatic stabilizers still work, they are not large enough to prevent a severe economic downturn. Moreover, they have been weakened through structural reforms like reductions in the progressivity of tax systems and a decrease in the public expenditure-to-GDP ratio. Third, due to the financial crisis and very low expectations on returns of potential investments for the near future, right now the ability of traditional monetary policy measures to boost investment and consumption is limited. Finally, we face the threat of hysteresis effects (increase in NAIRU) via a long-run reduction in human capital. So there is a need for adequate fiscal policy measures, and fiscal policy may well be more effective under the current circumstances than in "normal" times. Low capacity utilization and a larger number of liquidity-constrained households and firms may currently shift fiscal multipliers to above-average levels.

So, coordinated discretionary measures as proposed in the European Economic Recovery Plan are necessary.

Coordination among EU Member States is important due to their high degree of openness and the therefore relatively low multiplier effects. Most EU countries (including Austria) are already implementing such programs. The measures should be lasting because the downturn might be lasting, and contingent because the situation might get worse. So there has to be commitment to stick to the measures until the recession is over, and to do more if the recession gets worse indeed. As for fiscal policy, the necessity of a large and timely stimulus package is most obvious. Olivier Blanchard and other IMF experts¹⁾ explained concisely by the end of last year what such a stimulus package should look like.

But of course the long-term sustainability of public finances in Europe and around the world must not be undermined. Fiscal measures should not conflict with long-term goals of growth policy like in the Lisbon Strategy; this point is heavily emphasized in the European Economic Recovery Plan. Furthermore, in accordance with the Stability and Growth Pact, there has to be a commitment that consolidation will be carried out when times get better.

Slide 11 – The Austrian Fiscal Stimulus Package

In line with these principles the Austrian package encompasses consumption-stimulating measures, investment incentives and export facilitation, investments in infrastructure and job support measures. All measures together sum up to EUR 6.6 billion or 2.4% of GDP. Simulation results of the quantitative effects of these measures show that on balance, GDP growth will be pushed up by more than ¾% of GDP in 2009. By 2010, GDP should have increased by about 1.4% compared to a baseline scenario assuming no such measures. At the same time, the measures are expected to translate into a sizeable positive effect on employment, creating close to 25,000 jobs (+0.7%) in more than two years (calculated cumulatively, not reflecting job support initiatives and not adjusted for short-term work schemes).

3. The Crisis in CESEE

Slide 13 – CESEE Output Expected to Shrink in 2009

During the early stages of the current financial crisis, **the CESEE countries performed relatively well** compared to other world regions, and increases in risk premiums and downward revisions of growth prospects were rather contained. However, with the tightening of the crisis in the fall of 2008, the collapse in world trade and the global increase in risk aversion, emerging market economies in general came under considerable constraint. Moreover, country- as well as region-specific vulnerabilities moved into the focus of market participants and investors. Credit default swaps increased, but the increase was not at all homogeneous across CESEE countries.

With the change in global investors' sentiment, **growth prospects for CESEE countries had to be revised downwards substantially in the recent past.** Since the CESEE region experienced growth rates well above the Western European average, the turn in economic activity looks particularly sharp. According to the latest forecast by the European Commission, GDP growth in several CESEE and Commonwealth of Independent States (CIS) countries will be below the euro area average, implying that the catching-up success of previous years will come to a temporary halt. Among the countries hit hardest by the financial crisis are Ukraine, the Baltic countries and Hungary. However, CESEE countries must not be seen as a homogenous region. The financial crisis has a stronger impact on countries with weaker economic fundamentals, insufficient policy credibility and large economic imbalances. But the outlook for the CESEE region as a whole still remains more optimistic than for the euro area. And in the years to come, the region will have higher trend growth rates, on average, than the "old" EU Member States, simply because they are still in the process of convergence toward higher GDP per capita. Thus, CESEE will remain a driver of economic growth in Europe for the foreseeable future. For the moment, however, direct and indirect external support is needed as a decisive measure to prevent recession in CESEE from becoming worse than in the euro area.

Although the catching-up process in most CESEE and CIS countries over the last years was impressive, it was also characterized by some erroneous trends.

Slide 14 – High Share of Foreign Currency Credit in Some CESEE and CIS Countries Constitutes a Major Risk ...

Let me stress two aspects that have made the affected countries extremely vulnerable to external shocks. **First, in some countries credit has probably been expanded too fast.** The rapid process of financial deepening needed to fund the elevated rates of economic growth in the CESEE region was often accompanied by a rise in foreign ownership in the banking system. This was typically a win-win situation for the home and the host countries. The CESEE countries benefited from technology transfers and access to external funds while non-CESEE banks generated high rates of return on their investments. But the combination of high returns and needs for (external) funds led to unsustainably high credit growth rates in some countries. And in some instances, domestic regulations that were aimed at limiting credit growth were eluded by e.g. direct cross-border credits. Another concern in this respect is the wide-spread allocation of foreign currency credits. In some CESEE countries, the share of foreign currency credits in total credits increased tremendously, making them rather vulnerable to exchange rate shocks. Again, this trend is limited to some CESEE countries. High shares raise the potential for adverse balance sheet effects in particular for households. By contrast, there is a natural hedge for most companies, in particular for companies borrowing internationally or subsidiaries receiving I/C loans.

Slide 15 – ... in Case of Sudden Exchange Rate Depreciations

The risk of substantial depreciations already materialized in the recent past. The growing signals of an upcoming global recession following the Lehman Brothers bankruptcy and the sharply deteriorating economic perspectives for the euro area led to a sharp depreciation of CESEE currencies in the fall of 2008 and beginning of 2009.²⁾ In most countries, central bank interventions on foreign exchange markets helped to contain the extent of currency depreciation, and since the end of the first quarter of 2009 the recovery of several CESEE currencies has signaled a potential reversal in risk assessment.

Slide 16 – Huge Current Account Deficits in Some CESEE and CIS Countries

Second, huge current account deficits and capital inflows contributed to **overheating in some countries.** Again, this is not a common feature of the whole region, but concerns only a small part of CESEE. In Central Europe, the catching-up process has reached a more advanced stage in which the current account deficit has gone down and the repatriation of profits on inward FDI stocks constitutes the only or a main source of the remaining current account deficits. By contrast, in some Southeastern European countries current account deficits are still large and partly even widening, in particular in Bulgaria and Romania. High current account deficits trigger a further worsening of the net foreign asset position which, if financed mainly by short-term debt, constitutes a major macroeconomic risk given the relatively fragile international environment with its intensified risk aversion and potential reversal of financial flows.

Slide 17 – Crisis Leads to High Write-Downs in Emerging Markets

Against the background of the global recession and the macroeconomic imbalances in some CESEE countries, the feedback loops between the financial sector and the real economy will trigger severe write-downs in CESEE countries. In the IMF's Global Financial Stability Report of April 2009 the potential write-downs for banks active in emerging markets were estimated for the first time. Global potential write-downs in emerging markets amount to almost USD 800 billion. The potential write-downs for Eastern Europe are estimated to reach USD 185 billion or 9% of outstanding assets.

Slide 18 International Response to the Crisis – Timeline of Events with a Focus on CESEE

Although the potential write-downs for Eastern Europe are similar to those of other regions (Asia, Latin America...), the mere size of the write-downs points to the need for fast and coordinated policy reactions at both the national and international level. The aim is not only to prevent the economic downturn in CESEE from deepening further but also to avoid feedback loops between advanced and emerging economies. At the international level, the IMF and the European Union – prompted by the high exposure of Western European countries to CESEE and by the fact that many CESEE countries have joined the EU – have helped stabilize the region and will continue to do so in the future.

Without claim to completeness, the IMF and/or the EU agreed on, or started talks on, support packages for Hungary, Ukraine, Belarus, Serbia, Turkey, Latvia, Romania and Poland. As a consequence of the G20 meeting, the IMF funds were raised to USD 500 billion and additional Special Drawing Rights of USD 250 billion were agreed upon. The World Bank, the EBRD and the EIB announced to lend an additional EUR 24.5 billion to CESEE countries, and the European Union raised its current account support in two steps to EUR 50 billion. Wherever the macroeconomic fundamentals give leeway, the international rescue packages should be accompanied by national packages.

4. The Crisis in CESEE from the Perspective of Austrian Banks

Although the direct effects of the financial crisis on Austrian banks have so far been limited due to their relatively small exposure to the U.S. subprime market, **Austrian banks have been indirectly affected** to a significant extent due to higher refinancing costs, declining income and higher loan loss provisions.

Slide 20 – Austrian Banks' Exposure to CESEE and CIS Markets is High...

Austrian banks were first movers in the CESEE and CIS banking markets in the late 1980s. Since then, they have continuously expanded their market presence and are now significant players across the whole region. Among foreign banks operating in CESEE and the European members of CIS, Austrian banks have a significant market share, namely about one-fifth of bank credits extended to this region (as direct cross-border credits or indirectly via subsidiaries in these countries). While this share is sizeable, it also makes clear that not only Austrian but also other European countries' banking groups are exposed to this region – mainly Germany, Italy, France, Belgium, the Netherlands and Greece.

Slide 21 – ... but Exposure is Broadly Diversified across Countries ...

The exposure of Austrian banks is **broadly diversified across countries**. The focus is clearly on new EU Member States, which account for ¾ of Austria's total exposure to CESEE.

Slide 22 – ... and Subsidiaries in CESEE Have a Solid Local Funding Basis

Moreover, Austrian banks' subsidiaries have a solid local funding basis, which limits the contagion risks via the reversal of financial flows.

Slide 23 – Austrian Banks Continue to Support Subsidiaries in CESEE

Conversely, these home countries share a particular **responsibility** with respect to the stability of national financial markets and financing structures in CESEE and CIS, the disruption of which could severely exacerbate the impact of the international financial and economic crisis. Moreover, a deep slump of activity in the region would affect all EU countries' exports to this region and hurt foreign direct investment in this region, which predominantly stems from EU countries. Given their long-term strategic objectives in CESEE, Austrian banks continued to support their subsidiaries in CESEE in the past few months and will continue to do so in the future. This is evident from a questionnaire sent to five major banks, which shows that their net positions increased further in 2008.

5. Summary

Slide 24 – Summary

Let me finalize my talk by summarizing the main points. The dimension of the crisis called for fast and coordinated policy reaction. Although measures have been implemented that prevent more harm in the short term, it is also necessary to define sound medium-term strategies. Looking at the reaction of Austrian policymakers, we see a bank stabilization package of sufficient size, which guarantees the functioning of the Austrian banking sector. The fiscal package in Austria helps dampen the adverse impact of the crisis on the real economy.

Turning to CESEE, we see a heterogeneous impact of the crisis. Hence, it is wrong to lump together all the countries in the region. I am confident that the massive financial support provided by international institutions helps stabilize the region. Austrian banks are important players on CESEE markets with a regionally diversified exposure. In line with their strategic objectives, Austrian banks continue to support their regional subsidiaries, being aware of their responsibility.

To conclude, let me quote **Barack Obama**: "**If you're walking down the right path and you're willing to keep walking eventually you'll make progress.**" I am confident that we are on the right path and that together, we will be able to manage the crisis well.

Thank you very much for your attention.

1) Olivier Blanchard, Antonio Spilimbergo, Steve Symansky and Carlo Cottarelli (2008). "Fiscal Policy for the Crisis," IMF Staff Position Note, December 29, 2008.

2) Before, only Romania had witnessed a depreciation as a result of its large and rapidly widening current account deficit.