Currency and Competitiveness

The OeNB's Conference on European Economic Integration 2007

Compiled by Andreas Breitenfellner[2]

Summary[1]

The *Conference on European Economic Integration* (CEEI) 2007 of the *Oesterreichische Nationalbank (OeNB)* took place on November 19 and 20 in Vienna. Under the heading "Currency and Competitiveness," the CEEI explored the links between the external value of currencies and structural developments in the real economy, focusing specifically on the integration process in Central, Eastern and Southeastern Europe (CESEE).

In his opening remarks, Governor Klaus Liebscher drew attention to the success of the euro in a worldwide competitive environment. The securing of price stability and the simultaneous creation of approximately 15 million jobs since the establishment of Economic and Monetary Union (EMU) confirm the euro's success. Speaking on exchange rate issues, Liebscher described excessive exchange rate volatility as being unwelcome; however, he also recognized the "strong euro" as a cushion against recent crude oil price shocks. Other high-ranking speakers on the first day included John Lipsky, First Deputy Managing Director of the *International Monetary Fund,* and the central bank governors of Cyprus, Athanasios Orphanides, Malta, Michael C. Bonello, and Slovakia, Ivan Šramko.

On the second day, *OeNB* Director Josef Christl stressed that while exchange rates were significant for the competitive position of a country, they are certainly not the only important factor. After all, the new EU Member States exhibited a strong economic performance despite substantial real appreciation. He also stated that competitive problems of individual Member States can only be solved by structural reforms. The prominent speakers on the second day include Lorenzo Bini-Smaghi, Member of the Executive Board of the *ECB,* Jean Pisani-Ferry, Director of the Brussels-based think tank *BRUEGEL* and Wolfgang Reithofer, CEO of *Wienerberger AG.*

The conference addressed a wide range of issues, e.g. the worldwide current account imbalances, international currency competition, the role, objectives and challenges of regional monetary unions, the competitiveness of catching-up countries and related challenges for monetary policy. The discussion on euro area enlargement shed some light on the successful convergence process of Cyprus and Malta, which at the time were on the verge of adopting the euro, as well as on future challenges for potential euro area candidates. Finally, market participants were given the opportunity to share their views, which provided valuable insights into the corporate experience with exchange rate adjustments.

[1] *The conference proceedings will be published by Edward Elgar Publishing Ltd. in the course of the year 2008. Presentations and papers as well as information about speakers and the program are available at www.oenb.at under Services and Events.*

[2] *On the basis of notes taken by Andreas Breitenfellner, Stephan Barisitz, Sándor Gardó, Antje Hildebrandt, Thomas Reininger, Thomas Scheiber, Josef Schreiner, Tomas Slacik and Zoltan Walko.*

The Contribution of the Euro to Global Stability

In his opening remarks, OeNB Governor *Klaus Liebscher* explained that the *Eurosystem* had the primary objective to maintain price stability in the medium term rather than an exchange rate target. However, exchange rates are taken into consideration to the extent that they influence risks to price stability. "In this respect, excessive exchange rate volatility is not welcome," stressed Liebscher. Only with difficulty can the external value of a currency be attributed to individual factors of influence. Determining the effects of a currency appreciation is by no means easier, particularly because cheaper imported goods lower consumer prices. "In this sense, the 'strong euro' has cushioned our economies from recent crude oil price shocks," noted Liebscher. Certainly, the considerable current account deficits of the U.S.A. and the corresponding surpluses of Asian and oil exporting countries exert pressure on currencies, with the euro area carrying the major burden in this adjustment process. Liebscher maintained that all regions involved have to assume their respective responsibility for ensuring that their external and internal balances are sustainable. He recognized the improvement of the euro area's competitive position, which is reflected by sustainable economic growth and shrinking unemployment, in turn attributable to the stability-oriented framework of EMU and structural reforms. At the same time, he advocated further reforms to improve competitiveness as well as ambitious fiscal policy. Finally, Governor Liebscher congratulated the central bank governors of Cyprus and Malta on the introduction of the euro at the beginning of 2008. Both countries set a positive example for other EU Member States that have not joined the euro area yet.

The Multilateral Approach to Global Imbalances

In the first keynote speech, John Lipsky, First Deputy Managing Director of the International Monetary Fund (IMF), addressed the problem of global imbalances – net deficits or surpluses in trade and investment among large countries – against the backdrop of near-term risks to growth and stability. Among those risks, he emphasized a further increase of oil prices, continued housing market turbulences not only in the U.S.A., but also in Europe, and finally a second phase of financial market strains with a severe tightening of credit standards. Turning to the imbalances, more than a third of the U.S. current account deficit was financed by the increase of foreign holdings of asset-backed securities. Importantly, several recent exchange rate adjustments (appreciation in Brazil, Canada, Australia and the euro area; depreciation in China and Saudi Arabia) have not reflected the respective countries' current account positions. In his view, a three-part strategy could preserve growth while reducing imbalances: a rise in U.S. savings coupled with faster domestic demand growth in the rest of the world, and more exchange rate flexibility in surplus countries. In the framework of the IMF's *multilateral consultation,* five major global players have presented policy plans on their contribution to reducing global imbalances in an orderly fashion. In particular, the euro area and Japan plan to strengthen domestic demand and productivity growth as well as competition in key sectors by structural reforms; China envisages financial sector reforms and an increase in exchange rate flexibility as well as a

rebalancing of growth; Saudi Arabia plans to raise spending in the hydrocarbon sector as well as in needed infrastructure and social projects; and the United States plans to raise its public and private saving. The longer-term gain in global economic growth implied by the combination of these policy measures would outweigh the short-term loss.

The second keynote speech was held by *John Williamson,* Senior Fellow at the Peterson Institute. He stressed that the most controversial issue was neither the size of the imbalances, nor how to remedy them, but whether they constitute a policy problem that demands action. He characterized the do-nothing view as the view that the market will automatically induce a gradual adjustment in its own good time. Williamson admitted that such a benign scenario was possible. The rest of the world might gradually desire additional resources and thus reduce saved dollar assets, as globalization slows and societies age, and this would lead to a fall in the U.S. deficit. However, alternatively, a dollar crisis, with sharp dollar depreciation and a collapse in confidence that reduced U.S. consumption and investment, was also possible. In this case, the expenditure reduction in the U.S.A. would eventually be outweighed by the expenditure-switching effect of dollar depreciation, while these two effects would be mutually reinforcing in the rest of the world and would threaten to trigger a world recession. Thus, prudence suggests an active program of adjustment that would reduce the risk of disaster. The speaker appreciated the "multilateral consultations" designed by the IMF as exactly the right instrument, containing the right members in the right context with the right topic. However, he argued that there was a lack of U.S. commitment to change (fiscal) policy as part of a package. If and as soon as the U.S.A. show its willingness to engage in genuine negotiations, the IMF should convene a second round of multilateral consultations to negotiate a joint and simultaneous policy change. In his view, successful negotiations should comprise both demand (fiscal policy) and exchange rate adjustments aimed at keeping the effective rates of the non-East Asian currencies broadly unchanged; this approach had the merit of using intervention policy more actively as a subject for negotiation. In the ensuing discussion, Lipsky stressed that in multilateral consultations each of the players acknowledged their voluntary plan as being in their own national interest and in the interest of all the others. Moreover, their plans did not leave out any important adjustment measure. Thus, the crucial question is whether these multilaterally consistent plans will be implemented, in which case the euro area would gain a lot. While Williamson maintained that the proposed fiscal consolidation plans by the U.S.A. were not ambitious enough, Lipsky replied with the rhetorical question of whether the U.S.A. should really take the risk of implementing a procyclical fiscal policy at present.

Understanding Exchange Rates: Economic Fundamentals versus Market Microstructure

The first session, chaired by Peter Mooslechner, Director of the Economics Department of the Oesterreichische Nationalbank, was an introduction into the academic debate on exchange rates determinants.

Ronald MacDonald, University of Glasgow, referred to the apparently widespread perception in economics that exchange rate behavior is disconnected

from macroeconomic fundamentals, at least in the short and medium term. This disconnection leads to a three-part puzzle regarding exchange rate levels, exchange rate volatility and purchasing power parity (PPP). However, he argued, to abandon macrofundamentals would be to throw the baby out with the bath water. There are clear reasons why many researchers have not been able to produce good forecasting results: a failure to properly capture the underlying data generation dynamics, parsimony and error correction. MacDonald provided evidence that a forecast produced by a properly specified vector error correction model outperforms all benchmarks. The volatility puzzle is not as clear-cut as many economists believe, and there is empirical evidence and theoretical work which suggests that macrofundamentals can explain the volatility of exchange rates both inter- and intra-regime. The PPP puzzle suggests that PPP is not a good way of defining an equilibrium exchange rate. But empirical work suggests that meaningful equilibrium relationships do exist for real exchange rates in terms of macroeconomic fundamentals. Various approaches have exploited this information to produce measures of equilibrium and misalignment. MacDonald concluded that the future of exchange rate economics is bright and macrofundamentals will be on board.

Martin Evans, Georgetown University, emphasized that even in a microstructure approach, there is a role for macrofundamentals. According to his research, transaction flows in foreign exchange (FOREX) markets may convey fundamental information on the future evolution of macroeconomic variables – information that is not available from other sources (e.g. asset prices, interest rates or survey data). Market participants' information is heterogeneous and incomplete, and it takes time to spread it. FOREX order flows aggregate dispersed microinformation about the macroeconomy and convey it to market participants. Therefore, order flows account for much of the variation of spot exchange rates. While collecting transaction data is becoming easier, interpreting the data from limit order markets requires care. Evans concluded that the current challenge is to combine order flow and macrodata so that real-time macroinformation can be efficiently extracted. The ensuing discussion concentrated on the possible use of FOREX order flows for forecasting. In response to a question, Evans pointed out that the Lucas critique, which holds that a forecast could break down if too many policymakers exploit it – is, to some degree, justified: Once knowledge of order flows becomes public property instead of being disseminated slowly, forecasting ability becomes blunted.

Lászlό Halpern, Deputy Director of the Hungarian Academy of Sciences, drew the audience's attention to the *purchasing power parity puzzle* and its possible explanations. Given that there is a lack of strong evidence even for long-run determination of the exchange rate by using the purchasing power parity (PPP), he concluded that PPP concepts needed to be redesigned using nonlinear and panel techniques and taking into account sectoral heterogeneity in adjustment. Moreover, a theoretical conflict arises in a *new open economy macroeconomics* framework (NOEM), since with imperfect substitution and nominal rigidities a violation of PPP is a necessary condition. Halpern went on to conclude that the new challenge from trade theory is the difficulty of reconciling empirical facts about the Balassa-Samuelson effect with NOEM.

Furthermore, this effect is theoretically a short- or medium-term catching-up phenomenon, but appears to be staying quite long. As a promising path for future research, Halpern outlined the extension of NOEM by new trade theories.

Catching Up and Exchange Rate Appreciation

Session 2 focused on the drivers of exchange rate appreciation in catching-up economies. *Balázs Égert,* OECD (and formerly OeNB), spoke about the determinants of inflation rates in Europe. He started by addressing the *Balassa-Samuelson puzzle,* i.e. the fact that the size of the Balassa-Samuelson effect reported in the literature is small despite the large productivity gains observed in the tradable sector. Égert pointed out four reasons for explaining the puzzle: (1) the large dispersion of productivity gains within the manufacturing sector, (2) incomplete wage equalization between the tradable and nontradable sectors, (3) substantial productivity gains in the nontradable sector, and (4) the low share of market nontradables in the CPI basket. Using yearly panel data for a set of 11 euro area countries and 10 CEE countries for the period from 1996 (1999) to 2005, Égert shows that the Balassa-Samuelson effect does not have an impact on the inflation rate. At the same time, there was evidence in favor of other structural factors. Most importantly, Égert found that cyclical and external factors are important drivers of inflation rates in Europe.

Jiří Podpiera, Ceská národní banka, presented the results of a joint paper with Jan Bruha on the role of investments into product quality. Podpiera also referred to the Balassa-Samuelson puzzle in the context of the appreciation of the real exchange rate on the basis of tradable goods prices. Podpiera maintained that improvements of product quality, leading to price increases, can serve as a plausible explanation of this puzzle. This view is supported also by a shift to high-tech products and massive FDI inflows, as well as know-how transfers observed in CESEE over the past decade. Picking up on recent empirical findings, Podpiera also emphasized the role of an extension of product variety (for a given product quality) for price increases. Implementing a general equilibrium model, extended for this quality effect, the authors forecast a continued real exchange rate appreciation for various CESEE Member States. Furthermore, the authors conclude that quality improvements will likely complicate the fulfillment of the Maastricht inflation criterion under stable exchange rates.

The third speaker, *Enrique Alberola,* Banco de España, provided an assessment of the sustainability of external positions in CESEE Member States and the role of the exchange rate in sustainability. Alberola pointed out the puzzling positive relationship between net foreign liabilities and real appreciation in the these new Member States over the past decade. He attributed this positive relationship to the productivity-enhancing effect of debt inflows, which generated real appreciation without endangering competitiveness, the favorable valuation effects of appreciation on the net foreign position in some countries, and the fact that the cost of debt has been lower than the return from debt in most CESEE Member States. Notwithstanding this benign assessment, Alberola alluded to the trend of several of those countries' current account balances to deteriorate as a result of

excessive domestic demand and the increasing burden on net foreign positions. Against this background, he underlined the importance of maintaining financing flows, which in turn hinges on the success of sustainable real and nominal convergence. In this process, exchange rate appreciation may help relieve demand pressures and inflationary pressures.

In concluding the session, *György Szapáry,* former deputy governor of Magyar Nemzeti Bank, stressed the role of rapid domestic credit extension to the private sector for the creation of domestic demand pressures, which may then translate into external and internal imbalances. Moreover, he cautioned that part of this credit had not been used for productive purposes.

Preparing for the Euro: Lessons Learned and Challenges Ahead

Panel discussion 1, chaired by *Sir Samuel Brittan,* Financial Times, focused on selected countries' experience with euro adoption. Two of the countries represented (Cyprus, Malta) intended to adopt the euro on January 1, 2008, whereas Slovakia's entry to the euro area was planned for 2009.

Athanasios Orphanides, Governor of the Central Bank of Cyprus, first gave a short overview of recent economic developments in Cyprus, stressing the crucial role of the country's credible fixed exchange rate regime in achieving and maintaining price stability. At the same time, he identified the close monitoring of monetary aggregates (mainly credit to the private sector) and the current account deficit as the main pillars of successful monetary policy in Cyprus. As past key challenges on the road to the euro, he cited the implementation of EU accession-related reforms, the abolition of interest rate ceilings, the reform of monetary policy instruments and the gradual liberalization of capital movements, inducing significant capital inflows that brought the exchange rate under pressure. As the main challenges ahead, Orphanides named the easing of monetary conditions resulting from the convergence of interest rates and reserve requirements upon euro adoption, as well as inflationary expectations, i.e. concerns about euro-related price increases.

Michael C. Bonello, Governor of the Central Bank of Malta, outlined Malta's recent economic development, pinpointing the large public sector, capital controls, lack of central bank independence and structural rigidities (mainly labor market) as the major deficiencies of the Maltese economy in the late 1990s. Additionally, the country had been severely hit by two external shocks in tourism and the electronics sector at the beginning of the millennium. Not only did this lead to an economic slowdown, but it also adversely influenced preparations for EU membership. Thus, enhancing economic growth, strengthening external competitiveness, fiscal consolidation and structural reforms were on the top of the agenda. The central bank has committed itself to pursue a fixed exchange rate policy and to promote further reforms in the financial sector (alignment with EU norms, sequenced capital account liberalization). In the meantime, the government has adopted a fiscal consolidation program aimed at reducing the budget deficit to below 3% of GDP by 2006 and has implemented structural reforms (e.g. pension reform, downsizing of the public sector) to enhance competition, efficiency and

flexibility. According to Bonello, the main lessons from the Maltese experience are the importance of a shared vision between the government and the central bank on policy objectives, a credible commitment to joining the European Exchange Rate Mechanism (ERM II) and a clear target date for euro adoption.

Ivan Šramko, Governor of the National Bank of Slovakia, presented Slovakia's euro adoption strategy, which was approved back in 2003. In 2004, the government set the year 2009 as the target date for euro area entry, and the national euro changeover plan was adopted in 2005 (updated in 2007). Three in-depth impact analyses were carried out in 2006, confirming that the benefits of euro adoption for the Slovak economy, population and business sector will outstrip the estimated costs (e.g. technical costs of currency changeover, banking sector losses, likelihood of moderately higher inflation). Šramko noted that Slovakia currently fulfilled all *Maastricht criteria* except the public deficit benchmark. He predicted, however, that the general government budget deficit would fall below the reference value by year-end 2007 – even including the full costs of pension reform – and mapped ongoing fiscal consolidation for the years 2008 and 2009. He also stressed the sustainability of low inflation in Slovakia for at least the upcoming two years and underscored that no artificial measures (e.g. decrease in indirect taxes, regulated price freezes) were being taken to keep inflation at low levels in the run-up to euro adoption. While drawing attention to exchange rate developments (pronounced nominal appreciation based on strong fundamentals), Šramko stressed that Slovakia's euro adoption served as a precedent, since Slovakia will be the first CESEE Member State to adopt the euro after having operated a freely floating exchange rate regime for many years. For Slovakia, Šramko sees the main challenges for euro adoption in the problem of the impossible trinity, the *shooting a moving target* problem and the *Balassa-Samuelson* effect.

The final panelist, *Servaas Deroose,* European Commission, discussed euro introduction in the CESEE Member States, underscoring that the Treaty on European Union represents a rule-based framework, but offers leeway for the CESEE Member States in calibrating their convergence path. In this context, he added that there is no one-size-fits-all policy framework for euro adoption, given the differences in initial monetary and exchange rate regimes of *fixers* (EE, LV, LT, and BG) and *floaters* (CZ, PL, HU, RO); Slovakia in ERM II represents an intermediate group. The challenges for convergence – especially for the fixers – include high inflation, rising external imbalances and rapid credit growth. Accordingly, the fixers should urgently address the emerging overheating pressures by mobilizing all available domestic instruments under the constraints of a fixed exchange rate regime, while the floaters should step up fiscal consolidation and structural reforms, and should address emerging financial imbalances.

Exchange Rates and Central Bank Policy in East Asia

In his dinner speech, *Hans Genberg,* Executive Director (Research) of the Hong Kong Monetary Authority, referred to the issue of global imbalances from an Asian perspective. According to his first proposition, the focus on exchange rates should be deemphasized in multilateral policy surveillance in favor of

fundamental monetary and fiscal policies. Focusing on the exchange rate does not help rebalance current accounts for three reasons: First, exchange rate changes have weak effects on current accounts. Second, exchange rates are not policy instruments. Direct influence on intertemporal decisions such as saving and investment, which are reflected in the current account, are more effective. Third, exchange rates should be determined by market forces. This would support Genberg's second proposition, which holds that policy strategies in East Asia are increasingly centered on domestic issues. Inflation targeting is taking hold, and exchange rate coordination is losing ground. The only areas where Genberg sees a need for regional cooperation is in achieving more liquid markets and financial liberalization.

Exchange Rates Are not Decisive for Competitiveness

The second day started with the opening statement of *Josef Christl,* OeNB Executive Director. While acknowledging that exchange rates are an important indicator in evaluating a country's competitive position, Christl highlighted the importance of other factors for competitiveness, like unit labor costs, sectoral and regional trade structures, quality and technological upgrading of production and location factors, such as tax systems. He presented the CESEE Member States as evidence of his statement, pointing out their experience with real appreciation coupled with substantial gains in international market shares. Referring to the recently observed appreciation of the euro, Christl refused proposals to explicitly include exchange rate considerations in the monetary strategy of the ECB. According to Christl, the strong euro dampens inflationary pressure and thereby increases real income. It also acts as an incentive for export-oriented industries to increase their productivity. Thus, a strong currency can have positive effects in the short as well as in the long run.

The Euro and the Real Economy: A Policy Issue?

The session started with *Lorenzo Bini Smaghi,* ECB Executive Board member, discussing the issue of real and nominal convergence in the European Union with a special focus on the CESEE Member States. He posed the questions of whether nominal and real convergence can take place at the same time, of what the challenges in this respect are and of how monetary, fiscal and structural policies can best tackle them. Real convergence of a catching-up economy may entail a higher return on capital for some time and a substantial appreciation of the real exchange rate. Within a monetary union or with a fixed exchange rate system, the appreciation of the real exchange rate may take place through a higher inflation rate. This may fuel inflationary spirals, entailing overshooting of inflation and boom-and-bust cycles. In a context like this, nominal convergence is not consistent with the continuation of real convergence. Such a development, however, can be avoided by increasing wage and price flexibility, by fostering structural adjustment and by further investment in human capital. He concluded that by pursuing a prudent and well targeted macroeconomic policy, nominal and real convergence can go hand in hand.

Jean Pisany-Ferry, director of the Brussels-based think tank BRUEGEL, in his presentation focused on the growth effects of the euro. So far, he stated,

there is evidence that the introduction of the euro has had positive effects on trade, FDI and financial integration. The evidence of the impact on growth, however, is mixed. Basically, the euro may contribute to growth by enhancing the quality of macroeconomic policies, providing incentives for reforms and mitigating divergences within Monetary Union. EMU increases macroeconomic stability by providing a reliable, well-targeted monetary policy. A stable economic environment in turn is known to support growth. However, the loss of the exchange rate as a policy instrument may entail some costs. Concerning the incentives for reforms, Pisany-Ferry argued that the effects of the euro are likely to be uneven. The fiscal constraints imposed by the Stability and Growth Pact may induce structural reforms. The rewards of such measures, however, are only likely to occur in the medium to long run. This may prevent governments with a short time horizon from taking appropriate action, as it is usually associated with political costs. Pisany-Ferry made several proposals to strengthen the incentives for reforms. For instance, he advocated the introduction of peer pressure measures to foster policy learning (independent assessment and benchmarking, surveillance) or to highlight the tradeoffs between structural reforms, budgetary adjustment and monetary conditions. Finally, EMU seems to have helped moderate the dispersion of growth rates within the euro area. However, no final scientific agreement has been reached about what the sources of this development are.

International Competitiveness: Are Exchange Rates still Significant?

Session 4 was chaired by *Doris Ritzberger-Grünwald,* Head of the Foreign Research Division of the OeNB. The session tried to shed light on the question of whether exchange rates are still a decisive feature in evaluating a country's competitive position.

Julia Wörz, The Vienna Institute for International Economic Studies (wiiw), elaborated on structural aspects of competitiveness in different country groups. After defining the concept of competitiveness, she gave an overview of different indicators of competitiveness and their evolution. She first showed that the new EU Member States and the first and second tier of Asian tigers are especially open economies and that their export structure is very much characterized by trade in goods, as opposed to more advanced economies, which seem to export relatively more services. Wörz then went on to demonstrate that emerging market economies are lagging behind in terms of locational features, like the ease of doing business or governance indicators. However, this lag does not have an impact on these countries' export performance. Apparently, the competitiveness of these regions is determined mainly by structural features, like industry and the product composition of exports. She further showed that the determinants of competitiveness are different for trade in goods and trade in services. Cost factors (unit labor costs and labor productivity) play a stronger role for goods, while soft factors appear to be more important for services. Also, the general export orientation matters strongly.

The dynamics of product quality were addressed in the second presentation, delivered by *Deniz Igan,* IMF, who focused on the question of why international

market shares of CESEE Member States increased in the past decade during a period of real appreciation. The explanation for this puzzle lies in technological and quality upgrading. As these countries moved from low- to high-tech products and increased in quality as measured by unit value ratios, they were able to sell their products at higher prices and still remain competitive. The increases in market shares partly also reflected favorable initial conditions, such as low international market penetration, skilled human capital and locational advantages due to the proximity of rich European markets. Igan's analysis further showed that catching-up countries tend to benefit more from increases in unit value ratios of exports than developed nations do. However, it also became clear that real appreciation has a comparatively stronger impact on catching-up nations. As quality upgrading shows decreasing returns, in the future it will become increasingly difficult for CEECs to maintain and improve their competitive position, Igan concluded.

The discussant *Michael Peneder,* Austrian Institute for Economic Research (WIFO), noted that both presentations shared a focus on trade while overlooking productivity. However, according to Peneder, an exhaustive analysis of competitiveness should always elaborate on both of these factors. Referring to the second presentation, he also noted that technological and quality advances should not be seen as separate, as the two largely go hand in hand. In the ensuing discussion, questions related to perceptions of quality and to whether an increase in unit value ratios indicates a general improvement in quality rather than clever branding and marketing strategies. Further issues were the extent to which export-oriented companies in Eastern Europe can decide on the quality and technological composition of their production, as they are largely foreign owned and as such decisions are usually taken at headquarters.

How Do Central Banks and Foreign Exchange Traders Interact?

Session 5 was chaired by *István Pal Székely,* European Commission. The first presentation on communication and exchange rate policy by *Marcel Fratzscher,* ECB, focused on two issues. Fratzscher pointed out that first, a regime change in monetary strategy and instruments took place in the 1990s. The U.S.A. and the euro area have moved away from an actual intervention policy and have shifted to oral intervention policies to communicate the policy stance on the exchange rate. Second, from a backward-looking perspective, the effectiveness of exchange policy (actual and oral communication) was assessed. It was concluded that both forms of intervention (actual and oral) are generally effective. Furthermore, interventions are even more effective if there is e.g. some policy coordination across and within countries and if the exchange rate and monetary policy move in the same direction.

In the second presentation, *Áron Gereben* of Magyar Nemzeti Bank (MNB) elaborated on the use of the microstructure approach to foreign exchange markets in a central bank. He emphasized that learning about the exchange rate is highly important for the MNB against the background of Hungary's status as an emerging market and a small open economy with a mixed monetary regime and plans to enter ERM II in the foreseeable future. Putting the focus

on microstructural data was motivated by the observation of some comovements of financial flows with the exchange rate, leading to the empirical analysis of the relationship between customer order flow and the Hungarian forint exchange rate. The analysis showed that customer order flow was able to explain a significant part of the fluctuation of the exchange rate of the Hungarian forint to the euro. Furthermore, foreign clients and the central bank appear to have the role of push customers (positive correlation of order flow with the exchange rate), whereas domestic clients are the pull customers (negative correlation of order flow with the exchange rate).

Discussant *Antonio Scalia,* Banca d'Italia, commended the data sets used by the presenters but also raised some open issues. In the case of the first paper, he argued that the environment (and therefore the effectiveness of intervention) had changed, considering the growth of FOREX market turnover, the higher international diversification by asset managers or the role of hedge funds. Referring to the second paper, Scalia questioned the forecasting power of order flow.

Presentation of the Olga Radzyner and Franz Weninger Awards

The afternoon on the second day was opened by OeNB Executive Director *Josef Christl,* who presented the winners of two awards, the *Olga Radzyner Award* and the *Franz Weninger Award,* which the *Oesterreichische Nationalbank* bestows each year on young researchers in the field of economics. From among the numerous submissions from seven CESEE countries, the jury decided to confer the Olga Radzyner Award on Béla Szörfi, Kopint-Tárki Economic Research Institute, Budapest, for his master's thesis on "Development and Regional Disparities," to Jan Bruha and Jiří Podpiera, Ceská národní banka, for their joint paper on "Transition Economy Convergence in a Two Country Model: Implications for Monetary Integration," to Anna Lipinska, a Polish economist at the Bank of England, for her research paper on "The Maastricht Convergence Criteria and Optimal Monetary Policy for the EMU Accession Countries" and finally to Rosen Stoyanov Marinov, a Bulgarian expert from the IMF office in Geneva, for his work on "Competitive Pressure in Transition: A Role for Trade and Competition Policies?" The *Franz Weninger Award,* which is granted for outstanding master's and doctoral theses at Austrian universities in the field of monetary theory and monetary policy, went to Robert Hierländer, *University of Vienna,* for his master's thesis on "Monetary Theory and Policy in Closed and Open Economies: A New Keynesian Approach" and to Karin Lang, *Innsbruck University,* for her master's thesis "Analyse von Arbitragegelegenheiten im Bereich der Kapitalstruktur eines Unternehmens."

Financial Integration and Exchange Rate Arrangements

Graciela L. Kaminsky, George Washington University, delivered the third keynote lecture. She introduced her speech by pointing out that the U.S. *subprime* mortgage crisis has refocused public attention on the threats of financial integration, particularly in emerging markets, and has revived old discussions on the role of the exchange rate regime. Subsequently, she provided evidence that in the wake of financial integration, also a large number of

developing countries had deregulated their financial markets and had opened up to procyclical capital flows. While in developed countries procyclical financial flows only lead to larger booms, in developing countries they exacerbate both booms and busts. Moreover, the problem appears to be compounded in countries with fixed exchange rate arrangements, as many such countries resort to sterilization to prevent inflation and thus trigger even larger capital inflows. In addition, empirical evidence suggests that fixed exchange rate regimes may also fuel dollarization and portfolio imbalances. Kaminsky formulated the hypothesis that fixed exchange rate regimes may be self-destructive in the sense that governments peg to minimize the impact of liability dollarization, but that fixing triggers even more liability dollarization and overall financial fragility. The implication of these stylized facts is that countries have increasingly moved toward more flexible exchange rate regimes, which, however, have to be accompanied by a new anchor, such as inflation targeting, to establish credibility. Alternatively, monetary unification similar to EMU might be an option for some regions. However, Kaminsky emphasized that a monetary union was certainly not a remedy that would fix problems immediately and that it required more than mere exchange rate fixing. The ensuing discussion centered on the recently improved fiscal performance in Latin America and the shift toward U.S. dollar-denominated loans.

Do Exchange Rates Matter in Corporate Decision Making?

The closing panel discussion was chaired by *Reinhard Göweil,* business editor at the Austrian newspaper Kurier. The panel was formed of selected representatives from the industry and finance sectors. *Wolfgang Reithofer,* CEO of Wienerberger AG (a global market leader in brick production), pointed out that company strategy should not be predominantly determined by exchange rate risks. In the case of *Wienerberger AG,* currency risks are considered in the valuation process of potential acquisitions, its financing and the intragroup dividend policy. In addition, the money transaction risk is limited due to local nature of the brick business and low volume of cross-border deliveries. The more important accounting risk, which arises because individual financial statements of local companies are drawn up in local currency, should be controlled by a concept of balancing foreign currency assets and liabilities and thereby reducing equity fluctuation. Reithofer concluded that the impact of currency risk should be monitored; however, the strategy and investment options taken should be determined by industrial factors.

Peter Kuchner, a former CEO and troubleshooter in the machinery business, claimed that competitiveness was only marginally influenced by exchange rates. According to Kuchner, an innovative product, good quality and excellent service are the most important factors to compete successfully. Therefore, he emphasized the need for highly skilled labor. He cited the excellent products offered by Austrian banks as ways to cover exchange rate risks. Although these risks represent a chance to make profits, the development of core trade was more important, noted Kuchner. Hence, profits from foreign exchange speculation should be strictly separated from profits made on core business. Finally, Kuchner noted that a stable home currency, secured not least by the

Oesterreichische Nationalbank, was a crucial condition for small and medium-sized enterprises (SMEs).

Veronika Lammer, Head of Group Research at Erste Bank, focused on hedging exchange rate risks. She considered liabilities, receivables, the cross-correlation between currencies, the timing of cash flows with different currencies as well as the price sensitivity of goods to exchange rate fluctuations as potential risk factors. Additionally, she pointed out the importance of net currency risk and that the influence of these fluctuations on profits, not on sales, should be considered. Not only do defined rules for hedging, especially if it is only occasionally or partly, help to reduce the currency risk, a different financing strategy can also diminish that risk. Lammer finished her presentation by introducing different hedging products, their preferred application area as well as their pros and cons.

The last panelist, *Holger Schmiedling,* chief economist for Europe at the Bank of America, affirmed that exchange rates matter in corporate decision-making. The rising degree of openness in global business, as well as the globalization of production and demand, are major trends he identified in relation to currency threats. Furthermore, an environment of low, stable inflation reduces the risk of currency crisis and helps emerging markets to catch up. He also remarked that exchange rates matter more to countries than to global companies that establish hedges by sourcing their production in different countries. Therefore, these companies worry less about short-term fluctuations and align their strategies to fundamental values and implied long term impacts. The following discussion focused on the impact of euro introduction on the Austrian business environment. The panelists agreed that competition had increased due to better comparability, but admitted that the benefits of the euro outweighed its drawbacks.

Concluding Remarks

In his concluding remarks, OeNB Executive Director *Josef Christl* expressed his appreciation for the interesting and stimulating lectures and presentations held during the two days of the conference and for the fruitful exchange of ideas. Summarizing the highlights, Christl pointed out that a wide range of global and regional issues dealing with the external value of currencies had been covered. He drew special attention to the development of the catching-up CESEE economies and the further convergence challenges each of them have to tackle. Finally, he also acknowledged the achievements of Cyprus and Malta, which at the time were about to join the euro area (January 1, 2008). At the same time, he identified future tasks for potential candidates. In addition to the ground covered on the relevance of exchange rates in corporate decision making, the established findings and new questions raised during the conference may serve as a source for future research, concluded Christl.