

# Research Update

Economic Analysis and Research Department

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Against the backdrop of current inflationary developments and the ensuing political and media debate, the OeNB is going to publish an analysis on the potential contribution of supply and demand factors to price developments in Austria. (see page 3)

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## Editorial

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

*Has anybody ever written about the economics of heat?*

*The contributions to heat – beside, of course, the issue of global warming – by the computers of our hard-working researchers and the temperatures in my office would provide plenty of material currently.*

*In a more serious vein, much material is related to the "heat" generated by the steep price increases of oil and several other commodities that, at the moment, entirely absorbs the attention of economists all over the world. This inflationary surge is occurring against the backdrop of high uncertainty in the aftermath of last year's financial crises; both contribute to a heightened uncertainty in forecasting, complicating economic policymaking further.*

*To contribute to the unwinding of imbalances (above all, the imbalance between the need to act and the knowledge of what to do), we have assembled a few analytical presentations in this newsletter:*

- *First, we present our recent update of the economic outlook for Austria, which is somewhat better than expected.*
- *Second, we provide the results of our efforts to disentangle the supply and demand factors that have contributed to recent price developments in Austria, which have attracted a lot of public attention recently.*
- *Third, we report about a number of recent events organized by the OeNB, for example two meetings about Croatia's way into the EU and an East Jour Fixe meeting on price developments in "Emerging Europe."*
- *Fourth, we review a recent research workshop on "The Economics of Financial Stability" at which we tried to draw some basic lessons from the recent crises for our overall research agenda.*

*I hope the material contributes a little bit to keeping the "heat" under control and will help us all to enjoy a temperate and relaxing summer!*

## Clouds on the Economic Horizon – Inflation at a Record High Since 1993

According to the June 2008 economic outlook of the OeNB, Austria's GDP growth is projected to weaken compared with the economic boom years of 2006 and 2007 owing to the international financial crisis and the spike in commodity prices. Real GDP is projected to grow by 2.2% in 2008 and then dip to a low of 1.7% in 2009 before climbing back to 2.4% in 2010. Compared with the OeNB December 2007 economic outlook, growth expectations for 2008 and 2009 were downgraded by 0.3 and 0.6 percentage points respectively. At 3.1%, inflation in 2008 is at a record high since 1993 but is projected to fall to 2.4% in 2009 and to 1.9% in 2010. Employment growth remains robust, with a further drop in unemployment to 4.2% anticipated for 2008.

Austrian exports, which have been the engine of the country's GDP growth in recent years, will lose some steam owing to lower market growth and the higher external value of the euro.

However, this decline will be modest owing to three factors: Austrian exporters' focus on Eastern Europe, the diversified sectoral structure and the favorable trend in unit labor costs. Domestic demand is currently marked by sluggish consumer growth and a flat investment cycle. Unexpectedly high inflation is triggering a slight decline in real wages in 2008. Slowing employment momentum is

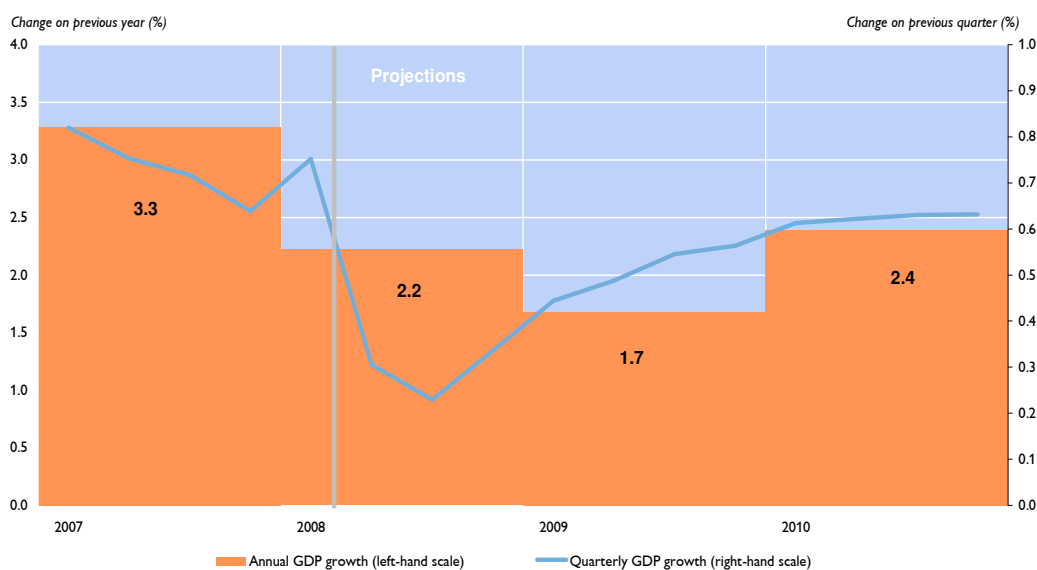
also dampening household income growth. Consumer growth will weaken to 1.0% in 2008 and is not expected to accelerate significantly in 2009 and 2010. Investment momentum will slow considerably on the back of the cooling of the world economy. As the current investment cycle is very flat compared with previous periods of economic expansion, investment is nevertheless expected to continue to grow in the downturn.

Inflation – fueled by the spike in commodity prices – has risen unexpectedly strongly. In April 2008, HICP inflation came to 3.4% and will fall only gradually. An inflation rate of 3.1% is projected for 2008 as a whole. At 2.4%, inflation is forecast to remain above the 2% mark in 2009 before dropping to 1.9% in 2010.

The Austrian labor market still looked to be in excellent health in the first half of 2008. Robust employment growth in 2008 is inducing a further drop in unemployment by 0.2 percentage points to 4.2%. In 2009 and 2010, unemployment is expected to rise slightly to 4.4%.

In 2008, the budget deficit (Maastricht definition) will deteriorate slightly to -0.6% of GDP, to be followed by a modest improvement to -0.5% in 2008 and 2009.

### Real GDP Growth (Seasonally and Working Day Adjusted)



Source: Eurostat, OeNB.

## Supply and demand factors in price developments in Austria

As part of the series of studies done at the OeNB to analyze the current causes of the pick up in inflation since last fall, the current issue of Monetary Policy & the Economy deals with traditional supply and demand factors explaining inflation.

In order to study demand side factors, Fabio Rumler and Maria Valderama empirically analyze inflation development in the context of a Phillips Curve from 1970 to end of 2007 in Austria, Germany, France, Italy and the Netherlands.

The evidence shows that inflation and the output gap moved together in the 1970's and early 1980's, but this relationship broke down (For Austria and Germany only in the early 1990s). Thus, the econometric evidence shows that the output gap was a significant determinant of the inflation development in the early years but is no longer significant in all the countries considered. In fact, taking into account economic developments in the last years and the position of the business cycle in these countries, most analysts would agree that despite higher growth rates in the last years, these growth rates coincide with a closing of the output gap after some years of poor economic performance. Thus, the current phase of the business cycle can not be characterized as a phase of overheating that would cause inflation pressures.

These results, which are consistent with a wide range of studies, make also sense for members of a monetary union and the monetary union itself. This is because in the monetary union monetary policy is based on euro area-wide developments, while inflation and output gap may still react to national or even global developments, which do not necessarily influence policy decisions.

These results have also important implications for monetary policy. They show that since inflation does not react significantly to the output gap, i.e. to the business cycle, it has become more difficult for policy makers to control inflation by influencing aggregate demand. This is also consistent with the current consensus which believes that anchored inflation expectations are crucial to keep inflation under control.

In his study of supply factors, Juergen Janger arrives at the following results and conclusions:

The use of a set of empirical proxies for competition intensity points to a clear lack of competition intensity in electricity and gas, dairies, wholesale of milk, cement and pharmacies. Some signs of weak competition can be found in retail sales of clothes, waste management, sewage and production of oils and fats. Competition seems to be strong in food retailing, bakeries, DIY-stores, petrol stations and shoe retailing.

A further investigation of food retailing reveals changes in the strategies of Austria's main food retailing chains away from prices towards optimising the product portfolio. To counter German discount stores, the big retailers chose a strategy of regionalisation of several key product lines such as milk and milk products. This means sourcing only from local producers with some cost disadvantages but also foregoing the possible contribution to lower prices from imports. At the same time, food producers are increasingly going international, supported by government policies to encourage exports. They are thus less dependent on the Austrian retailers and can justify price increases with reference to the international markets. However, only the Federal Competition Authority has the necessary investigative powers to detect possible price fixing.

Low competition in the energy sector has been a well-known fact for several years now. Production and distribution of energy are insufficiently separated, creating disincentives for grid use by competitors. To prepare for the integrated European energy market, the energy sector was concentrated even more, although it is still a long way to go before such a market is realised.

Although international price developments are by far more important than domestic developments and many more detailed studies are necessary, Austrian economic policy does have a range of options available. Competition policy should be improved markedly, via a reform of the complex institutional arrangement in Austria with a competition authority, a competition commission and a competition lawyer. Staff resources of the competition authority should be doubled at least to match similar institutions in other countries. Care should be taken in designing the envisaged food price monitoring, as it may

facilitate price fixing. European energy markets should be integrated further, while compulsory standards for energy-saving housing should be applied as early as possible.

However, anti-inflation measures in energy and food are judged to be of limited scope, due to the international dimension of the sectors and requirements of anti-climate change policies: for instance, energy and petrol prices should stay at a certain level to make the use of carbon-free technologies economically viable. Demand for cereal-intensive food such as meat is set to grow further in quickly growing population-rich emerging countries such as India and China. Austrian economic policy should thus focus on the services sector and

its trend contribution of 2 percentage points to Austrian inflation. Large price differences for identical services suggest that competition in sectors such as banking, insurance, construction, crafts, etc., could be further intensified. To this aim, product market regulation can be adapted to allow for competition (e.g. for real estate agents and property management); or to reduce barriers to competition via regulation of crafts, liberal professions, etc. To foster switching between different suppliers, price transparency of services should be increased via cheaper access to broadband internet. This could lower information and switching costs, raising price elasticity and thus intensifying competition.

## 36th Economics Conference of the OeNB: Toward the First Decade of Economic and Monetary Union

Attracting high-ranking central bank representatives, international and national politicians as well as economic policymakers and members of academia, the 36th Economics Conference of the Oesterreichische Nationalbank (OeNB) held on April 28 and 29, 2008, celebrated the 10th anniversary of Stage Three of Economic and Monetary Union (EMU). The aim of the conference was to take stock of this important chapter of recent economic and monetary history and at the same time develop some thoughts about the future of EMU. The first morning saw contributions from renowned central bankers and politicians, with the OeNB's Governor Klaus Liebscher opening the conference and Austria's Federal Chancellor Alfred Gusenbauer and Vice Chancellor Wilhelm Molterer presenting their views on "The Euro in an Enlarged EU – An Austrian Perspective" and "Policy Challenges and Opportunities for Austria." ECB President Jean Claude Trichet took stock of "The Eurosystem at 10" and Eurogroup President Jean Claude Juncker talked about "EMU and EU Policymaking Institutions – Intelligent Design or Learning by Doing?" Edward P. Lazear, Chairman of the Council of Economic Advisers, presented insights from the U.S. perspective in his contribution on EMU, the euro and Europe's role in the world economy. The Klaus Liebscher Prize for excellent scientific papers on European monetary union or European integration issues was awarded to Kerstin

Gerlach (University of Mannheim) and to Silvia Rocha-Akis and Aleksandra Riedl (Vienna University of Economics and Business Administration). The afternoon was then dedicated to academic discussions. Charles Wyplosz (Graduate Institute of International Studies) covered "Assessing the First Decade of EMU: What Have Academics Learned from the Experience of EMU? What Has EMU Learned from Academics?" In the subsequent panel discussion, leading academics examined various aspects of EMU, such as enlargement, financial integration, the impact of EMU on trade and guaranteeing the future of the euro. The panel comprised notable academics Mathilde Maurel (University of Paris 1), Philip Lane (Trinity College Dublin), Andrew K. Rose (University of California, Berkeley) and Charles Goodhart (London School of Economics). In his dinner speech, Arnout Wellink, President of De Nederlandsche Bank and Chairman of the Basel Committee on Banking Supervision, dealt with "Banking Supervision in the Euro Area: Experiences, Challenges and Prospects." The second conference day began with a broad overview of EMU from 1961 to the current challenges, as presented by Hans Tietmayer, Former President of the Deutsche Bundesbank, in his contribution on "Economic and Monetary Union from a Historical Perspective." In the subsequent panel discussion, Christine Marek (State Secretary in the Austrian Federal Ministry of Economics and Labour), Markus Beyerer (Secretary General, Federation of Austrian

Industry), Georg Kovarik (Chief Economist, Austrian Trade Union Federation), Bernhard Felderer (Director, Institute for Advanced Studies) and Karl

Aiginger (Director, Austrian Institute of Economic Research) reviewed Austria-specific aspects of EMU.

## 62nd OeNB East Jour Fixe “Soaring Prices in Emerging Europe: Temporary Phenomenon or Lasting Challenge?”

Worldwide inflation has soared substantially since mid 2007 – mostly induced by rising world market prices for energy and food. The countries in Central, Eastern, and Southeastern Europe (CESEE) were especially hit by unfavorable price developments, given their relatively high share of energy and food in the consumer goods basket. Still, there is quite a high dispersion of inflation rates in the region (in May 2008, year-on-year changes of the Harmonized Index of Consumer Prices (HICP) ranged from 4% in Slovakia to 17.7% in Latvia).

Against this background, on June 18 the OeNB invited renowned representatives from academia, international institutions, and CESEE central banks to understand the characteristics of this price surge in a better way, to learn from cross-country differences, and to debate possibilities and limits of policy measures to fight inflation in the region.

In the first session, general trends and main inflation drivers – especially food prices – were elaborated from a cross-country angle. Christoph Rosenberg (IMF) argued that the Baltics and Southeastern Europe had been affected most by food and energy inflation and pointed to necessary structural reforms to increase the respective supply across the CESEE region and beyond (e.g., arable land reform alongside improvement of farming infrastructure). Zdenek Lukas (wiiw) stressed that the prices for processed food have risen most since mid 2007. Mr. Lukas emphasized as the main reasons higher agricultural production costs (also due to higher energy prices) and a lack of competition in retailing and wholesaling. As Przemysław Woźniak (CASE, Warsaw) pointed out, the commodity price surge has come on top of recently accelerating price level convergence between emerging Europe and the euro area. Mr. Woźniak showed that the food price convergence trajectories lie for most of the countries below those for general goods prices, indicating that food could have been underpriced so far. Gert Wehinger (OECD) stated that inflation should recede soon as

global growth slows and a possible speculative bubble in food and commodity markets deflates, but long-term supply- and demand-side price pressures will remain. An adequate policy response should consist of enhancing competition, increasing energy efficiency, or promoting 2nd generation biofuels.

The following policy panel brought together seven central bank representatives from the region: Ágnes Csermely (Director, Magyar Nemzeti Bank), Diana Dragutinovic (Vice Governor, Narodna Banka Srbije), Valentin Lazea (Chief Economist, Banca Națională a României), Märten Ross (Deputy Governor, Eesti Pank), Peter Ševčovic (Board Member, Národná Banka Slovenska), Boris Vujčić (Deputy Governor, Hrvatska Narodna Banka), and Tina Žumer (Advisor to the Governor, Banka Slovenije). From the discussion of the panelists one can draw the following conclusions: (1) higher price pressures will indeed remain a longer-term macroeconomic challenge for emerging Europe; (2) uncertainty about the future development of prices is a key issue at this point; (3) it is a special task for monetary policy to contain inflation expectations via sufficient transparency, improvement of inflation forecasts (in the case of inflation targeters), and proper communication with social partners to dampen the risk of second-round effects; (4) increasing wage dynamics call for particular caution, especially considering the decline in productivity growth; (5) a determined reaction by central banks is necessary at this point as a belated response would possibly be much more costly; (6) rapid credit growth has contributed to the acceleration of inflation (but may be a less severe factor going forward given the incipient deceleration of lending dynamics as a consequence of the international credit crunch in several but not all CESEE countries).

## 4th OeNB Brussels Economic Round-Table: "Croatia on its way to the EU: What remains to be done?"

On 4 June 2008 the Representative Office of the OeNB in Brussels organized the 4th OeNB Brussels Economic Round-Table, titled "Croatia on its way to the EU: What remains to be done?". Its objective was to analyse the state of play of Croatian EU accession and its economic and political implications. Peter Mooslechner chaired a discussion panel, which included the following speakers: Maria Asenius (deputy head of cabinet of EU Enlargement Commissioner Olli Rehn); Branko Baricevic (EU Ambassador of Croatia); Harald Dossi (Director General of the Austrian Federal Chancellery); Hannes Swoboda (Member of the European Parliament); and Boris Vujcic (Deputy-Governor of the Croatian Central Bank/HNB).

As a way of introduction Peter Mooslechner gave an overview of the Croatian EU negotiation process. Out of 35 negotiating chapters 2 have been provisionally closed and 18 opened for negotiations (including chapter 17 on EMU). He pointed to the impressive track record of Croatia and stressed the close Croatian co-operation with „like-minded“ EU member states. In the field of monetary politics he stressed the excellent co-operation between the Croatian National Bank and the OeNB.

Maria Asenius scanned the critical areas of EU negotiations: administrative and economic reforms, fighting corruption, prosecuting war criminals, fostering minority rights and issues of regional co-operation. Previous rounds of EU enlargement demonstrate the importance of reform implementation, quality control and choosing/communicating the right date for EU accession.

Branko Baricevic called the EU accession process an "important learning process" for Croatia. Reforms would be necessary also without the perspective of EU membership. Croatia plans to fulfill the remaining 9 opening benchmarks by the end of June 2008. It aims at opening all negotiating chapters by the end of 2008, and negotiations shall be completed by the end of 2009. Croatia expects a conditional roadmap as part of the next EU-accession report.

Harald Dossi mentioned that Austria was one of the first to recognise Croatia as a sovereign nation-state and the first to ratify the Stability and Association Agreement. Austria quadrupled its exports into the Western Balkans in the last decade. 50% of total exports to the region go to Croatia and ¼ of its FDI is of Austrian origin.

According to Hannes Swoboda, the European Parliament will – for the first time – have to consent to the negotiation results before the ratification process in EU member states can start. He stressed the necessity of a fair social balance of reforms, which would also improve public opinion on EU integration.

Boris Vujcic analysed the positive Croatian economic performance: average GDP growth rates of 5% during the last 5 years, decreasing unemployment rates for the last 8 years, a fiscal deficit of 1,8% (2007), decreasing general public debt, a high – FDI-financed – current account deficit (8,5% of GDP in 2007), a foreign dominated banking sector (92% ), historically low inflation rates and controlled unit labour cost developments. Key economic challenges for Croatia are: maintaining its macroeconomic stability, implementing structural reforms, efficiently distributing EU funds, increasing the efficiency of the public sector and improving its investment climate.

### HNB-OeNB Dialog 2008

On June 2, 2008, the OeNB and the HNB held their third informal dialogue in Zagreb. The topics covered included exchange rate policy issues, implications of the Lisbon Treaty for EMU, Croatia's current state of EU accession negotiations, the country's economic situation as well as financial stability issues, such as recent FSAP experience and stress-testing. As in previous years, the program of the dialogue proved to be highly relevant for both sides, which was clearly visible by the lively discussions between HNB and OeNB staff members throughout the dialogue meeting.

## Research Workshop: “The Economics of Financial Stability”

Central Banks and international financial institutions have recently taken strong interest in quantitative models of financial stability. While some progress has been made, most of the recent models of financial stability are based on concepts from quantitative risk management. These concepts usually have a purely statistical focus and abstract from the underlying economics of the problem. Getting a clear view on the economics of the problem is essential because the relationships between financial markets, default, crises and the real economy are still poorly understood at an analytical level. Such a deeper understanding of the issues is however necessary to provide a sound and rational background for policy institutions that have to deal with financial crises prevention and resolution.

The Research Workshop “The Economics of Financial Stability” that took place at the premises of the OeNB from July 7 to 8, 2008 had the intention to contribute to a broader perspective on this important topic, to shape the research agenda on financial stability issues and to disseminate new ideas and modeling approaches. The workshop was jointly organized by Martin Summer (OeNB) and Hyun Song Shin (Princeton University) and brought together leading researchers in the field including: Viral Acharya (London Business School), Tobias

Adrian (Federal Reserve Bank of New York), Jürgen Eichberger (University of Heidelberg), Helmut Elsinger (OeNB), Ronel Elul (Federal Reserve Bank of Philadelphia), Falko Fecht (Deutsche Bundesbank), Hans Gersbach (Swiss Federal Institute of Technology, Zürich), Nobuhiro Kiyotaki (Princeton University), Guido Lorenzoni (M.I.T.), Frank Milne (Queen's University), John Moore (University of Edinburgh and LSE), Klaus Ritzberger (Institute for Advances Studies, Vienna), Alexander Stomper (Institute for Advanced Studies, Vienna and M.I.T.), Wolf Wagner (Tilburg University) and Jan Werner (University of Minnesota). In addition, the workshop was visited by a sizeable number of economists both from within the OeNB and from other central banks, universities and research institutions. The workshop covered a fairly wide selection of topics ranging from credit booms, the behavior of the interbank market and the role of risk management models to the interrelation between liquidity, business cycles and monetary policy. A general result of many presentations and discussions was that a systemic view on financial markets is imperative in order to get a complete picture of its inherent risks. A comprehensive summary of the workshop will be published in one of the upcoming volumes of the periodical “Monetary Policy and the Economy”.

### 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](http://www.oenb.at/en/img/ar_2007_tcm16-85363.pdf)

## INSIDE ECONOMIC ANALYSIS AND RESEARCH

Within our series presenting the divisions of the Economic Analysis and Research Department of Oesterreichische Nationalbank, it is the *European Affairs and International Financial Organizations Division's* turn this time.

The European Affairs and International Financial Organizations Division monitors and analyzes multilateral cooperation in the field of economic, monetary and fiscal policy and informs the OeNB's management and the responsible divisions about relevant developments.

Operating within a national and international network, the division serves as a hub for communication with other central banks, the ECB and international organizations and disseminates knowledge about these institutions.

The European Affairs and International Financial Organizations Division prepares the OeNB's representatives for meetings of the ECB Governing Council, the ECB General Council and the EU Economic and Financial Committee as well as for IMF meetings that are relevant to the OeNB.

Via a document management system, the division steers information and data from the ECB and other NCBs for the OeNB.

Moreover, the European Affairs and International Financial Organizations Division coordinates OeNB positions at the national level prior to their presentation in international bodies.

Recent areas of analytical work were:

- Benefits and costs of EU membership
- implications of the Lisbon Treaty on economic governance in the EU
- institutional questions of EU enlargement (e.g. central bank governance)
- implications of IMF quota and voice reform

The Division is headed by Franz Nauschnigg and Isabella Lindner (deputy), supervising a staff of 15 people.

### Olga Radzyner Award

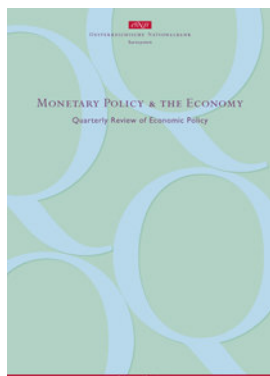
The Oesterreichische Nationalbank has established an award to commemorate Olga Radzyner, former head of the Foreign Research Division, who died in a tragic accident in August 1999. The award is bestowed on young economists for excellent research focused on topics of European economic integration and is conferred annually at the OeNB's Conference on European Economic Integration. Four applicants are eligible to receive a single payment of EUR 3,000 each from an annual total of EUR 12,000.

For detailed information, please visit our website at <http://ceec.oenb.at> or contact Ms. Eva Gehringer-Wasserbauer in the Foreign Research Division of the Oesterreichische Nationalbank either by e-mail at [eva.gehringer-wasserbauer@oenb.at](mailto:eva.gehringer-wasserbauer@oenb.at) or by phone (+43-1) 40420-5205.



## OeNB Periodical Publications

[http://www.oenb.at/en/presse\\_pub/period\\_pub/publications.jsp](http://www.oenb.at/en/presse_pub/period_pub/publications.jsp)



### **Monetary Policy & the Economy, Q1/08**

Inflationary Pressures Worldwide despite Downturn in Growth (Wolfgang Pointner, Martin Schneider, Josef Schreiner)

Current Inflation Developments in Austria (Fritz Fritzer, Ernest Gnan, Walpurga Köhler-Töglhofer, Fabio Rumler, Alfred Stiglbauer)

The Importance of Lease Financing for Austrian Municipalities (Bernhard Grossmann)

The Treaty of Lisbon (Sylvia Gloggnitzer)



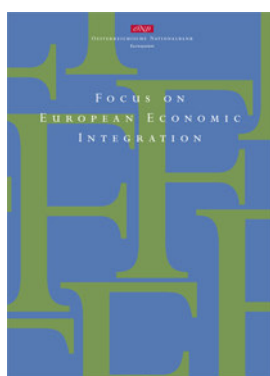
### **Financial Stability Report 15 (June 2008)**

Stress Tests for the Austrian FSAP Update 2007: Methodology, Scenarios and Results (Michael Boss, Gerhard Fenz, Gerald Krenn, Johannes Pann, Claus Puhr, Thomas Scheiber, Stefan W. Schmitz, Martin Schneider und Eva Ubl)

Systemically Important Accounts, Network Topology and Contagion in ARTIS (Michael Boss, Gerald Krenn, Valentina Metz, Claus Puhr, Stefan W. Schmitz)

Is Current Capital Regulation Based on Conservative Risk Assessment? (Thomas Breuer, Martin Jandačka, Klaus Rheinberger, Martin Summer)

Walking the Tightrope: A First Glance on the Impact of the Recent Global Financial Market Turbulence on Central, Eastern and Southeastern Europe (Sándor Gardó, Antje Hildebrandt, Zoltan Walko)



### **Focus on European Economic Integration 1/2008**

Euroization in Central, Eastern and Southeastern Europe – First Results from the New OeNB Euro Survey (Sandra Dvorsky, Thomas Scheiber, Helmut Stix)

Croatia: Coping with Rapid Financial Deepening (Sándor Gardó)

Labor Markets in Central, Eastern and Southeastern European EU Member States: General Trends and Migration Effects (Josef Schreiner)

Factors Driving Import Demand in Selected Central, Eastern and Southeastern European Countries (Thomas Reininger)

Determinants of Currency Crises: A Conflict of Generations? (Jesús Crespo Cuaresma, Tomáš Slačik)

## OeNB Working Papers

[http://www.oenb.at/en/presse\\_pub/research/020\\_workingpapers/working\\_papers\\_2008.jsp](http://www.oenb.at/en/presse_pub/research/020_workingpapers/working_papers_2008.jsp)

### Working Paper 140

Euroization: What Factors drive its Persistence? Household Data Evidence for Croatia, Slovenia and Slovakia (March 6, 2008) by Helmut Stix

The question asked in this paper is why people continue to use foreign currencies even after their economies have stabilized. Survey data for Croatia, Slovenia and Slovakia are employed to provide an answer. The results confirm the role of network effects and of remittances. Furthermore, the extent of currency substitution is found to be positively associated with the level of income and education. An important aspect of euroization seems to be age (the older are more likely to hold foreign currencies). In contrast, neither expectations about inflation rates, nor about exchange rates, do seem to affect the degree of euroization in a systematic and predictable way. Trust in the banking system is found to affect the choice between foreign currency cash and foreign currency deposits. Overall, the results support the view that the persistence in the use of foreign currencies is driven to a large extent by factors that are related to the past.

### Working Paper 141

The Real Consequences of Financial Market Integration when Countries Are Heterogeneous (April 28, 2008) by Kerstin Gerling

This paper studies the mechanisms through which financial integration affects the pattern of international capital flows and the domestic economic performances when explicitly accounting for wealth inequality on imperfect capital markets. Balancing the impact of a firm size and a credit rationing effect on the net credit position and on aggregate production will help predicting the distribution of gains and losses among and within countries on the basis of a country's aggregate wealth and its distribution. Altogether, the results contribute new explanations for some empirical puzzles. They also bear important implications for policy making, supranational treaty design and financial stability.

### Working Paper 142

Testing the tax competition theory: How elastic are national tax bases in Western Europe? (April 29, 2008) by Aleksandra Riedl and Silvia Rocha-Akis

In this paper, we test one of the fundamental assumptions in the tax competition literature, namely, that a country's taxable income depends on the tax policies pursued in the domestic and in neighbouring countries. Based on a panel of annual data of 14 Western European countries spanning the period 1982 to 2004, we show that the common trend in falling corporate income tax (CIT) rates can in part be explained by the existence of fiscal externalities in the form of international resource flows. Our results confirm the presumption put forward in recent empirical tax reaction function studies, that interdependent tax setting behaviour is evidence of tax competition. However, taxable corporate income is shown to react inelastically to domestic and to foreign tax rates. Thus, the observed rise in CIT revenues in Europe between 1982 and 2004 cannot be explained by the trend in falling CIT rates. Moreover, we find that large countries' tax bases are more responsive to neighbouring countries' tax policies, which is in contrast to the classic asymmetric tax competition literature.

## External Publications by Staff Members

### Regulatory capital for market and credit risk interaction: is current regulation always conservative?

Martin Summer, Thomas Breuer, Martin Jandacka and Klaus Rheinberger

Discussion Paper Series 2: Banking and Financial Studies No 14/2008

In the work of the Basel Committee there has been a tradition of distinguishing market from credit risk and to treat both categories independently in the calculation of risk capital. In practice positions in a portfolio depend simultaneously on both market and credit risk factors. In this case, an approximation of the portfolio value function splitting value changes into a pure market risk plus pure credit risk component can lead to underestimation of risk. It

can therefore not be argued that the current regulatory approach would always be conservative from a risk assessment perspective. We discuss this fact in the context of foreign currency loans and argue that under the traditional regulatory approach the true risk of a portfolio of foreign currency loans would be significantly underestimated.

### **Credit booms, monetary integration and the new neoclassical synthesis**

Peter Backé, Cezary Wójcik

Journal of Banking & Finance, Vol. 32 (2008), No. 3, pp. 458-470

Credit to the private sector has risen rapidly in many new Central and Eastern European EU Member States (nMS) in recent years. The lending boom has recently been particularly strong in the segment of loans to households, primarily mortgage-based housing loans, and in those countries that operate currency boards or other forms of hard pegs. The main aim of this paper is to propose a conceptual framework to analyze the observed developments with a view to exploring some policy implications at a stage in which these countries are preparing for their prospective integration with the euro area. To achieve this, we first use a stylized new neoclassical synthesis (NNS) framework, which has recently been advanced by Goodfriend and King. We then discuss the implications of the NNS model for credit dynamics and ensuing monetary policy challenges. Specifically, we emphasize consumption smoothing as an important channel of the observed credit expansion and we show how it is related to and how it affects the monetary policy making in MS. In doing so, we place our discussion in the context of the monetary integration process in general and the nominal convergence process in particular.

### **Struktur und Tragfähigkeit der Staatsverschuldung sowie Schuldenstrukturpolitik Österreichs [Structure, Sustainability and Management of Public Debt in Austria].**

Bernhard Grossmann, Eva Hauth, Gerald Wimmer, (2008). Study commissioned by Austria's Government Debt Committee. Vienna.

In its first section, this study compares Austria's debt position with that of other euro area countries, provides key measures for the level and structure of public debt and for debt financing costs, and analyzes the underlying debt management strategy. The second section explains financial accounts concepts and presents financial accounts data for the Austrian government sector within the framework of the national accounts. The third sector discusses concepts and indicators for measuring fiscal sustainability, and provides results for Austria using EU indicators based on the current stability program.

### **Verwaltungsreformen in Österreich: Stand und Perspektiven [Administrative Reform in Austria: Status Quo and Outlook].**

Bernhard Grossmann, Eva Hauth, Gerald Wimmer (2008). In: Platzer, R., Pilz, D., Hink, R. (eds.). So managen wir Österreich. Der neue Finanzausgleich und seine Folgen [Managing Austria. The New Fiscal Sharing Scheme and Its Consequences]. Vienna.

The purpose of this article is to present the status quo of administrative reform activities for the government as a whole and individually for the central government, regional governments and local governments, evaluating reform on the basis of "new public management" concepts. Against this backdrop, we explore the fiscal and human resources effects of reform and discuss policymakers' headcount objectives for the public sector. To conclude, we list issues that require policy action and discuss perspectives for the future.

## 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](mailto:econ.newsletter@oenb.at)

September 18, 2008	<b>“Worldwide demand for raw materials: Oil and bread as luxury goods?”</b> Speakers include Martin Lees (Club of Rome), Peter Brabeck-Letmathe (Nestlé AG), Wolfgang Ruttensstorfer (OMV), Stefan Schleicher (Wifo), Stefan Tangermann (OECD). Organized by the Austrian Chapter of Club of Rome ( <a href="http://www.clubofrome.at">www.clubofrome.at</a> ) in cooperation with OeNB
September 19, 2008	<b>Lecture by Märten Ross, Vice Governor Bank of Estonia</b>
September 29, 2008	<b>Workshop „Housing Market Challenges in Europe and the US - any solutions available?“</b>
November 17-18, 2008	<b>Conference on European Economic Integration „The Integration of European Labor Markets“</b>
January 23, 2009	<b>SUERF/East Jour Fixe Russian Financial System</b>
<i>Recent Events:</i>	
July 2 - 4, 2008	<b>Public Lecture “Risk and Liquidity” by Hyun Song Shin (Princeton University)</b>
June 18, 2008	<b>East Jour Fixe “Soaring Prices in Emerging Europe”</b>

## OeNB Activities at the Joint Vienna Institute (JVI)

August 25-29, 2008	<b>OeNB Summer School “Econometric Analysis of Real-Time Data” by Professor Simon van Norden (HEC Montreal)</b>
September 22-26, 2008	<b>Inflation, Exchange Rate Stability and Credit Growth: Challenges of EMU</b>
October 6-9, 2008	<b>Cash Circulation and Payment Systems in Austria</b>
November 10-14, 2008	<b>Monetary and Financial Statistics Collected and Compiled by the ESCB</b>
December 3-5, 2008	<b>Translation in a Central Bank Setting</b>

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