Oesterreichische Nationalbank
Eurosystem

Workshops

Proceedings of OeNB Workshops

Emerging Markets: Any Lessons for Southeastern Europe?

March 5 and 6, 2007

No. 12

Stability and Security.

Editorial

Suomen Pankki – Finlands Bank initiated this workshop series dedicated to emerging market economies and also hosted the first two workshops in Lapland in 2003 and in Helsinki in 2004. In 2005, the third workshop organized by Banco de España in Madrid focused on Latin America and in 2006 the workshop series returned to Finland again.

This publication comprises the papers presented at the 5th Emerging Markets Workshop held at the OeNB from March 5 to 6, 2007, in Vienna. In line with the OeNB's specific strategic research focus, the program concentrated on "Emerging Markets: Any Lessons for Southeastern Europe?" Since the region is of particular importance for the Austrian economy, the OeNB has always closely observed the economic developments in Southeastern Europe (SEE) as well as in the broader region. A few facts will illustrate this: In 2005, Austrian banks assets' in Central, Eastern and Southeastern Europe (CESEE) amounted to around 16% of their total assets, while contributing some 35% of pre-tax profits, Austria shows the highest share of exports to CESEE countries within the EU-15 and holds an outstanding FDI position in many of these countries – it ranks first among foreign investors in Bosnia-Herzegovina, Bulgaria, Croatia and Slovenia. Overall, it is estimated that the Austrian economy has benefited from CEE integration by a growth bonus of about 3½ percentage points in total since 1990.

This year's workshop was also dedicated to the memory of Olga Radzyner, former Head of the OeNB's Foreign Research Division, who would have celebrated her 50th birthday in 2007.

The economic literature does not provide a generally accepted definition of emerging market economies (EMEs). Still, one may describe such markets as middle income countries where – over a longer period – economic growth rates are higher than in industrialized countries, thus enabling them to catch up in terms of GDP per capita. Such an approach would indeed imply that a typical emerging market economy was based on secondary and tertiary sectors rather than on extraction and export of commodities. Other salient features of emerging markets are important FDI inflows and the subsequent build-up of strong export capacities. Given these characteristics, the question arises whether SEE countries can still be qualified as emerging market economies. Yet there is no straightforward answer to that question for the following reasons: Some of these SEE countries have perhaps not fully turned into emerging markets as economic growth has only picked up recently and as they are still at a very early stage of the catching-up process. It can be expected though that they will establish themselves as EMEs in the longer run as FDI has started to flow in and as exports have begun to grow stronger. Others can be viewed as EMEs, as they have been recording stable economic growth rates for some time already. Finally, one special case has to be highlighted: Slovenia, which adopted the euro on January 1, 2007, has achieved a large degree of nominal and real convergence with respect to the euro area. It is therefore difficult to argue that the country is still an EME, particularly if compared to some other member states of monetary union.

The workshop primarily dealt with the question of what EMEs in SEE had in common with EMEs elsewhere and what separated them from the latter. They share indeed a number of common features: First, following the former periods of crisis financial dollarization (in this particular case euroization) in SEE is substantial. Second, fighting inflation has been a general problem, which still persists in a number of countries. Third, political uncertainty is a non-negligible issue. Finally, public finances and the banking sector used to be a source of macroeconomic instability for some of these countries (but this is no longer the case for most of them).

Despite these common features, SEE economies differ to some extent very much from other emerging markets: First, EMEs in SEE are in most cases small economies, especially when comparing them to countries like Brazil, Argentina and Turkey. Consequently, export-led growth is a straightforward way toward economic convergence. Second, external debt is only a problem for some countries of the region (where debt amounted to about 70% to 80% of GDP in 2006) but not for the others. Third, European integration provides an economic and political anchor for SEE countries and euro adoption (via ERM II membership and fulfillment of the convergence criteria) is a realistic exit strategy from existing monetary policy strategies, which is not available for non-European countries.

In his keynote contribution, *Dimitri Demekas (IMF)* provided a number of additional explanations for these differences: SEE countries have undergone strong unconditional convergence, they have recorded important capital (in)flows and current account deficits associated with growth. These developments can mainly be attributed to financial integration, to the prospect of EU accession and/or euro membership, and to threshold effects. All this mitigates the traditional risks of capital flow volatility and sudden stops. Thus, superficial international comparisons often miss the point. Nevertheless, overvaluation and balance sheet risks are still present in SEE countries.

The other papers of this conference volume are grouped around four major topics: (i) industrial restructuring and financing, (ii) exposure of the nonfinancial corporate sector, (iii) restructuring of the banking sector and credit expansion and (iv) exchange rate issues, including depreciation as a possible adjustment strategy in boom-bust cycles.

- The three papers of the first group look at industrial restructuring and financing structures. Industrial restructuring and the role of FDI is an important issue as some SEE countries are struggling with the restructuring of the nonfinancial corporate sector or are still at a very early stage of the process. In this context, *Peter Havlik (Vienna Institute for International Economic Studies – wiiw)* documents the very fast productivity growth in the New Member States (NMS) and in the Commonwealth of Independent States (CIS). He argues that this fast growth is largely a jobless growth as employment elasticity to GDP growth is very low. *Adam Geršl (Ceská národní banka), Ieva Rubene and Tina Zumer (both ECB)* report mixed and thus somewhat disappointing evidence of productivity spillovers from FDI in the CEECs during the last six to seven years, while *Evgeni Peev* and *Burcin Yurtoglu (University of Vienna)* present the main features of corporate financing in the NMS.

- The second group of papers focuses on the effect that the public sector's debt structure and the corporate sector's foreign exchange exposure have on the external vulnerability of emerging markets, which constitutes an important issue for SEE. *Aitor Erce (Banco de España)* argues that looser international conditions favor domestic debt restructuring. Similarly, domestic financial market deepening and issuance clustering facilitate the financing of domestic debt on international markets. *Katalin Bodnár (Magyar Nemzeti Bank)* illustrates in her survey-based paper that although a weakening of the Hungarian forint would have a negative impact on small and medium-sized enterprises (SMEs), many of these SMEs are not even aware of this fact. In addition, they often lack foreign exchange risk management tools and two-thirds of domestic foreign exchange-denominated loans are not naturally hedged. *Enrique Alberola*, *Paloma Acevedo and Carmen Broto (Banco de España)* focus on the evolution of the public debt-to-GDP ratio and the share of foreign exchange debt, both of which have declined in emerging markets as a result of favorable financial conditions and authorities' proactive debt management strategies.
- The third set of papers looks at the restructuring of the banking sector and the ensuing credit expansion. *Dubravko Mihaljek (Bank for International Settlements)* concentrates on a number of challenges connected to the presence of foreign banks. He presents survey-based evidence that the quality of banking supervision in emerging markets increases with the presence of foreign banks. The essential questions are: What would happen if a foreign-owned bank that is important for the domestic banking system but of marginal interest for the parent company ran into difficulties? Who would rescue it? How to deal with the effects of mergers of parent institutions on the domestic market? And how should banking supervision react if domestic banks merged as a result of their foreign activities?

High credit growth has indeed been a permanent issue in Croatia and has started to become a major policy concern in other SEE countries. In this context the following questions arise: Are SEE countries different from CEE countries? And when is credit growth really excessive? *Balázs Égert, Peter Backé, (both OeNB)* and *Tina Zumer (ECB)* attempt to provide answers. By using small open OECD countries as a benchmark, they show that there is a large amount of uncertainty when it comes to determining the equilibrium level of the private credit-to-GDP ratio for CEE and SEE economies. Bearing this caveat in mind, their results indicate that some countries are very close or even above the estimated equilibrium levels, while others are still well below.

- In the fourth group of papers, *Reiner Martin* and *Ludger Schuknecht (both ECB)* present the results of an event study examining 23 countries that have experienced boom-bust episodes, distinguishing between countries that pursued an external adjustment strategy (depreciation) during busts and countries that relied on internal adjustment. The findings for CEE indicate that the boom is likely (to continue) but that it seems quite uncertain what will follow. Therefore, awareness of the associated policy challenges is essential and close monitoring is necessary in some areas, such as external balances and balance-sheet risks.

Some of the SEE countries (Albania, Croatia, Romania and Serbia) use foreign exchange interventions to achieve the ultimate goal of monetary policy, that is price stability. It is therefore interesting to see the effectiveness of foreign exchange interventions and the way how they are sterilized in markets which are at different stages of development. The paper by *Darko Bohnec (Banka Slovenije)* and *Marko Košak (University of Ljubljana)* points out that some central banks have been relatively successful in opting for a managed floating exchange rate regime and have implemented adequate sterilization policies. In this respect Banka Slovenije serves as a good example as it combined market-related instruments and capital controls with new instruments developed to compensate for underdeveloped financial markets and the lack of securities.

Among the other contributions dealing with exchange rate issues, *Iikka Korhonen* and *Tuuli Juurikkala (Suomen Pankki – Finlands Bank)* analyze the real exchange rate of oil producing countries. Their results show that the Balassa-Samuelson effect is not a relevant factor for these countries. Furthermore, the elasticity of the real exchange rate with respect to real oil prices is usually quite close to 0.5. The oil price has a direct effect on the equilibrium exchange rate in oil-producing countries, over and above the possible effect stemming from higher per capita GDP.

Markus Pramor (Center for Financial Studies) and *Natalia Tamirisa (IMF)* study co-movements of CEE and euro area exchange rate volatility against the dollar. According to their results, the Slovak koruna's long-term volatility has been closest to that of the euro, whereas the Polish złoty has been the least correlated currency. The study also highlights the fact that the correlation of volatility developments between the euro area and the CEEs has increased over time.

Finally, *Gunther Schnabl (University of Leipzig)* elaborates on the effect of foreign exchange rate volatility on economic growth in Eastern Europe and in East Asia. His results show that countries with a fixed exchange rate regime have grown on average faster than countries with flexible exchange rate regimes. An explanation might be that fixed regimes promote trade and macroeconomic stability and thus reduce macroeconomic uncertainty.

The contributions presented at the 5th Emerging Markets Workshop in Vienna gave a comprehensive overview of a large number of issues which are highly relevant for emerging markets and which stimulated lively discussions while at the same time raising further promising research questions related to recent economic policy challenges in SEE. Given the workshop's success and its very positive assessment, participants are already looking forward to meeting again at the 6th EME Workshop in 2008!

Peter Mooslechner
Doris Ritzberger-Grünwald
Peter Backé