Beyond the Crisis: Economic Policy in a New Macroeconomic Environment – Summary of the 37th Economics Conference

Ernest Gnan,
Burkhard Raunig

The 37th Economics Conference of the Oesterreichische Nationalbank (OeNB) on May 14 and 15, 2009, addressed the question as to whether the current situation – which may go down in economic history as the "Great Crisis" – may lead to lasting changes in the relationship between government and markets. The conference brought together distinguished representatives from the world of politics, business, central banks and science to discuss this topic.

From the "Great Moderation" to the "Great Crisis" – What Will Happen Next?

The last two decades until the first half of 2007 had been characterized by favorable macroeconomic conditions worldwide, involving moderate economic cycles along with very low and stable rates of inflation – a phenomenon called the Great Moderation by economists. The financial crisis that started in mid-2007, along with the severe subsequent downturn in the world's economy, raises the question as to whether this Great Moderation was a prolonged phase of fortunate coincidences or the temporarily favorable consequence of a bubble rather than the outcome of good economic policies. What caused the asset price bubble and its subsequent collapse? Could we have avoided this bubble, and thus the crisis, with different economic policies, i.e. different monetary and fiscal policies along with more stringent financial market regulation? What are the appropriate solutions for overcoming the crisis? What lessons can we learn from the current situation, in order to avoid similar crises in future or at least cushion their effects on financial market stability and the real economy?

Against the backdrop of these hot issues, this year's Economics Conference addressed in particular the question of how much of a lasting effect the current situation – which may go down in economic history as the Great Crisis – might have on the relationship between government and markets. The conference was divided into three sessions. In Session 1, high-ranking economic policymakers discussed the consequences of the crisis on monetary and economic policies and on financial market supervision. Session 2 provided insights into the latest findings of crisis research and their implications for economic policy. Session 3 applied the insights gained to Austrian economic policy.

Ewald Nowotny, Governor of the OeNB, who also chaired the first morning of the conference, opened the 37th Economics Conference with some fundamental remarks about the current economic crisis and solutions provided by economic policy. He recalled that the current economic situation was marked by worldwide problems in the banking sector and a global contraction of the real economy. This particular combination of factors required strategically coordinated macroeconomic policies – a point on which economists and economic policymakers were largely in agreement. The important thing was to raise aggregate demand, to strengthen bank balance sheets and to ensure the functioning of the credit system. This, in turn, required a well-chosen combination of expansionary monetary and fiscal policy measures. In lowering the key interest rate and providing liquidity to the banking system, the ECB had used the traditional monetary policy instruments in the current crisis. This had helped to ease tensions in the lending market. Governor Nowotny stressed that the range of measures taken was unlikely to stoke inflation. According to short-term inflation expectations, forecasts of the degree of capacity utilization in the real economy, as well as data on credit and monetary growth developments, there were no signs of inflation risks.

Crisis situations may call for monetary policy measures that go beyond the traditional operational framework of monetary policy. One possibility was for central banks to buy bonds and other financial assets outright, and the ECB had created the necessary framework conditions for making such purchases.

Besides monetary policy, which was a crucial pillar of crisis management, expansionary fiscal policies played a special role in strengthening aggregate market demand. In this context, Governor Nowotny stressed the importance of establishing an exit strategy upfront, in order to be able to return to a clearly defined path of fiscal consolidation.

The implementation of the Eurosystem's monetary policy measures and national crisis management required strong national central banks with the capacity to take adequate action. Nowotny emphasized that the OeNB was able to cope with these demands and that it also contributed directly to ensuring the stability of the financial market through its banking supervision activities.

The "Great Crisis" as a Turning Point for Economic Policy?

Session 1 of the conference addressed the question to what extent the *crisis would act as a turning point for economic policy. Werner Faymann, Federal Chancellor of the Republic of Austria,* presented *"Considerations about the current economic situation: What will happen next?"* He highlighted two aspects in particular, namely the social dimension of the crisis and measures to prevent further crises. With a further rise in unemployment looming in Austria and in Europe, social responsibility was playing a particularly important role. Upholding social standards was especially crucial in times of distress. Particular emphasis must be put on combating unemployment. In this respect, the stability of the financial system was of vital importance. Currently, the most important goal was to keep the crisis period as short as possible. According to Faymann, the government had to raise public understanding for the economic measures taken, in order to ensure confidence and counter misleading arguments. The financial support package for banks had created a safety net and thus contributed to strengthening trust in the Austrian banking sector. In addition, the fiscal stimulus package was driven by the need to support domestic demand. After all, investment in infrastructure, education and research and development was of particular importance in times of crisis. Faymann also pointed out that the measures taken were naturally putting a strain on the budget and that policymakers were fully aware that the fiscal stimulus would have to be unwound at some point. This notwithstanding, securing social stability remained the primary goal.

Turning to the issue of financial market regulation, Chancellor Faymann pointed out that there must be a consensus regarding regulation in order to prevent future crisis episodes. He called for strengthening financial market controls and increasing transparency. In particular, there was a need to discourage speculation with food commodities and similar speculation transactions. Relying solely on self-regulation of the market was simply not enough. Spending on research and development must not be reduced, since such spending constituted an investment in the future. Indeed, Europe had to strive to regain the leading role in environmental technology.

Arnout H.E.M. Wellink, President of De Nederlandsche Bank and Chairman of the Basel Committee on Banking Supervision, advocated *"A new structure for European and global financial supervision,"* concentrating in particular on institutional conclusions and challenges arising from the present crisis. The crisis had once again highlighted the need to improve the institutional framework of financial market supervision in Europe. After all, the large financial institutions in Europe operated on a cross-border level, while supervision was organized on a national level. The exchange of information and cooperation between national financial supervisors was inadequate owing to a focus on national interests. Based on a suggestion by the De Larosière Group, a European Systemic Risk Council should be set up to strengthen macroprudential financial market supervision. Similarly, a European System of Financial Supervisors should be established to improve microprudential supervision. With regard to the European Systemic Risk Council, Wellink stressed that establishing the Council's mandate above all required clearly defining the scope of macroprudential analysis. This mandate should ideally be comprehensive. In order to enable the Council to carry out systemic risk analysis, it needed to have access to all necessary information. However, Wellink acknowledged that making company-specific data available could well be problematic.

A European System of Financial Supervisors functioning as a network of national financial supervisors and European authorities would be faced with a range of new tasks that required the transfer of national decision-making power to a European level. The creation of such a network would be a welcome step, but certain necessary conditions would have to be fulfilled according to Wellink. Above all, the issue of burden sharing in such a system would have to be addressed. Burden sharing arrangements would have to be incentive-compatible and legally binding. Therefore, Wellink advocated a combination of general and specific burden sharing. The general part should ideally be based on proportionate contributions by the individual Member States depending on the size of their economies. This part should be relatively small, since it would involve cross-border fiscal transfers. The specific part should be based on contributions by countries with financial institutions in distress. Wellink finished by pointing out that financial stability in Europe was also dependent on the quality of supervision outside Europe. Key global players, such as rating agencies or hedge funds, which had thus far gone (largely) unregulated, would have to be subjected to direct and more comprehensive supervision from now on.

As the final speaker of the first session, *Lucas D. Papademos, Vice-President of the ECB,* addressed *"Monetary policy and the 'Great Crisis': Lessons and challenges."* Papademos highlighted the unprecedented magnitude of the monetary policy easing and the comprehensive provision of liquidity with which the Eurosystem had combated the crisis. By the end of April 2009, the balance sheet of the Eurosystem had increased to the equivalent of 16% of euro area GDP. By comparison, the Federal Reserve System's balance sheet amounted to 14% of U.S. GDP. These measures had helped smooth tensions in financial markets considerably. However, the deleveraging of banks' balance sheets had led to supply-side credit restrictions. Government capital injections and guarantees were crucial for avoiding a vicious cycle of financial asset write-downs and recession in the real economy. The exceptionally expansionary monetary policy measures taken by the Eurosystem would have to be accompanied early on by designing appropriate exit strategies for the period after the crisis. In particular, policymakers had to make sure that inflation expectations were kept firmly anchored at levels consistent with price stability. When the economy recovered, the currently very low money multiplier would increase again, and this would have to be reflected by a reduction in the provision of liquidity by the Eurosystem. Removing the dependence of the financial and economic system on support measures was also necessary. The measures would have to be unwound swiftly as soon as the end of the crisis was in sight. The ECB would inform the markets of any unwinding measures in good time.

Papademos argued that in future, asset prices should be considered more strongly in monetary policymaking. He maintained that monetary policymakers should implement an appropriate interest rate policy to prevent asset price bubbles from occurring in the first place instead of attempting to limit the effects of these bubbles bursting through monetary easing. Such a symmetric monetary policy would alter the incentives for the financial system so that asset price bubbles would be less likely to emerge. Maintaining price stability would thus be easier for the Eurosystem, since the deflation risk associated with financial crises would be avoided. According to Papademos, "leaning against the wind" would be compatible with the Eurosystem's two-pillar monetary policy strategy, as dangerous price bubbles were usually accompanied by excessive money and credit growth. Even small interest rate changes, especially in tandem with appropriate communication, could be sufficient to help prevent asset price bubbles, since investment strategies driving asset prices were very sensitive to changes in the yield curve and herd behavior could be prevented by suitable central bank signals. Papademos emphasized that monetary policy measures should be complemented by other, national economic policy measures (fiscal policy, regulatory and supervisory framework), especially in cases of national or regional asset price bubbles. After all, with one single instrument (the key interest rate) monetary policy could not pursue several different economic policy goals at once.

Will We Have to Redraw the Boundaries Between Government and Markets?

The afternoon session dealt with lessons from academic research for future economic policy and was chaired by *Peter Zöllner, Executive Director of the OeNB*. In the first panel, Josef Falkinger of the University of Zurich and Dennis J. Snower, President of the Kiel Institute for the World Economy discussed the *need to redraw the boundaries between government and markets. Josef Falkinger* argued that the boundaries between government and markets were in fact clearly defined by welfare economics. Assuming rational agents, complete markets and perfect competition, the market outcome was efficient on balance; the question of distribution had to be determined by politics and not by the markets themselves. Falkinger underlined that these assumptions were unrealistic, however. Over the past

15 years, economic research had taken wrong turnings in its strategic approach. First, the focus of interest had shifted from the real economy to finance. At the same time, people had assumed that financial innovation was a panacea for any market imperfections. Public economics, in contrast to many other fields of economics, had failed to adequately research and study market imperfections, such as monopolistic competition, rents, various frictions and transaction costs. Second, the significance of multiple economic policy targets had not been fully recognized any more.

In light of the rising government spending ratio associated with crisis management measures, the crisis would strengthen the role of governments considerably and for some time in dealings with the market. Whether the governments would be able to meet these increased requirements was as yet unclear, however. Even the structure of government spending had been changed by the crisis. Falkinger argued that the concept of a choice between government and markets was basically too narrow, as society was much more than just the sum of the two. Governments did not automatically stand for critical long-term thinking, and the markets could in fact carry out these functions. After all, herd behavior or irrational exaggeration were not limited to financial markets. Such phenomena could also be observed with elections, public opinion formation, media dynamics, economic research etc. Critical thinking and learning from success were the factors necessary to combat these phenomena. Rules and laws needed to be complemented by values and social norms.

Dennis J. Snower identified areas of economic policy that economic research needed to address more closely. The Reagan-Thatcher revolution had been based on several consistent principles: strengthening private markets, increasing incentives through low taxes, focusing on healthy public finances, creating wealth instead of redistributing it, and implementing monetarist principles in monetary policy. Snower questioned whether this market experiment was at an end and the role of governments and markets had to be redefined. He criticized that free financial markets did not reward real productivity that benefited the whole economy, but rather created considerable inefficiency, and underscored that in a new system, productive real economic activity had to be rewarded once more. Competition should be promoted again, as this had not been the case over the last few years. Social justice goals had to be made compatible with wealth creation by implementing suitable incentives.

Based on these ideas, Snower made three general recommendations for economic policy. First, the solvency problem had to be overcome in the financial sector. Systemically relevant institutions that were "too big to fail" had to be either broken up (a very difficult task) or they had to be given a solvency guarantee, which should be largely financed by the shareholders and bond owners (via obligatory debt-for-equity swaps in case of a crisis), while at the same time being subjected to stringent regulation and supervision. This would likely lead to an increase in financing costs, which would be desirable according to Snower, since these costs would include risk provisions. Second, he advocated the creation of independent budget monitoring bodies in the field of fiscal policy, following the successful example of independent central banks. These bodies would bring fiscal policy in line with the economic cycle, while at the same time ensuring that the public debt ratio did not rise. Third, the effect of automatic stabilizers should be strengthened, for example by introducing employment cheques for enterprises hiring long-term unemployed persons; the amount of these cheques would automatically increase with the period worked. Since our ability to predict crises was limited, automatic mechanisms were more effective than discretionary policies. Such measures would change the boundaries between markets and government in that they would help markets function better without returning to a state-administered economy.

Rethinking Financial Regulation: Policy versus Market Failures

The second panel focused on *"Rethinking Financial Regulation: Policy or Market Failure." Martin Hellwig, Director of the Max Planck Institute for Research on Collective Goods in Bonn,* analyzed the causes of the financial crisis. He underscored that, in order to understand the crisis, we had to study the mechanisms that contributed to the subprime mortgage crisis spilling over to the entire financial system. He identified three main causes of the crisis: flaws in subprime mortgage lending and securitization, flaws in the financial structure of financial intermediaries and flaws in the financial system's architecture. Between 2003 and 2006/2007, the activity of private investment banks on the subprime mortgage market increased dramatically. Over the same period, however, the quality of the mortgages decreased constantly. Risk premiums in this market segment fell, even though risk appetites remained the same. This was attributable to investment banks' heavy involvement in mortgage securitization and to investors' search for high yields. These investors, predominantly hedge funds and investment banks from the U.S.A. and Europe, gave too little thought to the inherent risk. Rating agencies also underestimated the risk involved in these securitizations. In summer 2006, real estate prices began to fall, and when rating agencies drastically downgraded mortgage-backed securities in August 2007, the market price of these securities dropped substantially. The subsequent losses and refinancing problems of the financial institutions affected caused the subprime crisis to spread to the entire financial system. Mutual mistrust brought about the temporary collapse of the interbank lending market, during which only central banks could provide the necessary liquidity. A lack of risk awareness, the search for yield, flawed risk management, rating agencies, and the expansionary monetary policy between 2002 and 2004 were important individual causes of the crisis according to Hellwig. Insufficient creditworthiness assessments, weak quality standards at the banks, a lack of regulation of credit derivatives and insufficient analysis and consideration of systemic risk by regulators were all proof of a faulty system design.

Javier Suarez, Professor at the Centro de Estudios Monetarios y Financieros, Madrid, made a case for introducing liquidity insurance as a complement to capital requirements so as to lessen the impact of systemic crises. This insurance would be financed by a mandatory liquidity charge to be paid to a supervisor. The charge should be set in such a way as to discourage financial strategies that would create systemic risk for all market participants. Revenues from this charge would go into an emergency fund with legal autonomy that would provide liquidity, and perhaps also capital injections, to banks in case of a systemic crisis. These liquidity charges paid by the banks and the existence of an emergency fund would probably make government intervention politically more acceptable. The suggested liquidity insurance system should ideally be implemented on an international level. The charges paid by the individual countries' banking sectors would represent ex ante established burden sharing in the case of an international banking crisis.

Fixing the Crisis: The Role of Regulation and Monetary Policy

The afternoon was completed by a panel discussion on *"Fixing the Crisis: The Role of Regulation and Monetary Policy." Axel Leijonhufvud, Professor Emeritus at the Department of Economics, University of California, Los Angeles,* underscored that economic policy and regulatory measures had to address the macroeconomic level as well as the regulation of financial institutions and instruments. It had turned out that the widespread monetary policy strategy of inflation targeting based exclusively on the development of consumer prices was more problematic than originally thought. This strategy only considered consumer price inflation (CPI), but not macroeconomic price levels. A too expansionary monetary policy could, however, materialize in rising asset and real estate prices without causing a notable increase in the CPI. Central banks should therefore consider not just pursuing a narrow CPI target, but also aim at stabilizing broader price levels. It was further necessary to limit leverage of financial institutions, improve the regulation of structured financial products and raise the transparency standards linked to these products.

Adam S. Posen, Deputy Director at the Peterson Institute for International Economics, Washington D.C., argued that monetary policy had a limited role to play in combating price bubbles on financial markets. Owing to inflation targeting, inflation expectations were very stable according to empirical evidence. He maintained that monetary policy should be used to achieve monetary policy targets and not to solve problems on financial markets. These should be countered with regulatory measures. It was not a given that central banks should perform supervisory functions. Evidence from several countries showed that there was no obvious correlation between banking supervision being carried out by central banks and the frequency of financial crises. In addition, he maintained that the central bank policy of "leaning against the wind" had never been successful in preventing financial market bubbles, and that there was no empirically stable relationship between monetary policy and asset prices. Posen concluded by pointing out that central bank independence was not the same thing as inactivity: An independent central bank could certainly – on its own accord – cooperate with fiscal authorities.

Important Role of Fiscal and Monetary Policy in Fighting Recession; Challenge of Budget Consolidation and Exit Strategies

In the evening discussion *(Kamingespräch),* Lucas D. Papademos, Marco Kranjic and Ewald Nowotny addressed *topical issues of monetary and economic policy.* First, *Lucas D. Papademos* focused on how to encourage banks to resume lending. The financial and real economic crisis were currently mutually reinforcing: The deep recession led to a higher number of credit defaults, which, in turn, further limited lending and caused the recession to get even worse, thus involving the danger of a vicious cycle. Extraordinary expansionary monetary and liquidity policy measures taken by the central banks in combination with bank support packages launched by governments had been basically successful in restarting lending. The continued deceleration of credit growth was not necessarily (or not predominantly) a supply-side phenomenon, but rather a reflection of weak credit demand. Papademos also broached the issue of the soaring budget deficit in the euro area countries – the average deficit in the euro area in 2009 would be about 5½%. Around 2 percentage points of this increase was due to discretionary expansionary measures, while another part was due to the effect of automatic stabilizers and other factors. Expansionary fiscal policy was currently completely appropriate, but a budget consolidation strategy was urgently required for the time after the crisis in order to ensure confidence in the sustainability, and thus effectiveness, of fiscal policy. A swift deficit reduction was also necessary in light of the fact that the debt ratio would otherwise increase greatly, or else budget crises could well follow the financial crisis. If governments failed to achieve the necessary consolidation, the Eurosystem would have to rely on monetary tightening to counter the associated possible inflation risks.

In general, modesty was in order about what monetary policy could achieve. For this reason, the EU Treaty clearly stated that maintaining price stability was the Eurosystem's primary objective. With regard to inflation targeting, Papademos confirmed that a clear definition of price stability was useful to be able to judge the success of central bank policy. If interpreted too narrowly over too short a time horizon, however, strict inflation targeting could also be misleading. The monetary strategy of the Eurosystem therefore combined a precise quantitative definition of price stability with the necessary flexibility in the time horizon applied for achieving this target.

Marco Kranjic confirmed that, for small countries in particular, weak credit demand reflected low investment demand, which in turn could be explained by poor sales prospects. Euro area membership made it much easier for small countries like Slovenia to obtain international credit. Kranjic underscored that any future institutional reform of European and global macroprudential supervision should be designed so as to avoid overlapping.

Ewald Nowotny addressed the exposure of Austrian banks in the Central and Eastern European countries (CEECs). He underlined that, in actual fact, there was little difference between exposure to a Western European country and that to CEECs, and that risk assessment depended on both the country and debtor in question. In addition, other countries had a much greater foreign exposure in relation to their economic power than Austria. The credit volume was still growing in Austria, albeit only slightly. However, there were substantial differences in the development of individual sectors and credit market segments, with large firms tending to suffer more from supply-side limitations. For this reason, the Austrian federal government had decided to set up a credit guarantee scheme worth up to EUR 10 billion for key businesses. In Austria, as in other countries, the current deep recession was causing a marked increase in the government deficit ratio. Nowotny stressed that the existing flexibility of the Stability and Growth Pact (SGP) was being used sensibly at present, but as soon as the economy recovered, governments had to proceed with fiscal consolidation in line with the SGP. The IMF had an extremely important role to play in dealing with the crisis. The exact form in which the EU and the euro area countries should be represented in the IMF was, however, still unclear. Central banks were in fact almost the only institutions that could maintain financial stability in emergencies. With regard to investments supported by economic stimulus packages, Nowotny underscored that their usefulness depended on how the funds were used – energy-saving investments, for instance, made sense, as they also supported long-term stability by reducing dependence on fossil fuels.

How Can a Small, Open Economy like Austria Be Protected against International Shocks?

The morning of the second conference day was dedicated to possible *economic policy solutions at the national level and lessons for Austria.* The session was chaired by *Wolfgang Duchatczek, Vice Governor of the OeNB.* In the first panel, Karl Aiginger, Director of the Austrian Institute of Economic Research, Vienna, and Michael Landesmann, Director of Research at The Vienna Institute for International Economic Studies, discussed about the degree *to which a small, open economy like Austria could be shielded from large, international shocks and looked at strategies for achieving greater shock resistance.*

Karl Aiginger called for the fast implementation of economic stimulus packages in view of very weak growth in Austria in the first quarter of 2009. The question was how Austria could protect itself from a repeat of such a crisis without adversely affecting growth and employment and without sacrificing international openness. Aiginger identified five levels of action: First, the production structure should be made more crisis-proof. Among other things, this could be achieved by greater regional diversification of exports and by strengthening the role of automatic stabilizers in the new budget law. Second, a higher growth path should be attained through education, innovation and a supply-friendly budget structure. The third level of action involved a focus on longer-term goals and economic indicators. In particular, this also included appropriate incentives for managers. Moreover, incentives for setting up companies should be improved, and wage policy, in order to be countercyclical, should be guided by long-term productivity developments, not short-term swings. The principle of prudence should be promoted in accounting. The fourth level of action was avoiding factors that increase the amplitude of business cycles. Mergers and acquisitions should be viewed more critically, as large conglomerates could increase vulnerability to crisis and reduce competition. The procyclicality of research expenditure should be eliminated, and governments should smooth research funding over the economic cycle. A higher return on equity and stable shareholder structures would promote a longer-term focus. The fifth level of action was about institutional improvement. The general government budget should achieve a considerable surplus in economic booms to create more room for maneuver in times of crisis. Ready-to-go infrastructure projects should be lined up and implemented in case of crisis, and companies with a convincing strategic business plan should be supported. Measures combating unemployment should be future-oriented, e.g. by promoting further education and training. Aiginger underscored that a country's ability to deal with a crisis greatly depended on its economic capacity, and this factor should be considered much more seriously by international analysts and rating agencies.

Michael Landesmann put the current crisis into historical context. Austria had pursued an expansionary, proactive economic strategy since the 1990s, the openness of the economy had increased and the service sector had gained in importance. Austria had become an exporting country, both in terms of trade and direct investment. The outcome of this striking development was now for the first time being tested for its resilience in a crisis. While the first phase of the crisis had been barely felt in Austria, the second phase manifested itself in a massive increase in risk premiums, which affected Austria just like other countries. A considerable crisis impact was felt during the third phase as export prospects turned gloomier.

The CEECs were also hit by the international financial crisis. Growth in the CEECs (like in other emerging economies) was dependent on capital inflows, and the resulting current account deficits made these countries even more vulnerable to the crisis. Naturally, developments were heterogeneous across individual countries. There were two economic policy responses – a significant real devaluation and/or a deliberate strong restriction of economic growth – and both had been explored and implemented. Both responses also had direct consequences for the Austrian economy: Exports collapsed and open foreign exchange exposures became an issue in the banking system. The gloomier longer-term growth outlook and increased loan defaults further contributed to a worsening of economic conditions. The CEECs' economic policy responses were relatively passive owing to their limited access to international capital. The private sector was marked by balance sheet adjustments so that domestic demand declined, and only the real devaluations will have a lagged expansionary effect.

How can a small, open economy be protected against such shocks? Landesmann maintained that Austria's economic structure had become more diversified over the last few years, labor market policy in the last 10 to 15 years had helped increase crisis resilience, and a flexible business sector had developed that could react flexibly to crises. He underscored that external and internal imbalances should be controlled in normal economic situations in order to create countercyclical leeway for crises. The banking and financial system should be regulated so as to avoid excessive financial leverage as well as insufficient diversification and risk provisioning. Austria was a financial hub that also played an important role in the development of Eastern Europe; maintaining stability was in the interests of all of Europe.

International Support Packages for Eastern Europe and Austria's Bank Bailout Package Have Helped Safeguard Financial Stability

The second panel discussion focused on the *Austrian experience with bank rescue packages and first lessons for the future. Rainer Münz, Head of Research and Development at Erste Group Bank AG,* differentiated between three types of government measures to help the banking system: capital injections, credit guarantees and taking over toxic assets. The third type was dominant in the U.S.A. and the only measure implemented so far in Switzerland. The volume of capital injections was largest in the U.S.A. at about 50% of GDP; in Austria, the bank rescue package amounted to about ⅓ of GDP, while it was much smaller in Spain and Switzerland at ⅕ and ⅙, respectively. Erste Bank made use of the bank rescue package by issuing hybrid capital and government-guaranteed bonds. The coupon rate for the participation capital was 8% if covered by profits, and after five years the dividend would rise successively if the capital had not been paid back by then. In numerous CEECs, international rescue packages had already been arranged or were being prepared, and national economic stimulus packages – albeit limited ones – had been launched to mitigate the effects of the crisis. Most CEECs had lower debt ratios than many Western European countries, which limited debt servicing costs and helped medium-term growth prospects in the region. After the crisis, politicians would have to take the important economic policy decision whether the debt ratio should remain high, leading to markedly higher financing costs, or a swift debt reduction should be achieved by means of primary surpluses.

Andreas Ittner, Executive Director of the OeNB, pointed out that the current bank packages benefited the whole economy. Austria had early on and proactively supported rescue programs for the CEECs as this was in the interest of European and global financial stability. The IMF's support programs were already beginning to take effect. Banks active in Eastern Europe undoubtedly had to increase risk provisioning. The exposure of Austrian banks to Eastern Europe was highly diversified and amounted to about EUR 200 billion, thus accounting for some 20% of the total exposure of all foreign banks to the region. The Austrian bank support package aimed at encouraging banks to resume lending and ensuring financial market stability. Its volume was set suitably high to take account of potential credit defaults. According to Ittner, the existing support packages had greatly increased the Austrian banks' risk-bearing capacity. The conditions banks had to fulfill in order to receive funds were defined with a view to balancing financial market stabilization and ensuring a level-playing field. The crisis highlighted the need to take action at the European level. In the medium term, banks would have to impose more stringent risk control, and capital ratios would have to be raised. Large banks that were "too big to fail" would also have to bear higher costs for implicit default guarantees by governments. A higher degree of regulation also involved economic costs (lower return on equity, lower credit volumes). Any reform of bank regulation must therefore be carried out with a sense of proportion.

According to *Helmut Ettl, Executive Director of the Austrian Financial Market Authority,* the bank rescue packages had stabilized the financial system, while at the same time changing the rules. These packages had been the appropriate response to the crisis – without them, the financial system might have collapsed. Their implementation had made it clear that systemically relevant financial institutions would not be allowed to fail. In the long run, however, this guarantee for systemically relevant banks would change incentives permanently. To discourage these banks from taking on excessive risk, they would have to be supervised more strictly in future. Financial leverage had to be limited. The capital ratio had to remain high over the entire cycle, and the current procyclicality of regulatory capital requirements should be eliminated via regulatory changes. In addition, Ettl called for a reassessment of the role of rating agencies and of accounting rules. The regulation and supervision of large financial institutions operating across borders could only be effective if also regulators and supervisors operated on a cross-border level. A European banking supervisory authority along the lines of the ESCB would be a good solution; simply promoting cooperation of national supervisors would not suffice. The single market for financial services needed an institutional counterpart in banking and financial market supervision.

Austria's Strategy in Eastern Europe: Chance of a Lifetime with (Manageable) Risk

The third panel discussion investigated whether *Austria's focus on Eastern Europe had been a source of fragility and asymmetric shocks.*

Silvia Sgherri of the IMF recalled the massive structural changes the financial systems of emerging economies had undergone over the past ten years. Financial integration allowed for risk diversification and better absorption of shocks. In the EU, financial market integration and the risk diversification this enabled had helped smooth economic fluctuations and had led to higher potential growth. Financial market integration also posed challenges, however, such as more rapid and stronger risk transfer between countries. Thus, the financial crisis that had originated in the U.S.A. had quickly spread to Europe – via asset prices as well as the credit channel – and had developed into a global economic crisis. At first, banks pursuing traditional business strategies had been barely affected by the crisis, but from fall 2008, they were also sucked into trouble because of increased risk aversion. Therefore, the whole of Europe was in the same boat facing a heavy storm. Notwithstanding the numerous parallel support measures taken, the crisis had revealed a lack of coordination between national financial market supervisors and insufficient information sharing. This lack of coordination (as e.g. apparent when it comes to rapidly conducting cross-border stress tests) was also an obstacle to efficient crisis management. Creating an EU supervisory authority was required to establish clear and consistent rules regarding burden sharing. A highly integrated economic region like the EU also required a strong European economic policy framework. To resolve the crisis, we needed more Europe, not less. Euro area membership was also proving a great advantage in the crisis.

Bernhard Felderer, Director of the Institute for Advanced Studies, Vienna, argued that the shocks emanating from Western Europe were more severe and more dangerous for Austria than those from the CEECs. Over the last few years, many CEECs had gone through an impressive economic catching-up process that would continue after the crisis. The latest developments in industrial production and GDP forecasts until 2010 showed that a range of Eastern European countries were still affected less by the recession than many Western European countries. If Austria had no trade relations with the CEECs, the effects of the crisis on Austria's export trade would be much worse. Some 30% of Austrian exports went to Germany, about 9% to Italy. The overall share of Eastern European countries was 23%, that of euro area countries more than 51%. While almost one-half of Austrian outward direct investment was made in Eastern Europe, one-third was still made in EU-15 countries. Economic integration with Eastern Europe was by no means a specifically Austrian phenomenon, but rather applied to Western Europe in general. Felderer stressed that Austrian banks' foreign exposure was not excessive and their exposure was not solely concentrated in Eastern Europe. In addition, the debt ratios of households and enterprises were significantly lower in Eastern European countries than in Western Europe, as were public debt ratios (with the exception of Hungary). Following marked currency depreciations in a number of Eastern European countries, especially in the fourth quarter of 2008, the currencies regained ground and partly recovered owing to the agreement of international support packages. According to Felderer, Austria's strategy in Eastern Europe – a logical step after the fall of the Iron Curtain – had not entailed extraordinary or unmanageable risks.

Walter Rothensteiner, Chairman of the Managing Board of Raiffeisen Zentralbank Österreich AG, refuted the claim that the Austrian banks had an overexposure to Eastern Europe. Austria's involvement was only logical in light of the country's historical and geographical ties with the region; it had been an opportunity that simply could not be missed. Expansion into Central and Eastern Europe had enabled Austria to reduce the economic dependence on Germany. Austria was the third-largest investor in the region after Germany and the Netherlands. Outward direct investment in Eastern Europe amounted to EUR 50 billion over the past 20 years. Eastward expansion had brought higher growth and employment. The exposure of Austrian banks in Eastern Europe was about EUR 200 billion – about one-half of the country's total foreign exposure – and was broadly diversified within the region. The financial aid packages provided by the IMF, the EBRD and the EU contributed to calming the situation. Rothensteiner emphasized that Austria had no alternative to its focus on Central and Eastern Europe. The fact that the Austrian labor market would soon be open to Eastern European workers highlighted the need to help the region develop further. In many Eastern European markets, the penetration with financial products remained well below average. For banks, therefore, the growth potential in the region was still high. The convergence and catching-up process would continue after the crisis, with low wages, high education levels, low taxes and favorable exchange rates making the region extremely attractive as a business location.

Also Austrian Businesses and Employees Face Considerable Crisis Consequences – How to Use the Crisis as an Opportunity

The morning's fourth and last panel discussion focused on the *economic consequences of the Great Crisis for Austrian businesses and employees and asked how economic policy could help.*

Monika Kircher-Kohl, CEO of Infineon Technologies Austria AG, started by quoting Schumpeter who said that every crisis had creative and destructive potential. The key question was how to proceed after the crisis. In every crisis, market shares were reshuffled, former market leaders collapsed and smaller competitors got their chance. The same was true for entire regions. The question was, therefore, how Austria could influence these developments in such a way that the country would emerge stronger from the crisis. According to Kircher-Kohl, the semiconductor industry had always been extremely dependent on the general economic situation. In the early 2000s, for example, semiconductor production had fluctuated by about 60 percentage points. As a rule, the sector was leading macroeconomic developments by half a year or three-quarters of a year. Thus, it had two quarters of recession behind it and the situation was already improving in the current quarter. The semiconductor industry was marked by intense competitive pressure and a high level of innovation, with the latter also driving innovation in downstream sectors. This was why the location of the microelectronics industry was crucial for regional economic development. Microelectronics could also make a large contribution to structural improvements, e.g. by improving energy efficiency. Proactive industrial and technological policy should invest more effort in creating new structures and tackling new issues, rather than in maintaining existing structures. Kircher-Kohl called for celebrating innovation. Avoiding risk should not be the main focus, as innovation was the only long-term job guarantee. Austria should have had an innovation strategy in place before the onset of the crisis, so that this strategy could have been reinforced during the crisis. In the current situation, people had to focus on the potential opportunities that would open up after the crisis. While the current government guarantees for business financing came late, they were nevertheless crucial for further development. We did not have to sacrifice our values and culture in the crisis; rather, we needed leadership in a positive sense, both in businesses and on a national and global level.

Erich Foglar, Acting President of the Austrian Trade Union Federation, addressed the effects of the crisis on employees. The approaches companies adopted during the crisis varied widely: While some found highly cooperative and constructive solutions, others introduced short-term working arrangements, still others demanded "voluntary" wage cuts or even relied on layoffs. Over the past 20 years, the dominance of shareholder value had created a system flaw. Foglar called on policymakers to use the crisis as an opportunity to adopt a new perspective. Wealth had not increased for everybody and wealth distribution had become more unfair. Economic policy had not kept pace with economic liberalization, leading to wage dumping, tax dumping, social system dumping and careless treatment of the environment. The collapse of LTCM, at the very latest, should have set alarm bells ringing, and policymakers should have taken action immediately but failed to do so due to pressure from the finance lobby. As soon as the crisis was over, policymakers had to resolve the question of how to reduce deficit and debt levels. Foglar underscored that this must not be done via cutbacks in the pension and healthcare systems. The U.S. real estate crisis had been caused by the fact that wages were too low for parts of the U.S. working population. Reducing unemployment was a top priority in the current situation. The EU should be more aware of its market power, show more self-confidence and protect the welfare state. According to Foglar, Austria was well-positioned to deal with the crisis. Education and training were the key for future prosperity, and suitable industrial and immigration policies were further success factors.

Markus Beyrer, Director General of the Federation of Austrian Industries, stressed the importance of the EU in dealing with the crisis. Many national economic stimulus packages had included certain protectionist elements, at least in the beginning, and such tendencies had to be resisted. Still, governments today were less eager to turn to protectionist measures than they had been during the Great Depression of the 1930s. Successful solutions would have to combine the stabilizing power of the state and dynamic market forces. Without industry, there could be no growth in Austria; the multiplier effect of Austria's key industrial businesses and their role as growth drivers became especially apparent during the crisis, which was why these businesses had to be supported. Long-term financing and large companies were particularly affected by credit restrictions, and the federal government's latest measures to provide guarantees for business loans were very important. With an export ratio of over 50% in many sectors, Austrian industry was very much export-oriented, and this would continue to be the basis of the country's prosperity. The crisis had to be used as an opportunity to undertake fundamental reforms, e.g. regarding the cost and organization of the country's education, healthcare and pension systems. In the short run, the important thing was to deal with the crisis efficiently. Wage policy should be adjusted so as to reflect the depth of the recession and correspond to the companies' (varying) productivity levels. Spare capacities should be used for research and infrastructure in the current situation. In the medium term, expansionary fiscal policy would have to be reversed again. Austria already was a high-tax country, so fiscal consolidation had to be achieved on the expenditure, not revenue, side.

Herbert Tumpel, President of the Austrian Federal Chamber of Labour, underlined that avoiding protectionism was not the only valid claim, and mentioned trade union freedom, the enforcement of labor standards and minimum ecological standards. According to Tumpel, free trade could only be fair and make sense if the same production conditions and requirements applied to all players. European policymakers were currently neglecting this issue. The measures taken at the European level to stimulate demand were insufficient. While the performance and export success of Austrian enterprises were important and commendable, export was not a stand-alone economic goal that should be given priority over domestic demand. There were massive imbalances in Europe, with the top exporting countries putting less competitive European countries under pressure. Tumpel strongly advocated tax coordination, as the contribution of rich people to tax revenues was shrinking, and reducing pensions was inacceptable. Policymakers had to focus on improving production conditions and on strengthening European demand. The demands made by industry for workers to accept a zero wage round this year and predictions of unemployment figures of 500,000 people did not help rebuild confidence, Tumpel said. While the bank support packages may well be in the interests of the entire economy, they also helped safeguard shareholders' assets. Crisis management had to consider social justice issues, the rich should also make a fair contribution to fiscal consolidation.

Central Banks Acted Quickly, Fiscal Policy Was Adequately Expansionary – Now Reform of Cross-Border Financial Supervision Is Required

The last speaker at the conference was *Dominique Strauss-Kahn, Managing Director of the IMF,* who focused on *"Crisis Management and Policy Coordination: Do We Need a New Global Framework?"* At the onset of the crisis, individual countries were not inclined to coordinate policies at the international level in dealing with the problems of cross-border financial conglomerates, which further destabilized the situation. As the crisis went on, however, a learning process set in, leading to more coordination. The support packages for Eastern Europe illustrated the advantages of international coordination. During this crisis (in contrast to the Great Depression of the 1930s), central banks worldwide were extremely generous in the provision of liquidity (sometimes relying on special measures), and they slashed key interest rates fast and to historically low levels. Fiscal policy measures – implemented at more or less the same time, though without explicit coordination – provided the national economies with additional demand impulses.

The picture was less favorable with regard to financial market stabilization. This might be due to the unresolved question of how to divide up the budgetary costs of cross-border bank support packages. The lesson to be learned from the crisis was, first, that regulatory arbitrage was damaging and had to be avoided. Second, crisis resolution tools had to be better coordinated. There were many suggestions to choose from, and now was the time to act quickly. Economic history showed that recovery after financial crises was only possible after the deleveraging of banks' balance sheets. Provided this deleveraging took place, global economic recovery could be expected to occur in the first half of 2010 according to Strauss-Kahn. Third, depositor and investor protection systems had to be coordinated. Finally, information sharing between home and host country supervisors had to become quicker and more extensive. The Basel Committee and the Financial Stability Board at the BIS in Basel would play a leading role in this process; the IMF would also be involved, in particular in a monitoring capacity. It was, however, difficult in practice to implement economic policy measures in response to early warnings, i.e. before the actual outbreak of a crisis.

As a result of its strong international ties, Europe was vulnerable to the crisis, as these ties involved the risk of contagion. This was why the IMF viewed the emerging countries of Eastern Europe as one entity. Current crisis management worldwide was very impressive. The international community had become closer, and there was great willingness to cooperate. Global institutions, including the IMF, had helped stabilize the situation. While the crisis was not yet resolved, the way to overcoming it was relatively clear. At present, problems were increasingly originating in the real economy, which caused credit defaults. The massive fiscal stimulus in China would contribute to smoothing out the existing global imbalances, but further measures would be required in this field. The fiscal costs of overcoming the crisis were significant. After the crisis, fiscal consolidation would be necessary to avoid fiscal crises. Euro area countries were unlikely to need IMF aid, but other EU countries might well benefit from IMF programs. Strauss-Kahn reiterated that the IMF prescribed the implementation of fiscal consolidation measures in aid programs only if the countries involved did not have sustainable budgets before the crisis.

Klaus Liebscher Award Goes to Tarek Alexander Hassan and Anton Korinek

Like in previous years, the authors of two outstanding scientific papers received the Klaus Liebscher Award at the 37th Economics Conference. After an introduction by Claus J. Raidl, President of the OeNB, Governor Ewald Nowotny introduced the award winners. *Tarek Alexander Hassan of Harvard University* showed that securities issued by large countries yielded lower returns than those by small countries. *Anton Korinek of the University of Maryland* pointed out systematic distortions of risk allocation on financial markets and deduced consequences for capital adequacy regulations and for risk management. After a short presentation of the papers by the authors, Klaus Liebscher handed out the awards.