SUERF Conference and Special East Jour Fixe Contagion and Spillovers – New Insights from the Crisis

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On February 12, 2010, the Oesterreichische Nationalbank hosted the SUERF Conference and Special OeNB East Jour Fixe on "Contagion and Spillovers – New Insights from the Crisis." More than 100 participants took part in the event jointly organized by SUERF – The European Money and Finance Forum, the OeNB and the Austrian Society for Bank Research. The conference focused on three aspects of contagion and spillovers: real economy channels of crisis transmission, financial sector contagion and spillovers to emerging markets.

Following some introductory remarks by the President of SUERF, *Cathérine Lubochinsky,* Professor of Economics and Finance, University of Paris 2, OeNB Governor *Ewald Nowotny* emphasized in his introductory statement the importance of SUERF's dedicated and systematic efforts of bringing together academics, practitioners from the financial industry and policy makers. He noted that the transmission of crises across borders has significant welfare and policy implications, which is why an understanding of the underlying mechanisms is vital. Governor Nowotny then sketched some striking features of the global crisis. He for instance referred to the fall of Lehman Brothers, which had set off an avalanche of worldwide deleveraging and had caused major disruptions in a financial system that had become more and more globalized in recent decades. With regard to Central, Eastern and Southeastern Europe (CESEE), Governor Nowotny mentioned the remarkable achievement that uncontrolled currency collapses had been avoided even though Ukraine had come close. Finally, he pointed to the forceful global policy response that had succeeded in preventing the crisis from escalating. In this respect, Governor Nowotny also underlined the important role of the Vienna Initiative.

The keynote session was chaired by *Philipp Hartmann*, Vice President of SUERF and Head of the Financial Research Division at the European Central Bank. The first keynote speech, "Contagion and Spillovers – Recent European Experience and the Way Forward," was delivered by *Jürgen Kröger*, Director of the Economies of the Member States I Department, DG ECFIN, European Commission. Kröger started by highlighting vulnerabilities created by the divergent developments of real effective exchange rates within the euro area and the potential for spillovers due to increased trade and financial openness. He then presented the results of an empirical study, which show that the impact of external shocks differs considerably across euro area countries and the financial transmission channel dominates across all countries. Kröger concluded with three policy lessons: First, timely correction of imbalances and divergences within the euro area is important for the cohesion of the euro area in withstanding external (and internal) shocks. Second, financial innovation/integration is good for risk-sharing, but complex instruments pose problems for risk managers, investors and policy makers. And third, given increasingly complex financial linkages across Member States, there is an urgent need for coordination across the euro area in financial regulation and supervision.

Javier Santiso, Director and Chief Economist at the OECD Development Centre, talked about how politics and elections shape financial and capital market

sentiment. He pointed to the clear link between elections and instability in debt and currency markets. Focusing on a comparison of Latin America and OECD countries, Santiso emphasized that in Latin America there is still a lot of room for structural reforms. As a case in point, education spending per pupil is still five times lower in Latin America than in OECD countries. In a politically unstable environment, market participants, however, tend to question the sustainability of new reforms. This is mirrored in systematic downgrades of investment banks' recommendations prior to elections, which are then followed by revisions (upgrades) after a certain transitional phase. Since this "election effect" has become weaker over time, Santiso concluded that capital markets tend to perceive Latin America's democracies as more mature than before.

Session 1, chaired by *Ernest Gnan*, Secretary General of SUERF as well as Counsel to the Board and Head of the Economic Analysis Division of the OeNB, dealt with real economy channels of crisis transmission. *Filippo di Mauro*, Head of the External Developments Division, European Central Bank, presented a study on "The Real Impacts of the 2008-09 Financial Crisis: What We Knew and What We Have Learned about International Linkages." He mentioned that it is a long-standing stylized fact that the U.S. business cycle leads the world economy, with the lead vis-à-vis the euro area cycle equaling about five quarters. Furthermore, U.S. downturns are transmitted faster than recoveries. Trade empirically figures as the most important transmission mechanism. Di Mauro also showed that financial variables can serve as important predictors of the probability of recessions. He concluded that the most recent crisis has confirmed the established wisdom that trade – not least through third-country effects – is the most important cross-border business cycle and crisis transmission channel. Financial market channels may, however, magnify global interactions, particularly during turbulent periods.

Julia Wörz, economist at the OeNB's Foreign Research Division presented a paper on "The Impact of the Global Recession in Europe – The Role of International Trade." The sample covers 38 countries, including the EU Member States, advanced OECD members and a number of CESEE countries. The particularly strong response of trade to the recent recession is traceable to several reasons, including increased vertical specialization and global supply chains. The econometric findings show that a high degree of export orientation is not necessarily related to a stronger growth downturn, but only if the share of industry in GDP is large. Countries specializing in consumption goods exports suffered relatively less than those specialized in intermediate goods exports. Furthermore, export orientation toward the EU-27 on average cushioned the impact of the crisis in 2009. Wörz concluded with two policy issues: First, should the particularly pronounced decline in manufacturing and industry be taken as a sign for lasting structural change, implying that short-term interventions should not aim at preserving existing structures? Second, will trade be able to spur growth during the recovery? On the latter issue, she recalled that trade, being merely a facilitator of transactions, ultimately is only a mirror of demand; in other words, demand will lead trade, and not vice versa.

The presentation by *Simon Evenett*, Professor of International Trade and Economic Development, University St. Gallen, dealt with the issue "Has Stabilization Limited Protectionism? Evidence from the Global Trade Alert." Evenett identified four key developments in global protectionism during the recent economic crisis:

First, the currently observed intensification of protectionist measures is not confined to any specific regions. Second, a new mix of protectionism has arisen. Discriminatory bailouts and subsidies are the most widely used protectionist measures, followed by trade defense, tariffs, public procurement and migration-related measures. Third, the sectoral incidence of protectionism has not changed. Finally, protectionism is so far showing no signs of slowing down. Although the current wave of protectionism is much less severe than the one in the 1930s, Evenett warned against complacency – rising protectionism has to be taken seriously: Vigilance, close monitoring and peer pressure are needed. As many contemporary protectionist measures are not self-terminating, the G-20 should develop principles for an unwinding.

Session 2 was chaired by *Peter Mooslechner*, Director of the OeNB's Economic Analysis and Research Department, and dealt with aspects related to financial sector contagion. *Már Gudmundsson*, Governor of the Central Bank of Iceland, held a keynote speech on the lessons from the crisis on cross-border banking. By way of introduction, Gudmundsson pointed to the high growth of international bank claims prior to the financial crisis and argued that there was a link between claim growth and crises in general. Gudmundsson then elaborated on the process of global deleveraging following the collapse of Lehman Brothers and the case of the Icelandic banking sector. In October 2008, three Icelandic banks failed and were put into special resolution regimes after years of rapidly expanding their activities abroad (total assets equaled 11 times Iceland's GDP before the collapse). Gudmundsson linked these events, on the one hand, to Iceland's boom-bust cycle and problems in the macroeconomic management in small open and financially integrated economies and, on the other hand, to weaknesses in the European supervisory legislation. Despite a common legal and regulatory framework for banking and finance, the safety net remained largely national. He concluded that the global and European frameworks for the operation of cross-border banking are in need of reform.

Ove Sten Jensen, Head of the Government Debt Management Department, Danmarks Nationalbank, talked about the nature of the crisis, its impacts and consequences for financial markets from the perspective of a public debt manager. Jensen noted that the primary goal of a debt manager lies in covering the central government's financing needs at the lowest possible borrowing costs. In the aftermath of the crisis, debt managers had to assume an additional role: to support financial stability. When the turmoil started, swap spreads widened considerably and the refinancing cost of governments increased heterogeneously across countries. Jensen had observed a "flight to liquidity and quality" as evidenced by investors' soaring demand for German government bonds. The crisis also revealed a breakdown of stable correlations among bond markets. Finally, Jensen emphasized the high uncertainty – with a view to future borrowing conditions – as to when fiscal stimulus packages and extraordinary monetary policy measures will be unwound.

Session 3, chaired by *Peter Backé*, Deputy Head of the OeNB's Foreign Research Division and Head of the Central, Eastern and Southeastern European Analysis Unit, focused on the spillovers of the crisis to specific emerging market regions and on two country cases. *José María Serena*, economist at the Banco de España, and *Reiner Martin*, Head of Section at the ECB and currently at

the OeNB's Foreign Research Division, presented a paper on "The Impact of the Global Economic and Financial Crisis on the CESEE region and on Latin America." This comparative analysis examines the macrofinancial vulnerability profiles of these two emerging market regions at the onset of the recent financial crisis and relates them to the actual knock-on effects the crisis had on both regions. The two presenters highlighted that CESEE and Latin America differ in some important structural features, which are of relevance for the transmission of external shocks. Booming economic conditions in both regions before the global crisis were largely driven by capital inflows, but also supported by region-specific features (commodity prices in Latin America, EU accession in CESEE). Despite notable differences in pre-crisis macrofinancial vulnerabilities between the two regions, both were hit hard after the fall of Lehman Brothers. CESEE was, however, affected more strongly given the region's higher trade openness and more pronounced drop in capital inflows. A fully-fledged financial meltdown materialized neither in Latin America nor in CESEE, with integration into European banking networks proving to be an asset for CESEE during the crisis.

Lars Tranberg Rasmussen, senior analyst at Danske Bank, presented a paper on "The Contribution of a Poor Economic Policy Mix to Economic Vulnerability – the Case of Latvia." He argued that the poor policy mix during the boom years (procyclical fiscal policy, benign neglect of rapid credit expansion) contributed to economic and financial vulnerability and has dented the competitiveness of the Latvian economy. The current situation is seen as very challenging, and there is no quick fix. A change in the exchange rate regime would bring forward the negative balance sheet effects that Latvian households and firms will be facing anyway. Internal devaluation, i.e. a real depreciation through goods and factor downward price adjustments, will take several years and Latvia's prospects for euro adoption over the medium term are slim, given the large fiscal adjustment needs.

Finally, *Dimitry Sologoub*, Head of Research at Raiffeisen Bank Aval, spoke on "Ukraine: The Story of Boom and Bust." He stressed the procyclical policy stance during the boom years between 2001 and 2007 and the stalling of structural reforms during the last five years, which substantially added to the weaknesses and vulnerabilities of the Ukrainian economy (low productivity growth, lack of trade diversification, widening external imbalances, banking sector risks, fiscal vulnerabilities). Low steel prices, contagion in the banking sector and the lack of a coherent policy response contributed to the depth of the crisis. Looking forward, the recovery after the crisis will be gradual, with weak policies constituting a drag on future performance. The ensuing discussion touched on the role of commodity price developments in the boom years before the crisis, the issue of foreign currency loans as well as on the political and economic outlook for Ukraine and Latvia.