OeNB Conference on European Economic Integration 2010 – Catching-Up Strategies after the Crisis

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The topic of this year's Conference on European Economic Integration (CEEI) of the Oesterreichische Nationalbank (OeNB), which took place in Vienna on November 15 and 16, 2010, was "Catching-Up Strategies after the Crisis."[2] Under this caption, the CEEI 2010 discussed the post-crisis growth of, and convergence prospects for, countries in Central, Eastern and Southeastern Europe (CESEE), with a particular focus on possible changes in growth models, monetary policy, financial integration, regulatory requirements and the role of capital and exports. More than 300 participants from over 30 countries and 220 institutions followed the presentations and discussions of high-level representatives of central banks, international organizations and academia.

In his opening speech, *Ewald Nowotny,* Governor of the *OeNB* and Member of the Governing Council of the *ECB,* discussed various challenges to future economic developments. He pointed out that, after the positive trend observed in the first half of 2010, we could now see light at the end of the tunnel, although major challenges remained. In particular, fiscal stabilization would require extraordinary efforts over the next few years. Fiscal debt had increased in all CESEE countries in the last two years, although public debt levels were still lower in CESEE than in the euro area. Moreover, the fiscal crisis had underlined the importance of competitiveness, which needed to be supported by, especially, wage developments. With regard to financial stability, Nowotny stated that the euro had acted as a shelter not only for the euro area countries, but also for a broader European region. Similarly, the Basel III agreement would ensure improved financial stability. However, there were also potential risks related to these regulatory changes that might compel some banks to reduce their credit volumes in order to comply with the new regulations.

Growth Experience and Foreign Banks' Activities in CESEE

In his keynote lecture, *Vítor Constâncio,* Vice-President of the *ECB,* addressed possible catching-up strategies to be employed after the crisis. He also stressed the importance of the proper use of fiscal policy as an anticyclical instrument. Together with wage moderation, fiscal stabilization is of crucial importance for financial stability. Previous macroeconomic and financial developments were characterized by increasing vulnerability. Current account deficits had widened as a result of excessive consumption growth and a credit boom that was also supported by foreign currency loans. The policy implications of these developments were often played down. Now they have to be addressed through different adjustment policies. Some countries could allow their currencies to depreciate, while countries with

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[2] *The conference proceedings will be published by Edward Elgar Publishing Ltd. in the course of 2011. Presentations and papers, information about the speakers and the conference program are available under Services and Events at www.oenb.at.*

fixed exchange rates would have to increase their competitiveness. In the second half of his lecture, Constâncio turned to financial stability, stating that the Vienna Initiative (a coordinated effort on the part of Western European banks to recapitalize their affiliates in the CESEE countries) had helped maintain confidence in financial stability in the CESEE countries, which showed how important multilateral coordination was for achieving financial stability. Moreover, he pointed out that, while the Basel III agreement constituted a robust regulatory framework, much still remained to be done to achieve financial stability in the CESEE region.

Catching-Up Prospects after the Crisis

Under the chairmanship of *OeNB* Governor *Ewald Nowotny,* Session 1 discussed past experiences of crisis resolution and the current prospects for catching-up in CESEE. There was consensus among the speakers that CESEE will be subject to long-lasting domestic and external challenges. With lower trend growth in the EU-15, elevated risk perceptions and lower capital inflows, potential output in the region may remain below pre-crisis levels. Strategies to not only close the output gap, but also bring potential output back to a higher level will thus be crucial for the region.

Based on experience gained in the Nordic financial crisis of the early 1990s, *Seppo Honkapohja,* Member of the Board of *Suomen Pankki – Finlands Bank,* outlined the elements of a successful policy response. He stressed the importance of correcting problems in competitiveness (i.a. by allowing the exchange rate to float – where the Nordic example had proven that this was a short-term policy response and had not precluded a subsequent euro area membership for Finland) and of restoring monetary policy credibility (by adopting inflation targeting). He moreover underlined that during the Nordic crisis, a clear fiscal strategy and gradual consolidation had been vital elements in crisis resolution. Growth had been restored by focusing on labor productivity growth and investment in education, research and development, and industrial restructuring (entailing the move toward information and communications technologies in the case of Finland).

Werner Röger, head of unit at DG ECFIN *(European Commission),* drew attention to Eastern Europe's substantial convergence with Eastern and Western Europe. He also stressed the importance of total factor productivity growth. The crisis will, however, result in lastingly lower levels of productivity growth and reduced investment-to-GDP ratios, thus slowing down future convergence. By contrast, lower EU-15 growth as a result of the crisis will partially offset this effect in the medium to longer term. Thus, Röger presented a rather positive outlook for the region's catching-up prospects, also based on relatively optimistic assumptions with respect to future investment ratios.

Dariusz Rosati, professor at the *Warsaw School of Economics,* analyzed an "integration growth model (IGM)" that allowed for successful catching-up in the CESEE region. This model was characterized by institutional harmonization and convergence, by an internationalization of production and trade integration and, finally, also by international financial integration of EU Member States in Eastern and Western Europe. As an implication of these integration steps, risk premia in CESEE had fallen sharply and facilitated strong inflows of foreign capital. The latter had financed a rapid expansion of domestic credit and had made possible large and growing current account deficits, together with a real appreciation of the domestic currencies. Thus, large imbalances and vulnerabilities had followed, in particular because capital inflows had often been biased toward the nontradable services sector, including real estate. Domestic policies had not responded adequately in terms of banking regulation, structural reforms or exchange rate regimes. Given the new, less favorable external environment, Rosati expected recovery to be sluggish and catching-up to slow down. Nevertheless, he clearly advocated sustaining the integration growth model and supplementing it with well-conceived policies in terms of financial regulation, prudent banking supervision, increased labor market flexibility and fiscal reforms as well as the adoption of the euro as soon as practically possible in each single case. At the EU level, he saw a need for the completion of the single market in services, improved governance and guarantees also for non-euro area EU members. The ensuing discussion centered on the roles played by flexible and fixed exchange rates in terms of the vulnerability to a crisis and on the role of wage flexibility in connection with international price competitiveness.

Challenges for Monetary Policy in the CESEE Region

Against the background of a still fragile economic recovery and prospects of weaker and probably more volatile economic growth in CESEE after the crisis, the first panel discussion – chaired by *Peter Mooslechner,* Director of the Economic Analysis and Research Department of the *OeNB* – brought together high-level representatives from CESEE central banks and the IMF to discuss the related challenges for monetary policy in the region. The general conclusion of this panel appeared to be that appropriate structural and fiscal policy measures were crucial for the conduct of monetary policy. At the same time, the crisis had shown that central banks – in order to properly support macroeconomic stability – would have to augment their policy instruments and to integrate financial sector stability into their price stability focus.

Marek Belka, President of *Narodowy Bank Polski,* emphasized that Poland and other CESEE countries were currently facing the challenge of preserving macroeconomic stability against strong capital inflows resulting from highly expansionary monetary policy in advanced economies. The most important risk to financial system stability in Poland relates to foreign currency lending to households; however, this type of lending has almost disappeared since the crisis, which reduces the future vulnerability of the Polish economy. Furthermore, he noted that the policy of flexible exchange rates had contributed to the generally good growth performance of Poland in the last two years, although he acknowledged that the eventual adoption of the euro remained the objective of Polish monetary policy.

Júlia Király, Deputy Governor of *Magyar Nemzeti Bank,* stressed that the crisis had prompted a reconsideration of international financial markets' risk attitude with regard to debt financing and external imbalances. In the post-crisis environment, it is an important task to develop local currency capital markets in CESEE so as to reduce the dependence on external financing sources. Király said that she was in favor of flexible inflation targeting as a monetary strategy that avoided reacting to excessive risk premium volatility with interest rate policy steps but, at the same time, also incorporated macroprudential policies to enhance systemic resilience and leaning against the financial cycle. A proper cross-border coordination of macroprudential measures is crucial in this respect.

Cristian Popa, Deputy Governor of *Banca Naţională a României,* noted that flexible inflation targeting had not prevented the build-up of external imbalances and that nominal appreciation had not been successful in containing soaring prices in the pre-crisis boom period. Popa also drew attention to a new role for central banks after the crisis, where financial sector stability would have a stronger weight in policy considerations (e.g. the provision of sufficient liquidity in the interbank market, which had not been an issue in CESEE before the crisis).

Boris Vujčić, Deputy Governor of *Hrvatska narodna banka,* found that price stability was currently an only minor issue for CESEE central banks (except for a certain probability that commodity and food prices might surge anew in the medium run), while the main focus of their attention was on sluggish credit growth and financial stability. Although Hrvatska narodna banka had relaxed its liquidity provisions for commercial banks to stimulate credit supply, credit growth in Croatia was still depressed, not least on account of a lack of demand for new loans, especially in the household sector. As regards financial sector stability, the crisis had brought about an increase in the indebtedness of the corporate sector, while it had had a favorable impact on the foreign currency exposure of banks in Croatia.

Leslie Lipschitz, Director of the *IMF Institute,* concluded that traditional monetary policy did not seem to be effective enough to avoid a resurgence of large capital inflows and external imbalances in CESEE – indeed, higher interest rates might simply exacerbate inflows. The armory required to curb renewed excesses must include serious microprudential, macroprudential and fiscal instruments, such as higher capital and liquidity requirements for banks to limit maturity transformation (especially in foreign currency) or limits on lending (or borrowing) in foreign currency to shift to domestic currency loans and hedge the exchange risk. Moreover, higher taxes on short-term real estate capital gains, transaction taxes on mortgage lending (e.g. for secondary residences) or on high loan-to-value loans might also be worth consideration.

The New Role of Growth Financing

Session 2, chaired by *Doris Ritzberger-Grünwald,* Head of the *OeNB's* Foreign Research Division, addressed the question as to whether the global financial crisis may have changed the modes of financing growth. The session brought together the views of researchers, central bankers and entrepreneurs. In the run-up to the crisis, growth in CESEE had mainly been financed by large capital inflows, which resulted in varying degrees of vulnerability. This raised concerns about the use of capital ("excessive" consumption, real estate boom) in CESEE. However, capital inflows, as well as internal and external demand, had fallen substantially during the financial crisis, which in turn raised the question as to whether we were witnessing a possible structural decline in capital inflows and, if so, what would be its long-term growth impact.

Against the background of tighter refinancing conditions, households' continued deleveraging and downside risks to internal and external demand, *Joachim Nagel,* Head of the Markets Department at the *Deutsche Bundesbank,* proposed that a more reliable model for financing sustainable future growth in CESEE be developed. This model would imply a slower but more sustainable financial deepening, as well as an enhancement of macrofinancial resilience. The main challenge was to strengthen internal sources of growth financing, i.e. to rely more strongly on local refinancing through domestic savings and local capital markets. Furthermore, the dependency of CESEE economies on portfolio and credit flows should be reduced by way of strengthening FDI flows. Finally, the mitigation of financial risk also required a reduction of the incentives for unhedged households to take on foreign currency loans.

Reiner Martin (ECB) and *Jarko Fidrmuc (OeNB)* looked at the interlinkages between capital flows, exports and industrial production. The main question addressed was whether the long-term growth prospects of CESEE countries had deteriorated since the export boom and capital inflows had come to a sudden halt in the wake of the financial crisis. Their results showed that exports and the stock of FDI in the CESEE region were positively related to industrial production, and thus to economic growth. Output growth in Poland, Romania, Slovakia and Slovenia, in particular, had profited from exports and FDI. By contrast, portfolio investment was only weakly related to the industrial growth performance of CESEE countries. These findings implied, first, that the CESEE countries should make determined efforts to remain attractive locations for inward FDI and to enhance their export prospects, and, second, that the reduction of portfolio investment inflows appeared to be unproblematic from a long-term growth perspective.

Wolfgang Ruttenstorfer, Chief Executive Officer of *OMV,* a globally active Austrian energy company, concluded that the old story of boom and bust cycles also applied to CESEE. Macroeconomic imbalances and policy weaknesses had magnified the effects of the global financial crisis and had generated an urgent need for secure funding. The international support programs of the EU, IMF and World Bank, as well as the Vienna Initiative, had turned out to be vital for multinational enterprises like OMV to maintain their business in the CESEE region. Countries where growth had previously been driven mainly by consumption should develop a more sustainable growth path in the future by strengthening investment and capital-enhancing productivity growth. Furthermore, the public sector is called upon to enforce the build-up of the infrastructure necessary for a modern economy, to support the development of domestic capital markets, to reform legal systems and to implement better public governance and efficient administrative procedures.

Marko Voljc, Chief Executive Officer of *KBC,* a Belgian banking and insurance company that had expanded to the Visegrád countries and Bulgaria, found that the potential for the CESEE region remained intact, although the financial crisis had dampened global investors' risk appetite and put a drag on loan demand. KBC embraced the Vienna Initiative, which helped not only the CESEE economies, but also the banking and insurance sectors to weather the storm. In the future, the CESEE region will still be able to attract external capital, owing to good fundamentals and an, in parts, strong recovery. However, emerging economies' competition for capital has increased, and an attractive business environment will be a key determinant of capital inflows. But the use of capital, too, will be scrutinized more closely than before the crisis. Sustainable growth would imply a (re)direction of capital inflows to productive ends, in particular toward export-generating activities, but also sound public finances. Finally, increasing reliance on domestic funding would support these goals.

The New Role of Exports

Session 3 was chaired by *Doris Ritzberger-Grünwald,* Head of the *OeNB's* Foreign Research Division. It involved a discussion of the new role of trade and firms in the changing post-crisis economic and fiscal framework. Three academic contributions discussed various processes of adjustment at the industry or firm level.

Jože Damijan, professor of International Economics at the *University of Ljubljana,* opened the session by presenting a paper on firms' trade patterns. By exploring a dataset of Slovenian exporting firms in the period from 1994 to 2003, he showed that the pattern of exporting activities tended to be determined by uncertainty and financial constraints. Moreover, export intensity was a nonlinear function of access to finance and a firm's size. In addition, firms' financial factors, such as their equity, return on assets, access to bank finance and to internal credit markets, played a more important role in export expansion than firm productivity. The paper's policy implications included the establishment and maintenance of a sound financial system as well as a different perspective on export promotion policies.

Professor *Joseph Francois* from *Johannes Kepler University Linz* and *Julia Wörz (OeNB)* proceeded by presenting a paper on the link between trade growth and its sector composition in the period from 1995 to 2007. In their paper, they challenged the widespread assumption that income elasticity was related to trade intensity and concluded that changes in income could be mapped into changes in the industrial and country composition of trade. As a consequence, an alternative explanation of the rise and fall of trade was offered, whereby changes in the composition of trade itself (i.e. countries moving into trade-intensive sectors) tended to be more important than the nature of trade and production (i.e. global supply chains). The results for the CESEE countries confirmed a considerable structural change in the region, with an all in all positive effect on their export performance. In particular, industries in the new EU Member States showed a successful restructuring toward rapidly growing industries. Consequently, domestic restructuring remained important for the CESEE countries as global trade patterns were partly moving away from CESEE's current specialization.

The third presentation in this session was by *László Halpern* from the Institute of Economics at the *Hungarian Academy of Sciences.* He elaborated on the collapse of trade in the wake of the crisis and on firms in selected EU countries. The main result of his presentation was that countries revealed heterogeneous profiles when the effect of the crisis is analyzed. Furthermore, he presented evidence based on the European Firms in a Global Economy (EFIGE) firm-level database, showing that the response of firms to the crisis differed, depending on their size and export behavior. Hence, the main conclusion was that a sustainable recovery required both restructuring on the basis of more research and innovation and policies aimed at synchronized labor market adjustment in the EU.

Monetary Policy and Financial Stability

In his keynote lecture, *Stephen Cecchetti,* Economic Advisor and Head of the Monetary and Economic Department of the *BIS,* compared monetary conditions in Central and Eastern Europe (CEE) to those in other emerging market areas. He revealed striking differences in some financial market segments. Since the collapse of Lehman Brothers, capital inflows into Latin America and Asia had rebounded and cross-border bank lending had risen. Net inflows of capital into the CEE region, by contrast, were still only moderate and the period of negative cross-border lending was just coming to an end. Moreover, while foreign loans outstanding in Asia and Latin America had again almost reached their pre-crisis peaks, the exposure of banks in advanced economies to CEE was still far from pre-crisis levels. Cecchetti highlighted several policy challenges associated with soaring capital inflows: Equity price rallies leading to the build-up of bubbles, the surge in foreign investors' ownership of local bonds and falling bond yields despite policy rate hikes had to be considered the most demanding policy tasks in the near future. With respect to the CEE region, Cecchetti noted that new regulatory reforms could curb the credit supply. Furthermore, in a banking system based on foreign-owned banks, there would always remain concerns about changes in the policy and/or lending strategy of the respective parent bank. Professor Cecchetti concluded that monetary policy was currently in transition and that this phase was especially prone to the risk of making errors. Since the CEE region was destined to grow faster than the euro area, a re-emergence of capital inflows could be expected. While some of these inflows could be channeled to the public sector, it was important to bear in mind that this would expose the private sector to the risk of crowding-out and that it would moreover weaken incentives for fiscal consolidation. The main challenges ahead were thus related to catching-up, namely a possible surge in capital inflows and asset prices. Existing policy frameworks had performed relatively well in the recent crisis. Consequently, there was no need to make rigorous changes to the existing framework. On the contrary, it was important to resist spillovers from the policies of other emerging markets. In particular, policymakers should continue to let exchange rates adjust freely, avoid capital controls as well as interventions regarding credit allocation and refrain from returning to financial repression.

The Catching-Up Experience of the Western Balkans

Session 4 of the CEEI 2010 was chaired by *OeNB* Governor *Ewald Nowotny* and dealt with the catching-up experience of the Western Balkan region.

To begin with, the first speaker, *Vladimir Gligorov,* senior economist at the *Vienna Institute for International Economic Studies,* outlined the stylized facts of a neoclassical growth path, which had been cut short by the global crisis in the case of the Western Balkan region. In this context, he warned that increased risks might now become a permanent feature, which would mean that neoclassical growth would lead to stagnation. Thus, the dilemma, in his view, was whether to work on the reduction of risks (and to stick to the neoclassical growth model) or to change the growth paradigm. In conclusion, Gligorov stressed the urgent need for structural reforms in the Western Balkans, which would, however, imply a slow recovery over the medium term and would also be subject to social and political risks.

The second speaker, *Boštjan Jazbec,* IMF Senior Advisor to the Governor of the *Central Bank of the Republic of Kosovo,* first highlighted the main stages of a textbook transition process, ranging from macroeconomic stabilization, price liberalization, trade liberalization, current account convertibility and privatization to the development of an institutional and legal framework. He stressed that, with a few exceptions, the institutional aspects were greatly overlooked during transition. In this context, Jazbec raised the question as to whether the transition process should actually start with institution building, as the creation of basic market institutions took time. In the Western Balkans in particular, the institutional setting needed to be improved, given poorly defined property rights, a weak rule of law, inefficient judicial systems and fragile legal frameworks – all factors that hamper foreign investment inflows into the region. However, unlocking the region's growth potential also called for better education, more strategic infrastructure investment, the supportive role of the EU institutional framework and a learning-by-doing approach, instead of dependence on international aid and investment.

Finally, *Michael Loufir,* Head of Emerging Markets Research at the *National Bank of Greece,* underlined that before the crisis, the Western Balkan countries Serbia, FYR Macedonia and Albania had experienced a slower catching-up process that had started from a lower level than that of the EU members Bulgaria and Romania. Turning to developments since the onset of the global crisis, Loufir showed that the Western Balkan countries had been more resilient to the crisis than the EU Member States mentioned earlier. Finally, he emphasized the region's future potential, given the still low level of economic development, competitiveness (low wages and tax rates) and the prospects for EU membership, but also underscored the importance of accelerating institutional, structural and economic reforms for purposes of enhancing the convergence process.

A Political Scientist's View on Crisis Management

Wolfgang F. Danspeckgruber, founding director of the Liechtenstein Institute on Self-Determination and professor at *Princeton University,* delivered a dinner speech. From a political scientist's perspective on crisis and crisis management, he provided a panoramic view of the contemporary geostrategic landscape. Danspeckgruber maintained that, in the post-bipolar world, cost-benefit calculations of individual actors had replaced the relatively stable strategic alliances of the Cold War period. As a consequence, different actors might have diverging perceptions of crises and their potential impact. Given its global geostrategic role, the U.S.A. was finding itself in a more severe crisis caused by its overstretched defense budget, as Danspeckgruber pointed out. This made a potential transatlantic trade bloc encompassing the EU and North America – a strategic alliance that would comprise roughly 800 million inhabitants – a desirable option. This held even more true as China and India were proving to be increasingly important global actors, which would, as Danspeckgruber anticipated, be of rising significance also in the CESEE region. Finally, he advocated the accession of Turkey to the EU from both a global geostrategic and a regional economic perspective. Europe would be likely to benefit from the dynamism of the Turkish economy and an enriched cultural background.

Central Banking for the 21st Century: An American Perspective

The second conference day began with a keynote lecture by Professor *Paul A. Wachtel* (Stern School of Business, *New York University),* who started out with a discussion of the evolution of modern central banking. He traced the concept of central banks back to the 17th and 18th centuries, pointing out that modern central banking – with central banks performing the main role of acting as a lender of last resort – dated back to the 19th century. In 1907, when the FED was established, its founders had already considered other roles for a central bank that went beyond panic avoidance and lender of last resort functions. After the post-war period with its emphasis on Keynesian thinking and the role of fiscal policy in macroeconomic policy, monetary policy had gained importance, in particular after the inflationary episodes of the 1970s. Overall, at the end of the 20th century, the key word had been central bank independence. According to this notion, a central bank was mainly responsible for monetary control. Other functions only played a minor role. The recent financial crisis had changed the views about central banking, bringing prudential and regulatory issues to the forefront. Wachtel drew attention to the various functions of central banks in the post-crisis world. The first function comprises monetary policy. Experience has shown that independent central banks achieve lower and less volatile inflation rates than those subject to government control. The second task is the supervision and regulation of individual financial institutions. In this respect, functioning as the lender of last resort plays a central role. In some countries, however, other governmental agencies are in charge of supervision and regulation, and in the case of the ECB, banking supervision is decentralized, taking place at the national level. Finally, a major responsibility is the regulation of systemic risk. The notion of central banks performing an explicit regulatory function with regard to systemic risk is new. The main aspects of a systemic risk regulator are the need to augment the oversight and supervision of large and interconnected institutions, the ability to address systemic problems that arise from smaller institutions and the need to have the authority over shadow banking. Wachtel concluded that the role of the central banks had possibly broadened after the global financial crisis. In addition, it was likely that central banks had become more political than they were before the crisis.

The New Role of Financial Integration

Session 5 was chaired by *OeNB* Governor *Ewald Nowotny* and dealt with the highly topical question of what role financial integration will play in a post-crisis setting.

Ignazio Angeloni, Advisor to the Executive Board of the *ECB,* gave an overview of various important aspects of financial integration. First, he noted that the traditional arguments in favor of financial integration (market efficiency, lower cost of capital, smooth transmission of monetary policy) were still valid today. More recently, however, the links between financial integration and financial stability had become more important. For instance, financial integration could increase market volatility by facilitating contagion across institutions and markets. Moreover, there were risks stemming from an underregulated financial sector and from a mix of banking and securitization. Angeloni also illustrated that the crisis had had disruptive effects on financial integration, which differed across financial market segments, however. Looking forward, he highlighted the powerful link between sovereign risk and financial sector risks. Government bonds played a central role in the collateralization process and, in addition, governments were the ultimate regulators and guarantors of the financial system. He concluded that a reform of euro area rules of governance was also critical for restoring financial integration.

The next speaker, *Christa Hainz* from the *Ifo Institute for Economic Research* in Munich, presented a paper analyzing firms' access to loans as well as their actual need for loans. Hainz stressed that access to loans was a major determinant of economic growth. However, owing to a lack of data, firms' use of loans was often taken as a proxy for their access to loans in academic research. In the paper, the authors developed a direct measure for access to finance, using data from the 2005 Business Environment and Enterprise Performance Survey to determine whether a firm without a loan was indeed credit-constrained or whether it did not have demand for financing. The paper came to the conclusion that analyzing information on the use of finance was not sufficient to identify financially constrained firms. Therefore, from a policy perspective, information about the use of loans was not enough to identify the types of firms that should be supported.

The third presentation in this session was delivered by *Andrzej Stopczyński,* Director of the *Polish Financial Supervision Authority*. He discussed the need for an enhanced role of local supervisors and shareholders' oversight. Stopczyński pointed out that the supervisors' primary task was to assure the long-term stability of the banking system. In this respect, it is not enough to focus on current capital adequacy ratios and liquidity measures. In his view, the recent experiences of many countries illustrated that banking supervision should shield economies against the risk of boom-bust cycles. Inter alia, Stopczyński underscored the importance of financing credit growth through domestic savings. Currently, one of the key issues is how to motivate banks to avoid unstable booms in consumer and mortgage lending. Stopczyński concluded that local supervisors should have effective tools at their disposal to avert local lending booms.

Challenges for Banking in the CESEE Region

The second and final panel discussion of the CEEI 2010 was chaired by *Andreas Ittner,* Executive Director of Financial Stability, Banking Supervision and Statistics at the *OeNB,* and focused on "Challenges for Banking in the CESEE Region."

Piroska Nagy, EBRD Director for Country Policy and Strategy, pointed out that, for CESEE countries in their current situation of fragile recovery, strengthening competitiveness was a major point. She stressed that it was now time for banks to clean up their balance sheets before the revitalization of lending and any economic recovery could really gain momentum. To stabilize and broaden the base of financial development in CESEE, the Vienna Initiative will help focus on the establishment of local currency capital markets, in which banks should participate.

Michael Hysek, Head of the Banking Supervision Department of the *Austrian Financial Market Authority,* familiarized the audience with the significant changes that banks would soon face in the legal and supervisory frameworks. These changes will comprise better risk capture (including securitization), more stringent capital requirements, the limitation of leverage, higher liquidity standards, more intensive (where necessary, intrusive) supervision, a strengthening of cross-border supervisory cooperation and other modifications.

María Teresa Fábregas Fernández, Deputy Head of Unit in the *European Commission,* outlined a number of Commission proposals for legal and regulatory adjustments in favor of a safer, sounder and more transparent future financial sector. She also discussed possible reforms of rules regulating rating agencies.

Swedbank's crisis-triggered woes in the Baltic countries were described briefly by *Håkan Berg,* Head of Baltic Banking in this large Swedish credit institution. While Swedbank had, for a period, needed government guarantees to borrow, it had aggressively restructured nonperforming corporate debtors in the Baltics, and in the second quarter of 2010, the bank's Baltic operations had turned profitable again.

Andreas Treichl, Chief Executive Officer of *Erste Bank Group,* stressed a particular issue that he perceived as problematic, namely the apparent lack of clarity about whether regulators actually wanted banks active in CESEE to go back to basics and emphasize bank lending financed through deposits or whether they wanted them to spread their activities to possibly risky undertakings in local capital – particularly bond – markets. He added that Erste Group would continue to dedicate itself to lending as a driving force of growth in the region.

Executive Director *Ittner* wrapped up the session by underlining that banks remained pivotal for supporting the real economy and that, therefore, cross-border banking – and probably also, to some degree, capital markets – would still be necessary for future growth in the CESEE region. However, cross-border supervisory cooperation would be indispensible for achieving and maintaining financial stability.

In addition to the official debates, the two conference days provided welcome room for informal discussions and networking between central bankers, government officials, financial sector managers, researchers and journalists. Both the media coverage and positive feedback from participants confirmed the CEEI's status as one of the leading forums for discussions of economic and monetary integration in CESEE.