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Editorial board:

*Josef Christl, Peter Mooslechner, Ernest Gnan, Eduard Hochreiter, Doris Ritzberger-Grünwald,
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Editors in chief:

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Manfred Fluch

Editing:

Oesterreichische Nationalbank, Economic Analysis Division

Translations:

Dagmar Dichtl, Alexandra Edwards, Michaela Meth, Irene Mühlendorf, Ingeborg Schuch, Susanne Steinacher

Technical production:

*Peter Buchegger (design)
OeNB Printing Office (layout, typesetting, printing and production)*

Inquiries:

*Oesterreichische Nationalbank, Secretariat of the Governing Board and Public Relations
1090 Vienna, Otto-Wagner-Platz 3
Postal address: PO Box 61, 1011 Vienna, Austria
Phone: (+43-1) 40420-6666
Fax: (+43-1) 40420-6696
E-mail: oenb.info@oenb.at
Internet: www.oenb.at*

Orders/address management:

*Oesterreichische Nationalbank, Documentation Management and Communications Services
1090 Vienna, Otto-Wagner-Platz 3
Phone: (+43-1) 40420-2345
Fax: (+43-1) 40420-2398
E-mail: oenb.publikationen@oenb.at
Internet: www.oenb.at*

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ANALYSES

Economic Recovery in the Euro Area and in Austria in a Dynamic Global Economic Environment

Antje Hildebrandt,
Martin Schneider,
Maria Antoinette Silgoner

The world economic recovery is continuing at a slightly more subdued pace. In the U.S.A., weaker consumer spending contributed to a slowdown in growth momentum. At the end of June 2004, the Federal Reserve abandoned its low interest rate policy and has since increased base rates by 50 basis points. In Asia, Japan's economy is back on the road to recovery and China's and Southeast Asia's high growth rates are by and large still on course.

Economic recovery in the euro area continued, albeit with marked divergences between countries. Growth is currently being fueled by external demand, in particular. The latest increase in crude oil prices triggered a rise in inflation. The ECB's projections paint a relatively upbeat picture of anticipated GDP growth. Although the outlook for price stability has deteriorated in the current climate of higher crude prices, in the medium term the price stability target will most probably be met.

In Central and Eastern Europe, the economy continues to grow at a more dynamic pace than in the former EU-15. The new EU Member States countries are now endeavoring to implement the next step of integration – the introduction of the euro.

1 Slowdown in Robust World Economic Growth

1.1 U.S.A.: Fed Ends Low Interest Rate Period at the End of June

Whereas U.S. economic growth in the first quarter of 2004 accelerated to 4.5% (annualized on the previous quarter), it slowed to 2.8% in the second quarter. In particular, weaker consumer spending (+1.6%, compared with +4.1% in the previous quarter), primarily attributable to the steep rise in energy prices and to reduced automotive sales, and a sharp deterioration in net exports contributed to this decline in growth. By contrast, private real estate investment and a sharp increase in corporate investment made a key contribution to growth. The rise in public expenditure slowed down.

Although growth in the second quarter of 2004 should not necessarily be interpreted as entailing a trend reversal, it could signify temporary sluggishness. The latest data are contradictory: since mid-2003 the Purchasing Managers' index compiled by the Institute for Supply Management ISM has outperformed its 10-year average and has been well in excess of the 50% mark, signaling growing goods production. However, the index in August slipped from 62% to 59%: order intake and output were equally

responsible. Recent data for industrial output and private residential construction were fairly positive. By contrast, the U.S. index of leading indicators suggests only moderate real GDP growth. According to the Conference Board, the index deteriorated in July for the second successive month, falling 0.3% to 116 points (sharpest decline since February 2003). However, it is too early to say that the index's uptrend (which has persisted since March 2003) has now ended. The forecasts widely assume real GDP growth of about 4.5% in 2004, which is likely to weaken to some 3.75% in 2005 (e.g. OECD and Consensus Forecasts). The upturn in the U.S. labor market slowed in June and July. Although the jobless rate in July dipped from 5.6% to 5.5%, job growth in both months was well below expectations. Productivity growth in the second quarter decelerated by 2.9% on the previous quarter (+3.7%) and unit labor costs advanced by 1.9%.

Consumer price gains in July 2004 slowed to 3% year on year. At 1.8% year on year, the rise in the core rate over the same period was smaller than in June (1.9%).

At the end of June, the Federal Reserve abandoned its low interest rate policy of maintaining the Fed

funds rate at 1% and increased it by 25 basis points for the first time in four years. Further hikes by 25 basis points each followed in August and September, taking the rate to 1.75%. It is the Fed's declared intention to increase base rates gradually.

One of the biggest risks currently for U.S. economic growth is the potential persistence of high energy prices, which could act to squeeze growth in the second half of the year. Another risk factor would be a renewed surge in core inflation, which could prompt the Federal Reserve to hike interest rates more sharply than originally planned, leading to a further curb on rate-sensitive spending. Similarly, an unexpectedly steep rise in interest rates could rein in consumption and investment sharply, since private households are currently relatively deep in debt and the saving ratio is low. In addition, the high current account and budget deficits (of almost 5% and approximately 4.5% of GDP in 2004, respectively) represent risks in the medium and long term.

1.2 World Economic Growth Driven by Asia and the U.S.A.

For the last nine quarters in a row, Japan's economy has been on the road to recovery, although growth lost considerable momentum in the second quarter of 2004. Real GDP grew by 0.4% compared with the previous quarter. Thanks to demand from Asia (especially China), exports performed robustly, albeit with some signs of weakness. By contrast, corporate investment – a key engine for growth – was unexpectedly poor. Although the relative weakness of domestic demand cloud the overall picture somewhat, private consumption could

prove positive in the next quarter and could keep the recovery on course.

Improved consumer sentiment is currently supported by a brighter labor market. Since early 2003 the jobless rate has fallen from 5.5% to 4.6% in mid-2004. In general, an increasingly broadly based recovery is expected this year. The Bank of Japan (BoJ) is standing by its almost zero interest rate policy. For 2004, both the BoJ and the IMF count on prices to fall, which would underpin hopes of finally beating deflation in the near future. Looking at fiscal policy, continued high budgetary deficits and total debt levels are a problem. However, plans to consolidate public sector budgets should be seen in a positive light.

Despite high oil prices, economic recovery in Asia (excluding Japan) has also continued in 2004, thanks to stronger exports and more animated domestic demand. In China, the government corrected its growth forecast for 2004 down to 7%, signaling a more balanced economic growth target. Nonetheless, data for the first six months of 2004 indicate continued high levels of growth and rising inflation. Despite a decline in bank lending, demand for investment continued to strengthen. Whereas inflows of short-term foreign capital to Asia (excluding Japan) are scant, since early 2001 foreign currency reserves have almost doubled. In the second quarter of 2004, however, hardly any foreign exchange reserves (China's excepted) were boosted any longer in a bid to prevent further risks (arising from this surplus liquidity) for prices and the economy. Economic recovery should be used to expedite financial market reforms that are currently dragging in certain countries.

2 Euro Area: Modest Recovery Continues

2.1 GDP Growth Largely Bolstered by Exports

Eurostat's initial forecast for real GDP growth in the euro area in the second quarter of 2004 indicates that the economy is continuing to grow at a stable pace: real GDP rose by 0.5% quarter on quarter (first quarter of 2004: 0.6%) and by 2.0% year on year (fourth quarter of 2003: 1.3%). By countries, Finland registered the highest growth (1%) on the previous quarter, followed by France and Belgium with 0.8% each. In Greece and the Netherlands, however, real GDP slipped by 0.6% and 0.2%, respectively. In addition, the subcomponents reflect marked differences between countries. For instance, German GDP growth in the second quarter was driven almost entirely by net exports whereas growth momentum in France was determined primarily by domestic demand.

Trends in gross fixed capital formation continue to look volatile.

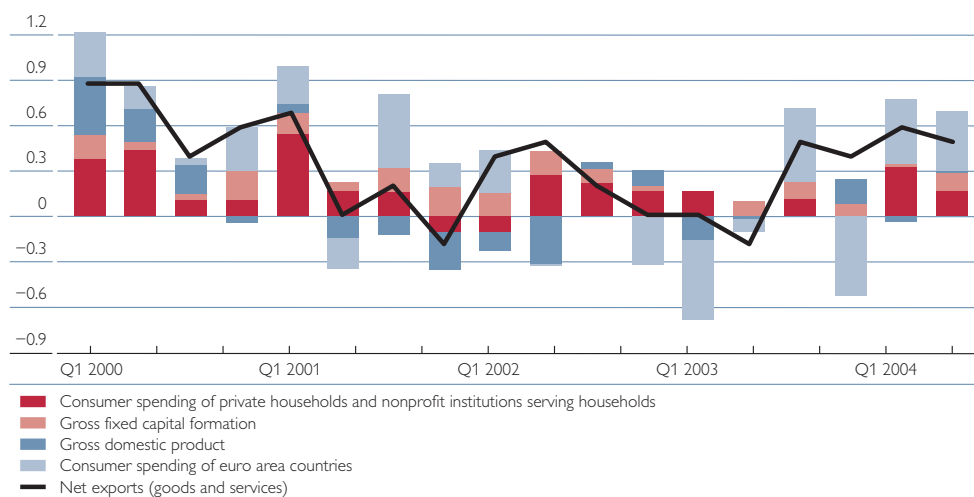
After rising by 0.8% in the fourth quarter of 2003 (compared with the previous quarter), this component contracted by 0.2% in the first quarter of 2004. For the second quarter of 2004, growth came to 0.1%. However, it should be noted that the contraction in the first quarter of 2004 was primarily the result of a steep decline in construction investment in Germany, which continued to fall sharply in the second quarter of 2004 as well. In the remaining countries of the euro area, by contrast, investment expanded.

After posting extremely low quarterly growth rates since early 2001, stronger private household consumption growth resumed in the first (+0.6%) and second (+0.3%) quarters of 2004. Tax cuts in some euro area countries are likely to have contributed to this development, boosting disposable income more sharply. However, leading indicators for consumption suggest that uncertainty still prevails. According to the European Commission, consumer confidence

Chart 1

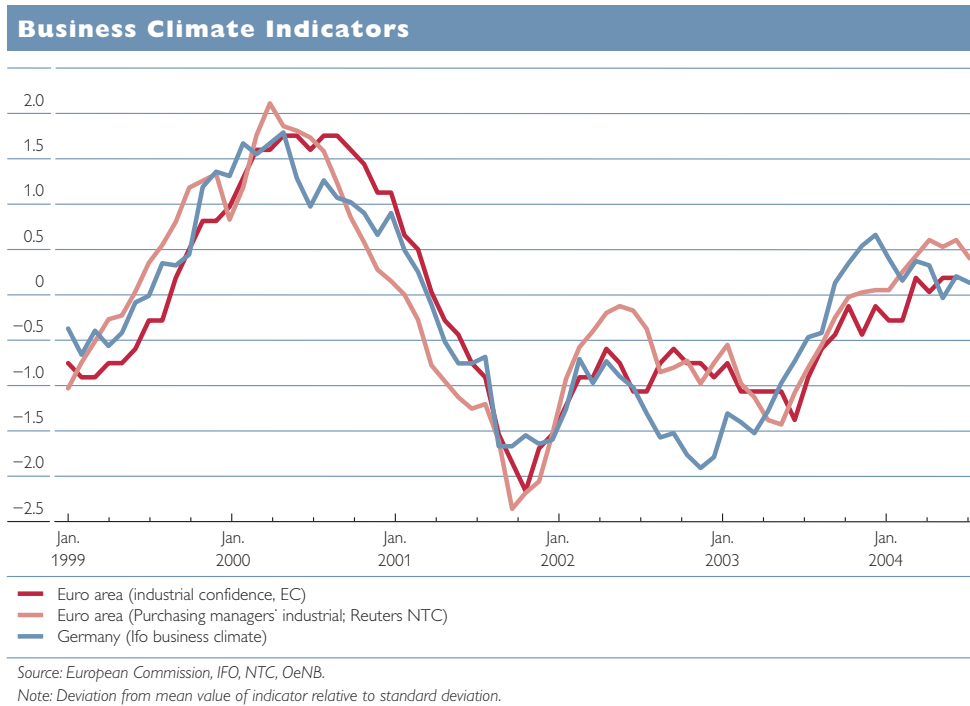
Quarterly Contribution to Growth from Real GDP Components in the Euro Area

Percentage points



Source: Eurostat.

Chart 2



has been stagnating since February 2004. In July, it stood at -14 points, or still somewhat below its long-term average of -12 points. The reasons for this are twofold: first, the labor market scenario remains unfavorable and, second, discussions about reforming healthcare and pensions systems are fueling uncertainty and dampening consumer demand.

After a paltry rise of 0.1% in the first quarter of 2004, public sector consumption grew by a stronger 0.6% in the second quarter. In particular, high budget deficits in Europe are likely to have contributed to low growth in the first quarter of 2004. The latest data available indicate that seven euro area countries will exceed the 3% deficit ceiling in 2004. To counter this development, some of these countries are curtailing public sector consumption.

The growth momentum of exports – interrupted in the fourth quarter of 2003 – continued. However, imports also kept surging. As

in the first quarter of 2004, the contribution of net exports to growth was 0.4% in the second quarter. The sizeable contribution of net exports to growth is due to growth differentials between the euro area and its trading partners. The leading indicators for economic growth have painted a relatively fickle picture in the last few months. Since early or mid-July, they have all signaled an uptrend, which has now leveled off in the last few months or, in some cases, even reversed gradually. This could suggest that the economic recovery has yet to stabilize properly.

2.2 Industrial Output Positive, Labor Market Scenario Remains Tight

Since mid-2003 the growth rates of seasonally adjusted industrial output in the euro area have been on a steady, albeit extremely volatile, uptrend. At 2.7% , year-on-year growth in June 2004 was lower than in May. Compared with the previous month, industrial output in June declined by 0.4% ,

having climbed four times in a row since February. In view of the data series' wildly fluctuating performance, a trend reversal cannot be inferred from the latest development.

At 9.0%, the seasonally adjusted jobless rate remained stable from April to July 2004. The tight labor market scenario can also be seen in the steadily falling share of public sector jobs (since early 2001) as a percentage of the total working population in the euro area. Since the second quarter of 2002, employment has been growing very little. In the first quarter of 2004, the increase in service sector employment just managed to offset the job cutbacks seen in other sectors. In the same period, labor productivity rose by 1.1% after more or less stagnating in previous quarters.

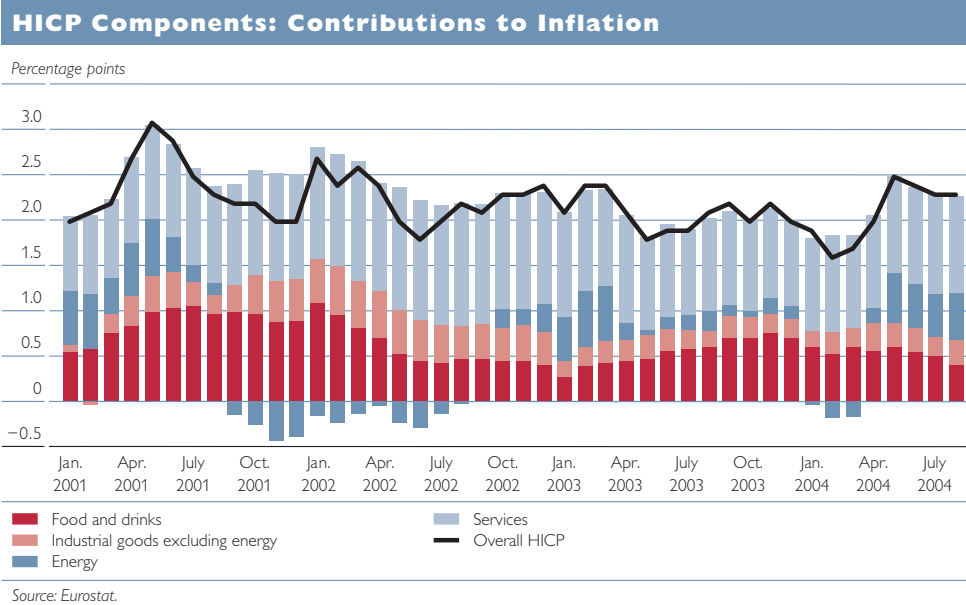
2.3 Energy Prices Are Fueling Inflation Again

In the middle of August 2004, nominal crude oil prices reached levels not seen since oil prices were first recorded. In August 2004 a barrel of crude (Brent) exceeded the previous

year's level by 44%. Despite these record prices, the situation still defies comparison with the 1970s and 1980s, as real oil prices were significantly higher at that time and price rises were considerably steeper, with oil prices tripling in short order. For the euro area, the increase in oil prices – primarily quoted in U.S. dollars – was dampened on the whole by the development of the euro's exchange rate against the U.S. dollar. Thus the rise in oil prices quoted in euro in August 2004 was only 30% higher on a year-on-year basis.

The increase in oil prices can be attributed to the global economic recovery and, in particular, to dynamic demand from fast-growing countries such as China and India. These factors also led to a steep rise in price of other commodities, particularly metals. The increase in crude oil prices was also attributable, above all, to geopolitical uncertainties and concerns about output losses in key oil producing countries, which have a direct impact on prices, especially since the short-term production ca-

Chart 3



capacity has almost been exhausted. Against this backdrop, the oil futures markets are not anticipating prices to drop markedly over the coming months.

In May 2004 the increase in crude oil prices triggered a jump in the HICP inflation rate from 2.0% to 2.5%. In the months since, the contribution of energy prices to inflation has been 0.5 percentage point. The fact that the inflation rate dropped back down to 2.3% in July is due above all to the decline in the price growth of unprocessed foods. Inflation remained at 2.3% in August.

Since March 2004, core inflation (increase in HICP excluding energy and unprocessed foods) has hovered around 2.1%, or 0.2 percentage point above the rates posted since mid-2003. There are two contributing factors: first, tobacco and narcotics prices, which currently enjoy inflation rates of 14% as a result of tax increases on tobacco in several countries, and second, the implications of the health reforms in Germany and the Netherlands, which are reflected in the prices for healthcare services and in pharmaceutical products. Excluding all these factors, core inflation is likely to just exceed 1.5%.

2.4 Lending Growth Continues in the Euro Area

The growth of loans to the private sector in the euro area has steadily accelerated since March 2004 (July: 6.2%). In addition, public-sector lending is continuing to grow dynamically. This means the trend (visible since early 2003) of a gradual upturn in lending is continuing. More animated lending growth, moreover, is primarily attributable to increased lending for residential construction. By contrast, consumer loans and loans

to nonfinancial corporations are growing only sluggishly. The reason for the rise in home loans is likely to be the low level of long-term interest rates.

Since its low in May 2004, growth in money supply M3 has picked up to some extent (July: 5.5%). In the period May to July 2004, the three-month average of growth rates was 5.2%. In addition, a shifting of portfolios into longer-term and higher-risk investment vehicles should be under way. This may be concluded from the ongoing tepid growth in other short-term deposits and in marketable financing instruments. Demand deposits recently notched up higher growth rates. The powerful expansion rates of cash and demand deposits moreover point to healthy demand for extremely liquid funds, due, in particular, to the current low level of interest rates.

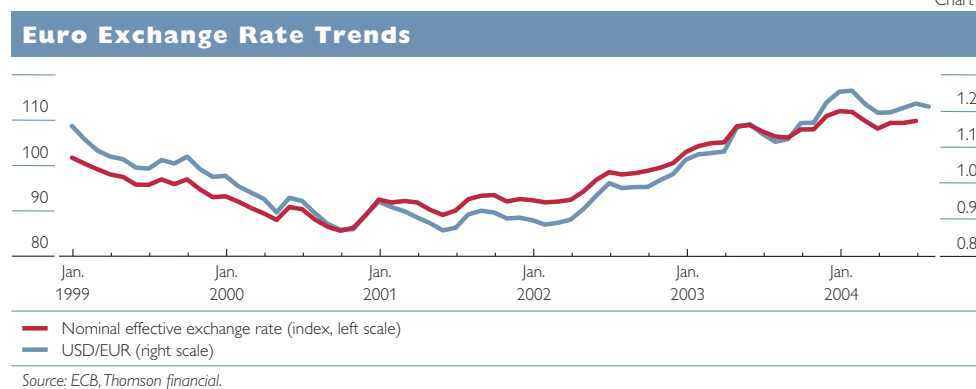
2.5 The Euro Exchange Rate Fluctuates between 1.20 and 1.24 per U.S. Dollar

Since attaining a high of USD/EUR 1.29 on February 17, 2004, the USD/EUR exchange rate has failed to reach comparable peaks. Since the end of May, the exchange rate has ranged between USD/EUR 1.20 to USD/EUR 1.24. This narrow band has seen fairly pronounced fluctuations, for which fresh U.S. economic data (particularly, the unexpectedly high U.S. current account deficit) were also to blame. In addition to these data, short-term speculative buying and selling were also responsible. Whereas the EUR/USD exchange rate between May and July 2004 rose by an average of 5.3% compared with the same three-month period in 2003, the increase in the nominal effective euro exchange rate was only 1.2% during the same period.

Long-term interest rates in the euro area recently fell and stood at 4.2% at the end of August, or close to their level at the start of the year. This means the steep rise from March to May did not continue. The interest rate gap (favoring the U.S. dollar) which opened up during this period has narrowed again dramatically. For the most part, the decline in long-term interest rates should be attribut-

able to higher oil prices, which have led to a heightened demand for bonds because of gloomier growth prospects and greater uncertainty. At the same time, long-term inflationary expectations determined from surveys have barely changed. Likewise, geopolitical uncertainties, which make investing in safe segments attractive, act to support the bond markets.

Chart 4



Since the start of this year, market prices have moved sideways, albeit in a slight downtrend. They were hit by interest rate hikes (both implemented and expected), higher oil prices and geopolitical uncertainties. These factors are likely to have overshadowed company news, which has been upbeat on the whole.

2.6 Increasing Optimism for Economic Growth

The European Commission's short-term economic forecast anticipates quarterly growth rates of 0.3% to 0.7% for the last two quarters of 2004, respectively. The outlook for the coming months therefore remains cautious. Positive driving forces such as the robust growth of the external economic environment and favorable financing conditions are currently being checked by the delayed effects of euro appreciation and the rise in oil prices.

The ECB has for the first time publicly released its economic experts' half-yearly (summer and winter) projections. These projections should be seen as supplementing those prepared in the intervening quarters in collaboration with the economists at both the ECB and the national central banks of the Eurosystem. The projections are published in the form of ranges so as to account for uncertainty to which every forecast is exposed.

Compared with the Eurosystem's projections prepared in June, the ECB's projections released in early September paint a somewhat more upbeat picture of predicted GDP growth. Accordingly, real GDP should grow by 1.6% to 2.2% in 2004 and by 1.8% to 2.8% in 2005. Robust export growth should increasingly feed through to domestic demand and should boost the momentum of investment and consumption growth.

The jobless rate should start to fall in 2005. In an environment of increased oil prices, however, predicted price trends are somewhat higher than they were in the June projections. For 2004, ECB experts now anticipate an increase in the HICP within a range of 2.1% to 2.3%, with energy prices making a significant contribution to inflation. In 2005 moderate domestic cost pressures and limited increases in import prices (owing to delayed euro appreciation effects) should offer a more favorable environment for price stability. The expectation of both modest wage growth and dynamic productivity growth will act to support prices. The inflation rate could therefore range between 1.3% and 2.3% in 2005.

3 Economic Growth in Central and Eastern Europe: Bulgaria, Croatia and Romania in Focus

3.1 Private Consumption Growth Nears Long-Term Trend Level

In the first quarter of 2004, economic growth in the new Member States of the European Union in Central Europe (Poland, Slovenia, Slovakia, the Czech Republic and Hungary) ranged from a low of 3.1% year on year in the Czech Republic to a high of 6.9% year on year in Poland. In the same period, growth levels of the current accession countries¹ (Bulgaria, Croatia and Romania) also lay within this range. In full-year 2003, by contrast, economic growth in all the new Central European Member States was slower than in the current accession countries.

Table 1

Real GDP Growth in Eastern Europe

	1999	2000	2001	2002	2003	Q4 2003	Q1 2004
	annual change in %						
Poland	4.0	4.0	1.0	1.4	3.8	4.7	6.9
Slovenia	5.6	3.9	2.7	3.4	2.3	2.5	3.7
Slovakia	1.5	2.0	3.8	4.4	4.2	4.7	5.5
Czech Republic	0.5	3.2	2.6	1.5	3.1	3.3	3.1
Hungary	4.2	5.2	3.8	3.5	2.9	3.6	4.2
Bulgaria	2.4	5.4	4.1	4.9	4.3	4.9	5.3
Croatia	-0.9	2.9	4.4	5.2	4.3	3.3	4.2
Romania	-1.2	2.1	5.7	5.0	4.9	4.6	6.1

Source: Eurostat, national statistical office, wiw.

Looking at growth dynamics from the demand side, the new EU Member States interestingly enough show a pattern that may be broadly characterized by the following common features.

First, compared with previous periods, *private consumption growth* in the first quarter of 2004 adjusted toward the long-term trend level. This

means the Czech Republic and Hungary saw a downward correction from quite a high growth level, partly as a result of fiscal consolidation measures. In Poland and Slovenia, private consumption growth accelerated from comparatively low levels, while in Slovakia it resumed at a moderate pace after last year's contraction.

¹ In view of the European Council's unconditional decision of June 2004 to enter into accession negotiations with Croatia, in this contribution the term "accession country" refers not only to Bulgaria and Romania, but also to Croatia, regardless of the fact that accession negotiations have not yet been formally opened.

Second, compared with previous periods, the first quarter of 2004 saw growth of *gross fixed capital formation* accelerate or resume (in countries like Poland and Slovakia, which had suffered from investment contraction). This said, the level of investment growth is still comparatively low in Poland and Slovakia. In general, demand for capital goods was supported by the dynamic trend in exports and by improved profitability in industry due to the decrease in unit labor costs or to their rise at a lower rate than producer prices.

Third, taking private consumption and fixed capital formation trends together, the contribution of total domestic demand to GDP growth increased in all countries with the exception of Hungary, where the investment take-off did not fully offset the slowdown in consumption.

Fourth, *real export growth* accelerated in almost all countries under review, except in Poland and Slovakia, where very powerful growth lost some speed. Fifth, the combination of high (or higher) export growth and the sizeable weight of exports as a percentage of total real GDP (ranging from 63% in Slovenia to 93% in the Czech Republic) meant that the contribution of exports to GDP growth was greater than that of total domestic demand. The only exception in this respect was Poland with an export weight of a mere 32%, which reflects the fact that Poland is the largest economy among these countries.

However, not all features of the economic growth of the new EU Member States in the first quarter of 2004 are common features: *import growth* and the contribution of *net exports* to GDP growth developed along quite different lines. In the Czech Republic and in Slovenia, both higher

domestic demand and higher export growth pushed up import growth to such an extent that the contribution of net exports to growth remained negative. In both countries, however, the deterioration of real net exports was not reflected in the balance of payments, which even improved and posted a modest surplus. Driven by higher export growth, Hungary's import growth also accelerated. The contribution of net exports to growth was close to zero. Despite stronger domestic demand, lower export growth in Poland and Slovakia dampened import growth, as a result of which the contribution of net exports remained positive. Moreover, this development was reflected in an improved balance of payments.

Turning to the current accession countries, Bulgaria reveals a growth pattern that is, at first glance, similar to that of the Czech Republic. In both countries, the corrective slowdown in consumption growth was more than offset by investment growth and the resulting increase in domestic demand fueling higher import growth and leading to a deterioration in net exports. However, this development was far more pronounced in Bulgaria, with booming investment demand (on the back of improved corporate profitability and a steep rise in loan demand) and a highly negative contribution to growth by net exports, which was reflected in a further deterioration of the goods and services balance. In Croatia and Romania, by contrast, the momentum of economic growth differed significantly from the common features outlined above for the new EU Member States in Central Europe. In Romania, domestic demand did not advance, as the deceleration in gross fixed capital formation growth more than offset the further rise in consumption growth. At

the same time, export growth declined. This combination of weaker (or constant) domestic demand and lower export growth dampened import growth. However, this slowdown was not enough to keep net exports from deteriorating further, which was reflected in the further worsening of the goods and services balance. In the first quarter of 2004 the Croatian economy continued to grow strongly. Although gross fixed capital formation advanced at a far slower pace than in the previous year, its contribution to GDP growth was similarly high to that of private consumption. By contrast, net exports made a negative contribution to growth of approximately one percentage point.

3.2 Heterogeneous Price Trends

Price trends have been quite heterogeneous in the Central and Eastern European countries under review. Among the new Member States in Central Europe, inflation rates (as measured by year-on-year changes of consumer prices in the second quarter of 2004) ranged from 2.5% in the Czech Republic to 8.0% in Slovakia. Among the current accession coun-

tries, inflation rates (in the first quarter of 2004) ranged from 1.9% in Croatia to 6.4% in Bulgaria and 13.6% in Romania.

In Hungary, Poland and in the Czech Republic, annual inflation rose in the first and second quarters of 2004, relative to average annual inflation in the comparable period a year ago. In addition to higher energy prices, this was primarily due to hikes in indirect taxes (related to EU accession) and to increased food prices, which were also partly accession-related.

By contrast, inflation decreased in Slovakia, where relatively low core inflation (below 3.0%) dragged down headline inflation, which was distorted by hikes in administered prices and by tax changes. Inflation also declined in Slovenia on the back of lower unit labor cost increases, attributable to the gradual deindexation of the economy. Although inflation in Romania was lowered steadily in recent quarters, in Bulgaria it rose steeply this year as a result of tax changes, a strong expansion in lending and rising food prices (owing to last year's drought).

Table 2

Inflation in Eastern Europe:

Annual Change in the Consumer Price Index (HICP)

	2000	2001	2002	2003	Q4 2003	Q1 2004	Q2 2004
	annual change in %						
Poland	10.1	5.3	1.9	0.7	1.4	1.8	3.4
Slovenia	8.9	8.6	7.5	5.7	5.0	3.7	3.8
Slovakia	12.2	7.2	3.5	8.5	9.4	8.2	8.0
Czech Republic	3.9	4.5	1.4	-0.1	0.8	2.0	2.5
Hungary	10.0	9.1	5.2	4.7	5.4	6.8	7.4
Bulgaria	10.3	7.4	5.8	2.3	4.7	6.4	6.7
Croatia ¹	6.4	5.0	1.7	1.8	1.8	1.9	x
Romania ¹	45.7	34.5	22.5	15.3	14.8	13.6	x

Source: Eurostat, national statistical office, *wiiv*.

¹ CPI.

3.3 Some Improved Rating Assessments for Sovereign Long-Term Foreign Currency Debt

Among the countries under review, Slovenia has the highest rating awarded by Moody's and Standard & Poor's for sovereign long-term foreign currency debt. Whereas for the last ten months Moody's did not make

any changes to its ratings of the countries under review, Standard & Poor's has upgraded the ratings of several countries (Bulgaria, Slovenia and Slovakia) in 2004. These upgrades reflect the improved economic scenario as well as a more prudent fiscal policy and, in the case of Bulgaria, the prospect of EU membership in 2007.

Table 3

Ratings for Sovereign Long-Term Foreign Currency Debt¹

Currency	Moody's			Standard & Poor's		
	Previous rating	Latest change	Current rating	Previous rating	letzte Änderung	Current rating
PLN	Baa1	12. 11. 02	A2	BBB	15. 05. 00	BBB+
SIT	A2	12. 11. 02	Aa3	A+	13. 05. 04	AA-
SKK	Baa3	12. 11. 02	A3	BBB	02. 03. 04	BBB+
CZK	Baa1	12. 11. 02	A1	A	05. 11. 98	A-
HUF	A3	12. 11. 02	A1	BBB+	19. 12. 00	A-
BGN	B1	05. 06. 03	Ba2	BB+	24. 06. 04	BBB-
HRK		01. 27. 97	Baa3		01. 17. 97	BBB-
ROL	B2	17. 06. 02	Ba3	BB-	17. 09. 03	BB

Source: Bloomberg.

¹ After the cutoff date for this analysis, Standard & Poor's raised Romania's foreign currency rating from BB to BB+.

Economic Forecasts for Central and Eastern European Countries

The OeNB establishes bi-annual forecasts of the economic development in the Czech Republic, Hungary and Poland as well as in Russia. These three new EU countries account for more than three quarters of the total GDP of all new Member States and, hence, are representative for this part of the European Union.²

When euro area growth was decelerating sharply during recent years, private consumption was the major pillar of growth in the three new EU countries under study, which implies that their GDP growth rates outperformed that of the euro area, partly even considerably. The current economic recovery in the euro area will stimulate export growth in the Czech Republic and in Hungary, in addition to the growth contribution by private consumption. In Poland, the current upswing in the euro area will maintain export growth at the high level of 2003 (when it was supported by the strong corrective depreciation of the zloty in 2002–03), despite the re-appreciation of the zloty. Correspondingly, according to the present forecast, GDP growth will accelerate in the Czech Republic, Hungary and Poland in 2004 and 2005 and remain at a high level in 2006.

It can be assumed that integration into the single market will further stimulate both exports and imports, even though the short-term (one- to two-year) economic effects of EU accession are nearly impossible to quantify precisely ex-ante. Exports will be supported further by decreases in nominal unit wage costs in industry. Gross fixed capital formation will be stronger, too, as a result of export demand, direct EU accession effects, higher profitability in industry and a cut in corporate income tax rates. The high (or higher) contribution of exports and investment to GDP growth as well as – in Poland – higher

² These forecasts, which are established together with the Suomen Pankki, the central bank of Finland, in particular with respect to Russia, are based on preliminary global growth projections and technical assumptions concerning the oil price and the euro / U.S. dollar exchange rate which are prepared by the ECB for the Eurosystem at the start of the process of the Broad Macroeconomic Projection Exercise. These underlying assumptions are pivotal to the forecasts presented here, as these three new EU countries have a strong export orientation towards the euro area, and Russia is one of the major global oil producing countries.

private consumption growth will lead to an increase in import growth, adding to the direct impact of EU accession on imports.

This year, private consumption will grow at a lower rate than in the previous year in the Czech Republic and, in particular, in Hungary, where it grew at an especially high pace in 2003. Among other things, hikes in indirect tax rates are dampening private consumption. This is also one of the reasons why the acceleration of private consumption growth (from a relatively lower level) will be fairly limited in Poland.

More generally, the economic environment expected for the next couple of years will provide a window of opportunity for fiscal consolidation measures. However, the upcoming elections (2005 in Poland, 2006 in Hungary and in the Czech Republic) might work against such measures. The moderate decline in GDP growth forecast for 2006 in Poland rests on the assumption of major fiscal consolidation steps taking place after the elections.

The risks to this forecast for the three new EU countries are, firstly, considerably weaker euro area growth and, secondly, strong monetary policy reactions by these countries' central banks to prevent second-round effects of the recent inflation pick-up, which so far has been primarily supply side driven (e.g. energy prices, food prices, hikes in indirect tax rates related to EU accession). This could weaken gross fixed capital formation growth in particular. Partly linked to this risk is the risk of an accelerated currency appreciation, which would weaken the price competitiveness of exports and enhance import growth. In this respect, however, the U.S. dollar/euro exchange rate also plays a role that should not be underestimated, in particular in the case of Poland.

Table 4

Three New EU Member Countries and Russia

Real GDP forecast of September 2004

	2001	2002	2003	2004 ¹	2005 ¹	2006 ¹
	Year-on-year change at constant prices, %					
Poland	1.0	1.4	3.8	5.8	5.4	4.1
Czech Republic	2.6	1.5	3.1	3.8	3.9	3.9
Hungary	3.8	3.5	2.9	3.6	3.7	3.8
Russia	5.1	4.7	7.3	6.9	5.9	4.8

Source: Eurostat, OeNB, Bank of Finland.

¹ Forecast value.

In Russia, high economic growth will continue in 2004, driven by high energy and other raw material prices. However, the high growth rates are attributable also to prudent monetary and fiscal policies, the structural reforms implemented in recent years, political stability and, generally, economic actors' increased optimism. Assuming that the oil price will decrease moderately from the current high levels and that the ruble will further appreciate in real terms, the forecast for Russia sees robust, but moderately declining GDP growth for 2004 to 2006.

Economic growth should be supported by all demand components throughout the forecast period. Private consumption growth should remain healthy, benefiting from wage increases, hikes in pensions and higher profits. While fiscal policy – supported by higher oil prices – has been designed to be more restrictive this year, a decrease in the fiscal surplus is planned for 2005. Gross fixed capital formation growth rates will continue to be high, albeit on the basis of a low starting level. Only slowly declining inflation and continuous nominal upward pressure on the exchange rate will imply a further real appreciation of the ruble. Thus, in addition to increased import demand resulting from strong economic growth, increasingly fierce cost-triggered import competition will take place. While this may also accelerate restructuring at the corporate level, it will probably lead to a decrease in net exports initially.

One of the major risk factors to this forecast is the oil price. It will continue to be a major risk factor for growth, as the dependence of the Russian economy on the extraction and export of energy has risen further recently. Irrespective of the price development, capacity constraints (e.g. with respect to oil pipelines) may imply declining net exports. A further risk factor would be an excessively quick real appreciation of the ruble. This would have negative effects on the competitiveness of industrial exports,

as the gain in competitiveness resulting from the sharp depreciation during the severe financial crisis of 1998 has already been eroded nearly completely. The dragging on or even escalation of the Yukos affair could increase the uncertainty regarding the authorities' respect for property rights and cloud the investment climate. Finally, the turbulences in the summer of 2004 have demonstrated the fragility of the banking sector.

4 Austria: Boom in Exports Remains Mainstay of Economic Recovery

In the first half of 2004, Austria's economic performance was driven by robust growth in exports. The forecast for growth in the second half of the year is also optimistic. For both the third and fourth quarters of 2004, the OeNB economic indicator predicts real GDP growth of 0.5% quarter-on-quarter.

For the year 2004, this means a growth rate of 1.7%.

The first half of 2004 brought a significant change in the breakdown of GDP growth. Whereas growth in 2003 was driven by domestic demand (in particular, extremely dynamic investment), exports were the mainstay of the economy in the first half of 2004.

Table 5

Breakdown of Real GDP Growth in Austria						
	2003	2004Q1	2004Q2	2003	2004Q1	2004Q2
	Annual change (annual figures) and quarterly change (quarterly figures), %			Contribution to GDP growth in percentage points		
GDP	0,7	0,4	0,9	0,7	0,4	0,9
Private consumption	1,4	0,3	0,5	0,8	0,1	0,3
Public sector consumption	1,1	-0,1	-0,1	0,2	0,0	0,0
Gross capital formation	5,8	-0,5	-0,8	1,3	-0,1	-0,2
Exports	1,9	0,6	5,8	x	x	x
Imports	5,0	-0,7	4,0	x	x	x
Net exports	x	x	x	-1,6	0,8	1,1
Statistical discrepancy	x	x	x	0,0	-0,4	-0,3

Source: Austrian Institute of Economic Research (WIFO), Eurostat.

In the second quarter of 2004, real exports of goods and services grew by an annualized 25% on a quarterly basis. Although growth rates such as these cannot be expected in the quarters to come, exports in 2004 will clearly be the mainspring of the economic expansion. In the first half of 2004, imports grew on the back of export growth, in particular. In the second half of the year, import growth should be driven more strongly by domestic demand.

In 2003, the rise in GDP was largely fueled by investment. After two years of decline, investment activity picked up sharply in early 2003. This can be primarily attributed to the need for replacement investment. Total investment contracted slightly from a high level in the first half of 2004. However, this dip also reflects the fact that economic recovery has still not stabilized completely. The boom in exports should, however, also be reflected in investment during the rest of 2004.

Results of the OeNB Economic Indicator of September 2004:

Continued Robust Growth in the Second Half of 2004³

The OeNB economic indicator forecasts continued robust economic growth in Austria in the second half of 2004. For both the third and fourth quarters of 2004, it predicts real GDP growth in Austria of 0.5% on a seasonally-adjusted quarterly basis. On a year-on-year basis, this means growth will quicken to 2.1% and 2.3%, respectively. For full-year 2004, growth thus comes to 1.7%. Compared with the OeNB's spring outlook, this means a revision of +0.2 percentage points. Growth will be fueled primarily by dynamic exports. During the second half of 2004, however, domestic demand should also make a greater contribution to growth.

Table 6

Short-Term Outlook for Real GDP

for the Third and Fourth Quarters of 2004 (Seasonally Adjusted)

2002				2003				2004			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Quarterly change (annual rate) in %											
0.5	2.1	1.3	1.5	1.4	0.1	0.6	0.8	0.7	1.8	2.1	2.3
Quarterly change in %											
0.6	1.0	-0.2	0.0	0.5	-0.2	0.2	0.3	0.4	0.9	0.5	0.5
Annual change in %											
1.3 (1.4) ¹				0.7 (0.7) ¹				1.7			

Source: OeNB results of the OeNB economic indicator of September 2004, Austrian Institute of Economic Research (WIFO).

¹ Based on nonseasonally-adjusted and nonworking day-adjusted data.

In view of continued modest employment and wage growth, private consumption is relatively stable. A further acceleration in growth in the second half of 2004 does not, however, look very likely. Public consumption growth is marked by ongoing consolidation efforts. In the first half of 2004, public consumption declined marginally. In the second half of the year, it is not expected to augment significantly either.

The outlook for 2005 will depend above all on how the world economic recovery continues to develop. Whether euro area countries – in particular, Germany – succeed in placing growth (driven primarily by exports in the first half of 2004) on a broader basis is crucial for Austria. Failing this, growth can be expected to lose mo-

mentum in Austria as well. Although oil prices are currently at a high level, this should not jeopardize economic recovery provided they do not rise further considerably. However, they may well have a certain dampening effect on cyclical developments.

4.1 Confidence Strengthens Further in Austria

Whereas euro area economic indicators are still trending unevenly, the economic climate in Austria has recently stabilized. Since spring 2003, the European Commission's economic sentiment indicator has been in up-trend except for a setback toward the end of 2003.

Confidence indicators provide a cautious gauge of the breakdown of GDP growth in the second half of

³ Since the first quarter of 2003, the OeNB economic indicator has been published four times a year. It forecasts real GDP growth for the current quarter and the next (in each case, on a quarterly basis, using seasonally-adjusted data). The figures are based on the results of two econometric models: a state space model and a dynamic factor model. Further details on the models employed can be found at www.oenb.at in the Monetary Policy and Economics section. The next publication is scheduled for January 2005.

2004. The order book for exports suggests that deliveries abroad will continue to perform positively although growth rates as high as those in the second quarter of 2004 will be difficult to repeat. In the quarterly business survey carried out by the Austrian Institute of Economic Research, WIFO, for the third quarter of 2004, capacity utilization was better than in the preceding survey. This can be interpreted as a sign of stepped-up investment. After surging in spring 2004, retail confidence fell back to its level at the start of the year, which makes a sharp uptick in consumption look rather unlikely.

4.2 Labor Market Starts To Improve

Employment growth is accelerating visibly, albeit at a low level. Although the unemployment rate is still high, the number of vacancies has been surging since March 2004, indicating a further improvement in the labor market and a decline in joblessness in the near future.

In 2004, employment statistics are particularly difficult to interpret for two reasons. First, the number of individuals drawing parental leave benefit continues to grow, underlining the importance of the distinction between registered employment and employment adjusted for persons on parental leave, in compulsory military training or registered in a training program of the Austrian Public Employment Service. Hence, the (economically relevant) adjusted employment figures are lower than registered employment figures. Second, AMS (Austrian Public Employment Service) training participants have been dropped from employment statistics since early 2004, which means that actual employment growth is distorted downward. In 2004, both these effects will roughly

cancel each other out. Growth in registered employment (year on year, January to August 2004) of 0.3% is therefore equivalent to approximately the number of actually newly created jobs. In the first eight months of 2004, growth in registered employment accelerated from +0.1% in January to +0.6% in August. Aggregated employment growth conceals highly divergent sectoral trends. Whereas jobs are being lost in industry, they are being created in the tertiary sector.

4.3 Oil Price Increase Triggers Rise in Inflation

Price trends in 2004 have basically been determined by the increase in crude oil prices. Inflation has consequently risen in the course of the year. At 2.2%, the rate of increase in the Harmonized Index of Consumer Prices (HICP) reached its highest level to date this year in August 2004. In 2003 prices edged up by a mere 1.3%. Compared with 2003, the relevance of certain subcomponents for aggregate inflation has changed perceptibly in 2004. In addition to energy, services made the biggest contribution to inflation. Since early 2004, government measures (e.g. the increase in energy tax or the introduction of the toll on freight vehicles) have added to inflation.

4.4 2003 Current Account Based on Payment Flows Almost Balanced

Vigorous export growth in the first half of 2004 improved the balance of goods and services. At EUR 1.89 billion, the current account surplus (based on payment flows) in the first seven months of 2004 exceeded that of the comparable period of the previous year by EUR 0.28 billion. This is wholly attributable to a reduction in

the goods deficit. By contrast, the surplus on services (with its important subcategory of tourism) suffered only a minimal decline. Finally, higher net payments from investment income and transfers resulted in a current account deficit. The current account (based on payment flows) turned from a surplus of EUR 0.02 billion in the first seven months of 2003 into a deficit of EUR 0.67 billion in the comparable period of 2004. The improvement in the merchandise balance is also reflected in the foreign trade data

compiled by Statistics Austria. The balance moved from a deficit of EUR 1.4 billion in the first six months of 2003 into a surplus of EUR 0.4 billion in 2004. The merchandise trade deficit continued to deepen with the “old” EU Member States while the surplus with the 10 new Member States remained more or less unchanged. By contrast, there was a marked improvement in the balance with non-EU countries (up by more than EUR 2 billion to EUR 2.6 billion).

Measures to Improve the Efficiency of the Operational Framework for Monetary Policy

Michael Pfeiffer

This study shows that strong interest rate expectations can have a massive short-term impact on counterparties' bidding behavior if certain conditions for monetary policy operations are present. This increases the probability of an undesirable reaction of potentially more volatile short-term money market rates.

Therefore, during the first quarter of 2004 the Eurosystem took steps to counter such potential negative repercussions on signaling the monetary policy stance. The modifications are to make an important contribution toward increasing the efficiency of the operational framework for monetary policy.

In another area – the risk control framework for eligible assets – the Eurosystem implemented measures to increase the precision and transparency of the valuation of these assets and adopted a more precise definition of the criteria for certain credit standards.

1 Introduction

The Eurosystem's principal monetary instruments are open market operations and standing facilities. Open market operations ensure that the European Central Bank (ECB), which always initiates these operations, provides refinancing to the financial sector on a regular basis. The most important type of open market operations is short-term tenders¹ (main refinancing operations, MROs).

The minimum bid rate for short-term tenders signals the Eurosystem's monetary policy stance. For the inter-bank market, the minimum bid rate is an important indicator for overnight rates, which as a rule do not deviate significantly from the former.²

In addition to providing central bank money on a regular basis, open market operations also serve as a tool to fine-tune liquidity conditions. In this way, the ECB reacts – if necessary – to imbalances in the money market, thus reducing the volatility of short-term money market interest rates.

Standing facilities, on the other hand, are available to credit institutions at their own initiative. Counterparties can use them to obtain short-term overnight liquidity (marginal lending facility) or to deposit liquidity surpluses (deposit facility).

An essential regulatory provision is that most credit institutions are required to maintain minimum reserves. To meet their minimum reserve requirements, credit institutions have to hold 2% of certain deposit categories on accounts with the national central banks. Compliance with reserve requirements is determined on the basis of the average of the end-of-calendar-day balances on the credit institutions' reserve accounts over a maintenance period. This allows credit institutions to smooth out liquidity fluctuations within their reserve management system, which eliminates the necessity of daily compensatory transactions in the money market. As a result, the number of transactions decreases, which in turn stabilizes short-term money market rates.

As has been the case in past years, the ECB's monetary policy decisions were implemented relatively smoothly and without major incidents in 2003:

- The average volatility of short-term money market interest rates over the course of the year, measured against the Euro OverNight Index Average (EONIA), i.e. the euro reference interest rate for overnight unsecured lending trans-

Refereed by
Friedrich Fritzer,
Economic Analysis Division.

¹ In these transactions, the ECB provides central bank money to the banking system in a predefined auction process.

² Short-term deviations from this general rule are possible in periods of temporary over- or underliquidity.

actions in the interbank market, was low. In particular, the spread between the minimum bid rate in ECB tender operations and the EONIA remained mostly stable at a low level. This suggests that in most cases the liquidity situation in the money market was balanced and that no serious tensions occurred.

- On average, recourse to both standing facilities – the deposit facility and the marginal lending facility – was at a low level. This is generally the case when credit institutions' liquidity is adequate to meet their needs, and the volatility of money market interest rates is insignificant.

Overall, the operational framework for monetary policy proved suitable to ensure a stable supply of central bank money to the banking sector also in 2003. At the same time, the structure turned out to be flexible enough to react quickly and effectively when faced with unforeseen situations; a fact that is also evidenced by the limited number of fine-tuning operations that had to be conducted.

Despite a very balanced and stable overall picture, there are occasional situations when temporary imbalances in the money market emerge. These may be caused when factors affecting liquidity (for instance, banknotes in circulation or certain central government transactions) take an unforeseen development. As a result, there is a temporary over- or undersupply of liquidity to the market, and short-term interest rates react accordingly.

In addition, it is also possible that interest rate speculation leads to bidding behavior on the part of credit institutions that does not correspond to their actual liquidity requirements.

Some such situations occurred in particular under the operational framework for monetary policy that was in effect up to February 2004. The section below presents a short analysis of some examples of such situations.

Another key factor within the operational framework for monetary policy is the fact that counterparties are only supplied with central bank liquidity against sufficient and adequate collateral. All collateral is subject to certain criteria in order to be eligible for use in Eurosystem monetary policy operations. In addition, the Eurosystem applies specific risk-control measures to prevent losses in the event that underlying assets have to be realized owing to the default of a counterparty. In recent years, these measures have been increasingly refined and adjusted to the requirements of modern financial markets. A further step in this direction came into effect in the first quarter of 2004 and is discussed in chapter 4 of this study.

2 Temporary Imbalances and Their Causes

It is important to note that this analysis focuses on the period following the switch to variable rate tenders in the MROs.³

Each national central bank submits a detailed set of data to the ECB on a daily basis, setting out the anticipated development of the autonomous liq-

³ Particularly in 2000, severe overbidding situations occurred in the context of the volume tender procedure, which is based on a fixed interest rate, combined with strong market expectations of increasing interest rates. The fixed rate tender procedure does not involve market risk for the bidding bank. In response to this fact, the ECB decided to switch to a variable rate tender procedure.

uidity factors up to the end of the current minimum reserve maintenance period. Autonomous liquidity factors include, for example, banknotes in circulation or government activities affecting liquidity. On the basis of these factors, together with the current aggregate reserves of the credit institutions, the ECB calculates the liquidity needs for the entire Eurosystem. This calculation is used to determine the respective tender allotments.

An underbidding situation occurs when the calculated liquidity requirements of the counterparties cannot be met because the bids submitted in the tender operation were not sufficient. Depending on the amount of the ensuing liquidity shortfall, this results in more or less significant fluctuations in money market interest rates.

Two episodes in March and in June 2003 serve as examples of clear underbidding. In both of these cases, the shortage in the amount of liquidity that would have ensured a smooth fulfillment of minimum reserve requirements was substantial: EUR 43 billion and EUR 20 billion, respectively. Since, by contrast, the annual average minimum reserve requirement was EUR 130 billion in 2003, these two cases deserve a closer look.

To analyze these temporary situations, it is first necessary to briefly describe how the operational framework for monetary policy has been functioning up to now. Particular emphasis must be given to the following two key factors:

- 1) The minimum reserve system with its maintenance period starting on the 24th calendar day of one month and ending on the 23rd calendar day of the following month.
- 2) The fact that the maturity of the main refinancing operations was two weeks.

The first factor is particularly relevant in the present context. As previously mentioned, compliance with reserve requirements is determined on the basis of the average of the daily balances on the counterparties' reserve accounts over the entire reserve maintenance period. This means that the credit institutions subject to minimum reserves have great flexibility for managing their reserves. Depending on their liquidity situation, but also contingent upon their assessment of how money market interest rates will develop, they will opt either for frontloading or backloading reserves.

A frontloading strategy is characterized by a liquidity surplus (more minimum reserves are held than the necessary average amount) in the first half of the maintenance period, which is attributable either to liquidity inflows from the financial institution's activities at that time or to the anticipation of an interest rate hike in the second half of the maintenance period.

In the opposite scenario, a credit institution that opts for backloading either expects liquidity inflows during the second half of the reserve maintenance period or an interest rate cut. Therefore, at the beginning of the reserve maintenance period, the credit institution will hold less central bank money than the required minimum reserve average. Instead, it will compensate for the reserve deficit later on, using either liquidity inflows or – if the interest rates have in fact been cut – by borrowing the shortfall at more favorable conditions in the money market or from the ECB.

Under the facts and circumstances described above, the dates scheduled for the ECB's interest rate decisions play a crucial role in market participants' decisions as to which strategy

to follow. Generally, the ECB Governing Council assesses the monetary policy stance at its first meeting of the month. Accordingly, interest rate decisions are normally taken during that meeting.⁴

If this provision is embedded in a minimum reserve regime with a maintenance period that begins on the

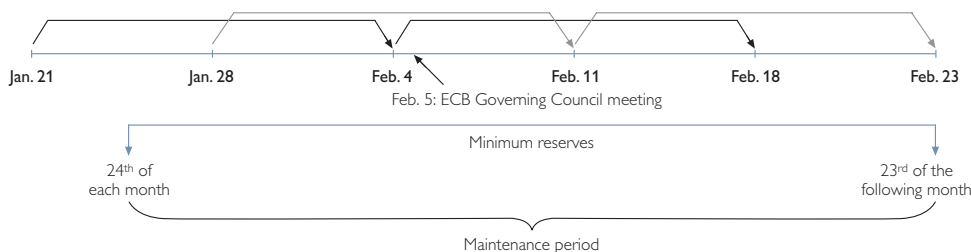
24th calendar day of each month and ends on the 23rd calendar day of the following month (that is, the “old” system), this implies that there is always the possibility of a key interest rate change within a particular reserve maintenance period.

Chart 1 illustrates this point.

Chart 1

Previous Minimum Reserve System and ECB Interest Rate Decisions

MROs with a maturity of 14 days and weekly tenders



Source: OeNB.

If market participants’ expectations of an imminent change in the key interest rates gather momentum, direct consequences on credit institutions’ bidding behavior in ECB tender operations are very likely to occur in this scenario. Since, as described previously, there is a close connection between credit institutions’ minimum reserve maintenance patterns and their bidding behavior, the bidding amounts (and the interest rates offered) in tender operations primarily depend on the following two factors: the liquidity requirement and/or the anticipated liquidity conditions at the end of the reserve maintenance period and the spread between short-term money market rates and the minimum bid rate for MRO tenders. These money market rates are of course also

influenced by interest rate expectations for the immediate future.

Heterogeneous interest rate bids for MROs reflect, inter alia, credit institutions’ differing expectations about the level of the marginal allotment rate as well as their willingness to resort to riskier alternative refinancing options in the money market. These decisions are obviously also influenced by the availability of eligible underlying assets, the anticipated credit risk premium and their individual balance sheet structure.

The money market reference rates for the interest rates offered in tender operations are the short-term rates for unsecured deposits and increasingly, the EONIA swap rates,⁵ owing to the high liquidity of this market segment, as well as corresponding repo rates.

⁴ On November 8, 2001, it was announced that the Governing Council of the ECB would assess its monetary policy stance, as a rule, only at its first meeting of each month. The exact schedule of these monthly meetings is published around mid-year for the following year. The ECB may, however, deviate from this schedule if necessary.

⁵ In an EONIA swap, a fixed-term interest rate is exchanged for the average of the EONIA rates over the course of a certain period, for example, one week. After the end of this period, the difference is usually paid out.

Basically, short-term money market rates (for example, the overnight rate) reflect the equilibria in the money market and also, to a certain degree, the expected level of the MRO minimum bid rate at the end of the reserve maintenance period, as well as the assessment as to whether liquidity conditions at this point are tight or loose. If these conditions are assessed as neutral, which means that the market does not anticipate a change in the key ECB interest rates and there is a high probability of neither a liquidity shortfall nor a surplus at the end of the reserve maintenance period, the difference between the overnight rate and the minimum bid rate for MROs is usually no more than a few basis points.

The earlier the market becomes aware of (or anticipates) probable imbalances, the earlier the short-term money market rate will deviate from the minimum bid rate. This amplitude normally culminates on the last day of the reserve maintenance period because then the most precise assessment regarding the amounts necessary to adjust discrepancies between the level of reserves held and the minimum reserves required (borrowing deficits/depositing surpluses through the Eurosystem's standing facilities) is available.

The factors described above show that expectations of imminent key interest rate changes can certainly lead to significant fluctuations in the bidding volume. Strong market expectations of a key interest rate hike can thus result in a substantially higher bids submitted in MROs (as previously mentioned, this phenomenon occurred in the period from 1999 through 2000). By contrast, expectations of a key interest rate cut usually lead to a marked decline in bids. In

this case, it is not possible to sufficiently adjust the bid rates (downward) in variable rate tenders because of the minimum bid rate. Instead, bidding interest will be regulated through the volume of bids. High expectations of interest rate cuts tend to exert a downward pressure on short-term money market rates, which may cause a temporarily fall below the minimum bid rate. This phenomenon has also been observed during underbidding episodes.

Interestingly, however, the money market rate can also rise considerably above the minimum bid rate as a direct result of significant underbidding, even though the market was anticipating an interest rate cut (see chart 2).

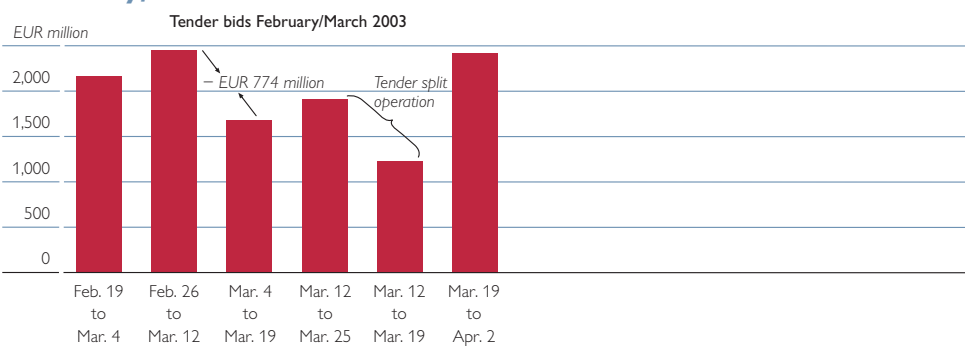
This is caused by a temporary liquidity shortage against the required minimum reserve maintenance, which in turn triggers an interest rate response that pushes the rate up and temporarily increases volatility. This is a typical example of a situation which the market does not classify as "liquidity neutral" as previously defined and therefore reacts accordingly. Generally it can be assumed that the higher the anticipated accumulated liquidity shortage, the higher will be the likelihood of a movement in short-term interest rates. Such market responses can move short-term interest rates temporarily to just under the level of the marginal lending facility.

The ECB normally responded to such situations with increased allotments in subsequent tender operations. In addition, so-called tender split operations were carried out on some occasions. This means that an additional operation with a maturity of one week was conducted in parallel to the regular MRO in order to realign the volumes of the outstanding tender operations.

Chart 2

Underbidding Episodes and Interest Rate Movement

February/March 2003



Source: OeNB.

Nevertheless, credit institutions frequently used the marginal lending facility, as the higher allotment amounts did not necessarily cover the entire shortfall.

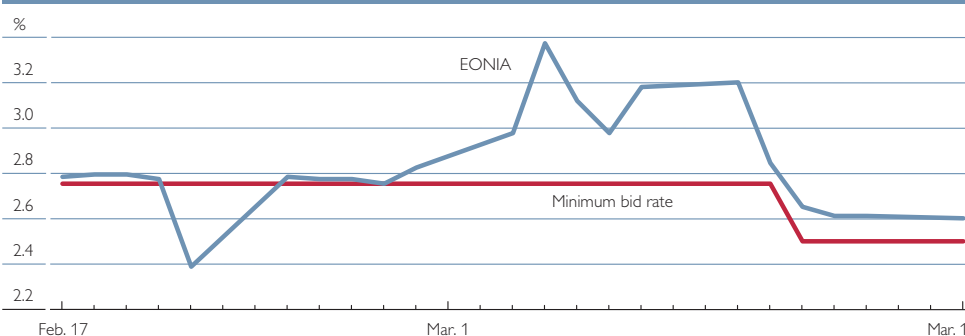
In addition to interest rate expectations during a given minimum reserve maintenance period, yet another aspect was relevant in the phased-out system: As a result of the two-week maturity of the MRO (with tenders on a weekly basis), at least the last MRO within a minimum reserve maintenance period overlapped with the subsequent one. This in turn could result in interest rate expectations for the next reserve maintenance period already having an effect on the bidding behavior during the current period.

From a central bank's perspective, distortions of bidding behavior prompted by speculation and the resulting tensions in the money market with phases of higher volatility are undesirable because the MROs do not just play a vital role in the regular supply of the market with central bank money but are also important factors in signaling the ECB's monetary policy stance.

In the current system of variable rate tenders, the minimum bid rate provides this signaling function (during the period in which the MROs were conducted as fixed rate tenders, the fixed rate of the tenders had this function).

Chart 3

EONIA and Minimum Bid Rate February/March 2003



Source: OeNB.

The greater volatility of short-term money market rates due to market participants' expectations, the more this signaling effect is endangered.

3 Measures to Reduce Distortions

In order to mitigate the previously described impacts of counterparties' expectations on the money market, the ECB Governing Council decided in early 2003 to implement the following changes to the operational framework for monetary policy, which came into effect in the first quarter of 2004:⁶

3.1 Minimum Reserve

Since – as previously described – the timing of the minimum reserve maintenance period was one of the major factors causing the imbalances experienced in the past, an obvious step was to implement a change in the reserve maintenance schedule.

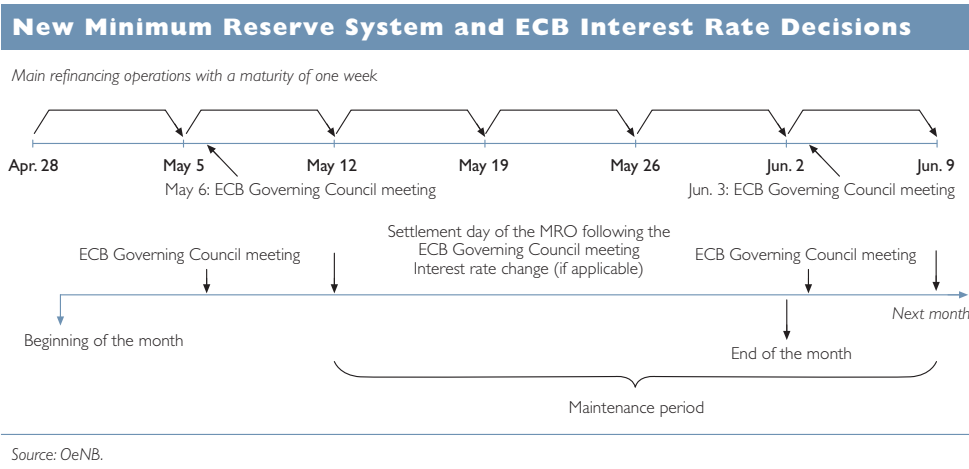
Under the new system, the reserve maintenance period always starts on the settlement day of the

MRO following the meeting of the ECB Governing Council at which the monthly assessment of the monetary policy stance is scheduled. As a complement to this redefinition of the minimum reserve maintenance period, changes in standing facility rates will generally coincide with the start of a new reserve maintenance period.

This means that instead of starting and ending on fixed calendar days, the reserve maintenance periods depend on the schedule of ECB Governing Council meetings. Consequently, the maintenance periods will vary in length.

As to the calculation of the minimum reserve, it is crucial that under the new system, the gap between the date on which the reserve basis is calculated, i.e. the last day of the month, and the start of the reserve maintenance period is at least as long as under the previous system. For instance, a credit institution's reserve requirement for a maintenance period starting in April would be calculated using its reserve base data from the end of February.

Chart 4



⁶ The measures implemented were influenced by the public consultation launched by the Eurosystem on October 7, 2002, to gather the views of market participants on a set of planned technical measures designed to improve the efficiency of the operational framework for monetary policy.

3.2 Tender Operations

As previously mentioned, the allotment rhythm of MRO allotments was also a factor that fostered potential distortions of bidding behavior in certain situations. Because tender operations with a maturity of two weeks were conducted on a weekly basis, MROs regularly overlapped with the subsequent reserve maintenance periods.

Although the maturity of 14 days can be considered adequate for supplying central bank money to the financial sector, the ECB decided to synchronize the maturity of MROs and new tender operations. Consequently, the maturity of the MROs was shortened from two weeks to one week.

A technical change was also implemented with regard to the longer-term refinancing operations (with a maturity of three months). Instead of on the first Wednesday of each minimum reserve maintenance period like under the old system, they are normally allotted on the last Wednesday of each calendar month under the new system.

3.3 Desired Effect of the Changes to the Framework

The combination of the changes outlined above is to help remove expectations of interest changes during any particular maintenance period, given that changes in the ECB's key interest rates will generally only apply to the forthcoming reserve maintenance period and that liquidity conditions will no longer spill over from one reserve maintenance period to the next. Furthermore, shortening the maturity of the MRO has solved the problem of

overlapping MROs (one refinancing operation extending over two minimum reserve maintenance periods).

In technical terms, this means that interest rate speculation of the kind previously described will no longer be relevant within the prevailing maintenance period, which in turn stabilizes the conditions in which bidding in the main refinancing operations takes place and thus reduces the volatility of short-term money market interest rates.

In addition, these measures will ensure that the reserve maintenance period always starts on a TARGET operating day, while ending on a non-TARGET day will be very rare.

4 Risk Control Measures

The eligibility criteria applied to underlying assets provide another important contribution to the smooth functioning of the Eurosystem's monetary policy operations.

Eligible assets are divided into two categories: tier one and tier two assets.⁷ Tier one consists of marketable debt instruments fulfilling euro area-wide eligibility criteria specified by the ECB. Tier two consists of marketable and non-marketable assets which are of particular importance to national financial markets and banking systems.

The most recent changes concern the risk control measures that are applied to the assets underlying Eurosystem monetary policy operations⁸ and can be summarized as follows:

Tier one assets were allocated to one of four liquidity categories, with a specific valuation haircut to be assigned to each category.

⁷ The ECB Governing Council has already committed to a decision to merge the two categories of assets into one single list.

⁸ The detailed provisions are set out in the "General Documentation on Eurosystem Monetary Policy Instruments and Procedures" (ECB, February 2004).

Table 1

Liquidity Categories for Tier One Assets			
Category I	Category II	Category III	Category IV
Central government debt securities	Local and regional government debt securities	Traditional <i>Pfandbrief</i> -style debt instruments	Asset-backed securities
Debt securities issued by central banks	Jumbo <i>Pfandbrief</i> -style debt instruments	Credit institution debt securities	
	Supranational debt securities	Debt instruments issued by corporate and other issuers	
	Agency debt instruments		

Source: ECB.

Table 2

Levels of Valuation Haircuts Applied to Eligible Tier One Assets in Relation to Fixed Coupon and Zero Coupon Instruments

Residual maturity	Liquidity categories							
	Category I		Category II		Category III		Category IV	
	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon
	<i>Haircuts in %</i>							
0 to 1 year	0.5	0.5	1.0	1.0	1.5	1.5	2.0	2.0
1 to 3 years	1.5	1.5	2.5	2.5	3.0	3.0	3.5	3.5
3 to 5 years	2.5	3.0	3.5	4.0	4.5	5.0	5.5	6.0
5 to 7 years	3.0	3.5	4.5	5.0	5.5	6.0	6.5	7.0
7 to 10 years	4.0	4.5	5.5	6.5	6.5	8.0	8.0	10.0
More than 10 years	5.5	8.5	7.5	12.0	9.0	15.0	12.0	18.0

Source: ECB.

The following haircuts apply to inverse floating rate instruments⁹:

Table 3

Levels of Valuation Haircuts Applied to Eligible Tier One Inverse Floating Rate Instruments

Residual maturity	Inverse floaters coupon
	<i>Haircuts in %</i>
0 to 1 year	2
1 to 3 years	7
3 to 5 years	10
5 to 7 years	12
7 to 10 years	17
More than 10 years	25

Source: ECB.

With regard to the haircut schedule for inverse floating rate instruments, a distinction between instruments with pre-fixed coupons and instruments with post-fixed coupons is no longer necessary. The minimum haircut applied to inverse floaters is

the haircut corresponding to the zero-to-one-year maturity bucket of the liquidity category or group to which the instrument is assigned.

Differentiation of instruments according to liquidity categories was instituted because, as a rule, if it should

⁹ An inverse floating rate instrument is a financial instrument where the rate of interest paid to the holder of the instrument varies inversely with changes in a certain reference interest rate.

become necessary to realize (sell) instruments with limited liquidity, markdowns and/or delays must be expected. Consequently, an appropriate valuation haircut, which is scaled up with increasing residual maturity (the maturity buckets were slightly refined compared to the old framework), is deducted ex-ante from the current market value of the instruments. This means that under the amended framework less liquid instruments are subject to significantly greater haircuts.

The classification of eligible tier two assets remains unchanged and distinguishes between the following four liquidity groups of eligible assets:

1. marketable debt instruments with limited liquidity;
2. debt instruments with restricted liquidity and special features;
3. equities; and
4. nonmarketable debt instruments, including trade bills, bank loans and mortgage-backed promissory notes.

The valuation haircuts shown in table 4 apply to tier two assets.

Table 4

Levels of Valuation Haircuts Applied to Eligible Tier Two Assets					
Residual maturity	Marketable debt instruments with limited liquidity		Debt instruments with restricted liquidity and special features		
	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	
	Haircuts in %				
0 to 1 year	2.0	2.0	4.0	4.0	
1 to 3 years	3.5	3.5	8.0	8.0	
3 bis 5 years	5.5	6.0	15.0	16.0	
5 to 7 years	6.5	7.0	17.0	18.0	
7 to 10 years	8.0	10.0	22.0	23.0	
More than 10 years	12.0	18.0	24.0	25.0	

Source: ECB.

A valuation haircut of 22% is to be applied to all eligible equities.

The following levels of valuation haircuts apply to nonmarketable assets: Trade bills with a maturity of up to six months are subject to a 4% haircut. Bank loans with a maturity of up to six months are subject to a 12% haircut. Bank loans with a maturity between six months and two years are subject to a 22% haircut. Mortgage-backed promissory notes are subject to a 22% haircut.

Previously, the risk control framework for Eurosystem monetary policy operations was based on two components: on the one hand, valuation hair-

cuts were applied to the price/value of the assets provided as collateral, and on the other, initial margins were applied to the credit the ECB extended to a counterparty under a monetary policy operation. In other words, if a participating bank was allotted EUR 100 million in a tender transaction, the basis for calculating the required collateral was EUR 100 million plus the corresponding initial margin (1% or 2%, depending on the maturity of the operation). This was the minimum amount which had to be collateralized. The collateral value¹⁰ of these assets was calculated on the basis of the current (market)

¹⁰ Credit institutions can transfer collateral assets to the central banks within the Eurosystem either in the form of repurchase agreements or in the form of collateralized loans.

value of the underlying assets less the appropriate haircuts. This concept of dual protection was established because, at the time the single operational framework for monetary policy was developed, the assets used in monetary policy transactions were not subject to daily valuation in all euro area countries. As a result, it was possible that assets were accepted on the basis of prices that were no longer current. Consequently, the Eurosystem applied initial margins to offset this market risk. Since, by now, all euro area countries value the assets used for collateralizing Eurosystem credit operations on a same-day basis, it is no longer necessary to apply an initial margin to the amount of liquidity provided and this practice has therefore been discontinued.

Furthermore, the trigger point used in margin calls (the tolerance level for a shortfall in underlying assets which, if not attained, requires the participating central bank to demand additional assets or cash from the counterparty) was reduced from 1.0% to 0.5%, bringing it in line with the lowest level of protection provided under the revised framework (initial margin = 0% and valuation haircut = 0.5%).

In order to guarantee coherence between the new valuation haircut schedules for tier one eligible (i.e. marketable) assets and those for tier two eligible assets, the latter also had to be modified to take into account both the discontinuation of initial margins and the new maturity buckets.

These changes represent another step toward a more precise and transparent valuation of underlying assets.

For Austria, initial comparative analyses indicate the following:

The average valuation haircut applied to the assets included in the pools held by Austrian counterparties seems to have increased only slightly as a result of the amended provisions. The reason behind this is that significantly more than 50% of the instruments (valued according to their market value) fall under liquidity category 1 or are either instruments with limited liquidity or floating rate instruments, which are subject to the lowest haircut within the respective liquidity category.

In addition to the valuation criteria for eligible assets, the requirements for eligible guarantees were specified in greater detail. In some cases, for example, a confirmation concerning the legal validity, binding effect and enforceability of a guarantee will have to be provided before the asset supported by the guarantee can be considered eligible.

5 Conclusions

This study shows that strong interest rate expectations – in this particular case, expectations of key ECB interest rate changes within a given minimum reserve maintenance period – can have a massive short-term impact on the counterparties' bidding behavior if the operational framework for monetary policy is set up accordingly. This is particularly the case when the maturity of the ECB's regular main refinancing operations and the minimum reserve requirements are organized in such a way that tender operations overlap with the subsequent reserve maintenance period. This increases the probability of an undesirable reaction of short-term money market rates, which may go hand in hand with heightened volatility.

The measures described herein are primarily intended to counteract such

movements. As they have come into effect only recently, it is too soon to empirically analyze their full effect. It can be said, however, that the revised concept is a suitable means to further improve the already high efficiency of the operational framework for monetary policy.

In another important area – the regulatory framework for eligible underlying assets – the Eurosystem implemented measures to increase the precision and transparency of the valuation process and adopted a more extensive definition of the criteria for certain credit standards.

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Expansionary Fiscal Consolidations? An Appraisal of the Literature on Non-Keynesian Effects of Fiscal Policy and a Case Study for Austria

Doris Prammer¹

This paper reviews the key theoretical and empirical findings of the literature on non-Keynesian effects of fiscal policy, or “expansionary fiscal consolidations.” Specifically, it seeks to identify why the empirical evidence is rather ambiguous about the effects that fiscal contractions have on private consumption, investment, national saving and output.

The empirical evidence surveyed in this paper is found to provide no clear support for the existence of expansionary fiscal consolidations. The safest conclusion seems to be that fiscal policy has lost some of its ability to stabilize the economy over the recent past.

Austria’s fiscal consolidation of 1995–1997, identified as expansionary by the European Commission, is found to have relied significantly on one-off measures.

1 Introduction

In the 1970s and early 1980s, in times of low nominal growth rates and high nominal interest rates, many European countries were running high deficits, as a result of which public debt rose rapidly. The high debt, in turn, decreased the ability of fiscal policy to stabilize the economy, given the sharp rise in interest expenditure. To tackle this problem, governments initiated fiscal adjustments in the late 1980s. In the EU Member States, these efforts were reinforced in the 1990s to ensure compliance with the fiscal criteria set out in the Maastricht Treaty for participation in the third stage of Economic and Monetary Union (EMU). However, once the founding members of the euro area had been selected in 1998, consolidation efforts were relaxed.

Exacerbated by only very moderate growth since the turn of the millennium, budget balances have consequently worsened considerably in Europe. In order to continue to meet the fiscal criteria established by the Maastricht Treaty and the Stability and Growth Pact and given the implicit financial liabilities posed by ageing populations, many EU Member States these days again face the need to implement major fiscal consolidations. This is true even more so in

the light of EMU enlargement, since sustainable public finances are typically seen as the key prerequisite for monetary stability in EMU.

Policymakers are usually hesitant to introduce fiscal adjustments because standard Keynesian textbook analysis indicates that a fiscal contraction will have a dampening effect on private consumption, output and employment. Yet, there is no consensus on the size or even the sign of the effects that fiscal policy has on economic activity, since a number of studies suggest that a fiscal consolidation might even stimulate economic activity in the short run, i.e. have “non-Keynesian” effects.

In Europe the idea of non-Keynesian effects of fiscal policy, also called “expansionary fiscal consolidations,” was first introduced by German policymakers and economists in the 1980s. The academic debate on expansionary fiscal contractions did not start until years later, sparked by Giavazzi and Pagano (1990), who studied the effects of fiscal policy in Denmark and Ireland in the 1980s. According to this much-cited paper, Denmark and Ireland saw drastic reductions in the cyclically adjusted deficits followed by above-average economic growth. Numerous studies have since sought to identify whether and under what

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conditions fiscal contractions can generate a favorable economic response.

This paper reviews the key theoretical and empirical findings of the literature on non-Keynesian effects. Specifically, it seeks to identify why the empirical evidence is rather ambiguous about the effects of fiscal contractions on private consumption, investment, national saving and output. While some studies find significant positive effects of fiscal contractions on these macroeconomic variables, others fail to find any support for the idea of non-Keynesian effects of fiscal policy.

The paper is organized as follows. Section 2 presents a survey of theoretical work ranging from Keynesian to non-Keynesian approaches. Section 3 discusses empirical work focusing on case studies and descriptive statistics. Section 4 reviews empirical regression analyses and discusses their results. Section 5 provides an Austrian case study based on the referred literature. Section 6 offers some concluding remarks.

2 Some Theoretical Insights: Contractionary or Expansionary Fiscal Consolidations?

2.1 Keynesian Effects

According to the traditional Keynesian textbook view a fiscal consolidation has short-run contractionary effects on domestic demand, national output and employment. While cuts in government expenditure directly reduce aggregate demand, tax increases dampen private consumption indirectly by reducing disposable income. In the Keynesian model, the initial impact on output of a change in fiscal variables is amplified by the fiscal multiplier, which increases with the marginal propensity to consume

out of disposable income. In theory, the Keynesian multiplier exceeds 1; with the ultimate effect on output being larger for a change in government consumption than for a change in taxes. Hence, even small changes in fiscal policy will affect output, which raises the potential of fiscal policy to stabilize the economy.

The exact size of this multiplier, i.e. to which degree crowding out/in through interest rates and openness is experienced, hinges on the given money market and the exchange rate regimes. If demand for money is very sensitive to the interest rate, changes in fiscal policy have a relatively large effect on output.

2.2 Ricardian Effects

The ability of fiscal policy to affect output and its components, as outlined by the standard Keynesian view, has been questioned by the Ricardian equivalence theorem.

The concept of equivalence as such was first introduced by David Ricardo (1820, reprinted 1951), who stated that for a given path of spending, deficit financing (taking into account the intertemporal government budget constraint) is equivalent to tax financing, and cannot be used to influence aggregate demand. Reacquainting the economics community with this equivalence concept, Robert Barro (1974) postulated the following: Agents with rational expectations realize that even governments that finance some extra spending through deficits will eventually raise taxes to be able to repay the borrowed funds. Therefore taxpayers, while being more liquid today because less money is taxed away, will not consume more but save more to pay for the higher taxes that one day will come. According to the Barro/Ricardo equivalence

theorem, deficits will thus affect neither consumption nor the total amount left for investment, implying that the tax multiplier in this model is zero.

The assumptions on which the Ricardo/Barro theory is based are very strong. Relaxing the necessary assumptions by allowing for imperfect foresight, liquidity constraints, distortionary taxation as well as nonaltruistic behavior with respect to bequests can limit the degree of Ricardian equivalence. Most important, in the empirical literature, Ricardian equivalence is highly ambiguous, which would support Ricardo's doubts that his equivalence idea might not work in practice.

2.3 Neoclassical Effects

The third "traditional" school of thought explaining economic effects of fiscal policy is the neoclassical paradigm. Neoclassical economics conceptualizes agents as farsighted, rational actors (like the Ricardian model) with finite life spans (unlike the Ricardian model) and assumes individuals to optimize consumption over their life cycles. In this setup, budget deficits may shift the tax burden to future generations, thus raising total life-time consumption for current consumers. Under the assumption of market clearing, increased consumption implies a reduction in private saving, which in turn causes interest rates to adjust to reinforce balance on the capital market. Thus, permanent deficits in particular crowd out private capital accumulation, which Bernheim (1989) regards as highly detrimental for the economy. For Austria, Zagler (2002), following Elmdorf and Mankiw (1999) quantified the maximal level

effect on GDP that is caused by the reduction in the capital stock – and hence implies reduced production possibilities – at 2.5% of GDP.

2.4 Non-Keynesian effects:

The Expectational View

If a change in current fiscal policy is taken to as a signal for future fiscal action, fiscal adjustments may affect aggregate demand in a different way than the conventional Keynesian view would suggest. According to such an "expectational view of fiscal policy," a fiscal contraction that is perceived to imply a permanent reduction in government spending as a share of GDP will fuel expectations of lower taxes in the future. Future lower taxes increase households' permanent income and thus are assumed to raise current consumption and investment such that aggregate demand increases, resulting in an upturn in output and employment. Being in contrast to conventional Keynesian wisdom, these effects are called non-Keynesian effects.

These ideas have also been introduced into neoclassical models in which individuals are infinitely lived and government consumption is pure waste. A fiscal adjustment designed to reduce wasteful government consumption clearly is associated with an increase in private wealth via reduced future taxation and hence stimulates private consumption.

An added feature of the recent literature on non-Keynesian effects is that it has tried to model nonlinear effects of fiscal policy. These models capture the switch of fiscal policy effects from Keynesian effects to non-Keynesian effects (and vice versa), as triggered by the state of the economy.

2.4.1 Nonlinear Effects in a Keynesian Setup

Blanchard (1990), and later on also Sutherland (1997) and Perotti (1999) introduced models in a Keynesian setup where the effects of fiscal policy on economic variables, above all on private consumption, depend on the level of public debt. In such setups, fiscal policy exhibits the usual Keynesian effects on consumption at moderate levels of public debt and debt accumulation, but develops non-Keynesian effects once debt reaches extreme values. In such models, fiscal policy thus gives rise to nonlinear consumer behavior.

The idea is that at high levels of debt, the amount of taxes necessary to stabilize the debt position induces a significant deadweight loss. The higher the tax rate required to consolidate, the larger the disruptions generated by the adjustment. So, if a consolidation is expected not to induce sharp tax increases in the future to pay back the debt, deadweight losses will be lower. Hence, expected permanent income increases, which positively affects consumption – which implies that a fiscal consolidation can be expansionary. Conversely, an expansion program implemented when the debt ratio is already high is very likely to trigger sharp tax increases to ensure the sustainability of public finances, thereby reducing income in the near future. In that case the effect of the tax hike on life-time income is much larger than the small positive effect of fiscal transfers – which indicates that a fiscal expansion can be contractionary in these times.

As Blanchard (1990) and Sutherland (1997) assume finitely lived consumers, at low levels of debt, consumers perceive the next stabilization program in the distant future when they

are very unlikely to be alive. As the burden of future very distortionary taxes is unlikely to fall on them, they discount future taxes heavily. Hence, the negative effects of a tax increase that does occur outweigh the positive effects of increased sustainability of public finances. Fiscal expansions exhibit the usual Keynesian effects on consumption when the debt ratio is low, since an intergenerational shift of taxes is still deemed possible.

In Perotti (1999) this nonlinear effect of fiscal policy is the result of the coexistence of liquidity constrained and unconstrained individuals. As constrained individuals consume all their disposable income in each period, their consumption function is purely Keynesian. For unconstrained, forward-looking rational consumers a change in government taxation may exert a positive impact due to positive wealth effects from expected lower distortionary taxes. If the stimulus to output induced by an expenditure increase is not able to outweigh the negative wealth effects generated by higher distortionary taxation, consumption will decrease, i.e. non-Keynesian effects may prevail. These non-Keynesian effects are stronger, the higher the debt level is, since higher financing needs imply higher distortionary taxation.

Hence in this model both expenditure and revenue shocks have the usual Keynesian correlation with private consumption in normal times (i.e. when debt ratios are low) due to the reaction function of liquidity constrained consumers. However, in exceptional times the strong non-Keynesian reaction function of unconstrained individuals might outweigh the Keynesian reaction function provided unconstrained individuals account for a high enough share in the

population. Thus the effect of a shock on consumption is the weighted effect on constrained and unconstrained individuals and depends on the level of government debt.

2.4.2 Nonlinear Effects in a Neoclassical Setup

In contrast to the models presented above, Bertola and Drazen (1993) investigate the possibility of nonlinear effects of fiscal policy, above all of government expenditure, in a neoclassical framework. In a neoclassical setup where consumers are infinitely lived and government consumption is pure waste, every cut in government spending increases private consumption. Reduced government spending in these models implies a decrease in the expected future tax burden, which in turn increases life-time disposable income and private consumption. Therefore, in normal times the relationship between government consumption and private consumption is inverse.

However, as government spending is on an upward path, a stabilization program is necessary at specific trigger points to ensure the sustainability of public finances. At very high levels of government spending, agents know that stabilization has to take place, which means that government spending falls sharply. This cut induces expectations that both future spending and the discounted value of future expected taxes will be lower. Thereby individuals' wealth and private consumption are increased. Hence, a further rise of government spending increases the likelihood that stabilization takes place soon, which in turn induces higher consumption.

Even though the model has a neoclassical structure, the result just presented for very high values of government spending (close to the trigger point) has a Keynesian implication – namely that higher government spending induces higher private consumption. So in this model the neoclassical inverse relationship between private and government consumption flattens out and even reverts shortly before consolidation episodes when the ratio of government spending/GDP increases further.

2.5 Nonlinear Effects: Further Credibility Effects

Among others² McDermott and Westcott (1996) highlight the wealth effects on demand induced by changes in interest rates. A country facing high levels of public debt or rapidly increasing public debt might face an interest rate premium on its debt, reflecting the underlying inflation risk or default risk. If a consolidation is perceived to have a permanent debt reducing effect, the sustainability of public finances becomes more credible. Hence inflation expectations as well as the default risk premium should be reduced, both resulting in a decrease of interest rates. This should increase the market value of consumer's portfolios – their wealth – and increase aggregate demand, and especially those demand components that are sensitive to interest rates.

Even though this channel allows for nonlinearities – at very high levels of public debt a fiscal expansion might increase interest rates, thereby reducing wealth and hence demand – it crucially hinges on the credibility of fiscal

² Alesina and Perotti (1997a), Giavazzi and Pagano (1990, 1996), Perotti (1999), Höppner and Assenmacher-Wesche (2001).

policy. If there is doubt in the government's ability to significantly decrease public debt, interest rates will most likely not change.

Furthermore, Auerbach (2002) hints that a theoretical foundation for the very popular view of a simultaneous decrease in real interest rates and higher aggregate demand is hard to derive. Using a simple IS-LM model, he shows that an increase in aggregate demand is usually accompanied by an increase in interest rates – even when expectational effects are taken into account. However, Auerbach (2002) qualifies his analysis as he allows for creative amendments to the simple IS-LM analysis, or supply-side effects that can bring about an increase in aggregate demand and a decrease in interest rates simultaneously.

2.6 Nonlinear Effects: The Supply Side

Alesina et al. (2002) introduce a supply-side model that emphasizes the labor market as the main transmission channel for fiscal policy.³ According to this model an increase in government spending, more particularly in the real compensation of government employees, puts upward pressure on private sector wages. If unions are strong enough to enforce their claims, an increase in the compensation of government employees or alternatively a hike in labor taxation increases overall unit labor cost. Standard assumptions on the link between the marginal profitability of capital and real labor compensation show that an increase in real compensation decreases profits and the shadow value of capital and hence curbs investment. Therefore the model explains an increase in private investment during episodes of fiscal contraction.

In contrast to the demand-side models presented above, in this supply-side model the reaction to fiscal policy does not hinge on initial fiscal conditions such as the level of debt or of government expenditure. It rather depends on the composition of the fiscal adjustment, namely on whether consolidation is brought about by labor tax increases or by cuts in government spending, wage expenditure in particular. At any rate, the Alesina et al. (2002) supply-side model does not incorporate nonlinearities due to the dynamics of fiscal variables, but rather relies on nonlinear effects caused by changes in the composition.

2.7 Some Critical Comments on the Practical Relevance of Theory

As already mentioned above, the theoretical rationale for the emergence of non-Keynesian fiscal consolidations in the models above hinges crucially on

- (a) the assumption of perfectly rational agents,
- (b) the credibility of the adjustment, and
- (c) the composition of the adjustment.

The variable driving private consumption behavior in all four models of the “expectational view” is the effect current policy has on expectations about future policy changes (such as a very high debt ratio). These policy changes are linked to the materialization of a rare and momentous event, and agents have to anticipate the effects of this credibly changed fiscal strategy.

In practice, however, building credibility seems to be a particularly slow and difficult process when it

³ For related work on that channel see Alesina and Perotti (1997b) and Lane and Perotti (2003).

comes to political decisions, since political agents often face a time inconsistency problem. This means that a strategy once adopted as the optimal strategy may cease to be optimal and has to be changed accordingly. In other words, when the framework conditions change, a consolidation policy may have to be reversed. In addition, changing governments often have little incentives to commit to their predecessors' actions, and often reverse at least part of their decisions; thereby not adding to the credibility of fiscal adjustments. Therefore agents that are learning from past errors – one of the major features of rational expectations – might not be willing to give credit to any fiscal consolidation, since they know from past experience that fiscal consolidations have often been reversed.

3 Empirical Evidence

The empirical literature on non-Keynesian effects of fiscal policy is very inhomogeneous not only with respect to the results, but also with respect to the approaches applied. The approaches currently used in the literature can be grouped as follows: Case studies focusing on a small number of countries (see section 3.1); descriptive studies on “successful fiscal consolidations” (see section 3.2.1) and, drawing on the latter, cross-country studies investigating the characteristics of expansionary fiscal consolidations, i.e. trying to identify/describe circumstances that support the emergence of non-Keynesian effects (see section 3.2.2); and finally cross-country or panel regressions testing econometrically for nonlinearities of the effects of fiscal policy on output and its components consump-

tion, investment or national saving (see section 4).

3.1 Empirical Literature: Case Studies

With their case study on large budget consolidations in Ireland and Denmark in the 1980s, Giavazzi and Pagano (1990) sparked the scholarly debate on nonlinear effects of fiscal policy. Denmark and Ireland, first identified by Giavazzi and Pagano as countries that “are the two most striking cases of ‘expansionary stabilization’ in Europe,” (1990, non-technical summary) are cited throughout the literature and have also made their way into macroeconomic textbooks.

3.1.1 Denmark and Ireland

Giavazzi and Pagano (1990)⁴ investigate in detail the periods of fiscal turnaround in Denmark in 1983–1986 and in Ireland in 1982–1984 and 1986–1989, periods in which the full employment deficit decreased by at least 7% of GDP, respectively. In Denmark, consolidation was followed by a strong expansion, as was the second consolidation round in Ireland (whereas after the first round, GDP growth had fallen considerably). Both expansionary consolidation periods were accompanied by concomitant monetary and exchange rate policies: an initial sizeable devaluation was followed by a currency peg to the Deutsche mark, which resulted in a dramatic decrease in nominal interest rates as well as disinflation. Furthermore capital flows were liberalized considerably and wage moderation helped to improve competitiveness in both countries.

At the same time, the two consolidation patterns differ in terms of composition: whereas the Danish gov-

⁴ Related work has been done by Alesina and Perotti (1997a).

ernment relied heavily on tax increases – mostly on direct taxation – the Irish consolidation was mostly achieved on the expenditure side; brought about by lower government transfers, a lower government wage bill and reduced investment. Simultaneously, the tax base was broadened while marginal tax rates on household income and corporate tax rates were reduced considerably.

As the overall findings were only partially supporting the existence of non-Keynesian effects the authors state that “part of the expansionary effects of the fiscal contractions analysed here must be attributed to the concomitant monetary disinflation, [...] and the liberalisation of capital flows.” Nonetheless, they conclude: “that there are cases in which the “German view”⁵ has a serious claim to empirical relevance” (Giavazzi and Pagano, 1990, p. 32).

Their conclusions are, however, highly controversial as fiscal policy was evidently not the major driving force behind the observed increase in growth rates. Summarizing the major criticism⁶ Eichengreen (1998, p. 256) states: “For Denmark and Ireland in the 1980s, for example, analysts argue that fiscal consolidation occurred during the period of the soaring US dollar; the favourable competitiveness effects of these countries’ depreciating real exchange rates therefore swamped the negative output effects of the contractionary fiscal impulse.” For Ireland, Blanchard (2000, p. 337) adds that “Productivity was increasing much faster than real wages, reducing the cost of labour for firms. Attracted by tax breaks, low labour costs and an educated la-

bour force, many foreign firms were coming to Ireland to create new plants.”

3.1.2 Other Countries

Taking into account some criticism, a more cautious subsequent study was provided by Alesina and Ardagna (1998), who focused on ten fiscal adjustments in the 1980s and 1990s. Only two out of the ten were classified as unambiguously expansive, namely Ireland 1987–1989 and Australia 1987. These consolidation episodes share sizeable devaluations as well as the policy of wage moderation, generating a boost in competitiveness.

Interestingly, the often cited case of Denmark was only considered as mixed evidence, since even though during the adjustment the economy was clearly expanding, in the immediate aftermath Denmark experienced a severe downturn.

3.1.3 Interpretation of Findings

To sum up the evidence of the case studies referred to above, it seems that the effects of fiscal policy can hardly be assessed on their own. As so many extraordinary factors are affecting the economy at the same time it is difficult to filter out the effects of fiscal policy keeping a *ceteris paribus* assumption, since mostly a significant change in fiscal policy was just part of a whole “policy package.” As Giavazzi and Pagano (1990, p. 33) state “This expansionary effect, however, crucially hinged upon the credibility of the fixed parity chosen by the monetary authorities: it is remarkable that in both our cases of “expansionary contractions” the shift in fiscal and exchange rate policy was preceded by a

⁵ *The German view states that an exceptional fiscal consolidation positively affects aggregate demand.*

⁶ *See also Barry (1991), Barry and Devereux (1995), and Andersen and Risager (1988).*

sizeable devaluation.” Whether accompanying structural reforms such as changes in wage systems or in monetary policy were unintended or in fact designed to minimize the adverse effects of fiscal policy has not been analyzed. Furthermore, as the case studies refer to specific countries in very specific situations, one should be hesitant to generalize the patterns observed in these countries.

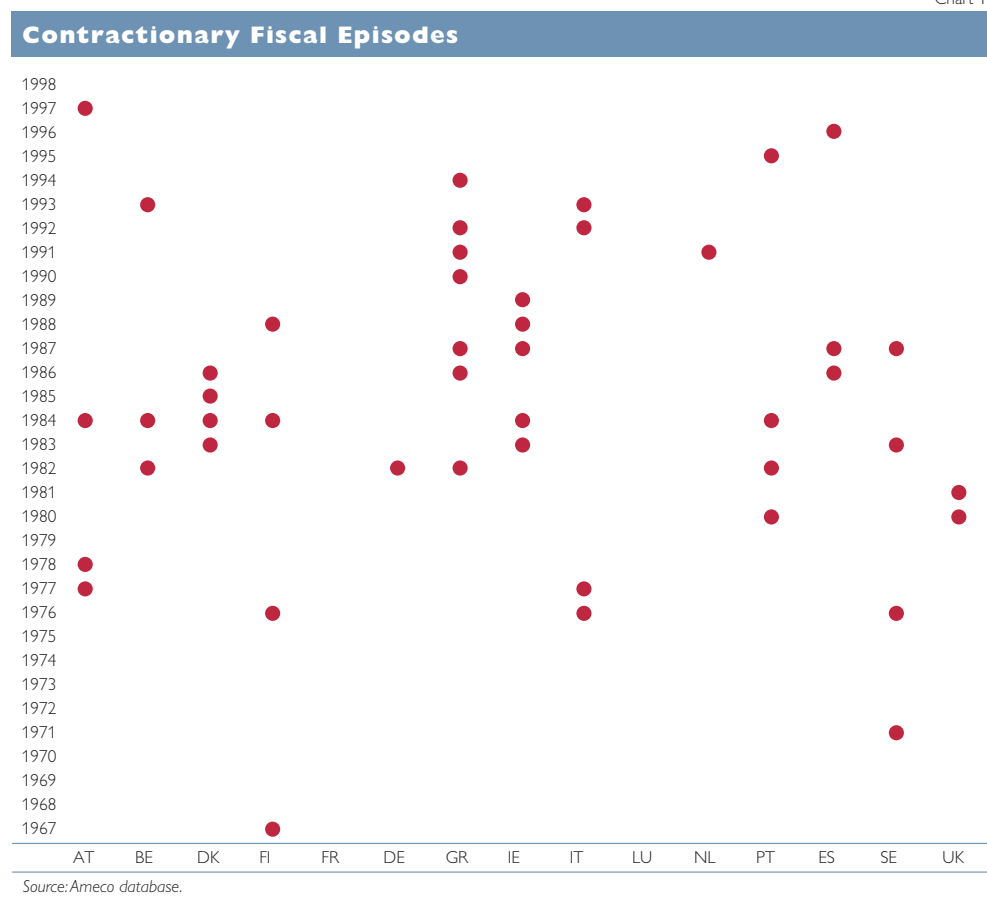
**3.2 Empirical Literature:
 Descriptive Evidence**

Based on observations from the case studies, attempts have been made to identify systematic characteristics of

exceptional fiscal periods and their effects on the economy.

A common theme of the closely related strands of literature on the characteristics of “successful fiscal policy” and on those of “non-Keynesian effects” is the attempt to identify periods of fiscal policy in which non-Keynesian effects are likely to be observed. Clearly, that literature draws heavily on the theoretical idea that non-Keynesian effects can only be observed in “exceptional” periods, which are typically defined as periods with large changes in cyclically adjusted primary balances, or alternatively periods of large and growing debt.⁷

Chart 1



⁷ To give one example, the European Commission (2003) defines fiscal consolidation periods such that the cyclically adjusted primary budget balance improves by at least 2 percentage points of GDP at time *t* or by at least 1.5 percentage points in each of two consecutive years.

Naturally due to the arbitrariness of the different definitions applied, the periods identified as exceptional fiscal episodes in individual studies vary considerably. Chart 1 indicates years which have been identified as contractionary fiscal episodes in at least half⁸ of the seven studies investigated, and hence can be considered as robust fiscal episodes.⁹

A closer look at some of the – seemingly very robust – remaining “exceptional” episodes uncovers further problems with the methods used and the underlying data. According to Alesina and Ardagna (1998) the consolidation periods identified in Spain in the period 1986–1987 should be excluded, since the improvement in the budget balance reflects high growth rates rather than discretionary fiscal policy measures. Due to methodological limitations of cyclical adjustments, part of the changes in the budget balance was incorrectly attributed to discretionary fiscal policy.

However, the episodes identified as strong fiscal contractions are not only subject to the definition applied and cyclical adjustment methods, but also to special influences – temporary measures – underlying the data. In the run-up to EMU, some EU countries relied particularly heavily on temporary measures to improve their budget balances. Hence most likely, the episodes identified in the different studies are not very robust, neither with respect to the definitions chosen, nor with respect to taking account of external/exogenous factors, such as temporary measures.

3.2.1 Successful Fiscal Policy Episodes

Further refining the concept of consolidation, part of the literature pays particular attention to “successful fiscal consolidations.” A successful consolidation is interpreted such that the debt/GDP ratio is reduced by a specified amount during/after the consolidation.

Even though this strand is not directly assessing non-Keynesian effects of fiscal policy, it is included in this literature survey because, in a way, it has paved the way for the descriptive literature on non-Keynesian effects of fiscal policy and because it is also (wrongly) used for policy advice on non-Keynesian effects.

Alesina and Perotti (1995, 1996, 1997a), McDermott and Westcott (1996), Alesina and Ardagna (1998), Alesina et al. (1998), Giavazzi and Pagano (1990)¹⁰ and Zaghini (1999) divide the consolidation periods into expansionary and nonexpansionary episodes and investigate the underlying asymmetries of successful and unsuccessful adjustments. In addition, Köhler-Töglhofer and Zagler (2004) find that the very characteristics supporting the reduction of debt/GDP ratio during consolidation periods also keep public finances on a sustainable path during fiscal expansions.

The main and almost unambiguous findings are that a successful fiscal adjustment is characterized by expenditure cuts rather than tax increases. Furthermore, expenditure cuts in successful consolidations fall mostly on cuts in transfer payments and government wage expenditure. Consolida-

⁸ As a result, the chart may not fully reflect the episodes referred to in the text (Austria and Ireland being cases in point).

⁹ Contractionary episodes of the following studies were investigated: Afonso (2001), Alesina and Ardagna (1998), Alesina and Perotti (1995), Alesina and Perotti (1996), Giavazzi et al. (2000), McDermott and Westcott (1996), Zaghini (1999).

¹⁰ Not derived by comparative statistics, rather by regression.

tions that rely heavily on increases in taxes, above all direct taxes on households and indirect taxes, and include very little expenditure cuts, tend to be unsuccessful. However, there is no consensus as to whether the size of the fiscal consolidation makes a difference between successful and unsuccessful episodes.

With respect to differences in macroeconomic variables between successful and unsuccessful consolidation periods, advocates of this literature conclude that GDP growth rates are higher in successful than in unsuccessful consolidations. Investment booms, private consumption grows, unit labor costs decrease and profits increase as well as trade balances improve during and after successful consolidations.

As revenue and expenditure items are sensitive to the cycle, asymmetries in the composition observed between successful and unsuccessful consolidations – such as less transfer payments during and immediately after successful adjustments – might be due to different positions in the cycle. Following Eichengreen (1998, p. 256) “An alternative interpretation, therefore, is that when there is sustained acceleration in growth for reasons having little to do with fiscal policy much of the induced reduction in the deficit takes the form of a fall in government transfers.”

Altogether, the literature on successful consolidations is mainly of a descriptive nature – simply comparing mean values, and therefore not able to take into account all possible correlations and causalities, as McDermott and Westcott state (1996, p. 741): “Given the interactions between economic growth and changes in public debt ratios, it is difficult to distinguish between the contribution of good

growth to successful consolidations and the effect of successful consolidations in boosting demand and growth.”

3.2.2 Non-Keynesian Fiscal Policy Episodes

Drawing on the experiences of the literature on successful consolidations, Alesina and Ardagna (1998), Alesina et al. (2002) and the European Commission (2003) investigate the characteristics of expansionary fiscal consolidation. They define periods of expansionary tight fiscal policy such that some measure of GDP growth (either actual growth, trend growth or the growth difference from G7 average rates) is higher on average during and after the consolidation than before.

In contrast to the literature on successful fiscal consolidations, the focus is now on the development of GDP growth rather than on the development of the debt ratio. However, the characteristics identified to influence the likelihood of expansionary fiscal consolidations turn out to be similar to those accompanying successful fiscal consolidations.

Whereas Alesina and Ardagna (1998) argue that expansionary adjustments are much larger than contractionary ones, the European Commission (2003) suggests that the size of the adjustment is not significantly different. At the same time, there is unambiguous consent among the authors that the composition of the adjustment plays a key role in determining whether the adjustment will have expansionary or nonexpansionary effects. Expenditure-based consolidations are more likely to be expansionary than consolidation periods based on revenue increases. Alesina and Ardagna (1998) and Alesina et

al. (2002) find that cuts in transfer spending as well as in government wages are characteristic for expansionary fiscal consolidations; a statement that is not verified by the European Commission, which does not find a significant difference in the development of the compensation of public employees.

Concerning the macroeconomic environment, the finding that growth is higher during expansionary consolidations is not surprising, given the definition of expansionary consolidation chosen. When the definition of expansionary fiscal policy is conditioned on higher growth rates after a consolidation, this is what one should actually be able to observe.

In order to avoid the argument that macroeconomic developments are mainly caused by accompanying monetary policy, the European Commission isolates so-called “pure expansionary consolidations,” which comprise roughly half of their “expansionary fiscal consolidations.” These episodes are characterized by fiscal consolidations in which the average change in real short-term interest rates between $t-1$ and $t+1$ is nonnegative. However, for running the comparative statistics, the European Commission does not apply this distinction but uses all episodes of expansionary fiscal consolidations.

We extend the European Commission statistics on pure expansionary fiscal consolidations to assess the composition and macroeconomic effects, once concomitant monetary policy is excluded. The striking difference is that compositional differences between pure expansionary fiscal consolidations and nonexpansionary consolidations are no longer significant. Hence, it seems that it is not the composition that is the driving factor be-

hind expansionary fiscal consolidations, but rather monetary policy. However, the macroeconomic environment is the same as under expansionary fiscal consolidations and significantly different from nonexpansionary fiscal consolidations.

4 Empirical Estimations

Empirical tests of theoretical hypotheses of non-Keynesian effects employ a number of different methods and focus on various components of growth. Following various theories, the regressions intend to capture the wealth effect that arises when the expected size of permanent income is altered due to different expectations about the tax path.

The variables on which non-Keynesian effects of fiscal policy are investigated are: The effects of fiscal policy on consumption (see section 4.1); effects of fiscal policy on national saving (see section 4.2.1); effects of fiscal policy on investment (see section 4.2.2) and effects of fiscal policy on GDP (see section 4.3.4).

4.1 Effects of Fiscal Policy on Consumption

Van Aarle and Garretsen (2003), Afonso (2001), Hjelm (2002), Höppner and Assenmacher-Wesche (2001), Miller and Russek (2003), Perotti (1999) and Giavazzi and Pagano (1996) all focus on non-Keynesian effects on a consumption function, mostly using cross-country/panel estimations for (a subsample of) OECD countries. Common to their estimation procedures is that they assume the existence of two different regimes: a Keynesian regime prevailing during “normal” times, and a non-Keynesian predominant in “exceptional” times. Exceptional times are defined in line with the ad hoc defini-

tions in the descriptive literature, either as large changes of cyclically adjusted primary balances; as strong fiscal contractions or expansions; or as times of high debt levels. These distinct regimes are intended to represent periods in which different expectations of the future tax paths are prevailing. Hence, this switch in expectations is empirically captured by a sign reversion of the effects of fiscal policy on macroeconomic variables, which is in line with the theory referred to above. Econometrically, the authors introduce dummy variables to capture the effects of the two different regimes.

Reviewing the empirical literature with respect to the regression methods applied, this paper assesses the results by Giavazzi and Pagano (1996) together with those of Aarle and Garretsen (2003), since the latter replicate the model designed by Giavazzi and Pagano. Both studies estimate various specifications of that type; whereas Giavazzi and Pagano test the robustness of the equations with respect to different estimation techniques, van Aarle and Garretsen test the robustness with respect to various definitions of exceptional fiscal episodes.

Depending on the different specifications applied, Giavazzi and Pagano (1996) find significant non-Keynesian effects with respect to roughly one-quarter of the estimated fiscal variables.¹¹ Van Aarle and Garretsen (2003) – focusing on the effects of fiscal adjustments of EU countries from 1990–1998 – can hardly support the existence of non-Keynesian effects of fiscal policy on consumption, since none of the estimated regimes turns

out to differ significantly from the other.

The second group of authors – Afonso (2001), Miller and Russek (2003) and Perotti (1999) – are interested not only in non-Keynesian effects but also assess the possibility of nonlinear effects of fiscal policy on consumption during different regimes. These nonlinear effects indicate whether the original effect of fiscal policy is changed – weakened – during exceptional times. Only in a second step do the authors assess whether the resulting non-linear effects are truly non-Keynesian.

This paper compares their results with respect to three definitions of exceptional fiscal episodes applied, namely a large change in the cyclically adjusted primary balance (Miller and Russek, 2003, Afonso, 2001); high debt levels (Perotti, 1999); and strong fiscal contractions or expansions. Judging from table 1 below, government expenditures are more likely to exhibit nonlinear effects on private consumption than government revenues. However, the empirical evidence is rather inconclusive, not only because the estimated effects in the studies are mostly not significant, but comparing the partly contradicting conclusions of the studies considered results in an even stronger inconclusiveness. Whereas Miller and Russek (2003) find only Keynesian effects during fiscal contractions, Afonso (2001) reports non-Keynesian effects during fiscal contractions. In contrast to this, Miller and Russek (2003) report non-Keynesian effects for fiscal expansions, whereas Afonso (2001) does not find any evidence

¹¹ *The fiscal variables are tax changes, lagged taxes, transfer changes, lagged transfers, public consumption changes, lagged public consumption.*

Table 1

		Exceptional episodes		Fiscal contractions		Fiscal expansions	
		expenditure	revenue	expenditure	revenue	expenditure	revenue
Afonso 2001	EU-15 panel	nonlinear (not sign.)	non-Keynesian (not sign.)	non-Keynesian (not sign.)	non-Keynesian (not sign.)	nonlinear (not sign.)	Keynesian
Miller und Russek 2003	OECD 19 panel	not estimated not estimated	not estimated not estimated	Keynesian (sign.)	Keynesian (sign.)	nonlinear (not sign.)	nonlinear (not sign.)
Perotti 1999	OECD 19 VAR	non-Keynesian (sign.)	non-Keynesian (? sign.)	not estimated	not estimated	not estimated	not estimated

Source: Author's compilation.

for non-Keynesian effects during exceptional government expansions.

In contrast to these two analyses, Perotti (1999) finds not only nonlinear effects between normal and exceptional times, but also non-Keynesian effects of government expenditure. Using a VAR framework to derive unexpected fiscal policy shocks, Perotti (1999) is only interested in assessing the effects of these shocks on private consumption, but “the results presented here have nothing to say about the effects of systematic fiscal policy as a stabilizing tool” (Perotti, 2002, p. 2).

In contrast to the authors above, Höppner and Assenmacher-Wesche (2001) use a Markov-switching approach, which allows for an endogenous determination of the two different regimes – Keynesian and non-Keynesian. Interestingly, the dates of the regime shifts do not correspond to any consolidation or expansion period identified in the literature, but they all fall into periods of business cycle downturns.

To sum up the results of the studies discussed above, empirical evidence does not appear to give an unambiguous answer about the existence of non-Keynesian effects on private consumption. Only a few out of a large number of empirical estimations in fact find non-Keynesian results on private consumption – not even taking

into account the problem of endogeneity or concomitant monetary policy.

4.2 Effects of Fiscal Policy on National Saving, Investment and GDP Growth

4.2.1 ... on National Saving

Giavazzi et al. (2000) find that the effect of fiscal policy on national saving is at odds with the Ricardian equivalence theorem. Even though nonlinearities in the national saving behavior are observed during exceptional times, the original effects during normal times are never reversed completely but continue to follow the traditional theory.

4.2.2 ... on Investment

Alesina et al. (2002) find that an increase in government spending during expansions reduces business investment, which is consistent with the supply-side model of the labor market channel. Taxes reduce investment dynamics, but their effect is much smaller than that of government expenditure.

As fiscal consolidations usually incorporate some kind of spending reductions, increases observed in private investment are to be attributed to the labor market channel of the supply-side model. The fact that investment rises even though government spending is cut, has also been observed in the descriptive analysis

of expansionary fiscal contractions. In other words, since no structural breaks have been found, business investment obviously does not react differently in normal and exceptional periods. So what makes a difference in terms of business investment growth is not the presence or absence of consolidation measures, but rather the composition of fiscal policy in general. This might be the reason why the authors question “the need for ‘special’ theories for large versus small changes in fiscal policy” (Alesina et al., 2002, p. 586).

4.2.3 ... on GDP Growth

Probably closest to the literature on consumption are Miller and Russek (2003), since they explicitly differentiate between different regimes when regressing the effects of fiscal policy on GDP growth. However, as their evidence on non-Keynesian effects of fiscal policy was rather inconclusive, the authors state that “The findings cast some doubt on the possibility that unusual fiscal outcomes reflect some systematic relationships in the macro economy. Rather, special circumstances and conditions may dictate when and where unusual fiscal outcome emerge” (Miller and Russek, 2003, p. 57).

Without allowing for two different regimes, in particular not explicitly allowing for exceptional times, von Hagen et al. (2001), Blanchard and Perotti (2002) and Perotti (2002) provide evidence that the impact of fiscal policy is generally rather small and decreasing over time. An

explicit distinction between pre-1980 and post-1980 effects in Perotti (2002) unveils that in the post-1980 period, unexpected government spending shocks exert significantly negative effects on output growth within the first three years after the shock in most of the investigated countries. On impact, fiscal policy thus tends to exhibit the usual Keynesian effects. Hence, in the short term the effects of fiscal policy mostly remain Keynesian even from 1980 onwards, which may change as time progresses. Furthermore, as these studies only focus on the effects of shocks, evidence on the existence of non-Keynesian effects of fiscal policy – not only of fiscal innovations – remains rather weak.

5 Austrian Case Study

This case study is intended to improve awareness of underlying methodological problems, in particular with respect to temporary measures. We assess the fiscal episode 1995–1997 since this episode was identified as an expansionary fiscal consolidation before the third stage of EMU by the European Commission.¹²

As in 1995 the cyclically adjusted primary balance only improved by 0.2 percentage points, and the consolidation package was only introduced in April 1996, we concentrate our analysis on the more important years 1996 and 1997.¹³

This consolidation package basically relied on revenue-raising measures such as abandoning exemptions from wage and personal income taxa-

¹² The period 1995–1997 was identified as expansionary with respect to the persistence criterion by the EC. This criterion required that the primary cyclically adjusted budget balance improves by at least 3 percentage points of GDP over three consecutive years and in each year the change in the primary cyclically adjusted budget balance cannot be below –0.5 percentage point of GDP. The periods chosen to assess the growth effects follow the methodology of the European Commission.

¹³ For details on the consolidation packages please see Brandner and Diebalek (2000).

Table 2

Austria's fiscal consolidation 1996–1997									
Consolidation year	Cyclically adjusted primary balance				Average real GDP growth		Cyclical condition		
	t-1	t	t+1	t+2	(t-2)-(t-1)	t-(t+2)	peak	trough	
1996	-0.7	0.70	2.50	1.40	2.00	2.80	1996	1998	
1997	0.7	2.50	1.40	1.10	1.60	3.40	1996	1998	

Source: Statistics Austria, Economic Cycle Institute.

tion and the introduction of an energy tax on electricity and natural gas. At the same time, expenditure measures were enforced, including a virtual freeze in nominal salaries, a reduction of the public payroll by 11,000 persons and cuts in the transfer system. In other words, the government opted for a mixed consolidation package.

In 1997, moreover, one-off measures contributed heavily to the improvement of the primary cyclically adjusted budget balance. The privatization of ASFINAG (the public sector road construction company) and of public utilities (providers of waste sewage disposal services and water suppliers) reduced government nominal investment expenditure from 2.8% of GDP in 1996 to 2% of GDP in 1997. Payments from PSK, the Austrian postal savings bank, and telecommunication licensing proceeds provided additional revenues of approximately 0.5% of GDP. In other words, the strong tightening of the fiscal stance was mainly an artefact resulting from one-off measures. Had it not been for the additional revenues and expenditure cuts arising from one-off measures, 1995–1997 would not even qualify as a consolidation period according to the European Commission's definition in Austria. Furthermore, it is not yet clear whether outsourcing has indeed short-run growth effects.

Moreover, this strong consolidation was not long lasting at all, since the fiscal stance was relaxed quite sig-

nificantly in 1998, deteriorating to 1.4% of GDP, which implies a deterioration of 1.1 percentage points from 1997.

To analyze the timing of Austrian fiscal consolidations, this paper looked at the growth rate cycles at the respective periods. Interestingly enough, the consolidation started in a period of accelerating growth rates, which implies that the consolidation could profit from good economic conditions. However, it seems that the fiscal consolidations were not able to extend the episodes of accelerated growth, but rather curbed them significantly, as the trough of the business cycle was identified in 1998.

6 Concluding Remarks

Even though the theoretical rationale for the existence of non-Keynesian effects of fiscal policy is straightforward, its empirical relevance crucially hinges on whether consolidation efforts of governments are credible. However, gaining credibility – apart from being a tough challenge – is a gradual process.

This might be one reason why the empirical evidence on expansionary fiscal contractions is rather weak. Some authors find unambiguous evidence for the existence of non-Keynesian effects of fiscal innovations, but the majority of the papers comes up with rather inconclusive answers. Comparing the partly contradicting conclusions of the studies considered results in an even stronger inconclusiveness.

The empirical evidence surveyed in this paper provides no clear support for the existence of expansionary fiscal consolidations. The safest conclusion seems to be that fiscal policy has lost some of its ability to stabilize the economy over the recent past during the 1990s. Possibly this diminishing power of fiscal policy is associated with the opening of economies and the rather fast integration of good

markets in Europe together with the liberalization of capital markets. Moreover, the Maastricht Treaty and the Stability and Growth Pact, which changed the fiscal framework in the 1990s, as well as the debate on the sustainability of pension systems for ageing societies may also have weakened the short-term effectiveness of fiscal policy in stabilizing output and employment.

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The Draft Treaty Establishing a Constitution for Europe – Institutional Aspects of Monetary Union

On June 18, 2004, the Intergovernmental Conference (IGC), constituted by the European Heads of State or Government, reached an agreement on the Treaty establishing a Constitution for Europe which provides a new, consistent legal architecture for the EU. The legal and institutional framework for the European System of Central Banks (ESCB), the European Central Bank (ECB) as well as for the single monetary policy is defined in both the constitutional provisions of Part I and the policy areas of Part III of the Constitutional Treaty. The Statute of the ESCB/ECB is attached to the Treaty as a protocol.

The constitutional provisions (Part I) not only define price stability as one of the EU's general objectives, but also confirm the *sui generis* nature of the ECB as enshrined in the Treaty on European Union. The Constitutional Treaty integrates the concept of "Eurosystème" and incorporates into primary legislation that the euro be defined as currency unit and symbol of the Union.

In the field of monetary union (Part III), a number of new provisions, which only apply to the euro area Member States, have been created. The procedure for amending the provisions on Economic and Monetary Union (EMU) have been simplified; however, this simplified amendment procedure does not apply to the constitutional provisions. Under certain circumstances, monetary policy decisions may be taken by super-qualified majority.

In principle, the Constitutional Treaty does not entail any change in substance in the field of monetary union and the amendments are largely of a technical nature. Thus, the framework conditions for monetary union as embodied in the Treaty on European Union have been reaffirmed.

Isabella Lindner,
Paul Schmidt

1 Introduction

The IGC started its proceedings on October 4, 2003, and at the European Council meeting in Brussels on June 18, 2004, reached an agreement on the Treaty establishing a Constitution for Europe.¹ The final draft will be submitted to the Member States for ratification, and the Constitutional Treaty shall – from the present point of view – enter into force on November 1, 2006.

In accordance with Article 48 of the Treaty on European Union, the European Central Bank (ECB) contributed to the IGC on institutional changes in the monetary area. The Governing Council of the ECB established a Task Force on the EU Draft Constitution which discussed the possible implications for institutional changes on the ESCB/Eurosystème and the ECB and developed the strategic

positioning of the Governing Council of the ECB. On September 19, 2003, prior to the IGC, the Governing Council of the ECB adopted an official opinion on the relevant aspects of the new Constitutional Treaty. Subsequently, the President of the ECB, Jean-Claude Trichet, communicated further monetary policy positions of the ECB Governing Council (ECB, 2003c; ECB, 2004a) to the respective Council presidencies.

This article describes the aspects of the Constitutional Treaty that are relevant to the ESCB/Eurosystème and aims to analyze the implications of the amendments to the Treaty, taking into account as much as possible the conclusions of the Working Party of IGC Legal Experts, which revised the Constitutional Treaty at the technical level, and the results of the ECB Task Force discussions.²

¹ In the following, the Treaty establishing a Constitution for Europe will be referred to as Constitutional Treaty.

² At the editorial close, the most recent material available to the authors was a consolidated version of the draft Constitution (CIG 87/04; CIG 87/04 add1 and add2) already containing a continuous numbering of Treaty articles.

Refereed by
Thomas Wagner,
Legal Division.

2 General Remarks

2.1 The Architecture of the Constitutional Treaty

The draft Constitution establishes a consistent constitutional architecture replacing the three-pillar structure of the set of existing treaties. Following a preamble, the Constitutional Treaty is divided into four main parts and a number of protocols, including the protocol on the Statute of the ESCB and the ECB, as follows:

- Part I “Constitutional Provisions,”
- Part II “The Charter of Fundamental Rights of the Union,”
- Part III “The Policies and Functioning of the Union,”
- Part IV “General and Final Provisions.”

Part I, Part III and the relevant protocols contain the legal and institutional underpinnings of the ESCB/Eurosystem, the ECB and the single monetary policy.

In this context, the question emerged whether the constitutional provisions of Part I are supreme over Part II, Part III and Part IV. So far, the European Court of Justice has considered all parts of the Treaty on European Union equal. However, the provisions in Part I of the Constitutional Treaty, which, *inter alia*, specify the institutional framework, prevail over the provisions of the other parts in so far as their amendment requires convening an IGC. By contrast, “Internal Policies and Action” (Part III, Title III) and thus also the provisions on monetary union are subject to a simplified amendment procedure. However, the ESCB/Eurosystem takes it for granted that

the various parts and titles as well as the protocols of the Constitutional Treaty are basically considered equal.

In conclusion, the Constitutional Treaty encompasses two amendment procedures for the provisions on monetary union:

- Regular amendment procedure: If the amendments are comprehensive, the President of the European Council shall call a Convention³ which examines the proposal and adopts by consensus a recommendation to the IGC. The amendments enter into force after being ratified by all the Member States in accordance with their respective constitutional requirements (Art. IV-443).⁴
- Simplified amendment procedure: “Internal Policies and Action” (Part III, Title III) and thus also the provisions on monetary union can be amended by a simplified amendment procedure. The European Council may adopt a European decision amending all or part of the above mentioned provision, acting by unanimity after consultation of the European Parliament and the Commission and, in the monetary area, the ECB. Such a European decision does not come into force until it has been approved by the Member States in accordance with their respective constitutional requirements. The application of this procedure implies that some provisions of the Constitutional Treaty may be amended without calling a Convention or an IGC (Art. IV-445).

³ *The European Council may decide by a simple majority, after obtaining the consent of the European Parliament, not to convene the Convention should this not be justified by the extent of the proposed amendments (Art. IV-443 (2)).*

⁴ *If, two years after the signature of the treaty amending the Treaty establishing the Constitution, four fifths of the Member States have ratified it and one or more Member States have encountered difficulties in proceeding with ratification, the matter shall be referred to the European Council (Art. IV-443 (4)).*

2.2 Monetary Policy Decision-Making by Qualified and “Super-Qualified” Majority

Current practice already requires a qualified majority in the Council for a large part of monetary policy decisions. The Constitutional Treaty does not provide for a significant extension of the scope of qualified majority voting. However, the Treaty stipulates that where Part III provides that the Council should act by unanimity, the European Council may adopt a European decision authorizing the Council (e.g. the Ecofin Council) to act by qualified majority⁵ (Art. IV-444). Under certain circumstances, decisions in the field of monetary union can be taken by “super-qualified” majority. Decisions regarding the following areas relevant for monetary policy now require either a qualified or a super-qualified majority:

- So far, the Council has been able to amend the ESCB/ECB Statute on a recommendation from the ECB and by qualified majority. An amendment proposed by the European Commission would have required unanimity in the Council. The Constitutional Treaty lays down that the Council decides on a proposal from the European Commission by qualified majority and on a recommendation from the ECB by super-qualified majority⁶ (Article III-187(3)). This strengthens the position of the European Commission vis-à-vis the ECB.

- The Council, on a proposal from the Commission and after consulting the ECB, may adopt appropriate measures to ensure a unified representation within the international financial institutions and conferences (Art. III-196(2)). Only members of the Council representing Member States whose currency is the euro are entitled to vote; decisions are made by qualified majority.
- The President, the Vice President and the other members of the Executive Board of the ECB are appointed by the European Council, acting by a qualified majority (Art. III-382 (2)).

The higher blocking minority threshold compared with the Treaty of Nice could make it more difficult to block majority decisions. The increase of both the super-qualified and the qualified majority thresholds might only slightly accelerate the decision-making process in the Council.

2.3 EU Legislative Acts

In exercising the competences conferred on it in the Constitutional Treaty, the EU will use European laws, European framework laws, European regulations, European decisions, recommendations and opinions (Article I-33). When authorized to do so (Art. I-35), the ECB will adopt European regulations and European decisions as well as recommendations and opinions (Art. III-190).

⁵ *If the Council acts upon a proposal of the European Commission or the European Foreign Affairs Minister, from November 1, 2009, this will require a qualified majority representing at least 55% of the Member States, i.e. at least 15 Member States and at least 65% of the Union’s population. At least four Member States, representing more than 35% of the Union’s population, are required to form a blocking minority.*

⁶ *If the Council acts upon a recommendation of the ECB in the field of EMU, from November 1, 2009, this will require a super-qualified majority representing at least 72% of the Member States comprising at least 65% of the Union’s population (Art. I-25(2), Conference, 2004).*

The ECB may adopt European regulations (formerly called regulations) for instance on the definition and implementation of the single monetary policy, on payment and settlement systems, on specific tasks relating to prudential supervision of credit institutions, on the capital and the capital subscription of the ECB or on the transfer of foreign reserve assets (see Article III-190.1(a)).

As European laws or framework laws are legislative acts, they have precedence over European regulations adopted by the ECB. This is mainly relevant for those areas which do not exclusively fall within the fields of competence of the ECB (e.g. payment systems).

3 Part I of the Constitutional Treaty: Constitutional Provisions

3.1 The Primary Objective of Price Stability

The Treaty on European Union defined the promotion of “non-inflationary growth” and “stable prices” as one of the objectives of the Union. The Constitutional Treaty now includes the concepts “balanced economic growth” and “price stability” (Art. I-3). Part I also explicitly states the primary objective of the European System of Central Banks to maintain price stability (Art. I-30). Another reference to price stability, which is the primary objective of the single monetary and exchange rate policy, can be found under Article III-177.

The application of the simplified amendment procedure for Part III made it even more important that price stability has been integrated in the objectives laid down in Part I of

the Constitutional Treaty. This implies that price stability is not only an operational objective of the ESCB/Euro-system but an objective that is binding for both the Union and its Member States.

3.2 Monetary Policy – An Exclusive Competence of the Union

Article I-12 stipulates the division of responsibilities between the Union and the Member States, according to which the Union has exclusive competence in the field of monetary policy for the Member States whose currency is the euro (Article I-13(c)). While the Union may legislate and adopt legally binding acts, the Member States may do so themselves only if so empowered by the Union or for the implementation of Union acts (Article I-12 (1)).

The Constitutional Treaty does not provide a definition of the concept “monetary policy”. The ESCB/Euro-system has adopted a broad interpretation of the concept monetary policy, referring to Article III-185, which describes the basic tasks to be carried out through the ESCB.

Primary legislation now stipulates that the currency of the Union is the euro, which is also listed under the symbols of the Union (Article I-8).

3.3 The ECB as an Institution Sui Generis

The Constitutional Treaty lists the ECB, together with the Court of Auditors and the advisory bodies⁷ as “the other Union institutions and advisory bodies” (Article I-30). However, when the institutional structure of the ESCB had been defined by the Treaty on European Union, the ECB had deliberately not been classified

⁷ *Committee of the Regions and the European Economic and Social Committee.*

as an institution of the Community. As the draft Constitution does not list the ECB among the political institutions, such as the Council, the European Commission or the European Parliament, the ESCB/Eurosystem presumes that the ECB is an institution *sui generis* and that the new institutional classification of the ECB does not imply any substantial change.

Article I-30 defines the concept “ESCB” and, for the first time, also the concept “Eurosystem”. The Governing Council of the ECB has used the term Eurosystem in its external communication since 1998. The Eurosystem comprises the ECB and the national central banks (NCBs) of the Member States which have adopted the euro.

The ESCB is governed by the decision-making bodies of the ECB (the Governing Council and the Executive Board) and pursues the primary objective of maintaining price stability. Without prejudice to this objective, it supports the general economic policies of the Union to contribute to the realization of the Union’s objectives. All other tasks of the ESCB are defined in Part III of the Constitutional Treaty and in the ESCB/ECB Statute. The Constitutional Treaty also states that the ECB has legal personality. The ECB has the exclusive right to authorize the issuance of banknotes.

While the Treaty on European Union emphasizes the independence of both the NCBs and the ECB⁸, Article I-30 of the Constitutional Treaty only refers to the independence of the ECB. In exercising its functions and in administrating its funds the

ECB is independent. The Community institutions, bodies and other agencies as well as the governments of the Member States respect this principle of independence. Only Part III (Article III-188) – which can be revised by a simplified amendment procedure – stipulates the independence of the NCBs.⁹

3.4 Transparency

The Constitutional Treaty provides the public with broader access to documents. The Treaty on European Union regulates public access to the documents of the European Parliament,¹⁰ the Council, the European Commission; the ECB stipulates its own transparency rules. The principle of transparency of the Constitutional Treaty (Article I-50 (3)) now also applies to the ECB when carrying out its administrative tasks (Article III-399 (1)). Restricting transparency to administrative tasks shall protect the ECB against public access which could negatively affect its core functions.¹¹

4 Part III of the Constitutional Treaty: The Policies and Func- tioning of the Union – Monetary Policy

The specific provisions on monetary union are incorporated in Part III, Title III, Chapter II of the Constitutional Treaty; they are subdivided into “Economic and Monetary Policy”, “Institutional Provisions”, “Provisions Specific to Member States Whose Currency is the Euro” and “Transitional Provisions”. The sections on monetary policy and the ESCB/Euro-

⁸ Article 108 Treaty on European Union.

⁹ See section 2.2.

¹⁰ Article 255 Treaty on European Union.

¹¹ See ECB, 2004.

system have been reorganized, i.e. the transitional provisions no longer include the provisions that referred to the European Monetary Institute (EMI), the second stage of EMU and the beginning of the third stage of EMU. The specific provisions for the euro area countries are summarized under a separate section. All other provisions are broadly in line with the Treaty on European Union. In principle, no changes in substance have been made to provisions regarding monetary union; adaptations have been largely of a technical nature.

4.1 Monetary Policy

The section on “monetary policy” describes the objectives and tasks of the ESCB and stipulates the ESCB’s primary objective of maintaining price stability¹² (Article III-185). Contrary to the Treaty on European Union, the definition of the ESCB and the reference to the legal personality of the ECB have been omitted because they are explicitly stipulated under Article I-30. In exercising their powers and carrying out the tasks and duties conferred upon them by the Constitutional Treaty, the ECB and NCBs are subject to the principle of freedom from any instruction (“Independence”, Article III-188).

4.2 Institutional Provisions

The section “Institutional Provisions” describes the coordination tasks and the composition of the Economic and Financial Committee. The provisions regarding the Monetary Committee (with advisory status), which was replaced by the Economic and

Financial Committee at the beginning of the third stage of EMU in 1999, have been canceled.

Title VI, “The Functioning of the Union”, contains the general institutional provisions on the Governing Council and the Executive Board of the ECB as well as on the participation of the President of the Council of Ministers in Governing Council meetings, the participation of the ECB President in Ecofin Council meetings and the relations between the ECB and the European Parliament (Article III-382, Article III-383).

4.3 Provisions Specific to Member States Whose Currency is the Euro

The “Provisions Specific to Member States Whose Currency is the Euro” are summarized under a separate section in a clear and structured manner. These provisions include the measures related to the surveillance and coordination of Member States’ budgetary discipline, the economic policy guidelines as well as the external representation of the euro. Only Member States of the euro area, which regularly hold Eurogroup meetings, are entitled to vote on these measures (Article III-194).

Arrangements for meetings between ministers of Member States of the euro area are laid down in the Protocol on the Eurogroup (Article III-195). The Eurogroup will continue to meet informally; to improve its working methods, it will elect a president for a term of two and a half years.

¹² The Draft Treaty establishing a Constitution for Europe lists the articles that do not apply to countries with a derogation (Article III-197 (2) (c)). It lists the objectives and tasks of the ESCB and thus also the objective of price stability (Article III-185 (1-3, 5)). According to the ESCB/ECB Statute (Article 43.1 of the Statute), however, the objectives and tasks of the ESCB (Article 2 of the Statute) apply to the Member States with a derogation.

The Eurogroup, acting by a qualified majority¹³ on a proposal from the European Commission and after consulting the ECB, takes decisions on the external representation of the euro (Article III-196). These decisions are taken to establish common positions and ensure unified representation of the euro within the international financial institutions and conferences.

Furthermore, it is the exclusive responsibility of the Eurogroup to conclude agreements on an exchange rate system for the euro or general orientations for the exchange rate policy vis-à-vis non-euro area currencies. The same holds for decisions on the euro central rates within the exchange rate mechanism (ERM II) and agreements on exchange-rate matters with countries or international organizations (Article III-326 in combination with Article III-197).

4.4 Transitional Provisions

The section “Transitional Provisions” contains regulations for Member States with a derogation, i.e. non-euro area countries. The provisions on EMU that do not apply to Member States with a derogation include for example the objectives and tasks of the ESCB/Eurosystem, the legal acts of the ECB or the appointment of members of the Executive Board of the ECB (Article III-197).

The “Transitional Provisions” also stipulate institutional regulations on the General Council as the third decision-making body of the ECB, the definition of the convergence criteria¹⁴ as well as the provisions on the abrogation of derogations after the convergence assessment. In accordance with the latter provision, the Council decides by qualified majority, after consulting the European Parliament, after discussion in the European Council and on a proposal from the European Commission. What is new is that this decision is to be based on a recommendation from the euro area Member States, acting by qualified majority.

The euro area Member States and the Member State concerned may decide by a simple majority, after obtaining the consent of the European Parliament, to irrevocably fix the exchange rate at which the euro is to replace the currency of the Member State concerned and to lay down other measures necessary for the introduction of the euro (Article III-198).

Where a sudden crisis in the balance of payments occurs, a Member State with a derogation may be granted macro financial assistance or take protective measures, such as the temporary introduction of capital controls (Article III-201, Article III-202).

¹³ In cases in which only a limited number of Council members has the right to vote (i.e. increased collaboration or euro area), the projected percentages will be inserted (and changed) in such a way that they will only apply to those Council members who have the right to vote and only to the population of the Member States they represent.

¹⁴ In order to ensure continuity in assessing the exchange rate criterion, the Constitutional Treaty still contains a reference to the no longer existing EMS.

5 Statute of the ESCB and the ECB

The ESCB/ECB Statute is attached to the draft Constitution as a protocol and was technically adapted by the Working Party of IGC Legal Experts (Conference, 2003a).¹⁵

- In line with Article I-30, Article 1 of the Statute contains the concept “Eurosystem”.
- Regulations were renamed European Regulations, Decisions were renamed European Decisions (Article 35), Community was replaced by Union, “ECU” was replaced by “Euro” and “EC Treaty” or “Treaty on European Union” were replaced by “Constitution”.
- Certain provisions on the establishment of the ECB and the ESCB (Article 1.1, Article 14.1) as well as the transition to the third stage of monetary union (Article 32.3, Article 50, and Article 51), the EMI protocol as well as the reference to the seat of the ECB (Article 37) have been omitted in the protocol.

6 Conclusions

Representing a new and consistent legal architecture, the Constitutional Treaty, is intended to enhance and streamline decision-making in the EU-25, both at the European and the international level.

However, the efficiency of the decision-making process of the Council, and thus of the Ecofin Council, may not be improved substantially by the Constitutional Treaty. The increase

of the blocking minority threshold compared to the Treaty of Nice could make it more difficult to block majority decisions; the higher super-qualified and qualified majority threshold is expected to accelerate the decision-making process only slightly. It remains to be seen to what extent the European Council will make use of the newly created possibility of widening the scope for majority decisions in the Council in cases where the Treaty provides for unanimity.

Up to now, a considerable number of decisions in the field of monetary union has been taken by qualified majority. The Constitutional Treaty slightly strengthens the European Commission’s position to influence monetary union: Proposals from the Commission to amend the ESCB/ECB Statute require a qualified majority in the Council whereas recommendations from the ECB require a super-qualified majority.

The introduction of the simplified amendment procedure which covers provisions of Part III of the Constitutional Treaty is likely to have a very fundamental impact on future developments in monetary union. The constitutional provisions of Part I of the Constitutional Treaty, which affect monetary union only to a small extent, continue to be subject to the standard procedure. This implies that changes in substance are less likely to occur.

The Constitutional Treaty takes into account the institutional developments in the area of monetary union

¹⁵ Irrespective of the draft Constitution, the ECB Governing Council was prepared for the forthcoming enlargement in the euro area and the voting modalities were adapted according to a Council decision (European Council, 2003) (Article 10.2 of the Statute). If there are more than 15 national central bank governors, the voting rights of the members of the Council of the ECB will be limited to 21, which means that 6 permanent members of the Executive Board of the ECB retain permanent voting rights and the 15 voting rights of the NCB governors will rotate. All members of the Governing Council who temporarily do not exercise a voting right will continue to attend meetings and will be able to participate actively in the discussions.

since the introduction of the euro. Thus, the Constitutional Treaty integrates the concept “Eurosystème” and incorporates the definition of the euro as the currency unit and one of the symbols of the Union. The Eurogroup continues to meet informally; but the Constitutional Treaty formally recognizes in a protocol its existence. Furthermore, the Constitutional Treaty defines a number of new provisions which only apply to the euro area Member States; it also defines areas of responsibility in which only euro area Member States have the right to vote. All in all, these amendments contribute to a better understanding of the institutional structure and workings of monetary union.

The Constitutional Treaty does not entail any changes in substance in the field of monetary union compared to the current legislation; most amendments were of a technical nature only. It stipulates that one of the objectives of the Union is to maintain price stability and confirms the sui generis nature of the ECB as enshrined in the Treaty on European Union. The tasks, mandate, status and legal and institutional framework of the ECB and of the ESCB remain widely unchanged. The framework conditions for monetary union as embodied in the Treaty on European Union have been reaffirmed. Thus, as regards monetary policy, the EU-25 is well prepared for the enlargement of the euro area.

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Central and Eastern Europe – The Growth Market for Austrian Banks

Peter Breyer

Although the Central and Eastern European banking market (excluding Russia) is relatively small with total assets of some EUR 350 billion (by comparison, total assets of banks operating in Austria were some EUR 605 billion at the end of 2003), it is nevertheless a growth market. In addition to higher economic growth, the low degree of bank intermediation (about a third of its Western European equivalent) suggests strong growth potential for banks in Central and Eastern Europe (CEE) in the coming years.

Above-average growth potential, higher interest margins than in Western Europe and restructuring potential have led Western European banks to invest heavily in the CEE banking sector. Approximately 70% of the CEE banking market is currently controlled by Western European banking groups. Austrian banks were among the first to invest in Central and Eastern European countries and are now some of the best-known Western European banks in the region (market share in the region: about 22%). As early as 2002 and 2003, steady expansion in the CEE region had a positive impact on the profitability of Austria's consolidated banking sector.

Favorable reports on the CEE banking market, however, often ignore potential risks. Key sources of risk in the Central and Eastern European banking market are macroeconomic imbalances, the risk of growing exchange rate volatility, credit risk, increasingly fierce competition and political risks.

1 Overview

With total assets of some EUR 350 billion, the Central and Eastern European banking market¹ remains a relatively small (by comparison total assets of banks operating in Austria were some EUR 605 billion at the end of 2003). The market is dominated by Western European banks: the market share of foreign-controlled banks in the CEE region is approximately 70%. As CEE countries catch up, the hope for rapid growth and higher

profits has been and is one of the main motives for foreign investors to move into the Central and Eastern European banking market.

Table 1 shows the CEE banking sector's current edge over its Western European counterpart in terms of profitability. Apart from Poland (where a tough economic climate has increased loan losses), profitability in most Central and Eastern European countries has been far higher than in EU countries.

Table 1

Selected Key Figures of Central and Eastern European Banking

Markets at End-2003

	ROE after tax %	Cost-to-income ratio	Solvency ratio	Lending growth
Czech Republic	23.7	52.7	14.5	11.8
Hungary	17.6	61.2	12.0	34.7
Poland	6.2	68.6	13.7	9.3
Slovak Republic	13.0	67.1	22.4	14.3
Slovenia	12.8	62.5	11.6	13.8
Croatia ¹	16.3	54.5	16.0	13.5
EU bank ²	10.7	65.7	12.4	4.0

Source: National central banks, BA-CA (2004).

¹ Data for Croatia: January to September 2003.

² EU banks: Weighted average of 27 major banks (BA-CA analysis of major EU banks in 2003).

¹ The Central and Eastern European banking market (CEE banking market) is defined to include Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Hungary, Macedonia, Poland, Romania, Serbia and Montenegro, the Slovak Republic and Slovenia.

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Foreign Research Division.

1.1 Good Market Position of Major Austrian Banks

Low profitability domestically (price competition, strong focus on business volume), geographical proximity and historical ties, as well as above-average growth and profit potential, were key reasons for Austrian banks' pioneering role in investing in Central and Eastern Europe. According to estimates of the Oesterreichische Nationalbank (OeNB), some 22% of the total assets of Central and Eastern European banks (excluding Russia) are currently held by Austrian banking groups (including Bank Austria Creditanstalt – BA-CA). This means Austrian banks are the biggest investors (well ahead of Italy and Belgium) in the Central

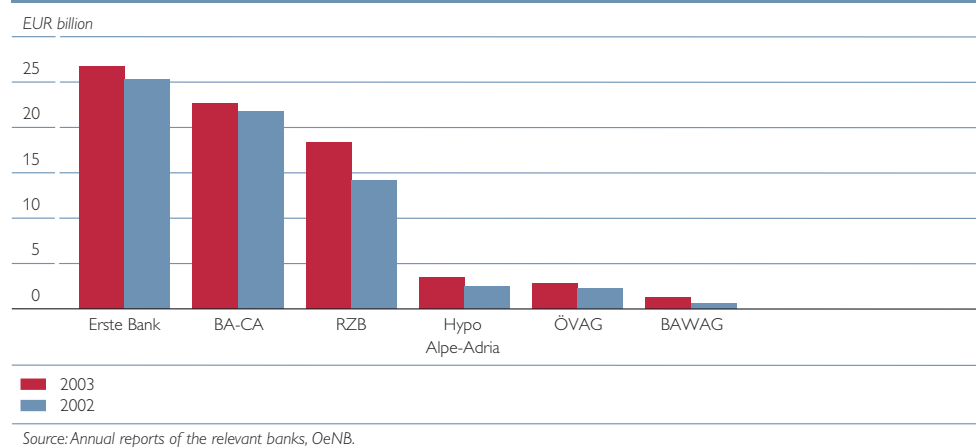
and Eastern European banking sector. Erste Bank, BA-CA and Raiffeisen Zentralbank (RZB) are among the most active Western European banks operating in the CEE region.²

Erste Bank, via its subsidiaries, is one of the biggest players in the Czech Republic (Česká spořitelna), the Slovak Republic (Slovenská sporiteľňa), Croatia (Riječka banka) and – now through its acquisition of Postabank – also in Hungary.

BA-CA, via its subsidiaries, holds a significant slice of the market in Poland (Bank BPH), Croatia (Splitska banka) and Bulgaria (Biochim) and is also represented by subsidiaries in seven other CEE countries.

Chart 1

Total CEE Assets of Austrian Banking Groups in 2002 and 2003



RZB has a very well-known brand name in CEE countries and controls a significant share of the market in the Slovak Republic (Tatra banka), Croatia, Serbia, Romania, Bosnia and Herzegovina, and Albania. With subsidiaries in 15 countries, RZB has the most extensive marketing network

of all Western European banks represented in Eastern Europe.

Major CEE operations are also run by ÖVAG (subsidiaries in eight CEE countries), Hypo Alpe-Adria Bank (HAAB, primarily in Croatia) and BAWAG (Slovak Republic, Czech Republic, Hungary).

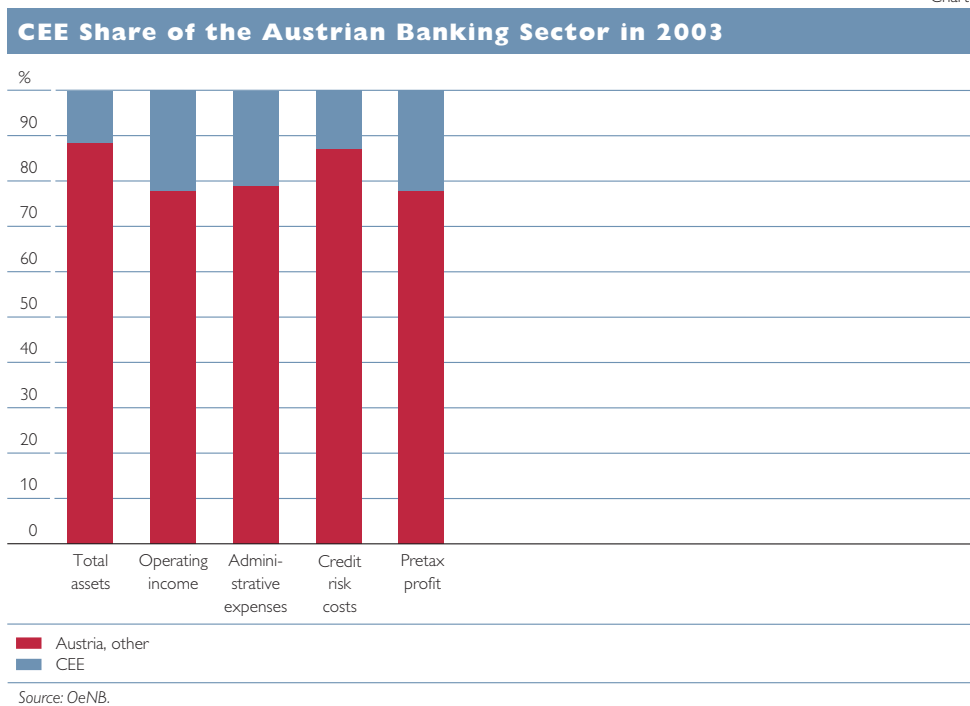
² By far the most important CEE markets for Austrian banks currently are the Czech Republic, the Slovak Republic, Hungary, Poland, Slovenia and Croatia. The total assets of these banking markets were some EUR 310 billion at the end of 2003.

1.2 Significant Contribution to Income from CEE Countries

As early as 2002 and 2003, steady expansion in the CEE region had a positive impact on the profitability of Austria's consolidated banking sector.

Although the CEE segment accounted for only some 12% of consolidated total assets at the end of 2003, 23% of pretax profit was generated in the region.

Chart 2



A breakdown of Austrian banks' business activities by region reveals that the profitability of their CEE operations is currently far higher than that of purely Austrian business. At 1.1%, return on assets (ROA: return on assets = pretax profit/total assets) in the CEE segment handsomely exceeded that of Austrian business (0.5%) in 2003. Higher profitability was primarily due to wider margins, lower credit risk costs and cost savings following extensive restructuring measures. Significant CEE exposure is likely to have greatly helped Austrian banks weather the economically difficult years between 2001 and 2003 better than German banks.

Will the CEE Banking Sector Remain more Profitable in the Medium Term?

Austrian bank pundits on Eastern Europe are convinced that high profits in CEE countries will continue to be generated in the coming years, basing their upbeat growth and profit outlook on three arguments:

- *Economic Growth:* Low base levels and EU accession should enable higher economic growth to be generated in CEE countries than in Western Europe over the next few years.

Chart 3

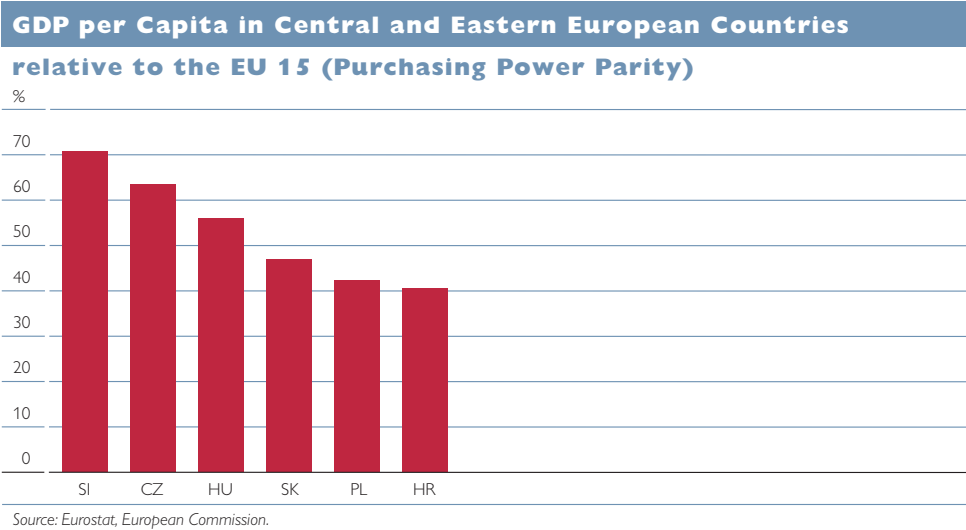
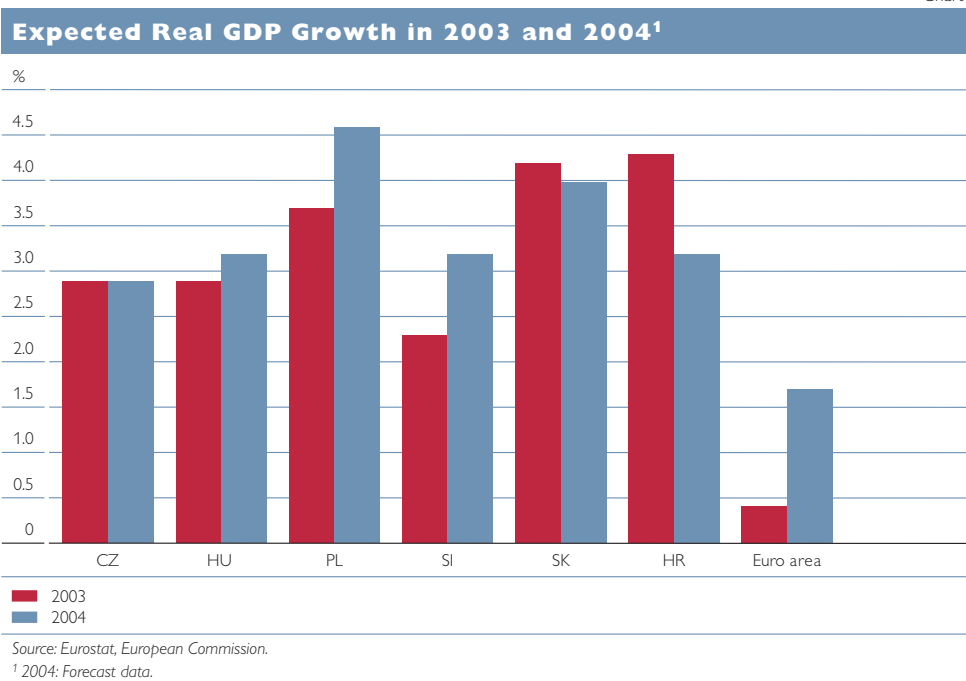


Chart 4



- *Low Degree of Bank Intermediation:* The intermediation of the banking sector (measured as the ratio of total bank assets to GDP) in CEE countries averages about 74%. This is less than a third of the value for the euro area and is equivalent to Austrian bank intermediation in

the mid-1960s. This, coupled with higher economic growth, and on-balance sheet liquidity reserves (customer deposits being far higher than loans granted) should offer banks in CEE countries strong growth potential in the years to come.

Chart 5

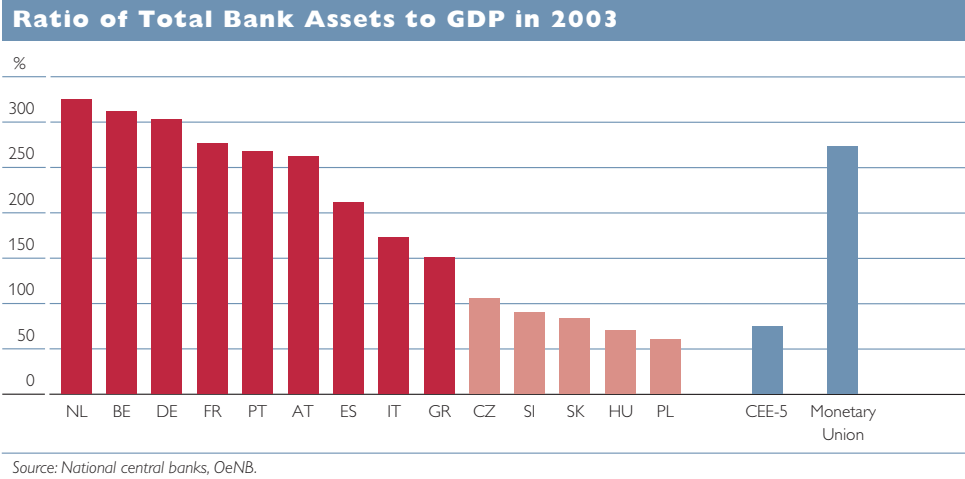
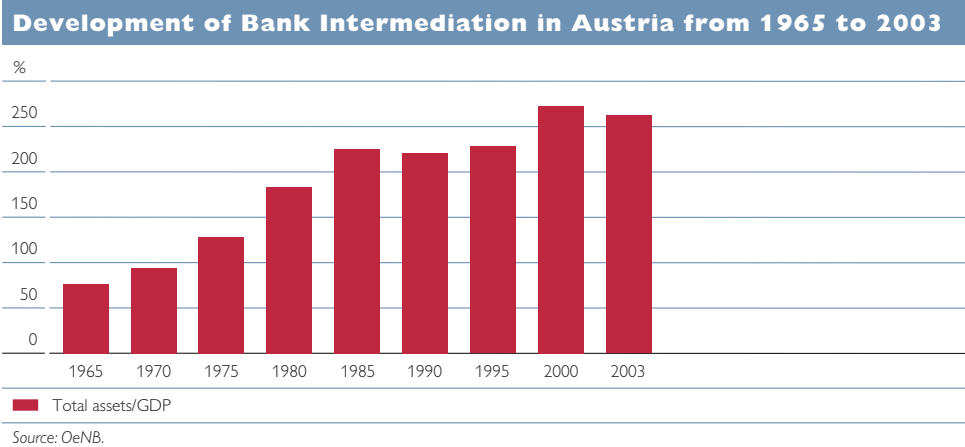


Chart 6



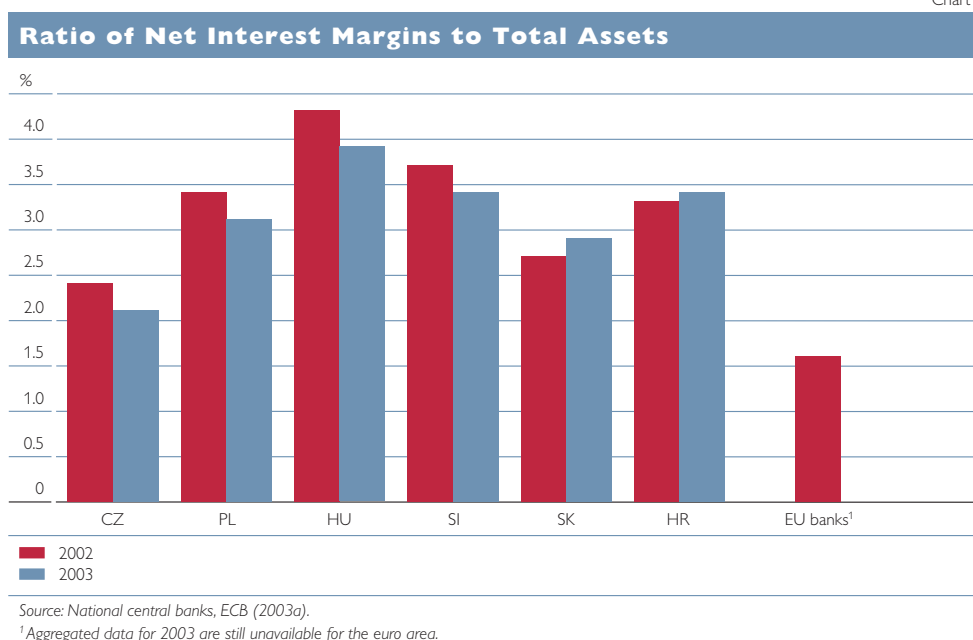
- *Higher Interest Margins:* In addition to successful restructuring measures, which were generally implemented following acquisitions by Western European banks, far higher interest margins were primarily responsible for CEE banks' edge in terms of profitability. Although it is widely anticipated that interest margins in CEE countries will converge towards the EU average on account of growing competition and lower country risk premiums, the extent to which this alignment process will continue remains contentious. Some experts currently support

the view that the margin edge will be maintained in CEE countries over the medium term. They argue that theoretically these margins ought to be higher given CEE countries' lack of previous loan loss experience and the resulting higher credit risk. In most CEE countries, market shakeout is, they contend, relatively well advanced and the degree of bank concentration on average higher than in the EU. Interest margins should have converged towards the EU average far more rapidly in the past few years. However, the theory that a margin edge can be maintained in the CEE

area as a whole over the medium term looks doubtful. As early as 2002 and 2003, net interest margins narrowed in most CEE countries. The fact that margins were shrinking less dramatically than expected can be attributed primarily to shifts in the loan portfolio (the share of private banking loans with higher margins increased while the share of inter-

bank claims and loans to large enterprises decreased). Fiercer competition could also exert additional pressure on interest margins. In future, entry barriers – at least in the new EU Member States – are likely to be far lower for new competitors on account of the European single passport regime.³

Chart 7



Identification of Risks

Favorable reports on the CEE banking market often ignore potential risks, against which strong growth and high profits need to be offset.

– *Macroeconomic Imbalances:* Most countries in the CEE region are faced with high budget deficits and, in some cases, also with high current account deficits (twin deficits) and so depend very heavily on the willingness of foreign investors to fund these deficits.

– *Exchange Rate Volatility:* Running twin deficits while entering a restrictive currency band (in the run-up to joining the euro) could make Central and Eastern European currencies subject to speculation. Although the future participation of accession countries in ERM II and the economic policy directives linked to EU membership will give rise to certain stabilization effects, the attacks on Western European currencies in

³ Under the European single passport regime, any bank registered in an EU Member State can open branches in another EU country without having to undergo major formalities.

Chart 8

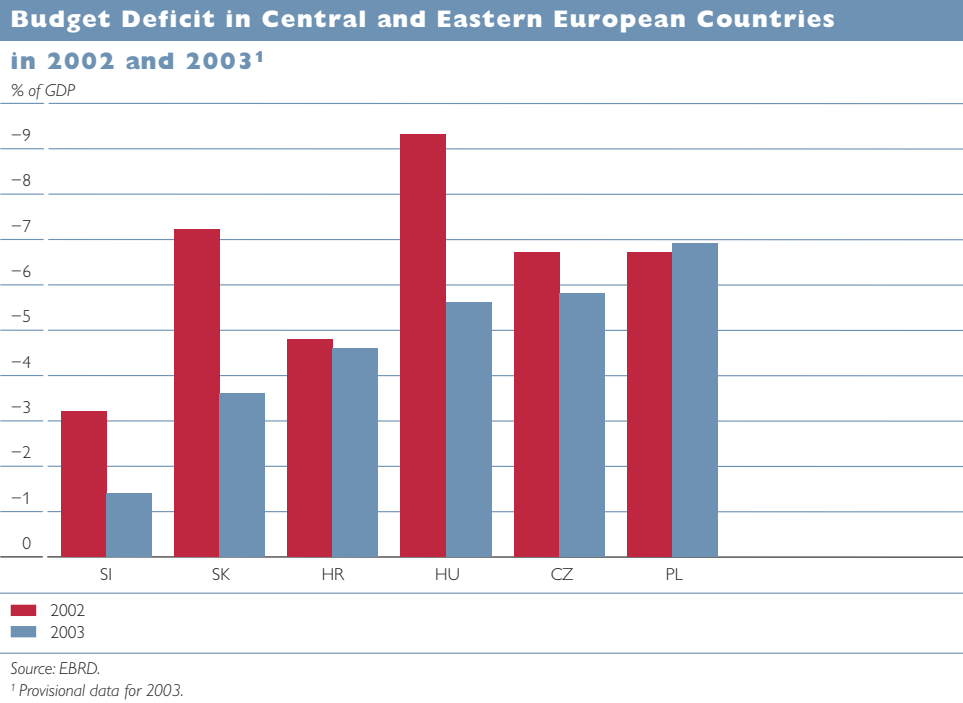
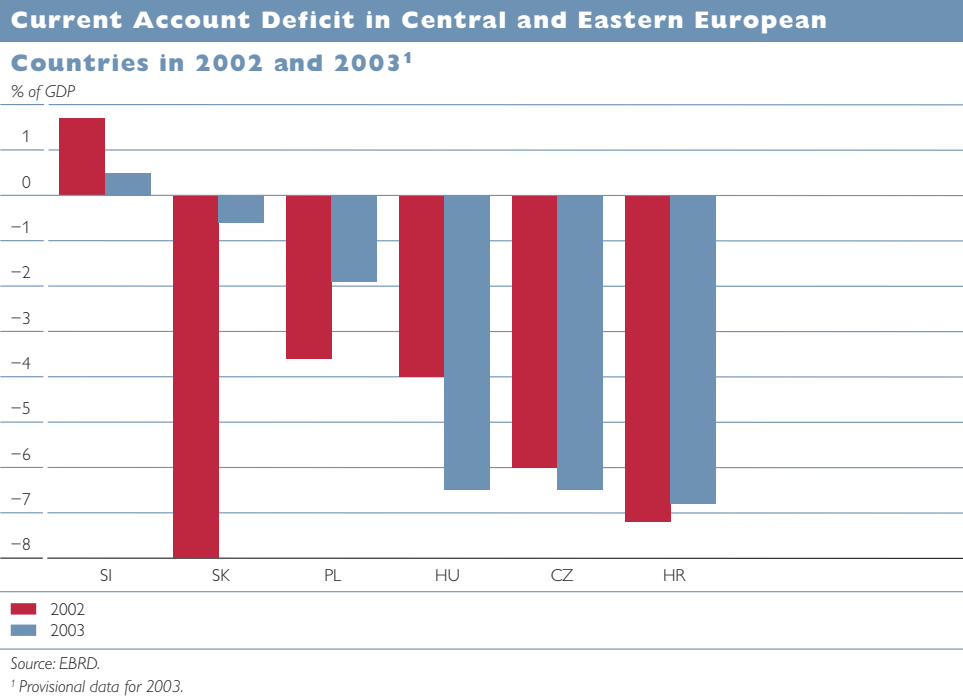


Chart 9



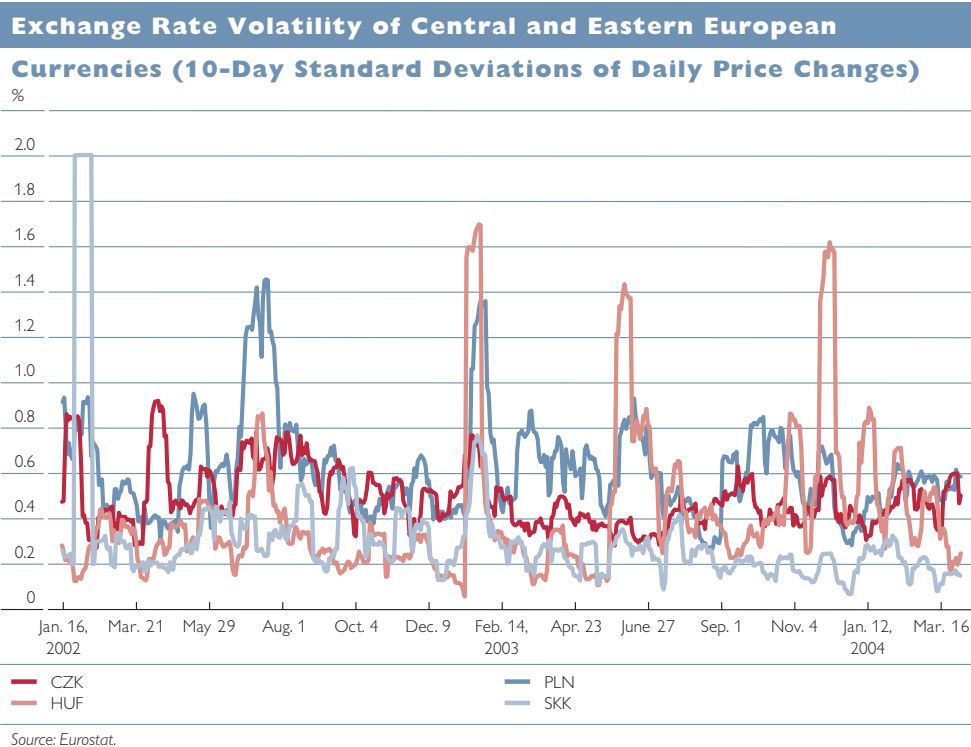
the early 1990s should not be forgotten. For instance, poor economic data and inappropriate economic measures in 2003 resulted

in a distinct increase in volatility for the Hungarian forint and Polish zloty (in 2003 the Hungarian forint and the Polish zloty were

devalued against the euro by 11% and 17%, respectively). In this respect, currency risks arising from growing demand for foreign cur-

rency loans (particularly in countries such as Hungary or Poland where interest rates are well above the EU average) are also a factor.⁴

Chart 10



– *Credit Risk:* The share of nonperforming loans (NPLs) as a percentage of total lending is far higher on average in CEE countries than in Western Europe.⁵ However, these high NPL ratios mostly date back to the 1990s when CEE countries were undergoing transition. In fact, fresh net risk provisions fell short of the EU average by a wide margin in many CEE countries from 2000 to 2003. This meant that particularly in Hungary, the Czech Republic (in 2002 and 2003) and the Slovak Republic

(where more provisions were released than made), a far smaller share of operating income was needed for credit risk provisions. Despite relatively low credit risk costs in recent years, two critical questions should be posed: first, whether the comparatively new and untested credit risk systems of CEE banks will be able to cope with a possible lending boom; second, whether a large number of loan losses will be the inevitable consequence of a strong expansion in total lending.

⁴ Exchange rate risk also has a strong impact on Austrian parent banks via their CEE subsidiaries. Austrian banking groups focus their foreign currency hedging strategies on their CEE subsidiaries' expected profits. The preferred instrument to hedge these profits against currency fluctuations is foreign currency swaps.

⁵ NPL ratios are comparable only to a limited extent, as their national definitions vary.

Chart 11

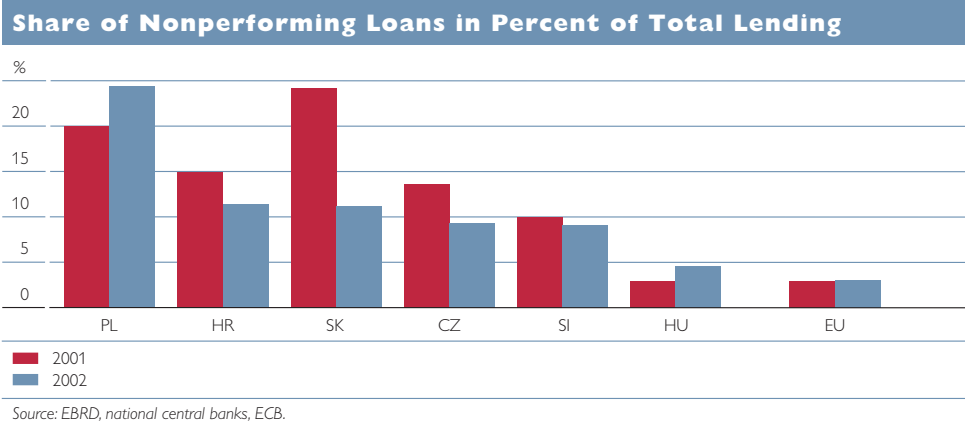
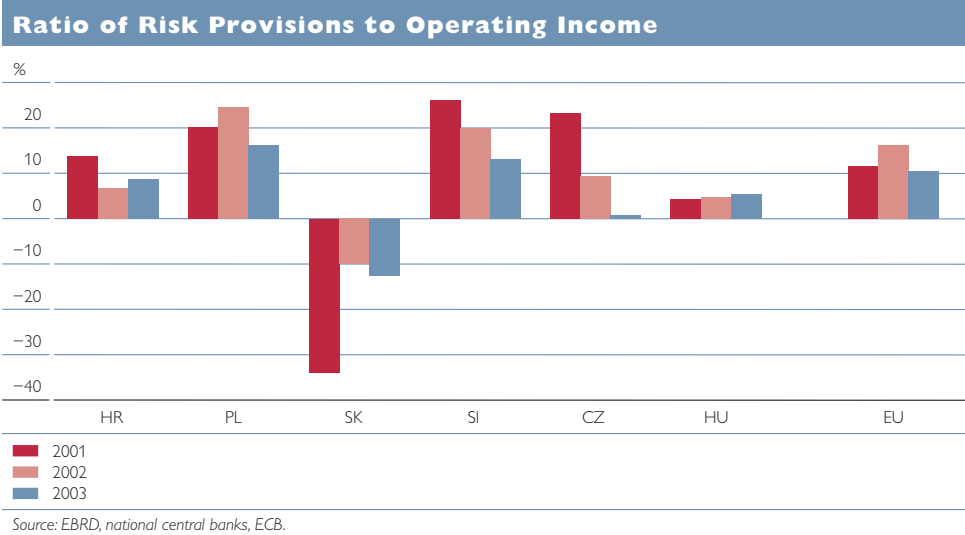


Chart 12



- *Growing Competition:* The question arises as to whether other Western European banks attracted by the growth and profit potential of CEE countries will expand into this region, thereby intensifying competition (for instance, no U.K. bank is currently present in CEE countries). Will this cause margins to shrink more quickly than expected? Since early May 2004, entry barriers – at least in the new EU Member States – have fallen dramatically. Henceforth, any bank registered in an EU Member State will be able to open branches in new Member States without a local banking license (European single passport regime).
- *Frequent Change of Government, Political Instability:* As a general rule, governments have served for shorter periods of time in many Central and Eastern European countries than in the EU. This has been due to two factors: first, relatively fragmented party political environments, with many populist parties (and, as a result, not very stable coalitions); second, the tendency on the part of voters not to reelect ruling parties after they have served only a single

period in office. It remains to be seen whether EU accession will further aggravate this trend and whether parties with only rudimentary budgetary discipline will

enter coalition governments. For instance, radical opposition parties in Poland have enjoyed tremendous popularity with voters in recent months.

Table 2

Number of Governments since 1993

Latvia	12	Slovenia	7
Lithuania	12	Slovak Republic	6
Estonia	9	Czech Republic	5
Poland	8	Hungary	5

Source: *The Economist* of March 11, 2004.

2 Banking Markets in Selected CEE Countries

2.1 Hungary

The total assets of banks operating in Hungary are about EUR 51 billion. At the end of 2003, 218 banks were registered in the country. Most of these banks (about 180) are small co-operative banks, which are of minor importance overall (market share: some 7%).⁶

At about 69%, the degree of bank intermediation in Hungary is somewhat below the CEE average (74%), and the degree of concentration (market share of the five largest banks) is around 57%. Foreign banks also play a leading role in Hungary. Following the privatization of Postabank and Konzumbank, approximately 82% of Hungarian bank assets are now controlled by foreign banks. However, OTP – the biggest Hungarian bank by far – remains independent and is almost entirely privately owned.⁷

In the past few years the Hungarian banking market has witnessed a dramatic growth in lending (according

to the PSZAF, private sector lending grew by 66% in 2003). Growth was driven by the introduction of government subsidies for housing finance in 2001. Banking industry representatives estimate that government subsidies for home loans account for some 70% of private households' demand for government-subsidized home loans. This makes Hungary the sole CEE country in which earnings from home loans make a significant contribution to the total income of the banking sector.⁸ Budgetary problems (the running costs of the scheme amounted to around 1% of GDP) led to a sharp retrenchment in state subsidies for home loans. As this measure was expected months in advance, it met with a response anticipating the change. As a result, demand for subsidized home loans continued to grow in 2003. Lending to wholesale customers and foreign groups is bitterly contested and marked by falling margins. Hungary's small and medium-sized enterprises (SMEs) still find it hard to obtain bank loans.

⁶ The figures relating to the Hungarian banking sector for 2003 are largely based on data provided by the Hungarian Financial Market Supervisory Authority (PSZAF).

⁷ OTP is listed on the stock exchange and owned by both management and foreign investors. It should be mentioned that the Hungarian government continues to hold a "golden share," with which majority resolutions adopted by the general meeting can be blocked (i.e. OTP's disposal is subject to approval by the Hungarian government).

⁸ See *The Economist* of August, 21, 2003 (House party).

For 2004, growth in personal loans is expected to flag significantly owing to the amended terms of home loan subsidies and to the increase in domestic interest rates. Hungarian banks are currently seeking to boost demand for consumer lending by launching new products such as foreign currency loans. Increasing the

demand for foreign currency loans – particularly by private households – could lead to risks arising for the Hungarian banking sector.

The Hungarian banking sector is adequately capitalized (average solvency ratio: 12.0%) and has been very profitable in the past few years (2003 ROA before tax: approximately 1.8%).

Table 3

Selected Key Figures of the Hungarian Banking Sector

	1999	2000	2001	2002
Number of banks ¹	43	42	41	38
of which foreign banks	29	33	31	27
Private banks' share of total assets (%)	92.2	92.3	90.9	89.2
Share of nonperforming loans (%)	4.4	3.1	2.9	4.6
Domestic personal loans (% of GDP)	25.8	30.2	31.5	34
Stock market capitalization (% of GDP)	36.4	25.8	19.2	17.4
EBRD index on bank reform (from 1 to 4+)	4.0	4.0	4.0	4.0

Quelle: EBRD.

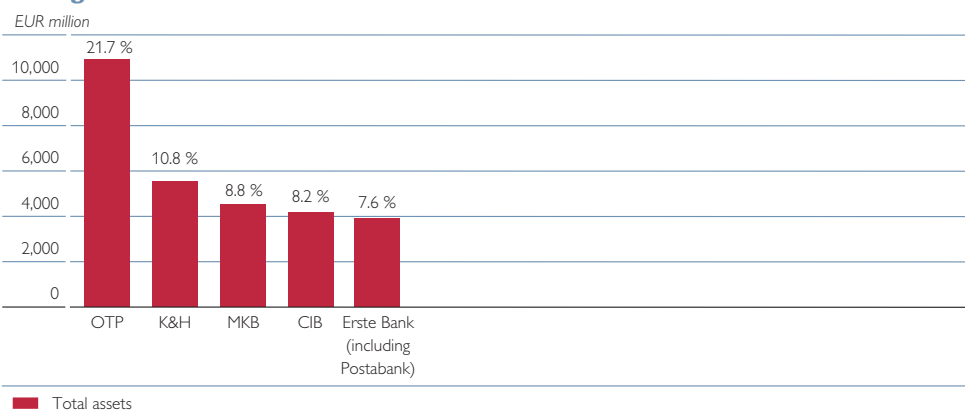
¹ Excluding cooperative banks.

As already mentioned, OTP (total assets: some EUR 11 billion) is by far the leading bank in Hungary. It is one of the biggest and most profitable banks in the CEE region and, in recent years, has also acquired banks in the Slovak Republic and in Bulgaria (OTP beat Erste Bank in the bidding race for a Bulgarian bank, DSK). Hungary's second-largest bank is K&H bank (controlled by the Belgian KBC

and the Dutch ANB-Amro). MKB is dominated by Bayerische Landesbank (BAWAG has a minority interest), CIB by the Italian Intesa. The acquisition of Postabank in October 2003 (purchasing price: EUR 400 million) allowed Erste Bank to increase its market share substantially. Including Postabank, Erste Bank's market share is approximately 8%.

Chart 13

Total Assets and Market Share of the Five Largest Hungarian Banks in 2003



Source: Hungarian Financial Market Supervisory Authority (PSZAF), OeNB estimates.

Note: Percentages refer to market share.

Austrian Banks Control around 20% of the Hungarian Banking Market

Seven Austrian banks currently operate in Hungary. The market share of Austrian banks is about 20% overall (including Postabank). Following its acquisition of Postabank, Erste Bank is now the biggest Austrian bank in Hungary (the fifth largest in the country with a market share of some 8%). Raiffeisen Bank Ungarn managed to overtake HVB Bank Ungarn this year and is now just ahead of the latter as the country's sixth-largest bank (market share: approximately 6%). Extensive banking operations are also carried out by Volksbank and Porschebank in Hungary. Bank Burgenland, which only recently established a subsidiary in Sopron, and the bank Samesch & Cie AG are represented by extremely small operations in the

Hungarian market (total assets of both banks: less than EUR 12 million). Excluding Volksbank, all major Austrian banks in Hungary generate far higher returns than in their domestic market.

In May 2004 a consortium consisting of Wiener Börse (the Vienna stock exchange) and Austria's major banks acquired the majority of shares in the Budapest stock exchange.

In 2003 RZB's subsidiary was the most successful Austrian bank in Hungary. Raiffeisen Bank Ungarn generated not only strong lending growth but also exceptionally high return on equity (ROE: 27.5%). The profitability of the BA-CA and Erste Bank subsidiaries was roughly around the Hungarian average. By contrast, the profitability of the Volksbank subsidiary was poor.

Table 4

Key Figures of Selected Austrian Banks' Subsidiaries in Hungary at End-2003

	HVB Bank Ungarn	Raiffeisen Bank Ungarn	Erste Bank Ungarn	Volksbank Ungarn
<i>EUR million</i>				
Total assets	2,799	3,189	2,072	583
Change on previous year (%)	+14.3	+37.9	+14.0	+20.7
Profit after tax	42	54	14	1
Change on previous year (%)	+18.7	+49.4	+102.2	+139.6
<i>%</i>				
Return on equity ¹	15.1	27.5	18.3	3.3
Cost-to-income ratio	50.7	49.6	68.5	84.4

Source: BA-CA, Erste Bank, RZB, ÖVAG.

¹ ROE after tax: HVB Bank Ungarn and Erste Bank Ungarn; ROE before tax: Raiffeisen Bank Ungarn and Volksbank Ungarn.

2.2 Czech Republic

With total assets of some EUR 80 billion, the Czech banking market is the second largest in the CEE region. The ratio of total assets to GDP shows that the Czech economy has a far higher degree of bank intermediation (105%) than other CEE countries (except for Croatia). At 66%, the degree of concentration (market share of the

five largest banks) similarly exceeds the CEE average.⁹ The country's biggest banks are without exception owned by Western European banking groups. The share of foreign bank assets as a percentage of total Czech bank assets is estimated to be about 90%.

Following the banking crisis of 1999–2000 and the subsequent estab-

⁹ The figures relating to the performance of the Czech banking sector in 2003 are largely based on data provided by Česká národní banka (ČNB – the Czech National Bank).

lishment of the government consolidation agency CCA, the big state-owned banks were successfully sold to foreign banking groups in 2000. Ample guarantees provided by the CCA were crucial to the success of the privatization. For instance, foreign banking groups were granted the right of transferring to the CCA within a two-year period loans that were in poor rating categories at the time of takeover (ringfence agreement).

As early as 2002 and 2003, the Czech banking sector generated renewed high profits (according to the Czech central bank, ROA after tax was 1.2% in 2003). Furthermore, it also boasted extremely healthy capital adequacy of 14.4% (preliminary figure for 2003).

The transfer of NPLs to the CCA resulted in a sharp reduction in total lending in 2002 in particular. This, in turn, also led to an improvement in the quality of the loan portfolio (with the NPL ratio falling from 19.4% to 9.4%). 2003 saw the collapse of two small banks (Union banka, Plzeňská banka), which did not, however, have an impact on the

stability of the country's financial market.

Czech banks continue to steer a very tight personal loans policy. The balance sheets of major Czech banks tend to be excessively liquid (deposits being far higher than total loans). The share of domestic personal loans as a percentage of GDP is one of the lowest in the region as a whole.¹⁰ A large proportion of deposits are still invested in low-yield government bonds. The aim over the next few years will be to redirect funds from government bonds to personal loans. In order to bolster the confidence of private sector banks, the ČNB established a Major Loans Register in November 2002. In addition, a government-subsidized home loan scheme was launched.

Preliminary ČNB figures for 2003 indicate a recovery in demand for loans – particularly by private households. Whereas lending to enterprises stagnated at 2002 levels, loans to private households grew steeply (+35%), albeit from a low base. Overall, lending to nonbanks in 2003 expanded by around 11%.

Table 5

Selected Key Figures of the Czech Banking Sector

	1999	2000	2001	2002
Number of banks	42	40	38	37
of which foreign banks	27	26	26	26
Private banks' share of total assets (%)	76.9	71.8	96.2	95.4
Share of nonperforming loans (%)	21.5	19.3	13.7	9.4
Domestic personal loans (% of GDP)	42.3	36.6	24.3	20.0
Market capitalization (% of GDP)	22.3	20.9	15.3	21.0
EBRD index on bank reform (from 1 to 4+)	3.0	3.0	3.0	3.0

Source: EBRD.

The Czech banking sector is dominated by three banks. With the takeover of IPB (a major bank on the verge of collapse in June 2000), CSOB be-

came the market leader (market share: 21%). CSOB is 82%-owned by the Belgian KBC. The second-largest bank in the country is Česká spořitelna, the

¹⁰ According to Standard & Poor's estimates, the share of personal mortgage loans as a percentage of GDP in the Czech Republic at the end of 2003 ranges between 7% and 8% (the equivalent in the euro area at the end of 2003 was around 34%).

formerly state-owned savings bank (market share: 19%), of which the majority shareholder (98%) is Erste Bank. Closely following Česká spořitelna is Komerční banka, which is

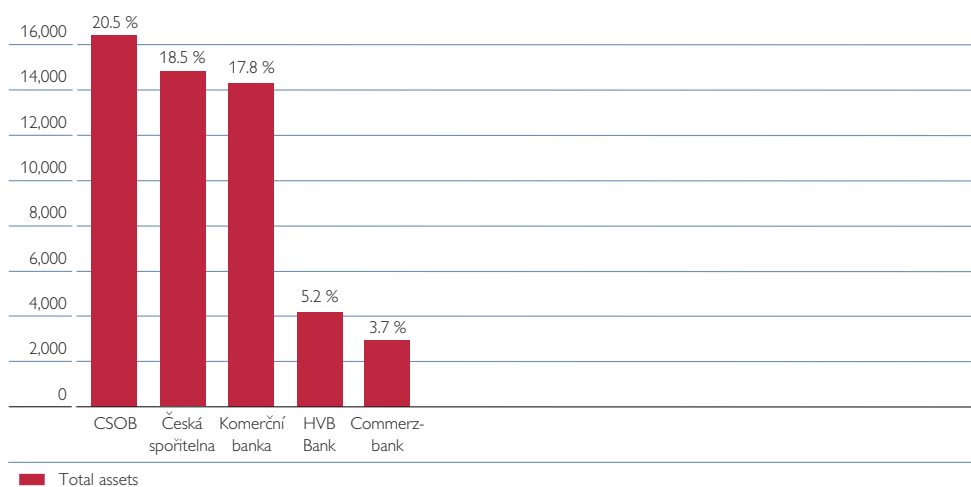
controlled by the French Société Générale (stake: 60%). Next, albeit trailing by a long margin, come the Czech BA-CA subsidiary, HVB-Bank and the Czech subsidiary of Commerzbank.

Chart 14

Total Assets and Market Share of the Five Largest Czech Banks

in 2003

EUR million



Source: Česká národní banka, OeNB estimates.
Note: Percentages refer to market share.

Market Share of Austrian Banks – Around 30%

Five Austrian banks are currently represented by their own subsidiaries in the Czech banking market, accounting for roughly 30% of total assets.

By far the biggest and most profitable bank is Česká spořitelna, Erste Bank's subsidiary. With an ROE of 23.7% (2003), the Czech subsidiary is also of crucial importance to the profitability of the entire Erste Bank group. In 2003, Česká spořitelna generated around 35% of Erste Bank's consolidated income.

HVB is the fourth-largest bank in the country, specializing specifically in corporate banking and leasing finance. With an ROE of 11.6%, the subsidiary's profitability is relatively low.

Although RZB sharply boosted the profits of its subsidiary, Raiffeisenbank a. s., in 2003, the latter's profitability (ROE: 12.1%) lagged behind the market average. The Raiffeisen group also operates Raiffeisen Stavebni sporitelna, a home loans specialist in the Czech Republic.

Volksbank operates Volksbank Prag, a small operation, which has nevertheless expanded considerably in the last few years. It was founded in 1993 and focuses primarily on SMEs and infrastructure finance. Since the takeover of Interbanka in September 2003 (the shares were bought by Bayerische Landesbank), BAWAG has also been active in the Czech banking market.

Table 6

Key Figures of Selected Austrian Banks' Subsidiaries

in the Czech Republic at End-2003

	Česká Spořitelna	HVB Prag S.A.	Raiffeisenbank a.s.	Volksbank Prag
EUR million				
Total assets	17,095	4,072	1,847	587
Change on previous year (%)	+3.6	+3.2	+5.3	+14.5
Profit after tax	241	41	6	4
Change on previous year (%)	+26.3	+16.6	+187.5	+220.9
%				
Return on equity ¹	23.7	11.6	12.1	19.5
Cost-to-income ratio	60.9	54.2	79.0	84.7

Source: BA-CA, Erste Bank, RZB, ÖVAG.

¹ ROE after tax: Česká Spořitelna and HVB Prag S. A.; ROE before tax: Raiffeisen a.s. and Volksbank Prag.

2.3 Slovak Republic

With 18 banks and cumulated total assets of some EUR 24 billion¹¹ the Slovak banking sector is comparable in size with its counterparts in Croatia and Slovenia. The degree of bank intermediation was 83% at the end of 2003. After the banking crisis of 1999–2001, the Slovak banking sector was almost completely privatized. About 96% of Slovak bank assets are owned by foreign banking groups. Following the market's shakeout of the last few years, the banking market in the Slovak Republic has become very concentrated. About 68% of the market is controlled by the five largest banks.¹²

Thanks to the transfer of NPLs to a government consolidation agency (between 1999 and 2001 some SKK 112 billion, or about 13% of GDP, were transferred), the subsequent disposal of banks to foreign banking groups and substantial cost savings, the Slovak banking sector weathered the crisis in 2002 (the banking sector's successful restructuring was praised by the IMF).

As early as 2002, consolidated figures indicated a sharp improvement in credit quality (the share of NPLs was reduced from 24% to 11% in 2002). In 2003 the NPL ratio was further lowered to 9.1%.

Capital adequacy levels are strikingly high. With a solvency ratio of 22%, the Slovak banking sector is more than adequately capitalized. Profitability, which recovered in 2002, was further improved in 2003. The return on total assets (ROA after tax) edged up from 1.1% to 1.2%. To be highlighted is the fact that the profitability of the Slovak banking sector in 2002 and 2003 was also positively influenced by the release of credit risk provisions.

Like the Czech banking sector, Slovak banks currently also have very ample liquidity. At the leading Slovak banks, customer deposits are on average approximately more than twice as high as loans granted. The largest banks are currently endeavoring to boost demand for personal loans by stepping up their marketing activities and offering new products.

¹¹ This figure also includes the foreign branches of the Czech CSOB in the Slovak Republic. Excluding CSOB branches, the total assets of the Slovak banking sector would be around EUR 21 billion.

¹² The figures employed are largely based on data provided by Národná banka Slovenska (NBS – Slovak National Bank).

According to preliminary statistics provided by the Slovak central bank, lending to nonbanks in 2003 grew by some 14%. Whereas corporate loans basically remained at 2002 levels, loans to private households rose steeply (+39%) in 2003. As in

2002, households' demand for loans focused on government-subsidized home loans. In 2003, however, lower lending rates also fueled strong growth in both consumer and credit card lending.

Table 7

Selected Key Figures of the Slovak Banking Sector				
	1999	2000	2001	2002
Number of banks	25	23	19	18
of which foreign banks	11	14	13	15
Private banks' share of total assets (%)	49.3	50.9	95.1	97.1
Share of nonperforming loans (%)	32.9	26.2	24.3	11.2
Domestic personal loans (% of GDP)	40.5	37.6	27.6	25.2
Market capitalization (% of GDP)	3.8	3.9	3.3	7
EBRD index on bank reform (from 1 to 4+)	2.7	3.0	3.3	3.3

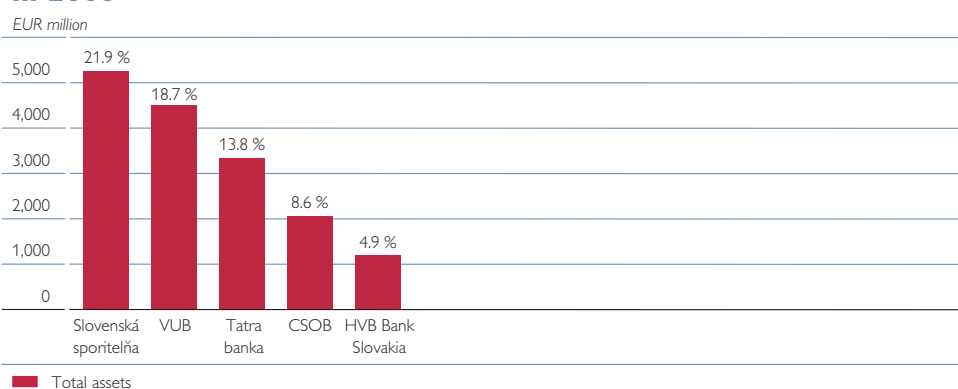
Source: EBRD.

In January 2001 Erste Bank acquired for EUR 411 million 87.2% of Slovenská sporiteľňa, the Slovak savings bank heavyweight (the sale of 20% to the EBRD lowered Erste Bank's stake to 67% shortly thereafter).¹³ With a market share of some 22%, Slovenská sporiteľňa is the biggest bank in the Slovak Republic.

The second largest is VUB, of which 95% is controlled by the Italian Intesa. RZB enjoys approximately 14% of the Slovak banking market via Tatra banka, its subsidiary. The CSOB branch network (part of Czech CSOB) is owned by the Belgian KBC. ING is the Slovak subsidiary of the eponymous Dutch financial group.

Chart 15

Total Assets and Market Share of the Five Largest Slovak Banks in 2003



Source: Národná banka Slovenska, OeNB estimates.

Note: Estimates refer to market share.

¹³ In May 2004 the government's remaining stake was bought by Erste Bank for EUR 72 million, which increased Erste Bank's own stake to 80%.

Austrian Banks Control more than 40% of the Banking Market

Five Austrian banks currently operate in the Slovak Republic. Austrian banks are by far the biggest investors in the Slovak banking sector, controlling about 40% of total assets.

The restructuring of Slovenská sporiteľňa, Erste Bank's subsidiary, was concluded in 2002, as was its complete integration into the group. Considerable progress was also made in operational terms in 2003. The cost-to-income ratio improved from 66.8% to 51.9%. Annual net profit was increased by 121% to EUR 66 million, and ROE came to an outstanding 19.2%. In 2003 the Bank posted robust growth in lending. Compared with the previous year, total lending grew by 50%. The fact that total assets climbed a mere 2.9% can

be attributed to the decline in inter-bank business.

Tatra banka also succeeded in sharply boosting total lending in 2003. However, both operating income and profit after tax were down slightly, albeit from a high level. With an ROE of 19.4%, the profitability of RZB's Slovak subsidiary remained very healthy.

HVB Bank Slovakia, the BA-CA subsidiary and the country's sixth-largest bank, significantly boosted both the loan portfolio and total assets in 2003. However, operating profit and net profit for the year were down. At only 10%, ROE lagged behind the average of the Slovak banking market.

Ludová Banka and Istrobanka – relatively small subsidiaries – are operated by ÖVAG and BAWAG, respectively

Table 8

Key Figures of Selected Austrian Banks' Subsidiaries in the Slovak Republic at End-2003

	Slovenská sporiteľňa	HVB Bank Slovakia	Tatra banka	Ludová Banka
<i>EUR million</i>				
Total assets	5,060	1,185	3,316	661
Change on previous year (%)	+2.9	+20.0	+13.6	-4.6
Profit after tax	66	15	48	7
Change on previous year (%)	+124.9	-17.7	-13.1	+30.2
%				
Return on equity ¹	19.2	10.0	19.4	9.1
Cost-to-income ratio	51.9	53.2	64.0	79.0

Source: BA-CA, Erste Bank, RZB, ÖVAG.

¹ ROE after tax: Slovenská sporiteľňa and HVB Bank Slovakia; ROE before tax: Tatra banka and Ludová Banka.

2.4 Poland

Poland is by far the biggest (and most competitive) banking market in CEE countries. The country's bleak economic climate also currently makes it one of the most unprofitable banking markets in the region. At the end of 2003, the consolidated total assets of Polish banks were about EUR 111 billion (or some 32% of to-

tal CEE assets). The degree of bank intermediation (total assets as a percentage of GDP) came to only 60%, or below the CEE average (74%). Mergers and acquisitions in the past few years have reduced the number of banks. The market share of the five largest banks at the end of 2003 was approximately 52%.¹⁴

¹⁴ For the figures (in the text) relating to the Polish banking sector, please also see "Summary evaluation of the financial situation of Polish banks," Narodowy Bank Polski (NBP), June 2004.

Unlike in other CEE countries, privatization in Poland has not been completely finalized. The largest Polish bank (PKO Bank Polski, market share: 17%) remains in state hands. The other major Polish banks are without exception under the control of Western European and American banking groups. The share of Polish bank assets owned by foreigners is about 68%.

Slowing economic growth (2002 real GDP growth was a mere 1.2%; signs of economic recovery only began emerging in the second half of 2003), a growing number of insolvencies and weakening demand for credit by corporate customers had an extremely negative impact on income in the Polish banking sector in 2002 in particular. Profits generated by Polish banks fell by around a third in 2002 (ROE at 5.8% was one of the lowest in the region). Despite modest improvements in the second half of the year, profitability was still very low in 2003. ROE improved only slightly to 6.2% in 2003, still lagging behind comparable figures in other CEE countries by a wide margin. Poland's

economy continued to recover in the first half of 2004. For 2004, profits are widely expected to surge in the Polish banking sector.

Insolvencies and falling profits of corporate customers resulted in a further deterioration in the quality of the loan portfolio in 2002. The share of NPLs as a percentage of total lending increased from 17.9% to 21.1% at the end of 2002.¹⁵ Although the share of NPLs was still high (20.9%) at the end of 2003, lower net loan loss provisions (the share of net loan loss provisions as a percentage of operating income fell from 24.2% to 15.9% in 2003) indicate an easing in credit risk.

Following stagnation in 2002, lending growth picked up pace again to some extent in 2003 (+9%). In view of the continued low degree of credit penetration (at 15%, the share of domestic personal loans as a percentage of GDP remains one of the lowest in the CEE region; the share of personal mortgage loans as a percentage of GDP was only about 4% at the end of 2003), however, growth was relatively weak.

Table 9

Selected Key Figures of the Polish Banking Sector

	1999	2000	2001	2002
Number of banks	77	74	71	62
of which foreign banks	39	47	48	47
Private banks' share of total assets (%)	75.1	76.1	75.6	73.4
Share of nonperforming loans (%)	13.3	15	17.9	21.1
Domestic personal loans (% of GDP)	18.7	18.1	18	15.2
Market capitalization (% of GDP)	19.9	18.1	13.7	14.3
EBRD index on bank reform (from 1 to 4+)	3.3	3.7	3.7	3.7

Source: EBRD, Narodowy Bank Polski.

An analysis of loan demand by segment reveals a trend similar to that in other new Member States. Whereas

the demand for loans by enterprises remains very restrained, traditional retail products (such as mortgage

¹⁵ In the past, the NPL classification standard set by the NBP was far more stringent than those in other countries. Heavy criticism from banks and investors led to the NPL rule being amended in early 2004. Loans are now classified as NPLs if payments are 90 days in arrears. Market participants estimate that this will roughly halve the share of NPLs as a percentage of total lending.

loans, consumer loans) have bounced back smartly. Robust growth in mortgage-secured loans can also be attributed to the growing popularity of foreign currency loans.

With total assets of EUR 19.3 billion, state-owned PKO PB is not only Poland's largest bank but also the biggest in the entire CEE region. According to press reports, up to 30% of PKO PB are to be privatized by the end of November 2004. In view of the political situation, however, it is

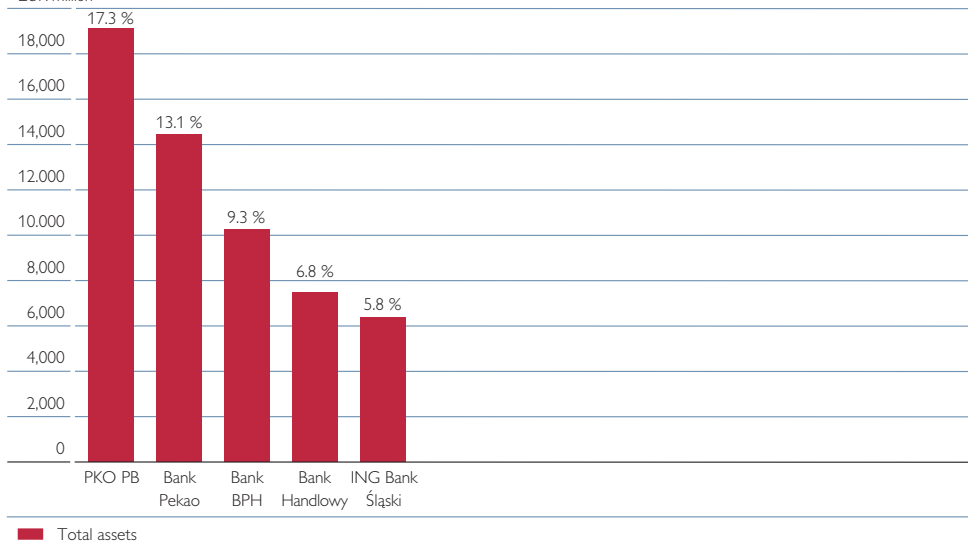
more than doubtful whether the privatization will go ahead as planned. The stock exchange-listed Bank Pekao, in which the Italian UniCredito holds a 53% stake, is the country's second-largest bank. BA-CA holds 71% in BPH-PBK, the third-largest Polish bank. The American Citibank owns 93% of Bank Handlowy, and ING Bank Śląski is dominated by the Dutch banking and insurance group, ING (ING holds 88% of the capital).

Chart 16

Total Assets and Market Share of the Five Largest Polish Banks

in 2003

EUR million



Source: Narodowy Bank Polski, OeNB estimates.
Note: Percentages refer to market share.

Relatively Few Austrian Banks Present in Poland

BA-CA and RZB are currently the only two Austrian banks represented by their own subsidiaries in Poland.

Bank BPH, BA-CA's subsidiary, has 3 million customers and a national network of branches with a particularly strong market position in Warsaw and Cracow. Bank BPH, with a recent market capitalization of EUR 2.6 billion, is listed on the Warsaw stock exchange. The bank's profitabil-

ity suffered badly in 2001 and 2002 on the back of merger activities (BPH, HVB's subsidiary, was merged with PBK, BA's subsidiary), the sluggish state of the Polish economy and high loan losses. In 2003, restructuring measures (e.g. staff cuts of 28% in the past few years), low risk costs and the disposal of financial assets improved performance. In 2003, profit after tax increased by 35%. At 7.4%, however, ROE remained modest. In addition to Bank BPH, BA-CA also

holds a stake in HypoVereinsbank Polen, which however only plays a minor role. In January 2004, BA-CA sold its holding in Gornoslaski Bank to Getin Holding (a Polish financial holding company) for EUR 50 million.

Despite its comparatively small size, Raiffeisen Bank Polen (RZB's subsidiary) has a well-known brand

name, particularly in the Greater Warsaw area. This allowed it to expand total lending by 16% in 2003 in a difficult market environment. Its profitability is equally good: profit after tax was sharply boosted from EUR 2.7 million to EUR 17.6 million, and ROE was a good 15.9%.

Table 10

**Key Figures of Selected Austrian Banks' Subsidiaries
in Poland at End-2003**

	Bank BPH	Raiffeisen Bank Polen
	EUR million	
Total assets	9,345	1,859
Change on previous year (%)	-9.1	+19.3
Profit after tax	81	18
Change on previous year (%)	+35.4	+537.2
	%	
Return on equity ¹	7.4	15.9
Cost-to-income ratio	66.6	77.8

Source: BA-CA, RZB.

¹ ROE after tax: Bank BPH; RIE before tax: Raiffeisen Bank Polen.

2.5 Slovenia

The total assets of the Slovenian banking sector were some EUR 21 billion at the end of 2003. At about 90%, the degree of bank intermediation (as a ratio of total bank assets to GDP) is relatively high. The dominance of Nova Ljubljanska banka (NLB) – with a market share of 34% it is by far Slovenia's biggest bank – means the degree of concentration is very high: the five largest banks of the country account for 66% of bank assets. Compared with other CEE countries, the state's extremely large share of the Slovenian banking market (almost 50% of the banking sector is still in state hands) and the limited influence of foreign banks are striking. Only 19% of Slovenian bank assets are majority-owned by foreign banks. Including equity interests, foreign banks control a somewhat larger share

of the Slovenian banking sector: overall, foreign banking groups hold some 34% of the equity capital of the Slovenian banking market.¹⁶

The fact that Slovenia has so far been spared a banking crisis (also likely to be the main reason for the state's large share of the banking market) is key to understanding the Slovenian banking system. Unlike in other countries of the region, demand for loans and leasing by private firms and households has enjoyed a steady long-term upwards trend as a result. At 41%, the share of domestic personal loans as a percentage of GDP was one of the highest in the CEE region at the end of 2002.

Compared with other CEE countries, the credit quality of the Slovenian banking sector is also very good. At 6.5%, the share of NPLs as a percentage of total lending was one of

¹⁶ The figures relating to the Slovenian banking sector are based on data provided by the Slovenian central bank (Banka Slovenije) and the IMF staff report on financial system stability assessment, update of April 2004.

the lowest in Eastern Europe (only Hungary and Croatia outperformed Slovenia in this respect). In 2003, a mere 13% of operating income needed to be used for additional risk costs.

Lending growth (+10% in the first three quarters of 2003), moderate risk costs and very high margins (at 3.4%, Slovenia, despite a decline,

still has one of the highest net interest margins in the region) were primarily responsible for the Slovenian banking sector's relatively good profitability (ROA: 1.0%). Capital adequacy is well below comparable figures in other CEE countries. At 11.6%, the solvency ratio is close to the average of Western European banks (11.2%).

Table 11

Selected Key Figures of the Slovenian Banking Sector

	1999	2000	2001	2002
Number of banks	31	28	24	22
of which foreign banks	5	6	5	6
Private banks' share of total assets (%)	57.8	57.5	51.1	51.4
Share of nonperforming loans (%)	x	6.5	6.9	6.9
Domestic personal loans (% of GDP)	38	38.7	40.4	41
Stock market capitalization (% of GDP)	11.8	13.7	14.7	19.1
EBRD index on bank reform (from 1 to 4+)	3.3	3.3	3.3	3.3

Source: EBRD, Banka Slovenije.

As already mentioned, Nova Ljubljanska banka, with a market share of 33.6%, is the leading bank in Slovenia. NLB is owned by KBC (which holds a stake of 34%) and the Slovenian state (further privatization is currently not envisaged, according to press reports). Nova Kre-

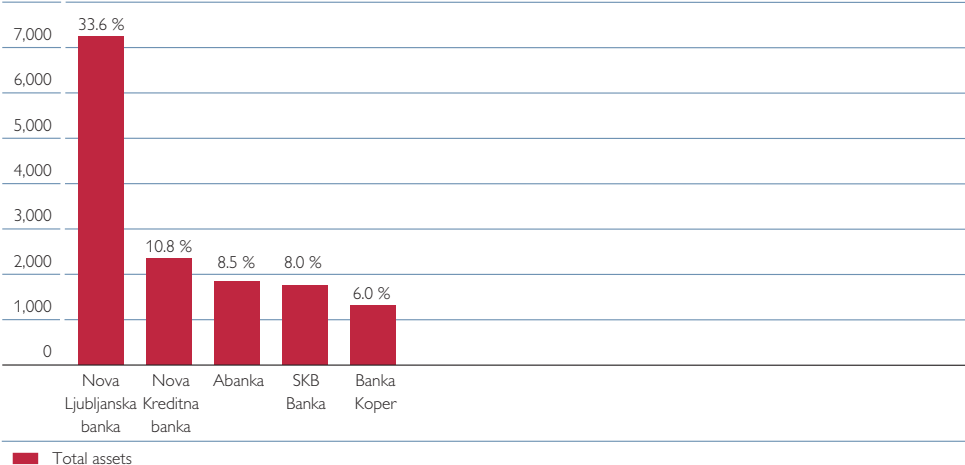
ditna banka – the country's second-largest bank (market share: 10.8%) – is in state hands. Abanka is also majority-owned by the state. The French Société Générale holds a stake of 99% in SKB Banka (market share: 8.0%). Banka Koper is controlled by the Italian San Paulo IMI.

Chart 17

Total Assets and Market Share of the Five Largest Slovenian Banks

in 2003

EUR million



Source: Annual reports, Banka Slovenije.
Note: Percentages refer to market share.

Share of Austrian Banks as a Percentage of the Slovenian Banking Market – Around 11%

BA-CA, RZB, Hypo Alpe-Adria Bank and ÖVAG are currently represented by their own subsidiaries in Slovenia. Kärntner Sparkasse is represented by a branch in Slovenia. With a market share of 4.3%, the largest Austrian bank in Slovenia is BA-CA d.d. As of October 2003, Raiffeisen Krekova banka accounted for 2.5%, Hypo Alpe-Adria Bank for 1.6%, and Volks-

bank-Ljudska banka for 1.3% of the market.

Austria's banks are currently pursuing an aggressive expansion policy in Slovenia (retail and corporate business) and advertising on a large scale. In 2003 Austrian banks' lending growth exceeded the market average by a wide margin. Nevertheless, the profitability of Austrian bank subsidiaries in Slovenia has been relatively low. At the end of 2003, the ROE of all Austrian banks in Slovenia lagged behind the Slovenian average.

Table 12

Key Figures of Selected Austrian Banks' Subsidiaries in Slovenia at End-2003

	BA-CA d.d.	Raiffeisen Krekova banka	Volksbank-Ljudska banka
<i>EUR million</i>			
Total assets	970	541	303
Change on previous year (%)	+26.7	+32.4	+49.0
Profit after tax	7	1	0
Change on previous year (%)	-33.2	-71.9	-10.1
<i>%</i>			
Return on equity ¹	9.8	1.9	1.7
Cost-to-income ratio	59.4	90.8	90.8

Source: BA-CA, RZB, ÖVAG.

¹ ROE after tax: BA-CA d.d.; ROE before tax: Raiffeisen Krekova banka and Volksbank-Ljudska banka.

2.6 Croatia

According to a news agency report,¹⁷ total assets of the Croatian banking market increased by 16% to HRK 203.8 billion (or around EUR 27 billion). At 107%, the degree of bank intermediation in Croatia was the highest in the CEE region. At 107%, the degree of bank intermediation in Croatia was the highest in the CEE region.

In Croatia the private sector makes greater use of the banking sector for financing than in other CEE countries. The share of loans to private firms and households amounts

to 41% of the country's GDP. Following the banking crisis in 1998–99 and the subsequent privatization of the major state-owned banks, the Croatian banking sector has been almost completely controlled by Western European banks. Overall, foreign bank subsidiaries account for some 91% of Croatian bank assets. At around 70%, the degree of concentration (market share of the five largest banks) is very high.¹⁸

The Croatian banking system was marked by healthy profitability in 2002 and 2003 (ROA after the first nine months of 2003: 1.6%) and

¹⁷ According to a report by Austria Presse Agentur of June 24, 2004.

¹⁸ For the figures (employed in the text) relating to the Croatian banking sector, please also see <http://www.hnb.hr/publikac/prezent/ebanking-sector.pdf>, in particular.

sound capital adequacy (solvency: 16.0%). The biggest risks in the Croatian banking system are strong growth in lending (largely financed by the buildup of net foreign debt) and the large share of foreign currency as a percentage of customer deposits (68% as of July 2003).

The steep rise in lending (2001: +28.5%, 2002: +40.0%) can be attributed to dynamic economic growth (2002 GDP growth: +5.2%) and to copious inflows of liquidity into the banking system. Considerable amounts of cash (primarily Deutsche marks) held outside the banking system until the end of 2001 had to be paid into bank accounts for the purposes of euro conversion. Since the Croatian population left most of this

cash in their accounts, the commercial banking sector suddenly found at its disposal additional liquidity of at least EUR 2 billion.

To contain the risk of excessively expansive lending growth, Hrvatska narodna banka (HNB – Croatian National Bank) introduced measures designed to absorb liquidity in early 2003. Commercial banks were accordingly obliged to purchase HNB securities as soon as their lending grew by more than 16% per year (or 4% per quarter). This measure reduced lending growth to about 16% in 2003 (2002: 40%). Despite the lapse of lending growth limits as of the end of 2003, HNB does not expect lending growth to accelerate at a fast pace in 2004.

Table 13

Selected Key Figures of the Croatian Banking Sector

	1999	2000	2001	2002
Number of banks	53	43	43	46
of which foreign banks	13	21	24	23
Private banks' share of total assets (%)	60.2	94.3	95	96
Share of non-performing loans (%)	20.6	19.8	15	11.5
Domestic personal loans (% of GDP)	22.1	27.8	34.2	45
Stock market capitalization (% of GDP)	14	14.5	16.8	16.1
EBRD index on bank reform (from 1 to 4+)	3.0	3.3	3.3	3.7

Source: EBRD.

With a market share of 24.8%, Zagrebačka banka (ZABA) is the leading bank in Croatia and ahead of Privredna banka Zagreb, which has a market share of 18.0%. Zagrebačka banka is 82%-owned by the Italian UniCredito (the remaining shares being held by Allianz). Privredna banka Zagreb belongs to Intesa, the Italian banking group (76%). Privredna banka Zagreb is followed by four Austrian subsidiary banks, with almost identical market share. Splitska banka, a subsidiary of BA-CA (merged with

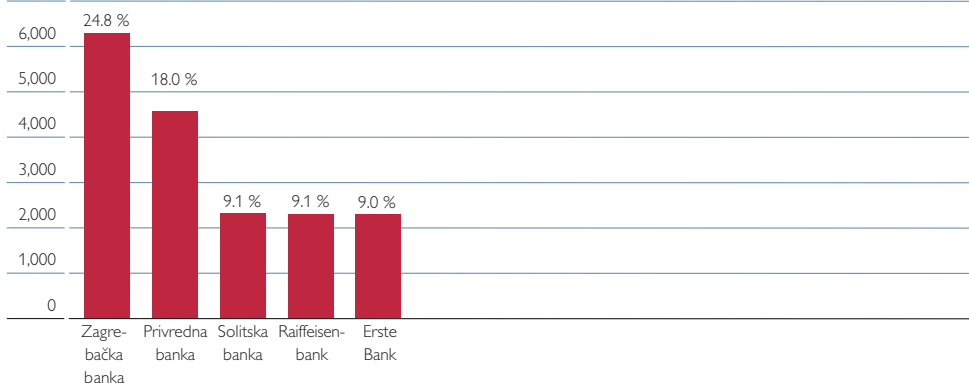
HVB Croatia in the third quarter of 2003) and Raiffeisenbank Austria d.d. each account for 9.1% of the market. Erste & Steiermärkische Bank (merged with Rijecka banka, Erste Bank's subsidiary, in the third quarter of 2003) has a market share of 9.0%. HAAB is represented in Croatia by Hypo Alpe-Adria Bank d.d. (HAAB's stake: 95%) and by Slavenska banka (HAAB's stake: 72%), thereby controlling some 8.9% of the country's banking market.

Chart 18

Total Assets and Market Share of the Five Largest Croatian Banks

at End-September 2003

EUR million



■ Total assets

Source: Hrvatska narodna banka.

Note: Percentages refer to market share.

**Market Share of Austrian Banks –
Around 38%**

The five Austrian banking groups operating in Croatia are Erste Bank, BA-CA, RZB, HAAB and ÖVAG. Their subsidiaries control roughly 38% of Croatia's bank assets.

In 2003 Austrian bank subsidiaries in Croatia continued to strengthen their total assets. The extraordinarily strong growth posted by Erste & Steiermärkische Bank d.d. (Erste Bank Kroatien) and by Splitska banka, BA-CA's subsidiary, was due to mergers (Erste Bank merged Rijeka banka with Erste & Steiermärkische Bank in the third quarter of 2003; BA-CA

merged its two units, HVB Croatia and Splitska banka).

The 2003 annual results for Raiffeisenbank Austria d.d. (ROE: 22.2%) indicate exceptionally high profitability. With a ROE of around 15%, Erste Bank's subsidiary generated an ROE which is roughly equivalent to that of the Croatian banking sector. BA-CA's subsidiary continued to grow in 2003 (its marketing network was expanded by 32 branches). At 12.8%, its ROE was slightly below the market average. Despite considerably improved income, Volksbank d.d.'s ROE fell short of the market average.

Table 14

Key Figures of Selected Austrian Banks' Subsidiaries

in Croatia at End-2003

	Splitska banka	Erste Bank Kroatien	Raiffeisenbank Austria d.d.	Volksbank d.d.
EUR million				
Total assets	2,509	2,551	2,446	355
Change on previous year (%)	+66.2	+126.5	+29	+52.1
Profit after tax	23	30	22	2
Change on previous year (%)	+71.0	+194.9	+12.9	+46.1
%				
Return on equity ¹	12.8	14.7	22.2	10.7
Cost-to-income ratio	57.3	62.5	64.8	86.7

Source: BA-CA, Erste Bank, RZB, ÖVAG.

¹ ROE after tax: Splitska banka and Erste Bank Kroatien; ROE before tax: Raiffeisenbank Austria d.d. and Volksbank d.d.

3 Conclusions

The Central and Eastern European banking market (excluding Russia) is relatively small with total assets of some EUR 350 billion (by comparison, the total assets of banks operating in Austria were some EUR 605 billion at the end of 2003).

The Eastern European banking sector is a growth market. The low degree of bank intermediation (about a third of its Western European counterpart), coupled with higher economic growth (EU accession could accelerate the CEE region's catch-up process), should offer banks in Central and Eastern Europe strong growth potential in the years to come.

Above-average growth potential and high profit potential (higher interest margins than in Western Europe and restructuring potential) have led Western European banks to invest heavily in the CEE banking sector. About 70% of the CEE banking market is currently estimated to be controlled by Western European banking groups.

Austrian banks were among the first to invest in Central and Eastern European countries and are now some of the best-known Western European banks in the region (market share in the region: about 22%). BA-CA, Erste Bank and RZB are among the most active Western European banks operating in CEE countries. As early as 2002 and 2003, steady expansion in the CEE region had a positive impact on the profitability of Austria's consolidated banking sector and was

primarily responsible for Austrian banks outperforming German banks in the past few years.

Favorable reports on the CEE banking market often fail to mention the potential risks, against which strong growth and high profits need to be offset. We consider the main sources of risk in the Eastern European banking market to be: macroeconomic imbalances, the risk of growing exchange rate volatility, credit risk (can relatively new and untested credit risk systems cope with a possible lending boom?), increasingly fierce competition (high profitability could attract additional competitors and cause margins to shrink more quickly than expected) and political risks.

The key characteristics of CEE banking markets are: the degree of concentration is relatively high (the five largest banks enjoy a large market share); a majority of bank assets are in foreign ownership (about 70%); customer deposits are generally far higher than loans granted (liquid balance sheets); the degree of intermediation is low (in particular, private sector as well as small and medium-sized enterprises are still largely financed outside the banking sector); the share of non-performing loans as a percentage of total lending is high; profitability is excellent (profitability ratios are on average higher than those of Western European banks); and capital adequacy is good (this should fuel strong lending growth over the next few years).

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HIGHLIGHTS

“60 Years of Bretton Woods”

A Summary of the Bretton Woods Conference

Christian Just,
Franz Nauschnigg

From June 20 to 22, 2004, the Oesterreichische Nationalbank (OeNB) and the New York-based Reinventing Bretton Woods Committee co-hosted an international conference in Vienna to commemorate the 60th anniversary of the Bretton Woods institutions – the International Monetary Fund (IMF) and the World Bank.

At the conference, speakers delineated the evolution of the international financial system, outlined future challenges and formulated possible solutions to crisis situations. Core issues included the governance of the international financial system, the development and future role of exchange rate regimes and a crisis prevention and resolution toolkit.

In his introductory remarks, *Klaus Liebscher*, governor of the OeNB, stressed the fundamental role the Bretton Woods institutions, i.e. the IMF and the World Bank, play in maintaining the stability of the international financial system and in ensuring welfare and the stability of the global economy. As platforms for international cooperation, the Bretton Woods institutions fulfill an important function especially for smaller countries like Austria, which may use these forums to actively participate in international rule-making and crisis resolution processes. With a view to the criticism the IMF, in particular, had to face after the Asian crisis, Mr. Liebscher stated that, whenever justified, criticism had brought about a change in the way the international financial institutions work, as had been the case with capital account liberalization. According to Mr. Liebscher, this example shows that the Bretton Woods institutions do react to constructive suggestions for improvement.

Furthermore, he underlined a number of important functions the IMF and the World Bank fulfill:

- Monitoring member states’ economic developments helps increase and maintain their living standard and prevents international financial crises.
- Therefore, economic standards and codes have been established to facilitate member states’ integration into the global economy.

- Moreover, *Financial Sector Assessment Programs* (FSAPs) have been implemented to help analyze strengths and vulnerabilities of national financial systems. (Austria has recently conducted such a program with excellent results.)

These and similar measures serve to strengthen member states’ economies, enhance their resilience to crises and thus curb the need for international financial assistance in crisis situations.

In case a financial crisis does occur, the private sector is also called upon to assume responsibility for its investment decisions. According to Mr. Liebscher, one important future challenge will be the establishment of a regulatory framework that is to facilitate the resolution of sovereign debt crises.

Mr. Liebscher pointed out that another major task of the Bretton Woods institutions, and of the World Bank in particular, is poverty reduction. Although not a “development” institution in spirit and by design, the IMF, too, plays a significant role in the efforts the international community undertakes to eradicate poverty.

As an impressive example of the strong track record of the Bretton Woods institutions, Mr. Liebscher mentioned their contribution to the successful transition process of former socialist economies, above all in Central and Eastern Europe. Austria has

played an important part in this respect as well, and it continues to support the Bretton Woods institutions through technical cooperation projects and as a sponsor of the *Joint Vienna Institute*.

According to Mr. Liebscher, the ongoing discussion about reforming the international financial institutions should be viewed as positive. However, in his opinion such a reform should not result in an expansion of the institutions' functions but rather in a return to their core responsibilities.

As *Marc Uzan*, executive director of the New York-based Reinventing Bretton Woods Committee, pointed out, the international financial system has changed considerably since 1944. Instead of a system of fixed exchange rates among major currencies, there is now a floating rate system, and global financial markets have replaced once pervasive capital controls. From a relatively small group of 35 countries, IMF membership has expanded to include virtually every country in the world. Particularly since the financial crises of the 1990s, the debate over how to improve the international financial architecture and how to strengthen the international financial system has intensified.

According to Mr. Uzan, integrating the emerging markets into the global economy poses much greater policy challenges than previously anticipated. One of the pivotal issues concerning the future development of the international financial system will be the exchange rate regime. Despite recent movements toward more flexible exchange rates, some important emerging economies, such as China, continue to peg their rates to other currencies. Another major issue, according to Mr. Uzan, will be

the future role of the IMF. If countries are to deal successfully with future challenges, they will need to reestablish the strong sense of international cooperation originally laid out in the Bretton Woods agreements.

Panel I: The Governance of the International Financial System

Zeti Akthar Aziz, governor of Bank Negara Malaysia, the central bank of Malaysia, also emphasized the importance of international cooperation. Some immediate challenges, in her opinion, are unsustainable current account imbalances and unstable capital flows. She called for adjustments in the international financial system and recommended taking precautionary measures to prevent crises instead of waiting for the next crisis to take effect.

The keynote speaker of this panel, *Jeffrey Shafer* (Citigroup), discussed the far-reaching changes the Bretton Woods system has experienced over the last 60 years: fixed exchange rates have been replaced by floating exchange rates, capital controls have been removed to allow free cross-border capital flows and, last but not least, the euro has been introduced. Although requirements for the governance of the international financial system may have changed, the IMF and the World Bank still constitute its core institutions. Sovereign states remain key players in the system, but given their increasing interdependence, they have to cooperate more closely. According to Mr. Shafer, major challenges comprise adjusting current account imbalances, improving financial sector surveillance and adapting the World Bank's role to match higher liquidity in financial

markets. In this respect, he advocated providing grants rather than loans. In addition to that, ways of dealing with countries whose debt levels have become unsustainable must be found. Concerning IMF governance, Mr. Shafer noted that the Executive Board of the IMF is no longer representative of the present geopolitical realities, with the EU, in particular, being overrepresented and Asia being underrepresented. Although EU votes nearly outnumber U.S. votes by two to one, the EU has less influence within the IMF than the U.S.A. Furthermore, Mr. Shafer called for the establishment of a G-4 consisting of the U.S.A., the euro area, Japan and China.

Kurt Bayer (Austria), executive director of the World Bank, gave an overview of the tasks of the World Bank, whose original mission was to reduce poverty and promote development. In Mr. Bayer’s opinion, the World Bank, together with regional development banks and their specialized institutions, still has the potential to contribute immensely to fulfilling this mission. Recently, strengthening the financial systems in developing and emerging economies has become even more important, particularly when bearing in mind that the damage caused by financial crises in these countries during the last few decades equals the amount of official development assistance they received.

Kemal Derviş, former Turkish minister of economic affairs, discussed the two fundamentalisms that characterized the 20th century – central planning and market fundamentalism – pointing to the fact that central planning has been discredited because of the collapse of communism. According to Mr. Derviş, the market, when left on its own, is not able to distribute all resources efficiently, but de-

pends on government support in fulfilling this task. State and market are thus complementary actors. Markets must be embedded in adequate framework conditions. Currently, this embedding exists at the national level, but not at the international level. In Mr. Derviş’ opinion the IMF has a key responsibility to correct market failures at the international level and to provide public goods like financial stability. Its two main functions are crisis resolution and the economic surveillance of member states. The sometimes excessive levels of public debt in emerging countries are not sustainable in the long run, especially since capital markets are highly volatile. Mr. Derviş advocated providing IMF financial assistance also on a long-term basis, as World Bank resources alone are insufficient in this context. The problem with IMF conditionality is that its implementation may lead to political problems in the respective countries.

Harold James, professor at Princeton University, pointed to the success of the Bretton Woods system, which had originally been based on three pillars: the IMF, the World Bank and an international trade organization, which was effectively established only in 1995, when the World Trade Organization (WTO) was founded. Mr. James explained that there has been a converse development in the monetary domain and in trade. While the monetary order is moving away from strict rules, i.e. from a fixed exchange rate regime to a system of floating rates, trade is experiencing a shift towards more rules and regulations, as established by the WTO. Historically, exchange rate adjustments served to solve trade problems, as was the case in the U.S.A. in 1971 and 1985. Applying this kind of solution will be-

come increasingly difficult, as half the world, i.e. the U.S.A. and Asia, have entered into an informal Bretton Woods system, in which currencies are pegged to the U.S. dollar. While the volatility of capital flows in emerging economies may create problems, one should not only bear in mind the costs, but also the benefits of free capital flows. History has shown that rapidly growing economies often tend to be instable. In many cases IMF conditionality is hardly acceptable from a political point of view. Quoting the situation in Austria in the 1920s as an example, Mr. James stated that the conditionality of the League of Nations had been too strict and had subsequently prompted other countries to refrain from accepting financial assistance by the League of Nations.

Among the topics of the ensuing discussion was the issue of moral hazard. Participants stated that, while moral hazard may play an important role in the political discussion, no empirical proof of its existence has been found so far. Exchange rate manipulation – i.e. creating export advantages by deliberately keeping exchange rates low – has so far only been an issue with Korea and Sweden, namely in the 1980s. It could, however, become a problem in China. With respect to the question of governance, some discussants advocated strengthening the IMF and World Bank boards of directors rather than letting informal groups take care of this issue, arguing that the number of “G-x”s was too large already. The main problem with financial crises is that, in general, they have a particularly severe impact on the poorest members of the population in developing and emerging countries.

Panel II: Exchange Rate Regimes

In his introductory statement on exchange rate regimes, *Guillermo Ortiz*, governor of the Banco de México, gave an account of Mexico’s experience with exchange rate regimes since the mid-1990s. Mexico was the first emerging market economy to implement a flexible exchange rate regime, introducing floating rates in 1994 after a sharp drop in foreign reserves following interventions during the Mexican crisis. Mr. Ortiz drew a positive picture of Mexico’s experience with floating exchange rates.

Michael Bordo, professor at Rutgers University, offered a historical account of the evolution of exchange rate regimes. At the beginning of the 20th century, there had been a clear tendency to join the gold standard, if possible. Now, at the beginning of the 21st century, the consensus is shifting toward floating exchange rates. However, in the period between World War I and World War II, some countries had negative experiences with flexible exchange rates because of speculations and beggar-thy-neighbor devaluations. Not until Milton Friedman argued for floating exchange rates did flexible rates become a real economic policy option again. Mr. Bordo emphasized the credibility of economic policy as a key factor; while countries traditionally pegged their exchange rates to other currencies and used them as nominal anchors, the new consensus increasingly tends toward domestic monetary anchors, mostly through inflation targeting. Emerging economies with fixed exchange rates are prone to encounter difficulties, in particular if they lack a lender of last resort and if their capital markets are not well developed, as external debt in foreign currency is likely to cause

currency mismatches and thus creates financing problems. According to Bordo, in cases like these, devaluations often have no effect on the real economy. When speaking of exchange rate regimes, one has to distinguish between *de jure* and *de facto* regimes. The *de jure* regime applied by the IMF appears to hollow out intermediary regimes – which *de facto* exist in much larger numbers – in favor of either fixed or floating exchange rate systems. The historical performance shows that pegs work well for developing countries but not for advanced economies. The more advanced an economy is, the sooner it can switch to floating exchange rates.

Based on the European experience, *Josef Christl*, executive director of the OeNB, analyzed whether currency unions might be an option for other regions, such as Latin America or Asia. In his remarks on optimum currency area criteria, Mr. Christl pointed out that for countries like Argentina these criteria remain important and that their endogeneity must not be presupposed. Concerning the costs and benefits of the European Economic and Monetary Union, he stated that the success and sustainability of a monetary union depend not only on a strong political will, but also on fiscal rules. Asia and Latin America may have taken the first steps of a Balassa sequencing by establishing free trade areas and customs unions; however, Mr. Christl said that he was not yet convinced that these regions could currently benefit from a monetary union given their varying degrees of economic development and lack of political will. He considers the adoption of inflation targeting a feasible monetary policy option for achieving macroeconomic stability and economic convergence, pointing to countries like Mex-

ico and Chile, which have attained relative stability by applying this strategy. In concluding, Mr. Christl said that the EU experience with economic and monetary integration cannot serve as a blueprint for other regions.

Masahiro Kawai, professor at the University of Tokyo, gave a presentation on how East Asia could contribute to a stable currency system. According to Mr. Kawai, the Asian crisis has shown that regional financial architectures are needed to complement the international financial architecture. In Asia, the regional architecture essentially involves the Chiang Mai Initiative, the ASEAN+3 dialogue and the Asian Bond Market Initiative. Deepening regional integration and macroeconomic interdependence throughout Asia require financial stability at the regional level. It is this regional financial stability that Asia needs to be able to play a role in international economic relations commensurate with its economic power. However, the fear of losing national sovereignty, the heterogeneity of the Asian economies and the peg to the U.S. dollar render closer cooperation difficult. To Mr. Kawai, key prerequisites for promoting closer cooperation on the basis of the IMF framework are, among others, stronger regional economic surveillance and an enhanced exchange rate policy coordination based on a G-3 (U.S. dollar, euro and Japanese yen) “currency snake” similar to the European currency snake of the 1970s.

Panel III: Crisis Prevention and Resolution

Pedro Malan, former finance minister of Brazil, emphasized how sharply circumstances have changed since the creation of the Bretton Woods system.

He quoted Hobsbawm, according to whom more changes have occurred since the end of World War II than in any other period of world history. It is important to remember the lessons we can learn from history and to bear in mind the interplay between past, present and future. We must expect financial crises to occur in the future and be prepared to overcome them in the best possible way. Exchange rate regimes and fiscal rules have to be adapted to changing circumstances; naturally, there can be no ideal regime that is valid for all countries at all times. Mr. Malan particularly stressed the importance of growth strategies for developing and emerging economies and emphasized the role institutions play in this context, using the wordplay, “It’s institutions, stupid!”

In Mr. Malan’s opinion there is a broad consensus that sustainable macroeconomic policies and stable – rather than fragile – financial systems are needed, while institutional weaknesses have to be eliminated. Addressing economic problems in individual countries is a key priority, but a number of international issues have to be solved as well. One such issue is the asymmetric distribution of information between borrowers and lenders. A surge in debt after the first oil price shock and a rise in interest rates originating in the U.S.A. had triggered the debt crisis of the 1980s, which was not overcome until the Brady Plan was introduced in 1989. In Mr. Malan’s opinion, the Sovereign Debt Restructuring Mechanism (SDRM) the IMF proposed is not an adequate means for resolving crises in emerging economies, in particular in his home country Brazil. Instead, he advocated a wider use of Collective Action Clauses (CACs) and stated that close

cooperation between the public and private sectors and international institutions is essential. As a case in point, he described Brazil’s experience with a debt rollover: Brazil had negotiated with the private sector, but the meetings had taken place at the respective central banks in the presence of an IMF representative. This cooperation had been key to the initiative’s success.

Richard Portes, professor at the London Business School and President of the Centre for Economic Policy Research (CEPR), summarized the status quo in crisis resolution, pointing out that while bailouts are not the path to success, disorderly sovereign debt workouts are very costly. Solving the IMF’s time inconsistency problem requires a clear regulatory framework on presumptive limits. The market itself cannot provide a clear institutional framework for the orderly resolution of government bankruptcies. The SDRM debate may not have produced an international framework for debt workouts; nevertheless, it has spurred the debate and the search for alternatives, which comprise applying CACs, reintroducing bondholders’ committees by establishing a New York Club, and creating a mediation agency independent of the IMF to coordinate the Paris, London and New York Clubs. This agency could also carry out other functions, such as monitoring the compliance with a code of conduct. Mr. Portes also presented a new proposal, suggesting that the IMF could act as a lender of first resort and offer a facility similar to a contingent credit line, which a country might use to fulfill its international obligations in the event of a liquidity crisis.

Gertrude Tumpel-Gugerell, member of the Executive Board of the European Central Bank, analyzed the

international crisis prevention toolkit. She particularly underlined the aspect of transparency, pointing out that greater transparency should make it easier for market participants to assess risks. Ms. Tumpel-Gugerell stressed the IMF’s increased efforts to promote the provision of data through the Special Data Dissemination Standard. She also emphasized that the Bretton Woods institutions have stepped up their efforts to achieve financial stability, e.g. by establishing an International Capital Markets Department and by drawing up the Financial Sector Assessment Programs (FSAPs). In addition, the IMF’s balance sheet approach ensures that countries’ balance sheets are monitored more closely in order to detect mismatches that may affect their debt-servicing abilities. Ms. Tumpel-Gugerell continued by saying that views were still evolving on the appropriate balance between transparency and confidentiality. In her opinion, the question whether all the efforts mentioned have actually improved crisis resilience remains an open issue. She noted that although there has been some contagion, risk differentiation among individual emerging economies has increased.

Anne O. Krueger, first deputy managing director of the IMF, said that the IMF’s mission – to provide a stable international financial system as a sound basis for promoting trade expansion and economic growth – has remained valid since its foundation in 1944, but that the methods used to achieve this mission have changed. Demands on the IMF have also altered, particularly since the capital account crises of the 1990s. Among other issues, Ms. Krueger focused on the pronounced changes in the IMF’s surveillance function and on its crisis resolution toolkit. She quoted the enhanced transparency in the dialogue between the IMF, its members and the broader public, the movement away from fixed exchange rates and an expanded definition of macroeconomic stability among the major changes in the Fund’s surveillance work. Ms. Krueger underlined the importance of CACs in crisis resolution, even though, in her opinion, it is still much too soon to evaluate to what extent CACs can improve the orderly resolution of sovereign debt crises. By way of conclusion, she said that the IMF, just like the world economy, is constantly evolving and that the Fund should, where possible, try to remain at the cutting edge of global economic developments.

NOTES

Abbreviations

ACH	automated clearing house	GNP	gross national product
APSS	Austrian Payment System Services GmbH	GSA	GELDSERVICE AUSTRIA Logistik für Wert- gestionierung und Transportkoordination GmbH (Austrian cash services company)
ARTIS	Austrian Real Time Interbank Settlement (the Austrian RTGS system)	HICP	Harmonized Index of Consumer Prices
A-SIT	Secure Information Technology Center – Austria	IBAN	International Bank Account Number
ASVG	Allgemeines Sozialversicherungsgesetz – General Social Security Act	IBRD	International Bank for Reconstruction and Development
A-Trust	A-Trust Gesellschaft für Sicherheitssysteme im elektronischen Datenverkehr GmbH	IDB	Inter-American Development Bank
ATM	automated teller machine	IFES	Institut für empirische Sozialforschung GesmbH (Institute for Empirical Social Research, Vienna)
ATX	Austrian Traded Index	ifo	ifo Institute for Economic Research, Munich
BCBS	Basel Committee on Banking Supervision (BIS)	IGC	Intergovernmental Conference (EU)
BIC	Bank Identifier Code	IHS	Institut für Höhere Studien und Wissenschaftliche Forschung – Institute for Advanced Studies, Vienna
BIS	Bank for International Settlements	IIF	Institute of International Finance
BOP	balance of payments	IIP	international investment position
BSC	Banking Supervision Committee (ESCB)	IMF	International Monetary Fund
CACs	collective action clauses	IRB	internal ratings-based
CEBS	Committee of European Banking Supervisors (EU)	ISO	International Organization for Standardization
CEE	Central and Eastern Europe	IWI	Industriewissenschaftliches Institut – Austrian Institute for Industrial Research
CEECs	Central and Eastern European countries	IT	information technology
CESR	Committee of European Securities Regulators	JVI	Joint Vienna Institute
CIS	Commonwealth of Independent States	LIBOR	London Interbank Offered Rate
CPI	consumer price index	M3	broad monetary aggregate M3
EBA	Euro Banking Association	MFI	monetary financial institution
EBRD	European Bank for Reconstruction and Development	MRO	main refinancing operation
EC	European Community	MÖAG	Münze Österreich AG – Austrian Mint
ECB	European Central Bank	MoU	memorandum of understanding
Ecofin	Council of Economics and Finance Ministers (EU)	NCB	national central bank
EEA	European Economic Area	ÖBB	Österreichische Bundesbahnen – Austrian Federal Railways
EFC	Economic and Financial Committee (EU)	OeBS	Oesterreichische Banknoten- und Sicherheitsdruck GmbH – Austrian Banknote and Security Printing Works
EIB	European Investment Bank	OECD	Organisation for Economic Co-operation and Development
EMS	European Monetary System	OeKB	Oesterreichische Kontrollbank (Austria's main financial and information service provider for the export industry and the capital market)
EMU	Economic and Monetary Union	OeNB	Oesterreichische Nationalbank (Austria's central bank)
EONIA	Euro OverNight Index Average	OPEC	Organization of the Petroleum Exporting Countries
ERM II	Exchange Rate Mechanism II (EU)	ORF	Österreichischer Rundfunk – Austrian Broadcasting Corporation
ERP	European Recovery Program	ÖBFA	Austrian Federal Financing Agency
ESA	European System of Accounts	ÖNACE	Austrian Statistical Classification of Economic Activities
ESAF	Enhanced Structural Adjustment Facility (IMF)	PE-ACH	pan-European automated clearing house
ESCB	European System of Central Banks	PISA	Programme for International Student Assessment (OECD)
ESRI	Economic and Social Research Institute	POS	point of sale
EU	European Union	PRGF	Poverty Reduction and Growth Facility (IMF)
EURIBOR	Euro Interbank Offered Rate	RTGS	Real-Time Gross Settlement
Eurostat	Statistical Office of the European Communities	SDR	Special Drawing Right (IMF)
FATF	Financial Action Task Force on Money Laundering	SDRM	Sovereign Debt Restructuring Mechanism (IMF)
Fed	Federal Reserve System	SEPA	Single Euro Payments Area
FFF	Forschungsförderungsfonds für die Gewerbliche Wirtschaft – Austrian Industrial Research Promotion Fund		
FMA	Financial Market Authority (for Austria)		
FOMC	Federal Open Market Committee (U.S.A.)		
FSAP	Financial Sector Assessment Program (IMF)		
FWF	Fonds zur Förderung der wirtschaftlichen Forschung – Austrian Science Fund		
GAB	General Arrangements to Borrow		
GATS	General Agreement on Trade in Services		
GDP	gross domestic product		

SPF	Survey of Professional Forecasters	UNO	United Nations Organization
STEP2	Straight-Through Euro Processing system offered by the Euro Banking Association	VaR	Value at Risk
STP	straight-through processing	WBI	Wiener Börse Index
STUZZA	Studiengesellschaft für Zusammenarbeit im Zahlungsverkehr G.m.b.H. – Austrian Research Association for Payment Cooperation	WEF	World Economic Forum
S.W.I.F.T.	Society for Worldwide Interbank Financial Telecommunication	WIFO	Österreichisches Institut für Wirtschaftsforschung – Austrian Institute of Economic Research
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer	WIIW	Wiener Institut für internationale Wirtschaftsvergleiche – The Vienna Institute for International Economic Studies
Treaty	refers to the Treaty establishing the European Community	WKO	Wirtschaftskammer Österreich – Austrian Federal Economic Chamber
UNCTAD	United Nations Conference on Trade and Development	WTO	World Trade Organization

Legend

- = The numerical value is zero
- .. = Data not available at the reporting date
- × = For technical reasons no data can be indicated
- 0 = A quantity which is smaller than half of the unit indicated
- Ø = Mean value
- = New series

Note: Apparent arithmetical discrepancies in the tables are due to rounding.

Irrevocable euro conversion rate: EUR 1 = ATS 13.7603.

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The *Annual Report* of the OeNB provides a broad review of Austrian monetary policy, economic conditions, new developments on the financial markets in general and the financial market supervision in particular, the changing responsibilities of the OeNB and the role of the OeNB as an international partner in cooperation and dialogue. It also contains the financial statements of the OeNB.

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annual

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Addresses of the Oesterreichische Nationalbank

	Postal address	Telephone	Telex
Head Office			
A 1090 Vienna	PO Box 61	(+43-1) 404 20-0	(1) 114669 natbk
Otto-Wagner-Platz 3	A 1011 Vienna Austria	Fax: (+43-1) 404 20-2398	(1) 114778 natbk
Internet: www.oenb.at			
Branch Offices			
Bregenz			
Anton-Schneider-Straße 12	PO Box 340 A 6901 Bregenz Austria	(+43-5574) 49 61-0 Fax: (+43-5574) 49 61-99	
Eisenstadt			
Esterhazyplatz 2	PO Box 60 A 7001 Eisenstadt Austria	(+43-2682) 627 18-0 Fax: (+43-2682) 627 18-99	
Graz			
Brockmanngasse 84	PO Box 8 A 8018 Graz Austria	(+43-316) 81 81 81-0 Fax: (+43-316) 81 81 81-99	
Innsbruck			
Adamgasse 2	A 6020 Innsbruck Austria	(+43-512) 594 73-0 Fax: (+43-512) 594 73-99	
Klagenfurt			
10.-Oktober-Straße 13	PO Box 526 A 9010 Klagenfurt Austria	(+43-463) 576 88-0 Fax: (+43-463) 576 88-99	
Linz			
Coulinstraße 28	PO Box 346 A 4021 Linz Austria	(+43-732) 65 26 11-0 Fax: (+43-732) 65 26 11-99	
Salzburg			
Franz-Josef-Straße 18	PO Box 18 A 5027 Salzburg Austria	(+43-662) 87 12 01-0 Fax: (+43-662) 87 12 01-99	
Representative Offices			
Oesterreichische Nationalbank		(+44-20) 7623-6446	
London Representative Office		Fax: (+44-20) 7623-6447	
5 th floor, 48 Gracechurch Street			
London EC3V 0EJ, United Kingdom			
Oesterreichische Nationalbank		(+1-212) 888-2334	(212) 422509 natb ny
New York Representative Office		(+1-212) 888-2335	
745 Fifth Avenue, Suite 2005		Fax: (+1-212) 888-2515	
New York, N. Y. 10151, U.S.A.			
Permanent Mission of Austria to the EU		(+32-2) 285 48-41, 42, 43	
Avenue de Cortenberg 30		Fax: (+32-2) 285 48-48	
B 1040 Brussels, Belgium			
Permanent Mission to the OECD		(+33-1) 53 92 23-39	
3, rue Albéric-Magnard		(+33-1) 53 92 23-44	
F 75116 Paris, France			
		Fax: (+33-1) 45 24 42-49	