The “East Jour Fixe” of the Oesterreichische Nationalbank

57th East Jour Fixe

Economic and Monetary Challenges in Southeastern Europe

The East Jour Fixe of the Oesterreichische Nationalbank (OeNB) was initiated in 1991 as a forum in which central bankers, government officials, members of academia and other experts on Eastern Europe meet to discuss specific transition issues. Bringing together the chief economists of Southeastern European central banks, the 57th East Jour Fixe on June 9, 2006, was another special event in this series of meetings. It was a follow-up to the first Special East Jour Fixe of that kind and composition, which had taken place on May 30, 2005.

While the first Special East Jour Fixe on Southeastern Europe (SEE) had dealt primarily with exchange rate policy, this year’s event addressed monetary and economic challenges in SEE. The workshop was organized in two sessions. In his introductory statement, Peter Mooslechner, Director of the OeNB’s Economic Analysis and Research Section, stressed the substantial progress the countries in the region have achieved in recent years. At an average real GDP growth rate of 5% in 2005, the economies in question continue to perform robustly compared with most other regions of the world. After a significant drop of foreign direct investment (FDI) flows in 2004, the SEE countries managed to attract more FDI again in 2005. Despite a broad range of different monetary and exchange rate strategies, most SEE countries have been remarkably successful in bringing down inflation. A useful strategy in many cases has been to use the euro as a nominal anchor, reference currency or legal tender. Mooslechner pointed out that, at the same time, a number of risks still persist. Most SEE countries continue to record high and rising trade and current account deficits. Up to a point, these external imbalances are to be seen as a corollary of the catching-up process. Partially, however, they also reflect buoyant domestic demand supported by rapid credit growth. To finance trade deficits, many countries strongly depend on workers’ remittances, FDI and foreign financial assistance.

The primary objective of the first roundtable session chaired by Peter Mooslechner was to provide information on recent economic developments and on policy measures that have been taken since the last meeting in May 2005. Gramoz Kolasi, Head of the Monetary Policy Department of Banka e Shqipërisë (Bank of Albania), reported a continuation of robust economic growth, a slight appreciation of the Albanian lek in both nominal and real terms as well as low and stable inflation (within the target band of 2% to 4% for the last two years). Moreover, credit growth picked up substantially in the almost entirely privatized banking sector. In addition, as the Albanian economy progresses through transition, the country risk – and thus the risk premium required by private savers – has declined. But Kolasi also stressed some challenges his country has been facing. Although the economy grew robustly at 5.5% in 2005, growth was slowed down by severe electric energy blackouts. Persisting problems in the energy infrastructure have forced Banka e Shqipërisë to revise its growth forecast for 2006 downward to 5%. On the fiscal front, despite improvements in reducing public debt from 68% of GDP in 2001 to

55% of GDP in 2005, public debt is still hovering at relatively high levels. In the short run, Kolasi sees potential threats mainly in the interruption of structural reforms, the skyrocketing credit growth (at an annual rate of 70% over the last ten months, although starting from a low level) and the increasing pace of consumer loan growth, which fuels the current account deficit (expected to reach 8.1% of GDP in 2006, up from 7% in 2005). Therefore, Banka e Shqipërisë intends to monitor the development and driving forces of these variables in more detail and to adopt counteracting measures if necessary.

The Head of the Economic Research and Statistics Department of Centralna banka Bosne i Hercegovine (CBBH), Amir Hadziomeragic, said that one of the greatest achievements of his country was the start of negotiations on a Stabilisation and Association Agreement with the EU in November 2005. The economy in Bosnia and Herzegovina (BiH) grew robustly at about 5% in 2005, and Hadziomeragic was confident that the sustainability of growth was guaranteed by a mix of prudent macroeconomic policies. In the wake of a successful tax reform, the efficiency of tax collection increased and, as a consequence, a fiscal surplus was recorded in 2005. According to Hadziomeragic, financial intermediation has also improved considerably in BiH. Foreign banks dominate the sector, and this trend is projected to continue. The potentially worrying implication of this development is rapid credit growth. The other major risks are large trade and current account deficits and the vital role of remittances. The good news Hadziomeragic could convey in this context was that foreign reserves have been continuously growing despite external imbalances and that exports are rising encouragingly. To address the rapid credit growth, the CBBH intends to improve financial surveillance, and the reserve requirement rate for commercial banks has been increased from 10% to 15%. Hadziomeragic also expressed concerns that structural reforms are not proceeding as quickly as envisaged.

Mariella Nenova-Amar, Director of the Economic Research and Projections Directorate of the Bulgarian National Bank (BNB), reported continuing high GDP growth in 2005 (5.5%) and highlighted three major driving forces behind the robust growth Bulgaria has experienced since 1997: Apart from the currency board arrangement, she assigns a major role to structural reforms and an extremely prudent fiscal policy. She voiced the BNB's determination to enter into ERM II immediately after joining the EU. Like other countries in the region, Bulgaria faces rising trade and current account deficits. The latter almost doubled in 2005 and are expected to deteriorate further in 2006 and to slightly improve after that. The main reason for the external imbalances is the inflow of capital to Bulgaria, financing a two-digit real growth rate of fixed capital formation, accompanied by the import of investment goods. Part of the capital inflows was channeled through the domestic banking system, leading to a relatively high growth rate of banking credit in the period from 2003 to 2004. By introducing administrative measures such as a limit on the quarterly growth rate of claims on the nongovernment sector, an excess of which is penalized by additional minimum reserve requirements, the BNB managed to moderate credit growth to 30% in 2005, and another slowdown to 20% is expected for 2006. As banks seem to have found ways to circumvent restrictions, the BNB considers alleviating these measures.

The Executive Director of the Research and Statistics Area of Hrvatska narodna nanka (HNB), Ljubinko Jankov, emphasized the beneficial effect of the EU integration process for Croatia and its economy. He said there was a broad consensus that the integration process helped the country move into the right direction. In his presentation, Jankov also focused on the challenges his country still faces. Croatia looks back on persistently high budget deficits and, despite recent improvements, the fiscal imbalance is still elevated, e.g. due to subsidies to the ship industry. Owing to a lending boom encouraged inter alia by large bank privatizations, the current account deficit is rising. It stood at 6% of GDP in 2005 and is projected to reach 7% in 2006. Moreover, external debt has reached worryingly high levels of more than 82% of GDP. The HNB has tried to counteract the lending boom with various tools, including administrative instruments. Although the latter were supposed to make borrowing abroad and lending at higher rates at home substantially less profitable, banks continued to borrow from abroad and relend domestically. This behavior might be explained by some inertia and the hope that restrictions may be alleviated soon. However, according to Jankov, this development also suggests that banks are not solely profit-oriented. On the contrary, for the sake of defending or expanding their market shares, they are willing to accept lower profits.

Aneta Krstevska, Director of the Research Department of the National Bank of the Republic of Macedonia (NBRM), underscored that for her country the year 2005 was one of the most successful years on record. While the economy grew at almost the same pace as in 2004 (by about 4%), the high current account deficit recorded in 2004 (almost 8% of GDP) was dramatically reduced to less than 2% of GDP. Traditionally, the current account deficit was financed chiefly by private transfers. The relatively low contribution of FDI is expected to increase in 2006 in the wake of a large power company privatization. Interest rates have been declining since the NBRM switched from volume to interest rate tenders. Unlike in other countries in the region, credit growth is not a big issue in the Republic of Macedonia, as it has been rather gradual. The financial markets have undergone substantial improvements, as e.g. market makers were introduced on the foreign exchange market and a second pillar was established for the pension system. This sound economic policy also gained the country EU candidate status at the end of 2005. According to Aneta Krstevska, it will be crucial for sustainable success to continue the sound macroeconomic policy stance, proceed further with structural reforms and keep up the gradual liberalization of the capital account. Private transfers, which reached the equivalent of 80% of the trade deficit in 2005, and their sterilization will also be a major challenge.

Nicola Fabris, Chief Economist of Centralna banka Crne Gore (CBCG), presented the most recent economic developments in Montenegro. The economy grew by 6.8% year on year in the first quarter of 2006. Although all branches of the economy expanded substantially, growth was most significant in construction and forestry, as they started from a low level. Also services, particularly tourism, recorded strong increases. The banking sector was characterized by a mixture of positive and negative trends. On the one hand, savings and banks' total assets went up strongly. Deposits and granted loans also rose, but the increase of the former was more pronounced. On the other hand, average weighted effective interest rates were extremely high, amounting to 12.04% at the end of the third quarter of 2005. Foreign direct investment recorded an unprecedented increase. Due to broad privatization, FDI inflows in 2005 were more than twice as high as cumulated FDI in the period from 2002 to 2004. Although current data are not yet available, the CBCG expects the current account deficit for 2005 to come to about 11% of GDP. A certain deterioration is expected inter alia because of high oil prices, a high level of FDI and increased aggregate demand.

Cezar Botel, Director of the Macroeconomic Modeling and Forecasting Department at Banca Naţională a României (BNR), focused on the challenges his country needs to deal with. On the one hand, at the end of 2005 foreign exchange-denominated credit accumulated to 54% of total nongovernment credit, which considerably undermines monetary policy effectiveness. On the other hand, the BNR has been facing the so-called Tosovsky dilemma: Lower interest rates are needed to prevent high speculative capital inflows, but higher interest rates are required to sterilize the incoming flows and keep inflation in check. Moreover, adverse supply-side shocks stemming from the adjustment of administered prices (23% of all prices), the high oil price and natural calamities put additional pressure on monetary authorities. Whereas the BNR initially used its instruments to address speculative capital inflows, in October 2005 the focus shifted back to fighting inflation and the BNR raised its key interest rates. The side effect of currency appreciatiation is a welcome additional instrument to contain inflation. Reserve requirements have been adjusted so as to induce the substitution of domestic currency credit for foreign currency credit. As a result, domestic currency credit growth overtook foreign exchange credit growth in late 2005 while the share of foreign exchange credit in total credit dropped under 50% in March 2006 and declined further thereafter. In 2006, the BNR is likely to be challenged by the inflationary impact of several adverse factor such as the newly introduced indirect taxes, an upward revision of the budget deficit, fast credit expansion or substantial capital inflows.

The Director of Research of Narodna banka Srbije (NBS), Milan Sojic, considered the general situation in Serbia relatively positive and expected the economy to grow at a robust rate of 5% in 2006. He praised the good cooperation of his country with the IMF and the World Bank and emphasized the fact that Serbia attracted FDI worth 6.2% of GDP in 2005. However, he expressed his dissatisfaction with high inflation in his country and announced that the NBS planned to reduce inflation over the next four years. An additional concern Sojic pointed to was the country's high foreign debt, which amounts to more than 60% of GDP (although public debt reaches only 46% of GDP). Another major challenge is the current account deficit, which came to 8.5% of GDP in 2005.

Ahmet Nuri Kipici, General Manager of the Research and Monetary Policy Department of Türkiye Cumhuriyet Merkez Bankası, structured his presentation around five topics. First, on the basis of the relevant figures Kipici, provided evidence of a rising involvement of nonresidents in the Turkish economy. For example, the shares of nonresidents in domestic debt and in the Istanbul Stock Exchange as well as FDI flows and foreign participation in the banking sector have increased considerably. At the same time, fundamental developments were broadly positive until early 2006. Apart from general political stabilization, the strong disinflation trend was sustained and the successful effort to reduce public debt levels (the gross public debt-to-GDP ratio declined from a peak of 107.5% in 2001 to 61.2% in 2005) continued. Kipici then drew the audience's attention to recent turbulences on the Turkish foreign exchange and bond markets. He emphasized, however, that despite a sizeable depreciation of the Turkish lira in the last couple of weeks before the East Jour Fixe meeting and despite rising bond spreads, financial stability and the process of further stabilization were not endangered. In the last section of his speech, Kipici sketched the challenges the Turkish authorities will have to face. In his own words, there is still a long and cumbersome way to go toward Basel II. In addition, the privatization of the banking sector has to be completed, and the central bank will have to cautiously watch the increasing danger of asset price bubbles and volatile commodity prices.

The second session on the agenda addressed the main focus of the 57th East Jour Fixe and was entitled "Inflation and Economic Policy Challenges." It was chaired by Doris Ritzberger-Grünwald, Head of the OeNB's Foreign Research Division. After an introductory statement by Ritzberger-Grünwald on inflation developments and the major driving forces of inflation in the region, Adalbert Winkler, Deputy Head of the EU Neighbouring Regions Division at the ECB, delivered a kick-off speech on this topic. He started off by presenting inflation records and trends in recent years. Whereas one could observe strong disinflation in the early 2000s, prices have picked up since 2004. The SEE countries operate a diversity of exchange rate regimes, ranging from using the euro as legal tender to applying a floating exchange rate regime. The ECB speaker pointed out that hard pegs tended to be associated with lower inflation over the whole period. With the exception of Serbia, however, recent evidence indicates a pick-up in inflation in countries with hard-peg arrangements. Under closer scrutiny it turns out that both demand- and supply-side factors have been driving inflation. In most SEE countries, domestic demand has been fostered by substantial capital inflows and private sector credit growth, amplifying the effect of soaring oil prices. According to Winkler, the major challenge for monetary authorities in the SEE countries is to contain inflation in an environment of limited monetary policy options, high capital inflows and strong credit growth. In this respect, he noted that the administrative measures implemented by several central banks in the region to limit the pace of credit growth might have the desired effects only temporarily, while creating distortions in the financial sector in the long run. Thus, under the given conditions, fiscal policy remains the major macroeconomic stabilization tool.

The session on inflation approached the issue from three different perspectives, and the nine countries were thus clustered around three distinct subtopics. The first subgroup included Romania, Serbia and Turkey, i.e. the three countries which until recently found themselves most distinctly "on the disinflation road," as the subsession was entitled. Romania's representative Cezar Botel spoke primarily about challenges to further disinflation on both the supply and demand side. Among the former, he first and foremost listed administered price adjustments and volatile price shocks, such as those of fuel, fruits or vegetables. These price shocks are of a substantial magnitude, and the uncertainty about their future paths prevents inflation expectations from stabilizing. On the demand side, the BNR faces persistent excess demand pressure, which chiefly stems from continuing consumer credit expansion, substantial capital inflows induced by interest rate differentials and unsteady wage-setting procedures. In addition, further fiscal tightening seems rather limited for a plethora of reasons. Hence, according to Botel, prudent wage policies and improved efficiency of public spending are crucial complementary factors in any monetary policy efforts geared at continuing disinflation.

In his second presentation, Kipici concentrated on the history of inflation targeting in Turkey. Inflation targeting was adopted after the stabilization strategy that was based on the crawling exchange rate peg ended in the deepest financial crisis on record. An inflation rate of 68% and generally poor economic conditions in the aftermath of the crisis called for an alternative regime. The major challenge for Türkiye Cumhuriyet Merkez Bankası was thus to establish credibility and communicate the medium-term outlook. Hence, a new Central Bank Law was adopted that opened the door for central bank independence and implicit inflation targeting. As Kipici expounded, this means that the strategy of monetary policy was set to gradually converge to inflation targeting. In the meantime, structural reforms to rehabilitate the financial system, the competition environment and public finances were introduced. As two major anchors, Turkey's IMF program and the EU played an essential role in this process. As a result, inflation has not only declined from 80% to 8% over the last four years, but has also outperformed the inflation target, while the real GDP growth rate averaged 7.5%. Among many possible explanations for this performance, Kipici cited the central bank's independence and strong political support as the major ones. Moreover, the gradual rather than full-fledged implementation of inflation targeting, which was further developed into an explicit inflation targeting strategy in late 2005, seems to have been a wise approach. In Serbia, Narodna banka Srbije was not independent until late 2000, which implied the monetization of fiscal deficits, buoyant inflation expectations as well as high inflation despite strong price regulation. Political changes and sharp price liberalization led to a surge in inflation (27% month on month in October 2000 alone). The fiscal deficit has been reduced since then, however, and has been financed mostly from "real" sources. After a strong devaluation, the exchange rate against the Deutsche mark (and later vis-à-vis the euro) was stabilized with the help of interventions, and these moves increased public confidence in the domestic currency. As a result of these measures, inflation went down from 111.9% in 2000 to 7.8% in 2003, with core inflation decreasing even more. Sizeable real depreciation following a relaxation of the exchange rate regime in mid-2002 – combined with surging oil prices and recently also a strong credit boom – caused inflation to gradually rise to more than 16% in 2005. Sojic said he was optimistic nevertheless, as core inflation has, in general, shown a downward trend since last year. This trend is likely to continue throughout the year 2006, owing to stabilizing supply- and demand-side factors, among which Sojic listed a relatively stable exchange rate, low inflation expectations, a fiscal surplus and lower inflationary impacts of economic growth. A tight monetary policy stance also helps to maintain the encouraging development of core inflation. But of course there are also risks, such as higher government spending and wage growth in the private sector, which potentially endanger the disinflation path. In the ensuing discussion, participants pointed out that the impressive disinflation performance particularly in Turkey might have been helped by strong global disinflationary trends. Some participants asked whether inflation targets in Turkey and Romania were not too ambitious. Kipici and Botel objected and said the Turkish and Romanian monetary authorities would not change the target for the sake of credibility and that they would rather try to persuade the government to gradually change administered prices in a stability-oriented manner.

Bulgaria, Bosnia and Herzegovina, and Macedonia were grouped under the headline of "Inflation developments: cyclical and one-off aspects." The BNB's Mariella Nenova-Amar argued that the government's initial attempt to contain hyperinflation in the second half of the 1990s by extending price regulations was a wrong step. In her opinion, both the adoption of the currency board arrangement and substantial market reforms were the crucial measures that curbed skyrocketing inflation. Nowadays, the most pronounced price pressures stem from oil prices, from the need to increase excise duties to minimum EU levels and from the deregulation of administered prices. Nenova-Amar also emphasized that the Bulgarian inflation index was not completely harmonized with respect to the consumption basket despite being published as such by Eurostat. If the remaining differences were adjusted for, inflation would be noticeably lower. As Bulgaria intends to adopt the euro as soon as possible after EU accession, the BNB and the Bulgarian government are determined to frontload all adjustments of excise duties that may cause inflationary pressure before EU accession. In Bosnia and Herzegovina, as Amir Hadziomeragic argued, the currency board arrangement also helped to contain inflation, which has been low and stable over the past years. In 2005, the inflation rate climbed to 3.6% chiefly due to surging oil prices and the upcoming introduction of a single VAT rate of 17%. Although the tax rate declined for some products, such as tobacco, the downward price adjustment seems rather rigid. However, after some overshooting in January 2006 (6.7%) in the context of VAT reform, inflation declined slightly later in the year. Hadziomeragic stressed that the recent rise in inflation was a one-off effect with no ramifications for the CBBH's credibility or for long-term inflation expectations. Hence, Hadziomeragic did not see any major inflation risk for the time being. Owing to the high unemployment rate, there did not seem to be any serious danger of increasing pressure on wages. Aneta Krstevska presented a similar case of inflation development and its driving forces in the Republic of Macedonia. Price increases have been low and stable (2.2% on average over the last ten years), mainly influenced by administrative and external factors rather than cyclical developments. As a result, economic agents have built stable inflation expectations. For the future, Aneta Krstevska sees potential risks of higher inflation rates in the necessary adjustment of administrative prices and the eventually emerging Balassa-Samuelson effect.

In the final subpanel discussion, the representatives of the central banks of Albania, Croatia and Montenegro gathered to exchange their views on "Inflation and monetary policy under different exchange rate arrangements." According to Gramoz Kolasi, the Albanian economy has been characterized by remarkably low and stable inflation rates since 1999 (2.4% in 2005) despite, or thanks to, a flexible exchange rate setting. Albania owes this admirable performance to its tight monetary policy and the slight but continuous appreciation of the Albanian lek in nominal terms. This encouraging exchange rate development boosts public confidence and has started to induce a shift from foreign currency- to Albanian lek-denominated assets in agents' portfolios. As the main driving forces of inflation, Kolasi cited skyrocketing oil and food prices – as in other countries in the region. By contrast, there is little pressure on prices via wage demand, as the Albanian labor market is extraordinarily flexible. According to Ljubinko Jankov of the HNB, inflation in Croatia has been driven particularly by (first-round) oil price hikes. He believes that the spillover from oil prices to other prices is moderate, as is inflationary pressure from aggregate demand. Owing to the high unemployment rate and the strict wage policy in the public sector, wage increases are also moderate. The HNB operates a successful exchange rate targeting regime and does not feel any need to switch to inflation targets. The exchange rate plays a crucial role in the highly euroized Croatian economy, and so far there has been no trade-off between exchange rate stability and inflation. Montenegro is also a euroized economy, as Nicola Fabris explained. However – unlike Croatia – it is euroized de jure, as it adopted the euro as its exclusive legal tender after a period in which the Deutsche mark/euro was used as a parallel currency to the Yugoslav dinar. With the import of credibility, inflation declined from 128% in 1999 to a mere 1.8% in 2005. Fabris stressed that despite, or thanks to, the very limited range of monetary policy instruments, the CBCG pays great attention to transparency and accountability, as it believes that these have significantly contributed to low rates of inflation. For 2006, the CBCG expects inflation to rise slightly to about 2.9% for several reasons such as, above all, the introduction of VAT on products previously exempt from taxes, high oil prices, the inadequate implementation of competition regulations, but also an increase in aggregate demand brought about by rises in salaries, loans, transfers from abroad and privatization revenues.

The ensuing discussion focused on a number of issues, ranging from the composition of consumer price indices to the limitations to monetary policy in most countries of the region to driving forces of inflation not explicitly mentioned during previous discussions, such as the depreciation in Serbia between 2003 and 2005.

58th East Jour Fixe

Slovenia: Economic and Monetary Integration

On June 26, 2006, the 58th East Jour Fixe of the Oesterreichische Nationalbank (OeNB) took place. The event was organized under the title "Slovenia: Economic and Monetary Integration." The objective of this meeting was straightforward: As Slovenia is the first country among the new Member States to adopt the euro, the 58th East Jour Fixe aimed to shed light on the factors and policies which laid the foundation for this achievement and to discuss future challenges for the country.

The event started with a kick-off statement by Peter Mooslechner, Director of the OeNB's Economic Analysis and Research Section. In his statement, he flagged the key features of Slovenia's economic performance. The country's economic transition took off from a relatively favorable starting point regarding economic structures and institutions. This and the rather swift establishment of broad macroeconomic stability allowed the country to follow a more gradual approach toward economic reform than other Eastern European countries. Already shortly after Slovenia's EU accession in 2004, the country displayed a strong commitment to achieving euro area entry and thus to fulfilling the Maastricht criteria. Its efforts have proved successful: On January 1, 2007, the country will be the first member of the 2004 enlargement round to adopt the euro. Nevertheless, the introduction of euro cash and the completion of interest rate convergence may still pose some challenges. Mooslechner concluded his statement by underlining the continuing need for structural reforms and enhanced flexibility of the Slovenian economy.

The first session of the East Jour Fixe was chaired by Doris Ritzberger-Grünwald, Head of the OeNB's Foreign Research Division, and started off with a presentation by Hermine Vidovic, Senior Economist at the Vienna Institute for International Economic Studies (wiiw). Vidovic provided an overview of the "Commonalities and Differences between Slovenia and other New Member States." She introduced the notion that "Slovenia is different" and went on to explain why this was the case: The Slovenian economy was characterized by stable and steady growth rates throughout the 1990s, quite unlike the other new Member States, which generally experienced periods of slower growth or even recessions. Another factor generally observed in the emerging economies of Eastern Europe, namely real appreciation, did not occur in Slovenia. This was mainly attributable to the country's managed floating exchange rate regime that was in place until Slovenia's ERM II entry in 2004. Gradual nominal depreciation helped stabilize the real exchange rate and thus supported the export sector. As Slovenia has a higher per-capita GDP than the other new Member States, it is not surprising that its exports per capita are also the highest among the new Member States, with exports going mainly to the rest of the EU. A substantial share, though, is also directed at the (other) markets of the former Yugoslavia. Slovenia's former exchange rate regime also had some drawbacks, however. As it helped shield the country's economy against foreign competition, productivity growth in Slovenia was thus generally lower than in the other new Member States, leading to unit labor costs in the manufacturing sector which are almost as high as in Austria.

The fact that Slovenia did not attract substantial amounts of foreign direct investment (FDI) may have played a role as well. Summing up, the country followed a more gradual approach to reforming its economy. Its reform course was characterized by steady and stable growth rates, external and internal equilibrium and political stability. In this sense, Slovenia can indeed be seen as different. Finally, Vidovic identified some challenges the country will have to face, such as a delay in structural reforms and privatizations. These challenges were discussed in more depth in the second session of the East Jour Fixe.

The second lecture of the first session was held by Boštjan Jazbec, Board Member of Banka Slovenije, Slovenia's central bank. He talked about Slovenia's path "From EU Accession to Euro Adoption." In evaluating the country's transition process, Jazbec took a rather pragmatic stance. He said that Slovenia was luckier than other countries. Owing to the small size of its economy and the geographical proximity to the regions of the Balkan wars, Slovenia could not attract sizeable amounts of FDI throughout the 1990s. Radical restructuring therefore was not really an option for the country. Thus, it adopted a more gradual approach, which proved successful. Jazbec stated that, in this respect, he also considered Slovenia different from the other new Member States. He then went on to discuss the fulfillment of the Maastricht criteria. From 2003 on, Slovenia had succeeded in reducing inflation owing largely to the stabilization of the exchange rate. In June 2004 the country joined ERM II. Since then only minor fluctuations around the central parity have been observed. Fiscal soundness as stipulated by the Maastricht criteria was already achieved several years ago and has been maintained since then. Interest rate convergence does not pose a problem, as euro interest rates in Slovenia are already low thanks to the strong competition in the banking sector. The only exceptions are interest rates on housing loans, which still need to be adjusted to euro area levels. Jazbec also addressed the structural challenges for the Slovenian economy and stated that, by comparison, Slovenia's financial sector was underdeveloped. The financial sector is still very much bank based. Accordingly, the main future challenges Jazbec identified relate to further interest rate convergence and financial sector development.

The second session, chaired by Peter Backé, Head of the OeNB's Central and Eastern European Analysis Unit, opened with a presentation by Jože Damijan, professor at the University of Ljubljana and former Minister for Growth in Slovenia. He spoke about the "Conditions for a Continued Successful Performance of the Slovenian Economy." In his lecture he strongly focused on the economic reform proposals which he helped develop during his time as President of the Economic Reforms Committee to the Slovenian Government and subsequently as Minister for Growth. First, he commented on the need for further reform in a country with seemingly sound fundamentals. He mainly identified two weaknesses in the Slovenian economy: First, the pace of restructuring is slow. Slovenia still has a comparatively high share of publicly owned companies, which is mainly attributable to the special path of transition the country took. Second, the competitiveness of the Slovenian economy is low. Labor costs per unit of GDP are the second highest in the European Union and the labor tax wedge is the greatest. The proposed key reforms for Slovenia include a simplified tax system which promotes more efficiency, the restructuring of public finance, privatizations and a university reform which inter alia stresses the promotion of technological development. The tax reform is mainly based on the introduction of a flat tax on personal income and corporate profits, a single VAT rate and a stronger focus on indirect taxes. Public expenditure is scheduled to be gradually decreased by 2% of GDP by 2008. As far as privatization is concerned, the central strategy is to sell the shares in public shareholding companies held by the two state capital funds (KAD and SOD) and to transform the two funds into globally diversified portfolio investors. The university reform aims at a deregulation of the university system and the introduction of a voucher system. Knowledge accumulation should be supported by increasing the spending on R&D to 3% of GDP by 2010.

Matija Rojec of the University of Ljubljana, who is also affiliated with Slovenia's Institute of Macroeconomic Analysis and Development (IMAD), offered an analysis of the role of FDI in Slovenia and the potential for further economic integration between Slovenia and Austria. With respect to FDI, Slovenia's situation is special, as the country has attracted only small volumes of FDI in comparison with other new Member States. This is underlined by the fact that Slovenia even became a net exporter of FDI in 2005, with investments mainly directed to the countries of the former Yugoslavia. This does not mean, however, that foreign investment enterprises (FIEs) do not play an important role for the Slovenian economy. Although they only represent 5.3% of all enterprises (16.8% of all assets), they account for 34.7% of exports and 37.9% of operating profits. These data also indicate that FIEs in Slovenia strongly focus on serving export markets. It is also apparent that FIEs often operate in high-tech and medium-high-tech sectors, in which they contribute substantially to productivity increases. Looking at the motives of foreign investors in Slovenia, most of them name long-term cooperation, access to the Slovenian market, the quality of the labor force and access to Southeastern European markets to be important factors. The motivation is similar for Austrian investors, the only difference being that access to the markets of former Yugoslavia is of less importance. High taxes and social contributions, complex administrative procedures and the inefficient judiciary system are seen as barriers to FDI. When discussing the potential for further economic integration between Austria and Slovenia, Rojec mentioned a second wave of privatization, which is under way.

The seminar concluded with a presentation by Georg Krauchenberg, trade representative of the Austrian Chamber of Commerce in Slovenia, which was entitled "Doing Business in Slovenia: The Experience of Austrian Companies." Krauchenberg showed that the economic ties between Austria and Slovenia are indeed strong. Austria is the single most important investor in Slovenia; Slovenia in turn has the highest import per capita of Austrian products among all trading partners. Krauchenberg identified the legal situation as the biggest risk for investors on the Slovenian market, citing the very long duration of court cases and property reservations as examples. Other obstacles for companies doing business in the country include comparatively high salaries and strongly progressive taxation, difficulties in obtaining permits for business operations and the restrictive law on the use of the Slovenian language.

Krauchenberg, however, also stressed the new opportunities Slovenia's EU membership has opened up for Austrian companies. To illustrate his point, he mentioned logistically important facilities, like the harbor of Koper. In his opinion, also the border areas of the two countries will benefit from the new prospects associated with enhanced cooperation on the level of small and medium-sized enterprises. New business opportunities may arise from the comparatively high prices for a number of consumer products in Slovenia. Austrian companies could enter these markets quite successfully and exploit the limited competition and the relatively high margins.

In the general discussion that ensued, it was pointed out that the proposed reform measures conform to the standard prescriptions of international institutions that give policy and reform advice. All speakers agreed, however, that these measures were important to ensure continued favorable economic development for Slovenia. The questions raised during the discussion mainly related to the implementation of the measures. In this context, most discussants shared the opinion that only a part of the proposed measures will be implemented and that some of them will presumably be watered down in the political process.

In retrospect, the seminar provided an instructive overview of Slovenia's integration progress so far and, just as importantly, the challenges ahead. The latter include further restructuring and privatization, enhancing efficiency in various sectors (e.g. education), improving the court system, public expenditure and the tax system as well as promoting financial sector development.

59th East Jour Fixe

Monetary Transmission in Central and Eastern European Countries

The 59th East Jour Fixe of the Oesterreichische Nationalbank (OeNB) on September 15, 2006, was dedicated to the monetary transmission mechanism (MTM) in Central and Eastern European countries (CEECs). In particular, it aimed at answering the following questions: What do we know about the MTM in the CEECs and how does the MTM in the CEECs compare with that in the EU-15?

The first session was chaired by Doris Ritzberger-Grünwald, Head of the OeNB's Foreign Research Division. It aimed at providing an overview of the MTM in a number of countries by presenting three pertinent studies that had been published in the OeNB's Focus on European Economic Integration 1/06. The first paper, "Monetary Transmission Mechanism in Transition Economies: Gliding on a Wind of Change," was presented by Balázs Égert of the OeNB's Foreign Research Division. This paper – coauthored by Fabrizio Coricelli (University of Siena) and Ronald MacDonald (University of Glasgow) – surveys recent advances in empirical studies of the monetary transmission mechanism (MTM) with a special focus on Central and Eastern Europe. In particular, it outlines the functioning of the separate channels in the MTM, explores possible interrelations between different channels and examines their impact on prices and the real economy. The empirical findings for Central and Eastern Europe are then briefly compared with the results for industrialized countries, especially for the euro area. The paper assesses the relative importance and potential development of the different channels, emphasizing the relevant asymmetries between the CEECs and the euro area.

The second paper, entitled "The Interest Rate Pass-Through in Central and Eastern Europe," was presented by Jesús Crespo Cuaresma of the University of Vienna and Thomas Reininger of the OeNB's Foreign Research Division. This study (coauthored by Balázs Égert) highlights the interest rate pass-through in five Central and Eastern European countries – the Czech Republic, Hungary, Poland, Slovakia and Slovenia, the CEE-5. The presenters emphasized that their pass-through estimates for several retail rates were generally lower than those reported in the literature, given the absence of cointegration between policy rates and long- or even short-term market rates. In addition, the pass-through was found to be declining over time in the CEE-5 and, as the authors argued, is likely to decrease further in the future. Finally, the pass-through in the CEE-5 appears to be similar to that in Spain and higher than that in the core euro area countries (e.g. Austria and Germany). The authors concluded that euro adoption by the CEE-5 would not further increase heterogeneity within the euro area with regard to the interest rate pass-through.

Zsolt Darvas, Corvinus University Budapest, presented the third paper, "Monetary Transmission in the New EU Member States: Evidence from Time-Varying Coefficient Vector Autoregression," which analyzes the transmission of monetary policy in selected new EU Member States with structural time-varying coefficient vector autoregressions (VAR) and compares the results with those in the euro area. In line with the Lucas Critique, Darvas pointed out that reduced-form models, like standard vector autoregressions (VARs), were not invariant to changes in policy regimes. He argued that many of the new EU members have undergone changes in monetary policy regimes, which calls for the use of a time-varying parameter analysis. The results presented by Darvas indicate that some parameters changed significantly as a consequence of regime changes, thus altering the shape of the impulse response functions. Monetary policy is found to have the greatest impact in Poland (comparable in strength with that in the euro area) and the least impact in Hungary, while the impact of monetary policy in the Czech Republic lies in between. Darvas pointed to the credibility of monetary policy and openness to explain these results.

The three papers were discussed by Benoît Mojon, Principal Economist at the Directorate General Research of the European Central Bank, who emphasized the importance of tackling the "black box challenge," i.e. of monetary policymakers reaching full understanding of the MTM. He noted that the black box remained fairly dark after the three presentations and that it was bound to remain so in the future. He underscored that the degree of measurement errors in the assessment of the MTM was high even in developed economies such as the euro area and the U.S.A. In particular, he highlighted the large margin of uncertainty in the impulse response functions drawn from VAR and Stochastic General Equilibrium models. Subsequently, Mojon compared the results of the three studies and pointed out that the results were reasonably in line with those of earlier studies. Next, he underlined that it was difficult to come to firm conclusions regarding country asymmetries in the MTM in the euro area. Nevertheless, he expressed the view that euro area participation was likely to increase the convergence of national practices regarding nominal wage setting and the terms of mortgage contracts, which could help reduce cross-country heterogeneity. Finally, he stressed the importance of relying on descriptive statistics so as to assess the importance of the individual channels. Mojon concluded by presenting the results of such an exercise for the current euro area member countries.

The second session was chaired by Peter Backé, Head of the Central and Eastern European Analysis Unit in the OeNB's Foreign Research Division. It focused on country-specific aspects of the MTM. Adam Kot, Narodowy Bank Polski raised the question of the effectiveness of monetary policy in an increasingly globalized world (based on a study coauthored by Tomasz Chmielewski). In particular, Kot maintained that the relationship between economic slack and inflation had been getting vague and blurred recently in the monetary transmission models supporting the monetary policy decision-making process in the NBP. However, he showed that the relationship was still robust when inflation measures were corrected for the following groups of goods: textiles, footwear, audio appliances and telecom devices. The reason for this is that the prices of these four groups have exhibited a downward trend irrespective of the developments in the rest of the consumption process during the last five years. Kot presented supportive empirical evidence obtained from VAR models.

Lenno Uusküla, Bank of Estonia and European University Institute, presented two relevant working papers of the Bank of Estonia to provide an overview of the central bank's monetary transmission research. The first paper on "The Importance of the Bank-Lending Channel in Estonia: Evidence from Micro-Economic Data" by Reimo Juks is an empirical analysis that provides evidence in favor of the existence of the bank lending channel in Estonia because (1) well-capitalized banks seem to experience a smaller outflow of deposits after a monetary contraction, and (2) the liquidity position of banks seems to be an important determinant of the loan supply, suggesting that more liquid banks are able to maintain their loan portfolios, while less liquid banks must reduce their loan supply after a monetary policy contraction. The paper concludes that this finding is consistent with the evidence for the euro area, where liquidity is also the most important determinant of loan supply. The second paper, which was authored by the speaker and Danny Pitzel, relies on a meta-analysis to explore the relationship between country-specific factors and the strength of monetary transmission. In particular, the paper aims to measure how financial development variables influence the strength of monetary transmission in Europe. The authors found some evidence that the transmission of monetary shocks is stronger in countries with greater financial depth. A greater relative importance of stock market capitalization compared to the debt level, however, decreases the effect of the shock. The statistical evidence on the relationship between financial depth and prices is not so clear, with the above-mentioned exception: The effect is negative for the relative size of stock market capitalization with respect to the debt level.

Anna Naszódi, Magyar Nemzeti Bank, analyzed the bank lending channel in Hungary (based on joint work with Csilla Horváth and Judit Krekó). The presenter first provided a brief overview of the theory and the empirical approaches used to investigate the existence of the bank lending channel. From the available methods, the authors chose the widely applied approach suggested by Kashyap and Stein (1995), which relies on discovering asymmetries in changes in the amount of loans to monetary actions in order to isolate supply and demand effects. Naszódi, Horváth and Krekó estimated an autoregressive distributed lag (ARDL) model where the asymmetric effects are captured by interaction terms. The results presented showed a significant asymmetric adjustment of loan quantities along certain bank characteristics. The existence of the bank lending channel – reflected in the loan supply decisions of banks – can explain these asymmetries. In addition, the authors could not find any sign of asymmetric adjustment in loan demand along these variables. The presenter concluded that, according to these findings, the existence of the bank lending channel in Hungary could not be ruled out.

Kateřina Šmídková, Executive Director of the Economic Research Department at the Czech National Bank, was the discussant of the second session. She pointed out that average inflation rates were different in countries at different stages of economic development (measured in terms of GDP per capita at purchasing power standards) and that this seemed to hold also for Central and Eastern Europe. This indeed indicates that the MTM functions differently in different countries. She highlighted three factors in the MTM that may be especially important in explaining the heterogeneity of the MTM between Central and Eastern Europe and the euro area. First, credit-to-GDP ratios are lower in less developed economies but increase with income convergence. As a result, the credit channel may become more important over time. Second, capital markets in low-income countries are usually less developed than in high-income countries. Consequently, a successful catching-up process may lead to capital market deepening, which could strengthen the asset price channel. Third, Šmídková noted that the degree of openness (measured as the sum of exports and imports over GDP) was a crucial issue for the exchange rate pass-through, as highly open economies are more sensitive to exchange rate changes than less open economies. She concluded her presentation by stressing that (1) the relative importance of the individual transmission channels in the CEECs was different from that in the euro area, (2) in the CEECs, there were less data but more structural breaks than in the euro area, (3) the importance of channels changed fast over time with progressing real convergence, and (4) forecasting models that have been developed for industrialized countries (i.e. closed and not converging economies) should be applied with caution to the CEECs.

In the ensuing discussion, a number of issues was explored, for example the question whether the importance of the exchange rate channel has been reduced by the introduction of inflation targeting. Other issues were the impact of financial deepening, capital flows and currency substitution on the MTM in the CEECs.