Ewald Nowotny: Austria's role in the international financial system

Speech by Mr Ewald Nowotny, Governor of the Austrian National Bank, to representatives of official Austrian institutions, New York, 28 April 2009.

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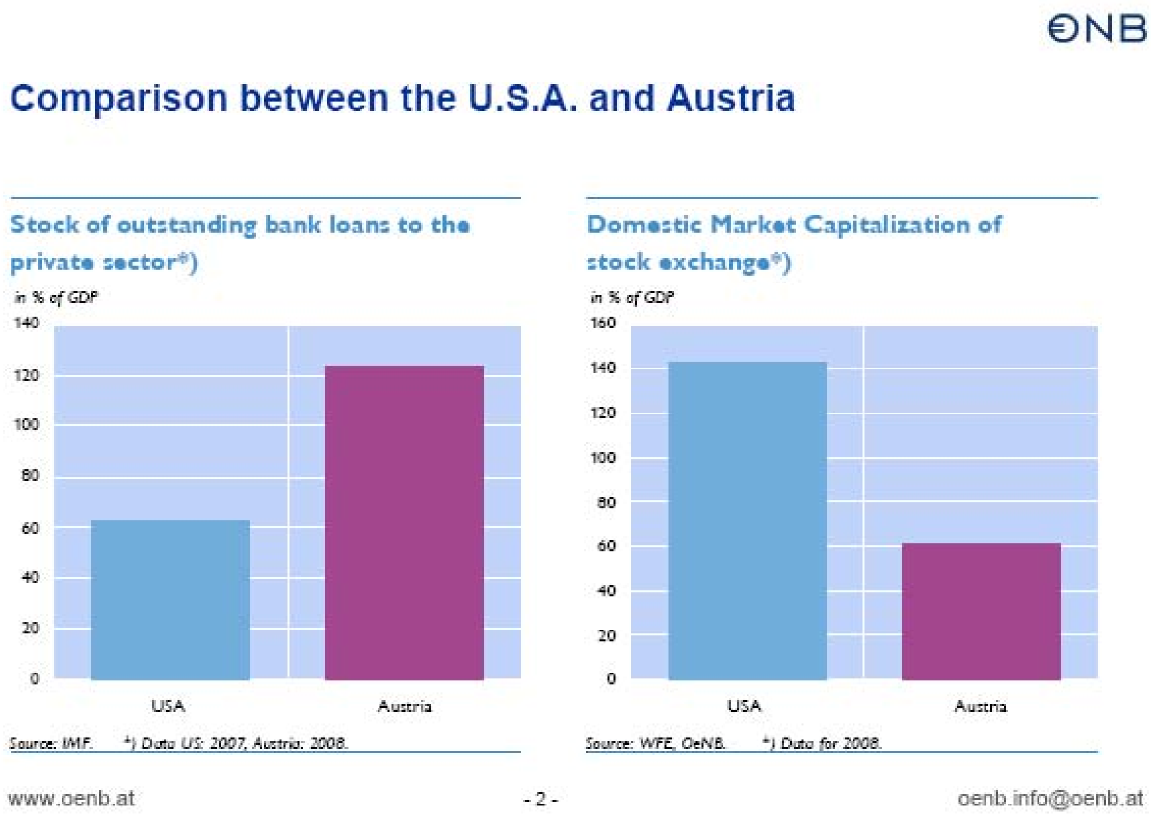
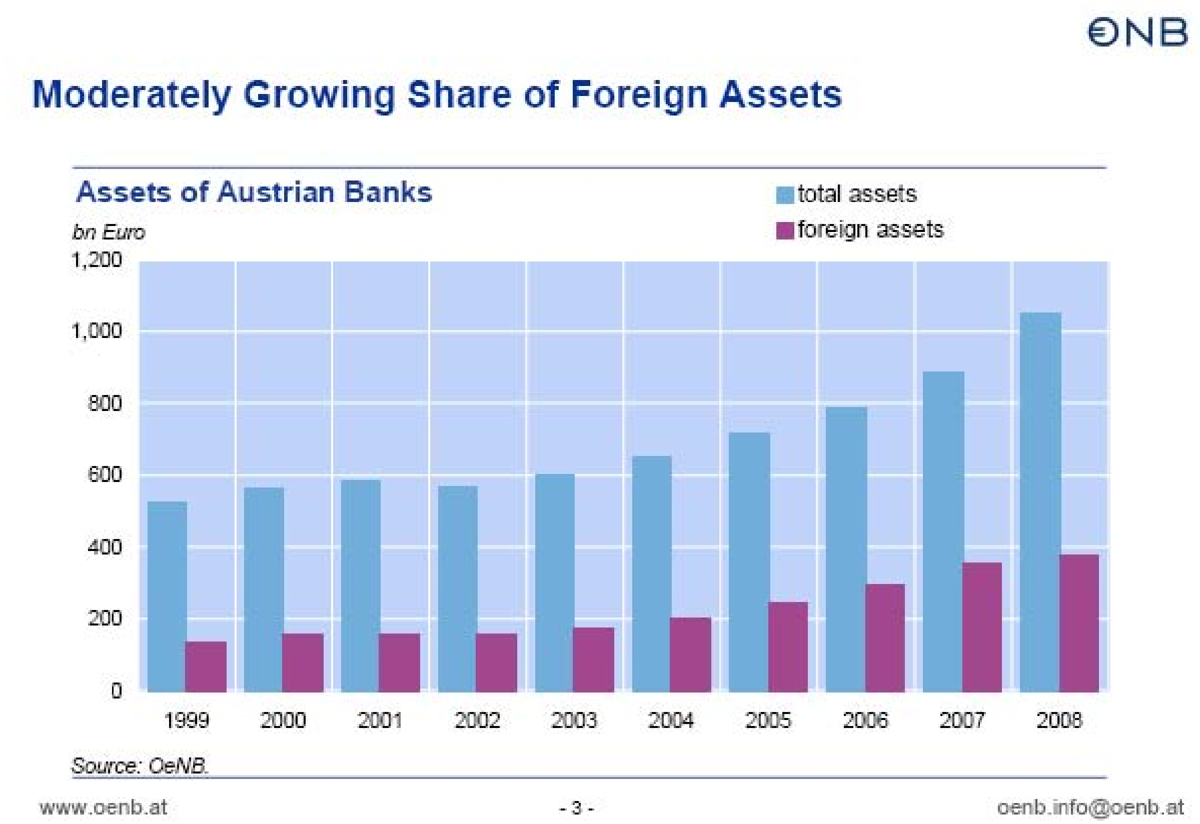
Ladies and gentlemen,

It is my pleasure to speak to such a distinguished audience tonight on Austria's role in the international financial system. Essentially, I would like to give you a brief overview on the key figures of the Austrian financial market and elaborate in more detail on the historical chances Austrian banks have found in Eastern Europe since the fall of the iron curtain. Then I would like to talk about the consequences of the current crisis for Austria, and the policy measures which have already been taken to stabilize the situation in Europe in general and in my country in particular. Finally, I want to share some ideas with you on how we might prevent such a crisis in the future.



The most significant difference between the financial market in Austria and the U.S.A. – next to the difference in sheer size, which is hard to ignore – is the structural importance of banks for financing the private sector in Austria, whereas the financial system in the US is a lot more market-based. This difference is probably most visibly reflected in the volume of outstanding bank loans to the private sector, which currently amounts to 120% of GDP in Austria and to only 60% in the U.S.A. On the other hand, the market capitalization of the stock exchange is 140% in the U.S.A. and only 60% in Austria.



The assets of Austrian banks have been increasing steadily over the last decade, and in 2008 they exceeded 1 trillion euro for the first time; banks assets amounted up to 373% of the Austrian GDP. This expansion was supported by the increase in foreign assets, which accounted for 361 billion euro in 2008 or 128% of GDP. More than half of the foreign assets of Austrian banks were located in Central and Eastern Europe (some 200 billion), thereof ¾ in EU Member States.

Austrian banks in Eastern Europe

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Austrian Banks in Central and Eastern Europe (CEE)

Foreign assets of Austrian banks: EUR 361 bn (2008)

- of which EUR 200 bn (55%) in CEE

- thereof ¾ in EU Member States

85% of total foreign loans in CEE covered by local deposits

In 2008, banks employed 80,000 persons in Austria and 140,000 abroad

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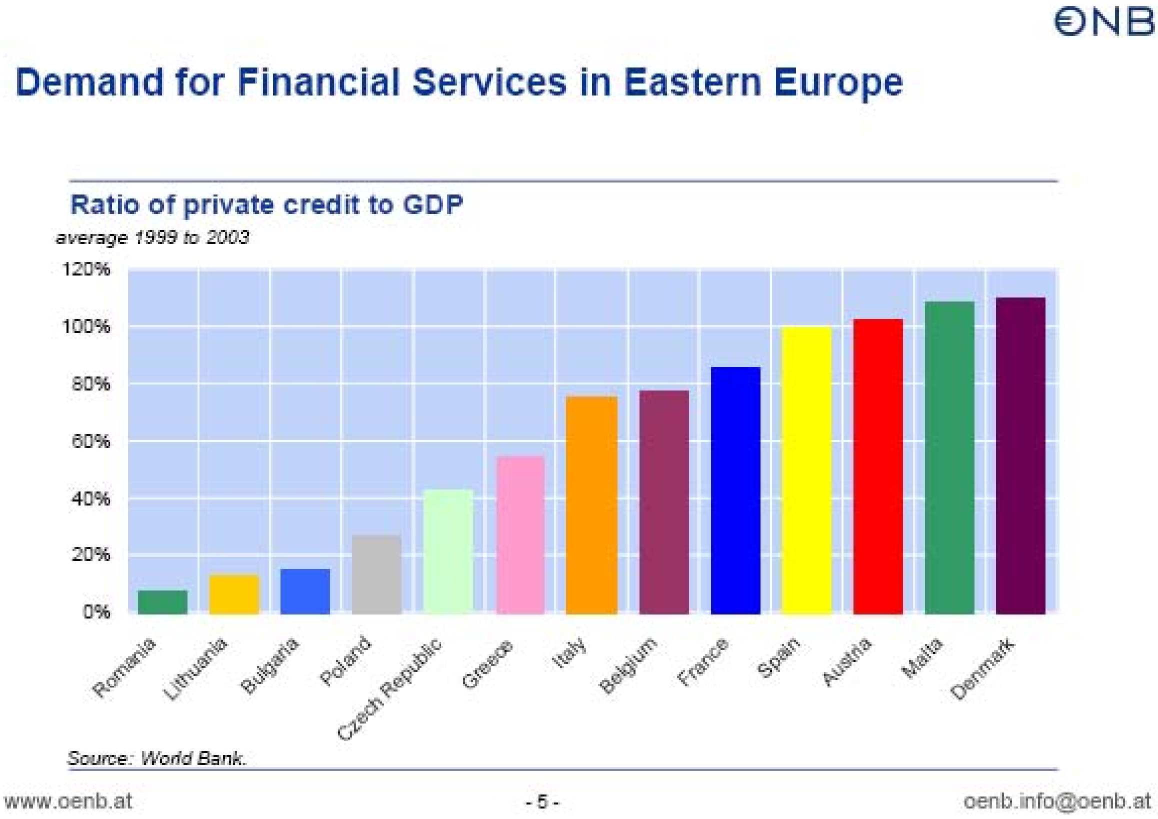
The end of communism in Europe in 1989 and the transition of Central and Eastern European economies provided Austrian banks with a historic opportunity. To that very moment, their business had been more domestically oriented, but all of a sudden the demand for banking services was increasing tremendously in their closest neighborhood. Over night, Austria changed from being a frontier state of the cold war and became a hub of European integration. To show you how close many of the newly emerging opportunities were located, let me give you some comparisons: Vienna is no further from Bratislava, the capital of Slovakia, than Stamford[1] is from New York; getting to Budapest, the capital of Hungary, from Vienna is like getting to Albany for you; Prague, the capital of the Czech Republic, is as far as Boston; and Ljubljana, the capital of Slovenia, as far as Washington. The proximity together with cultural similarities and a shared history gave Austrian banks some advantages on these new markets, and they did not miss their chance. Their strategy for the years after 1989 clearly was: Go east!

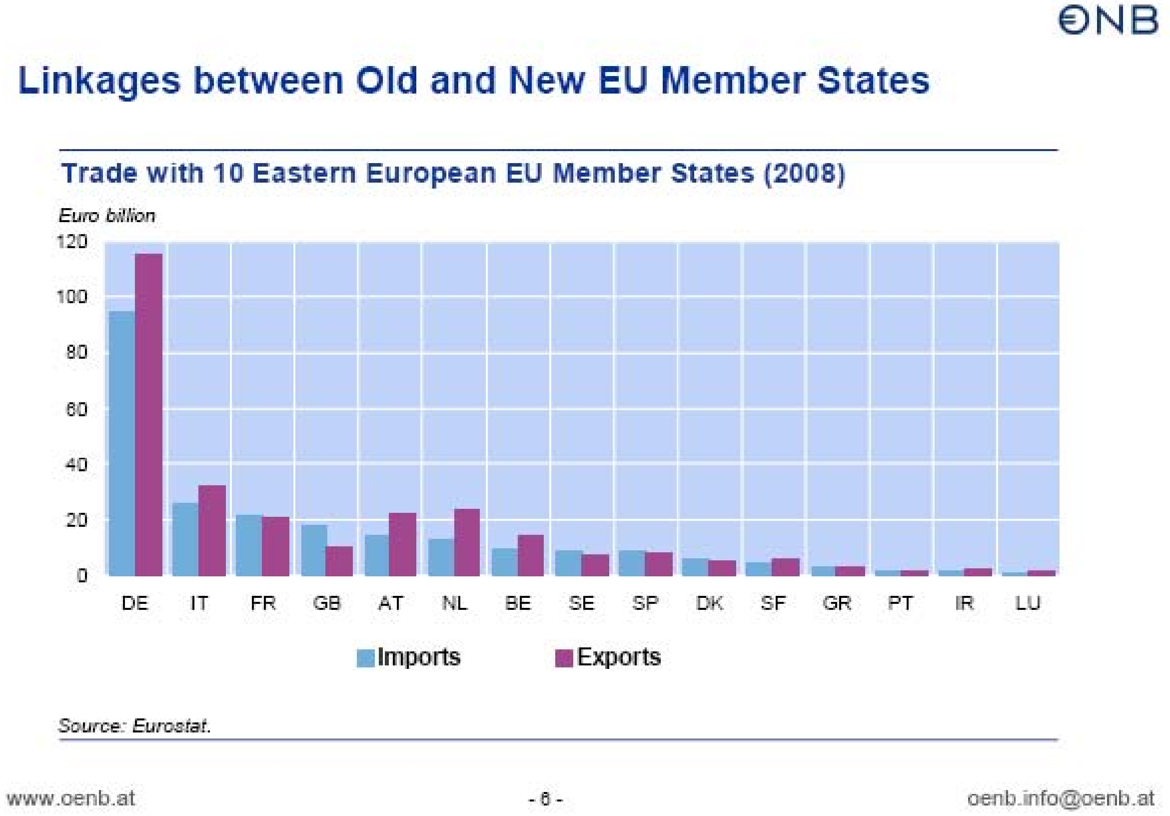
The engagement of Austrian banks in the Central and Eastern European countries has been very successful, and it has been beneficial for all parties involved – and even for some uninvolved. For Austrian banks, the investments in the region proved to be highly profitable and contributed most favorably to their earnings over the past years.

[1] Stamford, Connecticut, is part of the New York metropolitan area and hosts a cluster of corporate headquarters, many of which moved from New York in the 1980s both to lower their tax bill and to be closer to the homes of their top executives.



At the beginning of the transition in Central and Eastern Europe the domestic financial corporations in these countries were unable to fund the elevated rates of economic growth sustainably; in some cases, banks as we know them hardly existed. Even ten years after the beginning of transition, the ratio of private credit to GDP was much lower in these countries than in the mature EU economies. Therefore, foreign investors and financial intermediaries were highly welcome to fill the gap. After decades of centrally planned economic activities, domestic banks in these countries often lacked the experience or the corporate governance to support the establishment of dynamic markets. Foreign banks contributed to the necessary financial deepening in the region and thereby allowed for a smoother transition process.

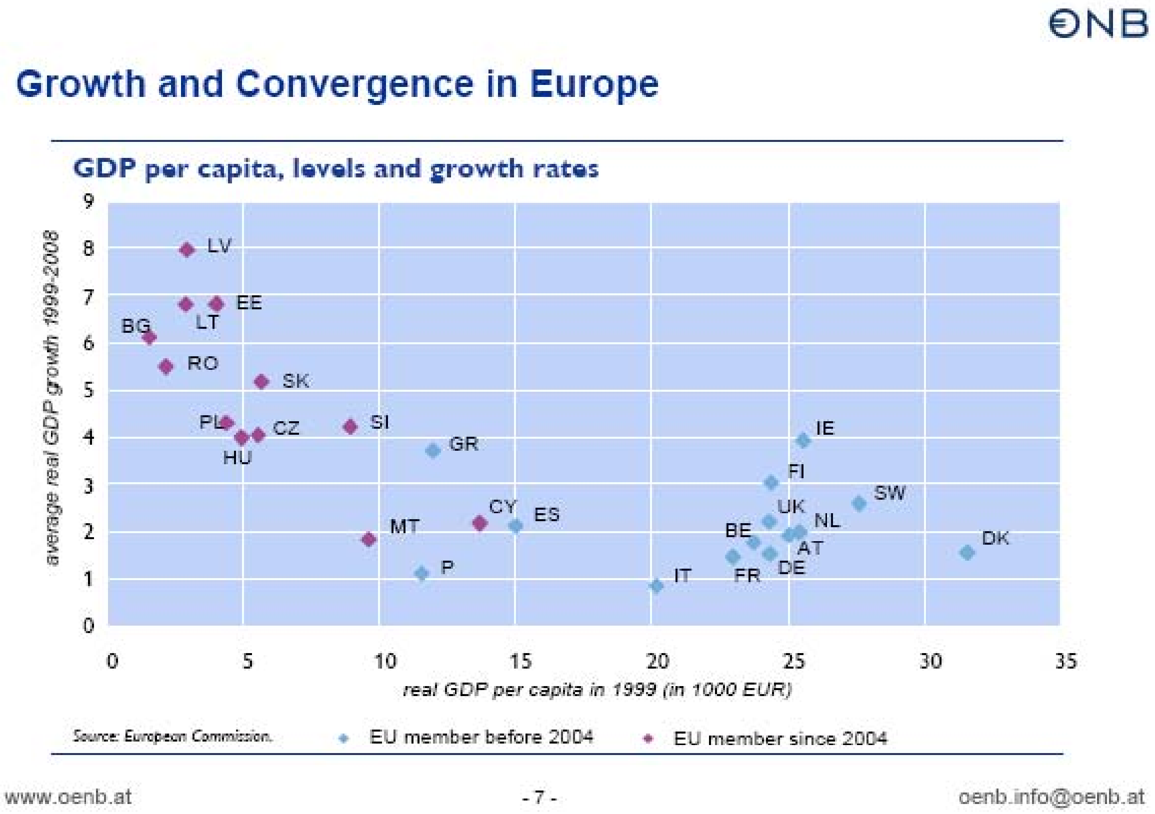
But in many Eastern European countries, access to financial intermediation is still far beyond the levels in OECD countries, and therefore the extension of financial activities in that region will offer an attractive business opportunity for Austrian banks and other international intermediaries in the future.

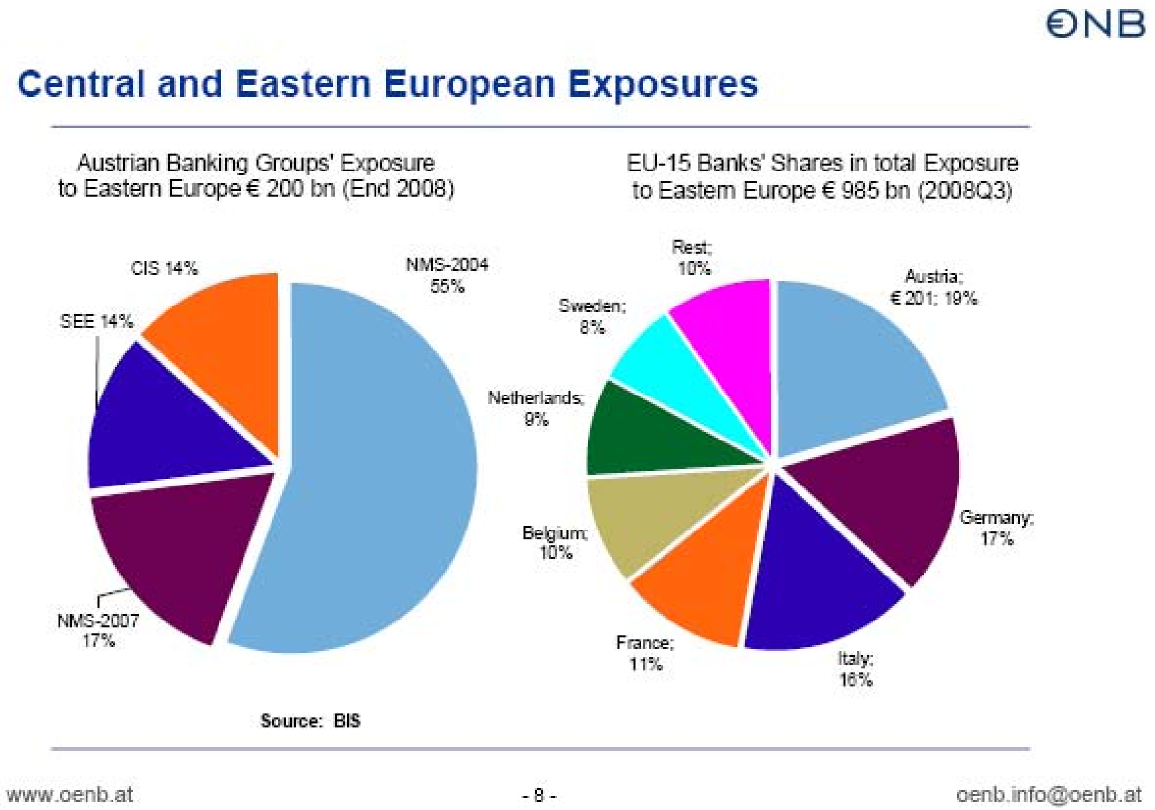


This financial strengthening of transition economies provided positive spillover effects by raising the demand for imported goods and services from the mature economies which were already members of the European Union. Thus, the financial integration of Central and Eastern Europe fuelled the prosperity of the whole continent. Around 20% of all euro area exports went to the 10 new EU member states in Central and Eastern Europe. The trade surplus of the euro area with those countries added up to 60 billion euro.

As countries in that region on average have higher trend growth rates than the “old” EU Member States, because they are still in the process of convergence towards higher GDP per capita, Central and Eastern Europe will remain a driver of economic growth in Europe for the foreseeable future.

I do not want to suggest that no mistakes were made. In some countries credit volumes were probably expanded too fast, and the capital inflows contributed to overheating; the wide-spread allocation of foreign currency credits made some countries rather vulnerable for macroeconomic shocks. But this happened only in a small part of Central and Eastern Europe, and above all the bigger economies experienced balanced growth over the past decade.





In this respect I also want to stress the very fact that Austrian banks have been prudently pursuing their cross-border financial intermediation: their exposure in Eastern Europe is the largest in Europe, but it is also well diversified over the whole region with a particular focus on countries which are members of the European Union – or even members of the European Monetary Union – already. Only 15% of Austrian banks' assets in Eastern Europe are located outside EU boundaries. Even a recent IMF Paper[2] drew the conclusion that "Austria (…) has the most diversified loan portfolio among the major home countries".

The current crisis and its impact

When the financial crisis started to unfold, it hardly affected the financial corporations in my country at all initially, as they did not hold lots of securities that originated from the U.S. mortgage market. Most of them were heavily engaged in Eastern and Central Europe, with little resources left to invest in assets which might turn out to be toxic ex post. But as the crisis spread around the globe and especially after the collapse of Lehman Brothers caused major disruptions on the interbank market, our banks were also suffering from the worsening conditions. The rising uncertainty on financial markets would in the end turn against every bank, regardless how prudent its business model might have been. In previous financial crises hot money flew out of certain countries or regions and made those economies suffer from an under-supply of capital, but this time liquidity evaporated globally. The financial stress caused asset prices to decline further as many financial institution tried to reduce their leverage by a kind of fire sale.

Of course, the financial crisis had its consequences for the real economy. Non-financial corporation saw their access to needed funds dwindle as the liquidity of the markets dried up; households saw the present value of their savings decline as asset prices dropped. Together these factors caused the effective demand in most economies simultaneously to stay behind their productive potential, resulting in a major global recession. As the whole crisis had started with a bubble on the housing market, some countries have also been hit by a slump of their property prices; this is true not only for the coastal areas of the U.S.A., but also for some European countries like Spain or Ireland. The burst of a bubble, the financial market crisis and the recession of the real economy all at the same time make the current situation particularly challenging. We know from historical comparison that a recession which goes along with a banking crisis tends to be especially long and severe[3]; we have seen this phenomenon in Sweden, Norway or Japan. Therefore, governments all over the world are in charge to take the required measures and to do so timely and well targeted. If we want to adhere to the audacity of hope, we also need the audacity for change; therefore, new instruments are needed and brave steps are warranted.

The neglect of risk and its consequences

One of the main reasons for the mess we are in now has been a general misperception of risk. In the financial industries, many believed that innovations like structured asset-backed securities would improve the diversification of risks and thereby help to reduce the markets' vulnerability to adverse shocks. However, the risks were never actually traded away, but stayed concentrated on the books of the financial corporations involved. There is nothing wrong with risk diversification, but obviously something is wrong with innovative products that are too complex to be understood by the very people who originate and distribute them. And there is something wrong with markets that are not properly understood by their participants

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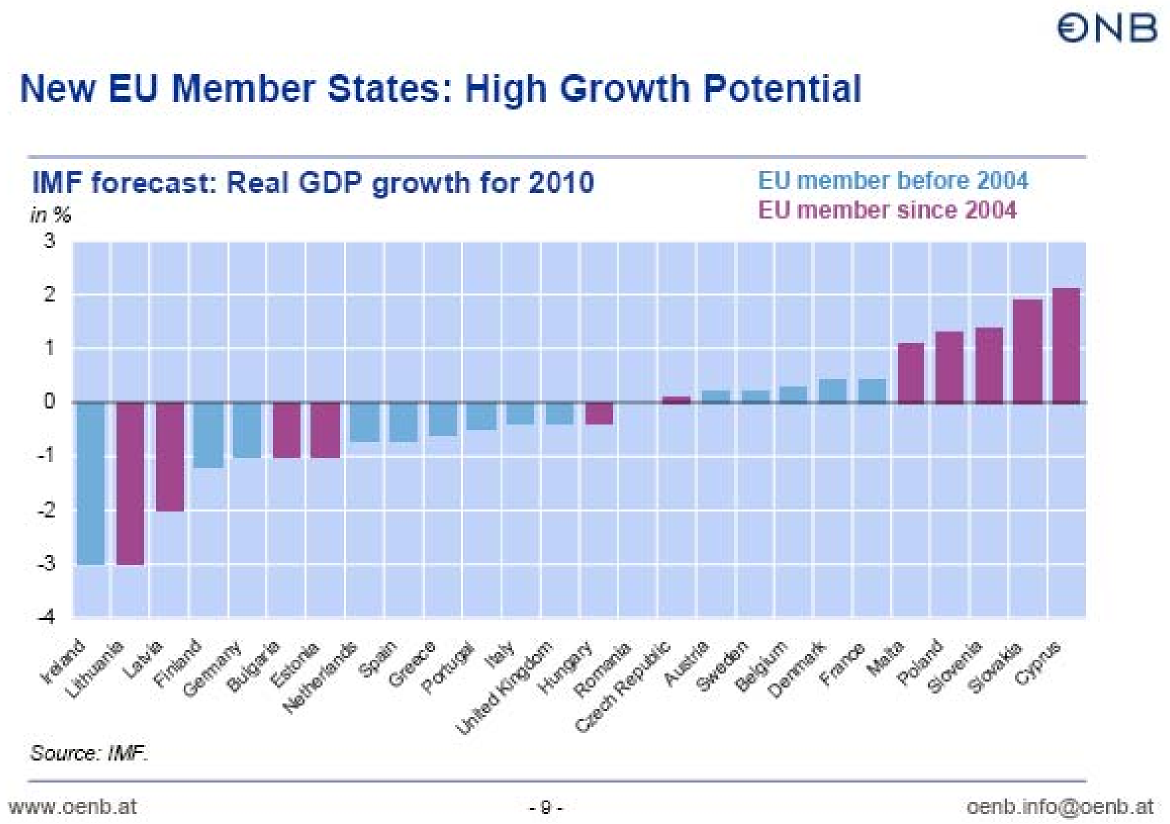
2 Andrea M. Maechler and Li Lian Ong (2009) "Foreign Banks in the CESE Countries: In for a Penny, in for a Pound?" IMF Working Paper 54/09.

3 Carmen M. Reinhart and Kenneth S. Rogoff (2008) "Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison" NBER Working Paper No. 13761.

and with participants who know the party must come to an end soon but keep on dancing just because the music is playing[4].

A second misperception with respect to risk was the belief that financial globalization would reduce country risks by the growing opportunities of international risk sharing. The core idea of risk sharing is that individual country risks should be negatively correlated, so if the home country is affected by a negative shock, some foreign countries face a positive shock at the same time, and the returns from those countries would protect internationally diversified investors from domestic income losses. But the increased financial globalization not only made it easier for investors to invest in different countries, it also made it easier for financial crises to spread across borders. If international investors have to recover from a crisis in country A, they might start selling assets from country B, which was until then in no way affected by any sign of crisis. This kind of crisis transmission, sometimes also referred to as contagion, has so far mostly affected emerging markets; now for the first time we witness this phenomenon on a global scale.

As a consequence of the crisis, the global risk perception has shifted towards a more prudent assessment, and like so often in financial markets, the market has tended to overshoot, going from risk ignorance to a very high degree of risk aversion. Such overshooting is currently taking place with regard to the spreads on government bonds in Europe. Whereas the interest on German 10-year government bonds has been decreasing, several European countries now face higher interest rates, which can partially be explained by the soaring demand for liquidity, which is of course highest for German papers. The rather unusual increase of the interest spread of Austrian sovereign debt versus Germany has in addition been associated with the exposure of Austrian banks in Central and Eastern Europe.



4 Widely quoted statement by Chuck Prince, then CEO of Citigroup, in a FT interview July 9, 2007 "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

In this respect I want to clarify again that Central and Eastern Europe's economic potential is still intact, and that growth rates in that region will exceed those in Western Europe and the U.S. for the years to come, so these investments are still to be viewed as assets rather than liabilities.

The euro as a shield in stormy times

Referring to a particularly negative episode in Austrian and in world financial history, Paul Krugman correctly stated: "Smaller countries – like Austria in 1931 – may once have been at the mercy of financial tides, unable to control their economic destiny"[5]. Now, Austria has not become a bigger country than it was in those unhappy days, but something else has changed in our favor since then: we are now members of the European Union and part of the euro area. In contrast to previous crises, this time our efforts to fight the recession are part of a coordinated European macroeconomic recovery plan upon which the European Commission and the EU member states already agreed in November 2008.

If we compare the situation with our last recession before entering the EU, which took place in the early 1990s, monetary union with our key trading partners is very helpful as it prevents competitive devaluations by some neighboring countries that harmed our economy back then. In that sense, the euro has worked as a shield for small open economies all over Europe.

What needs to be done now?

Policy makers are confronted with two main tasks at the moment. On the one hand they must restore stability in financial markets by bringing back liquidity, recapitalizing banks and getting toxic assets off banks' balance sheets. In Europe, we have some examples that can serve as guidance for how to deal with a banking crisis, for instance the Swedish and the Finnish experience of the early 1990s. (If anything, our own Austrian experience from the 1930s would rather qualify as an example of how not to save banks.)

In Austria we have already taken measures to establish confidence among savers, and our government has also presented a stabilization package for banks, to which it has allotted 100 billion euro, which is roughly 1/3 of the Austrian GDP; 15 billion euro are reserved for recapitalizing banks, 75 billion for bank guarantees and an additional 10 billion for insuring the domestic deposit protection.

In terms of GDP, the Austrian banks' stabilization package is among the biggest in the EU.

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[5] Paul Krugman (2009) "The Return of Depression Economics and the Crisis of 2008", Norton, page 4.

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Austrian Bank Stabilization Package: EUR 100 Billion

€ 15 bn
Recapitalization of banks

distributed: € 900 m
applications: € 7.2 bn
expected: € 2.75 bn
buffer: € 4.15 bn

= ~ 5% of GDP

€ 75 bn
Bank guarantees

Bank bonds:
€ 11.1 bn

OeCAG : € 4.8 bn
(clearing house)

€ 10 bn
Deposit insurance

Used: 0

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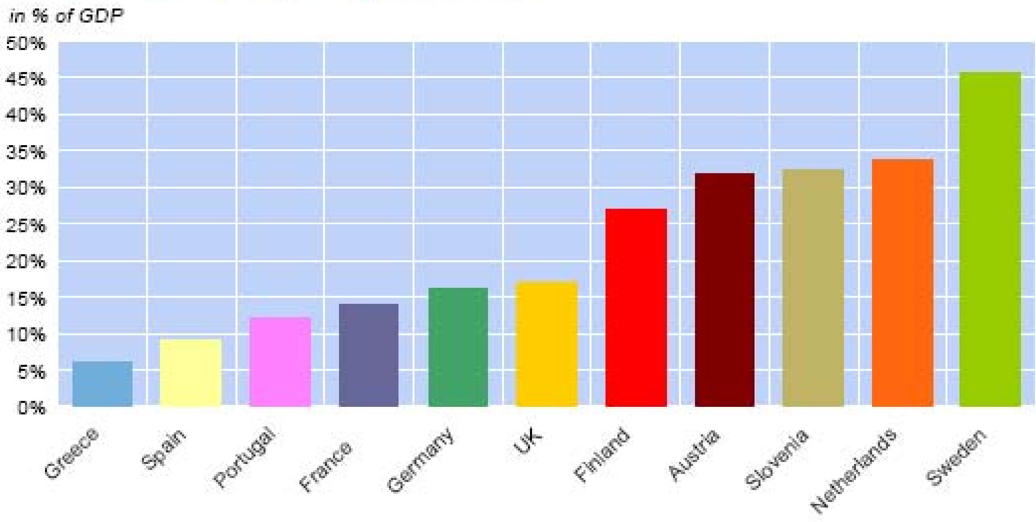
International Financial Support Measures

Bank stabilization packages in Europe



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The second task we now face is to fight the global recession and prevent it from turning into a lasting depression. This is a challenge for both monetary and fiscal policy. The main objective of monetary policy in the euro area has always been to preserve price stability, in the current state of affairs means to prevent deflation. I can assure you that, at the Governing Council of the ECB we will take all available measures to stabilize the inflationary expectations in the euro area and keep them anchored in positive terrain. We will keep the interest rate very low for as long a time as is required, and we stand ready to use unconventional measures of quantitative easing to assure European firms and consumers access to credit at appropriate conditions.

As for fiscal policy, the necessity of a large and timely stimulus package is most obvious. Olivier Blanchard and others from the IMF[6] explained concisely late last year how such a stimulus package should look like. It should be broad-based as the crisis will hit each economy as a whole; it should be fairly long-term as this crisis won't go away next quarter; and it should be supported by as many countries as possible as this is a global crisis and it is not the time for beggar-my-neighbor policies. Although the automatic stabilizers in most European countries help to adjust for the loss in effective demand, some additional discretionary spending is now needed.

The crisis also highlighted differences between the EU and the U.S. in terms of fiscal policy. While the two regions are roughly comparable in economic size, the EU lacks a federal budget like the U.S. In times of crisis, when timely and targeted action is warranted, the EU with its budget of 1% of total GDP is rather shiftless compared to the U.S. Federal budget of more than 20% of GDP. In terms of fiscal policy, European countries are mostly on their own when fighting recessions. Like in the U.S., not all states within the EU are affected in the same way by the crisis; but those EU Member States which are hit most severely by the crisis now are also the ones which will amass high budget deficits very quickly and therefore find it harder to finance their stimulus spending. Some of the new EU Member States have been affected rather harshly by the crisis already, and unfortunately it has not been understood yet by all remaining countries that assisting those countries is not only an act of European solidarity, but that it is also in their economic interest to support those countries which have relatively high import demand for their products. Like in the so-called "tequila crisis" of 1995, it was not immediately understood by all politicians in Washington that helping Mexico was in the best interest of the U.S., but thankfully those in charge in the administration knew how to deal with the situation. It also took some time before policy makers in Europe did recognize that it was in the best interest of Europe to pave the way for a European initiative for economic stabilization and recovery. For instance, the European Council at the level of heads of state and government, has already decided to double the ceiling for the EU's support facility for balance-of-payments assistance to 50 billion euro.

What shall be done in the future?

If macroeconomic policies work together in a well-coordinated way globally, I am convinced we will master this crisis and successfully prevent a global depression. But then we should also change the financial system in such a way that such a crisis will not occur again. Now in concluding, let me briefly point out some ideas how these changes in the global financial system should look like.

First, we need more cooperation or even integration of international financial supervision authorities. That means an end to the formerly common practice of some institutions to shop around for the lowest level of regulation on the globe and hence minimize their degree of supervision. Next, I think we must increase the number of institutions subjected to

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[6] Olivier Blanchard, Antonio Spilimbergo, Steve Symansky, and Carlo Cottarelli (2008). "Fiscal Policy for the Crisis," IMF Staff Position Note, December 29, 2008.

regulations which are at the moment reserved for commercial banks. Putting it simple, every single institution that has the capacity to create the kind of trouble a failing bank may create should be regulated like a bank; I am thinking here of highly leveraged institutions such as hedge funds, the need to regulate which is now generally understood. Then we should take a close look at the functioning of the rating agencies. They were wrong on Enron, they were wrong on the subprime market and yet their ratings continue to be of enormous importance for access to credit for many firms and even governments. As this importance is based on the assumption of superior information held by these agencies, I really wonder how such an assumption can be sustained any longer.

The crisis has shown the importance of international cooperation and the importance of financial institutions like the IMF, the EIB or the EBRD, as they have been able to help quickly and provide countries in need with appropriate credit lines. Whereas the European Union should consider establishing certain institutions of its own or at least funding the existing institutions more generously, on a global level the IMF has re-established its essential role. With respect to the conditionality of IMF loans we might as well question the wisdom of the market whether it is useful to contain public spending strongly in what has turned out to be the most severe crisis for generations. But the results of the G20 summit have shown that the willingness necessary for close cooperation among the big economies is there. The agreed upon increase in credit lines, the additional funding of the IMF and the creation of more Special Drawing Rights, all these measures will provide some stimulus to effective global demand, and the new approach to financial market regulation will help us to ensure financial stability and to control and trim the shadow banking system. Therefore, we can be confident that this crisis will be contained, and that recovery won’t take too long a time coming; and once prosperity is growing again, it will do so more sustainably and in a more balanced manner.