REPORT – VIENNA CONFERENCE

Contagion and Spillovers: New Insights from the Crisis

SUERF/BWG Conference & OeNB Special East Jour Fixe held at the Oesterreichische Nationalbank in Vienna on 12 February 2010

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On February 12, 2010 SUERF, the Oesterreichische Nationalbank and the Bankwissenschaftliche Gesellschaft continued their established tradition of jointly organised conferences. As evidenced also by the 115 conference participants, this year's subject of "Contagion and Spillovers – New Insights from the Crisis" turned out to be particularly topical, as first lessons from the financial crisis and global recession were being drawn, while concerns about Greece's government debt problems were threatening to spread to other countries within the euro area, with potential negative repercussions for the euro area as a whole being feared by observers.

The President of SUERF, **Catherine Lubochinsky**, Professor of Economics and Finance, University of Paris 2, welcomed participants and thanked OeNB Governor Nowotny for hosting the conference and housing the SUERF Secretariat, as well as Otto Lucius, Bankwissenschaftliche Gesellschaft, for sponsoring and advertising the event.

In his introductory statement, OeNB Governor **Ewald Nowotny** emphasized the importance of SUERF's dedicated and systematic efforts of bringing together academics, practitioners from the financial industry and policy makers. He noted that the transmission of crises across borders has significant welfare and policy implications and therefore an understanding of the underlying mechanisms is vital. Governor Nowotny then sketched some striking features of the global crisis. He thereby referred to the fall of Lehman Brothers, which set off an avalanche of world-wide deleveraging and caused major disruptions in a financial system that had become more and more globalized in recent decades. With regard to CESEE he mentioned the remarkable achievement that uncontrolled currency collapses have been avoided even if Ukraine came close to it. Finally, he pointed to the forceful global policy response that was successful in preventing the crisis from escalating. In this respect Governor Nowotny underlined the important role of the Vienna Initiative, which served as an instrument to avoid the well-known prisoner's dilemma, in which individual action leads to suboptimal results for the system as a whole, while coordination achieves better outcomes.

The keynote session was chaired by **Philipp Hartmann**, Vice-President of SUERF and Head of the Financial Research Division at the European Central Bank. The first keynote speech by **Jürgen Kröger**, Director of the Economies of the Member States I Department, DG ECFIN, European Commission, was titled *"Contagion and Spillovers – Recent European Experience and the Way Forward"*. Kröger started by highlighting vulnerabilities and the potential for spillovers in the euro area. In particular he drew attention to the divergent developments of real effective exchange rates, current account imbalances and net financial assets. Kröger also illustrated, that both trade and financial openness increased markedly in recent years and alongside the potential for contagion and spillovers rose. He then presented the results of an empirical study that investigates differences across euro area countries in terms of vulnerability and the relative importance of the various transmission channels. According to the model, the impact of external shocks differs considerably across euro are countries and the financial transmission channel dominates across all countries. Kröger concluded with three policy lessons: 1) Timely correction of imbalances and divergences within the euro area is important for the cohesion of the euro area in withstanding external (and internal) shocks. 2) Financial innovation/integration is good for risk-sharing, but complex instruments pose problems for risk managers, investors and policy makers. 3) Given increasingly complex financial linkages across Member States, there is an urgent need for coordination across the euro area in financial regulation and supervision.

Javier Santiso, Director and Chief Economist at the OECD Development Centre, talked about politics and elections shaping financial and capital markets sentiment. He pointed to the clear link between political processes (elections) and instability in debt and currency markets. The focus of his presentation was a comparison of Latin America – as a representative of an emerging market region – and OECD countries. Elections constitute the opportunity to launch new reforms. Especially in Latin America there is still a lot of room for structural reforms. As one concrete example, Santiso emphasized that the spending per pupil in Latin America is still five times lower than in OECD countries. However, in a politically unstable environment, the sustainability of new reforms is questioned by market participants. This is mirrored in systematic downgrades of investment banks' recommendations prior to elections, which are then followed by revisions (upgrades) after a certain transitional phase. The fears of the market have empirical foundations: historically, uncertainty about the economy's fiscal stance increased during times of elections. Also the real exchange rate showed greater variation shortly after the event of an election. Comparing Latin America with the OECD member states, the impact of elections on the fiscal stance is larger in the former. However, the link between elections and capital markets has become weaker over time. In particular case studies of Brazil, Chile and Mexico show that the 'election effect' vanished after 2006. From this Santiso concluded that capital markets tend to perceive Latin America's democracies as being more mature than before.

Session 1, chaired by **Ernest Gnan**, Secretary General of SUERF and Counsel to the Board and Head of the Economic Analysis Division of Oesterreichische Nationalbank, dealt with real economy channels of crisis transmission. **Filippo di Mauro**, Head of the External Developments Division, European Central Bank, presented a study on *"The Real Impacts of the 2008-09 Financial Crisis: What We Knew and What We Have Learned about International Linkages"*. It is a long-standing stylized fact that the US business cycle leads the world economy, with the US leading the euro area cycle by about five quarters and the influence becoming stronger over time. While in the most recent period the impact of a change in US GDP on the euro area has somewhat diminished, the persistence of US shocks has increased. Furthermore, US downturns are transmitted faster (2 quarters) than recoveries (6 quarters). Trade empirically figures as the most important transmission mechanism, while FDI and portfolio investment linkages are much less relevant. Among various financial variables, financial volatility in addition to the slope of the yield curve work best as predictors for the probability of a recession. Financial variables could have helped detect the US recession, but its depth was missed. The authors conclude that the most recent crisis has confirmed the established wisdom in the economics literature that trade – not least through third-country effects - is the most important cross-border business cycle and crisis transmission channel. However, financial market channels may, particularly during turbulent periods, magnify global interactions. They attribute the recent collapse in trade only marginally to financial reasons, such as restrictions on trade financing; the primary reasons were real, related to a sudden re-assessment of global demand prospects following a period of strong – and unsustainable – growth.

Julia Wörz, economist at the OeNB's Foreign Research Division presented a paper on *"The Impact of the Global Recession in Europe – The Role of International Trade"*. The study gives several reasons for the particularly strong response of trade to the recent recession, including increased vertical specialization and global supply chains. Due to sudden and severe financing constraints, demand dropped steeply in particular for durable consumption and investment goods, thus causing a sharp recession in the manufacturing sector worldwide. In its empirical estimates, which cover 38 countries, including the EU, advanced OECD members and a number of CESEE countries, the study assesses the effect of export orientation for the severity of the growth downturn in 2009, controlling for a number of country characteristics such as economic structure, macroeconomic imbalances, and countries' previous growth record. The authors find that greater export orientation is weakly related to a stronger growth downturn, but only when coupled with a dominance of the industrial sector in countries' economic structure. Countries specialized in consumption goods exports suffered relatively less than those specialized in intermediate goods exports. Furthermore, export orientation towards the EU-27 bolstered the impact of the crisis in 2009. Pre-crisis overheating as well as high debt ratios are also found to be systematically linked to sharper recessions in crises. The presentation concluded with two interesting and relevant policy issues: First, should the particularly strong decline in manufacturing and industry be taken as a sign for lasting structural change, implying that short-term interventions should not aim at preserving existing structures? Second, will trade be able to spur growth in the recovery? On the latter issue, Wörz recalled that trade, being merely a facilitator of transactions, ultimately is only a mirror of demand; so it will be demand which will lead trade, and not vice versa.

The presentation by **Simon Evenett**, Professor of International Trade and Economic Development, University St. Gallen, which dealt with the issue *"Has Stabilisation Limited Protectionism? Evidence from the Global Trade Alert"*, linked very well to issues raised by the previous speakers. Building on a data base on global protectionist measures, Evenett identified four key developments in global protectionism during the recent economic crisis: First, the currently observed intensification of protectionist measures is global, i.e. it is not confined to any specific regions. However, there is considerable variation across countries and regions: Russia, Ukraine, Indonesia, China, Ecuador, lead in the numbers of protectionist measures being taken, followed by the EU27 (taken as a whole), India, Japan, the UK and the US. Only Canada and Brazil have not shown above-trend levels of protectionist measures recently.

Second, a new mix of protectionism has arisen. Discriminatory bailouts and subsidies - the overwhelming majority of which benefited the manufacturing, not the financial sector - are the most widely used protectionist measures, followed by trade defence, tariff, public procurement and migration-related measures. The number of jurisdictions hurt by those measures is highest in the case of bailouts and subsidies, public procurement and tariff measures, but is also large in case of trade defence and migration measures. Third, other than the financial sector, the sectoral incidence of protectionism has not changed. Finally, protectionism is so far showing no signs of slowing down, despite the peak of the crisis and the trough of the recession being over and a brightening economic outlook. The current wave of protectionism is much less severe than the one in the 1930s. Reasons for the difference include, for one thing, a more flexible and active response by monetary and fiscal macroeconomic policies, limiting domestic corporate pressures for protectionism. For another, the spread of international supply chains has created an important corporate constituency opposing raising tariffs. Nevertheless, Evenett warned against complacency – rising protectionism has to be taken seriously: Vigilance, close monitoring and peer pressure are needed. As many contemporary protectionist measures are not self-terminating, the G20 should develop principles for an unwinding of subsidies, bailouts, export incentives and "buy national" policies.

Session 2 was chaired by **Peter Mooslechner**, Director of the OeNB's Economic Analysis and Research Department, and dealt with aspects related to financial sector contagion as well as the role of government debt management offices during the crisis. **Már Gudmundsson**, Governor of the Central Bank of Iceland, held a keynote speech on the lessons from the crisis on cross-border banking. By way of introduction, Gudmundsson pointed to the high growth of international bank claims prior to the financial crisis and argued that there was a link between claim growth and crises in general. He then explained that the international bank run following the collapse of Lehman Brothers was associated with an intense deleveraging and a transfer of funds to the U.S, a freezing of inter-bank funding markets, a run of cross-border banking operations as well as dysfunctional foreign exchange swap markets. Gudmundsson then elaborated on the case of the Icelandic banking sector. In October 2008, three Icelandic banks failed and were put into special resolution regimes after years of rapidly expanding their activities abroad. Gudmundsson linked these events on the one hand to Iceland's boom-bust cycle and problems in the macroeconomic management in small open and financially integrated economies and on the other hand to weaknesses in the European supervisory legislation. Inter alia he pointed to the fact that Icelandic banks' total assets equalled 11 times Iceland's GDP before the collapse. Moreover, he criticized that within the European Economic Area there was a common legal and regulatory framework but the safety net (i.e. deposit insurance and lender of last resort) remained largely national. In addition he described the cross-border crisis management following the collapse of Icelandic banks as non-cooperative. Gudmundsson concluded that the global and European frameworks for the operation of cross-border bank needs reforming as the alternative would be de-globalisation of finance.

Ove Sten Jensen, Head of Government Debt Management Department, Danmarks Nationalbank, presented the nature of the crisis, its impacts and consequences for financial markets from the perspective of a public debt manager. Mr. Jensen noted that the primary goal of a debt manager lies in covering the central government's

financing needs at lowest possible borrowing costs. In the aftermath of the crisis, an additional role for a debt manager emerged: supporting financial stability. The period before the crisis was characterized by the general perception that everything can be priced via swaps. Furthermore, competition among countries with respect to government bond markets was relatively low. When the turmoil started, swap spreads widened considerably and the refinancing cost of governments increased heterogeneously across countries. Mr. Jensen noticed a 'flight to liquidity and quality' as evidenced by the soaring demand of investors for German government bonds. The crisis also revealed a break down of stable correlations among bond markets. Historically we have faced high correlations of bond yields among EMU countries during normal times and low correlation between Europe and the US. On the one hand, in turbulent times correlations within the EMU broke down: member states have been treated more as individual countries, with more emphasis being put at country specific fundamentals. On the other hand, the correlation between Europe and the US increased, probably as a result of co-movement in monetary policy rates. Concluding, Mr. Jensen emphasized the high uncertainty linked to the timing of unwinding fiscal stimulus packages and extraordinary monetary policy measures for future borrowing conditions.

Session 3, chaired by **Peter Backé**, Deputy Head of the OeNB's Foreign Research Division and Head of the Unit for Central and Eastern European Analysis, focused on the spillovers of the crisis to specific emerging market regions and on two country cases.

José María Serena Garralda, economist at the Banco de España, and **Reiner Martin**, until 2008 Head of the Convergence Section of the ECB and currently seconded to the OeNB, presented a paper on "The Impact of the Global Economic and Financial Crisis on the CESEE region and on Latin America". This comparative analysis examines the macrofinancial vulnerability profiles of these two emerging market regions at the onset of the recent financial crisis and relates them to the actual knock-on effects the crisis had on both regions. The two presenters highlighted the following main findings: CESEE and Latin America differ in some important structural features which are of relevance for the transmission of external shocks. Booming economic conditions in both regions before the global crisis were largely driven by capital inflows, but also supported by region-specific features (commodity prices in Latin America, EU accession in CESEE). Between the two regions, there were notable differences in pre-crisis macrofinancial vulnerabilities. Still, both regions were hit hard after the fall of Lehman; CESEE was affected more strongly given higher trade openness and more pronounced drop in capital inflows. Three CESEE EU member states needed IFI/EU assistance packages during the crisis, while Latin America could manage without recourse to the Fund. However, a fully-fledged financial meltdown did not materialize either in Latin America or CESEE. Importantly, integration into European banking networks was an asset for CESEE during the crisis. As of now, the economic downturn has bottomed out in both regions. While the short-term outlook for Latin America is better than for CESEE, the medium-term growth perspectives are similar for both regions.

The two country cases featuring in this session were on Latvia and Ukraine, two Emerging Europe countries hit most hardly by the crisis. **Lars Tranberg Rasmussen**, senior analyst at Danske Bank, presented on "The Contribution of Poor Economic Policy Mix to Economic Vulnerability - the Case of Latvia". He argued that the poor policy mix during the boom years (procyclical fiscal policy, benign neglect of rapid credit expansion) contributed to economic and financial vulnerability and has dented the competitiveness of the Latvian economy.

The current situation is seen as very challenging, and there is no quick fix. A change in the exchange rate regime would bring forward the negative balance-sheet effects that Latvian households and firms will be facing anyway. Internal devaluation, i.e. a real depreciation through goods and factor downward price adjustments, will take several years and the prospects for euro adoption over the medium term are slim, given the large fiscal adjustment needs Latvia is facing.

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

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As on previous occasions, this joint SUERF-OeNB event managed well to provide a concise overview of currently relevant economic developments and policy issues in the area of real and financial contagion and to bring together the views of academics, financial practitioners and the policy makers.