

# Financial Development, Integration and Stability in Central, Eastern and South-Eastern Europe

*The OeNB's Conference on European Economic Integration 2005*

Compiled by  
Zoltan Walko<sup>1</sup>

The OeNB's second Conference on European Economic Integration (CEEI; its predecessors were called East-West Conference) took place from November 14 to 15, 2005, in Vienna. The OeNB organized the CEEI 2005 together with the European Central Bank (ECB) and the Center for Financial Studies (CFS) in the context of the ECB-CFS research network on Capital Markets and Financial Integration in Europe. The conference was entitled "Financial Development, Integration and Stability in Central, Eastern and South-Eastern Europe" and featured keynote lectures, panel discussions and the presentation of more than 20 research papers. The organizers selected the latter from around 120 papers which had been submitted by researchers from central banks, research institutes and academia in response to a call for papers. In order to be able to accept a large number of papers for presentation, the paper presentations on the second day of the conference were held in two parallel sessions. Both features – the call for papers and the parallel sessions – represented a novelty in the history of the conference series. The conference met with an overwhelming response, with around 300 – partly high-ranking – participants coming from 35 countries, including representatives of international universities and Austrian commercial banks.

The conference was opened by OeNB Governor Klaus Liebscher, who explained why financial development and integration was chosen as the topic for the CEEI 2005. Liebscher pointed out that financial deepening in the New Member States (NMS) and the further integration of European financial markets would constitute milestones on the path to more growth and employment in the enlarged European Union. However, beside the positive effects of financial integration, its risks should not be overlooked. Integration will produce increasingly complex financial structures, creating new challenges for credit institutions, lawmakers, financial market supervisors and central banks. Efficient mechanisms of financial market surveillance at the national level, but also close cooperation at the European level, are needed. For central banks, financial market development and integration are also of interest from a monetary policy perspective, as central banks are intent on the efficient transmission of policy signals in the unified currency area and the smooth functioning of payment and clearing systems, Klaus Liebscher concluded.

In his opening keynote lecture, Cesare Calari, Vice President for the Financial Sector of the World Bank, concentrated on the benefits and pitfalls of financial globalization. Going into more detail on foreign participation in the financial sectors of Central and Eastern Europe, Calari stressed the benefits of foreign ownership in terms of technical and managerial improvements, economies of scale, better access to credit, more competition and greater financial stability. At the same time, increased competition among banks trying to

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maintain profitability may create a moral hazard problem. Also, in several cases in the region, the insufficient quality of a foreign entrant bank has resulted in dubious business activity, while the concentration of foreign ownership may expose the target country's banking system to adverse developments in the country of origin. Calari stressed the importance of market discipline and the need for regulatory convergence and the dissemination of best practice to mitigate risks.

The opening panel discussion under the chairmanship of Klaus Liebscher focused on "The Current State and Future Prospects for the CEE Financial Sector." Alexandre Lamfalussy, former president of the European Monetary Institute (the forerunner of the ECB), addressed emerging concerns over "excessive" consultation and "regulatory overload" by warning against simplistic costs-benefit calculations and an ideological divide. Lamfalussy recalled that the framework was only one precondition for genuine financial integration, overcoming protectionist instincts was another. Irmfried Schwimann, head of unit in the Directorate General Internal Market and Services of the European Commission, presented facts and figures on the Central and Eastern European (CEE) financial sector. The CEE financial system is largely bank based, but insurance, stock markets and funds are growing fast. A high level of foreign ownership raises issues on financial stability and cross-border supervision. Given fast integration, accelerated through the transposition of EU legislation, there was strong potential for further development, as Schwimann pointed out. Stefan Zapotocky, Joint CEO of Wiener Börse AG, invited regional players to form a "Central European Exchange Alliance" together with the recently merged Vienna and Budapest stock exchanges. Such an alliance would increase international visibility, strengthen local markets and reduce the dominance of global players. Citing Austria's successful experience, Zapotocky expected 100% growth in market capitalization in the next three years through the integration of these very fragmented markets. Cristian Popa, deputy governor of Banca Națională a României, cited the financial sector's small size, its rapid growth, booming household credits, the importance of foreign capital, asymmetric risk perception, high transaction costs and limited diversification as common financial sector features in Central and Eastern European countries (CEECs). The management of dynamic risks and procyclical market behavior require complementarity between price stability and financial stability, which means that prudential and administrative measures must support traditional monetary policy instruments.

In his keynote lecture "Catching Up: Financially Integrating Europe," Eric Berglöf (EBRD, Stockholm School of Economics) set out to analyze the challenges which CEECs face during the process of financial integration with Western Europe. Despite different starting points and different policies, there has been convergence in several areas: Banks clearly dominate the financial system, investments are financed through internal funds, external funds consist mostly of FDI, and the enforcement of laws and regulations is generally weak. Berglöf stressed that financial integration has lagged behind real integration and that a financial system which focuses on entrepreneurship and the promotion of the entry and exit of firms is needed. Thus further financial development and integration are crucial for future growth and depend on con-

tinued improvements of the institutional environment, in particular on the better enforcement of existing laws and regulations and stronger corporate governance. He suggested that new regional initiatives, so-called “club-in-club” initiatives, may help to strengthen the process of financial integration as well as financial development. Such initiatives, for example the Baltic financial zone, may trigger an EU-wide change. However, “club-in-club” initiatives should be seen as a complement to, not as a substitute for EU integration.

Philipp Hartmann (ECB) chaired session 1, “The European Financial System as an Economic Driving Force.” The first paper, “The Financial System of the EU-25” by Franklin Allen (University of Pennsylvania), Laura Bartiloro (Banca d’Italia) and Oskar Kowalewski (Academy of Entrepreneurship and Management), gave an overview of the financial structure of the enlarged European Union. Using a wide range of financial indicators, Kowalewski pointed out the substantial differences between the financial structures in the old and new Member States. He stressed that given the dominance of banks in the EU financial structure, there was a great need for more harmonization and adaptation of regulatory changes in banking. The authors identified the review of safety nets as a further challenge, as the responsibility of the home country in bailing out foreign branches could create serious problems if small home countries are unable to bail out large banks. In the second paper, “The Impact of the Euro on Investment: Sectoral Evidence,” Tomas Dvorak (Union College, Schenectady, New York) showed that the effect of the euro on investment growth was positive and in fact strongest immediately following its introduction in 1999. The effect appears to be equally strong for countries with high and low levels of financial developments, whereas the effect is stronger for industries that depend on external finance. Dvorak found no evidence that the introduction of the euro increased the efficiency of capital allocation, however. The last paper of this session, titled “Financial Integration and Entrepreneurial Activity: Evidence from Foreign Bank Entry in Emerging Markets” by Mariassunta Giannetti (Stockholm School of Economics) and Steven Ongena (Center, Tilburg University), studied the effects of foreign bank lending on firm growth and capital structure, distinguishing between small versus large firms and firms with state or banking “connections” versus those without, and the effects on the industrial structure. The authors found that foreign lending stimulates growth in firm sales, assets, and leverage, whereas the effect is dampened for small firms. They also pointed out that the most connected firms benefited least from foreign bank entry. Furthermore, the authors concluded that foreign banks can have an effect on the industrial structure by decreasing the presence of small firms and by increasing the exit and the entry of firms. Going beyond comments on the presented papers, the discussant, Luc Laeven (World Bank), argued that the primary functions of financial systems are very hard, if not impossible, to measure. Existing financial sector indicators are good in measuring the size of the financial sector but less appropriate for measuring the functioning of the financial market, e.g. efficiency and quality, and the institutional environment.

Session 2, chaired by Doris Ritzberger-Grünwald (OeNB), investigated the question whether high credit growth in Central and Eastern European Countries was a matter of concern. The three presentations in the session

treated the topic from different angles, as pointed out by the discussant Dubravko Mihajek (Bank for International Settlements, BIS). Frédéric Boissay (ECB) and his coauthors (Oscar Calvo-Gonzalez, ECB, and Tomasz Kozluk, European University Institute) argued in their paper “Is Lending in Central and Eastern Europe Developing too Fast?” that credit growth was too fast in most of the CEECs covered in their sample, taking into account the fundamentals as well as catching-up effects. This was found to be especially true for countries with currency boards or tightly managed float systems. Andrea Schaechter, Christoph Duenwald and Nikolay Gueorguiev from the IMF focused on credit booms and policy responses in Bulgaria, Romania and Ukraine (“Too Much of a Good Thing? Credit Booms in Transition Economies: The Cases of Bulgaria, Romania and Ukraine”). They concluded that credit growth has supported strong economic performance but has also contributed to macroeconomic imbalances in Bulgaria and Romania and has raised prudential concerns in Ukraine. Deborah Revoltella (UniCredit Group) and Fabrizio Coricelli (University of Siena) presented the main results of the research project “The New Europe Household Lending Market” (coauthored by Andrea Moneta, Annalisa Aleati, Matteo Consalvi and Fabio Mucci, all from UniCredit Group) on the sustainability and the growth effects of the retail lending boom. Fast lending growth in the “New Europe” is driven by the mortgage market and an increasing role of households in banks’ lending portfolios. The high correlation between consumption and credit growth is considered to be an indication that retail lending markets are not yet promoting consumption smoothing. Nevertheless, the credit boom is not seen as leading to major imbalances. In his discussion, Dubravko Mihajek noted that the short credit market history and structural changes in credit demand in CEE countries complicate the assessment if credit growth is excessive. He also regarded a more disaggregated approach in assessing the impact of strong credit growth on the trade balance as necessary. The discussant warned against being too relaxed with respect to household lending and pointed out rising foreign debt, household indebtedness and property prices, and increased vulnerability to interest and exchange rate movements as negative side effects.

The dinner speech on the first day was delivered by Gertrude Tumpel-Gugerell, Member of the Executive Board of the ECB. In her lecture, Tumpel-Gugerell took a look at the history of financial development and integration in the EU over the past 15 years, focusing on whether past expectations have come true. She pointed out that both the “old” and the “new” Member States and candidate countries have gone through significant transformation processes and have been converging toward what has become a relatively similar financial system (mostly bank-based with large consolidated banks concentrating mainly on domestic markets, although in the case of the CEECs with a high share of foreign ownership). Notwithstanding these developments, both old and new Member States need to make further progress toward financial integration. This refers particularly to retail markets, market infrastructure, supervisory practices and aspects relating to the legal framework. Tumpel-Gugerell referred to challenges that stem from the rapid liberalization of the financial system, the high degree of foreign ownership of financial institutions, and the increasing share of foreign currencies in domestic lending activity in

some countries. With respect to the role of authorities in promoting financial integration, Tumpel-Gugerell stressed that the legislative framework favorable to the creation of a single market for financial services in the EU was now basically in place. Remaining challenges relate to the elimination of the last obstacles to financial integration by creating conditions that foster and guarantee the fair, homogeneous and transparent application of the rules for all market participants across the EU.

The second day of the conference started with a keynote lecture by René Stulz (Ohio State University), who started off by pointing out that in contrast to the neoclassical theory prediction, empirical evidence suggests that capital flows from emerging to developed markets. In his lecture, Stulz argued that this phenomenon was related to agency problems present in emerging markets both at the level of firms and countries where either corporate insiders or state rulers consume the private benefits that would otherwise accrue to the providers of capital. These agency problems lead to more concentrated ownership structures and also reduce the gains from financial integration. The examination of various indicators on governance at the firm and country level, data on ownership concentration, stock markets capitalization and the international diversification of (U.S.) portfolio investors produced evidence that corroborates the role of agency problems for ownership concentration and a lower degree of financial integration. René Stulz concluded with a plea for economic reform; improvements in governance would make it possible for Eastern Europe to benefit more from financial globalization.

Session 3a “Financial Sector Developments and Growth in Accession Countries and South-Eastern Europe,” chaired by Peter Mooslechner (OeNB), dealt with the question of how the development of financial markets might promote economic growth. In their paper “Importance of Financial Sectors for Growth in Accession Countries,” Gerhard Fink (Vienna University of Economics and Business Administration), Peter R. Haiss (Bank Austria Creditanstalt and Vienna University of Economics and Business Administration) and Goran Vukšić (Institute of Public Finance, Zagreb) analyzed this issue for eight CEECs and Malta. In their study, the authors regressed GDP growth on capital stock growth, the change in participation, the quality of human capital and different measures of financial intermediation. Although the results indicated that aggregate measures of financial intermediation usually enhance economic growth, only domestic credit to GDP and bond market capitalization were found to lead to higher economic growth, whereas private credit and stock market capitalization appeared to have no significant effect on growth. The second paper of the session, “The Finance-Growth Nexus and Financial Sector Environment: New Evidence from South-Eastern Europe,” by Arnaud Mehl (ECB), Cristina Vespro (ECARES, Université Libre de Bruxelles) and Adalbert Winkler (ECB) studied the determinants of the growth rate of GDP per capita for eight Southeastern European countries. Using a different set of explanatory variables (e.g. initial GDP, secondary school enrollment, government expenditure, openness, inflation) and pooled OLS estimations, the authors showed that it is not necessarily the degree of financial intermediation which matters for growth, but rather the quality of the financial sector (measured by means of foreign bank penetration, creditor rights and diverse EBRD

structural indicators). In the discussion, Sumru Altug (University of Koç) emphasized that the causality running from financial intermediation to economic growth should be considered with caution, as economic growth may also trigger substantial changes in the financial system (complex financial structures, financial innovations).

Session 3b, “Ownership Structure and Firms’ Performance”, chaired by Jan Krahnert (University of Frankfurt and Center for Financial Studies), provided an overview of the ownership structures and their consequences for companies’ investment performance in CEE. The first paper, “Ownership Structures and Investment Performance in Central and Eastern Europe” by Evgeni Peev and Dennis C. Mueller of the University of Vienna, compared the investment performances of selected CEECs and “old” EU countries. The authors found that foreign-owned companies had a relatively better investment performance, but their return on investment (ROI) was still less than their cost of capital. Furthermore, the overall effect of financial owners on investments was negative, as companies with nonbank financial institutions as shareholders generally showed a lower ROI; companies with bank owners had a higher ROI. In the second paper, “Ownership Competition in the European Transition Area: Towards a Viable Restructuring?” by Diana Pop (Laboratoire d’Economie d’Orléans) and Julien Le Maux (University of Paris I Sorbonne), the authors compared the impact of ownership concentration on economic performance in Romania and Croatia. The main finding of their paper was that in Croatia companies fare better if they have many large shareholders comparable in size, while Romanian companies perform better if the holdings of the largest shareholder are large relative to those of the other shareholders. The discussant, Zsuzsanna Fluck of Michigan State University, argued that banks offer comparably better monitoring, which might be a reason for their good investment performance, as suggested by the first paper. Commenting on the different effects of the shareholder structure on company performance in Romania and Croatia, Zsuzsanna Fluck argued that the different legal system might be an explanation.

Session 4a “Banking and Financial Stability,” chaired by Andreas Ittner (OeNB), focused on regulatory aspects of the banking system. The first paper, “Does Interbank Borrowing Reduce Bank Risk?” by Valeriya Dinger and Jürgen von Hagen of the University of Bonn, analyzed the extent to which interbank borrowing helps strengthen bank supervision. In their theoretical model, the authors postulate that interbank monitoring relating to interbank borrowing imposes discipline on small banks, which are dependent on interbank borrowing, and this complements traditional bank supervision. Using data for ten CEECs, the authors show that small banks indeed finance themselves on the interbank market, and they also tend to finance less risky projects than other banks do, confirming the predictions of the model. In the second paper, “Deposit Interest Rates, Asset Risk and Bank Failure in Croatia,” Evan Kraft and Tomislav Galac of Hrvatska narodna banka investigated how deposit rates, asset risk and bank failure were interrelated in Croatia during the last ten years. Using panel logit models, the authors tried to pin down the factors which could best predict bank failure in Croatia. Deposit rates were found to be very good at predicting bank failure, as risky banks tended to finance them-

selves from the retail deposit market. The third paper of the session, “Investigating the Early Signals of Banking Sector Vulnerabilities in Central and East European Emerging Markets” by Kardi Männasoo (Eesti Pank) and David G. Mayes (Suomen Pankki – Finlands Bank), took a wider approach in assessing the determinants of banking crisis in CEE. On the basis of logit models for a large bank-level dataset for the ten NMS and a number of countries from Southeastern Europe, the authors showed that macroeconomic variables tend to predict banking crisis well ahead of other variables. However, they additionally showed that these other indicators of the financial and banking system and of individual banks are of help in forecasting banking crisis at shorter time horizons. In the discussion of the papers, Helmut Elsinger (University of Vienna) suggested that some of the assumptions of the theoretical model of Dinger and von Hagen may be too unrealistic. He also noted that the risk measures used in the empirical part of the paper may be sensitive to untruthful accounting potentially practiced by unscrupulous banks. Regarding the last paper, Elsinger noted that it was bad news that only macroeconomic variables predict banking failure two years ahead well, which made it impossible to distinguish between individual banks on the basis of bank-level characteristics.

Session 4b, “Financial Integration of New EU Member States,” was chaired by Max Watson (Economic Advisor to the European Commission). The first paper, “Financial Convergence and Integration of New EU Member States” by Lorenzo Cappiello (ECB), coauthored by Bruno Gérard (CentER, Tilburg University and Norwegian School of Management), Arjan Kadareja (ECB) and Simone Manganelli (ECB), analyzed the degree of integration of stock and bond markets of the NMS with those of the euro area. Using two different econometric methodologies, the authors found that the degree of equity market integration has increased during the process of EU accession, especially in the larger NMS. By contrast, the authors did not find evidence for increased bond market integration. The second paper, “The Integration of Czech, Hungarian and Polish Bond Markets with the Euro Area Bond Market” by Thomas Reininger and Zoltan Walko of the OeNB, studied the integration of bond markets in the Czech Republic, Hungary and Poland with the euro area, benchmarking it to the experience of peripheral euro area countries during the run-up to euro adoption. The authors found that only the Czech bond market showed a considerable level of integration with the euro area on the basis of convergence in yield changes, comparable to that in the peripheral euro area countries two years prior to euro adoption, despite considerable convergence on the basis of yield levels. Discussing these results, the authors noted that while the lack of integration has some benefits at the current stage in the monetary integration process of these countries, stronger bond market integration is likely to become necessary at later stages. In the third paper, titled “International Capital Mobility and Current Account Targeting in Central and Eastern European Countries,” Matthias Köhler (Center for European Economic Research) measured financial market integration in the five Central European NMS using the Feldstein-Horioka approach in analyzing the relationship between domestic savings and investment rates, and using unit root tests for the current account. Using the first approach, the author did not find firm evidence that these countries had pursued active current account targeting poli-

cies in the past. However, using the second approach, he came to the conclusion that countries with severe current account problems seem to have actively used policies to achieve a better balance. In his comments on the first paper, Lieven Baele (Tilburg University and CentER) suggested some improvements and fine-tuning in the econometric methodology used by the authors, and also suggested additional factors which may explain the time variation in equity market correlation. Regarding the second paper, Baele pointed out that the interpretation of the integration parameters can be complicated by the existence of exchange rate risk, and also suggested some modifications to the applied methodology. Turning to the last paper, Baele focused on the possibility of an omitted variable bias in the analysis and pointed out that savings and investment rates may be correlated because they are driven by a third factor.

In Session 5a, “The Effects of Foreign Bank Entry” (chaired by Adalbert Winkler, ECB), Christa Hainz (University of Munich) presented the first paper, “Modes of Foreign Bank Entry and the Effects on Bank Interest Rates: Theory and Evidence,” (co-authored by Sophie Claeys, Ghent University). The paper studied the effect of different entry modes on the interest rate for loans in a model where domestic banks possess private information about their incumbent clients but foreign banks have better screening skills. The model predicts that interest rate spreads are higher if credit institutions enter through acquisition rather than greenfield investment. The result is empirically validated for a large sample of banks within ten CEE transition countries for the period from 1995 to 2003. The second paper, “Profitability of Foreign and Domestic Banks in Central and Eastern Europe: Does the Mode of Entry Matter?,” by Olena Havrylchyk (CEPII) and Emilia Jurzyk (Katholieke Universiteit, Leuven) showed that foreign banks, especially greenfield institutions, earn higher profits than domestic banks. The profits of foreign banks in the CEECs also exceed the profits of their parent banks, which explains why banks enter the CEEC market. Further, the authors examined the costs and benefits of foreign ownership by analyzing the determinants of profitability for domestic, takeover, and greenfield credit institutions. The profits of foreign banks are found to be less affected by macroeconomic conditions in their host countries, but greenfield banks are sensitive to the situation at their parent banks. The last paper of the session, presented by Rajdeep Sengupta (Vanderbilt University, Nashville, Tennessee), modeled foreign entry and bank competition as the interaction between asymmetrically informed principals: The entrant uses collateral as a screening device to contest the incumbent’s informational advantage. The entrant’s success in gaining borrowers of higher quality by offering cheaper loans increases with its efficiency advantage. The paper accounts for evidence suggesting that foreign banks tend to lend more to large firms, thereby neglecting small and medium-sized enterprises. The results also seem to explain why this observed “bias” is stronger in emerging markets. In his discussion of the papers, Bo Becker (University of Illinois) emphasized that in assessing foreign bank entry it was necessary to go beyond focusing on profitability and to look into loan volumes and pricing as well. Referring to the Claeys and Hainz paper, he pointed out that information advantages of FDI through acquisition as opposed to FDI through greenfield investment should disappear with time. As regards the Havrylchyk and Jurzyk paper, Bo Becker

emphasized the lower profitability of acquired banks before acquisition, which lends support to the conclusion that foreign ownership causes rather than chooses high profitability. He further pointed out that in line with the studies and as a generally plausible argument, one would expect countries with better creditor protection to host more foreign banks. However, better creditor protection being the case in Western European countries, one – perhaps surprisingly – finds less foreign banks there than in the eastern part of the continent. Thus, Becker concluded that there may be some slack in the system that attracts foreign bank entry in Eastern Europe.

Jan Krahnert (Center for Financial Studies) chaired Session 5b, “Interbank Lending and Systemic Risk.” Zsuzsanna Fluck (Michigan State University) presented the paper “Race to the Top or Bottom? Corporate Governance, Freedom of Reincorporation and Competition in Law”, coauthored by Colin Mayer (Said Business School). The authors found that given the prevalent technology in a country and its optimal governance structure, manager control induces firms to reincorporate in the most manager-friendly location. When shareholders have full or partial control over the reincorporation decision, there will be a diversity of governance structures. Furthermore, regulatory competition induces regional separation of start-up and old firms, as there is no governance structure that maximizes the social welfare of existing and new enterprises. The paper by Falko Fecht (Deutsche Bundesbank) and Hans Peter Grüner (University of Mannheim), “Financial Integration and Systemic Risk,” addressed the question of the costs and benefits of regional financial integration in the interbank market. The authors show that the relationship between the costs and benefits of financial integration in the interbank market is determined by the relative likelihood of offsetting regional liquidity shocks versus aggregate shocks and the cost of asset liquidation in case of contagion. In her paper, “Contagion Risk in Financial Networks,” Ana Babus (Erasmus University) observed that modern banking systems are highly interconnected both on the liability and asset side, entailing the risk of contagion. Ana Babus addressed the question of whether the links that banks form are such that contagion risk is at a minimum. It is shown that when banks are connected in an incomplete network, the degree of interdependence that is created is likely to be suboptimal. Complete networks ensure that banks always set the interbank linkages at a level that minimizes contagion risk. In his discussion, Sylvain Champonnois (Princeton University) observed common topics in the three contributions; all examining possible hazards associated with financial integration. Those hazards are associated with systemic risk in the banking system and a possible race to the bottom in standards. Furthermore, the relationships between the agents in the models are endogenously derived from their maximization problems. He raised the issue of the importance of these integration hazards.

The closing panel discussion, “Financial Integration and Commercial Bank Strategies in the CEECs,” was chaired by Josef Christl, OeNB Executive Director. The panel consisted of a selected group of premier-league CEE financial market practitioners. Alessandro Profumo (UniCredit Group) expounded the “UniCredit strategy in Central and Eastern Europe.” He stressed the size of the CEEC markets, strong economic growth, and continuing strong growth potential, and named UniCredit “the undisputed banking leader in the region.”

The high degree of complexity of the region makes it necessary to integrate different banking models, to diversify strategic approaches for various countries and to make people with different languages and mentalities work together fruitfully. In just six years, UniCredit made a number of large acquisitions, bringing total UniCredit investment in these six years – excluding the HVB/BA-CA purchase – to around EUR 2.7 billion. László Wolf (OTP Bank) focused on “Increasing Shareholders’ Value – The OTP Story.” Shareholder value can be raised two ways – through operational improvements or through acquisitions. On the one hand, OTP built a centralized back office in 2003 to boost efficiency and strengthen branches’ sales focus, enabling OTP to save significant resources. On the other hand, in recent years OTP has expanded strongly abroad and has acquired credit institutions in Slovakia, Romania, Croatia, Ukraine, Bulgaria and Serbia, countries whose financial sector is growing faster than that of Hungary. Pointing to the most recent impressive performance of OTP shares, László Wolf emphasized the pertinence of swift and efficient transformation measures. Reinhard Ortner (Erste Bank) spoke about banking consolidation and touched upon some key issues in the global arena. According to Ortner, banking is currently in a phase of consolidation in the U.S.A., linked i.a. to economies of scale. Having a cash flow mountain for redeployment at their disposal, U.S. banks may leapfrog into Europe in the future. On the other hand, European banking consolidation will need to be founded on increasing acceptance of cross-border transactions. However, there are a number of barriers to intra-European consolidation, including domestic protectionism, the absence of a European takeover code and differing accounting approaches. The real problems often boil down to three simple issues: Who is the CEO? Where are the headquarters located? What is the name of the entity? Ortner also stressed that many large top-performing institutions have substantial exposure to high interest-margin consumer finance business. “Financial Integration and Commercial Bank Strategies” was the topic Frederik von Dewall (ING Bank) presented. He also took a global view, but concentrated more on the geographic aspect, i.e. on long-term market dynamics by regions. In his view, Central, Eastern and Southeastern Europe are among the promising regions for banks, but they have to compete with other promising areas such as China and India. Looking at banking, Frederik von Dewall pointed to the large catching-up potential of CEE with the euro area in terms of the degree of financial intermediation. Despite various impediments to EU cross-border mergers and acquisitions, the latter have recently reached a total deal value comparable to that of the U.S.A. Merger synergies mostly come from lower cost bases. The general discussion focused on the question which indicator – cost saving or revenue growth – is more important for successful bank performance. A consensus emerged that both were important, but that in the short term, cost-cutting effects, which were more easily perceived by markets, were probably preferable. In the long term, though, revenue expansion is indispensable for success.

In his closing remarks, Josef Christl appreciated the width and depth of the issues covered in the lectures and presentations held during the two days of the conference. Summarizing the highlights of the conference, Christl acknowledged the impressive transformation process which took place in Central and

Eastern Europe during the past decade. He pointed out, however, that despite the success achieved, the CEECs continue to lag behind Western Europe in terms of their financial development level. He added that differences exist among the CEECs as well. Christl stressed that to promote financial integration across Europe, there was a need for “better regulation,” drawing on open, transparent and evidence-based policymaking, and a need to focus on the consolidation and consistent implementation of the legislative framework for financial services. He underlined that further financial development in CEE could be expected to foster economic growth and thus support the economic catching-up process. Moreover, Josef Christl pointed out that this process must be carefully monitored to guarantee financial stability. He also referred to evidence presented at the conference that the integration of the capital markets in the NMS with that of the euro area remains limited. He expressed his belief that this situation would change over the next few years. Finally, Christl highlighted the significant role of commercial banks in promoting financial development integration in CEE. He noted that commercial banks in the region were well aware of the benefits and challenges of doing business in CEE. Finally, Christl pointed out that the banking industry’s natural self-interest in pursuing its business activities while keeping risks on a manageable scale would have to be complemented by adequate regulation and supervision practices, in particular in areas like the effective supervision of financial conglomerates and of the nonbank financial sector, and the supervision of cross-border financial institutions.

# The CEEC Website

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Silvia Kirova



## Selected Abstracts

The selected abstracts below alert readers to studies on CEEC topics in other OeNB publications. You may find the full-length contributions at [www.oenb.at](http://www.oenb.at).

### **Main Features of Recent Banking Sector Developments in Selected Southeastern European Countries**

Peter Backé,  
Thomas Reininger,  
Zoltan Walko

The purpose of this paper is to provide a comparative stock-taking exercise of recent banking sector developments in four current EU candidate countries (CC-4), namely the two acceding countries Bulgaria and Romania and the two negotiating candidates Croatia and Turkey. The paper finds that a strong increase in foreign liabilities allowed boosting domestic lending in particular to households. At the same time, banks' credit risk that results from non-banks' foreign exchange exposure has significantly increased. Although in recent years (1) banks' profitability has increased, (2) their share of nonperforming assets has declined and (3) their capital adequacy ratios can currently be considered as still sufficiently high (despite the recent domestic credit expansion), considerable risks to macroeconomic and macrofinancial stability may arise if foreign liabilities and domestic credit growth continue to increase at such a rapid pace in the future.

Published in Financial Stability Report 11.

### **High Employment with Low Productivity? The Service Sector as a Determinant of Economic Development**

Andreas Breitenfellner,  
Antje Hildebrandt

Whether measured in terms of employment or value added, the service sector dominates the economies of industrialized countries. The positive connection between tertiarization and per capita income is confirmed in both country cross-section and time series analyses. This development can be explained by demand factors (e.g. the growing proportion of female employees) and supply factors (e.g. cost disease in the service sector). This paper analyzes data on 23 service activities, grouped into four subsectors (distribution, business, social and personal services). The analysis of each subsector's contribution to the development of employment and productivity between 1983 and 2003 illuminates the prevailing productivity gap between the EU-15 and the U.S.A. The corresponding investigation of four new EU Member States during their transformation processes points to an employment potential in the tertiary sector that has not yet been fully utilized. The study further identifies four tertiarization models (dynamic, lagging, managed and catching-up) that can be associated with different geographic regions. The process of tertiarization is compatible with growth in both employment and productivity. Different combinations of production- and consumption-oriented services can have a positive effect on growth. The concluding chapter discusses the role of the European Union's Lisbon strategy in enhancing the productivity of the service sector.

## **Oil Price Shock, Energy Prices and Inflation – A Comparison of Austria and the EU**

The marked increase in the price of crude oil has also affected the prices of motor fuels, heating oil and other forms of energy. The extent and speed of these price reactions have varied widely in EU countries, and the accompanying inflationary effects have differed accordingly. For monetary and economic policy, it is important to know the channels through which oil price fluctuations are transmitted in order to assess their effects on inflation, economic growth and employment.

This study presents a current overview of oil and primary energy markets worldwide and estimates the elasticities and the speed of adjustment parameters of motor fuel and heating oil prices in response to oil price fluctuations in the EU-25. In addition, we test whether prices react asymmetrically to increases and decreases in crude oil prices and examine their transmission to other forms of energy, such as natural gas, electricity, solid fuels and district heating. We highlight the effect of volume-based excise taxes, which have a strong differentiating as well as dampening effect on prices, and address the issue of whether fiscal policy should cushion the impact of price increases, for example by lowering energy taxes or by providing energy subsidies. Then we quantify the direct inflationary effects of an oil price shock in Austria in a simple simulation using the OeNB's inflation forecasting model. Finally, we derive conclusions for monetary and economic policy.

**Markus Arpa,  
Jesús Crespo Cuaresma,  
Ernest Gnan, Maria  
Antoinette Silgoner**

## **Reform of the Stability and Growth Pact**

The objective of the Stability and Growth Pact (SGP) is to secure sound fiscal policies, which have remained a national responsibility in Economic and Monetary Union (EMU). Ever since it first took effect, the SGP had been subject to a reform debate, ultimately leading to its redesign in 2005. The debate intensified in 2002, when several European countries suffered from growing budgetary problems, and culminated in November 2003, when the Ecofin Council decided not to act upon European Commission recommendations to move to the next steps of the excessive deficit procedure (EDP) for France and Germany and instead adopted conclusions putting the procedures in abeyance subject to certain undertakings by the countries concerned. Consequently, the Commission brought an action before the European Court of Justice. The conflict surrounding the correct procedure in line with the provisions of the Treaty establishing the European Community (the Treaty) and the SGP, i.e. the correct interpretation and implementation of the procedural and factual steps laid down therein, brought to light differences of opinion between the EU Member States and the Commission as well as among the Member States themselves.

Against this background, the European Commission presented concrete proposals to reform the SGP in the fall of 2004. At an extraordinary Ecofin meeting on March 20, 2005, the EU finance ministers reached a compromise on the reform of the SGP. The reform includes measures applicable to both the preventive and the corrective arms of the SGP. The top priority of the reform was to enhance Member States' national ownership of the fiscal framework

**Leopold Diebalek,  
Walpurga Köhler-  
Töglhofer,  
Doris Prammer**

and hence to safeguard the sustainability of public finances in EMU in the long run.

Experience to date does not allow for a final assessment, but from the vantage point of monetary policy, certain weaknesses remain that had already been pointed out during the reform debate.

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See also box 1, entitled “Economic Outlook for Central and Eastern European Countries,” in the Economic Analysis in Monetary Policy & the Economy 1/06.

# Transition and Economic Performance – Business Conditions in Eastern Europe

## **Presentation of the EBRD's Transition Report 2005**

As in the past years, the Oesterreichische Nationalbank hosted the presentation of the EBRD Transition Report in Vienna in 2005. The event, chaired by Peter Backé, Head of the Central and Eastern European Analysis Unit of the OeNB's Foreign Research Division, took place on December 9 as part of the OeNB's lecture series. The presentation comprised two modules. Samuel Fankhauser, Director of Policy Studies at EBRD, presented the Transition Report 2005, whereas Alexander Auböck, Country Director for the Czech Republic, Slovakia, Slovenia and Hungary, focused on EBRD's business projects, instruments and partners in transition economies from an operational perspective. He also stressed the growing shift of the EBRD's business in Central and Eastern Europe from providing credit to taking equity stakes.

Like its predecessors, the Transition Report 2005 covers Central European, Southeastern European, Eastern European and Central Asian countries and, in addition to detailed country analyses, is compounded of two thematic parts. The first part analyzes macroeconomic developments and in particular transition progress as measured by economic and institutional indicators. The second part of the report addresses a different transition issue every year and treats it in more detail. In 2005 the EBRD, in collaboration with the World Bank, for the third time conducted the Business Environment and Enterprise Performance Survey (BEEPS) of over 9,500 firms. The objective of the survey was to shed some light on the extent to which enterprises in transition economies believe obstacles such as weak regulation, corruption, red tape, labor market rigidities or a weak judiciary impair their performance and growth.

The report concludes that on the one hand especially Central Europe and the western Commonwealth of Independent States (CIS) made significant transition progress. In Central Europe, this was mainly a market reaction to improved regulation and progress in institution building related to EU membership. The entire region was distinguished by a dynamic economic performance associated with rapid credit growth in a number of countries.

The report also notes that on the other hand, although the business environment in all countries of the region has improved since the last survey in 2002, there are still some hindrances impeding business, in particular institutional weaknesses, red tape and difficulties in accessing external financing. It is noteworthy that these obstacles hit those companies hardest that can benefit the economy most.

## **Part I: Transition and Economic Performance**

Although the pace of economic growth in the region has slowed down somewhat, it is still projected to reach an impressive average of 5.3% in 2005, topping growth in most of the rest of the world, in particular the euro area. At 6.2%, the frontrunner is the CIS, where growth is driven primarily by surging commodity prices. Central Europe and the Baltic states (CEB) and Southeastern Europe (SEE) in turn recorded growth rates of 4.2% and 4.8%, respectively.

The EBRD employs a wide array of indicators by means of which transition progress is measured. Among CIS countries, particularly Armenia, Moldova, Ukraine and Georgia recorded progress. While no improvement could be observed in other CIS countries compared to 2004, Russia received both an upgrade (in the financial sector) and a downgrade (due to a rise in state ownership and control in the oil and gas sector), the only downgrade in the report. Among SEE countries, Serbia and Montenegro advanced most tangibly in the course of 2005. However, Serbia and Montenegro is a latecomer to transition and has a lot of catching up to do. In fact, Serbia and Montenegro is probably moving on at a slower pace than the CEB countries when they were at a comparable stage of transformation. The CEB countries received their upgrades in particular for the restructuring activities of firms and for reforms in the banking and the nonbank financial sector. Looking at the overall transformation progress, the CEB countries have retained their lead vis-à-vis the SEE and CIS countries and even managed to extend their edge somewhat.

The report also points out some important indicators of rising confidence in the region, such as foreign direct investment (FDI) and credit growth. FDI reached an unprecedented record high last year, and although it is still rather concentrated on specific regions (such as the CEB countries) as well as sectors (the majority of FDI in the CIS flowed to the oil and gas sector), the report suggests that the level of concentration has decreased. In addition, most transition countries witnessed a spectacular growth of credit, especially to households. While this can in general be perceived as a structural shift to deeper financial systems, it might also imply risks to macroeconomic and financial stability. On top of that, each country faces additional specific challenges, be it continuing high fiscal deficits in Poland, the Czech Republic, Hungary, Croatia or Albania, sizeable current account deficits in the Baltic states and a number of SEE countries, vulnerable financial sectors in Hungary (in macroprudential terms) and the CIS countries (in terms of the strength of financial systems) or the risk of “Dutch disease” in some CIS countries.

## **Part II: Business Conditions in Eastern Europe**

Although the business climate has not yet achieved the benchmark level of mature market economies, the region showed significant improvements and convergence toward the standards of advanced economies in all investigated categories. This holds true in particular for regulation, taxation and infrastructure. At the same time, the relatively less constrained labor market also seems to be converging to Western (continental) European patterns of e.g. shortages of skilled labor and regulation. Despite improvements, companies still point out painful shortcomings, such as institutional weaknesses, red tape and difficulties in accessing external financing. In the Czech Republic, Hungary and Azerbaijan, obstacles to business have even worsened since the last survey in 2002.

The survey also finds that obstacles most severely hinder those firms that are most likely to crank up growth or create new jobs. In addition, the benefits of reforms are spread out rather unevenly within countries, so that firms located outside capitals are still at a relative disadvantage. The report also documents that the market and ownership structure markedly affects the

firms' productivity and efficiency. Companies exposed to fierce competition (e.g. exporting firms) as well as foreign-owned firms experience faster productivity and efficiency growth.

The subsequent discussion centered among other things around the environmental standards of EBRD projects, the challenge for the region brought about by emerging China and the interest rates the EBRD charges compared to commercial banks. Overall, there was broad agreement that Eastern Europe is a dynamic and increasingly stable and attractive region. Despite further transition progress, however, there are still important challenges lying ahead for each country, particularly a poor judiciary, shallow financial markets, excessive bureaucracy, corruption and, in some cases, macroeconomic stability issues which will need to be tackled.

## *Growth, Poverty and Inequality in Eastern Europe and the Former Soviet Union*

### **Presentation of the 2005 World Bank Report**

On November 3, 2005, the Oesterreichische Nationalbank became the venue for the presentation of the World Bank's report on "Poverty and Inequality in Eastern Europe and the Former Soviet Union." The study is an update of the bank's analysis on poverty ("Making Transition Work for Everyone," released in 2000). It focuses on the impact of economic growth on poverty and inequality in the region between 1998 and 2003. The report was presented by Ruslan Yemtsov, Senior Economist and Regional Poverty Coordinator of the World Bank's Poverty Reduction and Economic Management Group in the Europe and Central Asia Region, in a session chaired by Peter Backé, Head of the OeNB's Central and Eastern European Analysis Unit. In his presentation, Yemtsov addressed three main questions:

What were the trends in poverty and inequality over the period under review? Why are the outcomes different across countries? And what can public policy do to promote poverty reduction in the future?

The bottom line of the study is that some 40% of previously poor people in Central, Eastern and Southeastern Europe as well as in the Commonwealth of Independent States (CIS) were pulled out of poverty between 1998 and 2003 as a result of strong economic growth. This is clear-cut evidence for the vital importance of growth for welfare and living standards.

The authors employ household consumption data to establish an indicator that makes living standards comparable across the 26 countries covered in the report. Poverty is measured by comparing data on household consumption per capita and defining an absolute poverty line of USD 2.15 per day (in terms of purchasing power parity in 2000). This poverty line definition, which is higher than the usual standard of USD 1 per day, is justified given that expenditures on heating and warm clothing are higher in the region's cold climate. Between 1998 and 2003, more than 40 million people moved out of poverty, which reduced the share of poor people from roughly 20% to 12%. However, sadly enough, over 60 million people still remained below the poverty line. In addition, another 153 million people are deemed economically vulnerable, subsisting on USD 4.30 or less a day. In other words, those people who are not considered poor at the moment could fall below the absolute poverty line in the event of a pronounced economic slowdown.

The distribution of poverty is not uniform across the region. It can be subdivided into four rather homogeneous groups of countries. In the eight new EU countries covered by the report (EU-8), poverty is low at less than 5% and is limited to specific population groups (e.g. the Roma). In the Southeastern European Countries (SEECs) and the middle-income CIS countries, the share of poor people is relatively small, as it does not exceed 20%. The situation in low-income CIS countries is dramatically different: more than 40% of the population has to get by on USD 2.15 or less a day (except in Azerbaijan). The study also covers Turkey and two countries outside the region, middle-income Colombia and low-income Vietnam, as a benchmark against the postsocialist countries.

The good news is that poverty almost halved over the period under review in response to the strong economic growth of the entire region, which was substantially higher than the world average. Moreover, while poverty declined in almost all surveyed countries (except in Poland, Lithuania and Georgia), the reduction was strongest in the populous middle-income CIS countries. Poverty declined fastest in capital cities, as opposed to other cities and rural areas.

Strong economic growth is the single most powerful force behind the significant poverty reduction in the CIS, where the number of poor people is largest. The reduction in consumption inequality (mainly in the CIS) is another crucial factor that contributed to the sharp poverty decline in the period under review: it declined everywhere in the CIS apart from Georgia and Tajikistan. No clear inequality trend could be observed in the EU-8 and in the SEECs. According to the study, by 2003 consumption inequality in the region was comparable to that in relatively egalitarian regions such as East Asia or in some of the world's rich countries. However, large regional inequalities continue to exist, both between and within countries. In spite – or rather because – of this positive news, the report issues a warning. Since the reduction in poverty resulted from a unique constellation of factors – rapid “catching up” growth in the CIS accompanied by reductions in inequality in some countries – prospects for a further reduction are less promising.

Economic growth can reduce poverty via three distinct channels – wage, employment and social transfers; the wage channel was by far the strongest and the most unambiguous in all subregions. While the working poor profited from real wage growth, the unemployed poor benefited to a much smaller extent, as growth in general failed to create more jobs than had been destroyed. The only exceptions were some rapidly growing CIS countries, such as Kazakhstan, Russia and Ukraine, where the employment rate increased substantially. In the EU-8 and in the SEECs, however, the ratio of employment to the working-age population is well below that of OECD countries and also well below the Lisbon target of 70%. Moreover, it trends in the wrong direction in many countries. On the one hand, the study warns emphatically that if this failure to expand employment persists, it will fundamentally limit the impact of economic growth on poverty reduction. This holds true even for countries in which poverty is relatively low: in Poland, for instance, poverty is rising in consequence of the growing divide between the employed and the unemployed. On the other hand, rising public transfers combined with higher coverage as well as some targeted social assistance programs helped reduce poverty. Social spending increased very strongly in real terms particularly in the SEECs and middle-income CIS countries. Still, most transferred resources were used to raise pensions rather than to support programs targeted at poverty reduction.

As poverty is not limited to the income dimension, the study also focuses on its nonincome components, such as access to education, heating, health care and potable water. The findings on these fronts are, however, rather mixed. While access to education has improved in general, the standards in several countries in all subregions are declining. In particular, the disparities in the quality of education have increased between the rich and the poor as well as between rural and urban areas. With respect to health care, the grow-

ing HIV/AIDS and also tuberculosis infection rates are the most pressing issues in the region. In some countries, in particular in the CIS and in SEE, the health care system has deteriorated to such an extent that it fails to provide adequate and timely health services. These facts notwithstanding, it would be possible to reverse the trend of declining life expectancy. Access to some key infrastructure services, primarily lighting and heating, has worsened in some countries of the low-income CIS group.

Unless economic growth accelerates, the report projects that 40 million people will remain poor and a further 110 million will continue to be economically vulnerable in 2007. Economic vulnerability and wide social and regional disparities are thus still the key concerns and challenges for the region. To end poverty by 2015, the World Bank urges all countries to focus on policies that will accelerate growth and to ensure that benefits are widely shared among the population. In particular, the authors call for a promotion of enterprise reform to encourage the shift of resources to more productive new firms. They recommend adopting policy measures that boost growth and productivity in agriculture and enhancing efforts to generate better opportunities for people living in lagging regions. In addition, the authors underscore the importance of improving the quality, accessibility and affordability of basic social services and of the social safety net. They also emphasize the significance of monitoring progress on poverty reduction.

The ensuing discussion focused on a variety of issues, inter alia on the effectiveness of anti-poverty measures as implemented by the international financial institutions and on the poverty effects of macroeconomic stabilization and structural reform programs. Moreover, the audience felt that the reduction in poverty witnessed in Central and Eastern Europe in recent years may have largely been a one-off development and that a further reduction in poverty in the region would be more difficult to achieve and would thus constitute a long-term challenge. The audience suggested two analytical topics for further examination: first, the impact of the current tax reforms on the distribution and elasticity of poverty, as well as its outcomes, and second, the need to better understand the link between ongoing public sector reforms (in the field of public administration, communal services, health care and education, specifically decentralization) and distributional and poverty consequences.

# The “East Jour Fixe” of the Oesterreichische Nationalbank

## 56<sup>th</sup> East Jour Fixe

### **Ukraine: Shifting Economic Horizons and Interlinkages**

The 56<sup>th</sup> East Jour Fixe of the Oesterreichische Nationalbank (OeNB) focused on Ukraine, a country so far only sparingly dealt with at events of this kind and which, in many respects, still remains quite exotic for economists although, over the last one and a half years, it has repeatedly been in the headlines of the political and economic media. Entitled “Ukraine: Shifting Economic Horizons and Interlinkages,” the 56<sup>th</sup> East Jour Fixe served to underline the OeNB’s dedication to focusing on a country that is actually not very far away from Vienna and in which Austrian banks have most recently strengthened their activities, with one Austrian credit institution even having acquired a key position in the Ukrainian market. As Doris Ritzberger-Grünwald, Head of the OeNB’s Foreign Research Division, pointed out in her introductory statement, Ukraine – being one of the largest countries of Europe and having become a direct neighbor of the European Union upon the enlargement of May 1, 2004 – exhibited impressive economic growth after the turn of the millennium. Most recently this uptrend, however, was followed by a more moderate performance. In this context, it would seem inappropriate to try to fully disentangle economic and political analysis.

The first session, presided by Ms. Ritzberger-Grünwald, was entitled “Ukraine – A New Economic Factor between Russia and the EU.” The first speaker, Clinton Shiells, Deputy Director of the Joint Vienna Institute (JVI), presented an econometric study co-authored with Marco Pani and Etibar Jafarov (both IMF). The paper deals with the question, “Is Russia Still Driving Regional – including Ukrainian – Economic Growth?” The authors examine the correlation of real economic growth between Russia and other CIS economies and the Baltic countries in the period from 1993 to 2004. While conceding the difficult nature of the exercise in view of limited data quality, Shiells showed that up to the Russian financial and economic crisis of 1998, a 1% growth increase in Russia tended to be associated with a 0.8% to 0.9% expansion in other CIS and Baltic countries. After the crisis, the correlation essentially went down to near zero, leading to the conclusion that the growth link has indeed broken down. However, Shiells also gave an alternative explanation, namely that transition effects reduced output in the countries observed during the period from 1993 to 1998, resulting in a high correlation, while countries recovered at different growth rates after that period. (For instance, Ukraine’s rebound only started a year after Russia’s.) The EU – despite enlargement – is not found to have “taken up Russia’s place.”

Vladimir Dubrovskiy, Member of the Supervisory Board and Leading Expert of CASE Ukraine, Kiev, presented a politico-economic analysis entitled “Ukraine One Year after the Orange Revolution: Economic Policy Challenges and Goals.” He started out with an overview of those components that were essential for the functioning of Ukraine’s society and economy before the change of government at end-2004. As opposed to profit-seeking, the Ukrainian society was predominantly rent-seeking. A hierarchy of authoritarian arbiters under the lead of the president was needed to regulate the appropriation of

rents. The wielding of this role required highly discretionary power (“vlast”) that contributed to weakening formally existing property rights and the rule of law in general, thus eroding social wealth. This environment was conducive to the emergence of informal networks and business administrative groups, led by “oligarchs,” who were the clients of the above-mentioned arbiters. According to Dubrovskiy, the partial depletion of the sources of rents, coupled with rising popular dissatisfaction with rampant corruption, contributed to triggering the “Orange Revolution.” However, although the Ukrainian people have become the principals of politicians, and despite some progress, a level playing field has not yet been achieved. Lacking the experience of democratic principles and of a competitive market economy, Ukrainians are still prone to egalitarianism, populism and paternalism – a fact that has partly been reflected in the policies and problems of the new government, as Dubrovskiy put it.

The two presentations were commented by William Tompson, Senior Economist at the OECD’s Economics Department in Paris. With respect to the first presentation, Tompson did not see the break in the growth linkage between Russia and other CIS countries to be so abrupt in 1998. In the discussant’s view, the weakening of the correlation may actually be linked to the effects of the disintegration of the USSR and, more generally, to the transition process. He added that Shiells’ alternative explanation was persuading. Regarding the second paper, Tompson doubted whether the Orange Revolution had really constituted a “revolution” in the sense that the arbiter-client relationship was now gone. Not surprisingly, the general discussion focused on a variety of topics, including the size of Russian FDI in Ukraine (judged to be generally underestimated in official statistics) and medium-term perspectives for Ukraine’s foreign trade orientation (West or East?). In response to questions, Dubrovskiy conceded that institutions were changing only slowly, but that a Ukrainian civil society, albeit weak, existed now. Thus, the democratic institutions that had existed formally in the period before the revolution could now start working. In his view, this can be considered a revolutionary change in the actual rules. Hopefully, Ukraine’s attempt at approaching the EU as fast as possible will create a framework for coping with populism, Dubrovskiy added. Shiells reiterated that the paper provides evidence of a structural break in 1998, but agreed that the process may be linked to the fact that transition countries were going their own way.

The second session, “Ukraine’s Financial Market and Austrian Banks’ Involvement,” was chaired by Peter Backé, Head of the Central and Eastern European Analysis Unit in the OeNB’s Foreign Research Division. The two speakers were Stephan Barisitz, economist with the Foreign Research Division, and Walter Demel, economist at Raiffeisen Zentralbank (RZB). Barisitz presented an overview of developments in the Ukrainian banking sector since the year 2000. He outlined an impressively swift, but fragile expansion of banking activities in recent years. Thus, the degree of financial intermediation (measured in terms of the ratio of bank assets to GDP) rose from under 20% in 1999 to 46% in the first half of 2005 (which is still a comparatively modest level, though). According to Barisitz, despite efforts at improving legislation and supervision, structural weaknesses continue to linger (banks’ inadequate risk management, insider lending, nonperforming loans, feeble creditor and

property rights). Political instability and the tumultuous change of government at end-2004 combined with weak confidence in the sector triggered a mini-banking panic, which was, however, quickly overcome in early 2005. Despite – or perhaps because of – this challenging situation, foreign strategic investors started to move into Ukraine in the second half of 2005, carrying out large acquisitions, with the RZB claiming the first-mover advantage.

Referring to this experience, Demel acquainted the floor with interesting aspects of Raiffeisen International’s purchase of the second-largest Ukrainian bank in his presentation “Bank Aval – A Unique Consolidation Opportunity.” Against the backdrop of the generous catching-up potential for banking services (particularly retail products) in Ukraine, Raiffeisen International paid USD 1.03 billion (ca. EUR 850 million) in October 2005 for a stake of 93.5% in one of the major Ukrainian retail banks, which has one of the largest branch networks in the country. Raiffeisen International had already been present in Ukraine with a subsidiary (Raiffeisen Bank); the planned merger between Raiffeisen Bank and Bank Aval should make Raiffeisen the country’s largest bank (in terms of assets). As Demel pointed out, Bank Aval had been classified “Best Bank of Ukraine” by the magazine “Euromoney” in 2003 and – like Raiffeisen Bank – has been among the banks enjoying the highest confidence levels.

The discussant of the second session, Peter Havlik, wiiw Deputy Director, asked the panelists what they thought of the likely future development of the Ukrainian banking sector: Will it remain basically domestically owned, like in today’s Russia, or will it evolve toward being predominately foreign-owned, as it happened (and is partly still happening) in most new EU Member States and candidate countries? On another – highly topical – issue, Havlik asked Dubrovskiy how he judged the recent price hike for Russian gas deliveries to Ukraine. Both Barisitz and Demel answered that there were indications that foreigners would make more inroads into Ukrainian banking, but that further developments would be influenced by policies and reforms chosen with a mid-term perspective and that these depended on upcoming elections and other factors. Dubrovskiy replied that Russia was certainly not satisfied with the geopolitical situation that had evolved since the Orange Revolution. Tompson added that while Russia had certainly handled the gas crisis badly, as far as he knew, Russia had not actually provoked the crisis. Ukraine had previously been sending out unclear signals in various areas of bilateral relations, including the Common Economic Space (CES) negotiated between Russia, Ukraine, Belarus and Kazakhstan. A lively general discussion ensued, which once again reflected the wide range and considerable weight of important issues Ukraine is currently facing.

## *Olga Radzyner Award for Scientific Work on European Integration*

The Oesterreichische Nationalbank has established an award to commemorate Olga Radzyner, former Head of the Foreign Research Division, who died in a tragic accident in August 1999. The award is bestowed on young economists for excellent research focused on topics of European economic integration and is conferred annually. This year, three applicants are eligible to receive a single payment of EUR 3,000 each from an annual total of EUR 9,000.

The submitted work shall be in the form of a master's or doctoral thesis, a working paper or a scientific article, and shall be in English or in German. Authors shall submit the work before their 35<sup>th</sup> birthday and shall be citizens of any of the following countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, the FYR of Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, Serbia and Montenegro, Slovakia or Slovenia.

To identify their work as a submission, applicants shall mark the envelope with the reference "Olga Radzyner Award" and send it to the Oesterreichische Nationalbank, Foreign Research Division, Otto-Wagner-Platz 3, PO Box 61, AT 1011 Vienna. The Oesterreichische Nationalbank shall receive the work submitted for the award in 2006 by October 2, 2006, at the latest.

For detailed information, please visit our website at <http://ceec.oenb.at> or contact Ms. Sonja Pierron in the Foreign Research Division of the Oesterreichische Nationalbank either by e-mail ([sonja.pierron@oenb.at](mailto:sonja.pierron@oenb.at)) or by phone (+43-1-40420-5205).