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The Oesterreichische Nationalbank's semiannual periodical *Focus on Transition*, first published in 1996, is addressed to all readers – researchers, policy-makers, students – with an interest in the analysis of developments in Central and Eastern Europe.

This volume of *Focus on Transition* contains four parts: an update on recent economic developments in selected countries, a studies section with three studies, a summary of the OeNB's latest transition-related activities (lectures, East Jour Fixe meetings, technical cooperation) and a statistical annex.

The enlargement process has continued in spite of public criticism of the European Union's transparency and legal structure. The Treaty of Nice, which lays down the institutional preconditions for EU enlargement, was adopted at the Nice Summit in December 2000, paving the way for enlargement. In the European Council's view, "that strategy [...] will place the Union [...] in a position to welcome those new Member States which are ready as from the end of 2002, in the hope that they will be able to take part in the next European Parliament elections." The Presidency's Conclusions of the Göteborg European Council at the end of the Swedish Presidency in June 2001 are more explicit: "Provided that progress towards meeting the accession criteria continues at an unabated pace, the road map should make it possible to complete negotiations by the end of 2002 for those candidate countries that are ready. The objective is that they should participate in the European Parliament elections of 2004 as members." The Conclusion also states that the "enlargement process is irreversible." The Danish parliament was first to ratify the Treaty of Nice, followed by the French parliament. But the ratification process faces unforeseen challenges after the referendum in Ireland. With a majority of 54% of the votes, the people of Ireland rejected the Treaty of Nice on June 8, 2001. Most likely, however, their refusal was not motivated by the EU's commitment to enlargement, but by a more general skepticism regarding the functioning of the Union. A second referendum is expected to be held in Ireland, possibly related to reassurances on neutrality.

During the Swedish presidency in the first half of 2001, substantial headway was made in accession negotiations: With some candidate countries, the complex and controversial chapters on the environment and on the free movement of capital and labor were provisionally closed during this period.

The recent economic progress in selected CEECs should be seen in the light of these developments.

The first study analyzes the financial system in five Central and Eastern European countries – Poland, the Czech Republic, Hungary, Slovakia and Slovenia. Highlighting major developments and problems, it is intended as a "stocktaking exercise" after the first ten years of transition. The first part examines the banking sector in the CEEC-5, discussing the history of bank failures and recapitalization programs, privatization, the structure of domestic credit and the efficiency and profitability of the banking sector. An analysis of capital markets is followed by a review of the structure of financial intermediation and an insight into private and public sector funding. The last part of the study briefly assesses the vulnerability to financial contagion including, in particular, any risks emanating from domestic capital markets in the CEEC-5.

The second study compares the patterns of EU trade with all OECD countries and all CEECs in the period between 1989 and 1998, focusing on the development of EU trade with the CEECs in comparison to intra-EU trade and trade with selected third countries. It analyzes the determinants of developments in the EU's intraindustry trade with OECD countries, using OECD estimates to predict potential shares of the EU's intraindustry trade with the CEECs. The main finding of this study is that, over the last decade, the structure of East-West trade has largely converged to that observed in the trade between EU Member States. The study forecasts a further continuation of this process.

In Bulgaria and Romania, the banking sectors have played a pivotal role in shaping economic developments and even triggering changes at important junctures. In this respect, the close connection between financial sector reform and industrial restructuring, or rather the lack of one or both of these factors, has played a decisive role on numerous occasions.

The third, and last, study aims at tracing and comparing the developments of the banking systems in the two countries since the onset of transition. For all their differences, both countries appear to have gone through some similar fundamental experience, which merits a chronological approach divided into a few major periods generally shared by both countries. Each chapter deals with one such period, providing a comparative analysis of the respective experiences of both countries. Notwithstanding the progress of reform in recent years, the paper shows that bankruptcy and liquidation procedures remain sluggish in both countries, particularly in Romania, where a major enterprise reform still lies ahead. Given the high levels of unemployment in both countries, particularly in Bulgaria, the paper concludes that the restructuring bottleneck can only be unplugged step by step; more far-reaching and energetic measures would be warranted in Romania.

Finally, let me draw your attention to the Olga Radzyner Award. The Oesterreichische Nationalbank has established this award to commemorate Olga Radzyner, the Head of the OeNB's Foreign Research Division, who died during a tragic accident in August 1999. The Olga Radzyner Award is bestowed on young economists for excellent research focused on monetary and finance issues in economics. This volume of Focus on Transition contains an invitation to submit applications as well as the conditions for participation.

We invite you to address any comments or suggestions you may have about this publication, or any of the studies it contains, to:

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Klaus Liebscher
Governor

RECENT ECONOMIC DEVELOPMENTS

Recent Economic Developments in Selected Countries

János Kun,
Katrin Simhandl and
Cezary Wójcik

I Introduction

This study reviews the economic developments in the four accession countries which border Austria (the Czech Republic, Hungary, Slovakia, Slovenia) and Poland between October 2000 and May 2001.

All countries under review experienced good or improving growth rates in 2000. In the Czech Republic, Hungary and Slovakia growth accelerated compared to the previous year. In the Czech Republic a three-year recession came to an end. Growth in the countries under review was boosted by foreign demand, especially by exports to the EU. Though some countries witnessed a slight slowdown in the last quarter of 2000 or in the first quarter of 2001, growth is still dynamic and export-driven. However, net exports are negative in some countries. The global economic slowdown does not seem to have had a strong impact so far, as export growth is still robust. One explanation may be that some Western firms with plants in the accession countries have relocated their production to cope with cost-cutting pressures. Turning to domestic demand, fixed capital investment and household consumption are also gaining momentum in some countries. This may be linked to elections to be held in Poland this year and in the Czech Republic and Hungary next year, developments which may be raising wages especially in the public sector, in turn boosting household consumption.

Inflation in these countries is still relatively high compared to the EU, which can be partly attributed to the catching-up process. Poland has made the greatest effort to reduce inflation, but this has had negative side effects on the real economy: extremely high real interest rates have increased unemployment. In the other countries inflation rose or fell only slightly in recent months; unemployment, too, oscillated within a narrow range.

The current account is in deficit in all countries. This cannot be regarded as a negative phenomenon given the modernization needs of these economies. Poland posts the highest deficit that is unsustainable in the long run, but it is declining. Deficits could be financed fully or to a large extent by net foreign direct investment, which was substantial in all countries. Foreign exchange reserves are considered to be sufficient.

As a general trend, the currencies of the countries under review appreciated against the euro in the last half year. Poland experienced the highest appreciation because of high interest rates, but appreciation was steepest (above 9% in six weeks) in Hungary after the country widened the currency fluctuation band in May 2001.

Structural reforms have continued. As mass privatization has been concluded, sales of utilities and financial institutions are on the agenda. Large banks in the Czech Republic and in Slovakia were sold to strong, experienced international banks. The sales were preceded by the removal of nonperforming assets from the banks' balance sheets; these assets then burdened government budgets. Sales of banks are under preparation in Slovenia.

Banking laws and central bank laws were amended in several countries to bring legislation in line with EU requirements. The amendment of the Czech central bank law derailed: it turned out to reduce rather than boost central bank independence. The Czech constitutional court canceled the main parts of the amendment, and parliament will have to deal with the question again.

Capital movements were fully liberalized in Hungary, and restrictions were substantially reduced in Slovenia (minor restrictions are still in force in the three other countries under review).

The five countries' accession prospects improved substantially. The institutional preconditions for EU enlargement were adopted at the Nice Summit in December 2000. The Treaty of Nice paved the way for enlargement. In the European Council's view, "that strategy [...] will place the Union [...] in a position to welcome those new Member States which are ready as from the end of 2002, in the hope that they will be able to take part in the next European Parliament elections."

The Presidency's Conclusions of the Göteborg European Council at the end of the Swedish Presidency in June 2001 contain a more concrete formulation: "Provided that progress towards meeting the accession criteria continues at an unabated pace, the road map should make it possible to complete negotiations by the end of 2002 for those candidate countries that are ready. The objective is that they should participate in the European Parliament elections of 2004 as members." The Conclusion also states that the "enlargement process is irreversible."

The Danish parliament was the first to ratify the Treaty of Nice, followed by the French parliament. But the process of ratification faces unforeseen challenges after the referendum in Ireland. The people of Ireland rejected the Treaty of Nice on June 8 with a majority of 54% of the votes. Most probably, the main reasons for the rejection were not enlargement commitments, but a more general skepticism about the functioning of the Union. A second referendum is expected to be held in Ireland, possibly including reassurances about neutrality.

Substantial progress with the accession negotiations was achieved during the Swedish presidency in the first half of 2001: the complex and controversial chapters on the environment and the free movement of capital and of workers were provisionally closed with some states during this period.

There are 31 chapters altogether, two of which ("Institutions" and "Others") have not been opened yet. The following table indicates how many chapters were provisionally closed with the five countries as of end-June 2001:

Countries	closed chapters
Hungary	22
Slovenia	20
Czech Republic	19
Slovakia	17
Poland	16

The first six applicant countries in alphabetical order – Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary and Latvia – prepared their first "Pre-Accession Economic Programmes" for the Commission in June; these programs outlined the economic goals of the applicant countries until 2004. Among the countries in our review, the Czech Republic and Hungary took part in the exercise. The Commission subsequently adopted the programs.

2 Individual Country Reports

2.1 The Czech Republic

After having declined for three years, real GDP in the Czech Republic rose by 2.9% in 2000. In the last quarter GDP increased by 3.8%,¹⁾ up from just 2.4% in the third quarter. For the year as a whole, growth was boosted mostly by general services, which increased by 7%, and by industry, which raised output by 5.7%. Agricultural output, however, contracted by 5.3%, and construction and financial service output also shrank. On the demand side, exports of goods and services, which gained 19.9% and 14% respectively, were the main engine of GDP growth. Gross fixed capital formation also advanced by 4.2%. Household consumption, however, posted only a moderate rise of 1.8%. Imports of goods in volume terms also surged, growing by 20.7%.

Like in the last quarter of 2000, real GDP augmented by 3.8% in the first quarter of 2001. Industry performed powerfully again, with output rising by +9.6%, while agriculture and construction fell back further by -7.2% and -1.4%, respectively. Export growth remained dynamic at 19.8%. Turning to domestic demand, gross fixed capital formation continued to climb, posting 7.3% growth. Imports surged by 21.8%. The Czech National Bank (CNB) expects GDP to enlarge by 3% for the whole year, while independent analysts forecast a rise of between 3% and 4%. In the light of the worsening external environment, growth is expected to be driven increasingly by investments, and the large foreign direct investment inflows into the country in recent years will probably boost production as well.

The unemployment rate (computed according to the ILO methodology) stood at 8.8% at the end of 2000 and diminished further to 8.5% in April. A slight decrease of unemployment was observed during the last half year, though with some fluctuations. When evaluating unemployment figures, it should be noted that the participation ratio²⁾ is rather low in the Czech Republic due to early retirement programs. This ratio stood at 60.2% in the first quarter of 2001. Real wages expanded by 2.9% over the year 2000 and jumped 5% in the first quarter 2001. Industrial productivity mounted by 9.9% in 2000 and by 10% in the first quarter of 2001, surpassing the increase of wages.

The annual rate of consumer price increase came to 3.9% in 2000. In May 2001, CPI inflation accelerated to 5%. Inflation has been on an upward trend since the beginning of this year, but is still lower than in the other countries in the region. The pickup in inflation can be explained by heftier world market energy prices as well as higher food prices.

In the past years, the CNB targeted net inflation.³⁾ In 2000, the target range of 3.5% to 5.5% was undershot, as net inflation came to only 3% at the end of the year. The government elaborated a timetable for the deregulation of administered prices this spring. According to a government resolution of April 2001, the deregulation of administered prices could add some

1 All percentage changes are over the same period of the preceding year unless otherwise indicated.

2 The ratio of employed plus unemployed persons to all persons over 15 years of age.

3 The net inflation index excludes regulated prices and the impact of tax changes.

1% to 1.5% to net inflation annually. This information enabled the CNB to announce a headline (CPI) inflation target. According to the announcement of April 2001, the target for January 2002 is 3% to 5%; it will be reduced to 2% to 4% by December 2005.

The Czech koruna appreciated against the euro during the review period with some fluctuations. The appreciation came to 1.6% from October to December 2000 and to 3.6% from January to end-June 2001.

On February 23, 2001, the CNB lowered the two-week repo rate by 25 basis points to 5%. At the same time, it slashed the discount rate by 100 basis points to 4% and the lombard rate by 150 basis points to 6%.

The current account deficit enlarged to USD 2.4 billion (4.7% of GDP) in 2000, which is about one and a half times higher than in the preceding year. The increase of the deficit was caused by the worsening of the trade balance, which could only be partly compensated by the more favorable development of services. Foreign direct investment (FDI) was more than sufficient to finance the deficit, as inward FDI amounted to USD 4.6 billion while Czech nationals invested only USD 0.1 billion abroad. Portfolio investment showed a negative balance of USD 1.8 billion. This was the consequence of increased purchases of foreign securities by Czech residents while foreigners added to their portfolio holdings in the Czech Republic at the same time.¹) Total official reserves (without gold) at end-December 2000 ran to USD 13 billion, which was equal to 4.1 months of imports.

In the first quarter of 2001, the current account deteriorated further. The deficit amounted to USD 0.8 billion, more than twice as much as in the first quarter of the preceding year. The main culprit, again, was the trade balance. FDI inflows were robust at USD 0.9 billion, and net investments were still high enough to finance the deficit. FDI inflows consisted entirely of greenfield investment, thus adding to the production capacity of the country.

In the year 2000, the central budget deficit amounted to 2.4% of GDP against the target of 1.8% prescribed by the budget law. The overall public finance deficit (including the losses of *Konsolidační banka* and taking privatization revenues as financing items) amounted to 4.8% of GDP. The situation has not improved in 2001: While the central government deficit for the year has been set at 2.4% of GDP (CZK 49 billion), the deficit had already reached 58% of this target by the end of May (compared to 38% of the target one year earlier). The Ministry of Finance expects the overall public finance deficit to run to 9% of GDP in 2000, including the losses of *Konsolidační banka* this year mainly in the wake of the collapse of the bank *IPB* in the year 2000. On June 15, the government announced a very ambitious federal budget deficit target of CZK 10 billion for 2002.

Structural reforms were continued in the period under review, but the restructuring of large, indebted enterprises is advancing only slowly.

The most important privatization was the sale of *Komerční banka*, the third largest bank of the country, and the last to remain in state ownership,

¹ Portfolio investment in the Czech Republic by nonresidents came to USD 0.5 billion, while portfolio investment by Czech residents abroad amounted to USD 2.2 billion.

to the French bank Société Générale on June 28, 2001 (the other two contenders were Italy's UniCredito and Germany's HypoVereinsbank). Société Générale will pay some USD 1.1 billion for 60% of the shares, a premium of 60% over the bank's share price. At the same time, the state guaranteed CZK 20 billion of nonperforming loans in the portfolio of the bank.

Besides the sale of Komerční banka, the main emphasis in privatization was on the sale of residual holdings of partly privatized firms still in the portfolio of the National Property Fund (NPF), as mass privatization had already been concluded in the past few years. Prague Waterworks was privatized successfully in April with its sale to a French-British consortium which paid EUR 174 million for a 66% stake; the municipal government of Prague will retain the rest of the stakes permanently. NPF and TelSource N.V., a Dutch-Swiss holding, decided in June to jointly offer for sale their stakes in Český Telekom, the Czech telecommunications operator, to a strategic investor.¹⁾ Privatization of the gas suppliers and the power supply sector is underway.

Some parts of the amendment of the Act on the Czech National Bank (CNB), which entered into force on January 1, 2001,²⁾ were canceled by the constitutional court on June 21 after the European Commission had also expressed its reservations. Parliament will have to vote on another amendment which – most probably – will provide full financial independence for the CNB and independence in setting monetary goals, thus ensuring conformity with EU legislation.

Konsolidační banka³⁾ terminated its contract with the Revitalization Agency on February 1 because of its limited success (the agency was a private enterprise which had been founded in 1999 to restructure large, highly indebted conglomerates). The assets, which had been under the management of the agency, have been handed over to another agency registered in Delaware, U.S.A. Konsolidační banka began to sell bad loans of smaller companies in packages. A first tranche was sold in February 2001 to a private investment bank for 7% of the face value of CZK 500 million (USD 13 million). The government decided to revoke Konsolidační banka's banking license as of September 2001 and to transform the bank into a new, nonbank entity which will be free of restrictions to engage in loan-equity swaps with the hope of facilitating enterprise restructuring in this way.

The Czech Securities Commission took several measures to increase the transparency of the Czech capital markets. It began to review the licenses of brokerage firms and investment funds last year to clean up the market. The number of brokerage firms was reduced from 400 a year ago to 50 by spring 2001, partly as a consequence of the review and partly as a result of unfavorable business conditions. 1,500 of the 1,700 publicly listed companies have been delisted.

1 NPF owns 51.1% and TelSource 27% of the stakes. They decided to offer 51% of the stakes for sale, two thirds of which will be sold by NPF, one third by TelSource.

2 See Focus on Transition 2/2001, p. 15.

3 As of end 2000, Konsolidační banka administered about 3,700 bad loans equivalent to about 15% of GDP.

The government has decided to transfer the supervision of the voluntary private pension funds from the Ministry of Finance to the Czech Securities Commission with effect from the second half of 2001. Membership in these funds, which manage investment equivalent to some 2.2% of GDP, spans about half of the labor force.

2.2 Hungary

Real GDP growth was solid at 5.2% in the year 2000, though it began to flag in tandem with the global economic slowdown. Growth ran to 4.5% in the third and 4.2% in the fourth quarter and was boosted above all by the 9.2% year-on-year rise in industrial output. All other branches contributed below average shares to GDP growth; in fact, agricultural production even shrank by 3.5%. On the demand side, the main engine of GDP growth was exports, which surged by 21.8% in volume terms. Internal demand was less dynamic: Gross fixed capital investment increased by 6.6% while final consumption expanded by 3.1%. Over the year, however, consumption began to gain momentum. The robust rise in exports of goods and services was accompanied by a 21.1% increase of imports.

In the first quarter of 2001 real GDP augmented by 4.4%. Industrial production widened by 10% and construction rose by 6.4%. The favorable foreign trade tendencies continued, with exports advancing 15.9% in the first four months of 2001 and imports mounting by 15.5% in volume terms. For the whole year of 2001 real GDP is estimated to rise by up to 5%, and exports are supposed to climb by 10% to 12%. This is slightly behind the rate of the previous year, but is still considerable given the decrease in world economic growth. Gross fixed capital formation is expected to expand by around 10%, and final consumption, especially household consumption, is anticipated to pick up speed, perhaps even outpacing GDP growth.

The current account deficit in the year 2000 shrank to USD 1.5 billion¹) (3.3% of GDP) on the back of the solid performance of tourism. FDI inflows amounted to USD 1.3 billion while Hungarian direct investments abroad soared to USD 0.6 billion. With portfolio investment outflows coming to USD 0.6 billion in addition, a substantial part of the deficit had to be financed by means of debt-generating liabilities. The current account in the first four months of 2001 was practically unchanged against the same period of 2000. However, with domestic demand increasing more dynamically, most analysts expect somewhat less favorable current account developments for the remainder of 2001. At end-2000 the country's gross foreign debt ran to USD 30.8 billion or 66.8% of GDP. Total official reserves excluding gold came to USD 11.2 billion, which equals nearly five months of imports.

In the year 2000, employees' net real earnings increased by 1.5%. Including the tax benefits for people with children, the increase was 1.9%. Real wage increases remained moderate because the government projection for inflation at the beginning of the year was tangibly lower than the actual turnout and wage negotiations were based on that lower figure. Real

¹ Hungarian balance of payments data are published in euro. They are converted into U.S. dollars at the exchange rates used for the IMF's International Financial Statistics for the end of the period in question.

earnings already began to rise faster in the last month of 2000 and continued to accelerate throughout the first quarter of 2001. Unemployment (according to the ILO methodology) amounted to an annual average of 6.4% in 2000. Within the year, the rate of unemployment sank, declining to 6% in the last quarter, a trend which continued also in the first four months of 2001. Productivity increased by 4.2% in 2000 and by 4.4% in the first quarter of 2001.

Consumer price inflation averaged 9.8% in 2000, just a slight decline compared to the consumer price increase of the previous year. Burgeoning energy prices were mainly responsible for the higher than expected rise, but food prices also rose at an above-average rate. The rate of price increase for food had reached its lowest level in mid-2000 and has been hovering above the 10% threshold since September, so far peaking in May this year at 10.8%. However, analysts expect inflation to ease in the remaining part of the year, partly due to base effects. The government's official estimate for the annual average is between 8% and 9%, and the National Bank of Hungary (NBH) forecasts a rise of 7% for December 2001.

The general government deficit in 2000 came to 3.5% of GDP, as projected. With inflation above expectations and robust growth in the real economy, revenues increased above plans and only about two thirds of the budgeted deficit had been reached by November. In December, the government effected additional expenditures: In addition to wage and pension bonuses, it provided additional capital to the State Privatization Agency (ÁPV Rt.) and to the Hungarian Development Bank. Moreover, it transferred some funds to a special reserve account and recorded them as expenditures. For the year 2001 a general government deficit¹⁾ of 3.4% of GDP is targeted. By the end of May, however, the deficit had grown to no more than 22.8% of the target.

The NBH kept its base rate unchanged at 11% during the review period. The two week deposit rate, the most important rate for monetary policy-making, was cut twice, on January 8 and February 5, 2001, by 25 basis points each to a final 11.25%. The preannounced monthly devaluation in the crawling peg system was reduced from 0.3% to 0.2% on April 1. The required reserve ratio was reduced from 11% to 7% on February 1, and the excess liquidity of the commercial banks evolving through this measure was sterilized by the compulsory purchase of government and NBH bonds. The ratio will be further reduced to 6% on July 1, while the base of required reserves will be widened and interest on required reserves will be increased to improve the international competitiveness of the Hungarian banking system.

In the last quarter of 2000, the Hungarian forint remained near the upper (stronger) limit of the fluctuation band, and since the beginning of the year it has remained at the limit most of the time because of the high interest rate differential, and because of market expectations that the fluctuation band would be widened and that the currency would appreciate.

The expectations materialized on May 4, 2001, when the NBH in consent with the government widened the fluctuation band of the forint from

1) Without local governments.

the present $\pm 2.25\%$ to $\pm 15\%$. This move was followed by further measures: all remaining foreign exchange restrictions were lifted on June 15, and the NBH declared that it would pursue an "implicit" inflation-targeting monetary policy. The inflation target will be set every quarter for an 18-month period. The first target is 4.5% CPI for end-2002 with an interim projection of 7% for end-2001. The tolerance interval is $\pm 1\%$. Since the introduction of the wider fluctuation band, the currency appreciated by about 9% with some fluctuations until June 27. The wider band is expected to decrease speculative capital inflows, and the appreciated currency will surely help combat inflation. It remains to be seen how the wider band will influence the current account.

Structural reforms continued in Hungary with the aim of preparing the country for EU membership. Some steps taken in the banking sector, however, appear to aim at strengthening the possibilities for political influence rather than the market economy.

On June 18, parliament adopted a new law on the NBH which assures full conformity with EU requirements. According to the new law, the basic task of the national bank is to defend the purchasing power of the currency. It should support the economic policy of the government, but only to such an extent that it does not endanger the fulfillment of its basic task. In the previous law the two tasks had to be fulfilled simultaneously. The new law strictly prohibits the provision of direct loans to the state compared with a narrow credit line under the old law.

The modification of the Banking Act, effective on January 1, 2001, enhanced supervision of financial conglomerates and introduced the trading book for credit institutions and investment service providers. The proposal of the government to give the Hungarian Financial Supervisory Authority the right to issue regulations failed to get the needed qualified majority in parliament. The Securities Code was modified in May this year to increase the protection of minority shareholders in case of buyouts.

In May, the Hungarian parliament adopted a law on the Hungarian Development Bank, a state-owned bank which primarily promotes public infrastructure development projects and other projects of public interest. The activities of the bank used to be regulated by the banking law. Under the new regulation, large exposure limits and connected party limits of the bank are relaxed, all its liabilities are guaranteed by the state, and the bank reports to the government.

Privatization was largely concluded in the late 1990s. Around 80 companies still await privatization; a further 97 remain partly or fully in state hands. Privatization revenues in 2000 were low, and the privatization of some major companies, in particular Antenna Hungaria and Malév, has not advanced during recent months. Ambitious health-care and pension reform plans have not materialized either. The government has announced that it plans to wind up ÁPV Rt. later this year. Two successor organizations will be established, one dealing with permanent state property, the other with sale and guarantee issues.

Early this year, ÁPV Rt. succeeded in selling its 23.76% stake in Budapest Bank to its strategic owner, GE Capital. According to the decision

of the government, Postabank, which was renationalized in a bailout process in 1998, will be “privatized,” that is, sold to the Hungarian Post, a state-owned company. The banking law, which generally limits the ownership share of nonbanks in Hungarian banks to 15%, was amended in June to facilitate the deal. Due to the merger of their owners, Bank Austria Creditanstalt Hungary and HypoVereinsbank Hungaria will merge shortly. The owners of ABN AMRO (Hungary) Bank and K&H Bank (owned by the Belgian Kredietbank) have decided to merge the two banks, establishing the second largest Hungarian bank.

In December 2000, Standard and Poor’s increased its ratings for Hungary, including its single A-plus/A-1 local currency and single A minus/A-2 foreign currency issuer credit ratings, which were reaffirmed in June 2001 with a stable outlook.

2.3 Poland

After robust GDP growth rates in the first half of 2000, economic activity strongly decelerated in the remainder of the year; in the third and fourth quarter GDP rose by 3.3% and 2.4%, respectively. For the whole of 2000 real GDP growth amounted to 4.0% compared to 4.1% 1999. Industrial production, too, showed a declining trend. After expanding by 10.7% in the first quarter of the year, it slowed down to merely 2.6% in the last quarter. For the whole of 2000 industrial output augmented by 4.3%. In the same period, services advanced by 4.6% and construction was down by 0.6%. Economic activity slowed down because the growth of domestic demand lost considerable momentum, falling from 5.1% in the first quarter to 1.3% in the third and 1.7% in the fourth quarter. For the whole year 2000 domestic demand mounted by 2.8%; consumption was up by 2.4% and gross fixed investment climbed by 3.1%.

Growth continued to decelerate at the beginning of 2001. GDP augmented by 2.3% in the first quarter of the year. In the same period, domestic demand fell by 1.4%, with gross capital investment contracting by 1.5%. Improved exports were the main engine of growth. In the first month of the year exports expanded by 18%, while imports rose by only 4.1%. For the whole of 2001, Polish GDP is expected to gain between 2.5% to 3.5%.

The deceleration of growth in the course of 2000 and 2001 was accompanied by a steady uptick of the unemployment rate, which surged from 13.6% in January 2000 to 15% at the end of 2000 and 15.7% in May 2001. The rise may be pinpointed mainly to the slowdown of economic activity as well as considerable restructuring in Polish companies. Gross real wages increased by 1.2% for the whole of 2000 and by 1.7% in the first quarter of 2001.

After the inflation rate peaked at 11.6% in July 2000, inflation eased substantially in the remainder of 2000. In December 2000 the year-on-year price increase amounted to 8.5%, bringing average inflation for the whole of 2000 to 10.1%. The speedy disinflation trend has continued in 2001. In March inflation amounted to only 6.2%, rising slightly later on to reach 6.9% in May.

Poland's current account deficit shrank to USD 9.9 billion in 2000, which represented about 6.3% of GDP compared to 7.6% of GDP at the end of 1999 and a high of 8.3% in March 2000. The better current account position was mainly due to an improvement in the trade balance. For the whole of 2000 exports expanded by 7.3%, imports rose by 1.7%.¹⁾

Most of the current account deficit was financed by foreign direct investment inflows, which hit a record USD 8.2 billion net in 2000 (1999: USD 6.3 billion) and covered about 82% of the current account gap. At USD 2.6 billion, net portfolio investment inflows almost tripled from 1999 (USD 0.9 billion). Conversely, other investment flows registered net outflows of USD 3.4 billion compared to inflows of USD 0.4 billion in 1999.

Official foreign exchange reserves were virtually stable during 2000, coming to USD 25.7 billion at the end of the year. At the end of 2000, Poland's external debt amounted to USD 67.5 billion (approximately 40.1% of GDP) higher than at the end of 1999, when it had stood at USD 64.9 billion. About 13% of the external debt were short-term, down from 17% in 1999.

During the first months of 2001, the current account deficit shrank further. In the period from January to April, it amounted to USD 2.8 billion (about 5.1% of GDP), down by about 32% from the same period of the previous year. Most of the improvement came with rapid export and weak import growth. Net foreign direct investment inflows amounted to USD 1.8 billion, while net portfolio inflows ran to USD 2.2 billion. Other investment posted net outflows of USD 1.7 billion. During the first five months of 2001, official foreign exchange reserves were stable, amounting to USD 26.1 billion in May.

The central budget recorded a deficit of 2.2% of GDP in 2000, thus exactly meeting the target laid down in the budget law for that year. The economic deficit²⁾ came in at 2.0% of GDP, much less than the targeted 2.7%. The targets for the 2001 central budget and economic deficits are 2.6% and 1.8%, respectively. The public sector deficit is to amount to 2.9%. However, in the first months of 2001, central budget developments were difficult to keep on track, and it is expected that the target for 2001 will not be met. Slower than expected GDP growth as well as lower inflation eroded the nominal base for tax collection and caused a substantial fall in revenues. As a result, at the end of May, the central budget deficit reached 99.3% of its annual plan. Revenues amounted to 33% of the plan. The expenditure side was kept under control, with spending amounting to 40% of the budget

1 Full-year figures mask considerable intrayear fluctuations, with exports falling in the first quarter of 2000 and then rebounding quickly in the remainder of the year.

2 The category "economic deficit of public finances" was introduced in November 2000. The new category is an attempt to capture the entire expenditure of the public sector, which increases the domestic demand for goods and services. Thus, the economic deficit covers the consolidated public deficit increased by wage and pensions arrears (compensations to government sector employees and to old-age and disability pensioners for the failure to make cost-of-living adjustments to their salaries and benefits in 1992) and diminished by the amount of subsidies to the Social Security Board, ZUS (compensations of the shortage of ZUS's income from the transfer of part of the premiums to open pensions funds).

estimate. The difficulties in executing the budget sparked a discussion about the need to revise the budget either by cutting spending or by increasing the budget deficit (or both simultaneously). No final decision had been taken by mid-June.

On April 12, 2000, the National Bank of Poland (NBP) floated the zloty and thus switched to a full-fledged direct inflation strategy. The NBP targets consumer price inflation. The target for CPI inflation for end-2000 was set at 5.4% to 6.8%. With inflation reaching 8.5% in December 2000, the target was overshoot.¹⁾

Prompted by concerns of rising inflation in the course of 1999 and the first half of 2000, the NBP raised its main official rates by about 600 basis points between September 1999 and August 2000. However, as the speed of price increase lost steam in the remainder of 2000 and in the first months of 2001, the NBP started to gradually cut interest rates. In February and March 2001, interest rates were reduced by a total of 200 basis points. As of the end of June, the lombard rate stood at 21%, the discount rate and the reverse repo rate at 19.5% and 17% respectively.

The zloty is a fully market-determined currency, with the central bank pursuing no intervention on the foreign exchange market. Against the backdrop of improving fundamentals as well as rising interest rates and expectations of their consecutive reduction, the second half of 2000 was marked by a steady upward trend of the Polish currency. After dipping to 4.24 in June 2000, the PLN/EUR exchange rate appreciated continuously in the course of the remainder of the year and reached 3.85 at the end of December, which represented a 9.4% rise in nominal terms. The appreciation trend gained momentum in 2001. Between January and the end of June 2001, the zloty strengthened further by 11.7% in nominal terms.

In the area of structural reforms, Poland further concentrated on resolving some implementation problems which had emerged after sweeping 1999 reforms of the pension system, the health care system, the education system and the state administration. A reform of the state-owned railway company, which was initiated in September, has been steadily implemented.²⁾ A consolidation and reconstruction scheme for the Polish steel sector is also on the agenda. In particular, the government plans a merger of four steel mills into a Polish Steel Holding (PSH), accompanied by financial consolidation. The new holding would control about 60% to 70% of the domestic production.

In June 2001, the Polish parliament approved an amendment to the banking legislation to bring its provisions more in line with EU laws. The new regulations stipulate inter alia that, after Poland's entry into the EU, EU-based banks will be able to operate in Poland without licenses and Polish branches could be set up in EU Member States. The amendment also broadens the list of banking activities. The new law is still to be approved by the senate and the president.

1) The target was overshoot for the second consecutive year of implementing the new monetary framework of direct inflation targeting, which had been introduced in 1999. The end-1999 target was set at 6.6% to 7.8%, whereas the rate of price increase reached 9.8%.

2) For more information about the reform, see Focus on Transition 2/2000.

In 2000 Poland privatized 180 companies, receiving PLN 27 billion (about USD 7 billion) in revenue, compared to the PLN 20.1 billion forecast in the 2000 budget. In 2001, privatization revenues are projected to be somewhat lower and to reach PLN 18 billion. The privatization plan for 2001 is very ambitious and envisages to continue privatizing further stakes of the national telephone operator TPSA, of Poland's leading oil company, PKN Orlen,¹⁾ and of the second largest Polish refinery, Rafineria Gdanska (RG), as well as of the state-controlled insurer PZU. A selloff of chemical companies, arms manufacturers and alcohol distilleries is also planned for this year. In the first part of 2001, most of the privatization projects were in a preparatory phase and no major deals were made in that period. More noteworthy transactions are expected to take place in the second part of the year.

In the banking sector, the privatization of PKO BP and the bank BGZ, the last two state-owned banks and Poland's largest retail banks, which are burdened by large amounts of nonperforming loans, is still at an early stage. As of the end of 2000, PKO BP has received Treasury-held shares in five major Warsaw Stock Exchange-listed companies worth about PLN 400 million as part of a needed capital injection seen as a preparatory step to the privatization of the bank. However, beside this move, no further progress has been made so far in 2001. In general, it seems that political constraints will keep the privatization of PKO BP only partial, as the government intends to retain the Treasury's dominant position in the bank's share capital.

2.4 Slovakia

Real GDP growth in Slovakia accelerated slightly in 2000, amounting to 2.2% as compared to 1.9% in 1999. After advancing by 1.7% in the first half of the year, economic growth gained momentum, reaching 2.5% in the third and 2.9% in the fourth quarter. The main engine of growth was the pickup in exports.²⁾ For the whole of 2000 real exports expanded by 15.9% and real imports went up by 10.2%. The improvement was particularly strong in the first half of the year. In the third and fourth quarters of 2000 exports rose by 16.1% and 15.1%, respectively, whereas import growth accelerated to 17.9% and 10.2%. All domestic demand components contracted discernibly in the course of 2000, showing, however, some revival in the second half of the year. Private consumption was down by 3.4%, government consumption decreased by 0.9% and fixed capital investment diminished by 0.7%. In the second half of the year private and government consumption rose by about 0.3% and 2.9% respectively, while fixed capital investment expanded by 3%. For the whole of 2000, industrial production was up 9.1%, construction output grew by 1.2%, and retail sales augmented by 2.3%.

1 Poland has floated 72% of PKN Orlen since the start of the selloff in late 1999. Under the present strategy, a stake of 10% is to remain in state hands.

2 This was particularly true during the first half of 2000. However, in the second half of the year domestic demand started to contribute more to the revival of economic activity, while the role of the external sector declined slightly.

The quickening of economic activity continued in the first quarter of 2001. During the first three months of the year, real GDP grew by 3%, with domestic demand showing a 4.6% increase. Industrial production rose by 7.9%, construction output by 10.5% and retail revenues by 4.4%. With domestic demand reviving, imports expanded by 26.4%. Exports increased by 11.8%. The central bank expects 2001 GDP to rise by between 2.8% and 3.2%.

After dipping to 16.1% in October 2000, the unemployment rate started to rise again. In December 2000 it stood at 17.9% and was virtually the same as in December 1999. In January 2001, the unemployment rate edged up to 19.8% of the labor force and then gradually decreased to 17.5% in May. In 2000 gross real wages contracted by 0.7%, while labor productivity increased by 18.4%. In the first quarter of 2001, gross real wages edged up by 0.6%, which represented the first quarterly rise since mid-1999.

Average annual inflation reached 12% in 2000 compared to 10.6% in 1999. The pickup was mainly due to a jump in prices in the first half of 2000, which was, in turn, to a large extent influenced by substantial rises in regulated prices introduced in mid-1999 as well as the surge in oil prices on international markets. The second half of 2000 witnessed a steady decline in inflation. In December 2000, year-on-year inflation slowed to 8.4%. In the course of the first quarter of 2001, inflation dropped further, hitting a low of 7.1% in March. However, it gathered pace later on, coming to 7.7% in May.

The current account deficit was USD 0.7 billion in 2000, down by 33% from USD 1.1 billion in 1999, and represented about 3.7% of GDP (1999: 5.6% of GDP). This considerable reduction was mainly attributable to the fall in the foreign trade deficit, which amounted to USD 0.9 billion compared to USD 1.1 billion in 1999, as well as to an improvement by USD 0.4 billion of the balance of services. For the whole of 2001, the National Bank of Slovakia expects the current account to widen to approximately 5.7% of GDP.

The net inflow of foreign direct investment reached a post-independence high of almost USD 2 billion, while the net inflow of portfolio investment amounted to USD 701 million compared to USD 624 million in the previous year. Official foreign exchange reserves rose substantially in the course of 2000. At the end of the year they amounted to slightly above USD 4 billion compared with USD 3.4 billion at the end of 1999. In December 2000, Slovakia's gross external debt was USD 10.5 billion (approximately 55% of GDP), virtually the same as at the end of 1999.¹⁾

In the course of 2001 the current account deteriorated sharply, reflecting recovering domestic demand and a weaker trade balance. In the first quarter of 2001, the current account deficit amounted to USD 0.3 billion as compared to USD 0.06 billion in the analogous period of 2000. The deterioration was mainly due to the worsening of the trade balance, with the deficit reaching USD 0.4 billion in the first quarter of 2001 against USD 0.16 billion

1 For the year 2000 the average rate of conversion was SKK 46.2/USD, and SKK 47.3/USD for the first quarter of 2001.

in the first quarter of 2000. During the same period, official foreign exchange reserves were virtually stable.

In 2000, the central budget deficit as well as the general government deficit came in above their targets of 2% and 3% of GDP, respectively. The central budget deficit amounted to SKK 27.6 billion compared to the target of SKK 18 billion, thus reaching about 4.1% of GDP. The general budget deficit, in turn, widened to about 4.3% of GDP compared to 3.4% of GDP in 1999. The planned target for the general budget deficit was mainly overshoot because a boost in pensions was adopted mid-2000. The target for both the 2001 central budget deficit and general budget deficit has been set at 3.9% of GDP.

In the period January through May 2001, the central budget deficit was SKK 2.25 billion, which represented 39.4% of the full-year 2001 target. Revenues were at 47% of the full-year plan, and expenditures at 45.7%.

The National Bank of Slovakia (NBS) follows a composite monetary policy strategy containing a strong monetary targeting element with M2 as an intermediary target. M2 growth was set at 9.3% for 2000. At the same time, the bank announced inflation targets for net inflation in 1999 and for core inflation for 2000.¹⁾ Moreover, monetary policy is also concerned, to a certain extent, with the development of the exchange rate. For the end of 2000, the core inflation target was originally set at between 4.5% and 5.8%, and was adjusted several times during the year. In December 2000 core inflation amounted to 4.6% and thus hit the lower bound of the original target. However, M2 growth came in above target. In December 2000, M2 posted an increase of 14.2% against the same period of the previous year.

Against the backdrop of declining inflation the NBS cut its main interest rates several times in the course of 2000 and 2001. After slashing interest rates by 25 basis points in December 2000, the NBS decided to lower interest rates once again by 25 basis points in March 2001. Moreover, as of January 2001, the NBS reduced the minimum reserve requirements for commercial banks from 6.5% to 5% and announced its intention to gradually cut reserve requirements to 2%.

The exchange rate of the Slovak koruna showed relatively large fluctuations in the previous year. For the whole of 2000, however, it showed a slight 4% nominal depreciation against the dollar, staying at SKK 44/USD at the end of December 2001. During the first six months of 2001, the koruna appreciated by about 3.7% in nominal terms. In the first two months of the year, the koruna was virtually stable, and at the beginning of March it started to appreciate gradually, with some acceleration in June. At the end of June the SKK/EUR exchange rate amounted to about 42.5. The NBS intervened several times on the exchange market in the course of 2001. The central bank was especially active in January and February, when it intervened to support the domestic currency. When the appreciation trend started off in early March, the NBS did not intervene against the rise of the koruna's value.

¹ Core inflation differs from net inflation in that the former includes food prices. Like net inflation, core inflation excludes changes in regulated prices, indirect taxation and subsidies from the full consumer price basket.

In 2000 and at the beginning of 2001, structural reforms and the privatization process were quite dynamic. Structural reforms focused on the banking sector, the financial market and the public administration. In the course of 2001, further packages of bad loans of the state-owned major banks Slovenská sporiteľňa (SLSP), the largest bank, Všeobecná úverová banka (VÚB), the second largest bank, and Investičná a rozvojová banka (IRB) have been transferred to Slovenská konsolidačná (Sko), a special state collecting agency set up to deal with nonperforming loans. Overall, nonperforming loans with a total volume of more than SKK 100 million (about 14.5% of Slovakia's GDP in 2000) have been removed from banks' balance sheets since 1999 to prepare bank privatization.

In April 2001, an 87% stake in SLSP was sold to the Austrian Erste Bank. In the same month, the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development acquired a 25.9% stake in VÚB. However, VÚB is to be sold to the Italian banking group IntesaBci in July. In addition to the 68.6% state-owned stake, IntesaBci will also acquire the stake owned by the IFC and the EBRD, thus taking over a total of 94.5% of the bank.

On May 1, 2001, a new law on the National Bank of Slovakia came into force. The law brought the central bank legislation in line with EU standards. In particular, it assured the independence of the National Bank of Slovakia and introduced new rules for the supervision of commercial banks and for minting coins. The amendment consolidates the supervisory jurisdiction of the NBS over the banking sector. In general, the former system of banking control exercised by both the NBS and the finance ministry was canceled, although state-owned banks will still remain under ministry supervision.

The government has continued its endeavors to privatize the remaining state-owned companies. However, no major deals have been reported in the last several months. Among the larger deals, the privatization of an 87% stake in the Slovak shipping company Slovenská plavba a prístavy is at an advanced stage. A 78.5% stake in the Slovakia's largest universal insurance company, Slovenská poisťovňa (SP) was offered for sale in mid-June; the transaction is to be finished by the end of this year. The privatization of SP will coincide with the termination of its monopoly on obligatory liability insurance for motor vehicles. The government intends also to privatize the public bus transport companies, SAD, by the end of 2001.

Moreover, in April 2001, the government approved the privatization plan for the country's three power distributors. The plan envisages the sale of a 49% stake in these three companies. The government also approved a document that should enable the privatization of state-run electricity producers, the water utilities Vodárne a Kanalizácie (VaK), and the gas distributor Slovenský plynárenská priemysel (SPP) to be speeded up.

As scheduled, the national privatization agency, the National Property Fund of the Slovak Republic (FNM), started repayment of the so-called privatization bonds, which had been issued in 1995 when the second wave of voucher privatization was canceled, in April 2001. The total value of the outstanding bonds amounts to USD 550 billion. However, the financing of this large-scale repayment is not yet fully provided. The first repayment of

about USD 120 million was covered by a new issue of state-guaranteed bonds. The government intends to use the privatization proceeds as a second source of financing.

2.5 Slovenia

Slovenian GDP expanded by 4.6% in 2000. This is a slowdown compared to 5.0% growth in 1999. 2000 was the first year since 1994 in which the main factor of GDP growth was net foreign demand, while domestic demand growth slowed down. Exports of products and services increased by 12.7% in real terms last year, while imports were up by 6.1%. Gross fixed investment augmented by 0.2%. Real growth rates in private consumption fell substantially to 0.8% in 2000, while public consumption growth decelerated to 3.1%. In 2000 industrial output grew by 6.2% on average. The first quarter of 2001 saw 3.1% GDP growth. The expansion of GDP was still boosted by net foreign demand. Exports jumped by 9.7% in real terms over the same period of 2000, while imports contracted by 0.6%. In the first quarter of 2001, industrial production rose by 5.8% on a year-on-year basis. The Institute for Macroeconomic Analysis and Research (IMAD) forecasts 4.5% GDP growth for 2001.

Total unemployment based on registered unemployment decreased from 13.6% in 1999 to 12.2% in 2000. This trend continued in the first four months of 2001, resulting in an unemployment rate of 11.7% in April. However, the survey-based unemployment rate (ILO definition) continues to be much lower. It stood at 7% in 2000 and held at 6.7% in the first quarter of 2001. Gross real wages grew by 1.6% in 2000. So wage rises remained below the advance of 3.5% in labor productivity. One challenge the government faces is to bring down the strong growth of wages in the public sector.

In 2000, CPI inflation rose to 8.9% (1999: 6.1%). This is partly the result of rising global oil prices. Core inflation, too, climbed to 6.9%. CPI as well as core inflation went on rising in 2001: Standing at 8.5% in January, consumer prices picked up speed steadily to 9.7% in May.

The current account deficit amounted to USD 594 million (3.3% of GDP) in 2000. This represents a better result than in 1999, when the current account deficit peaked at USD 783 million (3.9% of GDP). While the service account improved by USD 62 million, the change in the trade balance was more pronounced: The trade deficit was USD 164 million lower than in 1999, mainly because exports mounted by just USD 183 million. In 2000, net foreign direct investment came in at USD 134 million (1999: USD 144 million). Portfolio investment dropped substantially from USD 354 million in 1999 to USD 189 million in 2000. Other investment amounted to USD 396 million (1999: USD 178 million).

Slovenia's official foreign exchange reserves totaled USD 3.2 billion at the end of 2000 (1999: USD 3.168 billion). Total external debt reached USD 6.2 billion in 2000 and was thus higher than at the end of 1999, when it had stood at USD 5.4 billion. 2.2% of external debt were short-term. At the end of the first quarter 2001, total external debt had been reduced to USD 6.1 billion.

In the first quarter of 2001, the current account posted a surplus of USD 50.5 million compared to a deficit of USD 169 million in the first quarter of 2000. This is due to a rise in exports by USD 224 million and an increase in transfers. Foreign direct investment widened to USD 109 million, while portfolio investment and other investment declined compared to the first quarter of 2000. Gross official foreign exchange reserves totaled USD 4.9 billion at the end of April 2001.

Slovenian monetary policy is based on monetary targeting, but also places a strong de facto weight on exchange rate developments. On December 1, 2000, the Bank of Slovenia raised the discount rate from 9% to 10% and the lombard rate from 10% to 11%. On April 1, 2001, the central bank hiked the discount rate to 11% and the lombard rate to 12%. The monetary target relates to M3. For 2001, this target is to expand within a range of 11% to 17%. Even though M3 surged by 18.9% in March and 21% in April, the central bank still expects to meet this target. Last year, M3 rose by 16.3%. This was within the fluctuation band of 12% to 18%. The exchange rate regime is a managed float. The new governor of the central bank, Mitja Gaspari, signaled that the gradual introduction of a kind of fixed rate might be conceivable. The tolar depreciated against the euro by 7.1% in nominal terms last year and by 2.2% in the first four months of 2001. In real terms, it depreciated by 2.9% in 2000, but appreciated slowly from the fourth quarter of 2000. In June 2001, the central bank decided to introduce overnight deposits and to register 270-day bills once again. In the first month of 2001, monetary management was complicated by money inflows from privatization.

The general government budget deficit came to 1.4% of GDP in 2000, compared to the budgeted 1%. The budget for 2001 was passed in April 2001. It aims at cutting the general government cash deficit to 1% of GDP. For the first time, there will be a two-year budget for 2002/2003.

Structural reforms, which were delayed by political friction in 2000, appear to have gained some new momentum recently. The privatization process has not progressed as far in Slovenia as in the other advanced transition economies. However, the banking sector received a new impetus in spring 2001: In May the government agreed on a plan to privatize the two largest banks. The state-owned share is to be reduced to 25% plus one share. In the case of Nova Kreditna banka Maribor (NKBM), the process is scheduled to be completed by the end of 2001, whereas Nova Ljubljanska banka (NLB) will be privatized by March 2002 at the latest. While NKBM is looking for a strategic investor to buy 65% minus one share, NLB is looking for a more diversified set-up with a key investor to buy 34% of the shares.

In April, the French bank Société Générale acquired 96.5% of Slovenia's third largest bank, SKB, which was already privatized, in a friendly takeover valued at USD 126.8 million. The takeover process should be completed in July 2001. The privatization of insurance companies faces some delays, as the constitutional court canceled the privatization act for this sector and sent it back to parliament.

Another topic parliament will be dealing with is the draft of the new central bank law, approved by government on July 27, 2000. There were

some amendments after discussing the draft with the EU. The parliamentary procedure is scheduled to be started later this year.

The lifting of the restrictions on foreign portfolio investments by the Bank of Slovenia that were imposed in February 1997 is expected to give the capital market new impulses. The new measures, which took effect on July 1, 2001, include the simplification of the regime governing the acquisition of securities by foreigners on the Slovenian capital market.

Foreign investors making long-term portfolio investment are no longer subject to fees. These fees applied under the previous regime if Slovenian securities were sold to domestic investors within a period of six months after their purchase. However, the current system will still apply to the purchase of short-term securities. Also the limitations for Slovenian investors, other than banks and brokerage houses, on purchases of securities abroad were lifted.

Liberalization is also underway in the telecommunications sector: After this market was formally liberalized on January 1, 2001, a new telecommunications act defining the procedures came into effect on May 11, 2001. In the same month, the Austrian mobile phone operator Mobilkom took over Slovenia's second largest mobile communications operator, Si.mobil. The acquisition is valued at USD 127 million.

The cooperation in the region made a big step forward when the successor states of former Yugoslavia consented to a framework agreement to divide the assets and liabilities of the former common state on May 28.

Cutoff date for data: June 25, 2001.

S T U D I E S

The Financial Sector in Five Central and Eastern European Countries: An Overview

Franz Schardax
and Thomas Reininger¹⁾

I Introduction

This paper gives a condensed account of some current facts and issues related to the financial system in five Central and Eastern European countries: Poland, the Czech Republic, Hungary, Slovakia and Slovenia (referred to below as the CEEC-5).

The aim is to provide an overview of the degree to which the financial sector in the CEEC-5 is able to fulfill its main tasks, namely allocating resources, providing risk-sharing opportunities for households and enterprises and helping agents to economize on transaction and information costs. Particular emphasis will be placed on the analysis of the financial sector's function of channeling funds between different sectors of the economy.

The paper is organized as follows. Section 2 deals with the banking sector in the CEEC-5. After providing an overview of the situation at the outset of transition, we analyze the development of bank lending and the banking sector's efficiency and profitability. In section 3 we present key figures on the size, structure, liquidity and foreign participation in domestic capital markets. Section 4 deals with the structure of financial intermediation in the CEEC-5, providing insight into the funding of both the private sector and the public sector. Section 5 briefly assesses the vulnerability to financial contagion, including in particular the risks emanating from domestic capital markets in the CEEC-5.

The paper draws on several sources: Using the academic research literature, data published by international organizations as well as information we collected for this project from national sources, we have tried to provide the most recent facts and figures wherever possible.

2 The Banking Sector in the CEEC-5

2.1 The Legacy of Central Planning, Early Reforms and Early Bank Failures

Under central planning, the financial system was little more than a book-keeping mechanism for recording the authorities' decisions about the allocation of resources among various sectors and enterprises. At the outset of transition the following key reforms were implemented: (1) a two-tier banking system was introduced, (2) sectoral restrictions on specialized banks were lifted, (3) privately owned banks were admitted, (4) foreign banks and joint ventures were granted access, (5) the licensing policy for most kinds of banking business was liberalized, (6) the legal framework and supervisory system were adjusted.

A licensing policy that was mostly quite liberal coupled with shortcomings in the legal framework and supervisory system gave rise to the establishment of a large number of newly founded banks which often engaged in unsound practices. The state-owned commercial banks (which emanated from the old monobank system), in turn, suffered from an inherited burden of bad loans. Banking systems generally lacked capital and banking skills; moreover, political intervention in the activities of state-owned banks was

¹ Foreign Research Division, OeNB. The authors would like to thank the experts of the OeNB for their valuable support. The standard disclaimer applies.

pervasive. These deficiencies coupled with the uncertain economic environment prevailing at the beginning of transition resulted in the quick accumulation of bad loans and – finally – in a number of banking crises.

2.2 Recapitalization Programs

Although not all countries under review experienced fully fledged banking crises, all undertook large-scale bank recapitalization programs, mostly from 1992 to 1996. While Hungary, Poland and Slovenia had succeeded in stabilizing their banking systems by 1997 with the help of these programs, the Czech Republic and Slovakia faced continuing problems. Although the Czech Republic had concluded a large set of recapitalization measures by 1997, substantial additional public funds had to be put up to prepare the country's largest banks for privatization. Altogether, by 2000 the total fiscal cost of bank recapitalization since the reforms were launched amounted to 11.8% of GDP in 2000 in the Czech Republic, as table 1 below shows. While some funds may be recovered (e.g. by privatization revenues for Komerční banka), the figures presented in the table below do not include the not yet fully known costs of the recent failure of Investiční a Poštovní banka (IPB). According to the Czech Republic's preaccession economic program, these costs are estimated at CZK 75 billion (about 4% of GDP in 2000). Slovakia was last to recapitalize its banks, and the costs are among the highest in the region. However, the figures presented below for Slovakia represent the total amount of bad loan transfers from commercial banks to state institutions. They are not directly comparable with the other figures, because some costs will probably be recovered from those loans which are not entirely lost. In terms of total costs, Poland was most successful, as the cumulated costs of bank recapitalization were below 1.5% of GDP in the year 2000. Poland's success is attributable to the design of the recapitalization program, which provided the least incentive for moral hazard, but also to the small size of the Polish banking sector in relation to GDP. Besides, it should be noted that the early tackling of the bad-loan problem decreased costs in terms of GDP in 2000, which line 3 of table 1 makes evident.

Table 1

Fiscal Costs of Bank Recapitalization					
	Czech Republic	Hungary	Poland	Slovakia ¹⁾	Slovenia
Main part of recapitalization program completed in	1997	1994	1996	2000	1997
Fiscal costs up to the year indicated above in % of GDP in that year	8.9	7.2	1.6	13.1	2.5
Fiscal costs of recapitalization program up to the year 2000 in % of GDP in 2000	11.8	6.8	1.4	13.1	1.7

Source: International Monetary Fund (1998), Kawalec (1999), national central banks, OeNB.
¹⁾ Slovakia: Figures are not directly comparable (see text).

2.3 Privatization and Foreign Ownership

Progress in bank privatization differs among the CEEC-5. At the end of 1999, majority state-owned banks held only 9% of the assets of the banking sector (excluding the central bank) in Hungary, followed by 23% (exclusive

of Česká Spořitelna and Komerční banka¹) in the Czech Republic, while it was significantly higher in Slovenia at 42% and in the Slovak Republic at 51% (EBRD, 2000). In Poland, the state banks had a share of 22% in the total assets of the banking sector (excluding the central bank) and a significantly lower share of 13.5% in the sector's total equity at the end of 1999. In the meanwhile, several significant transactions have taken place to reduce state stakes even further. No major transactions were made in Hungary, where privatization was most advanced in 1999. However, the government intends to dispose of direct state ownership of Postabank (the country's sixth largest bank in terms of assets), but did not succeed in finding a buyer from the private sector who was willing to pay enough in its first attempt. Instead, Postabank is to be sold to the Hungarian Post Office. After selling a majority stake in Česká Spořitelna (the country's largest retail bank) at the beginning of 2000 to Austrian Erste Bank, the Czech Republic intends to sell the last significant state stake in a major bank in the course of 2001.²) In Poland, state ownership of banks underwent only small changes in 2000. The sale of a 10% stake in Powszechny Bank Kredytowy SA w Warszawie (PBK, rank four in terms of assets in Poland) to Bank Austria Creditanstalt International gave Bank Austria a controlling majority. The share of state banks fell only slightly to 21% of the sector's assets and to 11.5% of the sector's equity at the end of 2000. Two major banks, namely the largest (Powszechna Kasa Oszczedności BP, PKO BP) and the fifth largest bank (Bank Gospodarki Żywnościowej, BGZ) in terms of assets, are still owned by the state. The government intends to reduce its stake in the former bank, but wants to keep control of this bank for the time being, while the latter is to be privatized. The most radical changes in state ownership of banks are taking place in the Slovak Republic in the course of 2001. Slovenská Sporiteľňa, the country's largest bank, was sold to Erste Bank at the beginning of the year, and the other two major banks with substantial state stakes are to be privatized in the course of this year, too. There was no progress in bank privatization in Slovenia in 2000, but the government intends to sell majority stakes in the country's two largest banks in the course of 2000 and 2001.

Privatization efforts appear to have been a direct response to continued problems in running the banks in the Czech Republic, Slovakia³) and to some degree in Hungary, while in Poland and Slovenia the time span between recapitalization and privatization is larger. The mode of privatization that was chosen in most cases, namely tender or direct sales to foreign banks, resulted in strong foreign participation in CEE banking sectors, except in Slovenia.⁴) The main motivation for choosing this mode of privatization was probably the expected transfer of know-how in conducting banking business.

1 These majority state-owned banks accounted for a share of 15.0% and 15.5%, respectively, of total banking sector assets at the end of 1999.

2 Exclusive of Konsolidační banka.

3 Slovakia took concrete steps to privatize the country's two largest banks in 2000 and 2001.

4 The Czech Republic and Slovakia had initially opted for a partial privatization of state banks by means of voucher privatization, but eventually chose to fully privatize banks by direct sales to strategic investors.

Figure 1

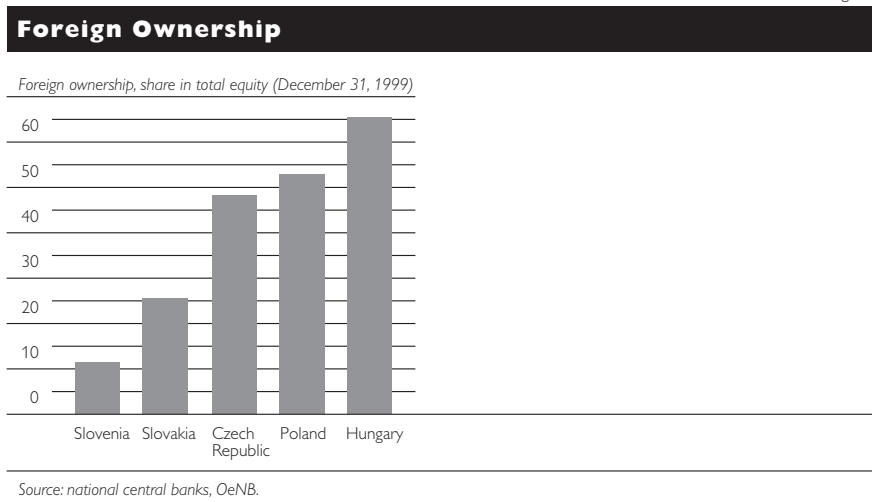
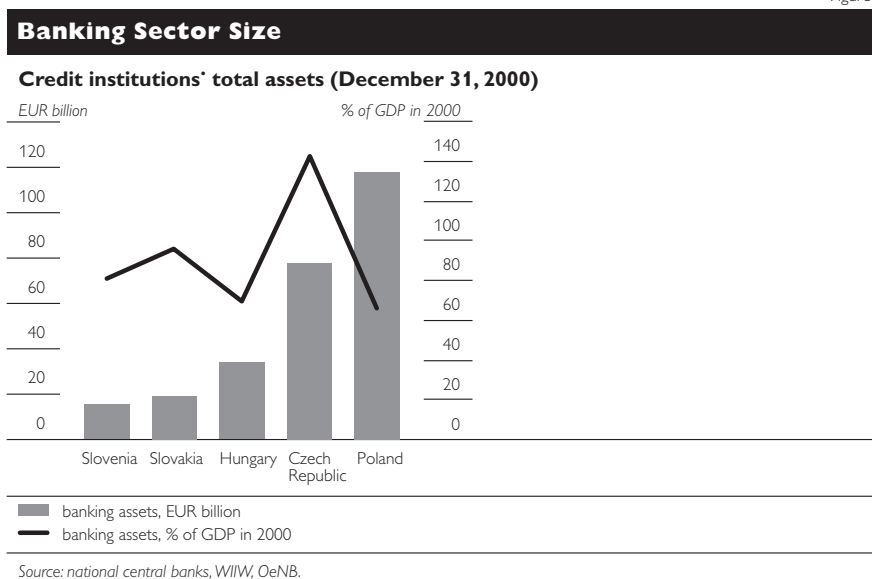


Figure 1 shows the share of foreign ownership in the banking sector's equity at the end of 1999. In Poland, this share increased slightly to 53.8% (from 53.1%) at the end of 2000. However, it has to be stressed that this foreign equity ownership implied the effective control of several Polish banks; these banks accounted for 71.7% of the sector's equity and 69.6% of the sector's assets at the end of 2000.

2.4 Size and Concentration of the Banking Sector

The size of the CEEC-5 banking sectors (excluding the central banks) is rather modest in terms of absolute volume as well as in relation to GDP, as figure 2 shows. At the end of 2000, credit institutions' total assets amounted to just EUR 117.4 billion in Poland, a country with a population of 38 million. With a level of 142.5% of GDP, banking assets in the Czech Republic stand out in comparison to the peer group. By comparison, total

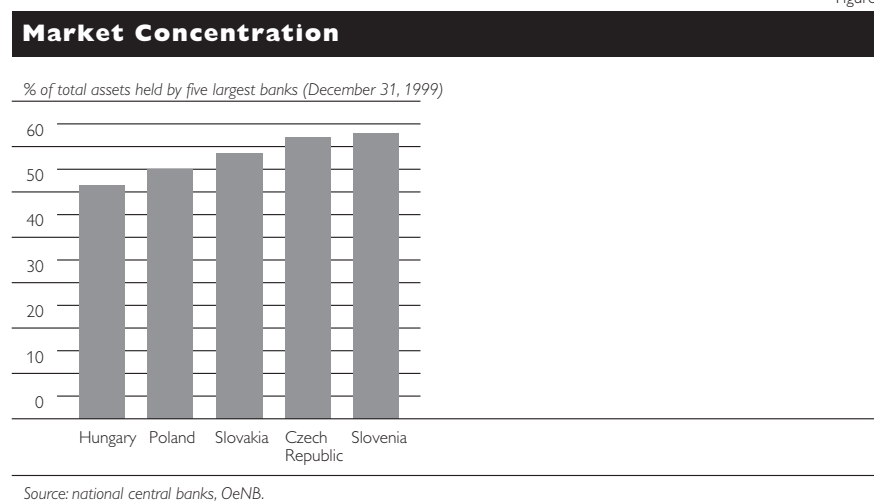
Figure 2



banking assets amounted to EUR 562.7 billion in Austria (273% of GDP) at the end of 2000.

The concentration in CEE banking sectors is slightly below the EU average. In the Czech Republic and in Slovenia, the market share of the five largest credit institutions was above the EU average of 60% in 1999. Considering that banking sectors in the smaller EU countries (which are probably a better benchmark for comparisons than the EU average) tend to be more concentrated, CEE banking sectors appear even less strongly concentrated at present. However, a number of mergers have taken place recently, and this trend is likely to continue.

Figure 3



2.5 Structure of the Stocks of Lending and Deposits

The change in the structure of the stock of domestic credit extended by the banking system, i.e. the banking sector and the central bank, (see table 2) is characterized by a strong cutback of central bank lending to the government in Poland and Hungary. In the Czech Republic, central bank credit to the general government has been zero since 1996, down from around 4% of GDP in 1993. In Slovenia, it has been roughly zero since 1992.

After having risen from 1992 to 1995, the stock of commercial banks' lending to government relative to GDP declined in Poland from 1996 and in Hungary from 1997 onward because the countries pursued cautious fiscal policies and because the role of direct financial intermediation between nonbanks and the government became more important (see also section 4.2.2).

This development helped boost the stock of bank lending to the corporate sector relative to GDP in Poland and Hungary to a level of above 20% of GDP in the year 2000 after it had fallen from the beginning of the 1990s up to 1995 in Poland and 1996 in Hungary. However, in Hungary, the high initial level of 1990–92 (27.0% of GDP) has not yet been reached again, and the increase of corporate lending fell far short of compensating for the decline of net credit extended to the public sector by the banking system (central bank and commercial banks), implying a substantial decrease in total domestic

credit. In Slovenia, bank lending to the corporate sector relative to GDP increased continuously from 1994 to an even slightly higher level than in Poland and Hungary, namely 23% of GDP in the year 2000.

On the other hand, the extraordinarily high level of credit to the corporate sector in the Czech Republic fell significantly both in absolute terms and relative to GDP from 1997 (57.3%) to 2000 (47.1%).¹⁾ This reduction was caused by the structural bad-loan problem and by the even more restrictive turn in monetary policy in 1997–98. Lower bank lending contributed to the recession in 1998–99, which in turn reinforced the decline in lending. The significant amount of nonperforming loans led not only to restrictive new lending by the banks, but finally also to the transfer of a substantial part of these loans to the state-owned consolidation bank, so that they no longer showed up in domestic credit.

A comparison of lending to households between those countries reveals a quite divergent pattern. While lending to households in relation to GDP rose continuously in Poland and Slovenia from 1994 to 2000, it augmented in Hungary and in the Czech Republic only from 1998 or 1999, respectively, after it had fallen substantially since 1994. Only in Slovenia did it exceed 10% of GDP.

Table 2

Stock of Domestic Credit of the Banking System

(Including Foreign Exchange-Denominated Credit)

	Poland		Hungary ¹⁾		Czech Republic		Slovakia ²⁾	Slovenia	
	1994	2000	1994	2000	1994	2000	2000	1994	2000
	average, in % of GDP								
Total	32.3	36.0	53.6	36.8	64.7	58.0	66.8	28.3	41.6
Net credit to public sector	15.7	8.4	28.8	10.1	1.0	4.7	20.6	8.3	6.0
Credit to OFIs ³⁾	0.0	1.3	0.0	1.1	0.0	0.0	0.0	0.2	1.1
Credit to corporate sector	15.4	20.3	18.9	22.2	55.2	47.1	41.7	15.8	23.0
Credit to households	1.2	6.1	5.9	3.4	8.6	6.2	4.5	4.0	11.5

Source: national central banks, WIIW, OeNB.

¹⁾ Hungary: The external debt for the government channeled through the central bank is excluded from net credit to the public sector and thus from total domestic credit, as the external debt of the government is not included for the other countries, either. Including this credit raises the corresponding figures by 32.4 percentage points in 1994 and by 12.9 percentage points in 2000.

²⁾ Slovakia: Due to a break in the time series, the year 1994 is not included.

³⁾ OFIs: Financial institutions other than deposit money banks.

The ratio of resident commercial banks' new net lending to the corporate sector (i.e. the change in the stock of credit to the corporate sector) to total gross fixed capital investment has fallen since the early 1990s, when it amounted to between 25% and 35%. In Hungary, the ratio averaged 30.7% in 1990–91. While the increase in the stock of credit to the corporate sector was sufficient to raise the ratio of this credit stock to gross domestic product (and to gross fixed capital investment) from 1996–97 to 2000 in Poland, Hungary

1 The extraordinarily high level of domestic credit to the corporate sector in the Czech Republic and in Slovakia mainly constitutes a country-specific legacy of the communist era. Moreover, some specific macroeconomic features of the early phase of transition played a role. In particular, the relatively low initial boost in inflation upon transition implied that the erosion of money was only moderate. With the differences between the countries being so strong, it seems to be more fitting to look at the development of credit aggregates than at their levels.

and Slovenia, it was not sizeable enough to imply a constant or even rising ratio of this increase to gross fixed capital investment in Hungary and, in particular, in Poland. In the years 1999–2000, the average ratio was highest in Hungary (18.9%), while it was even negative in the Czech Republic and in Slovakia, as table 3 indicates.¹⁾ The general decline in this financing ratio is probably attributable to not just one, but several partly interrelated factors: (1) the improved self-financing capacity of companies, (2) resident commercial banks' improved lending control and risk assessment coupled with tighter prudential regulations, (3) an insufficient increase in resident banks' lending capacity,²⁾ and (4) high real lending rates. The parallel considerable increase in nonresident banks' cross-border lending indicates that lending by resident (domestically or foreign-owned) commercial banks did not sufficiently meet the growing investment needs of an economy striving to catch up with the European Union. In addition, it has to be noted that an increasing part of gross fixed capital investment was financed by intercompany loans extended by the foreign parent company.

Table 3

Credit to the Corporate Sector by the Banking System					
	Poland	Hungary ¹⁾	Czech Republic	Slovakia	Slovenia
	change in % of gross fixed capital investment				
1994 ²⁾	25.6	3.6	30.0	..	29.7
1998 ³⁾	18.7	19.7	10.0	..	13.9
2000 ⁴⁾	11.4	18.9	- 8.6	-2.5	13.6

Source: national central banks, WIW, OeNB.
¹⁾ Hungary: The low level in 1994 is mainly due to a negative ratio of -11.1% in 1992. The average ratio for the years 1993–94 was 10.9%.
²⁾ 1994 denotes average of 1992–94.
³⁾ 1998 denotes average of 1996–98.
⁴⁾ 2000 denotes average of 1999–2000.

For several reasons, it is interesting to take a look at the currency breakdown of domestic credit. The following table shows the share of the *corporate sector's credit stock denominated in foreign currency* and extended by the domestic banking system in percent of the total stock of credit to the corporate sector by the domestic banking system. Except in Slovenia, this share significantly rose from 1994 to 2000, reaching almost 40% in Hungary and 25% in Poland (table 4).

To assess the impact exchange rate movements may have on the corporate sector, it is probably better to look at the net position, which is derived by subtracting the corporate sector's deposits denominated in foreign currency from their foreign exchange credit. It follows that the share of corporate sector credit denominated in foreign currency that was not covered by

- 1) While the change in the stock of credit generally shows the difference between the flows of new lending and repayment, it may also reflect extraordinary changes. Thus, the negative values in the Czech Republic and in Slovakia on average in the years 1999 and 2000, reflect – inter alia – the transfer of nonperforming loans from the commercial banks to the state-owned consolidation banks.
- 2) In particular, the traditionally large banks do not seem to have improved the efficiency of their internal organization of credit allocation enough, resulting at times in disproportionate credit restrictions.

Table 4

The Corporate Sector's Foreign Exchange Position

against the Domestic Banking System

in % of total credit (including foreign exchange credit)
extended to the corporate sector by the domestic banking system

	Poland		Hungary		Czech Republic		Slovakia	Slovenia		
	1994	2000	1994	2000	1994	2000	2000	1994	2000	
	<i>end of period</i>									
Gross position ¹⁾	10.3	23.7	11.8	38.0	6.0	18.5	13.8	23.4	20.9	
Net position ²⁾	7.3	17.2	- 0.9	29.9	3.4	10.1	3.6	17.7	12.4	

Source: national central banks, OeNB.

¹⁾ The gross position comprises credit denominated in foreign currency.

²⁾ The net position comprises credit minus deposits denominated in foreign currency.

(on-balance) foreign exchange claims against the domestic banking system amounted to about 30% in Hungary and 17% in Poland in the year 2000. However, when drawing conclusions about the impact of exchange rate movements on the corporate sector, some caveats have to be borne in mind. First, the calculation of the net positions offsets credits and deposits regardless of possible differences in their currency of denomination. Moreover, table 4 does not incorporate off-balance-sheet positions.

Taking this approach one step further, the next table includes the foreign debt liabilities of the corporate sector. When taking into account the foreign exchange-denominated deposits with the domestic banking system as well as the foreign assets held by the corporate sector, *the corporate sector's net foreign exchange position* in percent of the total credit received from the domestic banking system and foreign creditors amounted to about 49% in Poland, 43% in Hungary, 37% in Slovakia and 29% in the Czech Republic (table 5).

However, it has to be taken into account that the level of domestic credit to the corporate sector relative to GDP is significantly higher in the Czech Republic and Slovakia. Thus, relating the net foreign exchange position to GDP leads to the result that at the end of 2000 Slovakia had the highest ratio (28%), while Poland, Hungary and the Czech Republic had about the same

Table 5

The Corporate Sector's Foreign Exchange Position

against the Domestic Banking System and Nonresidents

in % of total credit (including foreign exchange credit)
extended to the corporate sector by the domestic banking system and foreign creditors

	Poland			Hungary			Czech Republic		Slovakia	Slovenia		
	1995	1997	2000	1995	1997	2000	1997	2000	2000	1995	1997	2000
	<i>end of period</i>											
Gross ¹⁾	30.8	42.2	57.3	55.5	57.7	67.2	40.2	45.9	52.6	58.7	56.9	61.7
Net ²⁾	21.0	32.7	48.6	30.2	42.9	43.2	25.8	28.9	37.4	22.1	17.4	22.8

Source: national central banks, OeNB.

¹⁾ The gross position comprises credit denominated in foreign currency.

²⁾ The net position comprises credit denominated in foreign currency minus both the foreign currency-denominated deposits with the domestic banking system and the corporate sector's foreign assets.

ratio, 20%. In the Czech Republic, the net foreign exchange position relative to GDP has been roughly unchanged since 1997, while it has increased in Hungary (from 15%) and more than doubled in Poland (from 9%).

It seems that financial conditions for the corporate sector are decisively determined by the exchange rate. This fact must not be overlooked when investigating the monetary transmission channels in the Central and Eastern European countries.

For exporters who generate revenues in foreign currency, foreign currency-denominated debt may serve as a hedging tool. Similarly, the increasing use of foreign currency-denominated debt is a sign of increasing financial integration with the EU, complementary to the real integration in terms of foreign trade. On the other hand, the marked increase in foreign currency-denominated credit probably also reflects expectations of enterprises of a continued future (trend) real appreciation and high real lending rates for domestic currency-denominated credit (in particular if measured against the producer price index of manufacturing).

Downward corrections of the exchange rate would affect the costs of debt servicing by enterprises that have incurred unhedged foreign currency-denominated debt. If such enterprises did not benefit from the downward correction on their revenue side (e.g. because they are mainly oriented to the domestic market), their overall financial situation would suffer.

Turning from banks' assets to banks' liabilities, deposits are mostly held in domestic currency. The share of *foreign currency-denominated deposits* is somewhat larger in Slovenia (see table 6), probably because of the history of high inflation in former Yugoslavia and soon after independence. In general, the share of foreign currency-denominated deposits shows a declining trend in the long term, reflecting growing trust in the local currency and continuous expectations of future real appreciation and relatively high real interest rates. Temporary increases in the share of foreign currency-denominated deposits seem to have been connected with times of economic turbulence (e.g. in Hungary in 1995 and in the Czech Republic in 1997).

Table 6

Foreign Exchange Deposits of Resident Private Nonbanks					
in % of money supply including foreign exchange deposits					
	Poland	Hungary	Czech Republic	Slovakia	Slovenia
	<i>end of period</i>				
1994	28.5	18.4	7.0	..	38.1
2000	14.6	16.9	10.6	15.5	31.9

Source: national central banks, OeNB.

One important element of financial stability is to avoid too large a *foreign currency mismatch in the banking sector*. The following table (table 7) summarizes the net foreign assets of the commercial banks as well as the net foreign exchange position of the commercial banks against domestic nonbanks (enterprises, households as well as the general government).

Table 7

Commercial Banks' Net Foreign Assets and Their Net Foreign Exchange Position

against Domestic Nonbanks

in % of GDP

	Poland		Hungary		Czech Republic		Slovenia	
	1994	2000	1994	2000	1994	2000	1994	2000
	<i>end of period</i>							
Domestic net foreign exchange position ¹⁾	-2.1	0.4	-6.6	4.5	..	0.4	-7.6	-10.4
Net foreign assets (NFA)	6.7	2.9	-2.6	-6.9	2.4	16.3	7.1	2.4

Source: national central banks, WIIW, OeNB.

¹⁾ The domestic net foreign exchange position includes holdings of externally issued foreign currency-denominated bonds of the national government (e.g. Polish commercial banks' holdings of Polish Brady bonds).

According to the table below, the foreign exchange exposure of the Hungarian banking sector seems to have improved in recent years.¹⁾ This primarily reflects increased domestic foreign exchange-denominated lending against a smaller decrease of foreign exchange-denominated deposits accepted from nonbanks. In addition, it can be assumed that a significant part of the foreign liabilities constitute liabilities to foreign parent companies. The domestic net foreign exchange position seems to have been significantly negative in Slovenia in the year 2000. While the share of foreign exchange-denominated lending was not particularly low (see table 4), the negative net position primarily reflects the comparatively high share of foreign exchange-denominated deposits (see table 6). However, it is a typical feature of the Slovenian banking sector that quite a substantial part of tolar-denominated credits is linked to the exchange rate. Moreover, it should be noted that this table includes on-balance-sheet positions only.

2.6 Banking Sector Efficiency and Profitability

In addition to taxes and transaction costs borne directly by savers and investors, bank interest spreads drive a wedge between returns to savers and financing costs for investors and thus affect the equilibrium between the supply of deposits and the demand for loans. Therefore, interest spreads may be interpreted as an indicator of banking sector efficiency if the impact of differences in the level of minimum reserve requirements on the interest spread is adequately taken into account. However, interest spreads are also a major determinant of banking sector profitability. In order to enable banks to take risks and to promote a stable and sustainable expansion of the banking sector, banking operations have to be sufficiently profitable.

In comparison with other catching-up economies, the interest rate spread between lending and deposit rates (IS) is rather low in the five Central European economies covered in this study. According to the World Bank's (2001) development indicators, in 1999 the spread between lending and deposit rates was lower only in 23 emerging market economies (of a total of 127 emerging market economies) than the CEEC-5 average of 5 percentage points. The Czech Republic's interest rate spread of 3.1 percentage

¹ The caveats mentioned above also apply in this case.

points (see table 10) was even comparable with that of the most developed industrial countries (which generally exhibit low spreads).¹⁾ Thus, financial intermediation is provided at comparatively low costs for the real sector in the CEEC-5. However, in real terms returns to savers and financing costs for investments are affected by the considerable difference between consumer and producer price inflation in the CEEC-5. As year-on-year changes in the CPI (more relevant for savings) normally exceed changes in the PPI of industrial producers (more relevant for investment) in the CEEC-5, real returns for savers fall and real financing costs for industrial producers rise accordingly.

On the downside, banking sector profitability in the CEEC-5 (with the exception of Poland) was clearly inadequate in recent years. In 1998–99 the banking sector even suffered losses in the Czech Republic and in Slovakia. By way of comparison, the banking industry's return on equity (ROE) in the EU was 11.7% in 1999. Preliminary figures for 2000 point to an improvement in banking profitability in most CEECs.

Table 8

Return on Equity (ROE)				
	1997	1998	1999	1 st half 2000
	%			
Poland ¹⁾	22.7	8.1	12.2	16.8
Slovakia	..	..	-182.7	- 6.3
Slovenia	10.3	11.3	7.8	12.2
Czech Republic	- 2.9	-17.9	- 4.3	6.6
Hungary	12.2	7.7	3.7	15.7

Source: national central banks, OeNB.

¹⁾ Commercial banks (excluding cooperative banks) only.

With a share of between 62.8% and 70.8% of gross income in 1999, net interest income is more important for CEEC banks' bottom line than for that of banks in the EU, where this share amounted to only 54% in 1999.

Table 9

Net Interest Income/Gross Income				
	1997	1998	1999	1 st half 2000
	%			
Poland	72.9	70.3	63.7	63.7
Slovakia	..	..	..	..
Slovenia	75.3	74.0	70.8	77.4
Czech Republic	45.4	67.9	62.8	67.1
Hungary	67.8	71.9	70.4	77.8

Source: national central banks, OeNB.

Obviously, the development of net interest income is strongly influenced by the development of spreads between contractual rates charged for loans and paid for deposits (IS), but for the analysis of profitability of the intermediary function of banks, defaults should be taken into consideration as well. To address this issue, Demirgüç-Kunt and Huizinga (1999) propose

¹⁾ Moreover, when comparing the interest spread in the CEEC-5 with that in the most developed industrial countries, it has to be taken into account that some of the CEEC-5, in particular Poland and Hungary, had far higher minimum reserve requirements than the most developed industrial countries at least up to 1999.

the use of net interest margins (NIM). The NIM is defined as the ratio of net interest income to average banking assets. Although the IS and the NIM will normally differ,¹⁾ the difference between the two measures may provide insights into the extent to which the spread between lending and deposit rates is eroded by loan defaults. Assuming an equal IS, the NIM should be lower for a bank with a larger share of non-interest-bearing assets (such as nonperforming loans), as these assets do not deliver the contractual interest rate and thus do not contribute to net interest income but are still included in banking assets.

Table 10

Lending Rate minus Deposit Rate¹⁾ to Nonbanks

difference of the annual average of rates in % p.a.

	1994	1995	1996	1997	1998	1999	2000
	percentage points						
Poland	10.9	11.0	8.5	7.3	7.2	6.9	6.7
Slovakia						6.7	6.4
Slovenia	6.0	4.2	4.8	4.7	4.3	3.9	3.5
Czech Republic	2.5	2.6	3.1	2.8	2.3	3.1	2.9
Hungary	7.1	6.5	5.1	3.3	4.2	4.5	3.9

Source: national central banks, OeNB.

¹⁾ Deposit rates are rates on household deposits excluding demand deposits. Including demand deposits would increase these spreads by about 1 percentage point in all countries in the year 2000.

Table 11

Net Interest Margin

net interest income in % of average banking assets

	1997	1998	1999	1 st half 2000
	%			
Poland	4.8	4.6	4.0	4.4
Slovakia	..	..	..	..
Slovenia	4.2	4.1	3.8	4.2
Czech Republic	1.8	2.9	2.3	2.0
Hungary	3.8	4.3	3.7	4.1

Source: national central banks, OeNB.

As expected, Hungary, which has low burdens of nonperforming loans, shows very small deviations between the IS and the NIM. In 1997 and 1998 the NIM even exceeds the IS in Hungary, which is probably attributable to the fact that revenues from currency forward transactions are in part registered as interest revenues while expenses related to these transactions are accounted for in other positions.²⁾ Contrary to expectations, there are large deviations between these two measures in Poland on the one hand and small deviations in Slovenia and in the Czech Republic on the other hand.

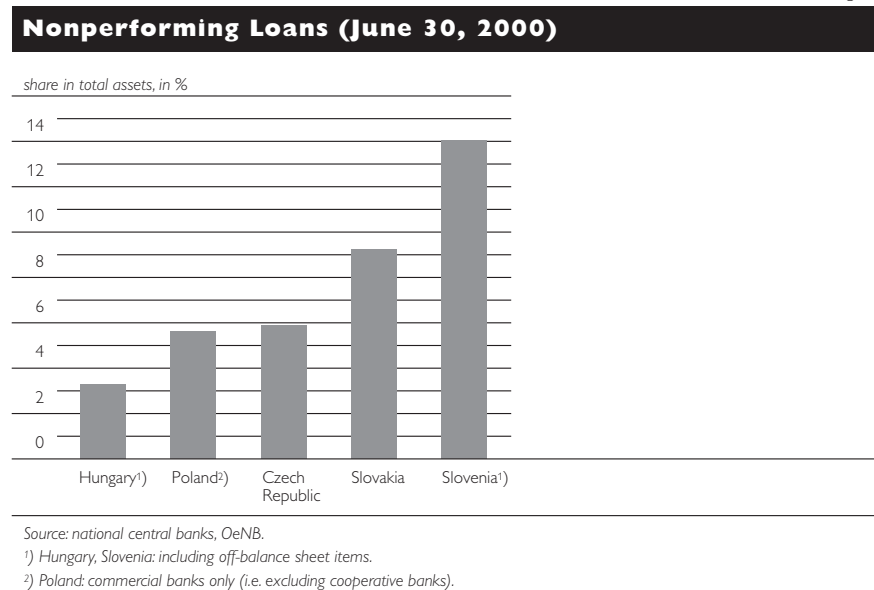
In the Czech Republic, both measures show that the difference between deposit and lending rates was too low to provide sufficient compensation for the exercise of the intermediary function.

1) Especially over time, differences between the two measures are likely to arise: Loan defaults, which affect the net interest margin by reducing the share of interest-bearing assets in bank assets, will mostly occur with a time lag in comparison with the specific date for which the spread between lending and deposit rates was calculated.

2) See National Bank of Hungary (2000).

Figure 4 below shows the size of nonperforming loans relative to total assets of the banking sector (excluding the central bank). Concerning the particularly high ratio in Slovenia, it has to be stressed that the value of collateral was exceptionally high there as well, amounting to 12.3% of total banking sector assets, while it was only about 2.5% of total assets in the Czech Republic (see also section 4.1).

Figure 4



The structure of expenses (in relation to gross income) of CEE banks is characterized by higher provisioning, but lower general operating expenses than of EU banks. In 1999, net provisioning charges amounted to 10% of gross income, while general operating expenses stood at 68% of gross income in the EU. However, general operating expenses in the CEEC-5 have increased strongly in recent years, with above-average growth rates for depreciation (resulting mainly from large investments in IT).

Table 12

Net Provisions/Gross Income

	1997	1998	1999	1 st half 2000
	%			
Poland	4.4	9.9	13.5	11.2
Slovakia	..	..	..	..
Slovenia	19.8	15.4	19.7	18.7
Czech Republic ¹⁾	34.0	15.1	- 3.7	-108.3
Hungary	- 1.4	8.1	13.7	1.8

Source: national central banks, OeNB.
¹⁾ The transfer of bad loans in the Czech Republic led to a large release of provisions in 2000.

However, aggregate banking sector figures hide considerable differences in profitability within the sector. The Hungarian National Bank (2000) shows these differences explicitly by defining two distinct groups of banks. The situation in the Czech Republic and in the Slovak Republic, where some successful banks exist in parallel with the problem-ridden state-owned banks, seems to be similar. According to the National Bank of Hungary (2000), early

Table 13

Operating Expenses/Gross Income				
	1997	1998	1999	1 st half 2000
	%			
Poland	55.6	63.0	65.2	62.5
Slovakia	..	..	..	..
Slovenia	61.4	63.3	65.2	59.5
Czech Republic	48.6	49.7	56.6	64.3
Hungary	54.5	59.6	68.8	73.7

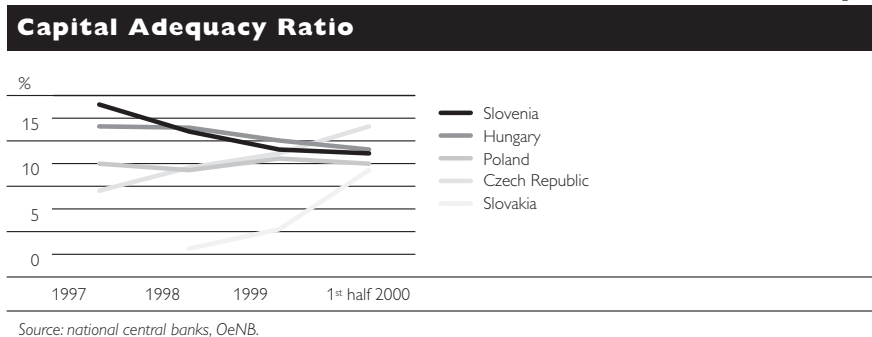
Source: national central banks, OeNB.

foreign entrants and quickly restructured domestic banks belong to the most profitable entities.

2.7 Capital Adequacy

Although international comparisons of capital adequacy ratios should be treated with caution, the level of these ratios is relatively high in the countries covered by this study (with the exception of the Slovak Republic, where consolidation measures are still underway). Of course, these capital adequacy ratios have to be seen in the light of rather high risks in CEE banking markets, which is e.g. evident in relatively high default rates or provisioning charges. As balance sheet growth in most cases exceeded ROE figures in the CEECs, increases in the capital adequacy ratio are the result of capital injections.

Figure 5



3 Capital Markets in the CEEC-5

The capital markets in the CEEC-5 comprise both equity markets and markets for debt securities denominated in local currency (LCY). Listings on foreign stock exchanges are touched upon only briefly, while international bond issues are not covered at all in this section.

3.1 Establishment of Equity Markets

The development of equity markets in the CEEC-5 was driven mainly by the privatization process. In terms of market capitalization, equity markets initially developed most rapidly in countries where mass privatization schemes were initiated, most notably in the Czech Republic and Slovakia. Market infrastructure and regulation was often put in place after the establishment of a rudimentary market. In Poland and Hungary infrastructure and an extensive regulatory framework were established first, and new listings grad-

ually entered the market. The latter approach proved more successful, which is reflected in the higher liquidity and better performance of stock indices in Hungary and Poland. The Czech, Slovak and Slovenian equity markets exhibit a more fragmented structure with a comparatively large number of small companies with low liquidity. Besides, Hungarian and Polish companies tended to be at a more advanced stage of restructuring than their peers in the other countries when they were listed, which had a positive impact on the development of the respective stock prices.

3.2 Establishment of Markets for Debt Securities Denominated in Local Currency

The emergence of these markets was linked mainly to the management of public debt and the process of macroeconomic stabilization. The securitization of loans to the central government denominated in local currency went in parallel to the declining importance of the central bank as a creditor to the public sector. Within the market for central government debt securities in local currency, it is worth distinguishing between privately placed and publicly issued securities, the latter comprising both marketable securities (T-bills, T-bonds) and nonmarketable ones (retail securities). Private placements were made mainly in the first half of the 1990s and were linked to (1) the recapitalization of commercial banks, (2) the securitization of central bank loans denominated in local currency to the central government, and (3) the conversion of foreign currency-denominated government bonds held by the central bank into local currency-denominated ones. Initially, privately placed bonds were mostly nonmarketable; in the meantime, most of them have been transformed into marketable bonds.

3.3 Size and Structure of Securities Markets

The ranking of the CEE countries by the *total capitalization* of their *equity markets* differs when measured in absolute or relative terms. At the end of 2000, Poland had the highest total market capitalization in absolute terms (USD 31.4 billion), while Hungary clearly exhibited the highest total market capitalization in relation to GDP (25.9%) as table 14 shows.

In the analysis of equity market capitalization, it has to be stressed that total market capitalization includes the total equity capital of all listed companies, thus including strategic holdings. It is useful to analyze free-float market capitalization (i.e. all portfolio holdings) as well. Unfortunately, such figures are available for the year-end 1998 only. Hungary had the highest volume of free-float market capitalization with USD 7.5 billion and 15.7% of GDP (Benoit, Demel, Reininger, 2001). At the end of 1998, the total market capitalization of the Hungarian equity market amounted to 29.5% of GDP.

Compared to the equity markets of most developed market economies, even the Hungarian equity market is still small in relation to the size of the economy (U.S.A.: 152.7% of GDP; Germany: 63.1%, end-2000¹) and even more so in absolute terms.

¹ Austria represents an outlier in this respect: Equity market capitalization amounted to only 15% of GDP at the end of 2000.

Table 14

Market Capitalization										
end of period										
	Poland		Hungary		Czech Republic		Slovakia		Slovenia ¹⁾	
	1997	2000	1997	2000	1997	2000	1999	2000	1997	2000
<i>USD million</i>										
Equity markets ²⁾	12,441	31,397	15,195	11,936	14,311	11,713	3,568	3,268	1,867	3,856
Debt securities ³⁾ in local currency (at nominal value)	21,767	34,349	13,199	15,707	7,142	10,998	2,957	2,807	2,362	2,145
thereof: central government publicly issued ⁴⁾	20,760	30,568	13,017	15,510	3,892	7,130	2,494	2,384	2,103	1,886
thereof: T-bills	17,097	24,393	8,157	10,752	3,892	7,130	2,494	2,383	151	315
thereof: T-bonds	9,170	5,658	3,249	2,941	2,220	4,371	1,201	717	0	95
retail securities	7,927	18,735	4,908	7,811	1,673	2,759	1,293	1,666	151	220
privately placed ⁵⁾	0	471	1,184	1,839	0	0	0	0	0	0
thereof: other issuers ⁶⁾	3,663	5,703	3,676	2,919	0	0	0	0	1,952	1,571
publicly issued	1,007	3,781	182	197	3,250	3,868	463	423	259	258
privately placed ⁵⁾	0	0	182	197	3,250	3,868	463	423	259	258
thereof: commercial papers (maturity under one year)	1,007	3,781	..	..	..	..	..	..	..	..
	723	2,638	..	..	..	..	..	..	..	..
<i>% of GDP</i>										
Equity markets ²⁾	8.6	19.8	33.2	25.9	27.2	23.7	18.1	17.0	10.3	21.2
Debt securities ³⁾ in local currency (at nominal value)	15.1	21.6	28.9	34.0	13.6	22.2	15.0	14.6	13.0	11.8
thereof: central government publicly issued ⁴⁾	14.4	19.2	28.5	33.6	7.4	14.4	12.7	12.4	11.6	10.4
thereof: T-bills	11.9	15.4	17.8	23.3	7.4	14.4	12.7	12.4	0.8	1.7
thereof: T-bonds	6.4	3.6	7.1	6.4	4.2	8.8	6.1	3.7	0.0	0.5
retail securities	5.5	11.8	10.7	16.9	3.2	5.6	6.6	8.7	0.8	1.2
privately placed ⁵⁾	0.0	0.3	2.6	4.0	0.0	0.0	0.0	0.0	0.0	0.0
thereof: other issuers ⁶⁾	2.5	3.6	8.0	6.3	0.0	0.0	0.0	0.0	10.7	8.6
publicly issued	0.7	2.4	0.4	0.4	6.2	7.8	2.4	2.2	1.4	1.4
privately placed ⁵⁾	0.0	0.0	0.4	0.4	6.2	7.8	2.4	2.2	1.4	1.4
thereof: commercial papers (maturity under one year)	0.7	2.4	..	..	..	..	..	..	..	..
	0.5	1.7	..	..	..	..	..	..	..	..

Source: Central European Rating Agency (CERA S.A.), national ministries of finance, national stock exchanges, Securities Market Agency (Republic of Slovenia), WIW, OeNB.

¹⁾ The privately placed central government securities include the exchange rate-indexed domestic debt denominated in foreign currency but payable in Slovenian tolar, amounting to 33% and 26%, respectively, of all outstanding privately placed central government securities in 1997 and 2000.

²⁾ Equity market capitalization is total market capitalization, i.e. including large stakes held by strategic investors, and not only portfolio equity capital ("free-float" market capitalization).

³⁾ Debt securities issued by the central bank are not included.

⁴⁾ "Publicly issued" means publicly issued and marketable, while retail securities are publicly issued and classified as nonmarketable.

⁵⁾ "Privately placed" central government securities have been transformed into marketable instruments to a large extent. Typically, a large part of these securities are bonds issued for the recapitalization of banks.

⁶⁾ "Other issuers" includes municipalities, banks and companies. (The volume of municipal bonds outstanding is rather small in all these countries.)

Almost all the benchmark equity indices calculated by the stock exchanges concentrate on the blue-chip companies of the main market segments. Within these benchmark indices, the five highest capitalized shares have a cumulative weight of (far) more than 50%.¹⁾ Minimum listing requirements of CEE stock exchanges are quite different, the Budapest Stock Exchange being the most restrictive, followed by Warsaw (Benoit, Demel, Reiningger, 2001).

The market capitalization (at face value) of *debt securities denominated in local currency (LCY)* in absolute U.S. dollar terms largely mirrored the absolute size of the total economy at the end of 2000 (e.g. USD 34.3 billion for Poland, USD 2.1 billion for Slovenia) as table 14 shows.

¹⁾ These indices are mostly market capitalization-weighted price indices, only the Budapest index (BUX) is a total return index (Benoit, Demel, Reiningger, 2001).

However, the Hungarian market for debt securities is the largest one, both with and without privately placed securities, if measured by market capitalization (at face value) relative to GDP. It is followed by the Czech Republic and Poland, which have about the same market size.

The smaller size of markets for debt securities denominated in local currency (relative to GDP) in the CEEC-5 in comparison with the most developed market economies is attributable to the lower public debt burden in the CEECs and to the higher (inherited) share of foreign currency-denominated debt in total public debt.

Thus, the Hungarian capital markets – both the equity market and the market for debt securities denominated in local currency – have the biggest weight within the whole national economy among the CEEC-5.

The *total equity market capitalization* was smaller than the *market capitalization of debt securities* denominated in local currency in Poland and Hungary at year-end 2000. However, it was bigger than the market capitalization of *publicly issued* debt securities (excluding retail securities) in all countries. On the other hand, the *free-float equity market capitalization* was probably by far lower than the market capitalization of *publicly issued* debt securities (excluding retail securities) in all countries.

Concerning the *issuer structure* of the market for debt securities in local currency, central government debt securities are predominant in each of the CEEC-5. It is only in the Czech Republic that debt securities of other issuers play a significant role compared to central government securities. In this country, the market capitalization of (mostly) long-term debt securities of other issuers even exceeded the market capitalization of long-term central government debt securities at the end of 2000. However, it is worth mentioning that in Poland the market for privately placed corporate debt securities, above all short-term commercial paper, grew dynamically from 1997 to 2000. Interestingly, companies are the largest group of investors in these securities, accounting for 39% of the nominal debt value in October 2000, followed by banks with 36% and insurance companies with 10% (CERA, 2001).

Looking at the *maturity structure* of all publicly issued debt securities (of the central government and other issuers), the volume of long-term paper was clearly larger than that of short-term paper in all countries at the end of 2000, reflecting the success of financial stabilization and disinflation. Also within the outstanding publicly issued debt securities of the central government only, long-term instruments were predominant in all countries, with the Czech Republic being the notable exception. Moreover, in the Czech Republic the outstanding volume of T-bills increased from 1997 to 2000, while it markedly decreased in Poland, Hungary and Slovakia. On the other hand, Poland, Hungary as well as the Czech Republic already have fixed-rate government bonds with a 10-year maturity or, in the Czech Republic, even with a 15-year maturity.

Another sign of the advances of the bond markets, in particular in Poland and Hungary, is the growing share of fixed-rate government bonds, while in the Czech Republic government bonds are traditionally fixed-rate bonds. In Poland, the share of fixed-rate bonds' face value in the nominal value of all

publicly issued central government bonds denominated in local currency (excluding retail securities) grew from 59% at the end of 1997 to 76% at the end of 2000. In Hungary, the share of fixed-rate bonds' face value in the nominal value of all (publicly issued and privately placed) central government bonds denominated in local currency grew from 47% at the end of 1997 to 65% at the end of 2000. On the other hand, in Slovenia, all government bonds are either inflation indexed or exchange rate-linked instruments.

3.4 Liquidity of Securities Markets

Poland stood out with the highest *equity turnover* in absolute U.S. dollar terms in 2000, after turnover had more than doubled from 1998 to 2000. In contrast, equity turnover only moderately increased in the Czech Republic and even declined in Hungary (from USD 16 billion in 1998). However, relative to nominal GDP, the top position of Hungary in terms of equity market turnover was still pronounced in 2000 at 26.2% of GDP (see table 15).

Within the equity markets, trading of shares takes place primarily on the main market segment of the stock exchange, where the most liquid blue-chip companies are listed. Except in Slovenia, the share of the main market segment in total turnover typically amounts to more than 80%.

Again, Poland had the highest *turnover of debt securities in local currency* in absolute terms in 2000 (USD 167.5 billion). And again, Hungary had by far the highest turnover in relative terms, with a level of 154% of GDP. The Czech Republic came second. From 1999 to 2000, the turnover of debt securities in local currency rose by more than 30% in Poland and in Slovenia, while it fell by more than 20% in Hungary and in the Czech Republic.

The turnover in debt securities was five to ten times as high as the turnover in equities in Poland, Hungary and the Czech Republic. In contrast, it is

Table 15

Secondary Market Turnover¹⁾ in 2000					
	Poland	Hungary	Czech Republic	Slovakia	Slovenia
	<i>USD million</i>				
Equity markets	19,452	12,106	6,845	272	943
Debt securities in local currency ²⁾	167,541	70,840	66,931	..	253
thereof: central government ³⁾	167,541	70,669	50,651	..	201
thereof: T-bills ⁴⁾	97,381	19,120	42,088	..	0
thereof: T-bonds	70,160	51,550	8,564	3,959	115
thereof: other issuers	0	170	16,279	488	53
	<i>% of GDP</i>				
Equity markets	12.2	26.2	13.8	1.4	5.2
Debt securities in local currency ²⁾	105.5	153.6	135.2	..	1.4
thereof: central government ³⁾	105.5	153.2	102.3	..	1.1
thereof: T-bills ⁴⁾	61.3	41.4	85.0	..	0.0
thereof: T-bonds	44.2	111.8	17.3	20.6	0.6
thereof: other issuers	0.0	0.4	32.9	2.5	0.3

Source: Central European Rating Agency (CERA S.A.), national ministries of finance, national stock exchanges, Securities Market Agency (Republic of Slovenia), WIW, OeNB.

¹⁾ Turnover is single counted.

²⁾ Slovenia and Slovakia: Turnover in debt securities includes the turnover on the stock exchanges only.

³⁾ Turnover in local currency-denominated debt securities of the central government includes turnover in privately placed securities, which seems to be more important in Slovenia than in the other countries. In any event, no data on the turnover of such securities are available for the other countries.

⁴⁾ The high turnover in T-bills is to a significant extent caused by sell and buy-back operations. This explains over 75% of the T-bill turnover in Poland, for instance.

striking that in Slovenia not only were the relative levels much lower than in the other countries, but also that equity turnover was significantly higher than the turnover of debt securities.

As to the *maturity structure*, the turnover in T-bills was lower than the turnover in T-bonds only in Hungary. Moreover, in Hungary the turnover in T-bills (in percent of GDP) was even lower than in Poland and in the Czech Republic, while the turnover in T-bonds (in percent of GDP) was far higher. This exceptional situation in Hungary can probably be explained by the following facts: (1) unlike in Poland and the Czech Republic, the Hungarian T-bill market was not open to foreign investors before June 2001, while the T-bond market was accessible to them, (2) in general, the T-bond market in Hungary already constitutes an institutionally more developed alternative for domestic investors than that in other countries of the CEEC-5. However, it is noteworthy that in Poland bond market turnover developed particularly well recently, more than doubling from 1999 to 2000.

Relating secondary market turnover to year-average market capitalization gives a measure of the *liquidity* of the capital markets. With foreign trading activity strong, the Hungarian equity market was clearly the most liquid market if measured by the turnover ratio based on total market capitalization.

The liquidity of the Hungarian equity market was even comparable to that of the equity markets in the most developed market economies. With total equity turnover amounting to 110% of market capitalization in 1998 and 85% in 2000, the Hungarian equity market reached the liquidity levels of the U.S. equity market (106% in 1999).

Table 16

Market Liquidity¹⁾ in 2000

turnover in % of year-average market capitalization

	Poland ²⁾	Hungary ²⁾	Czech Republic	Slovakia	Slovenia
	%				
Equity markets	63.6	85.3	54.7	7.9	25.6
Debt securities in local currency	539.9	447.5	657.5	..	11.1
thereof: central government	599.3	452.6	786.1	..	10.0
thereof: T-bills	1,601.4	615.3	1,053.8	..	0.0
thereof: T-bonds	441.5	691.8	349.6	267.6	53.3
thereof: other issuers	0.0	78.9	435.7	110.0	18.9

Source: Central European Rating Agency (CERA S.A.), national ministries of finance, national stock exchanges, Securities Market Agency (Republic of Slovenia), WIIV, OeNB.

¹⁾ The liquidity ratios are based on single counted turnover.

²⁾ The turnover in privately placed local currency-denominated debt securities of the central government was assumed to be zero for the purpose of calculating the liquidity ratios of all central government debt instruments and of all debt securities in local currency.

Reflecting the difference in turnover, market liquidity is considerably higher in both the short-term and the long-term debt securities market than in the equity market. Slovenia constitutes an exception when considering the whole debt securities market (including e.g. privately placed government bonds), but it is in line with the other countries if only the publicly issued T-bonds are taken into account.

Within the debt securities market, the market for central government securities was far more liquid than that for securities of other issuers in

2000. Within the market for central government securities, the T-bill market was significantly more liquid than the T-bond market in Poland and the Czech Republic, but not so in Hungary (see the above explanation on the turnover of T-bills in Hungary). In the Czech Republic, the market for T-bonds alone was even less liquid than that for securities of other issuers in 2000.

3.5 Foreign Participation in the Equity Markets

The share of the stock of foreign *portfolio investment* in total *market capitalization* at the end of 2000 was significantly higher in Poland, Hungary and the Czech Republic, with values between 18.6% and 26.1%, than in Slovakia and Slovenia, where it was below 5%, as table 17 shows.

Table 17

Market Participants					
stock of foreign portfolio equity investment¹⁾					
end of period	Poland	Hungary	Czech Republic	Slovakia ²⁾	Slovenia
	% of total market capitalization				
1997	21.5	17.0	21.2	..	8.3
2000	18.6	25.0	26.1	2.0	4.5

Source: national central banks, national stock exchanges, OeNB.
¹⁾ The stock of foreign portfolio equity investment is related to total market capitalization and not only to the outstanding portfolio equity capital (free-float market capitalization).
²⁾ At the end of 1999, the stock of foreign portfolio equity investment amounted to 3.8% of total market capitalization.

At first glance, this share does not seem to be particularly high in Poland, Hungary and the Czech Republic, either. However, it has to be stressed again that *total market capitalization* includes all strategic stakes as well. Thus, the implied share of foreign portfolio holdings in *total portfolio market capitalization* (free-float market capitalization) is significantly higher.

Unfortunately, a breakdown of the ownership structure of the total capital of all the listed companies exists only for Hungary. In this country, the

Table 18

Ownership Structure of Companies			
Listed on the Domestic Stock Exchange in Hungary			
	1997	1999	2000
	share in total, in %		
Total equity capital outstanding	100.0	100.0	100.0
All domestic investors	31.7	20.8	29.3
Government	14.2	7.1	8.3
Local government	1.0	0.8	0.7
Other general government	13.2	6.3	7.5
Private nonfinancial sector	13.0	9.9	14.9
Households	9.4	5.9	8.0
Nonprofit institutions	0.0	0.2	0.1
Nonfinancial companies	3.5	3.9	6.7
Institutional investors	3.7	3.3	4.9
Investment funds	0.9	0.5	1.1
Insurance companies, pension funds	1.1	1.3	2.6
Other financial corporations	1.7	1.5	1.2
Credit institutions	0.7	0.6	1.2
All foreign investors	68.3	79.2	70.7

Source: National Bank of Hungary, OeNB.

share of *total* foreign investment in the listed companies' equity, comprising both direct and portfolio investment, was about 70.7% at the end of 2000. The share of the government amounted to 8.3%.

Under the assumption that *all private domestic equity investment* (by households, companies, institutional investors and credit institutions) is regarded as *portfolio investment* in the sense of nonstrategic holdings, *foreign portfolio investors* held about 55% of *total portfolio investment* in the Hungarian equity market at the end of 2000, although their share in total market capitalization was no more than 25%.

Table 19 shows *minimum shares* of foreign buying or selling in percent of total equity market turnover. These values are derived by calculating the share of either total buying or total selling (whichever was higher) by foreign portfolio equity investors (according to balance of payments statistics) in total secondary market turnover for any given year. As the calculated share includes only either total buying or, alternatively, total selling by foreign investors, it does not include the opposite transaction (i.e. either selling or, alternatively, buying) by foreign investors with domestic investors (i.e. selling to or buying from domestic investors). Therefore, it has to be stressed that the actual shares of foreign buying or selling very probably exceed these minimum levels by far. (However, it is not possible to simply add the figures of buying and selling and relate that sum to total market turnover, as such a calculation would involve a significant amount of double counting which might even lead to ratios above 100%.) Based on these minimum shares of foreign portfolio investors' activity in the total *turnover* of the equity market, we may estimate the actual shares of foreign portfolio investors in Poland, Hungary, the Czech Republic and Slovakia as clearly above 50%, perhaps about 60% to 75%.¹⁾

Table 19

Foreign Share of Equity Market Turnover					
minimum share of foreign buying or selling					
	Poland	Hungary	Czech Republic	Slovakia	Slovenia
	% of total equity market turnover				
1996–1997 ¹⁾	33.5	68.1	37.0	..	5.5
1999–2000 ²⁾	56.4	39.3	50.7	37.8	1.9

Source: national central banks, national stock exchanges, OeNB.
¹⁾ Average share in the years 1996 and 1997.
²⁾ Average share in the years 1999 and 2000.

In addition, trading in CEEC-5 equities takes place not only on the local stock exchanges, but also on foreign stock exchanges, either in the form of ordinary shares or mostly in the form of depositary receipts (DRs). Because of their specific advantages for both CEE companies and investors, trading in DRs has gained considerable importance. For CEE companies, DRs offer the

1) The breakdown for the turnover (including sell and buy-back operations) in local currency-denominated central government bonds by market participants for the year 2000 in Hungary shows the share of foreign investors as 8.5%, far behind the shares of credit institutions (42%), institutional investors (21%) and companies (11.5%) (Hungarian State Treasury, 2001).

advantage of enhancing the liquidity of their shares, widening their investor base as well as improving their corporate image. As DRs are denominated in U.S. dollars and traded on an international exchange, their advantages for institutional investors are related to their better liquidity, the absence of conversion costs and to familiar market practices (Benoit, Schantl, Weyringer, 2001). Assessing trading in CEEC-5 equities on both local and foreign stock exchanges, it is fair to state that trading in these equities is overwhelmingly done by foreign portfolio investors, reflecting the high degree of integration of CEEC-5 capital markets in international markets. Moreover, at least in the case of Hungary, the majority of the equity of listed companies is owned by foreign portfolio or foreign strategic investors.

4 The Structure of Financial Intermediation in the CEEC-5

4.1 Funding of the Private Sector

4.1.1 International Comparison of the Private Sector's Funding Sources

The stock of domestic credit to the private nonfinancial sector provided by resident banks was markedly lower in the CEEC-5 at 25.6% to 53.3% of GDP on average in 2000 than in Portugal and Spain, the Southern European catching-up economies within the EU. In these two countries, this ratio was 84.1% and 65.1%, respectively, of GDP on average in 1998, the year before entering the euro area (see table 20).

Moreover, among the CEEC-5, the Czech Republic and Slovakia exhibited the highest levels at 53.3% and 46.2% of GDP, respectively. Their relatively high levels can be explained mainly by historical developments (see section 2.5). In addition, it has to be stressed that according to the national banking supervision reports, classified loans (i.e. watch loans and nonperforming loans) amounted to 12.8% of GDP in the Czech Republic and 8.6% of GDP in Slovakia (despite the reduction due to transfers of nonperforming loans to the state-owned consolidation bank, which simultaneously decreased the outstanding stock of domestic credit in both countries; see also section 2.5), as against 5.3% of GDP in Hungary and 3.4% of GDP in Poland at mid-year 2000. If we take into account the accumulated loan provisions at the time, the remaining net volume of classified loans was 8.0% of GDP in the Czech Republic, 4.2% in Hungary and 2.1% in Poland. These classified loans included as the lowest-ranked category so-called bad loans, or loss loans, which amounted to a gross volume (i.e. before the deduction of provisions) of 4.5% of GDP in the Czech Republic, 0.6% in Hungary and 1.2% in Poland (see also section 2.6).¹

Furthermore, coming back to the comparison with Southern European economies, around half of the domestic credit to the private nonfinancial

1 On the other hand, Slovenia had even higher level of classified credits than the Czech Republic at mid-year 2000 (20.1% of GDP and 16.4% of GDP net of provisions). However, these classified credits include off-balance sheet items and, in addition, are to a larger extent covered by collateral. The collateral value amounted to 9.9% of GDP against about 3.5% of GDP in the Czech Republic. Moreover, the volume of outstanding loss loans (2.4% of GDP) was lower than in the Czech Republic. It has to be noted that there is fairly large leeway for national differences in categorizing the outstanding credit stock into standard loans, watch loans and nonperforming loans (i.e. substandard, doubtful and loss loans).

sector was extended to households in Portugal and Spain, while in the CEEC-5 the corresponding share of household credits amounted to between only 10% in Slovakia and 33% in Slovenia.

The stock of foreign cross-border credit granted by nonresident banks to private nonbanks was between 11% and 30% of GDP in the CEEC-5 on average in 2000, while it was 12% and 6%, respectively, of GDP in Portugal and Spain on average in 1998. In all the CEEC-5 as well as in Portugal and Spain, these foreign banks' credits are predominantly medium- to long-term credits. While the stock of foreign banks' credit was tangibly lower than the stock of domestic banks' credit to private nonbanks in all countries listed in table 20, its growth rate was significantly higher than the growth rate of the stock of domestic credit to private nonbanks only in the CEEC-5, substantially increasing its ratio to GDP there. This was certainly linked to the liberalization of medium- and long-term capital flows in the 1990s. On the other hand, the corresponding ratio of the stock of foreign banks' credit to GDP even declined in Portugal and Spain, while the ratio of the stock of domestic credit to GDP sharply increased.

The volume of cross-border liabilities of resident commercial banks was far higher in Portugal and Spain at 51.3% and 29.8%, respectively, of GDP on average in 1998 than in the CEEC-5, where it amounted to between 3.7% and 17.8% of GDP on average in 2000. In Portugal and Spain, these liabilities consisted above all of short-term capital. Correspondingly, the Czech Republic, which has had the most liberal regime for capital flows (including short-term capital) for several years, showed by far the highest ratio among the CEEC-5 at 17.8%. Also in the Czech Republic, these cross-border liabilities

Table 20

International Comparison of the Stock of Domestic and Foreign Credit													
to the Private Sector													
annual average outstanding volumes													
	Poland			Hungary			Czech Republic			Slovakia	Slovenia		
	1994	1997	2000	1995	1997	2000	1994	1997	2000	2000	1994	1997	2000
	% of GDP												
Domestic¹⁾													
to nonbanks	16.6	19.8	26.4	21.6	20.9	25.6	63.7	63.8	53.3	46.2	19.8	26.3	34.4
Foreign²⁾													
to nonbanks	1.9	4.2	11.0	5.5	9.3	13.0	10.8	16.9	17.1	29.6	8.9	15.1	20.2
to banks	1.5	2.1	3.7	3.6	8.9	11.6	4.6	17.6	17.8	4.5	2.4	6.3	8.2
	Portugal			Spain									
	1994	1997	1998	1994	1997	1998							
	% of GDP												
Domestic¹⁾													
to nonbanks	61.2	71.5	84.1	55.0	59.4	65.1							
Foreign²⁾													
to nonbanks	15.5	13.4	12.2	6.8	5.7	5.9							
to banks	20.2	41.3	51.3	21.4	25.2	29.8							

Source: IMF, national central banks, VIIW, OeNB.

¹⁾ Domestic credit to nonbanks comprises domestic credit extended by resident commercial banks (including foreign-owned banks) to private nonbanks.

Domestic nonbanks do not include "other financial institutions," with the exception of Portugal in the year 1994.

²⁾ Foreign credit excludes (cross-border) intercompany loans, but includes the outstanding stock of both cross-border loans extended by foreign banks and international bonds held by foreign investors.

ities of commercial banks were predominantly short-term, with a share of about two thirds of banks' total cross-border liabilities. This stands in contrast to, for instance, Poland. In Portugal and Spain, these ratios have increased substantially since the full liberalization of short-term capital flows at the end of 1992.

To sum it up, in our view the liberalization of short-term capital flows led to a huge inflow of short-term capital to refund resident banks in Portugal and Spain. This fueled the growth of domestic credit to the private nonfinancial sector, which – inter alia – led to a partial substitution of predominantly medium- and long-term cross-border credit taken out abroad from foreign banks by the private nonfinancial sector.

In contrast, most CEEC-5 had not yet fully liberalized short-term capital flows at the end of the year 2000, and the CEE country which did so early and comprehensively, the Czech Republic, showed a pattern different from that of Portugal or Spain. There, domestic credit growth does not seem to have been enhanced by the inflow of short-term capital to banks, and thus medium- and long-term cross-border credit by foreign banks to the private nonfinancial sector grew in parallel to that inflow. This indicates that the domestic banking system could not efficiently handle the additional funding to successfully compete with these foreign cross-border credits to private nonbanks. On the one hand, it is certainly true that the resident commercial banks could have done even worse by increasing domestic credit by imprudently channeling short-term funds taken up abroad into new, risky loans to the private sector, thus adding new nonperforming loans to the existing stock of such loans. On the other hand, the resident commercial banks did not use the short-term funds from abroad to extend new profitable loans to the private sector which could have been denominated in foreign currency and thus could have constituted an alternative to medium- and long-term funding to private nonbanks directly from abroad. Thus, the domestic banking system did not successfully intermediate foreign short-term funds to productive investments of the private sector. In addition, existing structural deficiencies (in particular at the corporate level) prevented the Czech economy from reaping the potential benefits of the early full liberalization of the capital account; moreover, this liberalization increased the vulnerability of the currency regime. In view of these developments, the full liberalization of capital flows was probably premature in the Czech Republic.

4.1.2 Comparison of the Channels of Financial Intermediation to Enterprises

The following table, table 21, shows components of external funding of enterprises relative to the gross fixed capital investment (GFCI) on average in the years 1997 and 1998 and – for the CEEC-5 – in the years 1999 and 2000.¹⁾

1 This table does not contain a comprehensive list of all possible sources of external funding. For instance, privately raised new equity capital is not included. Moreover, one should be aware that GFCI includes not only fixed capital investment by the corporate sector, but also household investment, in particular in housing.

International Comparison of Channels of Financial Intermediation to Enterprises

external corporate funding relative to gross fixed capital investment (GFCI)

	Poland		Hungary		Czech Republic		Slovakia		Slovenia		Portugal	Spain	Germany	U.S.A.
	1998 ¹⁾	2000 ²⁾	1998 ¹⁾	2000 ²⁾	1998 ¹⁾	2000 ²⁾	1998 ¹⁾	2000 ²⁾	1998 ¹⁾	2000 ²⁾	1998 ¹⁾	1998 ¹⁾	1998 ¹⁾	1998 ¹⁾
<i>net flows or changes in stocks in % of GFCI</i>														
Domestic sources														
Bank credit ³⁾	17.1	11.4	20.4	18.9	5.5	-8.6	..	-2.5	14.2	13.6	32.8	19.9	17.0	6.8
Bond issues	2.3	1.7	1.2	0.1	2.1	2.9	1.1	0.3	0.2	0.2	3.5	1.4	..	..
Equity issues ⁴⁾	2.8	1.3	0.4	0.0	0.0	0.9	..	0.0	0.0	0.0	7.6	4.8	3.8	14.3
Foreign sources														
Intercompany loans ⁵⁾	4.0	4.0	4.1	3.1	6.3	4.1	1.2	1.1	1.2	1.7	2.8	2.1	..	..
Bank loans ⁶⁾	2.8	3.3	3.2	13.6	5.3	3.7	14.6	-1.2	7.5	9.6	2.2	2.3	..	..
Bond issues ⁷⁾	2.2	1.4	-0.3	-0.1	1.8	1.0	0.1	4.4	0.1	-0.7	0.3	0.0	..	..

Source: Central European Rating Agency (CERA S.A.), Fédération Internationale des Bourses de Valeurs (FIBV), national central banks, national stock exchanges, Securities Market Agency (Slovenia), WIIV, OeNB.

¹⁾ 1998 = average ratio in the years 1997 and 1998.

²⁾ 2000 = average ratio in the years 1999 and 2000.

³⁾ Domestic banks' credit comprises domestic credit (including foreign currency-denominated credit) extended by resident commercial banks (including foreign-owned banks) to the corporate sector.

⁴⁾ Equity issues: capital-raising public offers on the stock exchange.

⁵⁾ Intercompany loans: net disbursements, i.e. disbursements minus repayments, by foreign (parent) company.

⁶⁾ Foreign banks' loans: net disbursements, i.e. disbursements minus repayments; includes the relatively small amount of enterprises' trade credit.

⁷⁾ Foreign bond issues: net issues of international bonds, i.e. gross issues minus repayments.

Generally, the internal sources of enterprises to fund their fixed capital investment are more important than the external sources in all the countries that are compared in table 21. Usually, depreciation is the most important part of internal funding, followed by retained profits. For the CEEC-5 it was shown that also the sale of already completely depreciated assets constituted quite an important source of funding in the years 1995 to 1998 (Köke, 2001).

In Poland, Hungary and Slovenia as well as in selected EU countries (Portugal, Spain and Germany), the change in the stock of domestic credit extended by resident banks to enterprises was the most important source of external funding to enterprises, with a ratio of between 11.4% and 32.8% of GFCI, while in the U.S.A. it was equity issuance due to capital increases, with a ratio of 14.3%. Hence, the predominance of loan-based ("bank-based") versus equity-based ("market-based") intermediation exists in both the EU and the CEEC-5. In the Czech Republic, the very low value of 5.5% on average in 1997 and 1998 was linked to the recession. Moreover, while the change in the stock of credit generally shows the difference between the flows of new lending and repayment, it may also reflect extraordinary changes. Thus, the negative values in the Czech Republic and in Slovakia on average in the years 1999 and 2000, reflect – inter alia – the transfer of nonperforming loans from the commercial banks to the state-owned consolidation banks.

In Hungary, Slovakia and Slovenia, net inflows from foreign cross-border credits granted by nonresident banks came second as a source of funding on average in the years 1997 to 2000, while in Poland and the Czech Republic net inflows from cross-border intercompany loans of transnational corporations were a slightly more important source of financing than foreign banks' credits. Corresponding to our analysis of the outstanding stock volumes, the net inflow from foreign banks' credit was also higher in the CEEC-5 than in

Portugal and Spain. In contrast, in Portugal and Spain equity issuance due to capital increases was the second most important source of external financing with a ratio of 7.6% and 4.8%, respectively, of GFCI.

In Poland and the Czech Republic, the net issuance of domestic debt securities ranked fourth among the categories listed with a ratio of 2% to 3% in the years 1997 to 2000. In these countries as well as in Slovakia, the corporate sector gained some financing by the net issuance of international debt securities in the period covered.

It was only in Poland that equity issuance due to capital increases made a nonnegligible contribution to enterprises' external funding. Its size was roughly similar to that of external funding by the net issuance of domestic debt securities and to that of the net issuance of international debt securities on average in the years 1997 to 2000. With the exception of Poland, equity issuance due to capital increases has not yet constituted an important source of external funding in the CEEC-5. Even in Poland, the level of such funding was considerably lower than that achieved in the selected EU countries presented in table 21 in the years 1997 and 1998. However, one should not forget that the equity markets have played some role as an additional channel for the sale of state stakes in Poland and Hungary (see subsection 4.2).

4.2 Funding of the Public Sector

4.2.1 The Role of the Equity Market for the Public Sector

Up to now, the most important positive contribution of equity markets in the CEEC-5 to the macroeconomic development of the respective countries probably consisted in providing a channel through which the state could sell stakes in companies as part of the overall privatization process. Proceeds from such sales reached about 0.9% of GDP in Poland on average in 1997 and 1998, while they were about 3.3% of GDP in Hungary in 1997. However, in Poland this ratio declined to 0.2% on average in 1999 and 2000, and there were no sizeable flotations by the Hungarian state in the years 1998 to 2000.

4.2.2 Sovereign Debt Securities Denominated in Local Currency

The publicly issued debt securities denominated in local currency gained considerable importance within the central government debt denominated in local currency, as table 23 shows. Such securities were the main or exclusive source of financing budget deficits, while in parallel the inherited stock of central bank loans denominated in local currency to the central government was cut back drastically. At the end of 2000, the share of publicly issued debt securities denominated in local currency (excluding retail securities) in central government debt denominated in local currency amounted to between 70% and 100% in the CEEC-5, with the exception of Slovenia. In Slovenia, the low volume of publicly issued debt securities outstanding can partly be explained by the relatively low budget deficits during the 1990s and the relatively strong reliance on international bond issues.

The share of external and internal debt denominated in foreign currency in total central government debt fell considerably from 1993 to 2000 in Poland and the Czech Republic and from 1997 to 2000 in Hungary. In Poland, this sharp decline can partly be explained by the partial write-off

Table 22

Ratio of Central Government Debt to GDP			
end of period	1993	1997	2000
	%		
Poland	82.9	46.9	38.7
Hungary	88.7	62.9	55.5
Czech Republic	15.6	10.7	15.1
Slovakia	..	..	25.1
Slovenia	21.1	23.2	25.0

Source: national ministries of finance, OeNB.

of external debt by the London Club and the Paris Club in 1994. At the end of 2000, the share of foreign currency-denominated debt in total central government debt was lowest in the Czech Republic, which had, in addition, also the lowest total central-government-debt-to-GDP ratio, as table 22 shows. It is striking that in Slovenia the share of foreign currency-denominated debt tangibly increased from 1993 to 1997, while being roughly constant from 1997 to 2000. At the end of 2000, Slovenia and Slovakia had the highest share of foreign currency-denominated debt in total central government debt among the CEEC-5. However, these countries' vulnerability to nominal depreciations is reduced by the fact that total central-government-debt-to-GDP ratios are rather low in both countries.

Comparing the share of foreign currency-denominated debt in total debt of the central government (table 23) with the corporate sector's foreign currency position in percent of total credit to the corporate sector (table 5), we can see that the government's share of foreign currency debt was roughly similar to the corporate sector's net foreign currency position in Poland and Hungary and to its gross foreign currency position in Slovakia and Slovenia. Thus, the vulnerability of the public sector and the corporate sector to nominal depreciations of the local currency may seem comparable at first sight. However, the beneficial impact of nominal depreciations on the public sector's revenue side will probably be rather limited, while it will very probably be more pronounced on the corporate sector's revenues.

Table 23

Structure of Central Government Debt													
by type of debt													
end of period	Poland			Hungary ¹⁾			Czech Republic			Slovakia	Slovenia ²⁾		
	1993	1997	2000	1993	1997	2000	1993	1997	2000	2000	1993	1997	2000
	%												
Debt denominated in local currency	21.9	40.2	52.3	56.0	52.5	60.7	54.9	78.9	93.2	50.7	74.2	38.9	37.4
Publicly issued	15.3	27.1	37.9	14.7	30.9	42.3	23.4	75.6	93.2	50.7	0.3	3.8	6.1
Retail bonds	0.0	0.0	0.7	1.3	4.5	7.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privately placed	3.3	5.8	8.9	15.2	7.7	7.0	0.0	0.0	0.0	0.0	71.2	32.6	26.3
Loans, etc.	3.3	7.3	4.9	24.8	9.4	4.2	31.4	3.3	0.0	0.0	2.6	2.4	5.1
Debt denominated in foreign currency	78.1	59.8	47.7	44.0	47.5	39.3	45.1	21.1	6.8	49.3	25.8	61.1	62.6
Internal	7.1	6.7	2.4	0.0	0.3	0.3	0.0	0.0	0.0	0.0	12.9	20.5	12.4
External	71.0	53.1	45.3	44.0	47.2	39.0	45.1	21.1	6.8	49.3	13.0	40.6	50.2

Source: national ministries of finance, OeNB.

¹⁾ The external debt for the government that was channeled through the central bank is included in the external debt denominated in foreign currency in 1993, 1997 and 2000.

²⁾ The internal debt denominated in foreign currency includes the exchange rate-indexed domestic debt instruments.

Table 24 shows the structure of holders of publicly issued central government debt securities denominated in local currency (including retail securities). In Poland and Hungary, the shares of both domestic nonbanks and foreign portfolio investors increased at the expense of the share of the banking system from 1997 to 2000. In Poland, this development was a continuation of the change from 1993 to 1997. In contrast, the Czech Republic witnessed a similar development only from 1993 to 1997 and a quite interesting reversal of this trend from 1997 to 2000. Thus, in the Czech Republic as well as in Slovenia, the commercial banks were still the largest group of investors, with a share of 65% and 62%, respectively. Central banks held no such securities at the end of 2000 in any of the CEEC-5. It is probably only in Hungary that the demand for central government securities is really broadly based and, in particular, directly household-based with a large and rapidly growing share (21% at the end of 2000). This was to a large extent due to the policy of issuing debt securities directly aimed at households as investors, i.e. publicly issued, but nonmarketable bonds (retail bonds). In contrast, Poland did not start to issue such bonds ("savings bonds") until 1999. It is noteworthy that the share of foreign investors did not exceed 18% in any of the CEEC-5 at the end of 2000.¹⁾

Table 24

Holder Structure									
of Publicly Issued Central Government Debt Securities in Local Currency¹⁾									
share in total									
end of period	Poland			Hungary		Czech Republic			Slovenia
	1993	1997	2000	1997	2000	1993	1997	2000	2000
	%								
Total volume outstanding	100	100	100	100	100	100	100	100	100
All domestic investors	100	91	83	96	82	100	91	96	100
All nonbanks	14	32	47	59	61	3	45	31	39
thereof: retail securities	0	0	2	13	15	0	0	0	0
Intra-government									2
Private nonfinancial sector	..	..	..	39	35	1	13	2	3
Households				18	21	0	2	1	
thereof: retail securities	0	0	2	13	15	0	0	0	0
Nonprofit institutions									
Nonfinancial companies	..	..	..	21	14	1	11	2	3
Institutional investors				20	27	2	32	27	36
Privatization funds	..	..	..	..	..	..	..	2	..
Mutual funds	..	..	..	9	6	..	..	3	..
Pension funds				2	8	..	..	..	..
Insurance companies	..	..	..	10	12	..	..	19	18
Other financial corporations	..	..	..	..	..	..	..	2	..
Banking system	86	59	35	37	21	97	46	65	62
Credit institutions	46	59	35	32	20	81	46	64	62
Central bank	39	0	0	5	0	16	0	0	0
All foreign investors	0	9	17	4	18	0	9	4	0

Source: national ministries of finance, OeNB.

¹⁾ Includes retail securities (classified as publicly issued but nonmarketable debt securities).

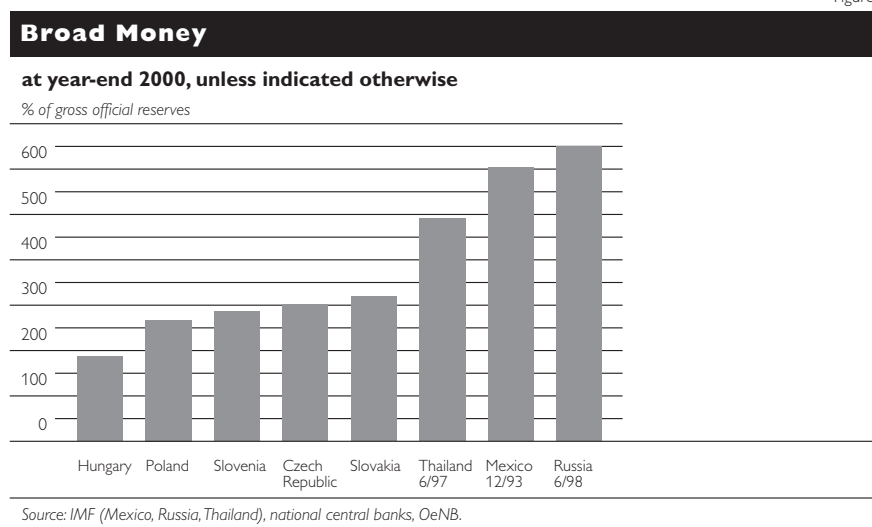
1) In the Czech Republic, where a sizeable corporate bond market coexists with the government bond market, the share of foreign investors in the total capitalization of the local currency-denominated bond market (including both the corporate and the government bond market) can be estimated to have fallen from 17.8% at the end of 1997 to only 5.4% at the end of 2000. This probably not only reflects the low level of yields at the end of 2000 in the Czech Republic, but also negative foreign perceptions of the debt servicing ability of the corporate sector.

5 Vulnerability to Financial Contagion

Recent experience with financial crises in Mexico, Southeast Asia and Russia demonstrated the importance (besides other factors) of vulnerability to short-term capital outflows for the outbreak and transmission of financial turbulences. Thus, in the following section the issue of the CEEC-5's current vulnerability to short-term capital outflows will be analyzed, using a number of indicators.

Figure 6 shows the relation between a broad range of liquid assets that can be easily switched into foreign assets (broad money including foreign currency-denominated deposits) and gross official reserves. As the figure shows, this ratio was markedly lower in the CEEC-5 at the end of 2000 than in a number of countries hit by financial crises.

Figure 6

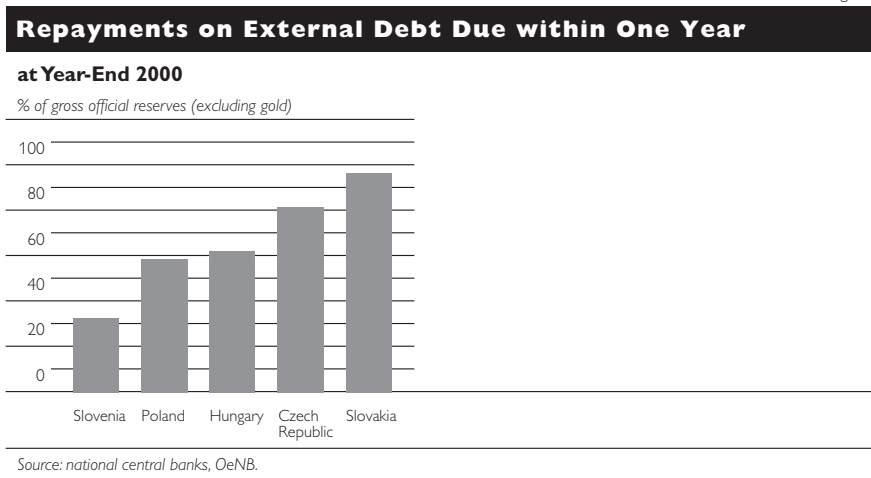


Another indicator that has been associated with financial contagion effects in the recent past is the ratio of external debt repayments due in the short term to gross official reserves. This ratio comprises both short-term external debt (i.e. external debt with an original maturity of below one year) and repayments on medium- and long-term external debt due within one year. Such ratios are shown in figure 7 below for the CEEC-5.¹⁾ In each of the CEEC-5, this indicator was below 100%, with a particularly low ratio for Slovenia.

However, it should be noted that this indicator does not include redemptions on local currency-denominated debt instruments held by foreign investors which are due within one year and which could be quickly transferred abroad unless they are reinvested. These flows are worth mentioning in Poland and especially in Hungary, where they reached 9% of gross official reserves at the end of 2000.

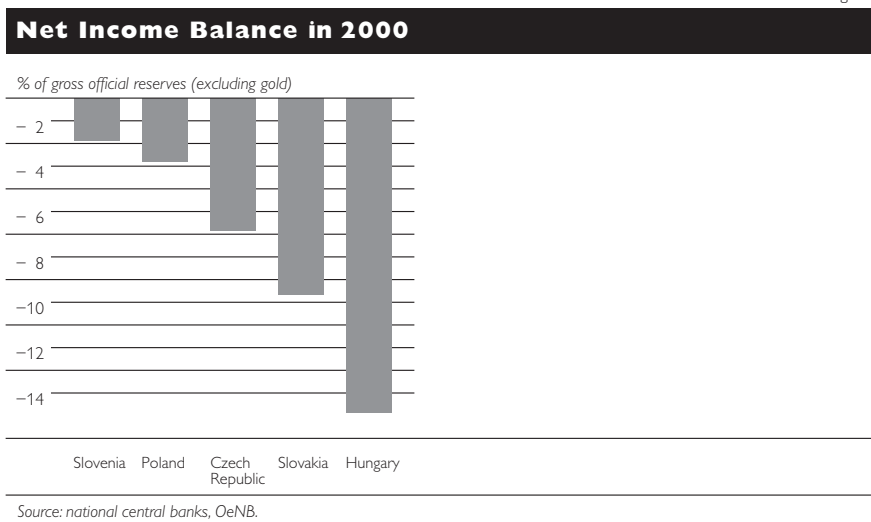
¹ These ratios were partly derived on the basis of estimates, assuming an average maturity of four years for the outstanding stock of private external debt in Poland and Slovenia and of total external debt in the Czech Republic and Slovakia. They exclude the repayment due within one year on local currency-denominated bonds held by foreign investors.

Figure 7



Another item that is not included in the ratio between external debt repayments due in the short term and gross official reserves, but may contribute to short-term commitments in foreign currency, is interest payments on external debt as well as on foreign-held debt instruments denominated in local currency. These flows are the main factor in the negative net income balance in the CEEC-5, with the exception of the Czech Republic. As figure 8 shows, negative net income reached sizeable amounts in Hungary and the Slovak Republic (see figure 8).

Figure 8



As shown in section 3, the liquidity of domestic capital markets is relatively high in Poland, Hungary and the Czech Republic. Thus, foreign investors can quickly sell their portfolio investment denominated in local currency and demand foreign currency for the conversion and repatriation of their proceeds. Therefore, table 25 reports the total stock of foreign-held portfolio investment in local currency-denominated debt securities and in equities in relation to gross official reserves. In general, this ratio is higher for equity portfolio investment.

Table 25

Risk Exposure to Foreign Capital Outflows

foreign portfolio holdings in % of official gross reserves (excluding gold)

end of period	Poland			Hungary			Czech Republic			Slovakia		Slovenia		
	1997	1999	2000	1997	1999	2000	1997	1999	2000	1999	2000	1997	1999	2000
	%													
Equity	13	20	22	31	40	27	31	21	23	4	2	5	5	5
Debt ¹⁾	8	7	16	4	16	20	13	9	5	..	..	0	0	0

Source: BIS, IMF, national central banks, national ministries of finance, OeNB.

¹⁾ "Debt" comprises foreign portfolio holdings of debt securities denominated in local currency of both the central government and other issuers.

However, equity portfolio investment can basically be expected to cause less pressure than debt portfolio investment on official reserves in the case of outflows of portfolio investment. A massive flight by foreign investors from the domestic securities markets would cause a larger fall in equity prices than in debt prices (because of the higher volatility of equity), thereby reducing the value of proceeds from the sale of securities to be converted into foreign currency.

On the other hand, it has to be stressed that the contribution of the equity markets to overall macroeconomic developments has been rather modest up to now when measured in terms of the funding of the corporate sector (see section 4.1). Until now, the relatively liquid equity markets have above all provided owners of equity capital, mainly foreign investors, with additional opportunities to optimize their asset portfolio according to their preferences and risk attitudes (see section 3). This raises the question whether the stability risk of financial contagion that the strong foreign participation involves for the whole economy – although it is probably still at a manageable level – does not exceed the benefits of international integration of CEE equity markets for the national economies, in particular in Poland, Hungary and the Czech Republic.

The size of accumulated short-term capital inflows other than portfolio investment, in particular the stock of short-term loans to enterprises and deposits with domestic banks, and its potentially destabilizing impact (e.g. on the confidence of residents into their own national currency) were still relatively small at the end of 2000 (see section 4.1), above all because such inflows were stemmed by restrictions on capital movements in Poland, Hungary and Slovenia.

This analysis does not deal with the risk off-balance-sheet transactions imply for gross official reserves. However, we do not expect this risk to be very large, as the figures published indicate that off-balance-sheet positions are rather small. In Poland, Hungary and Slovenia, these positions appear to be small mainly because of the restrictions on off-balance-sheet transactions applicable at the end of 2000.

When evaluating risks to financial stability arising from sudden capital outflows, exchange rate regimes have to be taken into consideration, too. As none of the countries covered in this paper uses an explicit exchange rate target with a narrow band at present, the central banks are not committed to meeting demand for foreign currency at a fixed rate. Thus, capital

outflows produce less pressure on official reserves than under a fixed-rate regime.

On the basis of the indicators presented above, it seems fair to conclude that vulnerability to sudden sizeable outflows of foreign capital (in addition to the scheduled debt service), which, for instance, may be triggered by financial contagion from the international markets and may itself provoke an outflow of domestic capital, can be considered rather low in the CEEC-5. However, this conclusion may change fairly rapidly if circumstances change accordingly.

Cutoff date for data: June 15, 2001.

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Intraindustry Trade Between the EU and the CEECs – The Evidence of the First Decade of Transition

I Introduction

Jarko Fidrmuc¹⁾

The Central and Eastern European countries (CEECs)²⁾ were isolated from other parts of the world economy for about 40 years. In the countries of the former Soviet Union (excluding the Baltic States), this period even lasted about 70 years. The autarky policy and the lack of feedback mechanisms in the central planning economies resulted in dramatic developments away from the overall path in the developed countries. The lack of up-to-date investment and the fact that research and development were overlooked caused output growth in these economies to slow down. It is generally argued (Kornai, 1989; Blanchard et al., 1991) that these countries were far from having achieved macroeconomic and microeconomic equilibria in virtually all sectors of the economy at the end of the 1980s.

Currently, there is a unique chance to observe rapid economic developments in the former central planning countries. Two features characterize this development. First, the macroeconomic and microeconomic disequilibria were rapidly eliminated during the first years of transition. Second, economic developments in the (largely) transformed economies remain more dynamic than those in developed countries.

In the first years of transition, the stabilization policy proposed to reach macroeconomic as well as microeconomic equilibrium necessitated dramatic development in Eastern Europe. High inflation or even hyperinflation were observed in the CEECs after price controls were removed, but inflation subsequently stabilized at relatively low but still two-digit inflation rates (Backé et al., 2001). Production inefficiencies were addressed and privatization was nearly completed within a few years in the more advanced CEECs (Djankov and Murrell, 2001). As a result, the output in the CEECs declined by a significant fraction of GDP, and unemployment peaked at internationally high levels (Svejnar, 1999). This contrasted sharply with these nations' intentions to improve the real income of the population immediately. Therefore, several countries (e.g. Poland and Romania) experienced a short but massive wave of emigration to Western Europe. This experience still possibly has a negative influence on the negotiations of the accession of the CEECs to the EU.

A similar jump to an "equilibrium level" has been observed in the trade orientation of the transition countries as well. As predicted by gravity models, Hamilton and Winters (1992) forecast a significant growth to the "potential level" of trade between the CEECs and the EU. Fidrmuc and Fidrmuc (2000) documented that this adjustment to the equilibrium level has been nearly completed recently.

These examples show that significant adjustments were reached during the first years of transition, at least in the more advanced transition economies. Indeed, the Czech Republic, Hungary, Poland and Slovakia have joined

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2 *Unless otherwise stated, this contribution covers the following CEECs: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.*

the OECD recently. Moreover, nearly all EU membership candidates have already adopted significant parts of the *acquis communautaire* as a requirement for accession to the EU.¹⁾

Nevertheless, the economic development in transition economies has remained more dynamic since the elimination of the initial disequilibria. Poland, and to a lesser extent also Slovakia, Hungary, Slovenia and the Czech Republic have attained annual GDP growth rates of up to 7%. National and international forecasts expect further growth under the assumption of sustainable macroeconomic policy (balanced budgets and current accounts). But it will take the CEECs about 30 to 40 years until they achieve 70% or 80% of the enlarged EU's average per capita GDP (Fischer, Sahay and Vegh, 1997; Wagner and Hlouskova, 2001).

There are several arguments that structural reforms give an additional impetus to macroeconomic success. The various issues of the transition report published by the EBRD show a positive correlation between structural reforms and growth or macroeconomic stabilization. This has provided a foundation for the regular computation of several transition indices covering various areas of reform in transition countries. Fidrmuc and Fidrmuc (2001) find a positive correlation between GDP growth and the EBRD's aggregate transition index. Similarly, de Broeck and Sløk (2001) showed that the deviation of the nominal exchange rate of transition countries from purchasing power parity (vis-à-vis the U.S. dollar) is negatively correlated with income per capita (as compared to the U.S. level).

The present paper compares the patterns of trade of the European Union with all OECD countries and all CEECs between 1989 and 1998. Thus, the set of included countries is larger and the length of the analyzed period is longer than in comparable studies.²⁾ Fidrmuc, Grozea-Helmenstein and Wörgötter (1999) compare selected Western and Eastern European countries at the starting (1989) and intermediate (1996) stages of transition. Djankov and Hoekman (1997) and Aturupane, Djankov and Hoekman (1999), Kaitila (2001) and Gabrisch and Segnana (2001) analyze the development of trade structures in the CEECs over a shorter period of time.

The paper analyzes relatively broad commodity groups (SITC three-digit commodity groups). The single data source (UN World Trade Databank), however, does not provide any information on import and export prices. Therefore, the paper does not cover the relatively recent issue of distinguishing between horizontal (that is, trade in products of the same quality) and vertical (trade in products of different quality levels) intraindustry trade in empirical analyses. Indeed, Burgstaller and Landesmann (1997), Aturupane, Djankov and Hoekman (1999) and other authors show that the EU's intraindustry trade with the CEECs is concentrated on vertical intraindustry trade.

The period under consideration was characterized by dramatic institutional changes apart from the opening-up of Eastern Europe, which is the focus of this analysis. Germany reunified in 1990. Slovenia and the Baltic

1 Last year's regular reports of the EU on the accession countries are discussed in Focus 2/2000, for example.

2 Fidrmuc (2000) and Fidrmuc and Schardax (2000) analyze earlier versions of the data presented here.

Republics became independent in 1991, while the former Czechoslovak federation divided into the Czech Republic and Slovakia in 1993. Austria, Finland and Sweden joined the European Union in 1995. Moreover, the UN introduced a new framework for trade statistics by detailed commodity groups (SITC Revision 3), starting with the last decade. All those developments affected the quality and availability of trade data during the investigated period.

Despite these limitations, the presented analyses show initial increases of intraindustry trade in all CEECs, but also a successive continuation of structural changes in the EU's trade with some CEECs in more recent years. Determinants of the EU's intraindustry trade with OECD countries are analyzed and used for predictions in the EU's trade with the CEECs in the long run.

The rest of the paper is organized as follows. The next section describes the development of the EU's trade with the CEECs in comparison to intra-EU trade and trade with selected third countries. Section 2 analyzes the determinants of the development of the EU's intraindustry trade with OECD countries. Section 3 uses the OECD estimates to predict potential shares of the EU's intraindustry trade with the CEECs. Finally, conclusions are drawn in the last section.

2 The EU's Intraindustry Trade with Selected Countries

The growth of Central and Eastern European exports to the EU went hand in hand with a significant restructuring of trade. The redirection of goods that were traditionally exported to the CEECs and the former Soviet Union to newly opened Western markets did not play an important role. Djankov and Hoekman (1997) find that the export growth concerned either products which were not exported to Eastern European countries or that such exports were substantially upgraded. In contrast to the initial expectation that the CEECs would specialize on labor- and resource-intensive products (Collins and Rodrik, 1991; Neven, 1995), the growth of intraindustry trade is one of the most important features in the development of East-West trade.

This paper applies the Grubel-Lloyd index of intraindustry trade (Grubel and Lloyd, 1971), which represents the share of the absolute value of intraindustry trade in trade turnover, that is:

$$GLI_t = 1 - \frac{\sum_i |X_{it} - M_{it}|}{\sum_i (X_{it} + M_{it})}, \quad (1)$$

where X and M denote the EU's exports and imports by three-digit SITC commodity groups i (as published by the UN), respectively. An index value of 0 shows that there is exclusive interindustry trade, i.e. a complete specialization on different products for each country, while an index value of 1 indicates exclusive intraindustry trade.

In 1989, the shares of intraindustry trade in the EU's trade with manufacturing products by SITC three-digit commodity groups (see table A.2) were between 15% (17.6% for Romania and 23.2% for Bulgaria) and nearly

40% (39.8% for the former CSFR and 40.6% for Hungary). These shares corresponded to the importance of intraindustry trade in the EU's trade with relatively peripheral countries like Greece (24.6%) and Portugal (40.6%) in 1989. However, these shares of intraindustry trade were far below the figures of more centrally located EU countries, which were between about 60% (Italy: 62.2%, Spain: 62.8%) and about 80% (France: 79.8%, the Netherlands: 75.0%).

During the 1990s, nearly all CEECs experienced significant growth of intraindustry trade (see table A.2). As a result, the shares of intraindustry trade in the EU's manufacturing trade with the Czech Republic (68.0%), Slovenia (60.0%) and Hungary (56.1%) were comparable to or even slightly larger than in the EU's trade with Spain (68.1%), Italy (63.1%) and Switzerland (65.9%) in 1998. In turn, Estonia (36.2%), Poland (44.5%) and Slovakia (44.6%) showed somewhat lower shares of intraindustry trade with the EU in 1998. Nevertheless, these figures were comparable to those of Ireland and Finland (both 45.4%). However, the share of intraindustry trade in the EU's trade with Romania (28.7%) and Bulgaria (33.2%) still remained only slightly above the share of EU intraindustry trade with Greece (22.1%), while the shares of intraindustry trade in the EU's trade with Lithuania (25.9%) and Latvia (25.0%) are slightly below this figure.

Nevertheless, several CEECs experienced slight declines of intraindustry trade after initial growth. This pattern of development has been observed in the EU's trade with Slovakia, where the highest share of intraindustry trade was observed in 1996 (50.8%), followed by a drop of about six percentage points. This pattern of development was less pronounced in Bulgaria, Hungary, Latvia and Romania, which could indicate a stabilization of the EU's intraindustry trade with these countries at the long-run levels.

The EU's intraindustry trade is concentrated on manufacturing products. Correspondingly, the shares of intraindustry trade in total trade (including manufacturing and nonindustrial products) of the European Union are slightly lower than those of the manufacturing trade alone (see table A.1). In 1998, the shares of intraindustry trade in total trade were up to 3 percentage points below the shares of manufacturing trade, although this difference reached -5.6 percentage points in the Netherlands. Only Greece had significantly higher shares of intraindustry trade in total trade (26.4% in 1998) than in manufacturing trade (22.1%), which reflects the importance of both the agricultural sector and tourism in this country.

3 Determinants of Intraindustry Trade in the EU's Trade with OECD Countries

According to the new trade theory, the shares of intraindustry trade of catching-up countries should increase as part of the convergence to the income level of developed countries. Furthermore, large countries are expected to have a more diversified trade structure than small countries, which are specialized on few products. Barriers to trade may also influence the structure of trade. Originally, Loertscher and Wolter (1980) note that intraindustry trade between countries is intense if the GDP per capita of trading countries is high, the difference in this indicator is relatively small, and if the aver-

age size of their aggregate outputs is high and similar. It is generally argued that GDP per capita is a proxy for factor composition. In particular, Helpman (1987) estimates:

$$GLL_{ij} = \alpha_0 + \alpha_1 \log |y_i - y_j| + \alpha_2 \min(\log(Y_i), \log(Y_j)) + \alpha_3 \max(\log(Y_i), \log(Y_j)) \quad (2)$$

on separate cross-sections of 91 country pairs from 1970 to 1981, where GLL_{ij} is the Grubel-Lloyd index (for four-digit SITC groups) in trade between countries i and j , Y and y are aggregate income and income per capita of the included countries, respectively.¹⁾ Based on models of trade in differentiated products, Helpman argues that the share of intraindustry trade is negatively correlated with income differences ($\alpha_1 < 0$) and positively correlated with country size ($\alpha_2 > 0$ and $\alpha_3 < 0$). Helpman finds that data supported these predictions. This result was confirmed by Durkin and Krygier (2000) and Hummels and Levinsohn (1995), although they questioned these estimates at the same time. This section starts with the estimation of a form of Helpman's equation (2) for the EU's intraindustry trade with OECD countries (see table 1):

$$\log \left(\frac{GLL_{i,t}}{1 - GLL_{i,t}} \right) = \alpha_0 + \alpha_1 \log |y_i - y_{EU}| + \alpha_2 \log(Y_i) + \alpha_3 \log(Y_{EU}) + \beta X \quad (3)$$

In comparison to (2), equation (3) reflects that the Grubel-Lloyd index (for manufacturing products) is defined between 0 and 1. Therefore, Hummels and Levinsohn (1995) suggest to use the logistic transformation, $\log(GLL_{it}/(1 - GLL_{it}))$, which removes this restriction. Furthermore, equation (3) does not distinguish between the maximum and minimum of total incomes of trading partners because the aggregate output of the EU-15 represents the highest GDP in the data sample in nearly all periods.²⁾ This does not change the interpretation of α_2 , which is again expected to be positive. The aggregate output of the EU-15, Y_{EU} , is used to scale the individual Y_i s.

Finally, equation (3) includes several other explanatory variables, which are denoted by X . In particular, the distance between trading partners serves as a proxy for transport and transaction costs, which have important effects on the trade volume, as documented by gravity models. Falvey (1981) shows that trade barriers (tariffs) reduce trade in vertically differentiated products, although the effect is expected to be weaker for horizontally differentiated products.

The distance between two countries is typically measured as the distance between their capitals. For the EU as a whole, however, this measure of dis-

1 Throughout the paper, GDP and GDP per capita was converted to Deutsche mark, which is used instead of ECU before the introduction of the euro in 1999.

2 As converted to Deutsche mark, only U.S. GDP was slightly higher than the EU's aggregate output in 1989 and 1998.

tance (that is, the distance between Brussels and the national capitals) is not appropriate.¹⁾ Deardoff (1995) argues that the overall geographic position of countries is more important than the position relative to other countries. Following this argument, Wei (1996) defines a remoteness measure as a weighted-average distance to other countries. Following this approach, the following remoteness indicator is used:

$$R_j = \sum_{j=1}^{14} w_j D_j \quad (4)$$

where D_j denotes a country's distance (as measured by the distance between capital cities) to 14 Member States of the EU (Belgium and Luxembourg are taken as a single region) and the weight w_j is the share of a member j in the EU's aggregate output.

Moreover, the participation in the EU might have important effects on trade structure as well, although the signs and magnitudes of these effects are ambiguous. On the one hand, Falvey's (1981) model of vertically differentiated products implies a positive effect of trade liberalization on vertical intraindustry trade. On the other hand, Krugman (1993) argues that countries may make more intensive use of their comparative advantages in a free trade area and specialize more. In addition, there is a political economy argument that industries with balanced trade (that is, with a high share of intraindustry trade), implying balanced interests of exporters and importers, are less likely to be subject to trade restrictions than other industries. In addition to the direct effect of the participation in a free trade area, the effects of other variables (e.g. transport costs as proxied by remoteness) may be different in intra-EU and extra-EU trade.

Finally, possible short-term effects are covered by annual dummies for the years 1991 to 1998 (not reported), which are included in several specifications, although they remain insignificant. This result is also confirmed by a joint Wald test. Table 1 reports seven formulations of (3) including various sets of explanatory variables.

In the first two specifications (3.a) and (3.b), the coefficients of the basic explanatory variables (differences in GDP per capita and country size) are very similar to those reported by Helpman (1987) and Hummels and Levinsohn (1995). However, these specifications provide a relatively poor fit for intraindustry trade of the EU, with an adjusted R^2 below 0.2, which is nevertheless comparable to the previous results. The inclusion of the additional explanatory variables markedly improves the explanatory quality. In particular, the inclusion of the remoteness indicator explains more than 80% of the variance of the EU's intraindustry trade.

The effects of trade liberalization within the EU are, as discussed above, ambiguous. It seems that the negative effects dominate if a measure of remoteness is included, as shown by (3.c) and (3.d). However, the importance of the geographical location, but not necessarily the size of transport

¹ This simple measure of distance, for example, would imply zero transport and transaction costs for Belgian trade with the EU. Note also that the geographic adjacency cannot be easily defined for the EU.

and transaction costs, is about twice as high in intra-EU trade than in trade with non-EU countries if different coefficients for these country groups are allowed,¹⁾ as shown by specifications (3.e) to (3.g). A Wald test also rejects the null hypothesis that the coefficients of the remoteness indicator are the same for EU and non-EU countries. In these specifications, EU membership is revealed to have positive effects on intraindustry trade.

However, the size of the coefficient on income per capita differential drops by about a half after the inclusion of the remoteness indicator in (3.c) and (3.d). Furthermore, the differences in income per capita turn out to be insignificant in specifications (3.e) and (3.f), when this variable even has the opposite (positive) sign. By contrast, the output of the trading partners of the EU, Y_i , is robust in all specifications of (3). The aggregate output of the EU, Y_{EU} , has no significant effects on the EU's intraindustry trade. Thus, it seems that countries' size and the distance to their markets are the most important determinants of intraindustry trade. Therefore, the last specification (3.g) provides a more parsimonious estimation of the determinants of the EU's intraindustry trade, which excludes all insignificant variables.

Table 1

Determinants of Intraindustry Trade in the EU's Trade with the OECD Countries, 1989–1998¹⁾							
Specification	(3.a)	(3.b)	(3.c)	(3.d)	(3.e)	(3.f)	(3.g)
Constant	-1.982 (-0.458)	-13.449 (- 0.411)	3.785 (1.870)	- 8.188 (- 0.540)	3.117 (1.744)	- 9.375 (- 0.702)	3.419 (12.950)
$\log |y_i - y_{EU}|$	-0.110 (-2.280)	- 0.112 (- 2.247)	- 0.057 (- 2.472)	- 0.057 (- 2.421)	0.023 (1.032)	0.026 (1.098)	
$\log(Y_i)$	0.246 (6.318)	0.247 (6.200)	0.307 (16.770)	0.307 (16.496)	0.258 (14.904)	0.258 (14.686)	0.259 (15.097)
$\log(Y_{EU})$	0.097 (0.209)	1.335 (0.377)	0.043 (0.198)	1.337 (0.815)	0.021 (0.110)	1.370 (0.948)	
<i>EU</i>			- 0.129 (- 2.040)	- 0.129 (- 2.000)	5.371 (7.489)	5.409 (7.394)	5.022 (7.941)
$\log(R)$			- 0.732 (-22.784)	- 0.732 (-22.359)			
<i>EU</i> $\log(R)$					- 1.348 (-15.875)	- 1.351 (-15.630)	- 1.309 (-17.112)
$(1 - EU) \log(R)$					- 0.611 (-18.835)	- 0.610 (-18.444)	- 0.619 (-19.709)
Annual dummies	no	yes	no	yes	no	yes	no
Number of observations	210	210	210	210	210	210	210
Adjusted R^2	0.183	0.151	0.824	0.818	0.863	0.859	0.863

Source: own calculations.
¹⁾ *T*-statistics are in parentheses.

1 This seemingly surprising result is consistent with Krugman's (1991) model of geography and trade.

4 Predictions of the EU's Intraindustry Trade with the CEECs

In contrast to the EU's trade with the OECD countries, the development of the EU's intraindustry trade with the CEECs seems to be influenced largely by short-term factors. At the beginning of economic transition, the shares of intraindustry trade increased despite sharp reductions of output in these countries. This development differs from the pattern observed in the OECD countries, which predicts a positive relation between intraindustry trade and aggregate income. Nevertheless, it may be explained by a convergence to "potential" shares of intraindustry trade given countries' structural determinants, which were discussed above. However, the dominance of the short-term adjustment results in a poor statistical performance of (3) when applied to the CEECs. Therefore, an estimation of (3) for the EU's intraindustry trade with the CEECs cannot be used to compute its equilibrium or potential shares.

Nevertheless, the results of previous estimations for the OECD countries (see table 1) may be used to compute out-of-sample forecasts for the EU's trade with the CEECs. This reflects the assumption that the CEECs are on a convergence path to stabilized developed economies. Although this approach may be doubted on the basis of the current differences between both regions, other authors successfully used this assumption to predict various macroeconomic indicators for the CEECs.

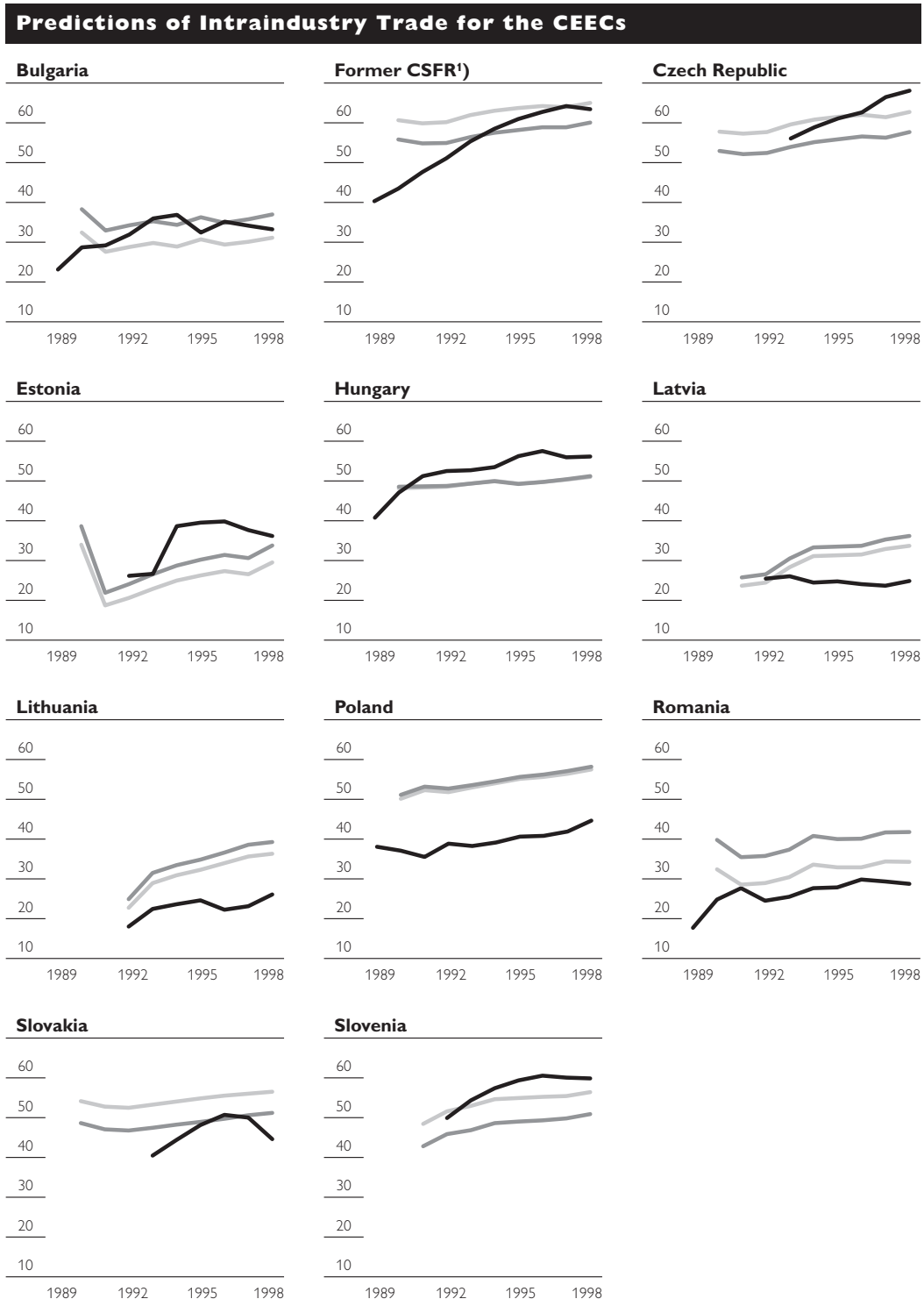
Figure 1 shows the development of intraindustry trade and the out-of-sample predictions calculated on the basis of (3.g). The estimations as computed for the EU's intraindustry trade with the OECD countries allow a comparison of predictions including and excluding the EU effects. In particular, (3.g) shows that there is a positive fixed bonus for the EU members, which is estimated by the coefficient on the EU dummy, and a negative effect for the peripheral countries (see table 1). As applied to the CEECs, the positive effects have likely dominated in the Czech Republic, Slovakia and Slovenia. Both positive and negative effects have been balanced in Hungary and Poland, while the negative effects of the peripheral location have prevailed in the other CEECs.¹⁾

The scenarios including and excluding the EU effects are computed because the structural parameters in some CEECs could already have adjusted towards their EU equivalents in a response to the Europe Agreements. Ideally, the observed shares of intraindustry trade should converge to the interval between the two predictions. However, slow reformers may still be on a convergence path to their equilibrium levels, which may even be interrupted by periods of economic crisis and reform reversals.

Indeed, figure 1 reveals the expected pattern of adjustment from a relatively low share at the beginning of transition to an equilibrium level. Former Czechoslovakia seems to be the best example of this adjustment.

1 However, this considers only the intraindustry trade of the current EU Member States with the CEECs. In general, the CEECs are not as peripherally located from the point of view of an enlarged Europe as implied by the remoteness indicator defined by (4). Furthermore, a successful catching-up in the CEECs will also shift the economic center of Europe eastwards.

Figure 1



— Development of the Grubel-Lloyd indices
 — Prediction using $\log(GLI / (1 - GLI)) = 3.419 + 0.259 \log(Y) - 0.619 \log(R)$
 — Prediction using $\log(GLI / (1 - GLI)) = (3.419 + 5.022) + 0.259 \log(Y) - 1.309 \log(R)$
 See table 1 and the text for detailed explanations.

Source: own calculations.

¹⁾ The predictions for former Czechoslovakia were computed using the total GDP in Deutsche mark of the Czech Republic and Slovakia and the remoteness indicator for the former capital, Prague.

There is a period of relatively high growth between 1989 and 1995, which is followed by a period of stabilization between both predictions. Despite a slight overestimate, a similar pattern can be seen in Hungary and Slovenia. The low shares of intraindustry trade are also correctly predicted for the EU's trade with Bulgaria.

However, intraindustry trade is somewhat overestimated in Poland, Romania, Latvia and Lithuania. The parallel development of predictions and observed shares of intraindustry trade indicates some structural problems in these countries (e.g. the high importance of agriculture and other sensitive sectors¹) in Poland). By contrast, intraindustry trade is underestimated mainly in the Czech Republic and to a lesser extent also in Slovenia and, as mentioned, in Hungary. These countries have recently experienced significant inflows of foreign direct investment with likely positive effects on intraindustry trade. Moreover, the Czech Republic may act as an inter-mediator for Slovak industrial exports.

Finally, specification (3.g) may be used to make predictions for the development of intraindustry trade in the long run. Including the EU effects and under a relatively optimistic assumption of an average annual GDP growth rate (in nominal terms converted to Deutsche mark) of 7% until 2010,²) the EU-15's intraindustry trade with the Czech Republic could reach nearly 70% of the bilateral trade volume. This indicator could be slightly lower (about 60%) in Hungary, Poland, Slovakia and Slovenia. The long-run predictions of the EU's intraindustry trade with Bulgaria, Romania and the Baltic States are between 35% and 40%.

5 Conclusions

The 1998 data indicate that the CEECs have already been participating successfully in the European division of labor. The European Union is the most important trading partner for all CEECs. The regional reorientation of Central and Eastern European trade towards the single market of the EU was associated with successful restructuring. The rise of intraindustry trade was one of the most important features of the recent developments in East-West trade in Europe.

Nevertheless, two groups of Central and Eastern European countries can be identified with respect to trade performance. The most advanced CEECs (Hungary, Slovenia and the Czech Republic) have already reached shares of intraindustry trade comparable to those of Italy, Spain and Sweden. Poland and Slovakia have reached slightly lower shares of intraindustry trade. Nevertheless, these figures are comparable to those of Finland, Portugal and Ireland. On the other hand, the shares of intraindustry trade in the EU's trade with Bulgaria, Latvia, Lithuania and Romania have still remained at the level of the share of the EU's intraindustry trade with Greece. However, the differences between these two country groups should not be overvalued, because similar differences can be found within the European Union.

¹ See Fidrmuc, Huber and Michalek (2001) for a discussion of trade in sensitive products in Poland.

² This figure assumes a real growth of about 5% and a real appreciation of about 2% on annual average.

The paper discusses the determinants of the EU's intraindustry trade with the OECD countries. In particular, income per capita differentials, which serve as a proxy for countries' endowments, turn out to be insignificant if additional explanatory variables related to trade liberalization and geographical location are included. By contrast, country size remains robust in various specifications. The aggregate output of the EU has no significant effects on the EU's intraindustry trade. Thus, countries' size and the distance to their markets are the most important determinants of intraindustry trade.

In contrast to the OECD countries, the development of the EU's intraindustry trade has been largely influenced by short-term factors. Therefore, the results of the estimations for the OECD countries are used to compute out-of-sample forecasts for the EU's trade with the CEECs. This approach is well-suited to describing the pattern of adjustment from low shares of intraindustry trade at the beginning of transition to equilibrium or potential shares as observed in Bulgaria, Estonia, Hungary, Slovakia and Slovenia. However, intraindustry trade is somewhat overestimated in Poland, Romania, Latvia and Lithuania, while it is underestimated mainly in the Czech Republic. These deviations from the equilibrium level can be partly explained by countries' structural reform performance.

Finally, long-run predictions of the development of the EU's intraindustry trade with the CEECs are presented. In 2010, the EU-15's intraindustry trade could reach 70% of the trade volume with the Czech Republic, 60% with Hungary, Poland, Slovakia and Slovenia and 35% to 40% in the EU's trade with Bulgaria, Romania and the Baltic States.

INTRAINDUSTRY TRADE BETWEEN THE EU
AND THE CEECs

Table A.1

Intraindustry Trade of Selected Countries with the EU-15																
	Austria	Belgium	Denmark	Germany	Greece	Spain	Finland	France	UK	Ireland	Italy	Netherlands	Portugal	Sweden	Switzerland	Norway
%																
1989	65.04	71.49	60.55	63.51	24.86	60.02	47.43	75.45	62.24	53.84	58.02	65.90	40.41	61.74	62.55	38.43
1990	66.55	71.92	59.64	72.30	27.30	63.37	45.30	77.79	69.73	52.99	57.85	69.15	42.99	62.31	62.44	34.11
1991	67.20	71.88	58.41	75.64	27.48	60.09	47.49	79.22	72.57	53.94	57.62	69.75	42.53	61.05	63.35	32.34
1992	67.57	72.61	59.10	74.98	25.80	63.22	47.14	80.38	73.25	51.84	56.90	70.32	41.51	61.23	64.02	33.10
1993	66.79	72.63	58.93	75.34	26.59	62.31	45.39	78.55	73.01	50.15	58.43	70.88	42.36	59.77	65.57	33.09
1994	66.90	72.26	56.92	76.17	27.78	62.08	45.53	79.20	74.37	49.69	57.89	71.55	41.92	60.23	64.37	33.33
1995	66.92	73.07	59.05	76.79	27.07	63.38	45.41	78.66	75.70	48.04	60.13	71.85	46.73	60.14	63.88	35.94
1996	67.20	74.21	59.58	76.07	26.44	64.73	45.97	78.74	75.83	49.88	59.54	72.04	50.16	60.56	64.42	34.12
1997	68.10	74.35	59.84	76.36	29.45	64.75	48.18	78.38	75.13	48.50	60.34	73.43	50.78	60.16	64.92	34.76
1998	68.01	74.57	60.76	77.01	26.35	65.94	44.48	79.54	75.17	45.65	61.38	72.90	50.48	57.30	65.02	34.98

	Bulgaria	CSFR	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovakia	Slovenia	Australia	Canada	Japan	New Zealand	U.S.A.
%																
1989	27.97	36.32	x	x	37.47	x	x	32.28	14.04	x	x	16.70	33.93	35.57	15.68	54.16
1990	30.47	41.30	x	x	42.63	x	x	32.70	23.82	x	x	18.98	37.52	37.99	15.27	57.33
1991	30.26	46.64	x	x	45.75	x	x	34.34	29.26	x	x	18.44	39.43	35.01	12.21	59.57
1992	31.31	49.72	x	17.98	48.48	16.90	11.57	35.50	25.70	x	49.11	21.07	39.67	33.10	13.31	61.30
1993	36.91	53.80	54.87	23.46	50.18	15.01	15.15	36.26	27.63	39.88	53.19	19.79	42.70	36.76	13.47	61.06
1994	35.32	56.51	56.62	35.47	51.31	17.74	19.37	37.56	30.44	43.50	55.65	18.54	41.01	39.37	14.30	60.56
1995	32.61	58.94	58.90	37.59	54.07	23.64	22.71	39.65	29.62	47.46	58.06	19.63	40.85	43.24	14.68	62.13
1996	35.23	60.42	60.33	38.09	55.24	20.93	21.20	39.41	30.29	49.65	58.67	19.97	46.03	47.32	14.74	62.64
1997	34.17	61.99	64.10	36.16	55.54	24.50	22.43	40.72	30.93	49.65	58.12	20.20	48.72	44.73	14.47	62.96
1998	34.02	61.75	66.01	29.99	57.25	22.61	26.31	44.42	29.24	44.74	58.11	22.69	49.93	38.90	17.29	63.97

Source: UN, own calculations.

Table A.2

Intraindustry Trade in the Manufacturing Sector of Selected Countries with the EU-15																
	Austria	Belgium	Denmark	Germany	Greece	Spain	Finland	France	UK	Ireland	Italy	Netherlands	Portugal	Sweden	Switzerland	Norway
%																
1989	67.36	71.02	66.09	66.15	24.64	62.76	51.21	79.79	65.85	59.41	62.22	74.98	40.60	66.30	62.72	48.48
1990	68.81	71.75	65.50	75.15	25.42	66.58	48.82	81.93	74.17	58.04	61.82	78.93	43.32	66.63	63.44	47.02
1991	69.66	71.90	63.91	79.96	24.69	63.35	52.05	83.55	77.76	58.40	61.57	79.37	41.98	64.89	64.03	45.30
1992	69.79	72.65	64.79	78.52	23.17	66.48	51.28	84.90	77.90	56.37	60.55	79.79	41.87	65.28	65.01	47.45
1993	68.73	71.36	62.78	79.59	22.46	65.44	49.20	82.28	76.41	55.31	61.02	78.00	42.10	63.34	66.43	44.89
1994	68.93	71.62	60.49	80.23	24.03	64.91	49.31	82.48	78.13	53.21	60.49	77.86	41.70	63.74	64.66	43.83
1995	67.43	72.48	61.45	80.59	23.78	65.53	47.07	81.65	79.47	50.64	62.20	77.55	45.99	62.17	64.30	46.83
1996	68.06	73.53	62.48	79.97	23.10	67.07	47.48	81.74	80.11	51.28	61.78	78.05	50.33	62.22	65.39	45.70
1997	68.93	73.25	62.75	80.15	26.10	67.25	49.95	80.98	78.75	48.94	61.67	78.62	49.97	61.79	65.76	44.24
1998	69.36	74.09	63.78	80.19	22.07	68.12	45.40	81.79	77.83	45.43	63.11	78.50	50.22	59.30	65.91	43.80

	Bulgaria	CSFR	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovakia	Slovenia	Australia	Canada	Japan	New Zealand	U.S.A.
%																
1989	23.17	39.83	x	x	40.60	x	x	37.88	17.58	x	x	18.96	43.57	36.23	23.69	58.64
1990	28.69	43.02	x	x	46.92	x	x	36.84	24.77	x	x	21.55	47.18	38.59	24.38	61.64
1991	29.23	47.18	x	x	51.15	x	x	35.27	27.60	x	x	21.74	49.59	35.43	18.74	64.08
1992	31.88	50.62	x	26.20	52.37	25.62	17.77	38.66	24.46	x	50.05	25.25	48.96	33.50	20.20	66.48
1993	35.95	54.85	56.03	26.67	52.65	26.19	22.25	38.07	25.42	40.45	54.49	21.49	52.26	37.44	19.32	65.73
1994	36.85	58.04	58.90	38.70	53.42	24.66	23.46	38.95	27.63	44.43	57.51	19.86	50.76	40.40	20.24	65.10
1995	32.38	60.52	61.07	39.51	56.20	24.92	24.43	40.41	27.84	48.12	59.55	20.55	51.11	44.41	19.58	66.96
1996	35.13	62.27	62.67	39.84	57.41	24.20	22.01	40.64	29.81	50.77	60.75	20.69	55.36	48.94	20.64	67.23
1997	34.13	63.73	66.49	37.66	55.91	23.87	22.93	41.72	29.32	50.01	60.23	20.62	57.71	46.16	20.94	66.45
1998	33.19	63.03	68.04	36.18	56.06	25.03	25.91	44.50	28.67	44.56	60.00	22.10	58.51	39.74	26.50	66.76

Source: UN, own calculations.

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The Development of the Romanian and Bulgarian Banking Sectors since 1990

Stephan Barisitz¹⁾

I Introduction

Romania and Bulgaria are currently the only two accession candidates to the EU in Southeastern Europe (with Slovenia being the third if it is included in this geographic region). In the view of outsiders, both countries have often been lumped together as reform “laggards,” although Romania and Bulgaria have frequently followed quite different paths, at times featuring substantial progress; in recent years, however, their paths have tended to diverge. A sometimes overlooked fact is that, until very recently, the external environment of both countries’ development has been especially unfavorable. The drawback derives not so much from their peripheral geographic location with respect to the major developed market economies in Western Europe, but from the fact that, again due to geography, Bulgaria and Romania have more than other transition economies been affected by the decade-long Yugoslav crisis, which obstructed transport links and regional and Western European trade with these countries and impeded inflows of FDI at times at which they would have been needed most.

Banking sectors have played a pivotal role in both countries in shaping economic developments and even triggering changes at important junctures. The close linkage of financial sector reform and industrial restructuring, or rather the lack of one or both, reemerges on numerous occasions as a decisive factor in this respect. This study aims at tracing and comparing the developments of the banking systems in the two countries since the onset of transition. For all their differences, both countries appear to have had some similar fundamental experience, which merits a chronological approach divided into a few major periods generally shared by both countries. Each chapter deals with one such period by consecutively analyzing the respective experiences of both countries. Specifically, the present study analyzes the development of legal foundations, banking supervision, banks’ major sources of assets, liabilities, earnings and related changes, bank restructuring, rehabilitation programs and the role of foreign banks and FDI, making brief reference to major traits of real sector development, given their importance for the state of health of banks.

Both Romania and Bulgaria encountered particularly difficult initial conditions for transition and the creation of market-oriented financial systems. This first phase, which started somewhat earlier in Bulgaria than in Romania, lasted well into the first half of the 1990s and is described in chapter 2. Under conditions of inconsistent or stop-and-go macroeconomic policies, sluggish structural reforms, continued widespread soft budget constraints and distorted incentives for banking activity, banks faced aggravating problems in the mid-1990s. These issues are the subject of chapter 3. The accumulation of problems led to full-blown banking crises in both countries, although the immediate causes were different, as were the effects on their economies. Bulgaria experienced its banking calamity from 1996 to 1997,

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Romania went through its crisis in the period from 1997 to 1999. Chapter 4 covers these events and the economic policy responses of the authorities, which varied substantially between the two countries. Newest developments are dealt with in chapter 5. Chapter 6 gives a summary, highlighting some important common aspects of and differences between the two countries' experiences and providing some tentative conclusions.

2 Initial Transition (until about 1993–94)

2.1 Bulgaria

The former socialist Bulgarian one-tier banking system of the 1970s consisted of three banking institutions: the Bulgarian National Bank (BNB, founded in 1879), the Bulgarian Foreign Trade Bank and the State Savings Bank. In the 1980s some modest attempts at reform were initiated. In 1981 the Mineralbank was established with the goal of extending credits to new small and medium-sized firms. In 1987 seven new “sectoral” state banks were formed mainly to reallocate long-term financing to enterprises of specific industrial branches. A further step toward decentralization of the Bulgarian banking system was taken in 1989, when 59 new (state-owned) commercial banks were spun off former BNB branches. Simultaneously, the requirement that certain banks engage in specialized lending was withdrawn. Thus, one could say that a two-tier banking system was introduced in Bulgaria that year. Most of the newly established credit institutions were small and regionally concentrated in their operations.¹⁾ In early 1991, the Bulgarian banking system consisted of the three above-mentioned big institutions plus 69 commercial banks.

Major legal changes followed only later. Among them was the Law on the Bulgarian National Bank (effective from June 1991), which established the BNB's formal independence. The BNB is, however, “accountable” to the National Assembly (the Bulgarian parliament). The BNB's degree of autonomy has actually been somewhat unclear, since parliament compelled the BNB on various occasions to extend loans to the Finance Ministry. The BNB was vested with the authority to grant and revoke licenses from commercial banks. The Law on Banks and Credit Activity (effective from March 1992) established the principle of universal banking, defined the possible legal forms of banks – a joint stock company or cooperative – and specified banking activities and licensing conditions. Commercial banks were given the right to acquire up to 10% of the stock of nonfinancial enterprises. The capital adequacy ratio of a bank had to conform to the Basel criterion of 8%. In 1992 banks were granted a period of one year to adjust to the capital adequacy requirement. This deadline was later extended to March 1995 and then to 2001. A number of important prudential regulations specifying the legal framework were adopted in early 1993, but enforcement was weak.

As in many other Central and East European countries, the collapse of central planning and of CMEA²⁾ trade (in 1990–91) and the initial shock of price and foreign trade liberalization and relative price changes in early

1 *Bulgarian National Bank (1995)*, p. 5–6.

2 *Council for Mutual Economic Assistance, byname Comecon.*

1991 precipitated an economic downturn, accompanied by a crisis in the banking sector. The initial burst of inflation – the CPI (year-end) amounted to 339% in 1991 and declined to 64% in 1993 – was accompanied by a steep devaluation of the Bulgarian lev (BGL). Since the majority of enterprises became loss-makers, debt arrears to commercial banks started to mount. The crisis was particularly serious in Bulgaria for three reasons: First, Bulgaria was more dependent than other economies on the CMEA market (which accounted for about 80% of the country's foreign trade turnover in 1989). Second, Bulgaria inherited a very high level of foreign debt (USD 10.0 billion or 87% of GDP in 1990), on which the Communist government defaulted in March 1990. Third, a peculiar legacy of the socialist Bulgarian industrialization drive is worth mentioning: The state-owned commercial banks' assets not only consisted of lev-denominated loans, but also of a large amount of investment credits denominated in hard currency.¹⁾ While the rapid inflation in the early years of transition wiped out a substantial proportion of enterprises' lev-denominated liabilities, the simultaneous fall of the lev increased the burden of servicing hard currency-denominated debt.²⁾

Although state-owned banks (SOBs) quickly faced mounting problems, newly founded private banks were free of the burden of the past and conditions in the early years of transition were such that the establishment of new credit institutions was easy. Start-up capital requirements were not high and many banks were reportedly even founded on borrowed funds. In the earlier years, banking supervision and monitoring were inadequate, especially with respect to private start-ups. Given the inflation and exchange rate dynamics and the radical changes in the foreign trade environment in the early 1990s, there were lots of short-term, trade-related and speculative sources of profits for credit institutions. The number of private banks steadily grew from 6 in 1991 to 29 at end-1994. Yet they all remained relatively small. In the same period, numerous mergers among state-owned banks caused their number to fall to 10 at end-1994. Consolidation frequently took the form of coupling financially distressed and relatively sound institutions to avoid bankruptcy. The Bank Consolidation Company was founded in 1993 to oversee the merger process and the eventual privatization of banks. One foreign bank was present in Bulgaria as of end-1994. The total number of credit institutions declined to 40 at year-end (table 3).

The simmering crisis affecting state-owned banks prompted the government to intervene and, beginning in 1991, to replace some nonperforming debt of a number of enterprises with special state bond issues. Subsequently, the initiative widened and led to the adoption by parliament in 1993 of the Law on the Settlement of Nonperforming Credits Contracted before December 31, 1990.³⁾ For this purpose bonds known as ZUNKs by the Bulgarian acronym of the above-mentioned law (*Zakon za urezhdane na neobsluzhivanite krediti*) were issued and placed in the portfolios of creditor

1 *State-owned commercial banks had been allocated hard currency-denominated investment credits from former state investment funds during the 1980s.*

2 *OECD (1997), p. 65–66.*

3 *Thus the state recognized its responsibility for policy-directed loans granted before end-1990.*

banks. While lev-denominated ZUNKs replaced the smaller amount of lev-denominated loans, approximately USD 1.8 billion of hard currency credits were covered by dollar-denominated ZUNKs. The operation was carried out gradually and only completed a year later. Both types of security did not fully cover overdue interest on respective loans; in contrast to dollar-denominated bonds, lev-denominated bonds themselves yielded below-market interest rates. Thus ZUNKs, while improving the situation of banks, still represented rather low-income assets. At the same time, they added a strain to the state budget. The ZUNK operation did not leave the SOBs to fend for themselves, as the BNB continued to provide accommodative refinancing.

Enterprise privatization only timidly started in the early 1990. Until then no meaningful initiatives at restructuring large state-owned enterprises (SOEs) had been taken. Commercial bank financing, soft budget constraints and lack of market exit mechanisms continued to prevail. Some restitution of urban property and agricultural land started in 1991–92. A general law enabling cash privatization, the Law on the Transformation and Privatization of State and Municipal Enterprises, was passed in April 1992 and started to be implemented in 1993. Progress was sluggish in the first years. Initially, the private sector mostly grew through the expansion of newly founded private firms. State-owned commercial banks accounted for the lion's share of the Bulgarian banking sector's assets and capital. Summing it up, despite major upheavals, the initial phase of transition in Bulgaria witnessed by and large the continuation of traditional financial relationships between SOBs and SOEs, complemented by the activities of some small private banks.

2.2 Romania

Given the political nature and the reactionary socialist economic policies followed by the Ceausescu regime right up to its violent overthrow in December 1989, reforms in general and banking reforms in particular started relatively late in Romania. Up to 1990, the Romanian monobank system consisted of the National Bank of Romania (NBR) and four specialized state banks: the Romanian Foreign Trade Bank, the Investment Bank (which financed long-term investment projects), the Bank for Agriculture and Food Industry, and the Savings and Loans Bank. In late 1990, the NBR gave up its commercial banking functions and transferred them to a new state-owned bank, the Romanian Commercial Bank.¹⁾ At the same time, the formal subordination as well as the sector-specific assignments of the specialized banks were abolished and these institutions were turned into commercial banks. The Investment Bank was renamed Romanian Bank for Development and the Bank for Agriculture and Food Industry became Banca Agricola. Private banking was permitted in 1990 and the first small private credit institutions appeared toward the end of that year. From that time on, the Romanian banking system effectively consisted of a two-tier structure.²⁾ The SOBs Banc Post and Eximbank were set up in 1991 and 1992.

1 *The Romanian Commercial Bank was to take up the tradition of a credit institution of the same name, founded in 1907.*

2 *Bichi (1998).*

The legal framework for these changes was established by the adoption of two laws in April 1991: the Law on the National Bank of Romania and the Law on Banking Activity. Among other prerogatives, the central bank law gave the NBR the authority to license and supervise commercial banks. The law also limited the amount of loans the NBR may extend to the state. Although the NBR is regarded as independent in the performance of its duties, it is "accountable" to parliament, and its governor and board of directors can be removed by the legislature at the request of the prime minister. The central bank's independence was infringed on some occasions by parliamentary interference (featuring orders to refinance agricultural credits, eliminate arrears, etc). Under the banking law, banks are founded as limited liability or joint stock companies and can freely compete for business within the framework of universal banking. Prudential regulations were only gradually enacted. One of the first rules referred to single customer exposure (which is not to exceed 10% of a bank's capital) and insider lending; both rules came into force in 1993. The Basel rules on calculating capital adequacy were adopted in 1994. However, implementation of the regulations was weak initially and the competent NBR departments were severely understaffed and encountered considerable difficulties in hiring and keeping qualified personnel.¹⁾

Romania was saddled with its own particularly wretched initial conditions of transition, at least in two regards: On the one hand, as alluded to above, there had been practically no attempts at reform before 1990; consequently, the Romanian population could not gather any experience with market-oriented economic mechanisms (save for the black market) prior to that year. Second, given the degree of irrationality of the Ceausescu regime's former industrialization drive, Romania's industrial structure inherited from socialism was extremely biased toward inefficient metallurgy, machine building, chemical industry and other heavy industrial branches; moreover, the regime's subsequent policy of forced and premature repayment of the country's external debt starved the entire economy of new investment throughout the 1980s, thus adding technological backwardness and dilapidation to structural distortion. Doubtlessly, this type of real sector environment provided a dismal backdrop for any market-oriented banking activity.

In an effort to wipe the historical financial slate clean, the authorities attempted to prevent debt inherited from the ancien régime from impeding the normal functioning of the banking system. In a round of successive write-offs at the beginning of the 1990s, unserviceable enterprise debts worth about half the 1990 GDP were written off against government budget deposits in SOBs or replaced by government liabilities. The authorities also provided guarantees for a number of old investment credits. Not all old non-performing loans were settled (although inflation reduced the significance of old relative to new debt), and most banks remained undercapitalized at the end of the exercise. Irrespective of these write-offs, the tightening of monetary policy in 1991, coupled with the phased liberalization of prices,

1 IMF (1995b), p. 56–57.

was accompanied by an explosion of interenterprise arrears and (new) enterprise credit arrears to the banking sector. As these arrears threatened to break down the production system, the authorities repeatedly intervened. For instance, in December 1991 parliament passed the Law on the Settlement of Outstanding Payments, instructing the central bank to address the arrears problem and clear the “blockage” of payments. This was achieved by the generalized extension of loans through the banking sector. Another state capital injection to prop up banks’ balance sheets followed in 1992. The amount equaled approximately 1% of GDP. But bad debts continued to accumulate and disrupt the economy.¹⁾

This difficult situation and the obvious lack of restructuring in the (state) enterprise sector was reflected in sluggish structural change in the banking system, where the five former specialized state banks continued to dominate by virtue of their size, branch networks and long-established contacts with SOEs, resulting in continued de facto market segmentation. With soft budget constraints prevailing, anecdotal evidence suggests that SOBs remained under pressure to lend in order to meet wage payments of big factories. As regards enterprise privatization, the government opted for a gradual approach; no major state firm was (fully or in majority) transferred to private ownership until the mid-1990s. The Law on the Restructuring of State-Owned Enterprises, adopted in November 1990, provided for the formal transfer of 30% of the capital of a large number of SOEs to eligible Romanian citizens by way of participation in investment funds. Thanks to the Law on Land Restitution (1991), substantial privatization of land took place in the early 1990s. The privatization of retail trade outlets stimulated small private start-ups, which expanded mostly in the service sector.

By end-1994 there were 20 banks in Romania, of which 7 were fully or majority state-owned and 13 privately owned. Of the latter, 3 were controlled by foreigners (table 4). The large state-owned commercial banks accounted for the bulk of deposits and customer lending in the first half of the 1990s, but this dominance was gradually eroded by the growing private banking sector, uninhibited by a legacy of nonperforming loans. All private credit institutions remained relatively small, though. Foreign-owned banks specialized on serving international clients active in Romania and on the foreign currency loan and deposit business. The interbank clearing system remained antiquated and too inadequate to allow for a prompt settlement of accounts.

1 OECD (1993), p. 34–35.

3 Banking Problems Worsen in the Mid-1990s

3.1 Bulgaria

In the mid-1990s, bank business in Bulgaria continued to be clearly dominated by SOBs. Of the ten relatively “large” banks at end-1995, nine were state-owned. The State Savings Bank (Derzhavna Spestovna Kassa, DSK) was (and continues to be) the largest SOB in terms of staff, branches and clients. Through strong competition from private banks offering higher deposit remuneration, the share of the former monopolist in household savings fell to about 30% in 1995. Until end-1995, the DSK was the only credit institution for which deposits had an explicit government guarantee. The State Savings Bank hardly lent any of its money to enterprises, but directed about half of its investment to government securities and the other half to credits on the interbank market. The State Savings Bank was at the time the largest supplier of interbank funds and the largest creditor to commercial banks after the BNB. Another unique place in the banking system was occupied by Bulbank (the former Bulgarian Foreign Trade Bank), whose equity capital in 1995 outweighed that of all other commercial banks of the country taken together and whose assets comprised more than a third of the assets of the entire sector.¹⁾ Bulbank has been extremely cautious in granting loans to firms and has specialized on the interbank market. At the beginning of 1996 the total number of banks in Bulgaria was 41. Foreigners controlled 3 of them.

Despite the fundamental changes of economic conditions for enterprise activity and industrial production after the collapse of communism, continuing political instability and short-lived governments did not allow a head-on attack on structural problems. Painful reforms were eschewed. High budget deficits and growing internal public debt as well as accumulating financial losses of the banking sector undermined confidence in the economy and, together with difficulties in imposing controls on foreign exchange transactions and capital movements, contributed to instability in the demand for money. Since there were few long-term profitable investments in Bulgaria in the first half of the 1990s, the population and investors either put their money in Bulgarian lev (BGL) accounts or opted for foreign currency accounts in commercial banks. Within the framework of a managed float of the Bulgarian currency conducted by the central bank, the major variables influencing savers’ rather short-term decisions were lev interest rates (largely determined by the basic interest rate of the BNB), CPI inflation and exchange rate developments.

As monthly inflation slowed in the first half of 1993 under an average basic annual interest rate of 60%, the relative return on lev-denominated assets began to grow. The BNB responded to the lower inflation by reducing the basic rate to 52% in the second half of 1993. This measure, coupled with a slight increase in inflation, appears to have prompted households and investors to shift their portfolios (toward hard currency), which brought about a decline in foreign exchange reserves used by monetary authorities to support the value of the lev. Despite a renewed increase of the basic rate

1 *Chaillié (1996), p. 4.*

at the beginning of 1994 (to 69%), the magnitude of depletion of foreign exchange reserves had apparently destabilized expectations too much for the decline in money demand to be reversed. In March 1994, the BNB gave up defending the lev, which subsequently depreciated by 50% against the U.S. dollar until end-April 1994. After (year-end) inflation had declined to 63.9% in 1993, the inflationary aftermath of the depreciation pushed price increases to 121.9% in 1994 (table 1).

While the immediate loss of confidence triggered by the 1994 crisis had been largely confined to the Bulgarian currency, pressures continued to build up which would eventually lead to a wider-reaching destabilization. The financial problems of the banking sector continued to worsen even though the macroeconomic situation calmed down in the second half of 1994 and the economy recorded a moderate recovery in 1994 and 1995. This recovery, which proved to be ephemeral, was driven by two main sources: large resource-oriented exporting firms primarily in the state sector (metallurgy, chemicals) and a growing private sector concentrated mostly in services, trade, agriculture and construction.¹⁾ Besides benefiting from the depreciation of the Bulgarian currency (of spring 1994), resource-oriented exporters were assisted by loose commercial bank credit, energy consumption subsidies and the acceptance of payment arrears. According to some studies, it appears highly doubtful whether most of these exporters were actually profitable.²⁾ In the mid-1990s, enterprise privatization continued to be sluggish and FDI remained marginal. These problems induced the government to launch a coupon mass privatization program, the legal foundations of which were laid in 1995.

In 1994 and 1995, the implementation of Bulgarian banking regulations remained difficult. Immediately after the exchange rate crisis of 1994 some banks managed to obtain licenses for the equivalent of very modest sums in hard currency, before minimum capital requirements were adjusted upward at the end of the year. Disregarding the two outliers, DSK and Bulbank, the capital adequacy of the remaining eight relatively large banks deteriorated from 1994 to 1995 – when it even turned slightly negative. Their loan portfolios worsened and their losses grew.³⁾ Most of these credit institutions became financially distressed over the period and received continuous refinancing support from the BNB as well as interbank credits from the State Savings Bank. Mineralbank and Economic Bank (Stopanska banka) accounted for the majority of BNB refinancing – at times absorbing daily liquidity injections – and were additionally subject to repeated and varying bailing-out attempts and strategies by the authorities. These bailing-out schemes consumed a large amount of resources and ultimately proved to be unsuccessful.

Most privately owned medium-sized and small banks do not seem to have fared better. While they appear to have largely fulfilled capital adequacy requirements, their declared losses expanded much faster than those of

1 OECD (1997), p. 21.

2 See e.g. Avramov and Sgard (1996).

3 These indications correspond to the Bulgarian accounting rules, which until 1996 differed substantially from those of the IAS.

SOBs, and their loan-loss provisioning was worse. The central bank has generally been less able to verify the accuracy of the information provided by medium- and small-sized banks than that provided by the SOBs. For lack of bank bankruptcy legislation, the BNB revoked the licenses of two private banks in 1995. But the latter appealed to the Supreme Court, which overruled the BNB's decision. Although the public authorities (BNB, DSK and government) are estimated to have injected financial resources amounting to about 15% of GDP into the entire banking sector in 1995, the total declared losses of the sector surpassed 3% of GDP that year.

Strongly distorted incentives appear to be among the major reasons why even private banks actively engaged in loss-making lending. Some of these interacting incentives were: widespread lack of structural adjustment, soft budget constraints in the state-owned enterprise sector, weak enforcement of property rights, insufficient banking supervision and lack of accountability for bank bankruptcy. The resulting "culture of nonpayment" is believed to have set the stage for a so-called "interface" between the state and the private sector, with loss-making firms and banks receiving resources from the budget and the monetary authorities. These resources were eventually channeled to the private sector via transfer pricing or other mechanisms.¹⁾ Such behavior appears quite rational (from a microeconomic point of view), as long as the state can be expected to stand ready to assist its own loss-making firms and bankers can get away without facing responsibility for incurred losses. This comes on top of adverse selection and moral hazard plaguing distressed SOB's behavior.

1995 and the first months of 1996 in many respects saw a repetition of what had happened to monetary and exchange rate policy in 1993 and the beginning of 1994, but the dimensions of the ensuing crisis turned out to be much more serious. Monthly inflation rates declined in late 1994 and (year-end) inflation fell to 32.9% in 1995. Given the continuing high basic interest rate at the beginning of 1995, a dramatic increase in the demand for leva led to a rapid rise in foreign exchange reserves, triggering a new attempt by the authorities to bring down interest rates in line with inflation. A growing budget deficit exerted much of the pressure for this attempt, owing to low tax revenue and expanding domestic and foreign debt service (after ZUNK bonds had been distributed and the Bulgarian government had achieved a rescheduling agreement with the London Club of creditors and started debt repayment). The general government deficit rose from 3.9% in 1994 to 5.7% of GDP in 1995 (table 1).

In a number of successive moves, the authorities cut the basic rate from 98% in March 1995 to 39% in August. This provoked a strong portfolio reshuffling away from the lev, associated with a big drop in foreign exchange

1 To mention just two examples: A state firm and a small private enterprise whose management is related or identical to that of the state firm enter into preferential relationships. The private firm either supplies an overpriced input to or purchases underpriced products from the state company. The two companies thus engage in "profit privatization," a particular kind of asset stripping. Or a private bank extends a loan to a related private company that subsequently "defaults" on this loan. The bank then counts on being bailed out by the monetary authorities. See Dobrinsky (1997), p. 16, and Rozenov (1996).

Table 1

Macroeconomic and Monetary Indicators for Bulgaria											
Year	GDP growth (real)	CPI inflation (year-end)	Exchange rate (BGL/USD, year-end) ¹⁾	Exchange rate (BGL/EUR or ECU, year-end)	Basic interest rate (year-end)	Broad money (M3, year-end)	Broad money (M3, year-end)	Budget balance (general government)	Current account balance	Gross foreign currency reserves (excl. gold, year-end)	External debt (year-end)
	%		BGL		% p.a.	change in %	% of GDP			USD mn	% of GDP
1990	- 9.1	49.8	0.007	0.004	..	12.2	109.3	- 4.9	-10.2	-	87.0
1991	-11.7	338.9	0.022	0.029	70.0	110.0	76.0	- 3.8	- 5.3	0.33	145.0
1992	- 7.3	79.2	0.024	0.030	41.0	53.7	79.0	- 2.9	- 4.2	0.90	160.4
1993	- 1.5	63.9	0.033	0.036	52.0	47.6	78.3	- 8.7	-10.1	0.66	127.7
1994	1.8	121.9	0.066	0.081	72.0	78.6	79.5	- 3.9	- 0.3	1.00	116.8
1995	2.9	32.9	0.071	0.093	34.0	39.6	66.3	- 5.7	- 0.2	1.24	77.4
1996	-10.1	310.8	0.487	0.611	180.0	124.5	74.9	-10.4	0.2	0.52	97.7
1997	- 7.0	578.6	1.777	1.976	6.7	359.3	35.3	- 2.1	4.2	2.12	95.8
1998	3.5	0.9	1.675	1.956	5.1	9.6	30.6	0.9	- 0.5	2.68	83.7
1999	2.4	6.2	1.947	1.956	4.5	11.4	32.3	- 0.9	- 5.5	2.90	80.5
2000 ²⁾	5.8	11.4	2.100	1.954	4.6	26.5	36.3	- 1.0	- 5.7	3.46	85.0

Source: IMF, EBRD, WIW, BNB.

¹⁾ Calculated in new Bulgarian lev.

²⁾ Preliminary data or estimates.

reserves, which started in the second half of 1995. Given the above-mentioned deterioration of the banking sector as well as the collapse of a number of financial pyramid schemes in mid-1995, the population began to lose confidence in the banking sector in the fall of 1995 and started withdrawing deposits, especially hard currency deposits. The BNB responded by stepping up the refinancing of commercial banks and establishing an explicit – although only partial – deposit insurance scheme in December 1995. The monetary expansion further exacerbated the situation of the foreign exchange market. By the time the authorities had once again jacked up the interest rate (February 1996), expectations that the BNB could defend the lev and prevent a full-blown banking crisis were evaporating. The destabilization was reinforced by the widely known prospect of more than USD 1 billion of external debt service due in 1996.

3.2 Romania

After the initial transition shock, real GDP growth turned positive in 1993 (+1.5%) and culminated in 1995 (+7.1%). Like in Bulgaria, two factors have been driving that growth: industrial exports and private sector activity. Industrial exports were concentrated in largely unstructured heavy industrial enterprises, dependent on energy and raw material imports and supported by a highly subsidized official exchange rate and preferential foreign currency allocations by the authorities. Since no major privatizations had taken place, private sector growth emanated from small firms in trade, services and private agriculture. Given the lack of structural reforms, the described growth pattern appeared unsustainable. Consumer price inflation (year-end), which had hovered at high levels in the early 1990s, contracted from 296% in 1993 to 27.8% in 1995 (table 2).

A strong increase in nominal interest rates in the fourth quarter of 1993 and the beginning of 1994 had contributed to moderating inflation. Real interest rates turned positive at the beginning of 1995. The situation changed

in 1996, when external demand from the principal markets in Western Europe weakened. The government then attempted to stimulate internal demand (1996 being an election year); budgetary policy was loosened and the NBR was asked to finance the enlarged budget deficit.¹⁾ This quick recourse to the NBR reflected the relatively weak political status of the monetary authorities at the time. The monetization of the shortfall boosted money and credit and pushed up the inflation rate to 56.9% in 1996. Real interest rates once again dipped to below zero.

In this unstable environment, the situation of commercial banks on the whole continued to deteriorate. Although the monetary authorities had voiced their intention to reduce the share of directed credits (with heavily subsidized interest rates) in the refinancing of credit institutions, no progress was achieved in this respect. Directed credits lent by commercial banks to different sectors of the economy (notably to agriculture and the energy sector) made up more than 50% of the central bank's refinancing volume in 1996. Owing to mounting competition from private banks which offered higher deposit interest rates, the share of the previously monopolist Savings and Loans Bank (*Casa de Economii si Consemnatiuni*, CEC) in total household deposits declined to about a third in 1996. Traditionally, the CEC has only invested in government securities and interbank credits. Meanwhile, the legal framework, although being formally improved, remained insufficiently enforced. In 1994, Romania adopted the Basel Accord capital adequacy standards. In 1995, minimum capital requirements and loan-loss provisioning obligations were raised, on-site inspections of banks by the NBR were launched and efforts at harmonizing national accounting standards with IAS were initiated.

Despite these steps, the financial state of two middle-sized private banks worsened alarmingly: Credit Bank and Dacia Felix Bank both engaged in unwise, predominantly insider and connected party lending. Dacia Felix moreover falsified its financial statements and committed fraud according to NBR reports. These two banks perhaps present particularly glaring examples of the lack of "banking culture" in Romania in the mid-1990s. Individuals, groups and institutions frequently viewed bank ownership as a way of solving cash flow problems.²⁾ After borrowing extensively on the interbank market, Credit Bank as well as Dacia Felix Bank became insolvent in 1995. Up to 1996 both banks received substantial amounts of "special credits," i.e. particular refinancing loans granted to distressed banks by the monetary authorities. After about one year of liquidity support and in the absence of clear legal provisions for dealing with bank insolvency, the NBR in mid-1996 petitioned the courts to declare the two institutions bankrupt according to the commercial code.

Over these years the private sector accounted for an increasing share of loans and overdue loans. In fact, the private sector's share in the total volume of nonperforming loans reportedly increased from about one third at end-1994 to about 60% at the end of 1996. Belief in the stability of the private

1 The general government deficit increased from 2.5% of GDP in 1995 to 3.9% of GDP in 1996.

2 Tsantis (1996), p. 15.

sector was further undermined by the collapse of a number of pyramid schemes in 1994–95, the largest of which was reported to have attracted deposits equal to almost USD 1 billion. Subsequently a number of mutual funds were established in 1995 which in fact operated as informal banks. Some of these funds were wound up in the spring of 1996, following the enforcement of rules on the computation of their net asset values.¹⁾ In 1996 a limited bank deposit insurance system – the Deposit Guarantee Fund – was established by government ordinance. The scheme covers all deposits in commercial banks up to a level of ROL (Romanian leu) 10 million (approximately USD 3,000 in 1996). Deposits at the CEC are excluded from the scheme and are fully guaranteed by the state. The continuing lack of a bank bankruptcy law may have contributed to explaining the slow reaction of the NBR to the problems of Credit Bank and Dacia Felix. Interest rate spreads in the banking system remained high, reflecting generally high credit risks.

In Romania, 31 banks existed at the end of 1996. The state continued to own 7 of them fully or in majority, and 24 were entirely or mostly in private ownership, with foreigners owning 8 of these 24 (table 4). All private banks were newly founded institutions; between them, they represented only about one fifth of total bank assets. At the end of 1996, four big fully state-owned banks – Banca Agricola, the Romanian Commercial Bank, Bancorex (the Romanian Foreign Trade Bank) and the Romanian Bank for Development – together accounted for 66% of total assets, 76% of total credits, 63% of all leu deposits (of both households and enterprises), 60% of foreign exchange deposits and 71% of total capital. Adding the Savings and Loans Bank (CEC) brings the share of the five big state banks in total leu deposits to 78%.

The segmentation of the banking system persisted, with the big state-owned banks continuing to essentially finance their long-term clients: public sector enterprises.²⁾ The share of overdue loans in total loans of the above-mentioned four big SOBs augmented from 4% at end-1993 to 15% at end-1996 (according to Romanian accounting standards).³⁾ The continued increase of nonperforming loans in 1996 was particularly worrying, given that year's relaxed monetary policy and declining interest rates. The two SOBs encountering the most difficulties were Banca Agricola and Bancorex, each having granted large credits to their traditional clients – notably in the agricultural, energy and foreign trade sectors –, which in many cases were not able to reimburse these credits. Banca Agricola lent almost exclusively to the farming sector and state-owned agribusiness enterprises. Bancorex was particularly engaged in supplying hard currency loans to petrochemical

1 *IMF (1997)*, p. 168.

2 *Doltu (1999)*, p. 2–3.

3 *The fact that nonperforming loans did not expand as quickly in the SOB sector as in the private sector in the years up to end-1996 can be explained by the overwhelming share of directed credits extended by the NBR to the state-owned credit institutions. These soft refinancing loans masked the very low quality of most respective claims.*

Table 2

Macroeconomic and Monetary Indicators for Romania											
Year	GDP growth (real)	CPI inflation (year-end)	Exchange rate (ROL/USD, year-end)	Exchange rate (ROL/EUR or ECU, year-end)	Interbank interest rate (year-end)	Broad money (M3, year-end)	Broad money (M3, year-end)	Budget balance (general government)	Current account balance	Gross foreign currency reserves (excl. gold, year-end)	External debt (year-end)
	%		ROL		% p.a.	change in %	% of GDP			USD mn	% of GDP
1990	- 5.6	37.7	35	47	3.8	22.0	59.9	1.0	-7.9	0.03	3.0
1991	-12.9	222.8	189	253	19.5	101.2	46.9	0.6	-4.1	..	7.4
1992	- 8.8	199.2	460	557	43.6	79.6	30.8	-4.6	-8.0	0.09	16.5
1993	1.5	295.5	1276	1424	61.4	141.0	22.3	-0.4	-4.5	0.04	16.1
1994	3.9	61.7	1767	2173	64.3	138.1	21.4	-2.2	-1.4	0.53	18.3
1995	7.1	27.8	2578	3384	45.2	71.6	25.3	-2.5	-5.0	0.28	19.1
1996	3.9	56.9	4035	5182	55.3	66.0	27.9	-3.9	-7.3	0.55	24.3
1997	- 6.1	151.4	8023	8859	90.3	104.9	24.8	-4.6	-6.1	2.09	27.1
1998	- 5.4	40.6	10951	12814	136.4	48.9	27.5	-5.0	-7.7	1.37	26.1
1999	- 3.2	54.8	18255	18345	..	44.9	25.7	-3.5	-3.8	1.53	25.8
2000 ¹⁾	1.6	40.7	25926	24142	..	26.8	22.0	-3.7	-3.9	2.50	27.8

Source: IMF, EBRD, WIIW, NBR.

¹⁾ Preliminary data or estimates.

plants and energy utilities to finance fuel imports from abroad. It relied on the highly subsidized official exchange rate.

The lack of creditworthiness of many recipient firms was not only due to inefficiency or bad management, but also to external constraints (e.g. price controls) imposed on these firms. Insufficient definition of property rights (particularly in agriculture) often blocked the recovery of problem loans. Furthermore, political interference and pressures to “promote” production and “assist” sectors in need continued to make themselves felt. Thus, SOBs in many cases constituted de facto state agents distributing quasi-fiscal subsidies which were either (subsequently) refinanced by the NBR, or they banked on eventually being bailed out by the monetary authorities or the Romanian state.¹⁾ Such self-fulfilling expectations are typical examples of moral hazard and have tended to reinforce adverse selection.

Mirroring the structural problems of the banking system, enterprise privatization and restructuring did not witness any major breakthrough in the mid-1990s. The most popular privatization method in the period between 1993 and 1995 were MEBOs (management and employee buyouts), focusing on small and medium-sized firms. In 1995 the government launched a second mass privatization program (after the one of 1990), which drove up the privatized share of companies subject to the program to a maximum of 60%.²⁾ But the behavior of privatized companies did not exhibit substantial changes, since hardly any new capital had been injected, management often remained unchanged and the state retained important stakes. In June 1995 the Commercial Bankruptcy Law was adopted. But the application of this law was hampered by a weak institutional framework and the lack of appropriately trained judges.

1 OECD (1998), p. 88–89.

2 Law on the Acceleration of the Privatization Process (adopted in June 1995).

4 Banking Crises and Economic Policy Measures

4.1 Bulgaria (1996–97)

By the beginning of 1996, the serious financial instability that had emerged in the fall of 1995 turned into a full-blown crisis. The vicious circle of increasing financial support to loss-making banks exerting pressure on the exchange market and thereby depleting foreign exchange reserves ran its course. In the spring of 1996 the BNB was compelled to accept a strong devaluation of the lev, which gave rise to a subsequent explosion of prices. Annual inflation expanded almost tenfold to 311% in 1996 (table 1). Between September 1995 and May 1996 liquidity equivalent to almost 6% of GDP was injected into the banking system, a clearly unsustainable policy. Mass bank runs mushroomed after the eruption of the exchange rate crisis.

In April 1996 the authorities finally presented a sweeping policy reform project the principles of which attracted the support of the IMF. Ensuing emergency negotiations with the Fund and the World Bank resulted in the elaboration of the 1996 Action Program of the Bulgarian government, which was endorsed by the international financial institutions and laid the foundation for an IMF-approved stand-by arrangement in mid-1996. The Action Program featured a series of strict measures addressing the deteriorating situation in the banking sector and in the economy as a whole. The program essentially dealt with the bankruptcy (liquidation) of several big enterprises and banks and with the isolation of other banks threatening to go bankrupt from any activity involving bank credit.

The execution of the program was kick-started by the BNB, which placed five banks under “conservatorship” in mid-May 1996 and filed applications to the courts for their bankruptcy. Conservatorship is a legal state whereby the activities of a bank are essentially suspended and the institution is placed under the control of an appointed “conservator.” Among the five banks were the largest private credit institution (First Private Bank) and one of the two most troubled state banks (Mineralbank). This move was made possible by the quick passage earlier in May 1996 of important amendments to the Law on Banks and Credit Activity which greatly expanded the BNB’s power to regulate commercial banks and established conservatorship and bankruptcy proceedings for banks. The amendments were accompanied by an enhancement of the deposit insurance scheme (of December 1995). In an attempt to placate depositors, the government provided full guarantee for household deposits and up to 50% guarantee for corporate deposits. State bonds were issued to cover liabilities to depositors of these banks. But bankruptcy proceedings turned out to take longer than expected.¹⁾

Subsequently, seven SOBs were recapitalized, essentially via a purchase from Bulbank of USD 400 million of ZUNK bonds and the transfer of these bonds to selected banks (“Bulbank scheme”). Given the degree of decapitalization throughout large parts of the banking system, this measure had only limited effect. All the recapitalized banks and seven private credit institutions with a negative capital adequacy were required to sign special Memoranda of Understanding, setting explicit guidelines under which these banks were to

1 IMF (1999a), p. 86–87.

strive for solvency and the satisfaction of prudential regulations and to achieve a capital adequacy of 2% by end-1997 and of 8% by end-2000. BNB refinancing was generally curtailed.

At the same time 64 enterprises, accounting for an estimated 29% of total economic losses in 1995 and employing roughly 25,000 people, were put on a "liquidation list," i.e. identified for immediate shutdown. This measure was accompanied by a special World Bank-financed program to assist workers laid-off by these firms. Another 70 enterprises, representing an estimated 58% of losses, were put on an "isolation list." These enterprises were to be isolated from commercial bank credits, while the service of their outstanding liabilities was simultaneously suspended. They were to face liquidation unless they managed to operate profitably under these "pure cash flow" conditions. But the winding up of most of the enterprises on the first list took longer than anticipated.¹⁾

As the crisis and depositors' panic did not substantially subside over the summer months of 1996 despite the announcement of the Action Program, the authorities were forced to take further measures in the fall of that year. A second wave of conservatorship and insolvency proceedings was initiated for another 9 banks at end-September 1996, reducing the total number of credit institutions permitted to conduct normal operations to 13. The basic interest rate was raised to an all-time high of 25% per month. Furthermore, the government announced a special emergency privatization program targeting some of the most valuable Bulgarian companies, with priority given to sales to foreign investors, in order to provide funds to meet the claims of depositors of affected banks. However, the insufficient speed of the actual implementation of these and other measures mentioned above as well as the high extent to which the incumbent socialist government was responsible for the crisis appear to have hampered the swift shoring-up of confidence in the banking system and the restabilization of the economy.

In the second half of 1996, the financial crisis spilled over into the real sector. Accelerating inflation substantially cut living standards and domestic demand while the harsh measures taken against some banks and large enterprises cut banks' incentives to lend to the nonfinancial sector, thus partially depriving firms of "soft" credits. As economic activity sharply contracted in most sectors, real GDP plummeted 10.1% in 1996 (table 1). The jobless rate rose to 12.5% at end-1996. The economic slump and the devaluation of the lev had a crippling effect on the state budget's capacity to service internal (ZUNK bonds) and external hard currency debt. Despite primary budget surpluses, the general government deficit increased from 5.7% of GDP in 1995 to over 10% in 1996. With the crisis approaching its climax, the largest part of the budget gap was covered by an emergency credit extended by the BNB to the Ministry of Finance in December 1996 after a decision by parliament to amend the budget deficit.²⁾ This was followed by a total collapse of the exchange rate and full-blown hyperinflation in the first months of 1997.

1 OECD (1997), p. 96.

2 Balyozov (1999a), p. 10.

At the height of the crisis in February 1997, the lev plunged to over 3,000 leva per 1 U.S. dollar (from 71 at end-1995), and monthly inflation exceeded 240%. The interbank market ground to a halt. Annual inflation jumped to 579% in 1997, with GDP falling another 7.0% that year and unemployment reaching 13.7%.

Given the degree to which it engulfed the financial sector and its monetary effects and repercussions on the real sector, the Bulgarian banking crisis of 1996–97 no doubt proved to be one of the most serious domestic financial crises of transition economies (so far), if not the most serious. The pervasiveness of “soft lending” and the extent to which distorted incentives were entrenched in Bulgaria prior to the crisis as well as the rigor of the ensuing rupture may be seen as some of the major factors explaining the dimension of the Bulgarian calamity. Of course, as the Bulgarian economy is small, spillover effects into other countries were modest, compared e.g. to the Russian crisis of 1998.¹⁾

The crisis triggered a dramatic redistribution of wealth toward holders of hard currency assets, whereas the negative real return of lev deposits reduced the value of the latter by almost 90%. In February 1997 the incumbent government finally yielded to demands for early elections and the appointment of a caretaker administration of opposition leaders empowered to conduct new negotiations with international financial institutions (IFIs). In March, the caretaker administration reached a major preliminary agreement with the IMF and the World Bank on a comprehensive stabilization and reform program. This, together with a strong political mandate provided by a clear victory of the opposition party United Democratic Front in April 1997, proved critical in restoring confidence, calming expectations and stabilizing the chaotic situation. A centerpiece of the new 14-month stand-by arrangement (of SDR 372 million or about USD 530 million) approved by the IMF the same month was the establishment of a currency board regime to support strong commitment to a fixed exchange rate. The arrangement was also supported by pledges from the World Bank and the EU.

The currency board has now been in operation since July 1, 1997. The Bulgarian authorities opted for the Deutsche mark as a reserve currency, given their strategic medium-term goal of joining the European Union. They announced their intention to maintain the currency board at the established exchange rate of BGL 1,000 : DEM 1 (adjusted to the euro at the same cross rate at the beginning of 1999) until their future entry into the EU and EMU.²⁾ As regards the banking sector, Bulgaria’s arrangement slightly deviates from a “pure” currency board regime: the central bank maintains a “Banking Department” equipped with a limited refinancing facility to be used only in case of emergency (systemic risk). The refinancing facility relies on surplus foreign reserves built up by the monetary authorities in excess of those necessary to fully back the currency. The stand-by arrangement also provided for the restructuring of domestic government debt and strength-

1 For an assessment of the spillover effects of the Russian banking crisis on other CIS economies see Barisitz (2000), p. 67–99.

2 Balyozov (1999b).

ened budgetary discipline and incomes policies. Many goals of the previous Action Program were maintained, and a number of further targets were set for enterprise restructuring and privatization.¹⁾

After the extreme spike in February 1997, monthly inflation fell to 12% in March, dipped below zero in April and remained at low one-digit levels for the rest of the year. The BNB began adjusting monetary policy in spring in preparation of the new regime. It stopped bank refinancing and lending to the government and discontinued interventions on the domestic market. Interestingly, the above-mentioned dramatic depreciation of the lev and the hyperinflation in fact eased the economic plight of a number of commercial banks by devaluing their lev liabilities, “recapitalizing” them with capital gains on their foreign currency assets (mostly dollar-denominated ZUNK bonds). While some rescheduling was carried out for government liabilities, skyrocketing inflation strongly improved the budgetary situation for the government (in the short term), given that many expenditure items, in contrast to revenues, were nominally fixed. Much of the price for these “windfall gains” of some big banks and the fiscal authorities was paid by many low-income earners, who saw their living standards deteriorate even further.

The (amended) banking law and the central bank law were replaced by a new Law on Banks and a new BNB law (both effective in July 1997), upholding the additional powers the BNB had acquired in mid-1996 and defining its position within the new currency board framework. By early 1998, courts had declared bankrupt almost all of the above-mentioned banks for which the BNB had petitioned bankruptcy proceedings. Two credit institutions were sold to outside investors. But the actual liquidation of these banks has proved to be a prolonged process. Prudential regulations and supervision were strengthened and much more strictly enforced in 1997. New capital adequacy requirements established accounting procedures paralleling those of the EU and targeted the step-by-step attainment of even higher ratios than those laid down by the EU. Privatization of the big SOBs finally started in 1997. United Bulgarian Bank – the country’s third largest bank – was sold in July 1997 to a consortium consisting of the EBRD, a foreign strategic investor and Bulbank. The same year, First Investment Bank (one of the ten largest banks) was sold to the European Privatization Investment Company (of Austria) and the EBRD. Confidence returned to the Bulgarian banking system in the second half of 1997. The fiscal situation also improved markedly and the general government deficit declined to 2.1% of GDP in 1997 (table 1).

While 28 commercial banks were active at the end of 1997 (down from 42 a year earlier), three quarters of all assets were concentrated in 7 large banks, 5 of which remained in state hands. The state’s share in total banking assets fell from over 80% at the end of 1996 to about two thirds a year later. Seven foreign-owned banks accounted for around 15% of assets. Apart from the privatization of United Bulgarian Bank, 1997 did not see any major infusion of capital into credit institutions. Still, the above-mentioned implicit

1 OECD (1999), p. 27–28.

“recapitalization” as well as a far-reaching change of banks’ behavior in extending credits to the real sector in favor of a much more cautious approach explain a great deal of the dramatic improvement in the capitalization, solvency and liquidity of banks observed over the year 1997. By December 1997, measured capital adequacy of the banking sector surpassed 20% of risk-weighted assets (table 3). In 1997 incentives and constraints for banks had changed substantially and the time of soft credits was, by and large, over. Lending to enterprises became less important and banks placed most of their assets in domestic and foreign securities, while maintaining high cash balances.¹⁾ Depositor confidence, however, did not return quickly after the devastating experience of the banking crisis; the share of deposits denominated in foreign currency exceeded 50% at end-1997 and short-term deposits became the main source of bank funding, reinforcing banks’ cautious lending behavior.

Enterprise restructuring, privatization and FDI made some first important steps forward in the second half of 1996 and in 1997. Although the liquidation of targeted firms was delayed, the Action Program’s “lists” phased out traditional patterns of behavior for a sizeable part of the economy. Furthermore, the curtailment of commercial credit tightened liquidity constraints of industrial firms at a time when successful restructuring might have afforded substantial investments. A voucher-based mass privatization program was finally launched in late 1996. Cash privatization revenues in hard currency doubled in 1996 and yet again in 1997. One of the factors pushing this development was the emergency privatization program of late 1996. In 1997 alone, funds amounting to USD 1.5 billion were contracted. A large part of this sum came from sales to foreign strategic investors. Yet, by end-1997 only about one fifth of state enterprise assets had been transferred to private ownership.

Table 3

Banking Sector-Related Indicators for Bulgaria								
Year	Number of banks (of which foreign-owned, year-end)	Asset share of state-owned banks	Deposit rate (one month, year-end)	Lending rate (less than one year, year-end)	Domestic credit (year-end)	Domestic credit to enterprises	Bad loans	Capital adequacy (capital/risk-weighted assets, year-end)
	number	%	% p.a.		% change	% of GDP	% of total loans	%
1991	75 (0)	..	57.7	83.9	..	7.2	..	..
1992	79 (0)	..	45.3	64.6	57.2	5.8	..	..
1993	41 (0)	..	53.6	83.7	56.0	3.7	6.6	..
1994	40 (0)	..	72.3	117.8	37.1	3.8	6.8	8.6
1995	41 (3)	..	25.3	51.4	16.8	21.1	12.6	4.6
1996	42 (3)	82	211.8	480.8	216.8	35.6	14.6	10.8
1997	28 (7)	66	3.0	13.9	155.5	12.6	12.9	23.4
1998	..	..	3.3	13.3	- 17.7	12.7	..	36.7
1999	27 (14)	48.9	3.3	14.1	0.2	14.6	12.0	41.6 ¹⁾
2000 ²⁾	34 (25)	20 ³⁾	3.1	12.1	5.0	..	..	..

Source: IMF, EBRD, BNB.

¹⁾ September 1999.

²⁾ Preliminary data or estimates.

³⁾ September 2000.

1 A detailed discussion of the reasons for Bulgarian banks’ reluctance to lend during and after the crisis of 1996–97 is furnished by Koford and Tschogl (1999), p. 123–151.

4.2 Romania (1997–99)

The crisis that shook the Romanian banking sector between 1997 and 1999 (and partly continued thereafter) was less severe than the Bulgarian crisis in 1996 and the beginning of 1997 (see chronology in table 7). Up to a point, in Romania, things did not deteriorate as much as come into the open. The less profound nature of the Romanian crisis may have been a political handicap in that it did not forge such a clear basic consensus in the population and the political elite that fundamental changes were required. This may have facilitated the early reemergence of political struggles within the government, which contributed to slowing and somewhat watering down reforms.

The parliamentary election victory of the opposition center-right parties in November 1996 led to the formation of a new government which put forward a macroeconomic shock therapy and a structural reform program at the beginning of 1997. Negotiations to receive the support of the IMF and the World Bank were immediately started. Among the major tenets of the program were: a tightening of monetary policy, the liberalization of certain consumer prices (energy, public services and food) and of the official exchange rate, the termination of directed NBR credits and the replacement of these quasi-fiscal subsidies by explicit budgetary subsidies (to be reduced successively), a strengthened banking legislation and the accelerated privatization of enterprises and credit institutions.¹) In February 1997 the authorities liberalized the exchange rate and started price liberalization. Directed credits were discontinued, but the budget did not fully take over the burden. In April 1997 the IMF approved a 14-month stand-by arrangement providing a credit of SDR 302 million (about USD 430 million) to support the new government's program. The World Bank committed funds of USD 560 million in the same month.

Inflation increased to 151% in 1997. This was attributed not only to price and exchange rate liberalization at the beginning of the year, but also to some weakening of the monetary stance later on. Price dynamics then declined, but given stop-and-go monetary policies, inflation still stood at 55% in 1999. Fiscal policies in 1998 turned out to be more relaxed than originally planned. The IMF stand-by arrangement veered off track in early 1998. Exchange rate liberalization and the termination of directed credits left the two most strongly concerned SOBs – the already fragile Banca Agricola and Bancorex – in increasingly distressed situations. The initial austerity and the curtailment of the traditional subsidization of Romania's large heavy industrial and agricultural sectors triggered strong cutbacks in industrial and farm output, bringing about a 6.1% contraction of real GDP in 1997. The economy continued to decline in the following two years, but at a decelerating pace (1999: –3.2%). Unemployment rose from 6.6% at end-1996 to 8.9% at end-1997 and 11.8% at end-1999. Real interest rates turned positive again in 1998 and continued their positive development in 1999. After the budget had taken on part of the quasi-fiscal subsidies, the general government deficit climbed to 4.6% of GDP in 1997 and maintained its high level in 1998, before contracting somewhat in 1999 (table 2).

1 OECD (1998), p. 72–73, p. 76–77.

Following the measures taken at the beginning of 1997 and the economic slowdown, the problem of nonperforming loans worsened, or actually became more visible. Given the continued weaknesses in banking legislature and some emerging uncertainty owing to the renewed political instability, many commercial banks became more cautious lenders. This apparently did not apply to Bancorex and Banca Agricola. The authorities are reported to have bailed out these two big ailing SOBs at a cost of about USD 1 billion in government bonds in late 1997. However, no serious restructuring plan was elaborated for Bancorex, the larger of the two institutions and the largest Romanian commercial bank in 1998. Even after the capital infusion, about 70% of Bancorex's loan portfolio was classified as nonperforming. Although a new management team was appointed in April 1998, the bank's situation continued to deteriorate.

Although the government initiated a restructuring plan for Banca Agricola, which succeeded in reducing the number of retail branches and cutting staff, the bank's management practices did not fundamentally change. Much of its investment remained nonmarket-determined and nontransparent, such as placements with risky and weakly supervised investment funds. The two ailing credit institutions continued large-scale distress borrowing, which pushed up interest rates in 1998. These high rates, in turn, contributed to worsening financial conditions for the business sector and thus exacerbated banks' problems.

The first half of 1998 witnessed an improvement of the legal situation: a new Law on the NBR, a new Law on Banking Activity and a Bank Insolvency Law were adopted during this period. The new central bank law strengthened the powers of the NBR, focusing its monetary policy authority on maintaining price stability. The NBR may only extend loans to the government under very restrictive and specified terms. The commercial banking law also appears satisfactory and has brought Romania closer to international standards. On its basis, a number of new and revised prudential regulations were passed to progressively tighten standards. By contrast, legislation on bank bankruptcy still seems to suffer from serious shortcomings. Although an Asset Recovery Agency (AVAB) was created to take on bad debts and work out loans, the law leaves the determination of a bank's insolvency to the courts instead of the NBR (in its capacity as banking supervisor), and the procedure to initiate bankruptcy proceedings remains cumbersome and ineffective.¹) On January 1, 1998, Romania adopted a new chart of accounts broadly in line with the French accounting system close to IAS. However, specific deviations from IAS continue to exist and underprovisioning has been widespread.

Major structural progress in banking reform was only achieved in 1999. Supported by a new ten-month IMF stand-by arrangement approved in August 1999 (SDR 400 million or approximately USD 547 million), the authorities carried through their first series of important bank privatization measures: The Romanian Bank for Development (a large credit institution) and the medium-sized Banc Post were both privatized in the first half of the

1 Frecaut and Wang (2001).

year. In both cases, controlling stakes were sold to strategic foreign investors. 51% of the Romanian Bank for Development went to the French bank Société Générale, while General Electric Capital Corporation (of the U.S.A.) and Banco Português de Investimento acquired 45% of Banc Post. The share of total private capital in both Romanian institutions increased to 90% and 83% respectively. After lengthy proceedings,¹⁾ the license of Credit Bank (one of the two ailing private banks mentioned earlier) was finally repealed in April 1999, while reorganization activities continued to go on for Dacia Felix Bank (the bank which had been charged with fraudulent behavior). Two smaller private banks (Bankcoop and Banca Albina) underwent bankruptcy proceedings.²⁾

As the depth of Bancorex's problems were investigated, it became clear in early 1999 that this big SOB was in much worse shape than expected. Public rumors produced a run on Bancorex in the spring of 1999 and the bank collapsed. Realizing the magnitude of Bancorex's problems, the authorities opted for the bank's closure and orderly removal from the banking system. All bad assets were transferred to the AVAB before end-July 1999. Most of Bancorex's remaining deposit liabilities (in leu and in foreign exchange) were transferred to the Romanian Commercial Bank (Banca Comerciala Romana, BCR). The remainder of Bancorex was merged with BCR, which absorbed the assets of the insolvent bank, as the authorities considered actual liquidation politically unfeasible and too lengthy to complete.

BCR was compensated for the acquired liabilities and the gap in Bancorex's balance sheet with government securities. The authorities approved the revocation of Bancorex's banking license on July 31, 1999, and the final absorption of assets was completed in September. Thus a big destabilizing factor was removed from the financial system. Largely as a result of this action, the total share of nonperforming loans in the banking system declined from 59% in 1998 to 37% at the end of 1999 (table 4). Interest rates, which had been pushed up by Bancorex's distress borrowing, gradually went down again. But this came at a heavy price for taxpayers. In the process of winding up Bancorex, the government had incurred new public debt coming to USD 1.5 billion (or 4% of GDP in 1999). Summing up the 1997 recapitalization, the 1999 compensation payments and likely payments for litigious debts, the total cost of Bancorex to the state has been estimated at around USD 2.4 billion. Given the modest reserves of the Deposit Guarantee Fund, the winding-up of Bancorex and other closures overburdened the fund. To reimburse depositors according to the regulations, it was compelled to take up substantial debts with the NBR.

Banca Agricola remained in dire straits in 1999, since more than two thirds of its loans were nonperforming by the middle of the year. Also in Banca Agricola's case, rumors on the bank's liquidity problems triggered heavy cash withdrawals which, however, did not lead to the institution's demise. In the second half of 1999 the authorities launched a renewed effort to restructure Banca Agricola. An administrative board was appointed in

1 See chapter 3.2.

2 National Bank of Romania (2000a), p. 87–88.

November 1999 to oversee the bank's day-to-day operations, and the board took more drastic measures in downsizing the bank. Most bad assets were transferred to AVAB in December 1999 in exchange for government securities. In April 2000 Banca Agricola was publicly offered for sale.¹⁾

Despite the closures and restructuring efforts, the total number of banks in Romania slightly grew to 34 at end-1999; 19 of them were fully or majority foreign-owned. The share of foreign-owned credit institutions in total banking assets expanded from about 10% at end-1997 to 43% at end-1999. This jump in foreign ownership was primarily attributable to the above-mentioned two privatizations involving foreign investors and to the contraction of state assets triggered by the bankruptcy of Bancorex. The 4 remaining state-owned banks accounted for 50% of total assets (table 4), while 11 domestically owned private banks accounted for the remaining 7% of assets. With the "takeover" of Bancorex, the BCR became the biggest Romanian credit institution. Since the BCR has traditionally been dealing with the domestic state-owned industrial sector, its portfolio has also given rise to concern.

In the realm of enterprise reform, the only major restructuring progress until 1998 took place in agriculture, which saw the closure of some unviable farms, and in the mining sector, where the labor force was adjusted by about one third by offering improved severance packages. For instance, 60,000 miners were laid off in the fall of 1997. About 1,500 small enterprises were privatized in 1999 with the assistance of World Bank programs, and privatizations/liquidations of 64 large and medium-sized companies involving international tenders were initiated. On the whole, the private sector is estimated to have grown to 60% of GDP in 1999, partly reflecting the newly created private firms. Still, structural problems at the enterprise level remain a key obstacle to stability and growth.

Table 4

Banking Sector-Related Indicators for Romania								
Year	Number of banks (of which foreign-owned, year-end)	Asset share of state-owned banks	Deposit rate (average, year-end)	Lending rate (average, year-end)	Domestic credit (year-end)	Domestic credit to enterprises	Bad loans ¹⁾	Capital adequacy (capital/risk-weighted assets, year-end) ²⁾
	number	%	% p.a.		% change	% of GDP	% of total loans	%
1991	12	..	..	..	..	..	..	..
1992	12	..	..	..	86.1	..	..	..
1993	14	..	42.5	86.4	110.4	..	..	..
1994	20 (3)	80.4	49.5	61.8	109.2	..	18.5	..
1995	24 (6)	84.3	32.4	47.5	123.6	..	37.9	..
1996	31 (8)	80.9	38.9	53.6	82.1	11.5	48.0	14.0
1997	33 (13)	80.0	34.1	55.6	82.1	13.7	56.5	13.6
1998	36 (16)	75.3	42.3	58.9	95.2	15.2	67.5	10.3
1999	34 (19)	50.3	41.3	62.0	26.8	10.5	36.6	17.5
2000 ³⁾	35 (. .) ⁴⁾	45.0	27.0	47.3	18.4	..	..	21.4 ⁴⁾

Source: IMF, EBRD, NBR.

¹⁾ Data for bad loans for Credit Bank between 1994 and 1996 and Dacia Felix Bank in 1997 are not included.

²⁾ Refers to Romanian incorporated commercial banks, excluding branches of foreign banks.

³⁾ Preliminary data or estimates.

⁴⁾ Mid-2000.

5 Most Recent Developments and Policies

5.1 Bulgaria (1998–2001)

Bulgaria's overall economic situation, and the situation of its banking sector in particular, have greatly improved since the adoption of the currency board. But there are still big challenges. Despite adverse external influences in 1998 (Russian crisis and global emerging markets financial crisis) and 1999 (Kosovo conflict), the country returned to the growth path, experiencing some modest expansion of real GDP in 1998 (+3.5%) and in 1999 (+2.4%) and reportedly an acceleration to 5.8% in 2000. The past tradition of high inflation was broken, and price increases (year-end) grew from 0.9% in 1998 to 6.2% in 1999 to 11.4% in 2000 (table 1). While the acceleration of inflation in the context of a currency board regime at first sight gives rise to concern, external factors (the strong oil price rise and the strengthening of the U.S. dollar in relation to the lev and its reserve currency, the euro) appear to take most of the responsibility for this development. Substantial adjustments of administered prices toward market levels also played a role. But these factors are not likely to persist and have already been partly reversed (oil price decline in the fourth quarter of 2000 and the first months of 2001). In any case, the relatively high price increases in 1999 and 2000 do not seem to have signaled a serious competitiveness problem, since unit labor costs declined during both years owing to productivity gains as a result of restructuring and investment.¹⁾

Given the deterioration of the country's terms of trade, the current account deficit widened sharply from 0.5% of GDP in 1998 to 5.5% in 1999. Although the terms of trade continued to deteriorate in 2000, the current account shortfall remained approximately at the level of the preceding year, since higher receipts from tourism offset the impact of the sharp rise in energy prices. The current account gap was fully covered by FDI and official financing. Fiscal policy remained prudent, with the general government deficit holding at about 1% of GDP in 2000. Gross official reserves expanded from USD 2.12 billion at end-1997 to USD 3.27 billion in January 2001. However, external debt remained high and amounted to about 85% of GDP at end-2000. The most pressing problem is high and rising unemployment, which grew from 12.2% in 1998 to 17.9% in December 2000. This rise was largely attributable to restructuring-related labor shedding.

The authorities' continuing reform drive was supported by the conclusion of an Extended Fund Facility agreement with the IMF in September 1998, providing for a three-year loan of SDR 628 million (approximately USD 860 million). Enterprise reform and privatization have made substantial strides since 1997, but there is still a long way to go. By mid-1998, all but eight of the firms on the "liquidation list" had been either closed or sold. The remaining eight were moved to the "isolation list."²⁾ By 1999, the isolation program was completed for all commercial enterprises concerned, either by privatization or liquidation. In the fall of 1999 the government approved updated restructuring plans for all infrastructural firms under isolation

1 IMF (2001), p. 7, p. 11.

2 See the above description of the 1996 Action Program of the Bulgarian government in chapter 4.1.

(utilities and railroads). But up to date very few liquidations of large enterprises have taken place outside this scheme, which itself required the explicit intervention of the state. 1999 saw the biggest privatization wave in Bulgaria since the onset of transition. The share of privatized long-term fixed assets climbed from 30% at end-1998 to 47% at end-1999 and 51% at end-2000. Major sales in the nonfinancial sector included the oil refinery Neftochim, the steel giant Kremikovtzi and Balkan Airlines. The remaining state-owned sector, however, continues to suffer from low financial discipline and a still widespread “culture of nonpayment.”

The banking sector has been one of the branches of the economy witnessing the most impressive structural changes. As mentioned earlier, bankruptcy proceedings were filed against a large number of credit institutions in 1996 and most of them stopped operations the same year or in 1997. By March 1998 all closed banks were declared bankrupt, but their liquidation was stretched through long court procedures. Regulatory and supervisory functions of the BNB have been substantially strengthened. On January 1, 1999, a new deposit insurance law became effective, which is less generous than the previous one and thus limits the potential fiscal cost of bank failure while putting more responsibility on depositors to monitor “their” banks. Most of the remaining large SOBs were sold to foreign strategic investors in 1999 and 2000. After the privatization of United Bulgarian Bank in 1997, Postbank was sold to a U.S.-Greek consortium in late 1998. In 1999, Société Générale acquired a stake of 98% in one of the best performing Bulgarian banks, Expressbank, and the UK emerging market investment house Regent Pacific Group purchased 98% of Hebrosbank (table 5).

In 2000, a definite breakthrough was achieved with the country’s two largest commercial banks successfully changing owners. Bulbank, which is significantly larger than any other single bank and accounts for about one third of all banking assets, was sold in July 2000. Bulbank stands out as the one large Bulgarian credit institution that survived the “storm” of 1996–97 in relatively good shape. It had received a large share of dollar-denominated ZUNK bonds and, in contrast to other banks, had not participated in the risky credit expansion policies prior to 1996, investing instead in domestic and foreign securities. The privatization was carried out despite fierce and open resistance of the incumbent management to the transfer of control to foreign strategic investors.¹⁾ A consortium of UniCredito Italiano (93%) and Germany’s Allianz Holding (5%) bought Bulbank for USD 313 million. Also in mid-2000, the National Bank of Greece acquired a 90% interest in (the already privatized) United Bulgarian Bank for USD 207 million.²⁾ As a result of these transactions, the share of total state-owned banking assets fell to below 20%, while that of foreign-owned banks reached 73% in the fall of 2000.

The country’s third largest bank, DSK (Derzhavna Spestovna Kassa, State Savings Bank), is slated to be privatized by 2002. The fourth largest bank, Biochim, is to be sold until end-2001. DSK, the former monopoly household

1 *Bokros (2000)*, p. 18.

2 *EBRD (2001a)*, p. 24.

deposit-taking institution, is still the largest Bulgarian bank in terms of staff, branches and clients. Since it was barred from taking foreign exchange deposits, the banking crisis of 1996–97 significantly reduced DSK's absolute and relative importance: At end-March 1997, DSK held only 13% of total (lev and foreign currency) deposits; until September 1998, its share recovered somewhat to 18%. After the crisis, the State Savings Bank became very active in the household credit market. By end-1998, DSK's total volume of loans had grown to more than half of its total assets – substantially above the sector's average of about 30%. DSK thus became the most active bank to credit the nonfinancial sector in an otherwise cautious environment. Steps are being undertaken to transform DSK into a full-fledged commercial bank. At the beginning of 2001 it lost its special 100% state deposit guarantee and, like other banks, is now subject to the deposit insurance law.

Over the last few years, the solvency, liquidity and capitalization of Bulgarian banks increased further. Since 1997 they have tended to invest primarily in relatively safe and liquid assets such as government securities. The percentage of classified loans in commercial credit contracted from 21% in December 1997 to 13% in December 1998. While minimum capital adequacy was set at 8% and raised to 10% by end-1998 and to 12% by end-1999, total capital adequacy in fact rose from 23% at end-1997 to no less than 37% a year later (table 3). However, some smaller and medium-sized banks still had a capital base deemed insufficient to adequately cover the risks associated with their activities. Some noncompliance has also been reported with respect to restrictions on single large exposures and insider lending. High liquidity and substantial security are bound to imply low profitability. Overall profits declined by about two thirds from end-1997 to end-1998.

Despite the above-mentioned extensive ownership changes, it is not yet clear to what degree and how quickly Bulgarian banks will overcome their reluctance to lend to the real sector.¹⁾ This type of lending seems to have risen somewhat recently, though. Credits to the nonfinancial sector reportedly augmented from 22% of total banking assets at end-1997 to 30% at end-2000. There still appear to be a number of valid reasons to be cautious in lending. One reason relates to the currency board regime, which bars commercial bank refinancing and confers a very restricted lender of last resort role on the central bank. In such a situation prudent credit institutions will keep higher liquidity reserves to do business. But setting aside the monetary regime, considerable risk and uncertainty have remained associated with crediting Bulgarian firms. Information on credit records of private firms is often patchy and hard to come by. Enforcement of creditor rights, particularly with respect to forcing bankruptcy or a turnover of management or seizing collateral from a delinquent borrower, continues to be weak. Banks continue to hold excess liquidity and tend to invest surplus funds in government securities and short-term placements. Nonbank financial institutions remain weak and do not constitute a meaningful alternative source of financ-

1 *Bank lending to the private sector in Bulgaria is low even in comparison to other transition economies. As of end-1999, according to an IMF study, the ratio of private sector credit to GDP was just 12%. See Feyzioglu and Gelos (2000), p.64.*

ing for enterprises. The Bulgarian Stock Exchange, founded in 1996, closed during the financial crisis, then reopened in October 1997. Its overall trade volume is very modest.

The authorities have attempted to eliminate some obstacles to financial intermediation by shoring up rules and regulations and, if necessary, by creating new institutions. A central credit registry accessible to banks was made fully operational in March 2000. In October 2000 parliament adopted amendments to the Commercial Code which simplify and accelerate enterprise bankruptcy procedures. Judges are being trained on bankruptcy issues. A modern bank bankruptcy law was submitted to parliament in September 2000. In any case, enforcement and implementation will be critical. Institution building and raising depositors' confidence in banks and banks' confidence in businesses obviously takes time after the dramatic turmoil of 1996–97. Notwithstanding banking sector stabilization, depositors continued to hold more than half of their deposits (55%) in hard currency at end-2000, while over 90% of deposits bear a maturity of less than one year. In mid-2000, Bulgaria had 34 commercial banks (including 7 branches of foreign banks). Total assets of the sector amounted to less than 40% of GDP by the end of the year. Eight of the ten largest banks (in terms of assets) were foreign-owned; two of these eight were branches of foreign credit institutions (table 5). Contagion from the newest financial turmoil in Turkey and Argentina has (so far) been limited and is likely to remain modest given the degree of Bulgaria's recent reform progress and its relatively strong fundamentals.

Table 5

Bulgaria's Top Ten Banks (as of End-2000)			
Rank	Credit Institution	Total assets (as of end-2000) <i>BGL mn</i>	Major foreign purchaser (share ¹), year of purchase) Share of all foreign investors in capital ¹) %
1	Bulbank	2,485.4	UniCredito Italiano (93%, 2000)
2	United Bulgarian Bank	1,207.5	National Bank of Greece (89.9%, 2000), EBRD (10%, 1997)
3	DSK Bank (Derzhavna Spestovna Kassa)	1,180.7	–
4	Biochim Commercial Bank	519.9	–
5	Bulgarian Post Bank	509.1	ALIKO/CEN Balkan Holdings Limited (78.2%, 1998)
6	SG Expressbank	439.1	Société Générale (98%, 1999)
7	BNP-Dresdner Bank	344.4	Banque Nationale de Paris (40%), Dresdner Bank (40%), EBRD (20%) (1994)
8	Hebros Commercial Bank	330.4	Regent Pacific Group Ltd. (97.6%, 2000)
9	First Investment Bank	319.3	European Privatization and Investment Company, Vienna (39%), EBRD (20%)
10	ING Bank N.V., Sofia Branch	263.8	ING Groep N.V. (100 %, 1994)

Source: BNB Quarterly Bulletin, Dec. 2000; information provided by Zdravko Balyzov and the BNB Statistics Department.

¹) Shares over 10%.

Table 6

Romania's Top Ten Banks (as of End-2000)

Rank	Credit Institution	Total assets (as of end-2000)	Major foreign purchaser (share, year of purchase)	Share of all foreign investors in capital %
1	Romanian Commercial Bank (Banca Comerciala Romana SA)	69,720	–	–
2	Romanian Bank for Development (Banca Romana pentru Dezvoltare SA)	37,694	Société Générale (51%, 1999)	55.99
3	Savings and Loans Bank (Casa de Economii si Consumatiuni)	22,804	–	–
4	ING Bank N.V., Bucharest branch	11,260	ING Bank N.V., Amsterdam (100%, 1994)	100
5	ABN AMRO BANK Romania SA	11,231	ABN AMRO Bank N.V. (99.73%, 1995)	100
6	Banc Post SA	9,394	EFG Eurobank Ergasias (19.25%, 2000), General Electric Capital (35% in 1999, decreased to 8.75% in 2000), Banco Português de Investimento (10% in 1999, increased to 17% in 2000)	45
7	Banca Agricola SA	9,282	–	–
8	Banca Comerciala Ion Tiriac SA	7,903	Redrum International Investments B.V. (7.5% in 1991, increased to 40.49% in 2000), Tiriac Ion (25% in 1991, increased to 26.37% in 2000 – Monaco), EBRD (20% in 1993, decreased to 5.87% in 2000)	76.11
9	Citibank Romania SA	7,715	Citibank Overseas Investment Corporation (99.9%, 1996)	100
10	Eximbank (Banca de Export Import a Romaniei SA)	5,730	–	–

Source: NBR, data provided by Cristian Popa (Vice Governor).

5.2 Romania (1999–2001)

After a three-year downturn, the year 2000 saw a modest economic recovery in Romania which is likely to gather momentum in 2001. Banking sector reform and banking development have continued to move on rather slowly, witnessing measured progress. The economy grew by 1.6% in 2000, driven by a recovery of industrial production and exports on the back of strong EU demand. Real GDP expansion is forecast to increase to about 4% in 2001. Inflation declined to 41% in 2000, which is much higher than targeted by the government. The still relatively high inflation rate is attributable to a severe drought, the hike in world oil prices, the continuing depreciation of the domestic currency and strong wage growth, partly related to poor financial discipline. Despite the recovery, the budget deficit amounted to 3.7% of GDP in 2000 (as opposed to 3.5% in 1999) (table 2). By mid-2000, the third tranche of the IMF stand-by credit granted in August 1999 had not been released, owing to some slippages in fiscal policy. Romania is currently (May 2001) in the process of negotiating a new stand-by arrangement with the Fund.

Progress in enterprise privatization and restructuring has been rather sluggish since 1999. The sale of the car manufacturer Dacia to Renault was the sole large enterprise privatization transaction involving a foreign

investor in 1999. In 2000, privatization procedures were slowed down before elections in November. A breakthrough is also constrained by the fact that most remaining SOEs slated for privatization are loss-makers. Notwithstanding the accelerated closure of some coal mines in 1999 and 2000, the authorities largely failed to tighten the financial discipline of the state-owned enterprise sector by tolerating high and, in many instances, rising tax arrears. This applies particularly to utilities, which, typically unable to cut off non-paying customers, “handed on” the financial burden to the budget.¹⁾ Inter-enterprise arrears continue to make themselves felt throughout large parts of the economy.

Limited restructuring and the weak shape of the real economy are reflected in the continuing accumulation of bad loans in the banking sector. This factor, as well as the authorities’ reduced preparedness to bail out insolvent banks and tightened banking supervision, have prompted credit institutions to remain very cautious in granting new loans to the real sector. Due to limited confidence in the leu, a large share of deposits are held in hard currency and a considerable part of lending is also carried out in foreign exchange. Like in modern Bulgaria, the banking system is not yet able to carry out its intermediation function effectively.²⁾ Many banks perceive T-bills and highly priced short-term deposits at the NBR as a more attractive investment than the extension of credit to the real sector. The Romanian stock market, the Bucharest Stock Exchange (BSE), founded in 1995, is still at a modest stage of development. Following early years of rapid expansion, stock values and turnover were badly affected by repercussions of the turmoil on Asian and Russian financial markets in 1998. The BSE remained a low-liquidity market in 2000.

Serious problems and unresolved issues in other parts of the nonbank financial sector add to the overall difficult situation. In particular the investment funds sector has been destabilized since the collapse in May 2000 of the country’s largest fund, the National Investment Fund (Fondul National de Investitii, FNI). This collapse was apparently caused by mismanagement, fraudulent practices and poor regulatory oversight. It turned out that, for years, the FNI had been little more than a pyramid scheme. The fund’s failure also involved the Savings and Loans Bank (CEC), which was a shareholder in the FNI’s management company, had invested in FNI certificates and issued a guarantee for investments in the fund. FNI’s collapse put pressure on the largely unregulated “popular banks,” which functioned as credit cooperatives without deposit insurance.³⁾ The largest institution of this type, Banca Populara Romana, closed its doors in June 2000 after being unable to meet its depositors’ demands. An emergency ordinance issued in July spelled out the central bank’s powers to authorize,

1 This is a long-standing problem that urgently needs to be overcome and in some respects mirrors the situation in Russia and Ukraine.

2 According to the EBRD, domestic credit to enterprises declined to only 11% of GDP in Romania in 1999. This is even weaker than the respective measurement for Bulgaria (15%). See EBRD (2000c), p. 148, p. 200. See also chart 1.

3 The aggregate assets of the popular banks have been estimated at some 2% of the banking system total.

regulate and monitor credit cooperatives. The licensing of new popular banks has been suspended.¹⁾

Banking regulation and supervision have been further improved and, after a slowdown in 2000, bank restructuring has lately regained momentum. In 1999, minimum capital adequacy requirements were raised from 8% to 12%. In late 1999 the NBR developed and then established an “early warning system” for banking supervision. Credit institutions are assessed and ranked on a scale of one to five, with institutions rating five being considered the weakest performers. The system incorporates regulations for troubled banks and specifies the point at which a bank’s license is to be withdrawn and bankruptcy proceedings are triggered. The establishment of a credit information center at the NBR in December 1999 is another positive development. Essentially similar to the Bulgarian central credit registry, the center will allow banks to obtain information on the credit history of borrowers.²⁾ In October 2000 new regulations were adopted in some of the areas of banking supervision most fraught with weaknesses, namely asset classification and provisioning.

The new government, formed at the end of 2000, has (so far) broadly continued the economic and banking reform policies of the previous government. In the wake of a stricter enforcement of regulations, several insolvent smaller and medium-sized private banks failed and had to be closed, but winding-up processes have been slow and cumbersome. Although the authorities had planned to privatize the Romanian Commercial Bank (BCR) and Banca Agricola in 2000, these plans did not materialize or were delayed. The sale of BCR, the country’s largest bank, is now expected to take place in 2001. As regards Banca Agricola, the public offer for sale in April 2000 did not attract sufficient demand, and the loss-making bank has been kept afloat with special credit lines from the NBR. In February 2001 Banca Agricola received an additional capital injection of around EUR 160 million in government securities with a view to making it more attractive to private bidders. In April 2001, a 98% stake in Banca Agricola was finally sold to an international consortium consisting of the Austrian Raiffeisen Zentralbank (RZB) and the Romanian-American Enterprise Fund. The new owners paid USD 15 million and pledged to increase the bank’s capital by USD 32 million.³⁾

In mid-2000 Romania had 35 banks. By end-2000 (before the privatization of Banca Agricola), foreign-owned banks were estimated to account for over half (53%) of total Romanian banking assets. Six of the ten largest banks (in terms of assets) were foreign-owned; three of these six were branches of foreign credit institutions (table 6). Domestic private banks made up about 3% of total banking assets; SOBs continued to hold around 45%. Capital adequacy grew from 18% in 1999 to 21% in 2000 (table 4). The share of “problem banks” in total assets is reported to have fallen from 12% at end-1999 to 8% in mid-2000. But these data must be viewed with caution, since they partly reflect continuing shortcomings in the accounting system

1 EBRD (2000c), p. 199.

2 EBRD (2001b), p. 26.

3 *Frankfurter Allgemeine Zeitung* (2001).

that need to be addressed. Another problematic aspect relates to the fact that since banks have significant foreign currency liabilities and foreign currency lending, they may be vulnerable to a serious erosion of market confidence in the domestic currency, and/or to a sharp unanticipated exchange rate depreciation. A major long-standing problem awaiting solution is banks' limited capacity to enforce contracts and collect debt. This is a problem which Romania and Bulgaria share and which appears to be the main reason why commercial banks in these two countries have failed to adequately intermediate financial resources and thus to contribute to growth (see chart 1).

Table 7

The Bulgarian and Romanian Banking Sectors: Chronology of Some Important Events

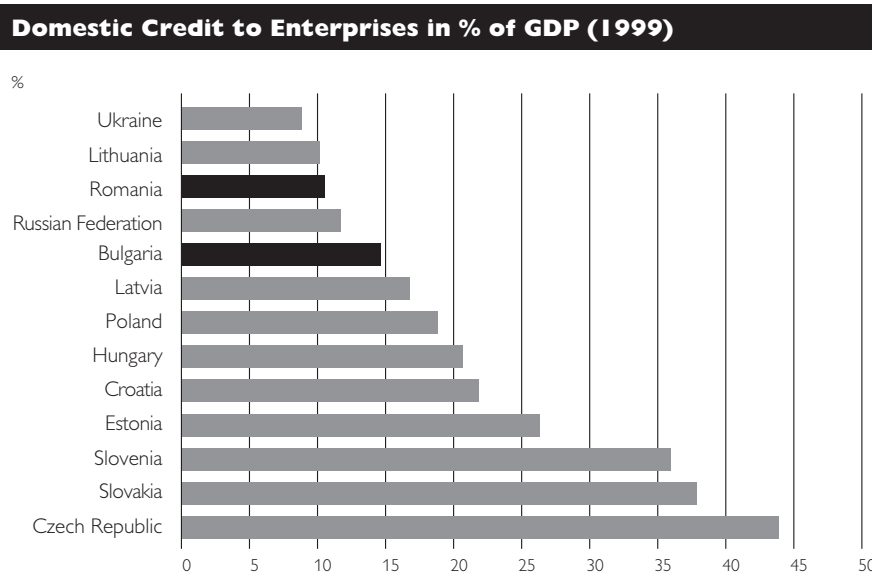
Bulgaria	Romania
1989	
<ul style="list-style-type: none"> Two-tier banking system established 	—
1990	
<ul style="list-style-type: none"> Private banking permitted 	<ul style="list-style-type: none"> Late 1990: two-tier banking system established, private banking permitted
1991	
<ul style="list-style-type: none"> Early 1991: liberalization of prices, foreign trade and the exchange rate June: Law on the Bulgarian National Bank adopted Replacement of some nonperforming bank claims by special state bond issues 	<ul style="list-style-type: none"> April: Law on the National Bank of Romania and Law on Banking Activity adopted Round of successive enterprise debt write-offs worth about half of 1990 GDP against government budget deposits in SOBs or replacement of debt by government liabilities Tightening of monetary policy, phased liberalization of prices December: Law on the Settlement of Outstanding Payments enacted
1992	
<ul style="list-style-type: none"> March: Law on Banks and Credit Activity adopted 	<ul style="list-style-type: none"> Further state capital injection in banks (approx. 1% of GDP)
1993	
<ul style="list-style-type: none"> December: Law on the Settlement of Nonperforming Loans Contracted before 31 December 1990 (ZUNK law) adopted 	—
1994	
<ul style="list-style-type: none"> March: exchange rate crisis: lev depreciates against U.S. dollar by 50% (until end-April), year-end inflation: 122% 	<ul style="list-style-type: none"> Breakdown of a number of financial pyramid schemes
1995	
<ul style="list-style-type: none"> Despite (short-lived) economic recovery financial conditions of most Bulgarian banks worsen Mid-1995: a number of financial pyramids collapse BNB revokes the licenses of two loss-making private banks, but Supreme Court overrules the decision Fall: run on commercial banks starts December: establishment of partial deposit insurance scheme 	<ul style="list-style-type: none"> Credit Bank and Dacia Felix Bank (two medium-sized private credit institutions) become insolvent June: Commercial Bankruptcy Law adopted
1996	
<ul style="list-style-type: none"> April/May: strong devaluation of the lev, mass bank runs gather momentum May: important amendments to the Law on Banks and Credit Activity passed, enhancing the regulatory power of BNB; deposit insurance scheme broadened May: government adopts Action Program: bankruptcy (liquidation) of several enterprises and banks and isolation of others from bank credits, BNB immediately puts five banks under "conservatorship," petitions for their bankruptcy June: recapitalization of seven SOBs ("Bulbank scheme") Mid-1996: stand-by arrangement approved by IMF providing for credit of SDR 400 mn Mid-1996: 64 firms accounting for 29% of total losses put on "liquidation list," 70 firms (58% of losses) put on "isolation list" September: second wave of conservatorship and insolvency proceedings initiated for another nine banks December: BNB extends emergency credit to Ministry of Finance GDP plummets 10.1% in 1996, lev depreciates more than 500% against U.S. dollar and year-end inflation grows to 311% 	<ul style="list-style-type: none"> Spring: shutdown of a number of mutual funds following the enforcement of rules on computing net asset values Mid-1996: NBR petitions courts to declare Credit Bank and Dacia Felix Bank bankrupt (according to Commercial Code) Establishment of a limited deposit insurance scheme – the Deposit Guarantee Fund Serious deterioration of the financial situation of Bancorex and Banca Agricola

Table 7

The Bulgarian and Romanian Banking Sectors: Chronology of Some Important Events

Bulgaria	Romania
<p>1997</p> <ul style="list-style-type: none"> January/February: Total collapse of exchange rate and hyperinflation (February: monthly inflation rate: 243%) GDP contracts 6.9% in 1997, annual inflation comes to 579% Defacto "recapitalization" of a number of larger banks through massive devaluation of their lev liabilities and capital gains on their dollar-denominated ZUNK bonds March: new government adopts comprehensive stabilization and reform program embraced by IFIs; centerpiece: currency board regime, other element: strengthening of banking supervision April: IMF approves new 14-month stand-by arrangement (SDR 372 mn) June/July: enactment of new Law on Banks and new central bank law, reinforcing the BNB's power within the currency board framework and strengthening prudential supervision July 1: currency board in operation (reserve currency: Deutsche mark) July: privatization/sale of United Bulgarian Bank to EBRD, Oppenheimer (U.S.) and Bulbank Sale of First Investment Bank to European Privatization and Investment Company, Vienna and EBRD <p>1998</p> <ul style="list-style-type: none"> Early 1998: nearly all the above-mentioned credit institutions, for which the BNB had petitioned bankruptcy proceedings, declared bankrupt Mid-1998: all but eight firms on the liquidation list closed or sold; the other eight transferred to isolation list September: conclusion of three-year Extended Fund Facility Agreement with the IMF (SDR 620 mn) Late 1998: Postbank sold to a U.S.-Greek consortium ALIKO/CEN (AIG major shareholder) <p>1999</p> <ul style="list-style-type: none"> January: new deposit insurance law becomes effective, which is less generous than the previous law September: stake of 98% of Expressbank acquired by Société Générale November: Regent Pacific Group (UK) purchases 98% of Hebrosbank Isolation regime terminated for all commercial enterprises concerned by privatizing or entering them into liquidation <p>2000</p> <ul style="list-style-type: none"> March: central credit registry operational Mid-2000: National Bank of Greece acquires a 90% stake of (already privatized) United Bulgarian Bank for USD 207 mn July: consortium of UniCredito Italiano and Allianz Holding (Germany) buys Bulbank for USD 313 mn October: amendments to the Commercial Code simplifying enterprise bankruptcy procedures enacted <p>2001</p> <p>—</p>	<ul style="list-style-type: none"> Early 1997: New government puts forward macroeconomic shock therapy and structural reform program; major tenets: tightening of monetary policy; liberalization of exchange rate; termination of directed credits; strengthening of banking legislation April: IMF approves 14-month stand-by arrangement providing a credit of SDR 302 mn Late 1997: the authorities bail out Bancorex and Banca Agricola at a cost of about USD 1 bn in government bonds GDP declines 6.1% in 1997, annual inflation reaches 151% <p>January: new chart of accounts, broadly in line with the French accounting system, takes effect in Romania</p> <ul style="list-style-type: none"> March: adoption of a new Law on Banking Activity, which tightens prudential standards April: adoption of a Bank Insolvency Law and establishment of the Asset Recovery Agency (AVAB) May: enactment of a new Law on the NBR, strengthening the powers of the central bank <ul style="list-style-type: none"> First quarter of 1999: 51% of the Romanian Bank for Development sold to Société Générale April: Credit Bank's license repealed April: General Electric Capital and Banco Portugues de Investimento acquire 45% of Banc Post Spring and summer 1999: runs on Bancorex, Banca Agricola and some other credit institutions, Bancorex crashes Bankcoop and Banca Albina (two smaller private banks) undergo bankruptcy proceedings July: Bancorex's license is withdrawn, its bad assets are transferred to AVAB, its remaining assets are merged with Romanian Commercial Bank, which is compensated for acquired liabilities by government securities August: the IMF approves a new ten-month stand-by arrangement (SDR 400 mn) Fall 1999: the authorities launch a renewed effort to restructure Banca Agricola: drastic downsizing, most bad assets transferred to AVAB in exchange for government bonds late 1999: NBR establishes an "early warning system" for bank supervision December: credit information center at NBR launched <ul style="list-style-type: none"> May: collapse of National Investment Fund, destabilization of the investment fund sector June: closure of Banca Populara Romana (the largest of the "popular banks") July: emergency ordinance spells out NBR's powers of regulating credit cooperatives <ul style="list-style-type: none"> February: Banca Agricola receives additional capital injection (about EUR 160 mn) in government securities April: 98% stake in Banca Agricola sold to consortium of Raiffeisen Zentralbank (RZB) and Romanian-American Enterprise Fund for USD 15 mn and pledge to raise bank's capital by USD 32 mn

Chart 1



Source: EBRD Transition Report 2000.

6 Conclusions

Comparing the two countries discussed above, there are a number of common points and differences. Here are some of the common points:

- Bulgaria as well as Romania were saddled with particularly difficult initial conditions (even if these conditions differed in detail).
- Both countries were victims of long-lasting negative externalities of the Yugoslav crisis (which obstructed transport, trade and FDI).
- Authorities conducted more or less parallel policies in the first years of transition: macroeconomic stop-and-go policies, generally loose monetary policies, weak banking regulations, lax enforcement, sluggish or delayed structural reforms.
- Prior to serious reform efforts, banks were typically subject to an economic environment featuring distorted incentives, a “culture of nonpayment” and widespread corruption.
- Liquidation procedures have tended to take long in both countries. This appears to be linked to some remaining impediments to structural adjustment.
- As a result of substantial strides in bank restructuring and an overhaul of the regulatory environment, Bulgarian as well as Romanian banks became much more cautious in extending credits to the real sector.
- This reluctance has been reinforced by high lending risks, including a lack of information on firms’ credit records and weak enforcement of contracts and creditor rights. The authorities are taking measures aimed at alleviating these shortcomings.
- After considerable delays and some experimentation, both countries eventually opted for the strategy of privatizing big banks through sales to foreign strategic investors.
- Nonbank financial institutions remain at modest stages of development in both countries.

The ways the major banking crises evolved and how the authorities reacted highlight some of the essential differences:

- The major crisis broke out earlier in Bulgaria (1996) than in Romania (1997). The Bulgarian calamity was more profound, but did not last as long. The Romanian reform program of early 1997 actually brought the banking sector's problems into the open.
- The Bulgarian policy response, to a great deal inspired by the IMF, was more radical (including the liquidation of a considerable number of big enterprises and banks and the subsequent establishment of a currency board regime), while at the same time it was supported by a wider societal consensus than the one in Romania.
- Probably due to the greater strength and depth of the remedial measures to tackle the Bulgarian crisis, Sofia's strategy has proved to be more successful. There can be no doubt that the Bulgarian banking sector today is generally healthier than its Romanian counterpart.
- The entirely different fate of the two former state foreign trade banks is a case in point. Whereas Bulbank followed prudent banking practices and refrained from massive lending in the precrisis period, Bancorex continued to accumulate dubious claims. Bulbank has remained the top Bulgarian bank (in terms of assets) while Bancorex went bankrupt.
- Whereas modern Bulgaria seems to have largely broken with past banking practices, things are evidently that clear in modern Romania yet.
- Since the adoption of its comprehensive reform program in 1997, Bulgaria has undeniably reduced its reform backlog compared to other EU accession candidates. While in 1999 Romania finally also appeared to have entered the catching-up lane, the authorities do not seem to have succeeded in sustaining this momentum.

Notwithstanding reform progress in recent years, Bulgarian as well as Romanian banks face some important challenges on their ways to becoming functioning market-oriented financial intermediaries:

- Bankruptcy and liquidation are still sluggish procedures in both countries. While Bulgaria has hitherto experienced more liquidations and deeper structural adjustment than Romania, most bankruptcies have required the explicit interference of state authorities.
- Mirroring this state of affairs, structural problems at the enterprise level remain a key impediment to stability and growth, especially in Romania, where major enterprise reform still lies ahead. Budget constraints do not yet seem to have been hardened in state sector.
- Weak contract enforcement and insufficient implementation of creditor rights constitute another expression of this restructuring bottleneck and contribute to explaining banks' reluctance to lend to the real sector.
- Given the high levels of unemployment in both countries, particularly in Bulgaria (where it reached 17.9% at end-2000), the restructuring bottleneck obviously can only be unplugged step by step. That said, more far-reaching and energetic measures would certainly be warranted in Romania.

- In Romania, a commercial bank's insolvency is determined by the courts, not by the NBR. This considerably reduces the speed and effectiveness of bank bankruptcy proceedings; therefore, the bank bankruptcy law should be amended. The corresponding Bulgarian legislation seems much more adequate.
- In contrast to the Bulgarian State Savings Bank DSK, which already complies with regulatory and prudential requirements valid for commercial banks, the Romanian Savings and Loans Bank CEC still needs to be put on a level playing field with other banks. Both credit institutions should be privatized (sold to a strategic investor) soon. Given the difficult and partly intransparent state of the CEC, this institution may require a substantial structural overhaul prior to sale.
- While many large banks have already been restructured/privatized in both countries, some significant problems remain with a number of smaller banks. Given increased FDI-induced competition, further mergers or exits of smaller credit institutions can be expected in the future. If properly managed, such banks' failures need not undermine depositors' confidence.
- Both countries – particularly Romania – suffer from some continuing shortcomings in accounting rules and/or their implementation, which need to be addressed.
- The financial basis/revenues of the Romanian Deposit Guarantee Fund are seriously insufficient and need to be strengthened.

7 Summary

This study describes and compares the development of the banking systems of the two Southeastern European EU accession candidates Bulgaria and Romania. Both countries' initial conditions were among the worst of the European transition economies; Bulgaria and Romania then suffered strongly from the external effects of the decade-long Yugoslav crisis. Both countries are found to have had some similar fundamental experience in the evolution of their banking sectors, which merits a chronological approach divided into a few major periods.

Initial transition started somewhat earlier in Bulgaria (1989) than in Romania (1990) and in both countries lasted well into the first half of the 1990s. The establishment of two-tier banking systems actually preceded the fundamental legal changes (1991–92) which created the formal framework for market-oriented activities of central and commercial banks. The independence of central banks as well as their banking supervision powers were in fact quite limited at the outset. The collapse of central planning and of CMEA trade and the initial shock of price and foreign trade liberalization precipitated economic downturns, which gave rise to mounting payment arrears and banking sector problems. In order to reduce banks' burdens of nonperforming loans inherited from the communist past, the governments intervened and replaced some of these bad assets by state bond issues or other government liabilities. In Bulgaria this included the replacement of domestic hard currency credits by dollar-denominated ZUNK bonds. However, accommodative refinancing by central banks continued.

With the burden of nonperforming loans removed, many newly founded private banks initially thrived in the unstable economic environment, conducting arbitrage transactions of various sorts.

Given sluggish structural reform in the financial as well as the real sectors of both countries, the situation of commercial banks continued to deteriorate in the mid-1990s. Political instability and short-lived governments did not seem to allow a head-on attack on structural problems. Painful reforms were eschewed or postponed. Stop-and-go macroeconomic policies, high and variable inflation rates, instability in the demand for money and accumulating financial losses of credit institutions undermined confidence in the Bulgarian and Romanian banking sectors. Bulgaria suffered at least three financial crises (1994, 1996 and 1997). Despite the temporary improvement of the economic situation in Bulgaria in 1995, large parts of the banking sector – SOBs as well as privately owned banks – became financially distressed and were subject to grossly distorted incentives, promoting a “culture of nonpayment” and widespread asset stripping. Corruption and fraud were not a rare phenomenon in Romania, either.

In both countries a number of financial pyramid schemes crashed in 1994 and 1995. In Romania directed credits (with heavily subsidized interest rates) onlent by commercial banks to different sectors of the economy (notably to agriculture and the energy sector) made up more than 50% of the extensive volume of refinancing of the central bank in 1996. Private as well as state-owned banks struggled with ballooning stocks of overdue loans. The two large Romanian SOBs encountering most difficulties were Banca Agricola and Bancorex (specializing on traditional clients in agriculture, energy and foreign trade), which in many respects were regarded as *de facto* state agents distributing quasi-fiscal subsidies and expecting to be subsequently bailed out. Limited deposit guarantee schemes were put in place in both countries but could not sufficiently calm depositors’ concerns.

Both countries’ banking crises unfolded and reached their climaxes in the second half of the 1990s. The strong depreciation of the Bulgarian lev in the spring of 1996 triggered a price explosion and was followed by mass bank runs. Realizing that their policies had become unsustainable, the Bulgarian authorities opted for a sweeping structural reform project which drew the support of the IMF. The essence of the Action Program of the Bulgarian government (of April 1996) was the bankruptcy (liquidation) of several big enterprises and banks, and the isolation of many others from any activity involving bank credit, with the threat of eventual bankruptcy. A special emergency privatization program was devised to provide financial means to meet the claims of depositors of closed banks.

But these strict measures did not seem to be enough to shore up confidence in the Bulgarian banking system and the country’s economy. Real GDP plummeted 10.1% in 1996. The economic contraction and the devaluation of the lev had a crippling effect on the state budget. The extension of a BNB emergency credit to the Ministry of Finance at end-1996 (after a decision of parliament to amend the budget deficit) was followed by a total collapse of the exchange rate of the lev and full-fledged hyperinflation in the first two months of 1997. GDP fell another 7.0% that year. After a new agreement

had been reached with the IMF and the opposition had achieved a decisive election victory in April 1997, a new government was formed and political stability and confidence were restored. A centerpiece of the stand-by arrangement with the IMF was the establishment of a currency board regime to support a strong commitment to a fixed exchange rate. The new regime linked the lev to the Deutsche mark on July 1, 1997 (since 1999 to the euro). Bank refinancing was accordingly phased out. Monthly inflation quickly fell to low single-digit levels by mid-1997.

Interestingly, the dramatic depreciation of the lev and the hyperinflation in fact eased the economic plight of a number of commercial banks by devaluing their lev liabilities while “recapitalizing” them with capital gains on their foreign currency assets (mostly dollar-denominated ZUNK bonds). Prudential supervision was strengthened and more strictly enforced in 1997. The same year, the privatization of big SOBs finally started with the sale of United Bulgarian Bank to a consortium including foreign strategic investors. Given the above-mentioned harsh restructuring measures and the incisive change of the monetary regime, Bulgarian banks in 1997 became much more cautious in extending credits to the real sector. On the other hand, their capital adequacy, solvency and liquidity strongly improved.

In contrast to Bulgaria, Romania’s banking crisis lasted longer, but was less severe and pervasive. The new government that came to power in Bucharest in November 1996 put forward a macroeconomic shock therapy and a structural reform program endorsed by the IMF. The program was launched in February 1997 and provided for a tightening of monetary policy, the liberalization of the official exchange rate, the termination of directed credits of the NBR and their temporary replacement by explicit budgetary subsidies, a strengthening of banking legislation and an acceleration of privatization. The program actually revealed problems that had previously been alleviated or concealed by an accommodating monetary policy. The measures contributed to a decline of GDP in 1997 by 6.1% and put the already fragile Banca Agricola and Bancorex in increasingly distressed situations. In the second half of 1997, the monetary stance was somewhat eased and later fiscal policy relaxed. Inflation climbed to 151% in 1997 and stood at 55% in 1999. In the absence of serious restructuring plans, the authorities are reported to have injected government bonds worth USD 1 billion into the two big ailing SOBs in late 1997.

The legal environment of Romanian banking improved in the first half of 1998 with the adoption of new central bank, banking and bank insolvency laws. But the enforcement of bank bankruptcy still left a lot to be desired. Major structural progress was only achieved in 1999. The Romanian Bank for Development (a large credit institution) and (the medium sized) Banc Post were both sold to foreign strategic investors in the first half of the year. In the spring of 1999, public rumors produced a run on Bancorex which triggered the collapse of the institution. The authorities finally opted for winding up Bancorex, part of which was merged with the (state-owned) Romanian Commercial Bank in the summer of 1999. This removed a big destabilizing factor from the financial sector. Banca Agricola remained in dire straits in 1999 and suffered heavy cash withdrawals; the authorities launched

a new effort to reshape and downsize the institution. Bad loans as a share of total loans declined in Romania from 57% in 1997 to 37% in 1999.

Bulgaria's overall economic situation and the state of its banking sector have greatly improved since the adoption of the currency board. Despite adverse external influences in 1998 (Russian crisis and global emerging markets financial crisis) and 1999 (Kosovo conflict), the country has returned to the growth path, with growth markedly accelerating in 2000. The past tradition of high inflation was broken. Gross official reserves, covering domestic money in circulation, have considerably expanded; however, external debt remains high. The most pressing problem appears to be high and rising unemployment. 1999 saw the biggest privatization wave in Bulgaria since the onset of transition. By March 1998 all closed banks had been declared bankrupt, but their liquidation has been stretched through long court procedures. In late 1998 Postbank and in 1999 Expressbank and Hebrosbank (three medium-sized to large SOBs) were sold to foreign strategic investors. In July 2000 the country's by far largest and most prudent commercial bank, Bulbank, was privatized in the same way. It changed owners for USD 313 million. As a result of these transactions, the proportion of state-owned banking assets fell to below 20% in the fall of 2000, while the share owned by foreigners rose to over 70%.

Since 1997 Bulgarian banks have tended to invest primarily in relatively safe and liquid assets such as government securities. The share of bad loans in total loans shrank to 12% in 1999, and Bulgarian banks' capital adequacy skyrocketed from 23% at end-1997 to 42% in September 1999. Despite the above-mentioned important ownership changes, Bulgarian banks have by and large remained reluctant to lend to the real sector. Domestic credit to enterprises amounted to 15% of GDP in Bulgaria in 1999, which is much lower than in some other transition economies like Hungary (21%) or Croatia (22%). Certainly the currency board regime compels commercial banks to keep higher liquidity reserves to do business. But considerable risk and uncertainty continue to be associated with crediting Bulgarian firms. The authorities have recently attempted to eliminate some obstacles to financial intermediation. For instance, a central credit registry accessible to banks took up operation in March 2000.

After a three-year downturn, 2000 saw a modest recovery in the Romanian economy. Progress in enterprise privatization has been rather sluggish from 1999 to 2001, as many SOEs remain loss-makers. This factor as well as the authorities' reduced preparedness to bail out insolvent banks and tightened banking supervision have prompted credit institutions to become very cautious in granting new loans to the real sector. Like in modern Bulgaria, the banking system is not (yet) able to carry out its intermediation function effectively. Domestic credit to firms only came to 11% of GDP in Romania in 1999. Serious problems and unresolved issues in the nonbank financial sector have not made things easier. Thus, the largest investment fund and the biggest "popular bank" (credit cooperative) of the country collapsed in 2000. In late 1999 the NBR elaborated an "early warning system" to detect banking problems. In December 1999, the Romanians established a credit information center – a few

months before the above-mentioned corresponding Bulgarian institution was set up.

After being kept afloat with special credit lines and capital injections, Banca Agricola was finally sold to an international consortium of investors in April 2001. As of end-2000 (before Banca Agricola's privatization), foreign-owned banks were estimated to account for over half (53%) of total Romanian banking assets, whereas SOBs held around 45%. The banking sector's capital adequacy had risen from 14% at end-1997 to 21% in mid-2000. A major long-standing problem awaiting a solution is banks' limited capacity to enforce contracts and collect debt. This is a problem which both Romania and Bulgaria share and which appears to be the main reason why commercial banks in both countries failed to adequately intermediate financial resources. Still, the greater strength and depth of the remedial measures to the Bulgarian crisis probably account for the greater success of Sofia's strategy. There can be no doubt that the Bulgarian banking sector today is generally healthier than its Romanian counterpart.

Among the challenges currently faced by the Bulgarian as well as Romanian banking sectors are the following: Bankruptcy and liquidation remain sluggish procedures in both countries, particularly in Romania, where a major enterprise reform still lies ahead. Another example for this restructuring bottleneck is the insufficient implementation of creditor rights, which contributes to banks' reluctance to lend to the real sector. Given the high levels of unemployment in both countries, particularly in Bulgaria, the restructuring bottleneck can only be unplugged step by step. Still, more far-reaching and energetic measures would certainly be warranted in Romania.

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O E N B A C T I V I T I E S

Vienna Seminar on the Accession Process¹⁾

Doris
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The Vienna Seminar on the Accession Process was held jointly by the European Central Bank (ECB) and the Oesterreichische Nationalbank (OeNB) in Vienna on December 14 and 15, 2000. The event was attended by high-level representatives of the Eurosystem (the ECB and the national central banks of the 12 euro area countries) and the central bank governors of the 12 countries negotiating accession to the European Union (Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, the Slovak Republic and Slovenia). Among the participants were also included representatives of the European Commission and the EU Presidency.

The aim of the Vienna Seminar was to deepen the understanding of key policy issues related to the enlargement process for both groups of central banks and to strengthen cooperation between them. The Vienna Seminar was the second high-level event on the accession process organized by the Eurosystem. The first initiative of this sort took place in Helsinki on November 11 and 12, 1999. On that occasion, the Eurosystem drew up its general accession policy framework.

On the evening of December 14, *Klaus Liebscher*, Governor of the OeNB, welcomed the participants of the seminar. In expressing his views on the process, he mentioned that Austria's geographic location, longstanding ties and traditionally very good relations with the accession countries gave it a special position. He called the economic opening-up of the current accession countries so far a success story, but also pointed out that several challenges are still lying ahead. Mr. Liebscher listed the large number of activities the OeNB has been pursuing to facilitate the preparations for a widening of the European Union to include Central and Eastern Europe ranging from technical assistance to analytical work and to the provision of platforms and meeting places to debate transition and accession-related questions and topics.

In his dinner speech, *Willem F. Duisenberg*, President of the ECB, described the accession process as a logical development from the historical perspective, e.g. by stating that although the term "enlargement" has become most common, the more appropriate word would be "reunification." Although much has been achieved until now, there are still major differences, which, together with the ongoing need for structural adjustment, make it necessary for applicant countries to maintain their reform efforts. Mr. Duisenberg reassured the audience that the Eurosystem has an open and positive attitude towards the prospect of the accession of new EU Member States, as well as their subsequent participation in the Exchange Rate Mechanism (ERM II) and adoption of the euro. Mr. Duisenberg drew the participants' attention to the main paper reflecting the Eurosystem's policy on the accession process, the October 1999 position paper entitled "The Eurosystem and the accession process," to which several paragraphs on the

¹ The proceedings of this seminar are contained in a publication entitled "Eurosystem Seminar with Accession Countries' Central Banks – Vienna 2000," which may be obtained either from the ECB, Bilateral Relations Division, or the OeNB, Foreign Research Division.

compatibility of currency board arrangements with ERM II and on euroization have been added in the meantime.

On December 15, *Tommaso Padoa-Schioppa*, Member of the Executive Board of the ECB, took over. In his welcome address he introduced the seminar and put it into a wider EU perspective. Mr. Padoa-Schioppa went on to recount some of the Eurosystem's main activities and policy positions on accession-related themes. The seminar itself, he observed, focused on three specific issues: price dynamics, the role of central banks in the accession process and cooperation between the Eurosystem and the accession countries' central banks.

The session on price dynamics, chaired by *Gertrude Tumpel-Gugerell*, Vice Governor of the OeNB, focused on the main challenges of the disinflation process that accession countries face in the years ahead, including those stemming from the process of catching up with the EU in terms of real income. She stated that identifying these challenges was particularly relevant, as they have an important bearing on the choice and design of monetary policy and exchange rate strategies.

The discussion was started with a presentation by *Pierre van der Haegen*, Director General of International and European Relations at the ECB, who gave an overview on price dynamics in the accession countries. The scope of the ECB's contribution was twofold: First, it broadly described the recent developments of price dynamics in accession countries. Second, it identified three main challenges likely to have an important impact on the monetary and exchange rate strategies to be followed by accession countries in the period ahead: (1) the completion of transition, (2) the parallel pursuit of nominal and real convergence, and (3) the need to adopt exchange rate strategies that permit the pursuit of disinflation while preserving external competitiveness in the run-up to EU and EMU accession.

The second presentation was given by *Peter Backé*, Special Adviser at the Foreign Research Division of the OeNB, who highlighted major driving forces of past and prospective price developments in the accession countries. The analysis of future developments placed particular emphasis on the implications of completing price liberalization and price adjustments, sectoral and economy-wide productivity movements, and wage developments. On this basis, the OeNB's contribution drew conclusions about future monetary and exchange rate policy options in the run-up to EU accession and beyond.

The round table on the role of central banks in the accession process was chaired by *György Surányi*, President of the National Bank of Hungary at the time. The discussion centered on central bank independence and the part central banks play in setting up a modern and sound financial sector. As both of these issues are very topical for the accession countries in the run-up to EU membership, many interesting statements about the gap between central bank legislation on the one hand and actual independence on the other were made. Financial stability issues were discussed, and experiences with different supervisory regimes were compared. Finally, the lender of last resort function of central banks and the interlinkages between this function, the banking supervisory task and the role of governments in bailing out banks were also touched upon.

The final session, a discussion about the cooperation between the Eurosystem and the accession countries' central banks, was chaired by *Fabrizio Saccomanni*, Central Director for International Affairs of Banca d'Italia. This session provided an opportunity to illustrate the many aspects and benefits of the intensive dialogue the Eurosystem maintains with the central banks of the accession countries.

The session started with an overview of cooperation issues and areas given by *Christian Thimann*, Head of the Bilateral Relations Division of the ECB. His findings are that the Eurosystem and the accession countries' central banks have already embarked on a wide range of cooperation activities, both at the technical and at the political level. These activities are aimed at preparing the smooth integration of the accession countries' central banks into the ESCB and subsequently into the Eurosystem.

All in all, the seminar can be regarded as a success not only because it facilitated an intensified economic analysis and interesting exchange of views, but also because it brought high-level Eastern and Western central bankers closer together and gave them an opportunity to deepen the knowledge of country-specific economic arguments. Therefore, it was announced that the dialogue started in Helsinki and prolonged in Vienna will become a regular event: the next Eurosystem Seminar with Accession Countries' Central Banks will take place in Berlin in December 2001.

Lectures Organized by the Oesterreichische Nationalbank

In the first half of 2000 the OeNB hosted five lectures by renowned economists and experts within its series dedicated to topics crucial to transition economies. Focus readers may benefit from the main insights drawn from the lectures, which are presented below. The invited speakers were *Martin Raiser*, Senior Economist at the European Bank for Reconstruction and Development, who presented the EBRD's Transition Report 2000; this lecture was accompanied by a press conference. *Hans Flickenschild*, Advisor in the IMF's European I Department, provided insights into the current problems of macroeconomic and structural policies in Croatia. The international community's High Representative for Bosnia and Herzegovina, *Wolfgang Petritsch*, presented his strategy for directing and monitoring the implementation of the civilian aspects of the Dayton Peace Accord in Bosnia and Herzegovina, focusing on the key issues of refugee return, economic reform and the effective functioning of state institutions under the heading of a lecture on economic consolidation by reform. The next speaker in this series was *Josef Tošovský*, Chairman of the Financial Stability Institute at the Bank for International Settlements, who delivered a lecture about the challenges of financial stability. *János Gács*, Project Leader at the International Institute for Applied Systems Analysis, provided a detailed account of wage convergence before and after accession, above all of Hungary, among other things drawing on the experience of the cohesion countries for his analysis.

The presentations are routinely rounded off with presentations by invited discussants and finally a discussion during which participants – representatives of the academic community, government bodies and reporters sharing a professional interest in the topics presented – have ample opportunity for an exchange with the speakers. The constraints on the length of the Focus on Transition do not allow a detailed account of the discussions.

Lecture by Martin Raiser

Presentation of the EBRD's Transition Report 2000

On November 17, 2000, Martin Raiser, Senior Economist at the European Bank for Reconstruction and Development, presented the EBRD's latest Transition Report in a lecture at the Oesterreichische Nationalbank. A press conference was also held in connection with this presentation. The event, which drew strong public interest, was chaired by Kurt Pribil, Head of the Foreign Research Division within the Section Economic Analysis and Research of the OeNB.

Drawing on the EBRD's experience as an investor in 26 countries of Central and Eastern Europe and the Commonwealth of Independent States (CIS), the Transition Report 2000 offers a comprehensive analysis of each country's progress in transition toward a market economy, while providing general in-depth overviews of important structural developments. Mr. Raiser started out by highlighting that the EBRD estimated the economies of the entire area to have expanded by an average of about 5% in 2000. This is the highest rate of real GDP growth of the whole region since the onset of transition. Moreover, as measured by the EBRD's transition

indicators, most economies in transition achieved their strongest advances in reform since 1997. These developments indicate that the region has overcome the repercussions of the Russian financial crisis. Furthermore, the overthrow of the Milosevic regime and the election of a new president of Yugoslavia have removed the last bastion of communist rule in Eastern Europe.

But, as Mr. Raiser pointed out, the Transition Report warns that the fruits of the current recovery are divided quite unevenly. The Report devotes a special chapter to a detailed analysis of employment, skills and transition, showing the resourcefulness of individuals in a difficult environment and their response to the decline in former state employment through self-enterprise and multiple job holdings. However, in order to cope, many people have also found themselves pushed into the shadow economy. With productive jobs scarce and hard to come by, many qualified employees in a number of CIS countries have clung to jobs bare of meaningful perspectives in ailing industries and are not able to realize their potential.

The Transition Report identifies the people and their skills and qualifications as the greatest treasure of the region. Unfortunately, this treasure is not put to efficient use everywhere. But it could be more effectively tapped by significantly improving the investment climate, Mr. Raiser maintained. For instance, obstacles to business start-ups should be removed. Many countries witness an urgent need for establishing a more viable social safety net for the victims of social and economic upheaval. In this way, resistance against the inevitable restructuring of industry could also be reduced. The Report argues that social security reforms to provide basic and targeted support to the poor are not simply a moral, but also an economic imperative for successful transition. Mr. Raiser then pointed to a chapter of the Report dealing with cross-border capital flows. Capital flows to the region have become more clearly differentiated since the Russian crisis, both in terms of recipient countries and in types of flows. After the setbacks in 1998 and 1999, net private flows to the region slightly expanded in 2000. FDI has been most robust.

The Transition Report generally gives a positive view of the economic prospects of the region. Perseverance with reforms, closer European integration of Central and Eastern Europe and better use of underutilized production capacities in the CIS countries can be instrumental for achieving sustained growth. On the other hand, Mr. Raiser cautioned, the lack of restructuring and technological innovation in the CIS poses a key obstacle to long-term economic expansion. The consequence of this weakness to innovate is already showing up in the widening gap of qualifications between workforces in the accession countries on the one hand and in the CIS on the other. Apart from that, the clear deterioration of educational standards in some CIS countries gives rise to concern over future economic chances for the younger generation.

Moreover, the Transition Report features a special assessment of the major challenges for economic policy in the FR of Yugoslavia. After ten years of mismanagement, armed conflicts and international isolation, the Yugoslav economy is in a deep crisis, but the prospects for recovery are favorable now.

Mr. Raiser stressed that the country and its capital hold a strategic position in Southeastern Europe and feature a potentially large market which would be interesting for foreign investors. Yugoslavia also has a large and formerly thriving SME sector. The Report supports the introduction of a comprehensive economic reform program, which would improve the business climate for domestic as well as foreign investors. Private entrepreneurs are perceived to be key to prosperity in Yugoslavia. The shedding of rigid industrial and power structures will be painful, though. The international community is aware of the necessity to provide assistance.

To conclude, the main messages of the Transition Report Update April 2001, are as follows:

Despite the continuing strong overall recovery in the region, some risks cloud the outlook for 2001, particularly a slowdown in the global economy. Growth in 2000 was registered in all countries of operation of the EBRD but one (Moldova), and only three cases of reform regression were observed (Belarus, Turkmenistan, Uzbekistan). Whereas Central and Eastern European countries tend to show more and more convergence in economic developments and policies, divergence and heterogeneity seem to have become the hallmarks of the CIS. With global growth flagging and the Russian economy slowing down, the aggregate GDP growth of the entire region is expected to decrease from 5.3% in 2000 to 3.7% in 2001.

Lecture by Hans Flickenschild

The Current Problems of Macroeconomic and Structural Policies in Croatia

On April 4, 2001, Mr. Hans Flickenschild, Advisor, European I Department, International Monetary Fund, delivered a lecture on “The Current Problems of Macroeconomic and Structural Policies in Croatia” at the Oesterreichische Nationalbank.

Introducing the topic, Mr. Flickenschild described the difficult position of the new government elected at the beginning of 2000. The country, which had been politically isolated before the election, needed to establish a new macroeconomic framework. The six-party center-left coalition had not had a chance to gain experience governing a country and was being closely observed by the international community.

Altogether, the IMF undertook three visits to Croatia in 2000 before a stand-by arrangement was concluded during the fourth visit in December. The arrangement was approved by the IMF Board in March 2001, has a duration of 14 months and a volume of SDR 200 million, to be made available in five equal tranches. In view of the country’s comfortable foreign exchange reserve level, good access to capital markets and the positive external outlook, the Croatian authorities do not intend to draw upon these funds and will treat the arrangement as precautionary.

The program has the following key parameters:

- Real GDP growth should accelerate to 4% in 2001 from an estimated 3.5% in 2000.

- The outlook for inflation is benign, with retail price inflation subsiding to 4.5% in 2001 from 7.4% in 2000 as a result of wage restraint, exchange rate stability and oil price moderation.
- The current account deficit should contract further in 2001 to 3.9% of GDP (from 4.6% in 2000).
- Fiscal policy aims to reduce the consolidated central government deficit to 5.3% of GDP in 2001 from an expected 6.5% in 2000. The deficit is expected to be financed mainly with privatization receipts. A telecommunications company, two banks, an insurance company and a pipeline are to be privatized this year.
- Wage restraint is to be achieved by a reduction of the government sector wage bill, a freeze of average wages in public enterprises and a social pact that limits wage increases in the rest of the economy.
- The registered unemployment rate of 22.5% in 2000 is to be reduced in 2001. Mr. Flickenschild noted that registered unemployment considerably overstates “true” unemployment, which stood at about 15% in 2000. Since one performance criterion in the agreement is a cut in public sector employment by 10,000, any employment gains will depend on the expansion in the private sector.
- The Croatian National Bank (CNB) expects demand for broad money to continue to advance quickly in 2001, reflecting faster growth in economic activity and strengthening confidence in the banking system, especially after repayment of the balances of insured deposits in failed banks at the end of 2000.

The program contains no performance criterion that relates to the exchange rate. The Croatian National Bank’s monetary policy is designed to ensure stability of the nominal exchange rate under the managed float regime that is in place. But the CNB will not resist persistent or large exchange market pressures or tolerate that the achievement of the quarterly international reserve targets is endangered.

The program is fraught with several risks: The 2001 growth projection could prove overly optimistic if economic growth in Europe slows substantially or if oil prices fail to decline. Moreover, the sensitive security situation on the Balkans may affect expectations. The main risks to the fiscal deficit target relate to wage policy in the public sector, health expenditure and tax revenues. Privatization may also face some risks. Despite considerable incentives, the outlook for FDI is somewhat uncertain. Croatia has some fear of foreign takeovers, especially land purchases. However, the privatization process should be completed in 2002. The program arranged with the IMF is accompanied by structural programs agreed with the World Bank.

One point the ensuing discussion focused on was the development of the banking sector. According to Mr. Flickenschild, the situation of the banking system has been improving since the 1998 crisis. The number of banks was reduced and three rehabilitated banks were sold to foreign banks in 2000. The supervisory framework has been strengthened. Real interest rates on loans are at a very low level. While household borrowing has increased, banks are still reluctant to lend to enterprises.

Responding to why the IMF is so optimistic about GDP growth and external trade, Hans Flickenschild pointed out that the country's integration with the world economy has just started: Croatia became a member of the World Trade Organization (WTO) in November 2000, it obtained asymmetric trade liberalization from the EU in September, and negotiations on a Stabilization and Association Agreement started in November. A free trade agreement with Bosnia and Herzegovina entered into effect at the start of 2001, an agreement with Hungary had just been concluded. Also the changes in the Federal Republic of Yugoslavia will have a positive impact on Croatia's further economic development.

Lecture by Wolfgang Petritsch

Bosnia and Herzegovina: Economic Consolidation by Reform?

On May 14, 2001, Wolfgang Petritsch, the international community's High Representative for Bosnia and Herzegovina, and Norbert Feldhofer, his economic adviser, delivered a lecture on "Bosnia and Herzegovina: Economic Consolidation by Reform?" OeNB Vice Governor Gertrude Tumpel-Gugerell introduced the High Representative.

As Wolfgang Petritsch pointed out, the international main actors in Bosnia and Herzegovina are the NATO-led military Stabilization Force (SFOR), which is the peacekeeping force, and the Office of the High Representative (OHR), which is the chief civilian peace implementation agency in Bosnia and Herzegovina. The OHR has 800 staff members of 25 nations and receives 53% of its funding from the European Commission. The High Representative's task is to direct and to monitor the implementation of the civilian aspects of the Dayton Peace Accord in Bosnia and Herzegovina on behalf of the international community as well as to coordinate the activities of the civilian organizations and agencies in Bosnia and Herzegovina. The mandate of the High Representative gives him far-reaching powers over Bosnia's political and constitutional institutions and designates him as the authority to impose laws if Bosnia and Herzegovina's legislative bodies fail to do so. Within this framework, Mr. Petritsch pointed out that during his term of office he has had to discharge approximately 60 obstructive public officials from office for violation of legal commitments.

High Representative Petritsch presented his strategy within the scope of the implementation of the Dayton Peace Accord, focusing on three key strategic areas: refugee return, economic reform and the effective functioning of state institutions.

Wolfgang Petritsch pointed out that since war broke out in 1992 more than 2.2 million people – over 50% of the local population – fled the country or were displaced from their homes. The return of refugees is a complex process that was not very successful initially, because the two entities of Bosnia and Herzegovina (the Bosniak-Croat Federation and the Republika Srpska) tried to maintain ethnically "clean" regions by blocking the return of refugees. Mr. Petritsch depoliticized the return issue, imposed the implementation of property legislation, under which all refugees and displaced

persons are entitled to repossess their prewar homes, and removed officials who obstructed the implementation of the property laws. The building up of a civil society that respects human rights is one of the highest priorities. Wolfgang Petritsch called the year 2000 a breakthrough in refugee returns.

In the economic sphere, High Representative Petritsch is concentrating his attention on revitalizing the economy through reform. The country must move from an aid-driven to an investment-driven economy. The crucial elements of the economic reforms are the creation of a single economic space, the improvement of the business environment and the achievement of a sustainable general government budget. Turning to particular achievements, Wolfgang Petritsch mentioned the introduction of anonymous vehicle registration plates to guarantee the freedom of movement. Moreover, Mr. Petritsch is strengthening government by focusing his activities on the establishment of independent public utilities. Within this framework, the High Representative mentioned the establishment of the Telecommunications Regulatory Agency to enable telecom sector reform. Further state-level regulatory mechanisms are set to follow in the electricity, gas and railroad sectors. Another important issue is the restructuring of the tax system. Progress has been made in equalizing tax rates in the two entities and in unifying the tax base. The implementation of a standardized income tax law is planned for this year.

The strategies of the OHR focusing on the improvement of the business environment comprise the reform of the financial and banking sector, the privatization of state-owned enterprises and judicial reforms. A significant contribution to creating a more favorable environment for enterprises in Bosnia and Herzegovina was the closure of payments bureaus and their replacement by a commercial bank-based clearing system. Significant progress has also been achieved in the area of bank privatization. Investment by foreign banks, mainly Austrian, Croat and Turkish banks, increased competition and has more than halved the cost of borrowing, which has now fallen from 30% to 10%. In pursuit of the creation of a business-friendly environment, 2,000 state-owned enterprises are scheduled to be sold this year either by tenders or vouchers and with the help of international experts. Success has been achieved in small-scale privatization. Tender privatization of 140 large-scale enterprises is aimed at attracting foreign investors to Bosnia and Herzegovina. The reform of competition law, contract law and property law will provide the framework for a functioning administration and society.

To achieve a sustainable general government budget, a Court of Audit and a Treasury are slated to be established, explained the OHR's economic adviser Norbert Feldhofer, who also mentioned that the current stand-by arrangement with the IMF and the currency board regime preclude domestic borrowing by the public sector, which therefore has to rely on international financial institutions.

A further central strategic priority of the High Representative is the building of independent, functioning public institutions and the strengthening of governance at all levels. In this area, a major recent achievement has been the creation of a (central) state-level court for Bosnia and Herzegovina, which is important for foreign investors wishing to settle legal disputes.

Wolfgang Petritsch also stressed the need to establish a modern, independent and single cross-entity media and public service broadcasting system in Bosnia and Herzegovina and welcomed the launch of the new public radio, which employs editorial staff of all ethnicities and is professionally run.

Mr. Feldhofer provided a brief overview of economic developments in Bosnia and Herzegovina. In 1998, the convertible mark (BAM) was introduced as the state currency. It has mostly displaced the Croatian kuna in the Croat-majority area and the Yugoslav dinar in the Republika Srpska. The BAM is pegged to the Deutsche mark at a 1:1 ratio under the currency board arrangement and will be pegged to the euro from 2002. Mr. Feldhofer pointed out that since the introduction of the BAM, reserve assets have increased to DEM 1 billion. The convertible mark acts as an anchor of stability.

Since 1996 real GDP growth in Bosnia and Herzegovina has always been positive and continues to decline from exceptionally high levels. The outstanding growth rate of approx. 85% in the first year is attributed to the start of international funding of USD 5.1 billion earmarked for medium-term-reconstruction in Bosnia and Herzegovina. The other explanation for the extremely high growth rate is, of course, the very low base level of economic activity in war-torn Bosnia in 1995. The reconstruction phase is now largely complete. Most international funding is now on the decline, but macro-economic stability has been largely maintained. GDP is expected to continue to grow at rates of between 5% and 10%. The inflation rate stayed at a very low level in the Federation (2% to 3%) and remained at a higher level in the Republika Srpska (about 14%). Norbert Feldhofer regretted that there was no reliable indicator for country-wide price increases in Bosnia and Herzegovina, but the central bank estimates that the country-wide average inflation rate amounted to 4% to 5%. Bosnia and Herzegovina is confronted with serious structural problems. Unemployment is extremely high (40%), and a recent survey showed that 60% of Bosnia's youth would leave the country if they had the chance. The average net salary in Bosnia and Herzegovina (about BAM 400 per month) is higher than in the other countries of the Balkans, which reduces the country's international competitiveness.

Wolfgang Petritsch pointed out that Bosnia and Herzegovina needs to reduce its strong dependence on the international community and that the Bosnian citizens, who are still deeply traumatized by war, have to begin to take ownership of their economic future. Moreover, regional cooperation is essential to ensure stability and prosperity in Bosnia and Herzegovina and is the precondition for a rapprochement to the European Union. It is a long way to EU membership, but Wolfgang Petritsch believes that Bosnia and Herzegovina could achieve this aim. In the short term, the authorities will strive to fulfill the accession criteria for Council of Europe membership, but their long-term aim must be Bosnia and Herzegovina's integration into Europe.

Lecture by Josef Tošovský

The Challenges of Financial Stability

On May 15, 2001, Josef Tošovský, Chairman of the Financial Stability Institute at the Bank for International Settlements, delivered a lecture entitled “The Challenges of Financial Stability.”

He began his lecture with an overview of the changing environment of financial services, continued with the topic of financial crises and policy reactions and concluded with his thoughts on how to bridge the gap between the macro- and microprudential aspects of financial stability.

The development of information technology has substantially changed the environment of financial services. The speed of information and money flows and the quantity of information have increased dramatically. Transactions can be carried out by using cash machines, plastic cards and computers, which changes personal relations between banks and their customers. Thanks to computers, financial engineering can use advanced mathematical models. At the same time, the new technologies raise concerns about privacy, security and risk management.

Previously, the trend was to increase state regulation, centralization and, in some cases, nationalization. Now, the opposite trends – liberalization, privatization and deregulation – prevail. Governments are retreating from economic management while retaining responsibility for the sound operation of financial systems. As governments have become smaller relative to their economies, market interventions might become less effective. Financial markets are witnessing rapid growth around the world. Short-term capital may enter or exit a country in huge volumes at any given time. Large and complex financial institutions are emerging.

These developments have great benefits: they help provide for the optimal allocation of capital, and help nations produce goods and services for which they have a competitive advantage.

However, in the new financial environment, crises unfold more quickly, more virulently and tend to have large dimensions. There is no agreement about how best to handle crises once they occur. A flexible and managed case-by-case approach is probably the most realistic course of action. A broad consensus has developed about how to strengthen the institutional framework so as to create more crisis-resistant financial systems and economies.

International organizations have assumed essential parts of this work. The IMF continues to stress the importance of implementing sound macroeconomic and structural policies, focusing on financial markets and crisis prevention. To this end, it has created the International Capital Markets Department, established the Capital Markets Consultative Group, performs the Financial Sector Assessment Program (FSAP) and elaborates Standards and Codes. The World Bank cooperates with the IMF on the FSAP and on the definition of Standards and Codes, and drew up Guidelines for Public Debt and Reserve Management. The Bank for International Settlements plays an important role in financial stability. Under its umbrella, the Committee on Global Financial Systems was established in 1971, the

Basel Committee on Banking Supervision was founded in 1974, the Committee on Payments and Settlements Systems was established in 1990 and the Financial Stability Forum and the Financial Stability Institute were created in 1999.

Key standards play an important role in establishing sound financial systems. The most important of these standards and the organizations which drew them up are listed below:

- International Accounting Standards (IASB)
- Principles for Corporate Governance (OECD)
- International Standards on Auditing (IFAC)
- Core Principles for Systematically Important Payment Systems (CPSS)
- Forty Recommendations of the Financial Action Task Force on Money Laundering (FATF)
- Core Principles for Effective Banking Supervision (Basel Committee on Banking Supervision)
- Objectives and Principles on Securities Regulation (IOSCO)
- Insurance Core Principles (IAIS)

As financial systems are becoming increasingly internationalized, governments are gradually losing national autonomy in exercising fiscal and monetary policy and in controlling domestic financial systems.

Much effort is being put into structural reforms and institutional arrangements for the regulation and supervision of financial markets. Here, the question being discussed is whether financial sector supervision should be combined under one roof, and whether banking supervision or consolidated supervision should be the responsibility of the central bank.

In dealing with how to bridge the gap between macro- and microprudential aspects of financial stability, Mr. Tošovský began by providing definitions. The macroprudential dimension can be defined as limiting the cost of financial distress to the economy, to avoid systemic risk, while the microprudential dimension of financial stability focuses on individual institutions.

When bridging the gap between the two aspects of financial stability, the problem of procyclicality arises, which can lead to financial instability. Financial market participants give inappropriate responses to changes in risk over time, and they tend to react to risk, even if it is correctly measured, in ways that are socially suboptimal. Risk is usually underestimated in economic booms and overestimated in recessions.

Procyclicality has the following causes: Banks' internal rating systems focus on the one-year horizon. As a result, the average rating of a bank's loan portfolio is likely to change over the course of the business cycle as the cycle changes. External rating agencies attempt to rate borrowers "through the cycle," but they are not always successful (as the case of Korea shows). Quantitative credit risk models tend to extrapolate recent history: good current economic conditions signal good future prospects. Accounting standards and taxation arrangements stand in the way of proper economic provisioning. Supervisory authorities also tend to overreact to prevent criticism of their own performance by being seen to be "doing something."

The policy options are to promote an improved understanding of risk, to use supervisory instruments in a discretionary manner, to apply regulatory, supervisory and accounting rules that help reduce the procyclicality of the financial system and to pursue an anticyclical monetary policy.

Lecture by János Gács

Wage Convergence before and after EU Accession

On June 8, 2001, János Gács, Project Leader at the International Institute for Applied Systems Analysis (IIASA) in Laxenburg and Senior Research Fellow of KOPINT-DATORG, Economic Research, Marketing and Computing Company Limited in Budapest, delivered a lecture on: “Wage Convergence before and after EU Accession: Economic Foundations, International Experience and Possible Scenarios for Hungary” based on a study prepared with Ágnes Hárs and Antonia Hüttl and commissioned by the Hungarian Ministry of Economics in Budapest. Michael Landesmann, Research Director of The Vienna Institute for International Economic Studies (WIIW) and professor of economics at Johannes Kepler University in Linz acted as discussant.

In his introduction, Mr. Gács pointed out that the concept of wage convergence emerged just about two years ago in the political debate on EU enlargement when some pressure groups demanded that Central and Eastern European countries should achieve 70% to 80% of the average wage level of the EU before acceding to the EU.

In his lecture, Mr. Gács focused on four questions: First, did the concept of wage convergence have any theoretical foundations; second, how did the poorer member countries of the EU, the so-called cohesion countries, achieve convergence before and after accession; third, what was the current position of Hungarian wages in relation to the EU and other candidate countries and fourth, what projections could be made for future Hungarian wages if Hungary acceded rapidly and if Hungary did not accede for the time being?

Answering the first question, Mr. Gács pointed out that economic theories essentially did not deal with wage convergence, particularly not in the sense that wages should converge before a country is regionally integrated. Wage convergence can be interpreted by applying the factor price equalization theory; however, this theory has very restrictive conditions which do not hold in real life. Alternatively, wage convergence can be interpreted in the framework of growth theory as a phenomenon accompanying real convergence, but it has no theoretical elaboration. Only very few investigations focus on the convergence of wages in the EU. The reason may be that previous enlargements have never before been preceded by such politically heated debates about the need to narrow the wage gap. However, it is worth mentioning that some wage indicators of the cohesion countries were so low at the time of their accession that if present convergence demands had been applied, they could have been kept out. Based on their current wage levels, some of the cohesion countries (particularly Greece and Portugal) could easily be expelled from the Union even now if wage convergence really were a criterion for EU membership. For example, total hourly wages in Portugal

reached 35% of the EU level at accession, and in 1997 they stood at 40% of the EU average.

In his response to the second question about whether the cohesion countries achieved wage convergence following accession, Mr. Gács presented time series and econometric results. Investigations show that while some countries follow a more or less clear convergence to EU levels, progress in other countries is ambiguous. Wage convergence can be considered part of the real convergence process following EU accession. While the relation between wage and GDP growth in the cohesion countries was not stable before accession, after accession these countries began to become connected through elasticities characterizing the EU as a whole: 1% per capita GDP growth is accompanied by 0.65% to 0.80% growth of aggregate wage rates.

Turning to the third question about the current position of Hungarian wages, János Gács analyzed various indicators. All indicators show that the distance to EU levels is large, but it is larger if calculated at exchange rate parity than at purchasing power parity. For example, in 1996 the gross wages of manual workers in manufacturing reached 11.2% of the EU average at exchange rate parity and 30.4% at purchasing power parity. In addition, particularly in terms of net wages, Hungary is lagging behind even its East European neighbors. In 1996, net earnings in Hungary at purchasing power parity reached only 60.1% of the Czech and 72.9% of the Polish level. On the other hand, the low wage level clearly contributes to the increasing international competitiveness of Hungarian products.

Answering the fourth and final question about the possible convergence paths for Hungarian wages, Mr. Gács elaborated four scenarios. According to the most optimistic scenario, namely of Hungary joining the EU in 2005, the country will experience sustained economic growth, wages will almost keep pace with the progress of labor productivity and the economy will be able to catch up 15 percentage points of its 70% lag behind the EU average level of wages at purchasing power parity in the next 20 years. The alternative scenarios show a more modest development. Even if the country joins the EU in 2005 and GDP grows fast while wages develop moderately, Hungary would hardly make up for any part of its lag behind average EU wage levels. The cohesion countries also experienced moderate wage developments in certain periods in the past decades.

As a policy conclusion, Mr. Gács emphasized that even with the help of the boosting forces of EU membership, wage convergence in backward economies takes considerable time. He recalled the experience of the east German Länder after unification with West Germany, which made them EU members as well. Wages increased rapidly for political reasons, but society had to pay a high price for convergence with unemployment. As soon as transfers from the West began to decrease, enterprises paid lower wages than negotiated with west German trade unions. This experience shows that if wage developments do not originate in an organic way in the productivity potential and structural characteristics of a given economy, the costs of fast convergence will be high, and the welfare benefits of higher wages may be eroded by correction mechanisms.

In his contribution, Michael Landesmann raised three issues: first, he touched on the theoretical background; second, he posed the question of nominal convergence; and third, he addressed the projections for the future development of wages in the accession countries.

On the first issue, Mr. Landesmann pointed out that theories consider productivity as equal to real wages and investigate the tradables sector only. Individual countries may behave differently; therefore, it may be misleading not to regard the data of the cohesion countries individually.

In Michael Landesmann's opinion, nominal convergence is no less important than real convergence. Nominal wages in accession countries will also close up to EU levels because of exchange rate appreciation. This closing up may be much faster in the accession countries than in the cohesion countries because the Balassa-Samuelson effect will be boosted by the advanced level of integration of the applicant countries with the EU.

On the issue of future developments, Michael Landesmann stated that it might be misleading to simply take the pattern of the cohesion countries to forecast wage formation in the accession countries. The accession countries' product markets are more integrated into the EU even today than those of the cohesion countries, and the accession countries are also closer to the center of the EU geographically. The presence of many EU citizens in the accession countries will help raise rental prices, which also contributes to nominal convergence. Buoyant tourism between the EU and the accession countries will also accelerate the closing-up. The fear of current account deterioration impedes a swift convergence of wages in line with per capita GDP in the accession countries. Mr. Gács analyzed unit labor cost, but competitiveness depends not only on unit labor cost, stated Mr. Landesmann.

The lively discussion after the presentations mainly focused on the problem of immigration from the East European countries after they join the EU. The question of the danger of a brain drain from Eastern Europe was also raised.

In his answer, Mr. Gács pointed out that he did not expect a great immigration wave from Hungary into the present EU after the country's accession to the Union. Labor mobility is low even within Hungary despite the 70% wage differences between the eastern and western parts of the country in some job categories. Beside housing problems and the high cost of commuting, the main reason workers do not move from the East to the West is that work patterns and work intensity are different in the western part of the country and workers from the East fear that they would not meet the standards.

On the brain-drain issue, Mr. Gács pointed out that in some highly productive and convertible labor categories, wages in Hungary were already close to West European levels. (It is a general experience that wage differences in developing countries are higher than in developed ones.) In his knowledge, after Germany opened its labor market for computer experts, only 1,300 Hungarian experts applied for jobs there, a low number considering that 4,000 students graduate annually as IT experts in Hungary.

The “East Jour Fixe” of the Oesterreichische Nationalbank – A Forum for Discussion

The East Jour Fixe of the Oesterreichische Nationalbank, a series of meetings initiated in 1991 as a forum in which economists, members of academia, government officials and other experts on Eastern Europe meet to discuss specific transition issues, now looks back on a decade-long tradition. This issue of Focus on Transition contains a special overview and chronology of these meetings over the past decade. After a pause in the second half of 2000, the East Jour Fixe series was continued in the first half of 2001 with three presentations. The meetings are always opened with speeches held by experts on key topical issues related to transition economies. High-profile discussants are invited to comment on the contributions, and finally policymakers, analysts and researchers engage in an exchange of views during the general discussion, which is given ample room on the agenda.

At the 39th East Jour Fixe meeting on February 9, 2001, Professor Andries Brandsma, Deputy Head of Unit of the Economic Affairs and Related Issues within the Pre-Accession Countries Unit of the European Commission, dealt with the macroeconomic dimension of enlargement, concentrating on the degree of integration of the candidate countries into the EU and on real economic convergence. The meeting was chaired by Peter Backé. Mr. Brandsma's lecture was discussed by Andreas Wörgötter of the Institute for Advanced Studies and Martin Wagner, University of Bern.

The 40th East Jour Fixe meeting on March 23, 2001, had Jakob de Haan, professor from the University of Groningen and CESifo, as its main speaker. Professor de Haan presented a paper written with Helge Berger and Erik van Fraassen on the most suitable monetary arrangement – a currency board or a central bank – for a transition economy seeking to reduce inflation. Peter Backé chaired the meeting, and Július Horváth from the Central European University Budapest and Thomas Url from the Austrian Institute of Economic Research commented the paper as discussants.

Finally, the 41st East Jour Fixe meeting was held on June 22, 2001, to mark the 10th anniversary of the East Jour Fixe series. Fritz Breuss, professor at the University of Economics and Business Administration in Vienna and researcher at the Austrian Institute of Economic Research, presented his recent study about the macroeconomic effects of EU enlargement on EU Member States and on the accession countries. Wilhelm Kohler, professor at Johannes Kepler University, Heinz Handler, Director General at the Austrian Ministry of Economic Affairs and Labour, and Jarko Fidrmuc, analyst at the Oesterreichische Nationalbank, were the discussants at this meeting chaired by Doris Ritzberger-Grünwald, Assistant to the Head of the Foreign Research Division. A more detailed account of the most recent East Jour Fixe meetings is presented below, followed by a review and a table listing all 41 meetings over the past decade.

Contribution by Andries Brandsma

The Macroeconomic Dimension of Enlargement

The 39th East Jour Fixe took place on February 9, 2001, and focused on "The Macroeconomic Dimension of Enlargement" of the European Union to the East. The meeting was chaired by Peter Backé, Special Adviser (Foreign Research Division).

The main speaker at the meeting was Mr. Andries Brandsma, Deputy Head of Unit, Economic Affairs and Related Issues within the Pre-Accession Countries, European Commission. He concentrated on the degree of trade integration of the candidate countries with EU economies and presented some thoughts on the prospective speed of real economic convergence.

Mr. Brandsma emphasized that the upcoming accession of candidate countries from the East is not the first enlargement of the European Union. It will also not be the first in which countries with a rather recent anti-democratic history are joining the European Communities. Moreover, as on previous occasions and although the Nice Summit paved the way for enlargement, additional reforms may need to be undertaken in order to ensure the functioning of the Union. As his personal view, Mr. Brandsma expressed cautious optimism about ongoing initiatives in Brussels to this end, which should culminate in the Conference of the Representatives of the Governments of the Member States in 2004.

Andries Brandsma described the economies of the ten Central and Eastern European accession countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Rumania, Slovakia, Slovenia) as already highly integrated into the EU system. Roughly 70% of the accession countries' exports go to the EU. Foreign direct investment has amounted to nearly 4% of GDP on average in recent years. However, whereas economic interaction with the EU has increased, trade and financial flows among the accession countries themselves have remained modest.

Mr. Brandsma emphasized that the speed of real economic convergence was a critical issue. In his view, the skills of the labor force have to be enhanced to spur economic growth in the long run. Apart from the qualification of the labor force, macroeconomic stability and institutional quality are important for sustainable growth. The year 2000 was the first year in which real GDP growth was positive in all ten countries. The EU Commission's Autumn 2000 economic forecast predicts that this will continue over the next two years. GDP growth is expected to be higher than 4% a year on average in the accession countries. This means an acceleration of growth from 3.5% between 1994 and 1999; by comparison, GDP increased by 2.25% in the EU in the same period.

Macroeconomic simulations of the EU's enlargement toward the east are based on Solow's neoclassical growth model and its recent extensions. Within this theoretical framework, three different enlargement scenarios were formulated: The "baseline" scenario assumes a relatively positive scenario with a continuation of economic reforms in the accession countries, but with no enlargement until 2010. Under these assumptions, the accession

countries are expected to grow by about 2.9% a year on average, just slightly faster than the EU (2.5%). The second scenario assumes the accession of five countries to the EU in 2005. The acceding countries are expected to grow faster than in the baseline scenario as a result of capital accumulation and total factor productivity growth. However, migration might have slightly negative growth implications for these countries. All this together could yield a growth rate of 3.8% on average (2005–2009). If reforms are comprehensive and targeted at bottlenecks, growth could reach up to 5%. The EU's GDP could increase by 0.4 percentage points in the long run. The third enlargement scenario assumes that all candidate countries will join the EU within the next ten years. This would allow for an even higher growth differential in the new member states. Average annual economic growth could be between 4.6% and 6.1% after accession. According to the most optimistic scenario, the EU's GDP could grow by 0.8 percentage point. Trade effects on top of the ones that have already taken place are not expected to have significant income implications, with the possible exception of the scenario in which all ten Central and Eastern European applicant countries join the EU.

Mr. Brandsma used these preliminary results to illustrate the possible speed of convergence of the accession countries to the EU average: The first scenario assumes that reforms will not be reversed in the next decade, and that additional reforms necessary for EU membership will be undertaken. This will lead to 4.5% average GDP growth. The second scenario assumes that EU membership will lead to a strengthening of the structural reforms that have been set in motion. In this case, GDP could grow by over 6% per year in the future Member States. This implies that annual economic growth in the candidate countries could be increased by up to 2 percentage points a year if comprehensive and forceful reforms are undertaken and if macroeconomic stability is preserved, which in purchasing power terms would raise their real GDP per capita to 47% (compared to 44% in the first scenario) of the EU average by 2010. In a longer-term perspective, it would take the average candidate country 27 years to reach 75% of the EU average, a level that corresponds to the threshold which is currently in force for Objective 1 support under the EU Structural Funds.

Andreas Wörgötter, Head of the Country Studies V Division of the OECD, and Martin Wagner, Assistant Professor at the University of Bern, acted as discussants.

Andreas Wörgötter was somewhat more sceptical than Andries Brandsma about whether the upcoming enlargement could be compared to former accessions. He stressed the differences between a peripheral southern enlargement and a central enlargement to the East. He further criticized that, due to their bilateral ("hub and spoke") nature, the Europe Agreements prevented candidate states from trading more with each other. Mr. Wörgötter pointed out that the growth prospects of each accession country had to be analyzed separately and that differences would have to be taken into account.

Martin Wagner first addressed the application of the neoclassical growth model to forecasts for Eastern Europe. He pointed out that these models are

sensitive with respect to the estimates of capital stock in the countries analyzed. In particular, measurement errors of capital stock lead to biased estimates of total productivity growth, which is computed as a residual in the model. Second, he questioned whether the available Central and Eastern European data could be used for forecasting purposes. As the time series are short, unreliable and biased by transformational recession, Mr. Wagner would prefer to estimate growth models for other world regions. In a second step, these results could be used to calibrate simulation models for Eastern Europe.

In the second part of his comments, Mr. Wagner presented the results of a recent study he performed together with Jaroslava Hlouskova (Institute for Advanced Studies in Vienna). They applied convergence parameters as estimated for various countries to accession countries. However, despite Mr. Wagner’s misgivings about Central and Eastern European data, both approaches lead to nearly the same conclusions about the prospective convergence of Central and Eastern European accession countries to the EU. This confirmed the robustness of the macroeconomic scenarios Mr. Brandsma presented.

The following general discussion focused mainly on the topic of migration and included questions about education and about the outcome of the Nice Summit. Some participants were more optimistic than Andries Brandsma about the level of education in the candidate countries, especially about the level of computer literacy, and expected brain drain to remain a problem for the accession countries. This could make them less attractive for FDI, which could in turn slow down real convergence. Other participants expected highly educated people to return to their home countries in the long run or simply considered the concern excessive. According to Mr. Brandsma, any potential brain drain would be temporary. He stressed that in the longer run migration and greater mobility would be beneficial for integration. In addition, the discussion addressed commuting as an issue of specific concern to Austria.

Contribution by Jakob de Haan

How to Reduce Inflation: An Independent Central Bank or a Currency Board? The Experience of the Baltic Countries

The 40th East Jour Fixe took place on March 23, 2001. The meeting was chaired by Peter Backé, Special Adviser (Foreign Research Division). The main speaker, Jakob de Haan, professor from the University of Groningen and CESifo, presented a paper written with Helge Berger and Erik van Fraassen on the topic of “How to Reduce Inflation: An Independent Central Bank or a Currency Board? The Experience of the Baltic Countries.” Július Horvath, associate professor at the Central European University Budapest and professor at Academia Istropolitana Nova, Bratislava, acted as a discussant.

Professor de Haan’s presentation centered around the question of the proper monetary arrangement for transition economies to achieve low infla-

tion. In doing so, he focused on two basic options – a currency board arrangement (CBA) and an independent central bank under flexible exchange rates.

Jakob de Haan started by presenting an extended Barro-Gordon model, which he used to analyze, in formal terms, three factors that are of major importance for assessing which of these two monetary arrangements a country should adopt: the stabilization culture of the country under consideration, the price stability orientation and the independence of the central bank of a potential anchor country or area, and the degree of synchronization of business cycles. The lower the first and the higher the second and third factors are, he concluded, the more attractive a currency board becomes.

He then listed additional considerations which are of relevance when judging the appropriateness of a particular exchange rate regime:

- Choosing the appropriate pegging currency is important, also because it affects *transaction costs*.
- The *political support* – both internal and external – for the chosen regime can determine its sustainability and is reflected in the interest rate premium.
- There is a loss of *seigniorage* in currency board arrangements compared to independent central banks. This loss can be mitigated or counterbalanced by the lower interest rates on government debt.
- The central bank in the CBA cannot exercise the *lender of last resort* function. This lack can be made up by accumulating foreign exchange reserves in excess of the monetary base, having a strong banking supervision or having an ample deposit insurance scheme.
- Based on this framework, Jakob de Haan then undertook a normative ex post evaluation of the monetary regime choices of the three Baltic countries. He pointed out that Estonia made the best choice in using the Deutsche mark and the euro as an anchor currency because of the strong correlation of output and inflation shocks between Estonia and Germany. The same correlations are negative in the case of Lithuania and the U.S.A., which implies that Lithuania’s choice was not fortunate. Latvia’s peg to the SDR is a solution between the two previous ones. Transaction costs are low for Estonia and Latvia, as their trade with the Deutsche mark/euro and the SDR areas is strong, but are high for Lithuania. Estonia also ranks best in terms of political support because its interest rate differential is much smaller than that of the two other countries. All three Baltic countries experienced banking crises in the last decade. They solved the crises either by letting the banks fail or by securing government or World Bank bailout.

In discussing Jakob de Haan’s presentation, Július Horváth made four main points. First, he presented his own calculation on the correlation of shocks between the Baltic countries on the one hand and Germany and the U.S.A. on the other, based on a somewhat divergent (structural VAR) methodological approach and distinguishing between (permanent) supply shocks and (temporary) demand shocks. Július Horváth’s results broadly confirmed Professor de Haan’s findings.

Second, Július Horváth noted that it is an interesting cultural issue – probably also an economic issue – that one sees a weakening of the importance of national monetary sovereignty across the world. CBAs have returned to what he called the developed monetary world since the 1990s, whereas previously these arrangements were perceived as an instrument of oppression.

Third, he argued that the cost of protecting a financial system under a CBA against a liquidity crisis may be rather high compared to the cost of a discretionary lender of last resort, and named Argentina as a case in point.

Fourth, Professor Horváth questioned whether corner solutions were the only viable exchange rate regimes, as has been widely claimed in recent years. He pointed out the IMF’s classification of exchange rate regimes, which showed that half of all countries still have some kind of intermediate regime.

Thomas Url, Senior Economist at the Austrian Institute of Economic Research (WIFO), who was to act as a second discussant, could not attend the meeting for health reasons. However, he submitted written comments on the paper, in which he made the following main points:

The question whether CBAs are more credible than independent central banks is related to the discussion during the build-up phase of EMS I, when it was argued that exchange rates are a highly visible and publicly controllable target. Therefore exchange rate pegs are preferable to other monetary/inflation targets and avoid the credibility problem associated with independent central banks’ incentive to play the tradeoff between inflation and growth. The break-up of EMS I showed us that the credibility gain of an exchange rate peg is fickle.

After summarizing the discussion on optimal currency areas, Thomas Url discussed the choice of anchor currencies, stating that the balance of payments includes not only the trade balance but also income flows, transfers and capital flows. If capital flows are large, the optimal weight of a currency basket also includes currencies that might not even appear in the trade account. To his knowledge this is why Lithuania chose the U.S. dollar as its anchor; this probably also explains Latvia’s choice of the SDR. He finds that Mr. de Haan’s recommendation to switch to a euro peg may be motivated by the Baltic countries’ aspirations to join the European Union, which will be associated with joining ERM II.

The ensuing discussion was lively and touched upon a broad range of issues. These issues included possible exits from CBAs, potential boom-bust cycles in CBAs, optimal inflation rates, seigniorage, the importance of the anchor currency, the differences and similarities between CBAs and dollarization/euroization, and lessons for other countries.

It was pointed out that an exit from a CBA should be considered very carefully, in particular if the regime functions successfully, for credibility may be linked to the CBA itself and not necessarily to the monetary policy-makers. Professor de Haan believes that the accession countries using CBAs should typically retain these arrangements until they join the euro area.

It is difficult to draw clear lessons from the Baltic CBA experience and to generalize any observations for other countries, as the Baltic countries are tiny economies which can finance their current account deficits more easily than larger ones and, as their government debt is at a very low level, they have no government debt market to facilitate speculative attacks.

Contribution by Fritz Breuss

The Macroeconomic Effects of EU Enlargement for Old and New Member States

The 41st East Jour Fixe was held to observe the 10th anniversary of the East Jour Fixe meetings organized by the Foreign Research Division of the Oesterreichische Nationalbank (this issue of Focus on Transition also contains a chronicle and an itemized list of the meetings held over the past decade). Doris Ritzberger-Grünwald, Assistant to the Head of the Foreign Research Division, chaired the meeting held on June 22, 2001. She emphasized that the topic selected for this special event reflected the focus of East Jour Fixe meetings in the previous decade and expectations of future developments. Doris Ritzberger-Grünwald recalled the foundation of this series of presentations by Eduard Hochreiter and its continuation by his successors as Heads of the Foreign Research Division, especially Olga Radzyner, who was instrumental in developing the profile of the meetings as an expert forum for presentations and discussions. Today's meeting, emphasized Doris Ritzberger-Grünwald, owed its success to Peter Backé, Special Adviser, and Jarko Fidrmuc, analyst, both of the Foreign Research Division.

Fritz Breuss of the Austrian Institute of Economic Research and the University of Economics and Business Administration in Vienna presented his recent study on the “The Macroeconomic Effects of EU Enlargement for Old and New Member States.”¹) Furthermore, this topic was discussed by distinguished economists in the field, including Wilhelm Kohler of Johannes Kepler University, Linz, Heinz Handler, Director General, Federal Ministry of Economic Affairs and Labour, and Jarko Fidrmuc, Oesterreichische Nationalbank. The record number of participants confirmed the general interest in the topic.

Fritz Breuss started with a broad overview of the Eastern enlargement of the European Union. He noted that the recent example of the negative outcome of Ireland's referendum on the Treaty of Nice demonstrated the keen interest of the national states in the form and scope of the EU's Eastern enlargement. Mr. Breuss went on to state that the fears of the population were not related to potential costs and gains from enlargement. Indeed, people often seemed to misunderstand the costs and gains. This led to the remarkable observation that, for example according to the Eurobarometer, the support for the future accession of CEECs was actually lowest in the countries which stood to gain the most from the EU's Eastern enlargement.

1 The paper was published as Working Paper No. 143/2001 by the Austrian Institute of Economic Research and may be downloaded from <http://www.wifo.ac.at/publ/verzeichnisse/wpapers/wp143.pdf>.

Therefore, as Mr. Breuss emphasized, it was necessary to provide detailed and up-to-date analyses on this topic. However, earlier studies did not include all integration effects of the Eastern enlargement of the EU. Furthermore, these studies usually analyzed only the impact on the two blocs of EU and accession countries. By contrast, the paper presented by Mr. Breuss addressed the issues not treated in the earlier studies.

The macroeconomic simulations are based on the Oxford Economic Forecasting World Macroeconomic Model. The model defines the individual EU countries (besides large OECD countries), three individual CEECs (Czech Republic, Hungary and Poland) and Eastern Europe as a bloc. The simulations are based on Eastern enlargement in two waves. In a first wave in 2005, the countries of the so-called Luxembourg group (the Czech Republic, Cyprus, Estonia, Hungary, Poland and Slovenia) are expected to join the EU. The countries of the so-called Helsinki group will become full members of the EU in a second wave of enlargement in 2007. However, this assumption about the EU’s enlargement to the East provides a largely technical framework for modeling. As a rule of thumb, one can augment the results of the three countries in the model by one third (the share of the countries of the Helsinki group in the aggregate GDP of the CEECs) to obtain an approximation of simultaneous enlargement by all accession countries.

The simulation of the EU’s Eastern European enlargement takes four effects into account: First, the abolition of remaining tariffs and the reduction of trade-related costs implies a trade effect. Second, the enlargement of the single market results in more efficiency and stronger price competition. Third, the four freedoms of the single market ensure factor movement, including migration (in addition to foreign direct investment), unrestricted by the transition period currently being discussed. Finally, the budgetary costs for rich EU members and the transfers to less developed new Member States are analyzed.

The first two effects have largely positive implications for all participating countries, although the trade effect is no longer as important as it was during the opening of Eastern Europe. In general, however, the CEECs are likely to gain more from enlargement. Nevertheless, there could be a significant variability within the EU: Countries more exposed to East-West trade will stand to gain more as well. Furthermore, small countries might gain more because the entrance of new members diminishes the importance of the domestic market and improves the relative competitiveness of small countries (the speaker referred to this as the “Casella effect”).

By contrast to the trade effect and the efficiency and competitiveness gains, the last two effects – factor movement and budgetary costs – are shown to have largely opposite effects on the old and the new members of the EU. Factor movement is assumed to have positive growth effects on the target region and negative growth effects on the source countries. Increased budgetary costs remain largely negligible for the EU. However, the EU cohesion countries are expected to face reduced transfers after enlargement. As the size of the EU and the CEECs is asymmetric, the CEECs are again expected to gain more.

On the whole, Eastern enlargement is a win-win game. Both old and new Member States are expected to benefit from enlargement. Because the involved regions differ in size, however, the CEECs will gain around ten times more from enlargement than the EU. Hungary and Poland are likely to reach about 8 to 9 percentage points of additional GDP growth until 2010, while the effects should be only slightly lower in the Czech Republic (6 percentage points). The EU will achieve about 0.4 percentage point of GDP additionally on average during this period. The increment will be highest in Austria, Germany and Italy (up to 0.8 percentage point), while costs could surpass benefits in Spain, Portugal and Denmark.

The first discussant, Wilhem Kohler, addressed several issues, concentrating on the structure of the Oxford Economic Forecasting World Macroeconomic Model. He stressed that welfare gains would be superior to GDP growth gains in the analysis of integration. With respect to the trade effect, Mr. Kohler emphasized the importance of the trade structure and tariff protection in important areas of the economy. Furthermore, he ventured that the Casella effect was likely to play a lesser role now that the single market has been established.

Heinz Handler gave a very positive assessment of the results presented. He stressed the importance of the study for the economic policy of national states. Hence it was important that the study is based on very plausible assumptions. Mr. Handler continued by addressing several issues, including the participation of the CEECs in EMU, the effects of FDI, single market effects and the baseline scenario.

Jarko Fidrmuc stressed the contribution of the paper to modeling enlargement in the accession countries. However, he noted that the formulation of the waves of enlargement did not fully correspond to the definition of country aggregates. The development in the new Member States after accession showed large fluctuations, he pointed out. This could imply that the model is less stable for these countries.

The general discussion stressed the importance of the study. Moreover, several participants pointed out more general issues exceeding the scope of the paper. One participant drew attention to the fact that too extensive budgetary transfers to the developing regions would be likely to have adverse effects as well. Furthermore, it was stressed that that exchange rate appreciation could reduce the accession countries' competitiveness, which would result in significant macroeconomic problems. In his answer, Fritz Breuss used his model to give an intuitive insight into some other effects during the accession of the CEECs to the EU. Furthermore, he announced that he would deal with some of the open questions in his further research.

The “East Jour Fixe” of the Oesterreichische Nationalbank – A Forum for Discussion for Ten Years

This is about an anniversary. Ten years have elapsed since the “East Jour Fixe” meetings of the Oesterreichische Nationalbank were launched in June 1991. At that time, the Foreign Research Division of the Oesterreichische Nationalbank issued an invitation to the first of a series of meetings entitled “East Jour Fixe,” the main purpose of which was – and still is – to discuss current issues related to the economic and political transformation in Central and Eastern Europe. Since then, the East Jour Fixe, which is held in Vienna four to five times a year, has become a highly regarded forum for discussion among decision-makers actually involved in the formulation of economic policies and representatives of universities and research institutes. The East Jour Fixe primarily aims at encouraging discussions among researchers and economic policymakers on topical issues related to transition economies, thus contributing to the formation of a coordinated Austrian position in the international community.

Typically, the Oesterreichische Nationalbank invites a guest speaker to the East Jour Fixe to give a brief presentation on the main topic, which is followed by comments of one or two invited discussants. The guest speakers are usually professionals from international organizations (such as the IMF, the BIS or the European Commission) who deal with transition economies, or Fellows from Western or Eastern research institutes or universities as well as experts from Eastern European central banks. The discussants come, in many cases, from Austrian research institutions (WIIW, IHS, WIFO), from the Austrian ministries involved and also from the Oesterreichische Nationalbank. In recent years, discussants from abroad, in particular from the accession countries, have played an increasingly important role. The contributions of the guest speaker and the invited discussants are designed to stimulate a general discussion among all participants.

In general, discussions at the East Jour Fixe have focused on the following areas:

- the current economic and political situation in the reforming countries and the ongoing reform process;
- micro- and macroeconomic aspects of economic transformation, with a particular focus on issues that pertain to monetary policymaking in a broad sense;
- Austria’s relationship with reforming countries: support of the reform process, economic consequences of the opening-up of Central and Eastern Europe.

Since the mid-1990s, EU enlargement issues have moved into the limelight at East Jour Fixe meetings. In fact, the accession process in general and its implications for central banks in particular have developed into the common denominator of this series of discussion gatherings. Of course, other topics, especially developments in Russia, have also featured on the East Jour Fixe agenda.

When looking back on ten years of East Jour Fixe history, a number of highlights come to mind. While any account of this sort clearly is highly subjective, it may provide valuable insights.

In the first few East Jour Fixe meetings, discussions centered on three topics: first, on the policy mix of the reform countries and the IMF programs

for these countries, second, on the financing needs of Central and Eastern Europe and, third, on the positions Austria could take on Central and Eastern Europe, specifically on the economic transformation process. There were intense discussions about the issue of shock therapy versus gradualism, with some search for intermediate positions (“minimum bang”), but also with a focus on sequencing and institution-building. A position paper on Austria’s stance vis-à-vis Central and Eastern Europe was drafted and discussed; clearly, the OeNB was well placed to provide an impartial platform for these discussions, in the absence of any other gatherings in Austria with a similar focus at the time. Moreover, the Bank actively contributed to the discussion and provided inputs through its IMF links.

From the fall of 1992 onward, the East Jour Fixe agenda was augmented by more narrowly defined topics discussed at individual meetings. “Public Finance in the Transformation Process” (main speaker: Vito Tanzi, September 1992) was one of the first of these more specific subjects on the agenda. Likewise, East Jour Fixe meetings with country-specific topics were introduced, the first being “Transformation Problems and Current Developments in Russia” (Heiner Flassbeck, November 1992). Actually, Russia has remained on the East Jour Fixe agenda since then, inter alia with Pekka Sutela, Hans-Georg Heinrich and Dalia Marin as lead speakers on different aspects of Russia’s transformation process. In 1993–94, several East Jour Fixe meetings were devoted to the implications of the economic opening-up of Central and Eastern Europe for Western Europe and, specifically, for Austria (especially Helmut Kramer, January 1993, and Palle Andersen and Peter Dittus, March 1994). While the overall assessment of the opening-up of Central and Eastern Europe on Austria was clearly positive, the early discussions about the effects of EU enlargement were more guarded (Helmut Kramer, January and May 1995). Later assessments on the same subject tended to be more buoyant, showing a wide consensus about the positive net benefits of an EU enlargement for Austria, while recognizing its significant redistribution effects (especially Wilhelm Kohler, April 1998). Furthermore, the enlargement debate was significantly enriched by including the Central and Eastern European view (András Inotai, June 1996).

In parallel, general issues of transformation were discussed time and again, like rent-seeking in transition (Oleh Havrylyshyn, June 1995) or the long-term growth potential of the CEECs (Vít Bárta and Thomas Url, May 1996). In this vein, another very stimulating Jour Fixe meeting centered on “Transformation in Central and Eastern Europe – ambitions, achievements and challenges” (Lajos Bokros, October 1996).

A further truly important line of East Jour Fixe meetings developed from 1993 onwards, with speakers from the European Commission (Rutger Wissels, Albrecht Rothacher, Leopold Maurer, Andries Brandsma, Alexandra Cas Granje) sharing their views on the transformation, the economic prospects of Central and Eastern European countries and, in later years, on the accession process.

Monetary and exchange rate policy issues featured as well at several instances. “Between Inflation and Capital Inflows: Dilemmas of Monetary Policy in More Advanced Transition Economies” were discussed in Septem-

ber 1998 (Dariusz Rosati); further Jour Fixe meetings focused on monetary transmission issues (Judit Neményi and Alexis Derviz, March 1999), on exchange rate policy issues (Domenico Mario Nuti, January 2000) and on alternative disinflation strategies (Jakob de Haan, March 2001, see separate report in this issue).

Summaries of the East Jour Fixe meetings have been published in the Focus on Transition since 1996. With this, the core contents of the meetings have become accessible to the public. Over time, the number of persons invited to the Jour Fixe meetings has increased from around 50 to 80, and interest in the meetings has remained high, with a steady 25 to 40 participants in each meeting.

The 10th anniversary of the East Jour Fixe did not pass by unnoted. Indeed, a special East Jour Fixe was organized on June 22, 2001, to mark this event (see separate report in this issue). Although the integration of Central and Eastern Europe into the European Union has made enormous headway, much remains to be done. There is ample scope and, in fact, a serious need to continue discussing current developments and future challenges thoroughly in the years to come, as Europe grows together. This bodes well for the further thriving of the East Jour Fixe series – presumably much along past and present lines, focusing on a fruitful combination of theory, empirics and political relevance.

The East Jour Fixe Meetings of the OeNB

Compiled by Barbara Nöblinger

No.	Date	Speakers ¹⁾	Topic	Discussants ¹⁾
1.	June 21, 1991	General discussion	Strategien zur Überwindung der Anpassungskrise in Ost- und Mitteleuropa Aspekte einer österreichischen Osteuropa-Strategie	
2.	October 18, 1991	General discussion Andreas Wörgötter Institute for Advanced Studies	Finanzierungsbedarf Osteuropas (Diskussionspapier des Österreichischen Instituts für Wirtschaftsforschung) Aspekte zu einer österreichischen Osteuropa-Strategie Österreich-Aspekte des Systemwandels in Osteuropa: Migration, Arbeitsmarkt, Außenhandel, Industriestruktur	
3.	January 31, 1992	Thomas Lachs and Wolfgang Duchatzek Oesterreichische Nationalbank Wolfgang Nitsche Federal Ministry of Finance Raoul F. Kneucker Federal Ministry of Science and Research Heinz Kienzl Oesterreichische Nationalbank	Tour d'horizon über Entwicklungen in den Ländern Zentral- und Osteuropas Überlegungen zu einer österreichischen Osteuropastrategie Maßnahmen des Bundesministeriums für Wissenschaft und Forschung zugunsten Ost- und Mitteleuropas Ost-Umfrage der Paul-Lazarsfeld-Gesellschaft	
4.	April 3, 1992	Wolfgang Duchatzek Oesterreichische Nationalbank Robert Holzmann and Georg Winckler University of Vienna Kazimierz Laski and Friedrich Levcik The Vienna Institute for Comparative Economic Studies	Tour d'horizon über Entwicklungen in den Ländern Zentral- und Osteuropas Policy-Mix in Übergangswirtschaften Alternative Strategies for Economies in Transition in Central and Eastern Europe	Susan Schadler International Monetary Fund

¹⁾ The affiliations were current at the time of the respective East Jour Fixe meeting.

The East Jour Fixe Meetings of the OeNB

No.	Date	Speakers ¹⁾	Topic	Discussants ¹⁾
5.	June 19, 1992	Wolfgang Duchatzcek Oesterreichische Nationalbank Peter Backé, Olga Radzyner and Kurt Mauler Oesterreichische Nationalbank, and Friedrich Levcik The Vienna Institute for Comparative Economic Studies Heinrich Schneider and Helmut Gruber Oesterreichische Nationalbank Raoul F. Kneucker Federal Ministry of Science and Research	Tour d'horizon über Entwicklungen in den Ländern Zentral- und Osteuropas Einschätzung der politischen und wirtschaftlichen Lage in ausgewählten Ländern Erfahrungen mit multilateraler technischer Hilfe Ostmaßnahmen aus dem Blickwinkel eines Fachministeriums	
6.	September 4, 1992	Vito Tanzi International Monetary Fund	Public Finance in the Transformation Process	Ewald Nowotny Vienna University of Economics and Business Administration Hans Seidel Austrian Institute of Economic Research
7.	November 5, 1992	Heiner Flassbeck German Institute for Economic Research	Allgemeine Transformationsprobleme und aktuelle Entwicklungen in Rußland	Peter Havlik The Vienna Institute for Comparative Economic Studies János Gács The International Institute for Applied Systems Analysis
8.	January 15, 1993	Helmut Kramer Austrian Institute of Economic Research Jürgen Pingitzer Oesterreichische Nationalbank Helmut Gruber Oesterreichische Nationalbank	Possible Impacts for Austrian Industrial Branches from the Opening-Up towards the East Zahlungsverkehrsprobleme in den Republiken der GUS Erfahrungsbericht Slowakei (technische Hilfe)	János Gács The International Institute for Applied Systems Analysis Andreas Wörgötter Institute for Advanced Studies
9.	March 19, 1993	Hans-Georg Heinrich University of Vienna Christian Haerper Paul Lazarsfeld Society for Social Research	Aktuelle Probleme des Reformprozesses in Rußland Neue Demokratien Barometer Präsentation jüngster Umfrageergebnisse – Ukraine und Belarus	
10.	May 19, 1993	Hans Seidel Austrian Institute of Economic Research Guzel Anulova Institute of World Economy and International Relations – IMEMO	Eine Produktivitätsagentur für Osteuropa? Perspektiven der Regionalisierung Rußlands am Beispiel Tatarstans	
11.	September 10, 1993	Károly Kiss Institute for World Economics, Hungarian Academy of Sciences	Western Prescriptions for Eastern Transition – A Comparative Analysis of the Different Economic Schools and Issues	Edith Kitzmantel Federal Ministry of Finance Andreas Wörgötter Institute for Advanced Studies
12.	November 26, 1993	Rutger Wissels European Commission Georg Winckler University of Vienna Peter Havlik The Vienna Institute for Comparative Economic Studies	Prospects for Growth in Eastern Europe: Policy Issues for the Medium Term Report about the IASA conference “Output Decline in Eastern Europe – Prospects for Recovery?” Report about the WIIW conference “Transformation of the East European Economies,” 1989–1993: Critical Assessments and Ways out of Recession	

¹⁾ The affiliations were current at the time of the respective East Jour Fixe meeting.

The East Jour Fixe Meetings of the OeNB

No.	Date	Speakers ¹⁾	Topic	Discussants ¹⁾
13.	January 21, 1994	Wojciech Maciejewski University of Warsaw Adalbert Knöbl International Monetary Fund Heinz Glück Oesterreichische Nationalbank	Current State of the Polish Economy and Problems with the Reforms Current State of Economic Reforms in the Baltic States Report about the conference “Development and Reform of the Financial System in Central and Eastern Europe”	Kazimierz Laski The Vienna Institute for Comparative Economic Studies
14.	March 11, 1994	Palle Anderson and Peter Dittus Monetary and Economic Department, Bank for International Settlements	Liberalization of Trade and its Impact on Employment with Special Reference to Eastern Europe	Helmut Kramer Austrian Institute of Economic Research Albrecht Rothacher European Commission's Representative Office in Austria Hans Seidel Austrian Institute of Economic Research Nick Vanston Organisation for Economic Co-Operation and Development
15.	June 17, 1994	Francesco Papadia Banca d'Italia Heinz Kienzl Österreichische Gesellschaft für Europapolitik Christian Haerpfer Paul Lazarsfeld Society for Social Research	Growth and Catch-Up in Central and Eastern Europe: Macroeconomic Effects on Western Countries Recent Opinion Polls in Russia: The Ostbarometer The Ostbarometer: Small Countries	G.M. Gregorash Bank of Slovenia FED Chicago
16.	October 14, 1994	Markus Rodlauer Senior Resident Representative of the International Monetary Fund in Poland Olga Radzyner Oesterreichische Nationalbank	Economic Transformation and IMF Support: The Example of Poland OECD Assessment of Poland	Leon Podkaminer The Vienna Institute for Comparative Economic Studies Andreas Wörgötter Institute for Advanced Studies
17.	January 20, 1995	Helmut Kramer Austrian Institute of Economic Research Peter Havlik The Vienna Institute for Comparative Economic Studies	EU-Osterweiterung – Unbequeme Fragen Auswirkungen der EU-Erweiterung auf die Assoziationsländer	Albrecht Rothacher European Commission's Representative Office in Austria Georg Winckler University of Vienna Klaus Schröder Stiftung Wissenschaft und Politik Forschungsinstitut für Internationale Politik und Sicherheit, Ebenhausen
18.	April 5, 1995	Roman Frydman New York University Director CEU Privatization Project	Privatization in Central and Eastern European Transition Countries	Andreas Wörgötter Institute for Advanced Studies Christian Haerpfer Paul Lazarsfeld Society for Social Research
19.	May 30, 1995	Helmut Kramer Austrian Institute of Economic Research	The Consequences of the EU Eastern Enlargement for Austria	Peter Bofinger Würzburg University Jim Rollo Foreign and Commonwealth Office, London
20.	June 12, 1995	Oleh Havrylyshyn International Monetary Fund	Rent-Seeking in Post-Soviet Economies and the Effect on Transition	
21.	November 10, 1995	Rutger Wissels European Commission	Latest Forecasts of the European Commission for Eastern Europe	Jarko Fidrmuc Institute for Advanced Studies János Gács The International Institute for Applied Systems Analysis Josef Pöschl The Vienna Institute for Comparative Economic Studies

¹⁾ The affiliations were current at the time of the respective East Jour Fixe meeting.

The East Jour Fixe Meetings of the OeNB

No.	Date	Speakers ¹⁾	Topic	Discussants ¹⁾
22.	January 31, 1996	Hans-Georg Heinrich University of Vienna Christian Haerpfer Paul Lazarsfeld Society for Social Research	Russia after the Elections Neue Demokratien Barometer	Peter Havlik , The Vienna Institute for Comparative Economic Studies Gerhard Mangott Austrian Institute for International Affairs
23.	May 22, 1996	Vít Bárta and Thomas Url Austrian Institute of Economic Research Kurt Mauler Oesterreichische Nationalbank	Economies in Transition: Long-term Growth Potential, Capital Accumulation and Labor-Capital Substitutability in Five Central European Countries Tschechische Republik – Erste Länderprüfung als OECD-Mitglied	András Simon Central Bank of Hungary Friedrich Fritzer Oesterreichische Nationalbank
24.	June 21, 1996	András Inotai Hungarian Academy of Sciences, Budapest Maria Leitgeb Federal Chancellery	Hungary's Preparation for Membership in the European Union The Austrian Approach to Eastern European Integration into the EU	Gerhard Fink Vienna University of Economics and Business Administration Hannes Porias Federal Ministry for Foreign Affairs
25.	October 25, 1996	Lajos Bokros The World Bank Former Finance Minister of Hungary	Transformation in Central and Eastern Europe – Ambitions, Achievements and Challenges	Andreas Wörgötter Institute for Advanced Studies Ewald Nowotny Vienna University of Economics and Business Administration
26.	December 6, 1996	Stijn Claessens The World Bank	From Plan to Market – Presentation of the 1996 World Bank Development Report	Leon Podkaminer The Vienna Institute for Comparative Economic Studies
27.	March 14, 1997	Tomás Jezek Chamber of the Prague Stock Exchange	Development of Capital Markets in Central and Eastern Europe – The Example of the Prague Stock Exchange	Gerhard Fink Vienna University of Economics and Business Administration
28.	July 20, 1997	Grzegorz W. Kolodko World Institute of Economic Development in Helsinki Former Minister of Finance and Deputy Prime Minister of Poland	From Shock Therapy to Therapy Without Shocks	Georg Winckler University of Vienna Maciej Krzak The Vienna Institute for Comparative Economic Studies and Oesterreichische Nationalbank
29.	November 28, 1997	Albrecht Rothacher European Commission Christian Haerpfer Paul Lazarsfeld Society for Social Research Maciej Krzak Oesterreichische Nationalbank	Preparation of EU Eastern Enlargement – The Commission's View Attitudes toward EU Accession in the Czech Republic, Hungary, Poland, Slovakia, Slovenia and Austria – The New Democracies Barometer Main findings of the OeNB's conference on “Current Account Imbalances in East and West: Do they Matter?”	Sándor Richter The Vienna Institute for Comparative Economic Studies Wolfgang Nitsche Federal Ministry of Finance
30.	April 1, 1998	Wilhelm Kohler Universität Linz Stefan Lehne Federal Ministry for Foreign Affairs	Eastern Enlargement of the EU: How Much is it Worth for Austria? EU Enlargement – Implications for Austrian Policy-Making	Jarko Fidrmuc The Vienna Institute for Comparative Economic Studies Wilfried Altzinger Vienna University of Economics and Business Administration
31.	April 28, 1998	Andries Brandsma European Commission	Presentation of DG II's Spring 1998 Economic Forecast for the Central and Eastern European Countries	Andreas Wörgötter Institute for Advanced Studies János Gács The International Institute for Applied Systems Analysis
32.	September 25, 1998	Dariusz Rosati Monetary Policy Council and Warsaw School of Economics	Between Inflation and Capital Inflows: Dilemmas of Monetary Policy in More Advanced Transition Countries	Maciej Krzak Oesterreichische Nationalbank István Ábel National Bank of Hungary

¹⁾ The affiliations were current at the time of the respective East Jour Fixe meeting.

The East Jour Fixe Meetings of the OeNB

No.	Date	Speakers ¹⁾	Topic	Discussants ¹⁾
33.	November 27, 1998	Pekka Sutela Institute for Economies in Transition, Bank of Finland	Russia: What Kind of a Market Economy?	Peter Havlik The Vienna Institute for International Economic Studies Wolfgang Nitsche Federal Ministry of Finance Stephan Barisitz Organisation for Economic Co-Operation and Development
34.	April 23, 1999	Judit Neményi National Bank of Hungary Alexis Derviz Czech National Bank	Monetary Transmission in Advanced Transition Economies: The Case of Hungary Monetary Transmission in Advanced Transition Economies: The Case of the Czech Republic	Helene Schuberth Oesterreichische Nationalbank
35.	June 18, 1999	Leopold Maurer European Commission Christa Peutl Federal Chancellery	The Current State of Accession Negotiations – Specific Focus: EMU, Free Movement of Capital and Financial Services The Current State of the Accession Process: Assessment and Challenges for Austria	Peter Backé Oesterreichische Nationalbank
36.	October 22, 1999	Alexandra Cas Granje European Commission	The European Commission's Economic Evaluation in the 1999 Regular Reports on the Enlargement Countries	Andreas Wörgötter Institute for Advanced Studies Sándor Richter The Vienna Institute for International Economic Studies Wolfgang Nitsche Federal Ministry of Finance
37.	January 14, 2000	D. Mario Nuti London Business School	Exchange Rate Policy in Poland, 1990 to 1999: Success and Underperformance	Leon Podkaminer The Vienna Institute for International Economic Studies Jarko Fidrmuc Oesterreichische Nationalbank Vít Bárta Czech National Bank
38.	May 19, 2000	Dalia Marin Ludwig Maximilians University, Munich Christian Haerpfer Institute for Advanced Studies	The Financial Crisis in Russia: What Can Be Done? Economic Behavior of Russian Households Before and After the Crisis	Helen Boss The Vienna Institute for International Economic Studies Stephan Barisitz Oesterreichische Nationalbank
39.	February 9, 2001	Andries Brandsma European Commission	The Macroeconomic Dimension of Enlargement	Andreas Wörgötter, Organisation for Economic Co-Operation and Development Martin Wagner University of Bern
40.	March 23, 2001	Jakob de Haan University of Groningen and CESifo	How To Reduce Inflation: An Independent Central Bank or A Currency Board? The Experience of the Baltic Countries	Július Horváth Central European University, Budapest and Academia Istropolitana Nova, Bratislava
41.	June 22, 2001	Fritz Breuss Austrian Institute of Economic Research and University of Economics and Business Administration, Vienna	Macroeconomic Effects of EU Enlargement for Old and New Member States	Wilhelm Kohler Johannes Kepler University, Linz Heinz Handler Federal Ministry of Economic Affairs and Labour Jarko Fidrmuc Oesterreichische Nationalbank

The affiliations were current at the time of the respective East Jour Fixe meeting.

*Olga Radzyner Award
for Scientific Work on Monetary and Finance Themes
for Young Economists from Central, Southeastern
and Eastern European Transition Economies*

The Oesterreichische Nationalbank has established an award which will be bestowed on young economists for excellent research focused on monetary and finance issues in economics. The panel of judges will give preferential treatment to topics dealing with the integration of Central, Southeastern and Eastern transition economies within Europe.

Three applicants are eligible to receive a single payment of EUR 2,500 each from an annual total of EUR 7,500.

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. The author shall submit the work before his/her 35th birthday, and shall be a citizen of a Central, Southeastern or Eastern European transition country.

To identify their work as a submission, applicants shall mark the envelope with the reference "Olga Radzyner Preis." It shall be sent to the Oesterreichische Nationalbank, Foreign Research Division, Otto-Wagner-Platz 3, POB 61, A 1011 Vienna, Austria. The Oesterreichische Nationalbank shall receive the works submitted for this year's award by September 10, 2001, at the latest.

For detailed information please visit our Internet homepage <http://www.oenb.co.at> or contact the Foreign Research Division of the Oesterreichische Nationalbank, Ms. Eva Wasserbauer, either by e-mail: Eva.Wasserbauer@oenb.co.at or by phone: (+43-1) 404 20-5205.

Technical Cooperation of the Oesterreichische Nationalbank with Countries in Transition

In the first half of 2001, the OeNB extended and intensified its cooperation activities with the accession countries of Central and Eastern Europe, the West Balkans and the CIS republics both at a bilateral and at a multilateral level.

At the bilateral level, the OeNB continued its series of highly specialized seminars for central bankers at the JVI started in 1997 with four one-week courses covering the following topics: "Preparing for EMU" (February 19 to 23, 2001), "Banking Supervision Today and Tomorrow – Recent Experiences and Future Capital Regulation" (March 5 to 9, 2001), "From Financial Accounting to Central Bank Planning and Budgeting – Actual Accounting Issues; Operational and Strategic Planning; Cost Accounting" (September 3 to 7, 2001) and "Monetary and Banking Statistics" (October 1 to 5, 2001). The OeNB still observes an ongoing strong demand for these seminars and highly positive reactions from the participants.

In addition to these seminars, the OeNB strengthened its bilateral technical cooperation activities with central banks in transition countries by organizing consultations and various study and information visits to the OeNB. Within this framework, the OeNB hosted a study visit from the Banking and Payments Authority of Kosovo on the "changeover to the euro" in February 2001. Moreover, the OeNB welcomed a high-ranking delegation from the National Bank of Romania in February 2001, which came to exchange views on "banknote production and coins." In June 2001, a two-day study visit was organized for a delegation from the Bank of Slovenia on the topic "disaster recovery plan and procedures." Furthermore, two representatives from the Czech National Bank visited the OeNB for ten days in June 2001 to gain a broad insight into "value-at-risk models." In the second half of this year, the OeNB plans to host an information visit for a high-ranking delegation of the National Bank of Kazakhstan on "human resource management." Bilateral cooperation was continued with the National Bank of Hungary. Staff members of the National Bank of Hungary will pay two study visits to the OeNB in the second half of 2001, the first to cover the topic "central bank legal harmonization," the second visit to cover the issue "communication strategy."

The demand for short-term bilateral workshops at the requesting central bank also continued to increase. Within this framework, the OeNB held a two-day workshop on "The Changeover to Euro Banknotes and Coins" at the Croatian National Bank in April 2001. Furthermore, the OeNB held a one-day workshop on "The Preparation of EU and EMU Accession – the Central Bank's Experience" with the National Bank of Slovakia as well as a two-day workshop on "Human Resource Management" with the National Bank of Poland, both in June 2001. One two-day workshop with the National Bank of Hungary is under preparation for the second half of this year covering – in parallel – "Future Capital Standards proposed by the Basel Committee and the European Commission – Review of Regulatory Capital Requirements for Credit Institutions," "Supervising Derivative Transactions" and "Practical Experience from EU and ECB Working Groups Concerning Future Developments on Banking Regulations and Macroeconomic Systemic Issues."

Apart from these short-term cooperation activities, the OeNB plans to further enhance the close cooperation with its counterparts in candidate countries by hosting a two-month research visit of an economist from the Czech National Bank, to prepare a research study on “Cost-Push Inflation in the Czech Republic” in the second half of 2001 at the OeNB’s Foreign Research Division. Research visits enable both the sending and the receiving central bank to jointly study and discuss transition issues. Moreover, the OeNB plans to host a two-week traineeship for one or two senior translators from the Czech National Bank in the second half of 2001.

At the multilateral level, the OeNB is currently taking part in the EU-financed Twinning Program on “Strengthening the Capacity of the Romanian Institutions for the Prevention and Control of Money Laundering” in cooperation with Italy. Moreover, the OeNB’s participation in the Phare Project on the topic “Management, Information Systems and Computerization of Accounting of the National Bank of Romania” was concluded in May 2001 and the Phare Project has now entered the implementation phase.

Within the framework of IMF-coordinated technical assistance, a representative of the OeNB took part in IMF missions to Lithuania on “Legal, Technical and Organizational Aspects of the Forthcoming Repegging of the Currency Board” in March 2001.

The JVI course in Applied Economic Policy (AEP) includes an “Austrian Segment,” which is jointly financed by the Austrian authorities, i.e. the Austrian Ministry of Finance and the OeNB. In the first part of this segment, experts from a variety of academic and organizational backgrounds spend three days presenting lectures devoted to specific features of Austria’s market economy, such as the political and economic structure, social partnership, issues of fiscal federalism, incomes policies, Austria’s experience with EU accession and the introduction of the euro. In the second part, the so-called study tour, participants spend three days visiting companies, state and local government authorities, banks, media centers and the like to gain an insight into the structures of Austria’s economy and administration. The program for each study tour is organized by the OeNB, and tours are accompanied alternately by an OeNB representative and by a representative of the Austrian Ministry of Finance.

Moreover, in addition to the four one-week seminars held by the OeNB every year, the Austrian authorities jointly organize two one-week seminars at the JVI. The topics for these two seminars in 2001 are “Foreign Direct Investment Policy” (May 14 to 18, 2001) and “The Challenge for Structural Reforms: Design, Implementation, Experience” (November 26 to 30, 2001).

S T A T I S T I C A L A N N E X

Gross Domestic Product

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
Annual change in %											
1991	-11.7	-11.6	x	-11.9	x	x	-7.0	-12.9	- 5.0	-14.6	-8.9
1992	- 7.3	- 0.5	-21.6	- 3.1	x	x	+2.6	- 8.8	-14.5	- 6.5	-5.5
1993	- 1.5	+ 0.1	- 8.2	- 0.6	-16.1	-16.2	+3.8	+ 1.5	- 8.7	- 3.7	+2.8
1994	+ 1.8	+ 2.2	- 2.0	+ 2.9	+ 0.6	- 9.8	+5.2	+ 3.9	-12.7	+ 4.9	+5.3
1995	+ 2.9	+ 5.9	+ 4.3	+ 1.5	- 0.8	+ 3.3	+7.0	+ 7.1	- 4.1	+ 6.7	+4.1
1996	-10.9	+ 4.8	+ 3.9	+ 1.3	+ 3.3	+ 4.7	+6.0	+ 3.9	- 3.4	+ 6.2	+3.5
1997	- 7.0	- 1.0	+10.6	+ 4.6	+ 8.6	+ 7.3	+6.8	- 6.1	+ 0.9	+ 6.2	+4.6
1998	+ 3.5	- 2.2	+ 4.7	+ 4.9	+ 3.9	+ 5.1	+4.8	- 5.4	- 4.9	+ 4.1	+3.8
1999	+ 2.5	- 0.8	- 1.1	+ 4.2	+ 1.1	- 4.1	+4.1	- 3.2	+ 5.4	+ 1.9	+5.0
2000	+ 5.0	+ 2.9	+ 6.4	+ 5.2	+ 6.6	+ 2.5	+4.0	+ 1.6	+ 8.3	+ 2.2	+4.6
1998											
3 rd quarter	- 1.8	- 0.6	+ 2.7	+ 5.4	+ 2.4	- 5.4	+4.9	..	- 8.1	+ 5.1	+3.3
4 th quarter	+ 1.2	- 3.1	- 1.2	+ 4.7	- 1.7	- 4.8	+3.0	..	- 8.2	+ 0.5	+3.4
1999											
1 st quarter	+ 0.8	- 2.0	- 3.1	+ 3.2	- 1.5	- 1.9	+1.6	- 4.6	- 2.7	+ 1.9	+2.9
2 nd quarter	+ 2.7	- 1.1	- 2.9	+ 3.3	- 1.1	+ 1.4	+3.1	- 3.2	+ 1.2	+ 2.9	+7.4
3 rd quarter	+ 4.8	+ 0.4	- 0.5	+ 4.2	+ 0.2	- 5.4	+5.0	- 3.6	+ 6.7	+ 0.5	+4.3
4 th quarter	+ 1.0	+ 1.1	+ 2.1	+ 5.9	+ 2.8	+ 1.8	+6.2	- 1.4	+ 7.3	+ 2.3	+5.0
2000											
1 st quarter	+ 4.8	+ 3.2	+ 5.4	+ 6.5	+ 5.5	+ 9.6	+6.0	+ 0.9	+ 8.4	+ 1.5	+6.3
2 nd quarter	+ 5.5	+ 2.4	+ 7.3	+ 5.6	+ 5.0	- 3.7	+5.2	+ 3.3	+ 6.5	+ 1.9	+3.6
3 rd quarter	+ 6.1	+ 2.4	+ 7.0	+ 4.5	+ 6.6	..	+3.3	+ 1.8	+ 8.8	+ 2.5	+5.8
4 th quarter	+ 6.5	+ 3.8	+ 6.0	+ 4.2	+ 8.7	..	+2.4	+ 0.4	+ 6.8	+ 2.9	+3.7
2001											
1 st quarter	..	+ 3.8	..	+ 4.4	..	..	+2.3	+ 4.8	+ 4.4	+ 2.9	+3.1

Source: WIW (The Vienna Institute for International Economic Studies); Estonia, Latvia, Lithuania: IMF; Russia: national sources from 1999. Quarterly data: national sources.

Due to revisions quarterly data may not match annual data.

Industrial Production

	Bulgaria	Czech Republic	Estonia ¹⁾	Hungary	Latvia	Lithuania ¹⁾	Poland	Romania	Russia	Slovak Republic ²⁾	Slovenia
Annual change in %											
1991	-20.2	-21.2	x	-16.6	x	- 4.9	- 8.0	-22.8	- 8.0	-19.4	-12.4
1992	-18.4	- 7.9	x	- 9.7	-34.6	-51.6	+ 2.8	-21.9	-18.0	- 9.3	-13.2
1993	- 9.8	- 5.3	x	+ 4.0	-38.1	-34.7	+ 6.4	+ 1.3	-14.1	- 3.8	- 2.8
1994	+10.6	+ 2.1	- 2.1	+ 9.6	- 9.5	-29.8	+12.1	+ 3.3	-20.9	+ 4.8	+ 6.4
1995	+ 4.5	+ 8.7	+ 2.0	+ 4.6	- 6.3	+ 0.9	+ 9.7	+ 9.4	- 3.3	+ 8.3	+ 2.0
1996	+ 5.1	+ 2.0	+ 3.5	+ 3.4	+ 1.4	+ 3.5	+ 8.3	+ 6.3	- 4.0	+ 2.5	+ 1.0
1997	- 5.4	+ 4.5	+15.2	+11.1	+ 6.1	+ 8.0	+11.5	- 7.2	+ 1.9	+ 2.7	+ 1.0
1998	- 7.9	+ 1.6	+ 3.2	+12.5	+ 2.0	+ 9.3	+ 3.5	-13.8	- 5.2	+ 5.0	+ 3.7
1999	- 9.3	- 3.1	- 1.7	+10.4	- 8.8	- 9.6	+ 4.8	- 8.0	+11.0	- 3.6	- 0.5
2000	+ 5.8	+ 5.1	+12.8	+18.3	+ 3.2	+10.7	+ 4.3	+ 8.2	+11.9	+ 9.1	+ 6.2
2000											
January	+ 5.2	+ 3.9	+12.0	+18.0	+ 4.3	+ 6.9	+ 7.9	- 3.2	+10.7	+ 2.0	+ 2.5
February	- 0.3	+ 5.1	+14.9	+24.0	+ 3.6	+14.3	+16.5	+ 4.4	+13.7	+13.3	+11.8
March	+ 8.6	+ 5.2	+12.8	+20.2	+ 2.0	+ 6.0	+ 6.7	+ 5.1	+ 9.6	+ 8.6	+ 7.5
April	+ 3.3	+ 2.8	+ 9.4	+12.6	- 3.8	-14.0	+ 5.2	+ 4.4	+ 5.5	+ 7.0	+ 7.6
May	+ 8.3	+ 6.5	+20.3	+29.0	+10.0	+ 0.7	+12.1	+ 9.2	+10.6	+10.2	+10.8
June	+ 8.0	+ 6.1	+16.3	+19.9	+ 5.6	- 3.9	+13.4	+10.6	+ 9.8	+ 7.7	+10.3
July	+ 0.8	+ 5.5	+10.3	+19.9	- 2.9	- 2.8	+ 7.8	+12.0	+ 8.5	+ 8.1	+ 8.1
August	+ 6.3	+11.0	+15.8	+23.2	+ 5.5	+17.2	+ 9.2	+12.9	+10.2	+ 9.9	+ 7.0
September	+10.4	+ 3.7	+12.5	+16.9	+ 1.5	+ 7.5	+ 5.0	+10.7	+ 7.2	+ 9.6	+ 3.7
October	+ 4.9	+ 9.0	+13.7	+16.2	+ 5.5	+ 4.8	+ 7.1	+12.3	+10.4	+15.4	+ 3.1
November	+ 6.6	+ 4.3	+12.1	+13.5	+ 2.4	+19.0	+ 4.8	+10.0	+ 7.6	+10.7	+ 5.7
December	+ 1.6	+ 1.4	+ 4.9	+10.4	+ 2.3	+20.2	- 2.2	+ 5.8	+ 2.5	+ 8.3	- 2.5
2001											
January	- 6.5	+13.8	+ 9.2	+16.0	+ 9.0	+28.0	+10.1	+19.0	+ 5.3	+11.0	+ 8.9
February	+28.0	+ 6.5	+ 4.8	+12.4	+ 6.0	+16.1	+ 0.1	+11.5	+ 0.8	+ 2.9	+ 2.8
March	+ 2.1	+ 9.8	+ 4.3	+ 2.7	+ 7.7	+ 2.4	+ 2.9	+ 9.3	+ 3.6	+ 2.5	+ 2.9
April	..	..	+ 4.9	..	..	..	+ 3.6	..	+ 5.2	..	..

Source: annual data: WIW; Estonia, Latvia, Lithuania: national sources. Monthly data: national sources.

¹⁾ Industrial sales.

²⁾ From 1999 change in % against 1998 monthly average.

Unemployment Rate

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
<i>End of period (in %)</i>											
1991	11.1	4.1	x	x	x	x	11.8	3.0	x	11.8	10.1
1992	15.3	2.6	x	9.8	2.3	x	13.6	8.2	5.2	10.4	13.4
1993	16.4	3.5	1.8	11.9	5.8	4.4	16.4	10.4	6.0	14.4	15.4
1994	12.8	3.2	1.5	10.7	6.5	3.8	16.0	10.9	7.7	14.6	14.2
1995	11.1	2.9	2.1	10.2	6.5	6.2	14.9	9.5	9.0	13.1	14.5
1996	12.5	3.5	2.6	9.9	7.2	7.0	13.2	6.6	9.9	12.8	14.4
1997	13.7	5.2	2.7	8.7	7.0	5.9	10.3	8.9	11.2	12.5	14.8
1998	12.2	7.5	2.7	7.8	9.2	6.8	10.4	10.4	13.3	15.6	14.6
1999	16.0	9.4	4.0	7.0	9.1	8.3	13.0	11.8	12.2	19.2	13.6
2000	17.9	8.8	5.9	5.7	7.8	12.6	15.0	10.5	9.6	17.9	12.2
2000											
January	17.2	9.8	5.4	7.0	9.1	10.8	13.7	12.3	12.0	19.5	13.3
February	18.1	9.7	5.6	7.2	9.1	11.2	13.9	12.5	11.9	19.5	13.0
March	18.8	9.5	5.7	6.0	9.0	11.4	13.9	12.2	11.3	19.3	12.6
April	19.0	9.0	5.3	6.9	9.0	11.2	13.7	11.9	10.8	18.8	12.4
May	18.9	8.7	5.2	6.7	8.6	11.1	13.5	11.5	10.2	18.6	12.0
June	18.2	8.7	5.0	6.0	8.4	11.1	13.5	11.2	10.1	19.1	11.8
July	18.3	9.0	4.8	6.6	8.2	11.6	13.7	10.8	10.0	19.4	11.9
August	18.0	9.0	4.9	6.5	8.1	11.8	13.8	10.5	9.8	17.4	11.7
September	17.8	8.8	4.9	5.7	7.9	11.8	14.0	10.2	9.8	16.6	11.7
October	17.8	8.5	5.5	6.2	7.8	11.7	14.1	10.2	9.8	16.1	11.9
November	17.7	8.5	5.8	6.0	7.8	12.1	14.5	10.3	9.7	16.7	11.9
December	17.9	8.8	5.9	5.7	7.8	12.6	15.0	10.5	9.6	17.9	12.0
2001											
January	18.5	9.1	5.6	6.0	7.9	13.1	15.6	10.8	9.6	19.8	12.2
February	18.7	9.0	6.2	6.3	8.0	13.2	15.8	10.8	9.6	19.7	12.0
March	18.4	8.7	6.8	5.6	8.1	13.2	15.9	10.4	9.6	19.2	11.8
April	18.5	8.5	6.7	5.8	8.0	12.8	15.8	..	..	18.3	11.7

Source: WIW; Estonia, Latvia, Lithuania: national sources.

Consumer Price Index

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
<i>Period average (annual change in %)</i>											
1991	+ 338.4	+56.6	x	+35.0	x	x	+70.3	+170.2	+ 92.6	+61.2	x
1992	+ 91.3	+11.1	x	+23.0	+951.3	x	+43.0	+210.4	+1,526.5	+10.0	+207.3
1993	+ 72.8	+20.8	+89.8	+22.5	+108.8	+410.4	+35.3	+256.1	+ 873.5	+23.2	+ 32.9
1994	+ 96.0	+10.0	+47.7	+18.8	+ 35.8	+ 72.1	+32.2	+136.8	+ 307.0	+13.4	+ 21.0
1995	+ 62.1	+ 9.1	+28.8	+28.2	+ 25.0	+ 39.5	+27.8	+ 32.3	+ 197.5	+ 9.9	+ 13.5
1996	+ 123.0	+ 8.8	+23.1	+23.6	+ 17.6	+ 24.7	+19.9	+ 38.8	+ 47.8	+ 5.8	+ 9.9
1997	+1,053.9	+ 8.5	+11.2	+18.3	+ 8.4	+ 8.8	+14.9	+154.8	+ 14.8	+ 6.1	+ 8.4
1998	+ 18.8	+10.7	+ 8.1	+14.3	+ 4.7	+ 5.1	+11.8	+ 59.1	+ 27.6	+ 6.7	+ 8.0
1999	+ 2.6	+ 2.1	+ 3.3	+10.0	+ 2.4	+ 0.8	+ 7.3	+ 45.8	+ 85.7	+10.6	+ 6.1
2000	+ 10.4	+ 3.9	+ 4.0	+ 9.8	+ 2.7	+ 1.6	+10.1	+ 45.7	+ 20.8	+12.0	+ 8.9
2000											
January	+ 7.9	+ 3.4	+ 3.3	+10.0	+ 3.1	+ 0.8	+10.1	+ 56.8	+ 28.9	+13.6	+ 7.8
February	+ 9.1	+ 3.7	+ 3.1	+ 9.8	+ 3.5	+ 0.8	+10.4	+ 55.7	+ 25.1	+16.4	+ 8.3
March	+ 9.6	+ 3.8	+ 3.1	+ 9.6	+ 3.2	+ 0.8	+10.3	+ 49.0	+ 22.4	+16.6	+ 9.0
April	+ 9.4	+ 3.4	+ 3.1	+ 9.2	+ 3.8	+ 0.8	+ 9.8	+ 48.9	+ 19.9	+15.9	+ 9.2
May	+ 10.4	+ 3.7	+ 2.9	+ 9.1	+ 3.1	+ 0.4	+10.0	+ 44.0	+ 19.4	+16.0	+ 9.1
June	+ 11.1	+ 4.1	+ 3.2	+ 9.1	+ 2.4	+ 1.2	+10.2	+ 40.9	+ 20.2	+15.4	+ 9.7
July	+ 8.2	+ 3.9	+ 4.1	+ 9.6	+ 2.9	+ 1.4	+11.6	+ 44.5	+ 19.1	+ 9.2	+ 8.8
August	+ 10.4	+ 4.1	+ 4.5	+ 9.6	+ 2.4	+ 0.9	+10.7	+ 45.4	+ 18.8	+ 8.7	+ 8.2
September	+ 11.4	+ 4.1	+ 4.7	+10.3	+ 2.2	+ 0.3	+10.3	+ 44.9	+ 18.6	+ 8.7	+ 8.9
October	+ 11.5	+ 4.4	+ 5.4	+10.4	+ 2.0	+ 1.1	+ 9.9	+ 42.9	+ 19.4	+ 8.5	+ 9.0
November	+ 10.6	+ 4.3	+ 5.7	+10.6	+ 1.6	+ 1.5	+ 9.3	+ 41.3	+ 19.8	+ 8.6	+ 9.7
December	+ 11.4	+ 4.0	+ 5.0	+10.1	+ 1.8	+ 1.4	+ 8.5	+ 40.7	+ 20.1	+ 8.4	+ 8.9
2001											
January	+ 8.7	+ 4.2	+ 5.8	+10.1	+ 1.4	- 0.4	+ 7.4	+ 39.9	+ 20.7	+ 7.7	+ 8.5
February	+ 8.4	+ 4.0	+ 6.0	+10.4	+ 0.6	- 0.2	+ 6.6	+ 40.0	+ 22.3	+ 6.7	+ 8.7
March	+ 9.2	+ 4.1	+ 5.8	+10.5	+ 1.4	+ 0.7	+ 6.2	+ 40.3	+ 23.8	+ 7.1	+ 8.9
April	+ 9.9	+ 4.6	+ 6.4	+10.3	+ 1.4	+ 0.8	+ 6.6	+ 37.5	+ 24.8	+ 7.6	+ 9.0

Source: WIW; Estonia, Latvia, Lithuania: IMF, national sources from April 2001.

Trade Balance

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
USD million											
1990	x	x	x	348.0	x	x	x	-3,427.0	x	x	x
1991	x	x	x	189.0	x	x	x	-1,106.0	x	x	x
1992	x	x	x	- 48.0	- 40.3	x	x	-1,420.0	x	x	791.1
1993	x	- 525.0	- 144.8	-3,247.0	18.6	- 153.1	- 2,293.0	-1,128.0	x	71,129.0	- 154.2
1994	x	-1,381.0	- 356.9	-3,635.0	- 301.1	- 201.6	- 836.0	- 411.0	17,374.0	80,154.0	- 337.5
1995	x	-3,678.0	- 666.1	-2,442.0	- 580.7	- 943.5	- 1,827.0	-1,577.0	20,310.0	69,389.7	- 954.3
1996	187.6	-5,877.0	-1,019.4	-2,645.0	- 799.1	-1,203.8	- 8,154.0	-2,470.0	22,471.0	60,713.4	- 881.7
1997	380.3	-4,540.0	-1,125.0	-1,734.0	-1,051.3	-1,784.0	-11,320.0	-1,980.0	17,025.0	55,691.7	- 771.6
1998	- 457.3	-2,554.0	-1,115.2	-2,080.0	-1,377.4	-2,083.0	-13,667.0	-2,625.0	16,869.0	40,188.5	- 774.9
1999	-1,081.0	-1,902.6	- 877.1	-2,054.0	-1,223.2	-1,830.8	-14,500.0	-1,092.0	36,155.0	- 1,103.1	-1,245.2
2000	-1,173.2	-3,285.4	- 788.5	-2,122.0	-1,061.0	-1,194.1	-13,165.0	-1,684.0	60,703.0	- 916.8	-1,081.2
2000											
January	- 164.4	- 115.0	- 40.8	- 134.8	- 70.0	x	- 1,459.0	- 593.6	4,071.0	- 53.7	- 91.0
February	- 107.2	- 197.2	- 77.7	- 186.8	- 69.4	x	- 1,149.0	- 745.7	4,686.0	- 81.2	- 84.0
March	- 31.4	- 162.5	- 80.8	- 181.3	- 99.0	- 191.4	- 1,242.0	- 771.3	5,626.0	- 32.4	- 137.5
April	- 47.4	- 136.7	- 80.6	- 48.3	- 101.2	x	- 1,076.0	- 690.6	4,725.0	26.3	- 121.3
May	- 106.5	- 249.4	- 101.0	- 130.5	- 118.9	x	- 903.0	- 697.6	4,914.0	- 76.2	- 119.3
June	- 79.8	- 234.1	- 74.7	- 220.2	- 101.7	- 300.7	- 1,042.0	- 826.2	4,991.0	- 13.2	- 21.5
July	- 98.5	- 371.7	- 64.7	- 182.3	- 119.7	x	- 1,040.0	- 821.3	5,016.0	- 24.0	- 91.1
August	- 49.8	- 375.0	- 66.2	- 43.4	- 119.1	x	- 1,326.0	- 69.0	5,352.0	- 99.5	- 119.6
September	- 87.7	- 77.6	- 59.2	- 279.1	- 111.2	- 226.8	- 974.0	- 78.0	5,233.0	- 25.1	- 36.7
October	- 163.9	- 389.4	- 100.9	- 251.4	- 119.5	x	- 1,058.0	- 159.0	4,915.0	- 144.7	- 75.1
November	- 89.0	- 260.9	- 128.1	- 61.7	- 147.3	x	- 861.0	- 194.0	5,840.0	- 165.6	- 87.8
December	- 149.6	- 596.5	- 102.5	- 384.9	- 141.8	- 384.9	- 1,038.0	- 587.0	5,333.0	- 227.3	- 96.3
2001											
January	- 80.0	- 215.0	- 94.4	- 317.1	- 80.3	x	- 1,516.0	- 157.0	5,187.0	- 114.1	- 32.6
February	- 46.4	- 206.1	- 45.6	- 99.5	- 91.7	x	- 725.0	- 249.0	4,665.0	- 111.6	- 43.0
March	- 152.7	- 339.2	- 98.0	- 112.8	- 120.4	..	..	- 130.0	4,718.0	..	..
April	..	- 313.3	- 112.8	..	..	x	..	..	4,308.0	..	..

Source: national central banks.

Current Account

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic ¹⁾	Slovenia
USD million											
1991	x	x	x	267.0	x	x	- 1,359.0	-1,012.0	x	x	x
1992	x	x	x	324.0	191.4	x	- 269.0	-1,564.0	x	x	926.2
1993	x	455.8	21.1	-3,455.0	428.0	- 83.5	- 2,329.0	-1,174.0	12,792.0	- 601.2	191.9
1994	x	- 786.8	- 165.2	-3,911.0	200.8	- 90.4	- 944.0	- 428.0	8,850.0	664.9	573.0
1995	x	-1,369.1	- 157.9	-2,480.0	- 17.9	- 56.6	5,455.0	-1,774.0	8,025.0	391.4	- 99.4
1996	x	-4,292.2	- 399.4	-1,678.0	-280.0	- 722.6	- 1,352.0	-2,571.0	12,448.0	- 601.2	31.4
1997	426.5	-3,211.0	- 562.6	- 981.0	-346.2	- 981.3	- 4,312.0	-2,137.0	2,060.0	-1,952.3	11.4
1998	-375.4	-1,336.0	- 480.3	-2,298.0	-707.8	-1,298.0	- 6,810.0	-2,968.0	687.0	-2,063.1	-147.2
1999	-660.2	-1,567.1	- 295.3	-2,076.0	-635.9	-1,053.4	-11,660.0	-1,296.0	24,647.0	-1,083.1	-782.6
2000	-696.2	-2,369.2	- 336.4	-1,497.0	-487.7	- 674.9	- 9,946.0	-1,400.0	46,342.0	- 713.0	-594.2
2000											
January	-245.1	x	x	- 78.1	x	x	- 1,210.0	- 12.0	x	- 13.5	- 22.4
February	-100.7	x	x	- 154.4	x	x	- 964.0	43.0	x	- 11.9	- 28.4
March	- 2.2	- 335.7	- 62.1	- 139.8	- 40.7	- 143.3	- 1,341.0	- 66.5	11,926.0	- 39.1	-118.4
April	- 35.0	x	x	19.9	x	x	- 855.0	- 85.0	x	59.4	- 44.0
May	- 72.4	x	x	- 72.5	x	x	- 405.0	- 294.0	x	- 94.5	- 82.8
June	27.5	- 386.2	- 73.4	- 406.3	- 76.1	- 172.1	- 836.0	- 15.0	10,943.0	- 45.2	31.9
July	- 27.8	x	x	9.4	x	x	- 690.0	- 91.0	x	5.6	- 64.6
August	115.7	x	x	157.3	x	x	- 956.0	- 48.0	x	- 3.5	- 90.1
September	- 26.8	- 532.9	- 830.6	- 271.2	- 63.5	- 420.9	- 606.0	- 22.0	10,546.0	- 13.3	25.6
October	-133.3	x	x	- 47.0	x	x	- 840.0	- 89.0	x	- 109.7	- 18.8
November	- 65.4	x	x	9.4	x	x	- 445.0	- 69.0	x	- 156.0	- 26.5
December	-135.8	-1,078.4	-2,665.9	- 523.1	-115.8	-1,016.8	- 798.0	- 649.0	12,927.0	- 233.2	-155.8
2001											
January	- 2.9	x	x	- 222.4	x	x	- 956.0	- 107.0	x	- 92.8	55.6
February	- 42.3	x	x	- 49.8	x	x	- 463.0	- 256.0	x	- 29.4	8.9
March	-115.8	- 708.3	..	- 43.7	35.3	..	..	- 92.0	11,500.0	..	..
April	..	x	x	- 1.8	x	x	..	..	x	..	..

Source: national central banks.

¹⁾From 1997: BOP Manual, 5th edition.

Total Reserves Minus Gold

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
<i>End of period (USD million)</i>											
1991	310.6	x	x	3,934.3	x	x	3,632.6	694.9	x	x	112.1
1992	902.2	755.0	170.2	4,424.7	x	45.3	4,099.1	825.9	x	x	715.5
1993	655.2	3,789.4	386.1	6,700.0	431.5	350.3	4,092.0	995.5	5,835.0	415.6	787.8
1994	1,001.8	6,144.5	443.4	6,735.5	545.2	525.5	5,841.8	2,086.2	3,980.4	1,691.2	1,499.0
1995	1,236.5	13,842.9	579.9	11,974.3	505.7	757.0	14,774.1	1,579.0	14,382.8	3,363.9	1,820.8
1996	483.6	12,351.8	636.8	9,720.2	654.1	772.2	17,844.0	2,102.8	11,276.4	3,418.9	2,297.4
1997	2,248.5	9,733.7	757.7	8,407.9	704.0	1,010.0	20,407.2	3,803.3	12,894.7	3,230.3	3,314.7
1998	2,830.8	12,542.1	810.6	9,318.7	728.2	1,409.1	26,432.3	2,867.4	7,801.4	2,868.8	3,638.5
1999	3,083.4	12,806.1	853.5	10,954.0	840.2	1,195.0	24,534.6	2,687.0	8,457.2	3,370.7	3,168.0
2000	3,342.3	13,019.2	920.6	11,189.6	850.9	1,311.6	25,656.9	3,922.2	24,264.3	4,022.3	3,196.0
2000											
January	2,826.6	12,779.0	731.0	11,244.5	816.3	1,206.0	26,019.2	2,670.9	8,912.4	3,338.8	3,074.3
February	2,772.3	12,644.2	739.5	11,549.9	782.2	1,401.0	25,290.7	2,573.0	9,606.2	3,433.1	3,014.1
March	2,715.3	12,556.9	727.6	10,681.3	847.2	1,334.9	25,292.1	2,716.3	11,456.4	3,672.1	3,290.0
April	2,799.5	12,602.7	743.6	10,313.3	847.7	1,232.6	25,320.6	2,711.4	13,409.9	4,122.4	3,190.9
May	2,784.8	12,819.9	702.1	10,714.2	805.7	1,236.3	24,593.9	2,797.2	15,877.7	4,030.0	3,106.7
June	3,014.5	12,989.9	810.2	10,503.3	832.0	1,377.2	24,872.9	3,152.8	17,684.6	4,015.0	3,142.4
July	2,747.8	12,948.2	774.1	10,231.0	888.4	1,371.0	25,027.2	3,523.6	19,955.2	3,899.3	3,096.4
August	2,695.9	12,234.7	763.4	10,351.3	852.6	1,341.0	24,705.9	3,614.1	20,288.9	4,331.0	2,981.0
September	2,870.3	12,387.5	770.1	10,555.0	816.6	1,301.6	24,613.7	3,790.2	21,473.9	4,166.2	2,972.3
October	2,976.1	11,925.9	765.9	10,088.6	864.6	1,303.8	24,508.0	3,908.4	22,289.9	3,939.1	2,943.3
November	3,142.1	12,279.7	774.1	10,760.1	861.1	1,226.5	25,208.5	3,841.4	24,035.2	4,007.2	2,950.7
December	3,342.3	13,019.2	920.6	11,189.6	850.9	1,311.6	25,656.9	3,922.2	24,264.3	4,022.3	3,196.0
2001											
January	3,112.0	12,959.5	855.1	10,752.5	813.0	1,286.1	27,231.9	3,998.1	25,888.5	3,918.4	3,112.9
February	3,027.2	13,121.8	765.0	11,114.0	848.7	1,430.9	27,898.5	4,075.4	24,590.7	3,916.6	3,187.0
March	2,980.3	12,783.4	737.5	10,689.9	852.7	1,239.7	27,145.8	4,204.0	25,942.2	..	3,106.0

Source: IMF.

Central Government Surplus/Deficit

	Bulgaria	Czech Republic	Estonia ¹⁾	Hungary	Latvia	Lithuania	Poland ²⁾	Romania	Russia ³⁾	Slovak Republic	Slovenia ⁴⁾
<i>% of GDP</i>											
1991	x	-2.0	x	-4.6	x	x	-3.8	-1.9	x	-3.4	+2.6
1992	-5.8	-0.2	x	-6.7	-3.0	x	-6.0	-4.4	-3.4	-2.8	+1.2
1993	-11.0	+0.1	-0.4	-5.6	-0.2	x	-2.8	-1.7	-4.6	-6.2	+0.9
1994	-6.5	+0.9	-0.6	-8.1	-1.9	-1.9	-2.7	-4.2	-10.3	-4.9	+0.0
1995	-6.6	+0.5	+0.3	-5.5	-3.8	-1.8	-2.4	-4.1	-3.2	-1.5	+0.0
1996	-10.9	-0.1	-1.5	-1.9	-0.8	-2.5	-2.4	-4.9	-7.9	-4.2	+0.3
1997	-3.9	-0.9	+1.8	-4.0	+1.2	-1.0	-1.3	-3.6	-7.0	-2.5	-1.2
1998	+1.5	-1.6	-0.2	-5.5	+0.2	-1.3	-2.4	-2.8	-5.0	-2.6	-0.8
1999	+1.8	-1.6	-4.6	-3.0	-3.0	-0.3	-2.0	-2.6	-1.6	-1.8	-0.6
2000	-0.7	-2.4	-0.8	-2.9	-2.8	-1.7	-2.2	-3.6	+2.5	-4.1	-1.4
1998											
3 rd quarter	+6.6	+1.0	-1.5	-3.0	+0.8	+0.3	-0.8	-0.2	-4.4	-2.4	x
4 th quarter	-2.7	-7.2	-5.1	-10.1	-3.8	-3.9	-1.8	-3.0	-5.0	-5.9	x
1999											
1 st quarter	+1.8	+0.5	-8.6	-9.0	+0.3	-1.3	-6.5	-2.0	-4.8	+0.6	x
2 nd quarter	+3.7	-1.7	-5.0	-2.5	-5.2	-3.8	-1.8	-5.6	-3.5	-4.1	x
3 rd quarter	-5.5	-0.5	-1.3	-1.5	-2.8	+1.6	+0.0	-2.5	-2.2	-2.6	x
4 th quarter	-2.2	-4.5	-4.6	+0.2	-4.1	+1.2	-0.7	-1.5	-1.6	-1.1	x
2000											
1 st quarter	-0.1	+1.9	-1.0	-4.3	-1.0	-2.6	-4.5	-6.7	+4.4	-0.4	x
2 nd quarter	+7.8	-2.8	-2.3	-1.1	-4.8	-2.0	-2.2	-5.9	+7.0	+0.1	x
3 rd quarter	-5.7	-2.5	+2.0	-0.4	-2.0	-0.6	-2.0	-1.9	+2.2	-3.1	x
4 th quarter	-2.5	-5.7	-1.5	-5.5	-3.2	-1.6	-0.7	-2.3	+1.2	-8.7	x
2001											
1 st quarter	-3.6	+0.5	+0.2	-1.1	..	..	-8.9	-4.9	+2.6	-2.6	x

Source: WIW; Russia: IMF; Latvia, Lithuania: national sources; Estonia: national sources from 1996; Russia: TACIS from 1996. Quarterly data: national sources.

¹⁾ Including social budget in 1993 and 1994.

²⁾ Since 1998: privatization receipts treated as financing items.

³⁾ Quarterly data are cumulative.

⁴⁾ General government deficit; revised methodology since 1999.

Gross External Debt

	Bulgaria ¹⁾	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania ²⁾	Russia	Slovak Republic ³⁾	Slovenia
	USD million										
1991	12,247.1	x	x	22,812.0	x	x	48,412.0	2,131.0	70,100.0	x	1,866.0
1992	13,805.7	7,762.3	x	21,644.0	x	x	47,044.0	3,240.0	80,200.0	2,981.0	1,741.0
1993	13,836.4	9,604.9	298.0	24,566.0	x	x	47,246.0	4,249.0	112,784.0	3,626.0	1,873.0
1994	11,338.4	12,209.7	534.0	28,526.0	x	529.0	42,174.0	5,563.0	121,600.0	4,310.0	2,258.0
1995	10,148.0	17,190.3	785.0	31,660.0	1,415.0	1,374.0	43,957.0	6,482.1	120,500.0	5,827.0	2,970.0
1996	9,601.6	21,180.5	1,387.0	28,043.0	2,025.0	2,081.0	47,541.0	8,344.9	125,000.0	7,810.0	3,981.0
1997	9,760.2	21,616.5	2,562.0	24,395.0	2,731.0	3,146.0	49,648.0	9,502.7	130,800.0	10,700.0	4,123.0
1998	10,274.3	24,348.4	2,900.0	27,280.0	3,060.0	3,577.0	59,163.0	9,884.1	145,000.0	11,900.0	4,915.0
1999	10,204.3	22,863.4	2,871.0	29,336.0	3,803.0	4,335.0	64,852.0	9,014.0	158,800.0	10,518.0	5,400.0
2000	10,364.3	..	3,025.7	30,757.0	5,662.5	..	67,517.0	9,917.0	..	10,454.0	6,217.0

Source: WIW; Estonia, Latvia, Lithuania: EBRD (European Bank for Reconstruction and Development).

¹⁾ Gross external debt in convertible currencies.

²⁾ Medium- and long-term gross debt.

³⁾ The official level of foreign debt in 1997 was USD 9.9 billion; however, this figure was distorted by an accounting operation.

Exchange Rate

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	Period average (ATS per 100 units of national currency) ¹⁾										
1991	65.64	x	x	15.62	x	x	1,104.00	15.29	x	x	42.35
1992	47.08	x	x	13.91	1,492.10	619.88	806.49	3.57	x	x	13.52
1993	42,145.65	39.90	87.92	12.65	1,722.52	267.77	642.13	1.53	1,162.41	37.80	10.27
1994	21,112.38	39.68	87.92	10.86	2,040.34	287.14	502.65	0.69	516.66	35.64	8.87
1995	15,002.23	37.99	87.94	8.02	1,910.82	252.04	415.73	0.50	219.13	33.93	8.51
1996	5,950.87	39.00	87.97	6.94	1,922.04	264.67	392.66	0.34	204.87	34.54	7.82
1997	725.62	38.50	87.92	6.53	2,100.91	305.11	372.16	0.17	209.07	36.30	7.64
1998	703.20	38.35	87.95	5.77	2,098.86	309.48	356.19	0.14	127.55	35.13	7.45
1999	58.27	3.10	7.29	0.45	182.84	26.75	26.97	0.0070	4.35	2.59	0.59
2000	43.33	2.38	5.42	0.33	151.69	23.00	21.17	0.0042	3.27	1.98	0.41
2000											
January	51.14	2.78	6.40	0.39	169.25	24.67	24.04	0.0054	3.50	2.37	0.51
February	51.13	2.81	6.40	0.39	171.21	25.43	24.54	0.0054	3.54	2.37	0.50
March	51.12	2.81	6.40	0.39	173.99	25.93	25.35	0.0054	3.64	2.41	0.50
April	51.08	2.76	6.40	0.39	176.95	26.41	24.95	0.0053	3.69	2.42	0.50
May	51.12	2.74	6.40	0.39	180.98	27.60	24.54	0.0054	3.90	2.34	0.49
June	51.13	2.77	6.40	0.39	175.32	26.34	23.95	0.0050	3.73	2.36	0.49
July	51.13	2.81	6.40	0.38	176.23	26.61	24.62	0.0049	3.82	2.36	0.49
August	51.13	2.83	6.40	0.38	181.05	27.66	25.38	0.0049	3.99	2.36	0.48
September	51.05	2.82	6.39	0.38	185.58	28.67	25.54	0.0049	4.13	2.32	0.48
October	51.15	2.84	6.40	0.38	188.37	29.25	25.23	0.0048	4.20	2.30	0.48
November	51.13	2.89	6.39	0.38	187.15	29.20	25.61	0.0047	4.20	2.33	0.48
December	51.13	2.86	6.39	0.38	180.11	27.87	25.85	0.0044	3.99	2.19	0.47
2001											
January	51.13	2.85	6.40	0.38	173.60	26.65	25.92	0.0041	3.76	2.29	0.47
February	51.13	2.89	6.40	0.38	175.58	27.13	26.53	0.0040	3.79	2.29	0.47
March	51.13	2.90	6.40	0.38	176.27	27.50	27.07	0.0040	3.84	2.29	0.47
April ²⁾	51.53	2.89	6.39	0.38	179.16	28.03	28.02	0.0040	3.88	2.31	0.46
May ²⁾	52.41	2.97	6.40	0.39	184.99	29.17	29.28	0.0041	3.78	2.36	0.47

Source: IMF.

¹⁾ Up to December 31, 1998, in Austrian schillings; as of January 1, 1999, in euro.

²⁾ Source: OeNB; Russia: OeNB, end of period.

Official Lending Rate¹⁾

	Bulgaria	Czech Republic	Estonia	Hungary ²⁾	Latvia	Lithuania	Poland	Romania	Russia ³⁾	Slovak Republic	Slovenia
<i>End of period</i>											
1991	54.0	9.5	×	22.0	×	×	36.0	18.0	5.0	9.5	×
1992	41.0	9.5	×	21.0	120.0	×	32.0	70.0	80.0	9.5	25.0
1993	52.0	8.0	×	22.0	27.0	×	29.0	70.0	210.0	12.0	18.0
1994	72.0	8.5	×	25.0	25.0	×	28.0	58.0	180.0	12.0	16.0
1995	34.0	9.5	×	28.0	24.0	×	25.0	35.0	160.0	9.8	10.0
1996	180.0	10.5	×	23.0	9.5	×	22.0	35.0	48.0	8.8	10.0
1997	6.7	13.0	×	20.5	4.0	13.0	24.5	40.0	28.0	8.8	10.0
1998	5.1	7.5	×	17.0	4.0	13.0	18.3	35.0	60.0	8.8	10.0
1999	4.5	5.0	×	14.5	4.0	13.0	19.0	35.0	55.0	8.8	8.0
2000	4.6	5.0	×	11.0	3.5	9.6	21.5	35.0	25.0	8.8	10.0
2000											
January	3.9	5.0	×	13.0	4.0	8.9	19.0	35.0	45.0	8.8	8.0
February	3.1	5.0	×	13.0	4.0	8.8	20.5	35.0	45.0	8.8	8.0
March	3.6	5.0	×	12.0	3.5	7.9	20.5	35.0	33.0	8.8	8.0
April	3.6	5.0	×	11.0	3.5	7.5	20.5	35.0	33.0	8.8	8.0
May	3.4	5.0	×	11.0	3.5	9.8	20.5	35.0	33.0	8.8	8.0
June	4.1	5.0	×	11.0	3.5	9.3	20.5	35.0	33.0	8.8	9.0
July	3.4	5.0	×	11.0	3.5	10.1	20.0	35.0	28.0	8.8	9.0
August	4.0	5.0	×	11.0	3.5	8.5	21.5	35.0	28.0	8.8	9.0
September	4.0	5.0	×	11.0	3.5	8.2	21.5	35.0	28.0	8.8	9.0
October	4.4	5.0	×	11.0	3.5	8.6	21.5	35.0	28.0	8.8	9.0
November	4.7	5.0	×	11.0	3.5	8.4	21.5	35.0	25.0	8.8	9.0
December	4.6	5.0	×	11.0	3.5	9.6	21.5	35.0	25.0	8.8	10.0
2001											
January	4.3	5.0	×	11.0	3.5	8.0	21.5	35.0	25.0	8.8	10.0
February	4.2	4.0	×	11.0	3.5	8.7	21.5	35.0	25.0	8.8	10.0
March	4.2	4.0	×	11.0	..	9.2	..	35.0	25.0	8.8	10.0

Source: IMF; Poland, Russia: national sources; Lithuania, Romania: OECD.

¹⁾ Due to currency board arrangements, the Bank of Estonia and the Bank of Lithuania do not lend to the government or to enterprises. Therefore these two countries do not define or publish discount rates. On October 9, 1997, the Bank of Lithuania introduced an "official lending rate": weighted average rate on domestic currency lending to residents.

²⁾ Base rate.

³⁾ Refinancing rate.

