



OESTERREICHISCHE NATIONALBANK  
EUROSYSTEM

# FOCUS ON EUROPEAN ECONOMIC INTEGRATION

## **1989–2009 Twenty Years of East-West Integration: Hopes and Achievements**

The Focus on European Economic Integration (FEEI) is a channel for communicating the OeNB's ongoing research on Central, Eastern and Southeastern European (CESEE) countries, thus reflecting a strategic regional research priority of the OeNB. Contributions to the quarterly FEEI include peer reviewed studies dealing primarily with macrofinancial and monetary integration as well as economic country analyses and cross-regional comparisons.

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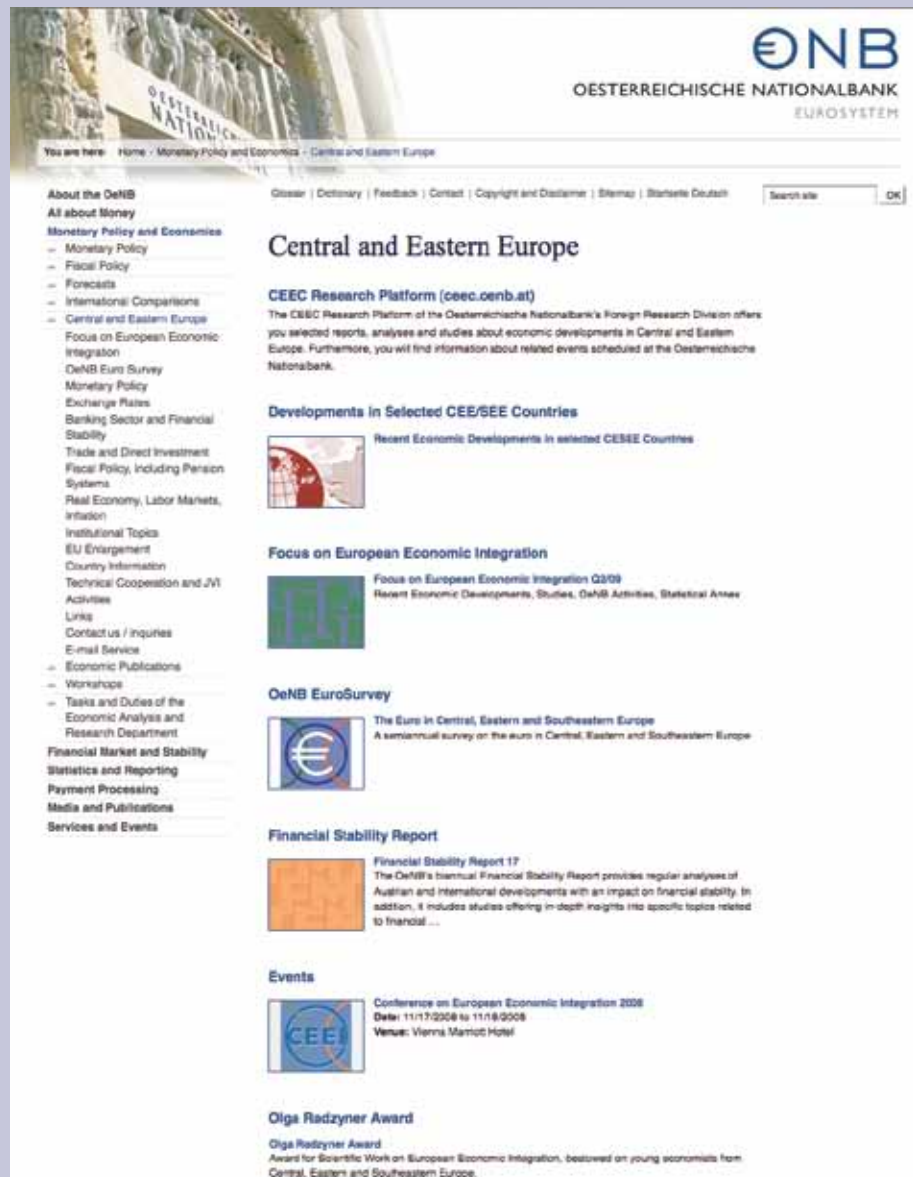


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#### Olga Radzyner Award

Olga Radzyner Award  
Award for Scientific Work on European Economic Integration, bestowed on young economists from Central, Eastern and Southeastern Europe.

## Twenty Years of East-West Integration – Hopes and Achievements

The year 2009 will enter the history books as a year dominated by the biggest economic crisis since the 1930s. But 2009 will also be remembered as a year in which strong and coordinated policy efforts were undertaken to shield the real economy, financial markets and banking sectors around the globe from the most adverse effects of the global downturn. Coordination and integration have been the words most frequently used to describe political and economic developments over the past decades, and their relevance remains indisputable. Twenty years ago, the fall of the Iron Curtain and the subsequent peaceful disintegration of the Eastern bloc ended the long-lasting division of Europe. Accompanied by hopes for prosperity, peace, security and stronger cooperation across the continent, these developments prepared the ground for the unified Europe in which we live today. They initiated a process of coalescence which finally culminated in the 2004 and 2007 enlargement rounds of the European Union. Cooperation and integration have thus become an integral part of our day-to-day European reality, forming a major component of our European identity.

This special issue of the OeNB's Focus on European Economic Integration is intended to pay tribute to these historic events. It provides a broad overview of the most important topics concerning East-West integration, illustrating their evolution over time from a central bank's perspective. In doing so, it gathers the profound knowledge of international experts who accompanied the Eastern European countries through the transition process and who have cooperated closely with the OeNB over the years. These contributions are supplemented by texts from OeNB experts underlining the strategic research focus adopted by the OeNB in the early 1990s in response to the changing international environment of Austria and its economy.

In 1989, almost overnight, Austria's position shifted from the dead end of what was then called the West right into the center of the "new" Europe. Given its central location but also its strong historical and cultural ties with Central, Eastern and Southeastern Europe (CESEE), it was a natural step for Austria to intensify its bilateral links with the region. Austrian businesses and banks were among the first to identify the economic potential of the CESEE region and to expand activities into these new markets.

This strategy has clearly paid off. As studies have shown, the political and economic integration of Eastern Europe – in connection with Austrian EU membership since 1995 – has caused a growth impulse for the Austrian economy of an additional 0.5% to 1% per year and has resulted in 100,000 to 150,000 additional jobs. Furthermore, the Austrian current account turned positive in 2002, and the degree of internationalization of the Austrian economy increased strongly as foreign direct investment was channeled into the CESEE countries. To a substantial extent, this development was driven by the banking sector. Austrian banks have become key players in CESEE markets, with their market shares amounting to around 50% in Slovakia and Bosnia and Herzegovina and more than 75% in Croatia. Business in the CESEE region accounts for more than 25% of total Austrian banking assets and for more than 40% of the banking sector's pretax profits.

But not only Austria benefited from the integration of Eastern Europe into broader European structures. Economic transition, European integration and EU membership spurred an unprecedented process of social, political and economic modernization and catching-up in the CESEE countries. This is best exemplified by the region's growth performance: From 2001 to 2008, the average growth differential of the CESEE EU Member States vis-à-vis the euro area amounted to around 3 percentage points, thus raising GDP per capita (in purchasing power parities) in CESEE from less than 40% of the Western European (EU-15) average to more than 51% within the same period. By 2008, the Czech Republic and Slovenia had reached income levels observed in some countries of the EU-15.

However, the current economic crisis has hit the CESEE region more severely than expected. Spillover effects from the close economic and financial linkages with Western Europe have in particular put a brake on the swift economic expansion of previous years and, according to recent forecasts, the economic catching-up process will come close to a standstill in 2009. Given the still substantial income gap, the comparatively low wage levels and the generally sound international competitiveness of the region, its medium-term growth potential is still intact. This is why, in the foreseeable future, the CESEE countries are bound to rank again among the fastest-growing economies of Europe.

Against this background, it is of utmost importance to sustain our commitment to the region. At the European level, this has been done by doubling the balance of payments assistance intended to support EU economies outside the euro area. Moreover, Austrian investors in CESEE are generally adhering to their long-term strategic business plans in the region. Steps like these are not only important on purely economic grounds, but also serve to uphold the values of cooperation and integration in an enlarged Europe and to further build upon the hopes articulated 20 years ago. If we remain committed to these values, I am sure that the success story of the past decades will continue well into the future.

Governor  
Ewald Nowotny

# Taking Stock of Twenty Years of Analysis and Research on CESEE at the OeNB

## 1 Building a New Europe

For Austria and its central bank, the Oesterreichische Nationalbank (OeNB), the last 20 years have been marked by fundamental change. From a monetary policy perspective, the period started in an era characterized by the Austrian schilling's informal peg to the Deutsche mark, commonly referred to as the "hard currency policy," which has proved a success for Austria, a small open economy, for a number of reasons. From an analytical point of view, maintaining the peg did not seem to be a very demanding task, considering that the anchor was clearly defined and observable on a daily basis. In economic policy terms, however, it was obviously much harder to stick to the hard peg option: The problems it involved ranged from mastering political difficulties to market turbulences and permanent real economy adjustment needs. Things changed significantly when Austria – together with Sweden and Finland – joined the EU in 1995. Though hardly debated in public, it was quite clear that Austria would participate in monetary union, if it were ever to be realized. After all, the peg to the Deutsche mark constituted a kind of monetary union already. The common currency, this long-term European project, became a reality as early as in 1999 and 2002, when the national currencies of 11 EU countries – including Austria – were replaced by the euro. In monetary policy, the "one member, one vote" principle in the Governing Council of the newly established European Central Bank (ECB) gave the OeNB much more responsibility and, as a result, required it to step up economic and monetary analysis.

The opening up of Central and Eastern Europe (CEE) happened more or less in parallel with these fundamental changes in the EU. Without a doubt, the fall of the Iron Curtain was a historic event for all Europeans, but it was of special importance for Austria. Not only did Austria find itself close to the heart of these politically and economically extraordinary developments, but its citizens were also reminded of their country's historical ties with the region, which, in many cases, had survived at the personal level. Austrian enterprises managed to be part of this transformation process and to profit from it right from the beginning. Their investment activities were mainly driven by three different motives: Some investors simply wanted to revive "the good old days," when Central Europe was one of the most innovative and developed regions in Europe; others, whose business opportunities were restricted by a very narrow home market, were looking to develop new markets and others again wanted to take advantage of the comparatively low labor costs in the region. Very often, all three motives seemed to play a role, but the objective of widening one's market was clearly the most important factor from the point of view of a small country. In addition, many multinational companies considering "going east" established their CEE headquarters in Vienna. As a result, the Austrian capital, a city with sound business infrastructures and a high standard of living, became a hub not only for air connections to the east but also for investment activities in CEE.

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For the OeNB, these institutional and economic dynamics, which to a large extent characterized European history in the 1990s, involved substantial challenges: On the one hand, Austria was in the process of integration into the EU and monetary union, on the other hand, the transformation of CEE as well as the growing number of EU members and monetary union applicants created an increasing demand for policy advice, knowledge transfer and technical assistance. Another newly evolving task was cross-border banking supervision. Not surprisingly, Austrian banks were among the first ones to participate in the restructuring and privatization of the CEE financial markets. In fact, Austrian banks established themselves as major players in many CEE countries, defending their market shares until today, as the conditions in the region have turned difficult in the wake of the global financial crisis. Especially since January 2008, when the OeNB was assigned additional key tasks in banking supervision, the stability of the CEE financial market has become a major issue for the OeNB.

## 2 “Going East” – The Obvious Strategic Choice from a Viennese Perspective

After the fall of the Iron Curtain, the OeNB decided to systematically use and increase its expertise in CEE issues and to share this know-how not only at home (e.g. with the social partners or commercial banks) but also with its counterparts in the ESCB. Admittedly, this strategy was half pushed and half pulled; as it turned out, Austrian members of any ESCB committee were immediately expected to be fully-fledged experts on CEE. As a result, the OeNB was one of the first central banks in the ESCB to specialize on a particular analytical topic. Consequently, apart from fulfilling its responsibilities to the Austrian economy, the OeNB had to develop a very clear focus on CEE issues. Suomen Pankki, the Finnish central bank, was in a very similar position, as the Finnish economy had a long-standing tradition of trade with Russia and the Baltic countries. In order to reap the greatest benefit from their expertise, the OeNB and the Bank of Finland Institute for Economies in Transition (BOFIT) agreed on a close cooperation in analyzing CEE economies, which turned out to be very fruitful and has remained relevant until today.

Moreover, the OeNB enhanced its already existing contacts in the region and established a kind of network between Austrian and CEE institutions, including not only central banks but many other organizations as well, from research and academic institutions to banking and commercial business organizations.<sup>2</sup> These network activities have never been a one-way street, as all participants have profited from a free flow of information in both directions. The challenges of preparing for EU membership first and participation in monetary union a few years later as well as the experience of living outside or inside the EU and living without or with the euro were just a few core topics among a broad range of issues discussed. A fairly regular and frequent exchange of experts was established, which, in the end, constitutes the backbone of institutional and personal relationships throughout the region.

<sup>2</sup> *It should also be emphasized that many other business areas of the OeNB – from accounting and cash logistics to controlling, financial markets analysis and supervision, payment systems and statistics – have contributed considerably to the OeNB’s cooperation and technical assistance activities in CEE.*



Much has happened since 1989: Many CEE countries have become members of the EU – Slovenia and Slovakia have even entered monetary union – which gave the new EU Member States a say in the Eurosystem/ESCB committees. Despite these major developments, the topics of transition, catching-up and convergence have not lost their importance. Quite on the contrary, the financial crisis has shown the urgent need for even more and deeper analyses of CEE economies and for including a larger number of countries in these analyses. When the Iron Curtain came down, our main focus was on the CEE-5 (Poland, the Czech Republic, Hungary, Slovakia and Slovenia). In the meantime, the regional focus has shifted south, in particular to the Western Balkan countries. In the OeNB's communication, this shift has been highlighted also by the use of the acronym CESEE – Central, Eastern and Southeastern Europe – rather than CEE. More recently, we have added some CIS countries to our portfolio, as Austrian banks have spread their activities to the region. At the same time, we did not give up or significantly reduce the analysis of the CEE-5 as originally planned, but, on the contrary, we had to take on board some urgent elements of economic developments in the Baltic countries in our analyses. Of course, this has been largely due to the financial crisis, which erased at least some of the progress in catching-up and harshly highlighted most, if not all, CESEE countries' position as emerging markets.

### 3 A Wide and Changing Range of Topics<sup>3</sup>

Analyzing CESEE requires a lot of flexibility, as the topics of interest change frequently. Three main areas of research can be identified: (1) transition: the fundamental change from centrally planned to market economies; (2) catching-up: the closing of the gap between the EU average GDP per capita and GDP per capita in CEE; and, finally, (3) integration: institutional change, mainly in an EU context.

With respect to transition, the case of East Germany and its unification with West Germany, of a few Asian and Latin American countries as well as, more recently, economic and institutional developments in China can to some extent be compared with CESEE. The latter, however, has been through a unique process in so far as it had been a fairly prosperous region before World War II and because of its medium-term prospects in the European integration context. One of the most visible parts of transition was the change from state to private ownership of many firms. Privatization took place in various ways: through voucher privatization, initial public offerings on the stock exchange or through direct sales to national and international investors. Another important issue was how to attract FDI in general, as modernizing the infrastructure and increasing production capacities required foreign expertise and capital.

Besides these practical issues, very general questions arose in the transformation process, mainly discussed in behavioral economics, such as how to deal with the lack of incentive mechanisms and how to install new ones; how to make economic entities more self-reliant so that they do not wait for decisions made by others; how to get rid of highly subsidized prices and how to find true equilibrium prices, including exchange rates. At the same time, the CESEE countries' heritage also contained some positive features, like low or even nonexistent public debts, which

<sup>3</sup> For an encompassing overview of the topics and issues we have addressed since the very beginning, see "CESEE-Related Activities of the OeNB's Economic Analysis and Research Department" in this issue.

provided room for fiscal action, albeit lacking the required instruments and decision-making bodies.

Catching-up remains a crucial issue. Most countries started from a very low level of GDP per capita, which decreased further at the beginning of the transformation process and, in some cases, even today continues to stand at levels half of those of the euro area. Therefore, adjustment speed is one of the major issues: An economy that is growing too quickly runs the risk of overheating, while an economy that is growing too slowly runs the risk of missing opportunities, triggering unemployment and a brain drain. In general, catching-up drives the convergence of several economic areas and leads to the adjustment of all kinds of prices and wages. The Balassa-Samuelson effect is a special phenomenon of this process and received widespread attention in the literature of the 1990s.

Finally, transformation has also implied integration and, hence, necessitated institutional change, which was a prerequisite for the first and the second round of EU eastern enlargement and is a crucial component of the negotiating processes with prospective EU members (such as Croatia) and of EU neighborhood policies in general. The most advanced CESEE countries have already qualified for monetary union. Slovenia and Slovakia introduced the euro recently.

The institutional changes on the path to EU and euro area membership also affected trade and capital agreements. In general, they led to an increase in trade, competition and competitiveness; in many cases, however, they also caused balance of payments deficits. Borders were opened – at least to some extent – also for workers, enhancing migration in one direction and the flow of remittances in the opposite one. In addition, there have been substantial institutional changes at the micro level, for instance to ensure central bank independence, which is an important precondition for EU membership.

#### 4 From General to Specific Issues

The character of the issues that had to be addressed also changed over time. At the beginning of the transition process, evaluations of first reform steps and of first experiences were at the center of interest. These ranged from the evaluation of outcomes (e.g. distributional effects) to the search for a new, adequate policy mix, as novel challenges were emerging. The appropriate wage level, the “right” exchange rate policy and the right speed of financial deepening, for instance the dynamics of credit growth, were among the issues discussed. The overall aim was to find a sustainable growth path, or, put differently, to avoid overheating without dampening growth prospects. This sounds very much like the key question of sustainable development in any economy, but as CESEE started from a very low income level, people were eager to catch up and to increase their living standards to Western levels quickly. In some cases, this led to the appearance of bubbles, mainly in the real estate or housing sectors, but also in lending. These bubbles were driven by various factors, sometimes by foreign investors, sometimes by domestic demand fuelled by (mostly foreign-owned) banks’ expansive lending practices.

In some countries, including the Baltics, the bursting of these domestic bubbles coincided with the – unrelated – arrival of the global financial and economic crisis, which triggered the worst downturn we have seen since the Great Depression of the 1930s. This crisis reached the CESEE region in late autumn 2008. It hit most

countries hard, as financial markets, which did not differentiate between the individual countries of the region, identified huge risks hidden in current account and other imbalances. The growth differentials between the EU-15 and CESEE melted and the catching-up process came to a halt. 2008 and 2009 were devoted to analyzing the financial crisis, its impact on the Western European banking system and the IMF's, the EU's and national support and stimulus measures. In the medium term, the focus will shift to a more thorough economic analysis that investigates the causes of the crisis and identifying measures to safeguard economic catching-up in the long run.

## **5 Research, Technical Assistance and Cooperation – The Main Pillars of the OeNB's Focus on CESEE**

A range of OeNB publications reflects the bank's extensive analysis of and research on CESEE-related topics.<sup>4</sup> "Focus on European Economic Integration" (the successor to "Focus on Transition") is the OeNB's flagship publication on transition and integration issues. Studies on CESEE topics are also published in "Monetary Policy & the Economy" and "Financial Stability Report." In view of the continuous demand for analyses of developments in CESEE, "Focus on European Economic Integration" has been published on a quarterly instead of a semiannual basis since 2009 and is indexed in EconLit.

Furthermore, the OeNB organizes regular events as a platform for discussion and an exchange of views, including, in particular, the one-day workshop series called East Jour Fixe and the internationally renowned two-day Conference on European Economic Integration (the successor to the East-West Conference). One feature of the annual conference is the presentation of the Olga Radzyner Award for Scientific Work on European Economic Integration bestowed on young economists from CESEE, which had been established to commemorate the former Head of the OeNB's Foreign Research Division, who died in a tragic accident in 1999. Olga Radzyner had been one of the key initiators and promoters of the OeNB's CESEE-related activities.

One of the most memorable events was the Conference on European Economic Integration that took place in 2004, the year the first CESEE countries joined the EU. A festive atmosphere prevailed at this event, where all CESEE national central banks presented the distinctive features of their home economies. Another highlight was the conference of 2005, which was organized together with the ECB and its financial integration research network. This event's much more academic character was reflected by a call for papers and by parallel sessions on an unusually wide range of financial and capital market issues. On the whole, all conferences featured topics of immediate relevance as well as outstanding speakers and always attracted a large audience – people from east and west, from policymaking, academia and banking – that showed great interest.

One of the main objectives of our events was and still is to share our knowledge and experience. Also, we aim to promote the catching-up process not only by analyzing it but also by providing active support. This idea was the basis for the

<sup>4</sup> See "CESEE-Related Activities of the OeNB's Economic Analysis and Research Department" in this issue.

Austrian Bankers' College International.<sup>5</sup> The first of these ABCi seminars in Weißenbach in Upper Austria was held in 1989, right after the fall of the Iron Curtain, and was a premiere for both speakers and participants, who learned a lot from each other. In the following six years, more than 4,000 bankers from 24 CESEE and CIS countries participated in knowledge exchange and received training in Austria. In fact, many long-lasting working relationships and close personal contacts started or were intensified at the ABCi seminars.

The Joint Vienna Institute (JVI), founded in 1992, is based on a much broader institutional and professional footing. A cooperative venture of six international organizations (including the IMF) as well as the OeNB and the Austrian Ministry of Finance, it provides training for officials and managers from former centrally planned economies to assist them in the transition process. Between 1992 and 2008, no less than 23,305 participants attended courses at the JVI, of which 8,915 were central bankers, 6,529 came from government ministries, and 7,861 from other institutions. We are proud to say that some of them are now in leading positions in politics or at eminent institutions, for example Dalia Grybauskaitė, President of Lithuania, Sergey Ignatiev, Chairman of the Central Bank of the Russian Federation, or Ilmārs Rimšēvičs, Governor of Latvijas Banka.

As a member of the ESCB and the Eurosystem, the OeNB has been providing its expertise on CESEE to the discussions of the Governing Council and the General Council of the ECB. Apart from contributing to the general debates on economic and monetary policy issues, the OeNB played a particular role in Slovenia's and Slovakia's efforts to enter the euro area. Moreover, the OeNB was actively involved in the discussions on ERM II topics at the Eurosystem/ESCB level and regularly provides its analyses on CESEE-related issues to the International Relations Committee as well as to the Monetary Policy Committee of the Eurosystem/ESCB. In addition, OeNB staff members have been invited to participate in numerous activities over the past decades, organized by the ECB and many other international organizations.

Apart from hosting high-profile events like the Eurosystem's high-level seminar with the Central Bank of the Russian Federation in March 2009, the OeNB maintains informal bilateral dialogues with a number of CESEE central banks. In March 2007, the Governor of the OeNB invited his counterparts from the central banks of the Czech Republic, Hungary, Slovakia and Slovenia to Vienna to discuss topical issues of mutual interest. In 2008, the Governor of Česká národní banka hosted the follow-up meeting in Prague. In 2009, this circle of governors was extended to include the Governor of Narodowy Bank Polski. The 2009 meeting was held in Budapest.

The OeNB has traditionally sustained close relations with BOFIT and Suomen Pankki. Apart from maintaining a regular exchange of researchers, the OeNB and the Finnish central bank share their expertise on CESEE for instance by contributing to each other's forecast. These combined results are used as an input to the external assumptions of the regular Eurosystem forecasting exercises. The OeNB also regularly hosts the Emerging Europe Seminar, an event originally designed by

<sup>5</sup> As early as in 1975, the OeNB created the Central Bankers Club, which brought together representatives of small and medium-sized European central banks for the discussion of and an exchange of views on topics of common interest.

Suomen Pankki and now organized on a rotating basis by several European central banks with a special expertise in emerging markets.

At the national level, the OeNB maintains an excellent working relationship with the Vienna Institute for International Economic Studies (wiiw), the leading Austrian think tank for CESEE-related issues. Co-authored papers, jointly organized events like the Global Economy Lecture as well as joint seminars at the JVI are elements of this fruitful cooperation.

## **6 Mission Accomplished? More Needs to Be Done!**

The OeNB's focus on CESEE has always been and will continue to be under permanent review. Over the years, there have been discussions in particular about which countries to include in our "country focus;" after all, some CESEE countries have become EU members, some are very small and far away and do not belong to the countries where Austrian businesses and banks are active. Both the current crisis and Austrian banks' strategy to enter the markets of the Western Balkans and the CIS, however, have shown that we were right not to exclude any CESEE country completely and to aim for the almost impossible goal of covering them all, albeit with different nuances and different intensity. Although CESEE research and analysis is certainly one of the most fascinating fields for economists today, we do hope that in the long run, our research will not be needed any more, when catching-up has been completed and a truly integrated Europe has become a reality not only in economic and currency terms, but also in the lives of the people.



# From Transition to Integration

# Twenty Years of East-West Integration: Reflections on What We Have Learned

## 1 Introduction

Michael A.  
Landesmann<sup>1</sup>

There is no doubt that the integration process of Eastern and Western Europe since the dramatic events of 1989 had unique features.

First among these features were the impressive speed and depth of liberalization that Central and Eastern Europe (CEE) implemented in its shift from a planned economy to a market economy. This liberalization process (including privatization as well as price, current and capital account liberalization) was probably more comprehensive in the short timeframe than anything previously witnessed in history. Second, the transition processes related to a number of economies that are located very close to advanced, high-income economies which had themselves reached a high level of mutual economic integration.

Both these features were typical of CEE economies in the period after 1989 and were at the root of a relatively successful process of catching up in economic and institutional terms as well as the rapid international economic integration in Europe we have witnessed over the past two decades.

Let us recall the main stylized phases of the processes of transition and integration of the economies of Central and Eastern Europe:

The period of disruption following the systemic break and the dissolution of the Council for Mutual Economic Assistance (CMEA)<sup>2</sup> had a different impact on different CEE economies both in terms of the length and depth of the initial contraction of GDP (also labeled “transformational recession”) and the ensuing economic recovery (see also the discussion in the contribution by Ritzberger-Grünwald und Woerz in this issue). From the mid-1990s, a process of consolidation began in the more successful CEE economies; the other CEE countries did not follow until the late 1990s. This consolidation paved the way for a period of sustained catching-up in income and productivity levels as well as in institutional terms. Private (international investors, banks, etc.) and public (such as the EU) external agents played an important role in this process of relatively successful transition and catching-up.

The geographic location – as mentioned above – definitely played a role, as did the EU’s willingness in the 1990s to embark on a courageous process of enlargement and take in a relatively large group of new members. This substantially increased heterogeneity within the EU and the “integrated European economic space” in general (chart 1). Furthermore, CEE itself featured some historical prerequisites – such as pre-WWII experience as market economies, a relatively high level of education and maturity in institutional development despite and in part also because of the socialist phase after WWII – that supported successful economic (and political) integration and catching-up.

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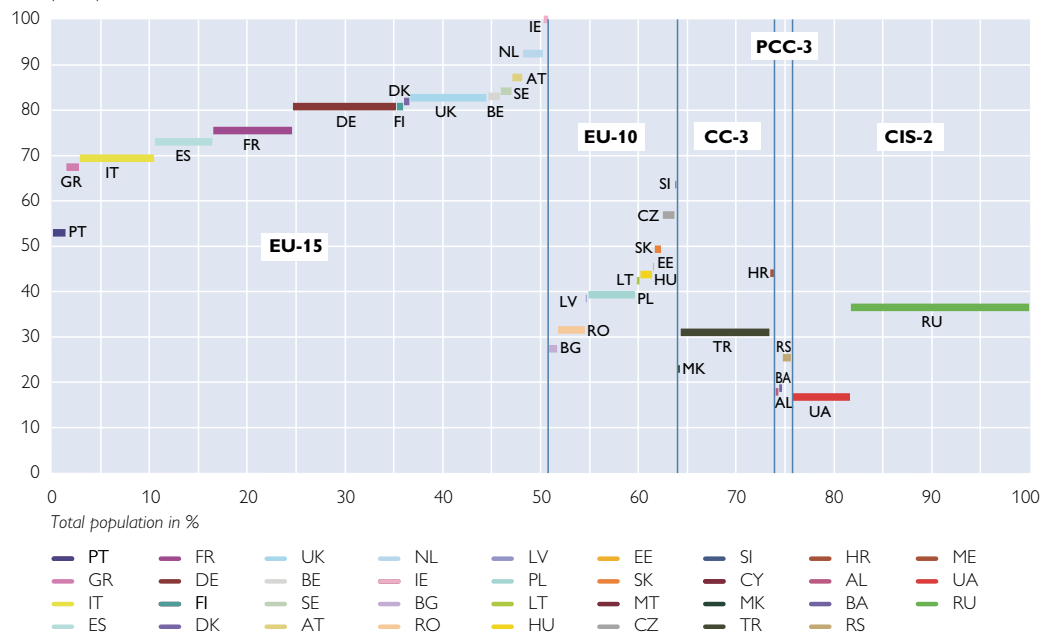
<sup>2</sup> *The organization that regulated trade flows and production coordination between the formerly planned economies until 1989.*



Chart 1

### GDP per Capita (PPP) and Population Share in 2008

GDP per capita in %, Ireland = 100%



Source: wiiw.

Note: PT = Portugal, GR = Greece, IT = Italy, ES = Spain, FR = France, DE = Germany, FI = Finland, DK = Denmark, UK = United Kingdom, BE = Belgium, SE = Sweden, AT = Austria, NL = Netherlands, IE = Ireland, BG = Bulgaria, RO = Romania, LV = Latvia, PL = Poland, LT = Lithuania, HU = Hungary, EE = Estonia, SK = Slovakia, MT = Malta, CZ = Czech Republic, SI = Slovenia, CY = Cyprus, MK = former Yugoslav Republic of Macedonia (FYR Macedonia), TR = Turkey, HR = Croatia, AL = Albania, BA = Bosnia and Herzegovina, RS = Republic of Serbia, ME = Republic of Montenegro, UA = Ukraine, RU = Russia; CC = candidate countries, PCC = potential candidate countries.

## 2 Transition, Integration and Catching-Up

We will discuss below a number of issues in the CEE countries’ transition and economic integration experience that also contained important lessons for the economics profession. Also, we will recount some of the lessons learned from the CEE countries’ specific experiences and from this unique phase in the East-West European integration.

### 2.1 The Transition Process

The first relative surprise for economists in the early phase was the depth of the initial “transformational recession.” The initial stage of transformation was characterized by a dramatic decline in economic activity that brought the GDP levels down by between 20% and 60% in the different CEE economies.

Despite having analyzed the features of planned economies within the discipline of comparative economic studies over the previous decades and despite having gained experience with reforms of socialist economies, the economics profession was not well equipped to advise on such a dramatic path of systemic change characterized by a fundamental adjustment of allocation mechanisms that in effect severely disrupted economic activity. The traditional tools of economic analysis were unable to explain these developments.

Furthermore, the political economy of transition, i.e. the interaction of political and economic processes of systemic change that either blocked important

reform steps or led to their implementation by different social and economic actors, was ill understood. The understanding of these processes definitely lagged behind the need to influence them. Only gradually did a body of analytical results accumulate owing to newly developed tools of positive political economy and institutional economics (for a synthesis of these results, see Roland, 2000).

It became clear early on that geographic location as well as an effective anchoring in institutional and behavioral terms into a process of transition mattered a lot for the direction and speed of systemic change and also the speed and extent of recovery. The extent and depth of the development of a relationship with an advanced grouping such as the EU-15 was seen as essential for understanding the differentiation of transition processes across the CEE economies.

## 2.2 Growth and Catching-Up Dynamics

All in all, the growth experience of the transition economies after the first phase of the transformational recession conformed to the picture painted by standard economic growth theory about the possibility of lower-income economies of converging toward higher-income economies (see e.g. the classic textbook on economic growth by Barro and Sala-i-Martin, 2006).

However, standard economic growth theory was mostly formulated in rather aggregate terms, which turned out to be insufficient to understand the convergence of the set of transition economies. In particular, it did not contain sufficient information on why we observed different catching-up processes in different CEE economies and, furthermore, why specific features of these catching-up processes could be detected only at a more disaggregated level. Examples of areas requiring disaggregated assessment are the state-owned enterprises (SOEs) and *de novo* enterprises in different sectors, the agricultural sectors and the degree of underrepresentation of tertiary activities, regional patterns of growth, etc.

One issue mentioned above was the importance of institutional and behavioral anchorage of CEE economies in an EU accession or candidacy process. Progress in this area explains both the speed at which transition processes took place and the different integration stages of CEE economies: some economies lagged behind in the accession process (e.g. the Western Balkans, given the violent disintegration of ex-Yugoslavia) compared to the first- and second-round accession economies (the CEE-10<sup>3</sup>).

The institutional participation in an EU accession process was important for two reasons: (1) as a signal to the “internal actors,” i.e. the economic and political actors within the countries, so that their expectations could be aligned, and (2) as a sign of reassurance to “external actors,” in particular those which could provide capital, know-how (in the form of technology but also in organizational terms and in terms of familiarization with market economy practices), and support in the setting of new types of activities (e.g. in the banking system) or in the transformation of old types of activities.

<sup>3</sup> The ten countries in CEE that joined the EU in 2004 and 2007: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

### 2.3 Trade Integration, Trade Specialization and Cross-Border Production Integration

Given the development of trade structures and trade specialization, traditional trade theory was in many ways insufficiently able to analyze and predict the development of trade patterns between the CEE-10 and the EU-15, which became by far the most important trading partners of the CEE-10.

The first important development was the speed of trade reorientation: Before the transition in 1989 to 1990, CEE economies were members of the CMEA, a tightly-knit trading bloc in which trade patterns were generated through a process of planned direction of trade and production flows. The breakdown of the CMEA meant that CEE economies could reorient their trade flows, but also that they were deprived of a secure market position in other CMEA economies. Hence, in the first phase, until about 1995, trade flows among former CMEA countries collapsed, and trade was reoriented very quickly, mostly toward the EU-15 economies. In the more recent period, trade amongst CEE economies recovered, partly because of the higher growth of these economies that made these markets attractive and the buildup of export capacities in CEE economies that could supply these markets, and partly because of the development of production networks of multinationals across CEE.

The second development that came as something of a surprise to traditional trade theory was the speed at which traditional patterns of trade specialization were changed in the direction of a dynamic upgrading of export structures, both in interindustry and in intraindustry trade. One reason for this rapid upgrading is the same one that drove the growth process in general: the potential to benefit from technology transfer, defined as learning not only about production processes, but also e.g. about product design, marketing and contractual know-how with Western trading partners.

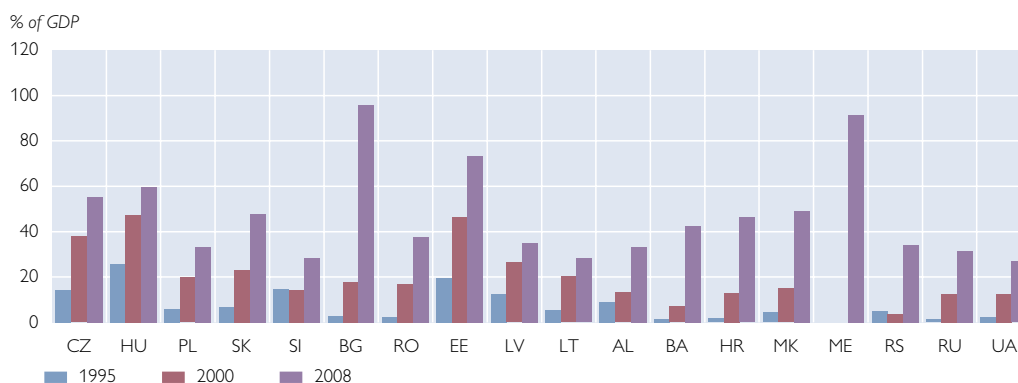
The early studies on the likely pattern of trade specialization between CEE economies and the more advanced EU economies were undertaken within the framework of the static Ricardian and Heckscher-Ohlin-Samuelson (HOS) theories: The prediction was that CEE would specialize in economic activities in which it has a comparative advantage vis-à-vis Western Europe; such activities would be lower-tech, less research and development intensive and less skill-intensive than in the Western European trading partner countries. This static framework was soon seen as being at odds with the rapid upgrading of export structures, at both the industry and the product levels.

Hence, over time, more sophisticated and more appropriate analytical frameworks were used: e.g. theories that (1) analyzed the emergence of horizontal and vertical patterns of intraindustry trade (e.g. Hummels et al., 2001; Dullek et al., 2005; Schott, 2004), that (2) looked at the dynamics of trade specialization jointly with differentiated productivity catching-up (Landesmann and Stehrer, 2001, 2002), or (3) theories of fragmentation, of trades in “tasks,” and of outsourcing (Arndt and Kierzkowski, 2001; Grossman and Rossi-Hansberg, 2008; Feenstra, 1998).

Furthermore, the importance of FDI in the upgrading processes of CEE's tradable sectors was recognized. Within a short period, most CEE economies had a very strong presence of foreign investors (chart 2) that played an important role in promoting productivity growth, redesigning product programs and strengthening export capacities. The location decisions of foreign investors were also major

Chart 2

### Inward FDI Stock



Source: *wiiw*, FDI database.

Note: CZ = Czech Republic, HU = Hungary, PL = Poland, SK = Slovakia, SI = Slovenia, EE = Estonia, LV = Latvia, LT = Lithuania, BG = Bulgaria, RO = Romania, AL = Albania, BA = Bosnia and Herzegovina, HR = Croatia, MK = former Yugoslav Republic of Macedonia (FYR Macedonia), ME = Republic of Montenegro, RS = Republic of Serbia, RU = Russia, UA = Ukraine. 1995 data for BA refer to 1998, 1995 data for MK refer to 1997, 1995 data for RS refer to 1999.

factors behind the reindustrialization process in the more successful CEE economies and the development of a new industrial belt of CEE cross-border production networks.

#### 2.4 Labor Markets: Productivity Catching-Up, Structural Change and Skill Bias

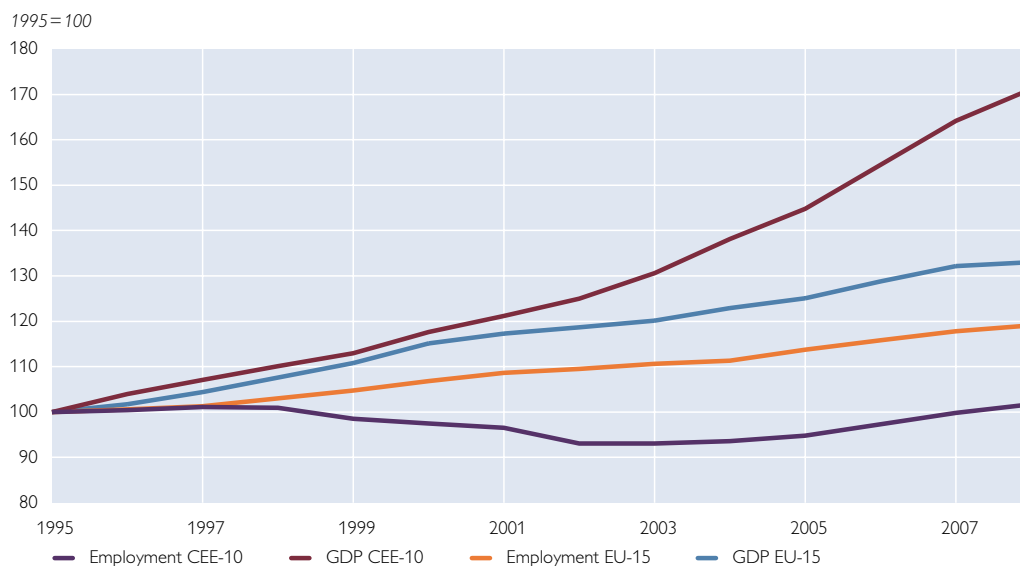
One of the interesting features of the catching-up processes in CEE was that employment developments were very disappointing for a long period after transition had started despite very favorable output (GDP) developments compared with those in the EU-15 (chart 3). There are a number of explanations for this (e.g. Landesmann et al., 2004):

- The very low responsiveness of employment to GDP can be simply seen as the other side of the coin of real income catching-up driven by productivity catching-up. Thus if the difference in the growth rates of GDP and aggregate employment were the same in the EU-15 and in CEE, there would be no productivity (level) catching-up between the two groups of economies. This is, of course, arithmetically correct, but does not provide much insight into the underlying processes.
- A more sophisticated argument developed in Landesmann et al. (2004) states that behind the relative output and employment performances lie more complex structural convergence processes. The argument is as follows: When transition began, a range of industries in which labor productivity gaps to Western European industries were particularly high were strongly represented in CEE. These industries (manufacturing and in many CEE economies, agriculture) consequently had a strong potential for productivity catching-up. Services, though, were strongly underrepresented in comparison with Western Europe. CEE then underwent not only a convergence of aggregate productivity levels, but also a structural convergence process – output composition and hence the representation of different sectors in the aggregate economy became more similar to that in the advanced Western European countries.

Thus the shares of heavy manufacturing industry and of agriculture declined, those of services (particularly market services such as retail trade, business and financial services) increased. Service industries are more labor-intensive, however. At the aggregate level, the combination of productivity catching-up (differentiated by industries) and of a structural convergence process led to a particularly sharp fall in the employment-output elasticity in the phase after transition, followed by a recovery, and hence to the U-shaped pattern of aggregate employment growth observed in the CEE economies over the longer period from 1990 to 2008 (see the development of aggregate employment in CEE in chart 3).

Chart 3

### Employment and GDP, CEE-10 and EU-15



Source: wiw, Eurostat.

Note: The CEE-10 are the ten countries in CEE that joined the EU in 2004 and 2007: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

## 2.5 Regional Patterns of Growth, Agglomeration and Structural Change

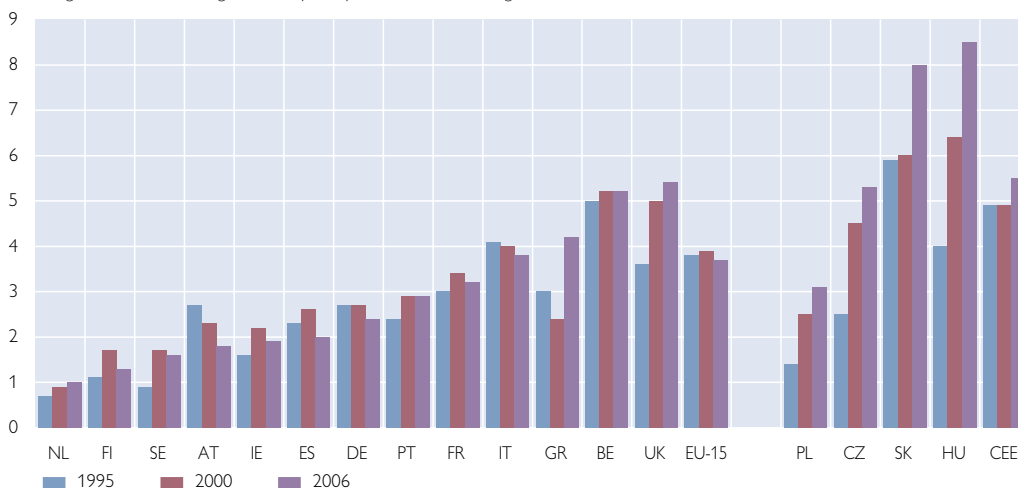
From the outset, a change in regional development patterns was expected, as the opening of CEE toward Western Europe would change the regional orientation of economic activity in the transition economies. However, a number of additional factors were at work, leading to important agglomeration phenomena, in particular a very significant strengthening of the economic importance of capital cities and a sharp increase in regional inequality to levels above those in Western Europe (chart 4).

What were these factors? Without any claim for completeness, the following factors have played an important role in the sharp increase in regional inequality and tendencies for an agglomeration of economic activity:

- One factor is the above-mentioned catching-up process in tertiary activities which had traditionally been underrepresented in CEE economies and which in the early phases of transition were most easily developed in capital cities or strong urban agglomerations. Such urban agglomerations provided both the

### Regional Income Disparities in the EU-27

Mean logarithmic deviation, regional GDP per capita at PPS. NUTS-2 regions, 1995, 2000 and 2006



Source: Eurostat, wiiw calculations.

Note: NL = Netherlands, FI = Finland, SE = Sweden, AT = Austria, IE = Ireland, ES = Spain, DE = Germany, PT = Portugal, FR = France, IT = Italy, GR = Greece, BE = Belgium, UK = United Kingdom, PL = Poland, CZ = Czech Republic, SK = Slovakia, HU = Hungary.

sophisticated markets and the necessary concentration of people with skills and, furthermore, the scope for complementarities between tertiary and other activities necessary to support the development of a vibrant service sector. As demand structures diffuse and purchasing power rises more generally, we expect this strong process of agglomeration to lose some momentum.

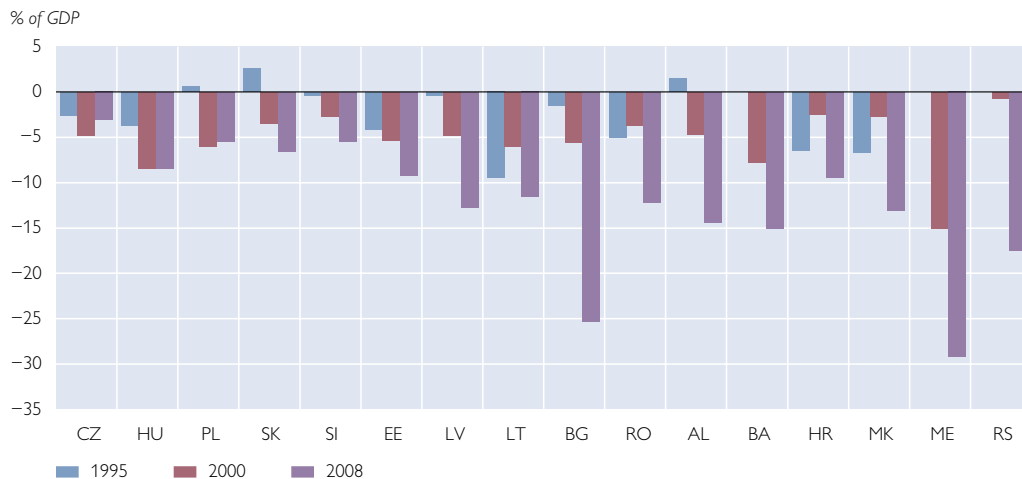
- The other factor is the strong concentration of FDI activity in regions bordering Western Europe. Such locations facilitated the easy integration of border regions into cross-border production networks, which also benefited from the more highly developed logistics and transport infrastructure. As infrastructure improves more widely, further labor supply pools can be tapped, and lower land prices will attract FDI to a wider range of regions. This – supported by appropriate regional and labor market policies – could somewhat reduce the degree of regional inequality in the future.

The same can be said about the state of problem of peripheral regions, e.g. regions which suffered from the location of outdated heavy industry from the socialist period, ailing mining regions, and rather poor agricultural regions, all of which have been undergoing major restructuring processes. As such adjustment proceeds, partly leading to emigration and partly to the development of new types of manufacturing, service or tourism activities, the set of peripheral, backward regions might shrink again.

Hence, while we have so far observed an increase and even overshooting in the levels of regional inequality in CEE compared to Western Europe, we expect this overshooting to disappear in the longer run, as some of the reasons for strong agglomeration and also for the strong peripherization of regions might to some extent disappear in the wake of the development of new industries, such as tourism, and the restructuring of old industries.

Chart 5

### Current Account Balances



Source: *wiiv*, Eurostat.

Note: CZ = Czech Republic, HU = Hungary, PL = Poland, SK = Slovakia, SI = Slovenia, EE = Estonia, LV = Latvia, LT = Lithuania, BG = Bulgaria, RO = Romania, AL = Albania, BA = Bosnia and Herzegovina, HR = Croatia, MK = former Yugoslav Republic of Macedonia (FYR Macedonia), ME = Republic of Montenegro, RS = Republic of Serbia. 2000 data for RS refer to 2001.

## 2.6 Macroeconomic Vulnerabilities: Current Accounts, Exchange Rate Regimes, Rapid Financial Intermediation Growth

One of the important macroeconomic features of most CEE economies, indeed of many catching-up economies more generally, is that they have large current account deficits (chart 5). These deficits are to a large extent natural, as catching-up economies usually are, and should be, net capital importers (capital imports are the counterpart of current account deficits). Net capital imports facilitate the catching-up process in that yet unexploited possibilities of productivity catching-up and gaps in the spectrum of economic activity are addressed, catching-up in financial intermediation takes place and the higher rates of return (a function of the previous factors) attract foreign investors and capital importers more generally.

Given the very high degree of capital market integration in Europe, consistent current account deficits can also be a source of vulnerability both in the short run (capital flows might be very sensitive to shocks) and in the longer run (countries may build up foreign debt positions that might become unsustainable). Unsustainable debt positions might in turn be a function of changes in external scenarios (such as a change in the general risk perception or a general shift in global interest rates) and of external shocks, as we have witnessed in the current crisis.

The experience of CEE over the most recent past has added to the knowledge about current and capital account vulnerability in emerging market economies. Two areas are particularly interesting examples of potential vulnerability: (1) the speed at which financial intermediation increased in some of the CEE economies over the recent decade and the related role of foreign banks, and (2) exchange rate regimes and policies, the crucial importance of which became apparent again in different CEE economies during the current crisis.

The degree of foreign banks' involvement in the region is a very specific feature of the CEE experience, as it also reflects the geographical proximity, the



institutional and behavioral orientation toward the EU economy that sets the CEE economies apart from other emerging market economies and their linkages with high-income countries. CEE links to international capital (particularly credit) markets are largely under the control of Western European banks, which, given their stakes in the EU accession and candidacy process, have been more than willing to promote a rapid expansion of financial intermediation. This process was further enhanced by quite a number of CEE economies' commitment to a form of pegged or fixed exchange rate regime and to a path toward EMU membership which – in the eyes both of the banking and the lending communities – diminished the danger of devaluation. In fact, the trend expectation following the Balassa-Samuelson argument was that the currencies would appreciate. When the international financial crisis hit, the high growth of private sector debt in CEE led to a sharp change in sentiment, and strong devaluations took place in countries which maintained flexible exchange rates, while countries with fixed or quasi-fixed exchange rate regimes came under extreme disinflation pressure, with GDP declining by up to 20 percentage points in 2009.

The experience of the recent crisis in CEE will most definitely contribute to our understanding of more appropriate policy scenarios for emerging markets more generally, and to a better evaluation of options for an appropriate financial market architecture and choices of exchange rate alignments.

## **2.7 Migration Flows: Projections and Perspectives, Migration Phenomena**

Migration from East to West was another hotly discussed topic over the past 10 to 15 years when it became clear that EU membership – though potentially delayed through transitory periods – implied full freedom of movement of labor across the entire enlarged EU. Much research was commissioned (see e.g. Alvarez-Plata et al., 2003, and Bruecker et al., 2009) to estimate the scale of expected migration flows in case of full liberalization of labor market access in the enlarged EU and to evaluate the consequences of any such migration flows.

Research on the complex topic of East-West migration and policies may have a lasting influence on migration research more generally in some areas. First, East-West migration does not follow the classical pattern of South-North migration, i.e. movements from low-income to higher-income economies, basically because East-West European educational attainment levels (skill levels) correspond much more closely than South-North levels. Preliminary statistical evaluations (see Bruecker et al., 2009) in fact show relatively high educational attainment levels of Eastern European migrants in Western Europe. Second, once EU membership has irreversibly fixed the right of access to labor markets across the EU, we might see many more instances of internationally less common forms of migration, such as a more extensive incidence of return migration flows, circular migration and multiple access; also, the demographic pattern of such flows might be different from the typical patterns of South-North migration. Such “newer” migration patterns might be associated with circular knowledge capital flows, bi- and multi-directional impacts on business activities and a much closer interaction between the four freedoms which characterize the Single Market (freedom of movement of goods, services, capital and labor).

Overall, one can say that the enlarged EU is entering an exciting new phase in which much can be learned about new forms of migration, the impact of the labor



market and integration policies on migrants and on host and sending economies. The continued heterogeneity of EU policies provides a stimulating experimental field in which such policies can be evaluated. We are at the beginning of a lot of inspiring research on migration in the enlarged European Union.

### 3 Conclusions and Perspectives for East-West Integration

This short paper attempted to evaluate a range of topics at the forefront of the discussion about the most remarkable historical experiment of the past 20 years, that of East-West European integration. Such integration comprises not only the processes of EU enlargement, but that of a much wider range of countries that has participated in the process of East-West European integration. The topics which have occupied researchers and policymakers alike range from the immediate issue of “transition,” i.e. the transformation of formerly planned economies into market economies, to the growth dynamics of catching-up, the interesting evolution of trade integration and changing trade specialization, uneven regional growth and labor market developments, migration issues and the vulnerabilities in the macro-economic scenarios of very open, externally fully liberalized economies in CEE. These vulnerabilities have emerged very clearly in the context of the current economic and financial crisis.

Just like all other important historical experiments, the past 20 years of East-West European integration opened a wide range of interesting new research lines, which are far from fully exploited. This paper points to some of these research areas, and it sheds some light on what we have learned from them so far and what we may still learn in the future.

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# Five Years after EU Eastward Enlargement

Marek Belka<sup>1</sup>

The inclusion of ten former Soviet bloc countries into the EU marks a high point in 20 years of East-West integration. In many ways, it concluded the region's struggle to join the family of Western democracies and market economies. At the same time, it created huge opportunities to bring living standards in the East closer to those enjoyed in the rest of the EU. The new Member States seized these opportunities, as evidenced by their impressive growth in the immediate years after EU accession (2004–2007). But the financial crisis, which deepened in late 2008, also shows that convergence cannot be taken for granted. This serves as a powerful reminder of the value of sound economic policies and as a call for better policy coordination across Europe.

In looking back at these five years of rapid change, three aspects of the new Member States' economic performance seem worth exploring. First, how resource inflows from the old Member States and the EU's policy framework contributed to the region's impressive achievements. Second, how these successes may have concealed the build-up of vulnerabilities. Finally, how such underlying weaknesses explain why the recent financial crisis has hurt some countries in the region more than others. A period of five years is too short to pass definite judgment. Nevertheless, the new Member States' experiences during both the catching-up period and the crisis allow for some tentative lessons for policymaking, both at the country and at the EU level.

## 1 Achievements

The new EU Member States' growth and policy performance in recent years has been truly impressive, second only to East Asia. While it may be difficult to establish a clear causality (due to the lack of an appropriate counterfactual), there is strong evidence that entry into the EU played an important role in this success – a process that in fact started before countries officially joined. Since the early 2000s, the economies of the new Member States have been growing considerably faster than the economies in other regions with similar initial income levels. Econometric evidence from a recent IMF study (Čihák and Fonteyne, 2009) suggests that with EU accession, real per capita incomes increased about one percentage point faster than can be explained by conventional growth determinants.

Growth has been consistently higher than in the old Member States, thus contributing to real convergence of per capita income levels. Price levels (in euro terms) have also been converging, to some extent via higher inflation (especially in countries with currencies pegged to the euro), but mostly via nominal exchange rate appreciation. With a few exceptions, the appreciation of real exchange rates appears to have been an equilibrium phenomenon, in line with productivity developments.

As part of this catching-up process, new and old Member States have become more and more integrated. Supermarkets in Warsaw offer the same variety of goods as in Berlin, and Czech vacationers share the Austrian ski slopes with Dutch and Scandinavians. Behind these changes in everyday life lies a remarkable increase of economic linkages, which has greatly enhanced the mobility of goods, capital and labor (except for services, where the internal market remains fragmented).

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For example, the share of new Member States' exports in old Member States' imports increased 2½-fold between 1993 and 2008. Growing interlinkages are also illustrated by the increasing degree of business cycle synchronization between new Member States and the euro area.

EU membership has accelerated real convergence through two key channels. First, it greatly facilitated the transfer of financial resources from West to East. Contrary to the experience in other emerging countries, capital in Europe flowed “downhill”: excess savings from the West were invested in the relatively capital-poor East, where a low initial capital stock and good growth prospects offered higher returns. This was achieved in the first place through the increase of cross-border financial linkages, especially the active role played by EU-based banks in deepening financial markets in the new Member States and providing access to global capital markets. Foreign direct investment was equally important for growth, especially where it went into productivity-enhancing greenfield projects, such as car assembly plants in Slovakia or computer manufacturing in Poland. Finally, official capital transfers in the form of EU structural funds are increasingly contributing to growth, particularly under the EU's 2007–2013 financial perspective.

The second impact of EU membership was on the policy framework. Adopting the *acquis communautaire* implied many important institutional reforms, from strengthening central bank independence to codifying property rights. In addition, the Maastricht criteria for euro adoption and the Stability and Growth Pact provided a framework for macroeconomic policy discipline. There is evidence that macrofinancial performance improved among the new Member States, although there have been substantial differences between individual countries. Inflation performance has been better in countries with inflation targeting regimes, where upward price pressures due to capital inflows and commodity price hikes could be absorbed through nominal currency appreciation. Fiscal performance – as measured by general government balances – has generally been stronger in the smaller countries. These countries also did better in terms of structural reforms toward meeting the Lisbon agenda objectives.

For much of the region, euro adoption remains the main outstanding building block to fully integrate in the EU's policy framework. Only two new Member States – Slovenia and Slovakia – have so far succeeded in meeting the Maastricht criteria and adopting the single currency. The remaining countries in the region are firmly committed to joining the euro area, although target dates vary. Before the crisis upset these plans, the main obstacles were the inflation criterion (mainly for smaller countries with fixed exchange rates) and the fiscal criterion (mainly for the larger Central European countries). In this context, there continues to be a debate about whether the Maastricht criteria are suitable for fast-converging economies.

Until recently, EU membership appeared to have had another tangible impact, the so-called “halo effect”: financial markets rewarded EU membership through lower borrowing spreads, beyond what can be explained by policy performance. This phenomenon has been explained by the implicit bail-out guarantee offered by the EU, the disciplining role of its policy framework or the prospect of imminent euro adoption. With the onset of the crisis, financial markets started to treat the new Member States like other emerging markets, focusing on risks and fundamentals.

## 2 Vulnerabilities

High growth rates and rapid financial deepening, driven by capital inflows, came at a price. From 2005 to 2008, several new Member States experienced a serious bout of overheating, characterized by high inflation rates, soaring real estate prices, large current account deficits (in some cases coupled with an overvalued exchange rate), and tight labor markets. Stock vulnerabilities in these countries increased as well, especially external debt ratios. Households and corporates incurred currency mismatches, as they took advantage of the lower interest rates offered by loans denominated in euro and Swiss franc. All this made countries prone to boom-bust cycles and heightened the vulnerability to sudden shifts in the exchange rate.

Fiscal policy was also weaker than met the eye. Structural deficits increased in most countries, even before one takes into account that potential growth was probably lower than assumed at the time. As revenues increased on the back of high GDP growth, many governments allowed nondiscretionary expenditures to expand rapidly. Fiscal policy was in many cases procyclical, adding fuel to the fire of already overheating economies.

To be sure, great differences exist between countries. In the larger Central European countries, external vulnerabilities remained largely contained, while they increased substantially in the smaller countries with fixed exchange rates, especially in the Baltics. Moreover, overheating pressures, especially in the latter countries, were accompanied by an erosion of competitiveness. Much of the capital inflows that drove economic growth went into nontradables, such as real estate, retail, and financial services, i.e. sectors that are unlikely to generate the income necessary to service the large debt built up during the boom years. Overall wages soared both in these sectors and in the rest of the economy, which further undermined competitiveness.

With the benefit of hindsight, could more have been done to detect and contain these risks and vulnerabilities? There were indeed warnings during the boom years, but they probably were not forceful enough considering how severely some countries were affected by the crisis. This reinforces the case for strengthening surveillance by international bodies like the European Commission and the IMF. Analytically, however, there remains a fundamental problem of separating vulnerabilities that are a natural byproduct of convergence from those that warrant policy intervention. Establishing such “speed limits” has proven exceedingly difficult.

Even if these risks had been fully recognized at the time, there remains the question of what policies could have been employed to contain them. With pegged exchange rate regimes, the countries experiencing the most acute overheating problems had no effective monetary policy tools at their disposal. More prudent fiscal policies could have helped, although realistically most countries would have found it politically difficult to tighten budgets well beyond what was required under EU rules. Tighter financial regulation, aimed directly at credit growth and currency mismatches, was at times hindered by coordination issues between home and host country supervisors. Ultimately, excesses – especially in lending and real estate markets – were grounded in unrealistic expectations about the speed of income convergence and quick euro adoption. Market participants, regulators, politicians and other opinion makers must take their share of the responsibility for not having done more to lean against the wind.

### 3 The Crisis

The post-accession boom in the new Member States came to a halt in the fall of 2008, when the global financial crisis intensified (growth in fact started slowing earlier in the Baltics). Decoupling, a popular theory earlier in the crisis, proved to be an illusion: the region's close trade and financial integration with the old Member States implied that the recession was quickly shared across the entire EU. Nevertheless, the new Member States as a group are growing somewhat faster than the old Member States. Real convergence is therefore continuing, albeit at a slower pace.

Contrary to perceptions by some outsiders, the effect of the crisis varies widely across the new Member States. Countries with high vulnerabilities were hurt most, as they were forced to adjust their large imbalances in much shorter time and at much higher cost than others. In many cases, the capacity to absorb the double shock of lower capital inflows and lower exports was limited by a commitment to hard currency pegs against the euro. The desire to qualify for euro adoption as soon as possible – the Central European countries' exit strategy from exchange rate vulnerabilities – further confines options in fiscal and exchange rate policy.

The two key elements in the new Member States' earlier success – capital inflows and adoption of the EU's policy framework – have implications for the region's ability to cope with the crisis. As mentioned above, dependence on capital inflows and associated large current account deficits made the region particularly vulnerable to the cross-country transmission of shocks. At the same time, integration was also an advantage; the impact of global deleveraging has been more muted in countries where a large part of external financing needs is covered by strong parent banks based in other EU countries. The first new Member States to experience balance of payment problems were therefore those with large domestically-owned banks without such recourse. On the other hand, close financial linkages have increased policy spillovers; for example, when some old Member States increased deposit coverage in late 2008, new Member States had to follow suit so as not to lose the confidence of depositors.

Similarly, the EU's policy framework offers advantages at the same time as it imposes constraints in times of crisis. The European Commission has effectively used several instruments to support new Member States in difficulties: its balance of payment facility is already providing exceptional external financing in Hungary, Latvia and Romania, jointly with funding from the IMF. The availability of EU grants and European Investment Bank loans was eased, which has made it possible to finance public expenditures that would otherwise have been cut and has led to provide a welcome countercyclical stimulus. The ECB has entered repo arrangements with central banks in several new Member States, which partly relieves constraints on foreign currency liquidity. More generally, EU institutions provide a much needed forum for policy coordination in times of crisis.

By the same token, institutional constraints imposed by EU membership can limit policy options. As mentioned above, fiscal deficit ceilings under the Maastricht criteria and the Stability and Growth Pact may make governments reluctant to provide countercyclical stimulus by letting automatic stabilizers operate fully, even if this is warranted. Countries participating in ERM II face additional constraints, as any change in their central exchange rate parity would have to be agreed with the euro area countries and the other ERM II members. They will, in any event, hesitate to allow adjustment through the exchange rate so

as not to run foul of the currency stability criterion. The prospect of euro adoption, while a useful anchor for sound policies in good times, may therefore provide an undue straightjacket in times of crisis.

#### 4 Policy Lessons

When we look back at the past five years, EU enlargement has been a great success. It has helped narrow the historical income disparities on the continent, anchored democratic and market institutions and created new opportunities for millions of people in both the East and the West. But convergence has not been without bumps in the road, with several years of exceptionally high growth followed by the painful recession that we are now seeing in some countries. This shows that EU membership is no panacea. The challenge going forward is to solidify sound policies and to modify EU institutions to help minimize such disruptive boom-bust cycles.

One lesson of the crisis experience is that sustainable policies do pay off. Countries that were able to reign in overheating pressures and contain vulnerabilities during the post-accession boom phase are now doing better and have stronger prospects to emerge quickly from the current slump. Flexible economic structures, be it in labor and currency markets or the fiscal sphere, are clearly of advantage when adjusting to rapid changes in a closely integrated environment. This calls for continued macroeconomic discipline and structural reforms.

The financial sector has played a key role both in the origins and in the transmission of the crisis. Given the high integration of banking systems in the new Member States with the rest of the EU, close cross-border cooperation at all levels is essential. Financial stability must ultimately become a shared responsibility, between supervisors in home and host countries as well as between financial regulators, fiscal authorities and central banks within countries. The recently published “De Larosière” report is a useful starting point for an important Europe-wide debate on these issues.

The EU’s policy framework has greatly contributed to the new Member States’ improved policy performance after accession. But, as outlined above, a rigid pursuit of the Stability and Growth Pact and the Maastricht criteria can at times get in the way of appropriate policies to deal with crises. Clarity on the euro roadmap is therefore all the more important, especially in the present testing economic environment. Other areas where the ECB could support non-euro area Member States include making available currency swap arrangements (to help stabilize exchange rate movements) or allowing their sovereign debt to be used as collateral for its monetary operations (to prevent crowding out through sovereign borrowing by euro area countries).

To sum up: If there is a lesson from the crisis for Europe, it is that a tightly integrated region requires a regional perspective from policy makers.

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# Challenges of Monetary Integration in CEE

Gertrude  
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## 1 Introduction

Since its creation in 1998, the ECB has taken a close interest in the monetary integration of accession and acceding countries. As early as November 1999, the Eurosystem organised a first high-level seminar on the accession process in Helsinki.<sup>2</sup> At that time, the ECB and the Eurosystem were considered to be far ahead of their time, since for most observers the accession process was still a distant and theoretical concept. In the meantime, accession has become reality, as evidenced by the two accession waves of 2004 and 2007. Two Central and Eastern European (CEE) countries (Slovenia and Slovakia) have in the meantime joined the euro area, and the three Baltic states have come to participate in ERM II.

Monetary integration consists of three distinct phases, which are nevertheless part of a continuum. The roadmap to the euro includes accession to the European Union (with the accession countries becoming members of EMU “with a derogation” upon entry), joining ERM II and the adoption of the euro. The first phase, EU membership, is subject to the fulfilment of the “Copenhagen criteria,”<sup>3</sup> which set the political, economic and legal requirements. Furthermore, entry into monetary union is subject to the Maastricht convergence criteria, and one of these criteria is related to ERM II membership.

This article is structured as follows: Section 2 recalls the ECB’s preparations of the accession process up to 2004; section 3 discusses the experience with enlargement after 2004, section 4 touches on the prospects of monetary integration, and section 5 concludes.

## 2 A Look Back on the Preparations for Monetary Integration prior to 2004

The ECB conducted considerable analytical and policy work prior to the accession waves of 2004 and 2007, which resulted in a series of yearly high-level Eurosystem seminars on accession. In its work, the ECB was able to draw on the experience and knowledge of various national central banks, including the OeNB, which had built up a tradition of research and analysis of CEE.

In the discussions it was clear from the start that monetary integration into the euro area would be the natural endpoint of the accession process (e.g. no opt-out options would be provided). However, euro adoption is subject to the fulfilment of certain economic criteria, i.e. the Maastricht criteria laid down in Article 121 of the Treaty establishing the European Community. Strict adherence to these criteria is meant to ensure lasting convergence and a smooth participation in the monetary union.

The criteria are essentially defined in terms of sustainable convergence, requiring the achievement of a high degree of price stability, the sustainability of the government financial position, the stability of the exchange rate against the euro as confirmed by stable membership in ERM II for at least two years and the durability of the convergence achieved as reflected in the long-term interest rate levels. Understanding the need for nominal convergence is crucial, since in a monetary union, diverging inflation rates quickly become unsustainable, with the real

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<sup>2</sup> See ECB (1999).

<sup>3</sup> As spelled out in the Presidency Conclusions of the Copenhagen Summit of June 1993.



interest rates of more inflation-prone countries falling to too low levels. This eventually leads to credit booms, overheating, loss in competitiveness and current account deficits.<sup>4</sup>

The ECB recognised that this monetary integration process would be accompanied by a number of challenges. First, many of the prospective Member States showed strong real convergence. The Eurosystem took the view that real and nominal convergence can be complementary in the medium term and should be pursued in parallel. While the catching-up process may be a source of upward pressure on prices, structural reforms that improve the supply side of the economy and enhance potential growth and market flexibility are conducive to an environment of lower inflation and interest rates. Conversely, by anchoring inflation expectations and providing for macroeconomic stability, nominal convergence is likely to have a positive impact on trade and investment, thereby supporting the desired increase in living standards and per capita income levels. Econometric investigations confirmed this, showing that, via the benefits of lower inflation and reduced deficit and debt ratios, the Maastricht convergence criteria contributed positively to real per capita income growth and convergence in the EU.<sup>5</sup>

Second, there was a need to lay a solid foundation for price stability. This involved bringing central banking frameworks (including central bank independence) fully in line with the *acquis communautaire*. The Treaty calls on CEE central banks to strive for price stability from their entry into the EU.

The third challenge relates to the choice of appropriate monetary and exchange rate strategies on the road to the euro. In the early 2000s, the CEE region was – and, by the way, continues to be – characterised by a variety of exchange rate regimes. The Eurosystem argued at the time that no single strategy is “best,” although it did emphasise the need for overall macroeconomic and structural policies to support exchange rate choices.<sup>6</sup> Overall, it is important to stress the need to ultimately strive for fulfilling the convergence requirements in a sustainable manner before the adoption of the euro. The ECB made it clear throughout the process that its assessments of convergence would be based on the principles of equal treatment and the strict observance of the entry criteria as laid down in the Treaty.

### 3 Five Years of EU Enlargement

Since May 2004, the EU has welcomed a total of 12 new Member States.<sup>7</sup> Owing to partly significant differences in the state of economic convergence and other country-specific circumstances, the speed of monetary integration has varied considerably across the new EU Member States. In fact, four of these 12 countries, including two CEE countries (namely Slovenia and Slovakia) have already adopted the euro, which reflects their high degree of sustainable convergence. The other new entrants are still faced with some important challenges to ensure sustainable

<sup>4</sup> See e.g. Noyer (2007).

<sup>5</sup> See Afxentiou (2000) and also Afxentiou and Serletis (2000).

<sup>6</sup> Some exchange rate frameworks are nevertheless incompatible with the criteria for euro adoption, e.g. unilateral euro adoption or managed regimes with an anchor other than the euro.

<sup>7</sup> The Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia joined the EU on 1 May 2004; Bulgaria and Romania joined on 1 January 2007.

convergence with the euro area. Three new Member States have already come to participate in ERM II, while some countries intend to join the mechanism once they will have reached a higher level of convergence with the euro area.

The experience with EU enlargement has been generally positive not only for the new Member States, but also for the EU as a whole, although a number of countries have in the past years built up considerable external and domestic imbalances.<sup>8</sup> Having entered the EU, most new Member States experienced robust economic expansion, although starting from different levels. As output growth accelerated significantly, their income levels were moving closer towards those of the euro area, even though in most countries they remained well below the euro area levels. In 2004, the per capita income levels of the new entrants were on average about half of the level of the euro area. In several countries, namely in the three Baltic states and Slovakia, the catching-up was most pronounced, as their per capita income levels increased by 10 percentage points and more after 2004. The catching-up in their standards of living was driven mainly by large capital inflows (including EU cohesion and structural funds), strong productivity growth and robust investment growth. Although the catching-up process was a common feature of all new Member States, there has been some noticeable diversity across countries. Besides their different growth performance and GDP per capita levels, the economies considerably vary in terms of their structural features, including the respective underlying exchange rate regimes.

The enlargement of the EU has further strengthened the trade and financial links between the new Member States and the euro area. As trade and the share of their exports in world trade expanded strongly, the countries became even more open. In particular intra-industry trade of the new entrants with the EU, lately also among the CEE countries themselves, has increased notably in some countries since 2004. Although the vast majority of the new entrants' total exports continues to be directed to the EU, for many economies the importance of export markets outside the EU has also grown considerably in recent years. Increased financial links with the euro area and further financial deepening via bank lending have likewise played a pivotal role in financing growth. A key characteristic of the CEE countries' financial sector is the high degree of foreign ownership and a strong reliance on bank financing. In fact, the share of assets of branches and subsidiaries of EU credit institutions in total bank assets in CEE almost doubled in five years, standing at around 80% in 2007.

A number of important policy choices in line with EU requirements, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective as enshrined in the central bank laws, has helped to drive down inflation to single-digit levels in most CEE countries. This process has been further supported by the overall impact of globalisation, increased competition in labour and product markets and, in countries with more flexible exchange rates, the nominal appreciation of the national currency. All these factors have more than compensated for the mostly adverse impact of changes in administered prices following EU accession (e.g. adjustment in excise taxes), while food and energy prices have contributed to the high volatility of inflation developments.

<sup>8</sup> See ECB (2009).

Notwithstanding the general achievements in terms of real convergence, the catching-up process increasingly became unsustainable in a number of CEE countries. In some, domestic demand growth turned out to be excessive, reflecting robust growth in disposable income, low – and in some cases even negative – real interest rates as well as strong credit growth. In many countries, fiscal and incomes policies were not sufficiently restrictive to prevent the economy from overheating. Thus, fiscal policy was generally too loose and countries had failed to make sufficient use of past favourable growth conditions to progress with fiscal consolidation and to build up additional fiscal buffers that would have alleviated the ongoing output adjustment. The strong growth acceleration was further fuelled by large capital inflows, which also included EU transfers. Absorbing significant and potentially volatile capital inflows posed a challenge to the new Member States, as it led to a high degree of external indebtedness. While some countries found their fixed exchange rate regimes to be under pressure, others were exposed to exchange rate swings. The overheating of the economies, in turn, contributed to a strong pickup in inflation, which reached even double-digit levels in some countries, and rapid increases in real estate prices. As the labour market situation became very tight, with wage growth by far exceeding productivity gains, most CEE countries were facing an erosion of international price competitiveness. For the new Member States with fixed exchange rates, the loss in competitiveness was in past months further aggravated by the recent strong depreciation of the currencies of some competitor countries.

As a consequence, several countries in CEE were confronted with significant domestic and external macroeconomic imbalances. In particular, the countries with fixed exchange rates experienced a substantial deterioration in their current account balances and a significant increase in their external debts. Besides their substantial external financing needs, the structure of current account financing made the new Member States highly vulnerable to sudden changes in investor sentiment. For example, some countries, and here mainly the Baltic states, relied heavily on debt financing, mostly in the form of loans from parent banks. In addition, considerable currency and maturity mismatches have built up in the private sector of some countries, which exposes them to exchange rate swings. The risk of adverse balance sheet effects resulting from strong exchange rate movements poses a risk to financial stability.

The impact of the global financial and economic crisis on the region initially appeared to be relatively limited, but this changed dramatically following the collapse of Lehman brothers in September 2008. The tightening of external financing conditions and the dramatic fall in global demand for exports from CEE resulted in a sharp reduction in growth in the region after end-2008. Reflecting the partly significant exposure to interbank financing, some CEE countries were directly affected by the global deleveraging of financial institutions. Although not solely related to the crisis, real GDP of the CEE countries shrank by an average 1.5% in the fourth quarter of 2008 in annual terms, with some countries even experiencing double-digit declines. To put this into perspective, this contraction follows an average annual growth rate of 3.5% over the past five years. While the strong trade and financial links can go some way towards explaining the significant impact of the current global crisis on CEE, the build-up of domestic and external imbalances over recent years appears to have intensified the impact.

#### 4 The Outlook – Challenges for Future Monetary Integration

The global financial crisis has highlighted how difficult it is to follow a fast and sustainable catching-up process. Moreover, it has underlined the need to implement sound macroeconomic policies and structural reforms. In fact, the countries that were most affected by the crisis are those that had built up large domestic and external imbalances in the past and had grown at unsustainable rates in previous years. This is particularly the case in some countries that had closely tied their currencies to the euro, such as the Baltic states, and had unsustainable fiscal positions, such as Hungary.

To return to a sustainable path of convergence in the medium term, countries face substantial policy challenges. In essence, the CEE countries need to reduce existing imbalances and vulnerabilities to ensure sound fiscal policies and to make further progress with structural reforms.

In particular, it is important that fiscal policies help to maintain confidence in the soundness of public finances, especially in the current situation of strongly deteriorating growth prospects and a shift in investor sentiment away from higher-yielding emerging market assets. Countries with large budget deficits are better advised not to stimulate growth by loosening fiscal policies. Instead, they should consolidate their public finances and keep a safe distance from the 3%-of-GDP deficit, the limit specified by the Stability and Growth Pact. Although many CEE countries still record low public debt levels, the expected worsening of budget balances is likely to substantially push up these levels. High debt positions pose a threat to the countries' long-term fiscal sustainability.

Moreover, policy measures should focus on fostering both competitiveness and sustainable growth. More effective labour and product market institutions would help to further improve the countries' adjustment capacities to swiftly react in case of economic shocks. In addition, it is essential that countries allow for a proper degree of competition in their product markets and that they create an environment that is conducive to higher investment in human and physical capital.

Furthermore, the countries in CEE need to strengthen their export performance by improving their competitiveness and to better absorb capital flows.

Going ahead, the ECB will continue to monitor and assess the prospects of monetary integration in CEE economies. Several new Member States will continue their process of convergence towards the euro area. A few other countries may join the EU in the years to come. With respect to the public discussion on whether to speed up the euro adoption process, it is important to recall the underlying principles of the process of monetary integration. In particular, prior to joining the euro area, a sustainable level of convergence has to be achieved, which requires sound domestic policies. Thus, adopting the euro cannot be a substitute for necessary domestic policy adjustments. This would go against the economic logic which underlies the convergence process in Europe specified by the Maastricht Treaty. Moreover, any premature adoption of the euro could make it considerably more difficult for a country to cope with the challenges ahead. Without sustainable convergence, the monetary policy stance of the ECB is likely to be inappropriate for the country concerned, which – lacking important tools to stabilise economic conditions at home – could face excessive output and inflation volatility.

## 5 Conclusions

The Central and Eastern European countries are currently experiencing their most severe economic downturn since the early 1990s. While this decline was also triggered by the global financial crisis, its scale is largely related to the significant imbalances and vulnerabilities that had built up in recent years. To unwind these imbalances, the countries have to undertake major economic adjustments. Looking ahead, Central and Eastern Europe has the potential to return to strong growth. However, to avoid any recurrence of a boom-bust cycle, it is important to ensure the sustainability of the convergence process and to avoid excessive output volatility. This requires the implementation of sound macroeconomic policies and structural reforms. Overall, the ECB is well prepared to deal with future cases of monetary integration, and the overall institutional framework based on the Treaty has proven its robustness.

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# From the Koruna to the Euro

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Slovakia is one of the few countries to have successfully introduced two currencies and two monetary policies in its economy in a relatively short period of time. This fact offers us an opportunity to compare (1) the period following the establishment of both an independent state and an independent currency with (2) the period when the national currency was changed and Slovakia joined the euro area.

## 1 The Slovak Koruna

The second half of 1992 was extremely dynamic and brought the decision to split Czechoslovakia into two independent states on January 1, 1993. One of the issues discussed at that time was the establishment of a new central bank in Slovakia that would assume all the responsibilities that a central bank must fulfill. However, it was also decided that – in the first few months following the setup of both the new states and the new central banks – the Czech Republic and Slovakia would each conduct their own economic policies while maintaining a common monetary policy. In other words, the decision was made to create a monetary union between the two new states and to use the Czechoslovak koruna as the common currency.

Initially, the monetary union was meant to exist for at least six months to allow both countries to prepare the launch of their own currencies and monetary policies. For the monetary union to work, the bank boards of both central banks transferred the responsibilities associated with monetary policy management to a Monetary Committee, in which both countries were each represented by three central bank delegates. After only a short period of time, however, it was clear that the monetary union was not feasible, mainly because of the different economic policies of the two states. The differing economic structures certainly played a role, and in addition, Slovakia had yet to establish all the institutions necessary for running the new state. Fiscal policy objectives likewise varied, and, eventually, the two states agreed to discontinue the monetary union and to introduce separate currencies on February 8, 1993.

That date marked the birth of the Slovak koruna and the day when the new Slovak central bank, *Národná banka Slovenska* (NBS), began to conduct an independent monetary policy. At first, the Slovak koruna was fixed to a five-currency basket and later to a basket consisting of two currencies – the Deutsche mark and the U.S. dollar – at a ratio approximating the shares of the two currencies in the current account. The new currency got off to an extremely difficult start. It was generally expected that the Slovak economy and the Slovak koruna would be a weaker link in the former federal republic. As a result, the new Slovak currency faced distrust by investors as well as Slovakia's businesses and the general population, particularly in its first five months. The subsequent 10% devaluation, which was supported by several administrative measures (e.g. the introduction of an import surcharge), by monetary policy and the NBS (both were increasingly gaining respect), successfully steered the Slovak koruna – after the first difficult year after its adoption – onto the standard route of a transition economy.

The restructuring of Slovakia's economy and financial sector, which got underway in 1999, as well as transparent privatization and changes in the legal, social and tax systems and also in the labor market environment made the economy

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– which at first had been trusted by only a few – a leader among the countries changing from socialism to a market-oriented economic system. Public finance reform in particular received close attention in many European countries, and the tax reform project was followed by several European countries. The consolidation of public finances and the reduction of the fiscal deficit enabled the central bank to enhance the quality of banking regulation and to standardize the implementation of monetary policy. The NBS thus succeeded in harmonizing its monetary instruments with those used elsewhere in Europe.

Despite the fact that Slovakia had significantly lagged behind in some areas of integration (e.g. into NATO and the OECD), it successfully caught up with integration trends thanks to its economic transformation and in-depth economic reforms. In 2004, when it joined the European Union along with nine other countries, the country's geographical affiliation with Europe was complemented by economic affiliation. As the Treaty of Accession stipulated monetary integration for all the new Member States, the NBS and the government of Slovakia subsequently started contemplating when full monetary integration with the euro area could be achieved.

## 2 The Decision on Euro Adoption

As early as 2002, when the public finance reform – the most challenging and most crucial prerequisite for euro adoption – was implemented and when it was obvious that Slovakia would successfully complete the EU integration process along with the other countries, the NBS in cooperation with the Slovak Ministry of Finance initiated the preparation of the Strategy of Euro Adoption in Slovakia. The first part of the strategy comprised an analysis of the Slovak economy and its outlook, with an emphasis on the degree of economic integration and independent monetary policy implementation. This analysis showed that thanks to the restructuring of the economy and reforms Slovakia had come to attract large foreign direct investment (FDI) inflows, mainly into the real economy, which significantly increased the economy's openness to around 170% of GDP. As a result, the economy became very sensitive to exchange rate fluctuations. At the same time, the economy's openness limited the NBS's options to independently use its monetary instruments to interfere in real economic developments. According to the analysis, the euro would bring clear benefits for the economy and the Slovak population if the economic development triggered in the late 1990s continued.

The analysis and the draft Euro Adoption Strategy were discussed and approved in 2003 by both the NBS and the Slovak government and became the beacon for the introduction of the euro in Slovakia. Based on the 2003 analysis, 2008 and 2009 were indicated as potential years for euro adoption. In 2004, the NBS and the Slovak government discussed the revised Strategy of Euro Adoption in Slovakia and made an unequivocal decision: They designated January 1, 2009, as the date for introducing the euro, since adopting the euro in Slovakia at the envisaged time would have significantly more benefits than disadvantages for the economy and the population. They also approved the road map for the entire process and a detailed time schedule to ensure a seamless transition to the euro.

The Slovak government thus gave a very clear and historically important signal about the Slovak economy, both at home and abroad: Slovakia would continue to reform its economy and implement a reasonable economic and monetary policy to

pave the way for the country's euro adoption. The Slovak parliament's confirmation of the adopted route to the euro is also considered a critical moment as it not only enhanced the credibility of the strategy but also was to shape the turn of events beyond the respective parliamentary term.

The Euro Adoption Strategy, whose key features and individual steps were finally defined in 2004, was fulfilled step by step both in terms of the economic (Maastricht) criteria and the legislative measures and alongside technical preparations for the euro changeover. In 2005, the National Euro Changeover Plan for the Slovak Republic was adopted. Slovakia's thorough fulfillment of the Euro Adoption Strategy and the National Euro Changeover Plan sent a clear signal about the country's determination to reach its goal. 2006 saw the establishment of the office of the Plenipotentiary of the Government of the Slovak Republic for the Introduction of the Euro, which was charged with coordinating the efforts of individual working groups and preparing an effective communications campaign aimed mainly at the Slovak population. The population was meant to see the euro as a step moving the country forward. The information campaign began in late 2005 with the design of the Slovak euro coins, which were selected in a public opinion poll. Based on these results, the Bank Board of the NBS chose three motifs that are currently used on Slovak euro coins.

### 3 Entry into ERM II

In line with the adopted Strategy, in 2005, Slovakia entered the European exchange rate mechanism (ERM II) and fixed the Slovak koruna exchange rate to the euro. Slovakia adopted a standard approach, which means that the central parity of the Slovak koruna to the euro was fixed at the market level, and opted for the standard fluctuation band of  $\pm 15\%$  around the central parity.

Entry into ERM II was another crucial step on the way to the euro. Not only was it a very strong commitment to the national economy, but it also showed countries abroad that Slovakia was serious about its changeover to the euro. Participation in the exchange rate mechanism was a unique experience not only for Slovakia, but also for other countries that planned to introduce the euro, in particular countries with a flexible exchange rate regime. After all, Slovakia was the first of the new EU Member States to enter ERM II with a flexible exchange rate regime. The market responded with an immediate strengthening of the Slovak koruna, which confirmed the irrevocability of the journey toward the euro.

The Slovak koruna steadily strengthened, except for a short hesitation immediately after parliamentary elections in 2006. In March 2007, the central parity of the Slovak koruna was revalued for the first time. This revaluation will surely be of interest to analysts as well as countries aspiring to adopt the euro. The new central parity was not set at the market rate, but rather at the (lower) equilibrium rate. The market response was unexpected for many economists: The Slovak koruna significantly strengthened in a short period of time instead of returning to its "balanced level." The latter had been expected, not least due to the method of determining the new central rate, which the market considered to be different from that set by the authorities. In fact, the Slovak koruna exchange rate jumped by more than 3% in response to the change in the central rate. From late November 2005 (ERM II entry) until mid-March 2007, the Slovak koruna firmed by a total of 15% against the euro.



Slovakia's strengthening currency did, however, not hamper economic growth. Owing to the well-defined road map to the euro, combined with a rational economic policy and, in particular, the implementation of profound structural reforms, foreign capital inflows were booming, mainly in the form of greenfield investments,<sup>2</sup> and the economy started to flourish. This lent support to the market sentiment that the economy could handle an even stronger exchange rate.

Slovakia experienced record-breaking economic growth and its fiscal deficit fell along with unemployment, the latter having for many years been one of the biggest problems in Slovakia. The Slovak koruna, which started to strengthen gradually, was then affected by the anticipated decision regarding its final central rate. In May 2008, slightly more than one year after the first central rate revaluation, the second revaluation took place – and again the central rate was not set at the market level, but this time at the stronger end of the fluctuation band of  $\pm 15\%$  around the previous central parity.

It was a great move forward from the last revaluation – by nearly 18%, and this level was soon understood by the market as a potential exchange rate level. The market exchange rate then only slightly strengthened toward this limit. In my opinion, this revaluation method will also be subject to analysis as to how it was determined and how markets responded. The conversion rate was not set on the standard day (Friday), but on Wednesday, which was a big surprise for the financial markets.

#### 4 The Introduction of the Euro

In July 2008, the “economic” preparations for the introduction of the euro were completed by an official decision that Slovakia met the requirements for euro adoption with effect from January 1, 2009, and the conversion exchange rate was set, as expected, at the central rate determined in late May. It needs to be clearly said that, prior to the second revaluation, hardly any analyst or economist had expected such a strong conversion rate. The exchange rate, which was set by using a “forward-looking approach,” reflected the anticipated development of the Slovak economy over the period of one to two years.

Following that date, all businesses in the Slovak economy significantly stepped up their preparations for the introduction of the euro, and today we can state, without any doubts, that the euro was introduced in Slovakia without any difficulties. Besides the completion of the preparations by Slovak businesses and the broad-based communications campaign, two issues resonated in Slovakia just before the changeover to the euro.

The first issue was the frontloading of euro banknotes and coins, which was an extremely complex process in terms of logistics and organization but was carried out seamlessly due to excellent cooperation among the NBS, commercial banks and entities that received euro cash before the official changeover date of January 1, 2009. The second issue was to persuade people to exchange all their available cash that they had at home at commercial banks before the changeover to avoid long lines after the start of the new year. This was also carried out without any difficulties. The thorough preparations paid off in the end and I believe that everybody was surprised at how smoothly the entire process went.

<sup>2</sup> Slovakia, for instance, became the world's largest producer of cars per capita.

The global financial and economic crisis started to affect Slovakia shortly after the decision that the country would adopt the euro as its national currency. Following the restructuring of the real economy and the banking sector, the financial sector was in very good shape and was thus not directly hit by the financial crisis, also thanks to the adoption of a very conservative business approach. Naturally, there will be some indirect implications, such as nonperforming or restructured loans, as the economy slows down and unemployment increases.

## 5 Potential Impact of the Crisis

The impact of the financial and economic crisis on an economy which has just introduced the euro will be the third issue of interest to analysts and economists. However, the key question here is about the relationship between the single currency and the development of GDP and other economic variables during a crisis and the subsequent gradual recovery of the economy – and only time will provide the answer to this question. Today, several months after the euro was introduced, it is very difficult to answer the question of whether the EU Member States with independent monetary policies are currently at an advantage. After all, a simple assessment of the currency components will not suffice; the openness of the individual economies and their dependence on foreign demand for growth will certainly play a key role, as will the stage of the economic cycle the country was in when the crisis hit. For Slovakia, the high GDP growth of 2007 and 2008 became unsustainable when foreign and subsequently also domestic demand fell sharply, and GDP declined even more markedly. On the other hand, a rational fiscal policy and the recovery of the economy over the past ten years combined with the effect from the single currency should trigger a faster return to economic growth once the crisis lets up. The future will show whether the introduction of the euro was prudent in this respect; I believe that the answer to this question will be positive.

## 6 Conclusions

To recap, Slovakia is a country that experienced two fundamental currency changes in the past 16 years. Comparing the two periods reveals several similarities but significantly more dissimilarities.

In 1993, the introduction of the Slovak currency was by necessity carried out swiftly, following on the heels of the establishment of the Slovak Republic, which lacked both an economic history of its own and a central banking track record, and because the monetary union with the Czech Republic had been extremely short-lived. This notwithstanding, the era of the Slovak koruna is regarded as a very successful period, not only because of the considerable commitment and enthusiasm involved in building the institutional aspects of the new economy, including the central bank, but also due to the approach to addressing the issues associated with the new currency. At first, the Slovak koruna had to pass a hard test to prove its viability, but after a few small “stumbles” it started its – as we know now – successful existence.

By contrast, the introduction of the euro in 2009 was preceded by elaborate preparations as would be expected from such an extensive project that was to impact not only the whole economy, but also every single citizen of the country. Carefully prepared and consistently implemented, the changeover to the euro proved to be a success. The guiding principles were reasonableness and a system-

atic approach to addressing relevant issues, including many uncertainties as to whether the step taken is the best one. In fact, doubts about the success of the future changes characterized both periods.

One of the essential questions was whether the population would accept the new currency, would get used to it and would understand it as the conclusion of Slovakia's integration into the European Union. Would Slovaks feel more European with the single currency? Today, several months after Slovakia's adoption of the euro, even the worst skeptics are surprised at how readily people accepted the new currency and identified with it. Public support for the new currency has reached more than 80%, clearly exceeding expectations. Similarly to the Slovak koruna, the euro faces a hard test in its new home country in light of the impact of the global financial crisis on the Slovak economy. I believe that the euro will pass it as successfully as did the Slovak koruna after its adoption.

At any rate, the story of Slovakia's euro adoption will be a useful lesson not only for economic theory, but also for countries, including non-European ones, striving to achieve monetary integration. With regard to the enlargement of the euro area, Slovakia has opened a new era for countries with flexible exchange rate regimes. Studying Slovakia's journey to the euro will definitely facilitate their monetary integration process. Additionally, the process has revealed weaknesses and/or partially outdated aspects of the Maastricht criteria, the mandatory two-year maintenance of a local currency with a flexible exchange rate regime in ERM II being just one example. Also from that point of view, the adoption of the euro in Slovakia has been a historical and successful event.

# Twenty (Five) Years of Banking Reform in CEE

Lajos Bokros<sup>1</sup>

Contrary to conventional wisdom, banking systems were far from uniform across the landscape in the former communist countries of Central and Eastern Europe (CEE). It is worth distinguishing among three different models of banking: (1) the classic Stalinist one-tier system; (2) the Polish-Hungarian reformist one; and (3) the regionalist two-tier model in former Yugoslavia.

The classic Stalinist banking system was characterized by the complete lack of risk management at all levels of decision making. Credit was directed and distributed according to the *mandatory targets of the detailed five-year plan* as defined by the central planning office in close coordination with the line ministries. The few banks that existed enjoyed monopolistic positions as their clients – enterprises, local governments and households – were assigned to them and they were acting as quasi departments of the finance ministry. Competition was unheard of, conditions, such as interest and exchange rates, were administratively determined. Hence, adjustment to changing economic conditions was impossible. Shortage of credit together with a huge monetary overhang reflected the extraordinary rigidities built into the system.

The Polish-Hungarian arrangement, which came into being after the reforms of 1968, maintained the one-tier model but credit allocation was more business-like. *Targets set by central planning ceased to be mandatory*, line ministries no longer had the right to give administrative orders to either enterprises or banks. Banks were expected to follow the broad parameters of the macroeconomic plan but had more autonomy in day-to-day decisions regarding the combination of resources other than large investments. Poland and Hungary were borrowing heavily from the West in order to invest in export-oriented ventures and support a higher living standard in what was to be similar to a more open consumer society. A private sector was allowed to thrive in agriculture, small-scale manufacturing and services.

The Yugoslav model followed the two-tier arrangement, with the central bank concentrating exclusively on financing commercial banks and the state. Commercial banks were largely owned by nonfinancial enterprises, which, in turn, were governed by workers' self-management councils and organized on a *regional basis*. The names of banks in all former Yugoslav territories still reflect the strong regionalization of financial services (Nova Ljubljanska banka, Zagrebačka banka, Novosadska banka, Vojvođanska banka, Beogradska Banka, etc.). These banks were more autonomous than their counterparts in any other socialist economy but not necessarily more effective and efficient. They suffered from a *fatal conflict of interest* as their most important clients used to be their principal owners at the same time. As a consequence, they were obliged to offer loans on preferential terms to their corporate owners no matter how creditworthy these latter might have been. Their subsequent losses were typically monetized by the central bank. No wonder that the Yugoslav model was a *highly inflationary one*.

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## 1 Early Reforms and Transformational Crisis

Preparations for a comprehensive banking reform started in Hungary as early as 1985 and a two-tier competitive system was launched in 1987. This model was later followed by all transition economies in CEE. Several new *state-owned commercial banks* (SOBs) were carved out of the mainframe of the former central bank. These were concentrating either on specific regions (e.g. in Poland) or various *branches of industries* (e.g. in Romania and Bulgaria). Former specialized financial institutions (foreign trade, investment and savings banks) were transformed into universal banks. Administrative rules and regulations were gradually eased, then removed. Banks, while still in state hands, started to compete for customers, created new products, entered into foreign exchange transactions and, finally, were allowed to collect retail deposits. New small private banks and joint ventures sprang to life as well.

Unfortunately, transition economies fell into a *very deep recession* as a consequence of the collapse of thousands of state-owned enterprises. It was no surprise, therefore, that *nonperforming loans* (NPLs) accumulated very quickly in the balance sheets of almost all banks. Most commercial banks became insolvent soon after their establishment and were in need of recapitalization for survival.

The emerging banking crisis was further exacerbated by the deterioration of the loan portfolio of the newly established private banks. The number of these banks rose very quickly and many of them acted like pyramid schemes due to the lack of adequate prudential regulation and effective supervision. Private banks collapsed by the dozens, mostly in the former Soviet Union but also in South-eastern Europe (notably in Albania, Bulgaria and Romania). Others concentrated on financing their owners, nonfinancial enterprises in the hands of emerging tycoons. The latter also benefited from the infamous “loans for shares” schemes, which resulted in the emergence of an *oligarchic class* still dominant in most of these countries even today.

## 2 Rehabilitation and Privatization of Large State Banks

Large SOBs were considered strategic assets by the fragile democratic governments and many of them were hesitating whether to privatize them or not. The first reaction to the emerging crisis was to rehabilitate the SOBs either by carving out the NPLs or by outright recapitalization (new share issue). Governments realized the *stock problem*, i.e. the inherited NPL portfolio, but failed to grasp the *flow problem*, i.e. the need to change governance in SOBs in order to prevent new NPLs from accumulating again. In many countries several banks were rehabilitated several times by using a huge amount of taxpayer money without any marked improvement in the financial situation of these banks. It is interesting that in the early stages of transition, bank privatization came to the agenda of governments only in the Baltic states, Poland and Hungary – perhaps because of past experience and tradition with private ventures and/or their broad acceptance by society wishing to get rid of all vestiges of the Soviet past.

When privatization was finally considered, it became an outright political issue. Governments wanted to keep some equity stake at least in domestic if not in state hands. But the need for further and substantive recapitalization and the importance of fixing governance in the future finally led to the privatization of large SOBs by inviting large *foreign strategic investors* in most countries. Swedish

banks, like Swedbank and SEB, acquired a dominant position in the Baltic states; Austrian banks, like Raiffeisen, BA-CA (later HVB and now UniCredit), Erste Bank and Volksbank, and the Flemish KBC purchased strategic assets in Central Europe; Italian banks, like Intesa and now UniCredit, as well as some Greek and Turkish banks gained important strongholds in Southeastern Europe over time. Overall, 75% of assets across the region (in CEE but not in the former Soviet Union other than the Baltics) are now held by foreign banks – an unprecedented level of penetration worldwide.

Although foreign commercial and, lately, investment banks appeared also in the Commonwealth of Independent States (CIS), as the former Soviet Union minus the Baltic states is now commonly referred to, they never gained prominence, let alone a dominant position in financial intermediation. Ukraine is the only large country where foreign banks now play a significant role in offering financial services alongside big domestic banks, which are typically in the hands of powerful oligarchs.

### 3 Banking Sector Development in the First Decade of the 21<sup>st</sup> Century

Privatization of systemically important banks in CEE resulted in a fundamental change of the landscape in financial services. Banks started to offer Western-style quality services to vast segments of society and gradually brought them into the mainstream of finance for the first time ever. Corporate as well as retail customers were able to raise loans en masse for the first time in decades and put their savings into safe and sound institutions. The shortage economy was transformed into a consumer society almost overnight. No wonder that an *unprecedented credit boom* was experienced in almost all countries of CEE, which, in turn, contributed to a substantial overheating of these economies. Credit growth was too quick in many countries and it has now exacerbated the swings in the business cycle. Despite all problems, even today, it is clear that foreign banks are the most solid backbones of the CEE economies and will clearly remain so for the future as well.

Stability and growth of the financial sector were achieved not only by recapitalization and privatization but also as a result of a quite substantial improvement in *prudential regulation and supervision*. For privatization to succeed it was absolutely indispensable to design a Western-style regulatory and supervisory framework, establish a strong regulatory institution largely independent from political interference and in an arms-length relationship with powerful business interests. Incipient domestic arrangements for regulation and supervision were supported and strengthened by growing contacts with Western counterparts and the fundamental requirements of EU accession. The contrast between CEE and CIS countries is clearly huge in this regard. In the latter, regulatory and supervisory institutions are still at the mercy of strong political and business interests and fail to implement prudential rules to prevent systemic risks from contaminating the whole financial sector. (The murder of Andrei Kozlov, first deputy chairman of the Russian central bank, is a brutal case in point and just the visible tip of the iceberg.)

Banking sector development cannot be separated from the evolution of the corporate sector, and that of nonbanking financial services either. The first decade of the 21<sup>st</sup> century has brought massive changes in this regard, too. Foreign corporations, especially large multinationals, now play a dominant role in exports, manu-

facturing, trade and services in almost all countries. These companies tend to bank with correspondingly large multinational financial institutions and demand a comprehensive portfolio of financial services, including trade finance, hedging, cash management, insurance products, investment vehicles and retail services for their own employees. These complex services can be offered only by large international financial institutions operating in several countries at the same time. No wonder that international consolidation in banking is advancing in Europe and that it has just been speeded up further by the unfolding global financial crisis.

#### 4 Impact of the Global Financial Crisis on Banking in CEE

One of the most important measures of financial sector development used to be the *ratio of total assets to GDP*. Transition economies were considered underdeveloped a decade ago because in all CEE countries this ratio was well below 100% and in many cases even below 50%. As many tenets of conventional wisdom in economics have now become obsolete, it is clear that banking sector development can no longer be evaluated on the basis of quantitative penetration. The *safety and stability* of the systemically important banks is the most important issue, and it is more related to the *quality*, rather than the quantity of assets in their balance sheets.

Another important lesson to be learnt from the financial crisis is that *macroeconomic policy does matter a lot*. Slovenia and Slovakia, those two transition economies which managed to join the euro area in time, are fully protected against a currency crisis; hence, balance sheets of banks operating in Slovenia and Slovakia are less exposed to risks of both corporate and personal defaults as a consequence of currency mismatch. Nevertheless, the recession in the real sector may prove to be deeper because competitive devaluation is not an option anymore. Countries with flexible exchange rates can better absorb external shocks but their banks are more vulnerable to the renewed accumulation of NPLs. Finally, economies with currency pegs (currency board arrangements) will probably suffer a much deeper recession even if the fixed exchange rate proves to be sustainable. In any case, bank balance sheets are likely to deteriorate in all transition economies; it is only the channel of macroeconomic shock which may be different. Hence, strengthening the capital base as well as the prudential regulation of systemically important banks looks like an indispensable task for governments once again.



# A Banker's Take on Twenty Years of CEE Banking Sector Developments

## 1 Point of Departure

Marianne Kager<sup>1</sup>

The past 20 years of East-West integration were full of memorable moments including both daunting – sometimes seemingly insurmountable – challenges and resounding successes. Naturally, neither the politicians in the transition economies nor the foreign investors knew at the outset whether this project stood a chance of succeeding in the face of economic turbulence, hyperinflation and poverty as well as several banking crises shaking the region.

And yet, East-West integration proved to be a huge success story at the close of the 20<sup>th</sup> century. Many decisive and critical events shaped the transition process. As a case in point, the 1998 financial crisis in Russia cast a shadow over the reform project – a spillover to other Eastern European countries with their fledgling banking systems and capital markets would have been disastrous, not least because it would have shattered investor confidence.

On the upside, the EU summit in Copenhagen in 1993 may be considered a catalytic milestone, holding out the prospect of EU membership to countries of Central and Eastern Europe (CEE) and laying down the conditions for accession. In hindsight, one may well debate to which extent the new CEE Member States fulfilled the Copenhagen criteria at the time of accession, but that is not the point here. More importantly, the prospect of membership gave CEE governments the clout to enforce reforms, which in turn had a positive influence on attracting foreign direct investment to these countries. Absent the EU accession perspective, foreign banks would not have invested that heavily in the region in the early days.

During the first years of transition, chaos reigned and severe shocks shook CEE. Following the collapse of the centrally planned economies, GDP per capita plunged by as much as 40% to 50%, and at times hyperinflation ravaged the economies in transition.

The formerly Communist countries lacked a modern banking and financial system and were instead burdened with a huge state-run “accounting machine.” The central banks provided the various economic sectors with means of payment, and specialized banks or in some countries central bank departments performed specific functions, such as taking in saving deposits or – in the case of the state-owned bank for foreign trade – managing foreign reserve assets. In 1989, all centrally planned economies featured such a monobank system, except for Poland and Hungary, which had already spun off particular activities into state-owned commercial banks.

The early years of transition were also characterized by substantial volumes of bad loans, which in most countries accounted for 25% to 35% of outstanding loans. Banking reform thus came at a high price (in the Czech Republic e.g. at the equivalent of 30% of GDP) and progressed only at a slow pace. Last but not least, capital controls were in place, which not only applied to foreign bank transactions, but also included a number of investment restrictions for nonresidents, such as the prohibition to purchase real estate or hold majority stakes in companies. Many of these restrictions were lifted only when the Europe Agreements with the applicant countries entered into force.

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This was, in a nutshell, the setting Western banks encountered when they first entered the new markets in CEE. What were their motives, how predictable were the risks they were taking on, how did the situation change over time, and how did the involved banks' business model change as well? These questions are not easy to answer, not even in retrospect.

## 2 Foreign Banks in CEE in the 1990s: A Time of Greenfield Investments and Acquisitions

With the outcome of the transition process and the various banking crises remaining unclear, foreign banks venturing into CEE more or less went out on a limb. In addition, the legal framework conditions awaiting them did not allow for large-scale market penetration in the first place. Banks initially followed their corporate customers into the region to provide them with basic banking services on site and then worked on gaining a foothold in the new market.

They started out by opening representative offices, later added branch offices and eventually even established banks in their own right. Western banks did not get heavily invested in the region until the massive privatization wave swept CEE, in some countries starting gradually in the mid-1990s, and peaking at the end of the 1990s and in the early 2000s.

It was also only in the mid-1990s that more and more signs pointed to a successful completion of the transition process. At least the countries in CEE had achieved economic stabilization, and while setbacks like that in the Czech Republic in 1998 could not be prevented, they did not reverse the positive trend. The situation in Southeastern Europe (SEE) was not as clear-cut, though, and certainly not in Russia and in the CIS countries after 1998; however, these countries likewise managed to stabilize their economies a few years later.

### 2.1 The Privatization Wave

With a view to attaining sustainable economic growth, it was imperative for the countries in CEE to swiftly set up a financial system modeled on the Western example not only to attract capital from abroad but also to provide the economy with financial services and with funds. Given the lack of both financial capital and banking know-how in the region, banks were first sold to foreign strategic investors in the mid-1990s. Only Slovenia chose – or rather, was able to afford – not to go down that road.

At the time, the bulk of banks in the CEE-10<sup>2</sup> were still owned by the state, and foreign banks' share ranged from 1% to 15%<sup>3</sup> in all but two of these countries. In 1994, Hungary had already started to sell large commercial banks to foreign investors, and in 1997, eight of the ten biggest Hungarian banks were already majority-owned by nonresidents. The only other country in CEE where foreign banks played a greater role at that time was Slovakia, where their share amounted to 33%. The “bank selloff” commenced in 1997 to 1998 and ended in 2002 to 2003 in CEE (2005 to 2006 in SEE). The swiftness of the selloff is attributable, among other things, to the fact that the (formerly) state-owned banks held rela-

<sup>2</sup> The ten countries in CEE that joined the EU in 2004 and 2007: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

<sup>3</sup> See *Bank Austria (1998)*.

tively large market shares; for instance, the four largest Czech banks held a good 60% of the market.

Around the year 2000, the situation stabilized also in SEE, as it became clear that Romania and Bulgaria, and perhaps also Croatia, would soon be able to join the EU. At the same time, the privatization wave also took off in these countries, sending Western banks on a shopping spree in these markets.

## 2.2 Investors' Strategic Interest

The particular attractiveness of the CEE market for Western banks is traceable to a number of reasons:

- The market displayed high growth potential;
- The market was characterized by a marked underprovision of banking services: Even based on the low GDP per capita, the intermediation rate of the regional banking system was extremely low. In 2000, loans as a percentage of GDP equaled a mere 34%<sup>4</sup> in the CEE countries that joined the EU in 2004;
- The EU membership perspective substantially reduced investment risk, because once accession negotiations had started in 1998, the accession road-map was likely to be adhered to;
- The large market shares held by the state-owned banks and the small size of the market in absolute terms made it possible for investors to snap up very large market shares in one go (in CEE, the top five banks of a country as a rule had a combined market share of more than 50%);
- The privatization of the large state-owned banks opened up the especially profitable retail business for investors;
- Profit expectations were excellent: The spreads to be earned especially in the retail business were high measured against the risk involved. In the CEE-5<sup>5</sup>, the spread between the lending and the deposit rate equaled 6.5% (unweighted average) in 1995 and still amounted to 4.9% in 2000; in the SEE-3<sup>6</sup>, the spread ranged between 13% and 21%.<sup>7</sup> The retail spread as measured against the deposit or loan rate versus the money market or swap rate still came to 6 percentage points in 2003 (euro area: 3 percentage points), a considerable margin notwithstanding the higher risk.

In retrospect, market developments actually met all of these expectations. Not only did the economies of these countries boom for years, but the financial market also developed at a greater-than-expected speed. As a case in point, loans and deposits roughly quadrupled in the above-mentioned countries between 2000 and 2008.

The use of banking products has likewise changed dramatically. In 2000, only 70% of the population in the CEE-5 had a bank account, which contrasts with almost 100%, e.g. in Slovakia and the Czech Republic as at year-end 2008. But even in SEE, product penetration has increased substantially since then, e.g. from 19% to 43% in Bulgaria and from 34% to 52% in Romania.

<sup>4</sup> See Bruckbauer (2004).

<sup>5</sup> The Czech Republic, Hungary, Poland, Slovenia and Slovakia.

<sup>6</sup> Bulgaria, Romania and Croatia.

<sup>7</sup> See Bruckbauer (2004).

### 3 Austrian Banks' Strategy

Against the backdrop of the recent financial crisis, Austrian banks are sometimes admonished for having taken on too great a risk with their CEE activities. Yet, their investments in the region basically tie in with the phases described above.

#### 3.1 Market Entry: Greenfield Investments Followed by Privatization

Austria's banks may well be called pioneers in CEE. While individual banks already ran representative offices in several Eastern European countries before 1989, they did not offer banking services in those markets. Austrian banks already began to increase the number of representative offices in 1990, and wherever legally possible, established banks or joint ventures; these, however, catered more or less to corporate customers only. The client base thus consisted mainly of non-resident corporate customers or joint ventures, and retail banking was still in its infancy. With parent banks responsible for refinancing, retail deposits were non-existent or hardly significant, and neither retail customers nor SMEs featured in the market strategy. A few acquisitions of small and medium-sized banks (Tatra banka in Slovakia, Unicbank in Hungary, Nova Banka in Slovenia) notwithstanding, the lion's share of Austrian banks' investments in the early 1990s concerned greenfield projects.

The beginning of the privatization process changed the scene. Erste Bank, which entered the CEE market only in the mid- to end-1990s, took over savings banks in the Czech Republic and Slovakia, thus becoming one of the region's retail banking leaders. Investments in Hungary and later in SEE strengthened its presence in the region. But all the other Austrian banks participated in the privatization wave as well, not only in CEE but also in SEE, where they had yet to establish their presence. Purchasing large banks went hand in hand with a change in the investors' business philosophy, spurring a trend to a universal banking strategy by the late 1990s at the latest. Banks' focus consequently shifted from large corporate customers to retail customers, as the latter were considered to represent the growth market of the future.

#### 3.2 Geographical Expansion

Around 2000, banks' strategy for eastward expansion started to focus on SEE, with foreign investors zeroing in on the most densely populated country after Poland: Romania. Apart from Austrian banks, banks from Italy (Banca Intesa and UniCredit), Belgium and the Netherlands (ING) and Germany (HypoVereinsbank) were bidding for SEE banking jewels.

The bidding contest boosted the prices of the banks up for privatization. While in the 1990s, the savings banks in the Czech Republic and Slovakia had changed hands for less than double their book value, in 2003, the Hungarian Postabank already went for an alleged 2.7 times its book value, still less than the 5.8-fold book value purportedly paid for the Romanian Banca Comercială Română.

In the mid-2000s, Austrian banks broadened their geographical focus further, seeking to expand into the CIS countries. The booming commodity and skyrocketing oil prices raised not only the attractiveness of the Russian market once again (after Austrian banks had suffered sizeable losses there in 1998), but also the investment profile of Ukraine, Kazakhstan and other countries in the area. High-

priced acquisitions followed (e.g. in Ukraine, Ukrsotsbank went for an alleged 5.2 times and JSCB for an alleged 4.7 times their book values).

### 3.3 Drivers of Austrian Banks' Investments

In their investment activities, Austrian banks were also driven by forecasts of market growth and return expectations (see above). Yet, a number of additional factors came into play.

The fact that Austria shares a border with four countries in CEE (1) fostered a very early and broadly-based (including small banks) market entry, (2) helped set up the client base during the early years, as many Austrian companies invested in the region, and (3) went hand in hand with intercultural understanding.

Small market volumes and high concentration were another incentive. In 2000, banking assets in the CEE-10 and Croatia totaled EUR 287 billion, which equaled 1.7% of euro area banks' total assets or about 50% of Austrian banks' total assets. At some EUR 120 billion, even Poland's banking market only equaled Svenska Handelsbanken's total assets, and Romania's banking assets matched those of Raiffeisen Landesbank NÖ-Wien.

At the end of the 1990s, Austria's major banks had a presence in all CEE countries, but their market shares were small in general. The privatization drive then opened up the possibility of purchasing the branch network of the large state-owned banks and thus entering the profitable retail business. Because the dominant state-run banks in CEE were rather small in absolute terms compared with banks in the EU, Austrian banks, which are also small by international standards, were able to acquire relatively large market shares at a reasonable expense. As a consequence, Austrian banks focused their international business on Eastern Europe, even if this choice meant not being present in other (emerging) markets. Bank Austria, for instance, sold its very profitable participations in South America. All in all, compared with other countries, the Austrian banking sector was the most active player in the CEE privatization process.

As from the turn of the millennium, Austrian banks thus pursued a two-pronged expansion strategy in CEE. In pursuit of market leadership, buying was the first option, and if bids were unsuccessful, banks at least expanded their branch networks to gain market share and become a market leader. All the Austrian banks active in CEE consequently invested in the retail business, a high-growth segment.

Another factor behind Austrian banks' predominance in CEE was that EU accession also changed the banking landscape in Austria considerably. Over just a few years, namely from 1990 to 1996, the three large Austrian banks Creditanstalt, Länderbank and Zentralsparkasse were merged into Bank Austria Creditanstalt; the latter then merged with the German HypoVereinsbank in 2000 following a year-long privatization debate in Austria. In the wake of this merger, the CEE business of HypoVereinsbank was taken over by Bank Austria in 2001, which significantly drove up the bank's exposure in the region.

That is not all, though: Following UniCredit's takeover of HypoVereinsbank, Bank Austria was in charge of large parts of the group's CEE business, while e.g. the Polish subsidiary became a direct participation of UniCredit. These developments impacted the bank's acquisitions and disinvestments of the past years. In assessing investment risk, it was no longer Bank Austria's total assets alone but the activities of the entire group that had to be factored into the equation.

Last but not least, the relatively high business volumes and profits of CEE subsidiaries, which are high compared with those in the Austrian market, are also endogenous. As long as the CEE financial sector, 77% (CEE-10 and Croatia) of which are serviced by foreign subsidiaries, continues to grow at a much faster pace than its euro area counterpart, CEE-based subsidiaries automatically carry more weight in group balance sheets.

Total banking assets in the CEE-10 and Croatia grew from close to EUR 200 billion in 1995 to EUR 800 billion in 2007, i.e. by no less than 300%. The respective growth rate of 130% posted by Austrian banks over the same period pales in comparison. In other words, even if their market shares in CEE had remained unchanged, the CEE business share in Austrian banks' consolidated balance sheet would have increased substantially.

#### 4 Austrian Banks' Position in CEE after Twenty Years

In a nutshell, Austrian banks did not plan to amass such high exposures to CEE from the very outset. Things changed, however, as massive privatization got underway in CEE. It is no secret that in their pursuit of market leadership in the region, Austrian banks were also driven by rivalries at home.

Twenty years later, Austrian banks have come to play an outstanding role in CEE, with a market share in the region equaling a good 20% (excluding Russia). Austrian investment increased most sharply over the past few years. In 2004, Austrian banks' total assets in CEE came to almost EUR 100 billion (somewhat more if Russia is included). Until end-2007, that figure had swelled to about EUR 180 billion (or over EUR 200 billion including Russia), primarily on the back of the substantial growth of the region's financial sector in recent years. In the CEE-10 and Croatia, the banking sector grew by an average 22% per annum after 2004 (1995 to 2004: 9%), in Russia even by 45%, and Austrian banks' subsidiaries flourished accordingly.

Even though the CEE banking sector is still smaller than the Austrian market, the recent explosive growth impacted the ratio between Austrian banks' CEE and domestic business; it increased from 1:6.4 (2004) to 1:4.3 (2007). While they are not measures of profitability or risk, market shares may nevertheless be indicative. We find similar dimensions when we take a look at Austrian banks' exposure to CEE. International banks' combined claims on CEE amounted to EUR 1,186 billion in 2008. According to the Bank for International Settlements (BIS), Austrian banks account for EUR 200 billion of these claims. Once we also include Bank Austria and Hypo Alpe-Adria Bank, which are not classified as Austrian in the BIS figures, as they are majority foreign owned, the figure comes to an estimated EUR 300 billion, i.e. a quarter of the total volume of outstanding claims, which more or less reflects Austrian banks' market share in CEE. Local-currency funding activities of subsidiaries account for about 40% of international banks' total CEE exposure. Another almost 20% are attributable to subsidiaries' foreign-currency lending, while the remaining 40% relate to cross-border loans to banks and nonbanks. These proportions broadly apply to Austrian banks as well, only the subsidiary-related financing percentages are somewhat higher.

This is certainly a big stake for a country like Austria, whose market share in the euro area banking market is comparatively negligible at 4%. With their CEE activities, Austrian banks consciously participated in the enormous growth in the



region. And obviously – though this has never been part of the public debate – bank acquisitions with prices of four to six times the book value can only be profitable if investors assume a massive growth potential. High margins and cost savings by rationalization alone would not be sufficient. This implicit growth assumption also proved to be true in the years up to 2008, when the recent financial crisis put an end to this favorable trend.

Based on twenty-twenty hindsight, people wonder whether too much risk has been concentrated on a few countries or a region. As far as the CEE concentration risk is concerned, the question is whether one may still talk about a homogeneous region now that the transition process has largely been completed. For one thing, there are no distinct and pronounced transmission mechanisms that would trigger instant contagion in all CEE countries. For another, Austrian banks' share in the total exposure to some countries in CEE has unarguably become substantial; this is particularly true vis-à-vis the Czech Republic, Hungary, Romania and Slovakia.

Returns on these investments generally developed favorably in the past years, with only the Russian crisis in 1998 inflicting sizeable losses on two Austrian banks. Between 2004 and 2007, the nominal return on equity never fell below 10% in the CEE-10 and Croatia in any one country and any one year, and even clearly topped 20% occasionally.

According to the profit and loss reports Austrian banks submitted to the OeNB, since the year 2000 the return on shares in affiliated enterprises alone, which is traceable primarily to distributed profits (excluding reinvested earnings) from CEE activities, has added up to a total of EUR 15.7 billion. The OeNB time series also shows that over the past years part of the CEE-based subsidiaries' profits was retained. Earnings from shares in affiliated enterprises gradually climbed from EUR 1 billion in 2000 to about EUR 2.2 billion in 2007; in 2008, this figure more than doubled to EUR 5.4 billion. In other words, parent banks repatriated profits they had hitherto reinvested in CEE, most likely also to make the relevant risk provisions in their group balance sheets.

Having said all this, Austrian banks' CEE activities have clearly been a success to date. The current financial crisis has doubtless presented Austrian banks with a formidable challenge. You have to hand it to the banks, though, that they did not capitalize on dubious financial innovations in international markets, but instead helped build up a banking sector and foster lasting values in CEE. Let us not forget, it is not Central and Eastern Europe that poses a threat to the financial sector, but rather it is the global financial turmoil, to which neither CEE nor Austria are immune.

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# Two Decades of East-West Integration in Review

# Macroconvergence in CESEE

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Julia Wörz<sup>1</sup>

The fall of the Iron Curtain revealed large differences between East and West in institutional, legal but also economic terms, which had built up over almost four decades of separation. Two decades after this event, we have witnessed an impressive catching-up process, which has resulted in considerably decreased income differences – albeit after an initial deepening of these differences due to the immediate post-transformation recession. This process was further characterized by radical structural change in the East and almost complete institutional and legal harmonization between the former blocs. Europe has grown together again and the East-West distinction has become obsolete in many respects. In this article we review some of the major developments observed in the real economy sphere of the Central, Eastern and Southeastern European (CESEE) countries since the start of transition. One of the major characteristics is the closing of the income gap, which we outline in the first section. Not only have income differences narrowed between East and West over these 20 years, greater equality has also been observed in the enlarged EU since the accession of ten CESEE countries, a further sign of successful European integration. We then turn to several indicators of structural and institutional convergence, which show no notable differences between East and West after 20 years of transformation. Finally, we touch upon the impact of the current financial and economic crisis on the integration process.

## 1 Real Income Convergence during the Transition Phase

The fall of the Iron Curtain 20 years ago implied tremendous disruptions for the formerly centrally planned CESEE economies. At the beginning, real incomes in those countries fell and living standards deteriorated immediately after the long-awaited and deeply desired opening up to the Western market economies.<sup>2</sup> As can be seen from chart 1, the bottom was reached in 1992. After three years of real income losses, a process of catching-up set in very rapidly. Between 1992 and 2007, the average real per capita income measured in 2005 purchasing power parities (PPPs) in today's ten CESEE EU Member States (EU-10)<sup>3</sup> rose continually from 37% to 52% of the level of the 12 initial euro area Member States (EA-12)<sup>4</sup>. As a comparison, per capita GDP in Portugal remained constant at 67% of the euro area level over the same period, while average incomes in Greece and Spain rose moderately from 72% and 82%, respectively, to 85% and 90% over the 15-year period. By contrast, average per capita income in the most successful cohesion country, Ireland, rose from 74% to 130%.

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<sup>2</sup> The loss in real income was sometimes substantial; see Landesmann's contribution "Twenty Years of East-West Integration: Reflections on What We Have Learned" in this issue.

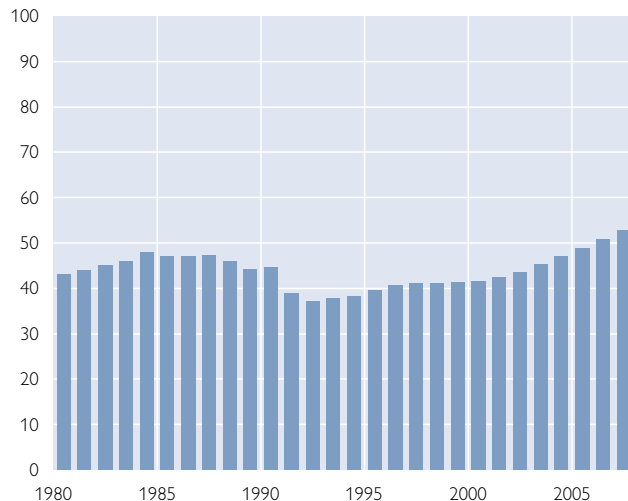
<sup>3</sup> Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

<sup>4</sup> Belgium, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

Chart 1

**GDP per Capita of the EU-10**

as a percentage of the EA-12 in PPPs



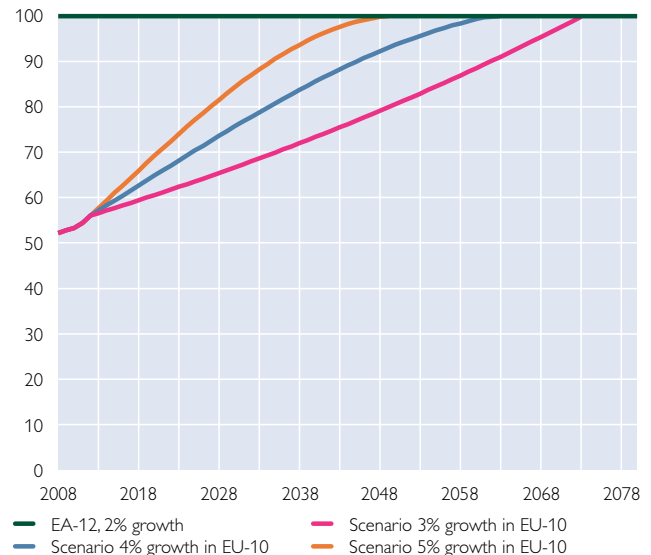
Source: World Development Indicators 2009.

Note: EU-10: BG, CZ, EE, LV, LT, HU, PL, RO, SI, SK; EA-12: BE, DE, IE, GR, ES, FR, IT, LU, NL, AT, PT, FI.

Chart 2

**Convergence Simulations for the EU-10**

as a percentage of the EA-12



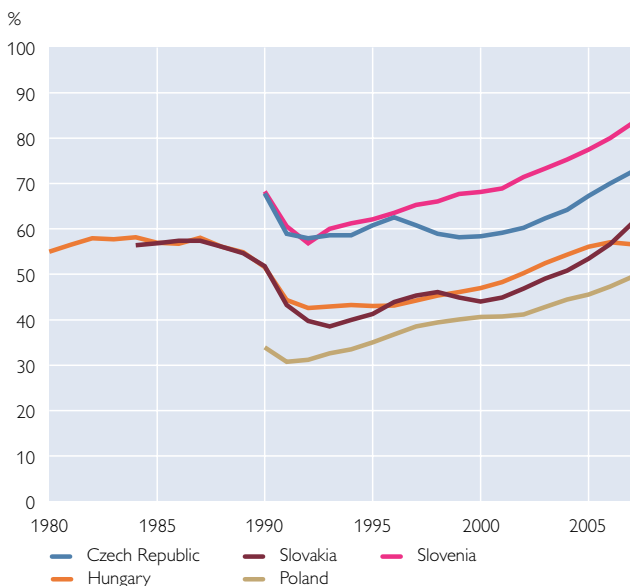
EA-12, 2% growth  
 Scenario 4% growth in EU-10  
 Scenario 3% growth in EU-10  
 Scenario 5% growth in EU-10

Source: Authors' calculations.

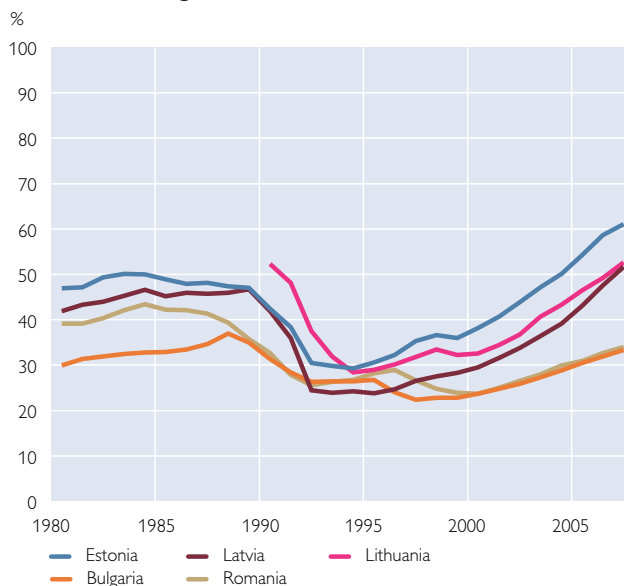
Despite this impressive catching-up performance, there is still considerable potential for convergence. The long-run impact of the current economic and financial crisis on this process remains an open question. Provided that the growth differential – albeit diminished in the short run – remains positive throughout the turbulent times, the crisis will delay the convergence process only marginally. The simulations in chart 2 are based on IMF projections (IMF, 2009) until 2015 and on three different assumptions concerning the average growth differential between the EU-10 and the EA-12 (which we keep as a fixed aggregate) beyond this date. The dates for reaching full convergence depicted above are purely hypothetical and are based on three different catching-up scenarios: In our most pessimistic scenario, the growth differential remains squeezed to only 1 percentage point after the financial crisis that began in 2008. We further assume an annual deceleration parameter which leads to a slowdown in the speed of convergence every year. In the most pessimistic scenario, this parameter is set at a very low level, which implies a reduction in the growth differential of 0.001 percentage points every year. In the moderate scenario, we assume a long-run growth differential of 2 percentage points and an annual reduction of 0.033 percentage points. Finally, in the most optimistic scenario we project that the 3 percentage point growth differential of the past five years will reemerge after the crisis, with an annual deceleration of 0.077 percentage points. This would lead to full convergence within approximately 40 years, which may seem a long time. However, it must be kept in mind that the benchmark – i.e. average income in the EA-12 – will also rise over this period, so that convergence will occur at a higher income level than today. Further, the scenarios depict the convergence of the EU-10 average. Given the large differ-

### GDP per Capita of the EU-10 as a Percentage of the EA-12 in PPPs (1980–2007)

#### CEEC-5



#### Baltic States, Bulgaria and Romania



Source: World Development Indicators 2009.

ences within this group, some countries will of course reach the benchmark considerably sooner and others later.<sup>5</sup>

Of course, such figures mask considerable differences between individual countries, which have been witnessed in the past (chart 3). Slovenia already started from a per capita income level of 60% of the EA-12 average in the early 1990s, and overtook one of the initial euro area countries, Portugal, in 2002. The Czech Republic, starting from a somewhat higher level, followed suit in 2006. Apart from these two instances, average income levels in the EU-10 remained below those of the EA-12 countries in 2007, ranging from 33% of the EA-12 mean in Romania to 83% in Slovenia. The timing of the catching-up process also varied substantially between individual countries. It began in the CEEC-5 (the Czech Republic, Hungary, Poland, Slovakia), and even within this narrow group very different dynamics were observed with respect to the growth performance. In the Baltic states, the turnaround to positive growth rates occurred in the mid-1990s, followed by extremely high growth rates and thus a steep convergence process. Unfortunately, the Baltic countries also became an example of the very narrow borderline between a steep convergence process and an overheated economy, as growth rates proved to be unsustainably high and triggered a deep

<sup>5</sup> Given the high uncertainty about such long-run developments, the literature is rather silent on this issue. Using sophisticated econometric techniques, Hlouskova and Wagner (2005) estimated a convergence time varying between 9 and 71 years, depending on the country, to reach 80% of the average per capita income level of the EU-14 (the EU-15 without Luxembourg) based on a mean growth differential ranging from 1.8% to 1.3%. Recently, Lein, Leon-Ledesma and Nerlich (2009) estimated in a simple manner a convergence period for the EU-9 as a group (Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Slovakia) of between 10 and 32 years, depending on assumptions concerning the annual catching-up rate, i.e. the percentage rate at which the gap in per capita GDP between the euro area and the EU-9 is expected to shrink. This rate is set to range between 3% and 7%.

recession even before the current global crisis. Bulgaria and Romania showed no signs of convergence until 1997 and 2000, respectively. Since then, the growth performance of these two “EU latecomers” has been in line with that of the CEEC-5.

## 2 Further Evidence of Convergence

The economic and legal integration of two initially distinct economic systems implied a rather high degree of inequality in Europe immediately after the beginning of the transformation process. Chart 4 illustrates the flip side of the rapid catching-up process, namely the dispersion of per capita incomes across European countries since 1995 (after the effects of the post-transformation recession had largely been overcome). In other words, in this section we examine inequality between countries in Europe.<sup>6</sup> In analogy to the economic growth literature, a reduction in national inequality can be referred to as evidence for “sigma-convergence.” We have found clear evidence for the closing of the average income gap between the EU-10 and the EA-12 (which corresponds to “beta-convergence” in the economic growth literature). This convergence in means is corroborated by a reduction in the variance of per capita income levels across individual countries, a process which can be observed for the enlarged EU, as indicated by the falling line for the EU-27 in chart 4. Inequality within the EU-27 has of course to date been driven most strongly by the large income gap between the eastern Member States and all other Member States (including the southern ones). However, these differences have narrowed, particularly in 2000, after the recessions ended in Romania and Bulgaria, and again in 2005 following the EU enlargement round.

It is often stressed that the EU-10 are not a homogeneous group of countries. Indeed, the data underline this. Inequality between countries in the EU-10 is much higher than within the EU-15<sup>7</sup>. Further, we see an initial increase in inequality within the EU-10 in line with the different catching-up dynamics outlined in the previous section. Up until 1999, inequality between the eastern Member States rose, and started to decline only thereafter. The recent reduction in cross-country inequality has been quite pronounced, so that the EU-10 countries are now again more homogeneous than the enlarged EU as a whole. This development suggests that formal integration into the EU has promoted convergence further by helping those countries which were lagging behind to grow more rapidly.

Convergence is, however, observed not only in real terms, but also nominally. The right-hand panel of chart 4 complements the picture by showing the concurrent trend toward price level harmonization. Average price levels have converged much faster toward those in the EA-12 than real incomes, and the process has accelerated since the enlargement round in 2004, reflecting again the reinforcing effect of institutional integration on the convergence process via, for example, common rules, common price-setting behavior and open borders.

All this suggests that accession to the EU helped smooth out income gaps between the EU-10 countries. To be fair, one should mention that the EU enlarge-

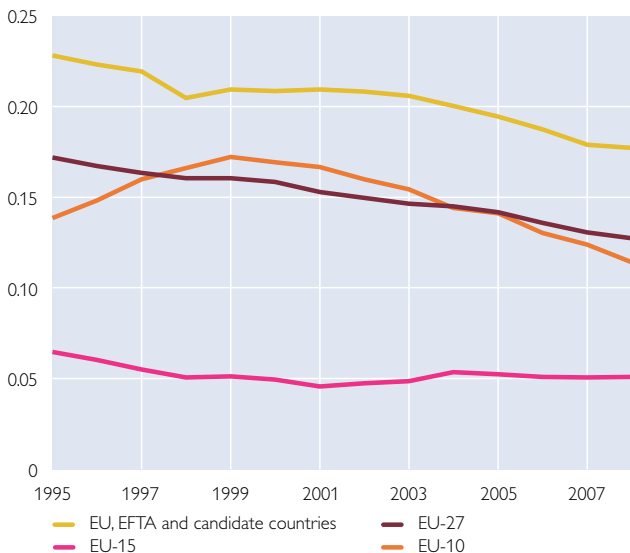
<sup>6</sup> “National” inequality measures the variation of incomes at the country-wide level, while “regional” inequality refers to the distribution of incomes within countries. The developments in regional inequality, i.e. real income differences between individuals or regions within each country, are discussed in Landesmann’s contribution in this issue.

<sup>7</sup> Belgium, Denmark, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom.

### Income and Price Convergence

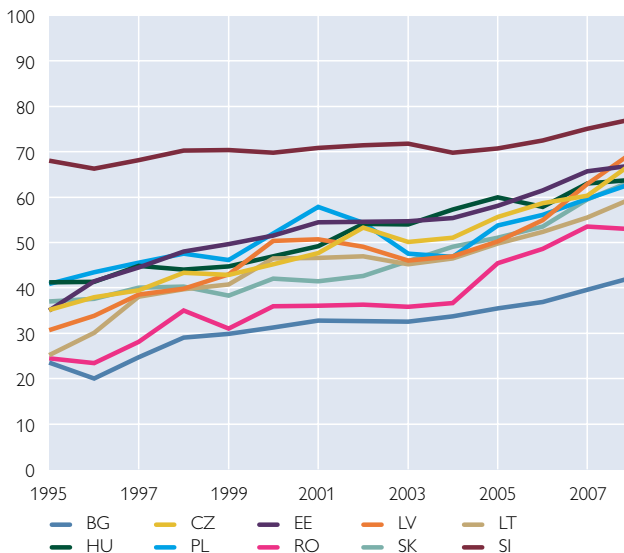
#### Gini Index for Inter-Country Inequality Based on per Capita GDP

Scale: 0 (total equality), 1 (maximum inequality)



#### Comparative Price Level Index for GDP

EA-12 = 100



Source: OeNB, Eurostat.

ment process coincided with ongoing globalization, and that it is difficult to disentangle the effects. In any case, the increased mobility of capital and labor supported equalization, as did the termination of the relatively strict East-West orientation of trade, foreign direct investment (FDI) and even infrastructure. All these developments helped overcome income differences, leading to a rather homogeneous economic area, which benefited all countries.

Another aspect of the catching-up process is the relatively fast wage convergence, which – among other factors – has kept migration within bounds. The above-mentioned income differences clearly exceeded those prevailing in countries of former enlargement rounds (up until 1995), representing strong incentives to migrate. On the other hand, convergence in per capita GDP and wage levels was also faster in the 2004 and 2007 enlargement rounds; in addition, transport costs declined considerably following enlargement. Along with temporary restrictions, all these factors explain why lower-than-expected migration flows into neighboring EU-15 countries were observed, and why migration into the U.K., Ireland, Spain and Italy was higher than expected. The number of foreign residents from the EU-10 in the EU-15 increased from 1.6 million to 3.8 million between 2003 and 2007, with 80% of the migrant population originating from Poland or Romania (Brücker and Damelang, 2009). The erosion of monetary migration incentives through the fast catching-up process, together with the recent global crisis, will reduce immigration from the EU-10 and promote return migration in the short run (Brücker, Damelang and Wolf, 2009). The robust growth performance of Poland in 2009 has in particular inverted the incentives for migration and triggered substantial return migration by Polish nationals.

### 3 Structural Convergence and Institutional Reform Progress

Real convergence comprises more than just catching up in terms of income levels: Adjustments to common economic structures are equally important, as is the development of appropriate institutions and the adoption of best practices in terms of regulations, legal frameworks and corporate governance (see, for example, ECB, 2002). In this section, we briefly review the progress observed in the EU-10 with respect to these issues over the past two decades.

The impressive growth performance of the EU-10 is grounded in substantial structural change, which was triggered by the transformation shock. While economic structures – very broadly speaking – have remained rather stable in the western countries, the share of agriculture in total value added has decreased in the EU-10, and the share of services has increased notably. Especially in the first years of transition, deindustrialization was very pronounced and a consequent restructuring toward services occurred, leading to structural convergence between the two regions.

Also at the more disaggregated level, we find strong evidence for the greater structural similarity between the EA-12 and the EU-10 toward the end of the transition period. According to data from the EU KLEMS database (Timmer, O'Mahony and van Ark, 2008), the manufacturing sector accounted for only 12% of total value added in the EU-10<sup>8</sup> in 1995 compared with around 20% in the EA-12. By 2005, this share had risen to 26% in the EU-10 and remained stable in the EA-12. While the manufacturing sector has gained strongly in importance, sectors such as utilities and construction have declined. Many service sectors, such as wholesale and retail trade, hotels and restaurants, and real estate, renting and business services, have gained in importance. There is still a gap to fill with respect to the globally most dynamically evolving category of business services. The increase in the EU-10 from only 1.6% of total value added for this sector in 1995 to 11% ten years later is notable. In the EA-12 this share lies at around 20%. To sum up, economic structures have remained rather stable in the EA-12, while the EU-10 countries have seen a substantial amount of structural change, becoming structurally more similar to the EA-12.

Over the past two decades, economic integration between Eastern and Western Europe and the establishment of production networks spanning across countries in the enlarged EU have proceeded at an increasing pace, with positive effects for both sides arising from the potential for increased specialization and thus the realization of economies of scale. As a consequence, the openness of the EU-10 has increased dramatically. In the decade up to 1989, their ratio of exports and imports to GDP rose from 34% to 39%, while the same ratio remained rather stable at 53% in the EA-12. Immediately after the fall of the Iron Curtain, the EU-10 countries became more open than their Western European counterparts. In 1990, the trade-to-GDP ratio jumped to 65% and rose further to 116% by 2007, compared with an increase to only 80% for the EA-12. Given their generally smaller size, a higher degree of openness was to be expected for the EU-10 countries, but the difference, and in particular the speed at which it occurred, is nevertheless impressive. Skyrocketing growth in imports and exports was not only the result of

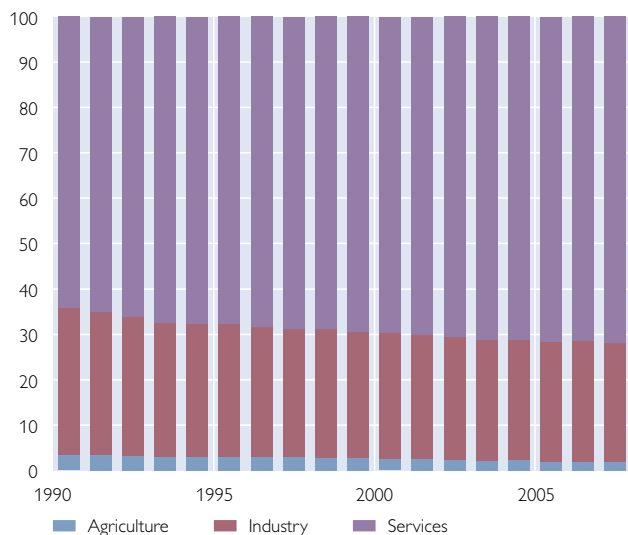
<sup>8</sup> Bulgaria and Romania are excluded from these calculations since they were not included in the EU KLEMS database.



### Structural Change: Shares of Sectors in Value Added

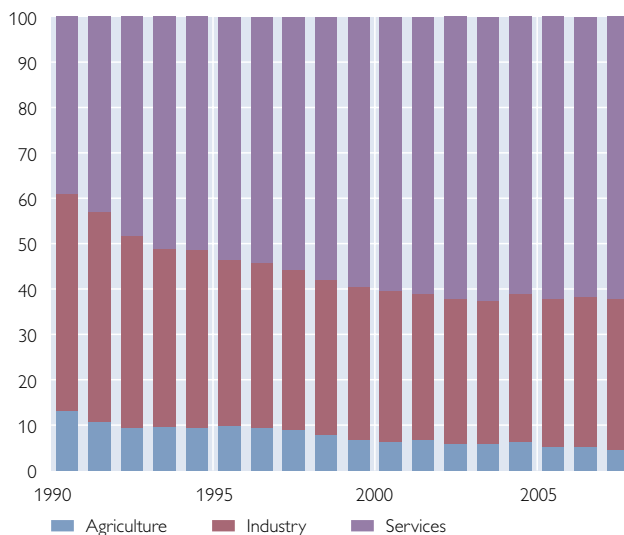
#### EA-12

% of total value added



#### EU-10

% of total value added



Source: World Development Indicators 2009.

investment decisions. It also reflected new possibilities for private consumption, as households were overwhelmed by the variety (and the availability) of consumer goods. This development was not only spurred by increased income levels (and decreased unemployment rates), it was also enhanced by the widespread availability of consumer credit.

The rapid and comprehensive economic integration is partly a result of the concurrent global trend toward increased international fragmentation of production chains. Nevertheless, integration has been particularly pronounced between Western and Eastern EU Member States owing to the massive flows of FDI that have taken place since the very beginning of the transition. Already by the end of 1990, almost all countries had passed privatization laws and accompanying legislation encouraging FDI inflows into Eastern Europe. At the beginning, FDI was mostly concentrated in the manufacturing sector, but it soon started to be directed toward services, in particular communication and financial intermediation. The contribution of FDI to subsequent economic growth is manifold and substantial. Foreign capital financed to a considerable extent the catching-up process, but in addition to providing financial means for investment, it also made possible important technological and knowledge spillovers, which were vital for the catching-up process.

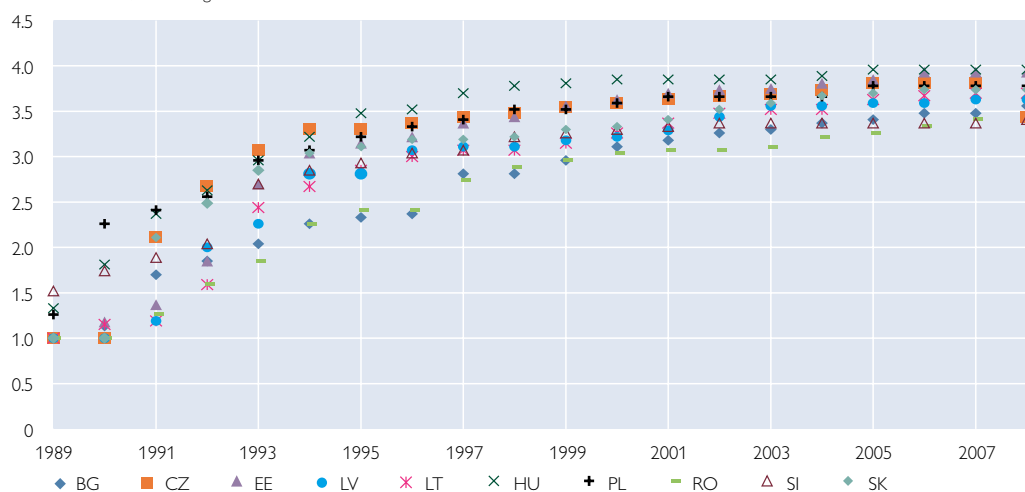
There is evidence that the productivity gains, which are reflected in per capita GDP growth rates of 4.2% on average over the period 1995 to 2008 (and as much as 5.5% on average since accession in 2004), have to a large extent been brought about by quality improvements (see Dulleck et al., 2005; Landesmann, 2003). Thus, the catching-up process has not been based solely on the price competitiveness of these countries, but has been accompanied by a successful shift toward increased quality in the goods produced and in the underlying production processes.

Far-reaching developments have also been observed in institutional terms in the CESEE Member States. The transition indicator constructed by the European Bank for Reconstruction and Development (EBRD) shows two important developments: First of all, the transformation to an “ideal” market economy is very advanced, according to the overall transition score, which is taken as the average over all categories (large- and small-scale privatization, enterprise restructuring, price liberalization, trade and foreign exchange system, competition policy, banking reform and interest rate liberalization, securities markets and nonbank financial institutions, and overall infrastructure reform). Second, a process of institutional convergence can be observed within the region. The initially rather large differences with respect to institutional performance were on average greatly reduced by the end of the 1990s. Some differences prevail in individual components of this overall transition score, in particular with respect to infrastructure (mostly road infrastructure), competition policy and probably also environmental issues, although the latter are not explicitly measured by EBRD transition indicators. There is still a relatively high degree of catching-up potential in some countries with regard to environmental issues. This comes as no surprise, as reaching these goals is costly and time-consuming, and private-public partnerships have proven to be complicated even under much more favorable circumstances. On the other hand, the transition can be regarded as having been complete throughout the region since the late 1990s with respect to small-scale privatization, price liberalization as well as the trade and foreign exchange system as defined by the EBRD.

Chart 6

### Average Transition Score, EBRD Indicator (1989–2008)

Index: 1 = lowest; 4.33 = highest



Source: EBRD.

## 4 Outlook

Over the past 20 years Europe has witnessed impressive progress toward economic integration. After four decades of radically different economic regimes in East and West, Europe has grown together quite impressively in only two decades since the fall of the Iron Curtain and the start of transition toward modern market-

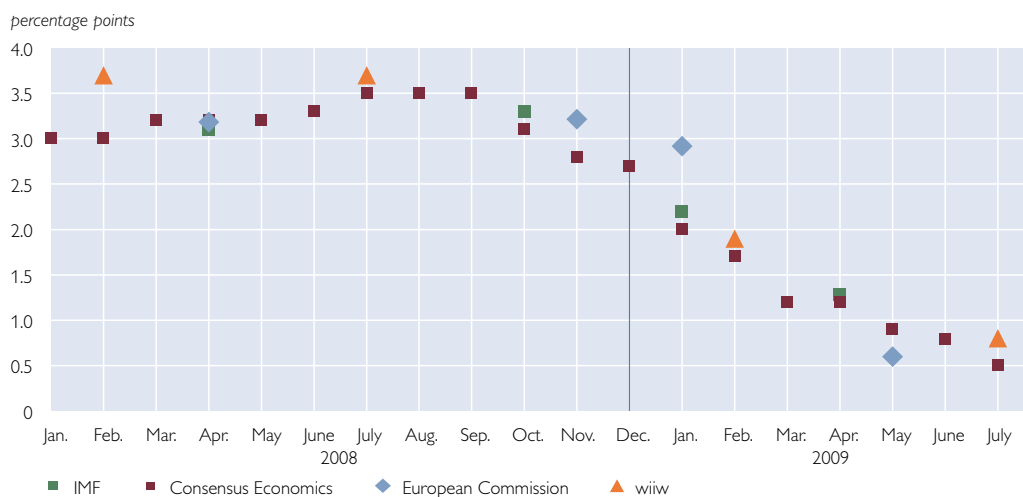
based economies by the formerly centrally planned economies in the East. This is reflected in income convergence in terms of average income levels as well as – to a smaller extent – in terms of intraregional income dispersion.

The catching-up process has encompassed a variety of aspects and has manifested itself in structural convergence at the sector level, increased trade and FDI integration, improved infrastructure, greater regulatory and legal homogeneity and the adoption of best practices with respect to the setup of institutions and corporate governance. This rapid progress in institutional reform has not yet been mirrored by equal progress in income convergence. For some countries, income convergence is still lagging substantially behind, but the progress in institutional and legal reform and improvements in the business environment provide a sound basis for income convergence to follow.

The economic and financial crisis will certainly affect the convergence process to some extent, either in a transitory manner, by delaying the catching-up process, or permanently, if potential output moves in opposite directions in East and West because of the crisis. In the wake of the global crisis, growth differentials between East and West are likely to have been eroded. This has been reflected in the growth projections with a certain delay. Chart 7 shows how, starting in spring 2009, the large positive growth differentials between the EU-10 and the euro area projected for 2009 were reduced from above 3 percentage points to below 1 percentage point.

Chart 7

**Projected GDP Growth Differential between the Euro Area and the EU-10 for 2009**



Source: IMF, Consensus Economics, European Commission, wiiw.

However, the catching-up process will continue when the crisis has eased, as the factors triggering this process are still in place: The continued income gap implies that the region is to be considered a catching-up region for some time to come; the newly created institutions and legal frameworks are functioning well (and will even improve further, as the European Commission has made this a precondition for further structural funding); and former restrictions on the free movement of goods, capital and labor have not been revived. In addition, the crisis

may even have helped in some cases (e.g. in the Baltic states), as the reality of a hard landing meant that very popular but unsustainable policies had to be changed into more reliable ones. And although short-run forecasts are still gloomy and adjustment costs high, it is very unlikely that the catching-up process will be put on hold forever or even reversed.

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# Austria's Economic Activities in CESEE

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Klaus Vondra<sup>1</sup>

## 1 Introduction

The development of the Austrian economy in the last two decades was determined by two major political events: the fall of the Iron Curtain in 1989 and Austria's accession to the European Union in 1995. Both events caused a major reorganization in the Austrian economy, which was aimed at improving the country's competitiveness in international markets especially during the opening of markets in the EU and the Central, Eastern and Southeastern European (CESEE)<sup>2</sup> countries. The following data<sup>3</sup> clearly highlight the success of this reorganization: While real Austrian GDP grew by 59% from 1989 to 2008, real goods exports (services) recorded a growth of 246% (106%). With export growth exceeding import growth, Austria's trade balance has been positive since 1998 (2008: 4.7% of nominal GDP). Nominal foreign direct investment (FDI) to the euro area went up by more than 1,600% between 1990 and 2007. Starting almost from zero, nominal FDI to CESEE countries even posted a growth rate of 12,500%. These developments have been frequently analyzed and discussed in the literature (e.g. Wolfmayr, 2004, for exports; Hunya, 2008, and Sieber, 2006, for FDI). The overall macroeconomic growth and employment effects in Austria are also widely discussed (e.g. Breuss and Schebeck, 1998, or Breuss, 2006).

This article provides a short review of the main economic effects the opening of the CESEE markets had on Austria up to 2008. It is structured as follows: Section 2 discusses the development of Austrian exports and section 3 that of Austrian FDI flows to CESEE countries. Section 4 describes the overall growth and employment effects in Austria that can be attributed to the closer economic links between Austria and the CESEE countries. Section 5 concludes.

## 2 Austria's Exports to CESEE Countries

The trade relations between Austria and the CESEE countries, which have a long historical tradition, have undergone a distinctive boost since 1989. However, the history of Austrian goods exports to CESEE can by no means be described as a linear process. To understand the huge increase of Austrian exports to CESEE over the last 20 years, we have to consider the influence of both economic and political factors as well as different historical developments. For the period between 1955 and 1989, the history of Austrian exports to Eastern Europe can roughly be divided into three phases (see Ragacs and Vondra, 2009). First, the ten years between the end of World War II and the ratification of the Austrian State Treaty were dominated by reconstruction activities. While, in 1937, 33.4% of Austrian exports had gone to the countries of the former Austro-Hungarian

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<sup>2</sup> There is no consistent definition for the region generally referred to as Eastern Europe. In this article the terms "Eastern Europe" and "CESEE countries" refer to countries which had been members or associates of the former Council for Mutual Economic Assistance (except Cuba, Vietnam and East Germany after reunification) and their successor states unless stated otherwise in the text.

<sup>3</sup> GDP and export data were provided by Statistics Austria. For figures on FDI (excluding special purpose entities and investment in private real estate) stocks, see www.oenb.at (Statistics and Reporting). Data on stocks are available for the period from 1990 to 2007. Except for employment, flow data are available up to the second quarter of 2009 but are not directly comparable with stock data. For a detailed analysis of both data types, see OeNB (2009).

Empire, this rate declined to 19.6% in 1947 and to 11.3% in 1955 (Stankovsky, 1998, p. 675). Second, in the 20 years following the signing of the State Treaty, Austrian exports to Eastern Europe strengthened again. During this time, trade relations were influenced by the demand monopoly of Eastern European governments and, therefore, also by the political and economic environment (Stankovsky, 1967). Third, from 1975 to 1989, the Austrian export share to CESEE clearly diminished. This decline was attributable to the Eastern European strategy of debt-financing the access to high-technology products, which turned out to be unsustainable (Fidrmuc et al., 2008, p. 469).

The last 20 years of trade relationships between Austria and CESEE were characterized by a massive expansion, with Austrian exporters quickly turning historical ties and geographic position into competitive advantages.

In the following, we will focus on the period from 1989 to the present. The rapid increase in the trade share of nominal goods exports to the CESEE countries in this period is shown in the left-hand panel of chart 1.

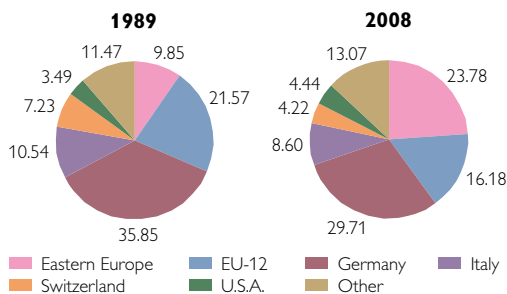
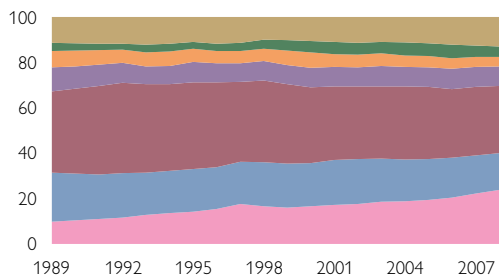
While in 1989, the share of Austrian exports to the CESEE countries amounted to only 9.8%, it went up to 23.8% by 2008. This rise took place at the comparative expense of exports to the old EU countries and Switzerland. In the right-hand panel of chart 1, the export shares of different regions are plotted by goods classes,

Chart 1

## History and Structure of Austrian Exports

### Goods Exports to Target Countries or Regions

% of nominal overall goods exports

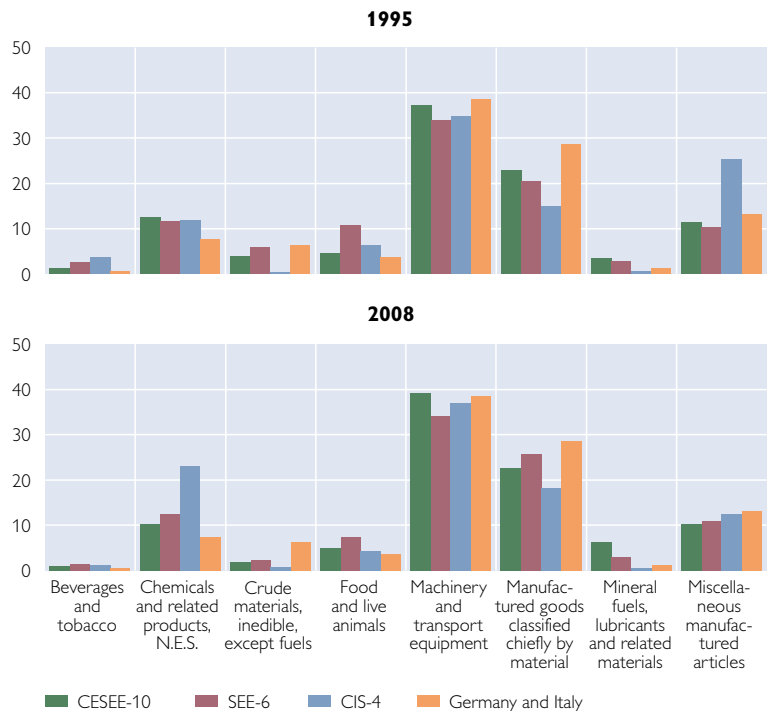


Source: Statistics Austria, OeNB, authors' calculations.

Note: EU-12: BE, DK, FI, FR, GR, IE, LU, NL, PT, ES, SE, UK. CESEE-10: BG, CZ, EE, HU, LV, LT, PL, RO, SK, SI. SEE-6: AL, BA, HR, MK, ME, RS. CIS-4: BY, MD, RU, UA. Eastern Europe: CESEE-10, SEE-6 without MK, CIS-4.

### Comparison of Export Shares of Selected Goods Relative to Total Exports to the Respective Region

%



comparing 1995<sup>4</sup> and 2008. The Austrian export industry is dominated by companies that produce and trade machinery and transport equipment. These exports account for almost 40% of Austria's total exports – a constant figure over the time horizon. Overall, the comparison of 1995 and 2008 reveals that the export structure did not change noticeably over time. However, there is a tendency toward exporting a bigger share of finished products (e.g. chemicals and related products) compared to basic materials (e.g. crude materials). Over the last two decades, the share of exports to CESEE in total Austrian exports more than doubled. Today the CESEE region – in its broadest definition – comprises 27 countries that differ with respect to size, stage of transition, current degree of development and many other factors. Therefore, it is useful to analyze the development of Austrian exports to this region for certain subsamples. Table 1 shows the shares and growth of exports to three distinct country samples: first, for Austria's four CEE neighbors, i.e. the Czech Republic, Hungary, Slovenia and Slovakia (CEE-4); second, for a broader set of CESEE countries; and third, for a sample including the CIS and Mongolia.

Table 1

### Export Shares and Export Growth (Goods, Nominal) of Selected Country Aggregates

	Exports in % of total exports				Export growth			
	1989–1993	1994–1998	1999–2003	2004–2008	1993–1998	1998–2003	2003–2008	1993–2008
	Period averages				%			
CEE-4	5.6	10.0	10.5	10.7	112.7	38.7	62.6	379.8
CESEE-10	2.2	3.8	5.0	7.1	172.7	85.3	108.9	955.7
CIS+MN	0.7	1.8	1.7	3.2	47.8	110.4	168.2	734.4
CESEE-27	8.4	15.6	17.2	21.0	113.2	56.4	90.6	535.8
<b>Total exports</b>	–	–	–	–	<b>65.8</b>	<b>40.1</b>	<b>48.7</b>	<b>245.6</b>

Source: Statistics Austria.

Note: CEE-4: CZ, HU, SK, SI<sup>1</sup>.

CESEE-10: AL, BA<sup>1</sup>, BG, HR<sup>1</sup>, EE<sup>1</sup>, LV<sup>1</sup>, LT<sup>1</sup>, PL, RO, RS (before 2006: YU).

CESEE-27: CEE-4, CESEE-10, CIS+MN;

CIS: Commonwealth of Independent States<sup>1</sup>.

<sup>1</sup> For these countries and aggregates, data are only available from 1992 onward.

The CEE-4 countries have always been the most important export markets for Austria, with around half of total exports to the whole region going to these countries. At the same time, Austria stepped up exports to countries beyond the CEE-4 at an above-average rate. This can be seen in both export shares and export growth. Moreover, export growth figures reveal that Austrian exporters focused on countries close to Austria at first and began to pay more attention to the other countries in the region only during the last few years.

### 3 Austria's Foreign Direct Investment in CESEE

Austria's strong ties with the CESEE countries are even more evident from FDI data. The considerable increase in Austrian FDI into these countries helped improve the historically very low overall Austrian FDI activity. In 1990, Austria's overall outward FDI stocks amounted to only 2.8% of GDP (inward FDI: 6.4%).

<sup>4</sup> For many CESEE countries, these data have only been available since 1995.



Over the last two decades, both ratios went up considerably and in 2007 outward FDI reached a 37.9% share in GDP (inward FDI: 39.9%); hence, both ratios now exceed the world averages in FDI (OeNB, 2009, p. 8).

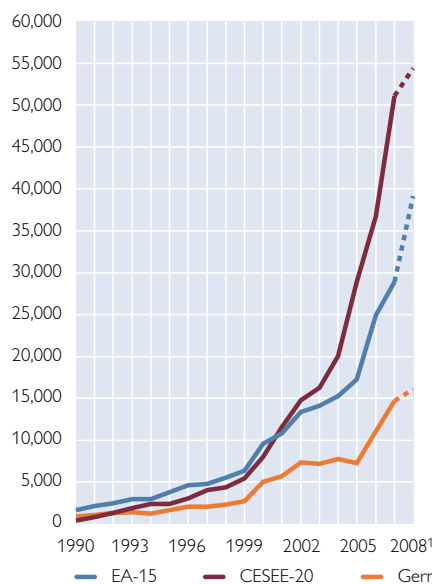
The left panel in chart 2 shows the enormous increase of nominal Austrian FDI between 1990 and 2007. Extrapolations of the 2007 FDI stock data for 2008 (based on 2008 FDI flow figures) indicate increasing overall FDI expenditures even for 2008 (see the dotted lines in the left and central panels of chart 2). Since 1993, Austrian FDI to the CESEE countries has outperformed Austrian FDI flows to Germany and, since 2001, Austrian FDI to the euro area as a whole. When we look at the change in the relative importance of target regions for Austrian FDI since 1990 (central panel in chart 2), the significance of the CESEE countries is even more striking. Starting at 10% of total FDI in 1990, the share of Austrian FDI to CESEE went up to nearly 50% in 2007. Over the same time horizon, the relative importance of Austria's FDI to the euro area decreased from about 45% in 1990 to less than 30% in 2007. The third panel in chart 2 shows the staff numbers of Austrian direct investment enterprises abroad, broken down by target regions. Starting from figures close to zero, Austrian direct investment enterprises predominantly generated employment in the CESEE countries. In 2007, a total of 573,300 persons were employed by Austrian direct investment enterprises, of which close to 407,900 (71%) in the CESEE countries (OeNB, 2009, p. 14). However, Austrian FDI also creates jobs in Austria. "A comparison of Austrian direct investors' employ-

Chart 2

### Development of Austrian FDI and of FDI-Induced Employment in CESEE

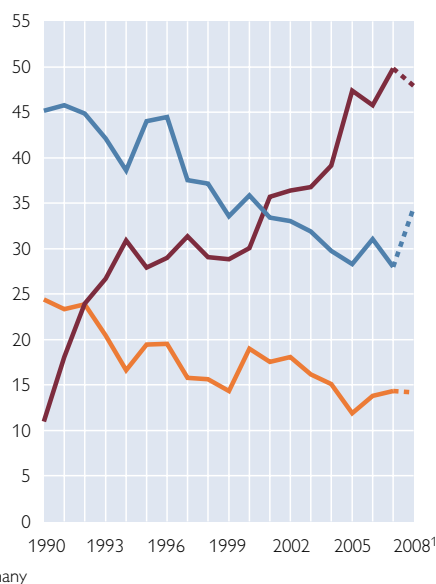
#### Austrian FDI to CESEE, the Euro Area and Germany

EUR million



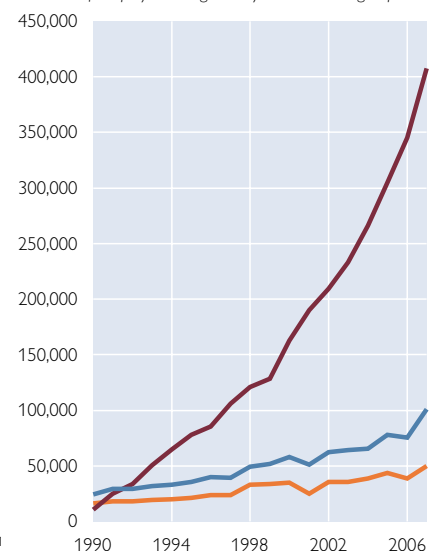
#### Austrian FDI to CESEE, the Euro Area and Germany in % of Total Austrian FDI

%



#### Employment in Austrian FDI Target Countries

Number of employees weighted by share in voting capital



Source: OeNB.

<sup>1</sup> 2008: Extrapolation based on FDI flow figures.

Note: EA-15: BE, DK, FI, FR, DE, GR, IE, LU, NL, PT, ES, SE, UK, SK, SI (since 2007).

CESEE-20: AL, BY, BA, BG, HR, CZ, EE, HU, LV, LT, MK, MD, ME, PL, RO, RU, RS, SK, SI, UA.

Double counting for Slovenian FDI since 2007. Both FDI stock data and employment data are available from 1990 to 2007.

ment figures at home and abroad shows that, for every 100 persons employed by the direct investor, another 152 are on the payroll of direct investment enterprises abroad” (OeNB, 2008, p. 17).

The reasons for the conspicuous increase of Austrian FDI are similar to those for the development of exports to the CESEE countries: Historical ties and Austria's geographic position have been transformed into competitive advantages. This also becomes evident from the fact that most of Austrian FDI has been invested in the CEE-4 and that Austria serves as the basis for many firms active in CESEE. Table 2 shows several FDI-specific indicators for CESEE as a whole, for selected countries and, for reasons of comparison, also for Germany.

Table 2

### Austrian FDI Stocks, Growth, Shares and FDI-Induced Employment in CESEE and Selected Countries

	FDI stocks (EUR million)		FDI growth		FDI in % of total Austrian FDI		Employment in target countries	
	1990–1998	1999–2007	1990–1998	1999–2007	1990–1998	1999–2007	1990–1998	1999–2007
	Period averages		%		Period averages		Period averages	
CESEE-20 <sup>1</sup>	2,290	21,432	970	832	25	39	63,902	249,705
Germany	1,564	7,638	159	438	20	16	21,483	37,126
Poland	139	2,546	3,050	518	1	5	3,464	21,856
Slovakia	170	2,044	45,400	658	2	4	3,616	26,012
Slovenia	190	1,115	790	276	2	2	2,371	7,502
Czech Republic	541	4,047	11,020	489	5	8	15,387	56,443
Hungary	1,095	3,797	396	344	13	8	35,453	54,941
Russia	35	1,256	-156	3,975	0	2	740	11,879

Source: OeNB.

<sup>1</sup> See definition in chart 2.

Note: Both FDI stock data and employment data are available from 1990 to 2007.

Employment: Number of employees in foreign firms weighted by share in voting capital.

The sharpest increase of Austria's total FDI to CESEE countries occurred in the period between 1990 and 1998, but even between 1999 and 2007, the increase remained very strong. In the period from 1999 to 2007, about 27% of Austria's total FDI was invested in the CEE-4 and in Poland. Russia has become comparatively more important for Austrian investors since 1999. In the Czech Republic and in Hungary, Austrian FDI generated even more employment than in Germany.

#### 4 Growth and Employment Effects of East-West Integration in Austria

The fall of the Iron Curtain had two major effects on Austrian external trade: On the one hand, Austrian firms were abruptly confronted with a larger market, which led to an increase in firms' profitability. On the other hand, Austrian firms found themselves in stronger competition, especially with low-cost countries, which forced them to improve efficiency. The overall effects of East-West integration on macroeconomic growth and employment in Austria have been analyzed in a multitude of studies. Table 3 presents a selection of estimated effects on GDP growth and employment.

The aggregate growth and employment effects are found to be positive in all studies on the topic, but the results vary markedly according to the simulated time

Table 3

**Growth and Employment Effects of East-West Integration in Austria**

Study	Analyzed effects	Time horizon	Effects on the Austrian economy					
			Average annual effect			Cumulative effect		
			GDP		Employment	GDP		Employment
			Percentage points		Thousands	Percentage points		Thousands
Breuss, Schebeck (1998a)	Opening-up of Eastern Europe	1989–1997	0.5	0.3	9.6	3.6	2.6	76.9
Breuss, Schebeck (1998b)	EU eastward enlargement	2002–2010	0.14	0.1	3.0	1.3	0.8	27.5
Breuss (2002)	Costs of delayed eastward enlargement	Six years	–0.13	n.a.	–1.3	–0.8	n.a.	–8.0
Breuss (2006)	Opening-up of Eastern Europe	1989–2003	0.5	n.a.	10.0	3.5	n.a.	77.0
Breuss (2006)	EU eastward enlargement	2004–2014	0.15	n.a.	n.a.	1–1.25	n.a.	3–28

period. As expected, the positive effects are stronger for time periods closer to the fall of the Iron Curtain. However, when analyzing the effects on specific sectors, the empirical results are rather heterogeneous. Using input-output tables, Falk and Wolfmayr (2006) showed in an analysis for seven EU countries (including Austria) that imports from low-wage countries also have significant negative employment effects in specific sectors, especially in manufacturing. In contrast, by estimating relative factor demands, Pfaffermayr (2001) found for a smaller country sample for the period from 1990 to 1996 that job creation by Austrian manufacturing firms in CESEE is complementary to domestic job creation.

## 5 Summary

This article presents the effects on the Austrian economy of 20 years of East-West integration. The fall of the Iron Curtain had a remarkably positive effect on the development of Austrian exports and FDI. Furthermore, even Austria's average macroeconomic growth performance was positively influenced, as was average employment both in Austria and in the CESEE countries. However, this does not imply that all economic sectors have benefited equally and that there have not been any adverse effects at all. Moreover, overall export and FDI growth rates to CESEE have been decreasing over time, for two main reasons: First, growth rates used to be exaggerated at the beginning of the transition process given very low initial growth levels. Second, as other competitors moved into the market, Austrian companies' first-mover advantage, which had been attributable to historical links and geographical vicinity, diminished and Austrian firms are now facing strong international competition. Finally, like all developed countries, Austria has been hit hard by the ongoing international crisis: In the first two quarters of 2009, total real exports of goods declined by 21%, and the FDI flow figures show a collapse of Austrian FDI activity. However, Austrian firms will be able to maintain their relative market position in the long run if the productivity gains that were triggered by the initial phase of Austria's EU membership and the opening-up of the CESEE countries will continue in the future.

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# The Monetary Integration of CESEE EU Member States: Achievements and Prospects

## 1 Introduction

This article reviews the process of monetary integration of the ten Central, Eastern and Southeastern European EU Member States (CESEE MS<sup>2</sup>) that joined the EU in 2004 and 2007.<sup>3</sup> We take briefly stock of the developments during the half decade since the 2004 enlargement. We then sketch current monetary integration plans, also featuring recent policy discussions against the backdrop of the global financial and economic crisis. Subsequently, we discuss the readiness of CESEE MS that have not become members of the single currency area yet (CESEE-8; i.e. the CESEE MS without Slovakia and Slovenia) to adopt the euro in the future. Finally, we conclude with some reflections on the future course of monetary integration.

Peter Backé<sup>1</sup>

To set the stage, let us recall that the monetary integration process in the EU is rule-based. When entering the EU, the CESEE MS undertook to strive for euro adoption by meeting the Maastricht convergence criteria. These prerequisites for euro area accession focus on macroeconomic stability (low inflation and long-term interest rates, a sound fiscal position and limited exchange rate movements) and must be fulfilled in a sustainable manner. Substantial structural and policy convergence before entering the single currency area is important to cope well with adjustment and stabilization challenges upon euro adoption (Papademos, 2004).

The exchange rate mechanism II (ERM II), a multilateral arrangement of fixed but adjustable exchange rates with central parities to the euro and fluctuation bands, is an important element of the monetary integration setup: Two-year participation in ERM II without devaluation and severe tensions is part of the exchange rate stability criterion. Though not subject to formal preconditions, ERM II entry is preceded by a consensus-building process of all parties involved to ensure that subsequent participation in the mechanism is smooth. To this end, major policy adjustments need to be undertaken prior to ERM II entry, and fiscal policy has to be on a credible consolidation path.

The European Commission and the ECB each prepare convergence reports every two years and, upon the request of a Member State, in the interim as well. These reports serve to inform decisions on euro adoption which are taken by the Council of the European Union, based on a proposal from the European Commission, after consulting the European Parliament and after discussion in the European Council.

<sup>1</sup> Oesterreichische Nationalbank, Foreign Research Division, [peter.backe@oenb.at](mailto:peter.backe@oenb.at). This article draws on Backé (2008) as well as on internal notes and valuable comments by Markus Eller, Sándor Gardó, Catherine Keppel and Josef Schreiner (all Foreign Research Division). Cutoff date: July 30, 2009.

<sup>2</sup> Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

<sup>3</sup> See also Tumpel-Gugerell's contribution "Challenges of Monetary Integration in CEE" in this issue.

## 2 The Record

Of the ten CESEE MS, Slovenia joined the euro area in 2007 and Slovakia followed two years later. Both countries had entered ERM II in 2004 and 2005, respectively.<sup>4</sup>

When reviewing past developments, it is instructive to compare the strategies of Slovenia and Slovakia in the run-up to euro adoption. The following stylized features stand out:

- Both countries stayed in ERM II for a relatively short period (two and two-and-a-half years, respectively, until they entered the euro area). While Slovenia kept its nominal exchange rate to the euro very close to the central parity during that period, the Slovak koruna appreciated strongly (two sizeable revaluations against the euro).
- On the fiscal front, Slovenia followed an incremental consolidation strategy, benefiting from a relatively good starting position, while Slovakia underwent several years of substantial fiscal restraint to bring budget balances in line with Maastricht requirements.
- Apart from the stabilizing effects of a stable exchange rate, Slovenia used tripartite mechanisms as well as some moral suasion and indirect tax policies to dampen inflation. In Slovakia, in turn, the exchange rate pass-through contributed to disinflation, although (according to empirical studies) to a lower extent than the size of the appreciation would suggest at first sight (namely by less than 1 percentage point in the reference period).

The Baltic states also entered ERM II in 2004 and 2005, respectively. All three countries were targeting euro area accession along similar timelines as Slovenia and Slovakia. However, Lithuania's quest for euro area accession failed in 2006, as the country was found to have missed the reference value for inflation by a small margin and as the sustainability of meeting the convergence criteria was not seen as having been sufficiently ensured. The other two Baltic countries have recorded inflation rates above the reference value in recent years, which has thus far thwarted their euro adoption plans. Finally, the other CESEE MS have not entered ERM II yet.

## 3 The Current State of Play

Table 1 provides a static and thus backward-looking snapshot on the current convergence performance of the CESEE-8 countries.

At the current juncture, Estonia is the only CESEE-8 country that could possibly meet the convergence criteria numerically in the near future. Inflation is falling fast in the context of moderating energy prices and a huge negative output gap. Inflation projections both by the IMF and by the European Commission suggest that Estonia could reach the price stability criterion by the end of 2009. However, meeting the budget deficit criterion during the ongoing deep recession will not be easy at all, even though the country had recorded sizeable fiscal surpluses until 2007 and has enacted consolidation measures to the tune of almost 6 percentage points of GDP this year. The fiscal outlook beyond 2009 is uncertain, as further fiscal adjustment measures for 2010 and beyond are currently still under discussion within the government.

<sup>4</sup> Furthermore, Malta and Cyprus joined the euro area in 2008, after having entered ERM II in 2005.

Table 1

**The Convergence Criteria and the CESEE-8 at End-July 2009**

	HICP	Long-term interest rates	Ongoing EDP	Fiscal balance		Public debt		ERM II participation	
	07/08–06/09 vs. 07/07–06/08	07/08–06/09		2007	2008	2007	2008		months
	%			% of GDP				yes/no	duration
Reference value	2.6	6.4							
Bulgaria	7.3	6.5	no	0.1	1.5	18.2	14.1	no	
Czech Republic	3.3	<b>4.8</b>	no	–0.6	–1.5	28.9	29.8	no	
Estonia	5.8	n.a.	no	2.7	–3.0	3.5	4.8	yes	61
Hungary	4.2	9.4	yes	–4.9	–3.4	65.8	73.0	no	
Latvia	10.0	9.3	yes	–0.4	–4.0	9.0	19.5	yes	51
Lithuania	8.6	10.5	yes	–1.0	–3.2	17.0	15.6	yes	61
Poland	4.0	<b>6.1</b>	yes	–1.9	–3.9	44.9	47.1	no	
Romania	7.0	8.8	yes	–2.5	–5.4	12.7	13.6	no	
Memo item:									
Euro area	1.8	4.1		–0.6	–1.9	66.0	69.3		

Source of fiscal and debt data: European Commission, Spring 2009 Forecast.

Note: Bold letters indicate that the criterion was numerically met at the given time.

Given its minimal public sector debt, Estonia has not issued a long-term government bond.

The table does not capture sustainability issues, the full spectrum of exchange rate stability aspects or legal convergence matters.

In Poland, euro adoption has become a focal point of the political debate since the fall of 2008, when the Polish government stepped up its efforts to prepare for euro adoption by 2012. This target date would have implied ERM II entry around mid-2009 (i.e. two years before the convergence assessment). The government has been trying to forge a consensus about the constitutional changes needed to achieve full legal convergence already before ERM II entry. So far, this consensus has, however, not been reached (and this might only change after the next parliamentary elections due in 2011). In the spring of 2009, the government took a more nuanced view on ERM II, arguing that it would aim at entering the mechanism once the global financial and economic crisis and the related exchange rate volatility have subsided to some extent.<sup>5</sup> At the end of July, the government effectively abandoned the 2012 target and announced that a revised plan for the adoption of the euro would be presented at a later point in time. The present downturn puts considerable stress on Polish fiscal accounts, as everywhere in the EU. The EU has opened an excessive deficit procedure (EDP) for Poland and has set a target date of 2012 for correction. If Poland made full use of this period and complied in 2012 (while fulfilling all other criteria at the same time), it could introduce the euro in 2014 at the earliest. While the Polish authorities are committed to reducing the deficit to below 3% of GDP by 2012, they hope to achieve this target earlier. At

<sup>5</sup> The governor of Narodowy Bank Polski (NBP) takes a more pronounced “wait-and-see” position on the matter, citing global financial turbulence and exchange rate volatility as the main reasons for delaying ERM II entry. In early 2009, the NBP put out a comprehensive analytical report on the future accession of Poland to the euro area, which came to the broad conclusion that, overall, Poland would benefit from entering into the monetary union.



any rate, a narrowing of the deficit will also be necessary to keep public debt safely below 60% of GDP.<sup>6</sup>

In late 2008, the Hungarian authorities also expressed the intention to get ready for ERM II entry (and speed up the process toward euro adoption), but macroeconomic fragility has stopped them, for the time being, from moving ahead on this track. More recently, after a new cabinet had taken office, the finance minister said that decisions on ERM II entry would most likely be made only by the next government, which is to take office mid-2010. Despite substantial achievements in fiscal consolidation in recent years, the budget deficit is still above 3%, and the EU has set a revised deadline of 2011 to correct the excessive deficit. Moreover, Hungary records public debt levels well above 60% of GDP.

Bulgaria had already in 2007 attempted to build a consensus for ERM II entry, but was not fully successful, given large and widening imbalances at the time. The country is considering renewing efforts, as macroeconomic disequilibria are narrowing substantially. Bulgaria has recorded fiscal surpluses in recent years and intends to keep its budget broadly balanced also in the current downturn.

The Czech authorities annually evaluate the country's readiness for future euro adoption. In past years, these assessments were not yet sufficiently supportive to move ahead with monetary integration and thus, as a first step, to prepare for ERM II entry. The next such evaluation is due in the fall of 2009. As in other countries, the current recession weighs on the fiscal accounts. The most recent fiscal outlook of the Czech finance ministry, released in May, projects budget deficits well above 3% of GDP up to the end of the projection horizon of 2012. This would imply euro adoption in 2015 at the earliest, provided that the excessive deficit is corrected by 2013 (and all other criteria are met).

Romania, in turn, plans to accede to ERM II in 2012 and to the euro area in 2015. This monetary integration strategy has already been in place for several years and has not been substantially revised since. Romania also belongs to those CESEE MS that are currently under an excessive deficit procedure, with 2011 set as correction deadline.

Inflation has started to moderate substantially in Latvia and Lithuania and could fall to very low annual year-on-year levels by 2010. At the same time, fiscal imbalances are high, despite major efforts to rein in deficits. An excessive deficit procedure was recently opened for both countries, and the EU set deadlines for correction by 2011 for Lithuania and by 2012 for Latvia. The situation in Latvia has been further aggravated by temporary pressures on the peg of the lats to the euro and by banking sector turbulence. Like Hungary and Romania, Latvia is currently undertaking an adjustment and reform program under the tutelage of the IMF and the EU.

Table 2 provides a comparative perspective of the current ERM II and euro adoption plans of the CESEE-8 and indicates the exchange rate regimes presently in place.

<sup>6</sup> Poland also has constitutional rules in place which foresee automatic adjustment measures if public debt goes beyond 50% and 55% of GDP, respectively.

Table 2

### CESEE-8: Current Exchange Rate Regimes, ERM II and Euro Adoption Plans

	Exchange rate regime	ERM II: Actual or planned date of entry	Target date for euro adoption
Estonia	Euro-based currency board	June 28, 2004	2011
Lithuania	Euro-based currency board	June 28, 2004	As soon as the criteria are met (2013 at the earliest according to EDP deadline)
Latvia	Peg to euro, unilateral $\pm 1\%$ band	May 2, 2005	As soon as the criteria are met (2014 at the earliest according to EDP deadline)
Bulgaria	Euro-based currency board	As soon as possible	As soon as possible
Czech Republic	Managed float, inflation targeting	2½ years before euro adoption	Currently no target date
Hungary	Managed float, inflation targeting	Not specified	Currently no target date (2013 at the earliest according to EDP deadline)
Poland	Float, inflation targeting	By end-2009	New target date will be announced in August 2009 (full use of correction period under the EDP would imply not before 2014)
Romania	Managed float, inflation targeting	2012	2015 (in line with EDP deadline, i.e. not before 2013)

Source: NCBs, convergence programs, EDP correction deadlines as set by the EU.

Note: Five of the eight countries covered in this table are currently under an excessive deficit procedure (EDP). The table indicates in italics the year in which the euro could be introduced at the earliest if the deficit is corrected in the year that has been set by the EU as a deadline for the correction of the deficit and provided that other criteria are fulfilled as well at that point in time. (Furthermore, it is assumed for this exercise that euro adoption will take place at the beginning of a calendar year).

## 4 The Implications of the Global Crisis for Monetary Integration

The global financial and economic crisis has put the risk of large exchange rate-generated shocks into the spotlight, a risk which had not received much attention during the very benign financial market environment until mid-2007. The renewed concern about such shocks was also fed by the considerable and, in some cases, paramount role that foreign currencies play in the denomination of financial assets and liabilities in most CESEE-8 countries (except in the Czech Republic). Consequently, major exchange rate shifts would likely have important implications for both macroeconomic and financial stability.

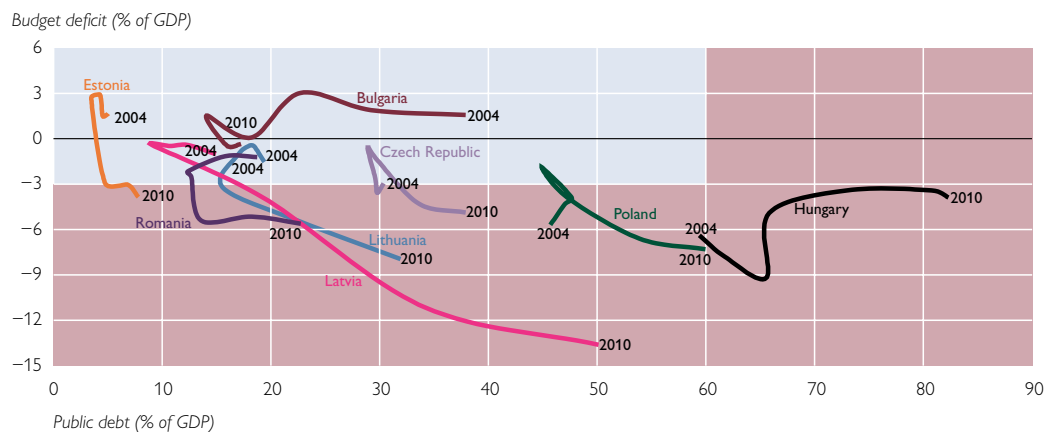
The arguments of the euro being an “umbrella” or “shelter” that protects countries from currency crises were particularly in vogue during late 2008 and early 2009 when most CESEE currencies, especially those with flexible exchange rates, came under strong pressure in a setting of very negative sentiment vis-à-vis CESEE countries. While the currencies softened substantially, there were no exchange rate collapses in CESEE MS despite the very harsh environment at the time. Since March 2009, risk aversion vis-à-vis emerging Europe began to moderate gradually, and CESEE currencies partially recovered as the EU, the IMF and other international financial institutions stepped up their support for CESEE countries and as global financial market conditions began to display tentative signs of some degree of stabilization.

At the same time, however, the deep real-sector ramifications of the crisis and their profound implications on fiscal balances became ever more visible. Headline fiscal positions in most CESEE MS had improved until 2007, in some cases until 2008. A closer look at past fiscal developments shows that favorable cyclical developments until 2008 had helped reduce headline deficits. Moreover, in a number (but not in all) countries, fiscal consolidation had been unambitious (especially in hindsight) and, in some instances, fiscal policy had even been procyclical during “good times” (Eller, 2009).

Since the fourth quarter of 2008, GDP growth has contracted sharply in CESEE MS from the boom levels recorded earlier in most countries of the region. Consequently, budget deficits soared and are projected by the European Commission to exceed the 3%-of-GDP level in 2009 in all CESEE MS but Bulgaria, with Estonia being marginally above this threshold. A further deterioration is forecast for 2010 (see chart 1).

Chart 1

### Public Finances in the CESEE-8 from 2004 to 2010



Source: European Commission, Spring 2009 Forecast.

Note: The projections for 2009 and even more so for 2010 are subject to an unusually large degree of uncertainty. Moreover, they do not capture developments since April 2009 (revisions of growth projections, new fiscal measures). The Polish finance minister also argued that the GDP growth forecast underlying the fiscal projections had been too pessimistic from the outset.

It is noteworthy that most CESEE MS have not made substantial use of discretionary policies to stabilize their economies in the current downturn. Some CESEE MS have even engaged in procyclical fiscal contraction to retain or regain the confidence of international investors.

It will be a key challenge to reduce deficits to below 3% over the medium term, given that growth prospects after the current recession are rather subdued for several years to come for most CESEE MS, while unemployment will be substantially higher than in mid-2009.

This may again tip the balance of arguments and alter the timelines of prospective euro adoption in the public debate in CESEE countries. While immediate exchange rate concerns have faded somewhat, the perceived short-term costs of meeting the convergence criteria – in particular the budget criterion – any time soon have risen substantially.

## 5 Adjustment and Stabilization

To put the issues at hand into perspective, it is important to take a step back and ask what determines the performance of a country that is part of a larger currency area. At this point, structural and institutional characteristics come into play.

According to optimum currency area (OCA) theory, a country may take part in a monetary union with little cost while enjoying its benefits if it is exposed to similar shocks as the currency area as a whole. This is usually the case when business cycles are broadly synchronized, which is, in turn, promoted by similar economic structures as well as close trade (in particular intraindustry trade) and

financial integration. Should a country be exposed to idiosyncratic shocks, the costs of partaking in a currency union are limited if other adjustment mechanisms, in particular price and wage flexibility (as well as labor mobility), function properly and if fiscal policy can be effectively used to dampen short-term economic fluctuations. In addition, more recently it has been stressed that appropriate regulation and its proper enforcement<sup>7</sup> play a key role in preventing fluctuations from becoming overly large in the first place. Vice versa, participation in a monetary union would be costly for a country characterized by a high exposure to asymmetric shocks, weak microadjustment capabilities and poorly functioning macrostabilization tools.

Two additional considerations deserve to be mentioned: First, there is evidence (but no full consensus) that joining a currency union fosters integration and business cycle convergence, and thus dampens the exposure to idiosyncratic shocks (endogeneity of OCA criteria). However, the dynamics of such a process are difficult to anticipate and the path to the new steady state may well be protracted. This suggests the importance of functioning adjustment and stabilization mechanisms in the interim. Second, joining a monetary union is less costly if the effectiveness of autonomous monetary policy for macroeconomic stabilization is limited or if the exchange rate is a source of shocks rather than a shock absorber. Vice versa, the more effective monetary and exchange rate policy is as an adjustment tool, the higher the potential costs to give it up are – provided, of course, that an economy is exposed to idiosyncratic shocks in the first place and that other adjustment tools do not function sufficiently well.

How well suited are the CESEE-8 to monetary integration from these structural and institutional angles? Despite considerable cross-country variation, the following broad picture emerges:<sup>8</sup>

The alignment of the economic structures of the CESEE-8 with those in the euro area is fairly advanced, though with some differences at more disaggregated levels. The trade openness of the CESEE-8 is comparable with that of euro area countries of a similar size, and the euro area is the main trading partner for the countries under review here. Still, the trading partners of the Baltic states are somewhat more diversified as they comprise non-euro area Nordic countries and Russia. Intraindustry trade accounts for a substantial share of overall trade with the euro area for most CESEE-8 countries (except for Latvia and Lithuania). Financial integration has reached comparatively high levels across the region. Business cycle synchronization with the euro area is diverse, being more advanced in Hungary, Poland (and Slovenia) than in the other countries under review. Business cycle alignment decreased in a number of CESEE-8 countries after 2005. Essentially, this was due to the growth spurt that many countries of emerging Europe had experienced during recent years.

Empirical work on the degree of price flexibility in CESEE product markets is relatively scarce. Overall, inflation persistence seems to be broadly comparable with that in euro area countries, while underlying drivers may vary somewhat.

<sup>7</sup> This not only includes prudential regulation and oversight of the financial sector, but more broadly also the abolition of regulatory incentives that may facilitate the buildup of asset price bubbles or excessive credit booms, or even the active use of regulatory disincentives. For a more detailed discussion, see Backé (2008).

<sup>8</sup> See Backé (2008) for a more detailed discussion and for numerous references to empirical studies on these issues.

Price liberalization in the CESEE-8 is essentially complete, whereas in product markets there is room for further competition. Data on business regulations provide somewhat varied evidence across different sources. In very general terms these data show that the CESEE MS rank at intermediate levels, except for the Baltic states, which tend to score higher.

The flexibility of CESEE labor markets is diverse, ranging from intermediate to relatively high according to various empirical studies. There is evidence of wage flexibility at the micro level (studies are available only for a few countries), including at least some downward nominal flexibility. Labor mobility between the CESEE MS and other EU countries rose after 2004 despite continued temporary restrictions, before stabilizing again more recently.

As to stabilization policies, the room for fiscal policy maneuver is severely constrained for most CESEE-8 countries as a consequence of the mixed fiscal record and the blow that the current crisis exerted on fiscal balances (see previous section).

Furthermore, there is relatively little evidence in favor of the effectiveness of monetary and exchange rate policy for macroeconomic stabilization and shock absorption in the CESEE MS. Rather, the exchange rate has tended to be a source of shocks, according to several empirical studies, also in noncrisis times. Only in Poland, which is larger and somewhat less open than the other CESEE MS, does the exchange rate seem to have played some role as a shock absorber.

## 6 Concluding Remarks

Overall, the exposure to idiosyncratic shocks seems to be relatively contained for most CESEE MS, while market structures imply that there is some scope to adjust to such shocks through factor price movements. The susceptibility to asymmetric shocks is potentially more pronounced in the Baltic states. But markets there are also more flexible, allowing for greater microadjustment via prices and wages.

The current crisis has shown that budgetary positions in most CESEE MS need to be improved substantially over the medium term to enable the countries to use fiscal policy for macroeconomic stabilization. At the same time, major fiscal adjustments are currently being implemented, especially in Hungary and in the Baltic states. Empirical studies suggest that, in many countries, domestic monetary policy has displayed only limited effectiveness as a stabilization instrument, while the exchange rate has tended to generate rather than smooth out shocks. Thus, from a structural angle, the CESEE-8 would seem to be relatively well placed for a smooth future participation in the euro area. These countries should therefore have a clear incentive to proceed with their preparations for euro adoption and to make substantial efforts to this end.

The CESEE-8 will face multiple challenges on their way to the euro, in ensuring a high degree of sustainable convergence. Addressing fiscal imbalances is a paramount task, not only to qualify for euro adoption but also to be able to smooth cyclical fluctuations once the countries have joined the euro area. Ideally, fiscal imbalances would be addressed with the least impact on growth. This implies potentially substantial reshufflings of revenue and expenditure structures. At the same time, fiscal policy should provide essential support to those economic agents hit hardest by the current crisis and its aftereffects. Bringing public finances in order is a very hard and thorny task, given the abrupt reversal of many years of con-

solidation by the current crisis and the relatively subdued short- to medium-term growth outlook for many CESEE-8 countries.

In view of the challenges ahead, the monetary integration of the CESEE-8 is likely to proceed only gradually in the next few years. Mounting short-term costs associated with the implementation of macroeconomic and, in particular, fiscal adjustment may prevent a number of CESEE-8 countries from achieving a position in the foreseeable future in which they could reap the benefits of participating in a monetary union – benefits that would tend to be particularly tangible for small open economies that are highly integrated with the euro area.

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# Central Banks in Transition: Legal and Institutional Challenges on the Way to EU Integration

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## 1 Introduction

Over the past 20 years, central banks in Central, Eastern and Southeastern Europe (CESEE) underwent fundamental changes, both as regards their legal underpinnings and their institutional setup. Ambitious central bank laws were enacted already at the beginning of the political and economic transformation process and amended in several steps during subsequent years. Furthermore, CESEE central banks faced enormous challenges in institution- and capacity-building. They had to adapt their structures continuously in order to fulfill the demanding tasks assigned to them, first in managing the economic reform process and, at a later stage, in preparing for EU accession.

The purpose of this article is to review the reform of central bank legislation in CESEE over the past two decades as well as the institutional developments at the individual CESEE central banks. It covers the following ten CESEE countries: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

This article broadly follows a chronological structure. Section 2 deals with the early years of transition, section 3 examines developments during the preparations for EU accession and section 4 describes new challenges arising from EU membership and lying ahead. Section 5 concludes.

## 2 Early Years of Transition: New Central Bank Laws and the Challenge of Institution-Building

Under the system of central planning, central and commercial banking functions were typically united under a so-called monobank. This monobank basically functioned as a department of the ministry of finance with the sole objective of fulfilling the overall central plan. Therefore, the first step of financial sector reform was the transition from the monobank to a two-tier banking system by separating central bank departments and branches which had previously performed commercial banking functions from the monobank and establishing them as commercial banks (see e.g. Wagner, 1998).

At the outset of political and economic reforms, many countries in CESEE adopted new central bank laws, which – unlike under the centrally planned regime – endowed central banks with monetary policy functions, thus transforming them, *de jure*, into key players in economic policymaking during the implementation of comprehensive macroeconomic reform programs. In their comparative overview of post-communist central bank legislation in the Czech Republic, Hungary, Poland, Slovakia and Slovenia, Radzyner and Riesinger<sup>2</sup> (1997) find that at that time, the central banks in these five countries already enjoyed a relatively high degree of legal central bank independence (CBI). However, the provisions on

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<sup>2</sup> The author published this study with Olga Radzyner in 1997 under her previous name, Riesinger.



direct central bank lending to the government – which was in principle still permitted by law, though typically limited to a specified maximum amount – constituted a weak point in these countries' central bank legislation.

Central banks in CESEE were given a high degree of *de jure* independence for several reasons. First, the establishment of an independent central bank from the outset was part of a general effort to create an institutional framework comparable to that of Western market economies. Second, another motivation for granting central banks a high degree of CBI was its alleged success. The impressive inflation performance track record the Deutsche Bundesbank, for example, had delivered in preceding decades had shown that a high degree of legal CBI sent the desired signal to politicians and economic agents and thus functioned as an effective device to achieve long-term price stability. Therefore, many of the new laws adopted in CESEE strongly mirrored the Western central bank laws of the time, in particular the German one.<sup>3</sup> Third, a specific reason for establishing highly independent central banks was the adoption of drastic stabilization programs in a number of CESEE transition countries, which mainly aimed at bringing inflation down from initially very high levels. Therefore, a high degree of credibility was required for anti-inflation policies and, hence, for central banks.

In practice, however, despite the relatively strong legal status of CESEE central banks, their monetary policy in the early years of transition was not free from political interference. A major weakness was the practice of some national parliaments, e.g. in Poland, to overrule central bank law when it came to direct budgetary financing (Radzyner and Riesinger, 1997).

At the same time, CESEE central banks were facing the enormous challenge of institution- and capacity-building. As these central banks had been transformed from monobanks into full-fledged Western-style central banks within a rather short period of time, they found themselves in a situation where they had to acquire – and apply – expertise on monetary policy strategies and instruments almost overnight. Furthermore, central bank staff was involved in the implementation and monitoring of economic reform programs, which, in many cases, had to be negotiated with the International Monetary Fund (IMF) and other international donors. Therefore, English language skills became very important for central bank staff already in the early years of economic transformation (see e.g. Tosovský, 2003). Some countries, such as Slovakia<sup>4</sup> or the Baltic countries, had not had central banks of their own in the years before the beginning of the reforms. For them, the task of institution-building was even more complex, as they had to set up new national central banks from scratch. In these cases, previous local branches of central banks were transformed into full-fledged central banks within a very short time span.

Therefore, the demand for technical assistance to central banks in CESEE increased tremendously in the early 1990s. The IMF played a key role in this context, in particular as regards technical assistance to the Baltic central banks and other central banks of successor states of the former Soviet Union. From the IMF's

<sup>3</sup> In this context, Hochreiter and Kowalski (2000) argue that for some provisions, e.g. on the central bank's objectives, the new CESEE central bank laws resembled the (pre-ESCB) Federal Act on the Oesterreichische Nationalbank rather than the Bundesbank Act.

<sup>4</sup> For details, see Kohútiková's contribution "From the Koruna to the Euro" in this issue.

viewpoint, modernizing a country's central bank had a far-reaching influence on the rest of the economy and played a catalytic role in shaping the financial system as a whole (Zulu et al., 1995). The IMF's activities covered a broad range of areas, such as drafting central bank legislation, preparing exchange rate reforms and improving statistics. As a case in point, Narodowy Bank Polski was modernized under an IMF technical assistance program (IMF, 2003). Furthermore, Western European central banks<sup>5</sup> were among the most important donors of technical assistance, standing ready to transfer their very specific expertise to their counterparts in the CESEE countries. In this endeavor, a core group of donor central banks, namely of the G-10 and Austria, coordinated their efforts among themselves and with the IMF. They started a series of regular semiannual meetings, coordinated by the Bank for International Settlements (BIS) and comprising both the donors and the recipients of technical assistance. This format enabled the donors to react in a timely and flexible manner to the changing needs expressed by recipients. At the same time, this coordination effort helped, at a very early stage, to build a network between Western and Eastern European central banks in a spirit of cooperation and solidarity. Moreover, technical assistance to CESEE central banks was provided via regional training institutes. One of these was the Austrian Bankers' College International, which was founded in 1989 upon the initiative of the Oesterreichische Nationalbank (OeNB). All major Austrian banks joined to form the basis of this project, with the OeNB functioning as its platform. By organizing international seminars and courses in the field of banking, finance and economics, the Austrian Bankers' College International aimed to start a dialogue between Austrian banks and their counterparts in CESEE.<sup>6</sup> In addition, in 1992 the Austrian Ministry of Finance and the OeNB, together with five international organizations,<sup>7</sup> established the Joint Vienna Institute (JVI), which offers extensive specialist training to public officials – among them numerous central bankers – from transition countries.

### 3 Moving toward EU Integration: Further Adjustment of Central Bank Legislation and Further Institutional Challenges

With the CESEE countries' conclusion of EU Association Agreements and official application for EU membership, the need for adjusting central bank legislation got a more practical dimension. In the second half of the 1990s, the creation of Economic and Monetary Union (EMU) became the main driving force for increasing the overall degree of CBI in Europe. The preparation of Stage Three of EMU entailed numerous and far-reaching adjustments to central bank legislation, also for the incumbent 15 EU Member States. The European Monetary Institute (EMI), the predecessor of the European Central Bank (ECB), published its first

<sup>5</sup> For a detailed account of technical assistance activities provided by the Dutch central bank, see *De Nederlandsche Bank* (2005).

<sup>6</sup> Every year from 1989 to 1994, the Austrian Bankers' College International offered around 40 one-week courses for CESEE bankers, thus providing specialist training to several thousand participants (OeNB, 1990). For more details, see also the contribution by Mooslechner and Ritzberger-Grünwald in this issue.

<sup>7</sup> Originally, the JVI was sponsored by the BIS, the EBRD, the IMF, the OECD and the World Bank. The WTO became the sixth sponsoring organization in 1998.

convergence report<sup>8</sup> in 1996 and established a list of features of CBI, thus specifying the requirements set out in the Maastricht Treaty<sup>9</sup> and the Statute<sup>10</sup> (EMI, 1996).

At this early stage, the list of CBI features was primarily meant to provide a benchmark for the incumbent Member States for adjusting their central bank statutes prior to Stage Three of EMU. However, the list of CBI features was elaborated further by the ECB in its subsequent convergence reports and thus became highly relevant also for the CESEE countries in their preparation for EU membership. All countries that joined the EU after 1999, i.e. after the beginning of Stage Three of EMU, were given the status of “Member States with a derogation.” This implied that they had to bring their central bank legislation into line with Treaty requirements prior to or upon EU accession.

In the run-up to EU accession, central bank legislation in the ten CESEE applicant<sup>11</sup> countries became subject to “institutionalized assessment,” which was carried out regularly by the European Commission. As a first step, the European Commission produced an Opinion on each country’s application to join the EU, assessing the country’s preparedness to fulfill the Copenhagen criteria for EU membership. The most important aspects of CBI were typically dealt with in chapter 11 (Economic and Monetary Union), which examined the respective country’s ability to fulfill the related Treaty requirements in the medium term.<sup>12</sup> As a second step, after the countries had gained official candidate status, the European Commission began to publish the so-called Progress Reports, monitoring the progress of these countries toward EU accession. The first Progress Reports were published in 1998 on the ten candidate countries at the time. On an annual basis, these reports provide an update of the European Commission’s assessment of candidate countries’ preparedness to fulfill the Copenhagen criteria, thus following up on the initial judgment presented in the respective Opinion. Consequently, the structure of the Progress Reports is very similar to that of the respective Opinion on each country, treating the issue of legal CBI in chapter 11.

The publication of these Progress Reports served a twofold purpose. On the one hand, it reflected the thorough and regular monitoring and negotiation process performed by the European Commission and the respective candidate coun-

<sup>8</sup> According to Article 122 (2) of the Treaty, the ECB and the European Commission are obliged to report to the Council of the European Union at least once every two years – or at the request of a Member State with a derogation – on the progress made in the fulfillment by the Member States of their obligations regarding the achievement of EMU. In particular, these convergence reports comprise two parts: the economic part, which deals with the fulfillment of the economic convergence criteria (also referred to as the Maastricht criteria), and the legal part, which mainly deals with CBI. In practice, the ECB and the European Commission submit and publish their convergence reports in parallel.

<sup>9</sup> Treaty establishing the European Communities (1957), as amended by the Treaty of Maastricht (1992) and, later, by the Treaty of Amsterdam (1997); hereinafter referred to as the Treaty.

<sup>10</sup> Protocol on the Statute of the European System of Central Banks and of the European Central Bank (1992); hereinafter referred to as the Statute.

<sup>11</sup> A country that has submitted its application for EU membership is called “applicant country.” An applicant country that has been granted official candidate status by the EU is called “candidate country.”

<sup>12</sup> For a comparative analysis of central banking issues in the European Commission’s Opinions issued on the ten CESEE applicant countries, see Horvath et al. (1997).

tries. On the other hand, it created a certain peer pressure, calling for the smooth and rapid adjustment of national legislations.<sup>13</sup>

The preparations for EU membership created further institutional challenges for the CESEE central banks, as they were required to perform additional functions during the preparation process. For example, analysis and know-how requirements on central bank staff increased because many topics they had to deal with were new or at least relatively unknown to them, as pointed out by Pöder (2006). During the negotiations of the EU Association Agreements, an important additional task for central bank staff was to participate in various committees and subcommittees and to present and explain their countries' economic and monetary policies vis-à-vis EU officials on a regular basis. Furthermore, central banks were actively involved in accession negotiations, typically leading discussions on the chapters Economic and Monetary Union and Free Movement of Capital and participating in negotiations on the chapter Free Movement of Services. Moreover, the submission of Pre-Accession Economic Programmes (PEPs) was in many cases coordinated by the respective central bank.<sup>14</sup> In addition, the necessity to harmonize numerous national laws with EU requirements within a very short period of time raised questions of quality control, e.g. regarding the translation of legal texts. In this context, Pöder (2006) emphasized the need to contain the "over-eagerness" of harmonizing legislation too fast without trying to adjust directives to better suit the national circumstances. At the same time, some central banks undertook major modernizing and downsizing efforts. As a case in point, Banca Națională a României cut down its number of employees in three steps from 4,829 in August 1999 to only 1,764 in September 2005, mainly by closing down a substantial number of its branches as well as by restructuring its internal organization (Popa, 2006).

In this very demanding phase of preparing for EU membership, technical assistance to CESEE central banks continued to play an important role. However, there was a clear shift in content requirements from rather general topics of economic policymaking to highly specific issues related to EU accession. At the same time, technical assistance increasingly provided tailor-made solutions that met the highly specific needs of individual recipient central banks rather than offering general training programs to increasingly heterogeneous groups of recipients.

Consequently, EU central banks gained importance as bilateral donors of technical assistance, especially those looking back at their own recent experience with preparations for EU membership such as the OeNB, which provided practical advice to a number of CESEE central banks on matters relating to EU membership. Some CESEE central banks benefited from comprehensive, multiannual programs of technical assistance financed by the European Commission early in the enlargement process. This form of technical assistance was called "twinning" and proved particularly successful because it created strong institutional links between "sister" institutions performing the same or highly comparable tasks. At a very early stage of the enlargement process, Narodowy Bank Polski took part in a

<sup>13</sup> For a detailed analysis of the first Progress Reports with respect to central banking issues, see Dvorsky, Backé and Radzyner (1998).

<sup>14</sup> For a detailed account of newly acquired central bank tasks and functions in the preaccession period, see e.g. Popa (2006).

two-year twinning program which covered a broad range of central banking topics and was led by the Banque de France and the Banca d'Italia. A few years later, the Česká národní banka took part in an 18-month twinning program with the Deutsche Bundesbank, focusing on financial stability matters. The central banks of Bulgaria and Romania also participated in multiannual twinning programs, which dealt with a variety of central banking issues and were carried out by a consortium led by the Banque de France and including the Banca d'Italia and De Nederlandsche Bank (ECB, 2008b). As of 1999, the Eurosystem set up a permanent Task Force on Central Bank Cooperation, reporting to the International Relations Committee, which serves to exchange information on technical assistance and coordinate joint activities. From a small donor central bank's viewpoint, one of the major achievements of this Task Force was to increase the participation of central banks in large-scale technical assistance projects. Within this framework, smaller donor central banks in the Eurosystem have been able to contribute to these large-scale endeavors despite their capacity restrictions.

#### 4 Maturing from Transition: EU Membership and Challenges Ahead

After EU accession, the national central bank statutes of new Member States remain subject to “institutionalized assessment” until the respective country introduces the euro. The institutionalized assessment of EU Member States with a derogation is carried out every second year by the ECB and the European Commission in their regular convergence reports. In December 2004, the ECB's and European Commission's convergence reports for the first time covered the eight new Member States in Central and Eastern Europe<sup>15</sup> (ECB, 2004, and European Commission, 2004). The next convergence reports were issued in May 2006 following requests from Lithuania and Slovenia and thus covered these two countries only. As a result of its assessment, the European Commission recommended that Slovenia join the euro area by January 2007 (European Commission, 2006b). Consequently, the convergence reports published in December 2006 only examined the remaining Member States with a derogation (ECB, 2006b, and European Commission, 2006b). The most recent convergence reports were published in May 2008, covered nine CESEE countries<sup>16</sup> and led to the admission of Slovakia to the euro area by January 2009.

According to the ECB's 2008 convergence report, the main elements of CBI, i.e. functional, institutional, personal and financial independence, are found to be fulfilled in all CESEE Member States examined.<sup>17</sup> Price stability is found to be the statutory primary objective of all central banks (functional independence), with one minor adjustment to be made in the case of Latvia. As regards institutional independence, the freedom from instructions is stipulated in all central bank statutes under examination, with some further adjustments required from the Czech Republic and Poland and some minor rewordings in the case of Bulgaria, Latvia and Romania. At this stage, the main weakness typically found in central bank legislation concerns the reasons for dismissal of the central bank governor; here, the convergence report points out need for adjustments in the central bank

<sup>15</sup> *The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.*

<sup>16</sup> *They included, for the first time, Bulgaria and Romania as the latest new Member States.*

<sup>17</sup> *For a detailed definition of the main elements of CBI, see Dvorsky (2004).*

laws of the Czech Republic, Latvia and Poland and requires minor modifications in the Hungarian and Romanian central bank laws. Finally, while all CESEE central bank laws clearly prohibit monetary financing, some further adaptations to central bank legislation in this field are required from the Czech Republic, Hungary, Poland and Romania (ECB, 2008a).

EU accession had far-reaching institutional implications for CESEE central banks as they became an integral part of the European System of Central Banks (ESCB). This implied that the CESEE central bank governors became members of the General Council of the ECB, which comprises the President and Vice-President of the ECB as well as the governors of the national central banks (NCBs) of all EU Member States.<sup>18</sup> The General Council meets at quarterly intervals and discusses a wide range of central banking issues, some of which are of particular policy relevance for the CESEE central banks (e.g. ERM II membership or economic and legal convergence). Therefore, CESEE central bank governors faced the necessity to bring forward well-founded arguments on highly sensitive issues in these General Council debates, requiring in-depth analysis and preparation at their respective central banks before each General Council meeting.

Furthermore, in order to find the necessary political support for top level issues, it was necessary to engage in informal networking activities with other ESCB central banks in time before the respective General Council meeting. Moreover, upon EU accession, the lower hierarchical levels also got involved in ESCB activities: The ESCB comprises 14 committees and more than 100 substructures, each of which holds several meetings per year. In practice, the work carried out in these committees and substructures is highly important because, due to their complexity and scope, many topics cannot be discussed in sufficient detail by the General Council (Dvorsky and Lindner, 2005). Participation in ESCB committees and subordinate groups brought about fundamental changes in the organizational and professional demands placed on CESEE central bank staff. Furthermore, as soon as their countries joined the EU, CESEE central bank governors began to participate in the informal Ecofin meetings, which are held every six months by EU finance ministers and central bank governors. In addition, CESEE central bank representatives became members of one of the EU's most important economic policy forums, the Economic and Financial Committee (EFC), which comprises representatives of EU finance ministries and central banks and deals with issues such as preparing convergence programs, convergence reports, ERM II decisions, EU balance of payment support, surveillance issues, etc.

Following the introduction of the euro in Slovenia and Slovakia as of January 1, 2007, and January 1, 2009, respectively, the Slovenian and Slovak central banks had to meet further institutional challenges: Their governors became members of the Governing Council of the ECB, which comprises the six members of the ECB Executive Board and all euro area NCB governors. The Governing Council generally meets at two-week intervals. In addition to monetary policy issues, the topics discussed comprise the entire spectrum of central banking issues. Accordingly, the 14 committees and their substructures meet much more often in their Euro-system composition than in their ESCB composition. This, in turn, increased the

<sup>18</sup> Six months before their countries joined the EU, CESEE central bank governors had been granted observer status in the General Council in order to familiarize themselves with the established working procedures.



workload (both in terms of quantity and quality) of the entire central bank staff in the two new euro area countries. Judging from the OeNB's own experience, the preparation for, and participation in, all these additional meetings poses a considerable challenge in terms of human resources (Dvorsky and Lindner, 2005). For Banka Slovenije and Národná banka Slovenska as relatively small central banks, it has been even more challenging to cope with the new tasks arising from Eurosystem committee work.

Following EU accession, the role of CESEE central banks in technical assistance also changed fundamentally. Given their very recent experience of negotiating EU membership and managing institutional changes, the CESEE central banks naturally turned from recipients of technical assistance to highly demanded donors. The Task Force on Central Bank Cooperation was expanded to include not only Eurosystem representatives but also a number of representatives from ESCB central banks such as to facilitate large-scale EU-funded programs. Thus, a program with Narodna banka Srbije was started in late 2008 with the aim to assess preparatory needs in view of the country's possible future EU accession. This program benefited from extensive participation by ESCB NCBs (ECB, 2008b).

Looking ahead, CESEE central banks will have to deal with a number of challenging issues, in particular with regard to communication policies. First, they will have to explain their new mandate and role within the ESCB and, at a later stage, within the Eurosystem to the public in their respective countries (see e.g. Pöder, 2005, for Eesti Pank, or Dvorsky and Lindner, 2005, for the OeNB). Second, they will need a clear and credible communication strategy regarding the projected path to ERM II membership and euro adoption. Popa (2006) describes the difficult role of Banca Națională a României in the process of drawing a roadmap for the introduction of the euro. This task has become increasingly difficult for CESEE central banks as the fulfillment of the economic convergence criteria is – by its nature – a moving target, a situation that is even more aggravated by the recent financial and economic crisis. Therefore, it is not without risk to publicly communicate official target dates for euro adoption, as could be seen from Lithuania's unsuccessful application for euro area membership in 2006. While managing the difficulties of communication policies on the one hand, central banks must see to a timely and well-structured preparation of cash changeover logistics in their countries on the other. It may be helpful for CESEE central banks to study the recent practical experience of Slovenia and Slovakia but since lead times in cash changeover logistics are still comparatively long, preparations will have to be started several months (if not years) before the EU officially gives the go-ahead for euro adoption.

## 5 Summary and Conclusions

During the past 20 years of transition, CESEE central banks have successfully addressed numerous institutional challenges, starting from managing the political and economic transformation process and continuing, at a later stage, to preparations for EU accession. In this process, it was of major importance to provide technical assistance to these central banks. Technical assistance involved bilateral donors – mainly EU central banks – as well as multilateral programs supported by the IMF, the BIS, the European Commission and, at a later stage, also the Eurosystem.



Reforms in the CESEE countries set out by enacting modern, Western-style central bank laws and went on to adjusting these laws in several steps with the effect that central bank legislation in CESEE is nowadays broadly in line with Treaty requirements.

Looking ahead, CESEE central banks have new challenges on their agendas. The recent financial crisis has clearly shown that the credibility of economic policy institutions, and in particular of national central banks, is decisive for successful crisis management. Therefore, to maintain the confidence they earned over the past 20 years, CESEE central banks will have to face challenges in communication policies. For Slovenia's and Slovakia's central banks, which have already joined the Eurosystem, it will be crucial – as it is for all the other Eurosystem central banks – to successfully explain their new tasks and mandate to the public. For the eight CESEE central banks outside the Eurosystem, the preparations for joining the euro area – albeit in a difficult economic environment and at differing speeds – will be a major task in the near future.

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# Banking Sector Transformation in CESEE

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Sándor Gardó<sup>1</sup>

Over the past two decades, the transition economies of Central, Eastern and Southeastern Europe (CESEE)<sup>2</sup> have made substantial progress in transforming their banking sectors from operation under a socialist system to operation under a market economy.<sup>3</sup> However, banking reform throughout the region has been anything but smooth, with the 1990s featuring major upheavals and turmoil. In response, thorough restructuring and privatization of state-owned credit institutions was carried out in the second half of the 1990s and the early years of the current decade, thereby laying a solid foundation for the future development of the banking sector. Moreover, bank regulation and supervision have improved substantially. In the process, foreign players have come to dominate the banking sectors of nearly all CESEE economies, and during most of this decade, dynamic financial deepening has taken place. Despite these major achievements, challenges remain, not the least in the context of the current financial crisis that has also affected banks in CESEE and their parent institutions, which are mostly from Western Europe.

## 1 The Initial Conditions

The Soviet-style centrally-planned economy as well as the Hungarian and Yugoslav systems of market socialism essentially consisted of a state-owned banking system, the so-called monobank system, under which a single bank was responsible for carrying out both central and commercial banking operations. Besides the monobank, a few specialized institutions were at work in most economies. Each of these institutions first and foremost served a particular economic sector (e.g. foreign trade, agriculture, households) as set out in administrative plans (central credit and cash plans). In this setting, banks were required to monitor and facilitate real sector plan fulfillment and payment flows. The aim was also to strictly separate the circulation of “accounting money” (for plan control and investment finance) and “cash money” (for wage payments and the population’s purchase of consumer goods). Soft budget constraints were omnipresent, implying that, in principle, no company could go bankrupt or turn insolvent. The collapse of this system – including its political, social and economic subsystems – provided an incisive point of departure for transition. These multiple and simultaneous shocks triggered the unraveling of state power and brought about a sustained weakening of the rule of law and public authority. The shocks also gave rise to transition recessions and caused banking crises, which were followed by important economic reform efforts. In light of credit institutions’ crucial role in functioning market economies, in particular the banking sectors soon became a focal point of reforms throughout the CESEE region.

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<sup>2</sup> This article focuses on the EU Member States that joined in 2004 and 2007 (in some instances, however, without Slovenia and the Baltic states), the two Western Balkan countries with the largest economies (Croatia, Serbia), and the three largest CIS countries (Russia, Ukraine and Kazakhstan).

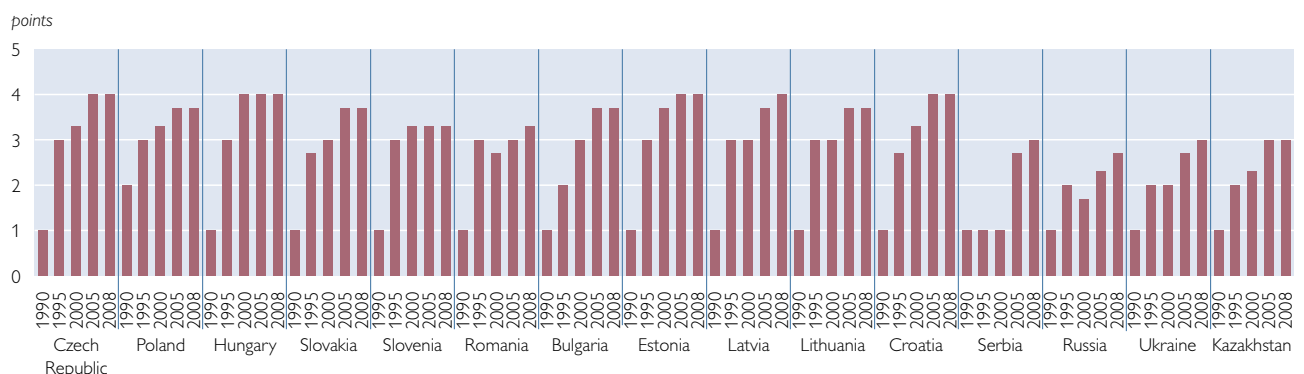
<sup>3</sup> See also Bokros’ contribution “Twenty (Five) Years of Banking Reform in CEE” in this issue.

## 2 Salient Features of Banking Sector Transition

Banking reform in CESEE has been a long, drawn-out process with two major reform waves, essential elements of which all countries had to go through to achieve sustainable market-oriented development. In fact, despite country-specific patterns and differences in time frames, the overall path of banking reform has been fairly similar in all countries of the region (see table 1). While the first reform wave largely embodied liberalization, the second one predominantly consisted of restructuring and institution-building. The major expansion of domestic credit to the private sector, triggered in most countries by the second reform wave, was recently interrupted by the global financial and economic crisis, which seems to herald a third wave of banking reform with an increased focus on risk management, regulatory and supervisory issues (in line with global trends) and the sustainability of financial catching-up. Once this severe external shock has been overcome, banking sector development is expected to resume as the convergence process regains momentum.

Chart 1

### EBRD Banking Sector Reform Index 1990–2008



Source: EBRD, OeNB.

Note: Reform progress ranges from 1 (little progress beyond establishment of a two-tier system) to 5 (standards and performance norms of advanced industrial economies).

### 2.1 The First Reform Wave

The first reform wave of the early 1990s essentially consisted of four stages: (1) initial liberalization, (2) some initial restructuring and tightening measures, (3) as a consequence, the emergence of an unsustainable equilibrium, and (4) renewed destabilization and crisis (see table 1).

In all countries of the region, the first wave of banking reform provided for the abolition of central credit and cash plans, price liberalization and the creation of a two-tier banking system with a clear separation of central and commercial banking activities. The first stage of reforms also included the liberalization of bank licensing and the establishment of regulation and supervision regimes, which proved to be lenient. In fact, given the legacy of a state-dominated and monopolized banking system devoid of competition for decades, most countries initially opted for wide-ranging liberalization of regulation and supervision in order to swiftly inject competition into the market. However, in an environment marked by political and economic instability, the stop-and-go character of structural reforms, continuing soft

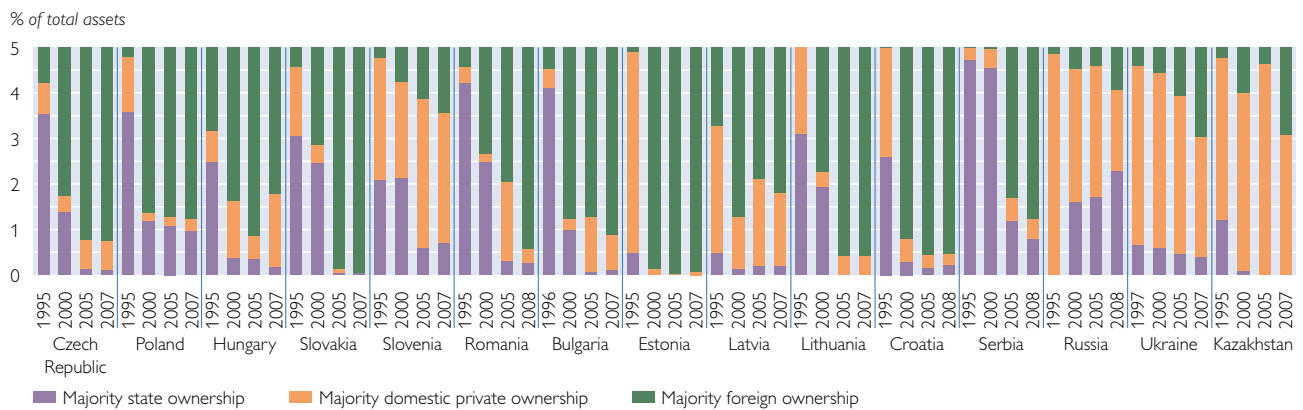
budget constraints in the corporate sector, and a lack of market-oriented know-how and governance on the part of newly founded banks, many banks soon became severely undercapitalized and faced serious bad debt problems.

As a result, authorities carried out “up-front rehabilitation measures,” typically by across-the-board replacement of bad loans in the portfolio of state-owned banks by government bonds. Such bad loans had not only been inherited from times of central planning (stock problem), but had also accumulated in the early years of transition as a result of imprudent lending to essentially bankrupt state-owned enterprises (flow problem). The nonperforming loans were transferred to a public “hospital bank” (consolidation bank) or debt recovery agency. This exercise resembled a major bookkeeping operation rather than a genuine restructuring measure, as it addressed only the symptoms (bad debts), but not the root causes of the underlying problems (e.g. bad management, inadequate banking supervision). Another popular policy of the time was “surface privatization,” i.e. partial, insider or nonconventional privatization of banks and enterprises, including management and employee buyouts as well as voucher privatization. Although expediency and social justice considerations may have argued in their favor, these modes of privatization injected hardly any new capital, expertise and management. In order to combat soaring inflation and improve oversight of credit institutions, some initial tightening of monetary policy and banking regulation was carried out.

Following the deep transition recessions, economic growth reappeared toward the mid-1990s, and in most countries the macroeconomic situation stabilized, while banking sector turbulences moderated and the sector started to consolidate. However, budget constraints in most countries remained rather soft. This included lenient lending conditions and directed loans granted by (former) state-owned banks on instruction of the government to (former) state-owned firms. The sector remained largely state-owned, while new privately owned banks and greenfield startups were relatively small, if numerous. Thus, a temporary and unsustainable equilibrium emerged: The absence of the concept of bankruptcy in socialism was carried over into the market-oriented economy. At the same time, a still fairly weak institutional and regulatory framework (chart 1) favored the widespread phenomenon of connected lending and, in several countries, the mushrooming of “pocket banks,” i.e. credit institutions which served as de-facto financial departments of their owner firms. In contrast, market-based lending was quite risky and often unprofitable under such circumstances. As a result, extensive insider lending, excessive portfolio concentrations and bank captivity to owners were not uncommon, with corruption, capital flight and fraudulent activities abounding in this environment. In some countries, financial pyramids came into being and enjoyed their heyday in the mid-1990s.

These underlying perverse incentives favored the reaccumulation of bad loans and were often complemented by new external shocks related, for instance, to adjustments in foreign trade, exchange rates or raw material prices. This set the stage for renewed macroeconomic destabilization, as a consequence of which a number of CESEE countries witnessed a renewed transition shock in the second half of the 1990s and suffered serious financial and economic crises. Often at around this point, deposit insurance funds were established, in some cases in a preemptive manner to calm savers’ concerns, create a level playing field, and prepare the sector for another shakeout.

### Ownership Structure of the Banking Sector 1995–2008



Source: EBRD, NCBs, OeNB.

## 2.2 The Second Reform Wave

After the second transition shock, at the latest, the need for deep-rooted banking sector reforms became evident, because credit institutions, burdened by a legacy of bad debt, were unable to act effectively as financial intermediaries and constituted an ever-growing drain on fiscal balances. In short, cosmetic restructuring measures were no longer enough. The following second wave of banking reform consisted of four stages: (1) the introduction of hard budget constraints for banks, (2) the extension of hard budget constraints to the corporate sector, (3) restructuring and the sale of the lion's share of the banking sector to – mostly foreign – strategic investors, and (4) ensuing substantial expansions of domestic credit to the private sector (see table 1).

As systemic banking crises were looming in many countries, CESEE authorities resolved to carry out incisive restructuring and recapitalization measures. As a result, in most countries at least one large bank went under. This sent out a clear signal that bankruptcy conditions for credit institutions were hardening, which corresponded to a necessary break with the past. However, given that hard budget constraints – while now valid for banks – were not yet fully applied to the corporate sector, banks became much more cautious in lending and reshuffled their portfolios toward government securities, central bank bills and foreign placements.

In the wake of restructuring, banking regulation and supervision were substantially tightened and accounting standards improved. Supervision has generally been moving forward from the formal verification of rules to substantive risk-based approaches, while accounting methods have been upgraded toward international standards. This contributed to formalizing hard budget constraints. The renewed turbulences had often proved to be too much for many of the fledgling deposit insurance funds, which were subsequently bailed out and overhauled by financial strengthening and by streamlining of guarantee levels to provide for viability and to adjust incentives. As property, contract and creditor rights strengthened, budget constraints were hardening throughout the region. This constituted a major change: market-oriented lending became possible and profitable.

As other strategies proved less effective in bringing about genuine change, the authorities in most countries took the decision to open up their banking sectors to

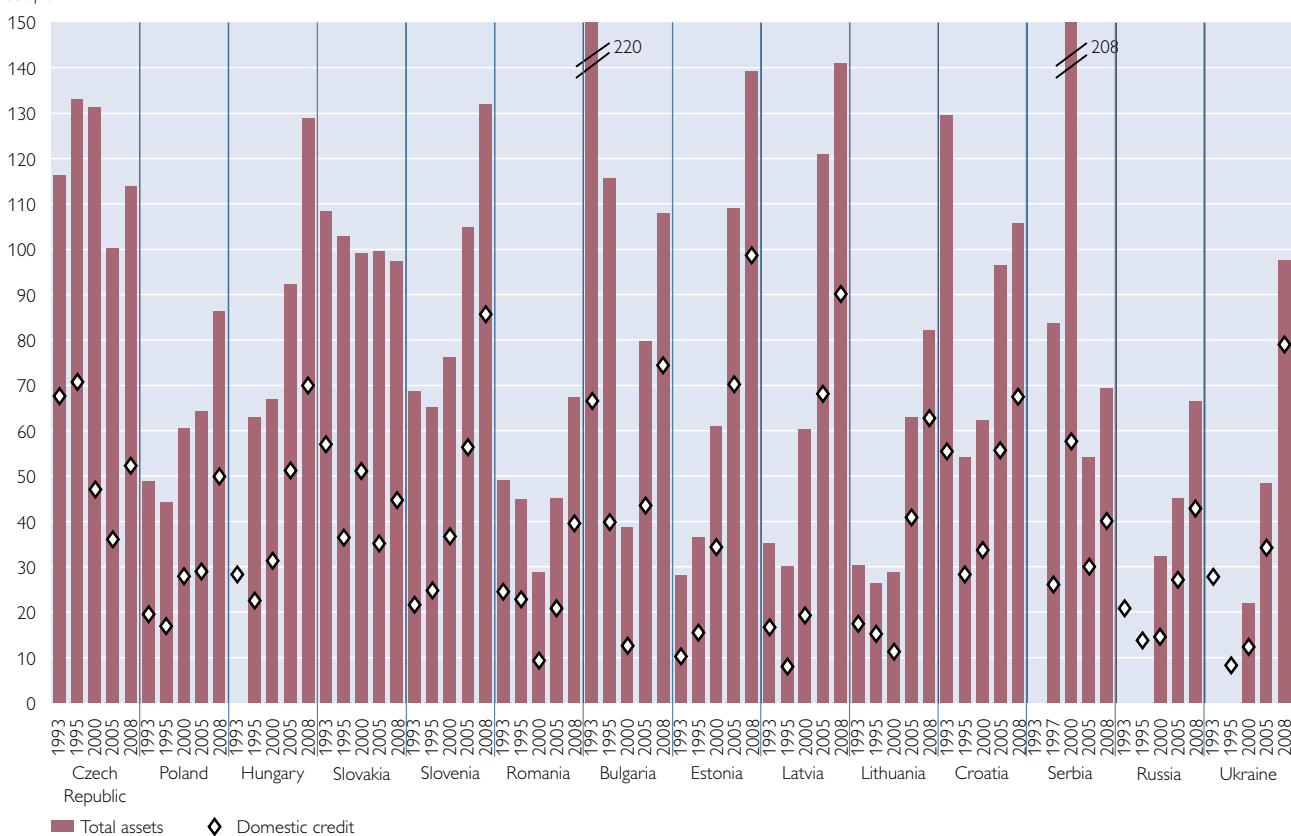
renowned foreign strategic investors (chart 2), often against the background of severe budgetary constraints. This “in-depth privatization” focused on attracting missing know-how, technology and capital, as well as on raising banks’ corporate governance, efficiency and competitiveness. Large numbers of foreign investors entered the market in most countries, attracted by the huge untapped catching-up and profit potential of CESEE banking markets. Around the turn of the millennium, mostly Western European investors, in particular from Austria, Germany, Italy and France, purchased many of the region’s largest banks and took over the lion’s share of the banking sector in CESEE. Thus, ownership linkups with the EU or within the enlarged EU were created, and Europe-wide banking networks emerged.

Subsequently, lending gathered momentum and turned into swift credit expansions or even credit booms in many transition economies (chart 3). This came not only on the back of improvements in the macrostructural environment, but was also fueled by supply- and demand-side factors. Primarily, strong economic growth, improved macroeconomic conditions with ongoing disinflation and falling interest rate levels, strengthened structural, institutional and regulatory environments, remonetization tendencies and the euro cash changeover in 2001 to 2002 played an important role in kicking off credit growth. Moreover, robust output

Chart 3

### Financial Intermediation in CESEE 1993–2008

% of GDP



Source: NCBs, OeNB.



and income growth underpinned credit demand, while at the same time the market entry of foreign banks led to fiercer competition and an increased supply of new financial products. In particular, banks began to refocus their activities on previously untapped market segments such as households and SMEs.

After 2003, however, credit booms also started to give rise to concerns, notably due to financial risks (first and foremost credit and also foreign exchange-related risks, as substantial chunks of domestic credit were extended in foreign currency)

Table 1

### Banking Reform Waves in CESEE: A Stylized Sequence of Events<sup>1</sup>

Analyzed countries <sup>2</sup>	HU	PL	CZ	SK	BG	RO	HR	RS	RU	UA	KZ
<b>Point of departure:</b> state-owned <sup>3</sup> banking system, soft budget constraints, regime change, external shocks, weak rule of law	89–90	89–90	90	90	90	90	90–91	90–92	91–92	91–92	92
Transition recession and banking crises	90–93	90–91	90–92	90–93	90–93	90–92	90–93	90–93	90–96	90–97	90–95
<b>First wave of banking reform</b>											
Liberalization of licensing policies, establishment of generous or lenient regulatory and supervisory systems	89–91	90–92	90–93	90–93	90–94	90–94	90–92	90–94	91–94	91–94	91–94
Up-front rehabilitation measures (e.g. swap of inherited and new nonperforming loans for government securities)	91	91	91	91	91–94	91–93	91–92	–	–	–	94–95
Surface privatization of banks (e.g. mass privatization, MEBOs <sup>4</sup> )	–	93–96	92–94	92–97	–	–	–	–	92–94	93–94	92–94
Initial tightening of banking regulation and supervision	–	–	93–94	94–95	–	95–96	93–94	96–97	94–95	94	94–95
Temporary stabilization of macroeconomic and banking situation	–	–	95–96	96–97	94–95	94–95	94–97	95–97	96–97	–	–
Accumulation of bad loans and structural problems, sometimes complemented by new external shocks	–	–	92–97	93–98	92–96	93–96	93–97	–00	–98	–98	94–97
Establishment of deposit insurance funds	93	95	94	96	95	96	94	–	04	01	99
New transition banking crises and (or) recession	–	–	97–98	97–99	96–97	97–99	98–99	99–00 <sup>5</sup>	98–99	98–99	–
<b>Second wave of banking reform</b>											
Important restructuring, resolution and recapitalization measures: in most cases at least one large bank goes under	92–93	93–96	97–00	98–00	96–97	98–00	98–00	01–02	98–99	98–01	95–97
Establishment of hard budget constraints for banks	92–93	93–94	98–99	99	96–97	99–00	99	02	99	01	97–98
Banks become much more cautious in lending	92–93	93–94	98	98–99	97–98	00	98–99	02–03	98–99	99	97–98
Substantial tightening of banking regulation and supervision, upgrading of accounting standards	92–94	94–95	96–98	98–99	96–97	98–99	98–99	01–02	99–04	00–01	96–03
Strengthening of property and creditor rights, hard budget constraints spread to real sector	95–96	96–97	99–00	00–01	98–99	01	00	03	–	–	–
In-depth privatization (e.g. takeover by strategic investor), FDI boom in banking	94–97	97–00	99–01	01–02	97–03	99–05	99–02	03–	04–	05–	07–
Introduction of credit registers or bureaux	99	–	02	04	00	99	–	–	05	–	04
Bank lending gathers momentum or turns into credit boom	99	98	04	04	01	02	01	04	01	01	00
Authorities' reaction and credit containment policies (e.g. prudential tightening, administrative restrictions)	–	–	–	–	03–09	03–	03–	05–	–	06–	05–

Source: Barisitz (2007, pp. 154–156), table updated.

<sup>1</sup> Country-to-country comparison: year or period of policy measure/event. For example: 91 stands for 1991, 03 stands for 2003, –98 stands for a policy measure/event going on until 1998, but with no clear starting point, 02– stands for a policy measure/event starting in 2002 and continuing past the cutoff date.

<sup>2</sup> HU = Hungary, PL = Poland, CZ = Czech Republic, SK = Slovakia, BG = Bulgaria, RO = Romania, HR = Croatia, RS = Serbia, RU = Russia, UA = Ukraine, KZ = Kazakhstan.

<sup>3</sup> In former Yugoslavia: socially-owned banking system.

<sup>4</sup> Management and employee buyouts.

<sup>5</sup> In former Yugoslavia: slump triggered by the Kosovo war, which contributed to pushing the banking sector to the verge of collapse.

and macroeconomic risks (overheating pressures, external imbalances). The authorities, satisfied with the catching-up dynamics, typically reacted with some delay to the continuing booms. They resorted to credit containment policies, including prudential tightening and increases of minimum reserve requirements and/or administrative restrictions. The effectiveness of these tightening measures was not always convincing, though, given the possibilities of circumvention.

The current global financial and economic crisis has brought the fast financial deepening seen during the earlier years of the current decade to an abrupt halt. In particular, as the crisis intensified after the demise of Lehman Brothers, credit dynamics in CESEE collapsed due to both supply and demand reasons. At the same time, foreign parent banks sustained their operations in the region, thereby preventing an even deeper recession.

### 3 Assessment and Conclusions

To sum it up, all transition countries in Central, Eastern and Southeastern Europe have undergone a period of radical transformation since the regime change from 1989 to 1991 and have made great strides forward in reforming their banking sectors. Two waves of banking reform that all countries went through can be distinguished. The first reform wave included extensive liberalization measures and initial limited restructuring and tightening efforts, while the second reform wave ushered in hard budget constraints, in-depth privatization and a major strengthening of the banking sectors' fundamentals. The market entry of foreign strategic investors has brought about enhanced stability and efficiency, while also strengthening competition. At the same time, a major improvement of the regulatory and supervisory frameworks in line with international and EU standards has taken place. Notwithstanding undeniable progress, a number of countries have not yet fully overcome some shortcomings in the effectiveness of legislation (e.g. weak contract enforcement, difficult access to collateral).

With the benefit of hindsight, one can say that the authorities initially were not fully aware of the time needed to change institutions and allow new structures to emerge that would enable countries to proceed from the formal introduction of new rules to the actual implementation of the rule of law. Thus, the fast demise of old structures created a systemic void that persisted for some years and that various economic agents took advantage of before the new institutions could grow into and occupy that void. A lesson therefore is that early and strong reforms are crucial. They have also proved to be economically less costly than hesitant reforms. Moreover, banks' problems during transition are closely intertwined with weaknesses in the corporate sector. In fact, high (short-term) political and social costs have often hindered a swift and radical reform of the corporate sector, which in turn often delayed the recovery of banks. Therefore, the coordination of banking and enterprise reforms is imperative. However, the capacity of CESEE countries to design and implement reforms was limited during the early stages of transition. Effectively, therefore, there was often little alternative to piecemeal and gradual reforms.

An important feature of banking reforms in CESEE is that Western European FDI has come to dominate the banking sectors of nearly all countries in the region. Where this is not the case (e.g. CIS countries), domestic (private and state) owners have succeeded in maintaining strong market positions. CESEE EU Member

States, candidates or potential candidates have typically been more attractive host countries for foreign strategic investors than countries that do not have an EU accession perspective. The clear requirements and expectations with respect to the rule of law and the observance of the *acquis communautaire*, which the perspective of EU membership holds, have certainly helped in this regard.

Privatization strategies favoring the sale of banks to foreign strategic investors have turned out to be more successful than other strategies in bringing about genuine change in the banking sectors. While foreign takeovers are not the only feasible way for establishing viable and competitive banks in the region, the necessary accumulation of human and financial capital will probably take longer if financial development is essentially home-grown. While the current global crisis highlighted the risk of cross-border contagion, this risk has not materialized. Rather, a number of domestically owned banks that refinanced themselves on international markets came under severe funding pressures.

The current global crisis has also interrupted the dynamic financial deepening process witnessed in the earlier years of this decade, thereby heralding a third wave of banking reforms, which – in line with global trends – will center on improving risk management practices and beefing up regulation and supervision to support the sustainability of financial convergence. But even if the pace of financial convergence has halted for the time being, the reform measures taken so far in most CESEE countries have created a good starting position for future dynamic development. The relatively low financial depth levels compared with the euro area offer long-term expansion potential, in line with and alongside income convergence. At the same time, future financial deepening will (have to) be less rapid than it was in the years before the current crisis.

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# Austrian Banks' Activities in CESEE

## 1 The Expansion of Austrian Banks to CESEE

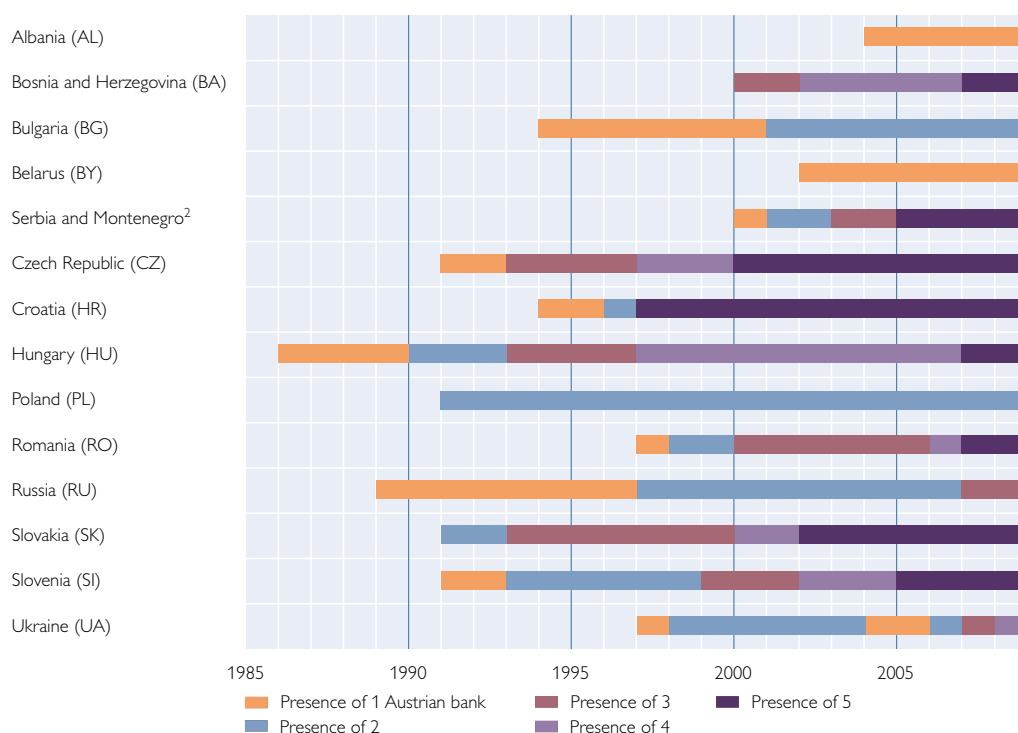
Austrian banks started to enter the Central, Eastern and Southeastern European (CESEE) markets as early as in the mid-1980s, thus being among the first to move into the region.<sup>2</sup> This step was primarily motivated by the wish to provide services to domestic corporations that had expanded to CESEE. In addition, it gave domestic banks the opportunity to gain ground in markets that – mainly for geographical and historical reasons – had close links with Austria. By the early 1990s, three Austrian banking groups had established subsidiaries in neighboring countries and also in Poland and Russia. Chart 1 shows the presence of the major Austrian banking groups in CESEE and in the Commonwealth of Independent States (CIS) in terms of the number of local subsidiaries.

Gerald Krenn,  
Claus Pühr<sup>1</sup>

During the recessions that struck most CESEE countries in the 1990s, Austrian banks and their subsidiaries – contrary to many state-owned banks – stayed clear of default, as at that time the subsidiaries were almost exclusively greenfield

Chart 1

### Development of the Six Major Austrian Banks' Subsidiaries in CESEE and the CIS<sup>1</sup>



Source: OeNB, banks' websites.

<sup>1</sup> Banks included: UniCredit Bank Austria AG, Erste Bank der oesterreichischen Sparkassen AG (Erste Bank), Raiffeisen Zentralbank Österreich AG (RZB), Volksbank AG (VBAG), Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse AG (BAWAG P.S.K.), and Hypo Group Alpe Adria (HGAA) or their respective predecessors.

<sup>2</sup> Serbia and Montenegro (CS) until 2005, from 2006 Montenegro (ME) and Serbia (RS).

<sup>1</sup> Oesterreichische Nationalbank, Financial Markets Analysis and Surveillance Division, [gerald.krenn@oenb.at](mailto:gerald.krenn@oenb.at) and [claus.puhr@oenb.at](mailto:claus.puhr@oenb.at). The authors would like to thank Markus Hameter, Johannes Pann, Thomas Reininger and Zoltan Walko (all OeNB) for their support and the provision of data. We also acknowledge valuable research assistance by Gregory Ivanov.

<sup>2</sup> See also Kager's contribution "A Banker's Take on Twenty Years of CEE Banking Sector Developments" in this issue.

operations with less risky loan portfolios than many state-owned banks that struggled with bad loans inherited from Communist times. While the restructuring and refinancing of state-owned banks proved costly and led many CESEE governments to proceed with full or partial privatization, more Austrian banks expanded into CESEE in the second half of the 1990s (see Barisitz, 2006). That period was marked by a significant departure from the banks' formerly homogeneous business models as their strategies diversified. Some banks continued to concentrate on their initial greenfield operations and a strategy of organic growth, whereas others acquired stakes in large state-owned banks in the first wave of privatization to accelerate their expansion.

At the turn of the millennium, the economic environment in most CESEE countries stabilized and banking activities entered a path of sustained expansion, boosted by robust economic growth and the anchor or prospect of EU accession (see Barisitz, 2006). EU-15 banks began to enter the markets in significant numbers, taking advantage of further large-scale privatizations. Apart from a few large domestically-owned national players or state-owned banks, the banking markets in CESEE were dominated by EU-15 banking groups at that time. As the CESEE countries began to prosper and EU membership negotiations started, in particular three Austrian banks (UniCredit Bank Austria, Erste Bank, and RZB) had already seized the opportunity of an early expansion into the region. They are now among the largest foreign investors in terms of total banking assets in CESEE.

In addition, the CIS started to become more important for Austrian banks at the turn of the millennium. With many of the CESEE markets passing on to a more mature stage of development, the CIS offered an opportunity for Austrian banks to prolong their strategy of pioneering expansion.

## 2 Current Exposure of Austrian Subsidiaries in CESEE<sup>3</sup>

The recent past has been characterized by both an increase in market shares that Austrian subsidiaries hold in CESEE and the CIS and a rise in the region's importance for the Austrian banking system. Regarding market shares, disaggregated data on the subsidiaries of the 11 Austrian banking groups active in the region reveal that these subsidiaries hold considerable cumulated shares in CESEE that come to or exceed 30% in six countries<sup>4</sup> (see chart 2). For the entire region (excluding Russia), Austrian subsidiaries' market share recently dropped by 1 percentage point to 22% at year-end 2008. Including Russia, this share stands at 15%.

Although some markets account for a significant share in Austrian banks' overall exposure to the CESEE and CIS markets – in terms of subsidiaries' aggregate total assets, the largest exposure is vis-à-vis the Czech Republic (more than EUR 50 billion), followed by almost equally large exposures to Croatia, Slovakia, Romania, Russia, and Hungary (around EUR 30 billion each) – no single country contributes more than 20%.

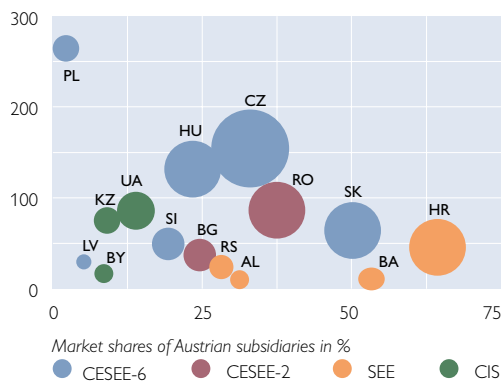
<sup>3</sup> In response to the increasing importance of CESEE operations for the entire domestic banking system, the OeNB started to collect data on the subsidiaries that primarily operate under host country supervision. At the beginning (i.e. in 2002), these data included basic balance sheet information, which were later augmented by more detailed, risk-related information. Section 2 is mainly based on data from these reports that have been available over the entire reporting horizon.

<sup>4</sup> Albania, Bosnia and Herzegovina, Croatia, the Czech Republic, Romania, and Slovakia.

Chart 2

### Austrian Subsidiaries' Market Shares at End-2008

Aggregate total assets, EUR billion



Source: OeNB.

Note: The size of the circle corresponds to the total exposure of Austrian banks vis-à-vis the respective country. CESEE-6 stands for CZ, HU, LV, PL, SI, and SK. CESEE-2 refers to BG and RO. SEE (Southeastern Europe) covers AL, BA, HR, and RS, and CIS refers to BY, Kazakhstan (KZ), and UA; RU is excluded due to the size of the aggregate banking system (EUR 680 billion).

The recent rise in subsidiaries' total assets (see chart 3) was mainly boosted by two driving forces: acquisitions, the bulk of which took place outside the EU Member States that joined in 2004, and annual loan growth rates that persistently exceeded 20% in virtually all organically developing entities and were even considerably higher in several cases. Nevertheless, the CESEE-10<sup>5</sup> account for roughly two-thirds of Austrian subsidiaries' total assets in the region. Outside the CESEE-10, Croatia is the most important market for Austrian banks' subsidiaries, closely followed by Russia, the largest market in the entire region.

On an aggregate level, these two markets gained further weight with the restructuring that followed the 2007 takeover of HVB Group (then Bank Austria's parent bank) by the Italian UniCredit Group (its current parent bank). The latter, also a pioneering institution in the region, put its Austrian subsidiary, henceforward UniCredit Bank Austria, in charge of the entire group's CESEE segment.<sup>6</sup>

Even on the aggregate level, this transaction had a significant impact on the Austrian banking system's overall exposure to the region. Given the fact that EU membership has always been cited as a major stabilization factor, this transaction notably increased the share of assets outside the CESEE-10 (from 25% at end-2006<sup>7</sup> to 34% at end-2007). However, there are many other, more refined ways to assess subsidiaries' risk positions, amongst which external sources such as bank or sovereign ratings play an important role. Up to early 2008, rating outlooks for the region were consistently positive, and up to mid-October 2008, actual downgrades were limited to sovereigns which are of only marginal importance to Austrian banks.<sup>8</sup> From October 2008 on, however, the large rating agencies issued qualitative analyses some of which described the outlooks as deteriorating both at bank and sovereign level. Shortly after, the first downgrades relevant to Austrian

<sup>5</sup> CESEE-10 refers to the eight CESEE countries that joined the EU in 2004 (CESEE-8: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia) plus the two that joined in 2007 (CESEE-2: Bulgaria and Romania).

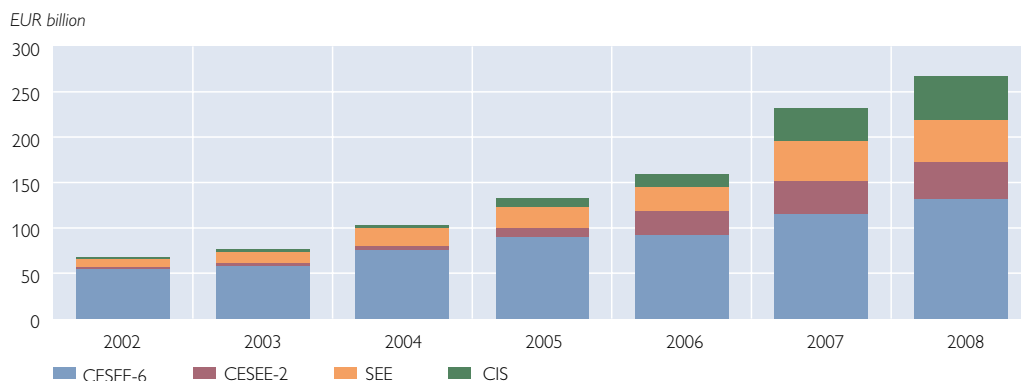
<sup>6</sup> The sale of the Polish Bank BPH (which became necessary as the Polish subsidiary reports directly to the Italian parent bank) and of the Croatian Splitska banka (which was required based on competition rules) was more than offset by the acquisition of Bulbank (BG), Živnostenská banka (CZ), Zagrebačka banka (HR, the largest local bank), UniCredit Bank (LV), UniCredit Tiriak Bank (RO), IMB (RU) and Unibanka (SK). In addition, UniCredit Bank Austria took control of the 40% stake in the Turkish joint venture Yapı Kredi.

<sup>7</sup> If one includes the exposure to Bulgaria and Romania already in the CESEE-10 category.

<sup>8</sup> For instance, Standard & Poor's downgraded the ratings of Kazakhstan and Lithuania.



### Austrian Subsidiaries' Total Assets in CESEE and the CIS (2002–2008)



Source: OeNB.

Note: In this chart, CESEE-6 includes CZ, HU, LV, PL, SI and SK, CESEE-2 refers to BG and RO, SEE covers AL, BA, HR, ME, and RS, and CIS includes BY, KG, KZ, RU, Tajikistan (TJ), and UA.

banks followed.<sup>9</sup> Nevertheless, at year-end 2008, more than one-half of Austrian subsidiaries' total banking assets in the region were still held in countries with investment grade ratings.<sup>10</sup>

### 3 Direct Cross-Border Lending by Austrian Banks to CESEE<sup>11</sup>

In addition to the assets of local subsidiaries, Austrian banks hold substantial exposures to CESEE and the CIS in the form of direct cross-border loans. From year-end 2002, credit to nonbanks more than quadrupled to EUR 67.4 billion. On an aggregate basis, direct lending to CESEE and the CIS grew at a steadily increasing pace, but local and regional differences are quite significant (see chart 4). In terms of total (i.e. direct and indirect<sup>12</sup>) cross-border lending to nonbanks in the region, the relative importance of direct cross-border lending remained constant at just under one-third of the total volume.

Regarding cross-border credit extended to customers resident in the CESEE-10, direct lending to the CESEE countries that joined the EU in 2004 increased at a fairly steady pace of about 20% per year to EUR 36.2 billion, whereas direct lending to Bulgaria and Romania grew at a significantly faster rate of more than 50%

<sup>9</sup> Still in 2008, Moody's reduced the sovereign ratings of Estonia, Latvia and Hungary, and Fitch cut the ratings of Bulgaria, Kazakhstan and Hungary by one notch and Romania's rating even by two notches.

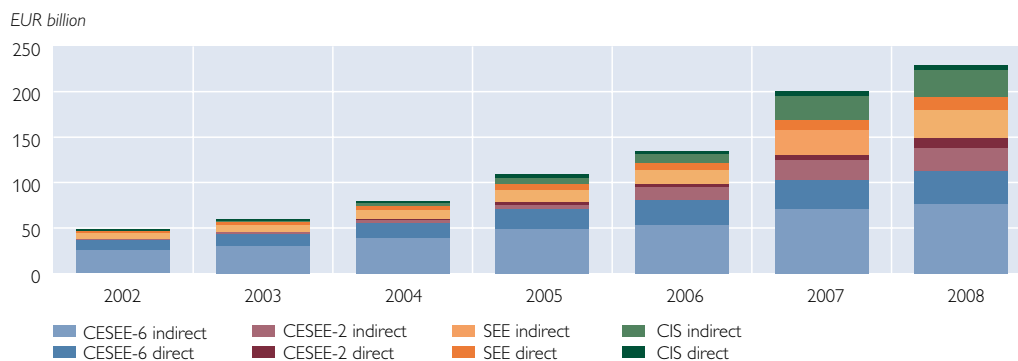
<sup>10</sup> Looking at Moody's Bank Financial Strength Ratings (BFSRs) instead of the country ratings, at year-end 2008, 39% of assets were held in countries with an average individual bank rating of C (adequate intrinsic financial strength), 58% in countries with an average rating of D (modest intrinsic financial strength) and only 3% in countries that were not rated at all or had an average rating of E (very modest intrinsic financial strength) (Moody's, 2009).

<sup>11</sup> The OeNB's primary data source for direct cross-border lending is the Central Credit Register, which provides detailed information on Austrian banks' credit portfolios on a customer-by-customer basis. For domestic and foreign borrowers, the register contains data on securitized and nonsecuritized lending as well as guarantees and other off balance sheet items exceeding a volume of EUR 350,000. For each borrower, banks report the outstanding volume, granted credit lines, the sum of collateral and finally their internal rating. A detailed description of the Central Credit Register is available in OeNB (2008) (German only).

<sup>12</sup> In this contribution, direct (cross-border) lending refers to loans extended by Austrian banks to customers resident outside Austria, whereas indirect (cross-border) lending covers loans extended by Austrian banks' foreign subsidiaries to customers resident outside Austria.

Chart 4

### Development of Cross-Border Lending by Regions (2002–2008)



to EUR 10.7 billion at year-end 2008. Together, the two regions account for a steady share of slightly over two-thirds of overall direct lending to CESEE and the CIS countries.

In contrast to indirect cross-border lending to CESEE and the CIS, customers from Croatia (with a share of 17%), Poland (13%), the Czech Republic, Hungary and Romania (12% each) were the leading recipients of credit from Austrian banks at year-end 2008. In Romania, and to a lesser extent also in Bulgaria, direct cross-border lending has grown faster than in all other countries since 2002. This development to some extent mirrors the trend of indirect lending to the entire region, which has also been expanding rapidly in the CESEE-8 (and also SEE and the CIS) – at the expense of the relative weight of the CESEE-2. This would suggest that, by and large, direct lending activities of Austrian banks have accompanied the expansion of indirect lending.

However, the co-movement of direct and indirect lending is far from ubiquitous. In Russia, for example, indirect loans expanded rapidly through both organic growth and acquisitions, whereas the relative importance of direct lending decreased markedly. The same applies e.g. to Slovenia and Ukraine. As a consequence of the ongoing financial crisis and the associated reassessment of the risk posed by the regional credit exposure, the dynamics of credit expansion lost momentum across the region in the second half of 2008. Notwithstanding differences among the countries, growth almost came to a standstill at year-end with as yet no sign of a recovery.

So far, the analysis was restricted to aggregate data, so that the large Austrian banking groups dominated observations. But direct cross-border lending to CESEE has become important for small and medium-sized banks, as well. Pühr et al. (2009) show that these banks, particularly in the eastern provinces of Austria, tend to extend loans to borrowers from immediate CESEE neighbors.<sup>13</sup>

Chart 5 shows a breakdown by province of aggregate direct cross-border lending to Austria's four CESEE neighbors at year-end 2008 (represented by the light

<sup>13</sup> Austria's immediate CESEE neighbors are the Czech Republic, Hungary, Slovakia, and Slovenia.

### Neighborhood Effects of Cross-Border Lending at End-2008



Source: OeNB.

blue slices within each circle).<sup>14</sup> Moreover, the chart provides information about the respective customers' countries of residence (represented by the columns next to each blue slice). The two measures indicate the influence of geographic proximity on whether Austrian banks extend loans to the region at all and if they do, whereto. The dominance of the Czech Republic in the north, Hungary in the east, and Slovenia in the south indicates that geographic proximity is indeed a significant factor in the choice of destination for direct cross-border lending by Austria's small and medium-sized banks.

#### 4 The Impact of the Expansion to CESEE on the Austrian Banking System

As shown in the previous two sections, the staggering organic growth of established subsidiaries, further acquisitions, as well as surging direct lending have contributed to an increase in the exposure of Austrian banks to CESEE and CIS markets. To assess the impact of this rapid expansion of the Austrian banking system's activities in CESEE as a whole, we need to take a look at the consolidated level.

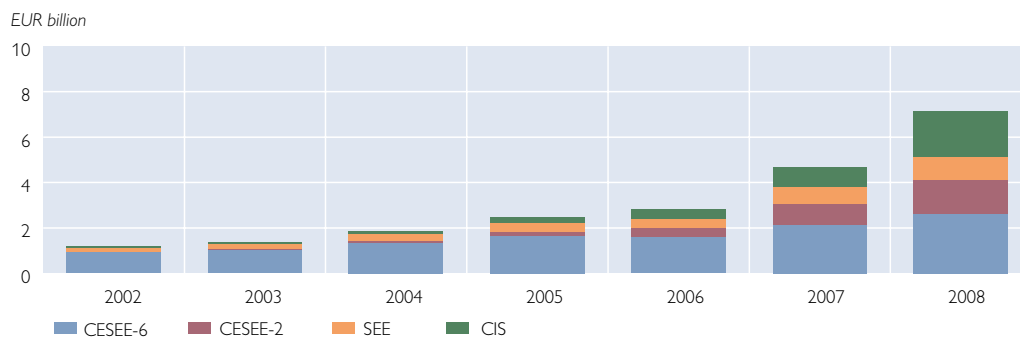
Unfortunately, systematic reporting with a breakdown by regions of balance sheet and profit and loss data was only implemented in 2008. However, the business segment reports<sup>15</sup> of the six major Austrian banks active in the region have shown a steep relative increase in total assets and an even steeper relative rise in pretax aggregate profits. In the second half of the decade, the share of total

<sup>14</sup> All Austrian provinces are included in chart 5 with the exception of Vienna. Home to all large Austrian banking groups except HGAA, Vienna more or less reflects the aggregate Austrian banking systems' geographic diversification of direct cross-border lending.

<sup>15</sup> The six major Austrian banking groups (see footnote 1 of chart 1) increasingly published business segment reports as part of their annual reports. For those who did not, the OeNB drew that information from bilateral surveys.

Chart 6

### Austrian Subsidiaries' Operating Income (2002–2008)



Source: OeNB.

Note: CESEE-6 covers CZ, HU, LV, PL, SI and SK, CESEE-2 includes BG and RO, SEE stands for AL, BA, HR, ME, and RS, and CIS includes BY, RU and UA.

assets in CESEE and the CIS rose by approximately 10 percentage points to just over one-quarter at year-end 2007. At the same time, the contribution of the CESEE and CIS business to pretax profits improved to more than 40%, thus significantly outpacing the growth of the regions' share in Austrian banks' total assets.

At end-2008, the 40 banking groups subject to this new reporting standard<sup>16</sup> held more than 30% of Austrian banks' total consolidated assets in CESEE and the CIS. At the same time, they hauled in EUR 2.9 billion in pretax profits, which helped to offset the losses incurred domestically and in the rest of the world. Again, subsidiaries played an important role (see chart 6), which can be partly explained by an observation made by Liebeg and Schwaiger (2007): They show that in CESEE – contrary to other emerging markets – foreign ownership had a positive effect on interest margins. They attribute this to the fact that for subsidiaries, refinancing is cheaper than for their domestic peers, as the subsidiaries have access to the internal capital market of the holding group and profit from implicit guarantees by the parent institution.

In the same study, Liebeg and Schwaiger confirm the assumption that interest rate margins in CESEE are the lower, the more developed an economy is. Thus, they provide evidence of a fact that is one of the main incentives for banks to move further east to less developed markets, where, however, higher profits have gone hand in hand with higher risks. Although financial deepening, and therefore a benign climate for banks, is expected to resume in CESEE and the CIS in the long run, the short- and medium-term outlook is less positive. Still, Austrian banks have on numerous occasions confirmed their intention to support local subsidiaries through these harder times.

While financial markets are already factoring in the region's economic downturn, the risk positions in bank balance sheets as well as the data reported reflect this development with a lag. In view of the adverse developments, profit contribution can be expected to shrink notably in the near future, and total asset growth in the region can be expected to decelerate (or even turn negative), at least in the

<sup>16</sup> In 2008, business segment reports were formally introduced as part of the OeNB's regulatory reporting requirements.

short term.<sup>17</sup> After all, expanding lending without providing for additional own funds would inevitably lead to lower capital ratios,<sup>18</sup> and investors are currently demanding higher capital ratios, which they consider a sign of a bank's higher risk-bearing capacity.

In their assessment of the impact of the crisis on Austria's financial sector, Schürz, Schwaiger and Übeleis (2009) claim that "judged by the sequence of events in previous crisis episodes, at the current juncture, the brunt of the feedback of the real economic downturn on the banking sector is yet to come." Accordingly, the risk emanating from the Austrian banking system's CESEE and CIS exposure was partially reflected in the size of Austria's bank package, which was comparatively large by EU standards.<sup>19</sup> The political will in Austria, but also internationally,<sup>20</sup> should instill confidence regarding the long-term success of Austrian banks' expansionary business model. But as events are still unfolding, it would be premature at this point to attempt a final assessment of the impact the global crisis will have on Austrian banks and of the role their CESEE and CIS business will play in that ongoing story.

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<sup>17</sup> In the second half of 2008, growth rates of direct and indirect cross-border lending decelerated significantly. They remained slightly positive on aggregate, but decreased in individual countries.

<sup>18</sup> Capital ratios decrease when risk-weighted assets (the denominator of the ratio) increase – independently of whether this rise stems from an expanding loan book or higher risk weights as part of portfolio migration to worse rating classes at the turn of the credit cycle.

<sup>19</sup> In a comparison of bank packages, Posch, Schmitz and Weber (2009) find that the Austrian bank package, together with the Irish bank package, is at the upper end in terms of size measured as a ratio of GDP.

<sup>20</sup> According to Schürz, Schwaiger and Übeleis (2009), the financial assistance provided by the EU and the IMF has helped to avoid bleak scenarios in CESEE and the CIS.

# Chronology of Events and OeNB Activities

# Chronology of Events 1989–2009

Majken Corti<sup>1</sup>

The following chronology<sup>2</sup> covers major events leading to and following the fall of the Iron Curtain as well as milestones of European integration. Furthermore, it pays tribute to the role of the European Commission and international institutions, such as the International Monetary Fund (IMF), in supporting the transition process.

Focus is given to the ten countries in Central, Eastern and Southeastern Europe (CESEE) that have, in the meantime, become members of the EU: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Slovenia. Considering the number of countries and time span covered, this chronology does not claim to be complete.

## 1988

May 23 János Kádár, Secretary-General of the Hungarian Communist Party, is forced to resign, mainly due to the country's economic difficulties and his own ill health, opening the way for the Hungarian parliament to adopt a reform package.

## 1989

June 4 The landslide victory of Solidarność in the Polish parliamentary elections leads to the formation of the first noncommunist government in the Eastern Bloc in September 1989.

July 14–16 At the Paris Western Economic Summit, the European Commission is charged with the coordination of economic restructuring assistance in Hungary and Poland, to be financed by the G-24.<sup>3</sup> This marks the beginning of the PHARE<sup>4</sup> program, which is soon afterwards extended to a larger group of countries and becomes one of the instruments to assist the CESEE countries in their preparations for joining the EU.

Sep. 11 Hungary opens its border with Austria, allowing more than 30,000 East Germans to flee to the West before East Germany bans its citizens from travelling to Hungary.

Oct. 18 East German leader Erich Honecker is forced to step down in the face of mass protests and growing pressure for reform.

Nov. 3 Czechoslovakia opens its borders to the West, allowing thousands of East Germans to travel to West Germany via Czechoslovakia.

Nov. 9 The Berlin Wall falls as East German authorities allow their citizens to enter West Germany directly via existing border points.

Nov. 10 Bulgarian head of state and leader of the Communist Party, Todor Zhivkov, is removed from office in an attempt to satisfy the growing pro-democracy movement. In February 1990 the party voluntarily gives up its claim on power.

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<sup>2</sup> Cutoff date: June 30, 2009.

<sup>3</sup> The G-24 was a group of Western industrialized countries founded to provide financial assistance to the transition economies of CESEE.

<sup>4</sup> Poland and Hungary: Assistance for Restructuring their Economies.



- Nov. 17 The brutal suppression of a peaceful student demonstration by riot police in Prague triggers a series of mass demonstrations in Czechoslovakia. This date marks the beginning of the Velvet Revolution, which brings down the Communist regime. Dissident writer Václav Havel is elected president in December.
- Dec. 16–25 The Romanian Revolution, claiming the lives of 1,104 people, overthrows the regime of Communist leader Nicolae Ceaușescu, who is executed together with his wife.

**1990**

- Jan. 1 Re-establishment of the Bank of Estonia.
- Jan. 2 The Polish złoty is pegged to the U.S. dollar and backed by a USD 1 billion stabilization fund provided by the G-24.
- Feb. 16 The Paris Club<sup>5</sup> and Poland sign a debt rescheduling agreement.
- Mar. 1 Re-establishment of the Bank of Lithuania.
- Mar. 2 Re-establishment of the Bank of Latvia.
- Mar. 11 Lithuania declares independence. An attempt by the Soviet army to prevent the secession fails.
- Mar. 14 The IMF approves an SDR 160 million compensatory and contingency financing facility for Hungary.
- Sep. 20 Czechoslovakia joins the IMF.
- Sep. 25 Bulgaria joins the IMF.
- Oct. 3 German unification.

**1991**

- Jan. 1 The Czechoslovak koruna is pegged to a currency basket with a band.
- Feb. 15 Czechoslovakia, Hungary and Poland found the Visegrád Group, an alliance to foster inter-state cooperation and further integration into the EU.
- Feb. 20 The IMF approves an SDR 1.1 billion extended fund facility for Hungary.
- Mar. 15 The IMF approves an SDR 279 million stand-by facility for Bulgaria.
- Apr. 11 The IMF approves an SDR 380.5 million stand-by facility for Romania.
- Apr. 14 Inauguration of the European Bank for Reconstruction and Development (EBRD) with the objective of supporting the transition process in CEE.
- Apr. 18 The IMF approves an SDR 1.2 billion extended fund facility for Poland.
- Apr. 19 The Paris Club reaches an agreement with Poland on debt reduction and with Bulgaria on debt rescheduling.

<sup>5</sup> The Paris Club is an informal group of public creditors that negotiates solutions to the payment difficulties experienced by debtor countries.

June 25	Slovenia declares independence. The ensuing ten-day war marks the beginning of the breakup of Yugoslavia. The Bank of Slovenia is established.
Aug. 20	Estonia declares independence.
May 4	Latvia declares independence.
Oct. 8	The tolar becomes the national currency of Slovenia under a managed floating exchange rate regime.
Oct. 15	Poland introduces a crawling peg regime, linking the złoty to a currency basket.
Dec. 9	Hungary pegs the forint to a currency basket with a band.
<b>1992</b>	
Apr. 3	The IMF approves an SDR 236 million stand-by arrangement for Czechoslovakia.
Apr. 17	The IMF approves an SDR 155 million stand-by arrangement for Bulgaria.
Apr. 29	Lithuania joins the IMF.
May 1–7	Lithuania and Latvia introduce temporary currencies – the talonas and the Latvian ruble respectively – alongside the Russian ruble to combat a shortage of cash and to pave the way for an independent monetary system.
May 19	Latvia joins the IMF.
May 26	Estonia joins the IMF.
June 1	The IMF approves an SDR 314 million stand-by arrangement for Romania.
June 20	The Estonian kroon becomes the sole legal tender in Estonia. The exchange rate is fixed against the Deutsche mark (against the euro as of January 1, 1999). The Estonian currency board arrangement has been maintained nominally unchanged until today.
July 20	Latvia temporarily introduces the Latvian ruble as sole legal tender and establishes a managed floating exchange rate regime.
Oct. 1	Lithuania temporarily introduces the talonas as sole legal tender.
Dec. 14	Slovenia succeeds to the IMF membership of the former Socialist Federal Republic of Yugoslavia and takes over its share of the member quota, assets and liabilities.
Dec. 16	The Paris Club and Bulgaria sign a debt rescheduling agreement.
<b>1993</b>	
Jan. 1	Peaceful breakup of Czechoslovakia into the Czech Republic and Slovakia. The Czech National Bank and the National Bank of Slovakia are established to replace the State Bank of Czechoslovakia, and two new currencies, the Czech koruna and the Slovak koruna, are introduced (the exchange rate regime remains unchanged). The Czech Republic and Slovakia succeed to the IMF membership of Czechoslovakia, dividing between them its member quota, assets and liabilities.

Mar. 5	The lats becomes the national currency of Latvia. The Latvian ruble remains legal tender for some denominations until July 1998.
Mar. 8	The IMF approves an SDR 476 million stand-by credit for Poland.
Mar. 17	The IMF approves an SDR 177 million stand-by credit for the Czech Republic.
June 21–22	With a view to eastward enlargement, the Copenhagen Criteria for EU accession are laid down at the European Council. They stipulate that a new Member State must (1) be a stable democracy, respect human rights and the rule of law and protect minorities, (2) have a working market economy and (3) adopt the common rules, standards and policies that make up the body of EU law.
June 25	The litas becomes the national currency of Lithuania, replacing the talonas.
Oct. 25	The IMF approves an SDR 25.9 million systemic transformation facility for Lithuania.
Oct. 27	The IMF approves an SDR 11.6 million stand-by credit for Estonia.
Nov. 1	The Treaty of Maastricht enters into force, creating the EU and setting the rules for the single currency, the Common Foreign and Security Policy as well as closer cooperation in justice and home affairs.
Dec. 15	The IMF approves an SDR 22.9 million stand-by credit for Latvia.

#### 1994

Feb. 1	European Union Association Agreements (EUAs) with Hungary and Poland enter into force, establishing the framework for the accession process.
Feb. 12	The Latvian lats is pegged to an SDR basket with a band (and repegged to the euro as of January 1, 2005).
Mar. 31	Hungary is the first CESEE country to formally apply for EU membership.
Apr. 1	Lithuania adopts a fixed exchange rate under a currency board arrangement. The exchange rate of the litas is pegged to the U.S. dollar (and repegged to the euro as of February 2, 2002).
Apr. 5	Poland formally applies for EU membership.
Apr. 12	The IMF approves an SDR 69.7 million stand-by credit for Bulgaria.
Apr. 14	The Paris Club and Bulgaria sign a debt rescheduling agreement.
May 3	Lithuania accepts the IMF's Article VIII obligations regarding the liberalization of capital movements.
May 11	The IMF approves an SDR 132 million stand-by credit for Romania.

June 10	Latvia accepts the IMF's Article VIII obligations.
June 29	The London Club <sup>6</sup> and Bulgaria sign a debt reduction (nearly 50%) agreement.
July 1	The Central European Free Trade Agreement (CEFTA) between the Czech Republic, Hungary, Poland and Slovakia enters into force.
July 22	The IMF approves an SDR 180.2 million stand-by credit for Slovakia.
Aug. 5	The IMF approves an SDR 545 million stand-by credit for Poland.
Aug. 15	Estonia accepts the IMF's Article VIII obligations.
Sep. 14	The London Club and Poland sign a debt reduction (nearly 50%) and rescheduling agreement.

**1995**

Feb. 1	The EUAs with Bulgaria, the Czech Republic, Romania and Slovakia enter into force.
Mar. 13	Hungary introduces a crawling peg regime. The forint is pegged to the Deutsche mark with a band (and re-pegged to the euro as of January 1, 2000).
Apr. 12	The IMF approves an SDR 14 million stand-by credit for Estonia.
Apr. 21	The IMF approves an SDR 27.5 million stand-by credit for Latvia.
May 16	A band is added to the Polish crawling peg regime.
June 22–27	Romania and Slovakia formally apply for EU membership.
July 21	Poland accepts the IMF's Article VIII obligations.
Sep. 1	Slovenia accepts the IMF's Article VIII obligations.
Oct. 1	The Czech Republic and Slovakia accept the IMF's Article VIII obligations.
Oct. 13	Latvia formally applies for EU membership.
Nov. 24	Estonia formally applies for EU membership.
Dec. 8	Lithuania formally applies for EU membership.
Dec. 14	Bulgaria formally applies for EU membership.

**1996**

Jan. 1	Slovenia joins CEFTA as its fifth member. Hungary accepts the IMF's Article VIII obligations.
Jan. 17	The Czech Republic formally applies for EU membership.
Mar. 15	The IMF approves an SDR 264.2 million stand-by credit for Hungary.
May 24	The IMF approves an SDR 30 million stand-by credit for Latvia.
June 10	Slovenia formally applies for EU membership.
July 19	The IMF approves an SDR 400 million stand-by credit for Bulgaria.
July 29	The IMF approves an SDR 14 million stand-by credit for Estonia.

<sup>6</sup> The London Club is an informal group of private creditors that negotiates solutions to the payment difficulties experienced by debtor countries.

**1997**

Apr. 11	The IMF approves an SDR 479.5 million credit for Bulgaria.
Apr. 23	The IMF approves an SDR 301.5 million stand-by credit for Romania.
May 26	The Czech Republic adopts a managed floating exchange rate regime.
July 1	Bulgaria adopts a fixed exchange rate regime under a currency board arrangement. The exchange rate of the lev is fixed against the Deutsche mark (and against the euro as of January 1, 1999). Romania joins CEFTA as its sixth member.
July 16	The European Commission presents its Opinions on the applications of the ten CESEE countries, proposing to begin accession negotiations with the Czech Republic, Estonia, Hungary, Poland and Slovenia but to postpone the start of accession negotiations with Bulgaria, Latvia, Lithuania, Romania and Slovakia.
Oct. 10	The IMF approves an SDR 33 million stand-by credit for Latvia.
Dec. 12–13	Official launch of the enlargement process at the European Council meeting in Luxembourg.
Dec. 17	The IMF approves an SDR 16.1 million stand-by credit for Estonia.

**1998**

Feb. 1	The EUAs with Estonia, Latvia and Lithuania enter into force.
Mar. 25	Romania accepts the IMF's Article VIII obligations.
Mar. 30	The EU officially launches the accession process of ten CESEE countries. The European Council adopts individual Accession Partnerships (APs) for each country. The candidate countries draw up national programs for the adoption of the <i>acquis communautaire</i> , setting out a timetable for achieving the priorities and objectives laid down in the APs.
Mar. 31	Bilateral EU accession negotiations begin with the Czech Republic, Estonia, Hungary, Poland and Slovenia.
Apr. 3	Formal beginning of the analytical examination of the <i>acquis communautaire</i> of the ten CESEE countries, the multilateral <i>acquis</i> screening process.
June 1	The European Central Bank (ECB) and the European System of Central Banks (ESCB) are established.
Sep. 24	Bulgaria accepts the IMF's Article VIII obligations.
Sep. 28	The IMF approves an SDR 627.6 million extended fund facility for Bulgaria.
Oct. 1	Slovakia moves from its fixed exchange rate regime to managed floating.
Nov. 4	The European Commission publishes Progress Reports assessing the ten CESEE candidate countries' progress in preparing for EU membership.

**1999**

- Jan. 1 Eleven EU Member States introduce the euro as an electronic means of payment, irrevocably fixing the exchange rates of their national currencies against the euro.  
Bulgaria joins CEFTA as its seventh member.
- Feb. 1 The EUAA with Slovenia enters into force.
- May 1 The Treaty of Amsterdam enters into force, clearing the way for EU enlargement.
- Aug. 5 The IMF approves an SDR 400 million stand-by credit for Romania.
- Oct. 13 The European Commission publishes the 1999 Progress Reports, recommending the start of accession negotiations with Bulgaria, Latvia, Lithuania, Romania and Slovakia, but also imposing certain conditions on Bulgaria and Romania.
- Dec. 10 The IMF approves an SDR 33 million stand-by credit for Latvia.

**2000**

- Jan. 15 Start of bilateral EU accession negotiations with Bulgaria, Latvia, Lithuania, Romania and Slovakia.
- Mar. 1 The IMF approves an SDR 29.3 million stand-by credit for Estonia.
- Mar. 8 The IMF approves an SDR 61.8 million stand-by credit for Lithuania.
- Apr. 12 Poland allows the zloty to float freely.

**2001**

- Apr. 20 The IMF approves an SDR 33 million stand-by credit for Latvia.
- Aug. 30 The IMF approves an SDR 86.5 million stand-by arrangement for Lithuania.
- Oct. 1 Hungary pegs the forint to the euro with a wide band, abandoning the crawling peg regime after six years.
- Oct. 31 The IMF approves an SDR 300 million stand-by credit for Romania.

**2002**

- Jan. 1 Euro notes and coins replace the national currencies in 12 EU Member States.
- Feb. 27 The IMF approves an SDR 240 million stand-by credit for Bulgaria.

**2003**

- Feb. 1 The Treaty of Nice enters into force, paving the way for enlargement by reforming EU voting rules.

**2004**

- May 1 The Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovakia and Slovenia as well as Cyprus and Malta join the EU. Their respective national central banks become members of the ESCB.

June 28	Estonia, Lithuania and Slovenia enter the European exchange rate mechanism II (ERM II).
July 7	The IMF approves an SDR 250 million stand-by arrangement for Romania.
Aug. 6	The IMF approves an SDR 100 million stand-by arrangement for Bulgaria.
<b>2005</b>	
May 2	Latvia enters ERM II.
Nov. 28	Slovakia enters ERM II.
<b>2006</b>	
Sep. 26	The European Commission adopts its final monitoring report on the preparedness of Bulgaria and Romania for EU membership. Both countries are considered to be ready to join on January 1, 2007, on the condition that a mechanism is established to verify that progress is made in the areas of judicial reform and the fight against corruption and organized crime.
<b>2007</b>	
Jan. 1	Bulgaria and Romania join the EU, and their respective national central banks become members of the ESCB. Slovenia adopts the euro.
Mar. 16	The Slovak koruna's central exchange rate in ERM II is revalued by 8.5%.
Dec. 13	The EU heads of state and government sign the Treaty of Lisbon. After ratification by all EU Member States, it will adapt the structures of the EU and its institutions to an enlarged Union, bring about changes in how EU legislation is proposed and adopted, and enhance the EU's role on the international stage.
<b>2008</b>	
Jan. 1	Slovenia is the first among the Member States that joined in 2004 or 2007 to take over the presidency of the EU.
Feb. 26	The exchange rate of the Hungarian forint is allowed to float freely.
May 29	The Slovak koruna's central exchange rate in ERM II is revalued by 17.6%.
Sep. 7–15	The world financial crisis escalates.
Nov. 4–6	In a concerted effort to avert a deepening of financial market pressures in Hungary, the IMF approves an SDR 10.5 billion stand-by arrangement, and the European Council approves a EUR 6.5 billion loan.



Dec. 23	As part of a concerted effort to stabilize the Latvian economy, the IMF approves an SDR 1.5 billion stand-by arrangement. On January 20, 2009, the European Council approves a EUR 3.1 billion loan. Furthermore, Scandinavian, Baltic and Eastern European countries provide bilateral financial assistance.
<b>2009</b>	
Jan. 1	The Czech Republic takes over the presidency of the EU. Slovakia adopts the euro.
Jan. 23	Launch of the Vienna Initiative. International financial institutions, including the IMF and the EBRD, and the European Commission meet in Vienna with home and host country supervisory authorities and banks active in CESEE to discuss the need for cooperation with a view to addressing the challenges caused by the financial crisis in CESEE and to secure commitments from foreign parent banks to support subsidiaries in host countries.
May 4–6	In a concerted effort to cushion the effects of the sharp drop in Romanian capital inflows, the IMF approves an SDR 11.4 billion stand-by arrangement and the European Council approves a EUR 5 billion loan.
May 6	The IMF approves an SDR 13.7 billion arrangement under the flexible credit line for Poland.

# CESEE-Related Activities of the OeNB's Economic Analysis and Research Department

## East-West Conference (1989–2003)

## Conference on European Economic Integration (2004–2009)

The OeNB's annual Conference on European Economic Integration focuses on Central, Eastern and Southeastern European issues and the ongoing EU enlargement process. Prior to 2003, the conference was called East-West Conference.

<b>Date</b>	<b>Title of Conference</b>	<b>Venue,<sup>1</sup> Coorganizers</b>
Oct. 1989	New Developments in Banking and Finance in East and West	Kranichberg, Austria
Apr. 1990	Erfahrungen Österreichs beim Übergang von administrativer Regulierung zur Marktwirtschaft	Moscow, Russia
May 1990	Challenges for European Bank Managers in the 1990s	Bad Gastein, Austria
Dec. 1990	From Control to Market – Austria's Experiences in the Post-War Period	Warsaw, Poland
Apr. 1991	Central and Eastern Europe: Roads to Growth	Baden, Austria, jointly with the IMF
Apr. 1992	Economic Consequences of Soviet Disintegration	jointly with the Institute for International Economics (IIE)
Oct. 1993	Europe, What Next?	
Apr. 1994	Reviving the European Union	jointly with the IIE
Nov. 1995	Central and Eastern Europe: Directing Monetary Policy towards EU Integration	
Sep. 1996	Private Capital Flows to Emerging Markets after the Mexican Crisis	jointly with the IIE
Nov. 1996	Monetary Policy in Transition in East and West: Strategies, Instruments and Transmission Mechanisms	
Nov. 1997	Current Account Imbalances in East and West: Do They Matter?	
Nov. 1999	Financial Crisis: A Never-Ending Story?	
Nov. 2000	Completing Transition: The Main Challenges	jointly with the Joint Vienna Institute (JVI)
Nov. 2001	Convergence and Divergence in Europe	
Nov. 2002	Structural Challenges and the Search for an Adequate Policy Mix in the EU and in Central and Eastern Europe	

<sup>1</sup> Unless otherwise indicated, Vienna, Austria.

Nov. 2003	The Economic Potential of a Larger Europe “Keys to Success”	opening of the new JVI
Nov. 2004	South Eastern EUROPEAN Challenges and Prospects	
Nov. 2005	Financial Development, Integration and Stability in Central, Eastern and South-Eastern Europe	jointly with the ECB and the Center for Financial Studies
Nov. 2006	The Changing Landscape of FDI in Europe	jointly with the EBRD
Nov. 2007	Currency and Competitiveness	
Nov. 2008	The Integration of European Labor Markets	
Nov. 2009	The Euro's Contribution to Economic Stability in CESEE	

#### East Jour Fixe (1991–2009)

The East Jour Fixe, short presentations or seminars at the OeNB that are organized by the OeNB's Foreign Research Division at irregular intervals, provides a platform for national and international experts to discuss CESEE-related topics.

Date	No.	Topics
June 21, 1991	1 <sup>st</sup>	Strategien zur Überwindung der Anpassungskrise in Ost- und Mitteleuropa Aspekte einer österreichischen Osteuropa-Strategie
Oct. 18, 1991	2 <sup>nd</sup>	Finanzierungsbedarf Osteuropas (WIFO discussion paper) Gedanken zu einer österreichischen Osteuropa-Strategie Österreich-Aspekte des Systemwandels in Osteuropa: Migration, Arbeitsmarkt, Außenhandel, Industriestruktur
Jan. 31, 1992	3 <sup>rd</sup>	Tour d'horizon über Entwicklungen in den Ostländern Überlegungen zu einer österreichischen Osteuropastrategie Maßnahmen des Bundesministeriums für Wissenschaft und Forschung zugunsten Ost- und Mitteleuropas Ost-Umfrage der Paul Lazarsfeld Gesellschaft
Apr. 3, 1992	4 <sup>th</sup>	Tour d'horizon über Entwicklungen in den Ostländern Policy Mix in Übergangswirtschaften Alternative Strategies for Economies in Transition in Central and Eastern Europe
June 19, 1992	5 <sup>th</sup>	Tour d'horizon über Entwicklungen in den Ostländern Einschätzung der politischen und wirtschaftlichen Lage in ausgewählten Ländern Erfahrungen mit multilateraler technischer Hilfe Ostmaßnahmen aus dem Blickwinkel eines Fachministeriums
Sep. 4, 1992	6 <sup>th</sup>	Public Finance in the Transformation Process

Nov. 5, 1992	7 <sup>th</sup>	Allgemeine Transformationsprobleme und aktuelle Entwicklungen in Russland
Jan. 15, 1993	8 <sup>th</sup>	Possible Impacts for Austrian Industrial Branches from the Opening-Up toward the East Zahlungsverkehrsprobleme in den Republiken der GUS Erfahrungsbericht Slowakei
Mar. 19, 1993	9 <sup>th</sup>	Aktuelle Probleme des Reformprozesses in Russland Neue Demokratien Barometer Präsentation jüngster Umfrageergebnisse – Ukraine und Belarus
May 19, 1993	10 <sup>th</sup>	Eine Produktivitätsagentur für Osteuropa? Perspektiven der Regionalisierung Russlands am Beispiel Tatarstans
Sep. 10, 1993	11 <sup>th</sup>	Western Prescriptions for Eastern Transition – A Comparative Analysis of the Different Economic Schools and Issues
Nov. 26, 1993	12 <sup>th</sup>	Prospects for Growth in Eastern Europe: Policy Issues for the Medium Term Bericht von der IIASA-Konferenz “Output Decline in Eastern Europe – Prospects for Recovery?” Bericht von der WIIW-Konferenz “Transformation of the East European Economies, 1989–1993: Critical Assessments and Ways out of Recession”
Jan. 21, 1994	13 <sup>th</sup>	Current State of the Polish Economy and Problems with the Reforms Current State of Economic Reforms in the Baltic States Report on the conference “Development and Reform of the Financial System in Central and Eastern Europe”
Mar. 11, 1994	14 <sup>th</sup>	Liberalization of Trade and Its Impact on Employment with Special Reference to Eastern Europe
June 17, 1994	15 <sup>th</sup>	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
Oct. 14, 1994	16 <sup>th</sup>	Economic Transformation and IMF Support: The Example of Poland OECD Assessment of Poland
Jan. 20, 1995	17 <sup>th</sup>	EU-Osterweiterung – Unbequeme Fragen Auswirkungen der EU-Erweiterung auf die Assoziationsländer
Apr. 5, 1995	18 <sup>th</sup>	Privatization in Central and Eastern European Transition Countries
May 30, 1995	19 <sup>th</sup>	The Consequences of the EU Eastern Enlargement for Austria
June 12, 1995	20 <sup>th</sup>	Rent-Seeking in Post-Soviet Economies and the Effect on Transition
Nov. 10, 1995	21 <sup>st</sup>	Latest Forecasts of the European Commission for Eastern Europe

Jan. 31, 1996	22 <sup>nd</sup>	Russia after the Elections Neue Demokratien Barometer
May 22, 1996	23 <sup>rd</sup>	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
June 21, 1996	24 <sup>th</sup>	Hungary's Preparation for Membership in the European Union The Austrian Approach to Eastern European Integration into the EU
Oct. 25, 1996	25 <sup>th</sup>	Transformation in Central and Eastern Europe – Ambitions, Achievements, and Challenges
Dec. 6, 1996	26 <sup>th</sup>	From Plan to Market – Presentation of the 1996 World Bank Development Report
Mar. 14, 1997	27 <sup>th</sup>	Development of Capital Markets in Central and Eastern Europe – The Example of the Prague Stock Exchange
July 20, 1997	28 <sup>th</sup>	From Shock Therapy to Therapy without Shocks
Nov. 28, 1997	29 <sup>th</sup>	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?"
Apr. 01, 1998	30 <sup>th</sup>	Eastern Enlargement of the EU: How Much Is It Worth for Austria? EU Enlargement – Implications for Austrian Policy-Making
Apr. 24, 1998	31 <sup>st</sup>	Presentation of DG II's Spring 1998 Economic Forecast for the Central and Eastern European Countries
Sep. 25, 1998	32 <sup>nd</sup>	Between Inflation and Capital Inflows: Dilemmas of Monetary Policy in More Advanced Transition Countries
Nov. 27, 1998	33 <sup>rd</sup>	Russia: What Kind of a Market Economy?
Apr. 23, 1999	34 <sup>th</sup>	Monetary Transmission in Advanced Transition Economies – The Case of Hungary Monetary Transmission in Advanced Transition Economies – The Case of the Czech Republic
June 18, 1999	35 <sup>th</sup>	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
Oct. 22, 1999	36 <sup>th</sup>	The European Commission's Economic Evaluation in the 1999 Regular Reports on the Enlargement Countries

Jan. 14, 2000	37 <sup>th</sup>	Exchange Rate Policy in Poland, 1990–1999: Success and Underperformance
May 19, 2000	38 <sup>th</sup>	The Financial Crisis in Russia: What Can Be Done? Economic Behavior of Russian Households before and after the Crisis
Feb. 9, 2001	39 <sup>th</sup>	The Macroeconomic Dimension of Enlargement
Mar. 23, 2001	40 <sup>th</sup>	How To Reduce Inflation: An Independent Central Bank or A Currency Board? The Experience of the Baltic Countries
June 22, 2001	41 <sup>st</sup>	Macroeconomic Effects of EU Enlargement for Old and New Member States
Sep. 7, 2001	42 <sup>nd</sup>	Monetary Transmission Mechanism
Nov. 30, 2001	43 <sup>rd</sup>	Why Unilateral Euroization Makes Sense for (Some) Applicant Countries
Feb. 22, 2002	44 <sup>th</sup>	Economic Transformation and Real Exchange Rates in the 2000s: The Balassa-Samuelson Connection
July 8, 2002	45 <sup>th</sup>	EU Enlargement to the East: Effects on the EU-15 in General and Austria in Particular
Sep. 6, 2002	46 <sup>th</sup>	Inflation in the Transition Economy of Poland: An Application of SVEqCM
Nov. 22, 2002	47 <sup>th</sup>	Monetary Policy in Croatia under a High Level of de facto Euroization
Feb. 13, 2003	48 <sup>th</sup>	The Next Step: A Special Focus on Equilibrium Exchange Rates and ERM II
June 24, 2003	49 <sup>th</sup>	Convergence
Dec. 15, 2003	50 <sup>th</sup>	Transition: Past, Present, Future
Apr. 16, 2004	51 <sup>st</sup>	Financial Systems in CEECs
June 1, 2004	52 <sup>nd</sup>	The Oil Price: Prospects and Macroeconomic Implications
Oct. 29, 2004	53 <sup>rd</sup>	Monetary Policies in New Member States
Mar. 7, 2005	54 <sup>th</sup>	Economic Geography & Fiscal Consolidation
May 30, 2005	55 <sup>th</sup>	Monetary and Exchange Rate Policy in Southeastern Europe
Jan. 20, 2006	56 <sup>th</sup>	Ukraine: Shifting Economic Horizons and Interlinkages
June 9, 2006	57 <sup>th</sup>	Economic and Monetary Challenges in Southeastern Europe

June 26, 2006	58 <sup>th</sup>	Slovenia: Economic and Monetary Integration
Sep. 15, 2006	59 <sup>th</sup>	Monetary Transmission in Central and Eastern European Countries
June 22, 2007	60 <sup>th</sup>	Central and Eastern Europe: Is Economic Convergence on Track? SUIERF Annual Lecture 2007: The Challenge of Enlargement of the Eurozone
Mar. 3, 2008	61 <sup>st</sup>	Commodities, Energy and Finance
June 18, 2008	62 <sup>nd</sup>	Soaring Prices in Emerging Europe: Temporary Phenomenon or Lasting Challenge?
Oct. 13, 2008	63 <sup>rd</sup>	Financial Deepening and Macrofinancial Stability in South-eastern Europe
Jan. 23, 2009	64 <sup>th</sup>	Current Trends in the Russian Financial System
Sep. 28, 2009	65 <sup>th</sup>	Credit Default Swaps – Blessing or Curse?

### Focus on Transition (1996–2003)

### Focus on European Economic Integration (2004–2009)

The Focus on European Economic Integration (FEEI; Focus on Transition until end-2003) is a channel for communicating the OeNB's ongoing research on Central, Eastern and Southeastern European countries, thus reflecting a strategic regional research priority of the OeNB. Contributions to the quarterly FEEI include peer reviewed studies dealing primarily with macrofinancial and monetary integration as well as economic country analyses and cross-regional comparisons.

#### Issue Studies

1/1996	Radzyner, O. and S. Riesinger: Exchange Rate Policy in Transition – Developments and Challenges in Central and Eastern Europe Backé, P.: Progress towards Convertibility in Central and Eastern Europe
2/1996	Backé, P. and I. Lindner: European Monetary Union: Prospects for EU Member States and Selected Candidate Countries from Central and Eastern Europe Krzak, M.: Persistent Moderate Inflation in Poland and Hungary
1/1997	Krzak, M. and A. Schubert: The Present State of Monetary Governance in Central Europe Radzyner, O. and S. Riesinger: Central Bank Independence in Transition: Legislation and Reality in Central and Eastern Europe
2/1997	Krzak, M.: Estonia, Latvia and Lithuania: From Plan to Market – Selected Issues Neudorfer, P.: Integrating Central and Eastern Europe: The Case of Foreign Direct Investment Horváth, A. et al.: EU Opinions – The Qualifying Round for Applicants



- 1/1998 Krzak, M.: Large Current Account Deficits – The Case of Central Europe and the Baltic States  
Backé, P. and O. Radzyner: The Introduction of the Euro: Implications for Central and Eastern Europe – The Case of Hungary and Slovenia  
Pautola, N. and P. Backé: Currency Boards in Central and Eastern Europe – Experience and Future Perspectives
- 2/1998 Krzak, M.: Contagion Effects of the Russian Financial Crisis on Central and Eastern Europe: The Case of Poland  
Dvorsky, S. at al.: The 1998 Reports of the European Commission on Progress by Candidate Countries from Central and Eastern Europe: The Second Qualifying Round  
Würz, M. and W. Müller: Prudential Supervision in Central and Eastern Europe: A Status Report on the Czech Republic, Hungary, Poland and Slovenia
- 1/1999 Krzak, M. and H. Ettl: Is Direct Inflation Targeting an Alternative for Central Europe? The Case of the Czech Republic and Poland
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Backé, P.: Exchange Rate Regimes in Central and Eastern Europe: A Brief Review of Recent Changes, Current Issues and Future Challenges
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Notes



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# Legend, Abbreviations and Definitions

## Legend

x = No data can be indicated for technical reasons

.. = Data not available at the reporting date

Discrepancies may arise from rounding.

## Abbreviations

AP	Accession Partnership
BIS	Bank for International Settlements
BOF	Suomen Pankki – Finlands Bank (Bank of Finland)
BOFIT	Bank of Finland Institute for Economies in Transition
CBA	Currency Board Arrangement
CBI	central bank independence
CC	candidate country (EU)
CEE	Central and Eastern Europe(an)
CEEC	Central and Eastern European country
CEEI	Conference on European Economic Integration (OeNB)
CESEE	Central, Eastern and Southeastern Europe(an)
CEFTA	Central European Free Trade Agreement
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
CPI	consumer price index
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EFC	Economic and Financial Committee
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERM (II)	exchange rate mechanism (II)
ESCB	European System of Central Banks
EU	European Union
EUAA	European Union Association Agreement
FDI	foreign direct investment
FEEI	Focus on European Economic Integration (OeNB)
GDP	gross domestic product
HOS	Heckscher-Ohlin-Samuelson (theory)
IIE	Institute for International Economics
JVI	Joint Vienna Institute
IMF	International Monetary Fund
MEBO	Management and Employee Buyout
NATO	North Atlantic Treaty Organization
NCB	national central bank
NPL	nonperforming loan
NUTS	Nomenclature des unités territoriales statistiques (Nomenclature of territorial units for statistics)
OECD	Organisation for Economic Co-operation and Development
PCC	potential candidate country (EU)

PHARE	Poland and Hungary: Assistance for Restructuring their Economies
PPP	purchasing power parity
PPS	purchasing power standard
SDR	Special Drawing Rights
SEE	Southeastern Europe(an)
SME	small and medium-sized enterprise
SOB	state-owned commercial bank
SOE	state-owned enterprise
SUERF	Société Universitaire Européenne de Recherches Financières – The European Money and Finance Forum
WIFO	Österreichisches Institut für Wirtschaftsforschung (Austrian Institute of Economic Research)
wiiw	Wiener Institut für internationale Wirtschaftsvergleiche (The Vienna Institute for International Economic Studies)
WTO	World Trade Organization

### National Central Banks

BNB	Bulgarian National Bank
BNR	Banca Națională a României (National Bank of Romania)
BoA	Banka e Shqipërisë (Bank of Albania)
BS	Banka Slovenije (Bank of Slovenia)
CBBH	Centralna banka Bosne i Hercegovine (Central Bank of Bosnia and Herzegovina)
CBCG	Centralna banka Crne Gore (Central Bank of Montenegro)
CBR	Central Bank of the Russian Federation (Bank of Russia)
ČNB	Česká národní banka (Czech National Bank)
HNB	Hrvatska narodna banka (Croatian National Bank)
MNB	Magyar Nemzeti Bank (Hungary's central bank)
NBP	Narodowy Bank Polski (National Bank of Poland)
NBS	Národná banka Slovenska (Slovakia's central bank)
NBS	Narodna banka Srbije (National Bank of Serbia)
NBU	National Bank of Ukraine
OeNB	Oesterreichische Nationalbank (Austria's central bank)
TCMB	Türkiye Cumhuriyet Merkez Bankası (Central Bank of the Republic of Turkey)

### ISO Currency Codes

ALL	Albanian lek
BGN	Bulgarian lev
CZK	Czech koruna
EUR	euro
HRK	Croatian kuna
HUF	Hungarian forint
PLN	Polish złoty
RON	Romanian leu
RSD	Serbian dinar
RUB	Russian ruble
SFR	Swiss franc

SIT	Slovenian tolar
SKK	Slovak koruna
TRY	Turkish lira
USD	U.S. dollar

### ISO Country Codes

AL	Albania
AT	Austria
BA	Bosnia and Herzegovina
BE	Belgium
BG	Bulgaria
BY	Belarus
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EE	Estonia
ES	Spain
FI	Finland
FR	France
GR	Greece
HR	Croatia
HU	Hungary
IE	Ireland
IT	Italy
LT	Lithuania
LU	Luxembourg
LV	Latvia
MD	Moldova
ME	Montenegro
MK	former Yugoslav Republic of Macedonia (FYR Macedonia)
MT	Malta
NL	Netherlands
PL	Poland
PT	Portugal
RO	Romania
RS	Serbia
RU	Russia
SE	Sweden
SI	Slovenia
SK	Slovakia
TR	Turkey
UA	Ukraine
UK	United Kingdom



**Definitions**

*Croatia, FYR Macedonia and Turkey* are candidate countries within the EU enlargement process. Candidate countries are countries which have formally applied to the EU for membership and have been officially recognized by the European Council as a candidate for membership. Accession negotiations with Croatia and Turkey were opened in October 2005. No date has been set yet for the opening of accession negotiations with FYR Macedonia.

*Albania, Bosnia and Herzegovina, Montenegro, Serbia and Kosovo under UNSC Resolution 1244/99* are potential EU candidate countries, i.e. countries that may become officially recognized candidates for membership. Western Balkan countries involved in the Stabilisation and Association process are recognized as potential candidate countries.

# Periodical Publications of the Oesterreichische Nationalbank

For further details on the periodical publications of the OeNB see [www.oenb.at](http://www.oenb.at)

## **Monetary Policy & the Economy** quarterly

This quarterly publication, issued both in German and English, offers analyses of current cyclical developments, medium-term macroeconomic forecasts and studies on central banking and economic policy topics. It also summarizes the findings of macroeconomic workshops and conferences organized by the OeNB.

## **Focus on European Economic Integration** quarterly

The Focus on European Economic Integration (FEEI) is a channel for communicating the OeNB's ongoing research on Central, Eastern and Southeastern European (CESEE) countries, thus reflecting a strategic regional research priority of the OeNB. Contributions to the quarterly FEEI include peer reviewed studies dealing primarily with macrofinancial and monetary integration as well as economic country analyses and cross-regional comparisons.

## **Statistiken – Daten & Analysen** quarterly

This publication contains brief reports and analyses focusing on Austrian financial institutions, cross-border transactions and positions as well as financial flows. The contributions are in German, with executive summaries of the analyses in English. The statistical part covers tables and explanatory notes on a wide range of macroeconomic, financial and monetary indicators. The tables and additional information and data are also available on the OeNB's website in both German and English. This series also includes special issues on selected statistics topics published at irregular intervals.

## **Research Update** quarterly

The quarterly English-language newsletter is published only on the Internet and informs an international readership about selected findings, research topics and activities of the OeNB's Economic Analysis and Research Department. This publication addresses colleagues from other central banks or international institutions, economic policy researchers, decision makers and anyone with an interest in macroeconomics. Furthermore, the Research Update offers information on publications, studies or working papers as well as events (conferences, lectures and workshops).

For further details see [www.oenb.at/research-update](http://www.oenb.at/research-update)

## **Financial Stability Report** semiannual

Issued both in German and English, the Financial Stability Report contains first, a regular analysis of Austrian and international developments with an impact on financial stability and second, studies designed to provide in-depth insights into specific topics related to financial market stability.

## **Workshops – Proceedings of OeNB Workshops**

three to four issues a year

The Proceedings of OeNB Workshops were introduced in 2004 and typically comprise papers presented at OeNB workshops at which national and international experts, including economists, researchers, politicians and journalists, discuss monetary and economic policy issues. Workshop proceedings are generally available in English only.

## **Working Papers**

about ten papers a year

The OeNB's Working Paper series is designed to disseminate, and provide a platform for discussing, findings of OeNB economists or outside contributors on topics which are of special interest to the OeNB. To ensure the high quality of their content, the contributions are subjected to an international refereeing process.

## **Conference Proceedings of the Economics Conference**      annual

The Economics Conference hosted by the OeNB is an international platform for exchanging views and information on monetary and economic policy as well as financial market issues. It convenes central bank representatives, economic policy-makers, financial market players, academics and researchers. The conference proceedings comprise all papers presented at the conference.

## **Conference Proceedings of the Conference on European Economic Integration**      annual

The OeNB's Conference on European Economic Integration (CEEI) focuses on Central, Eastern and Southeastern European issues and the ongoing EU enlargement process. The Conference Proceedings comprise contributions to the CEEI and are published in English by a renowned international publishing house. For further details see <http://ceec.oenb.at>

## **Annual Report**      annual

The Annual Report of the OeNB provides a broad review of Austrian monetary policy, economic conditions, new developments in the financial markets in general and in financial market supervision in particular as well as of the OeNB's changing responsibilities and its role as an international partner in cooperation and dialogue. It also contains the OeNB's financial statements.

## **Intellectual Capital Report**      annual

The Intellectual Capital Report is a review of the OeNB's intellectual capital and its use in the OeNB's business processes and services. The report clarifies the relationships between different types of human, relational, structural and innovation capital and describes various determinants that influence the OeNB's intellectual capital. The report provides an integrated view of the OeNB and serves to assess the consistency of the OeNB's intellectual capital with its knowledge-based strategic orientation.

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