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

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 Riesinger2 (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

1 Oesterreichische Nationalbank, European Affairs and International Financial Organizations Division, sandra.dvorsky@enb.at. The author would like to thank Franz Nauschnigg and Isabella Lindner (both OeNB) for helpful comments.
2 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. 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 over night. 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. Tosovsky, 2003). Some countries, such as Slovakia 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

---

1 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.

2 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 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. In addition, in 1992 the Austrian Ministry of Finance and the OeNB, together with five international organizations, 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

---

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

6 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-Grünewald in this issue.

7 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 in 1996 and established a list of features of CBI, thus specifying the requirements set out in the Maastricht Treaty and the Statute (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 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. 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-

---

8 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.

9 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.

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

11 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.”

12 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.\textsuperscript{11}

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 Põder (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.\textsuperscript{14} 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, Põder (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

\textsuperscript{11} For a detailed analysis of the first Progress Reports with respect to central banking issues, see Dvorský, Backé and Radzyner (1998).

\textsuperscript{14} 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 Europe15 (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 countries16 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.17 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

15 The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.
16 They included, for the first time, Bulgaria and Romania as the latest new Member States.
17 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. 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 Eurosystem composition than in their ESCB composition. This, in turn, increased the

16 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. Põder, 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.

References


