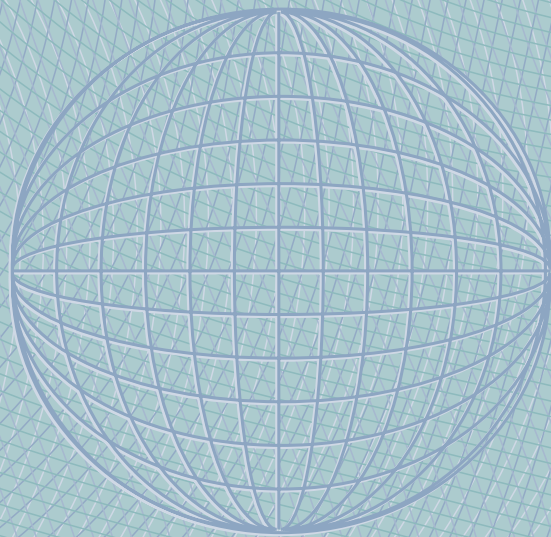




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F O C U S O N T R A N S I T I O N
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The views expressed are those of the authors and need not necessarily coincide with the views of the Oesterreichische Nationalbank.

Editorial

This is already the third issue of the Oesterreichische Nationalbank's semiannual publication "Focus on Transition," which is addressed to all those interested in the research and analysis of the economic aspects of transition in the countries of Central and Eastern Europe.

Like the first two issues, this issue contains four parts: an update of recent economic developments in the Czech Republic, Hungary, Poland, Slovakia and Slovenia, a studies section with two studies, a summary of the latest activities of the Oesterreichische Nationalbank on transition topics (lectures, discussions, technical cooperation and the like) and a statistical annex. Moreover, in view of the momentous changes which have taken place in Bulgaria and Romania in recent weeks and their prospective impact on the future path of transformation, we have included a special report on these two countries, as they are not covered in our regular reports on recent economic developments.

The two studies in this issue deal with the transformation of central banking in selected transition economies. The first study investigates the present framework and form of monetary governance in five Central and Eastern European countries. As these countries have all applied for membership in the European Union, the monetary framework in the EU is the relevant benchmark against which their monetary systems have to be measured. The second study analyzes the specific question of the present state of central bank independence in those countries, one of the cornerstones of the monetary aspects of the Maastricht Treaty.

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Adolf Wala

Chief Executive Director

RECENT ECONOMIC DEVELOPMENTS

Developments in Selected Countries

Maciej Krzak,
Peter Backé,
Kurt Mauler,
Olga Radzyner,
Sandra Riesinger

I Introduction

In 1996 *economic growth* weakened in the region analyzed¹⁾ compared with 1995, which was, inter alia, a result of sluggish demand in the EU, in particular in Germany, the largest trade partner of each of these economies. Hungary still felt the impact of the stabilization program it had introduced in 1995. In all other countries, domestic demand was strong, spilling over abroad in the form of high import growth rates. Investment growth was vigorous in all countries save Hungary.

Due to weak export performance and high imports, the *external position* deteriorated in nearly all countries. *Trade deficits* reached a high proportion of GDP across the sample. Hungary was the only country in which this ratio fell. Hungary's exports increased at a healthy 10% in 1996, which signals that it has already restored its competitive position. Large trade deficits were offset either by services or capital inflows, so these countries did not face any problems financing the trade gap. *Foreign direct investment* (FDI) in the region as whole increased further. Poland benefited most, as inward FDI more than doubled from the year before. In contrast to 1995, problems with portfolio capital inflows eased considerably in Poland and the Czech Republic, but flared up again in Slovenia and also showed up in Slovakia in 1996.

Inflation continued to fall in the region, with Slovakia posting a record low average annual inflation rate of 5.8%. 1996 was the first year since the beginning of transition in which Slovenia registered a single-digit inflation rate. However, disinflation in Hungary and Poland was slower than the respective governments had expected. Inflationary progress in the Czech Republic was negligible.

Structural reforms were continued. Hungary almost completed privatization of its banking sector, while other countries accelerated their efforts. Further steps to harmonize legislation with EU and OECD standards were taken. This implied, among other things, further liberalization of currency regulations. Hungary and Poland followed the Czech Republic and became OECD members in 1996.

2 Country Reports

2.1 Czech Republic

Although economic growth was expected to accelerate in 1996, it actually slowed, with GDP augmenting by 4.4% compared with 4.8% in 1995. *Industrial output* rose by 6.8% against 8.7% in 1995. Fixed capital formation increased by 12.4% in 1996 while private consumption and government expenditure grew by 5.3 and 1%, respectively. The *unemployment rate* ran to 3.5% in December 1996, up by 0.6 percentage points on December 1995, which is still one of the lowest rates among the OECD countries. However, the jobless rate rose further to 4.1% in February 1997, reflecting lower economic growth and the accelerated pace of industrial restructuring.

Nominal average gross wages increased by 18.0%, which translated into an 8.5% rise in real terms. This may be one of the factors why inflation proved persistent in 1996. The average annual rate of CPI inflation fell by only 0.3 percentage points to 8.8% in 1996 from 9.1% the year before. In early 1997, inflation started falling more visibly; in March 1997, the rate of inflation was

6.8% year on year. Producer price inflation amounted to 4.3% year on year in the same month.

The *current account* significantly worsened in 1996 and continued to deteriorate in the first months of 1997. It widened to USD 4.5 billion or 8.6% of GDP from USD 1.4 billion in 1995. This deterioration was caused by poor export performance (+1.3%) coupled with rapidly rising imports (+10.2%), especially of consumer goods (+30%), which resulted in a USD 5.9 billion trade shortfall equal to 11.3% of GDP. Sluggish economic growth in the EU is the primary cause of this development. Furthermore, the delayed restructuring of Czech enterprises may unfavorably impact their competitiveness and thus act as a damper on exports. The international reserves of the central bank amounted to USD 12.4 billion at the end of the year compared with USD 13.8 billion in 1995; their import cover declined to 5.3 months. In February 1997, international reserves had diminished further to USD 11.7 billion. *Gross foreign debt* increased from USD 16.5 billion in 1995 to USD 20.4 billion in December 1996, mainly due to external private borrowing. These figures evidence a marked change which occurred in 1996. Capital inflows, which had caused problems for the conduct of monetary policy in 1994 and 1995, ceased exerting upward pressure on the Czech koruna.

Monetary policy was set on a restrictive course in the second half of 1996 in order to slow rapid monetary expansion. The central bank increased headline interest rates, raising the discount rate from 9.5 to 10.5% and the lombard rate from 12.5 to 14% in August 1996. It also raised the mandatory reserve ratio from 8.5 to 11.5%. These measures helped bring down the rapid growth of M_2 , which rose by 9.2% in 1996. The continued commitment to a fixed nominal exchange rate largely determined the room for maneuver for monetary policy. Effective May 8, 1997, minimum reserve requirements on deposits were reduced from 11.5 to 9.5% with the aim of providing room for a rise in commercial banks' deposit rates to create an incentive for people to save.²⁾

The *Czech state budget* was practically balanced in 1996. However, weaker-than-projected economic growth caused an unexpected budget gap of CZK 1.6 billion or 0.1% of GDP instead of a programmed small surplus. The budget showed a deficit of CZK 8.5 billion in the first quarter of 1997. Other adverse tendencies prevailed in the first quarter of 1997 as well. The Czech Statistical Bureau revised its 1997 GDP growth forecast downward to 2.9 to 3.5% and revised upward its CPI inflation forecast to 8.2 to 8.8%. Economic growth faltered further in the first quarter; in March, industrial sales fell by 0.8% year on year after a 3.6% annualized decline in February according to preliminary estimates. The unemployment rate rose above the 4% mark for the first time during transition, and the trade gap continued to increase, so the concern about the sustainability of the current account deficit became serious. The Czech currency weakened versus the central rate of the fluctuation band. Pessimistic expectations concerning the prospects of the economy became widespread. These developments prompted the government to address the problem by means of a *restrictive fiscal policy* and *administrative measures* to curtail imports. These steps include a 5% reduction

of budget expenditures, a reduction of pay increases in the public sector from 11.9 to 7.3% and the introduction of a mandatory non-interest-bearing deposit for 180 days, amounting to 20% for imports of selected consumer and agricultural goods. The fixed nominal exchange rate was maintained.

Turning to *structural reforms*, the responsible ministries have been charged with preparing proposals for the accelerated privatization of the remaining state-owned banks and enterprises. The government announced steps to improve capital market regulations by amending the laws on investment funds and investment banks. The government is contemplating a restriction of commercial banks' investment activities in line with the EU regulations. In response to widespread criticism and the evident rigging of trade on the stock market, the government plans to establish an independent stock exchange commission.

2.2 Hungary

In 1996, GDP increased by only 1% in real terms compared with 1.5% in 1995, when the stabilization program was launched. Stagnation in the first half of 1996 was determined by the impact of this package. Growth resumed in the second half of the year. In 1996 *industrial output* rose by 2.3% compared with 4.8% in 1995. According to the estimates, investment fell by 3% in 1996, while it had been stagnant a year before. Sluggish demand and cuts in public investment were responsible for this weak performance. Private consumption posted a more pronounced fall than expected as well. Despite negligible economic growth, the *unemployment* rate dropped to 10.5%. The economy continued to recover in the first quarter of 1997, as industrial output increased by 5.4% year on year in this period. During the same period, the unemployment rate inched up to 11.0%, mainly for seasonal reasons.

On the positive side *inflation* eased; the CPI rose by 23.6% on average in 1996, down from 28.2% in 1995, though the progress was smaller than projected (20% at the beginning of the year). Average net wages in real terms decreased by 5.4%, compared with a fall of 12% in 1995. In March 1997, CPI inflation was down to 18.8% year on year, only a small improvement after 18.9% in January. Producer price inflation proved persistent, reaching 22.5% in February. The *deficit of the general government*, one of the two primary reasons why the government adopted a stabilization program in early 1995, decreased from 6.8% of GDP in 1995 to 3.3% in 1996. The cumulative budget balance reached HUF 113.1 billion in the first quarter of 1997, i.e. 35.6% of the planned deficit for 1997. The *current account deficit*, the second motive for launching the stabilization measures, continued to trend downward. The shortfall on current account came to USD 1.7 billion or an estimated 3.8% of GDP compared with USD 2.5 billion or 6.5% of GDP in 1995. The current account deficit is influenced by the trade gap, which expanded marginally to USD 2.6 billion from USD 2.4 billion in 1995. Thanks to higher tourist receipts, the services surplus was large enough to offset much of the trade deficit. According to balance-of-payments data exports grew by 10.3%, the fastest rate among the CEFTA³) countries, whereas imports rose by 10.1%. The current account deficit was

entirely covered by the inflow of *foreign direct investment*, which totaled USD 1.8 billion. The fall in gross official international reserves of the central bank from USD 12.1 to 9.7 billion was above all due to the repayment of foreign debt; gross foreign debt totaled USD 27.6 billion at the end of 1996. Reserves covered around seven months of imports and helped Hungary obtain an investment grade in the sovereign debt ratings compiled by Moody's and Standard and Poor's.

The exchange rate system was not modified in 1996. The forint was devalued automatically by 1.2% monthly relative to the basket. The Deutsche mark has replaced the 70% ECU share in the basket since January 1, 1997; the 30% USD share was not changed. Effective April 1, 1997, the forint will be devalued by 1.1% monthly. This reduction signals a counterinflationary stance of the authorities, as the rate of annual devaluation is lower than the producer price differential between Hungary and its main trade partners.

For 1997, the government projects 2.5% GDP growth and 18% average annual inflation. The increase in the general government deficit to 4.9% of GDP does not signal a troubling tendency; it is due to the change in the method of booking the foreign debt. Under the old methodology, the deficit would fall to 3.1% of GDP. The current account deficit is expected to reach USD 2 billion, as imports are likely to increase faster following the cut in the import surcharge tax from 6 to 4% on March 10, its further reduction to 3% effective May 15 and its planned elimination on June 30, 1997. Hungary is on track in fulfilling its IMF agreement, and the IMF positively evaluated its economic situation.

Among *structural reforms*, a further liberalization of regulations concerning the financial sector should be noted. On January 1, 1997, the new laws on banking, building societies and financial market supervision as well as an amendment to the Securities and Stock Exchange Act became effective. The banking law and the amendment to the Securities Act serve to strengthen prudential regulations, and the Financial Market Supervision Act integrates the supervision of banks and capital markets, which had hitherto been separated. Moreover, the central bank act was amended to restrict the potential coverage of budget deficits by the central bank to the case of short-term liquidity problems. Hungary liberalized its currency law further, allowing unlimited exports of currency for travel abroad. Moreover, capital transactions were eased: Foreign bonds with a maturity of more than one year were liberalized, provided their source are OECD governments or enterprises deemed creditworthy by international rating agencies.

Banking sector privatization continued. In November 1996, the government privatized Magyar Hitel Bank, the fifth-largest commercial bank. It also sold its stake in the partially privatized Külkereskedelmi Bank (Foreign Trade Bank), which completed the privatization of all but one of the large banks in Hungary; at least their majority stakes are in private hands now. The development of the banking sector has been positive in the last few years. Profitability has risen, banks' capital has grown and its composition improved, the share of bad loans has fallen, mergers have eliminated weaker institutions and supervision has been tightened. Despite these positive trends, the financial situation of some of institutions has still not been fully

shored up, as the run on Postabank, the country's second-largest bank, showed in February/March 1997.

2.3 Poland

The Polish economy ended 1996 on a strong note. Economic growth, which had been affected in the first half of 1996 by a protracted winter, considerably accelerated to around 8% in the second half of the year. GDP grew by an estimated 6% in real terms in 1996 compared with 7.0% in 1995. On the demand side, consumption and investment were the engines of economic expansion. Private *consumption and investment* rose by an estimated 8.2⁴) and 22.1% against 4.1 and 17.1% in 1995, respectively, whereas net exports were negative for the first time since 1991. *Industrial sold output* increased by 8.5% in 1996 and the productivity of labor in industry gained 10%, as employment fell by 1%. In the first quarter of 1997 robust growth continued, as industrial output rose by 7.4% on the corresponding quarter of 1996. According to preliminary estimates, GDP grew by 7 to 8% year on year in the first quarter of 1997.

At the end of 1996, 2.3 million persons were unemployed compared with 2.7 million at the end of 1995. The *unemployment rate* fell from 14.9% in December 1995 to 13.6% in December 1996 as a result of sustained economic growth and the policy of tightening eligibility criteria for unemployment benefits. The Central Statistical Office estimates that 16% of Polish employment is located in the gray economy. The unemployment rate continued to fall to 13.0% in the first quarter of 1997.

CPI inflation fell to 18.5% in December 1996 from 21.6% in December 1995. The average annual rate of inflation was 19.9% versus 27.8% a year earlier. Disinflation was not halted by rapid wage growth; real average take-home pay rose by 5.7%. In contrast to the first quarter of 1996, when progress with disinflation had been negligible, the rate of price increase diminished noticeably in the first quarter of 1997. At the end of March 1997, CPI inflation came to 16.6% year on year.

The *budget deficit* of PLN 9.1 billion (2.5 to 2.6% of GDP) in 1996 stayed below the planned deficit for the third straight year, but no further progress with its reduction was achieved. The deficit could have been lower if the government had not allocated large amounts to social security funds in December. The government continued to pursue a policy of primary budget surplus, so that the share of *public debt* fell to 51.2% of GDP in 1996 from 58.5% in 1995.⁵) The external debt ran to 57.2% of the total or USD 39.3 billion at the end of the year. In March 1997, the budget deficit stood at PLN 4.0 billion or 32.4% of the planned amount for 1997. This proportion is higher than in the corresponding period of 1996.

In 1996, the National Bank of Poland (NBP) officially adopted broad money as the intermediate target of monetary policy and the monetary base as the operating target. Both were met, but this did not prevent the rapid 42.7% *expansion of credit to the nonfinancial sector*⁶). This prompted the central bank to resort to moral suasion and induced the subsequent tightening of monetary policy at the end of 1996, when market rates rose by approximately 2.5% across the board. The tightening was prolonged to the

first quarter of 1997, when interbank rates rose another 1% on average, which implied a sharp rise in real rates, as inflation has been falling. Reserve requirements were raised to 20% from 17% on demand deposits and to 4% from 2% on foreign exchange deposits effective March 1, 1997, but the lombard and the discount rates were left unchanged at 25 and 22%, respectively. The NBP announced an additional increase in reserve requirements, this time from 9 to 11% for time deposits and from 4 to 5% on foreign currency deposits, effective May 1, 1997. Interbank rates fluctuated between 21.5 and 22.5% in April 1997. Despite the clamp on the monetary brakes, the credit expansion showed little signs of abating in the first quarter of 1997, when credit rose by 8.5%. The attractive interest rates started drawing foreign portfolio capital in April, which reinforced the upward pressure on the domestic currency, prompting frequent foreign exchange intervention to stop the appreciation.

Poland posted a *current account* deficit of USD 1.4 billion, or less than 1% of GDP in 1996 compared with a large surplus of USD 5.5 billion in 1995.⁷⁾ This turnaround was correlated with the ever-deteriorating official *trade deficit*, which reached USD 8.2 billion in 1996 against USD 1.8 billion in 1995. Exports increased only by 6.7%, whereas imports surged by 31.9% in 1996. The slowdown in Germany and other EU partner countries reinforced by the real appreciation of the zloty versus the Deutsche mark caused export performance to deteriorate substantially from 1995. The *unregistered cross-border trade surplus* decreased to USD 7.2 from 7.8 billion in 1995. Despite the current account deficit, Poland's *gross official reserves* increased by USD 3 to 18.0 billion, above all as a consequence of foreign direct investment in 1996, which rapidly rose to near USD 5.2 billion (USD 2.5 billion in 1995).⁸⁾ The reserves covered over six months of imports. In January to February 1997, the current account and trade balance posted record deficits of USD 1.1 and 1.9 billion, respectively. While export growth accelerated marginally, the surplus of unrecorded flows decreased further. The central bank's international reserves rose to USD 18.3 billion in February.

The *1997 budget* assumes a deficit of 2.8% of GDP based on a GDP growth projection of about 5.5%, and CPI inflation is targeted to drop to 13% year on year in December (15% annual average). The trade deficit and current account shortfall were forecast to reach USD 9.5 and 3.9 billion, respectively. The developments in the first three months of the year do not seem incompatible with these targets, with the notable exception of the current account.

The *main challenges* that Poland faces in 1997 are the *growing trade deficit* and *inflation*. A current account deficit of 0.8% of GDP in 1996 is no cause for concern, but the unfolding trend is dangerous, as this gap may reach 3 to 3.5% of GDP in 1997 according to some projections.⁹⁾ *Slow disinflation* is another challenge and more decisive progress requires structural reforms to dismantle monopolies, eliminate subsidies and remove the factual indexation of the economy.

Privatization and pension reform are government priorities in 1997. Restructuring efforts to prepare the oil, copper, banking and telecommunications sectors for privatization are being conducted under the headline of

consolidating their activities in order to enhance their competitiveness. The *mass privatization program*, which had been launched at the end of 1995, was a success in 1996, with over 95% of all Poles acquiring certificates of ownership for a small nominal fee of PLN 20. Plans for 1997 provide for the privatization of two large banks, Bank Handlowy and Powszechny Bank Kredytowy, over 400 firms including the copper giant KGHM, and the flotation of 15 National Investment Funds, which own over 500 small and medium-sized companies. Poland is planning to shut down seven coal mines and cut 17,000 jobs in 1997 as part of an effort to downsize this lossmaking sector. In February, Poland freed the prices of domestically produced fuels.

The government started preparations to implement the reform of the *pay-as-you-go pension system*. The drafted new system will be based on three pillars: a universal modest state pension, mandatory pension funds and optional individual pension plans to which contributions will be tax-deductible. The scheme would also abolish pension privileges for various employment groups. The government also adopted a draft law on convertible bonds, which pension funds could exchange into equity of newly privatized firms. A draft of the *new banking law* has also been approved by the government, but has not yet been passed by Parliament. The law aims at improving the security of banks' operations and bringing it in line with EU standards. It would, *inter alia*, reduce the maximum value of equity investments each bank could make to 15% of shareholder equity. The draft law leaves banking supervision within the National Bank of Poland, but subordinates it to a future Banking Supervision Committee, which has yet to be created. The government plans to push for parliamentary approval of the *new central bank act*, which is still under discussion. The new act would enhance the independence of the central bank and ban direct government lending by the central bank. The Polish draft constitution, which has been approved by the General Assembly and is scheduled to be put to vote in a referendum in May, will give the NBP the exclusive right to conduct monetary policy. The monetary policy guidelines will be approved by the Monetary Policy Council, a new body. The new draft constitution will forbid the state from borrowing directly from the NBP and build up public debt above 60% of GDP.

2.4 Slovakia

Slovakia reported the *record growth* rate and the *lowest inflation* among the CEFTA countries. Its GDP augmented by 6.9% in 1996, a notch higher than 6.8% in 1995, and the rise was driven by domestic demand. Investment was up by 33.3%, and government expenditure increased by 24.2%. This latter figure is not as worrying as it appears at first blush, since government spending includes public investment in the nuclear plant, the highway system and the modernization of Slovnaft refinery. On the supply side, *industrial production* was up only 2.5% on 1995, largely due to dwindling foreign demand for low-value-added industrial goods. Growth was propelled by the services sector. The *unemployment rate* fell from 13.1% in December 1995 to 12.8% at the end of 1996. The slow decline may be attributed to the accelerated pace of industrial restructuring taking place in Slovakia. In

February 1997, the rate of unemployment rose to 13.7%, i. a. for seasonal reasons.

Disinflation performance in 1996 was remarkable, as average annual CPI inflation dropped from 9.9% in 1995 to 5.8% in the year under review. In March 1997, the CPI rose by 6.3% year on year. *Average real gross wages* rose by a substantial 7.2% in 1996 after a 4.4% increase in 1995. Concerned about the rapid growth of M_2 , the central bank tightened the reins of monetary policy by raising the lombard rate from 13 to 15% in July and reserve requirements to a uniform 9% in August, previously they had varied between 9% and 3%. The tighter policy brought results; M_2 growth gradually declined from 19.5% in August 1996 to 13.9% year on year in February 1997 compared with 21% in the corresponding period of 1996. Boosted by high government expenditures, the *budget deficit* reached SKK 25.6 billion or 4.4% of GDP, rising from 1.6% of GDP in 1995. An even looser fiscal policy is planned for 1997, as the approved budget calls for a deficit of SKK 36.9 billion or 5.6% of projected GDP. This plan has put the central bank policy on a collision course with fiscal policy. In order to maintain inflation at the relatively low current level and to keep the nominal exchange rate stable, the central bank will have to stay on the monetary brakes like it did in the second half of 1996. At the beginning of 1997, the bank engineered a significant rise in interbank market interest rates when it ceased repurchase operations in January 1997. In order to discourage foreign portfolio investment, the fluctuation band of the koruna was widened to $\pm 7\%$ effective January 1, 1997.

The *deterioration of the external position* reflected the discrepancy between the growth rate in Slovakia and in its main Western trade partner countries. Like in the other countries reviewed in this report, export performance worsened in 1996 and imports remained strong. Since exports increased by 2.9% while imports jumped 24.7%, the trade gap widened to USD 2.1 billion in 1996 compared with balanced trade in 1995. The current account took a dramatic turnaround, posting a deficit of USD 1.9 billion or 10.2% of GDP compared with a surplus of USD 0.6 billion in 1995. This shortfall was matched by a capital account surplus of USD 2.1 billion. Hence, the foreign currency reserves of the central bank remained stable at USD 3.4 billion in December 1996. They stood at the same level at the end of February 1997 and cover 12 months of imports. *Foreign direct investment* remained at a negligible level. External debt rose by USD 2 to 7.8 billion at the end of 1996. According to preliminary figures, the trade deficit continued to widen in the first quarter, reaching SKK 15.9 billion, up from SKK 15.4 billion in the analogous period of the previous year. The government responded to these adverse developments by establishing the Export-Import Bank and a state fund to support exports. It also decided to follow the Czech Republic and introduce a 20% deposit for imports of selected consumer and agricultural goods from all countries, which took effect on May 1, 1997. The non-interest-bearing deposits will be held for 180 days in Slovak banks. According to government estimates, 44% of all Slovak exports will be affected by the Czech deposit measures imposed earlier.

The currency law was *liberalized* in December 1996 to pave the road to Slovakia's entry into the OECD. Residents are allowed to grant credits to

firms from OECD countries without any license and to borrow from OECD-based firms, provided the credits are used to pay for imports of goods and services. Purchases of real estate in OECD countries have been allowed as well.

Privatization in Slovakia has been slow since coupon privatization was canceled in 1995. The government opted for direct sales of firms. In February 1997, Parliament approved a law which would practically halt the privatization of the three largest banks and of the insurance company until 2003. After the veto of the President, it was amended to enable the privatization of two of the banks in question, Vseobecna Uverova Banka and Investicna a Rozvojova Banka. The privatization of the third bank, Slovenska Sporitel'na (the savings bank), and of the Slovak insurance company will be delayed until after the parliamentary elections to be held in 1998.

2.5 Slovenia

In 1996, economic growth lost some steam, as GDP rose by 3.5% in real terms compared with 3.9% in 1995. The sluggish economy in Germany and other trade partner countries is cited as a primary reason for this slowdown. Wages rose faster than productivity gains, lowering the competitiveness of Slovenian products. Gross real wages went up by 4.9%. Industrial output increased by 1%, with growth accelerating in the second half of 1996 after stagnating in the first half. An encouraging factor is the strong rise of 10.1% in investment goods. The unemployment rate remained at a high level of 14.4% in December 1996, up by 0.5 percentage points on December 1995. However, according to the definition used by the ILO, the unemployment rate was 7.3% in May 1996.

In 1996, exports stagnated at the previous year's level while imports declined by 1.0%. The foreign trade deficit was USD 1.1 billion, slightly less than in 1995. The current account was balanced. Capital inflows led to an increase of official foreign currency reserves by almost USD 0.5 to 2.3 billion at the end of 1996. These reserves cover nearly four months of imports. The country's foreign debt ran to USD 4.0 billion at the end of 1996, a USD 1.0 billion rise on 1995 which was due to the inclusion of Slovenia's portion of former Yugoslavia's foreign debt to the commercial banks grouped at the London Club.

Average annual retail price inflation at 9.7% had fallen to a single-digit level for the first time since the onset of transition, down from 12.6% in 1995. In February 1997, CPI inflation dropped to 8.5% year on year. Slovenia continued to pursue a balanced budget policy. The budget for 1997 had not been approved yet as of the writing of this report, because of the long overdue formation of the new coalition government after parliamentary elections in November 1996.

Privatization has been particularly slow and complicated in Slovenia due to the problem of identifying the ownership of firms. At the end of 1996, plans for the sale to the public of 1,348 enterprises had been approved, covering 90% of the firms selected for privatization. Insiders took control of 16% of privatized equity, mostly in medium-sized and small enterprises. 130 larger firms opted for public offerings of shares, as they are too big to be

acquired by insiders. 138 enterprises – mostly problem firms – are waiting for the approval of their privatization plans. It is expected that privatization will be completed by the end of 1997. The state-owned rehabilitated banks Nova Ljubljanska Banka and Banka Maribor are also scheduled to go on the block. The search for strategic investors, including foreign capital, has started.

A new banking act should be enacted in the second half of 1997 to harmonize Slovenia's banking sector regulation with that of EU countries. The new law would allow foreign banks to branch out in Slovenia without having to fulfill capital requirements there. The draft proposes the establishment of a deposit insurance scheme to be funded by participating banks. The state would step in only if the fund ran out of financial means to settle claims. The new draft also includes limits on enterprise ownership of banks to avoid connected lending. In 1997, the government will prepare the reform to introduce the VAT at the beginning of 1998. Work on the pension reform is pending as the payments to the pension fund from the budget are projected to reach 16.2% of budget expenditures in 1997 and are forecast to rise further. The present pay-as-you-go system is unsustainable in the long run. However, only little progress can be expected in 1997, considering that the reform is politically difficult to propose under the current balanced budget conditions. The model favored by the authorities is based on three pillars and similar in principle to the one that Poland and Hungary are working on.

In order to better monitor portfolio investment flows, the Bank of Slovenia issued a decree in February 1997 obliging foreign investors in Slovenian shares to open fiduciary accounts with fully licensed banks in Slovenia. Half of Slovenia's 28 banks are fully licensed. As of mid-April, banks had not opened such accounts yet, which led to a decline in turnover on the Ljubljana Stock Exchange.

- 1 *The region analyzed comprises the following five countries: the Czech Republic, Hungary, Poland, Slovakia and Slovenia.*
- 2 *See the Czech National Bank Monthly Bulletin 3/1997.*
- 3 *Central European Free Trade Association.*
- 4 *Polish statistics include government consumption in total consumption growth, which was up 7.2% in 1996 on 1995.*
- 5 *Public debt increased by 10.9% in nominal terms to PLN 185.4 billion.*
- 6 *Consumer credit surged by 108%, but the base of growth was low, since its share does not exceed 15% of total credit to the economy.*
- 7 *Starting in January 1996, the National Bank of Poland included the item "net unclassified currency flows" in the current account, an item which was formerly included in short-term capital, but mainly reflects the surplus of cross-border trading with Germany.*
- 8 *The balance-of-payments effect is much lower than this amount, as the latter includes investment in kind. The given figure captures only investments of at least USD 1 million.*
- 9 *Estimate of the Ministry of Finance.*

Editorial close: May 9

Special Report on Bulgaria and Romania

Peter Backé¹⁾

I Introduction

So far, transformation towards a market economy in Bulgaria and Romania has been less successful than in the most advanced transition countries. One reason for this divergence is that conditions at the outset of transition were worse: Both countries' economic development was less advanced than that of the vanguard countries and economic structures were (much) more heavily distorted, though for somewhat differing reasons. In addition, Bulgaria started the transformation highly indebted and declared a foreign debt moratorium in 1991. In contrast, Romania had practically no foreign debt due to the austerity course of the 1980s. Moreover, Bulgaria was particularly negatively affected by the breakdown of the CMEA, as the country effected roughly three quarters of its trade with the former socialist countries, while for Romania this share was less than half. The main reason, however, for the laggard progress with transformation has been a failure to implement, in a variety of policy fields, comprehensive and consistent structural reforms. Under these circumstances, sustained macroeconomic stabilization was not possible either. Moreover, performance was negatively affected by the design of macroeconomic policies, which was not always consistent or fully appropriate, as well as by the frequent halfheartedness shown in the implementation of fiscal, monetary and incomes policy measures. While both countries have accorded several stabilization and reform programs with the IMF since 1991, none of the loan agreements with the Fund which were concluded in support of these policy packages was in fact completed successfully.

These deficiencies and their effects on economic performance (see tables in the Statistical Annex) were substantial in both countries, though comparatively much more pronounced in Bulgaria than in Romania. In Bulgaria, significant crisis symptoms manifested themselves in 1994, when the country was beset by an exchange rate crisis that set off an upturn in inflation. In 1995, Bulgaria's macroeconomic performance improved perceptibly. Simultaneously, economic growth returned to moderately positive levels in real terms in 1994 and 1995, and external debt relief was achieved through rescheduling and debt forgiveness.²⁾ Furthermore, Bulgaria concluded an Association Agreement with the European Union in 1993 that went into force in February 1995. In December 1995, Bulgaria applied for EU membership. Last year, however, developments reversed in a dramatic manner and a deep economic crisis unfolded: The banking system partly collapsed, the exchange rate of the lev plummeted, inflation soared, GDP contracted sharply, internal debt and debt service exploded. External debt service was continued, but deep concerns arose about the country's medium-term ability to stay solvent. A standby agreement with the IMF was concluded in July, but slipped off track within a few months; the situation deteriorated steadily. Food and energy shortages emerged, inflation skyrocketed, real wages and pensions collapsed and social hardship grew. In early 1997, public protest set in against the dismal economic performance and the policies of the socialist-led government. This led, in early February, to an agreement between the major political forces to dissolve the Parliament, to install a caretaker government formed by the conservative-

liberal opposition and entrusted with a mandate to negotiate a policy package with the international financial organizations, and to hold parliamentary elections on April 19. These elections resulted in a majority for the alliance of center-right parties that had already formed the interim cabinet.

Romania, too, experienced an improvement of macroeconomic indicators towards the mid-1990s. Positive real growth started in 1993, quickened in 1994 and reached a high level in 1995. Simultaneously, inflation was reduced substantially, and the budget deficit remained relatively low. The current account deficit exhibited a decreasing trend in 1993/94, which reversed in 1995. The country's foreign indebtedness expanded, but remained within acceptable limits. In 1993, Romania signed an EU Association Agreement that came into force in February 1995, and in mid-1995, the country handed in its application for membership in the European Union. In 1996, the country suffered a considerable turn for the worse. As the year went on, negative economic trends intensified and it became ever more apparent that, in the absence of substantial corrective measures, the outbreak of an outright crisis was imminent. The deterioration of the situation was substantially accelerated by a relaxation of macroeconomic policies and increased administrative interference with the economy – in particular with monetary and exchange rate policy – during the runup to the parliamentary and presidential elections that took place in November 1996. Growth slowed, the fiscal position weakened considerably, monetary policy was accommodative, central bank preferential credits to agriculture and refinancing to two ailing banks soared, inflation began to speed up, the leu became increasingly overvalued, and the current account deficit rose considerably. Foreign indebtedness continued to burgeon, and its term structure worsened. At the same time, weaknesses in the financial sector became more pronounced and financial discipline deteriorated. The elections put a new President in office and resulted in a redistribution of powers in Parliament. Subsequently, a new centrist government took office.

Both administrations – Bulgaria's interim government and Romania's new cabinet – have begun to undertake a fresh effort towards stabilization and reform. The two countries have formulated comprehensive policy packages accorded with the IMF, the World Bank and the European Union. Both economic programs are supported by IMF standby agreements. The standby arrangement for Bulgaria was approved by the IMF on April 11, 1997, after the Fund had received assurances from the main political groups that the agreed policies would be followed after the elections. The standby credit has a volume of SDR 371.9 million and a duration of 14 months. In addition, the IMF granted Bulgaria funds on the order of SDR 107.6 million from the Compensatory and Contingency Financing Facility to cover the excess costs of cereal imports during the period from July 1996 to June 1997. The standby arrangement for Romania in an amount equivalent to SDR 301.5 million and a duration of 13 months was endorsed by the IMF Board on April 23, 1997. The main elements of both policy packages and the implementation measures taken so far are presented below.³⁾

2 Bulgaria

At the core of the Bulgarian program is the intended introduction of a currency board. The adoption of a currency board was proposed and, in fact, urged by the IMF from the fall of 1996 onwards. Witnessing the swift falling-apart of the 1996 policy package, the Fund came to the conclusion that at this stage, orthodox stabilization would not work in Bulgaria and that a major shift in strategy was warranted in order to break the macroeconomic deadlock and to establish lasting monetary confidence. After being debated fairly intensely for some time, the currency board idea was accepted by Bulgaria.

The currency board is to be set up by mid-1997. Its peg will be enacted at the then prevailing market exchange rate. Reportedly, the Bulgarian authorities favor July 1 as a starting date for the currency board and will opt for a peg to the Deutsche mark. In order to secure its functioning, the currency board arrangement is backed up by the following policies and measures:

Monetary policy in the preparatory phase of the currency board is to be tight. In particular, this entails the immediate elimination of any monetization of the budget deficit. Simultaneously, until the currency board is introduced, exchange rate policy will be based on a managed float regime, with the aim of smoothing fluctuations and avoiding an appreciation of the lev. Furthermore, the program foresees a significant replenishing of official foreign exchange reserves, which are expected to grow from USD 445 million in February 1997 to around USD 1.3 billion by the end of the year.

In the fiscal sector, a restrictive policy stance is to be coupled with structural adjustment measures which primarily relate to cutting public sector employment, targeting social expenditures more precisely, and improving revenue collection. The general government deficit is to be reduced from last year's 11% of GDP to 4% this year. As interest payments on the domestic debt are envisaged to fall even more strongly (as a share of GDP),⁴) this deficit target corresponds to a primary budget surplus of 4.5% of GDP (1996: 8.2%).

Structural reforms are to be broadened and speeded up. At the heart of the catalogue of structural reform measures is financial sector reform. Fifteen banks which had become insolvent last year were closed in early 1997. The program contains rehabilitation measures for one of the six state-owned banks and steps to improve the liquidity situation of another institute as well as the closure of further small private banks before the establishment of the currency board. The privatization of state-owned banks is to go ahead, and two institutes are to be sold until the fall. These steps are to be coupled with a reinforcement of banking supervision and an amelioration of the legal and regulatory framework for banks.

In addition, the program includes a comprehensive, fast-track privatization program for state-owned enterprises. All commercial companies that are still in state hands and half of the public utilities are to be sold off within two years. The closure of a group of 64 large lossmakers singled out last year is underway and should be completed by mid-year. Another group of non-profitable enterprises which were isolated from the economy in 1996 is

being restructured. These measures are rounded out by an incomes policy that provides for an exorbitant wage tax for lossmaking state-owned enterprises.

The structural reforms are complemented by a set of liberalization measures aimed at freeing prices and trade (especially in the agricultural realm) as well as facilitating private land ownership and deregulating some aspects of the exchange system (e.g. removing limitations to profit repatriation for small joint ventures). Prices for utilities remain administered, but are being raised to close to or at expenditure-covering levels.

Based on these policies and reform measures, the authorities hope to contain the drop in this year's real GDP to 5%, with positive growth setting in already during the summer months. Inflation is to fall to 2% per month by the end of 1997. The current account is to close with a small surplus.

The tightening of macroeconomic policy after the political accord in February and after the agreement in principle with the IMF in March has produced positive results. Inflation, which had soared to a monthly 44% in January and reached an all-time high of 243% in February, fell to 12.3% in March. In April, a deflation of 0.7% was recorded. In line with this development, the central bank subsequently lowered its basic interest rate, most recently on May 8 to 5.2% monthly. Yields on short-term government securities fell constantly in the same period. The recessionary tendencies of 1996, however, have still not been overcome: Industrial sales fell by 16.4% in March (year on year) after a decline by 24.2% in February. The unemployment rate has been on the rise and reached 14.5% in March 1997. Bulgarian official foreign exchange reserves have begun to recover and increased sharply in April, surpassing USD 1.1 billion at the end of the month. The increase in reserves was mainly due to central bank purchases of foreign currency and IMF funds received under the loan package approved in April. The lev has been trading slightly above 1,500 to the dollar since mid-March after having dived to an all-time low of 3,000 per dollar in February. Bread and fuel shortages have been brought under control. Under a stopgap budget bill approved on January 31, the deficit has been limited to the amount of interest and discount payments on Treasury paper. The budget deficit of the central government stood at BGL 298 billion at the end of March 1997 (1.4% of the GDP projected for 1997). There are signs of a beginning improvement of tax collection.

The economic program is heavily frontloaded, containing a comprehensive catalogue of 12 prior actions (measures to be implemented before IMF Board approval). All these steps were taken until early April, the most important ones being:

- the adoption by the government of a budget bill (its approval by Parliament is a precondition for the completion of the first review of the standby agreement);
- the completion of draft legislation for the currency board, of amendments to the banking law and of a new bank insolvency law;
- a major increase of prices for utilities (to achieve full or close to full adjustment to cost recovery levels) as well as for wheat (close to the world market price);

- appropriate immediate measures to strengthen weak state banks, pertaining in particular to the state bank mentioned above for which the authorities have already started a recapitalization process;
 - implementation of financial rehabilitation plans for enterprises.
- In addition, the following major measures have been taken recently:
- fuel prices were liberalized in early May;
 - the central bank has continued to sort out the problems in the banking sector by starting bankruptcy procedures for insolvent banks and/or by putting them under conservatorship. So far, four commercial banks have been declared insolvent by the courts;
 - a privatization program of large state firms is being prepared but has not yet started. In April, 60% of the soda ash plant Sodi were sold for USD 160 million to Belgium's Solvay, Bulgaria's largest sale so far.

The current IMF program for Bulgaria confronts the country's macroeconomic malaise and the deep structural weaknesses in a comprehensive and apparently consistent manner. Nevertheless, it entails certain risks which are primarily a reflection of the unfavorable financial and economic starting conditions under which policies are to be implemented. First, uncertainties relate to the future development of the exchange rate and inflation, which exhibited substantial swings during the first months of 1997. The uneven term structure of the external debt, which will result in a peak of debt service towards the end of 1997 and at the beginning of 1998, constitutes a second potential challenge to the program. The third and more general challenge, from today's perspective, is the remaining uncertainty about the effects, both on a macro- and on a microeconomic level, of the envisaged swift and, at the same time, sustained move from a state of endemic financial indiscipline to hard-budget constraints; this transition marks a precondition for the smooth functioning of a currency board arrangement. A fourth aspect relates to the two-phase design of the program: Potential unexpected developments in macroeconomic and structural policies during the preparatory phase of the currency board, i.e. during the initial orthodox stabilization phase, could put the timely establishment, and the proper functioning, of the currency board into jeopardy. The fairly high uncertainty about economic developments is, for example, reflected in GDP forecasts of various international research institutes for 1997, which oscillate between -4 and -9.3% in real terms.

To mitigate the risks, the program is, as has been shown, decidedly frontloaded, and the Fund intends to monitor developments particularly closely and to thoroughly reassess program projections and policies as well as preparatory steps for the establishment of a currency board at the time of the first program review to be completed by the end of June 1997. On the part of the authorities, success will crucially depend upon a particularly high readiness and ability to swiftly adopt corrective measures, if and when necessary. To this end, it would be helpful to develop contingency plans for problem areas.

Moreover, potential risks to the program must be seen and assessed against the backdrop of definitely conducive political conditions constituting the frame for the implementation of the policy package: The authorities have

displayed a strong political will as well as an unequivocal stabilization- and reform-mindedness; the government is backed by a clear majority in Parliament, popular support for the policy package appears to be solid, and the performance of the interim government – both in terms of policy design and implementation – has definitely been positive.

3 Romania

The Romanian program aims at correcting detrimental macroeconomic developments and, at the same time, at laying the groundwork for a sustainable stabilization by relying on a range of liberalization measures and structural reforms. The program specifically stresses instilling financial discipline into the economy, freeing the central bank from quasi-fiscal activities, and following a flexible, market-determined exchange rate policy.⁵⁾

The main targets of the program for 1997 are to cut inflation sharply from an annualized rate of 110% at the end of 1996 to 30% by December 1997. The general government deficit is set to be reduced from last year's 6.5% (including quasi-fiscal transfers of the central bank) to 4.5% in 1997. The current account deficit is to be reduced from last year's USD 2.3 billion to USD 1.4 billion in 1997, and official foreign exchange reserves are set to grow from USD 550 million at the end of 1996 to more than USD 1.3 billion by the end of 1997. As a consequence of the austerity and reform course, GDP is expected to fall temporarily in 1997, namely by up to 2% in real terms, but the economy is expected to return to robust economic growth before the end of the decade.

In the realm of macroeconomic policies, fiscal adjustment is more substantial than suggested by the reduction in overall deficit figures, given significantly rising interest expenditures (due to a switch towards full market-based placement of state papers) and a marked increase of social expenditures to assist those most affected by the policy package. Most of the adjustment is to be achieved via expenditure measures, and here primarily through subsidy cuts. The economic program provides for a restrictive monetary policy stance, with a specific tightness during the first months in order to counteract the emergence of strong inflationary expectations. In addition, the program relies on wage limits for noncommercial state enterprises and lossmaking state companies, where wage growth had often been far beyond productivity increases in recent years.

On the liberalization and structural reform side, the program has three mainstays:

First, it relies upon swift liberalization of regulated prices and trade. The remaining administered prices are being sharply increased and will be adjusted regularly afterwards.

Second, it focuses on reforms of the enterprise sector, displaying a two-pronged approach. On the one hand, the privatization process is to be substantially broadened and accelerated. Here, the authorities' daring aim is to sell off 60% of all state-owned enterprises until end-1997. On the other hand, priority is given to solving the problem of heavily lossmaking enterprises, with a specific concentration on chronically unviable firms in

agriculture and in the energy-intensive industrial branches. Subsidies to these sectors are to be reduced substantially, and nonviable firms are to be closed or sharply downsized early on in case initial attempts to privatize these companies fail. Restructuring programs will be applied only to lossmaking public utilities and a few other, specifically selected enterprises. In addition, the program contains measures to bar the reemergence of interenterprise arrears.

Third, the program contains a set of measures directed at financial sector reform. In this context, a strengthening of the legal framework for banking activities as well as of the supervisory powers of the central bank, furthermore the rapid closure of two insolvent banks, the initiation of bank privatization and facilitating foreign portfolio investment by removing obstacles are envisaged.

The Romanian government started implementing the program immediately after having reached a principal accord with the Fund in mid-February. What are the first results of the shift in policies? The increase in the price level turned out to be higher than expected, despite restrictive policies, especially in the monetary field, and the year-on-year inflation forecast of 90% in 1997 will most likely be beyond reach. As a consequence of price liberalization and adjustment, inflation climbed to an all-time high of 30.7% in March (against February), but in April, it eased to 6.9% monthly. In May, a temporary quickening can be expected due to the further adjustment of administered prices. Economic growth was strong in the first quarter of 1997. Industrial output rose by 14.3% year on year. Unemployment tended to decline, with a rate of 7.2% in March 1997 compared to 9.2% in March 1996. The central budget deficit stood at ROL 341 billion in January-February 1997 against the assumed target of ROL 12.6 trillion for the whole of 1997.

The trade balance showed a deficit of USD 183 million in January-February 1997, down from USD 267 million in the same period of the previous year. The current account posted a deficit of USD 151 million in January, compared with 73 million in January 1996. Official foreign exchange reserves rose sharply, in particular in April, when they almost reached USD 1.5 billion, propelled by capital inflows into securities and renewed access to IMF credits. Foreign direct investment was also on the increase in the first quarter of 1997.

The improved economic performance and the IMF backing has increased confidence in the leu: After a sharp depreciation during the first weeks of the year (from 4,100 lei per US dollar at the beginning of January to 8,500 lei per US dollar in the middle of February), the leu recovered and, since March, the (nominal) exchange rate has been fairly stable at a level of approximately 7,000 lei to the US dollar.

The Romanian authorities have also made good on fulfilling the set of agreed-upon prior actions. In particular, the government took the following measures: On February 18, the authorities (re-)liberalized the foreign exchange market, and the exchange rate policy was adjusted to program requirements (to make it more "market-determined" and "flexible"). Simultaneously, a range of food prices was freed and agricultural trade

considerably liberalized. The government has begun to cut public sector employment. The closure of a first tranche of heavily lossmaking large agricultural farms and industrial enterprises was effected as of end-April. Finally, the central bank revoked the licenses of the two insolvent banks mentioned above on April 18.

Besides these prior actions, the authorities have taken further upfront measures in line with the policy package agreed with the Fund: The privatization of state-owned agricultural trading companies has started. The functioning of the Treasury bill market has been improved markedly. The authorities have liberalized prices for a range of industrial goods and have adopted several measures to significantly raise the administered prices of utilities (primarily energy, transport, telecommunications). In April, the Romanian Parliament passed a revised Bank Privatization Law. In May, the government endorsed a Law on Bank Insolvency and an Amendment on the Law on Banking Activity and submitted these bills to Parliament. In addition, joint ventures and fully foreign-owned companies have been allowed to buy and own the land necessary for developing their business activities while operating in Romania. Furthermore, the Romanian central bank substantially raised minimum capital requirements for commercial banks in May.

Romania's new stabilization and reform program is courageous and based on a multipronged concept, tackling practically all major financial and economic problem areas that have emerged and that require corrective action. Still, program implementation may pose challenges that have not been fully anticipated yet. This may be particularly true of enterprise reform, above all of the closure of large lossmakers and measures to impede the future resurgence of interenterprise arrears. These steps may meet with stronger-than-expected resistance from networks of enterprise managers and parts of the country's administration, possibly supported by the employees of the affected companies. For the program to succeed, the authorities' steadfastness in fully implementing these parts of the policy package and in addressing potential problem cases with market-based measures will be instrumental. In this context, the government's resolve to proceed in substantive cooperation with labor unions could prove to be crucial to pushing through the necessary measures.

Furthermore, enterprise reform, in conjunction with a sustained tightening of macroeconomic policies (and in particular the slashing of subsidies) will fully bring to the fore the bad loan problem that has so far been partly disguised by recurrent rollovers. This will aggravate the situation of some banks which are already burdened by substantial substandard loans. This could, in turn, undermine the tight monetary policy, all the more so as the authorities do not seem to dispose of a fully-fledged strategy for coping with bank insolvencies yet and have apparently not earmarked a sufficient volume of budgetary means for this purpose so far. This potential weakness, which has also been pointed out by the Fund, might turn out to be particularly problematic in a situation in which not all facets of banking supervision have been fully developed yet. It will be up to the central bank to live up to its commitment to truly reinforce the surveillance of banks in order to detect potential problems in the sector early on.

Another issue fraught with uncertainty is the question of the impact of the stabilization and reform package on the external position of the economy, in particular on the country's export performance and the degree and pace at which foreign direct investment will be attracted during the course of the program.

Notwithstanding these potential caveats, there are, besides the general strength of the program, several factors that bode well for a successful implementation of the Romanian policy package. As in the Bulgarian case, one has to commend the strong and encompassing commitment of the authorities to achieve lasting stabilization and to iron out structural weaknesses, a commitment which has been singular in the course of Romania's transformation, the new government's good policy implementation record to date, the clear parliamentary majority the government has behind it, and the wide popular support the policy package has received in Romania.

- 1 *I gratefully acknowledge valuable comments by Olga Radzyner as well as contributions by Maciej Krzak relating to factual information on the implementation to date of the Bulgarian and the Romanian stabilization and reform programs as well as on the main economic developments during the first months of 1997.*
- 2 *Although the debt relief was substantial, Bulgaria's debt and debt service burden remained quite high.*
- 3 *In the remainder of this report, the data referred to are those on which the economic programs of the two countries under consideration are based. It should be noted that these data may not always be fully consistent with the figures contained in the Statistical Annex of this publication.*
- 4 *This is due to a significant reduction of internal debt denominated in lev, as measured as a share of GDP, resulting from highly negative real interest rates during the first months of 1997.*
- 5 *The country intends to reassess, during the course of the program, whether it would be appropriate to move from a flexible to a fixed exchange rate system (which would then most likely be a crawling peg regime).*

Editorial close: May 15

S T U D I E S

The Present State of Monetary Governance in Central and Eastern Europe

Maciej Krzak
and Aurel Schubert¹⁾

I Introduction

Monetary governance refers to the combination of the legal framework, the strategy and the operational framework of monetary policymaking in a particular country. In the economies in transition of Central and Eastern Europe, the institutional framework of monetary policy was practically created from scratch from the beginning of transformation. Six years of transition inspire us to ask what has been achieved. In this study we intend to highlight the shift from direct instruments to indirect instruments of monetary management. Furthermore, the paper gives a comparative overview of the different institutional setups of monetary policy in the countries examined. Our study is restricted to the CEFTA countries, i.e. the Czech Republic, Hungary, Poland, Slovakia and Slovenia, which appear most advanced in their respective degrees of monetary transition.²⁾ These countries also aspire to join the European Union along with five other transition economies. Sooner or later they will also voice an interest in becoming members of the prospective European Economic and Monetary Union (EMU). Though this perspective is still very remote – especially since the third and final stage of monetary union has not even started yet – we believe it is useful to examine the monetary frameworks in these countries in comparison to the monetary framework prepared for the conduct of monetary policy by the European System of Central Banks in EMU as published by the European Monetary Institute in early 1997.³⁾

In this study we focus on targets and instruments of monetary policymaking and dwell only briefly on the question of central bank independence.⁴⁾ We discuss exchange rate policy only within the context of monetary policy, concentrating mainly on the impact of capital flows on the effectiveness of monetary management. We do not go into a detailed description of the centrally-planned episode and first steps, as the topic has already been discussed comprehensively by Duchatczek and Schubert (1992 and 1993), nor do we touch on the issues of regulation and supervision of the banking industry. Specifically, we do not discuss the impact on monetary policymaking of bailouts of commercial banks by central banks.

The paper consists of five sections. After the introduction, in section 2 we briefly outline the tenets of the modern monetary framework in market economies with particular reference to the monetary framework developed by the EMI. In section 3, which is the core part of the paper, we analyze the evolution of the monetary framework in the five CEFTA countries. In section 4 exchange rate policy and regimes are briefly discussed in the context of monetary policy issues. Section 5 starts with a brief summary of the paper to proceed to the main conclusions.

2 Theoretical Underpinnings of Sound Monetary Policy

The theoretical standard for the institutional setup of monetary policy in developed market economies includes recommendations for central bank independence, monetary policy targeting, instruments, and the interdependence of monetary and exchange rate policy. The literature on these issues is still developing, with new studies steadily adding to our knowledge.

2.1 Central Bank Independence

According to the empirical evidence,⁵⁾ a strong negative correlation can be observed between the degree of central bank independence and the inflation rate. Central bank independence from political institutions is believed to allow and encourage the bank to focus monetary policy on long-run issues, especially on price stability. In this way it is free from political pressures to generate political business cycles by running expansionary policies before elections in order to support the incumbents' reelection efforts.⁶⁾ Independence has several facets: functional, personal and financial. Personal independence, for instance, is ensured by fixing terms of office for the governors of the central banks which are longer than the political election cycle or by diminishing the government's role in appointing the governor and by explicitly limiting the possible reasons for the removal of a governor to very few and transparent cases, all unrelated to monetary policy decisions. Functional independence refers to the central bank's autonomy in defining the intermediate goals of monetary policy and in implementing monetary policy. Financial independence includes, among other aspects, independence from the fiscal authority. This way the central bank cannot be forced to contribute to the financing of budget deficits either by directly purchasing government debt instruments or by simply printing money.

Whether a higher degree of central bank independence results in "a free lunch," i.e. lower inflation without the cost of wider output variability, is still hotly debated. Alesina and Summers (1993) and Walsh (1994) report no association between central bank independence and output variability, whereas Rogoff (1985) as well as Debelle and Fischer (1994) find evidence that higher central bank independence leads to stronger recessions during disinflationary processes. They suggest that a central bank should be granted only instrument independence, but not goal independence. If evidence swayed toward the latter view, then the current strong trend toward unrestricted independence would require mitigation and a critical evaluation of numerous banking acts in advanced and emerging market economies. At this stage of the debate, our stance is that the bank should be independent, but accountable. Accountability means that information about central bank targets and instruments is publicly available together with up-to-date information on the achievement of the targets.

2.2 Targets

In the medium to long run, a central bank is accountable for its adherence to the ultimate objective. Targeting has the advantage of enabling the central bank to recognize where it wants to go; it also has informational merit, as it lets the private sector know what to expect in the future. Targeting obviously makes central banks accountable for their actions. Outsiders obtain a chance to discuss the announced targets and to debate whether they are aimed in the right direction. It has become standard to describe central banks' goals by classifying them as ultimate goals and as intermediate and operational targets.

The ultimate goal could be an economic variable whose development is very important for the economy, such as price stability, the inflation rate, the rate of unemployment, the development of real GDP or the stability of

financial as well as foreign exchange markets. Multiple targets are likely to be incompatible and to create conflicts for the central bank concerned. The trade-off between some of them can be described with a welfare loss function of the government. A number of these targets, e.g. the unemployment rate or GDP growth, were proposed within the framework of an anticyclical role of monetary policy. Progress in targeting theory as well as empirical evidence have led to the widespread conviction that ensuring price stability – maybe in combination with financial stability – should be the only goal of monetary policy.⁷⁾ Disillusionment with monetary policy as a means to dampen business cycles rests on three important results of economic theory: (1) Monetary policy is unable to affect real variables in the long run; it can do so only in the short run; (2) there are long and variable lags between policy implementation and its impact on the economy, so at the time the policy becomes effective it may become counter-productive; (3) a time-inconsistency problem arises, i.e. if inflationary expectations are low and thus the marginal cost of additional inflation is low, policymakers are tempted to pursue expansionary monetary policies to push output above its normal level. The public will recognize and anticipate that behavior and adjust its expectations accordingly. Consequently, output will not change, but inflation will rise.

Economic theory establishes and explains the links between money and inflation in the following manner, depending on the time framework: In the long run, there is a systematic relationship between money and inflation, which is a purely monetary phenomenon. The quantity theory of money is valid and money is neutral, i.e. it does not influence real variables. Thus, in the equilibrium (dynamic steady) state, monetary policy can at best achieve price stability or, as the next best outcome, a desired rate of inflation.

In the short to medium run, central banks need other performance criteria than the achievement of the final goal, as monetary policy works with long (and variable) lags. Assessment can be based on monitoring the central bank's performance relative to its announced strategy, a set of procedures specifying how to act to achieve the final objective. Pure discretion would imply no strategy and no possibility of evaluating a central bank's behavior in the short run. From a different angle, the need for credibility of actions and the time-inconsistency problem decisively weaken the case for discretion. Most central bank strategies⁸⁾ are based on indirect targeting. However, one strategy that has recently gained importance – the United Kingdom, Sweden, Finland and Canada are among the countries whose central banks have adopted it – directly targets the inflation rate without a traditional intermediate stage.

The rationale for intermediate targets rests on the argument that instruments available to central banks affect the ultimate goals of monetary policy only with a long lag. This makes it hard to correct mistakes before they show up when the ultimate target is missed. Therefore, central banks use different (intermediate) variables which have strong and predictable links with ultimate goals and are easily observable. These variables are either under the direct or indirect control of the monetary authorities.

As a consequence, central banks distinguish between intermediate and operational targets.

In principle, the choice of an intermediate target should be based on its measurability, controllability and ability to predictably affect ultimate goals. The perfect intermediate target is a variable that a central bank can control and that at the same time has an exact relationship with the ultimate target of the policy. Economic theory has suggested a number of intermediate targets. The most popular are the short-term interest rate, nominal GNP (GDP), different monetary aggregates and the exchange rate. Nominal GNP has only been a theoretical alternative so far, especially due to shortcomings of statistical data. The criteria for choosing intermediate targets were first proposed in a seminal work by Poole (1970) and developed by follow-up research. Basically, the choice between an interest rate and a measure of the money supply as the appropriate intermediate target depends on the nature of the aggregate demand shocks occurring in a particular economy. A prevalence of monetary shocks calls for interest rate targeting, whereas a prevalence of real shocks calls for monetary targeting. In the case of supply shocks, the theory does not offer unambiguous answers.

Problems with monetary targeting at an early stage of economic transition mainly due to uncertainty concerning money demand and the monetary transmission mechanism led to a preference for the exchange rate as an intermediate target. Since exchange rate targeting has become popular in many of the economies studied here, we will dwell a little on its merits as a target. Fixing the exchange rate implies that the money supply becomes endogenous and the central bank can only directly control its domestic component. All other nominal variables, like the price level, the nominal wage rate or the quantity of money, have to adjust to the exchange rate. Preferably, a country should peg the exchange rate to the currency of an important trade partner country with a good price stability track record. This approach is particularly attractive to countries whose monetary authorities and policies lack credibility either because they have established a bad reputation as inflation-prone or because they have no track record yet, as is the case of the transition economies. The exchange rate target gives them a way to acquire credibility via the partner institution if the commitment is supported by the necessary conservative monetary policy. The other advantage of the exchange rate fix as a target is its high visibility and transparency to the public. It is evident that exchange rate targeting is mostly applied in the high-inflation countries aiming at a significant reduction of inflation or in countries which enter multilateral exchange rate agreements, e.g. the ERM. Crawling exchange rate pegs or crawling exchange rate bands are looser commitments. They are recommended for countries with moderate and persistent inflation which have stabilized their economies but still need support for further disinflation and desire flexible monetary arrangements. These forms of crawling devaluation at preannounced rates during a given period are aimed at anchoring inflationary expectations and at the same time protecting the balance of payments. Flexibility is required to absorb various shocks (external or domestic, demand or supply) of different magnitudes which hit the economy. In

particular, movements of portfolio capital can exert pressure on the exchange rate, which a band of feasible fluctuations can help to offset without requiring a change of the exchange rate regime or large-scale intervention.

For the choice of an operational target it is important for the target to have a strong and predictable impact on the chosen intermediate target. This implies that if a monetary aggregate is the intermediate target, a reserve aggregate such as the monetary base would be the preferred operational target. On the other hand, if the desired intermediate target is an interest rate or an exchange rate, then a short-term interest rate will be the preferred operational variable. Among the most broadly used operating targets are reserve aggregates such as reserves, nonborrowed reserves, the monetary base or the nonborrowed base and short-term money market interest rates, which are more directly responsive to the instruments of central banks (open market operations, changes in the discount and/or lombard rate and changes in reserve requirements).

Direct inflation targeting does not fit the traditional division into intermediate and operating objectives.⁹⁾ It has not been used by the reviewed economies in transition yet, but it is mentioned in the framework report of the EMI as a possible alternative for the European System of Central Banks to a strategy based on monetary targeting.¹⁰⁾ The alternatives, nominal GNP targeting, interest rate and exchange rate targeting, are dismissed in the report as not viable for the conduct of monetary policy in EMU.

2.3 Instruments

Modern central banks' tool kits consist of the discount and/or lombard rate, reserve requirements and open market operations. Access to the discount window is typically rationed by quantity restrictions (quotas) if the discount rate is below comparable market interest rates. At present, a general tendency away from below-market-rate discount and lombard lending toward open market operations at market interest rates can be observed. Theorists have long proposed a penalty discount rate. The lombard rate concept, which acts as a cap on interbank market rates, is based on this idea.

Reserve requirements are too unwieldy a tool to be used in the everyday conduct of monetary policy. Small changes potentially produce large swings in base money. Extremely small changes in mandatory reserve ratios to overcome this problem are too costly to engineer. The tendency is to assign them solely the role of a prudential norm designed to guarantee a minimal solvency of financial institutions or to abolish them completely. Reserve requirements usually do not pay interest and they act as a tax on bank deposits. In a stable economy with low interest rates and relatively low reserve requirements this is not a problem, but in inflationary economies with relatively high requirements such as the economies in transition, nonremunerated minimum reserves create a considerable wedge between deposit and credit rates.

Open market purchases and sales of securities have been the most important tool of monetary policy in advanced economies for years. Open market operations occur at the initiative of a central bank, which can

completely control their volumes. They are flexible and precise enough to fine-tune the conduct of monetary policy. They can be easily reversed when necessary, and they can be implemented quickly without administrative delays. Broad use of open market transactions is conditional on the development of money markets and the availability of marketable securities. Usually, government securities are used. Repurchase operations, rather than outright purchases, predominate, as they allow for more flexibility and precision.

2.4 EMU Framework

Knowledge of central banking is reflected in the framework for monetary policy conduct that has been proposed by the EMI report.¹¹⁾ The proposed institutional setup can be treated as a benchmark towards which the monetary frameworks of countries aspiring to enter the European Union, among them the ones examined in this paper, should evolve. The role and importance of central bank independence is emphasized in the report. The final goal is the achievement of price stability. The report leaves open whether monetary targeting or direct inflation targeting should be used by the European System of Central Banks. It rightly points to the fact that the differences between these two types are largely semantic, as both strategies place monetary aggregates at the center of the set of variables to be monitored.¹²⁾ The debate at the EMI exemplifies the current stage of controversy. The EMI stopped short of recommending direct inflationary targeting, leaving the option open. The nominated president of the EMI, Wim Duisenberg, strongly opposes the idea of direct inflation targeting on the grounds of the unclear signals such a strategy produces for monetary policy. In his view, it is a “look-at-everything” approach.¹³⁾ The difference between intermediate and final-target approaches may be more apparent than real, as intermediate targets are used to promote the final target of price stability. In fact, projected inflation plays the role of the intermediate target for direct inflation targeting. A country pursuing a pure intermediate monetary target places a 100% weight on money growth relative to its target, while a country pursuing direct inflationary targeting uses several indicators, one of them being money supply growth.

In order to allow and enable the public to assess the performance of the future European System of Central Banks, its targets will be announced and published. To make the ESCB more accountable, analyses and data relevant to monetary policy will also be regularly published. Explanations of deviations from targets and of policy responses by the ESCB will also become part of the communication with the public.

The ESCB will use open market operations to steer interest rates, manage the liquidity of financial markets and signal the stance of monetary policy. It will have at its disposal five types of open market transactions: While reverse transactions will play the main role, also outright transactions, the issuance of debt certificates, foreign exchange swaps and the collection of fixed-term deposits will be possible.

A marginal lending facility will allow eligible counterparties to obtain overnight credit on their own initiative (like the current lombard loan in

several countries). Deposit facilities will be available to absorb excess liquidity. The interest rate on the marginal lending facility will provide a ceiling for the overnight market interest rate while the deposit rate will provide its floor. The access to both facilities will be unlimited under normal conditions.

The framework for the monetary policy of the ESCB includes the possibility of imposing minimum reserves on financial institutions.¹⁴⁾ The ESCB may apply a uniform reserve ratio to the whole reserve base or differentiate reserve ratios across categories and maturities of eligible liabilities. The possibility of remuneration of the reserves held is not excluded.

In the following part of the paper we will discuss how institutional setups of monetary policy conduct in these countries square with these normative propositions. The brief description of the evolution of monetary conduct will precede it to give a broader perspective of prevailing tendencies. We begin with a short account of the starting point.

3 Present Monetary Policy Framework

3.1 The Initial Conditions

The organizing principle of the economy under central planning as a whole was based on the classical directive Soviet-type model to run the whole economy like one factory, where all externalities are internalized. The reality of centrally planned economies, including the monetary environment, has been described in numerous articles and books. We intend to refresh the readers' memory of the basic features of the monetary environment to underscore the point of departure of the countries reviewed.¹⁵⁾ It does not, however, apply to Slovenia, which as a part of former Yugoslavia experienced a system that was labeled market socialism at the time. At a small risk of simplification, it can be said that, under socialism, monetary policy in the (proper) sense of Western economics did not exist. With the exception of household decisions about savings and consumption, money was accorded a passive role.¹⁶⁾ Its issuance was subordinated to central economic plans expressed de facto in physical units, since money was used as a unit of account only. Financial markets played no role in the allocation of scarce resources. As a consequence, the central bank provided firms with funds in order to enable them to fulfill central planner's production targets. The state credit plan mirrored the central plan and directly allocated credits to firms and sectors. The interest rate only played a marginal role in the allocation of financial resources and did not reflect market conditions; investment credit and housing credit were usually subsidized. Thus, credit was rationed on the basis of state investment and production plans. Bankruptcy was excluded; firms always obtained the funds they needed without a proper screening of output profitability or of investment projects, so they worked under a soft budget constraint.

The structure of the financial system was rudimentary. The only financial assets were currency, bank deposits and, rarely, government bonds. Banking was a state monopoly, and the banking system has been termed a monobank system because all banks were state-owned and directly or indirectly depended on the central bank, which was usually involved in commercial

activities. The two-tier structure of the banking system did not exist. The existence of so-called specialized banks – investment, foreign trade and savings banks – blurred this picture only on the surface, as they were not allowed to lend funds to enterprises or, in particular, to channel individuals' savings into commercial loans. Central banks had little autonomy and were dependent on the government in their decisions. Their *raison d'être* was to implement various elements of the central plan, e.g. the state foreign trade bank executed the state monopoly of foreign exchange and handled all foreign trade transactions. In centrally planned economies, households used cash, while the enterprise sector made payments through bank accounts. These two circuits were separated; firms held cash to pay wages, but were allowed to keep only insignificant amounts of cash otherwise.

Central banks targeted credit plans, which in detail assigned financial funds to economic entities. They used instruments of direct monetary control, i.e. credit ceilings and interest rate ceilings. The exchange rate was mainly an accounting device to translate foreign prices into domestic prices. Often, a multitude of so-called conversion ratios for specific item groups was used. Domestic currency was practically nonconvertible. Foreign exchange controls were imposed not only on capital transactions, but also on current account transactions. There was no official foreign exchange market, so the need for foreign exchange intervention did not arise. The demand for foreign currency was rationed by administrative measures.

This account outlines a rigid model of central planning. It should, however, be made clear that long before the end of communism some of the reviewed countries, in particular Hungary and to a lesser extent Poland, started discarding features of the model. Former Yugoslavia already had a two-tier banking structure and market principles to allocate credit.

In the following section, we proceed to the analysis of the current frameworks of monetary policy in the countries examined.

3.2 Status of the Central Bank

Central banks are explicitly accorded a scope for independence from other authorities. The issues of central bank independence can be classified into personal, functional and financial independence. The central bank acts of the CEFTA countries were adopted relatively early in the transition process. Poland, whose central bank act already originated in the late 1980s, is an exception, although the old law is due to be replaced soon. Hungary modified its act in 1996. We will not dwell on the issue of central bank independence as reflected in legal material,¹⁷⁾ as this topic is covered in detail by the study by Radzyner and Riesinger in this issue of Focus on Transition. For the sake of completeness, we would only like to stress that the central bank acts in the countries reviewed in our paper display convergence with the requirements of the Maastricht Treaty. The weakest point is the financing of budget deficits by central banks, which is still allowed in all countries examined. While the potential amounts are limited, they are nevertheless large enough to enable the governments to seek cover for a substantial part of their deficits. However, three out of the five countries have not used this option so far.

3.3 Strategy

At the outset of transition in 1990 to 1991, the central banks in the former socialist countries had no experience or technology to apply monetary strategies based on indirect instruments of monetary control, as practiced by the advanced market economies. Money markets did not exist; the relevant instruments had yet to be created. Since then, the monetary environment has changed dramatically. The change was fostered by central bank activity, which helped construct interbank and foreign exchange markets in these countries.

3.3.1 Targeting

Targeting plays a prominent role in the monetary strategies of the group of countries analyzed. A division into ultimate, intermediate and operating targets has been adopted across our sample of countries. At the beginning of transition, the separation was not obvious and it took several years before this division clarified and became comprehensible for the public. For example, the National Bank of Hungary started distinguishing among these targets for the first time in its Annual Report of 1993. Poland formally stated this distinction for the first time in the guidelines for monetary policy in 1996.

The *ultimate (final) goal* of monetary policy in these five countries is price stability. Over the last years, there have been no changes in the formulation of the final goals. The formulations used in the official acts vary from internal and external stability of the domestic currency in the case of Hungary to just currency stability in the remaining countries, though the wording in Poland is different, stating that the central bank is obliged to pursue the goal of “strengthening the currency.” Hungary initially interpreted the goal of external stability of the forint in terms of a sustainable position of the current account. This was the case between 1990 and 1992 and later in 1994. In 1993, the stress was put on disinflation. In the Czech Republic, Poland and Slovakia, the central bank is also explicitly obliged to support the economic policy of the government. Since all these countries experience high inflation compared to the European Union or North America, the goal should be interpreted as a reduction of inflation.

Internal and external currency stability can conflict under certain conditions, as external stability in fact pertains to exchange rate policy. This stability can be interpreted in real or nominal terms. The choice of a real exchange rate anchor would leave the price level indeterminate. The fixity of the nominal exchange rate is congruent with the goal of domestic stability of the currency, if the exchange rate is pegged to the currency of a country with a good inflation record.

The stipulated support of government policy opens another area for conflict, as in an inflationary environment the central bank could endorse a more counterinflationary strategy than the one welcomed by the government. The government may point to the rule requiring support for government policy, so that the central bank could face pressure to soften its stance. The result is slower disinflation. The Maastricht Treaty explicitly stipulates that such a support should be legally limited to the cases which do

not interfere with the final goal. In this respect, the analyzed countries will sooner or later have to amend their central bank acts. It is evident that the world-wide recognition of the limits of countercyclical monetary policy is reflected in the formulation of the final goals in our sample of countries. None of them openly lists full employment as a final goal.

At the beginning of transition, four of the countries (Slovenia was the exception) resorted to exchange rate targeting. The exchange rate had the appeal of a transparent anchor in a period of sweeping systemic change. Over the years of transition, three out of four countries have shifted to monetary targeting as one of the intermediate targets. Setting monetary targets in an economy in transition poses numerous difficulties. As the number of economic agents rapidly grows and liberalization and privatization proceed, the money demand function becomes unstable. No historical data which would give reliable grounds for the estimation of parameters of such a function have become available. Strong shocks, including supply shocks (e.g. the liberalization of prices), hit the real economy, so Poole's (1970) analysis has only limited merit in the selection of targets. On the money supply side, changes in the money multiplier may be pronounced even when the reserve requirement is constant and the monetary base is fixed. The time lags with which the changes in money supply affect the real economy are unknown. It is no wonder that central banks changed their targets quite often in such a monetary policy environment. A dose of experimenting was also necessary to gain experience.

The evolution of adopting intermediate and operating targets proceeded in step with the shift from direct monetary management to indirect monetary management. The Czech Republic, for instance, initially set a target for an increase in the domestic credit volume in 1990, then switched to net domestic assets of the banking system and from 1992 on has tracked the broad money indicator (M_2), which has been announced to the public. Poland also targeted the net domestic assets of the banking sector until the end of 1993. In 1994 to 1995, Poland switched to targeting interest rates, apparently ascribing more relevance to monetary shocks than to real shocks; a large denomination of the zloty had been planned at the end of 1994 and shifts in money demand had been expected.

At present, the *intermediate targets* of the countries in question vary little more than final goals. The countries which target the exchange rate have usually adopted another target as well. The Czech Republic, Slovakia, Hungary and Poland have more or less stringent versions of fixed exchange rates (see Annex), so they have to adjust monetary growth accordingly. Therefore monetary targets can only be supplementary, as total money supply becomes endogenous under a fixed exchange rate regime and the central bank can control only its domestic component. The Czech Republic, Slovakia and Poland track broad money aggregates. In the Polish case, monetary targeting is more meaningful than in the Czech Republic or Slovakia, which have fixed exchange rates due to the looser exchange rate system of a crawling band. Slovenia, which formally has a managed floating system, is an exception, as it uses a narrow money aggregate: It has been targeting M_1 since 1991. This choice is based on the empirical evidence that

the money demand for M_1 is stable enough to warrant such a policy. Hungary does not supplement its preannounced exchange rate devaluation target with explicit targets for monetary aggregates, as money demand is believed to be too unstable to credibly validate such an announcement.¹⁸⁾ In the past, it targeted domestic credit expansion along with the real exchange rate or nominal exchange rate when the current account constraint was less binding (in 1993).

Table 1

Changes in Intermediate Targets in the Period of Transition							
	1990	1991	1992	1993	1994	1995	1996
Czech Republic ¹⁾	Increase in the domestic credit volume	Exchange rate and net domestic assets in the banking system	Exchange rate and net domestic assets in the banking system	Exchange rate and M_2	Exchange rate and M_2	Exchange rate and M_2	Exchange rate and M_2
Hungary	Real exchange rate and net domestic loan stock	Real exchange rate and net domestic loan stock	Real exchange rate	Real exchange rate and net domestic assets	Real exchange rate and net domestic lending	Exchange rate	Exchange rate
Poland	Exchange rate and net domestic assets	Exchange rate and net domestic assets	Exchange rate and net domestic assets	Exchange rate and net domestic assets	Exchange rate and interest rates	Exchange rate and interest rates	Exchange rate and broad money
Slovakia				Exchange rate and M_2	Exchange rate and M_2	Exchange rate and M_2	Exchange rate and M_2
Slovenia	n.a.	M_1	M_1	M_1	M_1	M_1	M_1

¹⁾ 1990 to 1992: Czechoslovakia.

In all of the countries with the exception of the Czech Republic, *operational targets* are compatible with monetary intermediate targets. Monetary intermediate targets call for reserve aggregates as operating targets, such as the monetary base, the nonborrowed base or bank reserves. Poland and Slovenia adopted base money, while the Czech Republic targets the interest rate, namely the one-week PRIBOR (Prague interbank offered rate), which endogenizes central bank money and thus potentially conflicts with the M_2 target. Since the fixed exchange rate takes precedence over the monetary target, this does not necessarily have to be problematic for monetary policy coherence. Hungary targets the interest rate differential vis-à-vis the main financial markets to influence short-term capital flows. It thus monitors the repo rate. In the past, it targeted open market operations (limits on repurchase agreements were set in 1993 to 1995) and refinancing by the central bank (1990 to 1992). Slovakia does not announce its operational target, but monitors the monetary base. The National Bank of Slovakia (NBS) is of the opinion that foreign exchange inflows compromise its ability to control the operational target, therefore it stops short of announcing a formal target.¹⁹⁾

Day-to-day central banking practice shows that central banks in these countries monitor other variables, in particular, interest rates, the trade balance, the current account or domestic credit expansion. For example, the National Bank of Poland monitored short-term interest rates in the first half

of 1996 and in the autumn of 1996 became sensitive to domestic credit expansion in the context of the rapidly worsening trade balance despite formally meeting its intermediate and operational targets.

3.3.2 Instruments

With the exception of Slovenia, perhaps, all of the examined economies started with transitory and inadequately developed financial systems.²⁰⁾ For this reason, at the beginning of transition direct instruments of monetary management played a prominent role in guaranteeing that monetary developments remained under control. All these countries experienced a decline in GDP as well as a surge of inflation during the period of price liberalization. Therefore, they needed monetary restraint to eliminate excess liquidity. Since then, direct instruments such as interest rate ceilings or credit ceilings have been abolished in all countries reviewed (see Table 2).

Table 2

Removal of Direct Controls		
	Interest rate ceilings	Credit ceilings
Czech Republic	1992	1993
Hungary	1991	1990
Poland	1990	1993
Slovakia	1992	1995
Slovenia	1991	1991

Since the onset of transition, central banking in the group of countries analyzed has been evolving to meet standards of the advanced Western economies. All sampled central banks use standard instruments from the tool kit of monetary control, so that the classification of instruments into discount rate,

reserve requirements and open market operations is applicable to each of them (see Table 3). The shift to give greater importance to “supply” driven instruments relative to “demand” driven instruments is noticeable. Discount and lombard facilities have been losing significance relative to open market operations over the course of transition.

The gradual approach to the removal of direct controls dominated. Slovenia was an exception, as it eliminated direct controls immediately after the declaration of independence. Poland phased out such controls in 1993. The Czechoslovak Federation phased them out in 1992, but Slovakia reintroduced them in 1993, to finally eliminate them at the end of 1995. Auctioned credit and repurchase tenders, which are indirect control procedures, have become common instruments instead.

Table 3

Introduction of Indirect Instruments of Monetary Management			
	Open market operations	Discount rate	Reserve requirements
Czech Republic	1993	1990	1990
Hungary	1990	1989	1987
Poland	1992	1990	1990
Slovakia ¹⁾	1993	1990	1990
Slovenia	1992	1991 ¹⁾	1991 ¹⁾

¹⁾ Inherited from the Federation.

Open market operations

Open market operations (OMOs) did not exist at the beginning of transition, and the creation of the necessary infrastructure could not happen overnight. They had to be implemented from scratch, and their importance has risen considerably. Over the years, the evolution of instruments was largely driven by changing problems of monetary policy. Commonly, central banks had to inject liquidity in the first years of transition. Only later on did they have to cope with the excess liquidity of the banking sector, after foreign exchange inflows had increased and after banks, having accumulated bad loans and having learned from the failures of the first years, restricted credit to the economy. OMOs were installed rather as defensive operations, i.e. to offset the impact of other factors on the monetary base, than as dynamic operations, i.e. to change the level of the monetary base or bank reserves permanently. Hence, new instruments were sought mainly to respond to the new challenges, in particular to the challenge of capital inflows, but the search also proceeded in accordance with a "vision" of what modern central banking should be. A distinct feature of these countries is a proliferation of central-bank-issued papers to help withdraw excess liquidity and contain the domestic loan expansion of banks, as state (Treasury) papers are not available in sufficient volumes. The auction system has become a method of choice to introduce market principles, i.e. ration liquidity by means of the interest rate. There is a visible shift to using OMOs to affect only the short end of the yield curve (Czech Republic, Hungary and Poland), where the markets are most liquid and directly exposed to central bank policy changes. The following table of refinancing in Slovakia illustrates trends which are common to all CEFTA countries: Central bank refinancing exhibits a downtrend while OMOs have gained considerable significance. The issuance of central bank securities has also dramatically increased.

Table 4

Relative Use of Monetary Instruments in Slovakia				
	1993	1994	1995	1996
	Average volume SKK billion			
Discount loans	4.4	2.0	0.8	0.9
Other refinancing	39.5	33.2	32.6	31.7
OMOs	0.0	0.4	2.1	13.0
Central bank bills	0.0	0.0	5.1	21.9

Source: National Bank of Slovakia.

In Czechoslovakia, OMOs were started on a very small scale in 1992, when the expected dissolution of the monetary union lowered money demand and a stronger inflow of foreign capital led to unwanted increases in money supply. Since a broader use of state securities for open market operations was not possible because the country had run budget surpluses for years, the CNB had to issue its own bills in 1993 to supplement repurchase operations in Treasury bills. In that year, seven CNB bond issues with a two-week maturity each were effected. In 1994, the CNB offered one- and three-month bills on the primary market. Repo tenders were introduced in secondary trading. Since 1994, the operational monetary management of the CNB has been based on repo operations, which replaced the hitherto

auctioned refinancing credits. The recourse to repo operations was propelled by the need to sterilize foreign currency inflows. In 1996, repo tenders of one- and two-week maturities were used to influence the one week PRIBOR. Table 5 – reproduced from Hrnčíř (1997) – presents evidence on the rapidly increasing relevance of OMOs for the monetary policy of the CNB.

Table 5

Liquidity Drainage by Open Market Operations of the CNB							
	1990	1991	1992	1993	1994	1995	1996
	CZK billion						
Reverse OMOs	0.0	0.0	-11.8	-26.4	-70.4	-89.4	-138.4
Refinancing	17.4	21.1	15.1	6.5	7.1	7.3	13.4

Source: Hrnčíř (1997).

Note: (-) drainage and (+) injection of liquidity.

In the middle of 1990, the *National Bank of Poland* (NBP) started to auction one-week NBP bills in an attempt to drain the excessive liquidity of the banking sector. Thus, rudimentary open market operations were started. The NBP diversified its sales of bills to three- and six-month maturities in 1991. It started to auction one- and three-month Treasury bills in May 1991, and due to the growing supply of Treasury bills, it suspended auctioning of NBP bills in early 1992. The launching of one- and three-year government bonds in 1992 enabled the central bank to conduct repurchase agreements and reverse repurchase transactions for the first time. In 1994, open market operations took off as the country's international reserves began to grow rapidly. The NBP stood ready to sterilize their impact on the money supply. The role of one- to fourteen-day reverse repurchase agreements became dominant. Outright operations of Treasury bills involved smaller amounts, as the NBP was reducing its portfolio of short-term Treasury securities. In November 1994, as the excess liquidity of the banking system became chronic, the NBP resumed auctions of its own bills. The introduction of the book entry form of government securities in 1995 boosted outright sales of Treasury bills, since their physical denominations were large and nonmarketable, while the book entry form has made it possible to break them into smaller amounts.

In *Hungary* OMOs are conducted by means of outright sales/purchases of government securities, repurchase/reverse repurchase agreements and foreign currency exchange swaps. Starting in 1993, the significance of open market operations increased steadily. Until 1993, the NBH had influenced a large part of the yield curve with posted interest rates, but later on withdrew and focused solely on the short end of the curve. Currently, one-day, one-week and overnight facilities exist. The one-week repo rate has been quoted since January 1994. In 1994, foreign exchange deposit swaps of one to three years were also actively used to ensure the medium-term liquidity of banks with foreign currency deposits. They were phased out in 1995, as they created too much liquidity and were replaced by foreign exchange deposit swaps available only for the purpose of project financing. Repurchase agreements were another plentiful source of banking sector liquidity in 1994. At the end of 1995, reverse repurchase agreements were activated in

order to drain the excessive liquidity of the banking sector caused by the unexpected inflow of foreign currency. Outright sales were also an important sterilization tool. In 1995, outright sales of government securities from the NBH portfolio were the main instrument, but this changed in 1996, when the reverse repo replaced them in significance. In 1995, to tighten monetary policy, daily limits on repo transactions were introduced, but they do not apply to a special overnight facility designated to ease unexpected liquidity problems. In return for this availability, the NBH charges a penalty rate of interest. Compared with standard lombard loans, it is a very expensive facility, especially if the loans are rolled over (everyday compounding interest rate).

As has been already mentioned, the development of open market instruments in *Slovenia* was catalyzed by the need to sterilize the inflow of foreign currency into the country, which in the 1992 to 1994 period averaged over 4% of GDP annually. In 1991 to 1993, the current account posted substantial surpluses, while in 1995 to 1996, the capital account posted a large surplus; in 1995, short-term capital inflows were estimated at nearly 10% of GDP.²¹) This excess supply of foreign currency conflicted with the counterinflationary policy of the Bank of Slovenia (BoS) in pursuing the ultimate goal of domestic currency stability. The BoS wants to reduce the Slovenian inflation rate to the levels recorded in the European Union. The variety of available instruments makes Slovenia distinct not only among transition economies.²²) Since the government has conducted a very prudent fiscal policy of surpluses or a balanced budget throughout the period of transition, too few government securities exist, so that the central bank cannot rely on them to conduct open market operations. To fill this vacuum, it had to introduce its own securities, driven by the need to reduce the monetary base. Foreign currency reserves have become practically the only channel of creating the monetary base since late 1991.

The central bank issues tolar bills with various maturities ranging from 2 to 60 days, so-called "twin" bills denominated in tolar and Deutsche mark, bills with warrants and foreign currency bills. Tolar bills indeed have characteristics of certificates of deposit, as they are nonmarketable. In contrast, foreign exchange bills with maturities of between two months and one year are transferable. Such bills with maturities of less than 120 days can be used to comply with minimum requirements for foreign exchange cover (see below). The most sophisticated instrument is the tolar bill with warrants, which has a maturity of six months and bears a fixed nominal interest rate. The attached warrant, which can be stripped, makes the paper attractive, as it gives an option to buy additional bills at a discount, which is in turn positively related to any excess of actual inflation and domestic currency depreciation over the officially projected rates. It is evident that this instrument is a bridge between instruments based on real and on nominal rates. Thus, it offers a hedge against adverse developments. Twin bills with maturities of between three and six months comprise tolar and foreign currency parts, which can be traded separately. They are sold at a discount and priced in tolar. Both instruments were broadly used in 1994 and 1995. Repurchase agreements concluded at daily auctions, in which the BoS buys

its own foreign currency bills from banks for four weeks, are actively used to inject high-powered money. Reverse repurchase agreements have never been introduced.

Table 6 illustrates the relative importance of different instruments in Slovenia over the course of transition. The figures display the significant role of foreign currency bills and repurchase agreements. Short-term loans have been the most actively used financing facility lately.

Table 6

Relative Use of Selected Instruments in Slovenia				
	1992	1993	1994	1995
	<i>SIT billion</i>			
Lombard loans ¹⁾	6.2	18.6	4.3	3.7
Liquidity loans ²⁾	n.a.	14.6	15.8	11.2
Short-term loans ²⁾			1.2	3.0
BoS bills issued:				
F/X bills ³⁾			87.3	120.0
tolar bills		4.3	74.3	168.0
twin bills		19.9	7.3	14.7
bills with warrants			33.1	13.9
Repurchase agreements F/X bills p		7.0	91.9	108.3
r		5.6	94.6	92.2

¹⁾ Total volume approved.
²⁾ Daily average volume.
³⁾ Outstanding balance on December 31; p = purchase; r = reverse operation.

Strings attached to instruments, such as a requirement that a participating bank has to purchase a certain amount of foreign exchange from nonbanks or that it has to accept exchange rates given by the BoS, are administrative distortions in disguise.

In *Slovakia*, OMOs were first used in 1993. In the beginning, repurchase transactions were conducted and Treasury bills were traded. National Bank of Slovakia bills were introduced in 1995 at a time when the state budget deficit turned into a surplus. The current account surplus coupled with the capital account surplus, the latter due to improved confidence in the Republic's fundamentals, triggered strong foreign currency inflows. The bank stood ready to sterilize their impact on the monetary base, therefore it attempted to reduce the excessive liquidity of the banking sector. Sporadic auctions of NBS bills were conducted in January to July 1995, and regular auctions have been launched since August 1995. Outright purchases and sales are another type of instrument which is available. No data on the relative use of OMO instruments are available, but the central bank puts great emphasis on repurchase transactions with maturities of up to seven days. Due to the inflow of foreign currency, reverse repo transactions have had a high significance.

Table 7

Slovakia: Instruments and Transaction Volumes			
	1993	1994	1995
	<i>SKK billion</i>		
Primary auctions of Treasury bills	n.a.	128.9	50.8
NBS bills sold	0	0	127.8
Volume of OMOs	n.a.	35.0	586.0

Source : NBS Annual Report 1995.

Standing facilities

The decommercialization of central bank activities involved redefining central bank lending facilities, making them available to banks rather than businesses. This process has taken place gradually, as the central banks inherited the financing of large public investment projects, a commitment they could dismantle only over time. Forms of preferential financing have been scaled down, though they still exist in all countries examined. For example, the NBH has schemes for investment project financing and export credit. All countries have discount rates and, with the exception of Hungary, also lombard rates. The structure of NBH interest rates is the least transparent, as it announces the so-called base rate, to which all other rates are related, and there are numerous rates. The discount rate, which stands a few points above the base rate, is one of them. The relevance of the discount window as a facility to inject liquidity has declined over the years. There is a tendency to eliminate discount loans as a form of a subsidized credit, and access to the discount window is limited. Slovenia discontinued discount loans in 1992.

The lombard rate, which at the beginning marked the price of another important source of liquidity, has been assigned the role of a ceiling on market rates and is used when central banks want to perform the role of a lender of last resort. This tendency is best exemplified by the evolution in Slovakia, where the lombard rate had originally been pegged to the discount rate, then tied to the discontinued auctioned refinancing credit rate and finally set autonomously. In Poland, access to the lombard facility is unlimited, and the lombard rate serves as a cap on interbank market rates. Forms of refinancing credit other than discount and lombard lending were used extensively at the beginning of transition. They were gradually subjected to a greater degree of market principles, e.g. auction refinancing credit in the Czech Republic. The lombard rate could not have been used from the beginning in any of these countries, as a portfolio of assets which could be provided as collateral was almost nonexistent. In Hungary, the overnight repurchase facility replaced the lombard window.

Reserve requirements

Reserve requirements were adopted early in the transition process and given the role of an operational instrument. Their initial levels were quite prohibitive to lending, as the reviewed countries wanted to check inflation, which accelerated in the wake of price liberalization. Less important in the beginning was the issue of the prudential impact of high minimum reserve requirements. After the initial phase, a tendency to reduce these ratios has been visible. However, this tendency has been frustrated at times by the need to use required reserve ratios as operational instruments to control the liquidity of the banking sector. The Czech Republic, Hungary, Poland and Slovakia resorted to this instrument in order to tighten monetary policy, even when they were well advanced in transition. Slovenia has left minimum reserve requirements unchanged for almost two years now and seems to be in the best position among these countries to approach Western standards in this field.

Table 8

Number of Changes in Mandatory Reserve Ratios								
	1990	1991	1992	1993	1994	1995	1996	1997 ¹⁾
Czech Republic ²⁾	1	0	2	2	1	1	1	1
Hungary	1	1	0	1	2	4	6	0
Poland	3	1	1	0	1	1	1	2
Slovakia	1	0	2	0	0	1	1	0
Slovenia	n.a.	3	1	0	0	1	0	0

¹⁾ Until April 15, 1997.

²⁾ 1990 to 1992: Czechoslovakia.

The use of minimum reserve requirements to contain unwanted money supply growth indicates that financial markets are still underdeveloped in these countries. Open market instruments to cope either with excess liquidity (reverse repos) or with shortages of liquidity within the banking system (repos) still have to be supplemented with “blunter” tools in situations of stress. Each of the countries realize that required reserve ratios are still too high by Western European standards, i.e. range between 8 and 20% for demand deposits, and will have to be lowered in order to reduce the cost of financial intermediation, which will help domestic banks compete with their foreign rivals. This need presents a challenge to monetary policy, as the money supply tends to grow when reserve ratios are lowered due to a higher money multiplier; this increase is hard to offset. These reserves are not commonly remunerated. Only Hungary and Slovakia provide interest, but interest rates are fixed well below respective inflation rate.

In *Czechoslovakia*, minimum reserve requirements were introduced in 1990, but until 1992 they were the same for demand and time deposits. Since 1992 minimum reserve requirements have played the role of an operational instrument. They were raised for the first time in November 1992 in conjunction with the removal of credit ceilings. When the country split, the Czech Republic effected a further increase, which was later reversed. Thus 1993 marked the year in which reserve requirements became an active instrument of monetary management. They were again raised in the Czech Republic in reaction to high capital inflows in 1994. Most recently they were raised in August 1996 and are scheduled to be lowered in May 1997 to 9.5% on deposits with commercial banks.

Unlike in the other countries in transition, the central bank in *Slovakia* did not use minimum reserve requirements as an operational instrument of monetary policy in earlier years. It had maintained reserve requirements at 9% on demand deposits and 3% on time deposits through August 1, 1996, when the latter was raised to 9% as well, but savings deposits earmarked for dwelling construction were excluded, so that the required reserve ratio remained at 3% on these deposits. The increase represented one of the NBS's efforts to tighten monetary policy.

The *Hungarian* central bank has used reserve requirements as an operational instrument. In 1987, it introduced a uniform requirement on liabilities of commercial banks. The mandatory reserves were gradually reduced until the launch of the stabilization program in March 1995 in order to make Hungarian banks more competitive. Subsequently they were raised

in a few successive steps, as monetary policy needed to be tightened. They were relaxed again in parallel with disinflation. At present, they are still high enough (12% for all deposits with commercial banks and 8% for deposits with savings banks) to create a wedge between deposit and credit rates. To narrow this wedge, the NBH pays interest on mandatory reserves, which distinguishes Hungary from the other countries reviewed in the paper. This interest rate is relatively high in nominal terms, but negative in real terms. The remuneration policy took twists, as this interest rate was drastically reduced in 1993 to 1994, to be increased again in 1995.

Reserve requirements were put in place in *Poland* in 1990 and have been actively used since then. The NBP introduced separate reserve requirements on foreign currency deposits, which accounted for more than 70% of total money supply in 1990. Different ratios were imposed on demand and time deposits. At the beginning of transition, the NBP frequently manipulated the minimum reserve requirements on domestic deposits. They were raised to the legal limit of 30% in 1990 and then slowly decreased. Yet these ratios²³⁾ are still very high by OECD standards. The declared course is to gradually align these ratios to the levels that will enable domestic banks to compete with foreign banks from OECD countries once their entry to the Polish market has been liberalized by the end of 1998. So far it has been more a verbal commitment than a fact. To the contrary, the minimum reserve ratio on foreign currency deposits has been raised twice since 1995 to lower their attractiveness relative to domestic deposits. The NBP believes that banks are more sensitive to changes of the reserve ratio than to changes in headline interest rates. The mandatory reserves do not pay any interest, which especially under the condition of high inflation is a penalty tax for banks and drives a considerable wedge between deposit and credit rates. Poland reduced the requirements on demand deposits in 1996 to establish a downward tendency ahead of the planned liberalization of financial services in 1998, but raised them again in February 1997 as an attempt to slow down domestic credit expansion by banks. Following this move, reserve requirements on time deposits were raised in May. Reserve requirements on foreign currency deposits were increased on the same dates in an effort to realign them with the requirements on domestic deposits.

Reserve requirements were in place in former Yugoslavia. In *Slovenia*, they gained operational meaning between October 1991 and April 1992. Since then they have played a passive role, consistent with their prudential function. The general tendency has been to reduce this requirement to levels in line with standards in more advanced economies. In this respect, minimum reserves on deposits with maturities of over one year were eliminated. From April 1992 to April 1995 the requirements remained unchanged. The most recent changes were introduced in April 1995. The scheme of reserve requirements is more complex than in other countries, where discrimination between demand and time deposits is standard, because Slovenia distinguishes among more categories of deposits.²⁴⁾

There are no reserve requirements on foreign currency deposits in Slovenia; instead, there are foreign exchange cover regulations. In the initial stage of independence, the lack of foreign currency reserves prompted the

BoS to adopt a regulation requiring banks to maintain 35% of the average monthly inflow and outflow in foreign currencies in the preceding three months in the form of liquid assets denominated in foreign currencies. This foreign reserve minimum was additionally imposed on household deposits to guarantee their safety and to boost the confidence of the public. The scale of the coverage ranges from a high of 100% on demand deposits to 5% on foreign exchange deposits of over one year. A slightly different scale applies to the accounts of nonresidents.

4 Exchange Rate System and Monetary Policy

At the beginning of transition, the reviewed countries generally favored more rigid exchange rate regimes compared to more flexible ones. With the exception of Slovenia, they introduced fixed exchange rates. Hungary chose the softest version, the adjustable peg, which explicitly allowed for discretionary devaluations. Slovenia adopted managed floating right from the start of independence. Their respective choices were motivated by a number of considerations.²⁵) Since then, a tendency toward more flexible exchange rate regimes has been observed in response to substantial inflows of foreign currency, which started interfering with the central banks' disinflation-oriented monetary plans. Fluctuation bands have been either introduced or widened to create more uncertainty as to the possible course of the exchange rate. Intra-band intervention has been allowed and used. In parallel to this process, the tendency to introduce more transparency to pegs can be recorded as well: The Czech Republic, Hungary and Slovakia reduced the number of currencies in their respective baskets. These general conclusions are supported by detailed facts.

The CNB sets the exchange rate. The regime of a fixed peg against a basket has been maintained since the start of the reforms. The original basket of five currencies was replaced by the basket of only two currencies, the DEM (65%) and the USD (35%), after the split of the Federation in 1993. In March 1996, the band for feasible fluctuations was widened to $\pm 7.5\%$ from $\pm 0.5\%$ on either side of the central rate. Since the Czech crown has been subject to upward pressure from the beginning of transition, the CNB mainly bought foreign exchange to meet its exchange rate target and sterilized its impact on the money supply to a considerable extent. It resorted to unconventional methods as well, since the deposits of the National Property Fund and Telecom were moved to the central bank from commercial banks, which meant draining liquidity from the banking sector. To curb excessive liquidity, the maximum limit on short-term (up to one year) open positions against nonresidents was set at 30% above claims against them with an overall limit of CZK 0.5 billion, effective August 3, 1995. To discourage trading with the CNB and to stimulate trading among banks, a 0.25% fee is charged on foreign exchange transactions with the CNB. Such transactions have no effect on money supply. Sterilization of capital inflows cost the CNB 0.3% of GDP in 1994 and 0.5% of GDP in 1995.

The central bank is responsible for exchange rate policy in *Slovakia*, which maintains a system of a pegged exchange rate against a basket of currencies that was streamlined from five currencies to two, i.e. USD (40%)

and DEM (60%). The growing external disequilibrium in 1993 led to a discretionary devaluation of the koruna by 10% against the basket, but since then the currency has been stable. The band has been gradually widened, like in the other countries of the region; it was expanded from $\pm 1.5\%$ to $\pm 7\%$. After the dissolution of the Federation, Slovakia temporarily reintroduced certain limits on currency convertibility due to a drop in international reserves. Considerable inflows of foreign currency in 1995 led to major purchases of foreign currency by the NBS by means of outright purchases, and the NBS conducted sterilization operations on a large scale in 1995 and 1996.

Both the central bank and the Ministry of Finance are responsible for exchange rate policy in *Hungary*. The initiative rests with the government, but its proposals are subject to the approval of the NBH. Hungary maintained an adjustable peg until March 13, 1995. Before the introduction of the crawling peg, the forint was frequently devalued in rather moderate to small steps. After a 9% devaluation in March 1995 against the basket, that system was replaced by the preannounced crawling peg with an initial monthly devaluation rate of 1.9% versus the basket, a rate which was later reduced to 1.1%. The composition of the basket was modified several times. The most important change was the reduction of the number of basket currencies to two. Other changes were driven either by disinflation considerations or by the competitiveness issue. Since January 1997, the basket has comprised DEM instead of ECU (70%) and USD (30%). This modification is intended to signal the determination to curb inflation. The width of the band within which the forint is allowed to fluctuate is relatively small at $\pm 2.25\%$. This reflects the fact that upward pressure on the currency is a relatively new phenomenon which has not been accounted for yet. Sterilized intervention policy started in late spring 1995.

The evolution of the exchange rate system in *Poland* from a rigid to a more flexible one went through several stages: the abolition of a fixed peg against a single currency (the USD) and the shift to a basket, the introduction of a crawling peg and then of a crawling band of 7% on either side of the central rate. In 1990 to 1993, the balance-of-payments constraint acted as a catalyst for exchange rate changes aimed at striking a balance between anchoring inflationary expectations and securing the necessary competitiveness to protect a sustainable current account position. In 1994 to 1995, the current account surplus and capital inflows put upward pressure on the zloty. The endogeneity of money supply under the crawling peg started frustrating NBP targets, so the central bank opted for more monetary independence. The crawling band was widened to 7% on either side of the central rate, which at the end of the 1995 had to be revalued. The crawling devaluation rate was reduced to 1% monthly against the basket in January 1996. Sterilization by means of purchases of foreign currency from commercial banks was only partial and very costly due to wide interest rate differentials. It is estimated that sterilization cost 0.6% of GDP in 1995 and 0.8% of GDP in 1996.²⁸⁾ Poland's basket of five currencies has not been modified since 1991.

According to law, the *Bank of Slovenia* is in charge of exchange rate policy. The country adopted a managed floating system from the beginning of

independence after an intellectually interesting debate between adherents of a fixed and a flexible regime.²⁹) For much of the period, Slovenia implicitly targeted the real exchange rate, actively using the option of managed floating. In 1994, large sterilizations of currency inflows were necessary. This intervention proved very costly, as evidenced by the fall in the BoS's operating surplus from SIT 17 billion in 1992 to SIT 1 billion in 1994. Total sterilization costs were estimated to reach 2.6% of GDP in 1992 to 1994, with the percentage spread evenly in 1992 and 1993 and jumping to 1.4% in 1994. The BoS intervenes on the foreign exchange market by means of purchases of foreign currency called "temporary repurchase agreements." Their construction resembles that of a foreign currency swap and purchase of foreign exchange with the right to repurchase by the counterparty. In 1995, the bank launched a new instrument, i.e. the sale of foreign exchange against a purchase of foreign exchange bills. Starting in April 1996, the BoS simultaneously offered a triple combination of existing instruments – foreign currency purchases, foreign exchange swaps and purchases of its own foreign exchange bills – to arrest appreciation of the tolar. Outright purchases played a smaller role. Sales of foreign currency and purchases of own foreign exchange bills were introduced in 1995, when the upward pressure on the tolar reversed in the second half of the year after the introduction of a series of administrative controls on inward capital movements.

Capital controls were reinstated in early 1995 and strengthened in 1996. A 40% non-interest-bearing tolar deposit on financial borrowing from abroad up to seven years was put in place in 1995. In 1996, 10% retention deposits were imposed on all foreign credits, and portfolio investors were required to open a fiduciary account with a Slovenian bank through which all transactions are performed. According to anecdotal evidence, this regulation induced enterprises to arrange longer maturities of loans (e.g. borrowing for 7 years and one day) and was gradually circumvented, which renewed tension on the forex market in 1996.

5 Summary and Conclusions

In this paper, we have sketched and analyzed how monetary governance has changed in the five Central and Eastern European economies which have advanced most in their transition from centrally planned to market systems. All of the countries managed to progress from direct instruments of monetary control to indirect instruments in a relatively short period of time, i.e. at most within three years. Their starting points were characterized by a lack of infrastructure for indirect monetary policy. Interbank markets did not exist. The conduct of open market operations was impossible because there were no marketable Treasury or central bank securities. Since then, significant progress has been made. The basis for modern central banking has been established. All countries have established the necessary infrastructure for open market operations, whose use has dramatically risen from zero levels. This change has been successful, as no major retreat was observed. The search for new instruments mainly responded to arising challenges, in particular to the challenge of very large capital inflows and the need to contain the excess liquidity of the financial sector. But the developments

were also in accordance with these countries' understanding of modern central banking.

The shift to indirect instruments of monetary policymaking could not proceed without a parallel development of financial markets, as experience clearly shows. Poland's early move away from direct instruments in 1990 was not successful, and it had to return temporarily to the use of credit ceilings, as it could not handle the excess liquidity of the banking sector in any other way because of the lack of instruments and markets for these instruments.

However, financial markets still remain underdeveloped, which determines the specific features of monetary governance in the countries analyzed. The central banks of these countries have developed instruments to cope either with excess liquidity (mainly reverse repurchase agreements) or with shortages of liquidity within the banking system (repurchase agreements). As the markets are immature, these operations have to be supplemented with "blunter" tools in the situation of stress, e.g. with required reserves. Required reserves still play a role as an operational instrument to control liquidity within the banking sector in Hungary, the Czech Republic, Poland, and Slovakia. Slovenia is in the best position to soon approach Western standards in this respect. Required reserves are still relatively high compared with those in Western European economies and will have to be reduced to lower the cost of financial intermediation and to improve local banks' international competitiveness. The (gradual) reduction of required reserves poses a challenge for monetary policymakers, as money supply will tend to grow and liquidity-enhancing effects will have to be offset. The proliferation of securities issued by the central banks in order to help withdraw excess liquidity and contain domestic loan expansion and because state (Treasury) securities cannot fulfill this function is another common phenomenon in the countries reviewed.

The following tendencies, which are consistent with tendencies noted in the more advanced countries, are observable in the countries reviewed: Open market operations have become the most important monetary instrument. The tendency to reduce amounts of central bank lending is visible. Tenders of repurchase agreements are popular. A shift to affect only the short end of the yield curve by open market operations is also evidenced by shortened maturities. A move toward monetary targeting has occurred. However, a relative ineffectiveness of monetary targets similar to that in advanced economies can be noted, as the targets are exceeded most of the time, e.g. in Slovakia, in the Czech Republic, in Hungary and to a lesser extent in Poland. Even if they are met, the course of inflation may prompt the central bank to attempt to influence interest rates, the exchange rate or simply to use moral suasion (e.g., Poland in 1996).

With the notable exception of Slovenia, all other countries in the group analyzed here started with a policy of exchange rate targeting. Hungary, however, did not commit itself to a nominal peg, but chose the looser form of an adjustable peg. The trend toward more flexibility in the exchange rate system followed has set in, as the countries are striving to free their monetary policies from external constraints resulting from large capital inflows. Poland exemplifies this path best with its shift from a peg to the

U.S. dollar to a crawling peg and then to a crawling band. Thus, at present exchange rate policies are not converging toward the Western European standard of increasing monetary integration, which requires fixed exchange rates.

The evolution of monetary governance will continue in the present direction, albeit at a slower pace concomitant with the widening and deepening of financial markets, whose development will boost the reliance on open market operations. The significance of central bank lending facilities will continue to diminish. Mandatory reserves will be lowered to levels compatible with Western European levels and will stop functioning as an operating instrument. The elimination of forms of preferential credits is indispensable to stop subsidized central bank credits. Discount credit can in fact be a form of such a subsidized credit, like the remnants of socialist state investment projects and other schemes such as export or agriculture financing. Lines of credit in the context of privatizations will probably be the last to be eliminated.

An attempt to use direct inflationary targeting as a monetary strategy cannot be excluded, as the difficulties of monetary targeting remain pronounced despite a certain stabilization of the demand for money compared to the early stages of transition. We do not foresee a reversal of the trend toward more flexible exchange rate regimes anytime soon. In the future, a reversal toward more stable exchange rate arrangements will be necessary when these countries start seriously preparing for participation in European Monetary Union. For now, it appears more reasonable for these countries to enjoy a somewhat higher degree of monetary autonomy in order to be able to deal with the problem of excessive capital inflows and to avoid (real) exchange rate developments which would contribute to unsustainable external imbalances.

Annex

Targets and Instruments of Central Banks in the CEFTA Countries

	Czech Republic	Hungary	Poland	Slovakia	Slovenia
Targets:					
a) ultimate target	a) safeguarding the stability of the domestic currency and supporting the government's economic policy	a) internal and external currency stability	a) strengthening the stability of the domestic currency and supporting the economic policy of the government	a) safeguarding the stability of the domestic currency and supporting the economic policy of the government	a) currency stability
b) intermediate	b) fixed exchange rate, M ₂ ;	b) exchange rate, M ₂	b) broad money (a proxy for M ₂), exchange rate;	b) fixed exchange rate M ₂	b) M ₁
c) operational	c) 1 week PRIBOR	c) interest rate differential	c) monetary base	c) no official target	c) base money
Instruments:					
a) direct controls	a) phased out in 1993	a) phased out in 1991	a) phased out in 1993	a) terminated in 1996	a) none since 1992
b) indirect controls	b)	b)	b)	b)	b)
1. interest rates	1. discount rate, lombard rate	1. discount rate, base rate	1. discount rate, lombard rate	1. discount rate, lombard rate	1. lombard rate
2. reserve requirement	2. in place, no interest	2. in place, pays interest below market (and below CPI inflation) rates	2. in place, no interest	2. in place, required reserves pay small interest	2. in place, no interest
3. open market operations	3. CNB bills, 1W and 2W tenders	3. repurchase and reverse repurchase agreements, outright sales of government securities, forex swaps	3. reverse repo transactions, outright sales of T bills, NBP bills	3. repo transactions, repo tenders, outright purchases and sales, issues of NBS bills	3. repurchase agreements, foreign exchange bills, twin currency bills, BoS forex bonds, BoS bond sales, forex swaps
Exchange rate system:					
a) type	a) fixed peg	a) crawling peg	a) crawling band	a) fixed peg	a) managed float
b) basket	b) 65% DEM, 35% USD	b) 70% DEM, 30% USD	b) basket: 45% USD, 35% DEM, 10% GBP, 5% CHF, 5% FRF	b) 40% USD, 60% DEM	b) not applicable
c) band	c) ± 7.5%	c) ± 2.25%	c) ± 7%	c) ± 7%	c) not applicable

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- 2 Romania is not an object of this study, as it will only join CEFTA in July 1997.
- 3 See European Monetary Institute (1997a).
- 4 For a detailed discussion of the present state of central bank independence in Central and Eastern Europe see Radzyner and Riesinger (1997) in this issue.
- 5 See Cukierman (1992), Alesina and Summers (1993).
- 6 For a short summary of the arguments for an independent central bank see Schubert (1997).
- 7 See Mishkin (1997) for the relevant arguments.
- 8 The EMI (1997a) identifies five key elements of any monetary strategy: 1. a quantified definition of the final objective; 2. a communications policy; 3. the availability of a broad set of indicators; 4. detailed information on monetary aggregates; and 5. tools to allow for forecasts of inflation and other economic variables.
- 9 An explicit inflation target is set, as are the index, its target level, the tolerance interval, the time frame and possibly the situations under which the target can be modified or even disregarded. In a useful simplification, inflation targeting is a monetary framework under which monetary policy decisions are guided by expected future inflation relative to an announced target. Inflation targeting has been explicitly adopted by New Zealand, Canada, the United Kingdom, Sweden, Spain and Finland. See Leiderman and Svensson (1995).
- 10 See EMI (1997a).
- 11 See EMI (1997a) and (1997b).
- 12 See Haldane (1995) for more information on this topic.
- 13 See *The Financial Times*, March 22, 1997.
- 14 It is interesting that only one role in the conduct of policy is mentioned in the document, i.e. stabilizing money market interest rates and possibly contributing to the control of monetary expansion by creating or enlarging a structural liquidity shortage.
- 15 This stylized description extensively draws on Duchatzek and Schubert (1992).
- 16 In the pure model, consumption is also rationed by administrative instruments and prices only register trades.
- 17 This would involve a study in its own right, whereas the purpose of this paper is to give an overview of the monetary policy framework in the reviewed countries. We recommend readers interested in details of central bank independence in Central and Eastern Europe to refer to the latest study by Radzyner and Riesinger (1997) or earlier work by Hochreiter and Riesinger (1995).
- 18 See Neményi (1997).
- 19 See Makúch and Nemeč (1997).
- 20 See section 3.1.
- 21 See Mencinger (1997).
- 22 This description draws on the *Annual Report of the Bank of Slovenia (issues from 1991 to 1995)*, on OECD (1997) and on Kranjec (1995).
- 23 As of the date at which this paper was written, they stood at 20% for demand deposits, 11% for time deposits and 5% for foreign exchange deposits.
- 24 As of the date at which this paper was written, they stood at 12% for deposits up to 1 month, 6% for deposits between 1 and 3 months, 2% for deposits between 3 and 6 months and 1% for deposits between 6 and 12 months.
- 25 See Krzak (1995) and Radzyner and Riesinger (1996) for a more detailed analysis.
- 26 See Gomulka (1997).
- 27 See, e.g. Lavrac and Stanovnik (1996) or Mencinger (1993) for an exposition of arguments.

Editorial close: May 2

Central Bank Independence in Transition: Legislation and Reality in Central and Eastern Europe

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and Sandra Riesinger¹⁾

I Introduction

In the recent past, the concept of central bank independence (CBI) has become increasingly recognized, especially in the Member States of the European Union, where the Maastricht Treaty was the driving force for a further strengthening of CBI, but also in a number of other countries that are amending their central bank laws accordingly.

The introduction of central bank independence constituted an important element in the political and economic transformation process in Central and Eastern Europe and was part and parcel of fundamental financial sector reform. Meanwhile, a number of reforming countries have concluded Association Agreements with the European Union and have officially applied for EU membership. Therefore, the issue of further strengthening central bank independence in order to fulfill the requirements of the Maastricht Treaty has gained even more importance. The main purpose of this paper is to examine the degree of legal CBI already achieved by the Central and Eastern European countries (CEECs²⁾), and to compare it to the standards set by the Maastricht Treaty.³⁾ In a second step, we want to analyze how CBI is implemented in practice and what role the central bank *de facto* plays in the context of the overall reform program.

Under the system of central planning, central banking and commercial banking functions were typically concentrated at a monobank, which basically “functioned as a department of the finance ministry” with the sole objective of fulfilling the overall central plan.⁴⁾ Therefore, the first step of financial sector reform was the transition from a monobank to a two-tier banking system, where central bank departments and branches which had previously performed commercial banking functions were separated from the monobank and established as commercial banks. Unlike under the centrally planned regime, the newly adopted central bank laws⁵⁾ endowed the central banks with monetary policy competences and a considerable degree of legal independence, thus *de jure* transforming them into key players of economic policy in the context of comprehensive macroeconomic stabilization programs. At the same time, some of the examined countries, such as Slovenia and Slovakia, had to face the enormous task of institution-building⁶⁾, because they had no history of central banks of their own and hence had to build up their national central banks from scratch. Central banking expertise had to be acquired within a very short span of time.⁷⁾ The adoption of modern central bank laws at the outset of the reforms was followed by a number of amendments in most countries,⁸⁾ further strengthening the autonomy of the central banks mainly in view of meeting the requirements of the Maastricht Treaty. As compared to Western countries, protecting the central bank from political pressures might have been even more important in transition economies, where reform-induced price shocks (due, e.g., to price liberalization, initial devaluations of the nominal exchange rate and the introduction of VAT) gave rise to demands for an accommodating monetary policy stance, thus increasing the temptation to bend the law.⁹⁾ Despite a relatively high degree of legal CBI in most transition economies, the actual implementation of existing laws has to be examined, focusing on the degree of actual CBI and the role of the central bank in practice.

2 The Role of the Central Bank in the Overall Economic Framework

There is a bulk of literature on the theoretical foundations of CBI.¹⁰⁾ An economically useful distinction of CBI was provided by Stanley Fischer, who defined the categories of goal independence and instrument independence.¹¹⁾ According to this definition, a central bank with imprecisely defined or undefined policy goals enjoys goal independence, as it is able to set its policy goals autonomously. On the other hand, a central bank with a clearly defined mandate (e.g. price stability) has instrument independence, if it has full power to develop and use monetary policy instruments in order to achieve the given goal. It is widely acknowledged in the literature that central banks should be endowed with instrument independence, but should not have goal independence. If the central bank can autonomously choose its policy goal regardless of the overall economic conditions, this would bring about a suboptimal result in terms of general economic performance. Therefore, most experts recommend that the central bank law clearly define a goal which has top priority for the central bank and for which the central bank can be held accountable in order to ensure democratic legitimacy. As regards the development of monetary policy strategies and the choice of instruments, the central bank should be endowed with a high degree of independence from any government body and must not be subject to instructions in fulfilling the tasks assigned to it by law.

One of the most prominent arguments why central banks should be independent is the time-inconsistency approach,¹²⁾ which is based on the assumption that central bankers generally take a longer-term view and are more concerned about inflation than government officials who strive to be reelected and therefore tend to prioritize short-term policy goals such as high output growth, high employment levels or high fiscal revenues. This argument is in a way a reflection of the Phillips curve model, according to which there is a trade-off between inflation and unemployment in the short run. Therefore, endowing an inflation-averse central bank with a high degree of independence from the government immunizes the central bank against politically motivated desires for monetary expansion and helps to stabilize expectations on price developments. An alternative approach to CBI refers to the principal/agent concept, according to which the principal (government) signs a contract with its agent (the central bank).¹³⁾ In this contract, the agent is made responsible for the achievement of a defined inflation target.¹⁴⁾ Persson and Tabellini¹⁵⁾ show that an optimal central bank contract may serve to eliminate the inflation bias while still preserving the advantages of stabilization.

The major objection to “perfect” CBI¹⁶⁾ refers to the need of coordination between monetary policy and fiscal and incomes policies. It is argued that “perfect” CBI could be interpreted in the sense of noncoordination between government and the central bank, which leads to suboptimal overall economic results.¹⁷⁾ We have to bear in mind that a high degree of CBI does not per se guarantee an anti-inflationary consensus in a country. In order to achieve the long-term goal of price stability at the lowest possible cost, it is desirable to ensure a broad political consensus which is supported by the

main players of economic policy, including not only the government but also the parties in the wage-setting process. This consensus could be embedded in an appropriate institutional framework, a widely known example being the Austrian model of social partnership.¹⁸⁾ In our view, this coordination of economic policies does not contradict the requirement that the central bank must be free from instructions from government bodies. A high degree of CBI does not automatically mean that there should be no exchange of information or discussion between the central bank and other economic policymakers. On the contrary, a broad anti-inflationary consensus is a precondition to successfully achieving the long-term goal of price stability at a low cost. The relationship between measured CBI and the sacrifice ratio, the latter being defined as the output loss per unit of disinflation, was recently examined by Andreas Fischer.¹⁹⁾ He showed a potential trade-off, namely that industrialized countries with a high degree of CBI have higher sacrifice ratios than those with less autonomous central banks. Another important objection to “unlimited” CBI refers to the requirement of central bank accountability to a democratically elected body, which may imply a certain limitation of CBI.²⁰⁾ The criticism voiced by American political scientists like Edward Luttwak against “central bankism” points in a similar direction.

The empirical CBI literature has focused on the measurement of both legal and actual CBI as well as on the relationship between the measured degree of CBI and different economic variables, especially inflation, but also real output growth, the unemployment level, etc. The pioneering work in measuring CBI was written by Bade and Parkin²¹⁾ in 1980, who for the first time compiled several aspects of legal CBI for the central banks of twelve industrialized countries. Alesina²²⁾ extended this analysis in 1988 and 1989 to another four industrialized countries and slightly modified the overall ranking of the examined central banks. A more comprehensive index was developed by Grilli et al.,²³⁾ who examined two dimensions of independence: political independence (appointment of the top officials, relations with the government, etc.) and economic independence (limits of lending to the government, choice of monetary policy instruments) for 18 industrialized countries. Eijffinger and Schaling (1993) constructed an index reflecting the number of government officials on the bank board, the appointment of the bank board and the location of final monetary policy authority and used it for twelve industrialized countries.²⁴⁾ The most comprehensive approach to measuring CBI was undertaken by Cukierman²⁵⁾, who, in a first step, created an index for the degree of legal CBI and tested it for almost 70 industrialized and developing countries.²⁶⁾ In a second step, Cukierman introduced a proxy to measure the degree of actual CBI, namely the turnover rate of central bank governors, and applied it to 55 industrial and developing countries in the years 1950 to 1989. An additional method used by Cukierman to measure actual CBI was the processing of answers to a questionnaire which had been distributed among central banks. The questions were primarily related to the actual implementation of legal stipulations and to deviations from legal regulations in practice.

While a number of models have been developed to measure the degree of CBI, they have been tested mainly for industrialized countries and for a number of developing countries. To our knowledge, only selected aspects of recent central bank legislation have been analyzed for a limited number of Central and Eastern European transition economies up to now: Eijffinger and Van Keulen (1995), for instance, include the new central bank legislation of the Czech Republic, Hungary and Poland in their survey of eleven countries.²⁷⁾ Moreover, Siklos (1994) constructed an index of legal CBI for the Czech Republic, Hungary, Poland and Slovakia and compared these indices to the inflation performance of these countries. Hochreiter et al. (1996) examine the creation and distribution of seignorage in the Czech Republic, Hungary and Romania in the year 1993, taking Austria and Germany as a benchmark.²⁸⁾ A brief overview of the central bank legislation in selected transition economies can be found in Hochreiter (1994) and Hochreiter and Riesinger (1995).²⁹⁾

Whereas the empirical literature provides evidence that there is a negative correlation between legal CBI and inflation as well as between legal CBI and inflation variability in industrialized countries, this correlation does not hold for developing countries. However, if a proxy for actual CBI, such as the turnover rate of governors (defined as the average term of office of central bank governors), is used to measure the degree of CBI, a strong positive association between inflation and CBI can be found for developing countries.³⁰⁾ However, it has to be noted that this correlation does not say anything about causality. As regards the relationship between CBI and real economic aggregates, such as real GNP growth, output variability, the level of unemployment and the like, no clear correlation has been found either for industrialized or for developing countries.³¹⁾ In the existing empirical literature, the relationship between CBI and inflation performance has not yet been examined for the Central and Eastern European transition economies. Nor will we attempt to analyze this relationship for the CEEC-5, because the track record of the CEEC-5 since the beginning of the transformation process is far too short to produce robust statistical correlations, as the time series available cover a maximum of seven years or even less (Czech Republic, Slovakia, Slovenia). The potential contribution of CBI to disinflation can hardly be quantified, as inflation is a very complex phenomenon, in particular in countries facing a regime shift. We doubt that the degree of CBI is the major factor explaining inflation performance in the CEEC-5. In an environment of economic transformation and stabilization programs, the inflation path is typically determined by a number of factors which are not directly influenced by the central bank: Other factors not under central bank control, like price liberalization, tax reform or widespread indexation, mainly determine the level and the variability of inflation during transition³²⁾ and are more predominant than the status of the central bank.

3 Reasons for Establishing Independent Central Banks in Transition Economies

Most countries in transition endowed their newly created central banks with a relatively high degree of legal independence already at the beginning of the reforms and are strengthening CBI further.³³⁾ One reason for establishing an independent central bank from the outset can be seen in the general effort to create a “Western” institutional framework comparable to that of market economies.³⁴⁾ Since the conclusion of EU Association Agreements and the official application for EU membership by a number of transition countries, this argument has taken on a much more practical dimension: The fulfillment of the institutional requirements of the Maastricht Treaty, and thus CBI, constitutes one of the conditions for joining the EU. According to Article 108 of the Treaty, all Member States have to make their national legislation regarding CBI compatible “at the latest at the date of the establishment of the European System of Central Banks (ESCB).”³⁵⁾³⁶⁾

Another motivation for CBI lies in its alleged success. The impressive track record of the German Bundesbank in terms of inflation performance over the last decades has demonstrated that a high degree of legal CBI sends the desired signal to politicians and economic agents and thus functions as an effective device to achieve long-term price stability. Therefore, the newly created central bank laws in the transition countries, which were often drafted with the assistance of international organizations (e.g. IMF, BIS) or of Western central banks, strongly mirror existing Western central bank laws, in particular the one on the Deutsche Bundesbank.

One of the specific reasons for establishing independent central banks was the adoption of drastic stabilization programs in a number of the transition countries analyzed, which aimed at bringing down inflation from initially very high levels. Therefore, a high degree of credibility of anti-inflation policies and hence of central bank credibility was needed from the outset of the reforms, first to successfully conduct a nonaccommodative monetary policy and later on to safeguard the results after successful stabilization. The adoption of legal provisions fostering CBI was certainly an important step to underpin central bank credibility, as a credible commitment of an autonomous central bank to price stability enhanced the confidence of the public in the stabilization policy. In our view, building up this “credibility bonus” for the new central bank had two dimensions: First, monetary policy credibility and its perception by the public was of enormous importance for the political and economic stability *within* the country. Second, credible central bank policies strengthened the confidence of *international* financial markets in the domestic market, which was particularly important for a number of transition countries that were in need of funds from abroad.³⁷⁾ In this context, it was extremely important to break with the ancien regime and to protect monetary policy authorities by law from political interference, thus sending the right signals to potential foreign investors as well as to domestic economic agents. However, the “credibility bonus” did not automatically result from a high degree of legal independence, but had to be earned repeatedly in practice. In this context the degree of actual independence of the central bank and its perception by the public (both at home and abroad) are of crucial importance.

We argue that the relatively high degree of legal central bank independence in Central and Eastern Europe helped to build up the necessary credibility of monetary policy in a period of economic transformation and stabilization. However, a number of factors contributing to inflation in these countries were not mainly determined by the central bank and the degree of its legal independence. The recent strengthening of legal CBI in the CEEC-5 can be seen rather as part of the overall reform of the institutional framework in these countries and as an effort to fulfill the institutional requirements of the Maastricht Treaty in view of future EU membership. Notwithstanding legislated CBI, the actual implementation of the central bank laws still shows some weaknesses.

In the following two sections, we will first go into several aspects of legal CBI in the CEEC-5, in particular against the backdrop of the requirements of the Maastricht Treaty (“benchmark”).³⁸⁾ We will then discuss how legal provisions are implemented in practice and what impact this implementation has on the overall credibility of the examined central banks. Throughout the paper, we will address the question of independence from whom and for what purpose.³⁹⁾

4 Legal Independence

We will base our analysis of legal CBI in the CEEC-5 upon the four-tier classification derived from the text of the Maastricht Treaty, a classification of CBI criteria which was first presented by the Bank of Japan and later modified by Bruni⁴⁰⁾: (1) principal statutory objective; (2) independence in the formulation of monetary policy; (3) prohibition of credit facilities to the public sector; and (4) status of the governor. For the purpose of examining additional aspects of legal CBI which might be of particular relevance for transition economies, we have broadened this classification in the following manner: Item (2) is extended to cover the formulation and implementation of monetary policy (including the choice of instruments and related issues). Moreover, item (3) is extended to what we will refer to as “financial independence” and will cover two aspects, namely limits to government lending as well as the issue of budgetary independence of the central bank. Under item (4), which we will call “personal independence,” we will examine the role and status of top central bank officials, including the managing board as well as the central bank governor. Furthermore, we have expanded this four-tier classification to include one additional aspect of legal CBI, namely accountability.⁴¹⁾ Thus, our classification covers all criteria contained in the standard distinction of “institutional,” “personal,” “functional” and “financial” independence as well as some additional aspects that we consider relevant for the analysis of the CEEC-5.

An explicit reference to the “independent” status of the central bank in the wording of the central bank law (statutory independence) is generally not seen as a necessary condition to achieve a high degree of legal CBI and is therefore not included in our classification system. However, it is interesting to note that – with the exception of Poland – all central bank laws in the CEEC-5 contain such a stipulation. The central bank acts of the Czech Republic, Slovakia and Slovenia contain very similar clauses endowing the

central banks with independence to fulfill their tasks as defined by the primary objective of monetary policy.⁴²⁾ The Hungarian central bank act gives the central bank independence “within the framework of this Act.”⁴³⁾ In Slovenia, the independence of the central bank is even postulated in the constitution (see below).

4.1 Principal Statutory Objectives

There is a general consensus in the literature that independent central banks tend to have a single, rather narrowly defined policy objective, the focus of which lies primarily on the stability of the domestic and sometimes also the external value of the national currency.⁴⁴⁾ One reason a single policy goal could be preferable to multiple goals is the need for transparency and credibility of monetary policy. In the presence of a range of – sometimes even conflicting – macroeconomic goals, the public could perceive the risk of policy shifts, which could jeopardize the credibility of monetary policy. However, having a single policy goal does not mean that the central bank can ignore other macroeconomic goals, but that it should have a clearly defined primary objective. Therefore, a number of central bank laws (such as that of Austria or Germany) as well as the ESCB and ECB Statute⁴⁵⁾ require the central bank to support the general economic policies. Price stability is generally regarded as a more desirable primary objective for a central bank than economic growth or full employment, because it can be influenced – though via a complicated transmission mechanism – by the central bank through the use of monetary instruments. The distinction between the internal and external purchasing power of the domestic currency, which is sometimes encountered in the formulation of monetary policy goals, could be a source of conflict in the conduct of monetary policy depending on the chosen exchange rate regime.⁴⁶⁾

According to Article 105 (1) of the Maastricht Treaty and Article 2 of the Statute, the core element of the future ESCB will be the objective of maintaining price stability. This stipulation will provide the operational framework for all participating national central banks (NCBs) from the beginning of Stage Three⁴⁷⁾ and will therefore be binding for the central bank legislation in the EU Member States as well as for membership applicants at the time of their EU entry.

In the CEEC-5, most central banks have a narrowly defined, primary policy objective which mainly focuses on the stability of the currency (see Table 1).⁴⁸⁾ The Hungarian central bank act mentions both the external and internal stability of the national currency. Although the text of the Slovene central bank law stipulates two primary objectives, namely a stable national currency and the general liquidity of the payment system, the central bank interprets price stability as its ultimate goal of monetary policy.⁴⁹⁾ The formulation of the Polish central bank law in this respect is rather vague, calling for “strengthening the Polish currency,” which is seen by the central bank as a requirement to enhance the stability of the national currency. The term “currency stability” is generally interpreted as implying the objective of price stability, and in this sense most central bank laws are in line with the Maastricht requirements. However, it is argued in the strictest sense⁵⁰⁾ that

Legal basis	Statutory objective	Formulation and implementation of monetary policy	Coordination with the government
<p>Czech Republic Act on the Czech National Bank, 1992</p>	<p>"... to ensure the stability of the national currency ..." (Art. 2)</p>	<ul style="list-style-type: none"> • "The Bank shall set monetary policy ..." (Art. 2a) • The Bank Board "shall set the instruments for implementation" (Art. 5.1) • The Bank "proclaims the exchange rate ..." (Art. 35a) 	<ul style="list-style-type: none"> • A member of Government may attend Bank Board deliberations in an advisory capacity (Art. 9.2) • The Bank shall act in an advisory capacity to the Government (Art. 10.2) • The Governor is entitled to attend meetings of the Government in an advisory capacity (Art. 11)
<p>Hungary Act of the National Bank of Hungary, 1991, as most recently amended in 1996</p>	<p>"... to safeguard domestic and external purchasing power of the national currency ..." (Art. 4.1)</p>	<ul style="list-style-type: none"> • The Bank "... develops its monetary policy as well as the instruments serving its implementation ..." (Art. 6) • The exchange rate regime "... is approved by the Government in agreement with the Bank ..." (Art. 13.2) 	<ul style="list-style-type: none"> • The Bank "... supports the economic policy programme of the Government ..." (Art. 3) • The Bank participates in "... the elaboration of the economic policy programme of the Government ..." (Art. 42) • The Bank and the Finance Ministry mutually reconcile their intentions on annual guidelines for monetary policy, budgetary estimates and financing of budget deficit" (Art. 43)
<p>Poland Act of the National Bank of Poland, 1989, as most recently amended in 1996</p>	<p>"...strengthening the Polish currency..." (Art. 5.1)</p>	<ul style="list-style-type: none"> • The Bank "initiates directions and forms the monetary policy... according to the recommendations of Parliament" (Art. 6.2.2) • Exchange rate regime determined by Council of Ministers on proposal of Bank President in consultation with the Finance Ministry and Ministry of Economic Cooperation (Art. 39.1) 	<ul style="list-style-type: none"> • The Bank "cooperates in the realization of the economic policy of the State ..." (Art. 5.2, Art. 6.2.1) • The Bank gives an opinion on the budget act (Art. 16.2) • Monetary policy guidelines are passed by Parliament together with the budget act. (Art. 17.2) • NBP President participates in sessions of Parliament and the Council of Ministers (Art. 50)
<p>Slovakia The National Bank of Slovakia Act, 1992</p>	<p>"... ensure the stability of the Slovak currency ..." (Sect. 2)</p>	<ul style="list-style-type: none"> • "The Bank shall define monetary policy ..." (Sect. 2.a) • "... the Bank Board shall ... set the instruments ... and determine specific monetary policy measures ..." (Sect. 6.1) • The Bank shall "establish the exchange rate..." (Sect. 28a) 	<ul style="list-style-type: none"> • The Bank "shall support the economic policy of the Government ..." (Sect. 12.1) • Bank Board meetings may be attended by a Government member in an advisory role (Sect. 12.3) • The Bank shall "serve in an advisory capacity" (Sect. 13.2) • The Governor shall "participate in meetings of the Government" (Sect. 13.3)
<p>Slovenia The Law on the Bank of Slovenia, 1991</p>	<p>"... stability of the domestic currency and general liquidity in payments ..." (Art. 2)</p>	<ul style="list-style-type: none"> • "The Governing Board of the Bank ... shall determine the monetary policy ..." (Art. 20) • "The Governing Board of the Bank ... shall adopt measures for the implementation ..." (Art. 20) 	<ul style="list-style-type: none"> • The Bank may "... give incentives for laws and other regulations in the areas of monetary and foreign exchange systems ..." (Art. 3)

this wording does not unambiguously reflect the primacy of maintaining price stability. In any case, a reformulation of the primary goal of monetary policy in the Polish law should be considered in order to bring legislation in line with the Maastricht standards.

4.2 Independence in the Formulation and Implementation of Monetary Policy

It is widely acknowledged in the literature that an efficient conduct of monetary policy should be coordinated in some way with the economic policies pursued by the government, while the legal provisions for cooperation mechanisms in this realm might differ from country to country. In this section, we will first deal with the formulation of monetary policy, and then with its implementation.

According to Article 105 (2) of the Maastricht Treaty and Article 3.1 of the Statute, the basic task to be carried out through the ESCB is the definition and implementation of monetary policy of the Community. The Treaty and the Statute also contain regulations that provide for a certain degree of cooperation between the ESCB and the Community, requiring the ESCB to "... support the general economic policies in the Community ..." (Article 105 of the Treaty and Article 2 of the Statute), as long as this does not affect the primary goal of price stability.⁵¹⁾ At the same time, the independent status of the ECB and the NCBs (being integral parts of the ESCB) is protected by the stipulations laid down in Article 107 of the Treaty, reproduced in Article 7 of the Statute: These provisions prohibit the ECB, the NCBs and members of their decision-making bodies "to seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body." Vice versa, it is also forbidden for Community institutions or bodies or any other external source of influence (e.g. governments, parliaments) to actively try to influence decision-making bodies in the ECB or NCBs. The EMI interprets these regulations as follows: The right of third parties to give instructions to the NCBs as well as the right to approve, suspend, annul or defer their decisions are incompatible with the Treaty and the Statute. According to the EMI, a right to censor NCB decisions on legal grounds is also incompatible with the Treaty and the Statute. The participation of third party representatives in decision-making bodies of the NCBs is regarded as unacceptable, if this representative has a voting right. However, a mutual consultation between the NCBs and government/parliament bodies is broadly regarded as being compatible with the Treaty and the Statute in order to assure a certain political dialogue between monetary and political authorities.⁵²⁾⁵³⁾

The formal responsibility to design monetary policy is exclusively given to the central banks in all of the CEEC-5 with the exception of Poland, where the central bank has to design monetary policy together with Parliament (see below). As regards decisions concerning the choice of the exchange rate regime, the Czech National Bank, the Bank of Slovakia and the Bank of Slovenia are formally responsible for setting the exchange rate, though important changes are in practice discussed with the government. In Hungary and Poland, the law stipulates that this question be resolved jointly with the government (see Table 1).⁵⁴⁾ A certain degree of overall policy coordination is required by the laws of the central banks in Hungary, Poland and the Slovak Republic, which have to "support the economic policy of the government." In this context it seems important whether the law directly links the requirement to support the economic policy of the government

with the principal statutory goal. The Czech and the Slovak central bank laws both provide a framework for mutual cooperation between the central bank and the government, where the participation of a government representative “in an advisory capacity” in Bank Board meetings as well as the participation of the central bank governor in government meetings are provided for by law. The Hungarian central bank law also contains provisions for cooperation between the central bank and the government, but with a less clearly defined operational framework. For instance, the government is represented at the sessions of the bank’s Board of Directors by a minister⁵⁵) – the law does not state explicitly whether this is only in an advisory capacity. Moreover, the Hungarian legislation goes one step further and entitles the Bank to participate in the preparation of the economic policy program of the government. Depending on how strictly the Treaty and the Statute are interpreted, the wording of Article 43 in the Hungarian central bank act could be an issue for discussion, if the “mutual reconciliation of intentions” between the bank and the Ministry of Finance is understood as an obligation for the central bank to consult political authorities. The Polish legislation determines very strong coordination mechanisms: The central bank has to submit the monetary policy guidelines for the following year to Parliament, where they have to be passed simultaneously with the budget act presented by the government. The National Bank of Poland is endowed with a right to give an opinion on the project of the budget act prior to its presentation. While the Polish legislation might have been intended to bring about an optimal degree of coordination between monetary and fiscal policies, an adoption of monetary strategies by Parliament is not likely to be compatible with the requirements of Article 107 of the Maastricht Treaty.⁵⁶) The Slovene central bank law does not contain any provisions for policy coordination. It is interesting to note that none of the central bank laws under consideration contains arrangements on the solution of potential conflicts between the central bank and government bodies.

It is widely recommended that a central bank be given the right to design monetary policy instruments and be allowed to use them autonomously, thus enjoying “instrument independence” as defined by S. Fischer⁵⁷). According to Article 105 (2) of the Maastricht Treaty as reproduced in Article 3.1 of the Statute, the ESCB has the responsibility “... to define and implement the monetary policy of the Community.” Furthermore, Article 12.1 of the Statute stipulates that the Governing Council, which is the highest decision-making body of the ESCB, comprising the members of the Executive Board of the ECB and the Governors of the participating NCBs, “shall formulate the monetary policy of the Community, including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB, and shall establish the necessary guidelines for their implementation.” The Executive Board of the ECB implements monetary policy in accordance with the abovementioned guidelines and decisions. While open market and credit operations as well as minimum reserves are explicitly mentioned as possible monetary policy instruments to be used by the ECB (Articles 18 and 19 of the Statute, respectively), it is interesting to note that the Governing Council may, by a majority of two

thirds, decide on the use of other monetary policy instruments (Article 20 of the Statute).⁵⁸⁾ This regulation endows the ECB with full instrument independence in S. Fischer's sense.

All central bank laws in the CEEC-5 – save the Polish law⁵⁹⁾ – explicitly state the central bank's formal competence to determine the instruments necessary for the implementation of monetary policy (see Table 1). In an environment of low budget deficits or even budget surpluses, it is of particular importance that the central bank has the right to issue securities in order to prevent any dependence on the government's issuing policy in this respect.⁶⁰⁾ While the central banks of the Czech Republic, Poland, Slovenia and Slovakia are expressly endowed with this right⁶¹⁾, it is interesting to note that the Hungarian legislation lacks an explicit provision in this realm. In practice, the Bank of Slovenia and the Czech National Bank have been issuing their own securities since the beginning of their operation, the National Bank of Poland reestablished the issue of own bills in 1994, and the National Bank of Slovakia for the first time issued its own bills in 1995. However, in practice the choice of instruments is somewhat limited by a number of factors. First, especially in transition countries the lack of well-developed financial markets may have necessitated the use of direct credit controls at least at the beginning of the transformation process before functioning money markets and money market instruments could be put in place. Second, the choice of the exchange rate regime – a decision which in most cases has to be taken jointly with the government (see above) – has a considerable impact on the degree of independence in the use of monetary policy instruments⁶²⁾: The adoption of a fixed exchange rate regime (with a small or without a fluctuation band around the central parity) prevents the central bank from actively using the exchange rate as an instrument of monetary policy. Depending on how tightly specified the constraints of creating credit are, instrument independence can be more or less restrained under such an arrangement.⁶³⁾ In countries where the pegged exchange rate has a wider fluctuation band (e.g. the Czech Republic), the width of the band determines the room for autonomous action of the central bank.⁶⁴⁾

4.3 Financial Independence

The term "financial independence"⁶⁵⁾ of the central bank covers the following two aspects in this paper:

- budgetary independence of the central bank itself – in other words: Does the central bank have the appropriate financial means to fulfill its tasks independently of government bodies? and the
- prohibition of direct credit facilities to the public sector.

For the budgetary independence of the central bank, it is of crucial importance whether the bank is entitled to determine its expenses and revenues autonomously or whether the approval of a government body is required. It is widely acknowledged that the central bank should not be financially dependent on the state budget; financial dependence would potentially put political bodies in a position to exert some influence on monetary policy decisions. Another important gauge of financial independence is the use and allocation of profits, which can be subject to a

decision of the central bank's organs, can be prescribed in detail by the central bank law or, theoretically, be subject to decision by the government or government-related institutions. Typically, the central bank laws stipulate that a major part of central bank profits be transferred to the state budget. Another very important issue is the coverage of potential central bank losses: The stipulation of automatic coverage of central bank losses by the state budget in the central bank law is generally regarded as a further guarantee for CBI.⁶⁶⁾ The approach of transferring central bank profits to the state budget and, at the same time, covering potential losses from the state budget can be seen against the following background: It is argued that profits or losses of the central bank are due to factors which have only little to do with the efficient management of the central bank as an "enterprise"; much rather, they are due to other factors determined by monetary policy strategies (e.g. the interest rate level). Therefore, a central bank's performance can only be assessed on the achievement of monetary policy objectives and not on the basis of the profit and loss account. The EMI's position on budgetary independence of central banks goes in the same direction: An ex-ante influence of third parties on a central bank's budget and/or profit distribution may jeopardize its independence, unless there is a safeguard clause in the law that guarantees the proper fulfillment of the central bank's tasks.⁶⁷⁾

In the CEEC-5, the responsibility to determine the central banks' budget is generally assigned to the banks' managing boards, while in Hungary the General Meeting has the ultimate say on the allocation of profits (see Table 2). The typical pattern for the use and distribution of central bank profits prescribed by all central bank laws examined is as follows: First, part of the profit is allocated to funds, which mainly aim at replenishing the bank's reserves in order to provide a cushion for potential future losses and, in addition, cover a range of other predefined purposes. Second, the profit remaining after deductions for allocations to funds is typically transferred to the state budget. The legislation in the CEEC-5 is more differentiated on the issue of the coverage of potential losses incurred by the central banks: According to the Polish and the Slovene central bank legislation, the losses have to be covered primarily by the resources from the abovementioned funds; only the Slovene law regulates the coverage of losses exceeding the funds. The Hungarian central bank law stipulates monthly transfers from the state budget in the case of central bank losses. Interestingly enough, the Czech and Slovak central bank laws do not contain any provisions in this area.

A crucial aspect of financial CBI is the legal restriction of central bank credits to the government: The central bank should not be impeded in fulfilling its stability mandate by having to meet the government's financial demands of extending direct loans (or simply printing money) to cover the state deficit. There is a general consensus on the legal prohibition of direct central bank credit to the government, be it in securitized or nonsecuritized form (e.g. advances or purchases of government papers on the primary market, overdraft facilities). Indirect central bank credit – the acquisition of government securities by the central bank on the secondary market – is permitted by a number of Western central bank laws.⁶⁸⁾ However, most of

Table 2

Financial Independence of Central Banks in the CEEC-5				
Limits to government lending		Budgetary independence		
Direct credit	Indirect credit	Ownership; management of budget	Allocation of profit	Coverage of potential losses
Czech Republic				
<ul style="list-style-type: none"> • Purchase of short-term (3 month) Treasury bills permitted • Maximum: 5% of previous year's state budget revenues (Art. 30.2) 	<ul style="list-style-type: none"> • In order to regulate the money market the Bank can buy and sell negotiable securities (Art. 32) 	<ul style="list-style-type: none"> • Bank budget approved by the Bank Board (Art. 47.1) 	<ul style="list-style-type: none"> • Profits are to be used to replenish reserves • Remaining portion transferred to the state budget (Art. 47.2) 	<ul style="list-style-type: none"> • No provision
Hungary				
<ul style="list-style-type: none"> • Short-term liquidity loans to bridge temporary difficulties permitted (Art. 19) • Maximum: 2% of planned budget revenues 	<ul style="list-style-type: none"> • The Bank enters into security transactions with repurchase agreements (Art. 9c) 	<ul style="list-style-type: none"> • Joint stock company owned by the state (Art. 54) 	<ul style="list-style-type: none"> • Upon decision of the General Meeting (Art. 56) • Monthly transfers of profits to the state budget (Art. 78.4) 	<ul style="list-style-type: none"> • Monthly transfers from state budget to cover losses (Art. 78.4)
Poland				
<ul style="list-style-type: none"> • Purchase of government securities on the primary market permitted • Maximum: 2% of the planned state budget expenditures (Art.34) 	<ul style="list-style-type: none"> • No provisions concerning the secondary market 	<ul style="list-style-type: none"> • Bank's own finances managed in accordance with economic policy guidelines adopted by the Sejm (Art. 73.1) • Board of Management determines financial plan for each year (Art. 73.2) 	<ul style="list-style-type: none"> • Profits allocated to statutory fund, reserve fund and special funds (Art. 69–72) • After deductions for funds part of the profit is transferred to the state budget (Art. 77) 	<ul style="list-style-type: none"> • Losses to be covered by reserve fund (Art. 70) • No provisions for losses exceeding reserve fund
Slovakia				
<ul style="list-style-type: none"> • Purchase of short-term (3 month) Treasury bills to cover fluctuations in the state budget permitted • Maximum: 5% of state budget revenue of previous year (Sect. 25.2) 	<ul style="list-style-type: none"> • Bank may purchase and sell negotiable securities for the purpose of regulating the money market (Art. 27) 	<ul style="list-style-type: none"> • Bank budget approved by the Bank Board (Sect. 38.1) 	<ul style="list-style-type: none"> • Profits used to replenish the level of reserves and other funds • Remaining profits transferred to state budget (Sect. 38.2) 	<ul style="list-style-type: none"> • No provisions
Slovenia				
<ul style="list-style-type: none"> • Short-term loans to bridge temporary imbalances in the budget permitted (Art. 61) • Maximum: 5% of budget of current year and not more than 1/5 of anticipated budget deficit (Art. 61) 	<ul style="list-style-type: none"> • "The Bank shall regulate the amount of money ... by purchasing and selling state securities" (Art. 25.2) 	<ul style="list-style-type: none"> • Financial Plan adopted by the Governing Board of the Bank and subject to approval of Parliament (Art. 82) 	<ul style="list-style-type: none"> • Profits may be allocated to fixed assets and special reserve fund (Art. 78) • Profits after these allocations are transferred to budget (Art. 83) 	<ul style="list-style-type: none"> • Losses are to be covered by special reserve fund (Art. 83) • If losses exceed special reserve fund, the rest has to be covered by the budget (Art. 83)

these laws contain safeguard clauses which limit this kind of transaction to operations conducted for monetary policy purposes. The main explanation for the absolute prohibition of direct central bank lending to the government is that the full and exclusive control of the monetary base has to be located at the central bank, thus excluding the government from any influence on the growth of the monetary base. The rationale behind the permission of indirect central bank lending to the government is that on the secondary market, government papers are traded at market rates, thus making public and private sources of funding close substitutes. According to Article 104 (1) of the Maastricht Treaty, "overdraft facilities or any other type of credit facility with the ECB or with the NCBs in favor of Community institutions or

bodies, central governments, regional, local or other public authorities ... shall be prohibited, as shall the purchase directly from them by the ECB or NCBs of debt instruments." Thus, the Maastricht Treaty explicitly prohibits only direct central bank credit to the public sector. As far as outstanding debt is concerned, the dates for the eventual amortization of the debt stock will have to be set. The practice in incumbent EU states is to find very long-term solutions to the repayment of such debt.⁶⁹⁾

In all five central bank laws under consideration, direct central bank lending to the government is still permitted, though to a differing degree, which is definitely not in line with the Maastricht requirements. However, the nature, maturity and maximum amount of these credits are precisely defined in the laws, which of course provides a certain safeguard clause for CBI. The most frequently encountered form of direct central bank credit to the government in the CEEC-5 is the purchase by the central bank of Treasury bills from the government on the primary market, as stipulated in the Czech Republic, Poland and the Slovak Republic. According to the Czech and the Slovak legislation, the maturity of these Treasury bills is limited to three months. The constraints on the maximum amount of these transactions are stipulated differently: While the Czech and the Slovak laws define the limit as a percentage of the previous year's budget revenues, the Polish central bank law⁷⁰⁾ imposes a percentage of planned state budget expenditures for the current year and does not specify the maturity (see Table 2). The Slovene legislation takes a different approach and provides for short-term central bank loans to the government which are exclusively devoted to the purpose of bridging temporary imbalances in the state budget. The maximum amount of these loans is defined as a percentage of the general budget deficit and, in parallel, of the budget expenses in the current year. The most recent amendment of the Hungarian central bank law (1997) mainly focuses on a redefinition of the relationship between the budget and the central bank: Similarly to the Slovene legislation, as of 1997 there remains only one exception to the prohibition of budgetary financing by the central bank, namely the granting of liquidity loans to the central budget for bridging short-term liquidity difficulties. The maximum amount of such financing is limited to 2% of planned budget revenues; the maturity may be up to 15 consecutive or separate days of a calendar month, and it has to be cleared by year-end. In addition, the amendment – in conjunction with the 1997 Budget Act – did away with a specific obligation of the Hungarian central bank to grant loans beyond the abovementioned limits in order to cover exchange rate losses resulting from the country's foreign borrowing activities. The new regulation shifted not only potential future, but also past losses resulting from foreign borrowing from the central bank's balance sheet to the state budget.⁷¹⁾

4.4 Personal Independence

One of the cornerstones of legal CBI is personal independence, which is to guarantee that central bankers are in a position to fulfill their legal obligations. Of particular relevance are the arrangements concerning the role, status and composition of the Bank's important decision-making

bodies, including the appointment procedures, rules for dismissal, the length of the term of office, requirements for professional competence and incompatibility clauses. It is widely agreed that limiting the political influence on the procedure of appointing top central bank officials increases the degree of personal independence of the newly appointed central banker. In this respect legislation provides for different procedures: Either the state president or the government have the right to appoint a candidate, or the decision has to be taken by the parliament, thus including the opposition parties in the decision-making process. Moreover, the reasons for dismissal of the top officials have to be limited to transparent, exceptional circumstances and have to be clearly defined by law. A related question is the possibility of reappointing central bank officials, which is generally seen as nonsupportive to independent behavior.⁷²⁾ It is widely agreed that the legislated term of office of central bank top officials has to be clearly longer than the electoral cycle, which in most countries means more than four to five years.⁷³⁾ Moreover, it is sometimes argued that the central bank law should contain requirements concerning the professional qualifications of the top officials. Finally, incompatibility clauses for the top central bank managers are recommended in order to prevent potential conflicts of interest. These generally acknowledged requirements concerning the role and status of the top officials are also reflected in the construction of different models to measure legal CBI.⁷⁴⁾

In the Statute, most of the abovementioned requirements concerning the personal independence of the central bank are taken into account: The term of office for the top officials of the future ECB (members of the Executive Board) is set at eight years, and no reappointment is possible (Article 11.2 of the Statute). Moreover, the minimum term of office for Governors of NCBs is established as five years (Article 14.2 of the Statute), but of course their term may be longer. The Statute stipulates the following appointment procedure for the ECB top officials: They are appointed “by common accord of the governments of Member States ... on recommendation from the Council after it has consulted the European Parliament and the Governing Council” (Article 11.2 of the Statute). The required professional qualifications of ECB top officials are that they have to be “persons of recognized standing and professional experience in monetary or banking matters” (Article 11.2 of the Statute). Furthermore, the reasons for dismissal of both the ECB top officials and NCB Governors are restricted to the following two predefined cases: first, either the conditions for the performance of their duties are no longer fulfilled or, second, they are guilty of serious misconduct (Articles 11.4 and 14.2 of the Statute, respectively). This means that they cannot be dismissed on the grounds of their monetary policy decisions. The EMI is of the opinion that the provisions for the security of tenure of office should also apply to other members of the decision-making bodies of NCBs. The EMI argues that this demand can be justified by the wording of Article 107 of the Maastricht Treaty, which refers to “any member of decision-making bodies” rather than only to “Governors.” Moreover, the EMI calls for incompatibility clauses for members of decision-making bodies which are not explicitly stipulated in the Maastricht Treaty.⁷⁵⁾ However, the Statute

Personal Independence of Central Banks in the CEEC-5						
Governor			Highest decision-making body			Incompatibility clauses
Term of office	Appointment	Dismissal	Composition; term of office of its members	Appointment	Dismissal	
Czech Republic 6 years (Art. 6.4)	Appointed by President of Republic (Art. 6.2)	<ul style="list-style-type: none"> • Criminal act • Inability to perform functions, based on Bank Board decision • Own request (Art. 6.6) 	<ul style="list-style-type: none"> • Bank Board (BB): 7 members, Governor and 2 Vice Governors, 4 senior CNB officers (Art. 6.1) • Term: 6 years (Art. 6.4) 	<ul style="list-style-type: none"> • Vice Governors appointed by President of Republic (Art. 6.2) • Senior CNB officers appointed by President of Republic (Art. 6.3) 	<ul style="list-style-type: none"> • Criminal act • Inability to perform function, based on Bank Board decision • Own request (Art. 6.6) 	BB membership incompatible with (Art. 6.5): <ul style="list-style-type: none"> • Membership in Parliament • Position in government • Top position in banks or enterprises
Hungary 6 years (Art. 58.2)	Appointed by State President on proposal of Prime Minister (Art. 58.2)	<ul style="list-style-type: none"> • Own resignation (Art. 58.5b) • Inability to perform functions (Art. 58.7a) • Conviction of a crime (Art. 58.7b) 	<ul style="list-style-type: none"> • Central Bank Council (CBC): Governor; Deputy Governors, non-bank members (1 more than number of Deputy Governors) • Term of Deputy Governors: 6 years (Art. 59.2) • Further members: 3 years (Art. 59.3c) 	<ul style="list-style-type: none"> • Deputy Governors appointed by State president on proposal of MNB Governor (Art. 59.1) • nonbank CBC members appointed by State president on proposal of Prime Minister; who has to consult with MNB Governor (Art. 57.3c) 	<ul style="list-style-type: none"> • For Deputy Governors: see provisions for President (Art. 59.3) • No provisions for nonbank CBC members 	<ul style="list-style-type: none"> • CBC members may not be party officials (Art. 69) • No ownership in or employment by or management of commercial bank (Art. 70)
Poland 6 years (Art.49.2), 2 consecutive terms possible (Art. 49.3)	Appointed by Parliament on proposal of State President (Art. 49.1)	<ul style="list-style-type: none"> • Own resignation • Inability to perform functions for more than 3 months due to illness • Criminal act • Tribunal's announcement disqualifying him (Art. 49.4) • Parliament's resolution on constitutional prosecution of president (Art. 49.5) 	<ul style="list-style-type: none"> • Board of Management: President, Deputy Presidents and members of the Board (Art. 51.1) • No provisions for term of office 	<ul style="list-style-type: none"> • Deputy presidents appointed by State President on proposal of NBP President (Art. 49.6) • Other Board members appointed by NBP president (Art. 49.6) 	<ul style="list-style-type: none"> • Deputy Presidents dismissed by State President on proposal of NBP President (Art. 49.6); no reasons defined • Other Board members dismissed by NBP President (Art. 49.6), no reasons defined 	No incompatibility clauses
Slovakia 6 years (Sect. 7.4), 2 consecutive terms possible (Sect. 7.5)	Appointed by President of Republic on recommendation of government with consent of Parliament (Sect. 7.2)	<ul style="list-style-type: none"> • Criminal act • Inability to perform function, based on Bank Board decision (Sect. 7.8) • Noncompliance with Sect. 7.6 • Voluntary resignation (Sect. 7.7) 	<ul style="list-style-type: none"> • Bank Board (BB): Governor, 2 Vice Governors, 2 executive directors, 3 other members (Sect. 7.1) • Term of Vice Governors and executive directors: 6 years (Sect. 7.4) • Other members: 4 years (Sect. 7.4) 	<ul style="list-style-type: none"> • Vice Governors appointed by President of Republic on recommendation of Government with consent of Parliament (Sect. 7.2) • Executive directors and other 3 members appointed by Government on recommendation of Governor (Sect.7.3) 	<ul style="list-style-type: none"> • Criminal act • Inability to perform function, based on Bank Board decision (Sect.7.8) • Noncompliance with Sect.7.6 • Voluntary resignation (Sect.7.7) 	BB membership incompatible with (Sect.7.6): <ul style="list-style-type: none"> • Position as Member of Parliament • Position in government • Top position in banks or enterprises
Slovenia 6 years (Art.14), reappointment possible	Appointed by Parliament on proposal of State President (Art.14)	No provision	<ul style="list-style-type: none"> • Governing Board: 11 members; Governor, Deputy Governor, 3 Vice Governors, 6 independent experts (Art.12) • Term of Deputy Governor and Vice Governors: 6 years (Art.15) 	<ul style="list-style-type: none"> • 6 experts appointed by Parliament on proposal of State President (Art.13) • Deputy Governor and 3 Vice Governors appointed by Parliament on proposal of Governor (Art.15) 	No provision	No incompatibility clauses except for experts (Art.13): <ul style="list-style-type: none"> • No BoS staff • No top position in organization supervised by central bank • No elected state officials

contains a provision requiring that the members of the ECB Executive Board are to be full-time central bankers; any other occupation is prohibited “unless exemption is exceptionally granted by the Governing Council” (see Article 11.1 of the Statute). The EMI derives the general principle that “... membership of a decision-making body involved in the performance of ESCB-related tasks is incompatible with the exercise of other functions which might create a conflict of interest.”⁷⁶⁾

A common feature of all central bank laws in the CEEC-5 is that the term of office of the governor comes to six years, which is longer than the electoral cycle in all countries. In this respect all central bank laws fulfill the standards set by Maastricht legislation. The duration of the appointment of the members to the central banks' highest decision-making bodies is also stipulated at six years, except for the Bank Board of the National Bank of Slovakia and for the non-central bank members of the Central Bank Council of the National Bank of Hungary (See Table 3). In the Czech Republic, Hungary and Slovakia, the central bank governor is appointed by the state president, whereas in Poland and in Slovenia, the parliament has the final say in appointing the governor. It is interesting to note that the Hungarian central bank law contains a professional qualification profile for the central bank governor as well as for the members of the Central Bank Council.⁷⁷⁾ Once appointed, the central bank governor is typically involved in the appointment procedures for the other members of the highest decision-making body, while the degree and the form of his involvement are regulated differently across the CEEC-5. It must be stressed that the members of the highest decision-making body are not appointed by the government in any of the countries examined, with the exception of Slovakia (see Table 3). All central bank laws in the CEEC-5 except the Slovene law exactly define and enumerate reasons for the potential dismissal of the central bank's governor, which puts them broadly in line with the Maastricht Treaty. The reasons for dismissal of other members of the highest decision-making bodies are clearly defined in the central bank laws of the Czech Republic, Hungary and Slovakia, while no such provision can be found in the Slovene law, nor does the Polish law define any reasons.

Only three central bank laws, namely the Czech, the Hungarian and the Slovak legislation, contain incompatibility clauses for all members of the highest decision-making body (see Table 3). The incompatibility clauses contained in the Slovene law only refer to the independent experts represented in the Governing Board. To our knowledge, none of the central bank laws analyzed contains a general prohibition for members of the highest decision-making body to exercise other functions which might create a conflict of interest. Therefore, if the Maastricht legislation is strictly interpreted, it seems that there is a need for adaptation of the incompatibility clauses in the central bank laws.

4.5 Accountability and Transparency

There is widespread agreement in the literature that central banks, though endowed with a high degree of independence, have to be held accountable – in one way or another – for achieving the legislated goals of monetary policy.⁷⁸⁾ It is argued that mechanisms for the democratic accountability of the central bank have to be put in place in order to create incentives for an autonomous central bank to fulfill its goals and to explain its actions to the public. For this purpose, a sufficient degree of transparency of monetary policy is needed, which enables the public to monitor monetary policy performance. Transparency can be legally guaranteed through different forms: In a number of parliamentary democracies, the central bank is primarily responsible to the parliament. In such cases the laws frequently stipulate that the central bank governor regularly meets with parliamentary bodies and explains and justifies the bank's monetary policy actions.⁷⁹⁾ Another approach is that the central bank is held directly accountable to the public and that it has to meet reporting requirements through regular publications (monthly/quarterly/annual reports, financial statistics, inflation reports). An important element of accountability is a clear definition of the ultimate goal, for which the central bank is held accountable. Moreover, a publicly announced intermediate target of monetary policy chosen to fulfill this goal could enhance transparency.⁸⁰⁾ A number of countries pursue the strategy of monetary targeting, arguing that the central bank should be held accountable only for the monetary impulses to inflation, which it can control more directly than inflation developments.⁸¹⁾ An alternative approach is direct inflation targeting, where more emphasis is put on transparency, because inflation forecasts are more widely understood than estimated monetary aggregates. Moreover, a formal inflation target is a direct reflection of the ultimate goal of price stability. As a third strategy, a number of countries have defined the exchange rate as intermediate target, pegging the exchange rate to the anchor currency of a low-inflation country.⁸²⁾

Maastricht legislation stipulates that the future ESCB will be held accountable to several European bodies as well as to the public at large. According to Article 109 b (3) of the Treaty, the ECB is obliged to submit an annual report on the activities of the ECSB and on the monetary policy of both the previous and current years to the European Parliament, the Council and the Commission, and also to the European Council. At the request of the European Council or on their own initiative, the ECB President and other members of the Executive Board can be invited to a hearing in the committees of the European Parliament. To fulfill the requirement of accountability towards the public, the ECB must, under Article 15.1 of the Statute, present quarterly (or more frequent) reports about the activities of the ESCB and must publish a weekly financial statement (Article 15.2). Moreover, the annual accounts of the ECB must be published (Article 26.2).

In the CEEC-5, the central banks are all accountable to parliament.⁸³⁾ While the Slovene legislation only contains a general notion that the activity of the central bank is supervised by Parliament, the central bank law stipulates no detailed reporting requirements. According to the Czech and the Slovak legislation, the central banks have to submit reports to Parliament

twice a year. Moreover, both laws contain regulations on the bank's general responsibility towards the public, requiring the bank to publish information about monetary developments at least every quarter.⁸⁴⁾ The Hungarian and the Polish central bank laws contain more comprehensive reporting requirements: In addition to an annual report to be submitted to Parliament, the National Bank of Hungary is obliged to furnish regular reports on monetary policy also to the government and ministries. In Poland, periodical reports on the implementation of the monetary policy guidelines have to be submitted not only to Parliament, but also to the Council of Ministers.⁸⁵⁾ Although reporting to the public is explicitly required only by the Czech and the Slovak legislation, in practice all five central banks publish monthly and annual reports. In addition, quarterlies on monetary policy developments are produced by the Czech National Bank, the National Bank of Slovakia and the Bank of Slovenia. However, the accountability of the CEEC-5 central banks to the national parliaments implies the potential danger of political influence on the central bank exerted by members of parliament, who may act as representatives of certain lobbies or interest groups,⁸⁶⁾ such as exporters asking for a devaluation of the domestic currency, entrepreneurs striving for lower interest rates on credits, etc.⁸⁷⁾ This danger, however, is very limited, because in most cases (except for Poland until the endorsement of the new constitution) the central bank only has to fulfill reporting requirements and is not obligated to follow any instructions given by parliament.

In sum, the CEEC-5 legislation on central bank accountability is broadly compatible with the requirements of the Maastricht Treaty.

5 Some Aspects of Actual Independence

Although the legal status of a central bank provides an important yardstick to assess CBI in a particular country, this is only one element determining the independence of the central bank, while the implementation of the central bank law in practice and the perception of CBI by the public – which is defined as the “reputation of independence” by Bruni⁸⁸⁾ – also play a very important role. Actual CBI may differ from legal CBI, as on the one hand, a number of factors reduce the degree of actual independence as compared to legal CBI, but on the other hand, there are also examples where actual CBI is higher than legal independence. As pointed out earlier, the “credibility bonus” of a central bank does not result automatically from a high degree of legal independence, but has to be earned and defended constantly in practice. Whereas laws and treaties provide the necessary legal framework, the most effective protection of CBI is a broad anti-inflationary consensus supported by policymakers and the public at large.

While we have applied the institutional requirements of the Maastricht Treaty and the Statute as a yardstick to assess legal CBI in the CEEC-5, we will analyze the degree of actual CBI by comparing the legal status of the central bank with the implementation of the law in practice, using indicators such as the turnover rate of governors, political vulnerability, overriding of the central bank law by budget laws, etc.

In most, if not all countries worldwide, CBI is potentially vulnerable, as the central bank law can be changed by a simple majority in parliament. This

implies that a government which relies on a majority of mandates in parliament could theoretically threaten to radically change the legal status of the bank. In this context, the frequency of political changes in parliament and the political readiness of the deputies to reduce CBI by changing the central bank law more or less frequently are very important determinants of central bank autonomy in practice. A case in point is Bulgaria, where Parliament passed (with a simple majority) a highly controversial amendment of the Central Bank Act in April 1996 which substantially modified the appointment procedures of the bank's top officials (see below). In order to preclude this potential danger for CBI, some experts even recommend that the central bank law should be written into the country's constitution or that a two-thirds majority of parliament should be required for any amendment of the central bank law.⁸⁹⁾ Interestingly, in most of the CEEC-5 the constitution contains some provisions on the central bank. Slovenia is the only country whose constitution explicitly states the independent status of the central bank. Moreover, the Slovene constitution determines the appointment procedure of the central bank Governor as well as the bank's accountability to Parliament. The Czech constitution defines the primary goal of the central bank as currency stability and contains appointment procedures for the members of the Bank Board. In Hungary, the constitution stipulates the main tasks of the central bank, the appointment procedure for the Governor and an annual reporting requirement to Parliament. The Slovak constitution only mentions the establishment of a central bank. An interesting case is the new draft constitution of Poland,⁹⁰⁾ which will entail, after its endorsement by referendum, fundamental changes in the central bank legislation. The draft constitution endows the central bank with the sole right to determine and implement monetary policy and to issue money. Moreover, it determines the bodies of the central bank, introduces a Monetary Policy Council, and stipulates appointment procedures, terms of office as well as incompatibility clauses for the Governor. In contrast to other countries analyzed, the Polish draft constitution explicitly prohibits the central bank from financing the state budget deficit.

Another threat to CBI may result from incomplete definitions or gaps in central bank laws and the way these imperfections of legislation are dealt with in practice. As Bruni⁹¹⁾ pointed out, sufficiently strong political pressure applied to at least one of the gaps may considerably weaken the degree of legal independence of the central bank. Finally, the extent to which legal CBI is translated into actual CBI is also influenced by the degree of general adherence to the rule of law, which depends on a country's history and culture. Under the socialist regimes, the general respect of law – unless enforced by severe sanctions in case of noncompliance – was widely reduced or destroyed.⁹²⁾ Moreover, as the transition economies have been undergoing a fundamental building and/or restructuring of institutions, the magnitude of unanticipated shocks and hence the temptation to bend the law might have been higher than in normal times.⁹³⁾ For instance, in an environment of high budget deficits, there might be a particularly strong temptation to override the central bank law by allowing for some form of central bank financing to the public sector despite its prohibition or limitation in the central bank law (see below).

However, it is also possible that legally rather dependent central banks nevertheless enjoy a high degree of actual autonomy, for instance on the strength of their governor's personality: If the central bank governor is a highly reputable person in public life who openly resists any political pressures to change the monetary policy stance, he or she might in practice enjoy a high degree of credibility which goes far beyond the degree of legal independence granted to the central bank by law. In a similar vein, it is argued that the quality and the reputation of the central bank's staff is an important component of actual CBI.⁹⁴⁾

In the following section, we will discuss selected aspects of actual CBI to shed some light on how the credibility and reputation of central banks can be jeopardized despite a relatively high degree of legal CBI or how legal CBI can be strengthened in practice.

5.1 Turnover Rate of Governors and Political Vulnerability

Although a number of different models to measure legal CBI have been developed up to now (see section 2), it is very difficult to quantify the degree of actual independence. The most prominent approach in this area was taken by Cukierman,⁹⁵⁾ who introduced the turnover rate of governors as a proxy for actual CBI. The turnover rate of governors is defined as the average term of office of central bank governors in different countries, with this indicator being based on the assumption that a higher turnover rate indicates a lower degree of actual CBI and vice versa. Empirical evidence as presented by Cukierman shows that even if the legal term of office is longer than the electoral cycle, the actual term of office can be significantly shorter.

In the following, we have attempted to measure the turnover rate of governors for the CEEC-5 (see Table 4). As our reference period, we have

Table 4

Turnover Rate of Governors in the CEEC-5		
Governors	Period of reference	Turnover rate of governors ¹⁾
Czech Republic • Josef Tošovský since Feb. 17, 1993 ²⁾	Dec.1992–March 1997	0.23
Hungary • Péter Ákos Bod Dec. 9, 1991–Dec. 14, 1994 • György Surányi since March 1, 1995	Dec.1991–March 1997	0.38
Poland • Zdzisław Pakuła July 13, 1988–Sep. 11, 1989 • Władysław Baka Sep. 21, 1989–Jan. 24, 1991 • Grzegorz Wójtowicz Jan. 25, 1991–Aug. 9, 1991 • Hanna Gronkiewicz-Waltz³⁾ since March 5, 1992	Feb.1989–March 1997	0.49
Slovakia • Vladimír Masár since Aug. 1, 1993 ⁴⁾	Nov.1992–March 1997	0.23
Slovenia • France Arhar since June 25, 1991 reappointed on April 1, 1995, for another 6 years	June 1991–March 1997	0.17

¹⁾ Calculated as the number of governors divided by the length (in years or fractions of years) of the reference period.
²⁾ As the Czech National Bank was established later than the central bank law was promulgated, Tošovský's term starts later than our period of reference.
³⁾ In the interim period: Deputy governor Andrzej Topiński Aug. 10, 1991–March 4, 1992.
⁴⁾ Before: Vice Governor M. Tkáč Jan. 1. 1993–July 29. 1993.

chosen the date of the promulgation of the respective central bank law as a starting point for all countries, because the main purpose of this exercise is to examine the actual implementation of central bank legislation.⁹⁶⁾ In determining the number of governors appointed, we strictly counted only governors who were officially nominated and excluded from our calculation “acting governors” or “acting vice-governors” who just served during an interim period.

The turnover rate of central bank governors in the CEEC-5 during the reference period, however, has to be interpreted with caution for several reasons: First, the differences between the chosen periods of reference, depending on the promulgation date of central bank laws in the individual countries, crucially influence the calculated turnover rate: As the reference periods are generally very short (a maximum of eight years), a small change in the base period leads to substantial distortions in the outcome and therefore makes it extremely difficult to produce a cross-country comparison. Second, the reasons for a premature termination of the governor’s term have to be carefully analyzed in every case before this step can be qualified as politically motivated: Did the governor resign voluntarily for solely personal reasons (e.g. health) or was there a fundamental political disagreement with the (new) ruling party? Was the governor forced to leave e.g. by an amendment of the central bank law? Was he dismissed?⁹⁷⁾

However, despite the abovementioned precautions, it might be interesting to take a closer look at the short history of central bank governors in the CEEC-5. Very low turnover rates of governors were measured in Slovenia, the Czech Republic and the Slovak Republic, with the reference period being shorter for the two latter, thus somewhat increasing their calculated turnover rate as compared to Slovenia. An interesting case in point is the Slovak Republic, where Governor Vladimír Masár was only appointed seven months after the establishment of the central bank in January 1993. Until his appointment the governor’s duties were fulfilled by Vice-Governor Marián Tkáč, who headed the National Bank of Slovakia as the Acting Governor until July 29, 1993. Hungary recorded a comparatively high turnover rate in the period under consideration: The first central bank governor during the reference period was Péter Ákos Bod, who was appointed in the same month the new central bank went into force. He followed György Surányi, who after one and a half years of tenure (July 1990 to December 1991) had been dismissed by the Prime Minister. This politically motivated step had been intensely debated.⁹⁸⁾ Péter Ákos Bod served only half of his six-year term until he resigned, as he had been increasingly in disagreement with the new coalition that came to power at the general elections in May 1994.⁹⁹⁾ As of March 1995, György Surányi returned to his former position, which could be seen against the background of a political change in Hungary: He was officially nominated central bank Governor at the same time Lajos Bokros was appointed new Finance Minister, and they both initiated the new stabilization package. The highest turnover rate was recorded in Poland: The first governor in the reference period, Zdzisław Pakuła resigned in September 1989 after the appointment of the new noncommunist, radical reformist government. Interestingly, the

first post-transition central bank Governor was Władysław Baka, who had been central bank governor already earlier (from 1985 to 1988) and who had been a member of the former ruling Communist Party Politburo. In January 1991, he handed in his resignation to President Lech Wałęsa, after a new government had been installed. He was succeeded by Grzegorz Wójtowicz, who served the shortest term in the CEEC-5 and who was dismissed as president of the National Bank of Poland in August 1991 for lack of supervision in a financial scandal, in which seven bankers, including Wójtowicz's first deputy, had been arrested for issuing unsecured credit guarantees.¹⁰⁰⁾ This scandal was followed by a difficult interim period of seven months, during which Vice-President Topiński was left to preside over the bank until a new central bank governor was appointed. During this interim period there were several attempts to agree on a new central bank governor: After Parliament had rejected the President's first candidate in August 1991, it also rejected Hanna Gronkiewicz-Waltz when she was first presented by Wałęsa as a candidate in December 1991, arguing that she lacked practical banking and management experience. It was only in March 1992 that Parliament finally approved Hanna Gronkiewicz-Waltz, after the President had nominated her again.

Although all central bank laws under consideration fulfill the Maastricht requirement of the governor's term of office exceeding the electoral cycle, the actual circumstances and number of appointments in some countries nevertheless substantially differ from the legislated tenures.

Table 5

Turnover Rate of Ministers of Finance in Hungary and Poland

Ministers of finance	Turnover rate of finance ministers
Hungary <ul style="list-style-type: none"> • Mihály Kupa Dec. 20, 1990–Feb. 12, 1993 • Iván Szabó Feb. 24, 1993–July 15, 1994 • Lázló Békesi July 15, 1994–Feb. 28, 1995 • Lajos Bokros March 1, 1995–Feb. 29, 1996 • Péter Medgyessy since March 1, 1996 	0.94
Poland <ul style="list-style-type: none"> • Andrzej Wróblewski Oct. 14, 1988–Sep. 12, 1989 • Leszek Balcerowicz Sep. 12, 1989–Dec. 22, 1991 • Karol Lutkowski Dec. 23, 1991–Feb. 27, 1992 • Andrzej Olechowski Feb. 28, 1992–June 5, 1992 • Jerzy Osiatyński July 1, 1992–Oct. 26, 1993 • Marek Borowski Oct. 26, 1993–Feb. 8, 1994 • Grzegorz Kołodko April 28, 1994–Feb. 4, 1997 • Marek Belka since Feb. 4, 1997 	0.98

Another interesting concept in this context is related to the political vulnerability of the central bank governor, which is defined as the propensity of the governor to lose his position within a short period of time following a political change in the country.¹⁰¹⁾ Defining this period of time as six months, Cukierman and Webb¹⁰²⁾ found strong evidence of political influence on central banks between 1950 and 1989 both in industrialized and in developing countries. We examined such a relationship between the changes of central bank governors in Hungary and Poland, where the turnover rate of governors was relatively high, and (preceding) changes in

the Ministries of Finance, which were used as a proxy for political change (see Table 5).¹⁰³) However, according to the abovementioned definition of political vulnerability and using the same reference period as for calculating the turnover rate of governors, no clear pattern emerges, as the turnover rate of finance ministers is substantially higher than that of central bank governors in both countries. While changes of the central bank governor in a number of cases seem to have been politically motivated (see above), they were not necessarily an immediate consequence of a political change in the government.

5.2 The Importance of the Human Factor

As shown in the previous section, the relatively high degree of legal protection for central bank top officials in Central and Eastern Europe (length of tenure, detailed procedures of appointment and dismissal) does not entirely save them from political pressure in real life. The pressures faced by central bankers in the first years of economic transformation in Central and Eastern Europe were and still are considerable: While the governments typically push for faster growth, demanding low interest rates and a competitive exchange rate level to support the export economy, the central bank is held responsible for lowering inflation (in some cases from extremely high levels¹⁰⁴). Therefore, the appointment of a conservative, “Rogoff-type” head of the central bank who is known for his or her strong preference for low inflation can enhance actual CBI even if the legal autonomy of the central bank is rather weak. Moreover, the personality of the central bank governor (and of his or her appointed deputies as well as of members of the highest decision-making body) is extremely important in order to strike the right balance between the necessary cooperation with the government and independence from it. A case in point is the Czech Republic, where cooperation has been the norm simply because Josef Tošovský the central bank Governor, is ready to bring monetary policy issues in line with fiscal policies through voluntary personal meetings with the Finance Minister and the Prime Minister.¹⁰⁵) In September 1993, Tošovský was elected “Central Banker of the Year” on the occasion of the annual meeting of the International Monetary Fund and the World Bank in Washington. In Poland, the relationship between the government and the central bank looks completely different: Governor Hanna Gronkiewicz-Waltz, who was running an electoral campaign as a candidate for the presidential elections in 1996 while she was still in office as central bank governor, was widely known for being in constant political disagreement with Finance Minister Kołodko, and his predecessors, and for resisting pressures from the government to relax her monetary policy stance. However, in Poland, too, the government and the central bank have found compromise solutions, one example being the widening of the exchange rate band in May 1995.¹⁰⁶)

Another potentially important element of actual CBI is the quality of the bank’s economic or research department and its reputation in comparison with research institutes in the country. It is argued that a central bank governor who can rely on a competent economic department providing him with the necessary argumentation can certainly more easily defend the

central bank's position in the case of disagreement e.g. with the minister of finance. The quality of the research or economic department is *inter alia* reflected by the quality of the bank's publications (annual/quarterly/monthly reports, working or discussion papers and the like).¹⁰⁷) Furthermore, in a number of countries the central bank performs the role of the government's main economic advisor, which considerably strengthens the central bank's reputation and public acknowledgment of its expertise. Moreover, a well-trained staff also in other, e.g. operational, central bank departments can contribute to the good reputation of the bank in the public, thus enforcing its credibility.¹⁰⁸) In general, the central banks of the CEEC-5 have thoroughly invested in their human capital in the last years, recruiting highly qualified staff and providing numerous training opportunities at home and abroad.

A related issue which is of particular importance for transition economies is the remuneration of central bank employees. While some of the CEEC-5 central bank laws contain provisions with regard to the remuneration of top officials (see below), this issue is generally not regulated for central bank staff. Especially in transition economies, where wage levels in the private sector are particularly attractive as compared to the public sector, it is extremely important which yardstick is applied to determine the wage level for central bank employees. In our view, it is advisable to orient the remuneration of the central bankers towards wage levels in the (private) commercial banking sector in order to stop the considerable brain drain already taking place. As the experience of technical assistance and training for the staff of central banks in transition economies has shown, there is a very high fluctuation rate especially for the young central bank personnel, who are typically attracted to positions in the central bank because of interesting training possibilities and who, once they have been trained, change to the private sector due to uncompetitive wage levels in the central bank. Although losses due to this brain drain represent opportunity costs that cannot easily be quantified, a number of central banks should consider redesigning wage schemes (as well as fringe benefits), taking into account the wage structure in the commercial banking sector. Only the Hungarian and the Polish central bank laws contain provisions on the remuneration of the central bank's top officials. According to the Hungarian legislation, it is the duty of the bank's General Meeting to determine the wages of the Governor, the Deputy Governors and the other members of the central bank Council. The Polish law only contains a notion that the remuneration of the President and the Deputy Presidents is determined "in accordance with the ... remuneration for persons holding state managerial positions ... on the basis of an average pay in the banking sector,"¹⁰⁹) thus providing a yardstick for the level of remuneration. However, the question who determines the remuneration of the central bank's top officials and by what criteria their remuneration is set can have implications for the independence of their behavior.

5.3 The Practice of Financial Independence

Although direct central bank credit to the government is legally restricted in all of the CEEC-5 and only permitted under certain conditions which are predetermined by law (see Table 2), in practice these restrictions have sometimes been overruled by the parliaments of some countries through the adoption of budget laws suspending this prohibition.¹¹⁰⁾

The most prominent example in this area is Poland, where every year Parliament suspends Article 34 of the Act on the National Bank of Poland, which exactly specifies the maximum amount of state securities the central bank is allowed to buy on the primary market. After suspending Article 34 of the central bank law, the Polish Parliament then determines the amount of government securities to be purchased by the bank through the adoption of the budget law, thus overruling the central bank law. However, as the new draft constitution prohibits direct central bank credit to the government, the practice of overruling by a simple majority in Parliament will no longer be possible once the new constitution is endorsed.

Another case in point is Hungary before the most recent amendment of the central bank law. At that time, budgetary financing by the central bank was allowed up to a daily limit of 3% of planned annual revenues of the central budget of that year. Moreover, in the original law, a transitory clause permitted unlimited financing in 1992, while the thresholds for 1993 and 1994 were set at 5 and 4% of planned annual budget revenues respectively. The latter limit, however, was effectively raised to approximately 6% of targeted revenues, as the 1994 budget law obliged the central bank to finance a budget deficit up to an amount of HUF 80 billion. To our knowledge, the one and only case of overruling occurred in 1994. As of 1997, there remains only one relatively minor exception to the prohibition of budgetary financing by the central bank (see 4.3).

Other countries did even not use the possibilities for direct lending to the government within the limits stipulated in the central bank laws, which was not particularly difficult for states that did not record any budget deficit. For example, the Bank of Slovenia has never made use of this possibility since its establishment in 1991. In practice, the question of budget deficit financing by the central bank constitutes a source of conflict between the ministry of finance and the central bank in all countries facing a fiscal deficit and is often a highly debated issue.

A potential source of conflict between the central bank and parliament may arise from the provision that the central bank's budget has to be approved by parliament. A conflict with parliament, for instance on excessively high wages, could eventually lead to public criticism and to a loss of credibility and independence.¹¹¹⁾ In the countries examined, only the Slovene central bank law requires that the financial plan of the bank, which is adopted by the Governing Board of the Bank, be approved by Parliament. However, up to now no conflict between the Parliament and the Bank of Slovenia has emerged on this issue.

As mentioned earlier, the performance of a central bank cannot be measured on the basis of its profit and loss account. However, if a central bank does record losses, it is extremely important for its reputation to

explain to the public the origins for these losses and the ways and means to cover them. At the same time, the bank has to make clear that these losses are of a temporary nature and will be quickly eliminated. An interesting case in point is the Czech National Bank, which recorded a loss in 1996. As the Czech central bank law does not contain any provisions regarding the coverage of potential losses, it is interesting to note that – according to the spokesman of the bank – the loss will be covered from future profits¹¹²⁾ and not from the state budget. This example shows that the necessary financial autonomy of the central bank could be maintained in practice even in the absence of legal provisions.

5.4 Policy Coordination Mechanisms in Practice

It is widely acknowledged that a central bank should coordinate its monetary policy with fiscal (and incomes) policies in order to achieve optimal overall results for the economy. The extreme model of an “absolutely” independent central bank can be equated to noncoordination between monetary and fiscal policies or even to the pursuit of a contradictory policy stance. This extreme model would imply the danger of policy conflicts between the government and the central bank, thus worsening the overall economic performance of a country.¹¹³⁾ Therefore, it is often recommended that a certain degree of cooperation between the central bank and other economic policymakers be provided for by law. This is reflected in a number of provisions of central bank laws in Western Europe as well as in the CEEC-5, which determine different forms of coordination between central banks and governments in designing monetary and fiscal policies (see e.g. Table 1). However, this coordination has to be implemented in the practice of political life: In this context Prose¹¹⁴⁾ emphasizes the importance of an institutional framework as a basis for coordinated policies, inter alia highlighting the model of the Austrian social partnership as an example of successful coordination of economic policies in practice. He examines the relationship between the degree of corporatism and various economic indicators in a number of Western countries¹¹⁵⁾ and shows that there is a significant negative correlation between the inflation rate and the degree of corporatism. Moreover, he finds a highly significant negative correlation between the unemployment rate and the degree of corporatism and concludes that countries with a high degree of corporatism have not only achieved price stability, but at the same time have been able to reduce the potential costs of anti-inflationary policies.

However, in practice the degree of actual cooperation between the central bank and the government is determined by a number of additional factors, such as the personality of the central bank governor (and, of course, his counterpart in the ministry of finance) as well as by the political affiliations which typically prevail in the two institutions. In Poland, for example, there is a long-standing debate between the central bank and the Ministry of Finance on the role and the status of the central bank, which is reflected by the long delay in adopting a new central bank law and the dispute on this issue. Despite several years of negotiation, the central bank and the Ministry of Finance have failed to reach agreement on two –

substantially differing – central bank law projects. Moreover, the central bank Governor's campaign for the presidential elections in fall 1996 against the candidate of the ruling government coalition has certainly not contributed to improving cooperation between the central bank and the government. In Hungary, on the contrary, the elaboration of the stabilization program of March 1995 jointly by Lajos Bokros, the Finance Minister at that time, and central bank Governor György Surányi provides a good example of successful cooperation between the central bank and the government. Another example of smooth cooperation between the central bank and the government is Slovenia. Also, the Czech Republic generally enjoyed a good cooperation (see 5.2). However, in one of the few visible instances of disagreement between Governor Tošovský and Prime Minister Klaus – which was on the early introduction of capital account convertibility proposed by the bank in 1993 – Tošovský was overruled by Klaus.¹¹⁶ During recent months, the government has repeatedly criticized the central bank's monetary policy stance as being too restrictive.

6 Conclusions

Reviewing the central bank laws in the CEEC-5, we can state that the central banks in these five countries generally enjoy a relatively high degree of legal CBI, even when the strict requirements of the Maastricht Treaty are applied as a benchmark. The weakest point in the existing legislation, however, concerns the regulations on direct central bank lending to the government, which in principle is still permitted, though largely constrained, in all countries examined in this paper. These clauses will have to be changed for the countries analyzed to meet the requirements set by the Maastricht Treaty, at the latest when they join the European Union. Progress in this direction is clearly underway in the CEEC-5, which is reflected in the recent amendments of central bank laws (e.g. Hungary) or planned law projects (e.g. Poland, Czech Republic). Generally, we see a growing awareness of the importance of CBI, a topic increasingly discussed in the countries analyzed.

As regards actual CBI, a somewhat more diversified picture emerges: Although the legal status of the central bank top officials is well protected by law, the central banks of some countries are not free from actual political interference. The second major weakness lies in the practice of some national parliaments (e.g. in Poland) to overrule the central bank law in the field of direct budgetary financing. However, also in this area improvements are close at hand.

We are convinced that a high degree of legal central bank independence in the CEEC-5, together with a high extent of actual CBI, was and still is necessary to build up the needed credibility of monetary policy in a period of economic transformation and stabilization. Moreover, a further strengthening of both legal as well as actual CBI will be of crucial importance in order to fulfill the requirements of the Maastricht Treaty in view of future EU membership.

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- 1 Both Foreign Research Division of the Oesterreichische Nationalbank. The standard disclaimer applies. We gratefully acknowledge the valuable comments of Peter Backé, Eduard Hochreiter, Margarethe Quehenberger and Doris Ritzberger-Grünwald.
- 2 Our analysis focuses on the Czech Republic, Hungary, Poland, Slovenia and the Slovak Republic (CEEC-5).
- 3 Treaty on European Union, in the following referred to as "the Treaty" or "the Maastricht Treaty" (1992).
- 4 See, e.g., Pönisch (1991) or Sundararajan (1990).
- 5 Except for the Polish central bank law, which is the only remaining central bank act from the pretransition period and which was already adopted in 1989, all other CEEC-5 central bank laws date from the years 1990-1992. However, the Polish law was amended several times (most recently in 1996). A draft for a new Polish central bank law has been debated in the last years, but has not yet been adopted by Parliament.
- 6 It must be noted, however, that all transition economies had to rebuild and modify their institutions.
- 7 This circumstance, of course, also applies to the successor states of the Former Soviet Union, where the former branches of the USSR Gosbank had to be transformed into independent central banks, as well as to the successor states of former Yugoslavia.
- 8 As a case in point, the last amendment to the Hungarian central bank law was approved by Parliament in December 1996 and went into force on January 1, 1997.
- 9 See Cukierman (1995).
- 10 For a comprehensive overview of CBI literature see Eijffinger and De Haan (1996) or Pollard (1993).
- 11 See S. Fischer (1995a).
- 12 See, e.g., Eijffinger and De Haan (1996).
- 13 See S. Fischer (1995b).
- 14 A prominent example of this approach is New Zealand, where the remuneration of the central bank Governor is linked to the realization of the targeted inflation rate.
- 15 Persson and Tabellini (1993), Eijffinger and De Haan (1996).
- 16 While both extremes, namely an entirely dependent as well as a fully independent central bank, can be clearly defined, it is extremely difficult to determine a threshold above which a central bank can be qualified as "independent," i.e. where the minimum critical mass for CBI is to be located.
- 17 See, e.g., Pollard (1993).
- 18 See Proske (1995).
- 19 See A. Fischer (1996).
- 20 See Eijffinger and Schaling (1993).
- 21 See Bade and Parkin (1980).
- 22 As cited in Eijffinger and Schaling (1993).
- 23 See Grilli et al. (1991).
- 24 See Eijffinger and Schaling (1993).
- 25 See Cukierman (1992).
- 26 The Cukierman survey includes prereform legislation in Hungary, Poland, Yugoslavia and Romania.
- 27 See Eijffinger and Van Keulen (1995).

- 28 See, e.g., Hochreiter et al. (1996).
- 29 See Hochreiter (1994) and Hochreiter and Riesinger (1995).
- 30 See Cukierman (1995).
- 31 See, e.g. Alesina and Summers (1993). However, some economists found that higher CBI can lead to stronger recessions during disinflation processes. See, e.g., A. Fischer (1996).
- 32 See, e.g., Krzak (1996).
- 33 Moreover, a number of Former Soviet Union (FSU) countries have recently strengthened CBI. For a comprehensive overview of central bank reform in the FSU, see Sundararajan et al. (1997).
- 34 See Cukierman (1995).
- 35 The European System of Central Banks (ESCB) comprises the European Central Bank (ECB) and the national central banks (NCBs).
- 36 The only partial exception to these obligations relates to the United Kingdom. In case this country chooses to exercise its EMU opt-out clause, the United Kingdom will not be obliged to make the Bank of England independent. (See Protocol 11 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland).
- 37 See Maxfield (1995).
- 38 As the EMI's interpretation of regulations laid down in the EU Treaty and the ESCB Statute is of particular relevance for central banks, we will repeatedly refer to EMI interpretations in our analysis.
- 39 See Banaian et al. (1993).
- 40 See Bank of Japan (1995) and Bruni (1995).
- 41 We are well aware that the issue of accountability is a "horizontal" aspect of CBI and is related to the other four categories described above. However, in our view this issue is particularly relevant with regard to the Maastricht requirements and deserves to be covered under a separate item.
- 42 See Article 9.1 of the Act on the Czech National Bank (1992), Section 12.2 of The National Bank of Slovakia Act (1992) and Article 2 of The Law on the Bank of Slovenia (1991).
- 43 See Article 6 of the Act on the National Bank of Hungary (1991).
- 44 See Cukierman (1992).
- 45 Protocol on the Statute of the European System of Central Banks and of the European Central Bank, in the following referred to as the Statute.
- 46 See, e.g., Swinburne and Castello-Branco (1991).
- 47 See European Monetary Institute (1996).
- 48 See Hochreiter and Riesinger (1995), where the 10 associated countries are reviewed.
- 49 See e.g. Bank of Slovenia, Annual Report 1995.
- 50 See EMI (1996).
- 51 "Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community..." (Article 105 [1] of the Treaty).
- 52 See European Monetary Institute (1996).
- 53 Aspects of accountability are dealt with in section 4.5 of this paper.
- 54 In practice, the CEEC-5 pursue the following exchange rate regimes: fixed peg (Czech Republic and Slovakia), crawling peg (Hungary), crawling band (Poland) and managed float (Slovenia). For details see Radzyner and Riesinger (1996).
- 55 See Article 46.2 of the Act on the National Bank of Hungary (1991).
- 56 However, the new draft constitution of Poland, which was adopted by the National Assembly at the beginning of April 1997 and still has to be endorsed by referendum on May 25, 1997, will change this stipulation: The monetary policy guidelines will be presented to Parliament only for its information. A change of the central bank law in this sense would bring about a substantial enforcement of CBI.
- 57 See S. Fischer (1995b).
- 58 For the specification of the operational framework see European Monetary Institute (1997a).
- 59 According to the new draft constitution, the central bank will be endowed with the sole right to determine and implement monetary policy.
- 60 The right to issue central bank securities is of particular importance in the absence of government papers (surpluses or balance of the state budgets), because in this case they constitute the only instrument available for the sterilization of capital inflows on the domestic market (e.g. Czech Republic and Slovenia).
- 61 See Article 33 of the Act on the National Bank of Poland (1989), Article 33 of the Act on the Czech National Bank (1992), Section 27 of The National Bank of Slovakia Act (1992), Article 25.4 of The Law on the Bank of Slovenia (1991).
- 62 See Bade and Parkin (1988).
- 63 The extreme case in this respect is a Currency Board arrangement: With the exchange rate being fixed vis-à-vis a low-inflation currency, the ability of the central bank to create domestic credit is limited by law

- to the countervalue of incoming foreign exchange. Such arrangements are in operation in Estonia and Lithuania and are currently being debated for Bulgaria.
- 64 See Cukierman (1992).
- 65 We will not deal with the issue of seignorage, as this would go far beyond the scope of this paper. For an analysis of seignorage in selected transition countries see Hochreiter et al. (1996).
- 66 See, e.g., Cottarelli (1993).
- 67 See EMI (1996).
- 68 See Cottarelli (1993) and Leone (1991).
- 69 See Backé and Lindner (1996).
- 70 It should be noted that the draft constitution explicitly prohibits direct central bank lending to the government.
- 71 The National Bank traditionally had the function of raising funds on the international capital markets; from this activity the Bank had incurred sizeable losses due to subsequent forint devaluations. The exchange rate losses on these foreign liabilities had been accounted as non-interest-bearing nonmaturing central budget debt to the NBH. Now the central budget will issue forex-denominated bonds to the NBH in exchange for the non-interest-bearing debt, plus part of the government bonds the NBH received in earlier conversion of the former debt. See Reuters, December 18, 1996.
- 72 See Neumann (1991).
- 73 In this context Neumann (1991) takes an extreme position and demands a sufficiently long, single term of office (minimum of 10 years, ideally between 15 and 25 years) with no possibility of reappointment.
- 74 See, e.g., Cukierman (1992) and Grilli et al. (1991).
- 75 See EMI (1996).
- 76 See EMI (1996).
- 77 These qualification requirements were introduced by the most recent amendment, see Article 58.3 of the Act on the National Bank of Hungary (1991, as amended in 1996).
- 78 See, e.g., S.Fischer (1995b).
- 79 See Zulu et al. (1994).
- 80 See EMI (1997b).
- 81 See EMI (1997b).
- 82 For the monetary strategies pursued by the CEEC-5, see Krzak and Schubert, also in this issue of Focus on Transition.
- 83 See Bank for International Settlements (1996).
- 84 See Article 3 of the Act on the Czech National Bank (1992) and Section 3 of The National Bank of Slovakia (1992).
- 85 See Articles 41 and 48 of the Act on the National Bank of Hungary (1991) and Article 20.1.2 of the Act on the National Bank of Poland (1989).
- 86 A case in point is Russia, where the central bank, "although it is legally independent from the central government (sic!), is answerable to parliament, whose members probably act as the representatives of loan hungry constituencies" (see Cukierman, 1995).
- 87 See Cukierman (1995).
- 88 See Bruni (1995).
- 89 See, e.g., Neumann (1991).
- 90 See Konstytucja Rzeczypospolitej Polskiej (1997).
- 91 See Bruni (1995).
- 92 Cukierman (1995) argued this point even more strongly.
- 93 See Cukierman (1995).
- 94 See, e.g., Cukierman (1992).
- 95 See Cukierman (1992).
- 96 Consequently, the starting dates for the Czech Republic and the Slovak Republic differ from each other and from the date of their formation as two independent states. As the Polish central bank law dates from the prereform period, the reference period is longest and starts even earlier than the "Big Bang." In Hungary, the promulgation of the central bank law took place only in December 1991, even though political consensus on the status of the central bank had already been reached in mid-1990. However, we wanted to avoid arbitrarily setting starting dates for the different countries and preferred a transparent and unbiased criterion to set the reference period.
- 97 An interesting example was the amendment of the Bulgarian central bank law in April 1996, which enabled Parliament to suspend the terms of the central bank Governor and Vice-Governors without prespecified reasons by a three fifths majority of the deputies.

- 98 *Surányi had signed a charter reaffirming democratic values a few months before, thus criticizing the government. This document, as the Prime Minister said, suggested that freedom of speech was somehow in danger in Hungary at that time.*
- 99 *See Reuters, January 10, 1995.*
- 100 *See Reuters, selected reports from the period 1990 to 1997.*
- 101 *See Cukierman (1993).*
- 102 *As cited in Cukierman (1993).*
- 103 *We did not analyze the Czech Republic, the Slovak Republic and Slovenia in this respect, because the period of reference is relatively short for these countries and the turnover rate of governors was low to begin with.*
- 104 *In Poland, for example, inflation was brought down from 586% in 1990 to 20% in 1996 (CPI, annual average).*
- 105 *See Business Central Europe, May 1995.*
- 106 *See Business Central Europe, May 1995.*
- 107 *See Cukierman (1992).*
- 108 *See, e.g., Pönisch (1991).*
- 109 *See Article 56 of the Act on the National Bank of Hungary (1991) and Article 49.7 of the Act on the National Bank of Poland (1989).*
- 110 *An illustrative example outside the CEEC-5 is Russia in 1993, where central bank Governor Gerashchenko and Finance Minister Fyodorov were in constant disagreement on the source of Russian hyperinflation. Interestingly, it was the reform-minded finance minister who claimed a more restrictive monetary policy stance and who criticized the practice of budgetary financing by the central bank. This dispute finally led to Fyodorov's resignation in January 1994, after his repeated demands for Gerashchenko's dismissal had not been met (see Reuters, 1993 and 1994).*
- 111 *See Cottarelli (1993).*
- 112 *See Reuters, January 22, 1997.*
- 113 *See Pollard (1993).*
- 114 *See Proske (1995).*
- 115 *Proske (1995) examines Austria, Germany, the Netherlands, Sweden and Norway as the group of highly corporatized countries, followed by Denmark, Finland, Belgium, Japan, New Zealand and the UK with a medium level of corporatism and France, Italy, Australia, Canada and the U.S.A. with a very low degree of corporatism. The examined time series covers the period from 1970 to 1991.*
- 116 *See Reuters, March 11, 1994.*

Editorial close: May 2

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

Lectures Organized by the Oesterreichische Nationalbank

Within the framework of a series of lectures dealing with topics of particular relevance to transition economies, the OeNB again hosted several lectures, notably by Pierre Siklos of the Wilfrid Laurier University of Ontario, who provided insight into the topic of the credibility of exchange rate regimes, by IMF staff member Richard Stern, who presented recommendations for private sector development in transition economies, and finally by Claudia Buch of the Kiel Institute of World Economics, who gave an overview of the consolidation of the reform process in the banking systems of the Czech Republic, Hungary and Poland. The brief overviews below are intended to give the reader some information about specific developments in transition countries, emphasize the relevance of macroeconomic insights for reform economies as presented by the speakers and touch upon some issues raised during the ensuing question-and-answer period.

Lecture by Pierre Siklos

The Connection between Exchange Rate Regimes and Credibility: An International Perspective

On December 11, 1996, Professor Pierre Siklos of Wilfrid Laurier University, Waterloo, Ontario, spoke to a group of OeNB economists about the link between exchange rate regimes and credibility. The starting point of Mr. Siklos's research is the reasoning that if the credibility of an exchange rate regime has consequences for inflation, one would expect the choice of the exchange rate regime to matter for inflationary performance. He uses a broader classification of exchange rate regimes than the textbook division between fixed and flexible rates in order to grasp the various modalities existing worldwide. Thus he distinguishes among floating regimes, pegs to a single currency or a composite currency, limited flexibility within a group of countries in a cooperative agreement (e.g. EMS), managed floating and a regime in which the exchange rate floats according to some economic indicator. A cross-country time series (quarterly data) framework was used. Estimation of a first-order autoregressive model of inflation in which inflation is conditional on exchange rate arrangement, lagged inflation (capturing persistence of inflation) and other (dummy) variables such as inflationary targeting by a country or geographical region delivered a variety of results.

Some results can be grasped intuitively – e.g. high inflation countries also had the most persistent inflation – but others were more surprising: Countries which pegged their exchange rates experienced higher, not lower, average inflation rates. However, when Siklos controlled for the same level of inflationary persistence, peggers experienced lower inflation rates than countries which allowed some flexibility of exchange rates. Another surprising result was that central bank independence did not matter for inflationary performance; the variables used as proxies were statistically highly insignificant.

Restricting the study to high-inflation countries, defined as the countries whose inflation rate exceeds 40% on an annual basis, he found exchange rate

regimes to have statistically insignificant effects on inflation. In this group the inflationary process was dominated by high persistence.

The model was also estimated separately for periods of falling and rising inflation, which added some new insights. Inflation persistence was found to be much stronger in periods of rising inflation than in periods of decelerating inflation. Managed floating and indicator-adjusted regimes produced the largest negative effects on inflation. Pegged and floating regimes had statistically worse, but identical effects. When the degree of inflation persistence was controlled, countries which pegged their exchange rates experienced the greatest drop in inflation persistence, which may be attributed to the “disciplinary” bonus of this kind of system.

Based on these results, Siklos’s conclusions were the following. If credibility is partially measured by how fast inflation falls over time on its own momentum, a floating regime is preferred, although regimes with a limited flexibility or indicator-adjusted regimes have comparable degrees of inflation persistence. In periods of rising inflation, systems with a limited flexibility in a cooperative setting possess the least persistent inflation rates, while floating, pegged or managed floating regimes do not differ much in a statistical sense. Inflation targeting always delivers lower average inflation regardless of the exchange rate system. The choice of the latter matters for inflationary performance, but it is impossible to pinpoint the one which decisively favors lower inflation.

At the end of his lecture, Siklos discussed the Hungarian and Czech cases to show how difficult it is to identify sources of credibility, as exchange rate regimes with limited flexibility have many benefits on the one hand, but also have numerous drawbacks.

Lecture by Richard Stern

Private Sector Development in Transition Economies

On December 12, 1996, Richard Stern, a staff member in the European II Department of the IMF, gave a lecture on private sector development in transition economies. In Mr. Stern’s view, the expansion of the private sector has lagged behind expectations in most transition economies. The basic reason for this is that the microfoundations for private sector development have not been fully and consistently laid in most transition economies.

Four preconditions have to be fulfilled for smooth private sector development. First, an appropriate legal and institutional framework has to be put in place, as it does not simply evolve on its own. The importance of this and the trickiness of this process has been increasingly acknowledged by the IMF during the recent past. Second, while privatization is not a panacea, it definitely is important, as the authorities can earn credibility if they properly design and consistently implement a privatization program. The sequencing of privatization is less crucial than establishing privatization goals and subsequently sticking to them. Privatization is most effective if it is linked to financial sector development in general and the establishment of investment funds in particular and if, in addition, the participation of

foreigners in the process is encouraged. Such an approach has a further advantage, namely that it eases the financial constraints on the transforming economy. Finally, it is important to ensure that capital is in fact available. This relates to issues like the ability to collateralize assets, the availability of land and investment protection for foreigners and the like. In the final part of his lecture, Mr. Stern presented a cross-country comparison of private sector development in four transition economies, namely the Czech Republic, Poland, Estonia and Latvia.

In the discussion, the changing approach of the IMF towards the relevance of a sound legal and institutional framework was noted with satisfaction and it was mentioned that Austrian and German economists had very much stressed the importance of such a frame already in the early phases of transition, although without earning full understanding in the discussion prevailing at the time. Furthermore, the political economy aspect of this issue was raised. Other points in the discussion related to the retreat of the state from agriculture, to the privatization of banks and to the issue of standard versus nonstandard methods of privatization.

Lecture by Claudia Buch

The Banking Systems of the Czech Republic, Hungary and Poland: From Gradualism to the Consolidation of Reforms

Claudia Buch of The Kiel Institute of World Economics held a lecture on April 28, 1997, in which she highlighted some of the most important aspects of banking reform in transition economies and reviewed the reform process in three of the more advanced reform states, i.e. the Czech Republic, Hungary, and Poland. Ms. Buch states that raising the static and the dynamic efficiency of the banking systems through internal and external financial liberalization has been identified as the main goal of the reforms. In a first stage of internal financial liberalization, the monobank system of centrally planned economies and, later, controls on the activities of commercial banks have to be abolished. All countries under review successfully implemented these reforms in the very early transition period. In a few other post-socialist economies, notably the Republic of Belarus, however, elements of central planning are still present or have even been reinforced recently. The second stage of internal financial liberalization requires reforms which are suited to raising the efficiency of the domestic banking system. These reforms comprise the recapitalization of the successor banks of the monobank, bank privatization, and the creation of a new institutional framework for the operations of commercial banks. Finally, internal financial liberalization must be accompanied by external financial liberalization, i.e., the introduction of capital account convertibility and the market entry of foreign banks.

The needed internal and external financial reform measures have been implemented gradually in the countries under review. Internal reforms designed to deepen and consolidate early reform measures have been partly held back for various reasons, and external financial liberalization – notably

the opening up for foreign banks – is incomplete as yet. The main reasons for these delays are organizational bottlenecks, fiscal constraints preventing the early recapitalization of the incumbent banks, and close ties between the government and commercial banks, which delayed more radical reforms. Delayed recapitalization of commercial banks is one main reason why bank privatization and external financial liberalization were not pursued more vigorously. As a result of the gradualism in banking reform, the traditional banks still enjoy substantial market power, interest rate spreads have not come down sufficiently, and credit allocation has been biased towards safe assets such as government securities.

There are several measures through which obstacles to reforms can be overcome. Strengthening banking supervision early on and enforcing prudential regulations can substantially raise the credibility of the reform program and contribute to an improvement in the incentive system of banks. If an already tight budget constraint of the government prevents the recapitalization of banks, foreign financial assistance can help to ameliorate this constraint and furthermore contribute to a transfer of know-how into the emerging financial systems. Finally, liberalizing the market entry of foreign banks and speeding up the privatization of domestic banks can help to break up implicit contracts between the government and commercial banks.

The risk of domestic banks which are burdened by nonperforming loans going bankrupt if foreign banks enter the market is often voiced as an argument against liberalizing market entry. Postponing external financial liberalization shields domestic banks which have not yet been recapitalized from the loss of market shares. Yet postponing the market entry of foreign banks is likely to be the wrong strategy for the transition economies. Gradual recapitalization through high interest spreads leads to a suboptimal investment level; credit allocation is potentially biased towards ailing, state-owned firms, and a greater transfer of know-how through foreign banks is prevented. A superior strategy would be to relieve domestic banks of their burden of inherited bad loans early on through recapitalization. Once the problem of inherited nonperforming assets has been dealt with through the recapitalization of banks, the case for a protectionist regime vis-à-vis foreign banks is substantially weakened. Internal and external financial liberalization can then proceed in parallel.

Ms. Buch concludes that in view of the progress that has already been made with respect to bank recapitalization in the countries under review, a strong case can thus be made for liberalizing the market entry of foreign banks even further. This includes the application of the concept of home country control for those banks whose home country banking supervision can guarantee compliance with international banking standards. Fears that the market access of foreign banks would put the overall viability of domestic banks at risk appear misplaced. Rather, domestic banks should be able to exploit their comparative advantages in the area of retail banking and the financing of small and medium-sized firms. The evidence in fact shows that new foreign market entrants tend to occupy certain market niches rather than enter the traditional banking business on a large scale.

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

The history and purpose of this series of meetings initiated in 1991 is described in detail in “Focus on Transition 1/1996.” The series was continued with two presentations held in December 1996 and March 1997. As always, the East Jour Fixe meetings were opened with speeches held by specialists about topical issues related to transition economies. The talks are subsequently commented by invited discussants. Policymakers, analysts and researchers have the opportunity for an exchange of views during the general discussion, which is a very important item on the agenda.

Stijn Claessens, Principal Economist at the World Bank, presented the 1996 World Development Report-From Plan to Market at the 26th East Jour Fixe, and at the 27th East Jour Fixe meeting, Tomáš Jezek, Chairman of the Chamber of the Prague Stock Exchange, provided recent information about the Prague Stock Exchange as an example of the development of capital markets in Central and Eastern Europe. The main findings of these meetings are reported below.

Contribution by Stijn Claessens, The World Bank

The 1996 World Development Report: “From Plan to Market”

Held at the 26th East Jour Fixe on December 6, 1996

Mr. Stijn Claessens, principal economist of The World Bank, chose to discuss six issues the World Bank sees as vital for transition economies.

The first issue Mr. Claessens went into is that “*reforms pay off.*” Consistent, sustained policies can pave the way for successful economic adjustment and rapid growth - even in countries lacking clear property rights and strong market institutions. In Central and Eastern Europe, the Newly Independent States (NIS), China, Mongolia and Vietnam, the most effective policies to date have been those that liberalize markets and trade, open the economy to new businesses, and help stabilize prices.

The second issue concerns the choice between “*rapid or gradual reform.*” This question has no single or simple answer. Many countries were not in a position to choose between the two. In Central and Eastern Europe and the NIS, economic reforms paralleled the dismantling of the old political system. These countries had to overcome huge trade declines as well as severe macroeconomic imbalances and structural distortions created by central planning. Therefore, they faced a difficult choice between rapid systemic reforms, which often entailed painful structural adjustment, or incremental efforts to introduce change. For most transition economies, the answer to the question about the pace of change has now become clear: faster and more consistent reform is better.

The third issue transition economies must tackle is “*getting property rights right.*” The first step is to move from the centrally planned regime of transfers and subsidies to one that allows for risk, imposes financial discipline, and creates profit-oriented incentives. Experience reveals a tension between promoting efficiency and rewarding existing stakeholders – managers and workers – with a share in ownership. Smaller assets are easiest to privatize,

and the outcomes are usually good. But larger assets are more problematic, and the trade-offs among the different means and ends of privatizing are intricate and intensively political. The broader goal is to develop efficient secondary trading, enabling ownership claims to be reorganized smoothly in response to the needs of a market economy.

The fourth issue Mr. Claessens raised is *“mobility, poverty, and pensions: revamping social policy.”* Some increase in the disparity of wages, income, and wealth is a necessary part of transition, because allowing the market to determine these elements creates incentives for efficiency that are essential for successful reform. The largest social problem is the funding of state pensions. Private pensions are desirable for a variety of reasons, but they are no substitute for directly addressing excessive spending in the state sector.

The fifth issue reform countries need to deal with successfully is *“creating institutions that support markets.”* Developing the rule of law is a priority. To ensure effective enforcement, the countries need to empower judges, prosecutors, and private lawyers. Moreover, they have to create other “watchdog” institutions, such as auditors or securities regulators, and they must develop such elements of civil society as a free press. A good financial system and functioning capital markets play an integral role in a market economy.

Finally, transition economies must consider *“international integration”* a key to successful reform. As transition countries had been isolated from the world market for a long time, there is a special need to integrate them into international organizations such as the IMF and the World Bank, the WTO, OECD, EU and also regional organizations.

Contribution by Tomáš Jezek

Chairman of the Chamber of the Prague Stock Exchange The Development of Capital Markets in Central and Eastern Europe – The Example of the Prague Stock Exchange Held at the 27th East Jour Fixe on March 14, 1997

Mr. Tomáš Jezek, Chairman of the Chamber of the Prague Stock Exchange (PSE), gave an overview of the developments on the Prague Stock Exchange since its establishment in 1993 and elucidated the steps taken to create European standards for the PSE.

Although it had already been established in the 1870s, the Prague Stock Exchange’s modern history has been exceedingly brief. The first modern-day trading commenced on April 6, 1993, after a 55-year hiatus (following the last session in 1938). But every cloud has a silver lining: The Prague Stock Exchange has now joined the fully electronic stock exchanges of the world and works with securities in a dematerialized form. It has a membership in excess of one hundred, including many subsidiaries of large international companies. The PSE has established a reliable clearing house with a wide scope of well-functioning services. Intensive effort has gone into the

development and strengthening of information flows about listed securities issues.

The stock exchange's renewal is related to the voucher privatization, the method chosen to privatize extensive assets. The two waves of voucher privatization took place in the period 1992 to 1995. At the outset, almost one thousand issues were launched in 1993, and subsequently, in 1995, more than seven hundred were registered at the stock exchange. Market capitalization amounted to CZK 500 billion (USD 18 billion) in 1996. Trading with all issues began in earnest. From the very first session, the trade value kept on increasing at a rapid pace. Having amounted to a mere CZK 9 billion in 1993, the trade value shot up to almost CZK 400 billion in 1996 (about USD 14.4 billion).

Currently, 120 issues are listed on the main and secondary markets. All other issues (1,500) are traded on the free market. The markets subject the issuers to strict disclosure rules in the form of internationally accepted quarterly financial statements. This information is then promptly disseminated by CEKIA, a subsidiary of the stock exchange. In addition, all transactions falling under the price-sensitive information category have to be reported. The free market issuers' reporting duties are less stringent. Besides shares and units, bonds are also traded on the stock exchange.

In March 1996, the stock exchange implemented continual trading in the most liquid issues. Derivatives trading will commence in the second half of 1997. The modernization of the trading system scheduled for 1997 will help to gradually meet the European standards. The stock exchange settles the trades via its subsidiary UNIVYC (Universal Settlement Centre). This allows for a wide range of capital market transactions to be performed by traders within the scope or rules delineated by the Czech legal environment.

Some people say the post-privatization capital market should bring a concentration of asset holdings, also called "the third wave of privatization," and the implementation of European legislative standards should wait until concentration has been completed. This, however, would lead to the loss of investor confidence, since the concentration of assets is to the detriment of minority shareholders.

The Prague Stock Exchange took the initiative to introduce a securities watchdog and started to prepare draft legislation for the establishment of an independent Securities Commission in mid-1996. The government gave the establishment of the Commission its approval at the end of 1996.

Mandatory reporting of all real-time capital market trading became effective March 1, 1997. This should help to attain transparency in trading and also reduce off-stock exchange trading. In addition, it should increase the volume of price-setting trades, thus increasing the reliability of the prices quoted by the Prague Stock Exchange. It is expected that 1997 will bring about a decisive move of the Czech capital markets towards European standards.

Technical Cooperation of the Oesterreichische Nationalbank with Central and Eastern European Transition Countries

In the first half of 1997, the OeNB continued its cooperation activities with Central and Eastern Europe and CIS republics both on a bilateral and on a multilateral level.

The OeNB staged a number of bilateral technical cooperation activities, organizing various short study and information visits as well as specific consultations for Central and East European central bankers at the OeNB. As a case in point, the OeNB organized a one-week study visit on balance-of-payments statistics for employees of the National Bank of Poland in March 1997. A high-ranking delegation from the National Bank of Russia spent several days at the OeNB in April 1997 to gather information on payment systems and electronic money. Moreover, the OeNB held consultations with representatives from the Bank of Slovenia (organizational and personnel matters), from the National Bank of Poland (computer support of the central bank's ledger) and the Central Bank of Russia (banking supervision). Furthermore, the OeNB will continue to host one-year traineeships for employees of Central or Eastern European central banks. Under this program, an employee from the National Bank of Hungary has been appointed to a traineeship position from May 1997.

In view of the new challenges the associated countries face in connection with EU accession, the OeNB will organize a one-week study tour on the organization of EU-related work of central banks for the National Bank of Poland in June 1997. Moreover, starting in 1997, the OeNB is organizing a series of four highly specialized one-week seminars exclusively designed for central bankers. These seminars, which are held within the organizational framework of the Joint Vienna Institute, are presented in English and cover the following topics: central bank accounting (February 1997, completed), internal auditing and central bank controlling (July 1997, under preparation), exchange rate and portfolio management (September 1997), and finally payment systems (November 1997).

At a multilateral level, the OeNB took part in the concertation meeting of the EU-financed technical assistance program for the Central Bank of Russia in St. Petersburg in October 1996. Under this program, the OeNB will contribute two one-week seminars in 1997, one on central bank accounting and one on human resource management. In January 1997, the OeNB participated in the coordination meeting of an EU-financed technical assistance program for the National Bank of Ukraine. The OeNB will contribute to this multilateral endeavor during the program's second phase, which is scheduled to start in October 1997. Within the framework of its cooperation with the Joint Vienna Institute (JVI), the OeNB organized several lectures for seminar groups as well as individual meetings for JVI course participants at the Bank in the first half of 1997. Moreover, as in the previous years, the OeNB and the Ministry of Finance jointly organized and financed a one-week study tour of Austria for the participants who completed the JVI comprehensive course begun in October 1996.

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

Gross Domestic Product

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
<i>Annual change in %</i>											
1989	- 1.9	4.5	x	0.7	x	x	0.2	- 5.8	x	1.0	-1.8
1990	- 9.1	- 1.2	x	- 3.5	x	x	-11.6	- 5.6	- 3.0	- 2.5	-4.7
1991	-11.7	-14.2	x	-11.9	x	x	- 7.0	-12.9	- 5.0	-14.5	-8.9
1992	- 7.3	- 6.4	-12.4	- 3.1		x	2.6	- 8.7	-14.5	- 6.5	-5.5
1993	- 1.5	- 0.9	- 8.5	- 0.6	-14.9	-30.3	3.8	1.5	- 8.7	- 3.7	2.8
1994	1.8	2.6	- 2.7	2.9	0.6	1.0	5.2	3.9	-12.7	4.9	5.3
1995	2.6	4.8	3.2	1.5	0.4	3.1	6.5	7.1	- 4.0	6.8	3.9
1996	- 9.0	4.2	3.1	1.0	2.5	3.5	5.5	4.1	- 2.8	7.0	3.5
1995											
3rd quarter	..	6.3	..	..	- 2.3	..	..	..	- 3.7	8.2	2.9
3rd quarter	..	5.0	..	..	- 3.5	..	..	..	- 4.3	8.5	1.6
1996											
1st quarter	- 2.6	4.6	- 0.3	0.0	2.3	..	3.9	..	- 3.3	7.3	1.5
2nd quarter	- 9.8	4.6	4.2	0.0	0.7	..	5.2	..	- 5.7	6.9	2.5
3rd quarter	..	3.6	4.5	1.0	3.8	..	7.3	..	- 7.3	6.9	3.4
3rd quarter	..	4.7	7.0	3.0	3.2	..	7.7	..	- 5.7	6.7	4.1

Source: WIIW (Vienna Institute for Comparative Economic Studies); Estonia, Latvia, Lithuania: IMF; Quarterly data: national sources.

Industrial Production

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania ¹⁾	Poland	Romania	Russia	Slovak Republic	Slovenia
<i>Annual change in %</i>											
1989	- 1.1	1.7	x	- 2.1	x	x	- 0.5	- 2.1	1.4	- 0.7	1.1
1990	-16.7	- 3.3	x	-10.2	x	x	-24.2	-19.0	- 0.1	- 4.0	-10.5
1991	-22.2	-24.4	x	-16.6	x	- 4.9	- 8.0	-22.8	- 8.0	-19.4	-12.4
1992	-15.9	- 7.9	x	- 9.7	-34.6	-51.6	2.8	-21.9	-18.0	- 9.5	-13.2
1993	-10.9	- 5.3	x	4.0	-38.1	-34.7	6.4	1.3	-14.1	- 3.8	- 2.8
1994	8.5	2.1	- 2.2	9.5	- 9.5	-29.8	12.1	3.3	-20.9	4.8	6.4
1995	5.4	8.7	4.7	4.6	- 6.3	1.0	9.7	9.4	- 3.0	8.3	2.0
1996	- 1.1	6.8	..	2.3	0.0	2.3	8.5	9.9	- 5.5	2.5	1.0
1995											
July	12.7	7.0	14.2	7.0	- 7.4	5.3	11.1	9.0	2.2	5.4	1.3
August	5.5	7.0	17.7	2.4	- 1.2	22.6	9.1	8.0	- 2.2	10.7	- 5.1
September	- 1.6	7.1	9.5	2.1	- 1.8	5.8	7.3	10.1	- 0.1	12.3	- 0.2
October	7.8	18.4	16.4	4.3	- 4.7	7.8	14.2	14.6	- 2.3	12.7	0.0
November	2.9	11.8	7.7	0.4	- 2.3	8.7	9.6	10.4	- 3.3	9.9	0.5
December	-15.9	7.7	- 4.4	- 4.5	- 6.5	5.7	1.6	5.2	- 2.2	2.7	- 5.7
1996											
January	7.4	12.0	5.3	2.6	0.3	17.3	9.6	8.4	3.0	11.6	- 5.0
February	- 5.9	13.4	5.0	4.6	0.0	14.7	8.7	7.0	0.6	9.7	- 4.0
March	- 6.9	4.5	2.9	- 1.6	- 5.8	0.2	7.0	2.3	0.0	1.1	- 6.4
April	- 4.8	12.8	9.3	5.2	- 1.9	- 1.3	14.8	12.7	4.8	1.6	11.5
May	- 8.2	6.1	5.2	- 3.2	3.2	1.7	9.1	10.6	- 5.9	0.0	- 0.5
June	- 1.5	1.6	- 4.6	- 0.2	6.0	- 8.3	2.6	6.0	- 2.8	- 1.8	-11.5
July	- 1.1	15.7	8.4	8.3	11.6	13.4	13.2	16.4	1.6	3.1	6.1
August	1.1	6.0	5.4	- 3.1	5.5	- 2.7	6.9	5.8	- 8.5	- 2.0	- 1.9
September	-11.1	7.0	8.4	2.4	- 0.6	- 7.9	8.1	10.5	- 6.8	3.1	5.1
October	- 6.9	5.0		5.1	2.6	14.0	13.3	9.2	- 4.0	3.8	9.9
November	- 8.0	1.4		5.9	- 4.9	-17.4	4.7	12.3	- 6.0	- 0.1	3.6
December	0.8	1.5		3.3	- 5.3	4.4	10.0	8.5	- 6.3	1.2	8.0
1997											
January	- 4.0	- 3.9	..	6.4	- 2.0	- 5.5	8.7	12.3	0.3	1.0	..
February	..	..	..	7.8	..	-11.0	8.8	..	..	..	..
March	..	..	..	3.6	..	..	4.8	..	..	..	..

Source: annual data: WIIW; Estonia, Latvia, Lithuania: national sources. Monthly data: OECD; Bulgaria, Russia: national sources from August 1996; Romania: national sources from September 1996; Poland: national sources from February 1997.

¹⁾ IIP - manufacturing.

Unemployment Rate

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
End of period (in %)											
1989	x	x	x	0.4	x	x	x	x	x	x	3.5
1990	1.7	0.8	x	1.9	x	x	6.3	x	x	1.6	5.8
1991	11.1	4.1	x	7.8	x	x	11.8	3.0	0.1	11.8	10.1
1992	15.2	2.6	x	13.2	2.3	x	13.6	8.2	0.8	10.4	13.4
1993	16.4	3.5	4.1	13.3	5.8	3.4	16.4	10.4	1.2	14.4	15.4
1994	12.8	3.2	4.1	11.4	6.5	4.5	16.0	10.9	2.1	14.8	14.2
1995	11.1	2.9	4.0	11.1	6.6	7.3	14.9	9.5	3.2	13.1	14.5
1996	12.5	3.5	4.3	10.7	7.0	6.2	13.6	6.3	4.0	12.8	14.4
1996											
January	13.4	4.0	4.7	11.3	6.6	..	15.4	9.3	8.8	13.7	14.4
February	11.4	4.1	4.8	11.6	6.8	8.3	15.5	9.4	9.0	13.7	14.2
March	11.4	3.0	4.7	11.6	7.0	..	15.4	9.2	9.0	13.3	13.9
April	11.0	2.8	4.7	11.2	7.1	..	15.1	8.3	9.0	12.5	13.8
May	10.4	2.7	4.6	10.7	7.1	7.0	14.7	7.7	9.1	11.9	13.7
June	10.0	2.8	4.1	10.6	7.0	..	14.3	7.1	9.2	12.1	13.3
July	10.4	3.0	4.3	10.8	7.1	..	14.1	6.4	9.2	12.5	13.3
August	10.4	3.1	4.1	10.8	7.1	6.4	13.8	6.2	9.2	12.3	13.5
September	10.5	3.2	4.2	11.0	7.0	..	13.5	6.3	9.2	12.2	13.7
October	11.0	3.2	4.4	10.8	7.0	..	13.2	6.3	9.2	12.0	14.0
November	12.0	3.3	4.4	10.6	7.1	6.2	13.3	6.1	9.4	12.2	14.0
December	12.5	3.5	4.3	10.5	7.2	..	13.6	6.3	9.3	12.8	14.4
1997											
January	13.4	4.0	4.6	10.6	7.3	..	13.5	6.7	9.5	13.6	14.6
February	..	4.1	..	11.1	..	..	13.4	7.1	9.5	13.7	..
March	..	..	..	11.0	..	..	13.0	7.2	9.6	..	..

Source: IMF; Latvia, Lithuania: national sources; Poland: national sources from March 1997.

Consumer Price Index

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia ¹⁾
Period average (annual change in %)											
1989	x	x	x	17.0	x	x	251.1	1.1	x	x	1,306.0
1990	23.8	9.9	x	28.9	x	x	585.8	5.1	5.3	10.6	549.7
1991	338.5	56.7	x	35.0	x	x	70.3	170.2	92.6	61.2	117.7
1992	91.3	11.1	x	23.0	243.6	x	43.0	210.4	1526.0	10.0	201.3
1993	72.9	20.8	89.8	22.5	108.8	409.6	35.3	256.1	875.0	23.2	32.3
1994	96.2	10.0	47.7	18.8	35.9	72.1	32.2	136.8	307.0	13.5	19.8
1995	62.2	9.1	28.8	28.2	25.0	39.7	27.8	32.3	198.0	9.9	12.6
1996	123.3	8.8	23.1	23.6	17.6	24.6	19.9	38.8	47.6	5.8	9.7
1996											
January	478.3	7.4	28.8	28.9	23.2	32.4	21.0	26.7	104.3	6.4	8.5
February	28.7	7.3	29.4	28.3	21.4	30.4	20.4	27.4	89.2	6.2	8.5
March	26.5	8.9	28.3	25.6	20.2	31.4	20.4	28.4	78.6	6.1	9.3
April	28.9	8.5	29.4	24.4	18.6	31.3	20.3	28.7	68.2	6.0	10.7
May	42.3	8.7	26.7	23.9	17.4	28.9	19.8	34.1	58.4	6.1	10.9
June	70.4	8.4	24.7	23.6	17.6	28.1	19.5	33.7	50.1	6.2	10.5
July	107.0	9.4	23.0	23.0	17.7	24.9	20.4	40.1	43.5	5.5	10.7
August	141.0	9.6	21.8	22.9	17.4	24.3	20.5	44.0	36.8	5.6	10.3
September	173.3	8.9	20.1	22.2	16.1	22.3	19.5	45.1	31.4	5.2	9.4
October	211.1	8.7	17.2	21.0	15.7	18.7	19.5	45.0	27.0	5.3	9.7
November	232.6	8.6	16.4	20.1	14.4	15.0	19.1	47.3	23.9	5.4	8.6
December	311.4	8.6	14.8	19.8	13.2	13.1	18.5	56.7	21.7	5.4	8.8
1997											
January	478.3	7.4	12.6	18.9	11.4	..	17.8	76.1	19.6	5.8	9.0
February	..	7.3	10.0	18.8	9.9	..	17.3	105.3	18.1	6.0	8.5
March	..	..	..	18.8	..	..	16.6	16.5	..	..	7.2

Source: WIIW; Estonia, Lithuania, Latvia: IMF; Hungary, Poland, Russia, Slovenia: national sources from March 1997.

¹⁾ Retail price index.

Trade Balance

	Bulgaria ¹⁾	Czech Republic	Estonia	Hungary	Latvia	Lithuania ²⁾	Poland	Romania	Russia	Slovak Republic	Slovenia
USD million											
1989	-1,199.0	x	x	537.0	x	x	240.0	2,559.0	x	x	x
1990	- 757.0	x	x	348.0	x	x	2,214.0	-1,743.0	x	x	x
1991	- 32.0	x	x	189.0	x	x	51.0	-1,254.0	x	x	x
1992	- 212.4	x	x	- 48.0	x	x	512.0	-1,420.0	x	x	791.1
1993	- 885.4	- 311.7	- 91.0	-3,247.0	37.0	-154.7	-2,293.0	-1,128.0	x	- 932.0	-154.2
1994	- 16.9	- 888.9	- 353.0	-3,635.0	-252.0	-204.9	- 836.0	- 411.0	19,711.0	58.5	-337.9
1995	121.0	-3,677.9	- 707.1	-2,599.0	-458.2	-698.0	-1,827.0	-1,231.0	22,754.0	24.1	-956.6
1996	..	-5,906.0	-1,141.1	-3,064.0	-789.5	-878.6	-8,154.0	-1,696.6	..	-2,105.8	-852.8
1996											
January	- 26.2	- 291.4	- 66.6	- 300.9	- 55.1	..	- 661.0	- 50.1	1,576.0	- 71.1	46.0
February	- 20.8	- 309.3	- 66.7	- 269.6	- 65.5	..	- 399.0	14.4	1,528.0	- 369.1	- 67.7
March	- 32.0	- 399.1	- 85.9	- 191.0	- 65.6	-152.3	- 382.0	- 100.1	2,592.0	- 82.9	-111.8
April	- 63.2	- 454.9	- 84.3	- 258.8	- 61.3	..	- 520.0	- 173.2	2,097.0	- 191.0	- 82.6
May	- 25.7	- 560.8	- 74.6	- 196.6	- 58.2	..	- 649.0	- 85.8	911.0	- 135.7	-146.2
June	47.5	- 493.7	- 82.4	- 215.5	- 47.6	-142.2	- 535.0	- 104.1	2,065.0	- 45.9	- 98.6
July	45.5	- 633.2	- 106.4	- 248.8	- 42.8	..	- 540.0	- 126.2	1,785.0	- 149.9	- 46.5
August	111.2	- 528.7	- 80.5	- 227.9	- 55.2	..	- 810.0	- 39.9	1,751.0	- 131.5	- 82.8
September	95.3	- 402.6	- 89.0	- 244.2	- 60.7	-155.1	- 764.0	- 30.1	2,810.0	- 66.9	- 27.3
October	..	- 560.4	- 122.9	- 272.5	- 75.1	..	-1,131.0	- 348.0	3,178.0	- 171.8	- 34.5
November	..	- 610.9	- 122.9	- 290.8	- 68.7	..	- 805.0	- 284.0	1,883.0	- 201.8	-150.3
December	..	- 658.2	- 158.8	- 347.7	-133.7	-429.0	- 958.0	- 369.0	2,906.0	- 480.1	- 50.7
1997											
January	..	..	..	- 210.0	..	..	-1,476.0	..	2,700.0	..	..
February	..	..	..	..	..	..	-2,182.0	..	..	..	..
March	..	..	..	..	..	..	..	..	..	..	..

Source: national sources; Hungary: UNB monthly report 2/97; Poland: national sources from February 1997.

Current Account

	Bulgaria ¹⁾	Czech Republic ²⁾	Estonia ²⁾	Hungary ²⁾	Latvia ²⁾	Lithuania	Poland	Romania	Russia ²⁾	Slovak Republic ¹⁾	Slovenia
USD million											
1989	-1,306.0	x	x	-1,437.0	x	x	-1,419.0	2,864.0	x	x	x
1990	-1,152.0	x	x	127.0	x	x	716.0	-1,656.0	x	x	x
1991	- 76.9	x	x	267.0	x	x	-1,359.0	-1,187.0	x	x	x
1992	- 360.5	x	36.1	324.0	191.0	x	- 269.0	-1,564.0	x	x	926.2
1993	-1,098.0	114.6	23.3	-3,455.0	417.0	-85.7	-2,329.0	-1,174.0	x	- 601.2	191.9
1994	- 31.9	- 49.7	-170.8	-3,911.0	201.0	-93.8	- 944.0	- 428.0	11,364.0	664.9	540.4
1995	- 25.6	-1,362.3	-187.9	-2,480.0	36.3	..	-2,299.0	-1,336.0	11,290.0	391.4	- 36.4
1996	0.0	-4,475.8	..	-1,678.0	..	..	-1,352.0	..	13,000.0	-1,940.8	46.5
1996											
January	- 159.4	..	..	- 294.0	..	..	- 709.0	- 39.0	..	- 19.6	114.9
February	- 26.7	..	..	- 313.0	..	..	- 447.0	9.0	..	- 326.5	- 9.6
March	- 61.5	- 541.1	- 93.2	- 219.0	- 97.7	..	- 513.0	- 126.0	5,846.0	- 73.5	- 56.3
April	- 64.1	..	..	78.0	..	..	-1,006.0	- 152.0	..	- 184.3	- 2.0
May	- 26.6	..	..	10.0	..	..	- 555.0	- 114.0	..	- 105.0	- 81.5
June	22.7	-1,163.7	- 57.8	- 196.0	- 80.1	..	- 539.0	- 98.0	..	- 28.2	- 15.2
July	- 14.0	..	..	- 33.0	..	..	- 436.0	- 175.0	..	- 110.1	28.4
August	195.8	..	..	- 99.0	..	..	- 645.0	- 13.0	..	- 110.1	30.7
September	100.1	-1,377.9	- 70.8	- 38.0	- 94.8	..	- 978.0	- 4.0	..	- 74.4	57.7
October	..	..	..	- 20.0	..	..	-1,174.0	- 361.0	..	- 142.2	54.2
November	..	..	..	- 53.0	..	..	- 650.0	- 511.0	..	- 226.4	- 70.0
December	..	-1,393.1	..	- 501.0	..	..	- 853.0	..	..	..	- 4.8
1997											
Jänner	..	..	..	- 300.0	..	..	-1,312.0	..	..	..	..
February	..	..	..	..	..	..	-1,925.0	..	..	..	..

Source: national sources; Poland: national sources from February 1997.

Total Reserves minus Gold

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
End of period (USD million)											
1989	x	x	x	1,246.0	x	x	2,314.3	1,859.0	x	x	x
1990	x	x	x	1,070.0	x	x	4,492.1	524.0	x	x	x
1991	320.0	x	x	3,936.0	x	x	3,632.6	695.0	0.0	x	112.1
1992	902.0	755.0	170.2	4,428.0	x	45.3	4,099.1	826.0	2,000.0	x	715.5
1993	655.0	3,789.4	386.1	6,771.0	431.6	350.4	4,091.9	995.0	5,835.0	449.5	787.8
1994	1,002.0	6,144.5	443.4	6,810.0	545.2	525.5	5,841.8	2,086.0	3,980.4	1,745.0	1,499.0
1995	1,236.0	13,843.0	579.9	12,052.0	504.0	757.1	14,774.1	1,579.0	14,382.8	3,418.4	1,820.8
1996	483.0	12,297.0	636.8	9,714.0	654.1	772.2		2,103.0	11,277.8	3,434.4	2,297.4
1996											
January	956.0	13,454.0	570.5	12,058.0	498.7	666.1	15,317.0	1,392.0	11,897.5	3,252.9	1,714.1
February	860.0	13,923.0	569.8	11,458.0	505.8	614.9	16,818.7	1,343.0	12,688.7	3,343.1	1,622.3
March	644.0	13,061.0	569.6	10,790.0	519.8	630.4	17,363.4	1,499.0	16,331.1	3,404.1	1,558.1
April	628.0	12,649.0	608.3	9,643.0	542.4	644.1	17,207.2	1,381.0	14,269.0	3,352.1	1,587.8
May	600.0	12,689.0	598.6	9,510.0	566.3	653.7	17,824.1	1,716.0	12,004.3	3,300.1	1,516.8
June	573.0	12,633.0	591.6	9,794.0	570.2	672.5	17,450.8	1,869.0	12,792.3	3,322.1	1,658.5
July	480.0	12,835.0	604.7	9,407.0	583.1	738.7	17,608.1	1,848.0	12,496.9	3,449.1	1,768.7
August	548.0	12,900.0	588.6	9,697.0	597.6	790.5	11,778.3	1,697.0	12,088.7	3,622.9	2,302.7
September	471.0	12,550.0	588.6	10,322.0	598.3	773.9	17,364.9	1,656.0	11,398.5	3,600.3	2,284.6
October	490.0	12,585.0	601.7	10,108.0	614.9	780.8	17,511.7	2,123.0	10,514.8	3,547.8	2,375.8
November	490.0	12,519.0	631.3	9,774.0	623.5	742.0	17,656.9	1,994.0	11,663.4	3,540.1	2,409.3
December	483.0	12,352.0	636.8	9,714.0	654.1	772.2	18,030.0	2,103.0	11,277.8	3,418.9	2,297.4
1997											
January	380.0	11,846.0	636.8	9,013.0	646.4	731.2	18,210.0	1,783.0	..	..	2,257.4
February	..	..	..	..	..	733.0	18,280.0	..	..	..	..

Source: IMF; Poland: national sources from December 1997.

Central Government Surplus/Deficit

	Bulgaria	Czech Republic	Estonia ¹⁾	Hungary ²⁾	Latvia	Lithuania	Poland ³⁾	Romania ⁴⁾	Russia	Slovak Republic	Slovenia ⁵⁾
In % of GDP											
1989	x	-1.2	x	-3.1	x	x	-3.0	7.5	0.7	-0.6	x
1990	x	-0.2	x	-0.1	x	x	0.4	-0.4	1.3	-0.2	x
1991	x	-2.1	x	-4.6	x	x	-3.8	-1.9	-2.7	-3.9	2.6
1992	- 5.8	-0.2	x	-6.7	-3.0	x	-6.0	-4.4	-3.4	-2.8	0.2
1993	-11.0	0.1	-0.4	-5.6	-0.2	x	-2.8	-1.7	-4.6	-6.2	0.3
1994	- 6.3	1.0	-0.6	-5.5	-1.9	-1.7	-2.8	-4.2	-10.3	-5.2	-0.2
1995	- 6.8	0.6	-0.5	-5.7	-3.8	-1.9	-2.6	-4.1	-3.3	-1.6	0.0
1996	-11.0	-0.1	-1.6	2.0	-0.8	-3.7	-2.5	-5.1	..	-4.4	0.1
1995											
3rd quarter	- 7.2	1.2	..	-1.6	-1.9	..	-2.0	-4.1	- 1.8	-2.2	..
4th quarter	- 4.4	-2.3	..	5.5	-5.6	..	-2.5	-6.2	- 3.7	-4.0	..
1996											
1st quarter	-10.6	0.5	-1.7	-3.1	-2.0	..	-3.4	-3.6	- 3.4	-2.6	..
2nd quarter	- 5.3	-0.8	-2.0	-4.4	-1.4	..	-3.0	-1.6	- 4.8	-1.8	..
3rd quarter	- 8.3	0.3	-0.6	0.4	-0.3	..	-0.8	-5.8	- 2.9	-4.8	..
4th quarter	-16.0	-0.5	-2.2	-0.9	0.2	..	-3.4	-9.4	- 2.2	-8.1	..

Source: WIIW; Latvia, Lithuania: national sources; Estonia: national sources from 1996. Quarterly data: national sources.

¹⁾ Including social budget in 1993 and 1994.

²⁾ Including privatization revenues.

³⁾ Up to 1990: general government surplus/deficit.

⁴⁾ 1990: including social insurance budget.

⁵⁾ General government deficit.

Gross Debt in Convertible Currencies

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania ¹⁾	Russia	Slovak Republic	Slovenia
	USD million										
1989	9,201.0	x	x	20,751.0	x	x	40,800.0	174.0	x	x	x
1990	10,007.0	x	x	21,505.0	x	x	48,475.0	230.0	56,200.0	x	1,954.0
1991	12,301.1	x	x	22,812.0	x	x	48,412.0	1,143.0	70,100.0	x	1,866.0
1992	13,857.7	7,082.4	12.8	21,644.0	66.0	66.4	47,044.0	2,479.0	80,200.0	2,981.0	1,741.0
1993	13,889.4	8,495.8	133.3	24,566.0	233.0	336.7	47,246.0	3,357.0	112,784.0	3,626.0	1,873.0
1994	11,411.4	10,694.2	174.9	28,526.0	359.0	505.4	42,174.0	4,562.6	121,600.0	4,310.0	2,258.0
1995	10,512.8	16,548.8	260.4	31,660.0	431.0	826.3	43,957.0	5,342.0	120,400.0	5,827.0	2,970.0
1996	9,860.0	20,412.0		27,646.0		1,216.8	43,600.0	6,872.4	124,000.0	7,810.0	4,001.0

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

¹⁾ Medium- and long-term gross debt.

Exchange Rate

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland ¹⁾	Romania	Russia	Slovak Republic	Slovenia
	Period average (ATS per 100 units of national currency)										
1989	1,575.08	x	x	22.40	x	x	9,194.37	88.68	x	x	x
1990	519.17	x	x	17.99	x	x	1,196.82	50.69	x	x	x
1991	65.63	x	x	15.62	x	x	1,104.00	15.28	x	x	42.35
1992	47.08	x	x	13.91	1,492.10	620.86	806.49	3.57	x	x	13.52
1993	42.16	39.90	87.97	12.65	1,722.52	268.02	642.13	1.53	1.17	37.80	10.27
1994	21.10	39.67	87.92	10.86	2,040.70	286.98	502.65	0.69	0.52	35.65	8.87
1995	15.01	37.99	87.93	8.02	1,910.82	252.04	415.73	0.50	0.22	33.93	8.51
1996	5.95	39.01	87.97	6.94	1,922.39	264.67	394.21	0.34	0.21	34.54	7.82
1996											
January	14.17	38.11	87.92	7.24	1,889.34	256.95	409.32	0.40	0.22	34.37	7.93
February	13.83	38.09	87.91	7.14	1,888.70	257.81	405.33	0.37	0.22	34.39	7.82
March	13.33	38.13	87.91	7.12	1,900.00	259.83	403.45	0.36	0.21	34.53	7.78
April	12.99	38.51	88.05	7.12	1,922.20	264.78	404.03	0.36	0.22	34.84	7.79
May	9.03	38.93	88.34	7.10	1,950.89	269.71	403.82	0.37	0.22	34.90	7.80
June	7.51	38.66	88.00	7.03	1,939.93	268.68	395.92	0.36	0.21	34.63	7.82
July	5.88	39.08	87.99	6.92	1,918.73	264.79	390.15	0.35	0.21	34.45	7.85
August	5.44	39.33	87.94	6.78	1,903.30	260.75	395.71	0.33	0.20	34.34	7.89
September	4.72	39.94	88.00	6.76	1,919.46	264.89	381.39	0.33	0.20	34.50	7.88
October	4.79	39.69	88.37	6.76	1,934.50	268.90	381.56	0.33	0.20	34.51	7.80
November	3.75	39.63	87.26	6.67	1,933.96	265.92	377.75	0.30	0.19	34.37	7.74
December	2.37	39.94	87.99	6.67	1,963.87	272.98	382.07	0.29	0.20	34.58	7.74
1997											
January	1.62	41.07	86.91	6.80	2,007.41	282.54	386.08	0.22	0.20	35.10	7.76
February	0.58	41.29	87.99	6.80	2,038.93	294.63	389.11	0.17	0.21	35.87	7.74
March ¹⁾	0.74	40.55	87.80	6.69	2,030.00	295.00	384.76	0.17	0.21	35.86	7.71
April ¹⁾	0.83	39.31	88.07	6.67	2,089.00	304.00	384.76	0.17	0.21	36.28	7.72

Source: IMF; Bulgaria, Czech Republic, Estonia, Poland, Russia, Slovakia: OeNB, end of period, from February 1997.

¹⁾ OeNB, end of period.

Discount Rate¹⁾

	Bulgaria	Czech Republic	Hungary	Latvia	Poland	Romania	Russia ²⁾	Slovak Republic	Slovenia
<i>End of period</i>									
1989	x	x	17.0	x	104.0	x	x	x	x
1990	4.5	x	22.0	x	48.0	3.0	x	x	x
1991	54.0	x	22.0	x	36.0	12.8	x	x	x
1992	41.0	9.5	21.0	120.0	32.0	61.8	80.0	9.5	25.0
1993	52.0	8.0	22.0	27.0	29.0	70.0	210.0	12.0	18.0
1994	72.0	8.5	25.0	25.0	28.0	66.1	180.0	12.0	16.0
1995	34.0	9.5	28.0	24.0	25.0	39.9	160.0	9.8	10.0
1996	180.0	10.5	23.0	9.5	22.0	35.0	48.0	8.8	10.0
1996									
January	34.0	9.5	28.0	24.0	23.0	35.0	160.0	8.8	10.0
February	42.0	9.5	27.0	24.0	23.0	35.0	120.0	8.8	10.0
March	49.0	9.5	27.0	24.0	23.0	35.0	120.0	8.8	10.0
April	67.0	9.5	27.0	19.0	23.0	35.0	120.0	8.8	10.0
May	108.0	9.5	26.0	15.0	23.0	35.0	120.0	8.8	10.0
June	108.0	10.5	26.0	13.0	23.0	35.0	120.0	8.8	10.0
July	108.0	10.5	26.0	13.0	22.0	35.0	110.0	8.8	10.0
August	108.0	10.5	25.5	12.0	22.0	35.0	80.0	8.8	10.0
September	300.0	10.5	24.5	11.0	22.0	35.0	80.0	8.8	10.0
October	240.0	10.5	23.0	10.0	22.0	35.0	60.0	8.8	10.0
November	180.0	10.5	23.0	10.0	22.0	36.0	48.0	8.8	10.0
December	180.0	10.5	23.0	9.5	22.0	35.0	48.0	8.8	10.0
1997									
January	..	10.5	23.0	8.0	22.0	50.0	48.0	8.8	10.0
February	..	..	22.5	..	22.0	..	42.0	..	10.0
March	..	..	21.5	..	22.0	..	42.0	..	..
April	..	..	21.5	..	22.0	..	..	..	..

Source: IMF; Poland, Russia: national sources; Lithuania, Romania: OECD; Bulgaria, Romania: national sources from August 1996; Czech Republic, Latvia, Slovakia: national sources from January 1997; Hungary: national sources from July 1997.

¹⁾ Due to currency board arrangements, the Bank of Estonia and the Bank of Lithuania do not lend to the government or enterprises. Therefore these two countries do not define or publish discount rates.

²⁾ Refinancing rate.