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Focus on Transition

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Contents

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Editorial

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

Like the previous 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 three 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.

The first study gives a comprehensive overview of transition developments in the three Baltic States, above all in the field of monetary and exchange rate policy, and reviews the economic background for these countries' outlook for integration into the EU. Moreover, we have spotlighted structural and market reforms in Estonia, Latvia and Lithuania to provide the reader with up-to-date information about countries not usually covered in this publication's section on recent economic developments.

The second study, entitled "The Opening of Central and Eastern Europe: The Case of Austrian FDI," investigates Austrian foreign direct investment (FDI) stocks and flows to the CEECs, which are also compared to Austrian FDI to the EU. Moreover, the study analyzes the role of such crossborder investment in trade and employment and in the Eastern integration process.

Finally, the third study provides an in-depth examination of a highly topical issue, namely the European Commission's Opinions on the ten Central and Eastern European countries. Apart from a comparative overview of the Opinions, the study concentrates on topics relevant to central banks (monetary and exchange rate policy, inflation performance, central bank independence, the banking sector, current and capital account convertibility and EMU relations). The Opinions are interpreted and commented and the Commission's recommendations assessed. The paper concludes with a summary of the Commission's proposed preaccession strategy and prospects for integration into the Union.

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

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Recent Economic Developments

Developments in Selected Countries

Maciej Krzak,
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1 Introduction

Economic growth displayed divergent trends in the region analyzed in the first half of 1997: While GDP growth accelerated on 1996 in Hungary and Poland, and advanced at a rate slightly lower than in 1996 in Slovakia, it fell short of expectations in Slovenia and even dwindled in the Czech Republic.

Inflation performance was more consistent among the five countries, as disinflation continued across the sample, albeit at an unequal pace. In Hungary and Poland, where inflation remains at double-digit levels, disinflation progressed faster than a year ago. In the Czech Republic, Slovenia and Slovakia, where inflation is already lower, gains were small if not negligible. Progress in reducing inflation appears to become more difficult once inflation has fallen below 10%. Among other things, the divergent pace of disinflation rates can be explained by the fact that Hungary and Poland have made further headway in adjusting relative prices than the three countries with lower inflation. Within the group of five, Slovakia continued to post the lowest CPI inflation rate.

With 1996 tendencies continuing,[1]) the *external position* deteriorated in nearly all countries in the first half of 1997. This development culminated in a currency crisis in the Czech Republic in May 1997, where intensive short-term capital outflows caused the fixed exchange rate regime to collapse and the koruna to devalue by 10%. The Czech current account deficit, which ran to 8.6% of GDP in 1996, continued to widen in the first quarter of 1997. In the wake of the Czech and Thai crises, international investors have subjected the individual countries to closer scrutiny, especially as the pace of current account deterioration was deemed worrying in Poland and as Slovakia's current account deficit surpassed 10% of GDP. The latest available statistics, however, point to a slight improvement of the external position of the economies: The current account deficits have stopped growing relative to GDP, though it is still too early to say whether the leveling-off of the deficits will be permanent. Hungary was again an exception in the region; its current account position improved consistently during the first eight months of 1997. Slovenia recorded a small deficit.

The worsening *current accounts* prompted the fiscal and monetary authorities of the more vulnerable countries to steer a more restrictive course. The Czech government tightened its fiscal stance, and the central bank raised interest rates. Poland, which will undershoot the target set for its 1997 budget deficit, aims at slashing the budget deficit further in 1998; moreover, the central bank moved to raise interest rates as well as minimum reserve requirements. The National Bank of Slovakia, meanwhile, kept interest rates unchanged despite a drop in inflation, for which it drew criticism from the government, since this made financing the budget deficit (approximately 5% of GDP) very costly at a time at which the country is saddled with a twin deficit. The government has not announced fiscal tightening measures to date. Hungary's macroeconomic position eased, as the government opted not to cut the budget deficit in 1997 despite reinforced economic growth. It aims at a deficit of a similar proportion to GDP as in 1997 for the next year, which will be an election year. Slovenia, finally, did not swerve from its balanced budget policy.

Structural reforms were pushed forward in all countries but Slovenia, which was bogged down in efforts to form a new government for months. Hungary nearly completed banking privatization, and Poland accelerated the privatization of its banking sector. Further steps to harmonize legislation with EU standards were taken in all countries save Slovakia, which in fact reversed gear as its government sought to curtail central bank independence. With the exception of Slovakia, all countries in the sample analyzed here – plus Estonia – were positively evaluated by the European Commission in July 1997 and shortlisted for an early start of accession negotiations with the EU. Slovakia was excluded from the shortlist for its poor political record.

2 Country Reports

2.1 Czech Republic

A mediocre economic performance in the first few months of the year, in particular the continued widening of the current account deficit of 8.6% of GDP in 1996, seriously undermined international confidence in the Czech economy. The government's initial response, the austerity package of April 1997, was judged to be insufficient. Against this backdrop, a *currency crisis* erupted at the end of May 1997. During the crisis, the Czech National Bank (CNB) jacked the lombard rate up to 50% from 14% and heavily intervened on the foreign exchange market, spending approximately USD 3 billion to defend the fixed rate, but to no avail. The fixed exchange rate system was subsequently replaced by a managed floating system. The koruna was devalued by approximately 10%. Since then, the discount rate has stood at 13%, up from 10.5%, while the lombard rate was cut back again to 23.0%. These rates are still very high in real terms.

In the first half of 1997, GDP grew by 1.3% on the corresponding period of 1996, compared with 4.3% a year earlier. This means a considerable slowdown despite the fact that consumer expenditure remained buoyant (first half of 1997: +5.4%; first of half 1996: +5.5%). The 2.1% investment contraction was the most important factor behind this slowdown. Fiscal constraint also contributed to this development, since government expenditure rose by a mere 2.7% year on year in the first half of 1997. The Czech Republic's net export gap continued to widen, albeit at a slower pace, as the robust rate of export growth nevertheless did not quite reach that of import growth (7.8% and 8.7%). GDP growth is predicted to accelerate to 2% for the whole of 1997.

The slowdown of the deterioration is confirmed by the balance of payments. The *current account* deficit stopped increasing as a share of GDP in the first half of 1997. It reached USD 1.9 billion in the first half of 1997, compared with USD 4.5 billion for the year 1996. The trade deficit came to USD 2.6 billion against USD 6.0 billion in 1996 as a whole. However, inward *foreign direct investment* flows reached only USD 473 million in the first half of 1997, compared with USD 1.4 billion for the entire previous year. Net portfolio investment flows were negative (-USD 145 million), which marks a strong reversal from the net inflows of USD 726 million registered for the year 1996. The currency crisis swallowed up much of the capital account surplus, so that in the end it offset less than 20% of the current account deficit in the first half of 1997 (in the whole of 1996, by comparison, it covered more than 90% of the current account deficit). Therefore, the central bank's foreign currency reserves dropped from USD 13.0 billion in August 1996 to USD 11.2 billion in August 1997, which covers almost five months of imports.

A further disaster struck in July 1997, when the eastern parts of the country were inundated for weeks. The damage inflicted by the heavy floods was enormous and reinforced the gloomy outlook, though a string of better-than-expected economic data later took most of the edge off the pessimism. It has become evident that the flood will have only a slight adverse impact on production. In the first seven months of the year, *industrial output* was at the same level as in the corresponding period of 1996, while the decline in construction was limited (–1.1%); the latter was mainly caused by the cuts in government spending. The devaluation of the koruna and the economic slowdown have had positive effects on trade flows in recent months. The trade deficit of the twelve months to July 1997 narrowed slightly in koruna terms to CZK 163 billion, a picture which is distorted by U.S. dollar figures on exports and imports, given the devaluation of the domestic currency and the appreciation of the U.S. dollar versus European currencies in June and July. Statistics expressed in the domestic currency signal that an export rally may be in the offing: In July, exports were up 18% year on year while imports had accelerated 10% year on year.

Disinflation, which was sluggish in the first half of 1997, virtually came to a halt in summer 1997. This is mainly due to hikes in regulated prices, above all in housing rents, which had been put off for a long time. In September 1997, the CPI increased 10.3% year on year, compared with 8.9% in September 1996. Housing and transportation costs surged 22.9% and 11.5%, respectively. Wages also fueled inflation, as they continued to grow at a pace significantly above the inflation rate despite the economic slowdown. In January to June, average nominal gross wages rose by 13.3%; the CPI, by contrast, advanced 6.9% in the same period. In July 1997, industrial wages were up 13% year on year. Rising import prices ensuing from the devaluation of the koruna also put upward pressure on the CPI and the PPI; the PPI accelerated 5.8% over the twelve months to September 1997, which compares with +3.9% year on year in September 1996.

The Czech Republic's poor economic performance was reflected in the rising *unemployment rate.* In September 1997 the jobless rate hit a record high during transition, namely 4.8% of the labor force (September 1996: 3.2%). The ongoing restructuring of industrial capacities, delayed for years, and rising pressures on company productivity are likely to trigger more layoffs.

The Czech authorities tightened macroeconomic policy in April 1997. At the time, they announced spending cuts amounting to CZK 45 billion or 8.3% of the total expenditures originally budgeted for 1997. However, the slackening of economic growth, the uptick of unemployment and incidental expenditure related to post-flood compensation and reconstruction have since caused the state budget to overshoot the target reset in April 1997. In January to August 1997 the budget deficit swelled further to CZK 11.2 billion. The government is forecast to miss its goal of balancing the budget in

1997; a deficit between 1% and 2% of GDP is likely. The Ministry of Finance envisages a deficit of CZK 20 billion in 1997, which it also blames on lagging revenues, as a result of anemic sales and dwindling business profits. The central bank is pressing the government to keep the budget balanced this year and to aim for a visible surplus in 1998, since the CNB would otherwise not be in a position to lower high interest rates, which are choking economic activity. The Ministry of Finance projects GDP growth of 2.2% and a CPI inflation average of 8.3% in 1998.

In 1996 problems surfaced in the Czech banking system. The sector is undercapitalized, burdened with huge bad loans, interconnected with the enterprise sector and overbanked besides. In 1997 the government announced its privatization plans for Komercni Banka (KB), Ceskoslovenska Obchodni Banka (CSOB) and Ceska Sporitelna (Savings Bank), the largest banking institutions in the country; they are to be sold off to strategic investors by way of open tender. However, no details have been released to date. The state's 36% stake in Investicni a Postovni Banka (IPB) will be taken over by Nomura. The CNB has started a consolidation program for small private banks, for which thirteen banks are eligible. Banks participating in the scheme will transfer nonperforming loans equivalent to the value of their share capital, plus an extra 10%, to a new company linked with Consolidation Bank, which was set up a few years ago to clean up nonperforming loans inherited from the communist period. Participation is subject to the approval of a business plan, which bidders will have to submit to the central bank, whose banking supervisory powers have thus been strengthened.

A draft revision of the Czech *banking law* has been prepared. Among other things, the draft regulates equity participation of banks in enterprises: In future, a bank may invest no more than 15% of its equity in shares of a single company and no more than 60% of its equity in shareholder equity altogether (based on the consolidated balance sheet). As of the second half of 1997, commercial banks must split their portfolios of securities into a trade portfolio and an investment portfolio and adjust their reserves accordingly. The government approved the creation of an independent stock exchange commission modeled after the American SEC. However, important capital market regulations have yet to be drafted.

In July, the European Commission put the Czech Republic on a shortlist of countries deemed eligible for an early start of accession negotiations with the European Union.

2.2 Hungary

GDP grew by 2.1% year on year in the first quarter of 1997 and accelerated to 4.3% in the second quarter, which translates into a – higher than expected – growth rate of 3.2% for the first half. On the supply side, *industrial output* expanded by a healthy 7.8% year on year in the first half of 1997. On the demand side, *investment* augmented by 8.3% in real terms year on year in the first half of 1997. The relatively strong pace of economic growth caused the *unemployment rate* to fall to 10.1% in October 1997 (10.8% in October 1996) despite the ongoing contraction of industrial employment.

Faster growth did not upset the internal and external equilibrium. Gradual *disinflation* continued in 1997. In September, the CPI was up 18.0% year on year compared with 22.2% a year ago. However, there are signals that further disinflation may encounter obstacles. Real wages rose by 5.7% in the first seven months of the year, much more than expected, since the government projected a mere 1% rise for the whole of 1997. In the industrial sector, which boasts double-digit productivity gains, such generous hikes may be warranted for the time being, but it is uncertain whether industry productivity gains are big enough to offset the weaker performance of other sectors of the economy. PPI inflation proved persistent; the PPI surged 20.7% in the twelve months to August 1997 on the same period of 1996, thus outpacing the CPI. The differential between PPI growth and the rate of forint devaluation led to a real-effective exchange rate appreciation nearing 1993 levels, which were the highest in the transition period.

So far, appreciation has not had an adverse impact on trade flows. According to the balance-of-payments statistics, the trade deficit narrowed to USD 1,272 million in the first eight months of 1997 from 1,762 million in the same period of 1996. Exports surged 41% while imports rose 29.6% in U.S. dollar terms in this period. These favorable tendencies caused the current account deficit to narrow to USD 676 million from January to August 1997 (corresponding period of 1996: USD 1,066 million). *Foreign direct investment* was buoyant, expanding to USD 1,431 million in the first eight months from USD 1,098 million in the same period of 1996. Notwithstanding these improvements, the foreign exchange reserves of the central bank shrank to USD 8.3 billion in August 1997 from USD 9.8 billion in December 1996. The reserves were used, along with privatization proceeds, to repay foreign debt. *Gross external debt* consequently fell to USD 24.6 billion in August 1997. The central bank's foreign exchange reserves still cover close to six months of imports.

The central bank steered a cautious course in the first nine months of 1997, gradually adjusting repo rates downward as disinflation progressed. In September 1997 it slightly reduced the base rate from 21% to 20.5%, and the discount rate from 20% to 19.5%. To support the process of disinflation, in mid-August the NBH cut back to 1% the rate of crawl at which the forint is devalued automatically each month relative to the Deutsche mark and U.S. dollar basket. On October 10, it also lowered the interest rate paid on minimum reserves (from 13.5% to 13% for reserves held against domestic deposits, and from 15% to 14% for reserves held against foreign currency deposits). On June 30, Hungary moreover eliminated, as planned, a 3% import surcharge which tended to dampen import prices.

The deficit of the social security system widened at a faster clip than expected in the first nine months. The budget of the central government, by contrast, was in line with initial predictions, reaching HUF 249.7 billion or approximately 78.6% of the projected 1997 deficit. Reaching the government's target for the 1997 deficit (4.9% of GDP) is thus still realistic. 4.9% is also what the government has targeted for 1998. In the light of accelerated economic growth and with a view to the parliamentary elections scheduled for May 1998, this means that fiscal policy will be somewhat relaxed in 1998.

In May 1997, the government approved a medium-term counter-inflationary program. This plan aims at cutting the CPI inflation rate to 18.0% in 1997, and to 13% or 14% in 1998. The government intends to gradually lower the crawling peg rate from currently 1% to 0.6% or 0.7% in the second half of 1998 to support disinflation. The program is based on a prospective GDP growth rate of 2% to 3% in 1997, and on an acceleration of growth to 3% to 4% in 1998, and to 4% both in 1999 and 2000. Exports and investment are expected to be growth factors while consumption is likely to rise more slowly. Real wages are projected to climb only moderately, provided a social consensus is reached, considering the fact that the public's expectations are high after a two-year overall drop of real wages by approximately 15%.

Hungary continued its efforts to harmonize domestic legislation with the EU's legal framework. The government drafted a law on venture capital and submitted revisions of the laws on banking, securities, insurance and currency to Parliament. Hungary has committed itself to allowing foreign banks and firms to open branches as of January 1, 1998. Under the revised currency law, nonresidents will no longer need a permit to buy real estate from January 1, 1998. The revised banking law allows banks to trade bonds and shares of companies and become members of the Budapest Stock Exchange. The draft law on venture capital is aimed at supporting the development of small and medium-sized firms through the creation of venture funds which will invest in small enterprises with good growth prospects in exchange for the acquisition of stakes in those companies.

The reform of the pension system, i.e. the introduction of a three-pillar system, was adopted by Parliament, and first measures were taken to overhaul the health care system. Banking sector privatization was successfully concluded in 1997. In April 1997 Takarékbank, a leading savings institution, was privatized. The privatization of the K&H bank (the Foreign Trade Bank), the second largest bank, was also completed. In September, GiroCredit Bank bought additional shares in the eighth-largest Hungarian bank, Mezöbank, thus augmenting its stake to 88.6%. The government's remaining stake of 25% in the largest Hungarian bank, OTP, was sold in October to international institutional investors (20%) and to small domestic investors (5%). The privatization of the telecommunications firm MATÀV has just entered its third stage.

Hungary has a standby arrangement with the IMF, but it has opted not to draw any funds, thus signaling the success of its economic recovery. The European Commission also placed Hungary on the list of transition countries deemed fit for an early start of accession negotiations with the EU.

2.3 Poland

Rapid economic growth of 7.0% in the first quarter of 1997 accelerated to 7.6% in the second quarter, which translates into 7.3% year on year for the first half of 1997 according to the Polish Central Statistical Office (GUS). Subsequently growth was only temporarily dented by the unprecedented flooding of the southwestern parts of the country for several weeks in July. The government puts the ensuing damages at PLN 10 billion (USD 3 billion). Despite this disruption, GDP forecasts for 1997 range from 6.3% to 7%, which is above the 5.5% projected by the government in its 1997 budget. *Industrial sold output* increased at a rapid clip of 11.3% in the first nine months of 1997 on the same period of 1996, while construction was even up 21.1% year on year, with housing construction finally starting to pick up again after years of decline. Detailed figures on the components of aggregate demand are not available, but the consumer boom which had started in 1996 evidently continued in 1997. Consumer credit shot up by 40.9% in January to September 1997. Investment expenditure by firms which employ at least 50 people surged by 24% year on year in the first half of 1997. Private firms invested much more heavily than the public sector; the sectors increased their investments by approximately 70% and 17% in current prices, respectively.

The *unemployment rate* dropped from 13.0% in December 1996 to 10.6% in September 1997. Robust economic growth, a booming private sector and the tightening of the eligibility criteria for unemployment benefits in January all contributed to the downward tendency. The Labor Ministry expects a break in the downtrend until the end of the year, as seasonal jobs are being phased out due to adverse weather conditions.

Inflation eased in 1997. Measured in terms of the CPI, inflation increased by 9.5% year on year in January to September; the uptick was much slower than in the same period a year ago (+14.0%). The CPI inflation rate was 13.6% year on year in September 1997 versus 19.5% in September 1996. The government projection of 13% year on year for December 1997 is still realistic, though inflationary pressure may be mounting. The GUS has recently revised upward its PPI time series; it replaced the 1994 industrial output structure by the 1995 structure. The revised twelve-month PPI inflation rate came to 12.7% and 12.5% for August and September, respectively, versus 9.8% as previously reported for August. The increase in producer prices may signal an overheating of the economy. The inflationary tensions may come from the rapid increase of real wages. Nominal take-home pay in the enterprise sector rose by 22.6% year on year in September, which translates into 7.9% in real terms. Broad money supply rose by 19.3% in January to September 1997 compared with 18.2% in the same period of 1996.

The *current account deficit* continued to widen to USD 3.2 billion in January to August 1997 (against a USD 48 million surplus achieved in the same period of 1996), hand in hand with a widening of the trade deficit from USD 4.5 billion to USD 7.3 billion in the same period. According to government projections, the current account deficit is not going to exceed USD 11 billion or 4.5% of GDP in 1997. Such a deficit is sustainable because the growth of foreign currency reserves has not been disrupted. The net foreign assets of the whole Polish banking system stood at USD 23.6 billion in September, up from USD 21.4 billion a year before. The NBP’s gross official reserves reached USD 19.9 billion in August 1997, up USD 1.9 billion from December 1996 and USD 2.3 billion from August 1996; they still cover over six months of imports. Imports are still growing strongly, but at a lesser pace than in 1996, which is an encouraging sign; in U.S. dollar terms, total imports grew by 20.9% in January to August 1997 compared with 30.2% in the same period of 1996. At the same time, exports grew by 8.7% compared with 6.0% in the same period of 1996.[2])

Both the central bank and the government took action in response to the widening of the current account deficit. After increasing reserve requirements in spring, the NBP raised headline interest rates in August, i.e. the discount rate to 24.5% and the lombard rate to 27%. This hike is also aimed at offsetting the impact of a bridging loan extended to the government to finance post-flood reconstruction. In September 1997 the NBP suddenly changed tack, entering commercial business again, and started to take in personal deposits with six- and nine-month maturities at above-market interest rates (21.5% and 22.5%, respectively) in order to induce commercial banks to raise their deposit rates. This was aimed at boosting domestic savings and helping contain imports of consumer goods. The commercial banks reacted as expected; they raised their rates accordingly. Turning to one of the NBP's core duties, namely securing exchange rate stability, it maintained the preannounced 1% monthly devaluation rate of the central exchange rate relative to the basket of five currencies. In terms of producer prices, the value of the zloty barely changed in the twelve months to September 1997. The threat of overheating prompted the government to revise its 1998 budget draft, slashing the projected deficit from 1.9% to 1.6% of GDP in 1998. This year's budget deficit is unlikely to exceed 2% of GDP (including privatization receipts), because of higher-than-expected economic growth. While the government borrowed from the central bank as late as in the first quarter of 1997 to bridge liquidity problems, this is no longer an option under the new constitution which went into force in October 1997.

Poland stepped up *structural reforms* in spring. A host of important regulations were passed by Parliament before it was dissolved, such as bills piloting the pension reform, the amendment to the central bank law, the new banking law and the law on securities trading. These regulations are also intended to harmonize the Polish legislation with EU standards. A new constitution was approved in a nationwide referendum in May 1997. It specifies, inter alia, that government debt must not exceed 60% of GDP, and that the government must not borrow directly from the central bank. The constitution also put the so-called Monetary Policy Council, with the central bank governor at its head, in charge of monetary policy. The constitution moreover empowers the central bank with sole responsibility for determining and conducting monetary policy, cutting back the role of the Sejm, which will have to be informed by the Council about monetary policy guidelines, but whose approval need no longer be sought.

The bills creating the basis for pension reform passed the Sejm in June. The current pay-as-you-go system is to be replaced by a three-pillar system consisting of first, a universal state pension (payroll tax financed); second, a supplementary mandatory scheme, the contributions to which will also be deducted from the payroll tax and whose accumulated savings will be managed by designated (universal or corporate) pension funds; third, optional individual pension plans to be financed from voluntary savings managed by private pension funds. A diversion of funds from the amount of payroll tax paid at present obligatorily to the social security authorities to fund the new scheme would entail a financing gap in the old system as long as the old and the new systems work in parallel. To prevent the state budget deficit from widening in the interim, proceeds from the privatization of large state-owned firms will be used to top up the budget. The reform is scheduled to start in January 1999.

The new central bank law stipulates that the principal goal of the central bank is to maintain price stability, and that the Bank shall support government policy unless such policy interferes with its principal goal. The Monetary Policy Council will have nine members. The President and the members of the Council will be elected for six-year terms during which they have to suspend their party affiliations as well as any other professional activities, with the exception of research and teaching. In order to make the NBP accountable to the public, the Council will convene at least once a month, and the views of its members will be published in the Official Gazette.

The Sejm also adopted a new banking law aimed at improving the security of banking operations and at preventing money laundering. The law allows banks to expand their lending activities, as it raises the limit on credit exposure to a single borrower to 25% from currently 10% of the banks' own funds (comprising statutory funds, share capital and reserves). Banks will have to seek NBP authorization for acquiring shareholder equity in excess of the 15% ceiling imposed on them (as a percentage of own funds). Start-up banks will have to temporarily meet higher capital requirements, also for off-balance-sheet operations, namely 15% and 12% in the first and the second year, respectively. Also in early August, the Sejm adopted the long overdue bill on public securities trading, which introduces international standards in Poland, and creates a legal framework for derivatives trading and the creation of closed-end funds. Moreover, it streamlines the procedures for the issuing of new stocks by listed companies.

In spring 1997, the government revealed its privatization plan for the remainder of the century. If it is fully implemented, only harbors and airports, the public road system, rivers and sea routes, the Polish Power Grid, the railway system and Polish Mail will remain in state hands by the end of the year 2000. Privatization made further headway in 1997, albeit at a pace slower than originally envisaged by the government: The number of firms sold in the first half of 1997 was 16, which compares with 120 privatizations by tender and public offering planned for the whole of 1997. However, a number of large privatizations were successfully concluded, pushing up privatization revenues to a record high. This list includes KGHM, the Polish copper monopoly, Bank Handlowy, Polski Bank Inwestycyjny and Powszechny Bank Kredytowy. The privatization of the Pekao group, the largest institution in terms of assets in the Polish banking system, is under preparation. The next stage of the mass privatization program started with the listing of National Investment Funds on the stock exchange in June 1997. Holders of certificates of ownership have been granted two years to convert their certificates into shares in the Funds.

In September 1997 parliamentary elections were held, in which the incumbent Social Democrats (27.1% of the vote) and the allied Peasant Party (7.3%) were defeated. The Solidarity Action for Elections, AWS, (33.8%) and the Union for Freedom (13.4%) decided to build a coalition. The designated prime minister, Jerzy Buzek (AWS), a chief architect of Solidarity's election platform, announced a gradual approach to disinflation so as not to smother economic growth, which he hopes will accelerate to 7% or 8% annually once a number of structural reforms have been implemented, such as the restructuring of the state-owned heavy industries, privatization and agricultural reform. At the same time, the premier does not project massive layoffs in downsized sectors such as coal mining; he wants to expand retraining activities instead to absorb free hands. Rapid growth is also seen as necessary for the financing of vital social needs, in particular in the education and health care sectors. In line with this policy, budget deficits will be reduced further, but only gradually. The strategic goal remains joining the EU. Poland was positively evaluated by the European Commission in July 1997 as eligible to start accession negotiations with the EU soon.

The budget draft prepared by the outgoing government is based on a forecast of 5.6% GDP growth in 1998 and 9.5% CPI inflation. In this economic environment, the budget deficit is projected to fall to 1.6% of GDP, as advised by the central bank and the IMF. The incoming government is unlikely to introduce crucial changes to the budget draft, as it is constrained by the strict deadlines of the legislative process.

2.4 Slovakia

Economic growth was high in 1997, but slower than a year ago: GDP grew by 5.1% in the first quarter compared to 7.3% in the first quarter of 1996. In the second quarter economic growth accelerated; on balance GDP was reported to have grown by 6% in the first half. All components of aggregate demand improved in the first half. Growth was driven by investment and consumption, which grew by 27.7% and 7.4%, respectively. Net exports deteriorated at a slower clip, as exports and imports augmented by 9.0% and 10.8%, respectively (corresponding 1996 periods: –1.6% and +18.5%). Government spending, which expanded rapidly in 1996, mounted by 2.8% in the first half of 1997. On the supply side, services were the engine of growth, while industrial output rose by 3.5%. Construction increased by 8.8%. Sustained economic growth did not feed through to a lower unemployment rate, which stood at 13.0% in September 1997 against 12.2% in September 1996. The restructuring of industrial capacities is under way.

In January to July 1997, the current account deficit continued to widen to USD 1.1 billion or approximately 11% of GDP, compared with USD 847 million in the same period of 1996. The capital account was in surplus, but did not suffice to offset the current account deficit. Consequently, the central bank's foreign exchange reserves fell. They were reported at USD 3.2 billion on October 22, 1997 (end 1996: USD 3.5 billion), which is sufficient cover for four months of imports. As a result of the further deterioration of the current account, Slovakia reintroduced an import surcharge, effective as of

July 1997, of 7% of the value of all imported goods, with the exception of some raw materials. This surcharge replaced the import deposit introduced at the beginning of May 1997. The latest figures available put the Slovak trade deficit at SKK 39.2 billion for the January to September period, compared with SKK 41.7 billion for the corresponding 1996 period. This slight improvement may signal that the further deterioration of the current account has been arrested.

Slovakia's external debt rose rapidly in 1997. In June 1997 it reached USD 9 billion, up from USD 6.1 billion a year earlier; it is expected to expand to USD 10 billion by the end of 1997. The Ministry of Finance links the growing debt to the financing of infrastructure projects, mainly freeway construction. External debt makes up for the absence of inward foreign direct investment, which has been a mere trickle so far, accounting for just USD 32.4 million in the first half of 1997.[3])

While *inflation* in Slovakia did not show further signs of easing, it did not edge up either; hence the government forecast of 6% for 1997 still appears realistic. The CPI was up 5.7% year on year in September 1997. This came as a surprise after the monthly result was high in August at 1% in the wake of a 10% increase in energy prices for enterprises and heating prices for individuals. Wage growth is likely to fuel inflation; real wages rose by 8.1% in the first half of 1997 on the corresponding 1996 period.

Slovakia has conducted a lax fiscal policy and a tight monetary policy in 1997. Money supply (M_2) rose by 13.5% year on year in August 1997, which was still faster than the central bank target of 10.7% for the whole of 1997. This explains why the NBS has not cut its lombard rate, which has stood at 15% since July 1996, despite the fact that inflation has dropped to about 6%. The budget deficit came to SKK 27.9 billion in the first nine months of 1997 compared to SKK 13.4 billion in the corresponding 1996 period. The macroeconomic policy mix applied will, in theory, produce high interest rates in real terms, which in fact, it has: Interbank market rates and repo tenders fluctuated in the range of 20% to 23% per annum in the first ten months of 1997.

The high interest rates made it difficult for the government to cover the budget deficit, and yields on government securities reached 30%. The government responded with a draft law to curb central bank independence by asking Parliament to raise the upper limit for direct state borrowing from the Bank from a current 5% to 10% of the previous year's budget revenues. The Cabinet also wishes to raise the number of banking council members from eight to ten, five of which would be appointed by the government itself. In order to make Parliament more supportive of these amendments to the central bank act, it also proposed that the NBS budget be henceforth approved by Parliament rather than by the banking council. These revisions have to be passed by a parliament which is controlled by the ruling coalition. No measures to cut the budget deficit, as suggested by the central bank, have been announced to date. The government forecast of the budget deficit for the whole of 1997 is SKK 36.9 billion or above 5% of 1997 GDP.

A high interest rate differential with other countries should in theory produce a strong currency as well. However, current account problems have overshadowed arbitrage opportunities. Furthermore, the koruna suffered from the currency crisis in the Czech Republic and was subject to depreciation pressure in summer. Only recently has this pressure waned: In October the koruna remained between 0.5% and 1% below the central rate of the fluctuation band (depreciation).

Due to Slovakia's poor political record, the European Commission suggested not to include the country in the first wave of negotiations on the EU's Eastern enlargement.

2.5 Slovenia

The government originally projected GDP to grow 4.0% in 1997, up from 3.1% in 1996. Actual GDP growth in 1997 is, however, likely to fall short of this figure, since the economy grew by a mere 2.2% and 3.8% year on year in the first and second quarters of 1997, respectively. Since the Slovene economy is highly dependent on foreign trade, the fragile recovery of its main trading partners, such as Germany and Austria, is one factor behind this worse-than-expected performance. Another factor is the delayed restructuring of the domestic industrial sector. Growth acceleration in the second quarter is likely to extend at least to the third quarter. In the first eight months of the year, industrial output edged up 1.1% on the corresponding period of 1996. Growth was fueled by the service sector.

The unemployment rate stood at 14.4% at the end of August 1997, up from 13.5% in August 1996. This increase is due to structural features; unemployment is heavily concentrated and also most persistent among the least skilled persons and in heavy industry. Long-term unemployment is problematic as well; as many as 59% of the unemployed have not held a job for more than a year. However, according to a survey conducted by the ILO methodology, the jobless rate came to 7.3% in May 1997, which suggests that the problem is not as acute as the official figures suggest.

CPI inflation proved stubborn in 1997, mainly because of relative price adjustments, i.e. hikes in the prices of oil products and energy. In spring, the government projected the average 1997 inflation rate to be 8.8%, down from a rate of 9.7% in 1996. In September, however, CPI inflation surpassed 10.1% year on year. Such inflationary inertia is due to energy price increases; the price of gasoline rose by 3.9% in September alone. CPI inflation reached 8.0% in January to September. Producer prices were up 6.6% year on year in September 1997. Wage growth remained moderate and cannot be counted an inflationary factor, as real gross wages were merely 2.8% higher in July than the 1996 average.

In 1995 to 1996, Slovenia posted small surpluses on current account despite high trade deficits, as merchandise deficits were offset by services and unrequited transfers. These tendencies prevailed in the first seven months of 1997 as well, though Slovenia may end the year with a slight current account shortfall. The current account deficit and the trade deficit came to USD 84.2 million and USD 575 million in January to July, respectively. The capital account surplus more than offset the current account deficit; hence the foreign exchange reserves of the Bank of Slovenia rose to USD 3.1 billion in August 1997, up from USD 2.3 billion in August 1996. They cover approximately 3.7 months of imports.

The draft budget was finally approved in July 1997. According to this draft, the budget deficit is expected to reach SIT 27.9 billion or about 1% of GDP in 1997 after a surplus of 0.3% in 1996. This is due to increased expenditure on public sector salaries and spending on social programs. The government targets a 0.5% deficit in 1998.

Structural reforms were delayed in Slovenia in 1996 and 1997, as it took months to form a new government after the inconclusive results of the latest parliamentary elections. The introduction of VAT was postponed once again; it is not likely to come into force before 1998. According to the IMF, Slovenia should accelerate reforms in specific areas such as foreign exchange (liberalization of capital flows), banking, taxation and labor legislation. The privatization of the public sector should also be pursued firmly. The two state banks, Nova Kreditna Banka Maribor and Nova Lubljanska Banka (NLB), which is the largest bank in Slovenia, finished rehabilitation programs in June and now await privatization. The timing and methods of privatization are subject to lively debate; no decisions have been reached as yet. A new banking law, which has already been drafted and whose adoption has been postponed several times, should be passed early next year. It will liberalize the rules applying to foreign banks for setting up branches, which is likely to lead to an increased presence of foreign capital in the banking sector and which should thus step up competition. There are more than 30 banks in Slovenia serving a population of 2 million, hence a consolidation drive is inevitable. The Council of the Bank of Slovenia voted to introduce a nominal interest rate for tolar-denominated short-term securities issued by the Bank of Slovenia and for securities with a maturity up to 60 days floated by commercial banks as of October 1, 1997. This is tantamount to the deindexation of these securities.

On July 15, 1997, the Slovenian Parliament ratified the Association Agreement signed with the EU in June 1996. This agreement grants Slovenia a transition period of three years for the liberalization of capital flows. To speed implementation of this agreement, Slovenia had amended its constitution to allow foreigners to own real estate even prior to ratification. Slovenia figures on the European Commission's shortlist of transition economies recommended for early accession negotiations with the EU. In October 1997 the Slovene government presented the national EU preaccession strategy, namely a set of economic and social policies aimed at implementing the essential reforms and concluding economic transition by the end of 2001, with the ultimate goal of full EU membership as of the beginning of 2002.

1 *See Focus on Transition 1/1997.*

2 *These figures are based on balance-of-payments statistics.*

3 *Balance-of-payments statistics.*

Studies

Estonia, Latvia and Lithuania From Plan to Market – Selected Issues

Maciej Krzak[1])

1 Introduction

This study elaborates upon the three basic interrelated challenges that the Baltic States have had to resolve: They had to create the institutional framework to support an independent state, stabilize their economies and implement market-oriented structural reforms. This analysis does not aspire to cover those issues comprehensively but focuses instead on the topics most relevant to central banks, such as macroeconomic stabilization, the institutional setup of monetary policy, developments in the banking sector, including banking supervision, and finally, integration in the European Union. Specific topics, e.g. agriculture, fiscal reform, energy sector reform, bankruptcy procedures, antimonopoly laws, consumer protection and foreign trade policy are not explicitly addressed here. Since the statistics on the Baltic States are still quite heterogeneous, cross-country comparisons are frequently based on quantitative indicators derived from different sources, which affects the quality of the evidence supporting the arguments in this paper.

Section 2 briefly describes the economic environment Estonia, Latvia and Lithuania inherited from the Soviet Union. Section 3 touches upon macroeconomic issues, including stabilization and current economic developments. Section 4 takes up selected structural issues in the real economy: changes in output structure, changes in the commodity composition of foreign trade and geographical destinations, and changes in foreign direct investment flows. Section 5 deals with structural problems inherent in institutional changes, such as the process of liberalization, privatization methods, the creation of a two-tier banking sector and the establishment of a monetary policy framework. The main policy challenges are covered in section 6, while specific policy problems related to the integration in the European Union are discussed in section 7 in the context of the European Commission's Opinions on whether the applicant transition economies are ready to join the EU. Concluding remarks follow in section 8.

2 Background and Initial Conditions

Estonia, Latvia and Lithuania reemerged as independent states on the world map only six years ago. At the outset, they had to confront jettisoning the legacy of fifty years of Soviet rule. They had to start dismantling the central planning system while at the same time establishing the institutions required in independent states. However, having previously experienced a period of national independence and market economy (1919 to 1940), they started out from a better position than other Soviet republics. Furthermore, the standard of living and the levels of productivity were higher in the Baltic States than elsewhere in the former Soviet Union. Moreover, due to the geographic location of the Baltics, i.e. their proximity to the Scandinavian peninsula, they already had a relatively well-developed transportation infrastructure that they could exploit for transit. Finally, they were not burdened with foreign debt, as Russia had assumed all external obligations of the former Soviet Union (FSU).

Before World War II, the Baltic States had been part of the European economy. After the takeover by the Soviet Union in 1940, all industrial property and real estate was nationalized and the collectivization of agriculture was imposed. The policy of rapid industrialization in the 1950s and 1960s was a vehicle to integrate the Baltic States' economies with the rest of the Soviet Union in line with the division of labor specified by the five-year central plans. The Baltic States' industries were constructed chiefly to produce goods for the vast Soviet market rather than the small domestic markets. At the same time, the policy of forced industrialization led to a heavy reliance of the three countries on inputs imported from the rest of the Soviet Union; about 87% to 90% of their external trade was transacted with the other parts of the former Soviet Union. There was little direct trade among the Baltic countries themselves, as goods were shipped to the capital for further distribution. In general, the Baltic States imported energy and raw materials, while they shipped food and manufactured goods to the rest of the former Soviet State.

Industrialization was supported by the inflow of migrants from other parts of the Soviet Union, in particular from Russia. As a result, the ethnic composition of the population changed significantly under the Soviet regime. Estonia and Latvia, therefore, have large Russian minorities. The percentage of Estonian nationals in the total population fell from some 95% in 1945 to about 62% in 1989, while the share of Latvian nationals in the population of the country dropped from about 77% in 1935 to 52% in 1989. By comparison, Lithuanian nationals accounted for about 80% of the population in 1989.[2])

3 Macroeconomic Developments and Policies

Macroeconomic stabilization was the most compelling challenge all three countries faced after their independence had been restored. The widespread liberalization of prices from 1991 to 1992 resulted in a surge of annual inflation to four-digit levels (see Country Tables). At the same time, economic activity declined at a rapid pace.

3.1 From Output Collapse to Growth

Economists hotly debated possible explanations of the output collapse in the transition economies without ever settling the issue.[3]) A number of factors of the output breakdown can be identified: The Baltics had to absorb two major external shocks at an early stage of transition, namely the collapse of exports to the former Soviet Union in 1990 to 1991 (a demand shock) and the energy price shock (a supply shock) in 1992, when Russia substantially increased its export prices for oil and other raw materials in order to align them with world levels. Other factors were possibly at work as well. One is credit contraction (a supply shock), but there is little evidence of it, except in Latvia, where real interest rates rose to high levels in 1993. The role of institutional uncertainty is yet another – unmeasurable – factor, but it cannot be disregarded either. Both factors reinforced the decline in investment, which had dried up in the highly inflationary environment. All these shocks contributed to the massive cumulative decline of GDP by about 50%[4]) from the 1990 level (official figures).

The deterioration of the former Soviet Union's economy hit Baltic exports hard despite the beneficial terms-of-trade shift resulting from the fact that the prices of manufactured goods were liberalized prior to those of imported inputs. This coincided with currency reforms in the Baltic States that necessitated new institutional and payment arrangements in trade with the former Soviet Union. Supply-side effects were significant as well: Previously the Baltic industries had benefited from Russian energy and raw materials that were below market prices. More expensive energy and raw materials in 1992 to 1993 rendered most of these industries unprofitable, as the share of industries with negative value added had been estimated to be higher in the Baltic States than the FSU average.[5]) Finally, the liberalization of foreign trade brought competitive pressure in numerous sectors in spite of undervalued domestic currencies and low incomes. Consumers showed a preference for Western goods.

Following at least four years of decline, output started to recover only in 1994, which shows how severe the transition collapse had actually been.[6]) The output composition has significantly changed: The Baltic States have undergone strong deindustrialization in absolute and relative terms, a trend that has only recently ended. The share of agricultural production has fallen considerably, while the share of services has increased rapidly. The service sector was the sector in which economic recovery started.

The pace of this recovery has been divergent across the Baltic States. Growth has been consistent in Estonia and Lithuania, whereas it came to a brief halt in Latvia, with Estonia clearly standing out as the growth leader. According to the recently revised figures, GDP growth in Estonia resumed in 1995 at a robust rate of 4.3%, and remained at 4.0% in 1996. Until the fourth quarter of 1996 economic growth was moderate. In the fourth quarter of 1996 the growth rate of GDP rose to 7.3% year on year, in the first quarter of 1997 it accelerated to 10.8%. Economic growth has been driven by consumption, investment and public spending. The share of investment in GDP was 26.8% in 1996. Investment by the public sector increased by 5% in 1996, while private investment advanced by 8% to 9%.[7]) The current situation of the Estonian economy can be summarized by one word: overheating. Inflation has recently started to tick up, as economic growth has doubled its pace. Anecdotal evidence shows that consumption has been increasing recently, rapidly fueling imports (sales of cars and automotive parts have surged). The 70% growth in consumer credit from December 1996 to August 1997 and the 16% rise in real retail sales year on year in June 1997 support this view. At the same time, the current account gap, which had already been high relative to GDP, has continued to widen on the back of the increasing trade deficit. Fears of overheating prompted the authorities to tighten macroeconomic policy during 1997; they raised the minimum capital adequacy ratio for banks in order to curtail domestic credit expansion. Moreover, they downgraded loans drawn by regional authorities, which requires banks to make higher provisions. A balanced budget policy is pursued rigorously.

Latvia was the first of the three countries in which GDP began to recover in 1994 (0.6%) after bottoming out in 1993. In 1995, a widespread banking crisis caused GDP to decline again by 1.6% in real terms. Growth resumed in 1996 at a moderate rate of 2.8%. In the first quarter of 1997, GDP grew by 2.6% year on year. Consumption stagnated in 1995 and 1996 due to the fall in real wages. Gross fixed capital formation increased by 12.6% and 7.5% in 1995 and 1996, respectively. Nevertheless, the investment share in GDP may be too low to warrant a sustained expansion. Gross capital formation was estimated at 21.9% of GDP in 1995, but since the increase in inventories accounted for almost one fourth of this figure, the share of gross fixed capital formation adjusted for the rise in inventories was in fact 16.6%.

In Lithuania, GDP stabilized in 1994 after an unprecedented collapse in 1991 to 1993, and economic growth resumed at a moderate rate in 1995. On the demand side, government spending and investment drove growth in 1995. The banking crisis did not stop economic growth as it did in Latvia, because the Lithuanian authorities chose a different policy response. The recapitalization of banks fed through to a rise in the budget deficit (see section 5.3 on banking below). Early in 1997, indicators signaled continued growth, albeit at a slightly lower pace than in the same period of 1996; GDP grew by 2.5% in the first half of 1997 compared to 3.1% in the same period of 1996. On the supply side, industrial production, agriculture and services were the engine of growth.[8])

The resumption of economic growth has helped alleviate the problem of high unemployment. The official rate of unemployment appears to be rather low in the Baltic States by transition economy standards, but the data cannot be considered reliable, because the official figures are much lower than the ones produced by the ILO methodology. The proportion of long-term unemployment is high, which thwarts prospects of a rapid reduction in the unemployment rate. In Lithuania agriculture acted as a buffer for unemployment, since the share of the labor force in agriculture remained above 20% despite the considerable drop of the share of agriculture in GDP.

Employment has been declining in Estonia and Latvia throughout the process of transition for two reasons. First, jobs have been shed in industry and agriculture, causing the shares of employment in industry and in agriculture, including forestry and fishery, in total employment to fall. Second, the labor force total has been shrinking due to emigration to Russia and Finland. The unemployment rate in Estonia, applying the ILO methodology, was 11.3% in the second quarter of 1997. According to the official figures, the unemployment rate dropped to 3.7% in September 1997 from 4.3% in December 1996. Latvia's poor growth record is reflected in the unemployment trends. The Latvian rate of unemployment edged up slighly in 1997 relative to 1996; the increased pace of modernization since 1996 is likely to displace more workers unless economic growth accelerates considerably. The official unemployment rate in Latvia was 7.3% in June 1997, compared with 7.1% a year before. However, according to the ILO methodology, the rate stood at 18.3% in November 1996. The Lithuanian unemployment rate was 5.6% in September 1997, down from 6.4% in September 1996. ILO estimates are not available.

3.2 Disinflation

Following price liberalization, the Baltic States experienced very high rates of inflation. By 1995, the CPI inflation rate had fallen below 30% in Estonia and Latvia and below 40% in Lithuania from rates of approximately 1,000% in 1992. Because it was slow to tackle stabilization, inflation subsided more slowly in Lithuania than in the two other countries. However, as its efforts became more intense, the pace of inflation in Lithuania caught up with the disinflation pace of the other two countries. 1997 may well bring the CPI inflation rate in Latvia and Lithuania to within single-digit levels; Estonia's inflation rate has recently edged up above 10% (see Country Tables).

The Baltic States have pursued exchange-rate-based counterinflationary strategies. Estonia and Lithuania introduced currency boards in 1992 and 1994, respectively, while Latvia opted for a peg of its currency to the SDR basket in January 1994 after a period of managed floating. The Baltics have conducted tight monetary and fiscal policies. Estonia has largely followed a policy of balancing the central government budget, which it relaxed only in 1995, while Latvia and Lithuania aimed to keep budget deficits under control. Latvia has recently decided to move toward a balanced budget as well. Lithuania and Estonia no longer permit the use of central bank credit to finance the budget deficit because this is inconsistent with the currency board setup. Latvia resorted to such financing only on a very limited scale that did not jeopardize its disinflation efforts. Inflation has not yet fallen to the levels in the anchor currency countries because relative prices have not fully adjusted yet (the prices of nontradables, in particular of those nontradables which are regulated by the authorities, rose relative to the prices of tradables), and because inflationary inertia is fed by entrenched inflationary expectations.[9]) Energy and public transport prices do not fully cover the cost of production. Judging from the evidence, the different approaches to handling inflation in Estonia and Lithuania on the one hand and in Latvia on the other hand do not seem to lead to divergent inflationary outcomes, though, as inflation rates have recently dropped to levels around 10% in all three countries.

3.3 Large Current Account Deficits

Inflation rate differentials between the Baltic countries and their main Western trading partners caused the Baltics' currencies to appreciate in real terms. This is probably the main factor behind the yawning current account deficits. Additional factors are the internationally uncompetitive industries and the pressure to import advanced consumer and investment products needed to restructure productive capacities. Across the region, exports have been growing more slowly than imports. Large trade deficits have become the rule across transition economies since 1996, and the Baltics are no exception. On the back of trade deficits, current account gaps have reached high proportions to GDP: The current account deficits of Estonia, Latvia and Lithuania came to 10.3%, 9.0% and 9.0% of GDP, respectively, in 1996 (see Country Tables). The Estonian and Lithuanian current account deficits continued to widen further to 16.8% and 11.4% of GDP, respectively, in the first quarter of 1997. The 1997 data on the Latvian current account were not available as of writing. However, the trade deficit was LVL 303.8 million (USD 525 million) in the January to July period compared with LVL 242.0 million in the same period of 1996, which suggests that a further deterioration of the current account has taken place because of the high correlation with the trade deficit. These developments in conjunction with recent currency crises in Southeast Asia and the Czech Republic raise the question of the sustainability of the current account deficit, i. e. the possibility of financing the deficit over time.

Economic theory offers but a general answer to the question of when a current account deficit exposes an economy to the risk of a currency crisis because the intertemporal budget constraint is quite lax. Subject to this constraint, any time profile of the current account is consistent with solvency provided the discounted sum of all current account balances is equal to the initial foreign debt of the country. Thus a country may run very large current account deficits for a long time and still remain solvent as long as it produces future surpluses to offset the earlier deficits. This model tacitly assumes that future policies are compatible with a current account time path that does not violate solvency. However, the sustainability of current account deficits depends on two additional factors: a country's willingness to service debts and the creditors' willingness to lend. The latter reflects the creditors' expectations about the future course of the borrower's economic policy and his willingness to pay. Diverting output from domestic to external use may become politically unfeasible. Therefore markets watch debt service ratios and will not accept values beyond a certain threshold they deem safe. Beyond that level, they simply cut off further lending, which may lead to a debt crisis. This suspension of long-term lending may bring about an abrupt reversal of short-term capital inflows, which could in turn ignite a currency crisis.

Practical conclusions should be based on empirical evidence, i.e. on the analysis of economic indicators of countries which have already experienced speculative attacks on their currency. Such evidence does not offer clear-cut criteria either, but it is much more operational. It can be said that, all other things being equal, a current account deficit is likely to be less sustainable if the imbalance is large relative to GDP. Moreover, the composition of this gap also affects sustainability. If the deficit is due to a reduction in national savings (higher imports of consumer goods) rather than an increase in national investment rates (imports of new technology), i.e. if the deficit finances consumption rather than investment, it is less sustainable. The composition and the size of the capital account are important as well: The higher the proportion of short-term capital inflows, the more vulnerable a country is to a currency crisis. The more fragile the financial system of a country, and the less politically stable, the more prone it is to a currency crisis.[10]) The faster money supply expands, the more likely it is to lead to a consumption boom and to an asset price bubble. The most widely used indicators to help formulate a judgment are the ratio of current account to GDP, the inward FDI (foreign direct investment) coverage of a current account deficit, the cover of imports by foreign exchange reserves, the relative appreciation of the exchange rate versus a hypothetical medium-term equilibrium rate and the external debt service ratio to exports.

Table 1 displays these indicators for the Baltic countries. Most of them suggest that the Baltic countries could be vulnerable to currency crises, but not to debt crises. Large current account deficits with regard to GDP have already been mentioned. Foreign currency reserves are low by emerging market standards, since they generally cover three months of imports. A positive factor is their continued growth, which implies that the capital account more than offsets the widening current account deficits. It also means that the financial markets' confidence has not eroded yet and that the countries may still avert a currency crisis. The real appreciation of the domestic currencies has been very strong, even adjusted for the initial undervaluation. In Estonia, money supply growth has been very high relative to nominal GDP; currency inflows are the only source of the monetary base. Confidence in the fixed exchange rate induced borrowers to take advantage of lower interest rates abroad. The share of foreign currency loans has been increasing, and accounted for 51% of total loans in June 1997. According to central bank data, the loan portfolio of the banking system increased by 88% between June 1996 and June 1997. This fueled a consumer boom; loans to individuals rose by 61.7% in the first half of 1997. The Latvian money supply has been growing rapidly as well in terms of nominal GDP growth. The share of external debt to exports is the only indicator that does not send a warning signal: The current account position is not threatened by the intertemporal constraint on the debt service.

Table 1

Selected Indicators of Current Account Sustainability

	Current account as a percentage of GDP in 1996	FDI/CA deficit in 1996	FX reserves in months of imports at the end of 1996	Real appreciation 1994 to 1996, PPI based	Debt/exports in %	Money supply growth in % in the last 12 months
Estonia	10.3 1st quarter 1997: 16.8	33.6	2.6	77.5	14.4	53.1 August
Latvia	9.0	63.4	3.2	52.4	27.2	35.7 July
Lithuania	9.0 1st quarter 1997: 11.4	21.8	2.2	50.0	37.1	21.1 August

Source: IMF, central banks; BIS (real effective exchange rates).

No single gauge can reliably predict a currency crisis, but a number of warning signals show when the risk is high. Overall, Latvia is the least prone to a balance-of-payments crisis, followed by Lithuania, while Estonia seems to be the most exposed. This result is derived by ranking each country's position by the value of each indicator on a scale from one to three and summing up all scores; the lower a country's total, the less crisis-prone the country is.

4 Structural Change in the Real Economy

4.1 Change in Output Structure

The structure of output in the Baltic States has changed significantly since the onset of transition, and by 1997 they had all become service-oriented economies. Most countries in transition have experienced relative deindustrialization, which has been particularly pronounced in the Baltic States, though least so in Lithuania. This relative deindustrialization reflects a still incomplete restructuring process away from heavy industry toward a structure more in line with natural resources and comparative advantages. Lithuania is the first Baltic State in which the downsizing of industry came to a halt in 1995. In Estonia, industry rebounded quickly in 1997, but it is still too early to judge whether the recent growth of industrial sales indicates a permanent change (see Country Tables).

Agriculture is another sector which has lost much of its importance, with its share in GDP more than halving over the course of transition. Construction also contracted, following a decline in investment and a drop in consumer incomes to below the levels at which housing construction is affordable. The service sector has become the engine of economic growth across the region. The following figures illustrate the described processes.

Table 2

Share of Sectors in Gross Value Added

	Estonia		Latvia		Lithuania	
	1991	1995	1990	1996	1990	1995
	in %					
Agriculture	18.8	8.1	21.9	9.5	27.7	9.3
Industry	39.9	22.9	36.4	28.2	32.8	29.0
Construction	6.7	5.3	9.7	5.2	10.5	6.7
Services	34.6	63.7	31.9	57.1	29.0	55.0

Source: European Commission (Lithuania, Latvia in 1990 and Estonia in 1995), Bank of Latvia (1997), Estonian Statistical Yearbook 1994, own calculations.

In Estonia, tourism and banking are among the fastest expanding sectors. After an initial unprecedented decline, industrial production rebounded little during transition. It grew by a sluggish 1.4% and 1.3% in 1995 and 1996, respectively. Only recently has it started to show signs of strong recovery, with industrial sales expanding by 12% in the first seven months of 1997 compared with the same period of 1996.

In Latvia, too, economic growth has been driven by the service sector, mainly by transport and communications. Services grew by an estimated 4.7% in 1996. According to the data from 1995, the level of industrial production was approximately 38% of the 1990 level. Industrial production during transition declined faster than GDP and practically bottomed out only in 1996, when 1.1% growth was registered. In the first seven months of 1997, industrial output rose by 0.7% year on year. As economic growth accelerated, industry continued its relative decline.

In Lithuania, trade and transportation showed large gains within the expanding service sector. Industrial output rebounded only in 1995, and since then it has grown at a faster rate than GDP. According to the latest available figures, it advanced by 3.3% in January to July 1997 compared to the corresponding period of 1996.

4.2 Switch of Foreign Trade Destinations and Composition

During transition, the commodity composition of foreign trade and its geographical destinations have changed considerably. Trade has been successfully redirected to Western Europe. Estonia stands out as the country which redirected its trade away from the former Soviet Union to the largest extent. Finland has become Estonia's largest trade partner, ahead of Russia, which still remains the largest partner for the other two countries.

Before transition, Estonia had specialized in exports of heavy industry products to the rest of the Soviet Union. Meanwhile, it has shifted away from such an energy-intensive production structure. Estonia's main exports in 1996 were textiles, foodstuffs, machinery and equipment, timber, paper and chemicals. Between 1994 and 1996 the share of foodstuffs in total exports diminished from 22.2% to 16.0%, whereas the share of machinery and equipment widened from 9.3% to 13.5% and that of chemicals from 8.6% to 11.1%. It should be noted that reexport activities play an important role. In 1996, only 29% of machinery and equipment exports were of Estonian origin. The five major groups in total imports in 1996 were foodstuffs, mineral products, chemicals, textiles, and machinery and equipment. Estonia's trade dependence on the former Soviet Union has declined dramatically; the European Union is now its largest partner, accounting for a 66.7% share of total imports and a 51.6% share of total exports in 1996. Estonia's major export partners in 1996 were Finland (18.3%), Russia (16.7%), Sweden (11.5%), Latvia (8.4%), Germany (7.0%), Lithuania (5.8%) and Ukraine (5.1%). The major import partners were Finland (36.2%), Russia (12.9%), Sweden (8.4%), Germany (8.0%) and the Netherlands (3.7%).

Latvia had specialized in exporting manufactured goods (consumer appliances) to the rest of the Soviet Union before transition, from which it had purchased cheap energy and raw materials. After independence, post-Soviet markets shrank and raw materials became much more expensive. Latvian manufacturing proved quite uncompetitive and went through a phase of painful downsizing. Latvia found its niche as an exporter of low-value-added products. In 1996, Russia, Germany, Great Britain, Lithuania and Sweden were Latvia's most important export destinations, while its imports came mainly from Russia, Germany, Finland, Sweden and Lithuania. In the first half of 1997, exports to and imports from the European Union reached 50.8% and 53.1% of total exports and imports, respectively (42.8% and 49.5% in the corresponding period of 1996). Despite its reduced share, Russia has remained Latvia's single largest trade partner. In first half of 1997, Russia's share fell from 24.8% to 19.6% of Latvia's total exports and from 19.6% to 15.7% of Latvia's total imports. Wood products accounted for 31.7% of total exports in the first half of 1997, followed by textiles at 16.2%. Cars, electrical parts and mechanical equipment came to 19.2% of all imports, followed by mineral products at 14.2%.

The data on Lithuania's trade commodity structure display similar tendencies. Russia has remained Lithuania's single largest partner, but its share of imports shrank from 53.7% in 1993 to 26.0% in 1996 and from 33.1% to 23.8% of exports, respectively. Germany has become the second largest partner, with shares of 15.7% and 13.0%, respectively, of exports and imports in 1996. Before the disintegration of the Soviet Union, Lithuania had been assigned the role of producing technologically advanced products, so its exports had concentrated on machines, processed metals, light industrial goods and chemicals. Food processing was another major export sector. During transition, the share of machinery and electrical equipment as well as mineral products in exports has diminished considerably, while the share of textiles has risen. The share of imports of mineral products has declined sharply while the share of imports of machinery and electrical equipment and of other items has augmented noticeably in total imports.

4.3 Foreign Direct Investment

The Baltic States opened their economies to FDI after independence by creating an "investor-friendly" legal framework allowing, among other things, nonresidents to freely repatriate after-tax profits or capital and to purchase or lease land. Moreover, they provided for tax incentives. FDI flows to region picked up once investor confidence had been boosted by the stabilization of the Baltic economies and the encouraging results of the structural reforms. This explains why inflows accelerated at a different pace in different countries: Estonia attracted foreign capital first and on the largest scale, as it was the first of the Baltics whose reform efforts were recognized by the international community of investors. Also, until 1995 Estonia's legal system was more favorable to FDI than the systems of the other two countries, since foreign investors shared the same legal rights as local businesses and were allowed to purchase and own real estate. Such a favorable treatment was adopted by Latvia and Lithuania only in 1995 and 1996. Estonia has attracted not only the largest stock of FDI overall and per capita among the Baltic States (see Table 3), but also the third-largest FDI stock per capita after Hungary and Slovenia among transition economies. After peaking in 1994, inward FDI trended downward in 1995 and 1996 (see Country Tables), which coincides with the resumption of growth and the adoption of more favorable FDI regulations in the other Baltic States. The downward tendency appears to have reversed in 1997, as the preliminary data on Estonia show a considerable growth of FDI inflows into the country. A new phenomenon in Estonia is a rise of outward FDI to USD 40 million in 1996 from negligible amounts before.

In 1996 to 1997, Latvia and Lithuania started to catch up after financial markets had become convinced that the banking crises had been overcome, and both countries entered on a path of solid economic growth. In 1995 Latvia was adversely affected by a banking crisis, but FDI picked up again in 1996. Latvia attracted more FDI in 1996 than Estonia or Lithuania, both in nominal terms and on a per capita basis; FDI rose from USD 180 million in 1995 to USD 288 million in 1996. A number of measures were taken in 1996 to facilitate FDI flows to Latvia, such as the repeal of the limitations on foreign investment in branches of foreign enterprises in Latvia, the gradual liberalization of the real estate market and the lifting of the restrictions on the purchase of privatization certificates. Until the end of 1996, FDI was mainly directed to transportation, communications and banking.

In 1995 amendments to the 1990 law on foreign direct investment effectively put foreign investors on an equal footing with local enterprises in Lithuania, as foreign firms were no longer required to take out permits and were also allowed to buy land. Lithuania has only lately attracted a larger volume of inward FDI, which grew to USD 152.4 million in 1996 compared with USD 72 million in 1995. Preliminary data point to the continuation of an upward trend in 1997. Manufacturing, wholesale and retail trade, postal services and telecommunications benefited the most. Within manufacturing, electrical equipment, food and beverages, tobacco, rubber and plastics, and furniture drew the most capital from abroad.

Table 3

Cumulative FDI Inflows per Capita

	1989 to 1995	1989 to 1996
	USD million	
Estonia	437	460
Latvia	221	280
Lithuania	95	135

Source: IMF.

5 Structural Reforms

The authorities of the Baltic States soon recognized that they needed sweeping structural changes in order to establish the institutional framework required for a modern market economy. In general, transition to a market economy involves numerous tasks, such as a far-reaching deregulation of prices, which is crucial for guiding the efficient allocation of resources.[11]) The liberalization of trade, services and capital movements is the key to a competitive production sector and to the freedom of choice for consumers. Liberalization also encompasses the reduction of tariffs and of nontariff restrictions on trade, securing the rights of foreign direct investors and establishing currency convertibility. The widespread privatization of state assets is necessary to improve corporate governance; in other words, enterprises need to become more responsive to economic incentives. This would allow for the elimination of various forms of subsidies, including credits at below-market interest rates. The establishment of a two-tier banking system and an efficient tax administration is also indispensable for a national macroeconomic policy geared to the needs of a market economy. Bankruptcy procedures and regulations on collateral are required to foster the restructuring of companies and to support the enforcement of contractual obligations. Finally, suitable social nets need to be established, as transition brings about unemployment. The Baltic States have embarked on all these tasks and have made decisive progress in many regards.

5.1 Liberalization and Deregulation

The three countries have rapidly liberalized their economies from the very beginning of transition. They liberalized prices early in 1991 to 1992, and simultaneously freed foreign trade and, to a large extent, capital transactions. The regulated prices cover basic consumer necessities with a large impact on incomes, such as rents and public transportation, electricity rates and heating prices. Estonia clearly embraced a very liberal model for its economy and dismantled almost all barriers to foreign trade, while the other two countries have been more moderate in their efforts. Currencies have been made convertible also for capital transactions. All three countries strive to harmonize their regulations with EU legislation.

In Estonia, the prices of the majority of goods have been freed, with the exception of the prices of land, oil shale, electricity, medicines, medical insurance services, public transportation and some municipal services. Regulated prices still make up close to 25% of the basket of consumer goods, which means that any changes will have a considerable effect on monthly inflation rates. Estonia is the only country in the region to have adopted a uniform tax rate on personal and corporate income (26%). The kroon has been convertible for current account transactions since the establishment of the currency board in 1992. In 1994 Estonia formally accepted the obligations of Article VIII of the IMF's Articles of Agreement. All foreign exchange controls had been removed by the end of 1994, and since then the currency has been fully convertible. Individuals are allowed to open accounts abroad. All restrictions on trade which originated in the Soviet time have been abolished as well. Tariffs are imposed only on imports of furs, and excise taxes are levied on cars, motorcycles and recreational boats; licensing is restricted to trade in drugs, arms and ammunition and similar items. Quantitative restrictions have been eliminated completely. There are no explicit export and import subsidies, and export tariffs exist only for objects of cultural value. The introduction of protective measures for a limited number of agricultural products is under consideration. This, however, should not be seen as a retreat from a liberal regime, but in conjunction with Estonia's transformation of the agriculture sector from a collectivist to a private system. The so-called producer subsidy equivalent calculated by the OECD was only 3% in 1995, compared with 49% for the EU.[12])

In Latvia, price liberalization and the reform of the tax system started before independence in early 1991. Goods and services with administered prices still represent about 20% of the basket of consumer goods, namely energy supply, utilities, transport and rents, whose prices do not cover the full cost of production. Foreign trade, wages and interest rates were liberalized immediately after independence. Quantitative restrictions and export tariffs have been almost completely eliminated. Only agricultural products continue to be highly protected. The producer subsidy equivalent was calculated at 8% in 1995. The government is committed to reducing tariff protection but has postponed the issue, as it is negotiating for admission to the World Trade Organization. Latvia accepted the obligations of Article VIII of the IMF's Articles of Agreement in June 1994 and subsequently removed almost all controls on capital account transactions.

In Lithuania, prices were almost fully liberalized in 1991 to 1992. The government still controls the prices for energy, housing, utilities and public transportation. Goods with administered prices represent approximately 10% of the basket of consumer goods. As in Latvia, nontariff restrictions do not apply in Lithuania. Import tariffs have been significantly lowered. There are some export taxes on raw materials. The export licensing system was abolished in 1993. Since mid-1994, import tariffs on some agricultural products have been reduced. The producer subsidy equivalent was calculated at 3% in 1995. The Lithuanian currency is fully convertible. Residents and nonresidents may open accounts in foreign currencies.

5.2 Privatization Methods and Results

The freeing of prices per se does not automatically ensure that economic agents decide on the basis of relative scarcities. Privatization is a means to improve corporate responsiveness to such scarcities. Under Soviet rule, all three countries had only marginal private sectors. The speed of privatization and the methods applied differ among the countries. The attitude to foreign participation is another distinctive feature.

Lithuania embraced privatization the earliest, but since it chose vouchers as the principal method of privatization, little new capital was injected, corporate governance was hardly changed and the restructuring of productive capacities was delayed. Insiders have taken control of numerous enterprises. Estonia, by contrast, chose to model its privatization on the method of Germany's Treuhandanstalt, i.e. it sought to attract cash-paying strategic investors. Estonians allowed foreigners to participate on an equal footing with nationals, while the other two countries restricted nonesidents' presence in the privatization process until recently. Latvia was slow with the start of the privatization process, but started to catch up in 1996 and 1997 and applied a multi-track method. Small-scale privatization has been completed in the region. Large-scale privatization, which has always proved a stumbling block in transition, was pioneered by Estonia. All Baltic States passed bankruptcy laws early in transition, but only Estonia attempted to apply its law actively to speed up the restructuring of state enterprises. The two other states have only recently started to use this legislative instrument. Estonia has been the least successful in privatizing the agriculture sector, as the restitution of property rights hampered the process.

In Estonia, ownership reform was one of the key issues during transition and proceeded without delays because there was a political consensus. The country followed a multi-track approach. Small firms were turned private largely through employee buyouts and auctions; small-scale privatization was completed in 1995. Large firms have favored privatization through sales to strategic investors; this approach was targeted at improving corporate governance through tenders and direct sales. The restructuring of privatized companies is usually left to the new owners, mostly on the basis of plans submitted at the time of bidding. With the exception of companies within the infrastructure sectors, almost all large enterprises had been sold by the end of 1996. More than three quarters of all state companies have already been sold to private investors. In 1996 the government launched a long-term program to sell infrastructure firms, namely ports, electricity companies, telecommunications firms, gas and railway networks. The privatization of agriculture has proved a more daunting task, and Estonia lags behind Latvia and Lithuania in this field. Restitution problems have impaired sales of land to potential buyers. A bankruptcy law was passed in 1992 and implemented more rigorously in Estonia than in other transition economies.[13])

Latvia also chose a multi-track approach to privatization. It has mainly relied on voucher privatization. These tradable vouchers could and can still be used for the purchase of shares in firms, land or housing units. Small-scale privatization and the privatization of agriculture are almost complete. With the privatization of large firms behind schedule, the Latvian government decided to push it in 1996 by transferring all remaining state assets to the newly created Privatization Agency. The figures reflect the success of this approach: Of the 380 state-owned firms that had been sold by the end of 1996, 200 were sold in 1996 alone; 147 firms were privatized in the first half of 1997. Big infrastructure companies, including shipping, telecommunications, electricity and energy, and oil firms will be put on the block in 1997. The government plans to complete the privatization of all remaining state enterprises by mid-1998, excepting railways, airports and the postal service. However, this plan may prove overly ambitious, as the poor financial condition of numerous firms and remaining legal inconsistencies tend to delay the process. Lately, international tenders and public offerings have become the preferred method of large-scale privatization. Foreigners are seen as active participants in a position to inject capital into the often ailing firms in need of restructuring. Restrictions on real estate purchases by nonresidents have been eased, which should help boost foreign direct investment; however, foreigners must own no more than 50% of a property. The introduction of a new solvency and bankruptcy act in September 1996 should enhance the restructuring of firms provided it is implemented efficiently.

Lithuania embarked on privatization in 1991, using a voucher system only. Up to 50% of all shares were reserved for managers and employees, so insiders took control of many firms. In late 1994, Parliament issued a “negative list” of 250 firms excluded from privatization (“strategic enterprises“). The first phase of privatization ended in 1995. In mid-1995, Lithuania changed its approach and adopted a program for the second stage of privatization for the sale of enterprises not bought during the first wave and the reclassified assets which had appeared on the “strategic list” before. This time the preferred mode of divestiture was cash sell-offs. The program had a slow start in 1996, as the initial offerings involved minority stakes or unattractive firms. In 1997 the range of firms eligible for privatization was expanded to include large enterprises in the transport, energy and telecommunications sectors. Lithuanian Oil, Lithuanian Telecom, air transport firms and Lithuanian Sea Transportation are being offered. The government decided to abolish the list of ineligible firms. While foreign citizens could not own land, they were allowed to hold a lease for up to 99 years until 1997, when the law was changed to also permit purchases by nonresidents. A bankruptcy act had been adopted in 1992, but supporting regulation was completed much later.

5.3 Banking Sectors

All three countries had to create two-tier banking structures. In a first step, the central banks in the individual countries became independent from the former Soviet central bank, and new national currencies were introduced. In a second step, the central banks gradually shed their commercial operations, a process which was completed in 1993. In contrast to Latvia and Lithuania, Estonia did not incorporate specialized banks into the central bank, but created new banks on the basis of their assets instead. Latvia and Lithuania first incorporated specialized banks into their central banks in order to consolidate banking activities and then spun the specialized banks off from the central banks. Apart from that, at the beginning the Baltics pursued similar policies with regard to the banking sector. The new banking institutions flourished in the first years of transition, as it was easy to enter the sector. Licensing was lax and capital requirements were low, as they were left unadjusted for inflation and currency depreciation. Prudential regulation was mostly lacking, and enforcement was weak. Like those of other economies in transition, the Baltics' banking systems suffered from a number of common shortcomings, such as a considerable share of nonperforming loans, undeveloped legislative frameworks, weak supervision, inadequately skilled banking staff and large spreads between borrowing and lending interest rates in the absence of competition. These drawbacks have been largely overcome, but at the price of a banking crisis in each country.[14]) Each country had to resort to at least some public funds to help restructure the banking sector. Estonia and Latvia relied on a decentralized model, injecting capital into the banks they considered viable and suitable for further privatization while leaving it to the banks themselves to deal with their bad loans. Lithuania chose a centralized approach instead: It set up a central agency to clean up the bad loans of selected banks and provided banks with government assets for recapitalization.

The banking crises had similar roots in all countries, such as banks' lack of competence in assessing risks and poor lending practices, namely excessive lending to connected parties or a single borrower and lending without proper collateral, or even fraudulent lending. In Estonia, inherited bad loans had more impact than in Latvia and Lithuania, because the crisis hit earlier. Estonia was affected in 1992, thus almost at the outset of transition, whereas the two other countries faced banking crises in 1995 to 1996 at a relatively advanced stage of transition. The banking crises coincided with the peak reform period of the financial sector. The latter two countries had maintained permissive regulations for too long. In all three countries, the balance sheets of the large banks had deteriorated enough to entail the threat of insolvency due to bad loans. Poor provisioning for nonperforming loans was the rule, and banks were reluctant to report loans as nonviable. The lack of transparency in accounting practices helped mask the problems, so they did not surface until later. The crisis had the indisputably positive side effect in each country of prompting the adoption of prudential regulation in line with international standards (see Table 4). This was instrumental for cleansing the banking sector of insolvent institutions. Whereas Lithuania and Latvia are still grappling with the consequences of their banking crises, the worst is over and their banking sectors have started to grow again. A further consolidation of their banking systems is inevitable, and the presence of foreign banks is likely to increase.

The approach to the banking crises differed among the countries, which may have had an impact on the financial situation of the sectors after their recovery as well. Currently, the Estonian banking sector is basically sound and the strongest in the region, though it is overbanked.[15]) After the crisis, the banking sector went through a phase of consolidation, and the number of banks declined considerably from 42 in 1993 to 14 in early 1997. Estonia's strongest banks started expanding abroad; Hansapank acquired the sixth-largest Latvian bank in terms of total assets (Hansapank Latvia). The privatization of the sector is almost complete, with the state having assumed minority stakes in two institutions. Foreign banks can establish branches under the same conditions as domestic banks. The capital market and nonbank financial institutions are comparatively less developed. Deposit insurance is not yet in place, but the respective law has already been drafted (see Table 4).

Latvia is the only Baltic State in which the banking crisis had a visible impact on the real economy; it brought the already weak growth to a standstill. The crisis surfaced when the Bank of Latvia required all banks to submit financial audits of 1994 accounts based on International Accounting Standards (IAS). The then-largest Bank Baltija, which held 30% of total deposits, refused to comply; its difficulties soon became evident to the public, which started to withdraw deposits. The Bank of Latvia wanted to provide liquidity at first, but withheld its support once it realized that the bank's insolvency was mainly caused by fraudulent lending. Bank Baltija was declared insolvent in July 1995 and was closed. As a result of the banking crisis in 1995, the number of commercial banks in Latvia declined to 38 at the end of 1995 from 55 at the end of 1994. Many banks were liquidated (operations in one third of all banks were suspended). The four major banks which collapsed accounted for around 30% of all assets and 46% of all deposits from private persons. Given the lack of deposit insurance, there were also runs on solvent institutions because many people believed that further problems would erupt. Household deposits fell from LVL 277 million in December 1994 to LVL 116 million in December 1995.[16]) The Bank of Latvia did not rescue the banks, and instead initiated sweeping regulatory changes to avoid the recurrence of a systemic crisis. These changes included the adoption of the Law on Credit Institutions, the introduction of international auditing standards, frequent on-site examinations and restrictions on accepting deposits from the general public. Latvian prudential regulation has become stricter than EU standards in several respects (see Table 4). After a stringent review, the Bank of Latvia initially renewed only twelve banks' licenses to take deposits from individuals. These banks are referred to as core banks. The minimum capital requirement was raised to LVL 1 million effective from April 1996. To restore confidence in the banking system, the government came up with a plan to refund up to LVL 500 per depositor in four installments, starting with LVL 200 and followed by three installments of LVL 100 in the three subsequent years. However, it altered this plan in 1996, limiting compensation to the recovered value of liquidated assets. A new scheme limiting insurance to LVL 500 at core banks only is under discussion.

In the two years since the eruption of the crisis, the condition of the banking sector has much improved. The number of core banks which meet all prudential regulation requirements had risen to 19 by July 1997. The consolidation of the sector continued, with the number of banks falling from

38 to 32. Total performing assets increased by approximately 140%, while the share of nonperforming assets dropped from 25% to 7.5% between June 1995 and June 1997. The privatization of the two remaining public banks, Latvian Savings Bank and Unibanka, is in progress. Prior to privatization they will be recapitalized, which means that the state will in fact be directly

Table 4

Selected Prudential Regulation

	Estonia	Latvia	Lithuania	EU standards
Minimum capital requirement	EEK 6 million from January 1993 EEK 15 million from June 1993 EEK 25 million from January 1995 EEK 35 million from January 1996 EEK 60 million from January 1997 EEK 75 million from January 1998	LVL 0.1 million until March 1993 LVL 1 million from April 1996 LVL 2 million from April 1998 ECU 5 million from January 2000	LTL 5 million from January 1994 ECU 1.9 million from July 1, 1995 ECU 3.8 million from January 1997 ECU 5 million from January 1998	ECU 5 million
Minimum registered capital for new banks	as above	LVL equivalent of ECU 5 million	as above	ECU 5 million
Capital adequacy ratio	10% risk weighted from October 1, 1997	10% risk weighted	13% risk weighted 10% from April 1997	8% risk weighted
Liquidity indicator	liquid assets at least 35% of liquid liabilities	liquid assets at least 30% of total liabilities	liquid assets at least 30% of total liabilities	none
Limits on lending as a percentage of own capital:				
• Credit concentration per client	25%	25% from January 1, 1996	25% (formerly 30%)	25%
• Total large exposure to all clients	800%	. .	. .	800%
Connected lending	20%	15%	10%	10%
Limits on FX exposure as a percentage of own capital (from January 1996)	30% overall 10% in any currency except for DEM	20% overall 10% in any currency	30% overall 20% except for USD	any amount exceeding 2% is subject to the capital adequacy rule
Loan classification and provisioning	loans overdue for 150 plus days have to be written off	10% for loans under observation 30% for substandard loans 60% for doubtful loans 100% for bad loans	. .	no EU-wide standard
Deposit insurance	no deposit insurance (draft law: up to EEK 20,000 per depositor and 90% of deposit)	. .	individual deposits up to LTL 4,000	ECU 15,000 until 1999, then ECU 20,000[1])
Audits	internal audits required; external audits based on International Accounting Standards	by international audit companies approved by the Bank of Latvia	audits based on international accounting standards from January 1997, checked by independent auditors	comprehensive external audits are standard practice
Quarterly balance sheet publication	. .	required for banks accepting household deposits	. .	no obligation, but most banks publish quarterly balance sheets

Source: central banks.

[1]) For those countries which already had ECU 15,000. Countries which started with limits below ECU 15,000 may retain these lower limits in the interim, but any change must be upward to converge to the specified limits.

involved in the restructuring of these banks. The minimum capital requirement will be raised to LVL 2 million in 1998 and then again to the EU standard of ECU 5 million in 2000. The requirement will enforce a further consolidation of the banking system. An ECU 5 million requirement has already been put in place as the minimum for new entrants into the business. A more stringent and detailed regulation of market risk evaluation is to be introduced.

In 1994 the Bank of Lithuania began to enforce loan loss provisioning. It intensified its supervision efforts in spring 1995 after the law on the Bank of Lithuania and the Commercial Bank Law had been passed in December 1994. Like in Latvia, these activities precipitated the eruption of the crisis, which started in those private banks which were saddled with nonperforming loans and which were undercapitalized. Consequently the activities of one large and two medium-sized banks were suspended. These banks accounted for 25% of total deposits. The three state-controlled banks, which held 50% of all deposits, were undercapitalized as well, but unlike the private banks, they were bailed out. The Bank of Lithuania acted as a lender of last resort to a limited degree, as it retained a buffer of foreign exchange reserves to preserve the integrity of the currency board arrangement and injected liquidity into two private banks. Unlike Estonia and Latvia, Lithuania opted for a centralized approach to dealing with nonperforming loans. The bad loans of the suspended private banks were transferred to a special asset management company; to avoid a moral hazard problem, the shareholders lost their rights and the full value of their shares when the state took over the administration of these institutions. The bad loans of the three large state banks were also transferred to the asset management agency. These banks were subsequently recapitalized by the government. To this effect, the government issued special bonds and transferred cash from the budget. Recapitalization is to be directly followed by the privatization of these banks. To restore confidence in the banking sector, the government decided to extend the limited protection scheme which used to cover deposits in state banks only to all banks on an equal footing (see Table 4).

5.4 Monetary Policy Frameworks

At the beginning of transition, the countries lacked an adequate institutional framework for monetary policy. In a first step, modern central banks had to be established. Subsequently, from 1992 to 1993, the central banks divested all commercial operations and actively helped introduce national currencies, which was indispensable for conducting an independent monetary policy.[17]) The central banks of all three states opted for an exchange rate anchor. Estonia took this step right away, while Lithuania and Latvia did so after brief episodes with a managed floating regime. Estonia and Lithuania chose a currency board arrangement (CBA) for their exchange rate systems in June 1992 and April 1994, respectively. Latvia went for a peg to the SDR, a strategy which did not interfere with the creation of a full-fledged modern central bank and its monetary policy responsibility. However, the independence of the Latvian central bank does not live up to the standards imposed on the central banks of the EU countries by the Maastricht Treaty, as it is allowed to finance budget deficits. All three central banks use only instruments of indirect monetary control; direct controls were phased out in 1993. Monetary policy instruments remained rudimentary in Estonia and Lithuania after the adoption of the CBA. Lithuania already elaborated and has started to implement a plan to gradually abandon the CBA, so it has begun to expand the range of its instruments.

The independence of the central banks of Estonia (Article 3), Latvia (Article 13) and Lithuania (Article 3) from government is explicitly laid down in the respective central bank acts. The Banks of Estonia and Lithuania report to Parliament, which has no say in the course of monetary policy. The central bank acts moreover enshrine personal independence; the terms of the governors are longer than the political cycles in each country. The Chairman of the Board of the Bank of Estonia and its President are appointed by the President of Estonia for five-year terms (Article 7).[18]) They can be dismissed only if found guilty of a crime by a court (Article 12). The Governor of the Bank of Latvia is appointed by Parliament for a six-year term (Article 22) on recommendation of at least ten members of Parliament.[19]) The Governor and other board members can be dismissed only if found guilty by a court or if they are unable to perform functions for a prolonged period (six months). Of course, they also have the option to resign (Article 22). The Chairman of the Bank of Lithuania is appointed for five years by Parliament on recommendation of the President (Article 10).[20]) The instances which may lead to a dismissal are also limited and are unrelated to monetary policy issues (Article 12). They comprise the inability to perform a function, a court conviction or an appointment to the board of another financial institution. However, the formal independence of the Bank of Lithuania has been compromised on a few occasions. During the banking crisis, the Governor and board members were pressed to resign.

The Estonian and Lithuanian central banks are financially independent from their respective governments, i.e. they cannot be forced to finance budget deficits either by extending direct credits to the fiscal authorities or by purchasing government securities or by simply printing money. This is consistent with their currency board systems, under which the monetary base must not exceed the gold and foreign exchange reserves of the Bank.[21]) The Latvian central bank is allowed to finance budget deficits, and it did so during the banking crisis in 1995. These loans must not exceed one twelfth of the annual revenue of the current budget (Article 36).

The functional independence of the central banks in Lithuania and Estonia is limited, as they have to follow the strict rules prescribed by the CBA (a tie-your-hands mechanism). They cannot independently determine the goals of monetary policy, as the exchange rate is the goal, and they may use only the instruments of modern central banking which are compatible with the CBA. They are free to impose a system of prudential regulation. However, the Lithuanian parliament set a precedent by overriding the regulations in deciding to let two state banks operate without fully complying with the Bank of Lithuania's prudential regulation and thus waived capital adequacy requirements pending the privatization of the two banks. The right to alter the exchange rate system and exchange rate levels is restricted to Parliament in Estonia and Lithuania. In Latvia, by contrast, this right is incumbent on the central bank (Article 4). All three central banks have been allocated own capital and are responsible for their own budgets; they are expected to finance all expenses from their revenues. They are required to distribute the profit which remains after appropriation to the state budget.

The formal division into a final goal and intermediate and operational targets is followed in Latvia, but not in Estonia or Lithuania. The CBA defines the actual target structure of central banks in the former two countries; the exchange rate is the intermediate and operational target, and the monetary base is fully backed by foreign exchange in each country. In Estonia and in Lithuania (Article 7), the final goal is to achieve currency stability. This framework is consistent with the CBA setup, since the external stability of a currency can conflict at times with its internal stability. The Bank of Lithuania is called upon to support government policy to the point where it does not interfere with the ultimate goal. The Latvian central bank pursues the goal of price stability (Article 3). Latvia uses the exchange rate as an actual intermediate target and net domestic assets as an operational target. The latter is in line with monetary theory, according to which the monetary base is endogenous under a fixed exchange rate regime and the central bank controls only domestic credit.

There are no standing refinancing facilities in Estonia, and no official interest rate is announced. In the second half of 1996, a standing deposit facility for banks was established in response to the excess liquidity of the banking sector. The Bank of Estonia is allowed to issue certificates of deposit, which it may repurchase from commercial banks under exceptional circumstances in its function of a lender of last resort. This is where the classical setup of a currency board is somewhat watered down. In Lithuania the regulations are more prudent; i.e. any foreign exchange in excess of the full cover of the monetary base can be used for lender-of-last-resort operations. Thus, the Bank of Lithuania may extend short-term liquidity loans to commercial banks or purchase government securities from them. Latvia has a refinancing facility for overnight loans as well as lombard credits and auctioned credits (uncollateralized); weekly auctions of the latter have been held since late 1993. The maturity is one month; moreover the Bank rations these auction credits by keeping allotments low. The Bank of Latvia has been accepting nonnegotiable term deposits from commercial banks since March 1995, which constitutes a liquidity-absorbing instrument. The denomination is LVL 10,000, to set it apart from the Treasury bill market denomination of LVL 100,000.

Open market operations (OMOs) are not forbidden in Estonia, which wanted to stimulate the development of the money market. Since May 1993 one-month discount certificates of deposit have been issued and auctioned off to commercial banks once a month, but the amounts are very limited. Therefore they can hardly be qualified as an instrument for the Bank of Estonia to control money supply; banking liquidity is changed by market-initiated transactions through the foreign exchange window. Lithuania intends to develop OMOs in the process of phasing out the CBA. Latvia has introduced repurchase agreements, although the money market is relatively illiquid. As the country has run budget deficits, the Treasury bill market offers a certain scope for OMOs. Treasury bill auctions were introduced in 1993; originally, 28-day bills were issued, then 91-day bills were added.

Reserve requirements are in place in all three countries. The approach to remuneration is not uniform. In Estonia, required reserves, which have been 10% for all deposits and most other liabilities since the end of 1992, are not remunerated. Excess reserves are remunerated at the Bundesbank's discount rate minus a preset margin. The other two countries do not pay interest on reserves held at their central banks. In Latvia, reserve requirements were introduced in July 1993, and a uniform ratio of 8% has been applied since then to commercial banks' lat and foreign exchange deposits. In Lithuania, the reserve requirement has been in place since 1991 and came to a uniform 12% until the banking crisis. During the banking crisis, the Bank of Lithuania lowered the reserve level temporarily to 5%.

As mentioned above, the cornerstone of the monetary system in Lithuania and Estonia is the CBA. Estonia has pegged the kroon to the Deutsche mark, while Lithuania has tied its litas to the U.S. dollar. In both countries, the monetary base is fully backed by liquid international reserves. The Eesti Pank cannot devalue the currency; this right is reserved to Parliament (Law on the Security of the Estonian Crown). The Bank of Estonia stands ready to buy and sell foreign exchange at the rate of 8 kroons to the Deutsche mark. It must not start any form of intervention aimed at achieving discretionary monetary policy goals. The Estonian currency is almost fully convertible within the capital account; thus the Bank of Estonia exerts almost no control over currency movements. In July 1996, the bank eliminated buy and sell rates to foster interest rate arbitrage. Lithuania, whose CBA started operating in March 1994, chose a rate of 4 litas to the U.S. dollar. Only under exceptional circumstances and with government approval can the Bank of Lithuania switch to a different anchor currency. The Law on the Credibility of the Litas specifies that the total amount of litas in circulation must at no time exceed the gold and foreign exchange reserves held by the Bank of Lithuania. The Bank retains the right to foreign exchange intervention. Latvia pegged its lat to the SDR in January 1994 at the rate of 0.8 lats per SDR. The Bank of Latvia is allowed to conduct either sterilized or nonsterilized foreign exchange intervention, but because the volumes are small, the latter is the rule. The Bank has influenced the liquidity of the banking sector by means of foreign exchange intervention: In 1996 the monetary base grew mostly due to unsterilized foreign exchange intervention.

The aspirations of the Baltic countries to join the European Union are likely to shape the evolution of their institutional frameworks for monetary policy. The analysis in this section shows that while all elements of central banking are in place in Latvia, the independence of its central bank still has to be reinforced. The two other countries will have to gradually dismantle their CBAs and at the same time replace them by institutional arrangements compatible with indirect monetary controls. This task is challenging, as these countries do not want to risk losing the hard-won confidence in their currencies.

6 Policy Challenges

The Baltic countries face numerous policy challenges. Most of them result from the plans to enter the European Union, which are discussed in section 7. This section tackles two general challenges, both related to macroeconomic policy.

6.1 The Phasing-out of the CBA

From the economic standpoint, a currency board arrangement is a system of fixed exchange rates in which the monetary base is automatically linked to foreign exchange flows. A CBA enhances the credibility of a counter-inflationary policy, as the scope for discretionary monetary action becomes strictly limited and is fairly transparent. In contrast to a conventional fixed peg, parity changes under a CBA require a parliamentary decision and a formal change of laws. Market participants see a strong link between the operation of the CBA and financial stabilization in Estonia and Lithuania. Both countries have signaled their intention to eventually dismantle their currency boards, as a CBA is a restrictive solution despite its instrumental role in bringing inflation down. Furthermore, a CBA is incompatible with EU central banking standards.

In general, current account deficits and capital inflows make a CBA a straitjacket for an economy. CBAs have been the cornerstone of economic stability in Estonia and Lithuania, but their drawbacks are becoming a serious constraint on monetary policy under conditions of massive foreign currency inflows. Capital inflows lead to an automatic rise in the money supply, which may make CBAs ineffective in fighting inflation. CBAs also reduce the ability to cope with various shocks, such as big changes in commodity prices, since the exchange rate cannot adjust. The freedom of a currency board to act as a lender of last resort is very limited, because currency boards cannot increase the money supply in periods of financial stress to assure the liquidity of the banking system. Estonia and Lithuania are likely to dismantle their CBAs for the above reasons in the coming years, but intend to link their currencies to the euro should the Deutsche mark cease to exist. The phasing-out process will probably be gradual. Another radical method would be to simply float the exchange rate,[22]) which is, however, less probable because EU integration requirements have to be met.

Lithuania's plan to peg its exchange rate to the euro,[23]) which involves three steps, has won approval from the IMF. In a first step, which has already started, the monetary powers of the Bank of Lithuania are to be gradually increased, while the CBA will remain operative. When the first step is completed, the central bank will stop covering its monetary base entirely with foreign exchange and buy government bonds from the public. With a sufficient portfolio, it can then engage in open market operations. In step two, the CBA will be eliminated, while keeping the litas pegged to the U.S. dollar. After completion of this step, the Bank of Lithuania will be able to conduct sterilized intervention if necessary. In step three, the U.S dollar will be gradually replaced by a U.S. dollar-Deutsche mark mix in which the Deutsche mark's share will be steadily increased. No intention to devalue the litas has been expressed in the plan. However, the ever-deteriorating current account may suggest an overvaluation of the litas with respect to the level at which the current account is balanced in the medium term.

Estonia has not presented a formal plan to exit the CBA yet. For eventual participation in EMU, Estonia will have to abandon the CBA sooner or later and replace it by a full-fledged central bank that uses various indirect instruments of monetary control.

6.2 Current Account Deficits

All the Baltic States have the problem of high and widening current-account shortfalls and strong capital inflows, and at the same time have fixed exchange rate regimes. According to economic theory, monetary restraint is ineffective under a fixed exchange rate, as a small open economy has a severely limited capacity to sterilize foreign exchange flows over time. In the beginning, a monetary contraction causes interest rates to rise, which attracts higher inflows of liquid foreign capital. These inflows can be sterilized only temporarily. Subsequently, money supply grows, inducing a return of interest rates to their initial level. A fiscal tightening would be needed to trim aggregate demand. Another theoretical way to cope with the problem is to devalue the domestic currency in order to stimulate exports and curtail imports, but this is incompatible with the currency board system and will have inflationary consequences unless productive capacities are underutilized. A combination of both methods, namely devaluation and fiscal restraint, which is called expenditure switching and expenditure reducing in the literature, is the most effective approach, as it works against the inflationary bias of a devaluation.

Estonia and Latvia have reacted to the emerging problems by adhering to theory. Both countries tightened their fiscal policies in 1997 by adopting balanced general government budgets. Estonia pursued this policy rigorously, while Latvia may show a small deficit at the end of 1997. Since the current account gaps continued to widen, the countries may be forced to tighten their budgets further. Lithuania continued to run a limited budget deficit in 1997. Estonia also attempted to curb domestic credit expansion by raising the capital adequacy ratio to 10%, which is higher than the 8% BIS requirement, and by reclassifying the risk of loans to local governments. This unusual step may be ineffective, as higher interest rates are likely to induce more capital inflows under the condition of high capital mobility. Then, the money supply would continue to grow at a rapid pace, which would translate into a higher demand for imports, adversely impacting the current account.

7 Integration with Europe

The Baltic States declared integration with Western Europe a strategic goal from the beginning of their independence, and there is broad political consensus in this matter. The three states see admission to the EU as part of a historical process culminating in their cultural, political and economic integration with the rest of Europe. To speed European integration, Estonia, Latvia and Lithuania concluded Free Trade Agreements early in transition, and in 1995, negotiated so-called Association Agreements (Europe Agreements) with the EU along with seven other transition economies. In autumn 1995, the three countries officially presented their applications for membership. In July 1997, the European Commission put Estonia on a shortlist of five countries it recommends for the beginning of entry negotiations on the basis of a thorough examination of ten applicants from Central and Eastern Europe. The European Commission is of the opinion that Latvia and Lithuania will not be able to cope with competitive pressure within the EU in the medium term, and that the market structures of their economies still need further development. Therefore, the Commission suggests that negotiations for accession to the EU start as soon as these countries have made sufficient progress in the critical areas pinpointed by the Commission. The areas requiring considerable improvements are shown in Table 5.

In its comprehensive opinion, the Commission states that all three countries are established democracies and meet the political criteria for membership. Estonia also meets the criterion of a functioning market economy and should be able to withstand competitive pressures within the EU in the medium term contingent on further progress in specific areas (see Table 5). Estonia still needs to realign its legal framework with the *acquis communautaire* and enforce the relevant national laws.

Table 5

Summary of the European Commission Conclusions

	Fit to start entry negotiations soon	Areas requiring further progress toward a market economy	Areas in need of reform to withstand competitive pressure	Areas in which legislation requires amendment
Estonia	yes	• land reform • pension reform	• export base (too narrow)	• intellectual property • public procurement • financial services • taxation • transparency of state aid
Latvia	no	• effective implementation of created legislative framework (must be speeded up) • privatization (must be completed) • establishment of regulatory bodies (is not comprehensive yet)	• exports (consist mostly of low-value-added items) • industrial restructuring • banking sector (weaknesses) • agriculture (in need of modernization)	• intellectual property • public markets • personal data • competition • taxation
Lithuania	no	• relative price adjustment • large-scale privatization • bankruptcy proceedings • enforcement of financial discipline on enterprises	• industry (substantial restructuring required) • agriculture (modernization required) • banking sector (weaknesses)	• intellectual property • public markets • capital market liberalization • financial services • taxation • competition

It is estimated that the per capita GDP in Estonia, Latvia and Lithuania came to no more than 25% of the average level in the EU in purchasing power terms in 1995. Thus the applicants would be net beneficiaries in the EU. They would be eligible for substantial agricultural assistance from the CAP and for regional aid, assuming these systems are still unreformed at the time of accession. However, the Baltic economies are tiny by international standards, so the states' prospective entry is not going to have a visible impact on the Community's GDP or budget. This should facilitate the negotiation process in the future.

8 Conclusions

Estonia, Latvia and Lithuania have made significant progress in transition. All three have succeeded in introducing national currencies, which was indispensable for exiting the hyperinflationary ruble area and creating independent monetary systems. They all embarked on comprehensive reforms to transform themselves into full-fledged market economies. They liberalized and deregulated their prices and trade regimes, and made their currencies convertible. Their economic stabilization has progressed consistently. Economic growth resumed at a moderate pace with a tendency to accelerate, and inflation has fallen to the lowest levels among transition economies. However, the exchange-rate-based stabilization brought about the well-known side effect of real-term currency appreciation resulting from the inflation differential and also from capital inflows that were encouraged by successful stabilization. This real-term appreciation caused huge trade deficits because imports rose much faster than exports, which ultimately entailed current account deficits of approximately 10% of GDP. So far, the Estonian, Latvian and Lithuanian commitment to stabilization has been rewarded by greater credibility and improved confidence of international financial markets, which has allowed the countries to finance these deficits. However, the shortfalls may prove unsustainable in the future if current negative trends continue. Therefore, the countries have started to correct their macroeconomic policies in 1997.

Structural reforms have also made headway: The most difficult step in transition, the privatization of large enterprises, is being tackled with vigor. Laws and institutions are being harmonized with EU legislation.

Estonia clearly stands out in the group of the Baltic States as the most committed to liberal reforms from the early days of transition. It has eliminated bureaucratic impediments to entrepreneurship more thoroughly than the other countries. Its privatization is the most advanced, and its banking system is the soundest. It has attracted the largest FDI stock and has redirected trade to the West more than the other two countries. It has recorded the best growth performance of the group, although accelerating growth in 1997 has led to an overheating of the economy. This is reflected in the recent break in the disinflation process: Estonia is lagging behind Latvia and Lithuania. The overheating exacerbated the current account deficit, as the trade gap has widened to almost 25% of GDP.

In the opinion of the European Commission, Estonia qualifies for an early start of negotiations on EU accession. Latvia and Lithuania have been judged unable to cope with competitive pressures within the EU in the medium term unless they achieve more progress with reforms and with the harmonization of their laws. Their progress will be reviewed again at the latest at the end of 1998. The two countries have recently accelerated their reforming efforts, which at the time of writing has brought their potential entry into the EU within closer reach.

Annex

Estonia – Selected Main Economic Indicators

	1992	1993	1994	1995	1996	1997[1])	latest
GDP current prices EEK million	13,158.0	22,060.0	30,268.0	41,279.0	52,379.0	16,200.0	Q2
GDP in USD million		1,668.3	2,329.9	3,600.4	4,352.6	1,182.2	Q2
GDP % change	– 21.6	– 8.5	– 1.8	4.3	4.0	11.7	H1
Industrial output % change		– 30.0	– 3.5	1.4	1.3	12.2	Jan.–July
CPI % change	1,069.0	89.8	47.7	29.0	23.1	11.9	Sep./Sep.
PPI % change		99.9	36.8	25.6	14.9	9.3	Sep./Sep.
Unemployment rate government, end of period	. .	3.9	4.5	4.1	4.3	3.6	Sep.
Unemployment rate	. .	6.6	7.6	. .	. .	11.3	Q2
Trade balance USD million	– 90.4	– 144.9	– 355.2	– 673.6	– 1,057.7	– 246.4	Q1
Trade balance % GDP		– 8.7	– 15.2	– 18.7	– 24.3	– 20.8	Q1
Exports USD million	460.7	811.7	1,327.4	1,856.3	2,063.8	620.8	Q1
% change		76.2	63.5	39.8	11.2		
Imports USD million	– 551.1	– 956.6	– 1,682.5	– 2,530.0	– 3,121.5	– 867.2	Q1
% change		73.6	75.9	50.4	23.4		
Current account USD million	36.2	21.6	– 165.0	– 165.4	– 447.3	– 162.5	Q1
Current account % GDP	. .	1.3	– 7.1	– 4.6	– 10.3	– 16.8	Q1
Central gov't budget balance % GDP	. .	0.2	0.0	0.2	0.7	. .	. .
General gov't balance % GDP	. .	– 0.6	1.3	– 0.8	– 1.6	. .	. .
Gross external debt USD million	. .	140.0	170.0	247.0	297.0	283.0	March
Gross foreign reserves excluding gold USD million	170.2	386.1	443.4	579.9	636.8	620.1	Q2
Nominal gross wage in EEK	549.0	1,066.0	1,734.0	2,375.0	2,986.0	. .	. .
Nominal gross wage in USD	. .	80.6	133.5	207.2	248.1	. .	. .
Nominal gross wage % change		94.2	62.7	37.0	25.7	. .	. .
Real wage % change	. .	2.3	10.2	6.2	2.1	. .	. .
FDI inflows in USD million	82.3	162.2	214.4	201.5	150.2	81.0	Q1
Average EEK/USD[2])	12.912	13.223	12.991	11.465	12.034	13.703	Q2
Average EEK/DEM	. .	8.0	8.0	8.0	8.0	8.0	
REER index	100	214.4	279.0	339.4	380.7	396.5	Jan.–July
REER change in %	. .	114.4	30.1	21.6	12.2	4.2	Jan.–July

Sources: European Commission, IMF IFS September 1997 (GDP, current account, trade balance, USD exchange rate, foreign currency reserves), own calculations. Statistical Yearbook of Estonia 1996: wages.

[1]) Latest: Reuters.

[2]) End-of-period rate for 1992, data for 1996 are preliminary REER from BIS.

Latvia – Selected Main Economic Indicators

	1992	1993	1994	1995	1996	1997[1])	latest
GDP current prices LVL million	1,004.6	1,467.0	2,042.6	2,349.2	2,768.7	1,510.0	H1
GDP in USD million	1,364.9	2,173.3	3,647.5	4,449.2	5,024.9	2,621.5	H1
GDP % change	. .	– 30.4	0.6	– 1.6	2.8	4.6	H1/H11996
Industrial output % change	. .	– 29.8	– 2.2	– 6.3	1.0	0.7	Jan.–July
CPI % change	951.0	109.1	35.9	25.1	17.7	8.1	Sep. yoy
PPI % change						2.9	Sep. yoy
Unemployment rate	2.3	5.8	6.4	6.3	7.0	7.1	Sep.
Trade balance USD million	– 40.0	3.0	– 301.0	– 580.0	– 927.0	– 525.5	Jan.–July
Trade balance % GDP	– 2.9	0.1	– 8.3	– 13.0	– 18.4	. .	. .
Exports USD million	800.0	1,054.0	1,022.0	1,368.0	1,502.0	. .	. .
% change	. .	31.7	– 3.0	33.9	9.8	. .	. .
Imports USD million	– 840.0	–1,051.0	–1,322.0	–1,947.0	–2,429.0	. .	. .
% change	. .	25.1	25.8	47.3	24.8	. .	. .
Current account USD million	191.0	417.0	201.0	– 16.0	– 454.0	. .	. .
Current account % GDP	14.0	19.2	5.5	– 0.4	– 9.0	. .	. .
FDI inflows in USD million	29.0	45.0	214.0	180.0	288.0	. .	. .
Average LVL/USD	0.736	0.675	0.56	0.528	0.551	0.576	H1
REER, PPI based	100.0	260.6	345.2	357.6	396.8	428.8	Jan.–July
REER change in %		160.6	32.5	3.6	11.0	8.1	Jan.–July
Consolidated state deficit	. .	. .	– 2.0	– 4.0	– 0.8	. .	. .
Gross external debt USD million	57.0	224.0	386.0	403.4	408.8	. .	. .
Gross foreign reserves excluding gold USD million	. .	431.6	545.2	505.7	654.1	672.5	July

Sources: European Commission (industrial output, budget balance), IMF IFS September 1997 (GDP, current account, trade balance, USD exchange rate, foreign currency reserves, unemployment rate), national sources: own calculations.
[1]) Latest: Reuters.
Data for 1997 are preliminary. Consolidated budget balance on an accrual basis. 1997 GDP, trade balance and LVL/USD: own calculations.
OECD External Debt Statistics. REER: BIS.

Lithuania – Selected Main Economic Indicators

	1992	1993	1994	1995	1996	1997[1])	latest
GDP current prices LTL million	3,387.0	11,108.0	16,981.0	23,829.0	31,115.0	17,230.0	H1
GDP in USD million	1,910.3	2,557.1	4,268.7	5,957.3	7,778.8	4,307.5	H1
GDP % change	– 34.0	– 30.4	1.0	3.0	3.6	2.5	H1'97/ H1'96
Industrial output % change	. .	. .	– 26.6	5.3	3.7	3.3	Jan.–July
CPI % change	1,020.8	410.2	72.2	39.6	24.6	8.7	Sep. yoy
PPI % change	. .	. .	. .	. .	. .	3.4	Sep. yoy
Unemployment rate	3.6	3.8	4.5	7.3	6.2	5.9	Oct.
Trade balance USD million	. .	– 154.7	– 204.9	– 697.9	– 887.1	– 224.1	Q1
Trade balance % GDP	. .	– 6.0	– 4.8	– 11.7	– 11.4	– 5.2	Q1
Exports USD million	. .	2,025.8	2,029.2	2,706.1	3,281.6	927.1	Q1
% change	. .	. .	0.2	33.4	21.3		
Imports USD million	. .	– 2,180.5	– 2,234.1	– 3,404.0	– 4,168.7	– 1,151.8	Q1
% change	. .	. .	2.5	52.4	22.5		
Current account USD million	. .	– 85.7	– 94.0	– 614.4	– 699.9	– 233.1	Q1 1997
Current account % GDP	. .	– 3.4	– 2.2	– 10.3	– 9.0	– 5.4	Q1
Inward FDI flows, USD million	. .	30.2	31.3	72.6	152.4	57.1	Q1
Inward FDI stock in USD million	. .	. .	262.2	353.9	647.0		
Average LTL/USD	1.773.0	4.344.0	3.978.0	4.0	4.0	4.0	Q2 1997
REER 1992 = 100							
General gov't balance % GDP	. .	. .	– 1.8	– 1.8	– 2.5	– 0.6	Q1
Gross external debt USD million	. .	. .	505.3	826.3	1,216.8	1,205.9	June
Gross foreign reserves excluding gold USD million	45.3	350.4	525.5	757.1	772.2	870.5	Q2 1997

Sources: European Commission (industrial output, unemployment, budget balance), IMF IFS September 1997 (GDP, current account, trade balance, USD exchange rate, foreign currency reserves), national sources: own calculations.

[1]) Latest: Reuters.

Data for 1996 are preliminary. National budget: Bank of Lithuania, 2/97. Net external debt: Bank of Lithuania, Annual Report 1996. REER: BIS.

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1 *Foreign Research Division of the Oesterreichische Nationalbank and The Vienna Institute for Comparative Studies. The standard disclaimer applies. I gratefully acknowledge the valuable comments of Olga Radzyner.*
2 *See Starrels (1993).*
3 *See, e.g., Laski (1993) and Winiecki (1993) as exponents of opposite views.*
4 *The quality of the statistical data, especially those for the final years of Soviet rule and the early years of transition, does not measure up to OECD standards, which must be taken into account when interpreting the data.*
5 *See Senik-Leygonie and Hughes (1992).*
6 *See Country Tables in the Annex.*
7 *According to the Eesti Pank Bulletin No. 3 (1997), nominal investment rose by 33% in 1996. Since the GDP deflator is unknown, a range is given for the increase of private investment. National accounts are available for 1994 only.*
8 *See The Bank of Lithuania (1997b).*
9 *See Richards and Tersman (1996).*
10 *See Milesi-Ferreti and Razin (1996).*
11 *The removal of price controls was also instrumental in eliminating the undesired monetary balances held by the public ("monetary overhang") through open inflation.*
12 *See the avis of the European Commission on Estonia.*
13 *See EBRD (1996), Estonia: Country profile.*
14 *See Krzak (1997) for more details on the evolution of the banking sectors in the Baltic countries.*
15 *See "Die grossen estlaendischen Banken rechnen mit Marktkonsolidierung" in Frankfurter Allgemeine Zeitung of October 6, 1997.*
16 *The 1995 exchange rate was 0.528 lats per U.S. dollar.*
17 *This helped the central banks insulate themselves against hyperinflationary tendencies in the rest of the former Soviet Union.*
18 *See the Law on the Central Bank of the Republic of Estonia.*
19 *See the Law on the Bank of Latvia.*
20 *See the Law on the Bank of Lithuania.*
21 *See e.g. the Law of the Republic of Lithuania on the Convertibility of the Litas.*
22 *Such a course was taken by Singapore and Malaysia in the early 1970s.*
23 *See Bank of Lithuania (1997c).*

Editorial close: November 10

The Opening of Central and Eastern Europe: The Case of Austrian Foreign Direct Investment

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1 Introduction

In the 1990s two major economic and political integration movements have been significantly changing Europe. These trends consist in the intensification of cooperation within the European Union – represented by the completion of the Common Market, the admission of new EU members and the preparatory steps for EMU – on the one hand and the opening of the former communist bloc on the other, marked by the continuing transition of these countries to a market system and their political rapprochement to the West. Austria's economy had to adapt to the ensuing changes in the international environment and the subsequent increase in international competition. Hence Austria responded by further intensifying economic integration with its main trading partners in Western Europe and by taking advantage of the opportunities offered in the neighboring countries to the East.

The present discussion of the stepped-up integration of the world economy, summarized by the term "globalization," indicates that international trade is no longer the only channel through which to foster internationalization. Today market maintenance and the international division of labor is influenced more and more by crossborder investments. As Austria's economy has already entered the stage at which foreign direct investment (FDI) has become significant on the inflow as well as on the outflow side, the following discussion of Austria's integration with the Central and Eastern European Countries (CEECs)[2]) in the recent past will concentrate on the role of FDI.

The CEECs in transition have high expectations about the possible benefits of foreign capital inflows, as FDI inflows are assumed to be accompanied by a transfer of technology, research capacity and management know-how. Theoretically, FDI inflows augment economic growth by promoting capital accumulation and by raising overall productivity and efficiency in the host country, either directly via the affiliate or indirectly via increased competition in the industry of the direct investment enterprise (see the discussion summarized in Stankovsky, 1995 and 1996a). UNCTAD (1997) also stresses the important role FDI can play in the restructuring and privatization of state-owned enterprises. While transnational corporations (TNCs) in general have helped to increase competition by exposing production in the host countries to the world market, there are also instances in which investment by multinationals stifled competition (e.g. when TNCs are attracted by special incentives or when they exploit monopoly situations).

A recent study (Hunya, 1997) claims that several of the abovementioned positive effects can be empirically validated: Direct investment enterprises in the CEECs are found to have above-average productivity, are more export-oriented and invest significantly more than domestic firms. However, foreign affiliates are more import-dependent than domestic companies. Any assessment of the extent to which positive expectations about the impact of FDI have already been fulfilled would go beyond the scope of this study. However, an analysis of available data on the dynamics of Austrian FDI activities during the past years may provide some insights into the effects such crossborder investment has had on the structure of the Austrian economy.

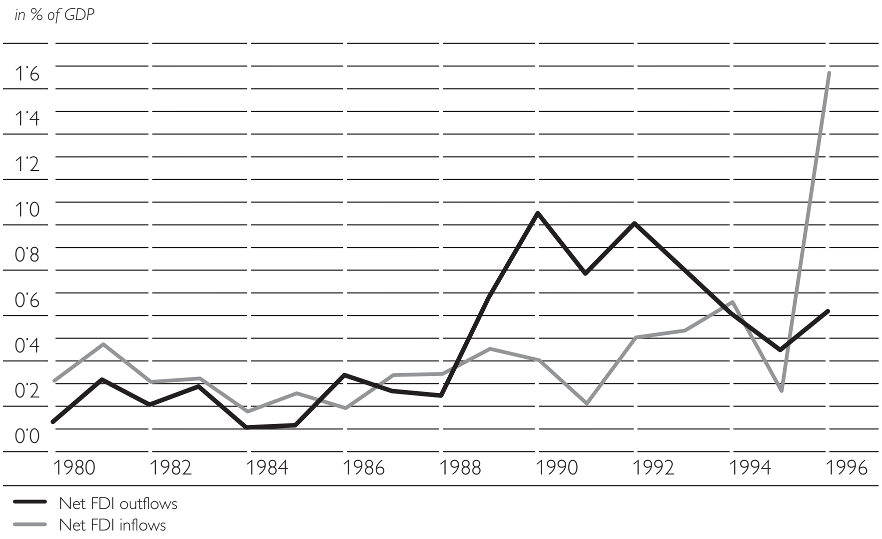
2 FDI and Austrian Internationalization Efforts

2.1 The Regional Structure of Austrian FDI

In parallel to a world-wide boom of FDI at the end of the 1980s, Austria's FDI activities abroad skyrocketed (Chart 1). Between 1989 and 1993 outward-directed FDI (referred to as ODI) increased to 0.8% to 1% of GDP, exceeding inward-directed FDI flows (called IDI). In parallel, average annual capital inflows in the 1990s have so far been significantly higher than in the decade before, with an extraordinary peak in 1996. This development illustrates a transition of Austria's economy from the function of a mere sales market and production site for foreign transnational corporations to that of an active participant in this type of international integration.

Chart 1

Austrian FDI Inflows and Outflows



Crossborder investments in Austria were traditionally dominated by acquisitions in and from the EU and other Western industrialized countries. However, the opening up of the CEECs significantly influenced the development of Austria's FDI outflows. Austria's geographical closeness and the historical relationship to this region, as reflected inter alia by the popularity of domestic brands in Eastern Europe, gave Austrian enterprises a strategic edge: They were among the first Western investors to take advantage of the opportunity presented by the new production and sales market. Since 1990 at least 23% of Austrian FDI outflows have been directed towards the CEECs; in 1995 they even surpassed Austria's direct investment in the EU (Table 1). Interestingly enough, Austria's information lead made it a connection platform for international FDI to Eastern Europe, especially at the beginning of transition.

The consequences of this development for outward and inward equity stocks are shown in Chart 2. From the beginning of the 1990s the relative share of Austrian FDI in the CEECs in total Austrian nominal capital expanded steadily. In parallel, the share of total Austrian investment in the EU decreased. In 1994, however, the two opposite trends came to an end, which again indicates the importance of cooperation and integration within the EU Common Market. A slight upward trend in the share of the total stock of inward FDI from the EU to Austria can be observed in the same period.[3])

Table 1

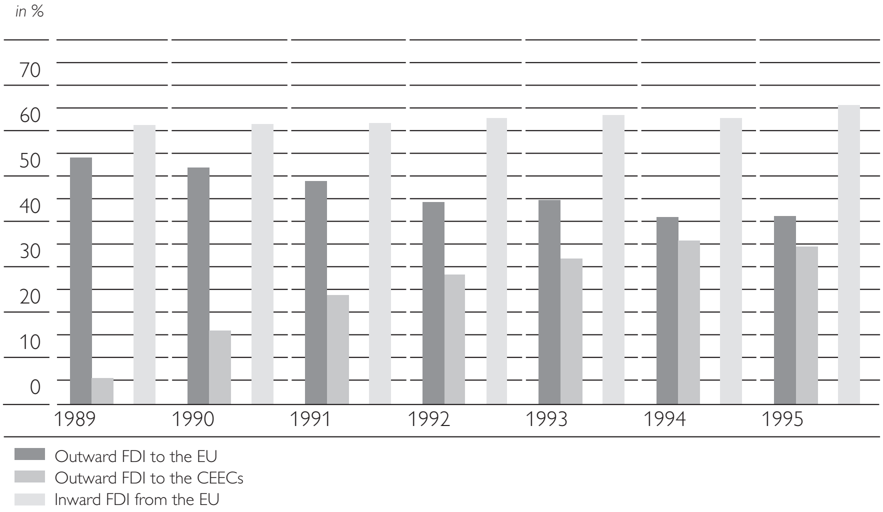
Austrian FDI Outflows

	1991	1992	1993	1994	1995	1996[1])	1997 1st half[2])
	ATS billion						
Total net FDI outflows	15.0	20.6	17.1	13.7	10.5	14.9	5.7
EU 15	8.1	13.1	6.5	5.9	3.5	4.8	1.4
	54%	*64%*	*38%*	*43%*	*33%*	*32%*	*25%*
Other Europe[3])	−1.9	0.1	1.7	0.9	0.1	3.0	0.6
	−13%	*1%*	*10%*	*7%*	*1%*	*20%*	*10%*
CEECs	5.9	5.0	6.0	5.2	6.2	3.5	3.3
	39%	*24%*	*35%*	*38%*	*59%*	*24%*	*57%*
thereof:							
Hungary	*4.4*	*3.2*	*2.9*	*1.9*	*3.0*	*1.3*	*0.7*
Slovakia	..	..	*0.3*	*0.6*	*0.6*	*0.5*	*0.2*
Czech Republic	..	..	*2.2*	*1.8*	*1.3*	*0.6*	*0.3*
Czechoslovakia[4])	*1.1*	*1.4*	*2.5*	*2.4*	*1.9*	*1.0*	*0.6*
Slovenia	..	*0.1*	*0.5*	*0.3*	*0.4*	*0.4*	*0.1*
Poland	*0.3*	*0.2*	*0.1*	*0.1*	*0.9*	*0.5*	*0.8*
Other countries	2.9	2.4	2.9	1.7	0.7	3.6	0.5
	19%	*11%*	*17%*	*12%*	*7%*	*24%*	*8%*

Source: OeNB, Balance of Payments.
[1]) Provisional revised figures.
[2]) Provisional figures.
[3]) Including Iceland, Malta, Turkey and Cyprus.
[4]) As of 1993, Slovakia and the Czech Republic.

Chart 2

Stock of Inward and Outward FDI Nominal Capital by Regions



2.2 Total FDI Inflows into the CEECs

The regional distribution of FDI outflows shows that from the beginning, Austrian investors' activities in the CEECs concentrated on the immediate neighbors, above all Hungary. This strategy broadly coincided with the preferences of other international investors. According to the WIIW data base,[4]) in 1990 Hungary, the former CSFR, Poland and Slovenia accounted for more than two thirds of the overall inflows into this region, a ratio that decreased only little over the years (Table 2). As total FDI inflows into the CEECs grew much faster than Austria's FDI outflows did (the former averaged over 50% between 1990 and 1995 while the latter rose by less than 10%, Austria's share in total FDI inflows to this region decreased dramatically over time [Stankovsky, 1996b]). In 1990 Austria accounted for one third of total inflows, a share which contracted to just 6% in 1995. Broken down by countries, this is true of all major destinations except Slovakia; here Austria still accounted for 30% of all FDI inflows in 1996. As a consequence Austria's share of the growing overall stock of FDI in the CEECs was halved between 1994 and 1996.

The dramatic expansion of FDI inflows into the CEECs that started in 1989, however, seems to have come to an end now, as the decrease in 1996 indicates. UNCTAD (1997) pinpoints this partly to a decline in privatization-related investments, but another reason is that the CEECs still face major problems in their transition to a market system. It is also argued that investors reduced their expectations because it turned out that the former promising advantage of a cheap and skilled workforce in this region frequently had the downside of a lack of logistical or management skills.

Table 2

Austrian FDI Market Share in Total Inflows to CEE Countries

	Flows							Stocks		
	1990	1991	1992	1993	1994	1995	1996	1994	1995	1996
	USD million									
Austrian FDI outflows	1,663	1,288	1,871	1,467	1,201	1,043	1,409	9,301	11,643	11,906
Hungary	900	1,700	1,641	2,550	1,300	4,570	2,100	7,095	11,926	14,690
market share in total inflows	*39.1%*	*22.2%*	*17.7%*	*9.8%*	*12.8%*	*6.4%*	*6.1%*	*22.5%*	*13.3%*	*10.7%*
Czech Republic	..	..	..	654	869	2,562	1,428	3,077	5,797	7,061
market share in total inflows	..	..	..	*28.9%*	*18.1%*	*5.0%*	*4.0%*	*25.5%*	*17.0%*	*13.6%*
Slovakia	..	..	..	135	185	181	154	531	728	920
market share in total inflows	..	..	..	*19.1%*	*28.4%*	*32.9%*	*30.7%*	*29.6%*	*28.4%*	*23.0%*
Czechoslovakia[1])	112	494	1,155	789	1,054	2,743	1,582	3,608	6,525	7,981
market share in total inflows	*15.7%*	*19.1%*	*11.0%*	*(27.2%)*	*(19.9%)*	*(6.9%)*	*(6.6%)*	*(26.1%)*	*(18.3%)*	*(14.7%)*
Slovenia	..	..	165	139	321	367	350	724	600	786
market share in total inflows	..	..	*5.5%*	*30.9%*	*8.2%*	*10.8%*	*10.8%*	*20.6%*	*42.4%*	*33.0%*
Poland	77	247	900	1,479	1,342	2,511	4,000	1,521	2,655	5,396
market share in total inflows	*0.0%*	*10.4%*	*2.0%*	*0.6%*	*0.7%*	*3.6%*	*1.2%*	*6.9%*	*6.5%*	*3.3%*
Total	1,089	2,441	3,861	4,957	4,017	10,191	8,032	12,948	21,706	28,853
market share in total inflows	*33.9%*	*20.7%*	*12.5%*	*10.1%*	*10.5%*	*6.0%*	*3.5%*	*20.4%*	*13.6%*	*10.1%*
CEEC total	1,521	3,236	5,170	7,615	7,540	13,780	12,437	18,815	31,332	42,984
market share in total inflows	*24.3%*	*15.6%*	*8.8%*	*6.8%*	*6.0%*	*4.5%*	*2.7%*	*15.6%*	*10.6%*	*7.8%*

Source: OeNB, WIIW.

[1]) As of 1993, Slovakia and the Czech Republic.

2.3 Aspects of East-West Integration

Although the figures discussed above reveal the scale of integration of the CEECs into Austria's network of international cooperation, one cannot ignore the fact that Austria's internationalization efforts are predominantly oriented towards its traditional trade partners in the OECD. In spite of the unique historical setting which evolved Austrian investors' priorities lie in the West because the main economic policy objective is the completion of the Common Market.

Having said that, another dimension must be taken into account in the analysis of FDI flows. Austria is a small economy with currently only few domestic TNCs. A great deal of Austria's FDI abroad is in fact carried out by enterprises which are in turn subsidiaries of foreign investors or TNCs. Especially in the case of FDI in the CEECs, the investments of these multinational corporations represent cases where Austria serves as a bridgehead to the East for these companies. Austrian investments held by investors who are themselves partly or totally owned by foreign companies will be labeled "partly non-Austrian-owned" below. (Wherever the Austrian enterprise is in fact a 100% foreign-owned subsidiary, this "partly-non-Austrian-owned" investment represents an FDI enterprise that is fully controlled by non-Austrian investors.)

Table 3 gives an overview of the proportion of Austrian nominal stock abroad that is partly non-Austrian-owned. In 1989, at the beginning of the Austrian FDI outflow boom, the total share of this type of investment had come to about 20%; after a slump in 1992 to 1993 it increased to almost

Table 3

Partly Non-Austrian-Owned Outward FDI, by Regions

	EU	*thereof Germany*	CEECs	*thereof Hungary*	Total
	ATS billion				
Austrian outward nominal FDI stock					
1989	9.13	*5.47*	0.99	*0.66*	16.80
1990	14.82	*6.99*	4.59	*3.46*	28.37
1991	18.95	*8.08*	9.28	*7.14*	38.45
1992	20.26	*8.96*	12.96	*9.44*	45.36
1993	27.21	*9.64*	19.38	*12.18*	60.43
1994	26.44	*9.52*	23.20	*12.18*	64.17
1995	29.67	*11.36*	24.91	*11.54*	71.44
thereof partly non-Austrian-owned outward nominal FDI stock					
1989	1.86	*0.90*	0.40	*0.21*	3.64
1990	3.17	*1.30*	1.77	*1.28*	6.63
1991	3.69	*1.17*	4.39	*3.49*	9.33
1992	3.64	*1.17*	4.30	*3.38*	9.23
1993	6.59	*1.15*	5.43	*3.00*	13.38
1994	10.14	*2.23*	6.52	*3.16*	18.41
1995	11.98	*2.54*	6.42	*2.31*	20.30
	in percent				
Percentage share of partly non-Austrian-owned outward nominal FDI stock					
1989	20.4	*16.5*	40.1	*32.3*	21.6
1990	21.4	*18.6*	38.7	*36.9*	23.4
1991	19.5	*14.5*	47.3	*48.8*	24.3
1992	18.0	*13.0*	33.1	*35.8*	20.4
1993	24.2	*11.9*	28.0	*24.6*	22.1
1994	38.3	*23.4*	28.1	*25.9*	28.7
1995	40.4	*22.3*	25.8	*20.1*	28.4

Source: OeNB.

30% at the end of 1995. As expected, this partly non-Austrian-owned ODI has a special role in FDI stocks in the CEECs. The fact that between 1989 and 1991 from 40% to almost 50% of all ODI in the CEECs fell into this group (one third to almost one half in Hungary) clearly stresses the importance of this investment channel. Since 1993, however, the share of this indirect investment has been decreasing, which might indicate two developments: First, multinational firms have started to invest directly in countries which used to be entered via the bridgehead Austria and second, Austrian FDI in the CEECs has become controlled more and more by Austrian firms. Interestingly enough, the ODI stock in the EU reveals the reverse trend. The share of partly non-Austrian-owned ODI stock in the EU widened from 20% in 1989 to 40% in 1995. Privatization in Austrian industry represented the driving force behind this development, especially behind the sharp rise in 1994, as the privatized companies either had or subsequently acquired subsidiaries abroad.

It can be argued that the analysis of stock data over time is biased, as the results tend to reflect the dominance of the majority of investments that already existed in previous periods. More in sights into underlying trends can be drawn from the separate analysis of new FDI in a period. Table 4 provides a closer look at the role of Austrian investors which are (partly) foreign-

Table 4

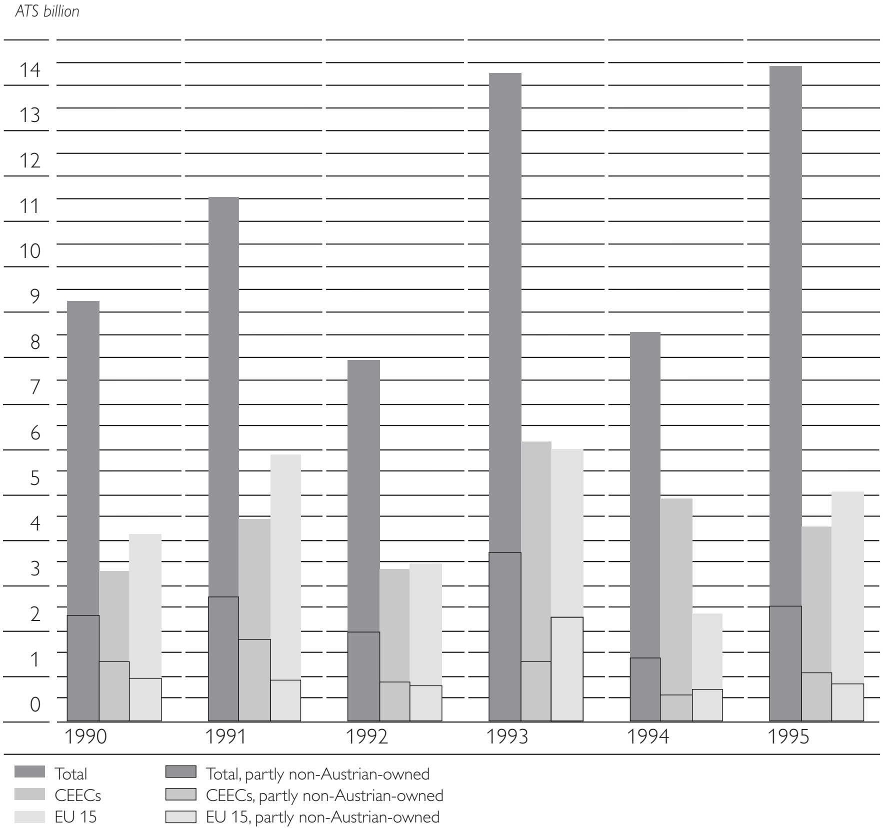
New Outward-Directed FDI Relationships

	1990	1991	1992	1993	1994	1995	Median 1990–1995
Total							
Number of new FDI relationships	354	450	340	411	353	411	
thereof partly non-Austrian-owned	*91*	*80*	*70*	*75*	*70*	*75*	
	25.7%	*17.8%*	*20.6%*	*18.2%*	*19.8%*	*18.2%*	*19.0%*
New nominal capital ATS billion	9.379	11.677	8.061	14.445	8.671	14.620	
thereof partly non-Austrian-owned	*2.373*	*2.759*	*1.965*	*3.764*	*1.395*	*2.577*	
	25.3%	*23.6%*	*24.4%*	*26.1%*	*16.1%*	*17.6%*	*24.0%*
CEECs							
Number of new FDI relationships	164	206	174	245	238	206	
thereof partly non-Austrian-owned	*44*	*40*	*40*	*46*	*45*	*46*	
	26.8%	*19.4%*	*23.0%*	*18.8%*	*18.9%*	*22.3%*	*20.9%*
New nominal capital ATS billion	3.360	4.497	3.405	6.232	4.939	4.340	
thereof partly non-Austrian-owned	*1.337*	*1.803*	*887*	*1.325*	*572*	*1.083*	
	39.8%	*40.1%*	*26.0%*	*21.3%*	*11.6%*	*25.0%*	*25.5%*
EU							
Number of new FDI relationships	125	161	109	113	75	132	
thereof partly non-Austrian-owned	*33*	*28*	*17*	*18*	*18*	*15*	
	26.4%	*17.4%*	*15.6%*	*15.9%*	*24.0%*	*11.4%*	*16.7%*
New nominal capital ATS billion	4.185	5.968	3.497	6.065	2.387	5.135	
thereof partly non-Austrian-owned	*935*	*905*	*791*	*2.314*	*708*	*843*	
	22.3%	*15.2%*	*22.6%*	*38.2%*	*29.7%*	*16.4%*	*22.5%*

Source: OeNB.

Chart 3

New Nominal Capital



controlled by examining the structure of new[5]) Austrian investments abroad over time. Between 1991 and 1995 a more or less stable proportion of about 20% of the total number of new Austrian FDI relationships per year were attributable to this type of multinational channeling. Weighted with the stock of nominal capital, the average proportion started at around 25%, with a declining trend. Between 1990 and 1994 the share in new projects in the CEECs reveals the same downward trend, and in 1993 and 1994 the proportion of partly non-Austrian-owned capital in the East was lower than in the EU. In 1995 the structure of new investment was the same as at the beginning of the 1990s, i.e. partly non-Austrian-owned TNCs channeled significantly more new FDI to the CEECs than to the EU (Chart 3).

3 The Structure of Austrian Outward-Directed FDI

3.1 Motives

Investors can pursue different goals by means of crossborder investments. According to Dunning (1993), one can broadly discriminate between the motivation to use resources (raw material, low labor costs, special skills etc.) in the host country, the objective to gain access to sales markets, and the wish to augment the efficiency or to improve the strategic position of a transnational group as a whole.

Table 5

Motives for New FDI Relationships

	New FDI relationships 1990 to 1995		Thereof partly non-Austrian-owned investment relationships	
	Number	*Percentage distribution[1]*	*Number*	*Percentage distribution[1]*
Total				
Labor cost	78	3.0%	10	1.4%
Taxation	47	1.9%	10	1.4%
Market access	1,659	70.0 %	334	74.0%
Securing of supply sources	60	2.3%	8	2.2%
Other reasons	475	22.3%	99	19.2 %
Sum	2,319	∅ number[2] 382.5	461	∅ number[2] 75
Percentage share of total	100.0		100.0	
CEECs				
Labor cost	69	5.3%	9	2.5%
Taxation	5	0.6%	. .	. .
Market access	848	70.8%	219	84.6%
Securing of supply sources	33	2.4%	4	2.5%
Other reasons	218	20.1%	29	10.8%
Total	1,233	∅ number[2] 206	261	∅ number[2] 45
Percentage share of total	53.2		56.6	
EU 15				
Labor cost	7	1.1 %	1	6.7 %
Taxation	30	3.3 %	6	17.3 %
Market access	508	72.0 %	75	51.8 %
Securing of supply sources	14	1.6 %	. .	. .
Other reasons	156	22.2 %	47	40.6 %
Total	715	∅ number[2] 119	129	∅ number[2] 18
Percentage share of total	30.8		28.0	
Other regions				
Total	371	∅ number[2] 61	71	∅ number[2] 12.5
Percentage share of total	16.0		15.4	

Source: OeNB.
[1]) Median between 1990 and 1995.
[2]) Median of totals between 1990 and 1995.

Table 5 gives an overview of the main motives for new Austrian ODI based on the self-assessment of the investor. The OeNB survey shows that in the period from 1990 to 1995 more than 2,300 new investment relationships were started, 53% of which were in the CEECs and 31% of which were in the EU region. This represents an average number of 380 new investments per year (206 and 119 for the CEECs and the EU respectively). Although 22% of the investors indicated no clear strategy (category "other reasons"), it is obvious that "market access (to secure sales)" is the predominant motive. It is noteworthy that the relative share of investors with this motive in the total sample as well as in the subsample of the CEECs and the EU is practically identical. The only difference between investors' motivation to go East or West is in the category "labor costs"; 5% of the investments in the CEECs versus 1.1% in the EU were driven by the opportunity to make use of cheap labor costs.

The right section of Table 5 shows motives for investment projects that were carried out by Austrian firms which were in turn partly owned by foreign TNCs. Interestingly enough, the distribution of motives behind partly non-Austrian-owned investments is only slightly different from the total sample. The most remarkable deviations of these investments is a higher percentage of "market access" (at the expense of "other reasons"). The differences between East and West within the subsample, however, are clearer: A top share of 85% of multinational enterprises' projects is based on the motive "market access." On the contrary, the reasons for analogous projects in the EU show a very different breakdown, although one must take into account that these results are based on a much smaller number of investments.

3.2 Outward-Directed FDI by Industry

About one third of the total Austrian FDI nominal capital stock abroad is allocated to manufacturing, two thirds to the service sector and only a negligible amount to mining and energy (Table 6).[6]) Petroleum products and chemicals are the largest industry (7.8%), and nonmetallic mineral products, construction, electrical equipment, metal, machinery and food products account for approximately 3% to 4% each. The largest divisions within the service sector are financial intermediation (19.2%) and trade and repair (16.2%). Services, however, include the position business and management consultancy (18.7%), which in turn contains holding companies. As these firms' investments are not necessarily in the service sector, the effective share of manufacturing is presumably higher than indicated. In general, the geographical breakdown reveals a striking similarity in the share that

Table 6

Sectoral Distribution of Outward FDI

	Nominal capital 1995						Share of partly non-Austrian-owned outward FDI (based on nominal capital)		
	CEECs	*thereof partly non-Austrian-owned*	EU 15	*thereof partly non-Austrian-owned*	Total	*thereof partly non-Austrian-owned*	CEECs	EU 15	Total
	ATS billion								
Total	24.91	*6.42*	29.67	*11.98*	71.44	*20.30*			
	Sectoral distribution in percent								
Mining. quarrying and energy	0.7	*1.0*	4.3	*7.1*	2.1	*4.5*	36.5	67.3	60.6
Manufacturing and construction	50.1	*60.5*	30.6	*26.9*	35.0	*36.4*	31.1	35.5	29.6
Food products. beverages and tobacco	8.1	*1.8*	1.7	*0.0*	3.7	*0.6*	5.9	0.0	4.6
Textile products. apparel and leather	1.7	*0.0*	0.6	*1.0*	1.0	*0.8*	0.0	65.5	23.5
Wood and wood products	0.4	*0.0*	2.9	*0.0*	1.4	*0.0*	0.0	0.0	0.0
Paper, publishing and printing	3.8	*1.5*	2.6	*2.0*	2.4	*1.6*	10.1	30.6	19.2
Petroleum products. chemicals and rubber	9.8	*31.4*	7.2	*13.4*	7.8	*18.1*	82.5	74.9	66.2
Other nonmetallic mineral products	9.9	*8.8*	2.1	*0.0*	4.3	*2.8*	22.9	0.0	18.2
Metal products	1.9	*1.3*	4.8	*0.4*	3.1	*0.9*	17.4	3.2	8.6
Machinery and equipment n.e.c.	1.8	*3.6*	3.6	*6.9*	3.1	*5.7*	52.4	76.2	51.7
Electrical and optical equipment	4.3	*4.7*	2.4	*1.7*	3.6	*2.6*	27.8	28.6	20.7
Transport equipment	0.5	*0.7*	0.5	*1.2*	0.4	*0.9*	34.9	98.8	67.9
Manufacturing n.e.c. and recycling	0.9	*0.0*	0.3	*0.3*	0.4	*0.2*	0.0	35.8	9.9
Construction	7.0	*6.6*	1.9	*0.1*	3.7	*2.2*	24.4	2.4	16.3
Services	49.3	*38.5*	65.2	*66.0*	62.9	*59.1*	20.2	40.9	26.7
Trade and repair	16.8	*29.9*	15.2	*15.9*	16.2	*21.4*	45.7	42.4	37.4
Hotels and restaurants	2.2	*0.2*	1.0	*0.0*	1.3	*0.1*	2.6	0.5	1.7
Transport and communications	0.5	*0.0*	0.3	*0.3*	0.6	*0.2*	0.0	34.8	9.3
Financial intermediation	19.2	*5.1*	17.7	*25.9*	19.2	*17.3*	6.8	59.0	25.6
Real estate and business activities	8.6	*1.3*	22.2	*20.6*	18.7	*17.5*	3.8	37.4	26.7
Other services	1.9	*2.1*	8.7	*3.3*	6.9	*2.6*	28.2	15.4	10.9
Total	100.0	*100.0*	100.0	*100.0*	100.0	*100.0*	25.8	40.4	28.4

Source: OeNB.

petroleum products and chemicals, trade and repair, and financial intermediation hold in Western and Eastern host countries. An important difference is that in the CEEC region, a smaller amount of capital is invested via holding companies. This might be an explanation for the larger share of manufacturing in the East (50%) compared to the EU (30%).

The largest differences between the industry classification of partly non-Austrian-owned investments and the total industry distribution can be found in petroleum products and chemicals as well as trade and repair; here indirect non-Austrian ownership is higher. The same is true of partly non-Austrian-owned investments in the CEECs. Interestingly enough, compared to the distribution of total investments in this region, the share of partly non-Austrian capital is much smaller in all other service divisions, especially in business consultancy (i.e. holdings). In the EU, petroleum products and chemicals again account for a higher share of partly non-Austrian ownership than of total investments in the Community. The distribution among service sectors, however, does not differ much between total and partly non-Austrian-owned investments in this region.

The role of partly non-Austrian-owned capital in the individual industries and regions in 1995 is summarized in the right section of Table 6. The relative share of partly non-Austrian-owned investments is high in petroleum products and chemicals, machinery, transport equipment as well as trade and repair. In addition, the figures underline how important partly non-Austrian-owned capital is within Austria's investments in the EU, where it accounts for a total share of 40.4% and is large in almost every industry.

Table 7 provides a crosstabulation showing a breakdown of the investor's business activity (in the home country) by the activity of his investment

Table 7

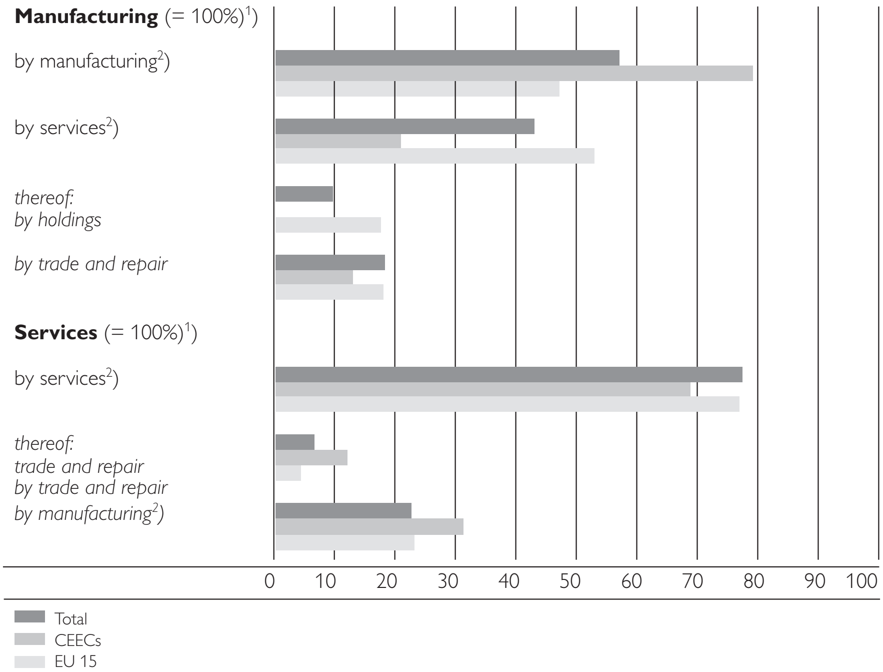
Cross-Sectoral FDI Relationships – Industry of Investor by Industry of FDI Enterprise

	Hungary	Czech Republic	Slovakia	Slovenia	Poland	Other CEECs	Total CEECs	EU 15	Total
	Number of FDI relationships								
Manufacturing	158	75	20	17	21	24	315	279	751
by manufacturing	108	54	14	15	15	19	225	152	456
by services	50	21	6	2	6	5	90	127	295
thereof:									
by holdings	2	..	..	..	..	..	2	14	27
by trade and repair	25	13	4	2	5	3	52	89	190
Services	304	112	42	25	44	21	548	311	1,045
by services	195	94	37	21	30	18	395	226	761
thereof:									
trade and repair by trade and repair	61	30	12	5	10	8	126	49	189
by manufacturing	109	18	5	4	14	3	153	85	284
Total	462	187	62	42	65	45	863	590	1,796
	Stock of nominal capital (ATS billion)								
Manufacturing	4.14	3.36	0.71	1.32	0.32	0.29	10.14	14.62	30.23
by manufacturing	3.34	2.87	0.48	0.89	0.30	0.16	8.03	6.88	17.24
by services	0.80	0.49	0.23	0.43	0.02	0.13	2.11	7.75	13.00
thereof:									
by holdings	0.02	..	..	..	..	..	0.02	2.56	2.85
by trade and repair	0.22	0.45	0.12	0.43	0.02	0.06	1.30	2.62	5.52
Services	7.40	3.87	1.06	0.72	0.93	0.78	14.77	15.05	41.20
by services	4.28	3.18	1.00	0.70	0.67	0.34	10.16	11.60	31.94
thereof:									
trade and repair by trade and repair	0.93	0.54	0.17	0.03	0.07	0.03	1.77	0.63	2.62
by manufacturing	3.12	0.69	0.06	0.02	0.27	0.44	4.61	3.45	9.26
Total	11.54	7.23	1.77	2.04	1.26	1.07	24.91	29.67	71.44

Chart 4

Industry of Investor by Industry of Investment Enterprise

Share of total invested nominal capital



[1]) Industry of investor.
[2]) Industry of FDI enterprise.

enterprise (in the host country). Investors with subsidiaries in the CEECs who are originally based in manufacturing hold the vast majority of their assets in the CEECs in subsidiaries in manufacturing, whereas in the EU more than 50% of manufacturing-based investors' nominal capital is invested in the service sector (Chart 4). The combination of manufacturing by trade and repair accounts for 12% of investments in the CEECs and 18% of investments in the EU respectively. As trade and repair are obviously not capital-intensive branches, the relative share of this type of investment increases to 23% in the CEECs and 16% in the EU, when based on the number of projects.

There are only minor differences between East and West in the industry mix of service companies' investments. 70% to 80% of their capital is again allocated to the service sectors of the host countries. When the relation is based on the number of projects, manufacturers' investment in services is in fact identical in the CEECs and in the EU.

3.3 Outward-Directed FDI and Trade

One striking consequence of the opening of the CEE countries was the stimulation of Austria's foreign trade with this region. Although the rapid growth of Austrian exports was gradually followed by an increase of imports, Austria managed to achieve a considerable trade surplus with its neighboring countries. This surplus rose from approximately ATS 4 billion to ATS 16 billion between 1990 and 1995.

The links between foreign trade and FDI can be diverse: First, companies consider FDI a strategy to strengthen their market position abroad – and consequently their exports – by establishing channels of distribution via foreign affiliates. Second, vertical integration, i.e. the outsourcing of production steps to affiliates abroad, can have a positive or a negative impact on foreign trade: Either the market share in the host country is increased, which subsequently induces more imports (of semi-finished goods) from the investing company, or production and direct sales abroad simply become a substitute for exports.

Chart 5.1 shows the booming exports to Austria's neighbors Hungary, the Czech Republic, Slovakia and Slovenia. In parallel, the intrafirm exports of companies which have affiliates in this region also posted significant growth. Consequently, between 1992 and 1995 exports within transnational groups reached a constant annual share of approximately 10% of total exports. A breakdown by countries (Table 8) illustrates the dominance of Hungary (ATS 2.3 billion to ATS 2.5 billion), although the intrafirm exports to affiliates in the Czech Republic also came to almost ATS 2 billion. During the same period total imports from Hungary, the Czech Republic, Slovakia and Slovenia within TNCs were boosted (Chart 5.2). In 1995, 5% of Austria's total imports from these countries were attributable to intrafirm trade.

The analysis of the aggregate data does not allow an ultimate statement on the net effect of ODI in the CEECs on Austrian exports. What may be stated decisively, however, is that the view that Austria's FDI activities in the

Table 8

Austrian Foreign Trade and Intrafirm Trade with CEE Countries

	Exports							Imports						
	1989	1990	1991	1992	1993	1994	1995	1989	1990	1991	1992	1993	1994	1995
	ATS billion													
Intrafirm trade														
Hungary	0.2	0.3	1.0	2.5	2.7	2.6	2.3	0.0	0.1	0.3	0.3	0.4	0.6	1.0
Czech Republic	0.1	0.2	0.2	0.3	0.5	1.4	1.6	0.0	0.0	0.0	0.1	0.2	0.4	0.4
Slovakia	..	0.0	0.0	0.1	0.2	0.3	0.3		0.0	0.0	0.0	0.0	0.1	0.1
Czechoslovakia[1])	0.1	0.2	0.2	0.4	0.7	1.6	1.8	0.0	0.0	0.0	0.1	0.2	0.5	0.5
Slovenia	0.6	0.6	0.7	0.6	0.6	0.5	0.7	0.6	0.7	0.7	0.8	1.0	0.6	0.9
Poland	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Other CEECs	0.1	0.2	0.2	0.3	0.3	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Total CEECs	1.0	1.3	2.1	3.8	4.3	5.0	5.1	0.6	0.9	1.0	1.3	1.6	1.8	2.6
Index	*73*	*100*	*164*	*293*	*329*	*383*	*388*	*75*	*100*	*114*	*149*	*188*	*208*	*300*
Total Austrian trade														
Hungary	8.7	10.5	14.5	15.6	16.5	20.0	21.1	7.8	8.7	11.5	12.0	10.8	12.8	12.6
Czech Republic	..	..	..	..	11.3	13.4	15.9	..	..	..	..	9.1	11.3	12.6
Slovakia	..	..	..	..	4.1	4.5	5.7	..	..	..	..	3.1	4.1	5.3
Czechoslovakia[1])	5.0	8.6	9.2	13.8	15.4	17.9	21.6	6.7	6.4	7.4	11.1	12.3	15.4	17.9
Slovenia	..	..	..	5.6	6.8	8.0	9.8	..	..	..	3.0	3.4	4.1	5.3
Total	13.7	19.1	23.7	35.0	38.8	46.0	52.5	14.6	15.1	18.9	26.0	26.5	32.3	35.8
Index	*72*	*100*	*124*	*183*	*203*	*240*	*275*	*96*	*100*	*125*	*172*	*175*	*213*	*236*
	percent													
Share of intrafirm trade in total trade with														
Hungary, the Czech Republic, Slovakia and Slovenia	..	..	..	10.2	10.2	10.3	9.2	..	..	..	4.8	6.1	5.3	6.8
Hungary, the Czech Republic and Slovakia	1.8	2.8	5.2	10.0	10.5	11.3	9.7	0.1	0.5	1.5	1.9	2.7	3.8	5.1

Source: OeNB.

[1]) As of 1993 Slovakia and the Czech Republic.

East had an overall negative impact on Austria's exports is not borne out by facts, at least not by the data for the period until the end of 1995, for several reasons: The steady expansion of deliveries (and the trade surplus) was accompanied by strong ODI, a considerable share of internal trade within TNCs has developed, and market access represented the predominant motive for investment in the CEECs.

Chart 5.1

Austrian Exports to the CEECs

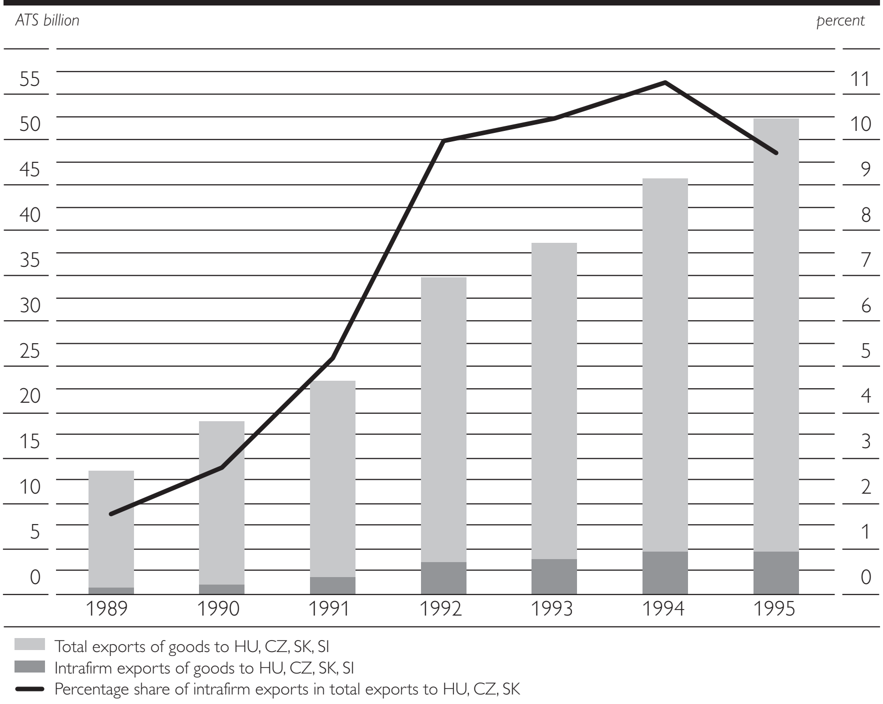


Chart 5.2

Austrian Imports from the CEECs

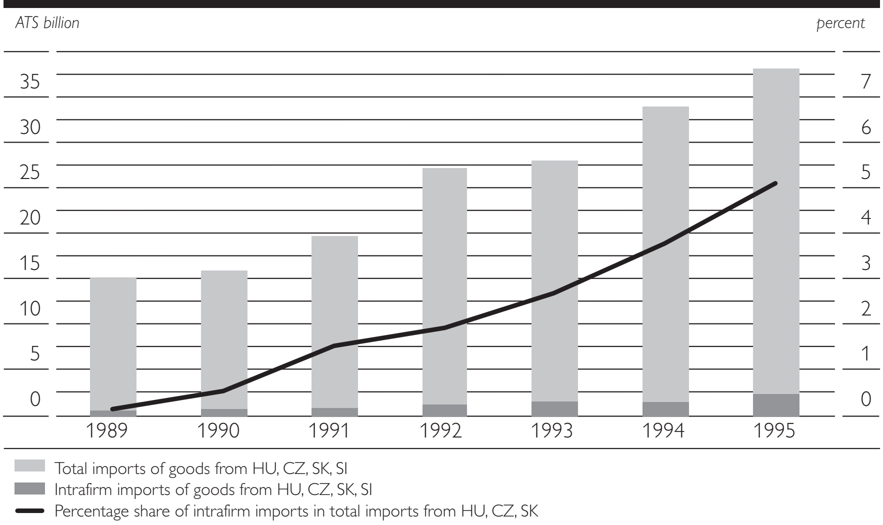


Table 9

Outward-Directed FDI and Employment

	1989	1990	1991	1992	1993	1994	1995
	1,000						
Number of employees outside Austria							
Hungary	2.0	7.5	20.1	24.8	33.2	39.2	44.2
Czech Republic	0.1	0.8	1.2	4.2	10.6	15.7	22.0
Slovakia		0.0	0.7	1.6	2.1	3.0	3.6
Czechoslovakia[1])	0.1	0.8	1.9	5.8	12.6	18.7	25.6
Slovenia	0.4	1.6	1.5	1.8	2.0	2.1	2.6
Poland	0.0	0.1	0.4	0.4	1.0	1.9	2.6
Other CEECs	0.3	0.7	0.7	0.7	1.5	3.2	3.1
CEECs total	2.8	10.8	24.7	33.5	50.3	65.1	78.0
CEECs[2]) total	2.2	7.2	16.3	23.3	33.5	45.5	55.1
EU 15	19.5	23.9	29.9	29.3	31.7	32.2	35.3
Rest of the world	7.2	9.0	8.5	10.0	8.9	8.7	11.6
Total	29.5	43.6	63.1	72.8	90.9	106.1	125.0
Number of employees in Austria							
CEECs[3])	32.1	70.8	70.3	93.2	162.4	172.3	177.7
CEECs[2])	13.6	30.2	34.2	48.5	60.1	68.7	79.0
Total	222.6	260.8	267.8	346.3	363.5	353.9	346.6
	per 100 employees						
Ratio home to host country employment							
CEECs[3])	9	15	35	36	31	38	44
CEECs[2])	16	24	48	48	56	66	70
Total	13	17	24	21	25	30	36

Source: OeNB.
[1]) As of 1993 Slovakia and the Czech Republic.
[2]) Subsidiaries of investors with investments in the CEECs only.
[3]) Investors with at least one subsidiary in the CEECs.

3.4 Outward-Directed FDI and Employment

One of the key aspects of FDI activity is its effect on employment. From the perspective of a multinational (or at least bilateral) enterprise group, variables like total employment, total labor cost or total turnover affect investment decisions. Problems involved in shifting employment from domestic sites to affiliates abroad or expectations about the establishment of competitive industries in the host country are the focus of attention within national labor market considerations.

As in the analysis of the link between FDI and trade, aggregate employment statistics (Table 9) are not sufficient to validate the hypothesis of a net gain or a net loss of jobs for the Austrian labor market. When the ODI boom set in at the beginning of the 1990s, the total number of employees who work for domestic companies with subsidiaries abroad increased significantly. This is obviously the result of the growing number of investors. When the rate of growth declined in 1994 and 1995, the total number of employees in direct investment companies fell. Although at the moment only a rudimentary gross/net flow statistic can be calculated, there is evidence that this development reflects permanent rationalization measures in the Austrian economy, especially in manufacturing. However, these figures provide no insight about whether Austrian foreign direct investors benefited from streamlining production via their subsidiaries compared to companies without FDI.

The accumulating number of investments resulted in a dramatic expansion of employment in Austrian affiliates abroad. Between 1990 and 1995 the number of employees in direct investment enterprises practically tripled. This net growth is clearly due to new foundations or acquisitions and can be attributed only partly to employment increases in existing direct investment enterprises abroad.

When the number of employees is used as an indicator of the degree of integration via FDI, a regional breakdown reveals clear differences between Austrian FDI in Eastern Europe and in the West. While the number of persons who work for subsidiaries in the East shot up from a negligible amount to almost 80,000 in 1995, the number of employees in the EU merely doubled to a total of 35,000. Within the CEECs, the subsidiaries in Hungary again dominate the picture, accounting for more than half of the total number of employees. The Czech Republic is next with 22,000 employees, while the number of workers in the other CEECs is not significant.

At the end of 1995, 36 persons were employed in the subsidiaries abroad for every 100 employees in Austrian direct investing companies. A breakdown of this result by region cannot be calculated without difficulties. For companies with at least one subsidiary in the CEECs (and at least one elsewhere), the ratio is somewhat smaller (100 to 44), but if only the investors in the CEECs are taken into account, the ratio is even higher (100 to 70).

However, one has to be careful not to jump to conclusions. A closer look at the regional productivity differentials reveals that the turnover per employee is comparatively low wherever the total number of employed persons is high (Table 10). If the productivity of Austrian (manufacturing) subsidiaries in the EU is taken as a proxy for domestic productivity, it turns out that for instance the 80,000 employees in the CEECs in 1995 are approximately as productive as 25,000 or even 20,000 workers in Austria. Another striking finding is that the age of an FDI investment is crucial for the level of efficiency: With the exception of subsidiaries in the CEECs, where the number of "mature" investments has not reached a significant level, cross-border investments older than four years clearly outperform the younger FDI enterprises in terms of productivity.

Table 10

Productivity[1]) of Austrian FDI Enterprises by Region and Age of Investment

	1989	1990	1991	1992	1993	1994	1995
Total	1.5	1.1	1.0	1.1	1.1	1.1	1.1
less than 5 years	*1.0*	*0.5*	*0.6*	*0.7*	*0.7*	*0.8*	*0.8*
5 years and over	*2.1*	*2.4*	*2.0*	*2.3*	*2.4*	*2.1*	*1.8*
CEECs	0.2	0.2	0.3	0.4	0.4	0.6	0.6
less than 5 years	*0.2*	*0.2*	*0.3*	*0.4*	*0.4*	*0.6*	*0.5*
5 years and over	. .	. .	. .	. .	. .	*0.6*	*0.6*
EU 15	2.2	2.0	1.7	1.8	2.1	2.2	2.3
less than 5 years	*1.7*	*1.6*	*1.5*	*1.5*	*1.7*	*1.8*	*1.9*
5 years and over	*2.6*	*2.6*	*2.3*	*2.7*	*2.6*	*3.0*	*3.2*
Other regions	1.3	1.2	1.4	1.5	2.0	1.8	1.6
less than 5 years	*1.0*	*0.8*	*1.2*	*1.5*	*1.9*	*1.3*	*1.1*
5 years and over	*1.5*	*1.7*	*1.8*	*1.7*	*2.1*	*2.1*	*2.3*

Source: OeNB.

[1]) Median of turnover per employee in manufacturing (ATS million).

4 Conclusion

Due to Austria's geographical closeness to the CEECs, the transition of these countries to a market system has offered Austria a historic chance to extend its international economic network. If FDI is taken as an indicator of integration, the statistics on investment inflows into the CEECs reflect the important role Austria's economy played in augmenting capital inflows into its neighboring countries especially at the beginning of the 1990s. Since then the Austrian share in total FDI inflows into this region has declined steadily, although the CEECs still account for a considerable amount of Austria's FDI outflows. At the same time the Austrian FDI figures indicate a further intensification of integration with Austria's traditional trading partners in the EU, both on the outflow and the inflow side. Another striking consequence is that "Austrian" FDI activities are more and more influenced by strategies of transnational investors who choose Austrian FDI enterprises as gateways for their own investments in East and West.

Intensified economic integration is connected with structural change within the involved economies, both in the countries of origin and in the host countries. The surplus in Austria's trade balance with the CEECs implies that the opening of these markets has so far stimulated Austrian growth and employment. The net effect of Austrian FDI for the domestic and the host economies, however, is not easy to assess. Although specific Austrian industries that face intensive international cost competition (e.g. textiles) made use of the opportunity to shift production sites abroad, the available information does not support the conclusion that so far Austrian ODI has generally been motivated by the wish to take advantage of low labor cost abroad. Much rather the analysis of FDI activities indicates that at least up to 1995, Austrian investors were predominantly driven by the motive to gain access to (new) sales markets.

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1 *Balance of Payments Division of the Oesterreichische Nationalbank. The standard disclaimer applies. I gratefully acknowledge the valuable comments of Michael Andreasch, Wilfried Bach and Eva-Maria Nesvadba.*

2 *Albania, Bosnia and Herzegovina, Belarus, Bulgaria, the Baltic countries, the Czech Republic, Croatia, Moldova, Macedonia, Poland, Romania, Russia, Slovenia, Slovakia, Ukraine and Yugoslavia.*

3 *This trend is even more pronounced when total inward FDI stock (including reinvested earnings) is taken into account (see Focus on Austria 3/1997 of the OeNB).*

4 *The results differ only slightly if other sources, e.g. the UNCTAD data, are used.*

5 *A "new" investment (relationship) in year t is an investment (relationship) that has not been recorded in the statistics in year t–1. Although no detailed checks of whether a "new" relationship in fact represents a mere administrative change of the statistical identifier could be performed, the results in the table are not distorted by the possible bias.*

6 *Since 1995 the industry classification of the OeNB Survey on FDI has been based on the NACE system.*

Editorial close: November 14

EU Opinions – The Qualifying Round for Applicants

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1 Introduction

The long-lasting approximation process has reached a new stage with the publication of Agenda 2000, which includes the Opinions of the European Commission on the membership applications of the ten Central and Eastern European countries (CEECs) and a reform package for the EU.[2]) This process had important cornerstones in the Copenhagen and Essen Summits of June 1993 and December 1994.[3]) The Agenda 2000 documents were presented to the European Parliament and the EU Council (at the Coreper level) on July 16, 1997. The European Commission recommended starting accession negotiations with *the Czech Republic, Estonia, Hungary, Poland and Slovenia.*[4]) Enlargement negotiations are scheduled for early 1998 with Cyprus, to whom this commitment had already been given. The Commission prepared its Opinion on Cyprus already in 1993. The Opinions on each applicant are an assessment of how far each candidate meets the criteria established by the Copenhagen European Council, where it was decided that the associated countries have to fulfill certain political and economic criteria and adopt and implement the EC *acquis communautaire*[5]) to become members of the European Union.

The recommendation of the Commission is not a binding proposal, because only the European Council can take the final decision about when, and with which countries, it will begin accession talks. Therefore, alternative conceptions of accession scenarios are currently being discussed among the EU Member States, such as simultaneous negotiations from a common point of departure for all ten applicants, or an invitation to all ten applicants to participate in an "open race" in which candidates can overtake each other. The final decision is likely to be taken at the Luxembourg Summit in December 1997. However, it has to be stressed that a common starting point in the accession negotiation process does not mean that there will be a common ending date as well. Consequently, any kind of differentiation between the applicants is not automatically tantamount to an exclusion from the process. The Commission proposes the annual presentation of a so-called "progress report" to the European Council on the further achievements of each applicant.[6]) Thus according to the Commission, countries not included in the first wave would nevertheless retain the prospect of starting accession talks as soon as they have made sufficient progress towards meeting the Copenhagen criteria.

The publication of the Opinions by the Commission is especially important, as they represent the first instance in which an EU body has compared the performance of transition countries along the same lines. Moreover, accession has a strong political dimension, which the Opinions also stress: "Accession of these countries is to be seen as part of a historic process, in which the countries of Central and Eastern Europe overcome the division of the continent which has lasted for more than 40 years, and join the area of peace, stability and prosperity created by the Union."[7]) However, EU membership also provides numerous economic advantages for both parties.

For first-wave countries, the recommendation means the acknowledgment of their efforts and also reflects the increasing international confidence in their economic development. Countries with whom negotiations have been postponed for the time being have to face the fact that they are perceived as lagging behind the front runners in many ways. Although their efforts may have been acknowledged, this recognition was not as visible as in the case of the five other countries, which may bring about some disadvantages (for example foreign investors are likely to be more interested in opportunities in first-wave countries). Nevertheless, these countries could profit from the additional time this would give them to adjust their economies to European standards and to the competitive pressures within the Internal Market.

Not only the associated countries have to be prepared for enlargement, so does the European Union itself. Agenda 2000 is a general assessment of the accession request and gives recommendations for a strategy for the successful enlargement of the Union. At the same time, it presents an evaluation of the impact of enlargement on the Union's policies. We do not intend to present the entire reform package in this paper, nor will we go into the proposed necessary reforms of EU policies. We will focus instead on the Opinions on applicant countries[8]) and the proposed preaccession strategy.[9])

The main purpose of this paper is to provide a comparative analysis and an assessment of the economic aspects of the Opinions. Regardless of the outcome of the final decision of the European Council, these documents are of outstanding importance, because they will serve as a basis both for the EU accession negotiations and for the design of the respective preaccession strategies. Although we will give a broad overview of all ten Opinions, our in-depth analysis will focus on the five countries that the Commission recommended for the start of membership talks. While the Commission's choice may be debatable, we will refer to other applicant countries only in specific cases. In the comparison, we will limit ourselves to topics relevant to central banks (monetary and exchange rate policy, inflation performance, central bank independence, the banking sector, current and capital account convertibility and EMU relations) and consequently leave out of account other important aspects.

The paper consists of three parts. *First,* we will provide a comparative overview of the Opinions' statements about the abovementioned central-bank-related topics in the selected countries. *Second,* we will critically comment the Opinions and assess the recommendations made by the Commission. *Third,* we will briefly summarize and comment the Commission's proposed preaccession strategy. In this part, we will also sketch some future prospects, touching on the problems involved in integrating the other five applicants into the Union and on their prospects of joining at a later stage.

2 Comparative Analysis Based on the Opinions

In *June 1993 the European Council in Copenhagen* classified the obligations of membership for associated countries and ensured that the applicant countries could become full members of the Union as soon as they fulfilled these criteria and as soon as the Union itself was ready for enlargement. The political criteria require the stability of institutions that guarantee democracy, the rule of law, human rights and the respect for and protection of minorities. The economic criteria call for the existence of a functioning market economy, and for the capacity to cope with competitive pressures and market forces within the Union. A third criterion for associated countries is the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

The Opinions are based on comprehensive questionnaires filled in by the applicant countries[10]) and some supplementary information (bilateral meetings with national experts until May 1997) the Commission collected to get a complete picture of each topic. The avis[11]) have the official cutoff date May 31, 1997.[12])

The structure of each Opinion reflects the Copenhagen criteria in the Commission's interpretation and treats the applicant countries equally. In other words, the Opinions are all structured along the same lines and have approximately the same length for each of the ten countries.

In this section, we intend to provide a comparative overview of the applicants' preparedness for EU membership as presented by the Commission. We will begin by summarizing the Commission's interpretation of the Copenhagen criteria and stating which applicant countries fulfill the criteria in the Commission's view. In the more detailed comparison, we will then deal with topics relevant to central banks and focus on the five countries recommended for a start of accession negotiations. We will present our comments separately in a later section of this paper.[13])

2.1 General Remarks

Each country avis is basically structured as follows. After an introduction (Part A), the main part (Part B) describes the political (B.1), economic (B.2) and the *acquis* criteria (B.3) and their degree of fulfillment as well as the administrative capacity to apply the *acquis* (B.4). Part C, Summary and Conclusions, summarizes the assessment of each country and contains the politically most sensitive recommendations by the Commission to the European Council about the preparedness of the respective country to join the Union.

Part B is the most comprehensive part of each avis. Besides examining the fulfillment of membership criteria, it contains a lot of detailed information about a number of different political, legal, economic and social aspects.

Section B.1 *(political criteria)* describes the structure and functioning of the legislative, executive and judiciary powers, as well the applicant country's record on the respect of human rights and the protection of minorities. The Commission's assessment of the fulfillment of the political criterion is conducted on the basis of the present situation and does not outline any future prospects, which contrasts with the methodology applied for the examination of the other criteria.

According to the Commission, even though a number of applicant countries still have to make progress on actually practicing democracy and protecting minorities, only one of the ten applicant states, namely Slovakia, does not satisfy the political conditions laid down by the European Council in Copenhagen.

Section B.2 examines the implementation of the *economic criteria.* Under the Copenhagen definition, the economic criteria comprise two main elements: the existence of a functioning market economy and the capacity to cope with the competitive pressures and market forces within the Internal Market. The Commission gives a picture of the present situation of the applicant economies and provides an analysis of expected progress over the medium term.

The Commission finds that five applicant countries can be regarded as *functioning market economies* (the Czech Republic, Estonia, Hungary, Poland and Slovenia). At present, Slovakia does not fulfill this criterion, but "has introduced most of the reforms necessary to establish a market economy." Latvia, Lithuania and Romania have made "considerable," while Bulgaria has made only "limited" progress in establishing a market economy.[14])

According to the Opinions, five applicants (the Czech Republic, Hungary, Poland, Slovenia and Slovakia) will have the *capacity to withstand the competitive pressures* and market forces within the Union in the medium term. Estonia "should be able to make the progress necessary" to become competitive in the Internal Market in the medium term. Latvia, Lithuania and Romania would "face serious difficulties" even in the medium term. In the case of Bulgaria, the Commission comes to the very critical conclusion that the country would not be able to cope with the competitive pressures and market forces.[15])

The Commission judges that within the group, the Czech Republic, Hungary, Poland and Slovenia will succeed in fulfilling the economic criteria in the medium term, while Estonia and Slovakia will come very close to this group.

Section B.3 *(acquis criteria),* which is the most comprehensive part of Part B, examines the capacity of each country to assume the obligations of membership, including the adherence to the aims of political, economic and monetary union, that is the capacity to implement the legal and institutional framework known as the *"acquis communautaire"* by means of which the Union puts into effect its objectives. The section describes the current and prospective situation of each applicant in each of the main areas of the Union's activities (for example the applicant's achievements in implementing the four freedoms, sectoral policies, justice and home affairs, environmental issues, EMU). The Commission depicts the present state of the countries' ability to implement the *acquis* and also provides an analysis of expected progress over the medium term. "In making this forward assessment, the Commission has taken into account programmes for progressively implementing the *acquis* under way … and the future development of the Union's policies, where the acquis is evolving rapidly."[16]) To illustrate the state of legislative adjustment in the applicant countries, the Commission presents a quantitative survey of the adoption and implementation of White Paper[17]) measures in different fields (see Table 1 below[18])).

The Commission concludes that the Czech Republic and Hungary will be able to comply with the *acquis* fully in the medium term if they continue their efforts on its transposition and make particular efforts in some fields. For Poland, the wording is slightly different; the Commission states that it "will be able to participate fully in the Single Market in the medium term."[19]) The Commission gave Estonia the most positive assessment in acknowledging that it is the only applicant country to have already completed the transposition process.[20]) Slovenia, on the other hand, lags behind somewhat in the realization of the *acquis* criteria; the Opinion lists a considerable number of sectors requiring marked improvement.[21]) With substantial further effort, Latvia and Lithuania would also be able to fully participate in the Single Market in the medium term. Slovakia requires further progress to ensure the effective application of the *acquis.* Bulgaria and Romania have not adopted the essential elements of the *acquis* yet, so the Commission concludes that it is not likely that they will be able to apply the *acquis* fully in the medium term.

In December 1995 the European Council in Madrid concluded that an adjustment of administrative structures in the CEECs is necessary for a harmonious integration into the EU. Therefore section B.4 examines the administrative capacity to apply the *acquis,* that is the current state and prospective ability of the public administration, including parts of the judicial system, to carry out the functions required. The strengthening of administrative structures and further[22]) administrative reform will be "indispensable" for all applicants.

Table 1

Number of White Paper Measures
Implemented by the Associated Countries

White Paper measures for the Single Market	Directives		Regulations		Total
	Stage I	Stage II/III	Stage I	Stage II/III	
Number of White Paper measures	295	293	99	212	899
Bulgaria	78	27	19	2	126
Czech Republic	126	92	36	163	417
Estonia	87	58	22	116	283
Hungary	213	167	66	133	579
Latvia	139	80	26	8	253
Lithuania	164	119	24	9	316
Poland	197	154	52	2	405
Romania	197	154	52	2	405
Slovenia	165	102	30	118	415
Slovakia	263	253	86	62	664

Source: Information provided by the Opinions.
Notes: The table is based on information provided by the applicant countries' authorities, and the number of measures does not necessarily indicate the Commission's agreement. The table shows the number of measures for which the authorities have notified the Commission of the existence of adopted legislation that is to some degree compatible with the corresponding White Paper measures.

2.2 Monetary and Exchange Rate Policy

No specific chapter in the Opinions is exclusively devoted to monetary and exchange rate policies; these issues are briefly analyzed in three different subchapters of Part B of each Opinion. Monetary and exchange rate policy issues are touched upon in two subchapters of section B.2 (economic criteria), namely "Liberalization" and "Financial Sector." In addition, a paragraph can be found in section B.3 *(acquis* criteria) under the heading "Economic and Monetary Union."

The Opinions state that price stability can be regarded as the ultimate *goal of monetary policy* in the five recommended countries, although this objective is not clearly reflected in the respective central bank laws in the cases of Hungary, Poland and Slovenia.[23]) As to the chosen *intermediate targets,* most of the countries which target the exchange rate (except for Estonia) have adopted another target as well: According to the Opinions, the Czech Republic sets a target range for money supply growth, and Poland moved from direct interest rate targeting to reserve money targeting in 1996. Interestingly enough, the Opinion on Hungary does not touch upon the choice of the intermediate target of monetary policy. Slovenia, which operates a managed floating exchange rate regime, officially targets money supply.

According to the Commission, monetary policy in the five recommended countries has been successful in establishing a stable macroeconomic environment and reducing inflation in the past years. This generally positive assessment is qualified somewhat for Hungary, where monetary policy "implemented since March 1995" is seen as successful and for Poland, whose monetary policy the Commission views "broadly speaking" as successful.[24])

With the exception of Estonia, which operates a currency board system, all recommended countries use *indirect instruments* to control money supply, such as open market operations, discount and lombard rates, and minimum reserve requirements. A special problem in Slovenia mentioned in the avis is the lack of government papers that results from the country's sound fiscal record (it has no budget deficit), which makes it difficult for the central bank to use open market operations to control money supply. Remarkably, the use of indirect instruments is not mentioned in the avis on Poland. Slovakia only recently switched to the full use of indirect instruments, since the remaining credit ceilings on individual banks were abolished only in January 1996.

Hungary got the best marks, as it were, compared to the other recommended countries for the *effectiveness of monetary policy.*[25]) Bank privatization is far advanced, the amount of bad loans has been markedly reduced, and the market for government papers is one of the most developed in the region. The Commission identifies a number of factors that still prevent monetary policy from being efficient in the Czech Republic. In Poland and Slovenia, however, the uncompetitive, state-dominated banking sectors are still waiting to be privatized and are typically burdened with a large amount of bad loans on their balance sheets. In Slovenia, widespread indexation, most importantly of interest rates and wages, is identified as the major problem preventing the efficiency of monetary policy.[26])

For each applicant country, the Commission briefly describes the chosen exchange rate regime and identifies a broad variety of different regimes across the ten applicant countries, ranging from the extreme model of a currency board with a fixed peg to rather flexible systems (see Table 2 below). Because the Opinions' cutoff date was May 31, 1997, the Opinion on Bulgaria could not yet fully take into account the country's switch to a fixed peg vis-à-vis the Deutsche mark and the introduction of a currency board arrangement at the beginning of July 1997.

The crawling peg regimes in Hungary and Poland and the fixed peg of the Estonian kroon are deemed very successful in curbing inflation.[27]) Although the currency crisis in the Czech Republic, which was very recent at the time, is analyzed in detail, the analysis does not substantially worsen the assessment of Czech exchange rate policy. No explicit assessment of the exchange rate regime can be found in the Opinions on Slovenia and Slovakia. The central banks of Latvia and Lithuania are praised for successfully maintaining the credibility of their exchange rate pegs despite the banking crises that both countries faced in 1995. While the Commission does not explicitly criticize the exchange rate policies pursued by Romania and Bulgaria (before the latter introduced a currency board), it does describe the difficulties the central banks experienced when they tried to intervene in the foreign exchange markets.[28])

Table 2

Exchange Rate Regimes in the Applicant Countries according to the Opinions

	Exchange rate regimes adopted		Exchange rate regimes adopted
Bulgaria	free float	Poland	crawling peg
Czech Republic	managed float	Estonia	peg to the Deutsche mark
Romania	managed float	Latvia	peg to the SDR
Slovenia	managed float	Lithuania	peg to the U.S. dollar
Hungary	crawling peg	Slovakia	peg to a basket

Source: Information provided by the Opinions.

A major monetary and exchange rate policy problem identified by the Commission is the massive *inflow of speculative capital,* mostly in the form of portfolio investments, that was observed in the last years and that endangered the ability of the central banks to control monetary aggregates. The Czech Republic (1994/95), Poland (since mid-1994) and Slovenia (mid-1992 to mid-1994) were particularly affected by these developments. It is interesting to note that the policy responses of these countries were quite different: The Czech Republic and Poland widened the fluctuation bands of their exchange rates in February 1996 and May 1995, respectively, to add a larger element of risk to currency speculation. Furthermore, in December 1995 the Polish central bank revalued the zloty by 6% in nominal terms. Slovenia, on the other hand, gradually imposed restrictions on capital movements to stem capital inflows. The Commission quite legitimately criticizes this policy as being incompatible with the EU Association Agreement. Interestingly, the Opinion on Hungary does not tackle the problem of speculative capital inflows at all.

2.3 Inflation Performance

After the initial surge in prices following price liberalization and the adjustment of prices to world market levels in the ten countries, inflation showed a declining trend almost across the board. However, considering the data provided in the Opinions, the countries will reach the European average only in the medium or even in the long term.

Table 3 shows the inflation performance of the ten applicant countries in the last three years. Slovakia has the best record among the applicants and posts the lowest inflation rate. By the end of 1996 the Czech Republic and Slovenia had managed to reduce their inflation rates to single digits, while CPI inflation in Estonia, Hungary and Poland was around 20%. In Bulgaria and Romania, which did not succeed in attaining a sufficient degree of price stability, the governments introduced radical macroeconomic stabilization

Table 3

The Inflation Performance of the Applicant Countries

	Inflation rate 1994	1995	1996
	annual average, percent		
Bulgaria	96.0	62.0	123.0
Czech Republic	10.0	9.1	8.8
Estonia	47.7	29.0	23.1
Hungary	18.8	28.2	23.6
Latvia	35.9	25	17.6
Lithuania	72.2	39.6	24.6
Poland	32.2	27.8	19.9
Romania	136.7	32.3	38.8
Slovenia	19.8	12.6	9.7
Slovakia	13.3	9.9	5.8

Source: Information provided by the Opinions.

and structural reform programs (primarily tight monetary and fiscal policies) in 1997.

Except in Hungary, where "almost all transactions take place at market prices,"[29]) the downtrend of inflation in the recommended countries could be endangered by the significant share of goods and services with administrative prices in the basket on whose basis the consumer price index is calculated. In the Czech Republic further price liberalization and deregulation could boost inflation in the near future, so that "some very firm action is needed to contain the existing pressures."[30]) In Estonia 25%, in Poland 23% and in Slovenia 26% of the goods and services in the basket are still under administrative control.[31]) The Commission does not explicitly mention any dangers in the case of Hungary. However, while it stresses the fact that inflation and interest rates follow a relatively stable and predictable downward path in Hungary, it also states that a more rapid reduction of inflation appears to be difficult.

2.4 Central Bank Independence

Each Opinion briefly treats the issue of central bank independence in two different sections in Part B, namely Chapter B.2.1, Financial Sector, and Chapter B.3.3, Economic and Monetary Union.

In the Commission's view, all central banks of the recommended countries with the exception of Poland enjoy a relatively high degree of *independence from government bodies in the conduct of monetary policy.* In the Opinion on Poland, the Commission states that the central bank is "not explicitly provided with formal independence from the government in the conduct of monetary policy." This legitimate criticism refers to the Polish central bank legislation in force until July 1997.[32]) However, on May 27, 1997, Poland adopted a new Constitution by referendum. This Constitution enshrined the independent status of the central bank and entailed fundamental changes in central bank legislation. Accordingly, the law on the National Bank of Poland was amended in July 1997 and endowed the central bank with the sole right to determine and implement monetary policy.

The Opinions very briefly touch upon *appointment procedures of central bank governors,* and conclude that in four of the five recommended countries, the central banks enjoy a high degree of personal independence.[33]) Interestingly enough, criticism is voiced on Hungary's handling of appointments, because according to the Commission, "appointments of new governors have coincided with changes in the government in practice."[34])

The Commission correctly identifies the weakest point in the applicant countries' central bank legislation, namely the provisions about *budget deficit financing by the central bank.* According to the Opinions, the central bank laws of the Czech Republic, Hungary, Poland[35]) and Slovenia are still not in line with the Maastricht Treaty, which requires an explicit prohibition of central bank credit to the government.[36]) Although the Opinions do not expressly say so, a fact well worth noting is that the central bank laws of the four abovementioned countries typically set a maximum amount[37]) for short-term liquidity loans to the government, but stop short of an outright prohibition of direct budget financing. The only exception is Estonia, whose central bank contains such a prohibition.

2.5 Banking Sector

The financial sector, especially the banking sector, plays an important financial intermediation role by channeling savings towards productive investment. The Opinions also stress the importance of a well-developed financial sector in judging the existence of a functioning market economy and the ability to fulfill the obligations of Economic and Monetary Union. Therefore, the Commission examines financial sector developments critically and in great detail.

It is very difficult to obtain a complete impression of the Commission's assessment of the banking sector, as eleven different subchapters of each Opinion refer to this topic.[38]) In analyzing the state of the banking sector, the Commission examines the following indicators: the degree of restructuring and state participation, the share of foreign ownership, the level of concentration, the fulfillment of the financial intermediation role and the ability to compete. The Commission sees the adoption of the legal framework as a necessary condition to create a stable financial environment in these countries, but distinguishes between adopted and implemented banking directives: The proper everyday functioning of the directives is essential for a country to compete in the Internal Market.

All applicant countries have introduced a two-tier banking system to clearly distinguish between central bank functions and commercial bank operations, although the Opinions on Latvia and Slovakia do not explicitly mention this fact. Banks still face the serious problems of undercapitalization, bad loans and a lack of competitiveness in most of the countries. Almost all of the countries introduced new banking laws in 1996 or 1997. However, in many instances they are far from fully compatible with the *acquis,* and their practical implementation and functioning requires monitoring even in countries with advanced legislation of an EU standard.

Table 4 shows the level of integration of White Paper measures on financial services into national legislation. We can see that Hungary, Lithuania, Poland, Romania and Slovakia are in a somewhat more favorable position than the others, but none of the countries has fully implemented all (high priority) Stage I measures yet. Table 5 gives an overview of the level of

Table 4

Number of White Paper Measures on Financial Services Implemented

White Paper measures on financial services	Directives		Regulations		Total
	Stage I	Stage II/III	Stage I	Stage II/III	
Number of White Paper measures	13	8	0	0	21
Bulgaria	6	3	0	0	9
Czech Republic	8	3	0	0	11
Estonia	8	6	0	0	14
Hungary	12	8	0	0	20
Latvia	9	5	0	0	14
Lithuania	11	6	0	0	17
Poland	10	7	0	0	17
Romania	10	7	0	0	17
Slovenia	7	0	0	0	7
Slovakia	12	6	0	0	18

Source: Information provided by the Opinions.

implementation of specific banking directives in individual countries. None of the applicants has implemented the Stage II Capital Adequacy Directive yet; consequently capital adequacy regulations are still based on credit risk alone in these countries (hence market risks are not handled).

The *level of competitiveness* in the banking sector differs among the five recommended countries. According to the Commission, the banking sector is sound and expanding in Estonia and Hungary, needs further reforms in Poland and, for several reasons, is not sufficiently competitive or strong in the Czech Republic and Slovenia. The Commission also stresses that competition is greatest in the Estonian banking sector, where branches of foreign banks can be opened and operated under the same conditions that apply to domestic banks.

According to the Commission, the *concentration* in the banking sectors of the applicant countries is very high. Nearly all of the banking sectors are

Table 5

The Implementation of the European Community's Banking Directives

Banking Directives	Czech Republic	Estonia	Hungary	Poland	Slovenia[1])
Stage I measures					
First Banking Directive	+	+	+	+	n.m.
Own Funds Directive	n.m.	+	+	+	n.m.
Solvency Directive	+	+	+	+	n.m.
Money Laundering Directive	–	–	+	+	n.m.
Deposit guarantee schemes	–	–	+	+	n.m.
Stage II measures					
Second Banking Directive	+	+	n.m.	n.m.	n.m.
Capital Adequacy Directive	–	–	–	–	–
Large Exposure Directive	+	+	+	+	n.m.
Accountancy Directives	n.m.	+	+	+	n.m.
Consolidated supervision	–	–	n.m.	–	n.m.

Source: Based on information provided by the Opinions.

Notes: "n.m." = not mentioned, "+" = implemented or partially implemented, "–" = differences between country and Community legislation exist.

[1]) The Opinion on Slovenia only says that the laws and regulations in the banking sector are similar to those of the EU, namely to the Stage I measures, and are being further harmonized with European directives under the new legislation to be adopted by the end of 1997.

dominated by a few large banks. In the Czech Republic, 80% of the banking business is concentrated in four main banks. The sector is also fairly concentrated in Estonia according to the Opinion; however, the avis contains no precise figures. The five largest banks accounted for just under 60% and 50%, respectively, of total banking assets in 1996 in Hungary and Poland. The three biggest Slovenian banks cover more than half of the market in terms of balance sheet totals.

State participation in these countries is higher than the European average, mainly for historical reasons and because of the incomplete privatization process. In the Czech Republic, the four major banks have not been privatized yet, and seven additional banks are partly owned by the state. The role of the state has been greatly reduced in the Estonian banking sector: At present, the state owns stakes in only two credit institutions; moreover, the government intends to sell these shares as well in the coming years. The bank privatization process is almost complete in Hungary, and resulted in a comparatively large share of foreign ownership, but the Commission stresses the need for steady continued privatization.[39]) At the end of 1996 the state held just below 50% of the total share capital of commercial banks in Poland, which means that the banking sector is still largely state-owned.

Bad loans remain a problem in the Czech Republic, Estonia, Poland and Slovenia. Bad loans were reduced to noncritical levels in Hungary following the adoption of repeated bank consolidation schemes.

The central bank is responsible for *banking supervision* in the Czech Republic, Estonia and Slovenia. In Hungary and Poland the supervisory authorities for banks[40]) are independent from the respective central bank.

It is also important to point out that the Czech Republic and Slovenia have some significant *country-specific difficulties.* The adopted privatization scheme has resulted in crossownership among Czech banks and investment funds, which hold shares in the enterprises to which banks lend. This leads to conflicts of interest in corporate governance, as banks are both owners and creditors. Slovenia has a relatively concentrated banking sector, but is nevertheless overbanked: According to the Opinion on Slovenia, many of the banks are too small, and the number of banks is too high considering the size and the economic needs of the country. The Slovene banking sector is burdened with another difficulty in meeting EU requirements, namely that banks have concluded an interest rate arrangement with the approval of the Bank of Slovenia and the Anti-Monopoly Office whereby the cartel sets an upper limit on commercial banks' deposit rates.

2.6 Current Account Convertibility

Applicants have taken on convertibility obligations – including current account convertibility – vis-à-vis the EU in the Association Agreements. All countries except Bulgaria and Romania have applied the obligations of Article VIII of the IMF's Articles of Agreement and have consequently introduced full current account convertibility. Some countries have liberalized even more, such as Estonia, where no exchange restrictions whatsoever apply to capital transfers to and from the country, and Latvia, where only few restrictions remain.

Table 6

Current Account Convertibility in the Applicant Countries

	IMF Article VIII obligations		IMF Article VIII obligations
Lithuania	May 3, 1994[1])	Slovakia	October 1, 1995
Estonia	August 15, 1994	Slovenia	September 1, 1995[1])
Latvia	June 10, 1994	Hungary	January 1, 1996
Poland	June 1, 1995[1])	Bulgaria	–
Czech Republic	October 1, 1995	Romania	–

Source: Information provided by the Opinions.
[1]) The respective Opinions do not indicate the exact date of the declaration.

The Bulgarian lev and the Romanian leu are convertible for most current account transactions, and, according to the Opinion on Romania, the Romanian authorities expect to be able to assume Article VIII obligations in the course of 1997.[41])

2.7 Liberalization of Capital Movements

The issue of capital account liberalization is presented in section B.3.1 (The Four Freedoms, Free Movement of Capital). In each of the Opinions, the Commission refers to the White Paper, which suggests "a sequence of capital liberalization, starting from long-term capital movements and those linked to commercial operations and subsequently focusing on short-term capital."

According to the Opinions, Estonia has introduced a far greater degree of liberalization of capital movements than the other applicants have; it already exceeds the obligations undertaken under the Europe Agreement. The Commission does not identify "any major obstacles for accession in the medium term" in the field of capital account liberalization.[42])

The Opinions draw a distinction between the Czech Republic, Hungary and Poland, although all of these countries have made progress with fairly substantial capital movement liberalization in the context of their accession to the OECD.[43]) In the view of the Commission, the liberalization of capital movements has been most substantive in the Czech Republic, and the Commission expects the country "to be able to eliminate, without major difficulties, the remaining restrictions on the movement of capital in the medium term and assume fully the Community acquis in this area." The Commission regards Hungary's and Poland's progress on capital account convertibility as "considerable," but "further efforts are still required" in specific areas in Hungary and across a broader range of items in Poland. This differentiation is largely echoed in Part C, Summary and Conclusions, of the three avis: Full capital account convertibility is not seen to constitute problems for the Czech Republic and appears to be within reach for Hungary, while in the case of Poland, the Commission concludes that "work is still needed" on the liberalization of capital movements.

The Commission is rather critical about the capital account regulations in Slovenia: The liberalization of capital flows has made slow progress and "under the current framework of monetary and exchange policies, there is little prospect of an important move towards further capital liberalisation." Consequently, in Part C, Summary and Conclusions, the Commission chooses an even more critical wording than in the case of Poland and states that "substantial work is still needed ... in the field of capital movements."

2.8 Economic and Monetary Union Relations

According to the Copenhagen criteria, applicant countries have to adhere, inter alia, to the aims of Economic and Monetary Union. Consequently, fulfilling the Maastricht criteria is not a condition for joining the European Union. Still, the convergence criteria "remain key points of reference for stability oriented macroeconomics policies, and must in time [but not necessarily upon accession] be fulfilled by new member states on a permanent basis."[44]) Each country Opinion contains the statement that "it is premature to judge whether [the respective applicant country] will be in a position, by the time of its accession, to participate in the Euro area; that will depend on the success of its structural transformation permitting to attain and to adhere permanently to the convergence criteria."[45])

The focus of the Commission's observations is on the two main obligations applicant countries will have to meet in order to participate in Stage Three of EMU as non-euro area countries: the adoption of the *acquis communautaire* of Stage Two of EMU and close and institutionalized monetary and exchange rate policy cooperation with the European Union.

The *acquis dimension of EMU* relates to the Treaty provisions on the coordination of economic policies (including adherence to the regulations of the Stability and Growth Pact that are binding for all EU Member States), central bank independence, price stability as the prime objective of central bank policy, the prohibition of direct central bank financing of budget deficits, the interdiction of privileged access of public authorities to financial institutions and, last but not least, the liberalization of capital movements.[46])

Monetary and exchange rate policy cooperation with the European Union has two main aspects. First, the newly acceeding countries will participate in the European System of Central Banks, though on a restricted basis.[47]) Second, upon joining the Union they are expected to participate in an exchange rate mechanism.[48])

The Commission concludes that participation in Stage Three of EMU as a pre-in country should pose "no problems" in the medium term for the Czech Republic, Hungary and Poland and "few problems" for Estonia. With this conclusion, the Commission implies that existing weaknesses can be overcome (in the case of Estonia "largely overcome") by the time the countries join the European Union. Typically, the criticism relates to the yet uncompleted harmonization of central bank legislation and to financial sector deficiencies.[49])

On Slovenia, the Commission arrives at the following assessment: In the detailed EMU-related review, it finds that the country's "participation in the third stage of EMU as a non-participant in the euro area should pose no problems in the medium term." Hence, based on this section, Slovenia is expected to eliminate in due time the weak spots identified by the Commission. As in the other four countries, these pertain to central bank legislation and financial sector restructuring, furthermore to monetary policies "able to curb speculative capital inflows without resorting systematically to capital controls." Part C, Summary and Conclusions, of the Opinion states that Slovenia's participation in the third stage of economic and monetary union with a pre-in status "could present some difficulties." This implies that, in the final analysis, the Commission is not fully confident that Slovenia can overcome EMU-related weaknesses until EU accession.[50])

3 Critical Assessment of the Opinions

In this section, we will analyze and comment the Commission's Opinions. We will begin with some remarks about the general conception of the Opinions, their internal consistency and the horizontal consistency with respect to other documents of the Agenda 2000 package. Second, we will comment on the Commission's interpretation of the Copenhagen criteria and its implications for the country assessments. Third, we will discuss the Commission's approach to select five out of ten applicants and will shed some light on the possible consequences of this selection in particular for nonrecommended candidate countries. Fourth, we will analyze in detail those parts of the Opinions which touch upon issues of relevance for central banks, namely monetary and exchange rate policies, inflation performance, central bank independence, the banking sector, capital account liberalization and EMU relations.

3.1 General Remarks

As pointed out earlier, the structure of each Opinion is basically a reflection of the Copenhagen criteria as laid down in June 1993. In checking the degree of fulfillment of these criteria for each of the applicant countries, the Commission has produced a comprehensive and, by and large, a very detailed analysis that covers the different aspects of each criterion. As this kind of exercise requires very specific expertise in a variety of different areas, the Opinions are obviously put together from contributions provided by different Directorates General of the Commission. While the Commission has certainly done a commendable job in providing ten in-depth country analyses in a very limited span of time, overlappings or double coverage of some topics could not be avoided fully. Moreover, a very important source of information for each Opinion was provided directly by the applicant countries (replies to detailed questionnaires, bilateral consultations with national experts), which was certainly even more difficult to check thoroughly simply for time and capacity reasons. Whereas some interlinkages between the different subchapters of each Opinion can be found, the Opinions generally create the impression of being a "patchwork" of different contributions rather than one integrative document.

One result of this rather piecemeal approach is that the wording of some subchapters presented in Part B of each country Opinion is not fully consistent with Part C, Summary and Conclusions, of the same Opinion. A case in point is the Commission's assessment of price liberalization in Estonia.[51]) Moreover, sometimes the views expressed in a particular sub-chapter are not consistent with the wording of other subchapters of the same Opinion. As an example, we would like to point out the Commission's assessment of the progress in privatization achieved by the Czech Republic.[52]) Furthermore, in some cases inconsistencies can be found even between the individual country Opinions and other documents of the Agenda 2000 package. This applies, e.g., to the differing statements on the fulfillment of the economic criteria by the applicant countries.[53])

3.2 The Application of the Accession Criteria

The accession criteria, as defined at the Copenhagen Summit, were formulated in a rather general way and needed to be made more explicit and operational. The White Paper was published to help fulfill this task. It gave concrete guidelines to applicants, though only in the area of the Internal Market *acquis.* The political and economic criteria were not interpreted in detail until the publication of the Agenda 2000 package.

Interestingly, the *political criteria* are assessed on the basis of the present situation in each applicant country, whereas the economic and *acquis* criteria are evaluated on a forward-looking basis. According to the Commission, this approach was chosen because "an assessment [of the political situation] could be conducted only on the basis of elements of the present situation which [the Commission] has been able to verify and confirm."[54]) While this consideration is certainly justified, the Commission's assessment of the political situation can only provide a snapshot of the situation in June 1997 and therefore has to be interpreted with caution. At the same time, the Commission stresses that the fulfillment of the political criteria is regarded as a primordial condition for membership. If we consider that the applicants have fledgling multiparty political systems, that they look back at a very short history of democracy and that a stable political environment and stable institutions are still in the process of being established, the fulfillment of the political criteria will have to be observed and regularly updated with great care also after the publication of the Opinions.

In 1996, the Commission's experts started to discuss intensely how the *economic criteria* should be interpreted and operationalized. The paper by Ilzkovitz and Daviddi[55]) constituted one of the important steps in this process and served as the basis for the methodology the Commission presented in Agenda 2000. According to the Commission's interpretation, the term *"existence of a functioning market economy"* comprises a number of different subconditions ranging from macroeconomic aspects[56]) to systemic requirements[57]) and also to political conditions[58]). The second part of the economic criteria, as defined in Copenhagen, refers to the *"capacity to withstand competitive pressure and market forces within the Union."* The Commission's detailed interpretation of this condition contains a number of microeconomic requirements[59]) as well as requirements on the economic policies pursued by the applicants.[60]) It is interesting to note that the very first subcondition the Commission lists as being necessary to withstand competitive pressures is the existence of a functioning market economy. Logically, this would imply that the second part of the economic criteria ("capacity to withstand competitive pressures") can be fulfilled only if the first part ("functioning market economy") is in place. Nevertheless, in the Opinion on Slovakia, the Commission concludes that the country will have the capacity to stand up to competitive pressures in the medium term, although at the same time it identifies a number of problems Slovakia will come up against on its way to becoming a functioning market economy.[61])

As mentioned, apart from the analysis of the present situation, the Commission has embarked on the enormous task of providing a forward-looking assessment of the *acquis* criterion. This appears to be extremely difficult: The applicant countries are compelled to approach a "moving target," because the Union's *acquis* itself develops very fast. Moreover, the *acquis* criterion also includes the "adherence to the aims of *political,* economic and monetary union" and thus comprises the very sensitive area of common policies. A prospective assessment of the fulfillment of the *acquis* criteria in the medium term, as provided by the Commission, therefore implicitly contains a judgment on the future political developments in the candidate countries, so that fulfillment cannot be assessed independently of the political situation.

Another very important question refers to *the respective weights of the individual criteria* applied by the Commission when producing an overall assessment of each country. While the Commission clearly states that the fulfillment of the political criteria is regarded as an indispensable prerequisite for starting negotiations, the weights of the different areas of the economic and *acquis* criteria do not appear quite clear to the reader. It seems to us that the Commission has given different weights to the conditions in the case of different countries. This is true, for example, of the Commission's assessment of Slovenia's readiness to join Economic and Monetary Union in the medium term, which is more critical than that of the other recommended countries: In the Opinion on Slovenia, deficiencies in central bank legislation are explicitly mentioned in Part C, Summary and Conclusions, although the deficiencies identified in the main text of the avis do not differ from those identified for the Czech, Polish and Hungarian legislation.[62])

3.3 The Country Recommendations

By recommending five applicants out of the ten to begin membership talks with, the Commission made a clear statement about which countries it considers to be most advanced in terms of political and economic transition and therefore most prepared for EU membership. Although Commission representatives have stressed several times that such a differentiation between the candidates should not be understood as discrimination, the publication of the Opinions in July 1997 sent a clear signal not only to the applicant countries, but inevitably also to the international community, and it triggered world-wide reactions.

The Commission's country recommendations undoubtedly have *political consequences.* The selection of only five out of ten candidates could create new, artificial boundaries between EU aspirants in Central and Eastern Europe, a fear which has been voiced repeatedly by the nonrecommended countries. In addition, new boundaries could be drawn between the ten associated countries and other Central and Eastern European transition economies that might also strive for EU membership at a later stage.

While it may be economically justified, the distinction between Estonia and the other two Baltic States, for example, appears to be rather problematic from the political point of view. This is not only due to the historic and geographic proximity of these countries, but also to the already high degree of economic integration between the Baltic States.[63]) Consequently, the Latvian and Lithuanian authorities expressed their disappointment. Prime Minister Skele of Latvia stressed that the Commission's decision to invite only Estonia to the accession negotiations was "due to the incompetence of Brussels and undermines Baltic unity."[64]) Nor did the Lithuanian government agree with the Commission's assessment; it underlined that for several reasons Lithuania was not "lagging behind leading EU membership candidates from Central and Eastern Europe."[65])

Other nonrecommended countries have also voiced their disappointment. The Romanian government expressed general criticism about the distinction made by the Commission among candidate countries, and Prime Minister Ciorbea emphasized the inconsistency of the Commission's viewpoint "with the principle of equal chances for EU associate countries" as declared in Copenhagen.[66]) Bulgaria, however, generally accepted the Commission's judgment.

In the case of Slovakia – the only candidate not recommended for primarily political reasons – the Commission's assessment may contribute to the necessary international pressure on Slovakia to improve its democratic system. On the other hand, the Commission's recommendation could be perceived as an exclusion from the accession process, which in Slovakia could negatively influence public opinion on EU integration.

However, the Commission's recommendations cannot be seen as having purely political effects; their consequences inevitably have an *economic dimension* as well. The opening of accession negotiations with only a selected group of candidates might have effects on the international financial markets, deterring potential foreign investors from investing in certain countries. Moreover, in our view it cannot be excluded that even the credit ratings for some countries, and for some companies, are downgraded. This would affect the competitiveness of these countries or companies by increasing financing costs. Furthermore, the accession of only a selected group of countries might decrease the degree of economic integration among applicant countries (e.g. in the form of CEFTA[67])), which only started to develop after the collapse of the CMEA. Moreover, when former CEFTA members become EU members, their economic relations with the remaining CEFTA countries will be determined solely by the Association Agreements, which – in some areas of trade liberalization (e.g. agriculture) – are not as far-reaching as the already existing CEFTA agreement. This could imply the reintroduction of trade restrictions in some areas.

In view of the political and economic impact of the Commission's recommendation, the final decision to be taken by the European Council has to be prepared with great care, because it might have an impact on the whole of Europe. Therefore, it comes as no surprise that EU Member States are currently discussing alternative approaches to the Union's Eastern enlargement. The broadest approach, which is supported inter alia by the European

Parliament,[68]) suggests extending a *simultaneous invitation* to all ten applicant countries (with the exception of Slovakia) to open accession negotiations. Although this approach would cause the least political difficulties in the Union's relations with the candidates, parallel negotiations with nine (in fact together with Cyprus ten) countries would probably exceed the personnel and administrative capacity of the Union and could thus slow down the approximation process for the most advanced countries. An alternative model recently suggested by German Foreign Minister Kinkel[69]) uses the metaphor of a "stadium" in which each candidate ("athlete") can take part in the "open race" for EU membership. We interpret this metaphor to mean that even "latecomers" (i.e. presently not recommended countries) potentially have the chance to join the race, pass others and even "cross the finish line" (i.e. join the EU) ahead of those in the lead today (i.e. the recommended countries). The implementation of such a "stadium model" in practice will crucially depend on the exact definition of the preaccession strategy.

3.4 Critical Assessment of Issues Relevant to Central Banks

In this section, we will analyze how central-bank-relevant issues are dealt with in the country Opinions, focusing on the following areas: monetary and exchange rate policy, inflation performance, central bank independence, the banking sector, the liberalization of capital movements, and EMU relations.

It has to be stressed that the most sensitive issues in membership talks will probably be agricultural policies, the free movement of persons and hence the opening of the labor market, as well as future regional transfers for new members (Structural Funds). Therefore, the Commission had to reserve ample room for these topics in each Opinion and touched rather briefly on the abovementioned central banking issues, as the applicants are generally more advanced here, so that these issues will probably not cause major problems during the accession negotiations.

3.4.1 Monetary and Exchange Rate Policy

As pointed out earlier, the area of monetary and exchange rate policy is treated in several subchapters of each Opinion, which inevitably leads to double coverage of some areas[70]) and some inconsistencies in the Commission's assessment of policies.

The Commission's analysis of the applicants' monetary policy goals, intermediate targets and instruments is performed accurately and gives a clear picture of the applicants' preparedness for membership in this area. While we agree with the Commission's assessment that *monetary policy* has generally been *successful* in reducing inflation in the Czech Republic, Slovenia and Estonia, the very positive wording in the case of Hungary ("undoubtedly successful") and Poland ("broadly speaking successful") does not seem fully consistent with the assessment of other candidate countries. Although the inflation performance – both in absolute terms as well as in terms of inflation reduction – of Hungary and Poland does not measure up to the achievements of other countries, even nonrecommended ones such as Latvia, Lithuania or Slovakia, the wording of the respective chapters on monetary policy in the individual country Opinions does not reflect this. Whereas Latvia's and

Slovakia's monetary policies are given an at least positive assessment similar to that of the recommended countries,[71]) the Opinion on Lithuania does not even mention monetary policy achievements.

As pointed out earlier, each of the Opinions contains a brief description of the *chosen exchange rate regime,* which is correctly elaborated for most countries. However, it is interesting to note that the Slovene exchange rate regime is depicted by the Commission as "shadowing the Deutsche Mark."[72]) In our view, the Slovene exchange rate policy stance in the past years deserves a more detailed analysis: While the nominal exchange rate of the Slovene tolar recorded a substantial depreciation vis-à-vis the Deutsche mark between 1991 and 1993, this tendency slowed down in the course of 1994, when the Bank of Slovenia started to keep the nominal exchange rate of the tolar stable against the Deutsche mark. This policy was maintained until mid-1995, when the tolar started to nominally depreciate again until the beginning of 1996. Since then, the tolar has been virtually stable vis-à-vis the Deutsche mark.[73]) Furthermore, we do not fully agree with the Commission's qualification of Latvia's exchange rate regime as a "peg to the IMF Special Drawing Rights (SDR)."[74]) To our knowledge, Latvia has only informally adopted a peg to the SDR; formally it operates a managed float.[75])

As mentioned earlier, the Opinions assess the exchange rate regimes adopted by most applicant countries as rather positive. However, although the Czech currency crisis is analyzed in detail and the growing current account deficit is identified as one of its main reasons,[76]) no considerations about the sustainability of the exchange rate peg can be found in the Opinions on Estonia or on Slovakia. Although in both cases the Commission correctly identifies the worsening current account deficits as serious risks for macroeconomic imbalances in the respective chapters on macroeconomic developments,[77]) no reference is made to this issue in the assessment of the prospects of their adopted exchange rate regimes.

It is remarkable that the Opinions do not touch upon or question the composition of the *currency baskets* in Hungary, Latvia, Poland and Slovakia.[78]) In view of the introduction of the euro in the near future and of the high degree of trade integration of these countries with the EU, the Commission could have suggested a critical revision of these currency baskets. In our view, the weight of the dollar, which is still very strong in these baskets, could be reduced further in favor of a European currency.

3.4.2 Inflation Performance

The Commission presents a description of the inflation performance of the applicants and focuses on trends until the present. As the sources of inflation are not fully examined, the Commission's assessment of the sustainability of the achievements in the medium term remains somewhat unclear: Some possible risks to a further reduction of inflation are mentioned (e.g. the role of administrative prices), but no prospective analysis is given of what happens if these risks are not properly handled. In any event, the Opinions do not analyze the issue of inflation inertia, especially that in Hungary and Poland.[79]) Thus the Commission does not fully consistently uphold its underlying principle of examining the economic criteria not only on basis of the present situation, but also on the expected progress in the medium term.

According to the Commission, sustainable price stability is a condition for macroeconomic stability and hence also a condition for the fulfillment of the economic criteria. Therefore, the identification of the basic trends and proper acknowledgment of efforts made by applicants is essential. However, the figures given in the tables sometimes contradict the main text of the Opinions. For example, the Opinion on Poland states that "the 1995 inflation outcome was quite disappointing, with the inflation rate at about the *same level* as it was in 1994"[80]), namely 29.4% in 1994 and 21.9% in 1995; see also Table 2 of this paper. Another case in point is the Czech Republic, where the Commission criticizes that the average yearly "inflation of 1995 was *stuck at* the previous year's level" [81]), namely 10.0% in 1994 and 9.1% in 1995; see Table 2 of this paper.

The Latvian and Lithuanian authorities[82]) claimed that the Commission did not take into consideration the most recent data (first months of 1997); it would have provided a much more positive picture of the inflation performance in their countries. However, the Commission cannot be blamed for an unequal treatment of candidates because none of the Opinions analyzes 1997 inflation figures.

3.4.3 Central Bank Independence

Each of the ten Opinions very briefly touches upon the issue of central bank independence. Typically, the Opinions mention the *statutory objectives,* the independent status of the bank from the government in the formulation of monetary policy and the *appointment procedures* for the central bank governor. We agree with the Commission that the central bank legislation of the applicant countries is broadly in line with the requirements of the Maastricht Treaty in the abovementioned areas. As pointed out earlier, the Commission correctly states that the weakest point in the existing central bank legislation concerns the *regulations on direct central bank lending* to the government, which in principle is still permitted, though largely constrained, in most candidate countries.[83])

However, while we share the Commission's criticism on the *appointment practices* of central bank governors in Hungary, where in the Commission's view appointments have "coincided with changes in the government," we do not fully understand why this deficiency is not also mentioned for Poland, where an even higher turnover rate of central bank governors has been observed in recent years.[84])

The issue of central bank *accountability* to parliament, which is required by the Maastricht Treaty, is explicitly mentioned only in the Opinions on the Czech Republic and Estonia, although comparable legislation is in place in Hungary, Poland, Slovakia and Slovenia.

Moreover, the following very *important aspects* of central bank independence have been *completely disregarded* in the Opinions' analysis – most probably because this topic is accorded only a limited space in each avis: the legislated term of office of central bank governors, their possible dismissal, the appointment and dismissal of other members of the highest decision-making body, incompatibility clauses for central bank officials and the budgetary independence of the central bank.

3.4.4 Banking Sector

As mentioned earlier, the adoption of the *acquis* in the area of banking legislation is seen as a necessary condition to create a stable financial environment in the applicant countries. Consequently, the Commission examines the degree of harmonization of the national banking laws with the European legislation for each candidate country. One important yardstick for a country's preparedness in this area is the number of *White Paper measures* already implemented. However, we do not fully understand the Commission's generally positive assessment of Estonia's banking sector in the Opinion, which is seen as "sound and expanding,"[85]) although the implementation of White Paper measures on financial services is clearly behind that of five other applicants (see Table 4 of this paper). In our view, it is difficult to judge the soundness of a banking sector which is not yet subject to a legislation harmonized with European standards, because many of the performance indicators typically used are not defined in a comparable way. Moreover, the Commission examines the implementation of the *European banking directives* (see Table 5 of this paper). Although the Opinion on Slovenia mentions the implementation of seven Stage I directives (see Table 4), it does not state which seven directives the Commission is referring to. As the Commission states that Slovenia's banking sector has some country-specific difficulties, it is particularly regretable that the legal framework is not described in more detail.

The very high *level of concentration* in applicants' banking sectors constitutes a main cause for concern for the Commission. Although this criticism is justified, we have to bear in mind that this characteristic stems mainly from historical developments. Commercial banks were initially established artificially: To introduce a two-tier banking system, most of the countries simply separated the former central bank into different parts. Moreover, as the banking sector develops and as the level of competition rises, among other things because of the presence of foreign banks, the degree of concentration tends to diminish.

The Commission also objects to the high level of *state participation* in the applicants' banking sectors as compared to the European average. Again, we principally share the Commission's concern with this defect, but we would put a bit more emphasis on the progress to be expected in the medium term after completion of the process of enterprise and banking privatization, which is clearly under way. Surprisingly, while the Opinion correctly states that the bank privatization process is "almost complete"[86]) in the case of Hungary, the Commission also underlines the importance of continued privatization.[87]) As only four of the majority state-owned banks had not yet been privatized at the time of the cutoff date, and as the Hungarian Privatization Agency had clearly committed itself to completing the privatization process, the Commission appears to have slightly overemphasized the importance of further privatization measures.

The *bad loan* problem of the applicants' banking sectors mentioned by the Commission in all but the Hungarian case cannot be examined separately from the problem of "bad" companies which have not yet reached a sufficient level of competitiveness. The governments of these countries usually have to take part in the consolidation of the banks and companies, which puts a burden on the state budget. Therefore, the problem of nonperforming loans cannot be seen as a weakness just of the banking sector, but also of the economy as a whole.

When it judged the competitiveness of banks, the Commission should have dealt with the question of *deposit guarantee schemes.* According to the "home country principle," the standards for deposit guarantees are determined by the legislation of the home country. Therefore, a deposit guarantee in the applicant countries logically gives foreign banks a competitive advantage in these markets, because it increases the customers' confidence in these credit institutions. Even in the case of Hungary, where the banking sector is quite developed, it will be difficult to raise the present amount of the deposit guarantee from currently HUF 1 million (approximately ECU 5,000) to the European level (ECU 20,000 from the beginning of 2000).

The Commission does not deal with the liberalization of *cross-border branching* in detail, although this step will be of crucial importance for the competitiveness of credit institutions within the Single Market. As this obligation of the Europe Agreement is a condition only for full membership in the Union, most of the applicant countries have not yet or only partially abolished the restrictions on the operation of foreign firms, including credit institutions through branches. OECD members have already undertaken to open their markets to foreign legal entities, so that foreign banks will also be allowed to open branches in these countries. However, the Commission does not mention the liberalization of cross-border branching at all in the case of the Czech Republic, unlike in the case of Hungary and Poland, where the Commission acknowledges liberalization. The OECD legal framework is not as strict as the relevant EU directive, therefore the harmonization with EU directives could necessitate further substantial adjustments of the banking legislation and of the operation of credit institutions in these countries. Estonia and Slovakia have also allowed foreign banks to open branches. However, whereas in the case of Estonia the Commission describes the equal competitive situation of branches compared with domestic banks, it does not say anything about the restrictions on branches of foreign banks in the case of Slovakia.

3.4.5 Liberalization of Capital Movements

It took incumbent EU members about 20 years to liberalize their capital movements. Most of the process of capital movements liberalization was completed during Stage One of European Economic and Monetary Union. This extended liberalization process on the remaining sensitive areas has recently accelerated because Stage Two is drawing to a close, and the freedom of capital movements is an obligatory and essential condition to join the third stage of EMU. Like the EU countries, who preferred step-by-step liberalization, most CEECs have chosen a rapid, but (in principle) gradual opening of their capital markets. However, they have a much shorter period of time to prepare themselves to completely free capital movements. This process of liberalization is much more advanced for the three countries that are already OECD members, as they had to undertake the obligations of OECD membership, and for Estonia, where the process has basically been completed.

As mentioned earlier, the Commission distinguishes between the degree of capital movement liberalization in the Czech Republic, Hungary and Poland (see section 2.7 of this paper). A thorough analysis of the three countries' foreign exchange regulations, as they stand, raises some doubts whether such a differentiation is really justified. In fact, apart from minor differences, the main features of the current Czech, Hungarian and Polish foreign exchange systems are very similar.[88])

The Commission's assessment does not take into account certain foreign exchange regulation and policy aspects. In the Czech avis, there is no reference to the rather comprehensive safeguard clause on the introduction of a deposit requirement for a number of inward capital transactions.[89]) The Polish and the Hungarian laws have no such clauses. Furthermore, the assessment does not mention that the Czech National Bank imposed limitations on commercial banks' short-term foreign exchange positions toward nonresidents in August 1995, thus in effect putting a cap on such short-term inflows. Hungary and Poland have not adopted such measures to get a grip on capital inflows. Finally, it should be noted that progress towards liberalizing cross-border branching is much more pronounced in Hungary and, to some extent, in Poland than in the Czech Republic.

In a similar vein, the overall assessment of Slovenia's progress in liberalizing capital movements seems slightly too critical, especially by comparison to the assessments of others (for example, relative to the favorable assessment of Slovakia in this realm). Clearly, the capital controls introduced by Slovenia constitute a drawback and will have to be phased out over the medium run.[90]) Notwithstanding these controls, it should be noted that the country has made tangible overall progress toward liberalizing the capital account.

3.4.6 EMU Relations

The Commission's EMU-related observations cover all relevant issues in an appropriate and plain manner. One can subscribe to the gist of the analysis, which is well-guided and based on broad and accurately presented factual evidence. Still, a few remarks and minor qualifications on some specific issues appear to be warranted.

Two of these comments relate to consistency issues. First, as mentioned earlier, there are cases where formulations in Volume I of Agenda 2000 are somewhat different from the wording on the same issues in the individual country Opinions. This is true of the Commission's assessment on the perspectives for a simultaneous joining of EU and EMU by applicant countries and for the references to institutionalized exchange rate cooperation between the CEECs and the euro area upon enlargement.[91]) Probably, these incongruities do not imply differences in accentuation.[92])

Second, in reviewing intra-avis consistency, an assessment incongruity between Part B, Chapter 3.3, Economic and Monetary Union, and Part C, Summary and Conclusions, of the Opinions on Slovenia – and on Slovakia[93]) – has to be mentioned: It remains unclear whether the Commission expects Slovenia (and Slovakia) to meet the obligations for participation in EMU as pre-in countries until EU accession or not. Although this divergence presumably did not occur on purpose, it is nevertheless relevant, in particular as the assessment in the Summary and Conclusions, which is very much in the public eye, is less positive than the one in the detailed analytical section.

A second set of remarks pertains (more directly) to the substance of the Commission's assessment. Here, it is pertinent to take up the question of how realistic it is for applicant countries to accede to the European Union and the euro area at the same time. The Commission is right in assuming that none of the five countries will be likely to fulfill the Maastricht criteria on a sustained basis in the medium run due to structural weaknesses the candidate countries can presumably iron out only in the long run. On economic grounds, there is thus a good case to expect that participation in the euro area will follow only some time after EU accession, especially if the latter indeed takes place in the medium run, as the Commission surmises.

The issue, though, has a further dimension: From a Treaty point of view, there is a major obstacle to joining the EU and EMU simultaneously. This is due to the specific phrasing of the convergence criterion relating to exchange rate stability: It requires two years of formal ERM (after 1999: ERM II[94])) membership prior to entering the euro zone. Most Member States agree that actual exchange rate stability is not sufficient to fulfill this criterion. As EU membership is a precondition for joining the ERM, according to the Community rules as they stand, a country can, from a legal point of view, in fact join Stage Three of EMU at the earliest two years after having acceded to the European Union. Agenda 2000 does not touch upon this point, apparently because Stage Three of EMU still constitutes such a distant perspective for the applicant countries. Nevertheless, not discussing the matter might contribute to creating misconceptions on the part of the applicant countries.

As regards exchange rate policy cooperation, the Commission's position is clear in that the applicant countries are expected to participate in EU exchange rate arrangements. The newly acceding countries do not have the option of staying outside the institutionalized policy concertation in this area (perhaps apart from truly exceptional situations).[95]) Here, the question arises why Agenda 2000 does not refer explicitly to the ERM II, the exchange rate arrangement scheduled to come into effect in Stage Three of EMU.

Apparently, the Commission has chosen to refrain from specifically mentioning ERM II mainly because determining the full set of rules and procedures on exchange rate cooperation in the third stage of EMU and foreseeing future developments in the area during the period up to enlargement is perceived as difficult.[96]) Still, this circumspection does not imply that "anything goes" when it comes to defining the exchange rate arrangement applicable for the CEECs.

In fact, from today's perspective, it is reasonable to expect that the basic institutional arrangement provided for by ERM II will also be the framework of reference for the CEECs upon their accession to the European Union, even though any formal decision on this issue is still some time away. A number of considerations appear to support this judgment. To begin with, two clear goals are assigned to institutionalized exchange rate cooperation within Stage Three of EMU, namely supporting the convergence efforts of the pre-in countries and ensuring the smooth working of the EU Internal Market. These objectives are equally valid for incumbent Member States and for newly acceding countries, and they will in all probability remain defining parameters for EU exchange rate cooperation for the foreseeable future. In practice, this will pose a severe constraint on granting special ("more flexible") institutional treatment to the applicant countries in the field of exchange rate concertation. Moreover, there is no economic need for a further "softening" as compared to ERM II standards, which already display a considerable degree of flexibility: Advanced transition economies that meet the criteria for EU membership should typically be in a position to accommodate their legitimate needs for exchange rate flexibility within the normal boundaries of the ERM II.

A further remark relates to a certain imbalance in Chapters 3.3 of the individual country Opinions: While the Commission is fairly precise about the action that has to be taken to increase the effectiveness of monetary policy, it remains silent about what it perceives to be the implications of aligning the exchange rate regimes and policies of the candidate countries with the EU framework. Obviously, this is an issue which will need further elaboration fairly early in the remaining preaccession period.

Concerning the Commission's final assessment in the area of EMU, the judgment Agenda 2000 reaches on the Czech Republic, Estonia, Hungary and Poland appears to be fair. As regards Slovenia, the assessment in Part B of the Opinion would seem to be more in line with the country's overall performance in the relevant areas, in particular in a comparative (cross-country) perspective, than the less positive judgment in Part C, Summary and Conclusions.

4 The Preaccession Strategy Proposed by the Commission

In the "Agenda 2000" documents, the Commission proposes reinforcing the preaccession strategy for applicant countries. The comprehensive description can be found in Volume II of Agenda 2000. Also, each of the Opinions[97]) as well as Volume I of the Agenda[98]) mention some elements of the preaccession strategy.

The proposed preaccession strategy introduces three new instruments to strengthen the enlargement process. First, the Commission proposes to bring together the current and future forms of EU assistance into a single framework under the so-called *Accession Partnership.* The Accession Partnerships will be worked out by the European Commission in bilateral cooperation with each candidate country. On the part of each applicant, they will comprise a precise commitment, including an exact timetable, on a multiannual program to eliminate the deficiencies[99]) identified in the Opinions. On the part of the Union, the Partnership involves the mobilization and coordination of different financing sources both from within the Union as well as from international financial institutions.[100]) Interestingly, the Commission proposes annual financing agreements and an "accession conditionality," which implies a yearly evaluation of the implementation of the abovementioned program by applicants.

Generally speaking, we welcome the Commission's proposal to create a unified framework for accession assistance. However, it will be a very difficult task for the Commission to *coordinate the different financing instruments* not only within the European Union (PHARE programs, balance-of-payments loans, agricultural aid, Euratom loans and direct funding by the Structural Funds from the year 2000), but also with the international financial institutions (EIB, EBRD and the World Bank). Besides this, the Commission's suggestion that the legal form of the Accession Partnerships should be solely a *Commission decision* could turn out to be rather problematic: It implies that the Council would not be included in this key dimension of the preaccession process. Therefore, this suggestion is likely to be debated or even changed by the European Council. Moreover, the *administration* of the Accession Partnerships will require considerable personnel capacity both for the Commission and the respective applicant country. Therefore, we welcome the Commission's proposal to make use of the already existing *institutional infrastructure of the Association Agreements.* It is noteworthy that the Commission speaks about cooperation with association bodies, but very much stresses the role of the association *subcommittees.*[101]) This could be seen against the background that cooperation with the "high-level" association bodies (Association Council and Association Committee) would necessitate the involvement of the Council. Moreover, the Agenda 2000 documents remain silent on the relationship of accession negotiations and Accession Partnerships: How will these two instruments be interlinked, and how will coordination between the two be guaranteed?

The second instrument proposed by the Commission is the submission of an *annual report* to the European Council on the progress of all applicant countries. For this purpose, the Commission will evaluate the applicants' progress in fulfilling the targets defined in each of the Accession Partnerships. According to the Commission, this instrument leaves the door open for nonrecommended candidates, because if an applicant is issued a positive progress report, the Commission will recommend the start of negotiations to the European Council.

We agree with the Commission that the annual progress reports are *an adequate instrument* to integrate the nonrecommended countries into the preaccession process. However, like in the already published country recommendations, the contents of these reports will have a very strong *political and economic signaling function.* Therefore, the wording and any recommendation will have to be carefully weighed before the reports are made public. While the Commission clearly says that the reports give nonrecommended countries an opportunity to enter into negotiations, it remains silent on the possible consequences of a negative progress report for a country that has already started accession talks.

The third proposal made by the Commission is to set up a *European Conference,* a multilateral instrument of cooperation in the areas of common foreign and security policy as well as justice and home affairs. According to the Commission's proposal, the European Conference should bring together EU Member States and associated countries.[102]) Remarkably, this instrument is outlined exclusively in Volume I of Agenda 2000, although Volume II contains the detailed description of the entire preaccession strategy.

In our view, the European Conference could be very important because it can provide an opportunity for EU members to convene with EU aspirants on a multilateral basis. Moreover, it might be interesting to extend the topics of the European Conference further in order to incorporate other accession-related issues of a horizontal nature. This could also render superfluous the multilateral ad-hoc dialogue the Commission proposes, thus streamlining preaccession procedures. To this end, it might be worth considering organizing the European Conference not only at the head-of-state level, but also – in a regular and substantive manner – at a ministerial level.[103])

5 Concluding Remarks

In this paper, we have undertaken the exercise to analyze in detail the Opinions on the ten Central and Eastern European candidates for EU membership. We are convinced that an in-depth discussion of these documents is indispensable, as their importance for the future relations between the Union and the applicant countries will be far-reaching. They will not only serve as a starting point for the EU accession negotiations, but also provide the basis for the multiannual programs to be drawn up within the framework of the proposed Accession Partnerships.

The Commission's analysis of the candidate countries is comprehensive and on the whole very detailed. In general, its main lines are well-guided and based on accurately presented factual evidence. However, although the Commission did try to interlink the different subchapters of each Opinion, the documents generally raise the impression of being a "patchwork" of different chapters rather than one integrative document. Due to this piecemeal approach, the analysis is not always fully congruous and displays some inconsistencies.

We conclude that the basic approach of the Commission to propose the Czech Republic, Estonia, Hungary, Poland and Slovenia for accession negotiations appears to be economically justified, although it does have a number of drawbacks. However, the integration prospects for the five candidates that are not recommended for starting negotiations will depend crucially on the implementation of the proposed preaccession strategy. In our view, it will be of particular importance that, as soon as the second-wave countries have fulfilled the criteria put forward by the Union they will be invited to join the negotiation process at any time. Moreover, as mentioned earlier, the recommendation of the Commission is not a binding proposal; the final decision can be taken exclusively by the European Council, most likely at the Luxembourg Summit in December 1997.

On the part of the present EU-15, successful Eastern enlargement will critically depend on the timely and adequate reform of the institutions within the Union, a matter which needs to be tackled regardless of enlargement, and on the efficient coordination of financial resources to support the approximation process.

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– 1997f. Commission Opinion on Estonia's Application for Membership of the European Union. Brussels.

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– 1997i. Commission Opinion on Lithuania's Application for Membership of the European Union. Brussels.
– 1997j. Commission Opinion on Poland's Application for Membership of the European Union. Brussels.
– 1997k. Commission Opinion on Romania's Application for Membership of the European Union. Brussels.
– 1997l. Commission Opinion on Slovakia's Application for Membership of the European Union. Brussels.
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1 *All Foreign Research Division of the Oesterreichische Nationalbank; Ágnes Horváth is an economist from the Hungarian National Bank currently at the OeNB. The standard disclaimer applies.*
2 *The Agenda 2000 package comprises more than 1,500 pages and, apart from the ten country Opinions, includes a comprehensive document about the impact of enlargement on the Union and its policies as well as the future financial framework beyond the year 2000 (see Volume I, Communication: For a Stronger and Wider Union). Moreover, Volume II describes the proposed preaccession strategy in detail (see Volume II, Communication: Reinforcing the Pre-Accession Strategy).*
3 *For details about the history of the enlargement process so far, see Backé and Lindner (1996).*
4 *Countries are listed in alphabetical order in the paper to avoid ranking the applicants.*
5 *The official wording for this third criterion is the "ability to assume the obligations of membership, including adherence to the aims of political, economic and monetary union"; in the following it will be referred to as the "acquis criterion."*
6 *According to the Commission's proposal, the first "progress report" would be submitted in December 1998. See Agenda 2000, Volume II, Chapter IV.1.*
7 *See each of the ten Opinions, Chapter A.a, The Context of the Opinion.*
8 *See sections 2 and 3 of this paper.*
9 *See section 4 of this paper.*
10 *The questionnaires had to be submitted to the Commission by July 1996.*
11 *The expression "Opinion" and "avis" (the equivalent French term) are commonly used interchangeably in English texts.*
12 *See Agenda 2000, Volume I, Part Two I, Assessment on the Basis of the Accession Criteria.*
13 *See section 3 of this paper.*

14 *See each of the ten Opinions, Chapter B.2.3.*

15 *See each of the ten Opinions, Chapter B.2.3.*

16 *See Agenda 2000, Volume I, Part Two I, Assessment on the Basis of the Accession Criteria.*

17 *The "White Paper on the Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union" is part of the preaccession strategy for the associated countries of Central and Eastern Europe adopted by the Essen European Council in December 1994. The White Paper identifies the key measures in each sector of the Internal Market and suggests a sequence in which the approximation of legislation should be tackled.*

18 *The Commission has tried to present the legislative acquis for each area in a way that distinguishes so-called key measures from the total number of measures applicable, and also proposes a further breakdown of key measures into two levels of priority, namely Stage I measures (the highest priority) and Stage II measures (ranked immediately after the highest priority). In the field of capital movements, Stage I measures are, for example, the unconditional liberalization of current payments and medium- and long-term capital movements. Stage II measures are, for example, the approximation of legislation on short-term capital movements, the admission of and trade in money market securities, the opening of deposit accounts abroad, etc. Stage III measures are areas of the acquis that are not or only partly covered by the White Paper. They include many other important areas of the Union's activity such as agriculture, environment, energy, transport and social policy.*

19 *For the Czech Republic the Commission identifies agriculture, environment and energy as the sectors requiring "particular efforts, including investment." For Hungary "particular efforts" are needed in the fields environment, customs control and energy. For Poland the Commission recommends "particular efforts and investment" in the sectors agriculture, environment and transport. See Part C of the respective Opinions.*

20 *With further effort, Estonia should also be able to participate fully in the Internal Market in the medium term (according to Commission representatives, medium term is understood to mean a period of five years). Here the Commission names only the field environment where "particular efforts, including investment" are needed.*

21 *The Commission sees a need for reform in the sectors environment, employment, social affairs and energy.*

22 *Bulgaria and Romania need "substantial" reform.*

23 *According to each of the ten Opinions, the formal objective of the central bank is "not clearly stated" in Hungary, consists in "the strengthening of the currency" in Poland and "is … implicitly price stability" in Slovenia. See Chapter B.3.3 of the respective Opinions.*

24 *See the Opinions on Hungary and Poland, Chapter B.3.3, respectively.*

25 *According to the Commission, Latvia and Bulgaria (prior to the introduction of the currency board) had the standard range of indirect instruments, but they are "not fully effective." Slovakia's monetary policy is qualified as "quite effective in driving inflation down to single digit levels," although the Commission stresses the rather late introduction of indirect instruments. Romania gradually introduced indirect instruments, but "the central bank lacks any significant experience" in using them. Lithuania's currency board arrangement is qualified as generally successful.*

26 *However, as of October 1, 1997, the Council of the Bank of Slovenia introduced a nominal rate for tolar-denominated short-term securities with a maturity of up to 60 days.*

27 *See the Opinions on Estonia, Hungary and Poland, Chapter B.3.3, respectively.*

28 *While both countries had formally adopted a free float, the central banks nevertheless tried to intervene in the foreign exchange market. The Bulgarian central bank sometimes had limited scope for intervention due to the lack of foreign reserves, and the central bank of Romania introduced administrative restrictions to stem devaluation pressures.*

29 *See the Opinion on Hungary, Chapter B.2.2, The Existence of a Functioning Market Economy.*

30 *See the Opinion on the Czech Republic, Chapter B.2.2, Prospects and Priorities.*

31 *The Opinion on the Czech Republic does not provide an exact percentage of goods with administrative prices in the consumer basket.*

32 *Every year, the central bank had to submit the monetary policy guidelines for the following year to Parliament, where they had to be passed simultaneously with the budget act presented by the government. For details see Radzyner and Riesinger (1997).*

33 *While the central banks of Lithuania and Slovakia are qualified as "largely independent" from government in terms of the conduct of monetary policy and appointment procedures, Romania's central bank is only seen as "relatively independent." The independent status of the Latvian central bank is viewed as "largely guaranteed" by the legislation. Bulgaria's central bank, though "formally independent from the government" in terms of appointment procedures and the conduct of monetary policy, is criticized for having been influenced by the government in practice.*

34 *See the Opinion on Hungary, Chapter B.3.3.*

35 *However, the newly adopted Polish central bank law explicitly prohibits the central bank from financing the state budget deficit. This stipulation is even included in the new Constitution.*

36 *This weakness in central bank legislation is also identified in the Opinions on Bulgaria, Latvia, Lithuania, Romania and Slovakia. See Chapter B.3.3 of the respective Opinions.*

37 *The definition of this maximum amount varies from country to country. For details see Radzyner and Riesinger (1997).*

38 *See each of the Opinions, Chapters B.2.1, Progress in Economic Transformation, Economic Structure, Financial Sector; B.2.2, The Existence of a Functioning Market Economy, The Capacity to Cope with Competitive Pressures and Market Forces, Prospects and Priorities; B.2.3, General Evaluation; B.3.1, The Free Movement of Services, The Free Movement of Capital; B.3.3, Economic and Monetary Union; B.4.2, Key Areas for Implementation of the Acquis (Single Market).*

39 *See the Opinion on Hungary, Chapter B.3.3, Current and Prospective Assessment: "it is important that the privatisation of commercial banks continues and that competition in the banking sector is increased in order to enhance the efficiency of the transmission mechanism and to increase the central bank's ability to control monetary aggregates."*

40 *The Hungarian Banking and Capital Market Supervisory Authority and the Polish General Inspectorate for Banking Supervision.*

41 *In September 1997, the Romanian central bank announced that it would take on the obligations under Article VIII, but the official declaration did not take place until mid-November 1997.*

42 *Consequently, the field of capital account liberalization is not mentioned in Part C, Summary and Conclusions, of the Opinion on Estonia.*

43 *The Czech Republic became a member of the OECD in December 1995, Hungary in May 1996 and Poland in November 1996.*

44 *See each of the ten Opinions, Chapter B.3.3.*

45 *See each of the ten Opinions, Chapter B.3.3. The statement of Agenda 2000, Volume I, Chapter II.1.3 on the same issue is the following: "It is unlikely that the applicants will be able to join the euro area immediately" upon entering the European Union, as structural reforms will not advance far enough during the preaccession period to ensure sustained macroeconomic stability.*

46 *See previous chapters for details.*

47 *In order to guarantee the effectiveness of monetary policy cooperation, the newly acceding Member States will have to ensure that "monetary policy... be conducted with market-based instruments and ... [that it] be 'efficient' in transmitting its impulses to the real economy." The key to achieving this is further financial sector reform.*

48 *In Chapter B.3.3 of each of the ten Opinions, the reference to institutionalized exchange rate policy coordination is the following: "All Member states shall ... be in a position to stabilise their exchange rates in a mechanism yet to be decided." According to Agenda 2000, Volume 1, Chapter II.1.3, the newly acceding countries "are expected to participate in an exchange rate mechanism and avoid excessive exchange rate changes."*

49 *In the case of Hungary, there is no reference to the financial sector, but the Commission sees a need for maintaining the stability orientation of monetary and exchange rate policies. The latter remark can also be found in the Polish avis. The Opinion on Estonia lauds the country's central bank legislation, but it remains somewhat open about whether the Commission reasons that Estonia has already fully completed legal harmonization in this area.*

50 *See the Opinion on Slovenia, Chapter B.3.3 and Part C. The Commission's assessment of Slovakia is of a very similar content and structure as the one of Slovenia. In the case of the other four applicants, the Commission sees problems, in the case of Bulgaria even serious problems, if these states were to take part in the third stage of EMU as pre-in countries in the medium run.*

51 *Part C, Summary and Conclusions, states that "prices have been liberalised to a very large extent" in Estonia. Whereas Chapter B.2.1, Price Regime, concludes that administratively priced goods "make up some 25% of the basket on which the consumer price index is calculated" and "administrative decisions ... can therefore have a sizeable impact on month-to-month inflation rates."*

52 *For example the Opinion on the Czech Republic states – rather critically – in Chapter B.2.1, Progress in Economic Transformation, that "the state still has a majority or significant stake in a number of large enterprises and, most importantly, in the four main banks." The same information is interpreted in a much more positive way in Chapter B.2.2, The Existence of a Functioning Market Economy: "private ownership has been extended, and the privatisation process is almost complete with only the main banks and some 60 strategic enterprises left in state hands."*

53 *While the country Opinions conclude that five applicants (the Czech Republic, Hungary, Poland, Slovenia and Slovakia) will have the capacity to cope with competitive pressures in the medium term, Agenda 2000, Volume I, states that only two countries (Hungary and Poland) will fulfill this criterion in the medium term "provided they stay on their current course. Three others (the Czech Republic, Slovakia and Slovenia) should be in the same position on condition that they strengthen their efforts and avoid policy reversals." See Chapter B.2.3 of the respective Opinions and Agenda 2000, Volume I, Part Two, Chapter I.2.*

54 *See Agenda 2000 Volume I, Part Two, Chapter I, Assessment on the Basis of the Accession Criteria.*

55 *Ilzkovitz and Daviddi (1996).*

56 *The Commission requires "macroeconomic stability ... including adequate price stability and sustainable public finances and external accounts." For details see Agenda 2000, Volume I, Part Two, Chapter I.2, The Existence of a Functioning Market Economy.*

57 *The Commission's list of subconditions further comprises the "free interplay of market forces, the liberalisation of prices and trade," the removal of "significant barriers to market entry (establishment of new firms) and exit (bankruptcies)," the existence of a "legal system, including the regulation of property rights" and the existence of a sufficiently well-developed financial sector "to channel savings towards productive investment." See Agenda 2000, Volume I, Part Two, Chapter I.2, The Existence of a Functioning Market Economy.*

58 *The Commission also mentions the necessity of a "broad consensus about the essentials of economic policy," a condition which certainly has a political dimension. See Agenda 2000, Volume I, Part Two, Chapter I.2, The Existence of a Functioning Market Economy.*

59 *The Commission speaks about "a sufficient amount, at an appropriate cost, of human and physical capital, including infrastructure (energy supply, telecommunication, transport, etc.), education and research, and future developments in this field," and about an increased proportion of small firms "partly because small firms tend to benefit more from improved market access, and partly because a dominance of large firms could indicate a greater reluctance to adjust." See Agenda 2000, Volume I, Part Two, Chapter I.2, The Capacity to Withstand Competitive Pressure and Market Forces within the Union.*

60 *The Commission refers to "the extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aids, support for SMEs, etc." as well as to "the degree and the pace of trade integration a country achieves with the Union before enlargement." See Agenda 2000, Volume I, Part Two, Chapter I.2, The Capacity to Withstand Competitive Pressure and Market Forces within the Union.*

61 *See the Opinion on Slovakia, Chapter B.2.2.*

62 *The main deficiency identified by the Commission is that a full prohibition of direct budget financing by the central bank, as required by the Maastricht Treaty, is still not in place. For details see section 2.4 of this paper.*

63 *The Baltic States concluded a free trade agreement (the Baltic Free Trade Agreement) in 1995. In January 1997 this was supplemented by an agreement on agricultural products eliminating all tariffs and quotas on mutually traded agricultural goods.*

64 *Reuters, BBC Monitoring Service, Riga, July 22, 1997.*

65 *Reuters, BBC Monitoring Service, Vilnius, July 22, 1997.*

66 *Reuters, BBC Monitoring Service, Bucharest, July 26, 1997.*

67 *The Central European Free Trade Association (CEFTA) was founded in 1991 and at present comprises the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia.*

68 *See Oostlander (1997).*

69 *This proposal was made by Kinkel on the occasion of the informal meeting of the EU foreign ministers in Bad Mondorf, on October 25 and 26, 1997. See Reuters, October 27, 1997.*

70 *As a case in point, the Czech currency crisis is desribed in detail in two different subchapters of the same Opinion. See Chapter B.2.1, Foreign Exchange Regime and Chapter B.3.3, respectively.*

71 *Latvia's monetary policy is qualified as "effective in reducing inflation"; Slovakia's monetary policy is seen as "quite effective in driving inflation down to single digit levels." See Chapter B.3.3 of the respective Opinions.*

72 *See the Opinion on Slovenia, Chapter B.3.3.*

73 *For a more detailed analysis see, for instance, Radzyner and Riesinger (1996).*

74 *See the Opinion on Latvia, Chapter B.3.3.*

75 *See International Monetary Fund (1997).*

76 *In Chapter B.3.3, Current and Prospective Assessment, the Commission states that "the rising current account deficit, while not being an immediate threat for the stability of the exchange rate, has provoked a currency crisis of which the effects on the Czech economy are still unclear." See the Opinion on the Czech Republic.*

77 *See Chapter B.2.2, Prospects and Priorities, in the respective Opinions.*

78 *The Hungarian currency basket comprises the ECU (70%) and the U.S. dollar (30%), the Polish basket consists of five currencies (45% U.S. dollar, 35% Deutsche mark, 10% pound sterling, 5% French franc, 5% Swiss franc) and the Slovak basket comprises the Deutsche mark (60%) and the U.S. dollar (40%).*

79 *For details see Krzak (1996).*

80 *See the Opinion on Poland, Chapter B.3.3, Current and Prospective Assessment.*

81 *See the Opinion on the Czech Republic, Chapter B.3.3, Current and Prospective Assessment.*

82 *See, for example, the statement by Latvian Prime Minister Skele. Reuters, BBC Monitoring Service, Riga, July 22, 1997.*

83 *The paper by Radzyner and Riesinger (1997) comes to similar conclusions.*

84 *For details see Radzyner and Riesinger (1997).*

85 *See the Opinion on Estonia, Chapter B.3.3, Current and Prospective Assessment.*

86 *See the Opinion on Hungary, Chapter B.2.*

87 *See the Opinion on Hungary, Chapter B.3.3, Current and Prospective Assessment.*

88 *For details see Backé (1996). Hungary's recent steps towards further liberalization (which are mentioned in the avis on Hungary) have led to even further convergence of regulations regarding capital account convertibility in the three countries.*

89 *According to the Czech Foreign Exchange Act, the safeguard clause can be applied with respect to proceeds from the issue of debt instruments, inward financial credits, inward borrowing through money market instruments, and deposits by nonresidents with Czech banks.*

90 *In fact, the Bank of Slovenia has already started this process by easing the regulations on custodian accounts in June 1997 (i.e. shortly after the avis cutoff date).*

91 *See section 2.8 of this paper.*

92 *In general, such relatively minor discrepancies are practically unavoidable in any exercise involving a major coordination and concertation effort to be carried out under significant time pressure.*

93 *As pointed out earlier, the content and structure of the Opinion on Slovakia is similar to that of Slovenia in this field and therefore contains similar discrepancies: While the Commission sees "no problems" for Slovakia to join EMU in the medium term in Chapter B.3.3, it states in Part C, Summary and Conclusions, that Slovakia's participation in EMU "could present some difficulties" and explicitly refers to the incompatibility of central bank legislation.*

94 *This is the arrangement that will govern exchange rate relations between the euro area and the pre-in countries after 1999.*

95 *This implies a certain differentiation between incumbent Member States that will not join the euro area from the outset and the newly acceding countries: Both groups are expected to join EU exchange rate arrangements. However, for the incumbents this is qualified by the fact that, for them, participation in ERM II will be voluntary.*

96 *The principles and main features of ERM II were approved only at the European Council in Amsterdam in June 1997 and thus just before Agenda 2000 was finalized. The second pillar of the mechanism, its operating procedures, are still to be laid down. Furthermore, it is clear that one cannot rule out that some features of ERM II will be developed further in the period up to the next round of EU widening. Finally, none of the incumbent Member States (nor any of the applicant countries) has formally adopted an elaborate position on the design of exchange rate arrangements after enlargement (in particular on the extension of ERM II to the East), and the ECB, which will have a key role to play in these matters, will only come into being in May 1998. Against this backdrop, it appears sensible for the Commission to have maintained, in Agenda 2000, a relatively low profile on the issue.*

97 *See each of the Opinions, Chapter A.b, The Pre-Accession Strategy.*

98 *See Agenda 2000 Volume I, Part Two III.2, Reinforcing the Pre-Accession Strategy.*

99 *The program will mainly refer to the adoption of the acquis, but also to the strengthening of democracy, macroeconomic stabilization and nuclear safety. See Agenda 2000, Volume I, Part Two III.2, Reinforcing the Pre-Accession Strategy and Volume II, Chapter IV.1.*

100 *See Agenda 2000 Volume I, Part Two III.2, Reinforcing the Pre-Accession Strategy and Volume II, Chapter III. A–D.*

101 *See Agenda 2000 Volume II, Chapter IV.2, Europe Agreements.*

102 *The wording "associated countries" would also comprise Cyprus and Turkey, which concluded Association Agreements with the Union in 1972 and 1964, respectively. However, a final decision on Turkey's participation in the European Conference had not yet been taken as of the date of writing.*

103 *According to the Commission, the "Conference would meet each year at the level of Heads of State or Government and the President of the Commission and, when necessary, ministerial level." See Agenda 2000, Volume I, Part Two V.*

Editorial close: November 14.

OeNB Activities

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 *Hubert Gabrisch* of the Institute of Economic Research at Halle, who compared transition in the CEFTA (Central European Free Trade Association) countries and transformation in East Germany, by *Richard Portes* of the London Business School and CEPR (Centre for Economic Policy Research), who emphasized the positive economics of enlarging the European Union to the East based, among other things, on measurements of the economic effects on enlargement using a calibrated general equilibrium model, by *Andrzej Ziolkowski,* who gave an account of the dire social impacts of Ukraine's economic policy course, by *Oldrich Dedek* of the Czech National Bank, who described the monetary and fiscal policy measures required to bring the Czech economy in line with the process of European monetary integration, and finally by *Heinrich Machowski* of the German economic research institute DIW, whose lecture treated Eastern European countries' prospects of joining the European Union. The brief overviews below are intended to present the insights drawn from lectures by renowned economists and experts about specific developments in transition countries to the reader.

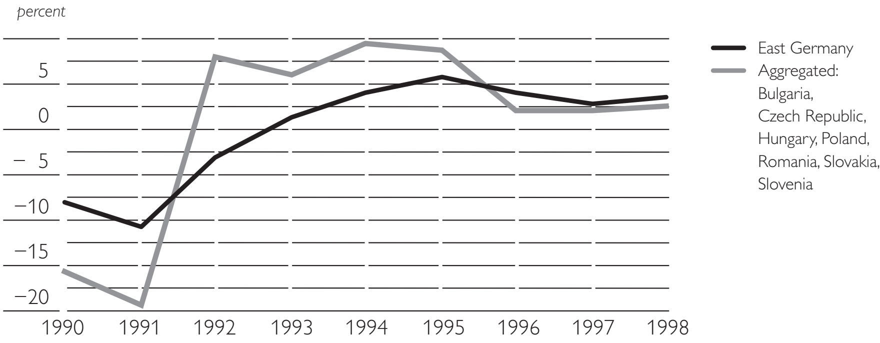
Lecture by Hubert Gabrisch

Transformation and Economic Development in East Germany and CEFTA Countries: A Comparison

On May 26, 1997, Dr. Hubert Gabrisch, head of section of the Institut für Wirtschaftsforschung (Institute of Economic Research) at Halle, Germany, held a talk about the progress in transition made in CEFTA (Central European Free Trade Association) countries, whose accession to the European Union is now on the agenda of international politics, by comparison with East Germany. Almost all CEFTA countries will have to open their commodity and capital markets completely and will have to stabilize their exchange rates by pursuing interest and inflation convergence. The member countries hope to speed up growth by strongly promoting transfers and foreign direct investment. They should, however, be alert to the fact that if this prescription is followed by the letter, the outcome could be an overvalued currency, as the case of east Germany proves.

Following a deep slump in 1990/91, the east German economy began to recover in 1992. GDP growth rates soared to close to 10%. By comparison, the aggregated growth rate of seven selected Central and Eastern European countries was significantly lower until 1995 (even in Poland and Slovakia at some 6% and 7% respectively). This period appeared to demonstrate that the east German transformation model of incorporation into the Federal Republic of Germany and huge transfer payments for the modernization and restructuring of capital stocks (accounting for about 50% of eastern German GDP) was more successful than the CEFTA approach. In 1996, however, growth in east Germany shrank to a meager 2% and is projected to stay weak for the next few years. The process of catching up with west Germany came to a temporary halt.

Real GDP Growth Rates in East Germany and Selected CEECs



The setback can be pinpointed to cuts in some transfer-financed investment programs. These cuts revealed that the sector of tradables was still too weak to sustain high growth. The low competitiveness of tradable goods is rooted in the currency union of July 1990 through which an overvalued Deutsche mark was introduced to East Germany. East German citizens took the introduction of the Deutsche mark to mean the introduction of the West German standard of living. Wages started to converge to West German levels, but since high wages were not financed by appropriate productivity gains, huge transfers from West Germany were needed to fill the gap. Not surprisingly, transfer-financed incomes were overwhelmingly spent for West German consumer goods.

In CEFTA countries, growth was linked to a hard balance-of-payments constraint from the very beginning of transformation. Nevertheless, these countries tried to attract foreign capital to modernize and restructure their capital stocks. Commodity and capital markets were liberalized and the exchange rates of most countries were stabilized. While this worked for the moment, nominal wages soon surpassed productivity growth in almost all countries, just as it did in east Germany – which comes as no surprise in an open economy. Inflation remained high and currencies appreciated in real terms. Trade and current account deficits went up and were increasingly financed by short-term capital lured by high interest rates. International capital markets lost confidence in the stability of the exchange rates. Hungary was the first country to be confronted with the threat of a balance-of-payments crisis. The government reacted with a stabilization package and devaluation in 1995. Consequently, GDP growth contracted and inflation rose. With the return of hyperinflation and negative growth rates, Bulgaria suffered a severe balance-of-payments crisis in 1996. The Czech government and central bank disregarded the dangers of a soaring current account deficit too long, so that a balance-of-payments crisis broke out in May 1997. The freeing of the koruna will entail higher inflation and lower real growth. On the whole, the aggregate growth rate of the region converged down to that of east Germany in 1997 from 1996.

The answer to the question of whether currency overvaluation and the inflow of foreign savings pose a problem for transformation economies, or whether they solve problems by spurring capital stock modernization and restructuring would appear to be that it is indeed a problem; developing country theory would imply this conclusion. Transfers, credits, capital or other funds may close a savings gap and speed up the growth process. The problem is one of cause and effect: An overvaluation causes a savings gap because imports are more competitive than domestic products, which is what happened in east Germany. Savings gaps cannot emerge in the case of an undervalued currency. A second argument postulates that trade deficits coupled with overvaluation are superior to a strategy of undervaluation, provided the net resource inflow is spent only to import superior technology. Technology imports, however, are made irrespective of the exchange rate. A country can have a high share of capital goods in its imports without running a trade deficit. Last but not least, experience is no proof of the success of a development strategy based on foreign savings: The economic miracle of West Germany (and also of Austria) in the 1950s was based on selective import protectionism, export promotion and restrictive income policies. The Deutsche mark was stable but undervalued, and the exchange rate was stabilized by capital import controls. For political reasons, East Germany never had the chance, or the time, to establish a competitive market economy. In retrospect, German unification was pulled off without having been based on a carefully constructed and well-founded economic concept. By comparison, the other countries in transition took advantage of the opportunity to adjust to the international market environment step by step. They still retain some of the customs tariffs and quota restrictions imposed to protect their markets and, as a last resort, they can still wield the very powerful instrument of currency undervaluation. When negotiating EU membership, CEFTA countries are well-advised to study the experience of West Germany and Austria and, of course, of eastern Germany. If commodity and capital markets are opened up too fast while exchange rates remain restricted and the wage-price spiral continues to heat up inflation, all hopes of strong economic growth in the wake of accession to the European Union could be thwarted. Mr. Gabrisch concluded by advising the CEFTA countries to resist any pressure to raise wages to levels not warranted by productivity gains, admittedly a tricky task in an open economy.

Lecture by Richard Portes

The Positive Economics of EU Enlargement

On June 13, 1997, Richard Portes, a professor at the London Business School and Director of CEPR (Centre for Economic Policy Research), gave a talk on the positive economics of enlarging the European Union to the East. In his lecture, Professor Portes concentrated on two new aspects of the research he undertook jointly with Joseph Francois and Richard Baldwin[1]), namely on using a calibrated general equilibrium model to measure the economic effects of enlargement and on utilizing a voting power model to produce an alternative estimate of the budgetary cost of an EU widening to the East.

In Professor Portes' view, the net cost of Eastern enlargement would be minimal for current EU Member States. Early estimates about the effects of enlargement on the EU budget have been revised downwards substantially lately and are largely counterbalanced by positive real income effects within the Union. Eastern enlargement will thus be a "phenomenally good bargain" for the European Union and its Member States. The EU should therefore speed up the enlargement process and swiftly take in candidate countries as they get ready for membership. Delaying enlargement would only perpetuate the bad equilibrium situation in Europe today, which is characterized by low investment and sluggish growth.

The countries of Central and Eastern Europe will reap tangible economic gains as a result of their inclusion in the Single Market and in EU policies. Candidate countries can probably expect substantial additional gains in real income in the wake of EU accession, because they would benefit from a lowering of their country risk, which in turn would spur investment and growth in these countries.

In the discussion after the lecture, Mr. Portes touched upon possible timetables for enlargement, stating that, from today's perspective and given the EU's enlargement track record, a first wave of EU widening to the East could occur around 2003. The candidates would be the Czech Republic, Hungary and Poland as well as possibly Slovenia and perhaps Slovakia and Estonia. A brief discussion of the political obstacles to enlargement and the sectoral effects of widening the Union rounded off the lecture by Mr. Portes.

1 *See Baldwin, Richard, Joseph Francois and Richard Portes. 1997. "The costs and benefits of eastern enlargement: the impact on the EU and central Europe." In Economic Policy 24 (April).*

Lecture by Andrzej Ziolkowski

The Social Consequences of Economic Policy in Ukraine

On June 24, 1997, Dr. Andrzej Ziolkowski held a speech on the social impact of economic policy measures taken in Ukraine. After the collapse of the Soviet Union and the introduction of a market economy at the beginning of the 1990s, numerous new economic and social regulations came into effect in Ukraine. Many segments of society were confronted with an entirely new situation brought on by these structural changes. Moreover, during this period, social benefits declined or were discontinued in the wake of the restructuring of state activities.

The government did not succeed in devising a consistent economic program. As a result, output shrank and inflation exploded, and the population's standard of living deteriorated massively. A phenomenon which might be labeled social exclusion. This negative circumstance, however, directly influenced budget expenditures.

Ukraine cannot control the labor market with traditional instruments such as demand policy or fiscal policy under the changed political, economic and social circumstances. A functioning labor market and the ability of the labor market to adjust to structural changes require options for active and flexible government intervention. As GDP declines (it contracted by about 10% to 20% annually in real terms in the last three years), unemployment rises; it is set to increase to 9% or more in the next few years.

Trade unions are opposed to radical action (strike threats), because they do not wish to endanger the fragile restructuring process. Some smaller free trade unions in Ukraine are attempting to coordinate their activities. Job seekers have difficulties in finding a job and need more support to return to the labor market.

The introduction of the new currency on September 1, 1996, did not improve the situation. Mr. Ziolkowski concluded his presentation with the statement that although the government had declared it would fight social exclusion, it did not succeed in following through with its object, so that the economic situation in Ukraine worsened.

Lecture by Oldrich Dedek

Monetary Integration Perspectives of the Czech Republic

On September 18, 1997, Oldrich Dedek, advisor to the Governor of the Czech National Bank, presented a lecture on perspectives of involving the Czech economy in the process of European monetary integration. His starting point was that many Czech economists and politicians tend to see this process as premature for practical policymaking. They argue that Central European countries seeking EU membership first need to address some more elementary issues related to the transition from a command economy to a full-fledged market-oriented economy. Hence it would not be practical to target the Maastricht criteria before the EU accession criteria have been fulfilled.

Mr. Dedek challenged this view by pointing out that the Czech Republic has made substantial progress in opening up the economy and in integrating domestic financial markets into the global framework, which had crucial implications for the autonomy of domestic policies as well as for macroeconomic stability standards. What this process requires has much in common with the discipline embedded in the Maastricht convergence criteria.

To illustrate the discipline imposed through integration, Mr. Dedek mentioned the recent currency turbulences, which he described as a kind of penalty for neglecting fundamental imbalances. The turmoil was precipitated by a failure to recognize that the Czech Republic had already become part of the global financial market, which tends to punish reckless policymaking. In this context he mentioned the debate "real versus monetary convergence." There is no doubt that a successful catching-up process is extremely important for the ability to withstand competitive pressures within the European Union. But in the Czech context, the idea of an existing trade-off between growth performance and disinflation, or complaints about the high cost of disinflation, caused politicians and economists to underestimate the signs of widening imbalances that, in the end, delayed the catching-up process.

Mr. Dedek then shifted his attention to fiscal policy. This segment, he stated, has always formed an integral part of the overall pattern of prudent macroeconomic behavior, despite a host of pressures exerted on the state budget through the reform of the pension and health care systems, banking sector consolidation and the like. However, the currency turbulences confounded the view that fiscal policy could have done no more for the benefit of macroeconomic stability. Fiscal policy measures would have been in order to help shore up the current account position by reducing domestic absorption, above all in the government sector. This requires the politically unattractive decision to move the budget into surplus as recommended by the Czech National Bank. Moreover, fiscal tightening is indispensable so as not to overburden monetary policy, because higher interest rates tend to trigger exchange rate appreciation, which impairs external competitiveness. Monetary tightening also undermines future growth performance because investment is highly sensitive to interest rate rises whereas consumption is much less sensitive to interest rate changes.

The experience with different exchange rate regimes and the potential commitment to a more fixed arrangement were also addressed. Mr. Dedek stressed the predominantly positive role of the exchange rate anchor in the early stages of economic transition and moved on to relate the mounting policy dilemmas against the background of greater capital mobility that resulted in a widening of the fluctuation band and in mechanisms to cope with market volatility. According to Mr. Dedek, the ability of market forces to identify a fundamentally more correct exchange rate level fell short of expectations if the concept of a fundamental exchange rate equilibrium is to be understood from the current account point of view. At the beginning of 1997, the real exchange rate appreciated sharply – propelled, among other things, by a wave of Eurobond issues – despite the fact that the Czech economy already displayed one of the highest current account deficits (as a share of GDP) among emerging markets. Mr. Dedek concluded that the present system of managed floating is not likely to pose a problem for the disinflation strategy pursued by the Czech monetary authorities. At the same time, the experience with the floating exchange rate regime demonstrates that exchange rate stability arises not from any official rules on the adopted exchange rate regime but rather from the concerted effort of all economic policies.

At the end of the lecture, Mr. Dedek expressed the need to continue with a resolute disinflation policy based on the understanding that the current single-digit, but still relatively high, level of inflation poses a problem for maintaining macroeconomic stability. In the longer run, a permanent real exchange rate appreciation makes the exchange rate prone to progressive weakening, which in turn fuels inflation. In the shorter run, high inflation leads to interest rate differentials, which puts into motion the forces of interest rate arbitrage. The high level of inflation is also a major stumbling block for the effort to reduce the importance of indexation in wage bargaining. With the accent on promoting further disinflation, Czech policymakers will have to tackle the thorny issue of how to quickly deregulate administrative prices. Finally, Czech policymakers must walk a fine line between enforcing the positive disciplinary pressure of the exchange rate in reducing inflation and preventing the destructive consequences of an overvalued currency.

Lecture by Heinrich Machowski

EU Eastern Enlargement after Amsterdam

On October 7, 1997, Dr. Heinrich Machowski, a professor at the German Institute for Economic Research (DIW), gave a lecture on the Eastern European countries' prospects of joining the European Union. In fact, between March 1994 and June 1996 ten Central and Eastern European countries applied for EU membership. The European Union had previously concluded agreements with those ten countries, which, however, made only vague references to their potential accession to the EU. Mr. Machowski, therefore, found that from a current perspective and for the foreseeable future it was rather unlikely that the abovementioned candidates would be granted EU membership quickly.

The first argument, underlying this assumption was that the European Union after Amsterdam could not absorb new members. Mr. Machowski provided three reasons for that statement. First, measures aiming at reforming the institutions as well as the decision-making process within the EU, which would be key to the Union's enlargement, are still lacking. An overhaul of major areas such as the Commission's size and makeup, the weighting of votes and the importance of majority decisions would be needed. Second, the EU members are not yet ready to introduce sweeping reforms of their common agricultural policy (CAP). In light of the current CAP modus operandi, the adoption of new members is simply too costly. Third, the same goes for the EU's goal of cohesion. As long as the financing mechanisms of that policy are not radically modified, to the detriment primarily of the poorer Member States, i.e. the net recipients, Eastern enlargement would be too big a financial burden.

Add to this two further obstacles looming large over EU enlargement. First there is what is called the Cyprus syndrome, which is characterized by the following vicious circle. The Greek government will consent to Eastern enlargement only on the provision that Cyprus is granted membership as well. This, however, is contingent on the approval of the Turkish government. Turkey, in turn, will only give its consent if it is allowed to join the European Union itself, a wish which meets with little approval by both Brussels and almost all of the Member States. Then, as Mr. Machowski was quick to point out, the EU citizenry is the second hurdle to be reckoned with. There is not one single EU member country in which people welcome the idea of the EU going east. Quite on the contrary, the taxpayers have spoken out clearly against the Eastern enlargement policy, which is true for Germany, Austria, Sweden and Finland.

The second theory, Mr. Machowski continued, boils down to this: According to the EU Commission none of the applicants is, in the medium term, in a condition to join the EU (see Agenda 2000), because basically none of those countries is in a position to adopt the *acquis communautaire* in its entirety. However, as laid down at the EU Summit at Copenhagen, this is one of the requirements aspiring members must meet. While this requirement, which dates back to 1993, has increasingly proved to be rather counterproductive, because it is questionable whether the full adoption of the *acquis* is a suitable condition for membership and because its implementation requires a great deal of time, it seems to be a blessing for the existing EU members for reasons political. Above all, it obviously allows Member States to drag their feet over the issue of Eastern enlargement. According to Mr. Machowski, Accession Partnerships and the upcoming European Conference are two further means of slowing down the process.

The next decade will provide the Central and Eastern European countries striving for EU membership with the opportunity to step up the adaptations of their economic, legal and administrative systems. In conclusion of his talk, Mr. Machowski pointed out that it remains to be seen, however, how well the politicians in charge of tackling that daunting challenge will come to grips with political and psychological issues during the waiting period that lies ahead of them.

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 a presentation in June 1997. The East Jour Fixe meetings are always opened with speeches held by experts on key topical issues related to transition economies. High-profile discussants are invited to comment on the contributions, and finally policymakers, analysts and researchers engage in an exchange of views during the general discussion, which is a very important item on the agenda.

Grzegorz Kolodko of the Helsinki World Institute of Economic Development, former Deputy Prime Minister of Poland, highlighted a number of transition policy issues at the 28th East Jour Fixe of the OeNB in a lecture entitled "From Shock Therapy to Therapy without Shocks." After his presentation of the steps in the transition process and the successes and failures transition economies experienced taking these steps, his speech was commented by Georg Winckler of the University of Vienna and Maciej Krzak of the Foreign Research Division of the OeNB. The report below elaborates on the main topics reviewed at the 28th East Jour Fixe meeting.

Contribution by Grzegorz Kolodko

From Shock Therapy to Therapy without Shocks Held at the 28th East Jour Fixe on June 20, 1997

Professor Grzegorz Kolodko of the World Institute of Economic Development in Helsinki and former Minister of Finance and Deputy Prime Minister of Poland in charge of the economy from 1994 to 1997, discussed transition policy issues within the framework of the 28th East Jour Fixe of the OeNB held on June 20, 1997. His lecture was commented by Professor Georg Winckler of the University of Vienna and by Maciej Krzak of the OeNB's Foreign Research Division and The Vienna Institute of Comparative Economic Studies. According to Professor Kolodko, transition is frequently misinterpreted as a process of rapid stabilization only, whereas in fact it encompasses three processes: stabilization, institution-building and microeconomic restructuring. A so-called shock therapy – which is, incidentally, a misnomer because, while liberalization is a shock, it cannot be labeled a therapy – is possible in the first stage, but is not feasible in the subsequent two stages. Merely following the prescriptions agreed on in the so-called Washington consensus of the early 1990s – i.e. low inflation, a budget deficit under control, a diminishing public-sector share of GDP, unrestricted trade and capital flows, advanced privatization – generates no more than the necessary conditions for economic growth. Institution-building and the restructuring of existing capacities are time-consuming processes that are required additionally. Inflation can be rapidly reduced to relatively low levels and budget deficits can be brought under control, albeit at a considerable output cost, but rapid privatization is tantamount to a cheap sellout of state assets; moreover, new regulations cannot take effect immediately. The case of East Germany must not be considered a model, as the country adopted the West German institutional framework.

On the topic of stabilization, Mr. Kolodko agreed that there was little alternative to a radical approach at the start, but he claimed that in a number of cases, including Poland, stabilization was overdone. Blind adherence to a doctrine of "liberalize, and then wait and see" is responsible for the plight of numerous transition countries: In Russia, Ukraine, Bulgaria, Romania, Albania and Latvia initial devaluations were excessive, real interest rates rose too high and acted retroactively on debts contracted under central planning. The tax on disproportionate wage growth was also unduly high, as inflation did not fall to projected levels. While the transitional contraction resulting from numerous shocks, such as the dissolution of the CMEA, was inevitable, it could have been less pronounced if no policy errors had been made and if the right strategies had been chosen to begin with. Reformers, for instance, started from the wrong premise that it would suffice to stabilize the economy and privatize state assets to generate long-term growth. The output decline was persistent, also on account of initial conditions. The economies of Hungary, Poland and Yugoslavia were more flexible than those of the Soviet Union, Czechoslovakia, Bulgaria and Romania at the turn of the 1990s because of piecemeal reforms implemented in the 1970s and 1980s.

Why has Poland experienced stronger growth than other countries embarking on transition? Mr. Kolodko explained that the core difference in Poland's performance versus those of other transition economies lies in the institutional arrangements there. As a case in point he cited that the transparent and comprehensive regulation of financial markets in Poland would prevent a crisis such as the one observed in Albania (pyramid schemes) or rule out insider trading, a phenomenon that troubled the Czech financial markets just recently. Professor Kolodko thinks that the case for a reregulation of financial markets is strong. The "Strategy for Poland," the medium-term program prepared by Kolodko which the Polish government implemented from 1994 to 1997, stressed the need to improve corporate governance in the state sector by applying market principles even before the sector is ready for privatization. The program also envisaged a role for industrial policy in terms of regional developmental policies rather than through the distribution of subsidies. The gradual downsizing of the coal mining sector in Poland is an example of this approach. What is still needed in Poland are agricultural reforms to reduce the huge number of subsistence farmers. The overnight withdrawal of subsidies would create an underclass, which is likely to migrate to cities in search of new jobs. Large urban areas are unprepared to absorb such a massive migration; jobs and housing are scarce. Thus the government chose to create incentives to establish small businesses in rural areas, and in this way to gradually induce the necessary shift of employment away from agriculture.

Mr. Kolodko noted a shift from the Washington consensus toward a new consensus emphasizing the role of an institutional setup helping to accomplish a successful transition. This new consensus redefines the role of the state, with the state responsible for the creation of market institutions. Recent publications of international institutions such as the World Bank and the EBRD suggest such a trend.

Professor Kolodko shared his experience of the constraints that an academic economist like him faces on entering the world of policymaking. Ultimately, transition is also about democracy. Markets, as the experience in South Korea or China shows, can exist efficiently without democracy for a long time. Democratic processes tend to slow down reforms, as different lobbies can voice their interests. While this renders the decision-making process cumbersome in a democracy, it ensures that reforms are endorsed by majorities.

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

In the course 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 organized a number of bilateral technical cooperation activities, hosting various short study and information visits as well as specific consultations for Central and East European central bankers at the OeNB. Within this framework, the OeNB held consultations with representatives from the Bank of Slovenia in June 1997 (on the topic "budgeting and controlling"), with the National Bank of Slovakia in August 1997 ("EU preaccession matters") and with the National Bank of Croatia in October 1997 ("monetary policy instruments"). Moreover, the OeNB invited two staff members of the Central Bank of Russia (CBR) to participate in a seminar on "Communications Techniques" at the beginning of November. Furthermore, under the OeNB's program of one-year traineeships for employees of Central or Eastern European central banks, the Austrian central bank is currently hosting a traineeship for an employee of the National Bank of Hungary that began in May 1997.

In 1997 the OeNB started a seminar program under which it organized a series of four highly specialized one-week seminars exclusively designed for central bankers. These seminars, which were held within the organizational framework of the Joint Vienna Institute, were presented in English and covered the following topics: central bank accounting (February 1997), internal auditing and central bank controlling (July 1997), exchange rate and portfolio management (September 1997), and payment systems (November 1997). As this seminar series has met with very positive reactions on the part of participants, the OeNB plans to continue its program for central bankers in 1998.

At a multilateral level, the OeNB takes part in the EU-financed technical assistance program for the CBR. Under this program, the OeNB contributed a one-week seminar on central bank accounting held at the CBR in June 1997. Moreover, the OeNB organized a one-week study tour at the OeNB on financial statistics, comprising both balance-of-payments statistics and banking statistics, for five employees of the CBR in November 1997. Since the beginning of 1997, the OeNB has also participated in the 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 started in October 1997. Within the framework of the TAIEX program, the OeNB will host a study tour for an employee of the National Bank of Bulgaria in December 1997 on EU preaccession matters. The cooperation between the Joint Vienna Institute (JVI) and the OeNB has traditionally been very intense; the OeNB organized several lectures for seminar groups as well as individual meetings for JVI course participants at the Bank also in the second 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 of the JVI comprehensive course in October 1997.

Statistical Annex

Gross Domestic Product

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	Annual change in %										
1989	−1.9	4.5	×	0.7	×	×	0.2	−5.8	×	1.0	−1.8
1990	−9.1	−1.2	×	−3.5	×	×	−11.6	−5.6	−3.0	−2.5	−4.7
1991	−11.7	−14.2	×	−11.9	×	×	−7.0	−12.9	−5.0	−14.5	−8.9
1992	−7.3	−6.4	−12.4	−3.1	×	×	2.6	−8.7	−14.5	−6.5	−5.5
1993	−1.5	−0.9	−8.5	−0.6	−14.9	−30.4	3.8	1.5	−8.7	−3.7	2.8
1994	1.8	2.6	−1.8	2.9	0.6	1.0	5.2	3.9	−12.7	4.9	5.3
1995	2.1	4.8	4.2	1.5	−1.6	3.0	7.0	7.1	−4.2	6.8	4.1
1996	−10.9	4.4	4.0	1.0	2.8	3.6	6.1	4.1	−6.0	6.9	3.1
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
4th quarter	..	4.7	7.3	3.0	3.2	..	7.7	..	−5.7	6.7	4.1
1997											
1st quarter	−11.7	1.5	10.8	2.1	2.6	..	7.0	..	0.3	5.1	2.2
2nd quarter	..	1.2	12.5	4.3	..	..	7.6	..	−0.7	..	..

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
	Annual change in %										
1989	−1.1	1.7	×	−2.1	×	×	−0.5	−2.1	1.4	−0.7	1.1
1990	−16.7	−3.3	×	−10.2	×	×	−24.2	−19.0	−0.1	−4.0	−10.5
1991	−22.2	−24.4	×	−16.6	×	−4.9	−8.0	−22.8	−8.0	−19.4	−12.4
1992	−15.9	−7.9	×	−9.7	−34.6	−51.6	2.8	−21.9	−18.0	−9.5	−13.2
1993	−10.9	−5.3	×	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	5.0	8.7	4.7	4.6	−6.3	1.0	9.7	9.4	−3.3	8.3	2.0
1996	0.1	6.8	..	3.4	0.0	2.3	8.7	9.9	−5.0	2.5	1.0
1996											
July	−1.1	15.7	8.4	8.3	11.6	13.4	13.2	16.4	0.2	3.1	6.1
August	2.0	6.0	5.4	−3.1	5.5	−2.7	6.9	5.8	1.6	−2.0	−1.9
September	−11.9	7.0	8.4	2.4	−0.6	−7.9	8.1	5.0	1.0	3.1	5.1
October	1.5	5.0	6.4	5.1	2.6	14.0	13.3	8.0	6.7	3.8	9.9
November	−1.1	1.4	−2.2	5.9	−4.9	−17.4	4.7	−3.1	−5.8	−0.1	3.6
December	−6.6	1.5	−3.4	3.3	−5.3	4.4	10.0	−8.0	1.6	1.2	8.0
1997											
January	−27.3	−3.9	5.2	5.8	−24.4	−5.5	8.7	−3.0	−4.3	1.0	0.3
February	−16.1	..	−6.0	6.8	11.5	−11.6	8.8	4.0	1.3	..	1.7
March	..	..	6.8	3.6	5.8	6.5	4.8	6.0	5.0	..	−1.3
April	..	..	6.2	11.4	2.5	10.9	15.9	−11.8	−3.9	..	4.3
May	..	..	−7.3	1.9	2.1	−1.9	6.6	−1.9	..	..	−2.9
June	..	..	−0.5	15.1	..	10.8	19.9	..	..	..	4.3
July	..	..	..	8.6	..	..	10.0	..	..	..	−0.1
August	..	..	..	11.9	..	..	8.5	..	..	..	3.5
September	..	..	..	..	..	..	16.4	..	..	..	..

Source: Annual data: WIIW; Estonia, Latvia, Lithuania: national sources. Monthly data: OECD; Romania: national sources from September 1996; Poland: national sources from April 1997; Slovenia: Bank of Slovenia monthly bulletin 9/97 from July 1997.

[1]) *IIP – manufacturing.*

Unemployment Rate

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	End of period (in %)										
1989	×	×	×	0.4	×	×	×	×	×	×	3.5
1990	1.7	0.8	×	1.9	×	×	6.3	×	×	1.6	5.8
1991	11.1	4.1	×	7.8	×	×	11.8	3.0	×	11.8	10.1
1992	15.2	2.6	×	13.2	2.3	×	13.6	8.2	4.8	10.4	13.4
1993	16.4	3.5	4.1	13.3	5.8	3.4	16.4	10.4	5.7	14.4	15.4
1994	12.8	3.2	4.1	11.4	6.5	3.8	16.0	10.9	7.5	14.8	14.2
1995	11.1	2.9	4.0	11.1	6.6	6.1	14.9	9.5	8.8	13.1	14.5
1996	12.5	3.5	4.3	10.7	7.0	7.1	13.2	6.3	9.3	12.8	14.4
1996											
July	10.4	4.3	4.3	11.1	7.1	..	14.1	7.0	9.3	12.5	13.3
August	10.4	4.5	4.1	11.1	7.1	6.6	13.8	6.6	9.2	12.3	13.5
September	10.5	4.8	4.2	11.2	7.0	6.4	13.5	6.3	9.2	12.2	13.7
October	11.0	3.2	4.4	11.1	7.0	6.4	13.2	6.3	9.3	12.0	14.0
November	12.0	3.3	4.4	10.8	7.1	6.4	13.3	6.1	9.3	12.2	14.0
December	12.5	3.5	4.3	10.7	7.2	6.2	13.2	6.3	9.3	12.8	14.4
1997											
January	13.4	4.0	4.6	10.6	7.3	6.3	13.1	6.7	9.5	13.6	14.6
February	13.7	4.1	4.5	11.1	7.5	6.3	13.0	7.1	9.5	13.7	14.5
March	14.5	3.9	4.5	11.0	7.5	6.2	12.6	7.2	9.6	13.4	14.4
April	15.3	3.8	4.5	10.8	7.6	5.9	12.1	7.0	9.6	13.0	14.3
May	14.8	3.8	4.2	10.6	7.7	5.6	11.7	6.8	9.6	12.3	14.1
June	14.2	4.0	3.7	10.3	7.6	5.3	11.6	6.9	9.5	12.3	14.1
July	14.2	4.3	3.7	10.5	7.5	5.3	11.3	6.9	9.3	12.8	14.4
August	14.0	4.5	3.5	10.4	7.3	5.4	11.0	6.8	9.1	12.8	..
September	13.6	4.8	..	10.3	..	5.6	10.6	6.9	9.1	12.9	..

Source: IMF; Latvia, Lithuania: national sources; Estonia, Latvia: national sources from August 1997; Poland: national sources from September 1997.

Consumer Price Index

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia[1])
	Period average (annual change in %)										
1989	×	×	×	17.0	×	×	251.1	1.1	×	×	1,306.0
1990	23.8	9.7	×	28.9	×	×	585.8	5.1	5.3	10.6	549.7
1991	338.5	56.6	×	35.0	×	×	70.3	170.2	92.6	61.2	117.7
1992	91.2	11.1	×	23.0	243.6	×	43.0	210.4	1,526.6	10.0	201.3
1993	72.8	20.8	89.8	22.5	108.8	409.6	35.3	256.1	873.5	23.2	32.3
1994	96.0	10.0	47.7	18.8	35.9	72.1	32.2	136.8	307.6	13.4	19.8
1995	62.1	9.1	28.8	28.2	25.0	39.7	27.8	32.3	197.5	9.9	12.6
1996	123.0	8.8	23.1	23.6	17.6	24.6	19.9	38.8	47.6	5.8	9.7
1996											
July	47.4	9.4	23.0	23.0	17.7	24.9	20.4	40.3	43.5	5.5	10.7
August	61.6	9.9	21.8	22.9	17.4	24.3	20.5	44.2	36.8	5.6	10.3
September	75.4	10.3	20.1	22.2	16.1	22.3	19.5	45.3	31.4	5.2	9.4
October	90.7	8.9	17.2	21.0	15.7	18.7	19.5	45.1	27.0	5.3	9.7
November	106.1	8.8	16.4	20.1	14.4	15.0	19.1	47.5	23.9	5.4	8.6
December	128.1	8.8	14.8	19.8	13.2	13.1	18.5	56.9	21.7	5.4	8.8
1997											
January	521.1	7.4	12.6	18.9	11.4	12.7	17.8	76.2	19.6	5.8	9.0
February	911.6	7.3	10.0	18.8	9.9	10.7	17.3	105.5	18.2	6.0	8.5
March	1,200.4	6.8	9.1	18.8	8.7	8.3	16.6	164.0	16.6	6.3	7.4
April	1,364.8	6.7	9.2	18.6	8.8	7.3	15.3	176.8	15.1	6.5	8.2
May	1,417.8	6.3	10.8	17.7	9.0	7.9	14.6	174.0	14.3	6.1	8.9
June	1,404.3	6.8	10.8	18.7	7.5	7.6	15.3	177.4	14.3	6.2	8.8
July	1,322.5	9.4	10.8	18.1	7.6	8.7	14.9	159.8	14.5	6.0	9.4
August	1,233.9	9.9	11.9	18.0	8.6	8.7	14.5	159.1	14.7	6.5	9.6
September	..	10.3	11.9	18.0	8.2	..	13.6	161.4	14.0	5.7	10.1
October	..	..	12.2	..	..	..	..	..	..	..	..

Source: WIIW; Estonia, Lithuania, Latvia: IMF; Estonia, Poland: national sources from September 1997; Lithuania: national sources from August 1997.
Slovenia: Bank of Slovenia monthly bulletin 9/97 from September 1997.
[1]) Retail price index.

Current Account

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	USD million										
1989	−1,306.0	×	×	−1,437.0	×	×	−1,419.0	2,864.0	×	×	×
1990	−1,152.0	×	×	127.0	×	×	716.0	−1,656.0	×	×	×
1991	− 76.9	×	×	267.0	×	×	−1,359.0	−1,187.0	×	×	×
1992	− 360.5	×	36.1	324.0	191.0	×	− 269.0	−1,564.0	×	×	926.2
1993	−1,098.0	114.6	23.3	−3,455.0	417.0	− 85.7	−2,329.0	−1,174.0	×	− 601.2	191.9
1994	− 31.9	− 49.7	−170.8	−3,911.0	201.0	− 93.8	− 944.0	− 428.0	11,328.0	664.9	600.1
1995	− 25.6	−1,362.3	−187.9	−2,480.0	36.3	−614.3	5,455.0	−1,639.0	9,499.0	391.4	− 22.9
1996	40.8	−4,475.8	..	−1,678.0	..	−722.6	−1,352.0	−2,612.0	10,576.0	−1,909.2	39.0
1996											
July	..	..	..	− 33.0	..	..	262.0	− 175.0	..	− 110.1	27.2
August	..	..	..	− 99.0	..	..	58.0	− 13.0	..	− 110.1	29.1
September	152.5	−1,377.9	− 59.7	− 38.0	− 71.9	−114.1	− 359.0	− 5.0	1,428.0	− 74.4	52.9
October	..	..	..	− 20.0	..	..	− 548.0	− 361.0	..	− 142.2	52.5
November	..	..	..	− 53.0	..	..	− 125.0	− 511.0	..	− 226.4	− 71.2
December	9.3	−1,393.1	−229.7	− 501.0	−202.5	−347.4	− 368.0	−1,027.0	4,400.0	− 540.3	− 16.6
1997											
January	..	..	..	− 300.0	..	..	− 899.0	− 151.0	..	− 221.9	38.1
February	..	..	..	− 298.0	..	..	− 233.0	− 31.0	..	− 118.8	− 17.4
March	234.7	−1,069.2	−160.2	21.0	− 87.3	−215.7	− 408.0	45.0	4,900.0	− 144.6	− 59.0
April	..	..	..	− 110.0	..	..	− 742.0	− 145.0	..	− 306.1	− 48.5
May	..	..	..	142.0	..	..	− 135.0	− 168.0	..	− 102.5	1.4
June	119.2	− 835.4	−155.8	− 317.0	..	−234.2	− 287.0	− 396.0	..	− 112.4	− 16.7
July	..	..	..	− 11.0	..	..	− 339.0	..	..	..	9.0
August	..	..	..	97.0	..	..	..	..	..	..	2.4

Source: national sources.

Trade Balance

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	USD million										
1989	−1,199.0	×	×	537.0	×	×	240.0	2,559.0	×	×	×
1990	− 757.0	×	×	348.0	×	×	2,214.0	−1,743.0	×	×	×
1991	− 32.0	×	×	189.0	×	×	51.0	−1,254.0	×	×	×
1992	− 212.4	×	×	−48.0	×	×	512.0	−1,420.0	×	×	791.1
1993	− 885.4	− 311.7	− 91.0	−3,247.0	37.0	−154.7	−2,293.0	−1,128.0	×	− 932.0	−154.2
1994	− 16.9	− 888.9	− 353.0	−3,635.0	−252.0	−204.9	− 836.0	− 411.0	19,380.0	58.5	−337.5
1995	121.0	−3,677.9	− 707.1	−2,442.0	−458.2	−698.0	−1,827.0	−1,577.0	21,947.0	− 227.5	−954.3
1996	208.0	−5,971.8	−1,141.1	−2,645.0	−789.5	−878.6	−8,154.0	−2,470.0	22,825.0	−2,105.8	−881.7
1996											
July	14.3	− 586.9	− 106.4	− 228.5	− 42.8	..	− 540.0	− 221.0	1,803.0	− 170.2	− 47.6
August	52.1	− 515.8	− 80.5	− 215.7	− 55.2	..	− 810.0	− 108.0	1,899.0	− 151.0	− 83.0
September	71.1	− 401.9	− 89.0	− 211.9	− 60.7	−155.1	− 764.0	− 146.0	2,488.0	− 88.4	− 33.0
October	− 3.3	− 578.7	− 122.9	− 228.3	− 75.1	..	−1,131.0	− 301.0	3,077.0	− 197.2	− 37.2
November	45.3	− 602.2	− 122.9	− 188.2	− 68.7	..	− 805.0	− 322.0	3,508.0	− 227.2	−154.3
December	− 13.4	− 642.5	− 158.8	− 266.9	−133.7	−276.2	− 958.0	− 451.0	3,176.0	− 486.8	− 62.4
1997											
January	127.0	− 467.0	− 89.8	− 210.0	− 49.2	..	−1,476.0	− 135.0	2,718.0	− 213.9	− 32.2
February	133.9	− 428.7	− 82.1	− 229.0	− 61.7	..	− 706.0	− 48.0	2,009.0	− 108.1	− 76.6
March	118.1	− 451.3	− 113.8	37.0	− 59.5	−169.7	− 885.0	− 1.0	2,224.0	− 148.4	−134.8
April	65.4	− 516.8	− 135.6	− 204.0	− 79.8	..	− 935.0	− 126.0	1,717.0	− 302.4	−128.4
May	62.1	− 369.4	− 113.5	− 53.0	− 65.5	..	− 824.0	− 171.0	2,275.0	− 125.2	− 94.9
June	− 26.2	− 297.7	− 137.0	− 301.0	− 80.9	−225.0	− 898.0	− 153.0	920.0	− 86.0	− 75.3
July	..	− 446.5	− 121.4	− 201.0	− 68.1	..	−1,011.0	..	1,200.0	− 102.4	− 37.1
August	..	− 257.6	− 107.3	− 111.0	..	..	− 717.0	..	..	− 46.9	− 50.7
September	..	..	..	..	..	..	− 961.0	..	..	..	..

Source: national sources.

Total Reserves minus Gold

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	End of period (USD million)										
1989	×	×	×	1,246.0	×	×	2,314.3	1,859.0	×	×	×
1990	×	×	×	1,070.0	×	×	4,492.1	524.0	×	×	×
1991	320.0	×	×	3,936.0	×	×	3,632.6	695.0	..	×	112.1
1992	902.0	755.0	170.2	4,428.0	×	45.3	4,099.1	826.0	..	×	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	415.7	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	1,691.2	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	3,363.9	1,820.8
1996	483.0	12,297.0	636.8	9,795.0	654.1	772.2	17,844.0	2,103.0	11,276.4	3,418.9	2,297.4
1996											
July	480.0	12,835.0	604.7	9,494.0	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	9,778.0	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	10,404.0	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	10,190.0	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	9,857.0	623.5	742.0	17,656.9	1,994.0	11,652.9	3,540.1	2,409.3
December	483.0	12,352.0	636.8	9,795.0	654.1	772.2	17,844.0	2,103.0	11,276.4	3,418.9	2,297.4
1997											
January	381.0	11,846.0	565.7	9,048.0	646.4	731.2	17,894.8	1,783.0	9,929.5	3,379.9	2,257.4
February	408.0	11,635.0	557.9	8,639.0	641.2	733.0	17,950.6	1,766.0	11,126.8	3,417.3	2,449.7
March	517.0	11,626.0	606.6	8,510.9	637.7	749.6	17,663.1	1,889.0	12,428.7	3,398.7	2,473.6
April	1,146.0	11,434.0	587.9	7,904.5	622.4	779.9	18,141.6	2,199.0	14,067.7	3,292.4	2,493.8
May	1,282.0	9,940.0	606.5	8,363.8	668.8	821.2	18,599.8	2,277.0	15,884.1	2,919.5	2,699.9
June	..	10,680.0	620.1	8,289.5	668.5	870.5	19,384.9	2,753.0	20,395.7	2,964.2	2,863.0
July	..	..	604.3	8,239.0	688.1	1,023.1	19,065.7	3,062.0	20,186.1	2,955.0	2,942.3
August	..	..	655.7	8,340.0	698.5	967.8	19,627.3	3,156.0	19,603.9	3,126.5	3,107.6
September	..	..	..	..	..	..	19,752.4	..	..	3,096.4	3,281.6

Source: IMF.

Central Government Surplus/Deficit

	Bulgaria	Czech Republic	Estonia[1])	Hungary[2])	Latvia	Lithuania	Poland[3])	Romania[4])	Russia	Slovak Republic	Slovenia[5])
	% of GDP										
1989	×	−1.2	×	−3.1	×	×	−3.0	7.5	0.7	−0.6	×
1990	×	−0.2	×	−0.1	×	×	0.4	−0.4	1.3	−0.2	×
1991	×	−2.1	×	−4.6	×	×	−3.8	−1.9	−2.7	−3.9	2.6
1992	−5.8	−0.2	×	−6.7	−3.0	×	−6.0	−4.4	−3.4	−2.8	0.2
1993	−11.0	0.1	−0.4	−5.6	−0.2	×	−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	−6.7	0.6	−0.5	−5.6	−3.8	−1.9	−2.6	−4.1	−3.0	−1.6	−0.0
1996	−11.5	−0.1	−1.6	−2.0	−0.8	−3.7	−2.5	−4.9	−4.2	−4.4	0.3
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	−2.3	−0.9	0.2	..	−0.3	−9.4	−2.2	−8.1	..
1997											
1st quarter	−13.8	−2.5	−1.0	−1.4	1.4	..	−3.8	−4.8	..	−4.2	..
2nd quarter	−4.8	−1.8	..	−2.8	..	..	−3.2	..	..	..	..

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	×	×	20,751.0	×	×	40,800.0	×	×	×	×
1990	10,007.0	×	×	21,505.0	×	×	48,475.0	1,140.0	56,200.0	×	1,954.0
1991	12,301.1	×	×	22,812.0	×	×	48,412.0	2,131.0	70,100.0	×	1,866.0
1992	13,857.7	7,762.3	12.8	21,644.0	66.0	66.4	47,044.0	3,240.0	80,200.0	2,981.0	1,741.0
1993	13,889.4	9,604.9	133.3	24,566.0	233.0	336.7	47,246.0	4,249.0	112,784.0	3,626.0	1,873.0
1994	11,411.4	12,209.7	174.9	28,526.0	359.0	505.4	42,174.0	5,512.0	121,600.0	4,310.0	2,258.0
1995	10,229.2	17,190.3	260.4	31,660.0	431.0	826.3	43,957.0	6,408.0	120,400.0	5,827.0	2,970.0
1996	9,655.2	20,748.2	. .	27,646.0	. .	1,216.8	40,423.0	8,272.5	124,000.0	7,810.0	4,010.0

Source: WIIW; Estonia, Latvia, Lithuania: national sources.
[1]) Medium- and long-term gross debt.

Exchange Rate

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	Period average (ATS per 100 units of national currency)										
1989	1,575.08	×	×	22.40	×	×	9,194.37	88.68	×	×	×
1990	519.17	×	×	17.99	×	×	1,196.82	50.69	×	×	×
1991	65.63	×	×	15.62	×	×	1,104.00	15.28	×	×	42.35
1992	47.08	×	×	13.91	1,492.10	620.86	806.49	3.57	×	×	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	392.66	0.34	0.21	34.54	7.82
1996											
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	0.23	0.20	35.05	7.76
February	0.49	41.83	88.02	6.80	2,038.89	294.62	389.21	0.17	0.21	35.97	7.74
March	0.72	40.91	87.98	6.75	2,059.43	298.62	387.90	0.17	0.21	35.95	7.72
April	0.78	40.33	88.04	6.70	2,065.57	301.06	385.82	0.17	0.21	36.21	7.72
May	0.78	38.63	87.99	6.61	2,073.17	299.57	377.85	0.17	0.21	36.03	7.72
June	0.73	37.54	88.01	6.57	2,114.19	303.92	375.38	0.17	0.21	36.33	7.76
July	0.71	37.54	88.08	6.57	2,173.48	315.16	371.15	0.18	0.22	36.93	7.75
August	0.70	37.88	88.00	6.55	2,194.42	324.23	372.49	0.17	0.22	37.24	7.65
September	0.70	37.45	87.74	6.43	2,141.94	314.87	364.36	0.17	0.22	36.58	7.55
October[1])	0.70	36.70	87.84	6.24	2,102.00	304.00	344.23	0.16	0.21	36.31	7.46

Source: IMF; Estonia: OeNB, end of period, from September 1997.
[1]) OeNB, end of period.

Discount Rate[1])

	Bulgaria	Czech Republic	Hungary	Latvia	Poland	Romania	Russia[2])	Slovak Republic	Slovenia
	End of period								
1989	×	×	17.0	×	104.0	×	×	×	×
1990	4.5	×	22.0	×	48.0	3.0	×	×	×
1991	54.0	×	22.0	×	36.0	12.8	×	×	×
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									
July	108.0	10.5	26.0	13.0	22.0	35.0	101.1	8.8	10.0
August	108.0	10.5	25.5	12.0	22.0	35.0	101.9	8.8	10.0
September	300.0	10.5	24.5	11.0	22.0	35.0	101.2	8.8	10.0
October	240.0	10.5	23.0	10.0	22.0	35.0	99.8	8.8	10.0
November	180.0	10.5	23.0	10.0	22.0	36.0	100.0	8.8	10.0
December	180.0	10.5	23.0	9.5	22.0	35.0	111.6	8.8	10.0
1997									
January	198.0	10.5	23.0	8.0	22.0	50.0	91.5	8.8	10.0
February	198.0	10.5	22.5	6.0	22.0	50.0	92.2	8.8	10.0
March	216.0	10.5	21.5	5.0	22.0	50.0	102.8	8.8	10.0
April	74.4	10.5	21.5	4.0	22.0	50.0	101.8	8.8	10.0
May	43.1	13.0	21.5	4.0	22.0	50.0	98.5	8.8	10.0
June	10.1	13.0	21.0	4.0	22.0	50.0	98.7	8.8	10.0
July	..	13.0	21.0	4.0	22.0	50.0	100.7	8.8	10.0
August	..	13.0	21.0	4.0	24.5	44.7	..	8.8	10.0
September	..	..	20.5	..	24.5	..	..	..	10.0

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