Oesterreichische Nationalbank

Focus on Transition

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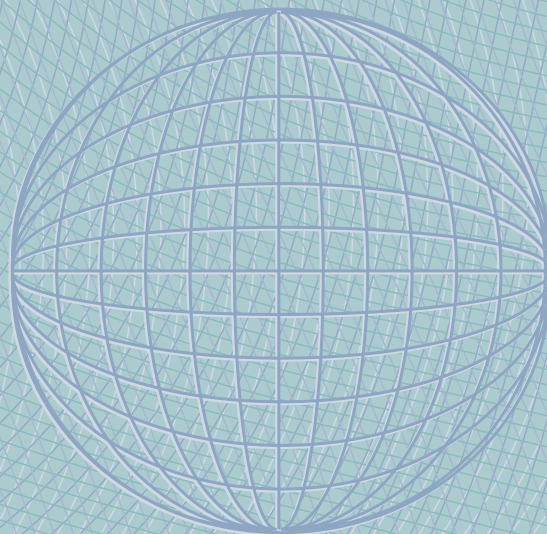

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Focus on Transition

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STUDIES

Contagion Effects of the Russian Financial Crisis on Central and Eastern Europe:
The Case of Poland 22
Maciej Krzak

The purpose of this paper is to analyze the channels of contagion through which the Russian financial crisis affects Poland, which serves as a case of a Central European economy (CEE) in transition. The financial turmoil in Russia exerted a global impact. It affected countries with strong trade links with Russia such as CIS countries, with looser links such as the CEEs, but also countries with hardly any links to Russia such as Brazil, a seemingly puzzling pattern. Furthermore, the moratorium on payments on Russian domestic debt to commercial institutions sent jitters to financial markets in developed economies, spilling over to emerging markets, such as the CEEs. The paper explains in brief how this connection could come about. The common wisdom is that CEEs are vulnerable to the fallout of the Russian crisis because of their close ties with Russia. This paper attempts to cast some light on the potential magnitude of the impact by using Poland as an example. The major flaw of this analysis is that much of it is by nature speculative, since the crisis is not over yet.

The 1998 Reports of the European Commission on Progress
by Candidate Countries from Central and Eastern Europe:
The Second Qualifying Round 38
Sandra Dvorsky, Peter Backé and Olga Radzyner

This study reviews the European Commission's 1998 regular reports on the progress towards EU accession of the ten candidate countries from Central and Eastern Europe. The focus is on those issues which are of particular interest from a central bank viewpoint. Therefore, the study examines the reports' accounts and assessments on monetary and exchange rate policies, (dis)inflation performance and preparations for integration into Economic and Monetary Union, with a specific focus on central bank independence and the liberalization of capital movements. This is complemented by a presentation and analysis of selected general issues related to methodology, the broad macroeconomic picture, the Commission's overall assessments in the economic realm and its main recommendations.

Prudential Supervision in Central and Eastern Europe:
A Status Report on the Czech Republic, Hungary, Poland and Slovenia 80
Michael Würz and Wolfgang Müller

This status report offers an overview of the progress the Czech Republic, Hungary, Poland and Slovenia have made in the implementation of twelve EU Directives on prudential supervision. The report is based on a survey carried out with the help of questionnaires sent to the four countries' central banks in the summer of 1998.

After a brief summary of the general historical, economic and political background outlining the fundamental changes the banking and supervisory systems in transition economies have gone through, the report presents the makeup of supervisory systems in the countries under review. The main chapter contains a condensed description of the objectives of each EU Directive and the current state of implementation in the four countries surveyed. The report's final chapters are dedicated to an overall assessment of the candidates' progress towards legal convergence with EU secondary legislation on supervision and the Basle Core Principles. The main conclusion to be drawn is that above and beyond the serious efforts undertaken in recent years, further measures will be needed to overcome persisting shortcomings, especially in the field of consolidated supervision.

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The views expressed are those of the authors and need not necessarily coincide with the views of the Oesterreichische Nationalbank.

Editorial

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

Like the previous issues of the Focus on Transition, this volume 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 in this volume examines the timely issue of the contagion effects of the Russian crisis on Central and Eastern Europe using Poland as an example. The analysis is speculative by nature, since the crisis is not over yet and its fallout for the real economy has yet to come. However, the study tries to cast some light on the contagion channels and on the potential magnitude of the impact of the Russian crisis on Poland.

The second study reviews the European Commission's 1998 regular reports on the progress towards EU accession of the ten candidate countries from Central and Eastern Europe. It concentrates on issues which are of particular interest from a central bank point of view. Therefore, it analyzes especially the Commission's review and assessment of monetary and exchange rate policies, disinflation performance, preparation for integration into EMU, with a specific focus on central bank independence and the liberalization of capital movements.

Finally, the third study reviews the progress the Czech Republic, Hungary, Poland, and Slovenia have achieved in implementing the EU Directives on prudential supervision. The report is based on questionnaires sent to the four central banks in the summer of 1998. The paper ends with an overall assessment of the candidates' progress towards legal convergence with EU secondary legislation on supervision and the Basle Core Principles.

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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Klaus Liebscher
Governor

Recent Economic Developments

Developments in Selected Countries

Maciej Krzak

1 Introduction

In 1998, the five countries covered by this report – the Czech Republic, Hungary, Poland, Slovakia and Slovenia – exhibited a mixed growth performance. The Czech Republic found itself in recession while the other four economies exhibited dynamic economic growth in the first half of 1998. Signs of a slowdown appeared in all countries but Hungary in the second quarter. Slovakia registered the most powerful GDP expansion in the group in the first half of 1998, but there is doubt about whether this growth, which was largely financed by state expenditures, is sustainable. The impact of the Russian crisis on economic expansion in this group of countries in the fourth quarter remains to be seen.

Inflation continued its downward trend in all countries with the exception of Slovakia, where it stabilized at the level of the previous year. However, Slovakia still noted the lowest CPI inflation rates in the group of five countries.

Current account trends have been mixed in 1998 so far. Before the outbreak of the Russian crisis, the Czech and Polish current account deficits had declined compared to the same periods of 1997 while the current account gaps had worsened in Hungary and Slovakia; the crucial difference between the latter two economies is that the current account deficit of Hungary is small relative to GDP while the Slovak one is huge (over 10% of GDP). Much as in the years before, Slovenia maintained a balanced current account. The impact of the Russian crisis on current account positions cannot be assessed yet; in Poland, a rapid worsening of the current account deficit in September 1998 signaled a reversal of the positive tendency. Slovakia had the largest current account deficit in terms of GDP in the first half of 1998.

Despite robust economic growth, budget deficits remained relatively high in Hungary, Poland and Slovakia, but the political will to cut them more decisively is gaining ground. The Czech Republic and Slovenia have the lowest deficit ratios.

In general, Slovenia has maintained the most stable macroeconomic position among the five countries. This year's GDP growth is likely to be around 4% in real terms; the current account will remain close to balance, and the budget deficit should not exceed 1% of GDP. Inflation will be down slightly on 1997, locked in the single-digit range for good.

The Czech Republic, Hungary, Poland and Slovenia are "first wave" candidate countries – along with Estonia and Cyprus – for accession to the EU. In November 1998, substantive accession negotiations between the EU and these countries began on the first 7 of 31 chapters of the *acquis communautaire*. Unsurprisingly, relatively few differences between the candidates and the EU have emerged, but these chapters were the least controversial, so hard negotiations are still ahead. At the same time, the Commission published its first regular reports on progress towards EU accession, an update of its avis of July 1997, on ten candidates encompassing Central and Eastern European countries plus Cyprus and Turkey.[1])

1 *For a detailed coverage of these matters, see the study "The 1998 Reports of the European Commission on Progress by Candidate Countries from Central and Eastern Europe" by Sandra Dvorsky, Peter Backé and Olga Radzyner in this issue.*

2 Country Reports

2.1 Czech Republic

Real GDP decreased by 1.7% year on year in the first half of 1998. The economic decline accelerated in the second quarter of 1998. Final consumption and gross capital formation were down 3.5% and 6.3% year on year in this period.[1]) As of the time of writing, the latest available information on the performance of the economy did not augur well for a reversal of these negative trends: Industrial production fell 1.8% in the twelve months to September, while industrial sales contracted even more, which implies that inventories increased. This may, in turn, induce further cuts in output. Construction was down 6.1% year on year in September while retail sales were down by 6.6% year on year in January to September 1998. The contraction in economic activity was arguably the most important factor behind a rise of the unemployment rate to 6.8% of the labor force in October 1998, marking an almost two percentage point increase in the last twelve months to October.

Inflation peaked in the first quarter of 1998; subsequently the disinflationary trend resumed. CPI inflation was 8.2% year on year in October 1998, down from 10.2% year on year in October 1997. The twelve-month average inflation rate sank to 11.2% in October from 11.4% in September. At 3.3% year on year in October 1998, the PPI rate had fallen considerably; this bodes well for further disinflation, as the PPI tends to affect the CPI with a lag.

The current account deficit declined to USD 0.5 billion in the first nine months of 1998 compared to USD 2.6 billion in the corresponding period of 1997. This improvement was correlated with a narrowing of the trade gap to USD 1.5 billion in the first nine months of 1998 from a shortfall of USD 3.4 billion in the same period of 1997. The reduction in the trade deficit was caused by an upswing in exports by 17% and a slowdown in import growth to 4.9% in dollar terms during the same period. These tendencies were of course related to the slowdown of the Czech economy and the stronger recovery in the EU. Net portfolio investment continued to be positive (USD 0.3 billion) in the first nine months of 1998 as compared to an inflow of USD 0.6 billion in the same period of 1997, apparently affected by the Russian crisis, as in the first half of 1998 the inflow had been USD 0.8 billion. FDI inflows reached nearly USD 1.2 billion in the January through September period of 1998 against USD 0.8 billion in the like period of 1997. Net other investment inflows were negligible. As a result of favorable developments, the foreign currency reserves of the central bank climbed; they stood at USD 12.7 billion in October 1998 versus USD 11.0 billion in the same month of 1997. These reserves covered more than four months of imports.

According to preliminary data, Czech external debt in convertible currencies reached USD 20.0 billion dollars in March 1998.[2]) The rating agency Standard & Poor’s downgraded Czech long-term foreign debt to A– from A

1 *Net exports were unavailable.*

2 *The figures given in CZK were converted at the rate of CZK 34.00 per U.S. dollar.*

in November 1998, arguing that the recession besetting the country, the lack of progress in restructuring banks and companies and in improving the legal framework made the Czech economy vulnerable in view of the deteriorating external environment.

In July, the central bank intervened to stop the nominal appreciation of the domestic currency. The Czech koruna was touched only slightly by the Russian financial crisis. The exchange rate was not weakened by interest rate reductions, which were engineered by the Czech National Bank (CNB) in the summer. The share of exports to Russia in total Czech exports was 3.4% in 1997, so the direct impact of the crisis was only limited. The stock market followed world patterns of behavior, with the PX50 falling by about 37% from its peak on July 21, 1998, until a trough on October 8, 1998; this was followed by a partial recovery.

Monetary policy was gradually relaxed in the third quarter and early in the fourth quarter of 1998 following the release of unfavorable data on economic activity and the easing of inflation. On October 26, the discount rate was reduced by 1.5 percentage points to 10%, while the lombard rate and the repo rate were cut by 1 percentage point to 15% and 12.5%, respectively. On November 13, the CNB cut the two-week repo rate again, this time by 1 percentage point to 11.5% (the fourth reduction in 1998), bringing the total reduction since July 1998 to 350 basis points. The preliminary experience with direct inflation targeting, which the Czech Republic introduced at the beginning of 1998, is positive, as the growth range of 5.5% to 6.5% in net inflation year on year in December 1998 is unchallenged. The net inflation rate was 3.4% year on year in October.[1])

The Czech state budget posted a surplus of CZK 9.4 billion in January through October 1998. Fiscal policy for 1999 is likely to be more expansionary: The government approved a draft budget with a deficit of CZK 31 billion (about 1.5% of projected GDP in 1999) to kickstart the ailing economy.

The parliamentary elections in June did not produce a majority for any party. The Social Democrats formed a minority government after signing a cooperation agreement with the Civic Democratic Party. The main points of the government program are: membership in NATO and the EU, completion of the privatization of the banking sector in the year 2000, an extension of the period for price deregulation until its completion in 2002, a balancing of budgets over the business cycle, a strengthening of financial market regulation and transparency, a reform of the tax system and active support for domestic industry and agriculture.

Structural reforms have been slow due to political instability since the fall of the Klaus government. With bad loans standing at more than 25% of total credits, the banking sector is in bad shape. Privatization of the banking sector has only begun: Agrobanka was sold to GE Capital in June 1998. The state intends to sell 51% of its 66% stake in Československa Obchodni Banka (CSOB), the former foreign trade bank, and additional shares of Česka Sporitelna (Savings Bank), in which the EBRD took a 12% stake. The

1 *The net inflation index excludes regulated prices and the impact of tax changes. The excluded items represent about 22% of the CPI.*

amended banking law is designed to be instrumental in tackling the problem of bad credits, as the law toughened disclosure requirements and provisioning criteria. These new regulations imply that banks will have to have put aside large amounts of money by the end of 2000, so large losses are likely to be recorded in the meantime. The year 2000 is the time the state plans to complete the sale of state stakes in the large banks to strategic investors. The restructuring of enterprises is proceeding rather slowly, as corporate governance still needs a major overhaul. So far banks have not been particularly active in insisting on repayment of industrial loans. The first months of operation of the Czech Securities Commission were very active. The Commission demonstrated the capacity to become a strong market regulator despite a shortage of funds to run this agency. The stock market still holds a relatively insignificant position for firms to raise capital, and turnover has been low because of the market's lack of transparency and tarnished reputation.

2.2 Hungary

Economic activity accelerated in Hungary in 1998, with real GDP growing by 4.8% year on year in the first half of 1998 versus 4.4% in the analogous 1997 period. Furthermore, by contrast to the other countries covered in this report, economic growth quickened from the first to the second quarter of 1998. Private consumption climbed by 2.9% year on year, while gross fixed investment was up by 10.6% in the first half of 1998. Strong growth was maintained in the third quarter, as the latest data available show: The output of industry, driven by exports, construction and retail sales, rose by 13.9%, 16.1% and 6.0% year on year in the first three quarters of 1998, respectively. Investments augmented by a 13.7% year-on-year rate in the first nine months of 1998. The government expects GDP to grow by around 5% in 1998 and 1999. Accelerating economic growth reduced the unemployment rate to 8.8% of the labor force in October 1998, the lowest rate of the entire transition period, versus 10.1% in the corresponding month of 1997.

Vigorous economic growth was accompanied by a further easing of inflation, mainly thanks to stagnating or falling food prices. The CPI increased 12.3% year on year in October 1998 compared with a 17.7% year-on-year enlargement in the corresponding month of 1997. The producer price inflation rate clocked in at 10.4% year on year in September 1998. Wage growth did not cause inflationary pressures, as it remained under control: Average real wages rose by 3.5% year on year in the first eight months 1998.[1])

The rise in domestic demand did not result in a worsening of the trade gap versus the same period of 1997, as exports rose faster than imports in dollar terms. The impact of the Russian crisis was reflected in September figures; exports to Russia dropped by 15.2% in the first nine months of 1998. The trade deficit reached USD 1.4 billion in January to September 1998 while it had stood at USD 1.3 billion in the corresponding period of 1997. The current account gap widened to over USD 1.3 billion in the first three quarters of 1998 from USD 0.7 billion in the corresponding period of 1997, mainly because the surplus on services as well as net income were

1 *Average real wages of full-time employees.*

lower. Net foreign direct investment inflows came to about USD 1.4 billion in January to September 1998, slightly lower than in the same period of 1997. Net portfolio investment inflows at USD 0.9 billion in the first nine months of 1998 stood in stark contrast to net outflows of USD 1.3 billion in the same period of 1997. However, the Russian financial turmoil led to a massive outflow of funds (according to the Government Debt Management Agency, more than USD 1 billion worth of bonds were withdrawn between August and October). This in turn impacted Hungary's foreign exchange reserves, which had been growing until the outbreak of the Russian crisis (USD 9.7 billion in July 1998 from USD 8.4 billion in December 1997), and proceeded to decline as a result of the turbulence, sinking to USD 8.8 billion in September 1998. These reserves covered around five average months of imports in January to September 1998. Gross foreign debt amounted to USD 22.7 billion in September 1998.[1])

Extensive capital inflows exerted upward pressure on the forint until late spring, so that it traded at the stronger limit of the band for months. However, the currency suffered from the Russian crisis, as did other Central European currencies; it depreciated all the way down to the weaker end of the band, prompting central bank intervention. The depreciation pressure induced the NBH to hike its repo rates by one percentage point in September, the first rise in interest rates since the launch of the stabilization program in February 1995. At the same time, the NBH announced a reduction in the crawling peg devaluation rate by 0.1 percentage point to 0.7% monthly, effective October 1, 1998. At the beginning of November 1998, the forint appreciated to the level near the central rate of the band, propelled by the waning of global pessimism.[2])

The stock exchange followed world patterns of behavior; it lost about half of its value within a two-month span during the Russian crisis. The decline was much stronger than that of other Central European stock exchanges due to the much higher participation of foreigners who rushed to exit the market, withdrawing funds to cover losses in other markets. Later on, the Hungarian stock market partly bounced back. In November 1998, the NBH successfully increased its earlier Eurobond issue; although the spreads over benchmark rates advanced considerably against the spreads of original amounts, they were favorable in comparison with the worldwide increase in spreads in the wake of the Russian crisis.

Subsiding inflation allowed the NBH to institute a series of interest rate cuts. The base rate was cut three times between April and the time of writing to stand at 18%. The NBH open market intervention rates were trimmed bit by bit, with a break in the aftermath of the Russian crisis, when the NBH raised its repo rate (see above). After the Russian crisis had abated, the NBH resumed lowering interest rates, as it had done since mid-1995. As a

1 *The NBH debt figures exclude intercompany loans. The borrowing of subsidiaries from their parent companies ran to about USD 2.1 billion in September 1998.*

2 *The main factors that helped contain pessimism were the G-7 statement that it will bail out economies with sound fundamentals which are only subject to abrupt short-term capital outflows, three cuts of interest rates by the Federal Reserve System and a rescue package for Brazil.*

result of a second round of cuts by 0.25 percentage point in late November 1998, the one-month passive repo rate and the overnight active rate were scaled back to 17.75% and 20.75%, respectively. In its 1999 monetary policy guidelines, the NBH states that the reduction of inflation will continue to be the main objective; the twelve-month CPI inflation rate should fall to 9% by the end of 1999. The crawling peg mechanism of the exchange rate will remain in place, and the NBH sees no need to widen the fluctuation band. The NBH and the government decided to adapt the currency basket by replacing the Deutsche mark by the euro. Moreover, they announced a further reduction of the crawling peg devaluation rate by 0.1 point effective January 1, 1999.

Hungary's central budget deficit was HUF 267.9 billion in the first ten months of 1998, while the general government deficit was HUF 347.9 billion.[1]) The targeted general government deficit for 1998 was originally set at HUF 419 billion or 4.9% of GDP and will likely stay within the limits on a cash basis.[2]) According to the 1999 draft, the budget deficit of the general government should stay below 4% of GDP, assuming 5% GDP growth in 1999.

Structural reforms were continued. In June 1998, a new law on venture capital and a new company law went into force. The self-governance of the social security system was abolished in August 1998, which may facilitate future reforms. The May recapitalization of Postabank (HUF 24 billion) proved insufficient, so the government is planning another capital injection of HUF 152 billion, as it expects the losses of the bank to reach HUF 158 billion by the end of 1998. In August 1998, a new management team took over the bank and announced a cost-cutting plan along with a program to restructure bank activities. HUF 40 billion will have to be added to the Hungarian Development Bank's capital to offset the loss resulting in part from the purchase of Postabank shares.

As expected, the Hungarian Civic Party (Fidesz), the Democratic Party and the Smallholders' Party formed a new government after the parliamentary elections in May 1998, in which the former ruling coalition was defeated.

2.3 Poland

Real GDP grew at the fast clip of 5.9% in the first half of 1998, but the year-on-year quarterly growth rates have been declining. Growth was mainly fueled by domestic demand, i.e. consumption and investment. The enterprise sector's investment outlays were up 26% in real terms year on year in January to August 1998. The slowdown of economic activity became more pronounced in the fall: The rate of growth of industrial sales in the third quarter 1998 was 4.0% compared with 10.9% in the first quarter.[3]) Indus-

1 *The figures do not include privatization revenue.*

2 *However, the Ministry of Finance expects the budget deficit including new bond issues to rise to HUF 601 billion or 6.7% of GDP because of extra expenditures, mostly of new capital injections to troubled Postabank and the Hungarian Development Bank (MFB).*

3 *The data are not seasonally adjusted.*

trial output rose by 5.8% year on year in the January to October period of 1998. In October, it fell by 1.1% year on year, the first such fall in six years. The government revised its predictions of 1998 GDP growth downward to the 1998 budget projection of 5.6% (in 1997, real GDP grew by 6.9%). The unemployment rate was 9.6% of the labor force in September 1998, down from 10.6% a year earlier.

Disinflation continued in 1998. Consumer price inflation came to 7.6% in the January to October 1998 period compared with a 10.8% rise in the like period of 1997. In October 1998, the year-on-year CPI inflation rate dropped to single digits – 9.9% – for the first time in eighteen years. The low rate of price increase of food tended to dampen the index rise, while service price inflation drove it up. In its budget, the government projected a 9.5% CPI rate year on year in December 1998. Producer price inflation was lower, running at 5.9% year on year in October 1998, a harbinger of further disinflation.

Poland's current account deficit reached USD 4.7 billion in the first ten months of 1998 versus USD 3.7 billion in the same period of 1997. The trade deficit of January to September 1998 was USD 10.7 billion versus USD 9.2 billion in the analogous 1997 period. At 13.4%, export growth fell marginally short of import growth in dollar terms (13.0%). In the first eight months of 1998 the current account posted a much better result than in the same period of 1997, and its rapid worsening in September and October was correlated with a rapid deterioration of the trade deficit in the same period. The latter can be attributed to the Russian crisis and possibly to the real appreciation of the zloty. According to the government forecast, the current account deficit will rise again in proportion to GDP, but should stay below 4% of GDP in 1998. Poland is well cushioned against a sudden deterioration of the current account deficit by its high gross official reserves, which stood at USD 27.1 billion[1]) at the end of September 1998 and covered around 7.7 months of 1998 imports at that time. The current account coverage by net foreign direct investment inflows of approximately USD 3.8 billion exceeded 100% in January to September 1998.[2])

Along with other emerging market currencies, the zloty suffered during the Russian financial turmoil, but the depreciation, though severe (the basket of currencies to which the zloty is pegged gained 9% in one week), was short-lived and mostly limited to the third week of August 1998. The currency recouped almost all losses in September and October, recently being boosted by the inflow of funds related to the sale of state's stake in Bank Przemyslowo-Handlowy (BPH) and the privatization of the state telecom Telekomunikacja Polska (see below). The zloty center parity rate is currently being devalued by 0.5% monthly versus the basket. The crawling peg rate was reduced by 0.15 percentage point for anti-inflationary reasons as recently as September 8, 1998, i.e. amid the Russian crisis. Under such circumstances, the NBP did not risk a rise in the attractiveness of Polish assets, which would have triggered undesired capital inflows. On October 28, the NBP

1 *Including gold; excluding gold: USD 26.1 billion.*

2 *Twelve-month net FDI inflow related to twelve-month current account deficit. Source: NBP.*

widened the band of zloty fluctuations from 10% to 12.5% on either side of the central parity versus the basket. The central bank is planning to replace the current five-currency basket by a basket consisting only of the euro and the U.S. dollar starting in 1999; the weights have not been specified yet.

Since May 1998, the central bank has been conducting a policy of gradual interest rate reduction. The most recent cutback took place on October 28, 1998, when the discount, lombard and open market intervention rates were lowered to 20%, 22% and 17%, respectively. In 1999, the NBP will adopt a new monetary policy strategy by switching to direct inflation targeting, with a CPI index rise between 8.0% and 8.5% year on year in December 1999 as a target.[1])

The consolidated budget deficit amounted to PLN 11.6 billion in the first ten months of the year. Before these figures were released, the government expected the deficit to reach 2.4% of GDP (PLN 12.5 billion) instead of the envisaged 2.7% of GDP (PLN 14.4 billion) excluding privatization receipts.[2]) The government is anticipating a budget deficit of 2.15% of GDP or PLN 12.8 billion for 1999. The draft budget has been revised to key in the impact of the Russian crisis and the possible slowdown of growth in the EU in 1999. The final draft is based on 5.1% GDP growth in 1999, down from a previously projected 6.1% and CPI annual inflation of 8.5%, but the deficit relative to GDP has stayed as originally planned despite hard bargaining within the ruling coalition to raise it. The government projects a current account deficit rise to 4.9% of GDP in 1999. Most of the Ministry of Finance's ambitious plans to streamline the tax code have been rejected by the senior coalition partner. The most important change to be effectively implemented is a reduction of the corporate income tax by 2 percentage points to 34%.[3])

The government launched the reform of provincial and local administration in July 1998 and embarked on three other crucial social system changes: the pension reform, healthcare reform and the reform of the educational system, all of which create a good deal of controversy among professionals and the general public. The latter three reforms are to be implemented by a new, largely decentralized state administration.

The privatization of banks was continued. 15% of a retail bank, Grupa Pekao SA, the second-largest bank in terms of assets, were sold to domestic investors in June 1998. The government is seeking a strategic investor to take over 55% of the bank. In October, the government sold its 36.7% stake in BPH, a regional retail bank based in Krakow and the seventh largest with regard to assets in 1997, to Bayerische Hypo-Vereinsbank. In October 1998, Poland started privatizing the telecommunications monopoly Telekomunikacja Polska (TP SA): 15% of the shares were sold to domestic and foreign investors. The listing of TP practically doubled the capitalization of the Warsaw bourse. The government is planning to seek a strategic investor for a

1 *See Monetary Policy Guidelines for 1999, NBP, October 1998.*

2 *Reuters' interview with senior Ministry of Finance advisor Stanislaw Gomulka on October 15, 1998.*

3 *In June, the Ministry of Finance published a whitebook outlining its plan for two-year tax reforms, which met with opposition within the coalition.*

25% to 35% stake in the company next year. The implementation of revised plans to restructure the coal mining sector has started. Plans to restructure the oil and steel sectors have been approved.

In line with the schedule agreed with the OECD, the new foreign exchange law was approved by the Lower House in November 1998. According to the law, all capital account transactions with a maturity of more than one year will be allowed with OECD counterparties. The invoicing of current account transactions in zlotys will be allowed. The law contains safeguards against the threat of financial or currency instability, e.g. under such circumstances, the central bank may impose interest-free deposits on capital inflows or require a surrender of foreign exchange. Poland announced that it will also keep on reducing tariffs under the WTO agreement.

2.4 Slovakia

Real GDP growth was strong, coming to 6.1% year on year in the first half of 1998 versus 6.2% in the corresponding period of 1997. Slovak industrial output was up by 6.9% year on year in September 1997. The unemployment rate was 13.9% of the labor force in October, up from 12.5% at the end of 1997.[1])

Inflation stabilized in Slovakia: The CPI inflation rate was 6.2% year on year in October 1998, unchanged from October 1997. The PPI inflation rate was much lower at 3.1% year on year in September 1998, down from 4.2% in September 1997, providing room for further disinflation.

The current account deficit reached over USD 1.4 billion in the first eight months of 1998, up from USD 1.1 billion in the same period of 1997. In the first half of 1998, the deficit stood at approximately 12% of GDP.[2]) The trade gap was USD 1.47 billion compared to USD 1.12 billion in the same period of 1997. After a decrease in 1997, due chiefly to the introduction of the import tax surcharge of 7% in July 1997, the deficit started to augment again in 1998; its rise coincided with the gradual phasing out of the surcharge, which was abolished on October 1, 1998. Until August 1998, Slovakia had still not attracted a much larger amount of FDI than in previous years: Net foreign direct investment ran to USD 155 million in the January through August 1998 period compared with USD 80.6 million in the whole of 1997. Portfolio investment outflows amounted to USD 58 million (1997: 11.4 million) while other investment inflows (loans from abroad) contributed most to closing the current account gap, which reached USD 1.75 billion (1997: 1.6 billion).

The capital account surplus, which financed the current account deficit, was high enough to expand the central bank's official reserves from USD 3.3 billion at the end of 1997 to USD 3.6 billion in August 1998.[3]) However, these reserves started falling during the Russian crisis and in the period of

1 *The methodology of calculating the unemployment rate changed in 1998 to exclude the following groups of jobless people: persons on maternity leave, under retraining or out of work for health reasons. If these groups had been included, the rise in unemployment would have been steeper.*

2 *Own calculations.*

3 *NBS figures.*

parliamentary elections: They had shrunk to USD 3.1 billion by the end of September 1998. Their fall slowed after the fixed exchange rate regime collapsed on October 2; official reserves came to USD 3.0 billion at the end of November 1998. These reserves covered almost three average months of imports in 1998. High inflows of other investment were reflected by the ongoing rapid enlargement of external debt, which widened to USD 11.9 billion in July 1998, up from USD 9.9 billion in December 1997.[1]) The size of this debt has become a major concern adding to currency instability.

In summer and fall, the central bank continued to conduct a policy of high real interest rates to countervail a lax budget policy. Payments of the principal amount on the state debt have been excluded from the state budget effective January 1998. Thus modified, the central budget deficit came to SKK 9.1 billion in October 1998, higher than the revised 1998 forecast of SKK 8 billion or 1.1% of GDP. Because of parliamentary elections, the budget blueprint for 1999 will not be delivered until the first quarter of 1999.

Along with other central European currencies, the Slovak koruna came under pressure during the Russian crisis. Before the crisis it fluctuated around 3% weaker than its central rate, while during the crisis it depreciated close to the weaker edge of the ±7% band, prompting the NBS to intervene. The downgrading of Slovakia's external debt to the speculative BB+ from investment grade BBB– in mid-September led to a further drop in confidence in the koruna.[2]) The upcoming parliamentary elections at the end of September added to the uncertainty. The overnight interbank interest rates briefly peaked at over 50%, and foreign currency reserves started to plunge at the end of September due to the growing demand of households and firms (contracting by almost USD 300 million in just a few days). In these circumstances, the central bank had to give up the fixed exchange rate against the basket (60% DEM and 40% USD) on October 1, 1998. The koruna has been floating since then. The immediate reaction was a 10% depreciation of the currency, which later stabilized and then even appreciated in October as pessimism about world growth prospects diminished and the opposition won the parliamentary elections. Nonetheless, the Slovak currency remained depreciated relative to the shadow lower limit of the former fluctuation band. The stock exchange index dropped dramatically in 1998, but the Russian crisis is only partly responsible for this development. Slovakia's exports to Russia accounted for a mere 3% of its total exports in 1997, which implies that the direct impact of the crisis should be limited.

The pace of structural reforms was very slow in recent years. Privatization has become nontransparent and slow. The program designed to revitalize enterprises lacked financial support. The banking sector is affected by a considerable share of bad loans estimated at between 20% and 33% of the total loans. In June 1998, the state recapitalized IRB, the third-largest bank, which was put under state receivership at the end of 1997.

1 *This debt consists mostly of commercial sector borrowing (USD 9.6 billion).*

2 *Moody's had already downgraded Slovakia in March 1998.*

After the opposition won the parliamentary elections, a coalition agreement (between SDK, SDL, SMK and SOP) was signed, and the coalition took 93 out of 150 seats. The government presented its program to Parliament on November 19, 1998, and is aiming at breaking a trend of rising budget deficits in 1999. Fiscal prudence is expected to dampen economic growth, which should stabilize at between 4% and 5%. The government intends to deregulate energy and municipal services prices, which is likely to cause a one-time rise of inflation. Moreover, the government has slated the restructuring and privatization of banks with the participation of foreign investors. The tax burden on corporations is to be lowered.

2.5 Slovenia

Real GDP grew by 4.8% year on year in the first half of 1998, but started to lose momentum in the second quarter. Industrial production was up 4.8%, marking a revival, as it had crept up by only 1% in 1996 and 1997. In September, industrial output climbed 3.4% year on year. Employment in industry continued to decrease in the same period, which implied rapidly improving labor productivity after years of sluggish growth. The rise of real gross monthly wages was a moderate 1.2% year on year. The registered unemployment rate was 14.3% in September 1998, just a tiny bit lower than 14.4% in the same month of 1997, so economic growth did not alleviate unemployment. Measured by the ILO methodology, the jobless rate was 7.7% in May 1998, up from 7.1% in May 1997.[1])

The pace of disinflation has been slow since late 1995. After a surge in the first four months of 1998, mainly due to price liberalization, CPI inflation slowed considerably starting in May. In October 1998, the CPI was up 6.9% year on year, while the inflation rate in the twelve months to September was 8.2%. The target rate for 1998 is 8%. PPI inflation stood at 5.2% year on year in September 1998.

Slovenia has had a balanced current account since 1995. The 1998 trends do not indicate any change in this pattern. In the first three quarters of 1998, the current account posted a surplus of USD 73.6 million. This result reflected the reduction in the trade deficit over the same period of 1997 due to faster export growth (6.8%) than import growth (4.2%) in dollar terms in the first eight months of 1998.[2])

The central bank's foreign exchange reserves amounted to USD 3.9 billion in October 1998, up from USD 3.3 billion at the end of 1997. Net FDI inflows reached USD 136.5 million in the January to August 1998 period, a rather modest amount compared with USD 210 million in the corresponding period of 1997.[3])

Monetary policy remained unaltered in 1998. In 1997 the fiscal situation had deteriorated, as the consolidated budget deficit ran to 1.1% of GDP fol-

1 *The ILO does not treat part-timers or temporary employees as jobless persons. The ILO survey is conducted quarterly.*

2 *As of writing, an aggregate figure had become available for September, but a breakdown was available for the first eight months only.*

3 *Balance-of-payments figures.*

lowing a surplus of 0.3% in 1996. A small consolidated government deficit of 0.9% of GDP (SIT 29.3 billion) was planned in 1998. In the January through August 1998 period, the gap came to SIT 19.1 billion, so the deficit was under control. The 1999 budget draft envisages a deficit of 0.8% of GDP, only marginally changed from the 1998 plan. The 1999 draft budget assumes 4% GDP growth and an annual CPI inflation rate of 8%.

The Russian crisis had but a limited impact on the Slovenian economy. The country's policy of a balanced budget, a balanced current account and restrictions on capital account transactions,[1]) kept it from being vulnerable to a flight of foreign capital; its foreign exposure is modest. Debt instruments do not play a significant role in the financial system. The nominal exchange rate of the tolar remained stable. The stock exchange index dropped in tandem with world trends, but the capitalization of the Ljubljana stock exchange is a mere 15% of GDP, and foreigner participation is low. The share of exports to Russia was slightly above 3% in 1997, so the direct effects on the real economy will be limited. However, some industries, such as pharmaceuticals, depend heavily on the Russian market and are therefore adversely affected. Given that Slovenia is a small open economy, Slovenia's growth would suffer from a slowdown of growth across Europe.

No important structural reforms have been implemented recently. The introduction of the VAT and pension reforms have been delayed. The pace of bank restructuring and privatization is glacial; two state-owned banks hold more than 50% of assets. The privatization of state enterprises is at the starting stage. So far, Slovenia has not yet implemented the often-announced changes required to bring the banking law in line with EU regulations.

Editorial close: November 25, 1998.

1 *E.g. interest-free deposits to be held in tolars for all non-trade-related loans with maturities of up to seven years.*

Studies

Contagion Effects of the Russian Financial Crisis on Central and Eastern Europe: The Case of Poland

Maciej Krzak[1])

1 Introduction

The purpose of this paper is to analyze the channels of contagion through which the Russian financial crisis affects Poland, used here as an example of a Central European economy (CEE) in transition.

The financial turmoil in Russia exerted a global impact even though Russia is a relatively small economy; its nominal GDP at current exchange rates was estimated at USD 449.8 billion in 1997, i.e. less than Spain's. The Russian crisis affected countries with strong trade links with Russia such as other CIS members, countries with looser links such as the CEEs, but also countries with hardly any links to Russia such as Brazil, a seemingly puzzling pattern. Furthermore, the moratorium on payments on Russian domestic debt to commercial institutions sent jitters to financial markets in developed economies. Obviously, channels of contagion other than the trade channel were at work.

The common wisdom is that CEEs are vulnerable to the fallout of the Russian crisis because of their relatively close ties with Russia. This paper attempts to cast some light on the potential magnitude of the impact by using Poland as an example. The major flaw of this analysis is that much of it is by nature speculative, since the crisis is not over yet. It is still too early to judge whether the impact of the Russian crisis is only temporary or whether it might have medium-term repercussions, but this is not an issue this paper aspires to tackle.

The paper is structured as follows. Section 2 discusses the contagion channels in general. Section 3 applies the methodology of section 2 to the case of Poland. The final section contains the summary and conclusions.

2 Contagion Channels

There are three main channels of transmission of one country's troubles to another: foreign trade, commodity prices and the financial channel.

The Trade Channel

The most obvious channel of contagion is trade. Countries lose competitiveness when their trading partners devalue. The sale by another country of products similar to those of a crisis country on world export markets can be a factor in the transmission of crisis, because a devaluation in a crisis country tends to depress competitors' exports. This, in turn, has a negative impact on the trade balance, and the awareness that such a deterioration may encourage a competitive devaluation by a country to which the trouble has spread may lead to massive withdrawals by investors in the forefront, which in turn leads to a depreciation of the currency involved. This explains why countries which trade and compete with the countries targeted by speculative attacks are themselves more likely to be attacked.[2])

1 *Foreign Research Division of the OeNB and The Vienna Institute for International Economic Studies. The standard disclaimer applies.* *I gratefully acknowledge the valuable comments of Olga Radzyner.*

2 *See Glick and Rose (1998). They find evidence that currency crises spread along the lines of trade linkages, ceteris paribus. See also Krugman (1998).*

The impact of the Russian crisis on the CEEs, however, is different. The collapse of the ruble makes imports expensive for Russians, which is of course compounded by the payment disruptions in the wake of the breakup of the banking system. A relatively important export market for CEEs simply vanished almost overnight, which entails an asymmetric demand shock for their economies, so their trade balances will tend to deteriorate (an exogenous drop in exports). Central European economies rapidly slashed Russia's share of their exports over the transition period as they successfully reoriented their trade towards the West, but it is still significant enough in a number of CEEs to affect the economic growth rate. In general, the former Soviet Union (FSU) countries are substantially more closely linked to Russia in terms of exports than other Central and Eastern European economies. Among the economies exhibited in Table 1 (countries with Europe Agreements), the Baltic states still have the tightest trade links with Russia despite enormous efforts to geographically diversify their foreign trade. The next economy is Poland, trailed by Bulgaria, but at around 8% each, the shares of exports to Russia are significantly lower than in the case of the Baltics.

Table 1

Selected Transition Economies:

Share of Exports to Russia in 1997

	Exports in percent of total exports
Bulgaria	8.0
Czech Republic	3.4
Estonia	18.7
Hungary	5.1
Latvia	21.0
Lithuania	24.5
Poland	8.4
Romania	3.0
Slovakia	3.7
Slovenia	3.9

Source: The Vienna Institute for International Economic Studies (WIIW), based on national statistics.

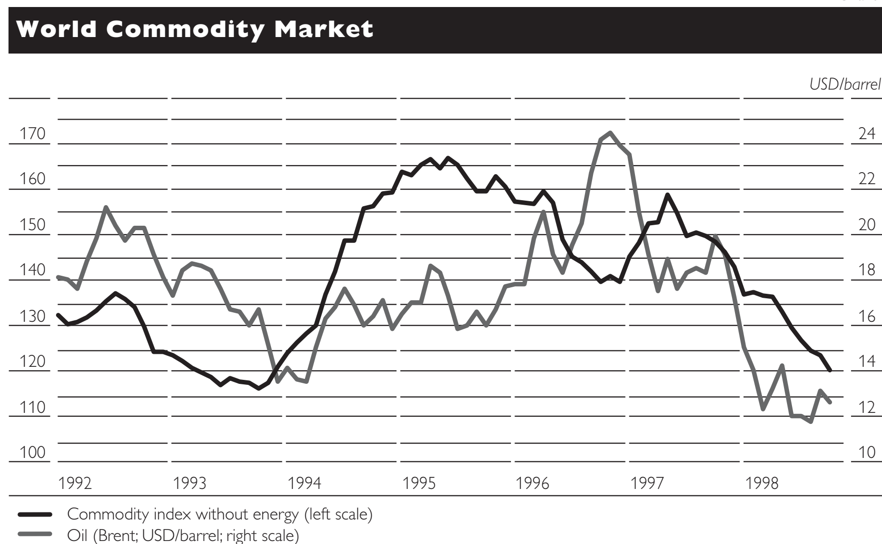
Therefore the macroeconomic impact of the collapse of exports to Russia on the countries displayed in Table 1 should be limited, with the exception of the Baltic states. However, this does not mean that specific sectors or regions in individual CEEs might not be seriously affected by declining Russian imports.

The Commodity Price Channel

Another channel through which problems spread from one country to another is commodity prices. World commodity price indices have been downtrending since the Asian crisis broke out (see Chart 1). The collapse of crude oil prices may be the most spectacular example: An oil glut occurred during a fall in world demand induced by the collapse of Southeast Asian economies. Through this channel, the Asian crisis could spread to economies as different as Russia and Chile. Their problems exhibit a link: Chile loses revenue due to a fall of the price of copper while Russia loses revenue due to the collapse of crude oil prices. Crude oil is Russia's most important single export item; the share of mineral products in total export

Chart 1

World Commodity Market



revenue was around 46% in 1997.[1]) All main producers of commodities, not only oil producers, like Australia, Canada, New Zealand and Latin American countries, are affected.

This transmission link is rather irrelevant for the CEEs mentioned in this paper, as they tend to be strong importers of raw materials. However, Kazakhstan, a major oil exporter, has been severely affected. Kazakhstan revised its growth projection downward, its budget position deteriorated, and its trade gap widened.

The Financial Channel

The first two channels directly affect the real economy. The third channel through which the emerging markets are linked is financial. The effect works through the increase in financial investors' risk aversion. The same risk class implies similar fundamentals and other common features, such as the depth of financial markets, their structure and the level of instrument sophistication. Above all, fundamental variables such as real exchange rates, current account deficits, external debt ratios and other financial and currency crisis indicators, such as the level of international reserves and the state of the banking system, are compared.[2]) Losses in Southeast Asia and later in Russia prompted a general shift out of emerging market assets, because risks were reassessed. Pension funds, mutual funds and the like tend to have general limits for emerging countries which they consider more risky. By dint of this logic, Brazil and Russia are linked, as investors first scrutinize the fundamentals of different countries, and when they find similarities between a country in crisis and another country, they tend to exit as soon as they can.

1 *According to the latest data available, crude oil and oil products accounted for 30.5% of total exports in 1996.*

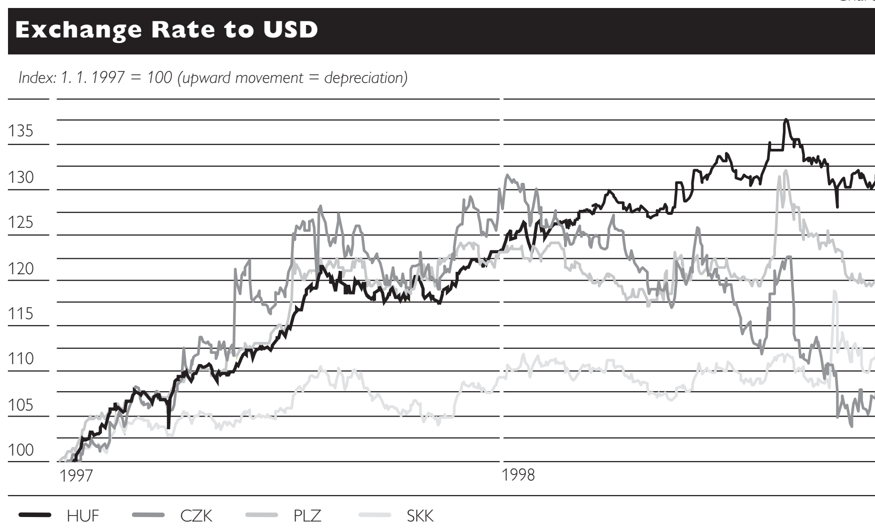
2 *See Sachs, Tornell and Velasco (1996) for a detailed description of the role of fundamentals in the spread of a currency crisis. References to that role are also made by Corsetti, Pesenti, Roubini and Tille (1998).*

The macroeconomic stabilization in the most advanced countries in transition, especially the resumption of growth and advances in structural reforms, in particular financial liberalization, encouraged flows of capital into these economies. This is why the CEEs are linked to world financial markets through their private creditors and investors. When financial market participants panic, the effects are visible. Financial markets in emerging economies are relatively illiquid and small, so sometimes even a single large foreign investor can upset the balance, and of course the effect is even greater when investors withdraw or enter en masse. The financial aspect of contagion involves losses on lending and other financial investments in emerging markets. These losses undermine the ability and willingness of banking institutions to take risks. Though Russia is a small economy in international terms, the crisis triggered shock waves when the government declared a debt moratorium because Russian assets represented a high proportion in financial funds' portfolios. For example, Russian securities accounted for over 14% of J.P. Morgan's EMBI (= emerging markets bond index).[1])

Furthermore, much of speculative investment was leveraged. Leverage cuts both ways: Losses mount and lenders ask for an improvement of the quality of the collateral. When Russia defaulted on its foreign commercial debt, banks called for margin, forcing leveraged investment funds (such as hedge funds) to sell assets to raise cash. However, there were no bids for these assets, as banks' own positions were also adversely affected, which meant that the banks did not want to assume a greater risk. Since the Russian bond market was moribund, investors had to sell other bonds, such as Latin American, Eastern European and American junk or even European corporate bonds, which substantially raised yields in a short period. Everybody rushed to liquidate positions, all at the same time (although they had been built up gradually over time), which drained liquidity off these markets, as only one side acted on the market. Furthermore, credit lines to some banks have also

Chart 2

Exchange Rate to USD



1 *See The Economist, October 31, 1998, p. 48.*

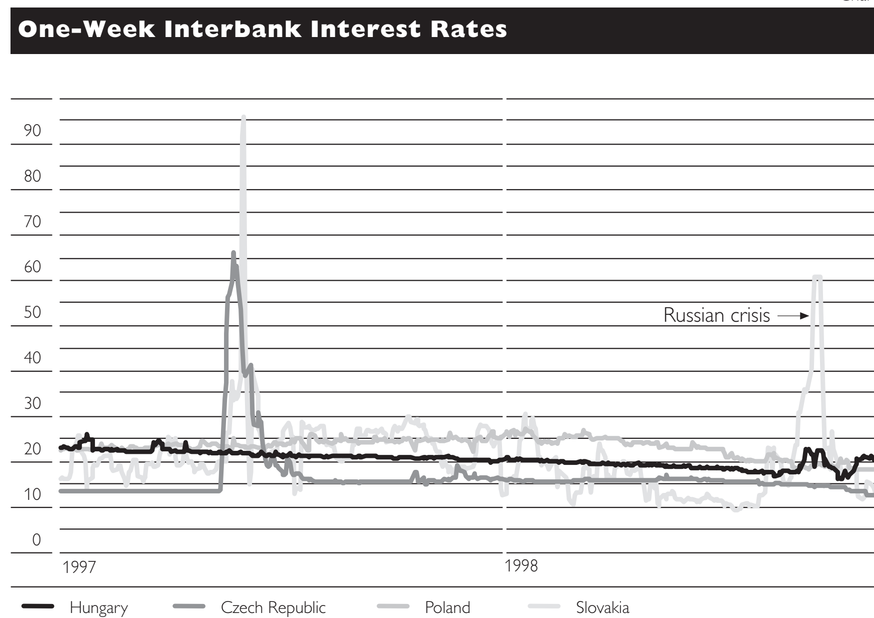
been reduced as rumors persisted that these banks could incur heavy losses or even fail due to their exposure to the emerging markets. The panicky withdrawal from emerging markets took its toll on the CEEs' financial markets.[1])

The CEEs' exchange rates temporarily depreciated rapidly (see Chart 2) in the aftermath of the suspension of the GKO market in Russia. The forint hit the bottom of its fluctuation band, prompting central bank intervention, and recovered from its low only in November. The Slovak koruna, which was trading far below its parity rate even before the crisis, came under additional pressure. On October 1, 1998, the central bank gave up the fixed exchange rate system and replaced it with a floating rate regime. This shift caused a temporary depreciation by around 10% of the koruna to the dollar. The switch in the exchange rate system cannot be traced solely to the fallout of the Russian crisis, which may have rather only accelerated the course of events as a result of Slovakia's deteriorating external position. The defeat of the ruling coalition, whose leader had followed the fixed-rate regime, in the parliamentary elections in September 1998 has certainly been a factor as well.

The Polish and Czech central banks did not react to defend domestic currencies by raising interest rates. Slovakia's interbank interest rates went up considerably during the crisis (see Chart 3), but this rise was only temporary. Hungary hiked its repo rate by 1 percentage point only and announced a reduction in the monthly crawling peg rate by 0.1 percentage point to 0.7% effective October 1. Altogether, these were rather modest measures to stabilize the domestic currency. In October 1998, the course to reduce interest rates was resumed. Unlike the Hungarian and Slovak central banks, the Polish central bank did not intervene on the foreign exchange market.

Chart 3

One-Week Interbank Interest Rates



1 *See also Annex 3.1 in EBRD (1998).*

The Russian crisis hit stock markets (see Chart 4) in much the same way the Southeast Asian crisis in 1997 had rippled around the world. The Budapest stock market was the most severely affected of the CEEs' stock exchanges because of the strong participation of foreigners.

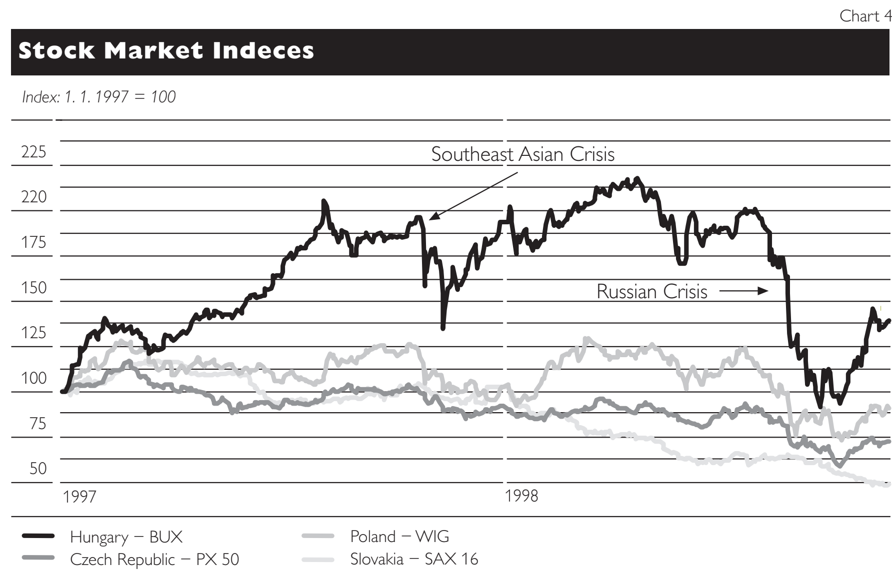


Chart 4

Stock Market Indeces

The immediate impact of the Russian crisis on the CEEs' financial markets proved to be rather temporary, as the expectations of a global financial crisis eased. Its impact on the real economy of these countries has yet to come. The overall effect is likely to extend to GDP growth, current account balances, capital inflows and budget deficits. Holding all else equal, GDP growth and subsequently unemployment will be adversely affected via a collapse of exports to Russia and to other CIS countries, such as Belarus or Ukraine. The collapse of exports will in turn tend to worsen the trade balance and the current account deficit. This may lead to a drop in foreign exchange reserves. A possible decline of capital inflows would in tendency lead to a diminished potential for a smooth financing of current account deficits, which would affect the growth of foreign exchange reserves adversely. Privatization receipts can also decline because of the weaker participation of foreign capital. The drop of privatization receipts below plan could in turn tend to exert pressure on financing the state budget, whose revenue side will also suffer from the lower GDP growth (tax collection). The current account worsening, along with lower net capital inflows, will tend to weaken the exchange rate of domestic currencies, whose depreciation may induce inflationary tendencies if it persists.

3 The Case of Poland

The potential impact of the Russian crisis on Poland will be detailed in this section on the basis of the structure presented in section 2. The analysis starts with the financial effects, as they were immediately visible, to proceed to the effects on the real economy. Some of the material, above all on the real econ-

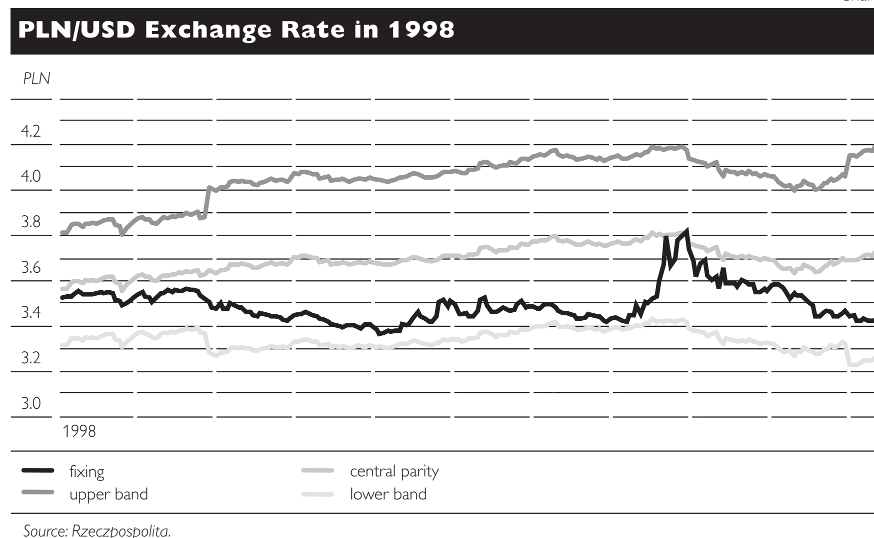
omy, is based on anecdotal evidence, without which, however, the presentation of the crisis impact would have to be put off until the end of 1999 at the earliest. The facts should be interpreted with a degree of caution, because it is premature to make a judgment on the impact of the Russian crisis, as it is only starting to be felt in the real economy.

The immediate fallout of the crisis was a rapid weakening of the zloty (see Chart 5). The collapse of the stock exchange index followed as nonresidents unloaded their portfolios (see Chart 4). According to estimates, foreigners owned about 30% of the capital on the Warsaw stock exchange. Nonresidents unwound their long positions in other Polish securities as well, but the rise in yields was small and short-lived.

The exchange rate of the domestic currency was hit only temporarily, as the chart illustrates. The basket of five currencies to which the zloty is pegged gained almost 9% against the zloty in the aftermath of the crisis. The central bank did not intervene during the zloty slide, which stopped once the currency had reached the weaker half of the fluctuation band. The central bank had ample foreign exchange reserves: They stood at USD 26.1 billion at the end of August 1998, so their shortage was not the reason the central bank held back. The National Bank of Poland (NBP) did not intervene to countervail the sellout of the domestic currency during the "black week" because it considered the domestic currency depreciation beneficial.[1]) First, this depreciation allowed the NBP to continue a policy of high real interest rates in order to pursue disinflation (at that time, the minimum repo rate was 19% and the lombard rate came to 24%, while CPI inflation was running at 11.9% year on year in July and dropped further in August). Second, this depreciation introduced much more uncertainty into the expected course of the zloty exchange rate, which had been a one-way bet for months; the increased volatility could deter the inflow of foreign speculative capital. Third, the depreciation offered a breathing space for

Chart 5

PLN/USD Exchange Rate in 1998



Source: Rzeczpospolita.

1 *See for example comments by Cezary Jozefiak, member of the Monetary Policy Council, and Ryszard Kokoszczynski, deputy governor of the NBP in late August 1998. Source: RBB.*

the NBP because the zloty exchange rate had been close to the stronger end of its band and the NBP had had to conduct costly sterilizing operations to arrest the zloty appreciation during the first seven months of 1998. The cost of these operations is reflected in the below-schedule contribution of central bank profits to the state budget (during the first seven months, the central bank paid 44.4% of the determined amount). The NBP's foreign currency reserves did not drop either in August or in September 1998; in fact, they even augmented slightly.

In September and October the zloty bounced back, eliminating all the previous losses against the basket. This confirmed the pattern of events from the recent past; the Czech crisis in May 1997, floods in July 1997, the Hong Kong stock exchange collapse in late October 1998, the first wave of the Russian crisis at the end of May and in June 1998 all affected the zloty, but only transitorily. Polish fundamentals prevailed in all these events, and the depreciation was only temporary. After the Russian crisis, strong fundamentals in Poland were only part of the reason for its fleeting impact; in October and November 1998, other factors such as an improvement in investors' sentiment toward emerging markets should be accounted for as well. After deteriorating for weeks, the expectations of world growth improved somewhat, buoyed by the G-7 communiqué and the replenishment of IMF coffers, a rescue package for Brazil, further cuts in key interest rates in the U.S.A. and rounds of interest rate reductions in Europe related to the launch of monetary union. One-time factors such as the partial sale of Bank Przemyslowo-Handlowy (BPH) and Telecom TP boosted the zloty as well.

A currency crisis in Poland could occur only if domestic residents lost confidence in the currency or in the Polish banking system, and if they reacted by starting a run on zloty deposits to convert them into foreign exchange and/or by withdrawing their hard currency deposits from Polish commercial banks. This course of events looks improbable because Polish fundamentals are sound (inflation is falling, the budget deficit is moderate, the current account deficit is under control because it is financed by FDI inflows and backed by large foreign exchange reserves) and because the macroeconomic policy course is a conservative one: The central bank is committed to pushing disinflation, and the government has shown its commitment to fiscal prudence.

Furthermore, the scope for speculation is limited by the fact that capital account convertibility is partial and short sales of zloty, e.g., are not allowed.[1]) Therefore foreign investors can only speculate by liquidating their zloty assets. While no reliable figures on these holdings are available, the figures in circulation (to which the central bank has not objected) tag liquid assets at USD 3 billion to USD 5 billion, which includes foreign currency swaps. The total could be as high as USD 9 billion, which is approximately a third of the NBP's foreign exchange reserves.

A number of indicators point to a low vulnerability of Poland to a financial or currency crisis. Poland is well cushioned against a sudden deterioration of the current account deficit by the central bank's high foreign exchange

1 *See the draft of the new foreign exchange law passed by the Sejm on November 19, 1998.*

reserves, which covered more than seven months of 1998 imports at the end of September. The ratio of gross foreign reserves to domestic broad money, an indicator of whether the central bank could sustain a run on the zloty by domestic residents, was about 50%, a favorable value. According to BIS data, short-term external debt amounted to less than 18% of these reserves at the end of 1997. The coverage of the current account deficit by net FDI inflows has been high in Poland and exceeded 100% in July 1998.[1]) Direct investment tends to stay in a host country even during financial turmoil.

The exchange rate and stock market were not the only channels through which the financial sector was affected. A number of Polish banks had business ties with Russia and made investments there. In a statement of the NBP, the total exposure of the Polish banking sector was given at about USD 150 million or 0.3% to 0.4% of banks' total assets.[2]) The affected banks (which accounted for some 31% of the banking system's assets of PLN 272.5 billion at the end of June 1998) have made provisions. These depressed their monthly profits in August and, in some cases, led to a downward revision of profit projections for the whole of 1998. The substantial revision in the case of Pekao is, however, also related to other bad credits.[3])

Table 2 below confirms the assertion that the reported losses or profit reductions have been limited, as the exposure to Russia was rather low. The provisioning should not dent banks' capital in a way that would have significant implications for their credit activities, with the exception of Pekao and BRE, which will probably have to replenish their capital. As of writing, there were no anecdotal reports about enterprises complaining about credit cuts. These banks could be indirectly affected if their borrower companies experienced financial stress due to the firms' exposure to Russia (exports) that would keep them from meeting their financial obligations. So far, no such cases have been reported. If the stock market tumbled, these banks' share portfolios might also have to be revalued, but the stock market has recapped most of the losses.

Table 2

Polish Banks' Exposure in Russia

Bank	Russian exposure	Provisions made	Exposure as a percentage of the bank's own funds[1])	Exposure as a percentage of the bank's assets[1])
	PLN million		*in %*	
Bank Handlowy	192.0	101.8	7.5	1.1
Bank Przemyslowo-Handlowy	40.0	20.0	2.9	0.4
Pekao	202.7	81.8	13.2	0.7
Bank Rozwoju Eksportu	188.0	108.0	20.8	2.2
Kredyt Bank PBI[2])	27.9	14.5	4.1	<0.3

Source: RBB, Rzeczpospolita, own calculations.
[1]) Capital and assets of banks as of June 30, 1998. Source: Gazeta Bankowa.
[2]) Kredyt Bank PBI reported USD 8 million, which were converted into PLN by the author.

1 *Twelve-month net FDI inflow related to twelve-month current account deficit. Source: NBP and own calculations.*

2 *See RBB, September 4, 1998.*

3 *See Kowalik (1998).*

Bank BIG BG was reported to have an exposure of less than PLN 10 million, a credit granted to a Russian entity. Other large Polish banks, such as Wielkopolski Bank Kredytowy and Powszechny Bank Kredytowy, reported no exposure to Russia.

Summarizing the influence of the financial channel of contagion, one could claim that the reassessment of Polish risk had limited implications, which, moreover, were mostly temporary and due to a general spreading of uncertainty.

Poland is vulnerable to the ripple effects of the Russian financial breakdown mainly through the trade channel. Poland's export exposure to Russia and the FSU was 8.4% (USD 2.2 billion) and 17.4% (USD 4.5 billion) of total exports in 1997, respectively. This is why the collapse of exports to Russia will impact Polish growth adversely. The GDP share of registered exports to Russia is about 1.6%, but the total is in fact larger because of unregistered trade with Russia (so-called cross-border shuttle trade or shadow trade), which is captured under the unclassified inflows in the balance-of-payments statistics. There are no reliable estimates of the Russian share of this surplus, but it is significant.

The collapse of exports to Russia and possibly other CIS countries is illustrated by a sudden worsening of the Polish current account deficit in September 1998. In the January to August 1998 period, the current account gap amounted to USD 2.4 billion, which was considerably lower than the USD 3.1 billion in the corresponding period of 1997: The deficit was estimated at less than 3% of GDP in the first half of 1998, bringing it below the 3.2% of GDP reported for 1997. The rate of export growth (20.7%) exceeded the rate of import growth (15.7%) in January to August 1998. The surplus of net unclassified inflows from January through August 1998, which are believed to encompass unofficial cross-border trade, exceeded the surplus in the same period of 1997. However, exports in September 1998 fell short of exports in the same month of 1997, while imports continued to expand at their trend rate of 1998. The result was a sudden increase in the trade deficit. The average monthly deficit in the first eight months of 1998 was USD 959 million, while the September gap alone reached USD 1,533 million. Unclassified flows posted a lower surplus than in September 1997: USD 438 million versus USD 583 million, respectively. The monthly current account deficit in September widened to USD 1,295 million compared with the average monthly current account shortfall of USD 302 million in the first eight months.

Caution is required when interpreting these data. The fall of the zloty at the end of August definitely led to leads and lags in invoicing. Polish importers may have delayed imports in August when the zloty lost value and settled them in September, when it recuperated. Deliveries abroad were lower in September 1998 than the 1998 monthly average and lower than in September 1997 partly because exporters may have moved ahead invoicing of exports when the zloty was weak. In September, Poland also serviced its debts to the Paris Club. This is a seasonal occurrence once a quarter, but it widened the current account deficit by around USD 300 million. In light of the above developments, the August and September figures should be considered

jointly. In August, the current account recorded an unanticipated surplus. The analysis of both months shows that the deterioration of the external position was not as pronounced as in the separate analysis of the two months. The sudden worsening of exports can also be a result of the real appreciation of the zloty throughout 1998.

Exporting companies' problems are highlighted by anecdotal reports. The hardest-hit sectors are food, cosmetics, pharmaceuticals, furniture and construction. Between 42% and 43% of exports to Russia consist of foods; medicines and cleaning products account for an additional 17%.

Table 3

Shares of Selected Exports to the FSU in 1997 by Sectors[1])

	Percentage of total exports in the respective category
	in %
Food and live animals	45.8
Beverages and tobacco	36.6
Raw materials except for fuels	2.8
Mineral fuels, lubricants and related materials	1.7
Animal and vegetable oils, fats and waxes	58.8
Chemicals and related products	34.3
Manufactured goods classified chiefly by material	10.5
Machinery and transport equipment	9.4
Miscellaneous manufactured articles	15.5

Source: Central Statistical Office (Glowny Urzad Statystyczny).
[1]) This breakdown is not available just for Russia.

In the short term, the financial crisis is reducing exports to Russia, as exporters stopped delivering goods until payments for past deliveries are made. Some exporters will also request 100% prepayment in hard currencies. When money transfers ceased and the foreign exchange market collapsed, the Russian banking system was disrupted, which in turn meant that Russian companies ran out of hard currency. It takes time to elaborate barter techniques; reportedly, a rising number of Polish exporters have already developed them quite well.

The breakdown of Polish exports to the FSU shows (Table 3) that the price elasticity of FSU imports from Poland can be relatively low, as these deliveries consist mostly of food (meat) and other agricultural products. The exports of chemicals from Poland consist mostly of pharmaceuticals and cosmetics. These products are price-competitive with products from other countries.

Moreover, trade disruptions could potentially arise on the import side of the Polish trade balance: In theory, Russian exports might be disrupted by Russian producers' difficulties, which, e.g., might consist in the inability to pay for component imports because of the devalued ruble or in the lack of commercial credit due to the breakdown of the payments system. In 1997, over 64% of Poland's imports of "mineral fuels, lubricants and other related materials" came from the FSU; crude oil and natural gas accounted for most of these imports. A disruption seems improbable, as Russia's most important exports are natural gas and crude oil, so Russia will try to step up deliveries

abroad in order to export its troubles away.[1]) Thus, Poland will not be affected from the import side unless the Russian economy in fact implodes.

The actual collapse of trade with Russia, potentially continuing into 1999, and the impact of the crisis on the global economic environment led to diminished GDP growth expectations for Poland in 1999. The government revised the macroeconomic assumptions of the state budget and subsequently the budget draft to incorporate the new growth projection. Instead of an original 6.1% in 1999, the government pencilled in a 5.1% GDP growth rate.[2]) As the government did not revise the projected budget deficit ratio to GDP upward (2.15% of GDP), a smaller nominal deficit will, de facto, imply a tougher budget. The NBP projects a 5.4% GDP growth rate in 1999, but independent institutions are more pessimistic than the government and anticipate between 4% and 5% GDP growth in 1999.[3])

An exercise based on a simple Keynesian model can cast some light on the size of the impact on Polish GDP growth of the hypothetical collapse of exports to Russia. Let us suppose that Russian imports from Poland will fall by either 20% or 40% in 1999. Assume in addition that all other CIS economies cut imports in the same manner; this is probably an overstatement to provide insight into a theoretical worst case. Then assume that the multiplier effect of the export loss on Polish GDP is two; this assumption is based on the analysis of national accounts and the rate of export growth relative to GDP growth in 1992 to 1997. Finally, the GDP share of total exports is 19% in Poland. Holding all else equal, the calculations yield the results summarized in Table 4.

Table 4

Direct Trade Impact of the Russian Crisis on GDP Growth in Poland

	in %	
Drop in Poland's exports to the CIS	**20**	**40**
Share of exports to the CIS	17	17
Percentage loss of total exports	3.4	6.8
Percentage reduction of Poland's GDP growth rate	1.4	2.8
GDP growth rate before the loss	6.1	6.1
GDP growth rate after the loss	4.7	3.3

Some explanatory remarks are necessary. In this exercise:

- the assumed elasticity of two is rather high; Poland mainly exports goods with low demand elasticity, such as food (43% of exports to Russia) and medicines. A depression in Russia and Ukraine may affect goods at the lower end; impoverished economies may raise their demand for cheap staples from low-cost producers, e.g. in Central Europe, which would cushion the export decline;
- a rising portion of trade can be bartered over time, as firms will start working out strategies to overcome the crisis, which, again, will help cushion the decrease in exports;

1 *Russia may, however, be close to current capacity limits.*

2 *See Rzeczpospolita of October 30, 1998.*

3 *See Rzeczpospolita of October 13, 1998.*

- in the event that it persists, a lower zloty value could become an offsetting factor, as, ceteris paribus, it will tend to boost Polish exports to other markets. If the Polish current account deficit exhibits a tendency to worsen, an adverse effect on the zloty's strength cannot be ruled out;
- on the other hand, cross-border trade is disregarded in this exercise. The surplus in cross-border trade may diminish substantially because of the devaluation of the ruble. Furthermore, in a deep and prolonged crisis the negative income effect may induce Russians to increase their consumption of Polish staples (the phenomenon of inferior goods). Despite these countertendencies, the overall effect most probably will be negative and will tend to exacerbate the current account deficit. According to anecdotal evidence, cross-border trade is depressed for the time being.[1])

This model disregards the so-called indirect effects of the Russian crisis. The direct effects have already been discussed. The indirect impact lurks in the background as a slowdown of growth in the OECD economies, in particular in the EU. The CEEs were able to diversify their trade away from Russia, and the bulk of their trade is conducted with the EU nowadays. Thus, a slowdown of growth in the EU will certainly imply tougher export conditions for CEEs. The 1999 growth projections by international institutions have been revised downward (see Table 5) due to the prolonged recession in Southeast Asia and Japan and the overall uncertainty the Russian crisis triggered on international financial markets. The IMF revised its world growth forecast to 2.5% from 3.7%. The European Commission cut its expectations for 1999 EU growth by half a percentage point in the autumn of 1998. These downward revisions are substantial; however, the EU, the largest trade partner of most CEEs, is still supposed to grow more in 1999 than it did in 1996, when it had expanded by 1.8%. No one would claim that 1996 was a year of economic breakdown in the CEEs. Therefore, were these projections to come true, the detrimental effects to CEE growth would remain within limits. The effects on the CEEs are hard to quantify; the uncertainty of any short-term predictions has become substantial recently because of the rapid changes, mostly for the worse, in the economic environment. This can be particularly devious in the case of expected growth, which tends to be a self-fulfilling prophecy. In the case of Poland, the possible reduction of the GDP growth rate in Germany is the most relevant because of the high share

Table 5

Regional Growth Forecasts for 1999

	World	U.S.A.	EU	Germany
	in %			
International Monetary Fund, Oct. 1998	2.5	2.0	2.5	2.5
European Commission, Nov. 1998	2.7	2.1	2.4	2.2
OECD, Dec. 1998	n.a.	1.5	2.4	2.2

Source: listed institutions.
n.a.: not available.

1 *It takes less than an hour to cross the border with Belarus now compared to about 24 hours before the outbreak of the crisis.*

of exports to Germany in total exports (32.9% in 1997). The five leading German economic research institutes tagged GDP growth at 2.0% for 1999 in their joint annual report in November 1998, down from 2.3% given in their previous report.[1])

The transmission of the Russian financial turmoil potentially extends to privatization and foreign direct investment as well. The exodus of foreign investors from securities issued in emerging markets can imply their diminished interest in the upcoming privatization of Polish state assets. This may indicate either scaled-down plans or lower revenue from planned selloffs, as the government will have to cut prices to attract investors. A test of the difficulties which may be in store is the privatization of the Polish telecommunications monopoly TP SA, which took place in fall. Originally, the market assessed the firm's value at USD 8 billion to USD 10 billion. The turbulence on world stock exchanges spilled over to Poland, also impacting the evaluation of the company. The government chose an IPO price that gave the value of the firm in the range between USD 5.5 billion and USD 7.2 billion; the actual price which was fixed during a special stock exchange session translated into the value of USD 6.2 billion. The interest of individual investors and foreign institutional investors was strong, as the sale coincided with the rebound of stock exchanges all over the world, but the government decided not to increase its tranche and to sell only 15%, although it would have been possible to sell 25% of the stock.[2])

In 1999, the government plans on PLN 15 billion of privatization revenues, PLN 6.9 billion of which are earmarked for financing the budget deficit. These plans look ambitious, especially given current market conditions and uncertainties. By way of comparison, the 1998 privatization plan envisaged revenue of PLN 6.7 billion.

In theory, investors' smaller appetite for emerging market risk may adversely affect inward FDI. According to a survey of foreign investors compiled by the Polish Agency for Foreign Investments, the entry to Poland is motivated by the large domestic market. Another incentive consists in Poland's prospects of entering the EU. Foreign investors' exports to the Russian markets are further down the list, so potential access to the Russian market is not a strong incentive to invest. If the survey is reliable, then inward FDI should not suffer, all other things being equal. It is more likely that the FDI inflow would be redirected if Polish growth slowed unexpectedly, but under current conditions, a rate of 5.1% in 1999 would still be a stellar performance in Europe and among emerging economies, considering that Asia is in recession and Latin America is still displaying worsening fundamentals. Industrial restructuring in Poland is going on despite the social tension it causes. Strong structural reforms – especially in the context of preparing for eventual EU membership – may encourage more inward FDI in the light of the improvement in investment conditions. So far, an outflow of short-term capital has not posed problems for financing the current account deficit in Poland, as net FDI inflows fully covered the shortfall in

1 *Source: Jahresgutachten des Sachverständigenrates, November 1998.*

2 *See Rzeczpospolita, November 9, 1998.*

the first eight months of 1998. A likely rise of the deficit in 1999 due to weaker exports to the FSU can either be counterbalanced by the growth of inward FDI or by a slight fall in foreign currency reserves remaining at comfortable levels.

4 Summary and Conclusions

This paper uses Poland as an example to describe the possible spread of the Russian crisis to a CEE. After weighing the evidence, it appears that the adverse impact on Poland's economy should be only limited. The trade and financial channels are relevant while the commodity price channel is not. Poland, and more generally most CEEs, did not raise interest rates to defend their currencies, as Brazil or Chile did during the Russian turmoil.[1]) The Polish central bank did not intervene to defend the exchange rate, as it found the weakening of the currency a windfall to cut the crawling peg rate and keep interest rates high without triggering an unwanted inflow of foreign portfolio investment.

The trade channel will probably have the most serious implications for Poland's economy. The likely severe contraction of exports to Russia in 1999, whether official or unofficial, led to diminished expectations of growth in the fourth quarter of 1998 and in 1999. In response, the macroeconomic assumptions of the state budget were revised. The uncertainties of growth prospects in the international economy have considerably increased the uncertainty of forecasts for Poland. Nevertheless, the fallout should be limited and is most likely to consist in somewhat slower growth, but not in a recession.

In conclusion, the following general observations should be reemphasized: The CEEs which display sound macroeconomic policies and low or falling inflation that allows them to weather the turmoil are relatively immune to the crisis despite their close links to Russia. Their current account positions must not be strained, because the crisis will lead to the deterioration of these positions. High foreign exchange reserves and low short-term external debt exposure are necessary safeguards against volatile outflows of short-term capital. The maximum sustainable current account gap in terms of GDP depends on the level of foreign currency reserves. In this context, high foreign debt and servicing it may pose problems, since a large devaluation of the domestic currency may be required to restore external equilibrium. Such a potential devaluation can cause the cost of servicing external debt to skyrocket, which could lead to systemic jitters in the banking sector due to its own loans or to the loans contracted by firms on the assumption of exchange rate fixity or an appreciation during the duration of the credit. On most of these counts, the arguments support the verdict that Poland will be able to contain the impact of the Russian crisis.

Editorial close: November 20, 1998.

1 *Hungary raised its repo rate by 1 percentage point, which was basically symbolic gesture.*

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The 1998 Reports of the European Commission on Progress by Candidate Countries from Central and Eastern Europe: The Second Qualifying Round

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1 Introduction

On November 4, 1998, the European Commission adopted and published, for the first time, "regular reports on progress towards accession by each of the candidate countries."[2]) These reports constitute another important step in the enlargement process of the European Union. According to the conclusions of the European Council in Luxembourg in December 1997, these regular reports, which will be released yearly, are to review the developments in the ten applicant countries from Central and Eastern Europe (ACs) from the adoption of the Opinions in July 1997, with a focus on assessing these countries' progress towards fulfilling the Copenhagen criteria for EU accession. While the Commission also prepared similar reports on Cyprus and Turkey, this study confines itself to the reports on the ten ACs as well as to the composite paper, which contains "a synthesis of the analysis in each of the regular reports as well as a series of recommendations."[3]) At the time of writing, the regular reports were being discussed by the Council. Based on the results of this discussion, the European Council in Vienna in December 1998 will take a position on the regular reports in general and on the Commission's recommendations in particular.

The main purpose of this study is to review and critically assess the 1998 regular reports from a central bank perspective.[4]) In doing so, we set out by examining the general structure and methodology of the reports (section 2). Subsequently, we look at some general macroeconomic issues (section 3). This is followed, in section 4, by an analysis of the Commission's accounts on monetary and exchange rate policies as well as on the ACs' (dis)inflation performance. Section 5 deals with Economic and Monetary Union issues. It sets out by discussing the integration path in this area and then moves on to scrutinizing the recent performance, with a specific focus on two areas, namely central bank independence and the liberalization of capital movements. After this in-depth discussion of specific issues of central bank interest, we broaden our focus and review the Commission's overall assessments on the ten candidate countries in economic matters as well as its main recommendations (section 6). The main conclusions of the study are summarized in section 7.

In order to set the stage for our analysis, we first put the 1998 regular reports into a broader context by swiftly reviewing major recent developments in the enlargement process. Since the Luxembourg Summit, a number of steps have been taken which have kept up the momentum of this process, some of them sending mainly political signals, others contributing more

1 Foreign Research Division of the Oesterreichische Nationalbank. The standard disclaimer applies. The authors gratefully acknowledge valuable comments by Thomas Wagner and Reinhard Petschnigg. This study was completed in early December 1998.

2 For simplification, these reports will in the following be referred to as the "regular reports" or the "reports."

3 See European Commission (1998 a). Most of the quotes in this study relate either to the composite paper or to the 1998 regular reports on individual candidate countries from Central and Eastern Europe. Quotes the context clearly shows as belonging to the composite paper or the individual country reports will, of course, be identified as such in the remainder of this study, but in such cases the source will not be stated again in a footnote.

4 We thus intend to perform a similar exercise as last year's exercise on the Opinions in Horváth et al. (1997).

substantively to the overall development. Both countries that have held the EU presidency this year – the United Kingdom in the first half of 1998 and Austria in the second – have given particular attention to the issue of enlargement. In fact, one of the main objectives and priorities of Austria's first-ever EU presidency is "to ensure that the integration of new partners into the Union makes headway and that it achieves the best possible results for both parties."[1])

On March 30, 1998, the accession process was officially launched with all ten ACs and Cyprus by a meeting of the foreign ministers of the Member States and the candidate countries. Earlier on the same day, the Council adopted the individual Accession Partnerships[2]) (APs) for each of the ten candidate countries from Central and Eastern Europe. Complementing the APs, the candidate countries drew up National Programmes for the Adoption of the *Acquis* (NPAA) setting out a timetable for achieving the priorities and objectives laid down in the APs. On March 31, 1998, the Council held bilateral intergovernmental conferences with the "first wave" candidates selected at the Luxembourg Summit, namely the Czech Republic, Estonia, Hungary, Poland, Slovenia (and Cyprus) to begin accession negotiations. The next step was the analytical examination of the *acquis communautaire,* often referred to as the "*acquis* screening," which was formally started with all the applicant countries from Central and Eastern Europe (and Cyprus) on April 3, 1998. This exercise is done differently for the two groups of candidates. Whereas the multilateral screening sessions for each chapter are rather short for the "first wave" countries and are immediately followed by bilateral sessions, the "second wave" countries (Bulgaria, Latvia, Lithuania, Romania and Slovakia) undergo a more comprehensive multilateral screening process, which will have to be concluded for all chapters before any bilateral *acquis* examination can be started. According to the composite paper, "the screening of 16 out of the total of 31 negotiating chapters was completed" for the "first wave" countries by the end of October, while the "second wave" countries will only start the bilateral screening process in the first quarter of 1999. On October 5, 1998, the Council decided to open substantive negotiations with the Czech Republic, Estonia, Hungary, Poland, Slovenia (and Cyprus) on the first seven chapters screened.[3]) On November 10, 1998, these negotiations were formally opened; this had, in fact, been one of the main operative goals of the Austrian EU presidency.

1 *See EU Presidency homepage, http://eu.presidency.gv.at.*

2 *The Accession Partnerships are the main instrument of the preaccession strategy. They contain priorities for the adoption of the acquis and lay out the assistance of the EU in support of these priorities. See European Commission (1998 a).*

3 *These seven chapters comprise those areas of the acquis communautaire which are presumably the least controversial in the accession negotiations between the EU and the ACs, namely Science and Research; Telecommunications and Information Technology; Education and Training; Culture and Audio-Visual Policy; Industrial Policy; Small and Medium-Sized Enterprises and Common Foreign and Security Policy. The opening of substantive negotiations had become possible because all applicant countries had submitted their position papers in time in September 1998 so that the Commission could produce Draft Common Positions for each of these chapters, and for each of the applicants. These common negotiating positions were adopted by the Council on October 5, 1998.*

2 General Remarks

The conclusions of the European Council in Luxembourg laid down that the regular reports will follow the same methodology as the Opinions, and this is restated in each of the regular reports as well as in the composite paper.[1]) In other words, the Commission assesses the candidate countries' progress towards accession in the light of the Copenhagen criteria. Consequently, the basic structure of the regular reports follows that of last year's Opinions. After an introduction (Part A), the core part of each regular report (Part B. Criteria for Membership) consists of four main sections, examining the political criteria (section B.1), the economic criteria (section B.2), the countries' ability to assume the obligations of membership (section B.3) and the administrative capacity to apply the *acquis* (section B.4). This is followed by the Conclusion (Part C) and by a Global Assessment of Implementation of the AP and the NPAA (Part D) which for obvious reasons does not have a matching counterpart in the Opinions. However, in contrast to the Opinions, the further breakdown of these chapters into subchapters is tangibly less deep in the regular reports, which in fact has a positive side effect: The problem of double coverage of certain issues and of occasional inconsistencies between certain subchapters, which was a weakness of the Opinions, is partly avoided in the regular reports.

In our view, the 1998 regular reports indeed follow, in principle, the same review and assessment method as the Opinions. However, one can also find certain differences. The Opinions basically embarked on a first stocktaking of the degree of fulfillment of the Copenhagen criteria by each applicant country. Consequently, the assessment and (implicit) ranking among the candidates was based on their preparedness to join the EU up to that point of time. The regular reports, in contrast, measure the progress achieved during the reference period, usually on the basis of the Opinions' assessments, and thus, for the first time, add a dynamic element to the analysis. As we will show in more detail in the review of central-bank relevant areas, the Commission's response to this altered setting is somewhat uneven. In some cases, the reports only give a final assessment of the progress achieved in the review period. In other cases, the reports also make an evaluation on the overall extent to which the candidates fulfill the conditions for membership at the time at which the reports were written. Finally, there are also some "intermediate" cases in which the reports use assessment formulations that are to indicate whether a country had already achieved a tangible degree of progress at the outset of the review period. In our view, it would be advantageous if future progress reports generally contained assessments both on the progress achieved in the review period and on the overall state of fulfillment of the Copenhagen criteria. Restricting assessments exclusively to recent developments would have drawbacks. Given the relative brevity of the review period, lauding applicants with a rapid pace of reforms and criticizing less ambitious candidates may distort perceptions if an assessment on the overall fulfillment of the membership criteria is lacking and the different starting

1 *See sections A.a) and B.2.1 of each of the ten regular reports as well as section I and section II.2 of the composite paper, respectively.*

points are not taken into account.[1]) This seems to be true, in particular, of comparisons among applicant countries, and especially with regard to judgments on the criterion that relates to the "ability to assume the obligations of Membership." Taking a more comprehensive approach to the assessment of meeting the Copenhagen criteria could also be justified on the grounds that the regular reports are an "update" of the Opinions,[2]) which of course contained a first evaluation of the overall fulfillment. It should also be noted that the conclusions of the European Council in Luxembourg in no way limit the Commission in this respect.

In the Composite Paper's review of the Commission's "definition of the Copenhagen criteria in the Opinions," it is stated that "[t]here is also an important time dimension, and the issue of track record, which was one of the factors considered in the Agenda 2000. In this context track-record means the irreversible, sustained and verifiable implementation of reforms and policies for a long enough period to allow for a permanent change in the expectations and behaviour of economic agents and for judging that achievements will be lasting." In the actual country assessments of the 1998 regular reports, the briefness of the track record period plays a major role in the cases of Latvia and Lithuania.[3]) If one revisits last year's Agenda 2000 on this matter,[4]) it turns out that sustained policy implementation and alignment with the *acquis* did play a tangible role for the judgments on the fulfillment of the criteria, but on the whole, the track record issue appears to have been somewhat less central to the assessments than in the 1998 regular reports. Moreover, the "track record" concept had been less precisely defined.

A further methodological issue is related to the exact review period of the 1998 regular reports. In the reports, it is indicated several times that the duration of the reference period is eighteen months,[5]) but when this timespan begins and, consequently, when it ends, remains open. On logical grounds, one would assume that the period starts June 1, 1997, i.e. the day after the cutoff date of last year's Opinions, namely May 31, 1997,[6]) to avoid

1 *This issue will become even more important from 1999 onwards, when the review period will be further reduced to twelve months. It should also be added that the shortness of the review period has other drawbacks as well. For example, a focus on just a short period makes it difficult to distinguish between temporary and more permanent slowdowns in the reform dynamics. While the former may be due to electoral cycles or unexpected, transient events, the latter may be associated with a general lack of political will to effect necessary changes.*

2 *See European Commmission (1998 a and 1997 l).*

3 *See the following statements in the composite paper (European Commission, 1998 a): "[I]n a number of areas, the implementation of economic policy and reforms [in Latvia and Lithuania] are too recent to allow the Commission to conclude today that they can already be considered as functioning market economies." On Latvia's activities in the areas of legal alignment and strengthening of administrative structures, the following is said: "Because much of the legislation has been recently adopted, it is too early to assess the efficacy with which it will be applied in some fields."*

4 *See Agenda 2000, Vol. 1, Part Two, Ch. I. (European Commission, 1997b) and the individual Opinions, sections B.2.2 (European Commission, 1997 d to 1997 m).*

5 *See e.g. section II.1 of the composite paper (European Commission, 1998 a): "… has been accomplished in the past eighteen months." Or see section II.2 of the composite paper (European Commission, 1998 a): "This first review, however, takes into account a year and half of extra observations."*

6 *See Agenda 2000, Vol. 1 (European Commission, 1997 b).*

any break in the observation period and to ensure continuity. However, if one added 18 months, this would yield November 30, 1998, as the cutoff date, which obviously would not make any sense. In order to discern the implicit cutoff date, we looked for the most recent developments covered in those sections of the reports we scrutinize in this study, and it turned out that these relate to events in early to mid-October 1998.[1]) It would be helpful, for the sake of transparency and clarity, if future progress reports defined the respective review period explicitly.

3 Macroeconomic Developments: Selected Issues

A short overview of the main lines of economic developments in the ACs during the review period is given in section II.2 of the composite paper. The individual country reports cover economic developments mainly in the respective sections B.2.2. These sections contain a record of macroeconomic developments since the Opinions, followed by a survey of the main achievements in the area of structural reforms by the applicants during the review period. This then constitutes the basis for the Commission's assessment on the economic criteria presented in section B.2.3 of each regular report.[2])

According to the composite paper, economic growth in most candidate countries continued to be high and "has not been significantly affected by the worsening international environment and the turmoil in the international financial markets." The engine of growth has been domestic demand (and fixed investment in particular), while the contribution of net exports has been "marginally negative." Unlike in the other ACs, real GDP growth has been negative in Romania and the Czech Republic which, according to the Commission, is due primarily to internal factors. Foreign direct investment in the ACs "has continued to increase, even if it is still [relatively] low," with the size of inflows being positively related to advances in privatization and structural reforms.

The catching-up process, measured in GDP per capita (at purchasing power parity) compared to the EU average, has gained further momentum. Unemployment has fallen in some ACs, disinflation has continued in most candidate countries, and fiscal accounts have generally been favorable. Due to the economic revival, all ACs have recorded negative trade balances and "in some countries (Estonia, Latvia, even Lithuania, Czech Republic, Poland and Slovakia) this deficit may be too large. The current account is also strongly negative in Estonia, Slovakia and Lithuania."

1 *The most recent developments covered are the flotation of the Slovak crown (October 1, 1998), the abolition of the Slovak import surcharge (October 1, 1998), the submission of an amendment to the Gaming Act by the Czech government to Parliament (October 1, 1998), the failure of two small Estonian banks on October 2 and 7, 1998, the implementation of an earlier decision of the Romanian government to impose an import surcharge as of October 10, 1998, the proposal of the Monetary Policy Council of the National Bank of Poland for streamlining, in the light of the introduction of the euro, the currency basket to which the zloty is pegged (October 13, 1998), and last but not least the accession of Latvia to the WTO on October 14, 1998. Moreover, the tables in sections B.2.2 of the regular reports include data on economic key indicators up to September 1998, which were released up to October 14, 1998, in the case of Bulgaria up to October 20, 1998.*

2 *These assessments are reviewed in conjunction with the main recommendations of the 1998 regular reports in section 6 of this paper.*

The composite paper concludes the review of recent economic developments with the assertion that the economic impact of the Russian crisis on the ACs "can be expected to remain limited at this stage," due to the successful trade reorientation towards the EU in recent years and, "more fundamental[ly due to] the [ACs'] perspective of EU accession," which "has had a noticeably favourable effect on market sentiment." Still, foreign financing has become more costly, especially for countries "that are perceived to have weak economic fundamentals." The individual country reports also deal with this issue, with the exception of the report on the Czech Republic. The other nine reports scrutinize, in this respect, the ACs' direct trade links with Russia and other CIS countries, "direct financial effects" (in particular the exposure of domestic banks to Russia) and implications for the ACs' access to international financial markets.

A closer look at the most central points the individual country reports make in their review of economic developments since the Opinions yields the following picture.

Bulgaria is lauded for the "considerable progress" it has made on macroeconomic stabilization, while structural reforms are found to have proceeded by and large at a satisfactory pace, but overall "[t]hey are still at a relatively early stage." Building on these achievements and renewing reform efforts (especially trade and price liberalization, privatization and an overhaul of public administration) will be crucial for further progress.

The report on the Czech Republic takes note of the "difficult" macroeconomic situation – in particular the fall in real GDP and the sharp rise of unemployment – and finds that prospects in this area "continue to look bleak." The recent fall in inflation and the "considerable narrowing" of external deficits are acknowledged. There has been "some progress" on structural reform measures but much more has to be done, first and foremost in the financial sector, "[o]ne of the key weaknesses" of the economy, in particular "with a view to improving the framework for corporate governance and accelerating enterprise restructuring."

The report on Estonia notes the country's extraordinarily fast growth in the review period. The country is lauded for disinflation and fiscal consolidation as well as for "remarkably high productivity growth." The authorities are commended for taking restrictive policy measures to contain risks associated with rapid financial sector development and continuously high external imbalances. On the 1997 current account, the report holds that "[m]ore than the level of the deficit," the "sharply increased weight of debt-creating inflows and portfolio investments" in its financing "has been a cause of concern." Structural reforms have continued. Future policies should concentrate on "further reducing external imbalances and inflation," on proceeding with price liberalization, and on improving regulations and supervision of the nonbank financial sector.

Hungary's economy "has performed better than envisaged in the reference macroeconomic framework outlined in the first 'Joint Assessment of Hungary's Medium-Term Economic Policy Priorities'" prepared by Hungary and the Commission in mid-1997, and "prospects have continued to improve." Contrary to earlier economic upswings, accelerating growth has

not increased external imbalances, "largely due to substantial [FDI-driven] modernisation of some productive sectors." Inflation has fallen substantially this year. Structural reforms have continued on many fronts, with the delayed tackling of the Postabank malaise and insufficient action in the health sector being the only greater points of criticism. In the future, the focus should be on improving "the implementation and enforcement of the legal framework" (especially in the areas of regulated monopolies and financial markets), on health reform and on a further strengthening of macroeconomic stability.

Latvia's macroeconomic situation is found to have "improved considerably," growth has accelerated, the fiscal position has been consolidated and disinflation has continued. "One point of concern ... is the size of the current account deficit" although it "is mostly covered by increased [FDI] inflows." Economic reforms have made steady progress in many areas, "[h]owever many important reforms are in progress, or have only recently started to be implemented, which makes it difficult to give an overall assessment of the effectiveness of the reforms and of the institutions that have been created." Priority should be given to "filling the remaining gaps in the regulatory and supervisory framework, especially in the financial sector," to simplifying the legal environment for enterprises and to maintaining macroeconomic stability, including a reduction of external imbalances.

In Lithuania, macroeconomic stability has improved and structural reforms have advanced. The current account "is deteriorating," but is increasingly being financed by FDI inflows, which are attracted by the country's "enhanced economic environment." Still, "the main risk on the macroeconomic side is that, at some point in the future, it may become difficult to finance the high and rising current account deficit." The main future challenges are to complete the reform program, to implement and enforce the legislation properly (with particular attention to bankruptcy rules) and to preserve macroeconomic stability, "notably by ensuring the sustainability of the external accounts."

Poland "has strengthened its macroeconomic stability." Growth has remained buoyant, unemployment has been reduced, "export performance has improved to the extent that the widening of the trade and current account deficits could be curbed in the next few years," inflation has fallen, and the budget deficit has been lowered. The country has "embarked upon a wide-ranging and broadly coherent set of further reforms." Future policies should continue to focus on implementation of reforms, especially further privatization and sectoral reforms. Public finance implications of reforms should be monitored closely. In addition, further financial sector development and improved SME access to financial markets are perceived to be priorities.

Romania's economic performance has "deteriorated" and the situation has become "very serious." Economic activity has taken a sharp downturn. Macroeconomic policies have been tight but are increasingly undermined by the "paralysis" of most structural reforms. External accounts have deteriorated and are a cause of "serious concern." The productive basis of the economy has shown a "fundamental weakness." Financial discipline and corporate governance have continued to be low, pressures for state intervention are increasing, and the financial sector has become even more fragile. The Commission concludes that the authorities "must give absolute and urgent

priority to restoring macroeconomic stability" and implementing a comprehensive set of structural reforms in a coherent manner.

In Slovakia, the overall economic situation has worsened despite ongoing high growth, as the country's fiscal position has "deteriorated significantly, external deficits [have] remained unsustainably high, and both inflation and unemployment [have] increased." The report identifies two core economic policy problems, namely insufficient coordination between monetary and fiscal policies and too-slow economic restructuring. Privatization and enter-

Table

Main Economic Indicators and Trends

		Real GDP growth rate	Inflation	Unemployment (ILO definition)	General government budget balance	Current account balance	Gross foreign debt
		in percent			*in percent of GDP*		
Bulgaria	1997	− 6.9	578 Dec.-on-Dec.	15.0	−2.6	4.1	96
	1998 latest	11.9 Jan.–June	5.5 Sept.-on-Sept.	n.a.	n.a.	n.a.	n.a.
Czech Republic	1997	1.0	10.0 Dec.-on-Dec.	4.7	−2.2	− 6.1	41
	1998 latest	− 1.7 Jan.–June	8.8 Sept.-on-Sept.	5.9 March	n.a.	− 1.9 Jan.–June	n.a.
Estonia	1997	11.4	12.5 Dec.-on-Dec.	10.5	2.1	−12.0	44
	1998 latest	7.3 Jan.-June	8.9 Sept.-on-Sept.	n.a.	n.a.	n.a.	n.a.
Hungary	1997	4.4	18.3 Dec.-on-Dec.	8.1	−4.6	− 2.2	n.a.
	1998 latest	"close to 5" Jan.–June	13.5 Aug.-on-Aug.	n.a.	n.a.	n.a.	n.a.
Latvia	1997	6.5	7.0 Dec.-on-Dec.	14.4	1.8	− 6.3	17
	1998 latest	6.4 Jan.–June	3.5 Sept.-on-Sept.	n.a.	n.a.	− 7.1 Jan.–June	n.a.
Lithuania	1997	5.7	8.4 Dec.-on-Dec.	14.1	−0.5	−10.3	15
	1998 latest	7.3 Jan.-June	3.6 Sept.-on-Sept.	n.a.	n.a.	n.a.	n.a.
Poland	1997	6.9	13.2 Dec.-on-Dec.	11.2	−3.1	− 3.2	28
	1998 latest	5.9 Jan.–June	11.1 Aug.-on-Aug.	n.a.	n.a.	n.a.	n.a.
Romania	1997	− 6.6	151.4 Dec.-on-Dec.	6.0	−3.6	− 6.7	27
	1998 latest	− 5.2 Jan.–June	50.8 Sept.-on-Sept.	n.a.	n.a.	n.a.	n.a.
Slovakia	1997	6.5	6.4 Dec.-on-Dec.	11.6	"N A"	− 6.9	51
	1998 latest	6.1 Jan.–June	5.9 Sept.-on-Sept.	12.1 Jan.–March	n.a.	−10.9 Jan.–June	n.a.
Slovenia	1997	3.8	8.8 Dec.-on-Dec.	7.1	−1.1	0.2	23
	1998 latest	4.8 Jan.–June	7.1 Sept.–Sept.	7.7 July	n.a.	n.a.	n.a.

Source: European Commission (1998b to k). The figures are taken from the tables on "Main economic trends" and "Main indicators of economic structure" contained in sections B.2.2 of the ten country reports, with one exception: The report on Hungary does not contain such tables, the data displayed above are therefore directly taken from the text of the report (section B.2.2) and from the statistical data annex of the report. The "Main economic trends" table in the report on Slovakia does not include general government deficit figures ("N A"), while the text itself indicates that the deficit is estimated to have reached about 5% of GDP in 1997, adding that it may have been even higher than that.

prise rehabilitation have often lacked transparency and, more generally, "the government still exerts considerable influence over the economy." Problems in the financial sector are substantial and "are damaging overall economic efficiency." The policy priorities that flow from this diagnosis are macroeconomic stabilization, banking sector reform and enterprise restructuring, based on transparent and market-based measures.

In Slovenia, macroeconomic stabilization has remained "well established." Growth has picked up, the fiscal stance "appears to be under control" despite a slight deterioration, and wage growth has slowed considerably. The implementation of reforms has often been "too slow," as "[o]n the whole, the relatively favourable starting position of the Slovene economy has continued to hold back the sense of urgency for structural reforms." Still, there has been some progress with privatization and "significant advances" on the liberalization and adjustment of administered prices. In the near future, the focus should be on "the determined and faster implementation" of planned reforms and on additional measures to improve the functioning of market mechanisms and to reduce state intervention, moreover on ensuring macroeconomic stability (in particular with regard to the evolution of the fiscal accounts).

In our view, the sections covering the macroeconomic developments since July 1997 are very well done. The accounts are thoughtfully and properly structured, perhaps with a single qualification. The sections on economic developments of nine of the ten country reports contain tables on "Main economic trends" and "Main indicators of economic structure" which give a concise overview of recent developments of the most relevant economic data. However, the English version of the report on Hungary does not contain such tables, which creates a certain unevenness.

The sections under review here provide a concise overview on key economic developments. Generally, all relevant policy measures and outcomes are covered; only in very few cases are bits of pertinent information missing (e.g. in the case of Hungary, the new venture capital law and the new Companies Act, both of which became effective in June 1998, could have been mentioned). In principle, factual developments are depicted correctly.[1]) The data quality is high, and the data presentation is largely consistent.[2])

1 *There are only very few and minor imprecisions, and they have no impact on the assessment. To give only a few examples, in the report on Bulgaria, the duration of the standby arrangement concluded with the IMF in the spring of 1997 is indicated inaccurately; furthermore, it is stated that "[i]n 1998, FDI inflows have slowed somewhat" while, in fact, in the first six months of 1998, according to balance-of-payments data, they were only a third of what they had been in the same period last year. In the report on Poland, it is stated that in the first nine months of 1998 real GDP continued "to grow at the same pace" as in 1997, while in fact growth slowed by more than a percentage point (both on the first three quarters of 1997 and on the whole of last year).*

2 *There are only a few slight incongruities between the data displayed in the tables and the references to the same indicators in the corresponding passages as well as some minor inconsistencies as regards the coverage of the most recent data. As to the former, the texts of the country reports refer, in several cases, to August 1998 figures while the tables contain September 1998 data on the same indicators; as for Polish unemployment, the text has the May 1998 rate, while the table exhibits the figure for August 1998. Sometimes, the text contains data on main economic indicators, which are however not displayed in the respective tables (e.g. Estonia's budget and current account balances in the first half of 1998, measured in percent of GDP) or which do not fully correspond to the figures contained in the tables (e.g. Lithuania's GDP growth in the first half of 1998). As regards the most recent data covered, the reports generally take into account figures released until mid-October; however, Hungary's September inflation rate published on October 9, 1998, is missing.*

The analysis undertaken in the reports is well-developed, and we generally share the essence of the Commission's assessments. Still, the sections merit a few remarks. First, on external accounts, the reports focus properly on the issue of how deficits are financed. However, it appears that there is no uniform underlying approach to judging whether the size of deficits is still within "tolerable" boundaries or whether they are already "too large." A case in point are the statements on the current account deficits in the reports on the Baltic countries, which do not take sufficiently into account, in their evaluations, that Latvia's deficit has been considerably smaller than that of the two other countries.[1]) Also, the summary assessment of the composite paper in this realm does not in all cases fully correspond to the results of the analysis in the individual country reports. A good example here is the judgment on the Polish trade balance, which is well analyzed and put into proper context in the report on Poland, while the composite paper simply states that it "may be too large," moreover without any differentiation with respect to ACs that have much higher deficits, while recording – at least in some cases – less advantageous macroeconomic and competitiveness-related developments.

Second, while banking sector and stock market developments are covered in an accurate and balanced manner in the ten country reports, this is not so true of some other segments of the financial sectors. The divergent accounts on developments in the insurance sectors are a case in point.

Third, on external framework conditions and their impact on economic developments in the candidate countries, we fully share the Commission's assessment that economic growth in the ACs was largely unaffected by the onset of "worsening international environment" in mid-1997. As to the Commission's analysis of the effects of the Russian crisis on the candidates, we have two basic observations. On the one hand, the Commission's overall judgment in the composite paper on the economic impact of the Russian crisis remains somewhat too general; moreover, it does not fully reflect some aspects of the assessments in the individual country reports, especially with regard to the Baltic countries. On the other hand, the assessment is not complete in two respects. Some effects of the Russian crisis on the ACs are not examined at all, or not fully examined, and the analysis itself is, in some instances, unbalanced among countries or, in the case of the Czech Republic, even missing. Going quickly through the list of actual or potential effects yields the following picture. We principally agree with the Commission that direct real economy effects on the ten ACs *as a group* will probably be limited because of the general reorientation of trade flows towards the West in recent years. Still, we would see the need for a certain differentiation among candidates, as *individual* countries' trade shares with Russia (and other CIS countries) differ substantially. In our view, the primary concern for the ACs relates to *indirect* real effects of the Russian crisis, i.e. the worsening of economic prospects in the candidates' main trading partner countries. However, the Commission does not deal with this key aspect of the Russian crisis either in the composite paper or in any of the country reports. We are aware that

1 *It should be noted that the composite paper does differentiate in this respect, as Latvia, contrary to Estonia and Lithuania, is not mentioned among the countries with a "strongly negative" current account.*

these considerations relate primarily to the economic performance in the near future, but nevertheless this feature should probably not be completely neglected in the type of forward-looking overall assessment the Commission itself gives. Moreover, this aspect is also important for the formation of expectations and thus has an impact on current developments (e.g. investment decisions) as well.

Moving on to financial market effects, the composite paper does not deal with the repercussions of the Russian crisis on foreign exchange markets in the applicant countries. In the individual country reports, this issue is only covered for Hungary and Poland, where these effects were more pronounced than in other countries.[1]) Moreover, there have been considerable impacts on most candidate countries' stock exchanges. Although the leading stock indices in almost all ACs recorded considerable losses in the aftermath of the Russian crisis, the Commission deals with this particular angle only in the country reports on Hungary, Latvia and Slovakia.[2]) A related circumstance is the impact of the Russian crisis on the availability and the cost of foreign financing. On this, we conform with the Commission's analysis. The effect of the Russian crisis on the ACs' banking systems is not mentioned in the composite paper, but it is covered in many, though not in all, country reports. In fact, the issue of banking sector exposure vis-à-vis Russia is not tackled in the reports on the Czech Republic, Poland and Romania.

Fourth, while we do agree with the general assessment on economic developments in Slovakia, we would like to add a few qualifications on some specific issues. To begin with, while fiscal accounts undoubtedly worsened considerably from 1996 to 1997, the report on Slovakia somewhat overstates the dynamics of deterioration.[3]) Also, we fully share the Commission's concerns in the area of enterprise restructuring, but we think that the analysis of the respective legal framework should look not only at pure regulatory content, but should also extend to issues of implementation.[4]) Furthermore, the

1 *In both cases, the pressure was temporary. The zloty began to recover in September, as the report on Poland correctly states, and has in the meantime practically reached its former position in the band. The pressure on the forint abated in October. Since early November the Hungarian currency has traded around its central parity.*

2 *See sections B.2.2 of the regular reports on Hungary, Latvia and Slovakia, respectively. We fully agree with the Commission that "[b]ecause of the lack of foreign involvement, the [Slovak] stock exchange was largely unaffected by the Russian crisis." The more pronounced downturn that set in towards the end of September appears to be connected chiefly to domestic factors.*

3 *The regular report on Slovakia states that "the general government deficit is estimated to have surged from 1.3% of GDP in 1996 to about 5% in 1997. Members of the opposition at the time question the accuracy of the statistics claiming that the deficit was higher than reported." Detailed budget figures compiled by the OECD show that the general government deficit increased from 1.9% of GDP in 1996 to 4.7% in 1997. The worsening was thus 2.8 percentage points of GDP (rather than about 3.7 percentage points or perhaps even more, as the report on Slovakia suggests). Moreover, on an accruals basis, the deterioration was somewhat lower: Tax and social security payment arrears by enterprises grew considerably in 1997, partly due to the newly enacted Enterprise Rehabilitation Act (see below). The budget certainly embarked on a wrong track in 1997, and our argument is solely about the momentum of deterioration.*

4 *In more concrete terms, we fully agree that the Enterprise Revitalization Act, which provides a scheme for enterprise rehabilitation, is fraught with several unfortunate features; in particular, it has led to a worsening of the fiscal discipline of enterprises that hoped to qualify for rehabilitation. Still, it should be noted that the Act has remained largely unimplemented due to the lack of funds effectively available for debt restructuring and relief operations.*

report correctly points out the very high degree of nonperforming loans in the three biggest Slovak banks. It may have been useful, thoug, to put this fact into perspective by indicating that the banks have built up fairly high provisions and reserves against these bad debts. In general, the Commission is perfectly right in concluding that it is now time to take decisive action to correct macroeconomic imbalances and to tackle structural weaknesses. The underlying message of the country report appearently is that Slovakia should be in a position to catch up fairly soon in the overall accession process, if necessary moves to correct macroeconomic imbalances and to tackle structural weaknesses are taken "swiftly and in a transparent and market-based way." This would fully concur with our assessment.

Finally, when discussing macroeconomic developments and policymaking in the ACs in the accession context, one cannot do without commenting on a relatively new instrument, the Joint Assessment of Medium-Term Economic Policy Priorities. The main purpose of this exercise is to regularly review the medium-term economic and monetary policy strategies of each candidate with a focus on satisfying the Copenhagen criteria for membership in the Union and the *acquis* in the area of economic and monetary policy (coordination of economic policies, submission of convergence programs, avoidance of excessive deficits).[1]) The Joint Assessment is elaborated by the respective candidate country in close cooperation with the European Commission within the institutional framework of the Europe agreements.[2]) The progress achieved by the candidate countries so far in developing a medium-term economic strategy and in concluding the Joint Assessment exercise differs substantially from country to country and is briefly presented in chapter D.1 of each regular report, which covers the current state of implementation of the APs. According to the regular reports, only two applicants submitted a medium-term strategy and subsequently completed their first joint assessment with the Commission in the review period, namely Hungary and Slovenia.[3]) Sections B.2.3 of both country reports refer to the Joint Assessment, thus forming part of the Commission's overall assessment on the fulfillment of the economic Copenhagen criteria. Moreover, section B.2.3 of the report on Latvia states that the joint assessment was "in its final stages" at the time the reports were finished. Bulgaria, the Czech Republic, Estonia and Poland had finalized a medium-term economic strategy during the review period; the joint assessment, however, was only under preparation.[4]) For Romania, the Commission states that the country achieved some progress in preparing a medium-term economic strategy. The wording for Lithuania and Slovakia, who had not yet established a strategy, is slightly more negative.[5])

1 *See e.g. Accession Partnership Hungary (1998).*

2 *The practical work is done in the EU Association Sub-Committees on Economic and Monetary Issues.*

3 *In fact, the Joint Assessment with Slovenia has been completed recently; the one with Hungary, which was a pilot project for the new instrument, was finished in June 1997.*

4 *While this is also mentioned in section B.2.3 of the reports on Estonia and Poland as one of the elements relevant to the assessment, the respective sections in the reports on Bulgaria and Czech Republic do not contain a comparable reference. See sections D.1 of the regular reports on Bulgaria, the Czech Republic, Estonia and Poland, respectively.*

5 *See sections D.1. of the regular reports on Romania, Lithuania and Slovakia, respectively.*

In our view, by developing the Joint Assessment framework and by getting implementation going, the Commission has done very substantial work. The Joint Assessments can indeed become instrumental from three angles. First, they can facilitate a smooth fulfillment of the economic accession criteria. Second, they serve as a preparatory exercise for the applicant countries in the area of economic policy coordination within the European Union. Third, a Commission-approved medium-term economic strategy will foster the credibility of the ACs' policies and thereby improve framework conditions for investment and growth.[1]) In institutional terms, it was appropriate to place the instrument in the framework of the Europe Agreements. Here, we welcome the recently stated intention of the Commission to improve the involvement of Member States in the discussion process on the Joint Assessments which have been established between the Commission and the candidate countries. In a more forward-looking perspective, when drawing up Joint Assessments will have become a routine exercise, the Union will probably have to reflect on how to adapt and align institutional structures and procedures to further improve the usefulness of this instrument in preparing the applicants for actual participation in economic policy cooperation within the European Union.

4 Monetary and Exchange Rate Policy and (Dis)inflation Performance

This section reviews the main assessments of the regular reports on monetary and exchange rate policies as well as on the (dis)inflation performance of the ten candidate countries. In doing so, we concentrate on issues that are of general relevance for the economic policy posture of the ACs, while we leave the treatment of those monetary and exchange rate aspects which are specifically relevant from the perspective of the ACs' preparations for eventual integration into Economic and Monetary Union to later sections.

Much as in last year's Opinions, the area of monetary and exchange rate policy is not treated in a single chapter in each of the regular reports, but, due to the structure of the reports, it is dealt with in a number of different subchapters. Sections B.2.2 of all country reports contain, in their subsections on "Macroeconomic developments," one or two paragraphs on monetary policy issues which are generally of a rather descriptive nature. In some, but not all regular reports, the Commission's assessment of the country's monetary policy is to be found in sections B.2.3, which assess economic developments since the Opinions in terms of EU membership criteria.[2]) Moreover, a number of country reports contains an assessment of monetary and exchange rate policy in sections B.3.3, which discuss the ACs' ability to assume the obligations of membership with respect to Economic and Monetary Union.[3])

1 *This being so, it is somewhat unfortunate that the report on Hungary, in its analysis of economic developments in the review period, only states that actual performance has been better than foreseen in the country's 1997 Joint Assessment but does not elaborate on the main contents and the underlying structure of this benchmark.*

2 *See the regular reports on the Czech Republic, Estonia, Lithuania, Poland and Romania, sections B.2.3, respectively.*

3 *See the regular reports on Bulgaria, Estonia, Hungary, Lithuania, Poland, Romania, Slovakia and Slovenia, sections B.3.3, respectively.*

The composite paper acknowledges that "inflation rates are diminishing and below the two digit level in Slovenia, Czech Republic, Slovakia, Latvia and Lithuania." This is confirmed in the country reports which find that, during the review period, practically all candidate countries have successfully continued or returned to the disinflation process; only in Slovakia has inflation slightly increased since 1996, while still remaining well within the single-digit range. According to the country reports, monetary and exchange rate policies have played a significant role for the progress towards lower inflation in a number of ACs; in some country cases, the Commission identifies other reasons which have (also) fostered disinflation. The composite paper, in turn, does not deal with monetary and exchange rate policy developments in the ACs during the review period.

Against this background, what are the main statements of the individual country reports on the monetary and exchange rate policies and on disinflation performance? For Bulgaria, the Commission notes that the "core" of the country's "successful stabilisation" has been "the operation of a fixed exchange rate under a currency board regime" since July 1, 1997. This monetary arrangement and the associated discontinuation of "inflationary financing of the budget deficit by the central bank" have been the "key element in the successful lowering of inflation" during the review period. In fact, already the credible prospect of the establishment of a currency board, supported by strong economic policies, reduced monthly inflation sharply in spring 1997. Moreover, "[t]he consolidation and further improvement of the macroeconomic stability will require a continued commitment to the currency board." The currency board is also seen to have strengthened financial discipline; also, there has been a link between the board and the progress achieved in the banking sector since last year.

Similarly, the Commission commends the Czech National Bank's "strict anti-inflationary" policy, which is identified as a main reason for the recent decline in inflation following a temporary acceleration of price increases after the flotation of the koruna in May 1997. Since August 1998, monetary policy has been eased in the light of improving inflation performance. The move from monetary to direct inflation targeting at the end of 1997 is termed "an important shift in the framework for monetary policy." The exchange rate regime in place since May 1997 is "a managed float against the DM." While this policy "is aimed at avoiding excessive volatility of the currency," the Commission finds that "the value of the currency has fluctuated considerably" since May 1997. During 1998, the koruna has strengthened, but this has not hurt exports, which "have remained buoyant."

On Estonia, the Commission states that "the limited scope for an autonomous monetary policy" in the context of the currency board arrangement, which has been in place since 1992, has "compound[ed] difficulties" in macroeconomic policy management caused by large capital inflows. Nevertheless, this limited room has been used well. The currency board arrangement and, in particular its automatic adjustment mechanism, "has functioned well despite serious strains on financial markets," even though it has entailed "severe adjustment costs." The report sees potential medium-term threats to the sustainability of the monetary framework, in case external accounts

and debt dynamics could not be controlled, but stresses that restrictive policy measures in 1997 and, in particular, in 1998 have "strengthened the credibility of the exchange rate commitment." Against the backdrop of the currency board, the report very much welcomes the increasing share of foreign ownership in Estonian banks: "With the role of the central bank as lender of last resort strictly limited, easy access by banks to foreign funds (in particular via their parent company) improves confidence in the resilience of the financial system in case of a slow down of the economy or large capital outflows." Disinflation was temporarily interrupted in the second half of 1997 and early 1998 due to higher adjustment of regulated prices, the depreciation of the DEM against the USD, and also partially to the strong growth in internal demand. Since this spring, inflation has begun to decelerate again.

The report on Hungary states that "[m]onetary policy has continued to operate within the framework imposed by [the] crawling peg exchange rate regime," which the central bank "has maintained [in the review period] as one of its main instruments for reducing inflation." Central bank interest rates and the rate of crawl have been gradually reduced "in an attempt to reduce inflationary expectations and moderate the growth of domestic demand," while at the same time balance-of-payments considerations and "the pace of the recovery" have also played a role in these decisions and, in particular, their timing. The (fairly narrow) band has been left unchanged. In the wake of the Russian crisis, the exchange rate regime was put to a test, and the central bank had to intervene "to stop the forint from depreciating faster than the monthly rate of crawl and eventually was forced to raise interest rates." Disinflation was moderate in 1997, due to the adjustment of energy prices, adverse seasonal trends in food prices and higher-than-planned nominal wage growth. This year, disinflation has accelerated "thanks to smaller increases in administered prices and consumption taxes as well as positive trends in the prices for food and imported raw materials" and despite higher wage growth than expected, which in turn is ascribed, inter alia, "to entrenched inflationary expectations."

In Latvia, monetary policy "is mostly focussed on maintaining the fixed peg" to the SDR. Monetary policy has been "prudent" in recent years. Latvia has experienced substantial capital inflows, which have led to a rapid growth of money supply. This, however, "has not been a source of significant inflationary pressure," as it has been accompanied by strong money demand growth. Furthermore, disinflation was helped by moderate wage dynamics, and in fact, "the main contribution to consumer price inflation has come from increases in administered prices."

The Bank of Lithuania's monetary policy, which "has been based [until now] on [a] currency board arrangement," has been "prudent" over recent years. The currency board has also had an impact on the country's fiscal policy, which has been geared towards "preserv[ing] the sustainability" of the monetary framework. The report takes note of the country's gradual exit strategy from the currency board, which has been implemented "in a pragmatic and prudent manner." In this vein, a wider set of monetary instruments has been introduced since last year "but in line with the Bank's intention their use has been rather limited." Disinflation has continued despite high wage

growth, increases in indirect taxes and administered prices; it has been supported "by the appreciation of the US dollar, to which the litas is pegged, and the decline in oil prices."

The successful reduction of inflation in Poland is attributed to sound monetary policies and the better-than-expected fiscal performance, which has allowed for some relaxation of monetary policies (although real interest rates are still higher than two years ago) and thus for a more balanced macroeconomic policy mix. Relatively moderate wage growth has also supported disinflation. The central bank has "sign[aled] its willingness to fight inflation" by reducing the rate of the crawl under the crawling peg regime in operation in Poland several times. Also, it has widened the fluctuation band to ±10%.

For Romania, the Commission finds that monetary policy has been tight and has operated in an improved framework, after special central bank credits to agriculture and enterprises had been discontinued. However, it is increasingly burdened by the failure to sustain structural reforms. Monetary policy has been "successful to some extent" in fighting inflation "through a strict control of the monetary base." It has been supported by fairly restrictive fiscal policies and a gradual real appreciation of the leu under a managed float, which may, however, not be sustainable, given falling foreign exchange reserves and the ballooning current account.

Slovakia has suffered from a lack of coordination between monetary and fiscal policy. Monetary policy has been restrictive and this stance has been "necessary ... to counter excess domestic demand." This policy also contributed to increasing the fragility of those banks "that depend on the interbank market for their financing." The report notes that Slovakia was forced to give up its fixed exchange rate regime on October 1, 1998, because mounting devaluation pressures had generated losses of international reserves. Disinflation has come to a halt in the last two years, which is seen to be attributable mainly to high domestic demand, some adjustment of administered prices, indirect tax increases and the introduction of an import surcharge.

In the review period, Slovenia continued to operate a monetary policy framework that combines the control of monetary aggregates with a managed float for the exchange rate. It is commended for having been "successful for achieving stability and preserving competitiveness," while its continued reliance on capital controls is criticized.[1]) The country has experienced some further disinflation in the review period, despite significant liberalization or adjustment of regulated prices (which in 1997 accounted for half of the rate of price increases). The report seems to suggest that disinflation has been helped by a considerable slowdown in wage dynamics.

In our view, the Commission's accounts on monetary and exchange rate policy and, more broadly, on the (dis)inflation performance of the ACs cover key developments appropriately, perhaps with one exception, namely the immediate effects of the introduction of the euro on exchange rate pegs of candidate countries. The report on Poland deals with this issue, stating that the Monetary Policy Council of the National Bank of Poland has announced

1 *We will return to this point in section 5.2.3 on the liberalization of capital movements.*

its preference for redesigning, as of 1999, the current basket by reducing the number of currencies from presently five to only two, namely the euro and the dollar, while a final decision on the issue is still pending. The regular reports on Hungary and Latvia, the two other basket peggers among the candidate countries from Central and Eastern Europe, do not bring up this issue. In fact, the National Bank of Hungary announced already in spring that, as of 1999, the euro will substitute the Deutsche Mark in the DEM-USD basket to which the forint is pegged.[1]) Latvia, in turn, has not made any decision to change its peg to the SDR, but is contemplating a gradual move away from this basket currency, if currency shares in trade invoicing change after the introduction of the euro. In the same vein, the choice of the reference currency will have to be reconsidered by those countries which are presently pursuing a peg to the Deutsche Mark. The regular report on Bulgaria explicitly states that the existing DEM peg will be replaced by an equivalent peg to the euro as of January 1999. The country report on Estonia, in turn, does not touch upon this issue. In fact, as a consequence of the introduction of the single currency, the peg of the kroon to the Deutsche Mark will be technically changed into a euro peg. When exactly this modification will be effected is still open. At the latest, it will have to be done when the DEM looses its status as legal tender. Finally, for Lithuania, which operates a USD peg, the introduction of the euro per se will not require an immediate technical adjustment of its exchange rate regime; still, the country is pondering a move to a USD-EUR basket in one to two years.

The accounts also contain a certain dose of analytical examination of monetary and exchange rate developments and of (dis)inflation performance. However, the analysis is not developed to the same extent in all ten reports. A case in point are examinations of factors that drive the (dis)inflation process. For example, lower raw material and energy prices are likely to have helped disinflation in all ten countries, they are mentioned only in a few cases. For some countries, the impact of wage developments, changes in indirect taxes and exchange rate movements are well elaborated, while this is not the case for some other countries. Finally, inflation expectations, one of the major factors that have slowed disinflation in a number of applicant countries, is only put forward in the explanation of the Hungarian case but not for the other nine countries. A further example of a certain degree of unevenness in the analysis among applicants are the examinations of the effects monetary policy has had on banking sectors and the real economy in the candidate countries.

The depth of the analysis of exchange rate developments is not the same for all countries either. A case in point is the report on Slovakia, which, in general, touches only briefly on exchange rate issues and examines the flotation of the koruna, in particular, quite summarily, while other reports (e.g. the ones on Romania and the Czech Republic) undertake more detailed investigations into the field of exchange rates. Also, the question of the sustainability of exchange rate pegs does not always appear to be tackled in a fully balanced and thorough manner. Still on exchange rate issues, the

1 *A formal decision was taken at the end of October 1998.*

appraisal of crawling peg regimes is not fully even. While in the case of Hungary, this system as such is seen as "instrument[al] for reducing inflation," the report on Poland only establishes a much more specific link between reductions of the crawl rate and the central bank's "willingness to fight inflation." In our view, preannounced crawling pegs typically demonstrate merits, compared to floating regimes, in terms of creating a transparent and predictable environment and of building credibility. Still, a crawling peg anchors inflation expectations both ways, as it establishes a ceiling as well as a floor for expectations, should not be ignored.

Furthermore, the underlying approach to the merits and benefits of currency board regimes does not seem to be wholly uniform. Clearly, the cost-benefit balance of monetary regimes can differ among countries and may shift over time, but this argument alone does not seem to be sufficient to explain why the reports on Bulgaria and, to a somewhat lesser extent, on Lithuania, focus on the advantages of a currency board while the report on Estonia is based on a much more differentiated approach.

This all leads us to conclude that the analytical depth in the regular reports may not always be fully sufficient to thoroughly assess one of the parameter for the EU membership criterion that relates to the "existence of a functioning market economy," namely "macroeconomic stability … including adequate price stability and sustainable public finances and external accounts."[1])

5 EMU Issues

This chapter sets out to present and discuss general issues which are raised in the composite paper and relate to the integration of the applicant countries from Central and Eastern Europe into Economic and Monetary Union. Subsequently, the developments in the ten countries in the review period and the respective assessments of the Commission are treated.

5.1 Integrating Central and Eastern Europe into EMU: General Issues

The composite paper's section on Economic and Monetary Union starts with some introductory remarks on the legally proper use of some parts of EMU-specific terminology. In particular, the Commission draws "a clear distinction … between participation in EMU – compulsory for all Member States – and adoption of the euro as a single currency." In fact, from January 1, 1999, onwards, "the EU will be in the EMU, even though some Member States will have a derogation. The legal requirements relating to the 2nd and 3rd stage and the capacity to take on the obligations of EMU will become the EMU acquis." This is why with the inception of Stage Three of EMU, "[i]t will no longer be accurate to refer to EMU as being in its 3rd stage."

The Commission then lays out a path for the integration of candidate countries into Economic and Monetary Union. In their preparations for the eventual introduction of the euro, EU applicants will have to go through "three distinct preparatory phases," namely the preaccession phase, the

1 *Agenda 2000, Vol. 1 (European Commission, 1997b), restated in section II.2 of this year's composite paper (European Commission, 1998a).*

accession phase and the final euro phase, and to meet the obligations that pertain to each of these phases.

In the *preaccession* phase, applicant countries are supposed to fulfill the criteria for EU membership. Meeting the economic criteria for EU membership "will ensure that the general economic framework – including institutions and policies – are broadly compatible with EMU," while in this phase, there is "no institutional requirement to assess progress made on convergence criteria." Moreover, candidate countries will have to fulfill EMU-specific legal obligations which are in principle binding for all EU Member States.

In the *accession phase,* i.e. between entry into EU and the joining of the euro zone, Member States, inter alia, have to observe "treatment of exchange rate policy as a matter of common interest and, later, participation in the exchange rate mechanism." Also, each country has to "further adapt" its "national central bank's statutes with a view to integration in the European System of Central Banks." Finally, they have to make progress towards fulfilling the Maastricht convergence criteria.

The *final euro* phase will begin if and when a country complies "with the necessary conditions for the adoption of the single currency, following the examination of the achievement of a high degree of sustainable convergence."

In our assessment, the section in the composite paper that deals with the integration of EU applicant countries from Central and Eastern Europe into EMU is well structured and raises the relevant issues.

The Commission's plea for using the proper language and terminology is absolutely in order. In particular, it is useful to differentiate between participation in EMU on the one hand and being part of the euro zone on the other: A uniform use of terms and concepts would facilitate the debate, even if it does not change its substance. While the distinction the composite paper highlights has been adhered to in the Council Regulations on the introduction of the euro and in the legal acts of the ECB, this has not always been the case for other official EU documents and even much less so for the public discussion on EMU issues.[1]) On one specific point, though, the line of argumentation of the composite paper appears to be somewhat too punctilious. We do not consider it legally problematic to term the – open-ended – phase that will begin on January 1, 1999, as "Stage Three of EMU," even after it has already begun.[2])

The Commission identifies "three distinct preparatory phases" (of which in fact only the first two are indeed "preparatory"). This is, to a certain degree, a departure from the Agenda 2000 documents in which the Commission did not principally exclude a two-phase scenario in which a country would join the EU and introduce the euro simultaneously, although such a scenario was dubbed "unlikely."[3]) As we have argued elsewhere, it

1 *To give only one example, the Stability and Growth Pact, inter alia, states that "[t]his... pact in no way changes the requirements for participation in stage three of EMU, either in the first group or at a later date."*

2 *This is so for the simple fact that there are a number of Treaty and ESCB Statute provisions referring to "Stage Three" which will remain effective even after January 1, 1999.*

3 *See each of the ten Opinions, sections B.3.3 (European Commission, 1997d to 1997m) and Agenda 2000, Volume I, section II.1.3 (European Commission, 1997b).*

may practically be ruled out, for both economic and legal reasons, that the ACs will introduce the euro simultaneously with their accession to the European Union.[1]) Therefore, we welcome the position the composite paper takes on this issue.

Also, the 1998 composite paper treats exchange rate issues during the phase between EU accession and the introduction of the euro somewhat differently than Agenda 2000 did. On this, Agenda 2000 stated that "all Member states shall … be in a position to stabilise their exchange rates in a mechanism yet to be decided" and, respectively, that the newly acceding countries "are expected to participate in an exchange rate mechanism."[2]) Juxtaposing the statements in the two documents, brings to light three salient points. First, the remarks in Agenda 2000 on institutionalized exchange rate cooperation concern a period that begins with EU accession, while the 1998 composite paper relates to a "later" period of the accession phase. Second, Agenda 2000 spells out what the future entrants "should" be able to achieve or "are expected" to do, while the composite paper focuses on the "obligations" of new Member States during the accession period. Third, in the 1998 composite paper, the institutional reference point for the "later" period of the accession phase is the exchange rate mechanism (apparently the ERM2), while Agenda 2000, for the period beginning with accession, refers in very general terms to an exchange rate mechanism without further specifying the design of such an arrangement.

The composite paper does not explain the reasoning behind its deliberations, nor does it lay out the causes for the shift in stress compared to Agenda 2000. While we do not intend to conjecture about the Commission's underlying considerations, two points should not go unnoted. First, even if the 1998 composite paper does not touch upon the issue of institutionalized exchange rate cooperation in the period immediately following EU accession, the Commission continues to reflect on this issue.[3]) Second, the wording on exchange rate coordination in the composite paper may be open to different interpretations. In our understanding, the composite paper does not principally exclude a scenario in which new Member States would enter the exchange rate mechanism simultaneously with their accession to the European Union. The sequence the composite paper establishes between EU accession and participation in the exchange rate mechanism *solely* relates to the *obligations* new EU entrants will face, in the Commission's view, in the *specific context* of their eventual *full integration into the euro zone.* On this, it should be noted that it is not yet fully clear whether formal membership

1 *See Backé and Lindner (1996), Horváth et al. (1997), Backé and Radzyner (1998).*

2 *See each of the ten Opinions, sections B.3.3 (European Commission, 1997d to 1997m) and Agenda 2000, Volume 1, section II.1.3 (European Commission, 1997b).*

3 *See de Silguy (1998), who holds that the exchange rate regime of the Central and Eastern european applicants is, "en général, celui du 'crawling peg': il se caractérise par des fluctuations de change limitées de la monnaie nationale et son rattachement à une monnaie forte (dollar et/ou deutsche mark). En conséquence, au moment de leur adhésion à l'Union, un mécanisme, des relations particulières ou un système ad hoc devront être imaginés pour les pays candidats qui out adopté le régime de 'crawling peg.' Ces méchanismes s'appliqueront avant qu'ils ne soient en mesure de participer au S[ysteme] M[onétaire] E[uropéen] bis."*

in ERM2 will indeed be a genuine prerequisite for an eventual advancing to the final euro phase.[1])

A further remark on the Commission's catalogue of obligations pertaining to the intermediate period between EU accession and entry into the euro zone concerns the "further adaptation of the national central bank's statutes with a view to integration in the European System of Central Banks." In our interpretation, this relates primarily to the need to fully harmonize regulations in the area of monetary policy instruments. The requirement for EU membership in this respect is that all instruments be market based,[2]) but obviously this qualitative criterion leaves ample room for designing instruments and procedures. Even though the full harmonization of instruments is not obligatory before entry into the euro zone, candidate countries may find it useful, as we have argued elsewhere, to commence the very complex and time-consuming process of an ever closer orientation of monetary policy instruments to ECB standards even before EU accession.[3])

5.2 The Review Period: Developments and Assessments

In presenting and discussing the developments in the review period and the Commission's assessments of those developments, we first take a comprehensive look at the main matters involved. We are deliberately leaving out of account two specific issues, namely central bank independence and the liberalization of capital movements, from the discussion in substance for the time being and keeping them for a subsequent in-depth analysis in separate subsections.

5.2.1 The Broad Issues

The individual country reports survey and assess EMU-related developments during the review period in sections B.3.3 (subsections on "Economic and Monetary Union"). Moreover, the EMU section of the composite paper ends with a comparative summary assessment of the overall progress made by the ten ACs in this area. It is convenient to begin our presentation of the

1 *Participation in ERM2 per se is "voluntary," although all EU Member States are "expected" to join the mechanism (see European Council Amsterdam, 1997). Whether the EU Member States that do not take part in the euro zone from its outset will have to join the exchange rate mechanism in order to qualify for entering the single currency area is not absolutely clear from a legal perspective. Those who argue that such an obligation exists base this claim on the principle of equal treatment, which is to ensure that the criteria for joining the single currency area will be applied in the same way for countries that enter the euro zone after 1999, as they have been interpreted for those countries which participate in the euro area from the beginning. As the latter countries had to participate formally in the exchange rate mechanism in order to qualify, it is argued that this should also be the case for the others, with formal participation in ERM2 being the benchmark. Those who doubt this line of reasoning point to the circumstance that, in a formal sense, ERM2 may not be the legal successor of ERM1; furthermore, they refer to the fact that at least some features of the exchange rate criterion were interpreted extensively (as regards the width of fluctuation bands and the period of participation) when the Member States which will participate in the euro zone from 1999 onwards were selected. In this latter view, actual exchange rate stability would suffice and, in order to ensure equal treatment, ERM2 would be the prime reference point for assessing exchange rate stability. So far, most EU countries have supported the position that argues for formal participation, but no political decision has been taken on this issue yet.*

2 *European Commission (1997b).*

3 *See Backé and Radzyner (1998).*

Commission's views with the basic statements the composite paper contains and to introduce the more detailed accounts of the country reports subsequently.

The *composite paper* begins its country-specific remarks by reviewing the assessment made in the Opinions on whether individual applicant countries will be able to "participat[e] … in EMU as [a] non-participant in the euro area" in the medium term.

For seven of the ten countries, the composite paper "confirm[s]" the assessment made in the Opinions, while the other three – Latvia, Lithuania and Bulgaria – are "upgraded" due to their "recent progress." According to the Commission, only in the case of Romania could participation in EMU in the medium term as a noneuro country pose "serious problems." Bulgaria's entry "can now be envisaged if it continues along th[e current] reform path," and the participation of the eight other countries is said to pose "few problems," provided that reform continues and existing weaknesses are properly addressed. Furthermore, the composite paper reaffirms the conclusion in the Opinions "that it [is] still premature to judge when [the applicant countries] will be ready to adopt the euro."

The EMU sections in the *individual country reports* start out with a statement on the degree of progress achieved since the Opinions. Poland is seen to have made "good progress," Bulgaria, Latvia and Romania "some progress," Estonia "some additional progress" and the other five countries "little additional progress."

Bulgaria's advances are linked to headway made in macroeconomic stabilization, central bank independence[1]) and the enhanced stability of the banking system, while there is a distinct need to accelerate and deepen financial sector reforms.

The Czech report notes the change in the monetary framework to direct inflation targeting, while "[s]ignificant problems still remain in the financial sector" and central bank legislation has not been changed in the review period.

Estonia is credited for the good functioning of its currency board "despite serious strains on financial markets," for the proper use of "the limited number of monetary policy instruments" and on central-bank-independence grounds.

The Hungary report focuses on exchange rate issues and the effects of the Russian crisis on the Hungarian foreign exchange market; it also refers briefly to issues of legal and actual central bank independence.

On Latvia, the remainder of the EMU section restricts itself to mentioning a limited change of the central bank law.

The EMU section in the report on Lithuania states that the central bank "has been implementing in a pragmatic and prudent manner a strategy foreseeing the eventual exit from the currency board arrangement." It concludes by stressing the need for further realignment of central bank legislation "[i]n the course of this process."

1 *In line with the structure of our study, this section restricts itself to stating whether the Commission refers to changes in central bank regulations or provisions on capital movements. The substance of these regulatory changes and other related issues will be discussed in more detail later in two separate sections.*

The Polish report starts out with reviewing changes in the exchange rate regime since the Opinion. It then turns to the transmission of monetary policy decisions to the banking sector, which is said to be "slow." Furthermore, recent rapid credit expansion may pose additional challenges to banking supervision. The report concludes by presenting changes in central bank legislation.

The report on Romania notes the good functioning of the foreign exchange market, an increasing pressure on the leu, the very slow banking privatization and the "very weak" state of the financial sector. It concludes by reviewing recent changes in central bank legislation.

The Slovak EMU section sets out with a critical remark on the limited restructuring of the banking sector. It then notes that "[t]he former government tried unsuccessfully to reduce the independence of the Central Bank." It ends by referring to the recent flotation of the Slovak koruna, after "[m]ounting devaluation pressures had generated losses of international reserves."

Finally, the report on Slovenia commences by reviewing the country's monetary policy framework, which has "achiev[ed] stability and preserv[ed] competitiveness, but has relied on extensive capital controls."[1]) The banking sector "is not sufficiently open to competitive pressures;" the still existing interest rate cartel will expire soon. The section ends on issues of central bank independence.

In our analysis, we first focus on structure and on factual contents. Subsequently, we will discuss the Commission's assessments.

Our observations on *structure* relate to the ten country reports. The EMU sections in the individual reports are relatively homogeneous in terms of their structure and in the fields they cover. They all start with an assessment of the degree of progress achieved since the Opinions that uses the same language – a fact which facilitates the comparison across countries. For six countries, the sections review developments in three areas, namely the monetary and exchange rate framework, the financial sector and central bank legislation. In three cases, the sections cover only monetary issues and central bank independence. In the case of Latvia, only one matter is covered, namely the central bank law, while in the case of Slovenia, limitations to capital movements are a fourth topic touched upon.

The *contents* of the sections are factually correct and accurately presented; there are only a few cases of minor imprecisions which have no real impact on the assessment.[2]) In some instances, the sections could have profited from a more detailed presentation of the facts covered.[3])

Our remarks on the *Commission's assessments* are twofold. First, we observe that the assessments in the Opinions are summarized somewhat inaccurately

1 *The summaries in this section on the main points the Commission makes on EMU issues in the individual country reports restrict themselves to stating whether the Commission refers to the issue of capital controls. The substance of these limitations will be discussed later in a separate section.*

2 *As an example one could mention that, in the case of Bulgaria, direct budgetary financing by the central bank was "effectively" stopped in early 1997 and not only with the introduction of the currency board arrangement from July 1997.*

3 *For example, it could have been useful to state that Lithuania has not taken any further measures to effect the exit from its currency board in the last few months.*

in the 1998 composite paper. According to the Opinions, the participation of the Czech Republic, Hungary, Poland and Slovakia in EMU as noneuro countries will pose "no problems" in the medium term, while that of Estonia will pose "few problems." On Slovenia, the detailed EMU-related review in the Opinion (section B.3.3) concluded that the country's participation would cause "no problems," provided that it addressed some weaknesses, while in the Opinion's Summary and Conclusions (Part C), it was stated that "some difficulties" "could" be involved.[1]) Against this background, it is not clear how the composite paper can conclude that the 1997 Opinions stated that the participation of the Czech Republic, Estonia, Hungary, Poland, Slovenia and Slovakia in EMU could pose "few problems in the medium term." Proper comprehension is complicated by the fact that the composite paper, based on the progress achieved in the review period, "confirms" the assessment of the Opinion for all these countries and by the fact that the individual country reports find that more or less pronounced progress in the area of EMU during the review period can be witnessed in all ten country cases. Moreover, neither the composite paper nor the report on Slovenia sort out the assessment inconsistency the Opinion on Slovenia displayed on EMU matters.

Second, we essentially share the assessments in the individual country reports on the progress achieved in EMU matters during the review period. As regards the assessment approaches and methods, we would plead in favor of a more explicit analytical treatment of EMU-specific issues in the future. Against the backdrop of the obligations a candidate country has to fulfill in the area of EMU before its accession to the European Union, it would seem useful to address two questions as a basis for arriving at an assessment on the degree of progress achieved in the review period: First, have applicant countries made headway to "conduct[ing] … monetary policy with market-based instruments" by removing the remaining weaknesses the Opinions pointed out?[2]) Second, has financial sector reform in the ten applicant countries made monetary policy more "efficient" in transmitting its impulses to the real economy?[3]) These issues are only rarely touched upon in the 1998 regular reports, while they were given fairly comprehensive coverage in last year's Opinions;[4]) in fact, there is one reference to monetary policy instruments (in the report on Estonia) and another one on the transmission mechanism (in the report on Poland). Likewise, it may be useful to put exchange rate developments into the specific context of EMU-related obligations,

1 *See Horváth et al. (1997).*

2 *See Opinions, sections B.3.3 (European Commission, 1997d to 1997m).*

3 *See each of the ten Opinions, sections B.3.3 (European Commission, 1997d to 1997m). It should be noted that the financial sector is of threefold importance for assessing progress towards accession. First, it is significant for the assessment to what extent an AC fulfills the economic conditions for EU membership: Applicant countries have to ensure that "the financial sector is sufficiently well developed to channel savings towards productive investment" in order to be regarded as functioning market economies. Second, it is important for a country's ability to assume the obligations of EU membership in the area of Economic and Monetary Union. Third, it has an acquis dimension which relates to EU directives that pertain to financial services. In this analysis, we only cover the second aspect, looking at financial sector issues purely from an EMU angle. A broader approach to financial sector issues would go beyond the scope of this study. A number of aspects that relate to the acquis dimension are covered by Würz and Müller (1998).*

4 *For a short review see Horváth et al. (1997).*

rather than to merely report them. The yardstick here would be to scrutinize whether the reforms applicant countries have undertaken improve the outlook for a "stabili[zation of] their economies in the long-run, as well as [for] avoid[ing] disruptive movements in nominal exchange rates and misalignments."[1]) To be sure, this is *not* to say that sections B.3.3 should revisit issues like monetary policy or financial sector reform in general. Rather, the point is that, based on the general review and assessment of economic developments the reports undertake in their chapters B.2, sections B.3.3 would probably benefit from some further elaboration of those issues which are particularly pertinent in the specific EMU context.

Apart from this, it remains somewhat open whether the assessments the EMU sections arrive at are solely based on the developments which these sections explicitly review - or whether developments which are inspected in other sections of the reports but are also relevant in the EMU context are also taken into account in the assessments. This question becomes relevant for some countries with regard to financial sector issues, and for all but one country with respect to the freedom of capital movements.

5.2.2 Central Bank Independence

Much as in the case of last year's Opinions, the regular reports only briefly discuss the issue of central bank independence (CBI). While CBI is treated for all countries in section B.3.3, which examines the candidates' ability to join the European Monetary Union, the reports on the Czech Republic, Poland and Romania also refer to this issue explicitly in section B.2.3, where the fulfillment of the Copenhagen economic criteria is analyzed. Moreover, the composite paper contains a general reference to CBI as one obligation "to be adopted to be in place for EU accession."

This year's regular reports concentrate mainly on the legal dimension of CBI and briefly examine whether any changes in central bank legislation were adopted since the Opinions. The regular reports rightly find that no legislative changes took place in the Czech Republic, Estonia, Hungary, Lithuania, Slovakia and Slovenia during the review period. Moreover, the Commission correctly depicts the introduction of a new central bank law alongside with the currency board arrangement in Bulgaria as well as recent changes in the central bank legislation of Latvia, Poland and Romania. Whereas in Poland and Romania entirely new central bank laws went into force at the beginning of January and July 1998, respectively, Latvia prohibited the central bank from granting short-term credits to government in an amendment to the existing law. In line with its methodology, the Commission does not undertake a specific assessment to rate the degree of progress achieved in the area of CBI. Rather, it performs a more general assessment on the candidates' ability to join Economic and Monetary Union. Only in the case of Poland is it explicitly stated that the country has made "significant progress" in the CBI realm during the review period, an assessment which contributes substantially to the Commission's broader judgment that the country has made "good progress" on all EMU-specific aspects.

1 *European Commission (1997c).*

In our view, the regular reports' accounts on central bank independence constitute a good case in point for the potential drawbacks that are associated with an approach that examines the progress achieved during the review period, but does not judge the overall state of fulfilling the conditions for EU membership; in particular it is a good example that such an approach can convey a skewed picture of the overall preparedness of ACs in specific areas to those who are not fully aware of the contents of last year's Opinions.

A country-specific remark on aspects of legal CBI relates to Poland: While the Commission provides a comprehensive picture of the changes in the country's central bank law, it does not mention that Poland's new Constitution, which was endorsed by referendum in May 1997, contains a number of stipulations related to the independent status of the central bank – provisions which had not been covered either in last year's Opinion.[1]) In our view, the stipulation of CBI even through constitutional regulations significantly increases the degree of protection against potential attacks on legislated CBI, and should therefore not be neglected.

Four of the regular reports briefly touch upon issues of actual CBI. As a case in point, the regular reports on the Czech Republic and Slovakia mention briefly that there had been calls or even outright attempts to reduce the degree of CBI during the reference period in both countries, which, however, remained fruitless. This in itself provides some recent evidence of the importance of a high degree of legal protection of CBI even through constitutional stipulations. In the same context, the Czech National Bank is lauded by the Commission for having "demonstrated that it is able and willing to take unpopular decisions if the need arises." Another reference to actual CBI can be found in the regular report on Poland, where the Commission acknowledges that the newly created Monetary Policy Council "… in the brief period of its existence … has established its authority." Furthermore, the regular report on Hungary remarks that "contrary to what has happened following previous general elections, the Governor of the N[ational] B[ank of] H[ungary] was not replaced following the May 1998 elections." This may be understood to suggest that Hungary's turnover rate of governors as one indicator of the degree of actual CBI was particularly high in recent years.[2]) However, our comparative analysis of turnover rates of governors in six of the applicant countries does not confirm this assumption, with Hungary scoring better results than Poland and Estonia.[3]) Generally, we find it hard to fully reconstruct why selected aspects of actual CBI are examined for some applicant countries and left out of account for the others. In order to ensure a fully balanced treatment of all the ten applicant countries, it would have been more appropriate to examine major aspects of actual CBI for all candidates in a more uniform and comparable manner.

1 *The Polish constitution endows the central bank with the sole right to determine and implement monetary policy and to issue money. Moreover, it contains provisions on the bodies of the central bank, introduces a Monetary Policy Council, and stipulates appointment procedures, terms of office as well as incompatibility clauses for the Governor. Most importantly, the Polish constitution explicitly prohibits the central bank from financing the state budget deficit. See Radzyner and Riesinger (1997).*

2 *See Radzyner and Riesinger (1997).*

3 *See Dvorsky and Radzyner (1998).*

A more specific point concerns the question of whether a currency board arrangement constitutes a principal obstacle to fulfilling all the requirements the Treaty on European Union lays down in the area of CBI. On this issue, the Opinions on the three currency board countries in the region – Bulgaria, Estonia and Lithuania – did not take a fully uniform view.[1]) We welcome the elimination of this ambiguity in the 1998 regular reports, which apparently presume that a currency board which is operated by (and embedded in) an independent central bank can be brought fully in line with the EU's legal standards on CBI.

5.2.3 The Liberalization of Capital Movements

The 1998 regular reports deal with the liberalization of capital movements primarily in sections B.3.1 (The Four Freedoms, Free Movement of Capital). In some instances, the Commission touches upon the issue in other sections as well. What are the main contents of the 1998 regular reports on capital account liberalization?

According to the Commission, Bulgaria has achieved limited liberalization so far. In the review period, it has improved framework conditions for FDI through a new law, in particular by reinforcing the national treatment principle and by allowing partly and wholly foreign-owned companies to buy land.

The Czech Republic has further extended the "very substantial degree" of capital account liberalization it had already achieved at the time of the Opinion, particularly by the adoption by government of changes to the Foreign Exchange Act "which should enter into force in 1999" and will further liberalize "credits and guarantees, issuing of foreign securities on the Czech market, operations in money market instruments and derivatives and purchase abroad of currency by residents." In a specific area, though, there was a setback, which also meant a violation of the country's Europe agreement: Companies with foreign participation were banned from operating lotteries "and similar games."

Estonia "has been progressing" since the Opinion on doing away with "residual restrictions," namely on the issuance of mining licenses to nonresidents, while limitations on the purchase of real estate remain.

Hungary had achieved "substantial" progress by the time the Opinion was written, and has advanced further by removing most of the remaining restrictions on medium- and long-term transactions as well as a few limitations on short-term operations. Explicitly, the report mentions permitting cross-border branching, raising the limits on the physical export of currency and granting the "full right" to "authorised resident foreign exchange banks" to "operate on non-resident accounts." At the current stage, short-term transactions and real estate transactions remain tangibly restricted,[2]) but Hungary plans to lift all remaining limitations by the year 2000.

1 *See the statements on this issue in the Opinions on Bulgaria, Lithuania and Estonia (European Commission, 1997d, 1997f, 1997i). See also Pautola and Backé (1998) for a more detailed discussion of what the Opinions said on this particular matter.*

2 *The exact wording on investment in real estate in the report is the following: "In addition, restrictions on the acquisition of real estate by non-residents remain, albeit limited to arable land, as well as purchases of real estate abroad by residents."*

On Latvia, the Commission states that the country "continues to have a liberal regime for capital movements" and fulfills the respective provisions of its Europe Agreement, except for limits on foreign investment inflows in some sectors.

Lithuania is said to have "reached already a high degree of liberalisation of capital movements" and "[t]here are no restrictions on the inflow or expatriation of capital by investment companies [sic!]."

Poland had already achieved "considerable success" in liberalizing capital movements at the time of the Opinion, despite some remaining shortcomings. Since then, according to the Commission, it has taken a number of further steps, in particular the "[e]ntry into force of the new Foreign Exchange Law which will fully free current transactions and a substantial portion of capital transactions" as well as other new laws on banking, on the central bank, on public trading and on investment funds. The purchase of real estate by nonresidents is singled out as an area in which "significant limitations" persist. Still, all remaining restrictions on capital movements "should be lifted before the end of 1999, as indicated in the Polish OECD liberalisation timetable"; incidentally, this is one of four references to this international organization in the capital account liberalization section of the Polish progress report. In contrast to the other country reports, the issue of capital account liberalization is again touched upon in the conclusion of B.3.1, which states that "Poland continues to make a phased liberalisation of capital movements but the timetable for future liberalisation remains to be clarified." Moreover, the matter of capital account liberalization is taken up again in Part D (Accession Partnership and NPAA), as further liberalization of capital movements is one of the short-term priorities laid down in Poland's AP. In its summary of Poland's progress in meeting these short term priorities, the Commission states that "[s]ignificant legislative steps are required in the field … [of] liberalisation of capital movements." Finally, in its discussion of the Polish NPAA, the Commission remarks that the program does not "clearly refer" to "some important issues … such as … restrictions on Acquisition of Property by Foreigners in Capital Movement."

The report on Romania mentions the country's adherence to the obligations of Article VIII of the IMF's Articles of Agreement in March 1998, a point that is repeated in section B.3.8 on External policies, Trade and international economic relations[1]). "In the field of the liberalisation of capital movements, restrictions on outflow[s] of foreign direct investment, profits and dividends have been removed and Romania has liberalised the T-bill market for non-residents" while numerous other restrictions remain in place. The capital account liberalization section of the progress report on Romania ends by discussing the issue of financial supervision.

On Slovakia, an amendment to the Foreign Exchange Act is said to have introduced "further relaxation" since the Opinion in the areas of issuing and trading foreign securities on the domestic capital market, investment by res-

1 *Romania's achievement of full current account convertibility is also reported in section B.2.2 of the country report, however without reference to Article VIII of the IMF's Articles of Agreement.*

idents in foreign securities, and the abolishment of the foreign exchange surrender requirement for residents.

Finally, on Slovenia, the Commission starts out by criticizing that the country did not take up the main recommendations of the Opinion. Consequently, "little" progress has been made, and the "[l]iberalisation of capital movements is still very slow." Capital controls introduced earlier on continue to be an obstacle to an alignment of legislation. "Nevertheless, some actions have been taken in 1998: in the field of portfolio investments (obligatory custody accounts) and external credits and loans (obligatory interest-free tolar deposits) restrictive measures [by] the Bank of Slovenia have been partially eased." This is not the only reference in the report to Slovenia's capital account restrictions. On the contrary, in section B.2.3 (Assessment in terms of the Copenhagen criteria, The existence of a functioning market economy) the Commission states that the capital account has to be liberalized further to improve the functioning of market mechanisms – a point which is highlighted again in the subsequent general evaluation section B.2.4. In section B.3.3 (Economic and fiscal affairs, Economic and Monetary Union), Slovenia's approach towards regulating capital transactions is criticized again: "Slovenia has resorted to capital controls which are an impediment to FDI flows. Restrictions on inflows are still used extensively, even though a number of ad hoc measures ... in February 1997 were subsequently relaxed in July of the same year." As in the case of Poland, further capital account liberalization is among the short-term priorities of Slovenia's AP and thus is also tackled in Part D of the report, with the Commission giving the following assessment on the progress achieved: "[A]lignment is still hindered by the restrictive measures imposed by the Bank of Slovenia, although some restrictions were partially eased in 1998."

The composite paper refers to the issue of freeing capital transactions only *en passant,* namely in its EMU section, where the "[c]ompletion of the orderly liberalisation of capital movements" is mentioned as one of the EMU-specific parts of the *acquis* that "need to be adopted to be in place for [EU] accession."

For a critical assessment of the Commission's account on the liberalization of capital movements, it is expedient to reflect first on the structure of the statements, subsequently on the factual content and finally on the Commission's evaluation. In doing this, the main focus is, for obvious reasons, on the reports' sections on "The Free Movement of Capital," while occasional references will be made to other parts of the reports dealing with capital account liberalization.

The sections on capital account liberalization are characterized by a tangible lack of uniformity in *structure.* Most, though not all, country reports contain a short introductory statement that summarizes the overall progress achieved in the realm of capital account liberalization. In some cases, this statement relates to the current status quo, while in others it refers to the situation at the time of the Opinions. Many, though not all, reports also contain an explicit statement on the degree of progress that has been achieved since the Opinions. Subsequently, the individual country sections list measures which were taken in the review period.

Another structural incongruity concerns the conclusions of the Internal Market subchapter. In the report on Poland, these conclusions take up the issue of capital account liberalization, while this is not the case in the other nine reports; there is no discernible reason for this differentiated approach.

Moving on to the *factual content* of the reports, one notices that the reports differ in the scope of facts that are covered. While most country sections are "to the point" and deal with the core matters of capital account liberalization, a few – in particular the ones on Poland and on Romania – touch upon issues which are not or only very loosely related to the heart of the matter. These differences, together with the structural disparities, are reflected in large divergences regarding length and depth of the individual examinations.

Another general observation pertains to the fact that, in some instances, there is a full enumeration of all liberalization steps (as e.g. in the report on Slovakia) while in other cases the enumeration is selective (as e.g. in the report on Hungary), but this differentiated approach is not made explicit in the individual country accounts. Some country reports also touch upon the remaining gaps in freeing capital movements, however again without fully clarifying whether gaps are listed comprehensively or selectively. Nor is it clear whether certain shortcomings which are found for several countries – like restrictions on the purchase of real estate – indeed relate solely to those countries where they are explicitly mentioned or possibly to others as well.

Do the reports expose factual developments in a correct manner? Moreover, do the reports cover all measures that are important for an assessment on progress since the Opinions? Do they also comprise all steps that deserve mentioning for reasons of presenting the ten country cases in a balanced manner? On these issues, one can conclude that, in most instances, liberalization measures are depicted correctly and without substantive omissions. Nevertheless, several imperfections can be noted.

For example, the statement in the report on Hungary that "restrictions … remain … [on] purchases of real estate abroad by residents" is inaccurate: As of January 1998, a foreign exchange permit is no longer required for buying or building real estate abroad by residents. Again on Hungary, the Commission states that "from 15 May 1998 … authorised resident foreign exchange banks have received the full right to operate on non-resident accounts." In fact, this step was already taken years ago. The measure Hungary did implement during the review period in the area of extending the scope of operations on deposit accounts by residents abroad – a measure which is not mentioned in the report – relates to liberalizing the opening of commodity exchange and stock exchange depository accounts as well as of margin accounts connected to hedging operations; this measure, though, became effective on January 1, 1998, and not in mid-May.

As regards Poland, the new act on the central bank is clearly a significant step forward towards a state-of-the-art regulatory framework, as discussed above, but, as for capital movements, the provision of article 46 should not go unnoticed, which allows the central bank to resort to a specific form of capital controls "should the implementation of monetary policy be jeopardized":

In this case, the Bank can introduce the holding of non-interest-bearing deposits at the central bank against foreign funds utilized by banks and domestic businesses. The former central bank law did not contain such a provision.

In the case of Poland and Hungary the reports include the countries' target dates for the full liberalization of capital movements.[1]) For other countries, like the Czech Republic or Slovenia, which have adopted similar target dates, this is not the case.[2]) Indicating the target dates of all rather than only some of the countries that have adopted such dates would have been appropriate for a balanced overall presentation.

The Commission reports Romania's adherence to Article VIII of the IMF's Articles of Agreement during the review period. Although this does not fall into the narrow area of capital movements, there is a good case for mentioning it in this section, given the close connection between current and capital transactions. However, the report on Bulgaria should have mentioned that this country, too, removed the remaining restrictions on current payments and adhered to by the provisions of Article VIII in September 1998. Such a reference would seem to be justified not only for reasons of a balanced account, but also because it is a relevant piece of information for the overall assessment (beyond the evaluation on capital account matters). Again on current payments, the Polish report's reference to the new Foreign Exchange Bill contains the potentially misleading statement that this bill "will fully free current transactions." In fact, current transactions were already fully liberalized back in 1995; the new piece of legislation solely reconfirms this state of affairs.[3])

Also, there are a few factual inconsistencies *within* individual reports. For example, on Slovenia two different dates ("July 1997" and "1998") are given as the time at which the restrictions on some capital movements were par-

1 *The report on Poland clearly links the country's target date to its binding obligations vis-à-vis the OECD, while no mention is made of Poland's National Programme of Preparation for Membership in the European Union, which states that the full liberalization of capital movements "should be completed in the year 2000" (Committee for European Integration, 1998). In the report on Hungary, it is left open to what commitment or intentions the given target date relates. As the report repeats, in a somewhat rephrased manner, the Opinion on this issue, the stated target date might relate to the liberalization plans Hungary had communicated to the Commission in its answers to the 1996 Questionnaire. Compared to Poland, Hungary has engaged in a legally nonbinding commitment vis-à-vis the OECD to fully liberalize capital movements by the end of the year 2000. The country's NPAA is somewhat less explicit on the timing (see Ministry of Foreign Affairs, Hungary, 1998).*

2 *In the OECD framework, the Czech Republic has declared its preparedness to finalize capital account liberalization by the end of 2001; in the National Programme for the Preparation of the Czech Republic for Membership in the European Union, the respective passage is comparatively soft: "Currently, the completion of capital movement liberalization is being contemplated for or around the year 2000" (Government of the Czech Republic, 1998). Slovenia's NPAA foresees a full liberalization of capital movements until 2001 (Republic of Slovenia, 1998), in line with the country's EU Accession Strategy (Institute of Macroeconomic Analysis and Development, 1998). Slovenia applied for OECD membership in 1996; the organization has not yet examined the country's regime of capital movements.*

3 *Moreover, in the report on Romania, it is stated that "[i]n the field of the liberalisation of capital movements, restrictions on [the] outflow … of profits and dividends have been removed." In the standard terminology, these transactions are, in fact, cases of current rather than capital transactions. However, in the practice of the EU, it seems to be quite common to treat such transactions under the heading of capital movements (see for example Slovenia's Europe Agreement).*

tially relaxed, while the correct date is June 1997. In the case of Poland, the two statements on the timetable for further liberalization are not fully congruent, at least not on the target date for full liberalization.

Last but not least, we turn to a critical evaluation of the Commission's assessments, starting out with comments on the general issues of appraising progress and then moving on to the individual country judgments.

A fundamental issue pertains to the Commission's approach to assessing any measure that removes restrictions on capital movements wholesale as evidence of progress towards EU accession, no matter how its timing, scope and sequencing fit into the overall reform process. This appears to be too formalistic and schematic – and it does not ensure that the liberalization of capital movements proceeds in an "orderly" fashion, as is called for in the composite paper.

To genuinely gauge the progress towards EU accession in this field, a more thorough analysis would appear to be appropriate. Such an examination would be concerned with the proper timing and sequencing of liberalization measures crucial to minimizing the potentially considerable risks associated with liberalizing capital movements, while reaping its undisputed benefits. In other words, the focus should be much more on ensuring the sustainability of the opening-up of the capital account that has already been achieved and (at least in cases where the Commission analysis itself takes a forward-looking perspective) also of the steps envisaged to further deregulate capital movements.

Whereas FDI and other long- as well as medium-term flows should be liberalized early on, planning the further liberalization of capital movements needs to be carefully considered against the backdrop of the overall macroeconomic performance and the record on structural, institutional and legal reforms. In this context, the most crucial factors are a sustainable in-depth consolidation of the fiscal sector, as well as a well-functioning, resilient and effectively supervised domestic banking and finance sector.

Two examples may suffice to make this point more comprehensible. First, in the light of the overall macroeconomic situation and the state of structural reforms in Romania, one may question critically whether the timing of liberalizing its Treasury bill market for nonresidents was indeed fully appropriate. Second, if the reports present the target dates of individual applicant countries for the complete liberalization of capital movements – as some of them do – it would make good sense to put these dates into perspective by raising the awareness about the implications these targets have for overall policymaking.

A second point concerns the relevance of capital account liberalization for the assessment on the fulfillment of the economic criteria for EU accession. More precisely, can limitations or slow progess in freeing capital movements have a bearing on the record of an applicant country in meeting the criterion of "the existence of a functioning market economy," as the 1998 report on Slovenia appears to suggest? While the issue of capital account liberalization clearly is important for a judgment in the Internal Market and the EMU areas, this is much less cogent for the functioning-market-economy criterion. The existence of a functioning market economy requires, according

to the Commission's own interpretation, that prices, as well as trade, be liberalized; however, this does not extend to capital flows.[1]) In line with this interpretation, none of the other 1998 reports contain a comparable criticism in the sections evaluating the performance on the market economy criterion, nor do any of the 1997 Opinions, although there are certainly cases in which liberalization is less advanced than in Slovenia. This is not to say that capital account convertibility issues should not be considered in the macroeconomic and structural context. On the contrary, the lack of a more comprehensive approach that links capital account liberalization to these issues is one of the main shortcomings of the Commission's overall analysis, as we have argued. However, given the established assessment and operationalization methods, it seems problematic to use arguments related to capital account liberalization in assessing the extent to which applicants conform to the economic criteria for membership.

A third point relates to the references to commitments undertaken in the OECD framework. The OECD has undoubtedly done substantive work in the field and it is therefore useful indeed to refer to the commitments some EU applicant countries have made vis-à-vis the OECD. Still, in a report that assesses progress towards EU accession, such statements should probably be qualified or refined in order to take properly into account that the OECD Codes of Liberalisation and the EU rules on the free movement of capital are benchmarks which differ in a number of respects regardless of all common features. Moreover, such references to commitments vis-à-vis the OECD should be made for all OECD Member States from Central and Eastern Europe (and not only for Poland, as is the case in the 1998 regular reports).

The Commission's assessments on the progress individual countries have made, in legal terms, *since the Opinion* can be shared in most cases, although evaluating the Commission's assessments is complicated somewhat by the fact that not all reports contain an explicit statement on the degree of progress achieved since the Opinions. The Commission's implicit assessments are not easy to infer in all cases.[2]) As regards the extent of *overall* progress to date, it is not possible to fully compare all ten countries for the same reason. Apart from these general observations, the sections on the liberalization of capital movements in the reports on Poland and on Slovenia merit special discussion.

The case of Poland is one of those in which the section on liberalizing capital movements does not contain an explicit statement on the degree of progress achieved since the Opinions. In our view, the overall tone of the section and the enumeration of a number of individual measures creates a somewhat too positive impression about the progress made in legal alignment, which is in the focus of the Commission's assessment. This is so for three reasons. First, an evaluation should not fully disregard the safeguard

1 *See Agenda 2000, Vol. 1 (European Commission, 1997b), restated in section II.2 of this year's composite paper (European Commission, 1998a).*

2 *Moreover, the 1998 regular reports use a less homogeneous language on the gradation of progress than the Opinions, which also makes comparing exercises more difficult.*

clause put into the new central bank law. Second and much more fundamentally, the new Foreign Exchange Act which is mentioned as Poland's central advance was still being discussed in Parliament when the Commission adopted and released the 1998 regular reports.[1]) According to the Commission's own method of basing its evaluation on "measures which have been adopted rather than those which are being prepared or are in the course of adoption,"[2]) this bill should not be taken into account when measuring Poland's progress.[3]) Third, the other steps mentioned in the Commission's account appear to improve framework conditions and do not necessarily liberalize capital movements *per se*.

On Slovenia, the assessment that little progress was achieved in the review period is principally correct. While it is clear that Slovenia has to phase out its capital controls subsequently, we would argue that the overall picture the country report conveys in the field of capital account liberalization is probably somewhat too negative. This is due to a number of facts. First, the very same issue of restrictions on capital movements is raised in five different sections of the report, with the references in sections B.2.3 and B.2.4 not really justified, as we have argued. Second, the report includes only a short and fairly general reference to the steps Slovenia has actually taken in the review period while the other country reports often present the concrete content of liberalization measures.[4]) Third, the report does not mention Slovenia's target date for full capital account liberalization, while the reports on Hungary and Poland do include this information. Fourth, the report does not contain a reference to the binding commitments Slovenia had undertaken in its Europe Agreement, which was signed in June 1996 and is expected to become effective on January 1, 1999, after a very

1 *Unlike in the section on capital account liberalization, there appears to be an awareness of this issue in Part D of the Polish report on the implementation of the short-term priorities of the NPAA. Otherwise, it would presumably not arrive at the conclusion that significant legislative steps are still required in the area of freeing capital movements.*

2 *As the Commission correctly states, "[t]his method is the only one which allows for comparison and measurement, on a objective basis, of the progress really achieved on the way to accession" (European Commission, 1998a).*

3 *The case was different for the liberalization measures adopted in May 1998 by the Czech government – a fact that cannot be clearly discerned from the information the Commission gives in its account. In fact, according to the Czech Foreign Exchange Act, taking these recent steps fell into the government's competence and was effected through a decree which did not have to be approved by Parliament. The decree determines that the measures come into force on January 1, 1999; therefore, a precise date of enactment is determined (which again is not discernible from the report on the Czech Republic).*

4 *The relaxations on portfolio investments enacted in June 1997 relate to earlier measures that restricted operations in this field in February 1997 when the Bank of Slovenia obliged nonresidents to conduct portfolio investment operations through custody accounts. The custodian bank is obliged to treat such an investment as a foreign exchange exposure and must hold equivalent foreign exchange reserves against it. As a consequence, charges on these accounts are substantial. This measure was already covered in the Opinion on Slovenia. In June 1997, portfolio investment operations in shares acquired by nonresidents who undertake not to sell, assign or otherwise dispose of these securities in the subsequent seven years, except to other nonresidents who must make the same commitment for seven years, were exempted from these provisions (see Bank of Slovenia, 1998). – Finally, as regards steps undertaken to relax limitations on capital movements in the review period, we, unlike the Commission, are not aware of any actions by Slovenia in the field of "external credits and loans (obligatory interest-free tolar deposits" that would have "partially eased" earlier measures.*

protracted ratification process on the EU side.[1]) While it is clearly up to Slovenia to take the appropriate measures, the Union itself could have promoted liberalization by speeding up the ratification process. Moreover, the report links Slovenia's capital account restrictions closely to the design of its monetary framework. While this link clearly exists, a full analysis would also have to consider whether there are also structural and institutional impediments, especially in the financial sector, that may hinder a faster and lasting removal of capital controls.

6 The Commission's Assessments and Recommendations

After this discussion of specific issues of central bank interest, we would like to broaden our focus by reviewing the Commission's overall assessments on the ten candidate countries in economic matters and, subsequently, the Commission's recommendations.

In the economic realm, applicant countries have to be functioning market economies and, moreover, they have to be able to withstand competitive pressure and market forces within the Union to meet the requirements for EU membership. To qualify for accession negotiations in economic terms, candidates have to fulfill the first criterion and should be able to satisfy the second criterion in the medium term.

In Chapter II, the Commission summarizes the assessments it has arrived at in the composite paper. The Commission regards the Czech Republic, Estonia, Hungary, Poland and Slovenia as functioning market economies. All these countries are seen to have made further progress since the Opinions, although weaknesses still remain. Slovakia is perceived to "come very close in terms of legislation and systemic features." Latvia and Lithuania have, according to the Commission, made substantial progress in becoming market economies; both countries, in particular Latvia, "are approaching the situation of Estonia in 1997," which was considered a functioning market economy in last year's Opinion. Bulgaria "cannot be regarded as a functioning market economy" despite "substantial progress," while Romania has not made any progress towards the criterion under review. Looking at the overall developments in the ten countries, the Commission registers "considerable progress ..., although ... economic conditions continue to vary considerably, because of different starting positions."

On the second criterion, Hungary and Poland "have continued to improve their ability to meet competitive pressures and should be well able to satisfy [this] criterion in the medium-term, provided that current efforts are maintained." Slovenia "should also be able" to do so, provided it speeds up the implementation of reforms. The Czech Republic "can also still be

1 *In the agreement, Slovenia committed to remove vis-à-vis the European Union sectoral and enterprise-type-specific restrictions on foreign direct investment inflows, on cross-border branching, on commercial and financial credits, on portfolio investment and on the acquisition of real estate. While these provisions will be phased in during a period of up to four years, some will become effective by the time the agreement enters into force. For example, in the area of financial credits, Slovenia will have to instantly eliminate the non-interest-bearing deposit instrument.*

considered to be able to meet [this] criterion, even though it lost some ground compared with last year." Slovakia's prospects to meet this benchmark in the medium term are rated as being "good, provided the government takes urgent steps to establish a fully functioning market economy." Estonia "is in a very similar situation, but its important external deficits continue to pose problems for lasting development, despite recent improvements." Latvia and Lithuania have made "great strides" towards being in a position to meet the criterion in the medium run. Bulgaria is perceived to also have made progress recently, while "Romania's situation has deteriorated." Thus, Hungary, Poland, the Czech Republic, Estonia, Slovenia and Slovakia should be able to meet the criterion in the medium term. For doing so, however, the Czech Republic, Estonia and Slovakia will have to put a particular stress on doing away with country-specific weaknesses. On condition of a sustained implementation of reforms, "Latvia, and to a lesser extent also Lithuania, should be able to make the progress necessary" to live up to the criterion in the medium term.[1])

The Commission's recommendations can be found in Chapter VII of the composite paper. The Commission "does not feel it necessary, on the basis of the [individual country] reports ..., to make new recommendations 'on the conduct or extension of the negotiations.'" Subsequently, the Commission focuses on seven of the ten countries reviewed in this study. It sets out by "highlight[ing] the particular progress made by Latvia. If the momentum of change is maintained, it should be possible to confirm next year that Latvia meets the Copenhagen economic criteria and, before the end of 1999, to propose the opening of negotiations." Lithuania is said to have made "[c]onsiderable progress," but additional measures and, in some areas, a longer track record are needed before the Commission can consider proposing the opening of negotiations. On Slovakia, the Commissions states that "[t]he new situation... following the [parliamentary] elections [in September 1998] also allows for the prospect of opening negotiations," provided that the political criteria are met, "measures to correct the economic situation are undertaken" and "transparency in its operation" is enhanced. Bulgaria is lauded for "considerable progress" in the economic realm, while Romania has not made further progress on the economic front since the Opinions. Slovenia and the Czech Republic are criticized for "a worrying slow down in the rhythm of transposition and application of the *acquis* ... If this stagnation continued, it would create a problem for the capacity of these countries to meet their obligations as future Member States in the medium term." The composite paper then returns to a broader focus again and states that "it seems that with regard to the adoption of the *acquis communautaire* ... the difference between the 'ins' and 'pre-ins' is not very important," which is perceived "to underline the global and inclusive character of the accession process." The Commission concludes by stating that

1 *In this study, we neither present nor discuss the general assessments of the Commission on the ACs' ability to assume the obligations of EU membership and their administrative capacity to apply the acquis, as this would go beyond the core theme of our analysis. The same is true, a forteriori, of a presentation of the reports' evaluations on the political criteria.*

"whatever the place of the candidate countries in the accession process and in the negotiations, the major lesson of the reports transmitted to the European Council is that the rhythm of preparation for accession must accelerate if deadlines are to be met." In the run-up to accession it will remain "necessary to guarantee the most objective possible measurement of the progress of each candidate for membership. This is why the Commission intends to submit further progress reports to the Council at the end of next year to allow it, if appropriate, to take decisions on the conduct or extension of the negotiations."

In our view, the wording of the assessments in the economic realm is clear and does not leave any crucial point untouched. In particular, we welcome the revised diction of the Commission's evalution on Slovakia's ability to withstand competitive pressures and market forces within the EU in the medium term. The new wording takes into account that the existence of a functioning market economy is, according to the Commission's own interpretation of the Copenhagen criteria, a precondition for the capability to withstand competitive pressures, while the judgment in last year's Opinion on Slovakia did not fully correspond to this basic exposition.[1])

The recommendations are also formulated in a lucid manner, perhaps with one slight exception. The portions on Latvia and Lithuania may create the false impression that a country has "to meet the Copenhagen economic criteria" in order to qualify for the opening of accession negotiations. This is, of course, only true of the market-economy criterion, but not of the criterion that relates to the capacity of a country to withstand competitive pressure and market forces within the Union. In line with the overall methodology, a more exact formulation could have been, for example, "to meet the criterion of a functioning market economy and to be able to cope with competitive pressures and market forces in the medium term."

Due to the specific focus of our study on central-bank relevant issues, we are not in a position to assess, in substance, the Commission's overall country assessments and the recommendations that flow from these evaluations. This is so because "it is the interplay and interaction of all conditions, and their mutually reinforcing effects on the economy, that are pertinent" for the overall judgments, as the composite paper states very appropriately. A closer look at the selected areas we have scrutinized shows that the current situation in Latvia, Lithuania and Slovakia – the three countries which have, according to the Commission, a prospect of launching negotiations – corresponds, in many respects, favorably to the benchmark established in 1997.

In an overall perspective, we welcome the dynamic element in the Commission's recommendations which ensues from its apt approach to single out "second wave" candidates by indicating that these countries are seen to have a prospect for accession negotiations and to differentiate further on how concrete this prospect is from today's perspective. Likewise, it is appropriate to indicate important slippages which could, if they persist, threaten a country's "first wave" status.

1 *See for example Horváth et al. (1997).*

Indicating the prospect for accession negotiations for some "second wave" countries, in particular, may also help to alleviate some of the concerns about potential negative effects of last year's decision to open negotiations only with a subgroup of Central and East European applicants, mainly relating to a possible redirection of foreign investment from these countries.[1]) The 1998 composite paper takes up this point and emphasizes that there has not been any FDI reorientation away from the "second wave" countries. In our view, cross-border investment flows are driven by a number of factors, and it is very difficult to isolate the effects associated with the differentiated treatment of applicant countries as regards the launching of negotiations. In other words, it may well have been the case that FDI and other flows would have developed even more favorably had an alternative approach been chosen.[2]) In a forward-looking perspective, it will remain very important to protect the inclusive nature of the accession process. If the reform course remains on track in Latvia and Lithuania and if Slovakia takes advantage of the new situation by implementing the necessary political, macroeconomic and structural measures, it will become ever more important to ensure that Bulgaria and Romania do not fall behind too much in this process.

Overall, the reactions from the applicant countries to the 1998 regular reports has been constructive and positive. There has been little criticism and, in most respects, the Commission's assessments and recommendations have been welcomed or at least accepted. This is also true of a number of shortcomings identified by the Commission, like for example slippages on the "*acquis* criterion." In most of their responses to the Commission's assessments and recommendations, the authorities of "second wave" countries underlined the need to further preparations for EU membership and, thereby, to shorten the period until the eventual opening of negotiations. Slovakia's reaction is noteworthy, as it first asked the Commission to delay its regular report on the country for a few weeks in order to allow for some extra time to make additional progress. In the meantime, this position has been modified in that Slovakia has requested the Council to ask the Commission to prepare a supplement to its 1998 report for the European Council meeting in June 1999. This raises a basic question: Should the Council give preference to handling the assessment process in a very flexible manner in order to be in a position to react to special situations or, alternatively, should it stick to the agreed procedures, mainly with a view to preserving the credibility of the overall process through steady, continuous implementation? For Slovakia, the prospect of an extraordinary evaluation could constitute a strong impetus to accelerate reforms. However, while in principle the country would appear to have a good chance to take all the necessary measures specified in the 1998 progress report quickly, it may be questionable whether

1 *See for example Horváth et al. (1997).*

2 *If one takes a closer look at some of the "second wave" countries, one can find good reasons for the presumption that internal factors were the main forces driving FDI dynamics in the review period. In the case of Bulgaria and Romania, political change and a fresh impetus to stabilization and reform (which unfortunately was only temporary in Romania) appear to dominate. Slovakia recorded a decrease in FDI inflows during the review period. Here, one could argue that the unfavorable domestic developments in Slovakia were aggravated by the negative signal associated with the decision not to open accession negotiations.*

a time span of six months would indeed be perceived as sufficient for demonstrating sustained implementation. Finally, we welcome the Commission's concluding reference to the 1999 regular reports. Given that three applicant countries now have the prospect of joining the "first wave" in the not-too-distant future, the stakes are high indeed for next year's reports.

7 Conclusions

This study has reviewed the European Commission's 1998 regular reports on the progress of the ten candidate countries from Central and Eastern Europe towards EU accession. The focus has been on those issues which are of particular interest from a central bank viewpoint. Therefore, the study has examined the reports' accounts and assessments on monetary and exchange rate policies, (dis)inflation performance and preparations for integration into Economic and Monetary Union, with a specific focus on central bank independence and the liberalization of capital movements. This has been complemented by a presentation and analysis of some selected general issues related to methodology, the broad macroeconomic picture, the Commission's overall assessments in the economic realm and its main recommendations.

In general, we conclude that the European Commission has done very valuable work drawing up those parts of the 1998 regular reports that we have reviewed in this study. Overall, these sections are well structured, properly focused, and based on accurately presented factual evidence. We also share most of the specific assessments the reports contain in the fields of monetary and exchange rate policies, (dis)inflation performance and EMU-related issues. In the detailed analysis, we highlight several features of the reports which we find particularly useful, while pointing critically to a few other points where we see room for further improvement in future regular reports.

On methodology-related issues, we argue for giving preference to comprehensive assessments which do not restrict themselves to simply measuring the progress achieved during the review period, but also judge the overall extent to which the applicants fulfill the conditions for membership. We also note a somewhat greater stress on track record issues as compared to last year's Opinions, and the fact that the review period is not clearly delineated. In the general macroeconomic realm, we essentially agree with the Commission's analysis; as for framework conditions, we maintain that the reports do not in all instances fully cover the impact of the Russian crisis on the ACs; furthermore, we underline the substantive work the Commission has done by establishing the Joint Assessment of Medium-Term Economic Policy Priorities. Monetary and exchange rate policies and (dis)inflation performance are reasonably well presented in the reports, a deepening of the analysis in some respects could contribute to further solidifying the basis for the assessments in this area. In our view, it is most appropriate that the Commission lays out a path for the integration of candidate countries into EMU. This excellent exposé has only one potential drawback: The statements on exchange rate cooperation in the period between EU accession and joining the euro zone are not fully tied in to the Agenda 2000 statements on the same issue, which makes full comprehension somewhat difficult. The sections that

evaluate the progress of candidates in the field of Economic and Monetary Union are well done. They could be further improved if some of the monetary and exchange rate issues of special relevance in the particular EMU context were analyzed more deeply. The specific portions on central bank independence are good; there is probably room for a more analytical approach to issues of actual central bank independence. Our assessment of the sections on the liberalization of capital movements is somewhat more mixed, as they contain several inaccuracies and rely on an assessment approach which appears to be too formalistic.

Due to the specific focus of our study, we are not in a position to make an assessment, in substance, on the Commission's overall country evaluations and the recommendations that flow from these judgments. Nevertheless, we have analyzed the principal approach the Commission has taken in drawing up its recommendations and welcome the dynamic element which ensues from singling out some "second wave" candidates by indicating that these countries have a prospect for the opening of accession negotiations in the not-too-distant future. Against this backdrop, the stakes are high indeed for the Commission's next series of reports on progress by applicants towards EU accession which are due in the fall of 1999.

Editorial close: early December 1998.

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Prudential Supervision in Central and Eastern Europe: A Status Report on the Czech Republic, Hungary, Poland, and Slovenia

Michael Würz,
Wolfgang Müller[1])

1 Introduction

The European Commission's Banking Advisory Committee published its own first review of the current state of preparations in the applicant countries this year.[2])

From Austria's point of view it is particularly important to take a closer look at prudential supervision in Central and Eastern Europe, because compared to banks in other countries, Austrian banks have committed themselves strongly to subsidiaries and participations in Hungary, Poland, the Czech Republic and Slovenia.

This led the Oesterreichische Nationalbank, as one of the bodies involved in prudential supervision in Austria, to conduct a survey on the system of financial supervision in the four applicant countries listed above. The survey intends to offer a comparative overview of which stages the four applicants have reached in their implementation of EU legislation in the area of financial services and points out where implementation may lag behind.

The assessment was based on questionnaires;[3]) legal documents, OECD publications, specialized papers and supplementary information were also taken into account.

We would like to stress that in the case of Slovenia, unlike in the remaining three countries, the evaluation of the supervisory system focused on draft legislation currently under review in Parliament rather than the existing law.[4]) Presuming that the amendment will be enacted soon, it seemed more appropriate to use the new legislation for the comparison, as it contains manifold changes.

For the other countries, existing legislation was used, as farreaching revisions and amendments have already taken place: In Poland the new Law on Prudential Supervision took effect as of January 1, 1998; in the Czech Republic the Banking Act was amended as of July 8, 1994, and twice in 1998; in Hungary a new Law on Financial Institutions and a Law on Investment Companies was passed in 1997.

2 Central and Eastern European Banking Systems in Transition

The banking systems in the Central and Eastern European Countries (CEECs) applying for membership were all built on the principles of planned economies. The basic structure showed slight variances from country to country.

1 *Financial Markets Analysis and Surveillance Division of the Oesterreichische Nationalbank. The standard disclaimer applies. The authors wish to thank Olga Radzyner and Peter Backé for their valuable comments.*

2 *See Document XV/1001/98 of the European Commission's Banking Advisory Committee: "Accession of new Member States to the EU: banking regulation and supervision in the accession states."*

3 *The Oesterreichische Nationalbank compiled a comprehensive set of questions and asked the four countries' central banks to provide the requested information. The questions concerned the organizational side of prudential supervision, the implementation of EU directives and the Basle Core Principles for Effective Banking Supervision. Most of the responses arrived after the deadline, which had been set on June 19, 1998.*

4 *Banking in Slovenia is regulated by the 1991 Law on Banks and Savings Banks. A comprehensive amendment is currently under review in Parliament. The amendment was adopted by the Government in July 1996, brought before Parliament in late 1996 and is expected to enter into force as of the end of 1998.*

The structure of the banking system was dominated by the requirements of central planning: Banking was a state monopoly, and the banking system consisted of a limited number of state specialized banks grouped around a monolithic central bank. Banks were not run as businesses; they were vital elements of the centralized allocation system.

In market economies, banks and financial markets play a key role. To accomplish a transition from central planning systems, where loans were granted on the basis of criteria not related to market performance, CEE banks and financial markets therefore urgently need to be developed and strengthened.

Restructuring the single-tier banking system to form a two-tier banking system separating the central bank and commercial banks became a top priority in all CEECs, not just the applicant countries, at a very early stage in the reform process. Yugoslavia took this step in 1971, followed by Hungary in 1987, Poland in 1989 and Czechoslovakia in 1990.

This restructuring brought about two main changes for the central banks: First, the departments that administered accounts and provided commercial credit facilities for businesses had to be converted into independent commercial banks. In other words, the central banks were obliged to shed their roles as quasi-commercial banks. Second, the central banks assumed functions similar to those fulfilled by central banks in market economies. They were called upon to safeguard their currency's internal and external stability, were vested with varying degrees of responsibility for managing government debt and official foreign reserves, and participated in prudential supervision.

The existing specialized banks were also transformed, sectoral restrictions were lifted and in addition to new state-owned banks, privately owned banks were admitted. Furthermore, foreign banks and joint ventures were granted access to the markets. Both the old and the new banks were free to conduct retail and corporate banking business, some were granted foreign exchange licenses; interest rates were liberalized. With the help of foreign advisors and following Western models, legal frameworks and a supervisory system were developed for the banking sector.

The difficulties involved in building a two-tier banking system were fairly similar in all CEECs:

The main problems in the transition phase were the insufficient capital base and the high level of bad debt. The latter was at first a burden inherited from the times of the planned economy, when politicians decided who should be granted a loan; later, however, the bulk of bad debt stemmed from the first years of transition. Criteria of economic soundness and risk were not applied, losses were automatically covered, and either there were no bankruptcy laws or they were simply ignored. Recapitalization programs were designed to replenish the newly founded state-owned universal banks' insufficient capital base.

At first, the main banks in the commercial sector were either directly or indirectly owned by the state. By privatizing the commercial banks, governments hoped to make their management more transparent, tighten their practices of lending, improve internal reporting structures and increase effi-

ciency. In the meantime, the countries under review, especially Hungary and Poland, have privatized large parts of their commercial banking sector.

This study focuses on the crucial challenges posed by the need to establish efficient supervisory bodies in the process of transforming the banking system.

EU accession negotiations have already begun with the countries reviewed in this paper. By the time of their entry into the Union, these future Member States will have to have adapted national legislation to comply with the EU Directives, which of course include the EU banking Directives.

According to the White Book[1]) published by the Commission in 1995, which advises CEECs on how to implement EU directives, stage I measures in the field of banking legislation include:

- the First Banking Directive (77/780/EEC),
- the Own Funds Directive (89/299/EEC),
- the Solvency Ratio Directive (89/647/EEC), and
- the Deposit Guarantee Directive (94/19/EC).

Before the accession countries attain membership status in the EU, they are required to adopt all the directives that have been issued so far by the EU, i.e. the banking legislation listed among Stage Two measures in the White Book.

As is well known, the EU Council has ruled that the Commission is to monitor the implementation of secondary legislation in the candidate countries and report regularly to the Council on the candidates' progress in adopting and implementing the *acquis communautaire.*

3 Organizational Structures of the Financial Markets' Supervisory Systems

In Slovenia, credit institutions are supervised by the Bank of Slovenia's supervisory division. Insurance companies are supervised by the state body for insurance supervision, which is part of Slovenia's Ministry of Finance.

An independent body, the Securities Market Agency, has been set up to supervise investment companies and funds, and brokerage houses dealing in stocks and securities.

An Office for the Prevention of Money Laundering has been established in the Ministry of Finance.

In Hungary, the formerly separate bodies of banking, securities and stock market supervision were combined as of January 1, 1997, to form a body called Hungarian Banking and Capital Market Supervision – HBCMS.[2]) By merging the supervisory bodies, the government aims to improve the supervision of the universal banking system.

In the Czech Republic, the Ministry of Finance is in charge of supervising insurance and investment companies; the Securities and Exchange Commission regulates and supervises the capital market.

Banking supervision is in the hands of the Czech National Bank (CNB). The CNB banking supervision department was reorganized as of June 1,

1 *"Preparation of the associated countries of Central and Eastern Europe for integration into the internal market of the Union." EU Commission (1995).*

2 *ÁPTF – Állami Pénz- és Tökepiaci Felügyelet.*

1998, to step up both on-site inspection and the analytical aspects of banking supervision.

In Poland, the banks' activities have been supervised by the Commission on Banking Supervision as of January 1, 1998. The Commission's decisions are implemented by a separate unit within the National Bank of Poland (NBP), the General Inspectorate of Banking Supervision.

Separate bodies were founded to supervise the investment and insurance sectors: The Securities and Exchange Commission, the State Office for Insurance Supervision and the State Office for the Supervision of Pension Funds.

4 Implementation of EU Directives

4.1 First Banking Directive (77/780/EEC)

a) Objectives

This Directive is aimed at removing infringements on banks' right of establishment and freedom to provide services. It is intended to remove the most obstructive differences between the Member States' legislation and administrative rules, in order to facilitate the establishment and implementation of credit institutions' cross-border services (e.g. licensing, trademark protection, cooperation in the field of supervision, etc.).

b) Implementation

In the countries under review, the Directive appears to have been largely taken into account in existing and pending (e.g. Slovenia) legislation. Possible shortcomings can be overcome in the course of legislative procedure.

Among other things, the definition of credit institutions in Slovenia's Law on Banking Supervision should be adapted to the concept put forward by Article 1 of the First Banking Directive.[1])

Also, the provisions on professional secrecy should be adapted to the First (Article 12) and Second (Article 16) Banking Directive as well as the BCCI Directive in the countries under review.

In Slovenia and Hungary the conditions of exemption from professional secrecy should be defined in greater detail, to allow supervisory bodies to exchange information. These provisions of the Directive will have to be implemented to clear the way for the conclusion of bilateral Memoranda of Understanding (MoU) with EU supervisory bodies.

The Czech Republic has not adopted the commitment to collaborate closely with the Member States' competent authorities in the supervision of credit institutions as laid down by Article 7 of the Directive. The Czech National Bank has stated that the provisions would be adopted when the Czech Republic attains full membership.

Slovenia and Hungary still require banks' management staff to hold the respective citizenship, which does not conform with the provisions of the Directive either. Such requirements infringe the EU's principle of the free-

1 *Article 1 reads as follows: "For the purposes of this Directive: – 'credit institution' means an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account [...]."*

dom of establishment and provision of services, as well as the provisions of the First Banking Directive.[1])

Poland appears to have largely implemented the Directive.

4.2 Own Funds Directive (89/299/EEC)

a) Objectives

The Own Funds Directive provides a harmonized concept of own capital by defining the distinction between core and supplementary capital.

b) Implementation

The main points of the Own Funds Directive have been implemented in Slovenia, the Czech Republic and Hungary.

The legal provisions in Hungary diverge from the Directive's definition of supplementary and subordinated capital in a number of points. The Hungarian authorities agree that by not utilizing the leeway granted by the Directive, Hungarian legislation may hamper the competitiveness of banks that are subject to supervision in Hungary. Furthermore, the Hungarian Banking Act prescribes far more deductions to be made in the calculation of core capital; this also results in requirements which are more stringent than the EU's harmonized legal standards.

Member States are, however, entitled to enforce stricter legislation; consequently these issues are unlikely to be seen as obstacles.

Poland has only partially implemented this Directive to date. The Commission on Banking Supervision has stated its intention to move closer to EU standards; full implementation is scheduled to be achieved in 2004.

With the exception of some technical adjustments planned for 1999, the Czech Republic's implementation closely corresponds to the Directive's requirements.

In Slovenia, the main components of the Own Funds Directive were incorporated into the Draft Banking Law and the Draft Decree on the Method of Calculating the Capital Adequacy of Banks and Savings Banks. Some points require further harmonization, as elements of the Basle Capital Accord which are not provided for by EU legislation were included.

4.3 Solvency Ratio Directive (89/647/EEC)

a) Objectives

The Solvency Ratio Directive's main purpose lies in the harmonization of standards regarding the ratio between own funds and risk assets as well as off-balance-sheet business. The Directive prescribes a minimum capital ratio of 8%, which means that the sum total of credit institutions' risk assets must not amount to more than 12.5 times the value of its own funds.

1 *To conform with EU legislation, the requirements might be rephrased to be more like e.g. the related Austrian article, which lays down that at least one executive board member of every credit institution subject to supervision by the Federal Ministry of Finance must be available to answer to the authorities and must have a good command of German.*

b) Implementation

In the Czech Republic, the existing CNB regulations do not quite conform with the Solvency Ratio Directive in some points, especially the weighting of assets and off-balance-sheet items. However, the CNB intends to attune its regulations to the Directive no later than in 1999.

In Poland, only basic elements of the Solvency Ratio Directive are included in the existing legislation on banking supervision. The Polish classification of own funds' risk categories is more stratified than the EU standards, and claims against regional governments and national credit institutions are treated more strictly than in the EU Directive.

However, the Polish government has announced that the Banking Act will be fully harmonized with the Solvency Ratio Directive as of January 1, 1999. Off-balance-sheet business will be included on the basis of the original exposure approach.[1])

Slovenia and Hungary can be said to have largely implemented the Directive.[2])

4.4 Deposit Guarantee Directive (94/19/EC)

a) Objectives

This Directive is built on two principles: First, all credit institutions registered in the EU must subscribe to a deposit guarantee scheme. Second, deposits in branch offices are covered by the guarantee system in the Member State of the head office. The minimum sum covered by deposit guarantee schemes has been set at ECU 20,000.

b) Implementation

In Slovenia, the main principles of the Deposit Guarantee Directive have been incorporated into the draft law. However, the guarantee is limited to natural persons, whereas the EU Directive also includes legal persons, although their coverage can be reduced by up to 10%.

At present, deposits in Hungary are only guaranteed up to a limit of approximately EUR 5,000, which is not in line with EU legislation, even if one takes into account EU transitional provisions.[3])

The Hungarian authorities argue that the fact that the average level of income in Hungary lies well below EU levels justifies a lower coverage margin.[4]) The Hungarian central bank regards the EU levels of coverage as too high for Hungary and therefore calls for a transition period of five years.

In the Czech Republic, the latest amendment of the Banking Act includes, among other things, a further step towards fulfilling the EU Deposit Guarantee Directive: Guarantees now also cover legal persons,

1 *One should bear in mind, however, that the marking-to-market approach is more widely recognized internationally.*

2 *Note that none of the accession states has implemented the Netting Directive, which provides for the recognition of bilateral netting agreements regarding some off-balance-sheet items. As a result, credit institutions may have to hold larger volumes of own funds to comply with the 8% minimum own funds requirement.*

3 *Article 7 stipulates that Member States may retain the maximum amount laid down in their guarantee schemes up until December 31, 1999, provided that this amount is not less than EUR 15,000.*

4 *From the Hungarian point of view, implementing higher coverage margins would entail moral hazard.*

and the upper limit for coverage has been raised from 80% to 90% of deposits (from CZK 300,000 to CZK 400,000).

Yet to comply with EU legislation, the coverage would have to amount to approximately CZK 770,000 (EUR 20,000). Furthermore, no mention of the three-month time limit within which depositors are to be paid is made (Article 10 of the Directive); in addition, deposits in branches abroad are not covered by the Czech deposit guarantee scheme, and Czech bank bonds as well as deposits in foreign currencies[1]) are excluded from the scheme.

In Poland, the Deposit Guarantee Directive has not been implemented yet, at least not as far as the levels of coverage are concerned. According to the National Bank of Poland, the minimum coverage prescribed by the Directive is to be introduced soon; no exact date was mentioned, however. The legislation currently in force provides for a coverage of approximately EUR 5,000, whereas the Directive calls for EUR 20,000.

4.5 Second Banking Directive (89/646/EEC)

a) Objectives

This Directive stipulates that Member States mutually recognize each other's banking supervision results. The annex lists core banking activities which a credit institution can conduct throughout the EU, provided it is licensed to do so in the country where the head office is established.

b) Implementation

Overall, banking supervision legislation in all four countries surveyed is very restrictive on access for foreign credit institutions and the principle of mutual recognition of supervision. The "single licence principle," for instance, cited in the EU legal framework, has not been implemented. To open a branch office in Slovenia, a foreign bank, regardless of whether it comes from an EU country or not, must obtain a license from the local authorities.

The Bank of Slovenia's expressly stated right to supervise EU credit institutions' branch offices, which is laid down in the latest draft law, also represents a serious infringement on the Directive's core principles (home country principle). In addition, a number of important provisions on supervision were not included in the draft.[2])

In Hungary, the requirements banks need to fulfill to be allowed to establish branch offices are much the same as for founding a subsidiary; such restrictions are not in compliance with the EU Directive.[3]) To establish a branch office in Hungary, a credit institution needs to obtain authorization both from the authorities in its home country and the host country's authorities.

1 *Pursuant to the Deposit Guarantee Directive, only deposits in currencies other than those of the Member States can be excluded.*

2 *E.g. minimum requirements for initial capital are not imposed on savings banks and savings cooperatives; there are no provisions on the competent authorities' right to withhold authorization under certain circumstances, etc.*

3 *The "single licence principle" defined in the EU Directive stipulates that a credit institution wanting to establish a branch office in another EU country is required to inform only its own domestic authorities, who then pass on the information to the host country's authorities. Accordingly, branch office supervision also lies in the hands of the home country authorities (home Member State principle).*

With the exception of the Czech Republic, all countries surveyed point out in their statements that the freedom of establishment and to provide services can only be granted once they obtain full EU membership, because their banking sectors are not yet ready for fully fledged cross-border competitive pressure. As this is a highly sensitive and controversial issue politically, the process of negotiations and adjustment in this field is likely to become rather protracted.

The Czech Republic has voiced its intention to correct existing shortcomings before it obtains full membership in the EU. This can be understood to imply recognition of the underlying home country principle. Some deficiencies remain regarding provisions on excluding credit institutions from the upper limit of shares they are permitted to hold in nonfinancial institutions and regarding the exchange of information with third countries (professional secrecy).

4.6 Annual and Consolidated Accounts Directive (86/635/EEC)

a) Objectives

The Annual and Consolidated Accounts Directive aims to harmonize provisions companies have to adhere to in order to protect shareholders' and third parties' interests. Inter alia, the Directive affects annual accounts and valuation rules (hidden reserves are authorized under certain circumstances).

b) Implementation

Due to the choices and generous leeway for interpretation the Directive offers, the degree of implementation does not seem all too relevant.

The definition of Slovenia's accounting standards was based on the international framework of the IAS (International Accounting Standards). Owing to the general character of EU and IAS guidelines, Slovenia was able to incorporate domestic specifics and experience into the definition of its own standards, as well as strong elements taken from U.S. accounting principles. Overall, Slovenia can be said to have implemented the Directive.

If one takes into account the ample scope for interpretation mentioned above, Hungary can also be considered to have largely implemented the Directive. Some deviations from the Directive, however, concern publication, the balance sheet structure and the profit and loss accounts.

Poland reports that it has fully implemented the Directive; the Czech Republic intends to adopt the regulations in 1999.

4.7 Consolidated Supervision Directive (92/30/EEC)

a) Objectives

The Consolidated Supervision Directive provides a platform for the supervision of banking groups on a consolidated basis. To render this supervision effective, it has been expanded to apply also to groups of companies which hold more than 20% of a financial institution's voting rights or capital, even if the parent undertaking is not a credit institution. The competent authorities must be in a position to receive all the necessary data for all undertakings in the group in order to be able to assess the credit institutions' financial situation in the group framework.

b) Implementation

None of the four countries under review appears to be close to full implementation of this Directive, which is so crucial to EU framework legislation.

In Slovenia, the Directive's basic elements have been incorporated into the draft law, the details, however, do not conform to EU legislation. The current draft proposal refers to a regulation which the Bank of Slovenia and Slovenia's auditing body have yet to compile, which is to define the details of consolidated supervision in Slovenia.

Hungary has only partially implemented this Directive so far. Hungarian legislation on banking supervision stipulates that consolidated supervision is to take place at least once every year. The law does not call for additional consolidated supervision between these annual supervision inspections, however.

Furthermore, the requirements of consolidated supervision are not defined clearly enough. Each credit institution is obliged to fulfill the banking supervisory requirements primarily on its own.

In the Czech Republic this Directive (as well as the Annual and Consolidated Accounts Directive) has not been incorporated into Czech legislation. Implementation is due to start in 1999.

It is remarkable that unlike the remaining CEECs, the Czech Republic has not even implemented the rudiments of the Consolidated Supervision Directive.

Poland has implemented only parts of the Directive. The new Banking Act contains provisions on consolidation; however, these provisions only relate to banks, not to financial holding companies, financial institutions, securities firms or companies providing ancillary banking services. Nonetheless, without full implementation of the consolidated supervision principle, the supervision of finance groups operating on an international level appears inadequate. Polish legislation on banking supervision does at least provide for international cooperation among supervising bodies.

4.8 Large Exposure Directive (92/121/EEC)

a) Objectives

This Directive prevents banks from granting an excessive volume of loans to a single debtor or a group of connected debtors. A loan is classified as a large exposure if its value is equal to or exceeds 10% of the creditor's own funds.

b) Implementation

Slovenia's draft law fully implements the Directive.

Legislation in Hungary largely corresponds to the Directive. The regulations on subsidiaries and parent companies are stricter in Hungary than in the EU Directive. This could be linked to the fact that Hungary has not yet established any efficient structures for consolidated supervision.

Czech legislation is largely in line with the Directive:

Article 4 (3) of the Directive states that a credit institution may not incur large exposures which in total exceed 800% of its own funds; in the Czech Republic this limit was set at 230%, which means that Czech legislation is stricter in this respect. The Czech authorities have, however, stated

their intention of bringing their regulations in line with the EU Directive by 1999.

Overall, legislation in Poland corresponds to the Large Exposure Directive; however, and this is no minor exclusion, the provisions on large exposures of consolidated groups were not included.[1])

4.9 Capital Adequacy Directive (93/6/EEC)

a) Objectives

The Capital Adequacy Directive (CAD) defines minimum requirements for initial capital and own funds to cover market risk with securities from banks' and security firms' trading portfolios. Securities which do not belong to the trading book but to the bank book need to be backed by own funds according to the Solvency Ratio Directive.

b) Implementation

In Slovenia, the Directive has not been implemented so far; this was explained by the commercial banks' minor trade volume. Nevertheless, a new decree is to implement the Directive's Annex III on own funds requirements for open foreign exchange positions.

In Hungary no regulations on market risk have been implemented yet. So far, this gap has been bridged by stricter requirements on credit risk and, above all, off-balance-sheet business.

A recent amendment to the Hungarian Banking Act will regulate trade in securities as of the beginning of 1999. The amendment of the Act on the Flotation of Securities, on Investment Services and on the Securities Exchange contains some elements of the CAD, such as the definition of the securities trade book and the daily marking-to-market requirement. Provisions on the capital requirements for the trading book are forthcoming.

In the Czech Republic, no steps have been taken so far to implement this Directive, but the government plans to implement measures as of 1999.

In Poland implementation has not begun, nor have any plans to commence been announced yet.

4.10 Money Laundering Directive (91/308/EEC)

a) Objectives

The Money Laundering Directive is designed to combat the laundering of profits derived from criminal activity, above all drug trafficking. To this end, credit and financial institutions are required to identify their customers in any transactions amounting to EUR 15,000 or more.

b) Implementation

So far, only Slovenia has fully implemented this Directive; it introduced the necessary measures in a special law published in 1994.

In the remaining three countries under review the Directive has been implemented by and large; however, according to the Commission's Banking

1 *The Large Exposure Directive similarly applies to both single credit institutions and consolidated groups of institutions. The Directive was implemented in both in Article 27 (large exposure) and Article 30 (groups of credit institutions) of the Austrian Banking Act.*

Advisory committee, anonymous accounts are legal in Hungary, the Czech Republic and Poland.[1]) The Hungarian authorities are considering abolishing these accounts and identifying the owners of existing anonymous savings accounts.[2]) Furthermore, these accounts are not covered by deposit guarantee schemes.

4.11 BCCI Directive (95/26/EC)

a) Objectives

This Directive is intended to improve the efficiency of banking supervision in the wake of the collapse of the Bank of Credit and Commerce International (BCCI).

b) Implementation

The Slovene draft law largely corresponds to the Directive. However, some adjustments should be made in the provisions concerning the granting of licenses, central administration, professional secrecy and external auditors.

In Hungary this Directive has not been formally implemented thus far; some provisions are nevertheless already inscribed in existing legislation. The crucial "principle of close links" (if the supervisory body is obstructed in properly performing its duty by the close links between the credit institution and other legal or natural persons, no license is to be issued) has not been fully incorporated into Hungarian legislation to date.

In the Czech Republic, on the other hand, the Directive has been largely implemented, while some formal shortcomings remain regarding the exchange of information between the supervisory authorities and external auditors.

In Poland, the Directive has not been sufficiently implemented up to the present. Some of the principles are contained in the existing law on banking supervision, such as the exchange of information between the competent authorities to safeguard the stability of the financial market.

4.12 Netting Directive (96/10/EC)

a) Objectives

This Directive is designed to foster a wider recognition of bilateral netting. Automatic bilateral netting of claims in the same currency should be allowed, so that only a single net sum, rather than gross liabilities, needs to be backed by own funds.

b) Implementation

As doubts regarding the applicability of bilateral netting agreements prevail in the legislature of the countries under review, none of the countries have so far implemented the Netting Directive.

1 *The Polish delegation at the sub-committee meeting on financial and economic affairs in Brussels on November 26, 1998, stated that there are no anonymous accounts in Poland.*

2 *According to reports in the press on November 2, 1998, a draft proposal to abolish anonymous accounts has already been brought before Parliament.*

5 Summary and Conclusions

5.1 Implementation of EU Secondary Legislation

In recent years, all four candidate countries under review (the Czech Republic, Hungary, Poland and Slovenia) have undertaken serious efforts to comply with EU secondary legislation and the Basle Core Principles for Effective Banking Supervision.

From the prudential supervision point of view, the most serious flaws are to be found in the fact that the *Consolidated Supervision Directive* has not or only partially been implemented:

The *Czech Republic* has not implemented even parts of the Directive; *Hungary* cannot be said to have included the concept of consolidated supervision into its current practice; *Poland* does not appear to have implemented it sufficiently, whereas *Slovenia* at least plans to implement parts of the Directive in the draft law which Parliament has yet to review and pass.

The implementation gap is less wide in the case of the *Deposit Guarantee Directive:*

As regards the level of coverage, the *Czech Republic, Hungary* and *Poland* have not yet fully implemented the Deposit Guarantee Directive. *Slovenia* has not established a deposit guarantee scheme so far; the draft law currently under review by the Slovene Parliament does not correspond to the Directive in all details.

Further efforts will also be needed to achieve compliance with the *First and Second Banking Directives:* The underlying *single licence principle* of EU framework legislation has not been put into force by any of the countries surveyed. *Hungary, Poland* and *Slovenia* do not intend to implement the Directives' main objectives, above all the right of establishment and the freedom to provide services, before their accession to the EU; only the *Czech Republic* is committed to full compliance ahead of attaining full membership.

The fact that the *Capital Adequacy Directive* has not been implemented should be noted; however, on account of the minor scale of trading activities in the countries under review, this shortcoming does not appear to be particularly significant, at least not as far as prudential supervision is concerned.

The existence of *anonymous accounts* in the countries under review[1]) – with the exception of Slovenia – should not be left unmentioned either.

Cooperation with EU supervisory bodies and with authorities in non-EU countries appears to be possible within certain limits, in practice, however, such cooperation is likely to be restricted.

The *Solvency Ratio Directive* has been implemented to varying degrees; the restrictive handling in comparison with EU guidelines may largely be due to problems in each individual banking sector and the underlying reform process. Moreover, this restrictiveness does not infringe on EU Directives.

1 *See footnote 1 on page 90.*

5.2 Assessment of the Effectiveness of Prudential Supervision in the Applicant Countries under Review

Overall, it appears to be too soon to attempt a final assessment of prudential supervisory bodies' effectiveness in the candidate countries under review, because the definition of legal frameworks and the implementation of concepts and objectives have not been completed yet.

All the countries under review seem to have staffed their supervisory agencies well enough to enable them to comply with international requirements effectively.

The restructuring of supervisory bodies' legal and administrative framework, which has been largely oriented on Western European models, shows the characteristics of committed professionalism and appears to be going into the right direction.

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OeNB Activities

Lectures Organized by the Oesterreichische Nationalbank

The OeNB continued its series of lectures dealing with topics of particular relevance to transition economies by hosting several presentations, notably by *Richard Rose* of the Centre of the Study of Public Policy at the University of Strathclyde, who entitled his presentation about the series of New Russia Barometer surveys he organized on the topic "Getting Things Done in an Anti-Modern Society"; *Ilian Mihov* of INSEAD, who shared his conclusions about Bulgaria's monetary policy in a presentation labeled "The Currency Board in Bulgaria: An Assessment of the First Year of Operation"; *Julio G. Lopez* of the Universidad Nacional Autonoma de Mexico, who spoke about "The Financial Crisis in Mexico – Lessons for Eastern Europe"; *Ágnes Horváth* and *Balázs Zsámboki,* who provided insights into "Banking Sector Restructuring: The Hungarian Case"; *Zbigniew Zimny,* Chief of the Investment-Related Development Issues Section of UNCTAD, who presented the World Investment Report 1998 (WIR 98) at a press conference together with OeNB Vice Governor Gertrude Tumpel-Gugerell. Each of the presentations was followed by a highly animated discussion, which cannot be recounted in full below due to the constraints on the length of this publication. The brief overviews which follow are intended to give the reader the benefit of the insight drawn from lectures by renowned economists and experts about specific developments in transition countries.

Lecture by Richard Rose

Getting Things Done in an Anti-Modern Society

On June 15, 1998, Professor Richard Rose of the Centre of the Study of Public Policy at the University of Strathclyde held a lecture at the Oesterreichische Nationalbank about the series of New Russia Barometer surveys he organized in Russia. To say that Russia is in transition, he began, raises the question: Where is it coming from? The Soviet Union, with a technologically sophisticated military-industrial complex, was not a premodern third world society. But it was not modern. The Soviet system could be effective, but it lacked prices, adherence to legal rules, transparency in cause-and-effect relations, and the capacity to make rational calculations about inputs, outputs, and efficiency. Instead of being modern in the Weberian sense, Professor Rose noted, it was "anti-modern"; that is, it relied on command and control systems of bureaucracy *without* the rule of law. Decision-making was opaque and uncertain, and inefficient. The complexity of the system added to the inefficiencies with which it acted.

Professor Rose continued by asking how much the life of people in the Russian Federation had changed since the collapse of the Soviet Union. According to Professor Rose, a series of seven New Russia Barometer (NRB) nationwide sample surveys of the population he organized starting in January 1992 showed that the legacy of the Soviet past remains very important. A big majority appreciates the major gains in freedom possible under the new regime: The very weakness of the state gives people more scope to do what they like and greater confidence in their freedom from the state. But the new regime is not popular, he said, because it is viewed as unresponsive to popular wishes, even though elections are held. A major-

ity of Russians consistently reject the adoption of undemocratic alternatives, such as dictatorial or military rule, and even though the Communist regime in retrospect appears popular, a majority does *not* want it back. The current regime, while unpopular, is accepted as a lesser evil. But this also means that those associated with it, starting with President Yeltsin and including members of the Duma and leaders of political parties, are very much distrusted.

Professor Rose asserted that in microeconomic terms, the objective of individuals is to avoid destitution. The multiplicity of economies and distorted price structures make it misleading to apply Western criteria, including dollar-equivalent prices, to life in Russia. Professor Rose pointed out that the NRB surveys show that while most Russians occasionally do without food or clothing they really need, very few are consistently short of these necessities. Moreover, energy for heating and light remains plentiful, a sign that domestic consumers have not been required to pay world market prices and that collecting payment for energy is not yet widespread. While most Russians have work, and are not unemployed, they frequently have no money because they are not payed, and the delay or default in payment of wages started long ago. Because Russians cannot get enough to live on from the official economy, they choose from a portfolio of economies. He explained that more than half of all people cope by combining an intermittent wage with nonmonetized resources, such as growing food, do-it-yourself production and by helping and receiving help from friends and neighbors. About one in six people, Professor Rose commented, combine two money economies, one official and one unofficial. Only one in six people are really vulnerable because they rely solely on the official economy.

Today Russia faces what Professor Rose labeled a "low-level equilibrium trap," for the great majority of households can manage to get by indefinitely by relying on multiple economies. Furthermore, he acknowledged, there is sufficient discretionary income to create markets of tens of millions for everything from Western snack foods to VCRs. Years before the August 1998 crisis, the New Russia Barometer was documenting the negative climate for investment stemming from antimodern unpredictability and the absence of the rule of law as understood in modern market systems.

The contrast between the survey evidence of Russia and the evidence from the New Democracies Barometer surveys of the Paul Lazarsfeld Society documents the fundamental differences between the societies of these two areas, Professor Rose remarked. The typical post-Communist society in Europe shows more regard for the rule of law and democratic accountability and, while markets are imperfect, they are not perversely "antimodern." Negotiating the enlargement of the European Union thus becomes, inter alia, a process of differentiating between post-Communist societies that are positively advancing toward the standards of a rule-of-law state and market governance and those that are not.

Lecture by Ilian Mihov

The Currency Board in Bulgaria: An Assessment of the First Year of Operation

On June 29, 1998, Assistant Professor Ilian Mihov of INSEAD, The European Institute of Business Administration, presented his conclusions about Bulgaria's experiences during the first year of operation of the Bulgarian Currency Board. The main points of his presentation are summarized below.

The road to a market economy for Bulgaria has not been an easy one. In the first seven years of transition, output declined by more than 35% from its 1989 level, inflation was consistently higher than in most other transition economies, bank runs posed a serious threat on several occasions, and the rapid succession of eight governments in the span of seven years are indicative of the country's political instability. By mid-1996, it had become clear that macroeconomic stabilization had to take a different course. After a long debate, Bulgarian Parliament voted for the introduction of a currency board arrangement as of July 1, 1997, with the fixed exchange rate set at 1,000 Bulgarian leva to the Deutsche mark.

The current monetary arrangement in Bulgaria could be classified as a "modernized" currency board. In addition to an issuing department, which fulfills this currency board function, the Bulgarian National Bank has a banking department and a banking supervision department. The currency board has thus retained the lender-of-last-resort function, which, however, remains very limited.

The currency board's first year of operation was quite successful. Economic performance conformed well with expectations based on other episodes of credible exchange-rate-based stabilization: Among other things, inflation dropped sharply to between 15% and 25% per year, real wages started increasing, the budget shifted into surplus, deposits at banks increased. For the first time since 1990, annual inflation is expected to drop below 10% in 1998 (inflation stood at only 2.3% in the first six months). Output growth is forecast to run to around 4% to 5% per year for the next two years.

At this point policymakers in Bulgaria face three key questions:

1. What will the economic challenges be in the near future?
2. Is the currency board an optimal monetary arrangement in the long run?
3. If the decision is made to dismantle the currency board, what strategy should be adopted instead?

To understand the challenges confronting monetary authorities and policymakers today, one must analyze the causes of the consecutive economic crises in Bulgaria in the 1990 to 1997 period. Tentatively, it is possible to isolate three distinct episodes in which the economy underwent either some sort of sharp contraction or suffered overall instability: March to April 1994, May to July 1996, and December 1996 to January 1997. Although the proximate causes might be different in each case, the inefficiency of the real sector and state control over major commercial banks were at the heart of each of the crises. The banking sector was instrumental in the transmission of policy shocks, and in some cases it was also the generator of the initial contractio-

nary impulse. One can argue that the governments in Bulgaria created a vicious circle, which inevitably ended up in widespread economic collapse in the first months of 1997. To avoid large budget deficits and the politically risky growth of budget items such as "subsidies," the government resorted to using the banking sector as an instrument to save state-owned loss-making enterprises. State banks were forced to lend to these enterprises to keep them afloat. A significant portion of these loans was not repaid, causing banks' balance sheets to deteriorate. To prevent these commercial banks from collapsing, the central bank used various refinancing facilities to pump liquidity into the economy. Thus, although the books of the government looked relatively sound, the economic situation in Bulgaria steadily deteriorated. The lessons learned in the last eight years will hopefully provide the new government with sufficient incentives to speed up closing down and selling off lossmakers. Privatization of the banking sector is another important step toward reducing unnecessary and outright detrimental government intervention in economic development.

Another short-term challenge is the effect of the economic crises in emerging markets on Bulgaria. The direct influence of these events is quite negligible. Foreign portfolio investment is not large enough to trigger any sort of currency speculation if portfolio capital is withdrawn from the country. Trade channels are also relatively weak, since the EU countries are now Bulgaria's most important trading partners. There is, however, a significant indirect effect. A crisis makes it very difficult to attract new funds from foreign investors because they perceive an increase in the riskiness of emerging market investments. It is possible that because of these developments, bank privatization will slow down until the worldwide financial crisis abates.

Provided the policymakers in Bulgaria deal successfully with the short-term challenges, the question of optimality of the CBA (currency board arrangement) in the long run still remains. It is hard to construct a plausible theoretical model to justify the currency board as an optimal institution. A conceivable situation under a currency board arrangement is that in which a significant drift in the real exchange rate occurs and only extensive, prolonged deflation will take the economy back to equilibrium. In most situations more flexible policies are also more efficient (in terms of welfare). Empirical evidence corroborates this assumption. Currency boards do survive financial crises, but this survival is accompanied by a very large loss of output and a sharp increase in unemployment. It is important to understand from the very beginning that the currency board is only a temporary tool for macroeconomic stabilization.

There is, however, no agreement on what a country can do to exit a CBA without causing unnecessary financial turmoil. The difficulties involved in constructing a credible exit strategy are well known. A necessary condition is to leave the CBA from a position of strength, i.e. when an economy's growth prospects are good, the financial sector is fully privatized and stabilized, and the budget is in good shape. Bulgaria's aspiration to join the EU and subsequently EMU pose another constraint on the timing of the exit strategy from the currency board. It is quite unlikely that it will be possible to atune monetary policy to EMU standards under the current institutional

design and the present exchange rate link between the Bulgarian lev and the Deutsche mark. While Bulgaria may well enjoy excellent growth prospects during another two years of what might be termed its currency board honeymoon, it is crucial that these issues be recognized and addressed today as important strategic questions for the future economic growth of the country.

Lecture by Julio G. Lopez

The Financial Crisis in Mexico – Lessons for Eastern Europe

On July 17, 1998, Julio G. Lopez, professor of economics at Universidad Nacional Autonoma de Mexico, presented aspects of Mexico's 1995 crisis and the lessons they hold for Eastern Europe. The immediate and most significant trigger for the turmoil was the contraction of private investment. The fall in government expenditure, the result of a restrictive fiscal policy stance, also contributed to the crisis. Nonoil exports responded dramatically to the large depreciation of the peso; oil exports also grew. The improvement of the trade balance lessened the magnitude of the drop in the level of total demand, while the depreciation of the domestic currency intensified the recession.

The recovery initiated in 1996 appears to have been triggered in the main by higher government expenditure, and particularly an expanding government domestic deficit. The expansion of exports was another important factor spearheading the recovery, with both oil and nonoil exports growing at a high rate. Imports recuperated, and the import coefficient in fact rose. Accordingly, the export surplus was below the level it would have reached had import substitution taken place; this restrained the revival. The most important factors leading to an improvement in business supply conditions were the correction of the trade deficit, the enlargement of the domestic government deficit, and the (albeit much less pronounced) recovery of private investment.

Most international financial institutions, and a large part of the press, have presented Mexico's experience as an extremely successful story of recovery from a deep crisis, and have effusively praised Mexico's economic authorities for their skills. However, their depiction seems very misleading, to put it mildly. On the one hand, the recovery, though swift and strong, has also been lopsided, and the working classes have hardly benefited from it. On the other hand, the important change towards a more expansionary fiscal policy stance, which stimulated the recovery, was forced on the government by the stronger-than-expected deterioration of the economic situation that gave rise to strong pressure emanating from public opinion. Moreover, the expansionary fiscal policy stance was made possible only by the rise in the price of oil, which gave the government the possibility of enlarging its expenditure without incurring a larger total deficit.

Lecture by Ágnes Horváth and Balázs Zsámboki

Banking Sector Restructuring: The Hungarian Case

Ágnes Horváth and Balázs Zsámboki, both from the National Bank of Hungary, gave a joint presentation on September 11, 1998, in which they provided insights on the recent history of banking sector restructuring in Hungary.

The lecturers reviewed the role of the banking sector in the process of transition. The reform of the financial system comprises two main tasks, namely developing an independent central bank and creating new commercial banks or strengthening existing ones. A crucial issue for established commercial banks is the bad loan problem. Typically, governments seeking to reform the banking sector have three policy options. They can

- give banking institutions the time they need to earn their way out of problems (as Russia did until 1995), or they can
- act directly by injecting capital (Czech Republic, Poland and Hungary), or they can
- liquidate institutions with insufficient value in order to prevent their problems from increasing and spreading to other institutions (Baltic states, from 1995 also Russia).

The Hungarian approach handled consolidation in two phases, with a first phase of loan consolidation in 1992/93 followed by a recapitalization phase in 1993/94. The total cost of consolidation amounted to HUF 357 billion (i.e. approximately 10% of GDP at that time). The lessons of the Hungarian consolidation are threefold: First, bank consolidation is a precondition for privatization. Second, unless reforms alter unsound lending policies, financial resources provided to banks are wasted. Third, measures to improve efficiency, profitability and corporate governance should be preconditions for bank recapitalization.

After financial rehabilitation, Hungarian banks were privatized between 1994 and 1997. Most of the banks were sold to financially powerful professional investors from abroad. Today, two-thirds of the registered capital of banks are owned by a diversified range of foreign investors. Competition within the sector has been intensifying. As a consequence, margins have eroded and banking products and services have improved. In 1997, the sector grew by 8.2% in real terms, and the total balance sheet to GDP ratio rose to 72%. Simultaneously, Hungary witnessed a strong credit expansion without a deterioration of the quality of the asset portfolio – the share of bad loans remained negligible – and the sector's earning position became healthier.

Hungary has gone a long way to bring its banking laws in line with EU standards and is planning additional steps in this direction. For example, next year, state-of-the-art market risk and trading book regulations will take effect. Hungarian rules still differ from EU Directives in other respects as well, for example on the capital requirements for credit cooperatives, the cross-border branching of banks (here the rules already meet the OECD standards), and on several aspects regarding banking supervision. Also, reserve requirements are very high in Hungary as compared to those in the future euro zone.

In the ensuing discussion, a broad number of issues was covered. Inter alia, the impact of the Russian crisis on the Hungarian banking system was examined and judged to be as limited. Another question raised was who the banks' counterparties are in hedging foreign exchange risk; the fact that most of these counterparties are domestic private persons and enterprises was felt to constitute a potential weakness of the very good development of most of the Hungarian banking sector. Also, the topic of potential transition periods for adopting EU standards in the area of financial services was discussed briefly. As an example in this context, the deposit insurance cover as prescribed by EU rules was felt to be too high in the case of Hungary; from the viewpoint of the Hungarian central bank, this calls for a transition period of five years.

Presentation by Zbigniev Zimny

UNCTAD's World Investment Report 1998

On November 10, 1998, Zbigniew Zimny, Chief of the Investment-Related Development Issues Section of UNCTAD, the United Nation's Congress on Trade and Development, presented the World Investment Report 1998 (WIR 98) at a press conference together with OeNB Vice Governor Gertrude Tumpel-Gugerell. The Report highlights the latest global investment trends.

According to Mr. Zimny, foreign direct investment (FDI) by transnational corporations (TNCs) may reach a record of between USD 430 billion to USD 440 billion in 1998 after having risen considerably in 1997, i.e. by 19% in terms of world inflows (USD 400 billion) and 27% in terms of outflows (USD 424 billion). The 1998 increase is projected despite slower world economic growth and the crises in financial markets, stated Mr. Zimny.

TNCs' foreign assets, foreign sales and foreign value added all rose to new records in 1997. FDI is becoming a major stimulus to globalization; at the same time, its growth is a direct result of globalization and economic liberalization.

A comprehensive analysis of investment trends shows how the landscape of global business is changing. The major factors behind the acceleration of FDI are soaring levels of cross-border mergers and acquisitions, increasing numbers of privatizations and strong efforts by countries to attract inward FDI. The world's 100 largest TNCs alone now account for over USD 2 trillion in foreign sales and employ six million foreign staff members.

Mr. Zimny pointed out that increases in FDI in 1998 will probably be concentrated in the developed countries, as well as Latin America.

Largely due to the Asian financial crisis, however, FDI flows into Asia and the Pacific may well be no higher than in 1997 at best, which would mark the first time since 1985 that FDI flows into this region did not rise. Within the Asia-Pacific region, it is probable that there will also be some moderation of inward FDI to China, after six years of rapid gains that saw total FDI inflows in 1997 reach USD 45 billion – this figure represents almost one third of total FDI flows to all developing countries.

Mr. Zimny remarked that TNCs' considerations of where to locate new foreign investments are shifting. Traditional factors, such as the existence of a pro-FDI regime, natural resources, market growth prospects and market size, as well as labor market conditions, continue to remain important. But increasingly firms are also seeking investment locations that offer people-made advantages, so-called "created assets," which range from technological advantages to specific labor skills.

Countries that develop such assets become more attractive to TNCs. The rise in the importance of created assets represents the single most important shift among the economic determinants of FDI location in a liberalizing and globalizing world economy.

The press conference was followed by a symposium entitled "Perspektiven für Investitionen in Zentral- und Osteuropa" (Outlook for Inward Investment in the CEEs) organized and chaired by Franz Nauschnigg of the OeNB. In the course of the symposium, Mr. Zimny reported that FDI in Central and Eastern Europe increased by more than 40% to a record of USD 19 billion in 1997.

Katharina Helmstedt of Austria's Economics Ministry presented data showing an increase in Austrian FDI in the CEEs of 16% in the first quarter of 1998.

Christian Imo (Stock Exchange) presented Vienna as a Financial Center for Central and Eastern Europe. Ferdinand Schipfer of the Oesterreichische Kontrollbank presented the Austrian system of guarantees for FDIs. Peter Neudorfer of the OeNB explained how the return on profit of Austrian FDI in Central and Eastern Europe has increased in recent years.

Gábor Hunya (WIIW) reported that FDI had positive overall effects on the CEECs' manufacturing industries.

The presentations were followed by a lively discussion.

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

The East Jour Fixe of the Oesterreichische Nationalbank, a series of meetings initiated in 1991 as a forum in which economists, members of academia, government officials and other experts on Eastern Europe meet to discuss specific transition issues, looks back on a long tradition. For more details on the history and purpose of these meetings, see "Focus on Transition 1/1996." The series was continued with two presentations on September 25, 1998, and on November 27, 1998. The East Jour Fixe meetings are always opened with speeches held by experts about 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 considered important and is therefore given ample room on the agenda.

Dariusz Rosati, professor at the Warsaw School of Economics and member of the Monetary Policy Council in Poland, presented his insights on the topic "Between Inflation and Capital Inflows: Dilemmas of Monetary Policy in More Advanced Transition Countries" at the OeNB's 32nd East Jour Fixe on September 25, 1998. His lecture was discussed by Istvan Ábel, National Bank of Hungary, and Maciej Krzak, Foreign Research Division of the OeNB. Professor *Pekka Sutela,* Head of the Institute for Economies in Transition of the Bank of Finland (BoFIT), was the keynote speaker at the 33rd East Jour Fixe: "Russia – What Kind of a Market Economy?" He described the main structural elements that have emerged in Russia's market economy and that, in his view, will remain characteristic of this country for years to come. His speech was commented by Peter Havlik, Deputy Director and Senior Economist of the Vienna Institute for International Economic Studies (WIIW), Wolfgang Nitsche, Deputy Director of the Division for Economic and Integration Affairs of the Austrian Federal Ministry of Finance, and Stephan Barisitz, Economist at the Non-Member Economies Division of the OECD's Economics Department. The main findings of the most recent East Jour Fixe meetings are reported below.

Contribution by Dariusz Rosati

Between Inflation and Capital Inflows: Dilemmas of Monetary Policy in More Advanced Transition Countries

Dariusz Rosati, professor at the Warsaw School of Economics and member of the Monetary Policy Council in Poland, chose the topic "Between Inflation and Capital Inflows: Dilemmas of Monetary Policy in More Advanced Transition Countries" for the lecture he held at the OeNB's 32nd East Jour Fixe on September 25, 1998. Professor Rosati's lecture was chaired by Olga Radzyner, Foreign Research Division of the OeNB, and was subsequently discussed by István Ábel, National Bank of Hungary, and Maciej Krzak, Foreign Research Division of the OeNB.

Professor Rosati used the opportunity to present the preliminary results of his recent paper, which centered on the main monetary policy issues related to capital inflows into Poland from 1995 to 1998. Foreign capital tends to flow into transition economies once overall stability has been achieved and once economic growth has resumed. Capital inflows generally increase domestic money supply; this additional growth may become inconsistent with inflation targets. A key policy dilemma is how to keep monetary policy restrictive enough to reduce inflation further, while at the same time avoiding excessive capital inflows attracted by a high interest rate differential adjusted for the expected nominal depreciation of the domestic currency.

Professor Rosati developed a simple model to analyze whether a rise in interest rates leads to a fall in money supply or, to the contrary, to a rise via an increased inflow of foreign capital. The model was estimated and then tested. This econometric exercise produced an ambiguous result: The impact of higher interest rates on domestic credit expansion was stronger than the impact on inflows of portfolio capital when a narrow monetary aggregate was used, but it was weaker when money was measured by a broad aggregate. Thus, the econometric evidence from his model proved to be of little comfort for Polish monetary policy; according to the model, the interest rate hike may have an undesirable effect on inflation.

In addition, Rosati tested which of two options – the first being a cut in the crawling peg devaluation rate by 1 percentage point, the second an interest rate increase by 1 percentage point – has a greater impact on money supply. He came to the conclusion that the first option has a stronger impact, which suggests that a policy of real appreciation is a more effective way to disinflate.

During the discussion István Ábel reviewed the Hungarian experience with capital inflows under a crawling peg regime with a narrow fluctuation band. The Hungarian central bank has successfully coped with inflows mainly by sterilized intervention. The cost of sterilization has been relatively low. Mr. Ábel pointed out that the link between interest rates and capital inflows should not be overstated, as the latter are determined by a number of factors, with investors' confidence playing an important role. Maciej Krzak suggested that the issue of possibly destabilizing short-term capital inflows attracted by interest rates raised to combat inflation could be resolved by resorting to

capital controls on short-term inflows, as Chile and Spain did. In fact, Spain applied temporary capital controls in the late 1980s and early 1990s even after it had acceded to the European Union. This proposition proved controversial in the discussion.

Contribution by Pekka Sutela

Russia – What Kind of a Market Economy?

Professor Pekka Sutela, Head of the Institute for Economies in Transition of the Bank of Finland (BoFIT), gave the main presentation at the 33rd East Jour Fixe: "Russia – What Kind of a Market Economy?" He described the main structural elements that have emerged in Russia's market economy and that, in his view, will remain characteristic of this country for years to come. His speech was commented by Peter Havlik, Deputy Director and Senior Economist of the Vienna Institute for Comparative Economic Studies (WIIW), Wolfgang Nitsche, Deputy Director of the Division for Economic and Integration Affairs of the Austrian Federal Ministry of Finance, and Stephan Barisitz, Economist at the Non-Member Economies Division of the OECD's Economics Department. The main findings of the 33rd East Jour Fixe meeting, which was chaired by Olga Radzyner, are reported below.

Professor Sutela pointed out that today, seven years after the launching of economic reform in Russia, major decisions on the structural setup of the Russian economy have already been made. He stressed that in a very real sense it can be said that Russia's transition from a centrally planned economy to a market one is over. The central institutions of Russian capitalism appear to have taken shape with amazing speed. Four unique characteristics have emerged: (1) the dominance of insider ownership in the sphere of property rights, (2) a largely demonetized barter economy, (3) a strong intertwining of political and economic decision-making devoid of the rule of law, and (4) a recurring gap between objectives set and resources available.

The goal of fast privatization and the inevitability of political compromise led to a quite unique distribution of ownership rights. In the first phase, when two thirds of industry changed hands, most production plants chose a method that issued an average two-thirds of the shares to workers and managers of respective enterprises, either free of charge or for a nominal sum. Although it may be a bit early to judge, the widespread lack of capital has not so far persuaded a large number of workers to sell their shares to outsiders. Where there has been some dilution of employee ownership, it has mostly occurred in favor of managers who seem to have strengthened their positions in recent years, according to Professor Sutela. This reality belies the widespread impression that a small number of financial institutions, media companies and production oligarchs control the commanding heights of most of the Russian economy. What is more, with the recent collapse of the banking system, many oligarchs themselves are now threatened by bankruptcy.

As Professor Sutela put it, the Russian economy can be regarded as a market economy, but not a money one. Whereas broad money supply, M2, comes to less than 20% of GDP, with the latest crisis the ratio of rubles in circulation to GDP has dropped to 4% – which is much lower than in

developed market economies. While most savings of households may be in dollars, over half of production is traded by barter or by using money substitutes of various sorts. The considerable amount of quasi-money circulating in Russia is also connected to efforts at tax evasion, given an overly complicated, inefficient and at times confiscatory tax system. In order to survive and be successful, a Russian entrepreneur has to dissipate his energy among a number of different activities, which reduces his overall productivity. The latter include rendering special services to the authorities, carrying out certain export activities and extensive barter transactions. Professor Sutela emphasized that this feature of the Russian market economy may largely explain why it has not yet begun to grow. The demonetized state of the economy and pervasive barter activities also make it more difficult to discern profitable from unprofitable enterprises and may disguise value subtractors.

Rarely have, in Professor Sutela's assessment, economic and political power been so intertwined as in modern-day Russia. The most important and corrupting consequence is the inability to draw the line between what is lawful and unlawful. Legislation, its interpretation and its execution are so confused, contradictory and subject to daily change that it is probably impossible to live – let alone run a business – without breaking various regulations, on purpose or inadvertently. In contrast to Poland, entrepreneurial activity is seriously lagging behind and stagnating on a modest level in Russia.

The "virtual economy," a term Professor Sutela draws from recent economics literature, corresponds to the gap between objectives set and resources available, something that is a Russian tradition. Pay rises are agreed to that cannot be afforded, budgets are written and approved that no one takes seriously and programs and plans are ceremoniously drafted, sometimes with serious-minded international organizations, whose aim is simply to attract more funds from outside. Whereas the described traits may be the least well understood characteristics of the Russian market economy and while they are, in Professor Sutela's opinion, responsible for locking Russia into a possibly long-term no-growth situation, some of them can also strengthen the economy against external shocks. In a nonmoney economy, the impact of a possible banking crisis will be relatively small. Falling stock exchange prices will not influence demand via the wealth of households because households own hardly any securities.

In the discussion, Peter Havlik addressed the question of why reforms in Russia and other CIS countries are taking so much longer than reforms in Central Europe to bear fruit. He felt that, apart from other reasons, history (70 years of Communism in Russia versus 40 years in Central Europe) and psychology (Central European countries felt liberated from Communism, Russia did not) play a role. Low investment and the disinterest of managers in FDI may be explained by the continuing instability and major uncertainty about the future of Russia, inducing very short-term-oriented behavior. Managers fear that foreign investors could take control of firms, thereby putting an end to asset-stripping practices and endangering the positions of managers themselves. Wolfgang Nitsche doubted whether a market economy could really exist without money, given the reduced role of prices and the

fact that standard economic policy instruments cannot work properly in such an environment. He added that the Russians were apparently "living a lie," refusing to put an end to the pervasive barter system because such a measure would immediately expose unprofitable and value-subtracting enterprises, push the economy into mass bankruptcies and therefore possibly give rise to revolutionary upheavals. Stephan Barisitz questioned the idea that all major elements of "capitalisme à la russe" had already been established, pointing to the as yet lacking market-oriented banking system, tax system and incentives for enterprises to restructure. He was somewhat more optimistic that the Primakov administration might reembark on serious reforms sooner than often expected.

In the ensuing general discussion, Professor Sutela pointed to a fifth important element of the Russian market economy: its resource orientation. Exports of mineral resources keep the Russian economy going and thus stabilize its structure. The discussion then focused on the reasons for the "blindness" of international financial institutions vis-à-vis Russia and identified their dominant political motivations for assistance, with "Russia being too big to fail" cited.

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

In the second half of 1998, the OeNB continued its cooperation activities with Central and Eastern European countries and CIS republics both on a bilateral and on a multilateral level.

On a bilateral level, the OeNB in 1998 successfully continued its series of highly specialized seminars for central bankers, which was started in 1997, with four one-week seminars on the following topics: EU – Selected Issues Part One (February 1998), Financial and Balance-of-Payment Statistics (April 1998), EU – Selected Issues Part Two (June 1998) and Selected Macroeconomic Issues from a Central Bank Viewpoint (September 1998). For 1999, the OeNB plans four one-week seminars on the topics of Human Resource Management (August 1999), The Analysis of Industrial Enterprises and Banks from a Central Bank Viewpoint (August/September 1999), Financial and Balance-of-Payments Statistics (October 1999), EU/EMU – One Year of Experience (December 1999). Furthermore, the OeNB has established an intensive cooperation with the National Bank of Georgia (NBG). After a preparatory visit of a senior OeNB expert to the NBG in October 1998, a staff member of the NBG will pay a two-week study visit to the OeNB in February 1999 on the topic of macroeconomic analysis and forecasting methodology.

On a multilateral level, the OeNB takes part in the EU-financed technical assistance program for the Central Bank of Russia (CBR). Within the PHARE framework, the OeNB hosted three study visits for experts from the National Bank of Poland in the second half of 1998, the first on the topic of international organizations (July 1998), the second on legal and technical aspects of cross-border payments (October 1998) and the third on organizational issues and strategic planning (October 1998). Within the framework of IMF-coordinated technical assistance, a senior staff member took part in IMF missions to Albania on payment systems issues in September and November 1998, respectively.

In 1998, the Joint Vienna Institute's (JVI) mandate was extended by another five years. For these second five years of operation of the JVI, the Austrian authorities have been asked to increase their contribution to the academic program. Therefore, the new course in Applied Economic Policy (AEP), the successor of the former Comprehensive Course, will for the first time have an "Austrian segment." This segment, which will be jointly financed by the Austrian Ministry of Finance and the OeNB, will comprise 2½ days of lectures devoted to specificities of the Austrian economy, such as the political and economic structure, the issue of fiscal federalism, incomes policies, Austria's experiences with EU accession and implications of the euro introduction. These lectures will brief participants for the study tour, which will be held immediately afterwards and will be shortened to three days. As previously, the program for each study tour will be organized by the OeNB. Moreover, Austria will increase its contribution to the seminar program of the JVI. In addition to the four one-week seminars held by the OeNB every year, the OeNB and Ministry of Finance will jointly organize two one-week seminars. The topics of these Austrian seminars in 1999 will be as follows: The Changing Role of Government in Economic Reforms (October 1999), and Foreign Direct Investment and Privatization

Policies (December 1999). Austria's increased contribution to the JVI academic program is a logical continuation of its long-lasting support of the Institute.

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	×	×	+3.8	+1.5	–8.7	–3.7	+2.8
1994	+1.8	+2.6	–1.8	+2.9	+0.6	–9.8	+5.2	+4.0	–12.7	+4.9	+5.3
1995	+2.9	+4.8	+4.2	+1.5	–0.8	+3.3	+7.0	+7.2	–4.1	+6.9	+4.1
1996	–10.1	+3.9	+4.0	+1.3	+3.3	+4.7	+6.1	+3.9	–3.5	+6.6	+3.1
1997	–6.9	+1.0	+11.4	+4.4	+6.5	+5.7	+6.9	–6.6	+0.8	+6.5	+3.8
1997											
2nd quarter	–8.3	+0.5	+12.4	+4.3	+7.1	+9.0	+7.6	×	–0.6	+6.2	+5.4
3rd quarter	–10.0	–0.1	+11.5	+5.1	+8.5	+6.4	+6.8	×	+1.0	+6.6	+3.0
4th quarter	+2.4	+2.2	+13.5	+5.3	+7.4	+4.5	+6.5	×	+2.6	+6.9	+6.5
1998											
1st quarter	+18.5	–0.9	+9.3	+4.5	+7.7	+6.9	+6.5	–9.4	–0.1	+6.2	+6.5
2nd quarter	+6.3	–2.4	+5.5	+5.1	. .	+9.5	+5.3	–1.0	–0.9	+6.0	+3.2

Source: WIIW (The Vienna Institute for International Economic Studies); Estonia, Latvia, Lithuania: IMF; Estonia: national source from 1997.
Quarterly data: national sources.

Industrial Production

	Bulgaria	Czech Republic	Estonia[1]	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	–20.2	–21.2	×	–16.6	×	–4.9	–8.0	–22.8	–8.0	–19.4	–12.4
1992	–18.4	–7.9	×	–9.7	–34.6	–51.6	+2.8	–21.9	–18.0	–9.3	–13.2
1993	–9.8	–5.3	×	+4.0	–38.1	–34.7	+6.4	+1.3	–14.1	–3.8	–2.8
1994	+10.6	+2.1	–2.1	+9.5	–9.5	–29.8	+12.1	+3.3	–20.9	+4.8	+6.4
1995	+4.5	+8.7	–1.4	+4.6	–6.3	+0.9	+9.7	+9.4	–3.3	+8.3	+2.0
1996	+3.8	+2.0	+0.0	+3.4	+0.0	+3.5	+8.3	+9.9	–4.0	+2.5	+1.0
1997	–8.6	+4.5	+12.0	+11.1	+7.6	+5.0	+10.8	–5.9	+1.9	+2.7	+1.0
1997											
July	–15.2	+3.9	+9.1	+8.7	+8.1	+2.9	+10.2	–10.7	+3.4	+3.6	+1.6
August	–6.3	+4.1	+6.6	+11.3	+2.2	–3.6	+8.5	–19.4	+3.0	–1.7	–0.8
September	–22.0	+8.5	+13.4	+18.7	+10.9	+0.7	+16.1	–15.6	+2.4	–0.7	+1.4
October	–26.4	+9.8	+12.5	+14.3	+13.6	–4.4	+10.7	–11.6	+2.3	+2.4	+0.9
November	–27.7	+8.3	+14.1	+14.1	+12.3	+13.9	+11.3	–11.7	+3.7	+3.3	+0.1
December	–24.5	+10.9	+16.3	+16.1	+22.5	+20.7	+13.3	–14.3	+4.2	+5.2	+2.7
1998											
January	–12.0	+6.5	+8.8	+8.7	+14.7	+1.6	+7.7	–24.0	+1.5	+0.6	+8.0
February	+21.0	+8.8	+10.3	+11.7	+12.5	+12.4	+10.3	–24.1	+1.4	+2.4	+8.9
March	+6.8	+11.2	+14.5	+20.5	+17.0	+22.0	+15.0	–17.8	+1.2	+10.9	+12.5
April	–5.0	+3.5	+1.2	+9.2	+1.3	+5.0	+3.9	–18.2	+0.8	+5.6	–6.3
May	–11.0	+9.7	+4.6	+18.0	+10.6	+10.4	+9.5	–16.7	–2.1	+7.5	+3.0
June	–4.0	+6.4	+7.4	+14.0	+9.9	+6.7	+4.8	–13.7	–2.5	+4.6	+4.2
July	–14.0	+7.5	+1.3	+16.1	+1.6	+5.4	+6.0	–15.8	–9.4	+8.3	+1.1
August	–15.0	+1.1	–2.2	+13.4	–0.1	+5.1	+6.0	–16.8	–11.5	+9.1	+8.6
September	–23.0	–1.8	–10.7	+14.0	–11.1	+5.6	+1.1	–5.3	–14.5	+6.9	+3.4
October	. .	. .	–10.1	. .	. .	. .	–1.1	. .	–11.1	. .	. .

Source: Annual data: WIIW; Estonia, Latvia, Lithuania: national sources. Monthly data: national sources.
[1]) *Industrial sales.*

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	6.6	9.9	12.8	14.4
1997	13.7	5.2	3.6	10.4	6.7	6.7	10.3	8.8	11.3	12.5	14.8
1997											
July	14.2	4.3	3.7	10.5	7.5	5.3	11.3	7.2	10.9	12.8	14.4
August	14.0	4.5	3.5	10.4	7.3	5.4	11.0	7.1	10.9	12.8	14.4
September	13.6	4.8	3.5	10.3	7.1	5.6	10.6	7.2	11.0	13.0	14.4
October	13.4	4.9	3.6	10.1	6.8	5.9	10.3	7.6	11.1	12.9	14.5
November	13.5	4.9	3.6	10.3	6.7	6.3	10.3	8.1	11.2	12.6	14.5
December	13.7	5.2	3.6	10.4	7.0	6.7	10.3	8.9	11.3	12.5	14.8
1998											
January	14.2	5.6	3.9	10.8	7.0	7.4	10.7	9.3	11.3	13.4	15.0
February	14.3	5.6	3.9	10.6	7.0	7.5	10.6	9.7	11.4	13.6	14.9
March	13.7	5.5	4.1	10.3	7.1	7.5	10.4	9.6	11.4	13.4	14.7
April	13.0	5.4	4.0	9.8	7.1	6.9	10.0	9.4	11.6	13.2	14.4
May	12.1	5.3	3.7	9.5	7.0	6.2	9.7	9.2	11.5	12.9	14.3
June	11.4	5.6	3.4	9.1	7.2	5.5	9.6	8.9	11.5	13.5	14.1
July	11.1	6.1	3.4	9.2	7.3	5.4	9.6	8.8	11.5	14.1	14.2
August	10.8	6.4	3.3	9.0	7.4	5.4	9.5	8.7	11.5	13.8	14.2
September	10.7	6.8	3.5	8.9	7.6	5.6	9.6	8.7	11.5	13.8	14.3
October	11.1	6.8	. .	8.8	8.2	6.0	9.7	9.0	11.6	13.9	. .

Source: annual data: IMF; monthly data: national sources.

Consumer Price Index

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	Period average (annual change in %)										
1989	×	1.4	×	17.0	×	×	251.1	1.1	×	×	×
1990	23.8	9.7	×	28.9	×	×	585.8	5.1	5.3	10.4	×
1991	338.5	56.6	×	35.0	×	×	70.3	170.2	92.6	61.2	×
1992	91.2	11.1	×	23.0	243.6	×	43.0	210.4	1,526.6	10.0	207.3
1993	72.8	20.8	89.8	22.5	108.8	409.6	35.3	256.1	873.5	23.2	32.9
1994	96.0	10.0	47.7	18.8	35.9	72.1	32.2	136.8	307.6	13.4	21.0
1995	62.1	9.1	28.8	28.2	25.0	39.7	27.8	32.3	197.5	9.9	13.5
1996	123.0	8.8	23.1	23.6	17.6	24.6	19.9	38.8	47.8	5.8	9.9
1997	1,082.2	8.5	10.6	18.3	8.4	8.9	14.9	154.8	14.8	6.1	8.4
1997											
July	1,267.2	9.4	10.8	18.1	7.6	8.7	14.9	159.8	14.7	6.0	8.1
August	1,132.2	9.9	11.9	18.0	8.6	8.7	14.5	159.1	14.9	6.5	9.0
September	974.6	10.3	11.9	18.0	8.2	8.6	13.6	161.4	14.1	5.7	9.2
October	825.8	10.2	12.2	17.7	7.6	9.0	13.1	169.2	12.9	5.9	8.7
November	748.6	10.1	12.4	18.2	7.3	9.0	13.2	165.4	11.6	6.2	9.1
December	578.5	10.0	12.5	18.4	7.0	8.3	13.2	151.4	11.0	6.4	8.8
1998											
January	382.1	13.1	10.9	17.7	6.3	6.5	13.6	131.9	10.1	7.2	9.0
February	43.1	13.4	13.1	17.1	6.2	6.4	14.2	109.3	9.3	7.5	9.1
March	27.4	13.4	13.3	16.4	6.0	6.7	13.9	66.1	8.5	7.2	9.4
April	28.4	13.1	12.6	16.0	6.0	7.0	13.7	59.6	8.0	7.0	9.1
May	22.1	13.0	13.0	15.8	5.4	6.7	13.3	56.6	7.5	7.6	8.3
June	18.9	12.0	11.0	14.2	5.9	6.0	12.2	55.0	6.4	7.4	8.3
July	13.0	10.4	10.5	14.1	4.6	5.1	11.9	56.0	5.6	7.0	7.7
August	6.1	9.4	10.3	13.5	3.7	4.4	11.3	51.7	9.5	5.7	7.6
September	5.5	8.8	9.6	12.5	3.5	3.7	10.6	50.8	52.2	5.9	7.1
October	4.7	8.2	8.1	12.3	2.9	. .	9.9	47.1	58.8	6.2	6.9

Source: WIIW; Estonia, Latvia: IMF; Estonia, Lithuania, Latvia: national sources from October 1998.

Trade Balance

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	USD million										
1989	−1,199.0	454.6	×	537.0	×	×	240.0	2,559.0	×	×	×
1990	− 757.0	− 252.3	×	348.0	×	×	2,214.0	−1,743.0	×	×	×
1991	− 32.0	339.7	×	189.0	×	×	51.0	−1,254.0	×	×	×
1992	− 212.4	−1,901.6	×	− 48.0	×	×	512.0	−1,420.0	×	×	791.1
1993	− 885.4	− 525.3	− 91.0	−3,247.0	37.0	−154.7	− 2,293.0	−1,128.0	×	− 932.0	−154.2
1994	− 16.9	−1,381.2	− 353.0	−3,635.0	−252.0	−204.9	− 836.0	− 411.0	17,838.0	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	20,807.0	− 227.5	−954.3
1996	187.6	−5,877.3	−1,141.1	−2,645.0	−789.5	−878.6	− 8,154.0	−2,470.0	23,076.0	−2,292.5	−881.6
1997	396.0	−4,589.6	−1,446.0	−1,734.0	−935.0	−930.0	−11,268.0	−1,980.0	17,325.0	−1,471.8	−771.6
1997											
July	×	− 437.2	− 121.4	− 218.9	− 68.1	−137.8	− 901.0	− 200.0	1,800.0	− 85.5	− 37.7
August	×	− 271.7	− 107.2	− 101.6	− 65.3	−105.5	− 717.0	− 68.0	900.0	− 37.5	− 69.7
September	84.1	− 135.1	− 95.9	− 107.7	− 78.9	−128.0	− 905.0	− 72.0	700.0	− 50.1	12.1
October	×	− 287.4	− 149.5	− 127.3	−101.6	−146.3	− 860.0	− 224.0	2,000.0	− 105.2	− 54.5
November	×	− 362.4	− 140.2	− 23.4	−106.7	−188.6	− 949.0	− 285.0	2,400.0	− 29.9	− 36.1
December	− 66.4	− 493.6	− 160.0	− 289.4	−117.3	−241.0	− 1,213.0	− 458.0	1,400.0	− 185.6	− 43.1
1998											
January	×	− 138.1	− 112.7	− 232.0	− 52.9	−110.1	− 1,443.0	− 60.8	400.0	− 148.2	− 86.5
February	×	− 73.2	− 117.9	− 165.0	− 64.4	−133.0	− 813.0	− 12.4	0.0	− 142.1	− 85.5
March	22.2	− 229.6	− 136.5	− 129.0	−115.1	−203.3	− 986.0	− 185.5	600.0	− 180.9	−106.4
April	×	− 256.2	− 170.0	− 241.0	−109.2	−183.3	− 1,006.0	− 229.5	− 300.0	− 252.5	− 89.2
May	×	− 253.7	− 139.5	− 202.0	− 91.6	−180.1	− 815.0	− 297.0	200.0	− 172.7	− 87.9
June	5.3	0.8	− 158.1	− 331.0	−102.8	−214.6	− 940.0	− 132.4	− 300.0	− 204.0	− 34.6
July	×	− 277.8	− 164.1	− 327.0	−106.6	−173.1	− 968.0	− 143.9	400.0	− 157.4	1.5
August	×	− 153.8	..	− 298.0	..	..	− 706.0	..	..	− 208.8	..
September	..	..	..	..	..	..	..	..	..	..	..

Source: national sources.

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	455.8	23.3	−3,455.0	417.0	− 85.7	−2,329.0	−1,174.0	×	− 601.2	191.9
1994	− 31.9	− 786.8	−170.8	−3,911.0	201.0	− 93.8	− 944.0	− 428.0	9,284.0	664.9	600.1
1995	− 25.6	−1,369.1	−187.9	−2,480.0	− 16.3	−614.3	5,455.0	−1,774.0	7,938.0	391.4	− 22.8
1996	15.9	−4,292.2	−423.1	−1,678.0	−454.0	−722.6	−1,352.0	−2,571.0	12,096.0	−2,098.1	38.9
1997	445.7	−3,155.8	−608.9	− 981.0	−442.5	−944.5	−4,268.0	−2,338.0	3,300.0	−1,343.1	36.6
1997											
July	×	×	×	− 11.0	×	×	− 319.0	− 248.0	×	− 56.0	10.6
August	×	×	×	97.0	×	×	− 136.0	− 104.0	×	10.4	− 13.6
September	126.9	− 650.7	−125.8	− 10.0	− 72.7	−139.2	− 451.0	− 57.0	− 900.0	− 49.8	80.9
October	×	×	×	0.0	×	×	− 60.0	− 310.0	×	− 89.5	18.6
November	×	×	×	71.0	×	×	− 280.0	− 222.0	×	− 10.7	45.8
December	53.7	− 601.7	−211.2	− 367.0	−123.4	−407.4	− 325.0	− 551.0	300.0	− 145.1	− 11.8
1998											
January	×	×	×	− 210.0	×	×	− 965.0	− 119.0	×	− 142.3	− 15.5
February	×	×	×	− 16.0	×	×	− 279.0	− 43.0	×	− 189.2	− 28.4
March	− 62.4	..	−122.7	− 155.0	− 85.1	−292.8	− 755.0	− 176.0	− 1,700.0	− 126.9	− 31.0
April	×	×	×	− 63.0	×	×	− 440.0	− 284.0	×	− 254.7	− 18.8
May	×	×	×	18.0	×	×	− 116.0	− 296.0	×	− 200.6	− 16.5
June	90.6	..	− 90.7	− 478.0	..	−383.0	− 19.0	− 157.0	− 4,300.0	− 180.9	7.1
July	×	×	×	− 167.0	×	×	− 86.0	..	×	..	35.9
August	×	×	×	..	×	×	242.0	..	×	..	..

Source: national sources; sum of monthly figures need not correspond to the annual result.

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	×	×	×
1990	×	×	×	1,070	×	×	4,492.1	524	×	×	×
1991	320	×	×	3,936	×	×	3,632.6	695	×	×	112.1
1992	902	755.0	170.2	4,428	×	45.3	4,099.1	826	×	×	715.5
1993	655	3789.4	386.1	6,771	431.6	350.3	4,091.9	995	5,835.0	415.7	787.8
1994	1,002	6144.5	443.4	6,810	545.2	525.5	5,841.8	2,086	3,980.4	1,691.2	1,499.0
1995	1,236	13843.0	579.9	12,052	504.0	757.1	14,774.1	1,579	14,382.8	3,363.9	1,820.8
1996	484	12352.0	636.8	9,795	654.1	772.3	17,844.0	2,103	11,276.4	3,418.9	2,297.4
1997	2,249	9733.7	757.7	8,476	704.0	1,010.0	20,407.2	3,803	13,018.3	3,230.3	3,314.7
1997											
July	1,643	10,787	604.3	8,212	672.5	1,091.3	19,065.7	3,062	20,186.1	2,955.0	2,942.3
August	1,833	11,191	655.7	8,312	688.1	1,023.1	19,627.3	3,156	19,603.9	3,126.5	3,107.6
September	1,980	10,936	691.4	8,211	698.5	967.8	19,752.4	3,659	18,737.0	3,096.4	3,281.6
October	2,113	11,003	725.6	8,708	698.3	973.6	20,845.8	3,652	18,447.7	3,356.4	3,371.0
November	2,139	10,139	680.4	8,743	691.0	1,025.6	20,691.9	3,813	12,201.4	3,391.5	3,359.2
December	2,249	9,778	757.7	8,408	704.0	1,010.0	20,407.2	3,803	13,018.3	3,230.3	3,314.7
1998											
January	2,081	9,866	677.9	8,610	699.2	997.5	20,407.2	3,584	10,479.7	3,106.6	3,261.4
February	2,267	10,300	714.0	9,102	708.2	1,021.7	22,649.1	3,587	10,212.1	3,147.6	3,299.3
March	2,337	10,621	659.1	9,496	743.0	1,096.2	22,789.4	3,311	11,910.5	3,088.3	3,286.1
April	2,385	11,092	700.4	10,011	763.8	1,096.9	23,889.5	3,294	10,956.6	3,294.5	3,350.2
May	2,635	10,996	757.8	10,124	792.2	1,112.8	24,454.0	3,244	9,625.6	3,668.3	4,054.5
June	2,670	10,760	815.8	9,606	805.1	1,109.8	24,278.5	3,270	11,160.5	3,735.6	3,656.4
July	2,679	11,393	734.7	9,746	814.3	1,669.1	25,810.6	3,210	10,805.1	3,715.5	3,568.1
August	2,508	11,413	830.2	9,400	815.3	1,621.3	26,106.9	3,122	8,197.6	3,567.0	3,570.6
September	2,551	12,700	783.8	8,791	739.2	1,472.2	26,112.0	2,872	8,840.3	3,055.8	3,821.8
October	2,599	. .	754.4	. .	685.2	1,438.5	. .	. .	. .	. .	3,852.9

Source: IMF; Slovakia: national sources from September 1998.

Central Government Surplus / Deficit

	Bulgaria	Czech Republic	Estonia[1])	Hungary	Latvia	Lithuania	Poland[2])	Romania[3])	Russia	Slovak Republic	Slovenia[4])
	% of GDP										
1989	×	−1.2	×	−3.1	×	×	−3.0	7.5	0.7	−0.5	×
1990	×	−0.2	×	−0.1	×	×	0.4	−0.4	1.3	−0.2	×
1991	×	−2.0	×	−4.6	×	×	−3.8	−1.9	− 2.7	−3.4	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	− 6.2	0.9	−0.6	−5.5	−1.9	−1.9	−2.7	−4.2	−10.7	−5.2	−0.2
1995	− 6.6	0.5	−0.5	−5.5	−3.8	−1.8	−2.6	−4.1	− 3.1	−1.6	0.0
1996	−10.9	−0.1	−1.6	−1.9	−0.8	−2.5	−2.5	−4.9	− 4.3	−4.4	0.3
1997	− 3.9	−1.0	1.5	−4.1	1.2	−1.0	−1.4	−3.6	− 4.6	−5.7	−1.1
1997											
1st quarter	− 7.4	−2.2	−0.7	−5.8	1.4	−0.6	−3.5	−4.8	− 7.2	−2.9	×
2nd quarter	− 3.8	−1.5	−0.4	−2.6	2.1	−0.3	−3.7	−2.1	− 8.1	−6.0	×
3rd quarter	− 0.9	1.1	4.6	−3.8	1.4	0.5	1.7	−4.2	− 6.4	−8.7	×
4th quarter	− 2.6	−1.1	2.3	−4.2	0.0	−3.7	0.1	−3.5	− 5.7	−5.2	×
1998											
1st quarter	7.2	2.0	−0.7	−7.6	3.1	−0.8	−3.0	−3.4	− 4.6	0.7	×
2nd quarter	− 5.7	−1.3	−0.1	−0.8	1.0	−0.7	−4.6	−4.4	− 5.2	−2.7	×
3rd quarter	6.6	1.0	. .	−3.1	0.8	. .	−0.7	−0.2	− 3.3	−2.4	×

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

[1]) *Including social budget in 1993 and 1994.*

[2]) *Up to 1990: general government surplus/deficit.*

[3]) *1990: including social insurance budget.*

[4]) *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	×	52,400.0	×	×
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	58.4	21,644.0	64.6	56.0	47,044.0	3,240.0	80,200.0	2,981.0	1,741.0
1993	13,889.4	9,604.9	153.9	24,566.0	235.8	328.0	47,246.0	4,249.0	112,784.0	3,626.0	1,873.0
1994	11,411.4	12,209.7	186.0	28,526.0	373.8	494.0	42,174.0	5,528.6	121,600.0	4,310.0	2,258.0
1995	10,229.2	17,190.3	286.4	31,660.0	462.6	763.0	43,957.0	6,458.5	120,500.0	5,827.0	2,970.0
1996	9,571.0	21,180.5	405.3	27,646.0	472.2	1,286.0	40,423.0	8,334.3	125,000.0	7,810.0	4,010.0
1997	8,803.0	21,616.5	. .	23,747.0	. .	. .	38,496.0	. .	130,800.0	9,900.0	4,176.0

Source: WIIW; Estonia, Latvia, Lithuania: World Bank; Czech Republic: national sources from 1997.
[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
1997	0.73	38.50	87.91	6.53	2,100.91	305.11	372.16	0.17	0.21	36.30	7.64
1997											
July	0.71	37.54	88.08	6.57	2173.48	315.16	371.15	0.18	0.22	36.93	7.75
August	0.70	37.88	88.00	6.55	2194.42	324.23	372.49	0.17	0.22	37.24	7.65
September	0.70	37.45	87.98	6.43	2141.94	314.87	364.36	0.17	0.22	36.58	7.55
October	0.70	37.58	87.99	6.33	2118.60	309.32	361.53	0.16	0.21	36.69	7.47
November	0.70	36.81	88.03	6.22	2099.47	304.95	348.18	0.16	0.21	36.38	7.46
December	0.70	35.98	87.89	6.20	2118.22	312.44	354.48	0.16	0.21	36.19	7.45
1998											
January	0.70	36.13	87.95	6.19	2147.23	319.40	361.05	0.15	0.21	36.36	7.46
February	0.70	36.95	87.90	6.14	2155.84	319.07	360.67	0.16	0.21	36.13	7.45
March	0.70	37.80	87.97	6.10	2163.67	321.31	375.66	0.16	0.21	36.68	7.46
April	0.70	37.80	87.95	6.04	2142.27	319.20	373.40	0.15	0.21	36.50	7.48
May	0.70	38.40	88.01	5.93	2098.86	312.21	365.28	0.15	0.20	36.48	7.52
June	0.70	37.89	88.00	5.84	2101.05	315.16	362.36	0.15	0.20	36.21	7.52
July	0.70	39.60	87.93	5.81	2104.36	316.18	365.61	0.15	0.20	36.20	7.48
August	0.70	39.13	87.99	5.68	2086.73	314.58	350.99	0.14	0.19	35.75	7.46
September	0.70	39.00	87.94	5.44	2041.60	299.61	332.29	0.13	0.08	34.85	7.44
October	0.70	39.39	87.90	5.34	2020.51	287.92	337.27	0.12	0.07	35.95	7.43
November[1])	0.70	39.75	87.79	5.43	2060.85	300.00	345.42	0.12	0.07	36.08	7.39

Source: IMF; Poland: end of period from October 1998; Lithuania: end of period from November 1998.
[1]) End of period.

Discount Rate[1])

	Bulgaria	Czech Republic	Estonia	Hungary[2])	Latvia	Lithuania	Poland	Romania	Russia[3])	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
1997	6.7	13.0	×	20.5	4.0	13.0	24.5	40.0	28.0	8.8	10.0
1997											
July	5.4	13.0	×	21.0	4.0	×	22.0	40.0	24.0	8.8	10.0
August	5.9	13.0	×	21.0	4.0	×	24.5	40.0	24.0	8.8	10.0
September	6.0	13.0	×	20.5	4.0	×	24.5	40.0	24.0	8.8	10.0
October	4.9	13.0	×	20.5	4.0	13.0	24.5	40.0	21.0	8.8	10.0
November	5.9	13.0	×	20.5	4.0	13.0	24.5	40.0	28.0	8.8	10.0
December	6.7	13.0	×	20.5	4.0	13.0	24.5	40.0	28.0	8.8	10.0
1998											
January	6.1	13.0	×	20.5	4.0	13.0	24.5	40.0	28.0	8.8	10.0
February	5.5	13.0	×	20.0	4.0	13.0	24.5	40.0	39.0	8.8	10.0
March	5.3	13.0	×	20.0	4.0	13.0	24.5	40.0	30.0	8.8	10.0
April	5.4	13.0	×	19.5	4.0	13.0	24.5	40.0	30.0	8.8	10.0
May	5.1	13.0	×	19.5	4.0	13.0	23.5	40.0	150.0	8.8	10.0
June	5.2	13.0	×	19.0	4.0	13.0	23.5	40.0	80.0	8.8	10.0
July	5.2	13.0	×	19.0	4.0	13.0	21.5	40.0	60.0	8.8	10.0
August	5.1	11.5	×	18.0	4.0	13.0	21.5	35.0	60.0	8.8	10.0
September	5.1	11.5	×	18.0	4.0	13.0	21.5	35.0	60.0	8.8	10.0
October	. .	. .	×	. .	4.0	. .	20.0	. .	. .	. .	. .

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

[1]) *Due to currency board arrangements, the Bank of Estonia and the Bank of Lithuania do not define or publish discount rates. On October 9, 1997, the Bank of Lithuania introduced an "official lending rate": this is the weighted average rate on domestic currency lending to residents.*

[2]) *Base rate.*

[2]) *Refinancing rate.*