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

## ***In Memoriam Olga Radzyner (1957 to 1999)***

*Some of our readers may have already heard, others may simply have missed her name in the list of contributors: Olga Radzyner, Head of the Foreign Research Division of the Oesterreichische Nationalbank, who founded and masterminded the Focus on Transition, died in an airplane crash along with her family on the Cape Verde Islands on August 7, 1999.*

*Born in Warsaw, Olga Radzyner was educated in Vienna, where she attended the Lycée Français. She graduated with the French baccalauréat and the Austrian Matura, studied economics at the University of Vienna and graduated in 1980. In May, 1981, she joined the Oesterreichische Nationalbank, where she spent her entire professional life. She started her career at the Oesterreichische Nationalbank as an economist in the International Division and moved on to country analysis in the Foreign Research Division in 1983. Her personal background as well as her fluency in seven languages provided an ideal basis for her professional specialization, namely the analysis of Central and Eastern European economies and the coordination of technical assistance. In 1993, she was appointed Deputy Head and, in 1997, Head of the Foreign Research Division.*

*Olga Radzyner's analytical interest in Central and Eastern Europe remained a constant throughout her professional life. She was a country specialist on Poland, Hungary, the former Soviet Union and its successor states. Moreover, she wrote numerous articles, undertaking cross-country comparisons of macroeconomic developments and policies in transition countries, especially monetary and exchange rate policy, central bank independence, economic issues related to EU approximation, to name only the most recent topics that she covered. Olga Radzyner displayed an uncanny acumen about breaking issues in her field of expertise, and it was mainly on Olga Radzyner's personal initiative that the Bank in 1996 decided to make this expertise on Central and Eastern Europe accessible to a broader public and created a new regular publication exclusively devoted to transition economies, the Focus on Transition. Meanwhile, the Focus on Transition has over 2,000 readers in more than 30 countries, and the international community, above all international institutions and other central banks, has reacted to the articles published therein.*

*As a consequence of her participation in international conferences and very specialized training programs – and, of course, her outgoing nature, her highly personal approach and her warmhearted manner, Olga Radzyner*



*had established an outstanding network of international contacts. This network was exceptional in several ways: It comprised people in the East and in the West, and covered different institutions, such as central banks, ministries and international organizations. Most importantly, Olga had established not only professional contacts, but in many cases had made friends. Her international networking skills made her the ideal candidate to represent the Bank in several international bodies dealing with the coordination of technical assistance and training. In 1993, Olga Radzyner was appointed official representative of the OeNB at the BIS group of coordinators of central bank technical assistance and at the Executive Board of the Joint Vienna Institute. Moreover, she was appointed Austrian coordinator for the EC TACIS training programs for the Central Bank of Russia and Ukraine National Bank. Her profound knowledge of the economic problems faced by transition countries and, at the same time, her regular personal contacts with representatives from these countries enabled her to optimally assess the changing needs for training and technical assistance. On the other hand, her own analytical work benefited from this continued “hands on” dialogue.*

*Olga was not only an outstanding specialist in her field. All of us who had the privilege of working with her appreciated her keen intelligence, her kind personality – and her wonderful sense of humor. Olga Radzyner set a hard-to-follow example with her undauntingly creative approach and the seemingly inexhaustible energy with which she tackled her many endeavors.*

*We will sorely miss her.*

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.

This volume of the Focus on Transition contains five parts: an update of recent economic developments in selected countries, a studies section with two studies, a special report about macroeconomic developments and economic policy in Ukraine, a summary of the latest activities of the Oesterreichische Nationalbank dealing with transition (lectures, discussions, technical cooperation), and a statistical annex.

In the next few years, the crucial challenge for Europe will be the scheduled enlargement of the European Union. The European Council of Helsinki gave the enlargement process a renewed impetus by extending the accession negotiations to all Central and Eastern European candidate countries. To keep the accession process manageable even now that the Union is negotiating with a comparatively large number of countries, it will be essential to key the pace of negotiations as objectively as possible to the further progress of the candidate countries toward fulfilling the conditions for EU membership. The update reflecting the economic progress in selected CEECs should specifically be seen in the light of such deliberations.

Increasing integration into international financial markets entails higher financial flows between economies, which, beside its positive impact on investment projects and the spillover of managerial and technical know-how, can also have inflationary effects and can enhance the vulnerability of an economy's financial system. The first study analyzes these aspects for advanced transition economies. The paper gives a brief overview of macroeconomic effects of capital inflows with an emphasis on the impact of capital inflows on the current account in the Czech Republic, Hungary, Poland and Slovenia. Against this background, the paper presents stylized facts on the influence of capital flows on exchange reserves and monetary aggregates in CEECs. The paper goes on to investigate the impact of various kinds of capital inflows and other variables on the development of inflation in Hungary. It finally examines the development of several monetary and real variables in the accession countries, in particular the development of M2/reserves, of short-term debt/reserves, stock prices, real exchange rates and unit labor costs, the indicators identified as the most reliable early warning signals of financial crises. In the case of Hungary there is evidence of an impact of FDI on the inflation rate. There seems to be a fairly robust relationship between the development of the nominal exchange rate and the inflation rate, whereas the statistical link between nominal interest rates and inflation seems to be much weaker. The levels and dynamics of financial indicators presented in the paper point to a relatively moderate vulnerability of the CEECs to financial crises at present.

The second study reviews the recent changes in exchange rate regimes in Central and Eastern Europe and is based on a paper presented at the OeNB's East West Conference in 1999. The analysis starts with an account of the developments of exchange rate regimes in the Central and Eastern European EU applicant countries since the onset of the Asian crisis, proceeds to analyze

these developments against the backdrop of the recent emerging market crises and ends with an assessment of the current and future monetary challenges for CEECs. The paper shows that recent changes in exchange rate regimes in Central and Eastern European EU applicant countries do not display a uniform trend. Where policies have been broadly sound and consistent, intermediate exchange rate regimes have performed reasonably well and have weathered the storm of financial contagion after the Russian crisis. There is no standard single exchange rate regime path which would lead from the variety of today's regimes to EU accession, participation in ERM II and finally adoption of the euro. While a certain degree of exchange rate flexibility appears reasonable for most applicant countries during the remaining years of the preaccession period and beyond, alternative strategies relying on a fixed or quasi-fixed exchange rate also appear to be feasible, provided that the demanding preconditions for their viability are lastingly met.

The volume also contains a special report about macroeconomic and economic policy developments in Ukraine. The report reviews the arduous transition of the country in the first eight years of independence. Ukrainian output is estimated to have shrunk by more than 50% of GDP since 1992. Although impressive progress has been made in some areas of reform, structural reform has been hampered by the longstanding rivalry between the executive and legislative branches and the potent position of special interest groups. While inflation has been brought under control in recent years and a certain degree of monetary stability has been attained, Ukraine has run up twin deficits (shortfalls in the budget and the current account), which make the economy vulnerable to external shocks.

I would like to draw your special attention to a highlight of the OeNB's Central and Eastern European integration activities, namely the East West Conference, which took place from November 21 to 23 at the Vienna Hilton. The broad variety of topics covered under the conference's title "Financial Crisis: A Never-Ending Story?" ranged from the possible causes of crises to their unpleasant tendency to spread rapidly from one country to the next.

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

Franz Schardax

## I Introduction

In the second quarter of 1999 a pick-up in growth rates<sup>1)</sup> in the five countries covered in this report – the Czech Republic, Hungary, Poland, Slovakia and Slovenia – was recorded, which was sustained in Hungary, Poland and the Czech Republic in the third quarter of 1999. Differences in growth performance remained large during the first three quarters of 1999, ranging from a contraction by 0.9% in the Czech Republic to an expansion by 4.1% in Slovenia. By the end of the year, Poland and Hungary are expected to catch up with (or overtake) Slovenia, as Slovenia's surge in GDP growth in the second quarter was heavily influenced by the introduction of a VAT in July. Economic growth in the Czech and Slovak Republics is likely to remain subdued. In Slovenia and Poland and to a lesser degree in Hungary, growth was driven by domestic demand, whereas the other countries profited mainly from the improved demand in the EU.

In all countries inflation rates increased in recent months, but the magnitude and the causes for the rise in inflation differed. Sharp hikes in administered prices were responsible for the surge in inflation from a level of about 7% year on year in the first half of 1999 to a level of about 14% in the Slovak Republic in the second half of 1999. In the other countries the rise in inflation in recent months was much less pronounced. Besides governmental measures (changes in taxes and tariffs, intervention food purchases, hikes in regulated prices), which were an important inflation-stoking factor in all countries but the Czech Republic, the increase in commodity prices contributed to the upturn in inflation. Current account developments seem to have been driven to a large extent by rising demand in the EU and by country-specific policy measures in the second and third quarters of 1999. Accelerating export demand from the EU supported the marked improvement in Hungary's current account balance in the third quarter (which until then had worsened in the year-on-year comparison) and the continued improvement in the Czech and Slovak Republics' trade and current account balances. The austerity package in the Slovak Republic (coupled with the introduction of an import surcharge) and the introduction of a VAT in Slovenia heavily influenced import demand in the two countries, leading to import restraint in the Slovak Republic and to strong growth in the second quarter and a subsequent slowdown in imports in Slovenia in the third quarter of 1999. Poland was the only country to report increasing current account deficits in a year-on-year comparison in each of the first three quarters of 1999 and is also expected to post the highest current account deficit in 1999. Polish economic institutes expect a deficit of slightly above 7% of GDP.

Lower nominal GDP growth than expected and the higher-than-expected fiscal impact of structural reforms caused budgetary targets for the public sector to be exceeded in all countries but Hungary,<sup>2)</sup> where targets seem to have been broadly met. Slovakia was the only country which took strong fiscal measures in the course of the year to avoid a larger over-

1) Unless stated otherwise, comparisons are year on year.

2) Final figures for public sector deficits were not available at the time of writing. The above statement is based on the most recent available data.

shooting of budgetary targets. Consolidated public sector deficits in 1999 were estimated to have ranged from about 1.5% of GDP in Slovenia to about 5% of GDP in the Czech Republic. Except in the Czech Republic and Slovenia, budgets for 2000 were already approved by parliament. A significant reduction of the general government deficit in relation to GDP (in comparison with budget outcomes in 1999) is planned in Poland while Hungary and Slovenia aim at more moderate reductions of the deficit-to-GDP ratio. In the Czech Republic and in Slovakia the government's draft budget envisages a public deficit of roughly the same size as in 1999.

The accession process advanced during the review period. The *acquis* screening with the first-wave countries<sup>1)</sup> (the Czech Republic, Estonia, Hungary, Poland, Slovenia and Cyprus) had been finished by November 1999. Substantive accession negotiations were opened with the first-wave countries on 23 of 31 chapters of the *acquis communautaire* by the end of 1999, including the chapters which are most relevant from the central banking perspective, Economic and Monetary Union, the Free Movement of Capital and the Free Movement of Services, in particular Financial Services. Negotiations on the chapter "Economic and Monetary Union" were already provisionally closed. Altogether, nine chapters were already provisionally closed with the Czech Republic, Hungary, Poland and Slovenia. Slovakia also finished its *acquis* screening with the EU in December 1999. Based on the 1999 Regular Reports of the European Commission, the European Council decided in December 1999 to extend accession negotiations from the year 2000 onwards to all Central and Eastern European EU applicants and thus also to Slovakia (for a more detailed review of the regular reports and the European Council decisions, see box).

### **The European Commission's 1999 Regular Reports and the Helsinki European Council<sup>2)</sup>**

*On October 13, 1999, the European Commission published this year's Regular Reports on the progress of the applicant countries on their way to EU accession. This annual review instrument, which assesses the applicants' performance in fulfilling the Copenhagen criteria for EU membership, was introduced by the European Council in Luxembourg in December 1997 as part of an enhanced preaccession strategy for the candidate countries. The 1999 regular reports contain the following main recommendations for Central and Eastern Europe:*

- *accession negotiations should be opened with all Central and Eastern European candidates – this would extend negotiations to Latvia, Lithuania, Slovakia, Bulgaria and Romania; opening negotiations with the latter two should be contingent on certain political and economic conditions;*
- *the negotiation process should differentiate among candidates, taking full account of each candidate's preparatory progress; negotiating chapters should be closed only after the candidates have satisfactorily fulfilled the commitments undertaken on their way to membership;*
- *institutional reforms within the EU should be completed by 2002 so that the Union itself is ready for enlargement;*

<sup>1</sup> According to the European Council's decisions in Helsinki, the distinction between "first wave" and "second wave" countries is no longer valid but will be used here for reasons of simplicity.

<sup>2</sup> Author: Peter Backé.

- further trade liberalization should be undertaken – trade restrictions for agricultural goods should be progressively reduced on a reciprocal basis, and the Union should be ready to consider refraining from the use of commercial defense instruments.

The **general economic analysis** of the reports focuses on a review of the main economic developments between the fall of 1998 and the early autumn of 1999. These parts of the reports discuss the effects of the international financial crisis and of the Kosovo conflict on the applicants, depict broad macroeconomic developments – slower growth, falling inflation and increasing trade and current account deficits – and selected structural reforms and related issues (privatization, FDI flows and trade integration).

Assessing the **economic performance** of the individual applicants, the reports carry the following key messages:

In principle, the reports distinguish between three groups of Central and Eastern European candidate countries classified according to whether they fulfill the economic criteria for EU membership (the existence of a functioning market economy, the ability to cope with competitive pressures and market forces within the EU in the medium term). The Czech Republic, Estonia, Hungary, Latvia, Poland, Slovenia appear to meet the conditions, Bulgaria and Romania would not, and Lithuania and Slovakia are borderline cases. Moreover, the Czech Republic and Romania are criticized for not having made tangible progress during the course of the last year.

- **Bulgaria** is commended for its macroeconomic stability “thanks to implementation of sound fiscal and incomes policies under the currency board arrangement” and some advances with structural reforms. In general, the country has made progress, but further steps are needed to establish a functioning market economy and to enable the country to cope with competitive pressure and market forces within the Union in the medium term. The Commission urges Bulgaria to give priority to completing privatization and to accelerating enterprise and banking sector restructuring.
- The Commission notes the deepening of the economic recession, the narrowing of the external imbalance and the reduction of inflation, furthermore some progress with financial sector reform in the **Czech Republic**. The Commission advocates focusing on faster restructuring and privatization, continuing price liberalization and improving the legal framework for enterprise activity.
- On **Estonia**, the Commission points out improvements in macroeconomic stabilization and advances in restructuring and consolidating the financial sector. Economic policymaking should now concentrate on the implementation of the remaining structural reforms, in particular the restructuring of the oil-shale sector, the finalization of the pension and health reforms and the strengthening of financial sector supervision.
- The Commission sees **Hungary** as macroeconomically stable, but is somewhat concerned about a potential further widening of the current account deficit. Progress with structural reforms in a number of areas is acknowledged. Policymakers should now address the deterioration of the fiscal deficit and give priority to health sector reform.
- The Commission welcomes **Latvia’s** success in maintaining macroeconomic and financial sector stability through an appropriate policy response to the effects of the Russian crisis. Indeed, the worsening environment, notes the Commission, has spurred reforms in several areas. Macroeconomic stability should be upheld and structural weaknesses eliminated.
- **Lithuania** has preserved macroeconomic stability, but has become more vulnerable, partly because the country’s policy response to the Russian crisis allowed a serious deterioration of fiscal and external balances. The Commission urges Lithuania to cut the fiscal deficit and to complete structural reforms, including forceful implementation of ongoing reforms (in particular financial sector privatization and restructuring of the energy sector).
- According to the Commission, macroeconomic stability in **Poland** is well established and was unscathed by the Russian crisis, although the widening of external deficits should be brought in check. Some progress in privatization and in social sector and territorial reforms is noted, but further reform and privatization, alongside with medium-term fiscal consolidation, is needed.
- **Romania** is criticized for persisting macroeconomic instability and legal uncertainty. Generally, the country is not considered a functioning market economy, nor will it be able to cope with competitive pressure and market forces within the EU in the medium term. Recent commitments of the government to stabilize the economy and to tackle structural problems are noted. The Commission considers that Romania should concentrate on improving financial

discipline and restructuring the large loss-making public enterprises, and it should adopt as well as implement a clear medium-term economic strategy.

- **Slovakia** is lauded for its courageous policy decisions and the impressive reform agenda of the government which took office in the fall of 1998. If reforms are well implemented, the country should fulfill the functioning-market-economy criterion in the next year. Slovakia should focus on continuing bank and enterprise restructuring as well as the further consolidation of macroeconomic stability.
- **Slovenia** has maintained macroeconomic stability and reinvigorated the reform process. The Commission encourages the country to speed up its gradual approach to structural reform. Priority should be given to privatization, including privatization of the two state banks, improvements in corporate governance and the legal environment for enterprises, and to the restructuring of public utilities.

The **European Council in Helsinki** in December 1999 broadly followed the main recommendations made by the Commission. Only in a few respects did it take a slightly modified stance. The European Council did not link the opening of accession negotiations with Romania and Bulgaria to further progress in the economic realm, as the Commission had proposed, but it did underline the importance of the political criteria. Moreover, it specified that the EU should be internally ready for enlargement by the end of 2002. Furthermore the European Council declined to take up the Commission's proposals for further trade liberalization. It should be noted that in the runup to the Helsinki summit, the Council did not enter into a substantive discussion on the Commission's economic analysis; Member States did not see a need to jointly examine in depth either the assessment of general developments or the country-specific judgements.

To conclude with a **brief assessment**, the Commission's main recommendations and the European Council's conclusions generally constitute a good basis for carrying the enlargement process further. It is welcome indeed that the Union has set itself a deadline for becoming ready for enlargement. To keep the accession process manageable in a setup in which the Union negotiates with a comparatively large number of countries simultaneously, it will be essential to key the pace of negotiations as objectively as possible to the further progress of the candidate countries toward fulfilling the conditions for EU membership, as was intended. This means that the speed of enlargement must not compromise its quality, as in particular the Commission has pointed out, and that differentiation should be applied equally to all ten Central and Eastern European candidates. Furthermore, in order to ensure the success of the accession process, the economic criteria for EU membership must continue to play an eminent role, even if their relevance for opening accession negotiations was diminished by the decisions taken in Helsinki.

The economic analysis and the assessments contained in the 1999 Regular Reports are generally very well founded. In a few instances, it would have appeared equally legitimate to arrive at slightly different conclusions when interpreting and judging developments (e.g. the issue of whether Slovakia should already be considered a functioning market economy). What is indisputable is the sound quality of the economic analysis in the 1999 reports and the valuable contribution of the accurate analysis to the accession process.

Sources: European Commission, Reports on progress towards accession by each of the candidate countries, October 1999: Composite paper, section VI (main recommendations), Composite paper, section III 2 a (general economic analysis), individual country reports, sections A 2.4 (country-specific performance).

## 2 Country Reports

### 2.1 Czech Republic

Recent GDP figures seem to indicate that the Czech economy is on the way to recovery. The modest GDP growth rates of 0.4% and 0.8% recorded in the second and third quarters of 1999 were mainly the result of an improvement of net (goods) exports.<sup>1</sup> In the first three quarters of 1999 goods exports grew by 5.3% in real terms whereas the growth of goods imports

<sup>1</sup> GDP fell by 0.9% in the first three quarters of 1999.

remained subdued (first through third quarter of 1999: +2.9%). Private and public consumption contributed positively to the growth of GDP, too, while gross capital formation continued to shrink (first through third quarter of 1999: -5.3%). The main factor behind the fall in investment demand was the difficult financial situation of enterprises and banks, which will continue to hamper investment activity in the near term. Industrial production and construction slowly recovered in the course of 1999 but posted negative growth rates of 4.8% and 7.8% respectively in the first ten months of 1999. Conversely, retail sales recorded growth of 1.1% in the same period.

Between August and November 1999 the unemployment rate remained steady at 9%, which, however, represents a rise by two percentage points against November 1998. Despite the disappointing growth performance of the Czech economy, gross real wages rose by 7.4% during the first three quarters of 1999. Wages grew most rapidly in the public sector after public sector wage restraint in 1998.

CPI inflation reached an all-time low of 1.1% in July 1999, and the net inflation rate was even negative in that month (-0.5%). Falling food prices, the recessionary environment and the comparison with high monthly inflation rates in the first seven months of 1998 were the main factors responsible for rapid disinflation in the Czech Republic in 1999. In autumn 1999 CPI inflation quickened slightly, reaching 1.9% in November 1999. The net inflation rate stood at 0.6% in that month.

The improvement in the current account continued in the first three quarters of 1999. In the second quarter of 1999 the Czech Republic even recorded a current account surplus (for the first time since the first quarter of 1994), which contributed to the achievement of a largely balanced current account (a shortfall of USD 167 million, or about 0.5% of GDP) in the first three quarters of 1999. The improvement was attributable mainly to the narrowing of the trade deficit from USD 1.5 billion to USD 992 million in the January to September 1999 period. Besides the koruna's real depreciation in the first months of 1999 and weak domestic demand, an improvement in the structure of foreign trade (a growing share of products with higher value added) is becoming an increasingly important factor in the favorable development of the Czech trade balance. After net foreign direct investment inflows had doubled in 1998, FDI surged to USD 3.4 billion in the first nine months of 1999 (first through third quarter of 1998: USD 1.9 billion). Official foreign currency reserves increased slightly in U.S. dollar terms from USD 12.6 billion at the end of 1998 to USD 12.7 billion (5.6 months of imports) eleven months later, mainly because of central bank interventions in October. Gross foreign debt decreased from USD 24.3 billion at the end of 1998 to USD 22.8 billion at the end of the third quarter of 1999.

Although there were signs that the end of the recession might be near and although inflation had bottomed out, the Czech National Bank continued to ease monetary policy in the course of 1999. At the time of writing, the two-week repo rate stood at 5.25% (since November 26), which is 975 basis points lower than in July 1998. Discount and lombard rates were lowered by 800 and 1,150 basis points, respectively, from July 1998. At the end of 1999, the discount rate came to 5%, the lombard rate to 7.5%. Further-

more, the minimum reserve requirement was lowered from 5% to 2% in October. However, because of rapid disinflation, ex-post real interest rates fell only very recently. Taking into account the fragile situation of the banking sector, unsurprisingly the monetary relaxation did not translate into credit growth. Only since August did credit volumes tend to grow in a month-on-month comparison, though they still declined in the year-on-year comparison in October.

In the first quarter of 1999 the koruna depreciated by nearly 10% against the euro in nominal terms. However, since the second quarter of 1999, the closing of the current account gap and expectations of continuing FDI inflows led to a reappreciation of the koruna against the euro. When the koruna came close to its 1998 year-end value against the euro in October, the Czech National Bank acted against the koruna's strength with open market interventions and by talking down the currency. After a brief weakening, the koruna stabilized at around 36 CZK/EUR.

The Czech National Bank, which has followed a direct inflation targeting strategy since the beginning of 1998, significantly undershot its 1999 inflation target for the second time in a row. While the range for year-on-year net inflation<sup>1</sup>) in December 1999 was set at 4% to 5%, net inflation stood at only 0.6% in November 1999. For the end of 2000, an inflation target range of 3.5% to 5.5% was already announced in 1998. According to its latest forecast the CNB expects net inflation to come to between 1.9% and 3.6% at the end of 2000, at the low end of its target range. In December 1999 the central bank declared that it would aim for the lower bound of the target range rather than for the mid-point.

In December, the finance minister announced that the central government budget deficit in 1999 could be below previous estimates of CZK 40 billion (slightly above 2% of GDP) while initially the budget was approved with a deficit of CZK 31 billion. The widening of the central government budget deficit from 1.6% of GDP in 1998 to about 2.2% of GDP in 1999 seems to indicate a relatively moderate loosening of the fiscal stance. The consolidated general government deficit, however, is a greater cause for concern. According to the OECD a widening of the consolidated general government deficit from 2.4% of GDP in 1998 to around 5% of GDP in 1999 is probable. On the basis of the government's first budget draft, the OECD forecasts a slightly smaller central government budget deficit (in relation to GDP) and a slightly higher consolidated general government deficit in 2000. Parliament rejected two budget proposals submitted by the government. According to the finance minister the envisaged deficit will be somewhat lower in the new proposal.

In 1999 structural reforms concentrated on the banking sector as well as on large, highly-indebted industrial conglomerates, typically the banks' main debtors.

The privatization of banks has made progress. In June 1999, the 66% state stake in Československá Obchodní Banka (ČSOB), the third-largest

<sup>1</sup> The net inflation index excludes regulated prices and the impact of tax changes. The excluded items represent about 20% of the CPI.

bank, was sold to the Belgian KBC Bank for CZK 40 billion (USD 1.1 billion). The 24% stake in ČSOB held by Slovakia was sold to KBC and the EBRD in December. By December 1999 the government had entered into exclusive negotiations with the Austrian Erste Bank on the sale of the state's 52% stake in Česká Spořitelna, the country's largest savings bank. The negotiations are scheduled to be concluded at the end of January 2000. In the light of mounting losses, the bank's share capital was doubled to CZK 15.2 billion, and Konsolidační Banka took over bad loans with a market value of CZK 14 billion for a price of CZK 20 billion<sup>1</sup>) to prepare Česká Spořitelna for privatization. Furthermore, the portfolio of Komerční Banka (Central Europe's largest bank by assets) had to be cleared of bad loans with a nominal value of CZK 23.1 billion, and a share issue underway will ultimately double Komerční's equity, with the government retaining a majority stake. The privatization of Komerční Banka, which was scheduled to be completed by mid-2000, suffered a setback in December, when a case of fraud was discovered. This fraud could cost the bank up to CZK 8 billion on top of already forecast losses on the order of billions of koruna.

In April 1999, the government adopted a revitalization program for large loss-making conglomerates. With some delay, a revitalization agency (RA) was set up in August as a subsidiary of Konsolidační Banka. In October, an internationally well-known investment bank (Lazard Frères) was chosen as the agency's administrator. The RA has a wide range of responsibilities in the restructuring of troubled firms, including: administration of assets, determining how to maximize their value, implementing cost-cutting programs and formulating new business plans as well as deciding to whom firms are to be sold or whether they should be liquidated. The government proposed nine companies for participation in the program, but the board of the revitalization agency had not taken any decision by the end of 1999. Although the government devoted considerable effort to the revitalization program, its chances of success appear to be somewhat dubious. Because of delays in setting up the agency and the serious financial condition of several companies and some of their bank creditors, quick action had to be taken without involving the RA. In addition, the scope of the program appears rather small in relation to the economy as a whole.

In December, an amendment to the bankruptcy and composition law passed the first reading in Parliament. It will speed up bankruptcy procedures somewhat and enhance creditors' rights and control mechanisms during bankruptcy proceedings. However, even if the present formulations are not weakened, the improvements will apply only to future bankruptcy cases.

## 2.2 Hungary

Economic growth slowed down to 3.3% in the first quarter of 1999 before accelerating again. GDP growth in the third and fourth quarters of 1999 are expected to be in the order of 4% and 5%, respectively, while forecasts for 1999 as a whole are in the range of 3.7% to 4.3% (1998: 5.1%). According to most forecasts, improved import demand from the EU should lead to a

<sup>1</sup> These capital injections come on top of a large bailout in 1998.



further slight acceleration of GDP growth to about 4.5% in 2000. In the first half of 1999 growth was mainly driven by investment (+6.6%) and private consumption (+4.5%) while imports grew somewhat more quickly (+11.3%) than exports (+8.8%). Industrial production and construction recorded growth rates of 9% and 6%, respectively, in the first ten months of 1999.

The unemployment rate in November 1999 (9.2%) remained largely unchanged in comparison with the corresponding period of 1998 (9.3%). Gross real wage growth accelerated in the first three quarters of 1999 (1998: 3.7%), reaching 5.9%.

Inflation fell to single digits in January 1999 for the first time since 1987 and stayed just below 10% in the first half of 1999. Mainly because of hikes in regulated prices and rising energy prices, the inflation rate climbed to slightly above 10% in the second half of 1999. Average inflation in 1999 is estimated by government and central bank experts to have stood at 10%. In 2000 the economic authorities would like to achieve a reduction of the average inflation rate to between 6% and 7%, which appears very ambitious. According to independent analysts a reduction to 8% to 8.5% is more realistic.

The current account deficit amounted to USD 1.3 billion in the first ten months of 1999 and thus remained close to previous year's level in the corresponding period (USD 1.4 billion). While the current account deficit exceeded 1998 levels at the beginning of 1999, the deficit eased during the course of the year as the economic situation in the EU improved. For 1999 as a whole the central bank expects a current account deficit of USD 2 billion to USD 2.3 billion (4.1% to 4.7% of GDP). Between January and October 1999 net FDI inflows amounted to USD 1.1 billion, USD 0.3 billion more than in the corresponding period of 1998. Foreign direct investment consisted mainly of greenfield investments. In the same period Hungary received net portfolio investment inflows of USD 1.2 billion. Hungary's gross foreign debt (inclusive of intercompany loans) stood at USD 28.4 billion at the end of October 1999 (USD 26.7 billion at the close of 1998). Official currency reserves at the end of October 1999 amounted to USD 10.2 billion (more than five months of import cover), slightly above the level at the end of 1998.

From November 1998 the central bank lowered the key two-week deposit rate in several steps by a total of 375 basis points to 14.25%, most recently on December 17. The base rate was reduced from 17% to 14.5% from end-1998.

Hungary retained its crawling peg exchange rate regime introduced in 1995 and continued to lower the automatic monthly devaluation rate. At the end of December 1999 government and the central bank announced a reduction of the monthly devaluation rate from 0.4% to 0.3% from April 1, 2000. The forint's previous peg to a EUR/USD basket (70/30) was replaced by a pure euro peg as of January 1, 2000. Over the medium term, the abandonment of the crawling peg regime in favor of a fixed euro peg with a wider fluctuation band (at present  $\pm 2.25\%$ ) is planned. From April 1999 the forint mostly traded at the stronger end of the fluctuation band.

Relations between the government (in particular Prime Minister Orban and his junior coalition partner, the Smallholders' Party) and the central bank are strained. In September, the latent conflict broke out over losses which had occurred at CW-Bank, a Vienna-based subsidiary of the National Bank of Hungary (NBH). Losses in recent years accumulated to a total of HUF 70 billion (0.6% of GDP). At present a parliamentary subcommittee is conducting an inquest on this case. Prime Minister Orban declared that he would not participate in appointment procedures to top management positions at the National Bank of Hungary until it has been determined who is responsible for the losses. As the contracts of two vice governors of the NBH terminated in September and December 1999, only one vice governor<sup>1)</sup> is in office. This is a breach of Hungarian central bank law, which states that at least two vice governors must be in office.<sup>2)</sup>

The consolidated public sector budget 1999 was approved with a deficit of 4% of GDP. According to preliminary statistics of the Ministry of Finance, the target was even slightly undershot (3.9% of GDP) despite high monthly deficits at the beginning of 1999. A significant improvement of the development of budget revenues towards the end of the year, a restrictive implementation of the budget, cuts in public investments (construction of highways) and one-off revenues (in particular concession fees) helped to achieve the budgetary target.<sup>3)</sup> In late December 1999 the central government budget for 2000 was approved with a deficit of 3% of GDP. The budget is based on assumed GDP growth of 4.5% and an average inflation rate of 6% to 7%. The target for the consolidated public sector deficit was set at 3.5% of GDP. In contrast with initial plans taxes and social security contributions will remain largely unchanged in 2000.

Hungary's rating for long-term foreign currency debt was raised by Moody's from Baa2 to Baa1 on June 25, 1999. Standard & Poor's continues to give Hungary's foreign currency debt a BBB rating.

Starting from a comparatively advanced level of structural reform, only small structural reform steps were implemented in Hungary in 1999. Two insolvent smaller banks were recapitalized directly or indirectly with public funds while a third small bank was closed. Liquidation of the ailing CW-Bank, a subsidiary of the NBH, started in October 1999. According to a government resolution its assets will be taken over by the Hungarian Development Bank. The National Bank of Hungary started operating an RTGS system on September 3, 1999.

The advanced privatization process continued with the sale of the remaining 5.75% state stake in the telephone company MATAV in June

1 *The contract of the last vice governor in office ends at the beginning of 2004; Governor Suranyi's term in office ends in March 2001.*

2 *The present composition of the Governing Council is not in conformity with the law either: According to the law there should be an equal number of external members and vice governors, while the NBH now has three external members and only one vice governor.*

3 *However, it should be noted that part of the revenues of social funds (which are included in the consolidated public sector deficit) were derived from the sale of company shares (which are treated as financing items by international standards). Thus, by international standards, Hungary's consolidated public sector deficit would probably come to around 4.5% of GDP.*

1999. Concession fees for the operation of a 1800 MHz mobile phone frequency yielded higher-than-expected revenues.

The pension reform (three pillar model) which had come into force in 1998 was somewhat watered down: Planned increases of contributions to the compulsory, fully-funded second pillar at the expense of contributions to the first (pay-as-you-go) pillar, which should have taken place in 1999 and 2000, were canceled for budgetary reasons.

### 2.3 Poland

After a period of slowing GDP growth rates which lasted until the first quarter of 1999 (GDP: +1.5%), economic activity strongly rebounded in the remainder of the year (third quarter of 1999: +4.9%). In the first three quarters of 1999 GDP growth reached 3.2%, and the acceleration of growth is expected to have continued through the fourth quarter of 1999. Growth was driven by strong domestic demand, in particular by investment and private consumption, which grew by 7.1% and 5.4%, respectively, in the third quarter of 1999. Net exports declined, as exports fell faster than imports in real terms. Industrial production was up by only 2% during the first three quarters of 1999, but it recovered powerfully (third quarter of 1999: +7.4%) in the course of 1999. Services and construction contributed to the expansion of GDP with growth rates of 4.6% and 3.7%, respectively.

After unemployment dipped slightly below the ten percent mark in mid-1998, it began to rise again in 1999. In November 1999 the jobless rate stood at 12.5%, 2.6 percentage points above the level of November 1998. Gross real wage growth slowed down in the first three quarters of 1999 (+3.2%) from the corresponding period of 1998 (+3.9%).<sup>1)</sup>

In autumn 1998, CPI inflation fell below 10% for the first time since the beginning of the reform process, and it continued to fall quickly until February 1999, when the inflation rate stood at 5.6%. However, in March prices began to increase faster again, and in November 1999 CPI inflation reached 9.2%, which is exactly the level recorded a year earlier. Because of the low base for comparison, the central bank expects inflation to keep rising in the first quarter of 2000 before returning to the long-term downward trend. The central bank attributes the renewed rise in inflation chiefly to higher tariffs for food imports, intervention food purchases and burgeoning fuel prices.

Poland's current account deficit reached USD 8.8 billion<sup>2)</sup> in the January to October 1999 period, a rise of more than 80% compared with the previous year. For 1999 as a whole the current account deficit will probably slightly exceed 7% of GDP. The trade deficit, which constitutes most of the current account shortfall, widened to USD 11.2 billion during the first ten months of 1999 (January to October 1998: USD 10.8 billion). However, the widening of the current account deficit in the first three quarters of 1999 against the same period of 1998 was attributable mainly to the reduction in the surplus of unclassified transactions by about USD 2 billion and the

1 From January 1999 an increase in the mandatory premium for social security is included.

2 Figures on a balance-of-payments basis.

USD 900 million higher deficit on services. Although the trade balance with the EU (on a customs basis) improved during the first three quarters of 1999, this did not suffice to compensate the negative effects of the Russian crisis on the Polish current account balance. 60% of the current account deficit in the January to September 1999 period were financed by foreign direct investment inflows (USD 4.8 billion), which increased by 22% in comparison with the corresponding period of 1998. Between December 1998 and November 1999 official reserves (including gold) declined slightly from USD 27.4 billion to USD 25.4 billion but still represented a level of 7.8 months of imports. Gross external debt remained approximately constant at USD 42.7 billion at the end of 1998 compared to USD 42.8 billion at the end of the first half of 1999.

The central government budget adopted by Parliament envisaged a deficit of PLN 12.8 billion (2.15% of GDP) in 1999. The consolidated public sector<sup>1</sup>) deficit was to reach 2.9% of GDP, which would have meant a very moderate loosening of the fiscal stance. While the central government probably succeeded in attaining its budget target, the government conceded that the general government deficit is likely to have reached 3.5% of GDP in 1999. Most of the overrun occurred at the social insurance board (ZUS), which received PLN 7.1 billion of additional subsidies to cover revenue shortfalls. The budget targets of the central government and the public sector for 2000 had to be amended because of the recent rise in interest rates, the additional cost of recently introduced reforms and because the President vetoed parts of the planned tax reform. The amended targets for the central government budget deficit and the consolidated public sector deficit were set at PLN 15.4 billion (2.28% of GDP) and PLN 18.6 billion (2.75% of GDP), respectively. In comparison with 1999 outcomes this would mean a significant tightening of the fiscal stance. Furthermore, budgetary targets for the year 2000 stand a much better chance of being met than in 1999, as nominal GDP is likely to exceed underlying assumptions based on an average inflation rate of 5.7%.

From January 1999 the National Bank of Poland (NBP) pursued a policy of direct inflation targeting while retaining, for the time being, the crawling band regime. The Polish central bank targets consumer price inflation, the target for end-1999 was originally set at 8% to 8.5% year on year, but was lowered to 6.6% to 7.8% in March 1999 because of unexpected disinflation. However, the sudden change in inflationary trends resulted in an overshooting of the inflation target, as CPI inflation ran to 9.2% in November. For end-2000 the NBP set an ambitious target for CPI inflation of 5.4% to 6.8%. In reaction to slowing GDP growth and inflation, the Polish central bank eased its stance at the beginning of 1999. The reversal of inflation and economic growth trends were reflected in a change in the central bank's policy stance. After a minor interest rate hike in September 1999 the NBP raised its key rates between 250 and 350 basis points in November 1999 in order to

<sup>1</sup> The consolidated government balance includes the central government, social security funds and the local governments. Changes in public-sector commitments are excluded. Privatization revenues are counted as a financing item.

meet the inflation target for end-2000. At present, the central bank's main lending rate, the intervention rate, is set at 16.5% while discount and lombard rates stand at 19% and 20.5%, respectively. In the near future a decision of the government and the central bank concerning the timing of the flotation of the zloty is expected.

1999 turned out to be a volatile year for the zloty. Starting at 7% above parity, the Polish currency descended to levels near parity in March as a result of worries in emerging markets and a deterioration of Polish macroeconomic data. Expectations of large privatization inflows drove the zloty back to levels of about 6% above parity in July before it plunged to 2% below parity at the end of October. Supported by higher interest rates, the Polish currency recovered again, ending 1999 at about 2% above parity.

Far-reaching reforms of the pension system, health care and state administration took effect in the first months of 1999.<sup>1)</sup> Some problems in the implementation of these reforms continued into the second half of 1999 and will probably be resolved only in the course of 2000. Inter alia because of inadequate computerization, ZUS was unable to transfer payments in a timely manner to the newly created private pension funds and to monitor contribution payments. Furthermore, several large, loss-making enterprises failed to pay their obligatory contributions for pensions and health care.

Privatizations in the banking sector continued. The largest transaction was the sale of 52% of Grupa Pekao SA, the country's second-largest bank by assets, to Unicredito Italiano and Allianz in June 1999 for the equivalent of USD 1.1 billion. An 80% stake in Bank Zachodni, a leading regional bank, was sold to Allied Irish Bank. The privatization of the last two remaining state-owned banks, Hungary's largest retail bank PKO BP and BGZ Bank, which are still burdened by large volumes of bad loans, was postponed to after 2001. In December, shareholders of Bank Handlowy and BRE voted in favor of merging these institutions, which would create Central Europe's largest bank by capital. However, the merger did not proceed yet because a court ruled that it violated minority shareholders' rights.

Bids in a tender for a 25% to 35% stake in Telekomunikacja Polska (TP SA) were rejected by the Treasury Ministry in December. A new tender for this stake will be launched at the beginning of 2000. Furthermore, a new telecoms law is expected to come into effect in 2000, which will introduce new interconnection regulations and an independent regulator. This should result in lower prices for customers. 30% of the equity of PZU, the country's largest insurer, was sold to a consortium consisting of Eureko, the pan-European insurance and financial services alliance, and BIG Bank Gdanski. Another 20% to 30% stake in the company will be sold by a public offering in the first half of 2000. Other large privatization projects proceeded in the oil and air transport sectors in the last quarter of 1999. A 37% equity stake in LOT, the Polish national carrier, was sold to Swissair, while 30% of the shares of PKN, a refinery and oil distributor, were floated on the stock exchange. Altogether, privatization revenues in 1999 are estimated to have reached the

1 See Focus on Transition 1/1999.

record level of PLN 15 billion. In 2000 privatization revenues are expected to peak at PLN 20 billion.

After prolonged debates (also within the government coalition), Parliament agreed on a tax reform package scheduled to come into effect at the beginning of 2000. The tax reform, as approved by Parliament, contained a lowering of personal income and corporate taxes between 2000 and 2002, the elimination of tax exemptions and an increase of indirect tax revenues. However, the proposed changes to the personal income tax will not take effect at January 1, 2000, because of a Presidential veto. Corporate tax rates will be lowered from 34% to 30% in 2000 and will fall to 28% in 2001 while investment-linked tax concessions have been canceled. Indirect tax revenues will rise because of the introduction of 7% of VAT for certain municipal services and an increase in excise taxes on tobacco and fuels.

#### **2.4 Slovakia**

In the first three quarters of 1999 real GDP advanced by 1.8%. Economic growth was dampened by the implementation of austerity measures taken to tackle Slovakia's massive twin deficits of previous years. Gross fixed capital formation declined by 15.8% while private (+0.8%) and government consumption (+0.6%) basically stagnated. On the demand side, the main locomotive of growth was clearly the improvement of net exports, with exports progressing 6.6% and imports declining 1.6%. Domestic demand and GDP growth (+0.6%) in the third quarter of 1999 were affected by additional austerity measures taken in mid-1999. Construction was particularly hard hit, with output tumbling 27.5% in the first ten months of 1999; industrial production decreased by 5.6%.

Unemployment, already at very high levels, continued to grow. In November 1999 the unemployment rate reached 18.3%, which is 3.8 percentage points higher than in the corresponding month of 1998. Gross real wages declined by 1.9% in the first three quarters of 1999.

After hovering around 7% in the first half of 1999, CPI inflation jumped to around 14% in the second half as a result of large hikes in administered prices, which took effect in July.

The current account was USD 800 million in the red (5.7% of GDP) after the first three quarters of 1999, so that the deficit in U.S. dollar terms diminished by nearly 50% against the corresponding period of 1998. This significant reduction resulted mainly from an improvement of the trade balance by approximately the same magnitude to USD 804 million<sup>1</sup>). The improvement in trade and the current account was particularly strong after the reintroduction of an import surcharge of 7% at the beginning of June 1999. The import surcharge will be gradually reduced to zero until the beginning of 2001, but the scope of goods' categories on which it is levied (at present slightly less than 75% of all imports) will be broadened somewhat in January 2000. After net FDI inflows increased in 1998, they fell by more than 50% to the very low level of USD 168 million during the January to September 1999 period. Thus, the current account deficit was financed

<sup>1</sup> Converted at a rate of SKK 41.318/USD.

mainly by portfolio investment. Official foreign exchange reserves rose from USD 2.9 billion at the end of 1998 to USD 3.4 billion (3.8 months of imports) on December 21, 1999, after falling to a low of USD 2.5 billion in June 1999. This increase resulted mainly from the proceeds of the euro-bond issue of EUR 500 million in June/July 1999 and foreign exchange interventions in December. Gross external debt declined from USD 11.8 billion at the close of 1998 to USD 10.3 billion in August 1999. The decision by the central bank to abolish the required foreign exchange position limit in February, which led to a strong decline in commercial banks' short-term debt, accounted for most of the change.<sup>1)</sup>

The 1999 central government budget was approved with a deficit of SKK 15 billion (1.8% of GDP) in March 1999, while the target for the general government deficit was set at 2% of GDP. This indicates a very significant tightening of fiscal policy in comparison with 1998, when the central government budget deficit amounted to 2.7% of GDP and the general government deficit even reached about 5.5% of GDP. Initially, the government intended to reduce the budget shortfall mainly by cutting expenditures, but in May the government had to take additional fiscal measures with an emphasis on revenue enhancing measures, such as the reintroduction of the import surcharge and the increase in VAT rates, on the order of 2.5% of GDP, to meet deficit targets. As of the end of November the central government budget deficit stood at SKK 11.8 billion, which makes the achievement of the target likely. The limit for the general government deficit will probably be exceeded – the government hopes that the deficit level will be no higher than 3% of GDP. In December Parliament approved the central government budget for 2000 with a deficit of SKK 18 billion (about 2% of GDP). The consolidated public sector deficit is to remain constant at 3% of GDP. The budget is based on the assumptions of GDP growth of 2.5%, an average inflation rate of 10% and an unemployment rate of 16% to 17%.

The monetary policy of the National Bank of Slovakia (NBS) uses M2 as an intermediary target; simultaneously, the central bank intends to stress the inflation target more. In mid-June the end-1999 target for net inflation was raised from a range of 5% to 7% to a range of 6% to 7.5%. The target for M2 growth remained unchanged at 6%. Year-on-year M2 growth stood at 11% in October, so the M2 target will probably be overshoot, while the net inflation rate is likely to hit the lower end of the target corridor for end-1999. In 2000 the central bank will focus on the development of the core inflation rate, which differs from net inflation in that it includes food prices. The core inflation target was set at 4.5% to 5.8%. In July 1999 Marian Jusko, previously the bank's vice governor, replaced Vladimir Masar as the NBS governor after expiration of Masar's term.

In the first months of 1999 the koruna came under severe downward pressure and depreciated by about 10% between the beginning of the year and mid-May. News about the government's fiscal measures led to a turnaround in the development of the SKK/EUR exchange rate. At the end of 1999 the SKK/EUR exchange rate stood at SKK 42.4 per euro, which means

<sup>1</sup> Concomitantly, the foreign exchange reserves of the banking system fell significantly.

a nominal year-on-year appreciation of 2% against the euro after the Slovak central bank had even intervened against the koruna in December 1999.

Besides macroeconomic stabilization, the government announced its aim of improving the competitiveness of the Slovak corporate sector by speeding up structural reform. The implementation of a functioning bankruptcy framework, privatization of state assets, bank restructuring and the reduction of enterprise taxes were identified as priorities for achieving this aim. Progress in improving bankruptcy procedures has remained limited, and privatizations were delayed because opinions within the ruling coalition differed on how far privatization should go. However, in the fourth quarter of 1999 tenders for a 51% stake in the Slovak telecoms company and a 36% government stake in the mobile phone company Globtel were launched. Both transactions are to be concluded by the end of the first quarter 2000. Furthermore, the government announced its intention to sell minority stakes in SPP, the Slovak gas company, and in the oil transit company Transpetrol in 2000. Privatization proceeds and swaps of shares in these companies for bonds of the National Property Fund will be badly needed to repay SKK 30 billion of Fund of National Property bonds<sup>1)</sup> due to mature at the beginning of 2001.

A tax reform is scheduled to go into effect at the beginning of 2000. The reform encompasses lower direct taxes for enterprises and households, a cut-back in the corporate income tax from 40% to 29%, tax relief for low-income earners and the option for small entrepreneurs to pay a lump-sum tax. The revenue shortfall will be compensated by an increase of excise taxes on beer, cigarettes, spirits, fuels and of the road tax.

In August 1999 the government approved a program to restructure and recapitalize the banking sector. Banks' capital adequacy is to be raised to 8% of assets, and problem loans should be reduced to 20% of total loans.<sup>2)</sup> Estimates put the costs of bank restructuring and recapitalization at roughly SKK 90 billion (about 11% of GDP). In December the Slovak central bank transferred SKK 17.8 billion of reserves to the Ministry of Finance, which were used for capital increases of SKK 4.3 billion and SKK 8.9 billion respectively, for Slovenská sporiteľňa (SLSP), and Všeobecná úverová banka (VUB). Furthermore, the government had previously issued guarantees for problem loans of Investičná a rozvojová banka (IRB), which had been under forced administration since December 1997. SLSP and VUB, in turn, placed funds for six months to an amount of SKK 7.8 billion at IRB, which enabled IRB to repay a short-term loan from the central bank. This was a precondition for the subsequent lifting of forced administration by the NBS.

## 2.5 Slovenia

GDP growth in the first three quarters of 1999 (+4.1%) was influenced by a sharp rise in domestic demand in anticipation of the introduction of a VAT on July 1, 1999. This factor caused a surge in GDP by 6.4% in the second quarter of 1999, while economic growth in the first and third quarter of 1999

<sup>1)</sup> These bonds were issued by the previous government instead of the second wave of coupon privatization.

<sup>2)</sup> In mid-1999 approximately 35% of all loans in the banking sector were considered problem loans. Provisions cover half of this amount.



was only about half as high. According to the forecast issued by IMAD (Institute for Macroeconomic Analysis and Development), GDP is estimated to have grown by 3.75% in 1999 as a whole, coming close to the previous year's growth of 3.9%. Investment (+14%) and government consumption (+5.1%) are expected by IMAD to post the strongest growth rates among demand components. Although industrial production recovered somewhat during the course of 1999, a decline of 2.3% was recorded from January to September. Construction output expanded by 9.2% in the first nine months of 1999.

The unemployment rate (national definition), which has remained stubbornly high in recent years, eased from 14.5% in January 1999 to 13% in October 1999. However, part of the decline was due to changes in the method of calculation. The unemployment rate on an ILO basis (7.5% in the third quarter of 1999) remained practically unchanged during the first three quarters of 1999 in comparison to the corresponding period of the previous year.

The disinflationary trend Slovenia experienced between spring 1998 and June 1999 was interrupted by the introduction of a VAT. CPI inflation rose from 4.3% in June 1999 to 7.8% in November 1999. Gross real wage growth picked up during the course of the first half of 1999 but decelerated in recent months as inflation rates climbed while nominal wage growth was kept in check by an agreement of the social partners. On average, real wages gained 3.2% in the first nine months of 1999. The wage agreement between the social partners was renewed for another two years in spring 1999 and should help to prevent an inflationary wage-price spiral triggered by the VAT.

For the first time since gaining independence, Slovenia posted a nonnegligible current account deficit in 1999. As a consequence of strong import growth in the second quarter of 1999 (prior to the introduction of the VAT), the trade deficit amounted to USD 823 million in the first three quarters of 1999 (a rise of more than 50%). In the third quarter of 1999 the trade shortfall was slightly below the deficit in the corresponding period of 1998. The current account deficit in the period January 1999 to September 1999 reached USD 423 million, some 2% of full-year GDP. Foreign direct investment continued to shrink from already low levels in the same period, amounting to only USD 30.5 million. Official foreign reserves also shrank, dropping to USD 3.2 billion at the end of September 1999 (compared to USD 3.6 billion at the end of 1998) or about four months of imports. Gross foreign debt swelled from USD 4.96 billion to USD 5.58 billion in the first three quarters of 1999.

Slovenia's monetary policy, which is based on monetary targeting (but also places a strong weight on exchange rate developments), remained basically unaltered in 1999. Discount and lombard rates remained unchanged from January 1, 1999. In November 1999 M3 growth was within the target corridor of 16% to 24% for 1999. The tolar depreciated by 4.9% against the euro in the course of 1999. In the second quarter of 1999 the tolar depreciated somewhat faster, while fluctuations were small during the rest of the year.

Slovenia's fiscal stance loosened somewhat in 1999. At the end of October the central government budget<sup>1)</sup> reached a level of 1.6% of full-year GDP after budget balances had worsened for some months. Thus, a budget overrun for 1999 looks very probable, as the general government deficit was set at 0.7% of GDP. The budget for the year 2000 is still awaiting parliamentary approval. The government's draft envisages a general government deficit of 1% of GDP.

The pace of structural reforms quickened markedly in Slovenia in 1999. A new banking law went into force in February.<sup>2)</sup> Capital controls were eased in several steps in the course of 1999: Fees for foreign portfolio investors' custodian accounts were lowered from 2.5% to 0.7% per quarter (as of July 1, 1999), and the minimum holding period for foreign portfolio investments in Slovenia was reduced in two steps from seven years to one year (as of September 1, 1999). Moreover, only investments of up to 10% of a company's capital are to be counted as portfolio investment (before: 50%) since February 1999. Furthermore, foreign financial loans are no longer subject to non-interest-bearing deposits (before: 40% of the loan volume for all loans of up to seven years). However, the central bank retains the legal right to reinstate such deposits temporarily in emergency situations. In April 1999, a new foreign exchange law<sup>3)</sup> took effect, which brought regulations in this field in line with the EU Association Agreement.

A flat-rate 19% VAT went into effect on July 1, 1999. A reduced rate of 8% will apply to food, school books, hotel services and a few other items. The reform of the corporate and income tax regimes originally scheduled to be passed together with the introduction of the VAT was delayed and is one of the major reform tasks for the future.

After prolonged discussions in December 1999, Parliament approved the legal basis for the pension reform, which will go into effect at the beginning of 2000. The reform will modify the current pay-as-you-go system and complement it with a voluntary fully-funded pillar. The retirement age will gradually be raised from 58 to 63 years for men and from 53 to 61 years for women while leaving open the option of early retirement at 58 in case the insured person has worked for 40 years (men) or 38 years (women). Furthermore, the pension indexation formula will be modified.

Bank privatization is an item on the government's near term reform agenda. The sale of 20% to 30% of the equity of the country's largest bank, Nova Ljubljanska banka, to foreign portfolio investors and domestic privatization funds was scheduled for the last quarter of 1999 but was postponed. Furthermore, the government announced its intention to sell a part of its stake in Nova Kreditna banka Maribor (the country's second-largest bank) in 2000. However, some observers fear further delays in bank privatization because of the upcoming election year.

Editorial close: December 31, 1999.

1) *Figures for the general government balance on a monthly basis are not available.*

2) *See Focus on Transition 1/1999.*

3) *See Focus on Transition 1/1999.*

S T U D I E S

# *Increasing Integration of Applicant Countries into International Financial Markets: Implications for Monetary and Financial Stability*

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## **I Introduction**

Increasing integration into international financial markets entails an increase in financial flows between economies. Deeper integration into international financial markets can provide very important benefits: Access to foreign capital eases financing constraints for investment projects and thus increases economic growth. Beside the direct impact of additional resources, inflows of foreign capital often has positive externalities, such as spillovers of managerial and technical know-how, especially in the case of FDI. However, increasing capital flows also pose additional challenges for central banks. Capital inflows can have inflationary effects and can increase the vulnerability of an economy's financial system. Capital flow reversals may trigger financial crises. This paper analyzes these aspects for four advanced transition economies (the Czech Republic, Hungary, Poland and Slovenia), widely expected to be among the first countries to join the European Union. As a consequence, the issue of financial integration is highly relevant for this group of countries.

In this paper we would like to define "monetary stability" as price stability, and financial stability as an absence of financial crises. Our definition of financial crises is based on the definition provided by Kaminsky and Reinhart (1998), who distinguish between balance-of-payments crises<sup>2)</sup> and banking crises. Balance-of-payments crises are characterized by "devaluations/flotations of the exchange rate and/or losses of official reserves in connection with large increases in interest rates." Banking crises contain the closure, merger or takeover by the public of one or more financial institutions as a consequence of bank runs. If no bank run occurs, the closure, merger, takeover of or provision of large-scale government assistance to an important financial institution (or group of institutions) that marks the start of a string of similar outcomes for other financial institutions is also subsumed under the term "banking crisis." Often, both types of crisis are strongly interlinked, a situation we will label as a "twin crisis."

The paper is organized as follows. Section 2 deals with the impact of capital inflows on monetary developments. It starts with a brief overview of macroeconomic effects of capital inflows with an emphasis on the impact of capital inflows on the current account in selected CEECs (the Czech Republic, Hungary, Poland and Slovenia). Based on this brief theoretical introduction, we will present stylized facts on the influence of capital flows on exchange reserves and monetary aggregates in CEECs. Section 3 investigates the impact of various kinds of capital inflows and other variables on the development of inflation in Hungary. For reasons of data availability, this kind of analysis could be undertaken only for Hungary. Next, we turn to issues of financial stability. We briefly discuss how capital inflows can pose a threat to financial stability. Subsequently, we analyze the development of several financial indicators in the accession countries that Reinhart and Kaminsky (1999) as well as Lizondo and Reinhart (1998) identified as the most reliable early

<sup>1)</sup> We would like to thank Maria Dienst and Andreas Nader for excellent statistical support. We are also very grateful for helpful comments from Peter Mooslechner, Peter Backé, Kurt Pribil and Doris Ritzberger-Grünwald.

<sup>2)</sup> The term "currency crisis" is also often used for this kind of crisis in the literature.

warning signals of financial crisis. Finally, Section 5 contains conclusions about monetary and financial stability.

## **2 Impact of Capital Flows on Monetary Developments**

### **2.1 Macroeconomic Effects of Capital Flows**

After inflows of foreign direct investment had been small at the beginning of transition, an increase has been recorded recently. According to the World Investment Report 1999 (UNCTAD, 1999), the CEECs have been catching up with the rest of the world since 1993. Moreover, other forms of capital flows (portfolio investment) have started to develop dynamically in recent years. However, the capital inflows are heavily concentrated on a few countries in the region. It is no coincidence that these countries (the Czech Republic, Hungary, Poland and Slovenia) are generally seen among the best-performing countries in the region and the countries which are most likely to join the European Union before the other CEECs.

From a balance-of-payments point of view, a surplus in the financial account (which is equivalent to a net capital inflow) will automatically be accompanied by a deficit on current account and/or an increase in official reserves. A current account deficit can result from imports of investment goods, including modern equipment. In such a case, capital inflows finance an enlargement or upgrade of production capacities, which has positive effects on the trade balance and the current account due to increased export opportunities and/or import substitution after completion of the investment. Furthermore, imports of investment goods are expected to adjust relatively quickly to the changed economic situation in the case of a reversal of capital flows, without entailing significant welfare effects. Conversely, imports financed by capital inflows may be used for increased private consumption. Calvo, Sahay and Végh (1995) note that capital inflows to the CEECs were largely used to finance consumption growth between 1990 and 1993. This is also documented in table 1. The current account deficit is more frequently associated with a real growth of private consumption than with an increase in capital formation. This can be seen in a relatively high and negative correlation between the current account (as a share of GDP) and private consumption.

The development of the current account, consumption and investment exhibits different patterns in the CEECs covered by this study. In the Czech Republic, at the beginning of economic transition the current account posted surpluses, mainly because both private consumption and investment declined in real terms. However, high private consumption growth fueled a rapid rise in imports of consumer goods and resulted in burgeoning current account deficits (up to 7.6% of GDP in 1996) in the later phase of economic reforms. Simultaneously, capital formation slowed down sharply and even declined in real terms from 1997. The current account deficits in Hungary can be traced to investment and consumer goods both, which is reflected by a relatively high negative correlation between these variables between 1991 and 1994. This indicates that increases of imports have been related to the growth of consumption and investment to about the same extent in Hungary. However, the recent period (1995 to 1998) is characterized by an improvement of

growth driven by both private consumption and investment, and by a simultaneous reduction of the current account deficit. This positive development may have several internal and external reasons. Among them, Inotai (1999) argues that the early FDI has already created new export capacities contributing both to GDP growth and the recent improvement of external balances in Hungary.

In Poland, there is a high negative correlation of private consumption with the current account, indicating a high share of consumer goods in Polish imports. As investment is negatively correlated with the current account, too, investment and private consumption seem to have caused expanding current account deficits in Poland recently. Unlike other CEECs, Slovenia posted a balanced current account throughout the period for which data are available.

Table 1

**The Current Account and Selected GDP Components in CEECs**

|                           | Czech Republic                |                                      |  | Hungary                       |                                      |  | Poland                        |                                      |  | Slovenia                      |                                      |  |
|---------------------------|-------------------------------|--------------------------------------|--|-------------------------------|--------------------------------------|--|-------------------------------|--------------------------------------|--|-------------------------------|--------------------------------------|--|
|                           | Current account <sup>1)</sup> | Real capital formation <sup>2)</sup> | Real private consumption <sup>2)</sup> | Current account <sup>1)</sup> | Real capital formation <sup>2)</sup> | Real private consumption <sup>2)</sup> | Current account <sup>1)</sup> | Real capital formation <sup>2)</sup> | Real private consumption <sup>2)</sup> | Current account <sup>1)</sup> | Real capital formation <sup>2)</sup> | Real private consumption <sup>2)</sup> |
| 1991                      | 1.2                           | -17.5                                | -28.5                                  | 0.8                           | -10.4                                | -5.6                                   | -2.6                          | -4.4                                 | 6.3                                    | 1.0                           | -11.5                                | -11.0                                  |
| 1992                      | -1.0                          | 8.8                                  | 15.5                                   | 0.9                           | -2.6                                 | 0.0                                    | 1.1                           | 2.3                                  | 2.3                                    | 7.4                           | -12.9                                | -3.6                                   |
| 1993                      | 0.3                           | -8.1                                 | 2.9                                    | -9.0                          | 2.0                                  | 1.9                                    | -0.7                          | 2.9                                  | 5.2                                    | 1.5                           | 10.7                                 | 13.9                                   |
| 1994                      | -0.1                          | 17.3                                 | 5.3                                    | -9.4                          | 12.5                                 | 0.2                                    | 2.5                           | 9.2                                  | 4.4                                    | 4.2                           | 12.5                                 | 3.8                                    |
| 1995                      | -2.7                          | 21.0                                 | 7.0                                    | -5.6                          | -4.3                                 | -7.1                                   | 4.6                           | 16.9                                 | 3.6                                    | -0.1                          | 17.1                                 | 9.2                                    |
| 1996                      | -7.6                          | 8.7                                  | 7.1                                    | -3.8                          | 6.7                                  | -3.2                                   | -2.4                          | 20.6                                 | 8.6                                    | 0.2                           | 4.2                                  | 2.4                                    |
| 1997                      | -6.1                          | -4.9                                 | 1.7                                    | -2.2                          | 9.2                                  | 2.6                                    | -4.2                          | 21.9                                 | 7.0                                    | 0.2                           | 10.1                                 | 3.3                                    |
| 1998                      | -1.9                          | -3.7                                 | -2.3                                   | -4.8                          | 11.4                                 | 3.8                                    | -5.3                          | 14.8                                 | 4.5                                    | 0.0                           | 13.7                                 | 2.4                                    |
| Correlation <sup>3)</sup> |                               |                                      |  |                               |                                      |  |                               |                                      |  |                               |                                      |  |
| 1991/1998                 |                               | -0.245                               | -0.382                                 |                               | -0.534                               | -0.240                                 |                               | -0.147                               | -0.568                                 |                               | -0.541                               | -0.266                                 |
| 1991/1994                 |                               | -0.786                               | -0.939                                 |                               | -0.840                               | -0.670                                 |                               | 0.927                                | -0.700                                 |                               | -0.281                               | -0.125                                 |
| 1995/1998                 |                               | 0.107                                | -0.461                                 |                               | 0.586                                | 0.534                                  |                               | -0.153                               | -0.461                                 |                               | -0.900                               | -0.731                                 |

Source: EBRD, OECD, IMAD (Slovenia).

<sup>1)</sup> As a share of GDP.

<sup>2)</sup> Real growth.

<sup>3)</sup> Correlation of current account (as a share of GDP) and real growth of selected GDP components in indicated periods.

As Calvo, Sahay and Végh (1995) note, the correlation of capital inflows with consumption rather than investment makes CEECs more similar to Latin American than to Southeast Asian countries. However, this does not necessarily need to cause concern in the CEECs. As Calvo et al. conclude, private consumption is still relatively low given the level of resources in these countries. Therefore, the recent increase in consumption could reflect a shift towards the equilibrium level of consumption that would be consistent with the efficient use of all available resources. However, there is a risk that capital inflows may not be available throughout the whole period of convergence to safeguard the effective allocation of resources and an equilibrium level of consumption in line with countries' resources. Wages and consumption could overshoot the equilibrium level. In both cases, private consumption and real wages may eventually fall, creating social tensions.

To avoid an increase of the current account deficit, a central bank may choose to intervene against the country's own currency in response to capital inflows, thus increasing its exchange reserves. Under a fixed exchange rate

regime, capital inflows, which are converted at a fixed exchange rate to domestic currency, inevitably increase monetary aggregates unless the central bank pursues a sterilization policy (for example through the sale of government paper).<sup>1)</sup> However, sterilization comes at a cost: When a central bank's domestic liabilities carry a higher interest rate than official exchange reserves do, it operates at a loss and thus increases the quasi-fiscal deficit. Under conditions of full capital mobility, sterilization becomes ineffective, as any funds which are withdrawn from the money market by central bank sterilization operations will quickly be replaced by new capital inflows. The cost of sterilization would skyrocket. As a consequence, in highly integrated financial markets, central banks have to accept some effect of capital inflows on monetary aggregates, which may cause inflationary pressures.<sup>2)</sup>

## 2.2 Capital Flows and Exchange Reserves in CEECs

Chart 1 shows that, as far as data are available, the growth of official reserves (excluding gold) in the CEECs was largely determined by the surplus on the financial account, whereas the development of the current account did not play an important role (with the partial exception of Slovenia). The Czech Republic, Hungary and Poland posted increasing exchange reserves financed by capital inflows. Declines in exchange reserves, e.g. in Hungary in 1996 and in the Czech Republic in 1996 and 1997, were likewise largely caused by a decline (in the Czech Republic) or even a dramatic reversal of capital inflows (Hungary). The capital flows to Hungary switched from a peak surplus on the financial account of USD 3.8 billion in the fourth quarter of 1995 to a deficit of USD 0.6 billion in the first quarter of 1997, which subsequently widened to USD 1.0 billion (maximum of the period under review). Contrary to the development in the Czech Republic and Hungary, Poland largely succeeded in avoiding outflows of capital and a resulting decline of exchange reserves. In Slovenia, both capital flows and changes of reserves fluctuated strongly, with the average value relatively close to zero.

The relatively close relation between capital flows and exchange reserves is confirmed by the high correlation of these two variables (see table 3). In Hungary, this correlation came to 0.66 between 1990 and 1998. We found the highest correlation (0.80) for the Czech Republic (1993 to 1998). By contrast, the development of exchange reserves in Slovenia, where capital inflows were relatively smaller, was rather influenced by other factors (e.g. by the current account).

We can also see a common trend in the development of capital flows in Central and Eastern Europe, which has been described by other authors.<sup>3)</sup> This common trend could indicate the relevance of international factors in the explanation of capital flows to Central and Eastern Europe. The highest inflow of foreign capital to Hungary and the Czech Republic was observed between 1993 and 1995, while both countries experienced a slowdown of

1 See Oblath (1998) and Durjasz and Kokoszczyński (1998) for a discussion of central bank interventions in Hungary and Poland, respectively.

2 This effect on monetary aggregates can be avoided if capital inflows are utilized to repay foreign debt.

3 See Calvo, Sahay and Végh (1995) and the UNCTAD World Investment Report 1999.

capital inflows or even capital outflows between 1996 and 1997. Hungary in particular experienced a high volatility of capital flows in 1998, but for the year as a whole, foreign capital inflows were recorded in both countries. Correspondingly, the correlation of capital flows in the Czech Republic and Hungary is relatively high and positive ( $\rho = 0.37$ ); the correlation of the development of foreign reserves is even higher ( $\rho = 0.53$ ).

Although Poland experienced episodes of capital outflows at the beginning of the 1990s, on the whole capital flows to Poland are correlated with flows to Hungary to a relatively high degree (0.27) in the period 1990 to 1995.<sup>1)</sup>

Table 2

**Interdependence (Correlation Matrix) of Capital Flows in the CEECs**

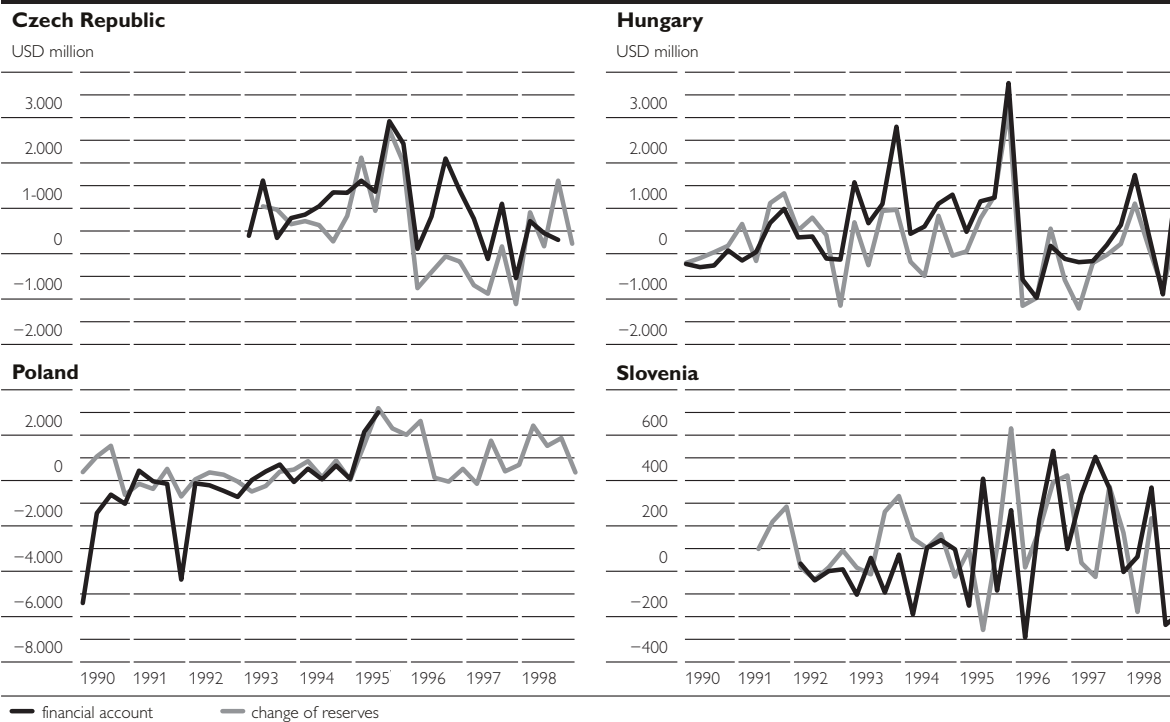
|                |        | Financial account |       |       |       | Change of exchange reserves |       |        |       |
|----------------|--------|-------------------|-------|-------|-------|-----------------------------|-------|--------|-------|
|                |        | CZ                | HU    | PL    | SI    | CZ                          | HU    | PL     | SI    |
| Czech Republic | $\rho$ | 1.000             |       |       |       | 1.000                       |       |        |       |
|                | N      | 23                |       |       |       | 23                          |       |        |       |
| Hungary        | $\rho$ | 0.371             | 1.000 |       |       | 0.532                       | 1.000 |        |       |
|                | N      | 23                | 36    |       |       | 23                          | 36    |        |       |
| Poland         | $\rho$ | 0.433             | 0.270 | 1.000 |       | 0.322                       | 0.157 | 1.000  |       |
|                | N      | 10                | 22    | 22    |       | 23                          | 36    | 36     |       |
| Slovenia       | $\rho$ | 0.167             | 0.020 | 0.362 | 1.000 | 0.048                       | 0.316 | -0.218 | 1.000 |
|                | N      | 23                | 28    | 14    | 28    | 21                          | 29    | 29     | 29    |

Source: IMF International Financial Statistics.

Note:  $\rho$  = Pearson correlation, N = number of observations.

Chart 1

**Financial Account and the Development of Reserves in Selected CEECs**



Source: IMF International Financial Statistics.

<sup>1</sup> In the IMF's International Financial Statistics, quarterly balance-of-payments data are available only up to 1995.



Table 3

| <b>Capital Flows and Exchange Reserves in the CEECs</b>                        |   |   |   |   |
|--|---|---|---|---|
| <b>Correlation of the Financial Account and Exchange Reserves in the CEECs</b> |   |   |   |   |
|  | Czech Republic  | Hungary   | Poland  | Slovenia  |
| Review period  | 2 <sup>nd</sup> quarter 1993 to<br>3 <sup>rd</sup> quarter 1998 | 1 <sup>st</sup> quarter 1990 to<br>4 <sup>th</sup> quarter 1998 | 1 <sup>st</sup> quarter 1990 to<br>2 <sup>nd</sup> quarter 1995 | 1 <sup>st</sup> quarter 1992 to<br>2 <sup>nd</sup> quarter 1998 |
| Correlation  | 0.797   | 0.663   | 0.483   | 0.190   |

The development of exchange reserves, which we found to be closely correlated with capital flows,<sup>1)</sup> indicates that capital flows to Poland also continued in the more recent period. Capital flows to Slovenia developed relatively independently of those in other CEECs, as both indicators show.

### 2.3 Capital Flows and Monetary Aggregates

In the previous section we saw that capital flows fueled sizeable increases in exchange reserves in most CEECs. The aim of this section is to investigate to what degree this capital inflow-driven buildup of exchange reserves had an impact on the development of monetary aggregates, to assess the inflationary potential arising from capital inflows.

Calvo, Sahay and Végh (1995) argue against sterilization activities by CEE central banks in the early phase of transition (until 1993), because they ascribe increasing capital flows in this phase to rising money demand. Therefore capital flows are assumed not to pose a danger for price stability. The development of inflation rates until 1995 lends support to this view. Although M2 grew often more quickly than nominal GDP in the CEECs during this time period, inflation rates declined (inflationary shocks such as the devaluation in Hungary in 1995 are, of course, exceptions).

Approximately in 1993, CEE central banks started to sterilize inflows, which is documented by a sharp increase in the share of net foreign assets in the monetary base, as central banks were trying to reduce net domestic assets in response to quickly growing net foreign assets. Table 4 provides an overview of the extent of sterilization operations in the CEECs: According to this table, in Slovenia the increase in net foreign assets was matched most closely by a decrease in net domestic assets. In Hungary and Poland, increases in net foreign assets were offset by declining net domestic assets to a rather high degree, while in the Czech Republic the degree of sterilization appears to be the lowest. However, one should be aware of the problems involved in this simple comparison: As Oblath (1998, p. 197) points out, we are dealing with ex post information. This means that we cannot tell to what extent the sterilized amount would have contributed to an increase in the current account deficit and/or the monetary base. In addition, the reaction of capital inflows in response to sterilization measures is not captured.

The extent of sterilization is also an indicator for the degree of integration into international financial markets. As stated above, under conditions of

<sup>1</sup> A close relation between capital flows and the development of exchange reserves is assumed in some other studies, too: Calvo, Leiderman and Reinhart (1993) use changes of exchange reserves as an approximation of capital flows to selected Latin American countries.

Table 4

**Development of Components of Monetary Aggregates in CEECs**

**Czech Republic**

|      | Monetary base |          | Monet. authorities |                  |     | M2          |          | Banking system |          | Nominal GDP | GDP deflator |
|------|---------------|----------|--------------------|------------------|-----|-------------|----------|----------------|----------|-------------|--------------|
|      | CZK billion   | % change | CZK billion        | NFA as a % of MB | NDA | CZK billion | % change | CZK billion    | % change |             |              |
|      |               |          |                    |                  |     |             |          |                |          | NFA         | NFA          |
| 1991 | x             | x        | x                  | x                | x   | x           | x        | x              | x        | 29.4        | 46.2         |
| 1992 | x             | x        | x                  | x                | x   | x           | x        | x              | x        | 13.0        | 16.8         |
| 1993 | 166           | x        | 148                | 89.0             | -57 | 697         | x        | 194            | 503      | 18.6        | 17.9         |
| 1994 | 223           | 34.4     | 204                | 91.6             | 17  | 840         | 20.4     | 233            | 607      | 14.4        | 10.9         |
| 1995 | 343           | 53.6     | 400                | 116.7            | -59 | 1,086       | 29.3     | 344            | 741      | 20.2        | 9.8          |
| 1996 | 344           | 0.5      | 367                | 106.7            | -34 | 1,156       | 6.4      | 310            | 845      | 13.8        | 9.6          |
| 1997 | 345           | 0.1      | 367                | 106.4            | -25 | 1,175       | 1.7      | 429            | 746      | 6.9         | 6.5          |
| 1998 | 422           | 22.5     | 403                | 95.4             | 19  | 1,214       | 3.4      | 510            | 704      | 8.4         | 11.0         |

**Hungary**

|      | Monetary base |          | Monet. authorities |                  |      | M2          |          | Banking system |          | Nominal GDP | GDP deflator |
|------|---------------|----------|--------------------|------------------|------|-------------|----------|----------------|----------|-------------|--------------|
|      | HUF billion   | % change | HUF billion        | NFA as a % of MB | NDA  | HUF billion | % change | HUF billion    | % change |             |              |
|      |               |          |                    |                  |      |             |          |                |          | NFA         | NFA          |
| 1991 | 799           | 52.3     | 237                | 29.7             | 311  | 1,183       | 29.4     | 279            | 904      | 19.6        | 25.4         |
| 1992 | 888           | 11.1     | 274                | 30.8             | 391  | 1,506       | 27.3     | 317            | 1,189    | 17.8        | 21.6         |
| 1993 | 1,019         | 14.8     | 549                | 53.9             | 189  | 1,759       | 16.8     | 593            | 1,166    | 20.6        | 21.3         |
| 1994 | 1,169         | 14.7     | 636                | 54.4             | 237  | 1,988       | 13.0     | 615            | 1,373    | 23.0        | 19.5         |
| 1995 | 1,516         | 29.7     | 1,576              | 103.9            | -270 | 2,355       | 18.4     | 1,508          | 846      | 28.6        | 25.5         |
| 1996 | ..            | ..       | ..                 | ..               | ..   | 2,854       | 21.2     | ..             | ..       | 22.8        | 21.2         |
| 1997 | ..            | ..       | ..                 | ..               | ..   | 3,507       | 22.9     | ..             | ..       | 23.9        | 18.5         |
| 1998 | ..            | ..       | ..                 | ..               | ..   | ..          | ..       | ..             | ..       | 19.2        | 13.4         |

**Poland**

|      | Monetary base |          | Monet. authorities |                  |         | M2          |          | Banking system |          | Nominal GDP | GDP deflator |
|------|---------------|----------|--------------------|------------------|---------|-------------|----------|----------------|----------|-------------|--------------|
|      | PLN billion   | % change | PLN billion        | NFA as a % of MB | NDA     | PLN billion | % change | PLN billion    | % change |             |              |
|      |               |          |                    |                  |         |             |          |                |          | NFA         | NFA          |
| 1991 | 10,943        | 28.2     | 3,709              | 33.9             | 4,492   | 26,102      | 37.0     | 7,791          | 18,311   | 44.4        | 55.3         |
| 1992 | 14,860        | 35.8     | 5,951              | 40.0             | 4,987   | 41,108      | 57.5     | 13,405         | 27,703   | 42.1        | 38.5         |
| 1993 | 15,993        | 7.6      | 7,702              | 48.2             | 3,468   | 55,924      | 36.0     | 17,212         | 38,712   | 35.5        | 30.5         |
| 1994 | 19,615        | 22.6     | 11,340             | 57.8             | 6       | 77,302      | 38.2     | 26,448         | 50,854   | 35.1        | 28.4         |
| 1995 | 28,441        | 45.0     | 36,636             | 128.8            | - 9,989 | 104,352     | 35.0     | 49,184         | 55,169   | 45.6        | 27.9         |
| 1996 | 34,262        | 20.5     | 51,789             | 151.2            | -18,944 | 136,517     | 30.8     | 61,524         | 74,993   | 25.8        | 18.7         |
| 1997 | 45,919        | 34.0     | 72,284             | 157.4            | -32,798 | 176,391     | 29.2     | 82,808         | 93,583   | 21.8        | 14.0         |
| 1998 | 53,656        | 16.9     | 95,610             | 178.2            | -49,159 | 220,765     | 25.2     | 96,300         | 124,465  | 17.4        | 12.0         |

**Slovenia**

|      | Monetary base |          | Monet. authorities |                  |      | M2          |          | Banking system |          | Nominal GDP | GDP deflator |
|------|---------------|----------|--------------------|------------------|------|-------------|----------|----------------|----------|-------------|--------------|
|      | SIT billion   | % change | SIT billion        | NFA as a % of MB | NDA  | SIT billion | % change | SIT billion    | % change |             |              |
|      |               |          |                    |                  |      |             |          |                |          | NFA         | NFA          |
| 1991 | 16            | x        | 7                  | 40.8             | 9    | 120         | x        | 47             | 73       | 77.6        | 94.9         |
| 1992 | 37            | 133.1    | 71                 | 190.7            | - 34 | 267         | 123.0    | 158            | 109      | 191.3       | 208.2        |
| 1993 | 51            | 38.2     | 103                | 199.8            | - 54 | 432         | 62.2     | 152            | 281      | 41.0        | 37.1         |
| 1994 | 81            | 56.9     | 189                | 235.0            | -111 | 626         | 44.7     | 321            | 305      | 29.1        | 22.6         |
| 1995 | 101           | 25.2     | 250                | 248.4            | -151 | 812         | 29.8     | 365            | 447      | 19.9        | 15.2         |
| 1996 | 117           | 15.6     | 330                | 282.8            | -214 | 1,001       | 23.3     | 488            | 513      | 15.0        | 11.1         |
| 1997 | 143           | 23.0     | 559                | 390.1            | -416 | 1,235       | 23.3     | 669            | 566      | 13.8        | 8.8          |
| 1998 | 172           | 19.7     | 594                | 346.1            | -423 | 1,476       | 19.5     | 702            | 774      | 11.6        | 7.3          |

Source: IMF International Financial Statistics, National Bank of Hungary.

Monetary base: reserve money.

NFA: Net Foreign Assets = foreign assets - foreign liabilities.

NDA: Net Domestic Assets = monetary base - net foreign assets.

M2: money + quasi-money.

<sup>1)</sup> Exclusive of long-term foreign liabilities.

full capital mobility, sterilization is ineffective. Thus, the conduct of sterilization operations would make little sense. One way to assess the effectiveness of sterilization is to estimate offset coefficients. The change in the central bank's net foreign assets is explained by a change in net domestic assets and other variables. A coefficient of  $-1$  for net domestic assets would imply the total ineffectiveness of sterilization (or full integration into financial markets), as any decrease in net domestic assets would be met by an increase of equal size in net foreign assets. Buch, Heinrich and Pierdzioch (1999) present a good overview of attempts to estimate offset coefficients in CEECs. They find that CEECs exhibit a rather high degree of financial integration, except possibly Slovenia, which was not covered in their study. Thus, the possibility of finding evidence of a relationship between capital inflows and inflation in CEECs should not be ruled out *ex ante*, as sterilization policies seem not to have succeeded in fully insulating monetary aggregates from capital inflows.

### 3 Capital Flows and Inflation: The Case of Hungary

Because of a lack of data on the other countries covered by this study, we are able to explore these relationships in greater detail only for Hungary. This section discusses bivariate and multivariate relations between various types of capital flows and selected monetary variables in Hungary between 1992 (FDI) or 1994 (portfolio investment) and 1999.

Table 5 shows the result of Granger causality tests applied to capital flows (foreign direct investment and portfolio investment in Hungary) and selected monetary variables including various price indices, real and nominal effective exchange rate indices, and various interest rates. We can see that the motives of direct investors to come to Hungary are highly different from those of portfolio investors. Direct investors are motivated mainly by real wages and exchange rates, while portfolio investors are attracted by the interest rate level. Various price indices are the only variables which exhibit a statistically significant relationship with both types of investment. Simultaneously, prices also seem to be influenced by both types of capital flows. Thus, the

Table 5

| <b>Result of Granger Causality Tests on Capital Flows and Selected Variables</b> |   |             |             |      |   |             |             |      |
|--|---|-------------|-------------|------|---|-------------|-------------|------|
|  | H0: Selected variables do not Granger cause capital flows |             |             |      | H0: Capital flows do not Granger cause selected variables |             |             |      |
|  | FDI   | FDI         | PI          | PI   | FDI   | FDI         | PI          | PI   |
| Number of lags   | 2   | 4           | 2           | 4    | 2   | 4           | 2           | 4    |
| Number of observations   | 28  | 28          | 24          | 24   | 28  | 28          | 24          | 24   |
| Real wages   | 0.79  | <b>5.66</b> | 0.07        | 0.25 | 0.18  | 0.38        | 0.10        | 1.16 |
| CPI, beverages   | 0.08  | 0.48        | <b>5.46</b> | 2.69 | <b>8.84</b>   | <b>5.99</b> | 1.21        | 0.98 |
| CPI, services  | 0.49  | 2.80        | <b>3.59</b> | 2.30 | <b>4.88</b>   | 1.85        | 1.06        | 0.78 |
| CPI, energy  | <b>6.28</b>   | <b>3.23</b> | 1.78        | 1.10 | 0.51  | 0.69        | 3.14        | 1.24 |
| CPI, foodstuffs  | 2.13  | <b>3.74</b> | 0.41        | 0.17 | 0.02  | 0.55        | 1.19        | 1.09 |
| CPI, total   | 1.80  | 2.36        | 2.81        | 1.40 | 1.85  | 0.37        | <b>3.55</b> | 2.12 |
| Real effective exchange rate   | <b>6.60</b>   | <b>3.12</b> | 0.05        | 0.28 | 0.33  | 0.57        | 0.87        | 0.30 |
| Nominal effective exchange rate  | <b>8.00</b>   | <b>4.63</b> | 0.34        | 0.36 | 0.46  | 1.79        | 1.26        | 0.44 |
| Lending rate   | 0.95  | 0.63        | <b>9.19</b> | 3.38 | 1.47  | 0.60        | 0.53        | 2.91 |
| Deposit rate   | 0.13  | 0.16        | <b>5.76</b> | 3.10 | 0.41  | 0.20        | 0.88        | 0.73 |
| Treasury bills   | 0.04  | 0.18        | <b>4.50</b> | 2.72 | 0.87  | 0.37        | 0.41        | 1.24 |
| Discount rate  | 0.34  | 1.42        | <b>7.05</b> | 2.85 | 0.66  | 0.47        | 1.92        | 0.12 |

Note: FDI – Foreign Direct Investment; PI – Portfolio Investment; italics – not significant, normal print – significant at the 10% level, bold print – significant at the 5% level.

relation between prices and capital flows could be mutual. Capital flows do not seem to have any other significant effects on the Hungarian economy. These results are largely similar to those presented by Halpern (1996).

However, Granger causality tests do not provide information on the character of the relationship between selected variables. Furthermore, omitted variables may bias the test results. Therefore, we specified a vector auto-regression (VAR) model of inflation in Hungary. The endogenous variables include the consumer price index (CPI), interest on Treasury bills (TBR), and the nominal effective exchange rate (NEER). The interest rates on Treasury bills are highly correlated with lending rates and other interest rates. Therefore, this variable can be taken as a proxy for the general level of interest rates in Hungary.

Furthermore, we included two exogenous variables, direct and portfolio investment (FDI and PI, respectively) converted to Hungarian forints. All variables are first differences, as indicated by D( ) in table 6.

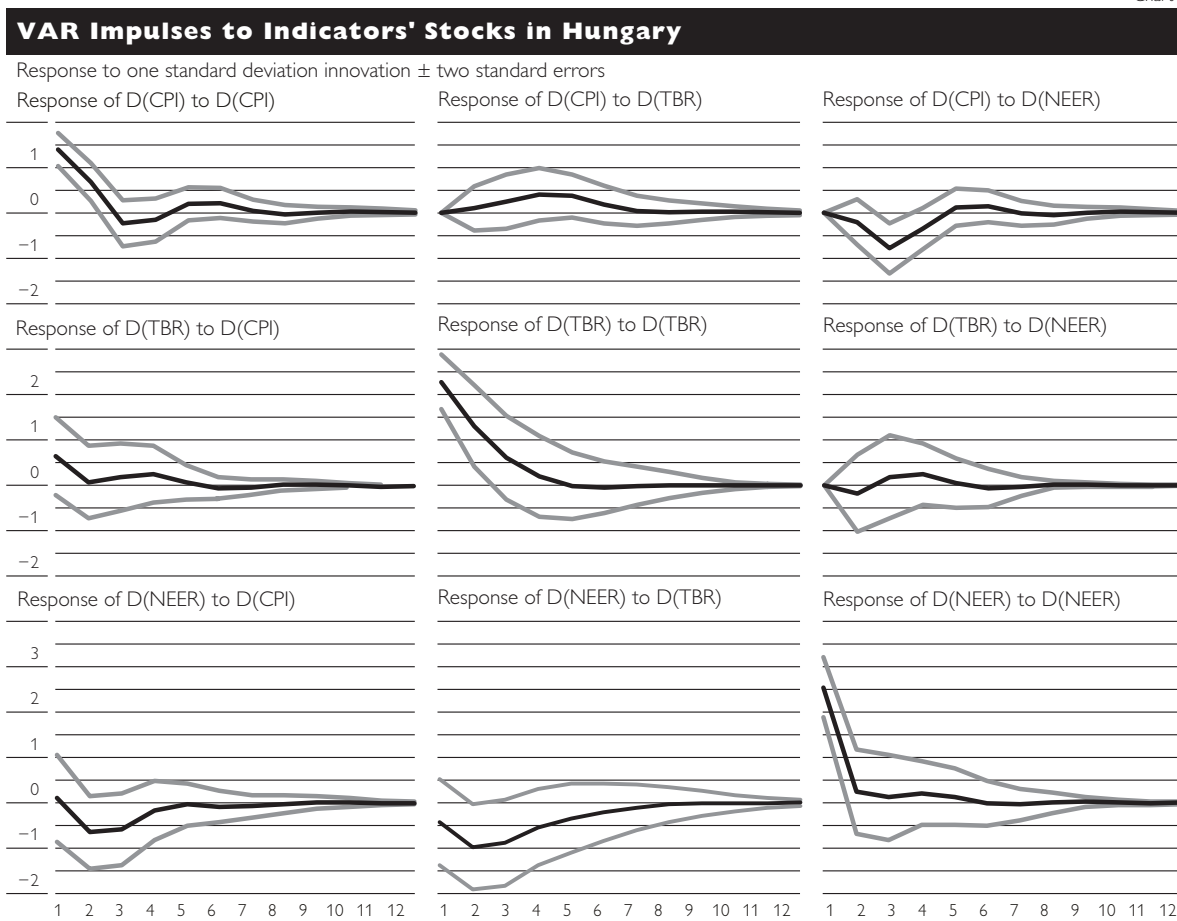
This model explains about 60% of the variance of the quarterly changes in consumer prices and about one third of the changes in interest rates and the exchange rate. As estimated impulse-response functions reveal, interest rate growth and exchange rate depreciation (displayed as a downward move-

Table 6

| <b>VAR Model of Inflation in Hungary</b>                          |                                      |                                      |                                      |
|---|--------------------------------------|--------------------------------------|--------------------------------------|
| <b>1<sup>st</sup> quarter 1992 to 1<sup>st</sup> quarter 1999</b> |                                      |                                      |                                      |
| Endogenous variables  | D(CPI)                               | D(TBR)                               | D(NEER)                              |
| D(CPI(-1))  | 0.476582<br>(0.15251)<br>(3.12482)   | -0.200883<br>(0.25815)<br>(-0.77818) | -0.285508<br>(0.28163)<br>(-1.01376) |
| D(CPI(-2))  | -0.416958<br>(0.15264)<br>(-2.73172) | 0.187135<br>(0.25835)<br>(0.72435)   | -0.162131<br>(0.28185)<br>(-0.57523) |
| D(TBR(-1))  | 0.026429<br>(0.12961)<br>(0.20392)   | 0.560851<br>(0.21937)<br>(2.55665)   | -0.411247<br>(0.23933)<br>(-1.71834) |
| D(TBR(-2))  | -0.014794<br>(0.13908)<br>(-0.10637) | -0.055568<br>(0.23541)<br>(-0.23605) | -0.102888<br>(0.25682)<br>(-0.40062) |
| D(NEER(-1))   | -0.083702<br>(0.11932)<br>(-0.70152) | -0.068417<br>(0.20195)<br>(-0.33878) | 0.096950<br>(0.22033)<br>(0.44003)   |
| D(NEER(-2))   | -0.265803<br>(0.10562)<br>(-2.51661) | 0.101204<br>(0.17877)<br>(0.56611)   | -0.014731<br>(0.19504)<br>(-0.07553) |
| Exogenous variables   |                                      |                                      |                                      |
| USD(-1)*FDI(-1)   | 9.87E-06<br>(3.6E-06)<br>(2.77474)   | -6.08E-06<br>(6.0E-06)<br>(-1.00968) | 6.69E-06<br>(6.6E-06)<br>(1.01891)   |
| USD(-1)*PI(-1)  | -1.02E-05<br>(4.3E-06)<br>(-2.37475) | -1.08E-06<br>(7.3E-06)<br>(-0.14826) | 3.90E-06<br>(7.9E-06)<br>(0.49141)   |
| Constant  | 2.706011<br>(0.95027)<br>(2.84761)   | 0.339926<br>(1.60843)<br>(0.21134)   | -1.750549<br>(1.75476)<br>(-0.99760) |
| R-squared   | 0.621711                             | 0.349859                             | 0.309447                             |
| Adj. R-squared  | 0.470395                             | 0.089802                             | 0.033225                             |
| F-statistic   | 4.108703                             | 1.345319                             | 1.120285                             |
| Log likelihood  | -50.74219                            | -66.00380                            | -68.52901                            |
| Akaike AIC  | 4.120151                             | 5.172676                             | 5.346828                             |
| Schwarz SC  | 4.544484                             | 5.597009                             | 5.771161                             |

Source: IMF International Financial Statistics.  
 Note: Standard errors and t-statistics in parentheses.

Chart 2



ment of the exchange rate index) have inflation-increasing effects, which disappear after one to two years. Depreciation and inflation cause the interest level to rise with a lag of about two quarters, an effect which disappears after one year. The nominal effective exchange rate reacts most rapidly to a change in the other endogenous variables. An inflation shock causes a depreciation with a lag of two or three quarters, while higher interest rates cause a depreciation already after one quarter. These effects diminish within the course of one year.

In this system, the coefficient of foreign direct investment is statistically significant and positive in the first equation while portfolio investment exhibits a statistically significant negative relation with the inflation rate.

However, the relationship between portfolio investment and the inflation rate is not robust: When the interest rate variable is changed, the t-value of the coefficient of portfolio investment is no longer significant. Both types of investment seem to reduce the interest level and support an appreciation of the nominal effective exchange rate in Hungary. Other model specifications, which included the aggregated financial account, performed considerably worse. There is no significant relationship between the financial account and the inflation rate. These effects are, incidentally, in accordance with the experiences of other countries (see Christoffersen and Wescott, 1999, and Calvo, Leiderman, and Reinhart, 1993).

## **4 The Impact of Capital Inflows on Financial Stability**

### **4.1 Theoretical Considerations**

Capital flows can pose a threat to financial stability via two main channels: First, capital flows may cause an excessive real appreciation of the exchange rate and second, they may produce a currency and maturity mismatch of assets and liabilities in the financial sector. While the first channel is relevant for both flexible and fixed-exchange-rate systems, the second one is decidedly more relevant for fixed-exchange-rate systems. A fixed-exchange-rate system encourages borrowing at lower interest rates in foreign currency as long as the exchange rate target of the central bank remains credible, which might result in high open foreign exchange positions of banks (i.e. a currency mismatch of assets and liabilities) and firms. Even when capital inflows take the form of purchases of domestic currency-denominated assets by foreigners rather than borrowing in foreign currency capital, inflows pose additional risks for financial stability. As explained above, under conditions of full capital mobility, the central bank has no control over the monetary base under fixed exchange rates. If the monetary base increases because of capital inflows, broader monetary aggregates will expand by more than the initial inflow amount because of the money multiplier. Thus, there will be a rise in the ratio of M2/official reserves, which means that the gap between liquid domestic assets (which could be converted into foreign currency-denominated assets) and the stock of foreign exchange available for meeting this demand grows. Although this problem could be mitigated with the use of higher minimum reserves, it cannot be avoided altogether.

Under conditions of less than full capital mobility, when sterilization is partly effective, there are still some unwanted side effects. Beside the fiscal costs of sterilization, the structure of capital inflows is likely to change in response to sterilization operations. Montiel and Reinhart (1999) find evidence for a change in the composition of capital inflows in favor of short-term and portfolio flows as a result of sterilization operations. At fixed exchange rates, capital inflows also tend to increase maturity mismatches in the banking sector, as foreigners' deposits with domestic banks will often have shorter maturities than the credits which are funded by the deposits.

In the light of the preceding discussion, a floating exchange rate system looks like a preferable solution. It certainly has the big advantage that it does not encourage quasi-arbitrage between domestic and foreign interest rates, which would increase the fragility of the financial system. However, a floating regime is not entirely free from complications, either. White (1999) gives a good overview of challenges for central banks which arise from the adoption of a floating exchange rate and direct inflation targeting framework. For transition economies, the issue of exchange rate overshooting seems to be of particular relevance. The expectation of large FDI inflows as a result of privatization projects might also attract short-term inflows, which could push up the exchange rate to overvalued levels. Beside the negative impact of an exchange rate misalignment on the real sector, strong expectations of exchange rate appreciation could induce banks and businesses to borrow excessively in foreign currency.

## 4.2 Developments of Economic and Financial Indicators

As we defined financial stability as the absence of financial crises, we decided to analyze variables which are associated in the literature with financial crises. Kaminsky, Lizondo and Reinhart (1998), who concluded extensive studies of a large number of balance-of-payments crises, identify the real exchange rate, banking crises, exports, stock prices, the M2/reserves ratio and output as the most reliable leading indicators of balance-of-payment crises. The real exchange rate, stock prices, the M2 multiplier, output and exports are mentioned by Reinhart (1999) as the most successful “predictors” of banking crises. As there are neither adequate time series of these indicators nor enough observations of crises available in CEECs, the empirical testing of the relevance of these indicators for transition countries is impossible at present. Thus we had to stick to presenting the “stylized facts” in developing a set of indicators of financial vulnerability which is based on Kaminsky, Lizondo and Reinhart’s (1998) and Reinhart’s (1999) findings. We divided our set of financial indicators into two groups, namely monetary and real variables. The first group of variables should be expected to reflect credit booms and asset bubbles fueled by the strong money supply growth resulting from capital inflows. The second group of variables tends to mirror symptoms of the excessive real appreciation of the exchange rate.

Table 7

### Broad Money and Reserves

|      | M2 / reserves  |         |        |          |
|------|----------------|---------|--------|----------|
|      | Czech Republic | Hungary | Poland | Slovenia |
| 1993 | 6.20           | 2.59    | 6.12   | 4.16     |
| 1994 | 4.98           | 2.65    | 5.26   | 3.30     |
| 1995 | 2.79           | 1.40    | 2.82   | 3.54     |
| 1996 | 3.30           | 1.78    | 2.64   | 3.08     |
| 1997 | 3.60           | 2.05    | 2.43   | 2.20     |
| 1998 | 3.38           | 1.97    | 2.30   | 2.51     |

Source: *WIIW Monthly Reports, National Bank of Hungary.*

Note: No figures by Hungarian M2 are available for 1998. The 1998 figure is extrapolated using the ratio of M2/M3 in 1997.

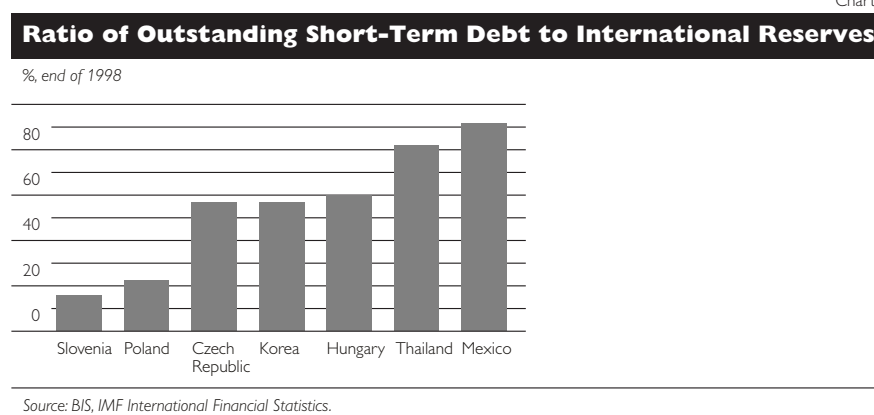
### 4.2.1 Monetary Variables: M2/Reserves, Short-Term Debt/Reserves, Stock Prices

When the reforms began, the Czech Republic and Poland had to cope with very low levels of international reserves, resulting in high M2/reserves ratios. Approximately in 1993 CEE central banks started to sterilize capital inflows, resulting in a sharp fall in this ratio until 1995. By then international reserves had accumulated to a level deemed sufficient and – as stated before – the management of continuing capital inflows from the viewpoint of monetary and financial stability became an important issue in the accession countries. Apart from Slovenia,<sup>1)</sup> all countries had started to follow a strategy of exchange rate targeting by that time, and steps to liberalize the capital account had been taken, with the Czech Republic leading in this respect.

<sup>1</sup> Slovenia pursues a policy of monetary targeting but pays very strong attention to exchange rate developments. Thus, in practice this policy comes very close to a strategy of exchange rate targeting.

In the next two years this ratio again worsened markedly in Hungary and the Czech Republic, albeit starting from a low level. Although this indicator did not seem to have reached<sup>1)</sup> an alarming level by 1997, the Czech Republic experienced a currency crisis. Thus, a capital inflow-driven credit boom does not seem to be the main cause of the crisis in the Czech Republic. Comparing a measure of liquid domestic assets such as M2 with the amount of foreign assets available in the economy to satisfy the demand for domestic assets if there is a run on the currency may yield insights into the severity of an exchange rate correction in the case of a loss of credibility. This could explain why the fall of the Czech koruna was fairly limited and why the currency crisis did not develop into a twin crisis.<sup>2)</sup>

Chart 3



While Reinhart's (1999) set of financial indicators includes the M2 multiplier, we decided to include the ratio of short-term debt/reserves instead. Except for Poland, which experienced a noticeable growth trend of the M2 multiplier in the 1990s, in our view the development of this indicator does not yield many insights for our purposes. As Reinhart's (1999) investigations focus on the *evolution* of selected variables, the ratio of short-term debt/reserves might not fit the author's concept. However, high *levels* of short-term debt/reserves are associated with several recent crises (Thailand, Korea, Mexico, Russia). Thus, we believe the level of this ratio might be a relevant piece of information for the analysis of the vulnerability of the financial system. Generally, low levels of this ratio seem to reflect the limited vulnerability of accession countries to sudden outflows of short-term funds. It also confirms the view that CEEC banks have not borrowed aggressively abroad to fund domestic credits.

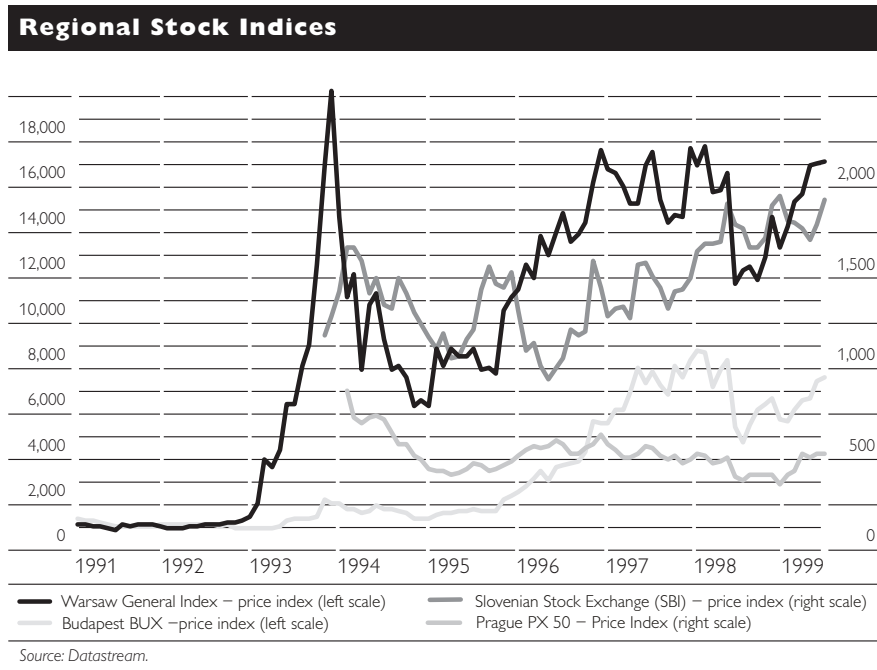
Stock prices fell significantly before the Czech currency crisis, but even sharper falls had occurred in 1994 and occurred again after the crises in Asia and Russia. The bubble observed in Poland and the Czech Republic in 1994 was a result of the underdeveloped state of the stock market and had very little effect on the banking sector and the economy as a whole. Although

1) Before the onset of the crisis, Korea's and Mexico's M2/reserves ratios reached levels of 6 to 7.

2) Obviously, the Czech banking system has problems, but they are a consequence of poor lending practices rather than exchange rate losses.



Chart 4



the market capitalization and liquidity of accession countries' equity markets have improved strongly, their role for the economy as a whole is probably still fairly unimportant. However, falls in CEE stock indices as a result of poor profitability of banks (which have heavy weights in the indices) and large corporations might signal problems for the banking sector.

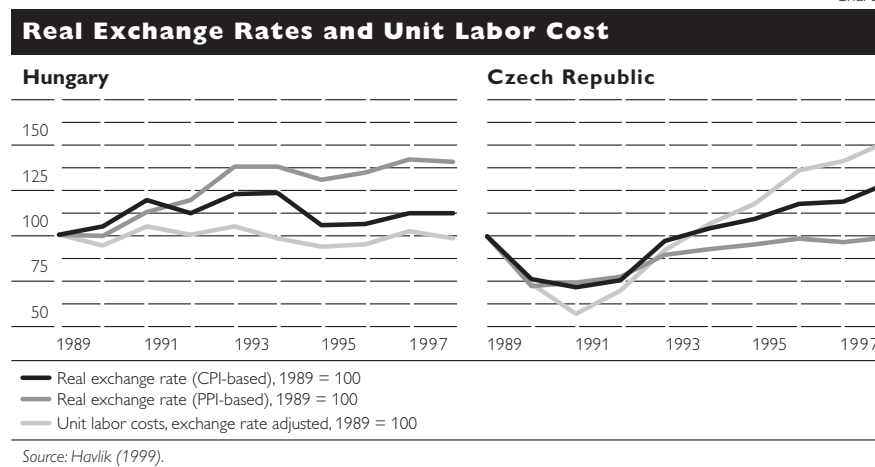
#### 4.2.2 Real Variables: Real Exchange Rate, Export Volumes, Output

Empirical studies by Halpern and Wyplosz (1997) and Krajnyak and Zettelmeyer (1997) that attempt to estimate equilibrium dollar wages for transition countries point to significant undervaluations of exchange rates<sup>1</sup>) at the beginning of transformation. In the meantime, all regional currencies have appreciated significantly in real terms (on the basis of consumer prices), which raises the question of whether real appreciation might have gone too far. Things are complicated by the fact that equilibrium exchange rates are likely to appreciate during the transformation process. We would like to repeat some of the arguments made by Halpern and Wyplosz (1997) stating why this should be the case: First, when formerly highly inefficient economies begin to respond to market forces, large gains in productivity can be expected. In parallel, a reduction of the sizeable industrial and agricultural sectors will take place, while the service sector (banking and finance, marketing, etc.) should grow strongly. When incomes begin to grow, demand for nontradeables rises, resulting in real appreciation. Second, if productivity gains in the tradeables sector outperform productivity gains in the nontradeables sector, according to the Balassa-Samuelson effect, a real appreciation

<sup>1</sup> Slovenia is an exception in this respect. However, Halpern and Wyplosz (1997) calculate equilibrium wages for Slovenia on the basis of data for former Yugoslavia, which is clearly problematic.

takes place. Although this might sound as if it contradicted the previous argument, these effects are not mutually exclusive and may occur together or sequentially. Third, in planned economies, natural resource prices and prices for public utilities were commonly set below market prices, leading to low nontradeables prices. These prices were raised gradually, resulting in real appreciation. Finally, improvements in product quality and better marketing should contribute to an improvement in the terms of trade.

Chart 5

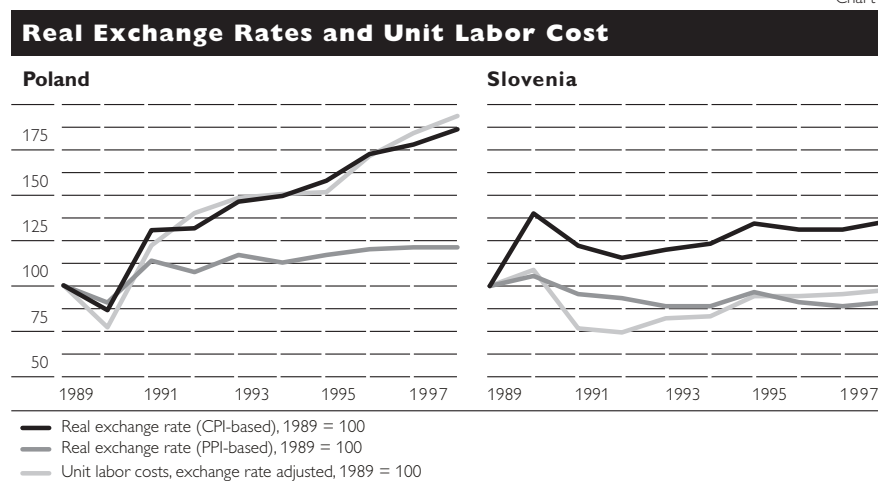


All countries in our sample except for Poland show a fairly uniform appreciation of the real exchange rate on a CPI basis of about 30% to 40% between 1989 and 1998. In the case of Poland the appreciation amounted to 85%. Consistently with the arguments presented above, the real appreciation on a CPI basis (which has a much higher content of non-tradeables) is significantly more pronounced than the appreciation on a PPI basis. In 1998 the Czech Republic and Hungary more or less again reached the PPI-based real exchange rate levels of 1989, while Slovenia continued to remain below the 1989 level. Poland proved to be an exception once more with a real appreciation of more than 20%. As real exchange rates on a PPI basis (which represent the tradeables sector better than the exchange rates on a CPI basis do) did not appreciate much against the currency of the most important trading partner, namely the European Union, there seems to be little concern of an exchange rate misalignment.

The analysis of unit labor costs yields a more mixed picture, though. Slovenia and Hungary experienced only small rises in exchange rate-adjusted (ECU-based) unit labor costs of 6.8% and 12.2% respectively, whereas unit labor costs in Poland and the Czech Republic shot up by 108% and 56%, respectively. Several observations seem to confirm the high relevance of unit labor costs for explaining trade and current account deficits: First, Slovenia, which experienced the smallest rise in exchange rate-adjusted unit labor costs, has traditionally had a balanced current account or even surpluses. Second, episodes of very large current account deficits (Hungary 1994, Czech Republic in 1996) occurred after sharp rises in exchange rate-adjusted unit labor costs. At first glance the massive rise in Polish exchange rate-adjusted unit labor costs, which did not cause severe macroeconomic imbalances up to

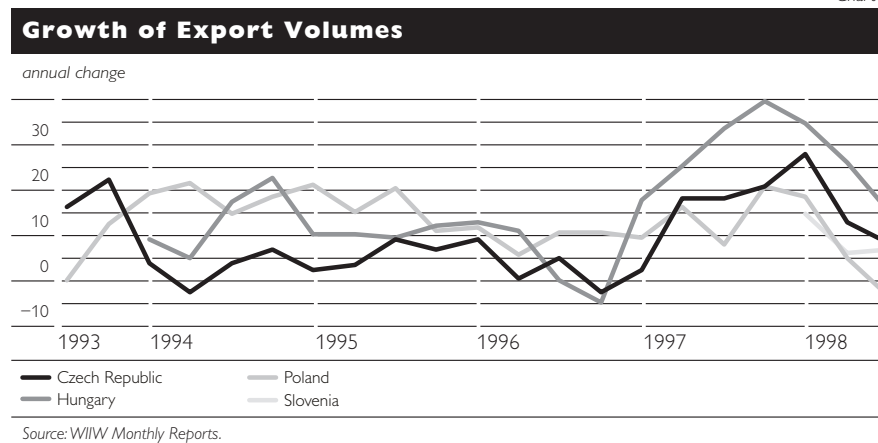
1998, seems to be hard to explain. However, it should be noted that by far the largest rise in unit labor costs occurred in 1991, which indeed caused a marked erosion of the previous trade balance surplus. Nevertheless, the current account remained in check as a result of the debt relief granted Poland. The debt relief caused a rise in Poland's equilibrium exchange rate, as it reduced the need to achieve surpluses in the trade balance in order to service its foreign debt. Second, trade in U.S. dollars, and in particular trade with CIS states, is more relevant for Poland than for the other countries covered in this paper. Approximately 16% of (classifiable) Polish exports went to CIS countries before the Russian crisis.<sup>1)</sup> As the Russian ruble's real appreciation before the crisis was in excess of the real appreciation of the Polish zloty, Poland's trade-weighted (effective) exchange rate appreciated less than the ECU-based rate before the Russian crisis. As a result, until the outbreak of the Russian crisis there were no visible symptoms of an overvalued exchange rate in Poland. However, if one perceives the loss of the CIS export markets for Poland as permanent (at least for the medium term) the possibility exists that the zloty became overvalued at the end of 1998.

Chart 5



Source: Havlik (1999).

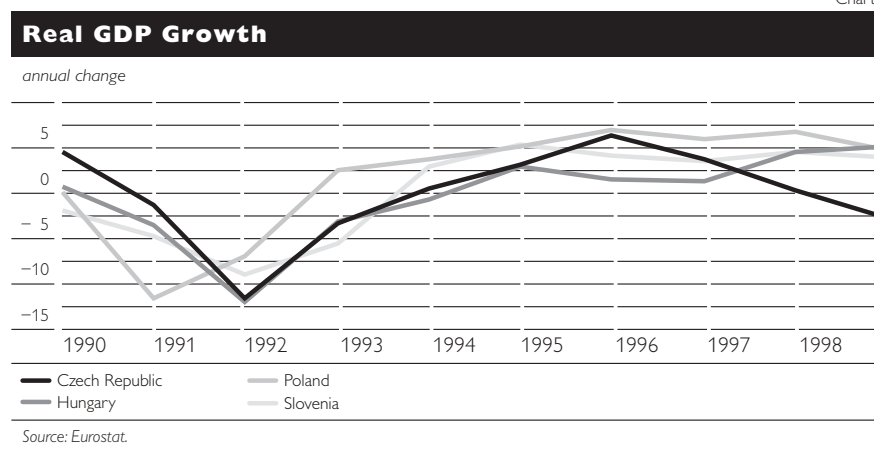
Chart 7



1 Poland's surplus in unclassified trade was also reduced significantly by the Russian crisis.

Output and export dynamics also support the view that no exchange rate misalignment occurred in Poland until 1998, while in the Czech case symptoms appeared which might point to a misalignment of the Czech koruna under short-run considerations. Before the Czech koruna's devaluation in 1997, Czech exports markedly lagged Polish exports whereas the situation reversed after the devaluation of the Czech currency. GDP growth rates paint the same picture: Continued high GDP growth rates in Poland contrasted with slowing growth rates and rising current account deficits in the Czech Republic before the Czech currency crisis.

Chart 8



## 5 Implications for Monetary and Financial Stability

When drawing conclusions for the conduct of monetary policy from our results, one must take into account the limits of the study, in particular the shortness of the time series and possible effects of structural changes in the transition economies covered. Bearing these caveats in mind, we consider the results of our VAR model for Hungary to be fairly encouraging. As mentioned before, most of the variance of the first differences of the CPI is attributable to the explanatory variables. There seems to be a fairly robust relationship between the development of the nominal exchange rate and the inflation rate, whereas the statistical link between nominal interest rates and inflation seems to be much weaker. Thus, this result provides support for the strategy of exchange rate targeting Hungary pursued throughout the sample period.<sup>1)</sup> As interest rates are set in accordance with the exchange rate target and thus play a rather passive role, one would expect a stronger impact of exchange rate developments than of interest rates on inflation. However, throughout the sample period, Hungary had restrictions on capital movements in place which provided the National Bank of Hungary with some leeway in its interest rate policy notwithstanding the exchange rate target. As a result, *ex ante*, the possibility of a relationship between interest rates and the inflation rate might be considered. However, it is not certain that a statistically significant relationship between exchange rate variables and inflation

<sup>1</sup> Since 1995 Hungary has pursued a crawling peg regime; before the introduction of this system, Hungary had applied a policy of devaluations on an irregular basis.

can be found, as the exchange rate's role as a nominal anchor might be disturbed, for example by the process of price liberalization. Our findings of a poor (statistical) link between interest rates and inflation on the one hand, and a fairly good linkage between the exchange rate and inflation on the other hand are in accordance with Christofferson and Wescott's (1999) results for Poland.

Our results suggest that, while Hungary sterilized capital inflows to a relatively high degree, it did not manage to prevent capital flows from having a certain effect on the inflation rate. The VAR model and the Granger causality test provide evidence for an impact of FDI on the inflation rate. Although the negative relation between portfolio inflows and the change in consumer prices would indicate a dampening effect of portfolio inflows on the inflation rate, this result should be treated with some scepticism. First, it is contrary to theoretical expectations and second, the relation is statistically not very robust. As FDI inflows seem to be related to the inflation rate while this is not the case for the financial account as a whole, one may conclude that FDI causes some demand-driven inflation whereas the danger of a credit boom as a result of a large total inflow amount channeled through the banking system seems to be rather limited. This would suggest that growth in monetary aggregates seems to be a very weak link between capital inflows and inflation.

The levels and dynamics of financial indicators presented in this paper point to a relatively moderate vulnerability of the CEECs to financial crises at present. Few signs of a worsening of the indicators which seem to be caused by increasing financial integration could be detected. This positive overall assessment is supported by the relatively limited impact of the Russian crisis on the more advanced CEECs. However, there is no definitive answer as to how far the indicators applied in this study were able to "predict" the balance-of-payments crises in Hungary in 1994/95 and in the Czech Republic in 1997. It seems fair to conclude, though that the development of exchange rate-adjusted unit labor costs was a very relevant indicator in both cases. While the Hungarian crisis occurred under conditions of limited integration into international financial markets, the question of to what degree the advanced state of integration of the Czech Republic contributed to the Czech crisis cannot be fully answered. Among the indicators which we presented in this paper, the "real variables" reflect the problems in the Czech economy better than the "monetary variables." If imprudent intermediation of capital inflows were the main factor behind the crisis, the "monetary indicators" should look worse. Thus, we would draw the conclusion that excessive real appreciation (measured by exchange rate-adjusted unit labor costs) in the runup to the crisis is more relevant for explaining the Czech currency crisis. However, the question of whether capital inflows contributed to the worsening of exchange rate-adjusted unit labor costs in the runup to the crisis remains open.

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# Exchange Rate Regimes in Central and Eastern Europe: A Brief Review of Recent Changes, Current Issues and Future Challenges

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## I Introduction

Exchange rate regimes and policies have been among the most contested and controversial issues in Central and Eastern Europe (CEE) since the very beginning of transition ten years ago. The purpose of this brief review is to shed some light on a few selected exchange rate issues that are pertinent to Central and Eastern European EU applicant countries. The review starts out by giving an account of the developments of exchange rate regimes in CEE from the onset of the Asian crisis until today, thus covering the last two-and-a-half years. Subsequently, these developments are examined and scrutinized against the backdrop of the recent emerging market crises and, more broadly, the financial crisis theme in general, on occasion with a particular stress on selected country cases. In a further step, the analysis is extended to current and future challenges for exchange rate policies in Central and Eastern Europe. The review ends with short conclusions.

It would go far beyond the objective and the scope of this brief article to revisit and reproduce the debate on *fixed versus flexible exchange rate regimes*. In order to set the stage for the analysis, it is sufficient to recall that, basically, the choice of the exchange rate regime is dependent on the size and the degree of openness of an economy, the nature and source of shocks it is exposed to, its structural features, the preferences of policymakers, and furthermore also on credibility-related considerations.<sup>2)</sup>

In the recent debate on exchange rate regimes, there has been growing support for the view that, in a world of integrated capital markets and greatly increased capital mobility, *intermediate exchange rate regimes* – standard-type pegged regimes and heavily managed floats based on unstated exchange rate rules – are inherently unstable: Large and volatile capital flows render such regimes prone to disruptive and very costly currency and financial crises, regardless of how underlying economic fundamentals develop. Therefore, it is argued that the future, which will entail further increases in capital mobility, will belong exclusively or almost exclusively to corner solutions, i.e. to free (or only very lightly managed) floats on the one hand and to super-strict regimes – currency boards, the adoption of a foreign currency as sole or parallel legal tender or joining a monetary union – on the other hand.

A different view concedes that the substantial increase in capital mobility over the last decade has clearly made the management of intermediate regimes much more challenging. However, it holds that there are still good reasons for many countries to adopt intermediate regimes. If the overall macroeconomic policy stance is coherent and the financial system is robust, functions well and is properly supervised, such regimes can be reasonably

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2 For a concise overview see e.g. IMF (1997).

viable, in particular if they are adopted in the context of a broader economic and political integration process. Capital account liberalization, if carefully timed and sequenced, can support intermediate exchange rate regimes during the transitional period in which these conditions are put in place. Corner solutions, in turn, will tend to constitute the exception rather than the rule for most countries: Currency boards require very demanding preconditions in order to be lastingly viable, while free or only lightly managed floats tend to have significant drawbacks, in particular for the development of the real sectors in small open economies “which lack the size for developing the necessary market infrastructure to cope with exchange rate volatility.”<sup>1)</sup>

## 2 An Account of Recent Developments

Table 1 displayed below contrasts the exchange rate regimes of the applicants in mid-May 1997 when the Thai baht came under severe pressure (which led to its flotation seven weeks later) with the regimes that are currently in place. It shows that exchange rate regimes in Central and Eastern Europe have varied widely across countries: One can find all kinds of arrangements, from currency boards to lightly managed floats.

There is *no uniform trend* which would characterize the evolution of exchange rate regimes in Central and Eastern Europe over the review period of the past two-and-a-half years. Some countries, like Poland, the Czech Republic and Slovakia, have moved or continued to move towards greater exchange rate flexibility – either, like Poland, within the framework of a deliberate strategy<sup>2)</sup> or as a consequence of a successful attack on “standard” exchange rate pegs, fixed pegs to be more precise (Czech Republic, Slovakia)<sup>3)</sup>. This move towards more exchange rate flexibility has been combined with or followed by the adoption of direct inflation targeting frameworks (Czech Republic and Poland), or by a more eclectic strategy that has brought together elements of monetary and direct inflation targeting (Slovakia). Other countries have not advanced towards greater exchange rate flexibility. Hungary and Latvia have retained standard-type pegs with narrow bands, the former operating a crawling, the latter a fixed peg. The number of currency board countries has increased from two to three, with Bulgaria joining Estonia and Lithuania. Also, it should be noted that the two countries that operate crawling peg regimes (Poland and Hungary) have greatly reduced their crawl rates, especially more recently.

In terms of *corner solutions versus intermediate exchange rate regimes*, the following picture emerges: Three countries have typical intermediate regimes – Hungary and Latvia as well as Slovenia, which operates a tightly managed float; the number of clear-cut intermediate regimes has thus gone down over the past two-and-a-half years. Three countries, namely the currency board countries, have definite corner solutions. The degree of exchange rate man-

1 European Central Bank (1999).

2 Poland embarked on this route back in 1991 when it switched from a fixed to a crawling peg. Since the mid-1990s, this has been complemented by a successive extension of fluctuation bands.

3 In both cases, the regime change was preceded by a widening of fluctuation bands in 1996 (Czech Republic) and 1996/97 (Slovakia) respectively.



Table 1

**Exchange Rate Regimes in Central and Eastern European EU Candidate Countries**

**Before the Outbreak of the Asian Crisis and in Late 1999**

|                | May 14, 1997<br>(when the Thai baht came under a fierce speculative attack)   | November 14, 1999  |
|----------------|---|--|
| Bulgaria       | Managed float (DEM reference currency)  | EUR peg under a currency board (BGL 1.95583 = EUR 1)   |
| Czech Republic | Fixed peg to a basket (65% DEM, 35% USD)<br>Fluctuation band: $\pm 7.5\%$   | Managed float (EUR reference currency)   |
| Estonia        | DEM peg under a currency board (EEK 8 = DEM 1)  | DEM/EUR peg under a currency board<br>(EEK 15.6466 = EUR 1)  |
| Hungary        | Crawling peg versus basket (70% DEM, 30% USD)<br>Fluctuation band: $\pm 2.25\%$<br>Automatic monthly devaluation: 1.1%                        | Crawling peg versus basket (70% EUR, 30% USD)<br>Fluctuation band: $\pm 2.25\%$<br>Automatic monthly devaluation: 0.4% |
| Latvia         | SDR peg (LVL .7997 = SDR 1)<br>Fluctuation band: $\pm 1\%$  | SDR peg (LVL .7997 = SDR 1)<br>Fluctuation band: $\pm 1\%$   |
| Lithuania      | USD peg under a currency board (LTL 4 = USD 1)  | USD peg under a currency board (LTL 4 = USD 1)   |
| Poland         | Crawling peg versus basket (45% USD, 35% DEM,<br>10% GBP, 5% FRF, 5% CHF)<br>Fluctuation band: $\pm 7\%$<br>Automatic monthly devaluation: 1% | Crawling peg versus basket (55% EUR, 45% USD)<br>Fluctuation band: $\pm 15\%$<br>Automatic monthly devaluation: 0.3%   |
| Romania        | Managed float (USD reference currency)  | Managed float (USD and EUR reference currencies)   |
| Slovakia       | Fixed peg to a basket (60% DEM, 40% USD)<br>Fluctuation band: $\pm 7\%$   | Managed float (EUR reference currency)   |
| Slovenia       | Managed float (DEM reference currency)  | Managed float (EUR reference currency)   |

agement in the other four countries has been diverse, with little central bank intervention in the foreign exchange market in the Czech Republic and Poland since early 1998. However, even in these two cases, the authorities appear to have remained genuinely concerned about exchange rate developments.

During the course of the last two-and-a-half years, three of the ten countries – Bulgaria, the Czech Republic and Slovakia – have carried out *exchange rate regime changes*. Poland and, to a lesser extent Hungary, have made tangible alterations within particular regimes. The other five countries, in turn, have undertaken no change or only technical adaptations.<sup>1)</sup>

The two cases in which “standard” peg regimes collapsed are closely linked in terms of timing to *emerging market crises* events: The breakdown of the Czech peg occurred on May 27, 1997, i.e. at the onset of the Thai crisis, while the collapse of the Slovak peg took place in the immediate aftermath of the Russian crisis, on October 1, 1998. (Bulgaria, in turn, took the

1 Clearly, this categorization does not convey any information about the occurrence of currency crises during the review period, as there is no systematic interrelation between changes in exchange rate regime and currency crises. Regime changes can be undertaken in calm times (as the Polish case illustrates), while they may or may not be associated with currency crises if they are enforced by speculative attacks. Regime changes do not have to lead to “currency crashes” – one possible definition of currency crises – as the Czech and the Slovak case show (see section 3 and charts 1a and 1d). Vice versa, currency crashes can occur under floating systems without regime changes, as repeated currency collapses under such regimes in Romania and in Bulgaria before the adoption of the currency board demonstrate. The same holds basically true if currency crises are understood as incidents of “major exchange rate pressure,” which, again, can but does not have to be associated with regime changes.

decision to move to a currency board already in early 1997, i.e. in times of international market tranquility.) On the other hand, the peg regimes of Hungary and Latvia as well as the tightly managed float of Slovenia were maintained during the recent bout of emerging market crises.

Table 1 shows that the exchange rate policies of Central and Eastern Europe are primarily oriented towards the *euro* today. Up to now, this has largely been the legacy of the role of those currencies which have been superseded by the euro, in particular the Deutsche mark.<sup>1)</sup> Looking at the current state of affairs in individual countries, the euro is the dominant currency in the baskets of Poland and Hungary, while Bulgaria's and Estonia's currencies are already fully linked to the euro. Moreover, the single currency has become the reference currency for all applicant countries with (managed) floating exchange rate regimes.

### 3 Interpreting Recent Developments

What was the impact of the 1997 to 1999 emerging market crises on exchange rate regimes in Central and Eastern Europe? Three issues, namely the robustness of intermediate exchange rate regimes, the drawbacks and advantages of different exchange rate arrangements in crisis times and the impact of a crisis environment the implementation of planned regime alterations, are examined further in this section.

#### 3.1 The Robustness of Intermediate Exchange Rate Regimes

The viability of intermediate exchange rate regimes has increasingly been questioned in recent years. What does the recent experience of Central and Eastern European EU candidate countries contribute to the debate on this proposition?

At first glance, the cases of the *Czech Republic* and *Slovakia* could be seen as evidence of an intrinsic fragility of intermediate regimes.<sup>2)</sup> A somewhat closer analysis, however, shows a somewhat different picture. Although the cases of these two countries are in many ways different, they share one common feature: One can explain the collapse of both the Czech and the Slovak exchange rate pegs by shifts in domestic economic fundamentals rather than interpreting them as crises of the self-fulfilling variety: In both cases, the breakdown of the peg originated from domestic policies which were unsustainable and inconsistent with the maintenance of the fixed exchange rate regime.<sup>3)</sup>

The Czech exchange rate peg had become vulnerable due to a gradual loss in price competitiveness which resulted from sluggish structural reforms on the one hand and from an inappropriate macroeconomic policy mix in the wake of massive capital inflows between 1993 and 1996 under a fairly liberal

1 Only in Poland did the introduction of the euro lead to an imminent strengthening of the orientation to the single European currency, as compared to its precursors. For the future perspectives of the euro's role as an anchor currency for CEE see section 4.

2 For detailed reviews of the Czech case, see Begg (1998), UN ECE (1998), OECD (1998). For a thorough analysis of the Slovak case, see OECD (1999a).

3 Begg, Halpern and Wyplosz (1999) arrive at a very similar conclusion on the Czech case (while they do not discuss the Slovak case).

foreign exchange regime on the other hand. In particular, there was no fiscal response to the inflows (in fact the overall budgetary stance tended to be expansive at the time)<sup>1</sup>), and real wages soared because of weak corporate governance and the absence of incomes policies. This led to an overheating of the economy and a large current account deficit. Export growth stalled in 1996 and turned slightly negative in the first months of 1997, while the economy began to run out of steam, unemployment started to rise, the fiscal position worsened and conflicts within the ruling coalition were compounded. This combination of unsustainable macroeconomic policies and incomprehensive and partly inappropriately designed reform measures set the stage for the demise of the Czech exchange rate peg. In Slovakia, the reasons for the breakdown of the exchange rate regime have to be sought in the very expansive fiscal stance in the years 1996 to 1998, leading to a surge in the current account deficit and to a fast increase in external debt unfolding against the backdrop of major deficiencies in structural reforms. The crises elsewhere – in Thailand and in Russia respectively – helped trigger the speculative attacks, but were not themselves the underlying causes of the collapse of the two regimes. It should be added that in both cases, fiscal policy stances tightened after the turbulences, which improved the macroeconomic policy mix and strengthened the commitment to undertake structural reforms. This limited the depreciation both currencies experienced after their flotations (see charts 1a and 1d).

However, in the course of the recent emerging market crises, *cases of contagion occurred which were largely unrelated to underlying changes in economic fundamentals* in CEE. One of these instances stands out prominently. After the Russian devaluation and partial default in August 1998, Hungary, Poland, the Czech Republic and, to a lesser extent, Slovenia experienced significant financial contagion effects, although their trade and financial relations with Russia were relatively small and although – in contrast to Slovakia at the time – domestic policies were broadly consistent and sound.<sup>2</sup>) To a varying degree, these countries experienced capital outflows that led to exchange rate pressures, rising interest rates and tumbling equity prices (see charts 1a to 1e, 2 and 3). In the event, the robustness of typical intermediate exchange rate regimes (the Hungarian narrow-band crawling peg, Slovenia's heavily managed float) did not differ much from that of more flexible regimes (Poland's wide-band crawling peg, the Czech Republic's managed float). After a general initial flight to quality, markets began to differentiate

1 From 1993 to 1997, the Czech general government balance moved from a slight surplus to a deficit on the order of 2% of GDP; this relapse was twinned with a strong growth of contingent fiscal liabilities.

2 Central and Eastern European countries also experienced financial contagion effects from the Asian crisis in 1997 and the Brazilian turbulences in early 1999, respectively. The Asian crisis had a significant impact on a limited number of specific areas. Stock markets were temporarily affected in the Central European countries (see chart 3) and more pronouncedly and lastingly in the Baltics; moreover, the latter group of countries (most markedly Estonia) also experienced a rise in interest rates for some time. Furthermore, as discussed, mounting pressure on the Thai baht helped trigger the attack on the Czech exchange rate regime. (The collapse of the Czech peg, in turn, hardly affected the countries in the CEE region, except for Slovakia, which experienced substantial but temporary exchange rate pressure; see in particular chart 1a to 1e). The effects of the Brazilian crisis on CEE were generally mild and very transient (see charts 1a to 1e, 2 and 3).

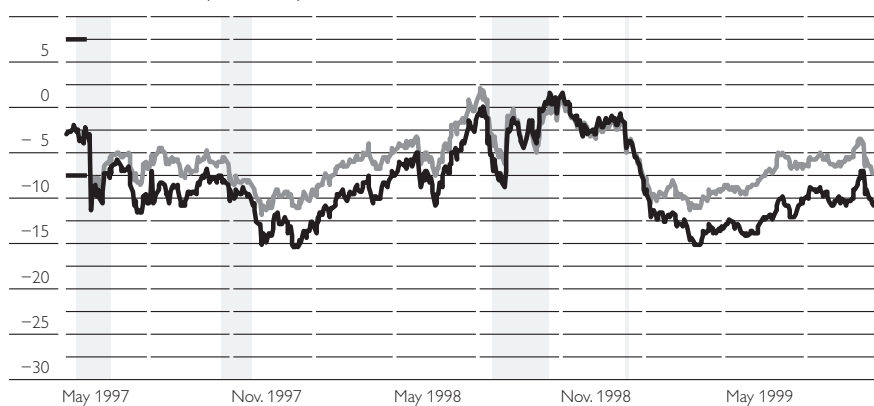
among countries according to fundamentals, no matter what exchange rate regime was in place.

*In all charts, four periods are specifically singled out by gray bars: the attack on the flotation of the Czech koruna (mid-May to end-June 1997), the Asian crisis (end-October to end-November 1997), the Russian crisis (mid-August to mid-October 1998) and the Brazilian crisis (mid-January 1999).*

Chart 1a

### Nominal Exchange Rate of the Czech Koruna

CZK/basket and CZK/DEM (inverted scale), %



Fixed exchange rate regime until May 27, 1997:

Composition of the basket 65% DEM, 35% USD; width of fluctuation band:  $\pm 7.5\%$ .

Since May 28, 1997: Floating exchange rate regime.

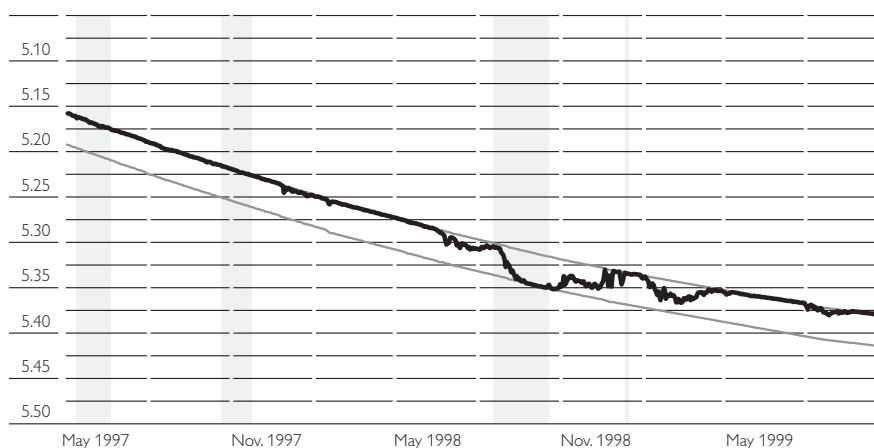
— CZK against the former basket throughout the whole period

— CZK against the former basket until May 27, 1997;  
thereafter against the DEM (and thus since January 1, 1999 against the EUR)

Chart 1b

### Nominal Exchange Rate of the Hungarian Forint

ln of HUF/basket (inverted scale)



Composition of the basket: May 1, 1997 to December 31, 1998: 70% DEM, 30% USD;

January 1 to October 31, 1999: 70% EUR, 30% USD

Monthly rate of crawl: May 1 to August 14, 1997: 1.1%; August 15 to December 31, 1997: 1%;

January 1 to June 14, 1998: 0.9%, June 15 to September 30, 1998: 0.8%; October 1 to December 31, 1998: 0.7%;

January 1 to June 30, 1999: 0.6%; July 1 to September 30, 1999: 0.5%; October 1 to 31, 1999: 0.4%.

Width of the fluctuation band: throughout the whole period  $\pm 2.25\%$ .

Source: Economics and Research Department, National Bank of Hungary.

Chart 1c

**Nominal Exchange Rate of the Polish Zloty**

*In of PLN/basket (inverted scale)*



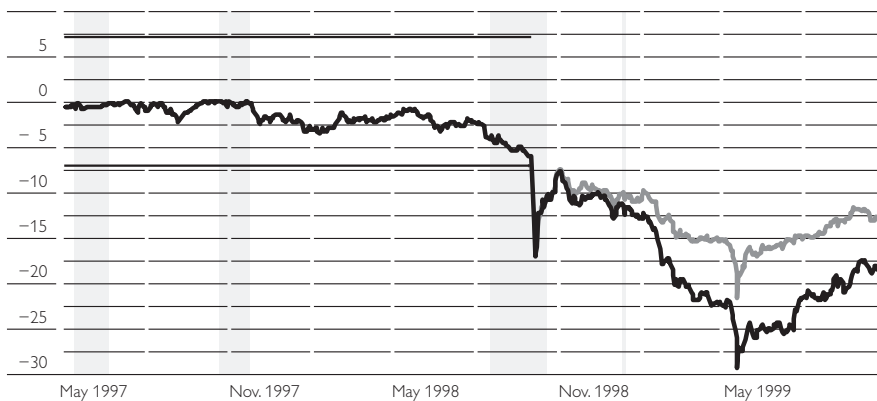
Composition of the basket: May 1, 1997 to December 31, 1998: 45% USD, 35% DEM, 10% GBP, 5% FRF, 5% CHF; January 1 to October 31, 1999: 55% EUR, 45% USD.  
 Monthly rate of crawl: May 1, 1997 to February 26, 1998: 1.0%; February 27 to July 17, 1998: 0.8%; July 18 to September 10, 1998: 0.65%; September 11, 1998, to March 24, 1999: 0.5%; March 25 to October 31, 1999: 0.3%.  
 Width of the fluctuation band: May 1, 1997, to February 26, 1998:  $\pm 7\%$ ; February 27 to October 28, 1998:  $\pm 10\%$ ; October 29, 1998 to March 24, 1999:  $\pm 12.5\%$ ; March 25 to October 31, 1999:  $\pm 15\%$ .

Source: Economics and Research Department, National Bank of Hungary.

Chart 1d

**Nominal Exchange Rate of the Slovak Koruna**

*SKK/basket and SKK/DEM (inverted scale), %*



Fixed exchange rate regime until October 1, 1998:  
 Composition of the basket 60% DEM, 40% USD; width of fluctuation band:  $\pm 7.0\%$ .  
 Since October 2, 1998: Floating exchange rate regime.  
 — SKK against the former basket throughout the whole period  
 — SKK against the former basket until October 1, 1998; thereafter against the DEM (and thus since January 1, 1999, against the EUR)

Chart 1e

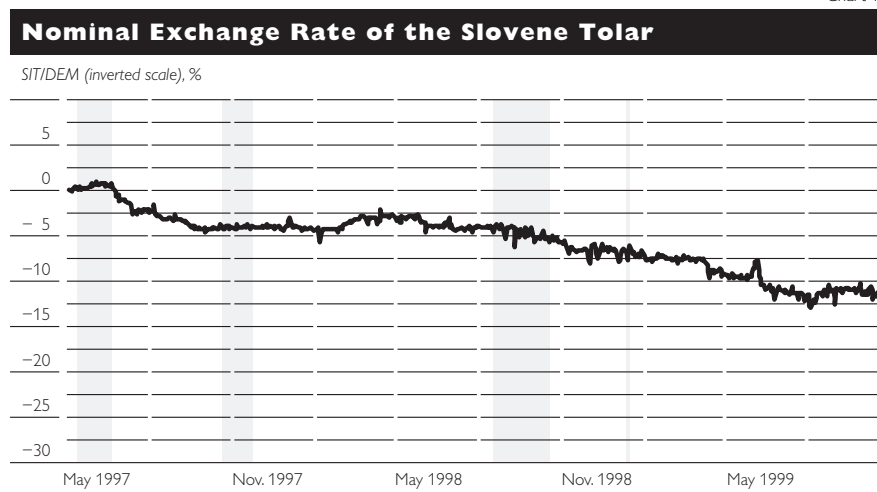
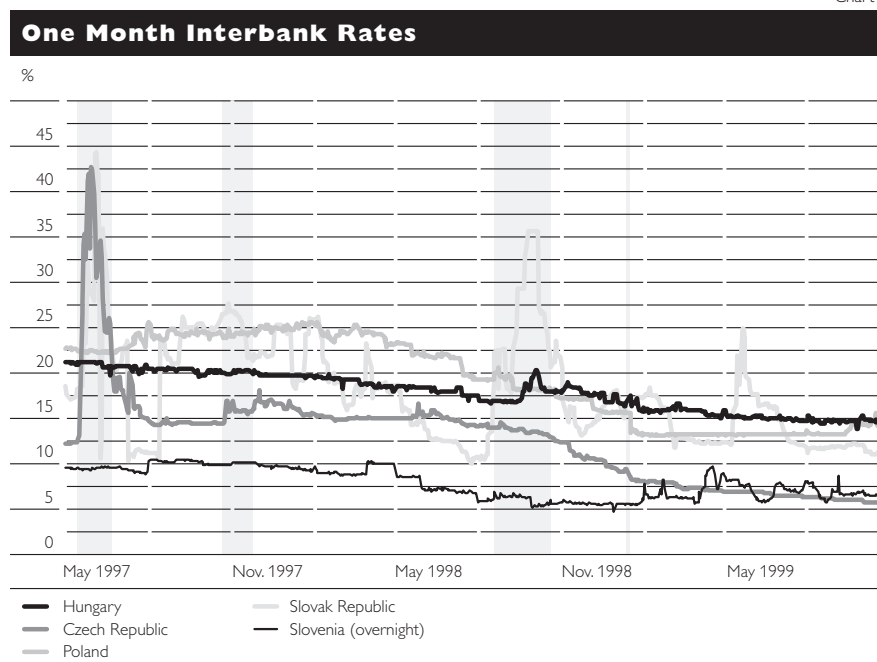


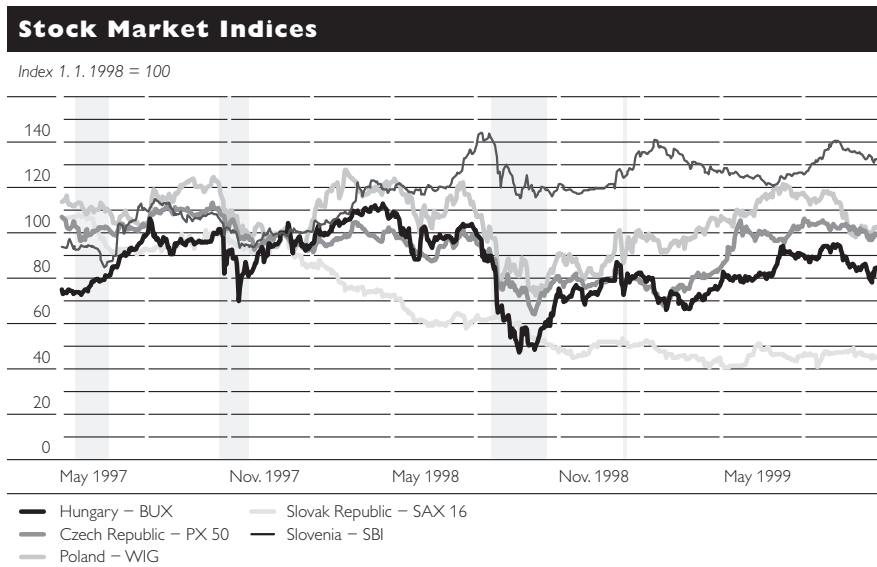
Chart 2



Although the case of the Baltics is somewhat different, as these countries had significantly closer economic and financial ties to Russia than the Central European countries, the pattern is similar. All three countries weathered the storm reasonably well and retained their exchange rate regimes, Estonia and Lithuania their currency boards and Latvia its narrow-band fixed peg, although its financial sector had by far the highest exposure to Russia of all applicant countries.<sup>1)</sup>

<sup>1</sup> For a comprehensive account of economic developments in the Baltics, see OECD (1999c).

Chart 3



Thus, the *tentative conclusion* from the Central and Eastern European experience to date is that intermediate exchange rate regimes – at least up to the current stage of transition – can be reasonably robust, if backed up by sound and consistent macroeconomic and structural policies, especially financial sector reform (focused on ensuring that financial institutions have a strong capital base and are subject to functioning ownership control, and effective supervision). In other words, these cases show that the consistency of the overall policy mix matters more than the choice of the exchange rate regime. Several further factors also seem to matter:

- a high degree of commitment to the policy framework in place as well as the readiness to underscore this commitment by tackling existing weaknesses in a determined manner (in the case of Latvia, for example, this meant sorting out the effects of the Russian crisis on the financial sector) and by undertaking “recommitting” activities during crisis times (lowering the rate of crawl in Hungary in the immediate wake of the Russian crisis to signal that the exchange rate regime in place was there to stay, while simultaneously raising the ex post yield of domestic debt instruments expressed in foreign currency and dampening inflation expectations);<sup>1)</sup>
- the independence and reputation of the central bank, including the personal reputation of the central bank governor;
- the country size (small countries – like very large ones – are less likely to become the target of a speculative attack);

<sup>1</sup> Hungary announced in late August that it would reduce its automatic monthly crawl rate from 0.8% to 0.7% as of the beginning of the fourth quarter of 1998. In late October 1998 a further cut to 0.6% as of January 1999 was proclaimed. Poland took a similar step reducing its crawl rate from 0.65% to 0.5% as of September 10, 1998. (More recently, both countries cut crawl rates further: On March 24, 1999, the Polish rate was reduced to 0.3% and on April 20, 1999, Hungary announced further reductions to 0.5% as of July 1, 1999, and to 0.4% as of October 1, 1999.)

- restrictions on short-term capital movements in the cases of Slovenia and Hungary (Begg and Wyplosz, 1999, examine differentials between onshore and offshore forint interest rates to show that Hungarian controls were effective in reducing short-term capital outflows at the peak of the crisis in September 1998; remarkably, the figures presented by Begg and Wyplosz, 1999, do not display any sizeable differentials between onshore and offshore rates in the period up to August 1998, which appears to be at odds with claims that controls reduced inflows of short-term capital during the precrisis period as well);
- an approach which emulates currency board features with the objective of underscoring exchange rate commitment (this was apparently the case in Latvia, where the central bank has stuck to a 100% backing of the monetary base by official foreign exchange reserves, except for a few and very brief periods, and it has tended to accept relatively large interest rate swings).<sup>1)</sup>

### **3.2 Advantages and Drawbacks of Different Regimes in Crisis Times: The Interest Rate Issue**

A second question about the effects of the recent emerging market turbulences on CEE exchange rate regimes is the question of what relative advantages and drawbacks different exchange rate regimes have in times of international financial market crisis. One of the issues which has been debated in this context is that, in the aftermath of the Russian crisis, interest rates increased significantly in Hungary and remained at relatively high levels in the months after the crisis, while there was only an insignificant and very transient blip of interest rate in the Czech Republic or in Poland. Moreover, stock prices fell more sharply in Hungary than in the two other countries.

Begg and Wyplosz (1999) link this rise in the cost of borrowing directly to the exchange rate regime and state that countries which operate narrow band regimes have to let interest rates rise more sharply in crisis times than countries with a more flexible regime, in order to defend the narrow band; markets are aware of this and price this risk into equities and bonds even beyond immediate crisis times.

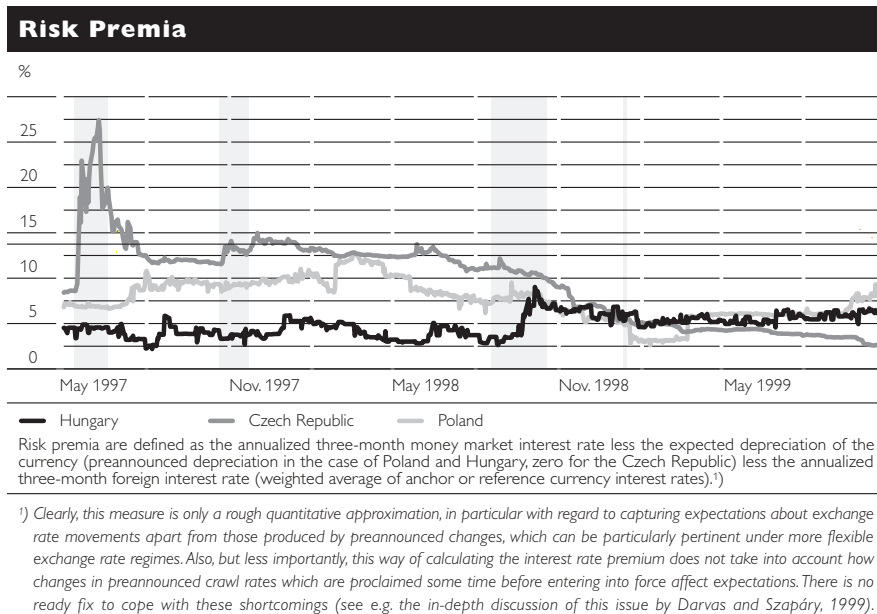
The counterargument, put forward by Darvas and Szapáry (1999), is that the Hungarian interest rate rise was not related to the exchange rate regime per se but primarily due to the rise in the risk premium in Hungary to the level of that of the two other countries, as international capital markets shifted from an assessment in which country-specific factors played a major role to an assessment in which the regional aspect dominated, in the aftermath of the Russian crisis. In this interpretation, the sharp drop in the prices of shares during the fall of 1998 reflected, to a degree, a correction of the stock market rally in the period before the Russian crisis “which contained an element of overreaction.”

Risk premia developments in Hungary, Poland and the Czech Republic are depicted in chart 4, which shows a tangible degree of volatility of risk premia for these three countries over the recent past. Whether the under-

<sup>1</sup> See OECD (1999b).



Chart 4



lying shifts in market sentiment are related to the design of exchange rate regimes at all, and if so to what extent, is difficult to gauge. In the assessment, the importance of macroeconomic developments – or more precisely, the perception of these developments by the markets – should not be underrated. In the Hungarian case, one may argue with good reason that some portion of the risk premium rise in autumn 1998 was due to an increasing current account deficit at the time (as compared to the very favorable data for 1997) unrelated to the Russian crisis, while there was apparently some uncertainty about the authorities' resolve to use fiscal adjustment measures to cope with potential future external imbalances. In a similar vein, the fact that the risk premium has remained around 5% during most of 1999 may also reflect developments in the fiscal and the external accounts<sup>1)</sup> rather than constituting a prolonged upward effect due to the features of Hungary's exchange rate regime. Also, it is interesting to see that Hungary's risk premium has developed more favorably than Poland's since the spring of 1999 and especially in the most recent months, while both countries exhibit similar risk characteristics. Thus, apart from outright crisis periods where evidence is not clearcut, the surveyed cases do not lend support to the view that the performance of an intermediate exchange rate regime, in terms of the cost of borrowing over a longer time horizon, is worse than that of alternative arrangements.

### 3.3 Impact of a Crisis Environment on Planned Regime Changes

A third question is whether the external crisis environment actually made planned exchange rate regime alterations more difficult to implement. Here, the cases of *Romania* and *Lithuania* are noteworthy. International turbulences contributed to locking these two countries into their regimes, although they

<sup>1</sup> The OECD (1999b) appears to share this perception.

had intended to alter them: Lithuania had planned to exit its currency board to a “standard” fixed peg, while Romania had intended to move from its managed float to a crawling peg. But, in both cases, the external environment was not the only impeding factor. The case of Lithuania shows that exiting a currency board is intrinsically difficult, in particular if it cannot be undertaken from a position of definite strength. In Romania, the country’s fragile macro-economic situation and its structural weaknesses have played a major role in delaying an exchange rate regime change.

#### **4 Broadening the View: Current and Future Challenges**

The choice of the exchange rate regime is a dynamic issue. This is particularly true of Central and Eastern European countries headed for EU and EMU integration. Obviously, the final exchange rate regime and monetary policy destination for this group of countries is joining a common currency area, i.e. participation in the euro area. The challenge is to formulate strategies for the intermediate period towards eventual full monetary integration which are both economically sound and institutionally fitting with respect to the integration framework of the European Union in general and Economic and Monetary Union in particular.

##### **4.1 Institutional Issues**

According to the EU framework, the process of *monetary integration* of applicant countries will take place in three stages. Applicants will first join the European Union, then participate in the exchange rate mechanism (ERM II)<sup>1</sup>) and finally adopt the euro. The framework, which is based on the equal treatment principle between incumbent and future members of the euro area, does not envisage the possibility of “short cuts”; the three steps have to be taken one by one. In particular, the euro cannot be introduced without a prior fulfillment of the convergence criteria. Furthermore, the accomplishment of the criteria can only be examined for EU Member States and the fulfillment of the exchange rate criterion, as it stands, requires a two-year period of formal membership in the ERM II which can only commence after EU accession. Moreover and most fundamentally, it is obvious from the sequencing this overall integration framework entails that meeting the conditions for EU membership (i.e. the Copenhagen criteria) is the basis and the precondition for further integration in the monetary field.

The constraints on exchange rate policies become tighter as integration into EU and EMU structures proceeds. There are no formal constraints on

*1 The ERM II governs exchange rate relations between the euro area and those EU Member States which have not yet introduced the single currency. It is based on fixed but adjustable central parity rates of the participating currencies vis-à-vis the euro. In order to avoid significant misalignments, realignments shall be conducted in a timely fashion. There will be a standard fluctuation band of  $\pm 15\%$  around the central rates of participating currencies, but formally agreed (as well as informally accorded) narrower bands will also be possible. Intervention at the formal margins will in principle be automatic and unlimited, with very short-term financing available. However, the ECB as well as the participating NCBs can suspend intervention if it were to conflict with their prime objective of price stability. The flexible use of interest rates by central banks of non-euro countries will be an important feature of the mechanism, and there will be the possibility of coordinated intramarginal intervention.*

exchange rate regimes before EU accession, but exchange rate policy should be conducive to an orderly integration into EU and EMU and be embedded, in a consistent manner, into a stability-oriented overall policy framework. Upon EU accession, applicant countries will have to treat their exchange rate policies as a matter of common concern. Inter alia, this includes that they will be expected to join ERM II, though not necessarily in the immediate postaccession phase. Depending on country-specific circumstances, in particular progress with convergence, entering ERM II could also take place later. Participation in ERM II is based on a fixed (but adjustable) peg to the euro; crawling pegs and exchange rate links to other anchor currencies than the euro will have to be phased out in time. Equally, floating regimes will have to be exited.

Currency board arrangements do not appear to fit into the ERM II framework in its current form.<sup>1)</sup> Similarly, retaining standard pegs with narrow or zero bands when entering ERM II will only be possible under mutual consent. How to handle these issues is still an open question which probably will have to be tackled if and when EU accession of CEE countries with such arrangements comes closer. It should be dealt with in time to avoid uncertainties about the range of possible monetary integration paths and about the credibility of such exchange rate arrangements. Economic considerations will be important when taking decisions on ERM II compatibility and participation, especially in currency board cases where the intricacies of exiting the exchange rate arrangement smoothly, the implications of potential exiting problems for other CEE countries with currency board arrangements and the suitability of introducing monetary policy temporarily in a context where it is not needed, will have to be weighed appropriately.

Conversely, strengthening constraints on exchange rate policies will tend to make it harder, as integration goes on, to stick to pure versions of alternative monetary policy strategies (monetary targeting or direct inflation targeting); conflicts of targets could emerge and would probably have to be resolved in favor of exchange rate stability, at least during the more distant period in which qualification for the euro zone will become the main objective.<sup>2)</sup>

#### 4.2 Economic Issues

There are *three main economic questions* about exchange rate regimes and policies in the runup to EU and EMU integration. First, what is the appropriate degree of exchange rate flexibility during the transition period towards full monetary unification and how does it change over time? Second, what is the appropriate choice of anchor currency? Third, how much time should the transition towards full monetary integration take; in other words, what is the optimal timing for entirely giving up monetary independence?

1 Countries with currency boards cannot make use of the flexibility of the ERM II for nominal exchange rate movements (bands and realignments), of interest rate flexibility by central banks or of the full application of intervention rules.

2 However, it should be mentioned that Finland and Spain were able to adhere to a direct inflation targeting strategy while at the same time fulfilling the EMU exchange rate criterion, as the targets did not collide.

During the early phase of transition, bringing down inflation from high levels and establishing a basic degree of credibility was a top priority for economic policymaking. In this phase, the exchange rate was a “natural” nominal anchor for a substantial number of transition economies. However, there is no clear evidence that exchange rate stabilization was associated with better growth and inflation performance than money-based stabilization. There are cases of successful disinflation with exchange-rate and with money-based strategies both. Slovenia (managed float since 1991) and Latvia (float from 1992 to 1994) are the two prime examples.<sup>1)</sup>

After initial stabilization had been achieved, the case for retaining the exchange rate as a nominal anchor became less compelling, mainly for three sets of reasons which have been pointed out recurrently in the debate on CEE exchange rate policies over the recent years: exposure to country-specific shocks, further increasing capital mobility and trend real appreciation (as well as other arguments related to the ongoing adjustment of relative prices).<sup>2)</sup>

*Exposure to country-specific real shocks* tends to be costly, if the given economy does not dispose of a sufficient degree of fiscal and price/wage adjustment capability. It is intrinsically difficult to assess the exposure of CEE countries that are undergoing comprehensive structural change in an exhaustive and forward-looking manner.<sup>3)</sup> In any case, the picture in the ten applicant countries is quite diverse. Nevertheless, even in the most advanced transition economies, convergence in production structures and foreign trade patterns with the euro area will take time. The flexibility of most CEE economies, in turn, appears to be bounded (though it is higher than in Western Europe), with the Baltic States constituting positive outliers so far. This would seem to call for prudence in exchange rate policies, keeping away from premature moves towards rigid exchange rate commitments, while putting a particular stress on preserving or even enhancing economic flexibility where tight exchange rate regimes are in place (and, if it became clear that this could not be appropriately achieved, exiting such arrangements in a timely manner).

A second line of argument relates to the potential vulnerability of intermediate exchange rate regimes to *speculative attacks*. As shown in sections 2 and 3, Central and Eastern European EU applicant countries have so far been able to contain such vulnerability where ever the commitment to the monetary and exchange rate framework in place was strong and other policies were supportive. However, capital mobility will increase further in the runup to EU accession, as the remaining capital controls are removed (which is a precondition for joining the European Union), market confidence grows and financial sector development progresses. Will intermediate regimes remain viable options under such circumstances? Generally, coping with capital mobility calls for a multipronged policy response, which may but does

1 For a brief record of the main contributions to the debate on this issue, see Cotarelli and Doyle (1999).

2 See e.g. Wagner (1998), Masson (1999), Beaumont (1999).

3 For some further exploration of this issue, see Backé and Radzyner (1998). Empirical studies on the subject have been done by De Grauwe and Aksoy (1999) and by Gros and Vandille (1999).

not necessarily have to involve changes in exchange rate regimes. Clearly, one of its possible features could be to throw risk into the wheels of speculation by moving towards a flexible or largely flexible exchange rate regime. It has been increasingly advocated to make use of this option and adopt wide-band pegs or loosely managed floating regimes.<sup>1)</sup> However, in contrast, the introduction of currency board arrangements for Central European countries like Hungary, Poland and the Czech Republic has been proposed on the very same grounds.<sup>2)</sup> Conversely, it may well be possible to stick to limited or even zero exchange rate flexibility under a standard-type exchange rate regime, if the overall policy framework in place is successively strengthened further, in particular the fiscal position, the resilience of the financial sector and its supervision. Under such a strategy, the exchange rate regime could actually be designed in a number of ways. One approach could be to emulate unilaterally the post-1993 ERM approach, i.e. combining hard outer fluctuation bands with soft inner bands. This would mean a commitment to keep the exchange rate within narrow margins over a longer time horizon while tolerating wider fluctuations in the short term. Thereby “one-way bet” situations could be largely prevented and a fairly high degree of exchange rate stability within wide outer bands could be achieved, as the ERM I experience after 1993 showed. Other conceivable approaches are unilateral fixed pegs without formal bands (Austria before EU accession had such a system) or with narrow bands.

Fast-growing (catching-up) economies typically experience a *trend real exchange rate appreciation*, due to higher productivity advances in the traded than in nontraded goods sectors (Balassa-Samuelson effect). Here the argument is that, under such circumstances, price stability can hardly be achieved unless there is some room for nominal appreciation, as this real appreciation can manifest itself either through nominal appreciation or through higher inflation. In order to discuss this issue further, it is important to gauge the magnitude of the effect – which depends on the share of the nontraded goods sector and the productivity differential in the traded goods sector at home and abroad. As a rule of thumb, for dynamic small, open economies which are in the early stages of the catching-up process, its magnitude typically tends to be somewhere on the order of 2 to 3 percentage points of real appreciation per annum. This effect will persist also in the longer run, as differences in price levels between EU applicant countries and the European Union are still significant, but it will probably ease off somewhat, as the dynamics of productivity advances in CEE will tend to decelerate relative to other countries during the later catching-up stages. Given the extent of the prospective trend real appreciation, either approach – low inflation cum trend nominal appreciation or somewhat higher inflation cum nominal exchange rate stability – appears economically feasible. Modest positive inflation differentials of CEE countries with the euro area under a fixed rate regime should not be seen as a problem, if they result from real convergence. However, a tightly fixed exchange rate regime (be it a currency board or a

1 See e.g. Begg and Wyplosz (1999), Masson (1999).

2 See Dornbusch and Gavazzi (1999).

standard rigid fixed peg) may become problematic in a more distant perspective, when a country seeks to meet the inflation and the exchange rate convergence criteria simultaneously. Like the ERM II compatibility issue, this is a potential problem which will require a careful weighing of economic and institutional aspects.<sup>1)</sup>

When determining the *proper degree of exchange rate flexibility* over time, the arguments in favor of more flexible regimes will have to be pondered against the benefits which are associated with limiting exchange rate variability, in particular that more fixed regimes foster trade and investment but also that an exchange rate anchor may play a disciplining role for monetary and fiscal policies as well as for wage formation. Moreover, dropping an exchange-rate based framework and opting for a domestic monetary policy anchor may raise a number of implementational problems.<sup>2)</sup> Under direct inflation targeting, as adopted by the Czech Republic and Poland, a central bank must be in the position to forecast inflation and to assess the relationship between monetary policy instruments and the inflation target. Besides, in a context of swift structural change and productivity increases, it is difficult to identify the proper disinflation path and the appropriate medium-term inflation target – a choice which is further complicated by measurement problems.<sup>3)</sup> Moreover, the selection of the target is made more difficult through the incomplete process of price liberalization and adjustment. Apart from the challenges that are involved in making a monetary framework function in a transition context which does not rely on an exchange rate anchor, it should also be noted that there are diverging views on whether such a strategy will make disinflation to low levels more easily achievable than an exchange rate-based arrangement.<sup>4)</sup>

To sum it up, there is no single path for exchange rate regimes during EU and EMU integration. While a certain degree of exchange rate flexibility appears reasonable for most applicant countries during the remaining years of the preaccession period, alternative strategies relying on a fixed or quasi-fixed exchange rate appear to be feasible, too, provided that the demanding preconditions for their viability are met. Tight exchange rate regimes, notably currency boards, will raise some questions about ERM II participation and the concurrent fulfillment of the inflation and exchange rate criteria which will have to be addressed at the appropriate time.

The question of the *appropriate anchor currency* for CEE can be answered much more briefly than the convoluted issue of the proper degree of exchange rate flexibility. The “natural” anchor currency for the EU applicant countries from Central and Eastern Europe is the euro, because it underlies a

1 Further arguments for some exchange rate flexibility relate to the fact that the disinflation from moderate to low levels may take time (e.g. due to inertial factors or due to a phased process of price liberalization or the adjustment of regulated prices to full cost-recovery levels). This may require some (downward) flexibility of the nominal exchange rate during the process in order to maintain a reasonable degree of price competitiveness.

2 For the problems related to direct inflation targeting in transition economies, see e.g. Krzak and Ettl (1999).

3 The CPI in transition economies typically exhibits a tangible upward measurement bias (see Skreb, 1998, and Beaumont, 1999). On the debate of the optimal pace of disinflation, see several contributions to Cottarelli and Szapáry (1998).

4 See Surányi and Vincze (1998) and Beaumont (1999) for diverging views on this issue.

large and rising proportion of trade and capital flows. The share of the euro in foreign trade invoicing, for example, ranges from 45% to 65% of CEE exports and is only slightly lower on the import side. Moreover, the appeal of the euro is rising, as the financial market of the single currency area is becoming increasingly deep and liquid. Still, a degree of caution may be warranted: The external balances of some applicant countries appear to be quite sensitive to real effective exchange rate fluctuations.<sup>1)</sup> In these cases it may make sense to advance to a clean euro link or orientation in a more gradual manner.

#### 4.3 The EU Candidate Countries' Monetary and Exchange Rate Integration Strategies

Against this backdrop of institutional and economic arguments, what are the monetary and exchange rate integration strategies of Central and Eastern European EU applicant countries?

*Estonia* and *Bulgaria* intend to retain their currency board arrangements until full monetary unification, while *Lithuania* plans to move to a more standard-type fixed peg over the next few years (while retaining some currency board principles, especially the full backing of base money by official foreign exchange reserves), coupled with a repegging of its currency from the U.S. dollar to the euro in the second half of 2001.

Is Estonia's and Bulgaria's strategy the best economic choice? This depends on whether the two economies continue to demonstrate sufficient strength and flexibility to prosper under the constraints of their currency board arrangements over an extended period of time and in fact whether they prove their readiness and capability to smoothly sustain a nominally fixed exchange rate and to adjust without having a monetary policy of their own. If this is the case for either of them, the institutional feasibility issue will have to be resolved, as outlined above.

*Hungary* will replace its EUR/USD basket by a clean euro peg as of January 2000 and plans to further reduce the rate of the crawl in a gradual manner and exit into a fixed peg, within a wide fluctuation band of  $\pm 15\%$ , as soon as inflation differentials between Hungary and the euro area are fully offset by differences in productivity growth. Whether the widening of the band will be phased in before the crawling peg is abandoned is still an open issue.

In the case of Hungary, the question about the timing of the band widening has dominated the debate about exchange rate policy choices and options. However, equally if not more important is the question what monetary framework will be put in place after the widening of the band: Will it essentially be an exchange rate-based framework of the hard outer band/soft narrow band-type (like the ERM I between 1993 and 1998), or will a wide band be complemented with alternative anchors for inflation expectations, e.g. through a more prominent and direct role for the authorities' inflation target? Either approach would appear to be feasible with respect to EU accession and subsequent ERM II participation.

1 See Feldman et al. (1998).

*Poland* intends to float the zloty sometime in the year 2000 to determine its “equilibrium level” by market forces before fixing it, at a subsequent stage, to the euro within a band of  $\pm 15\%$ .

Here, the question is how the intermediate floating phase will affect exchange rate developments. Given that inflation developments in Poland show some sensitivity to exchange rate movements, the intended continuation of gradual disinflation under a direct inflation targeting strategy and a floating exchange rate will presumably not entail overly wide exchange rate swings.

*Latvia* is retaining the SDR as the anchor basket currency for the near future (as currency shares in trade invoicing are seen to broadly correspond to the weights the individual currencies have in the SDR basket) and will probably not switch to the euro until it joins the EU. The narrow band is to be maintained until eventual integration into the euro zone.

In this case, two questions will arise, namely whether the timing of the intended repegging to the euro is indeed appropriate or whether it should be undertaken earlier in the process and, after EU accession, whether the narrow bands can and should be preserved when entering ERM II.

The monetary integration strategies of *applicants which operate floating exchange rate regimes* are less explicit. However, several of them have indicated their willingness to undertake certain exchange rate commitments when entering the European Union or perhaps already in the immediate preaccession period. Again, as long as the overall policy framework is stability oriented and, upon EU accession, exchange rate policy is treated as a matter of common concern, floating regimes can be retained until participation in ERM II commences.<sup>1)</sup>

#### **4.4 Beyond EU Accession: The Overall Length of the Monetary Integration Process**

The EMU strategies of most candidate countries also deal with the issue of the overall duration of the monetary integration process, which leads back to the third question raised above on the *optimal timing for giving up monetary independence* fully and irrevocably.

Most peg countries, but also some of the current floaters, have indicated that they want to keep the intermediate phases between EU accession, ERM II membership, and the adoption of the euro as short as possible and to move to full monetary integration within two or three years of having joined the European Union. Undoubtedly, this is a very ambitious objective, in particular if EU enlargement proceeds smoothly and accession of the first applicants indeed takes place in four to five years. Such a strategy would imply tight constraints on fiscal, monetary and exchange rate policies in the immediate post-EU accession period – in a phase in which the newly acceding countries will have to adjust fully to the rigors of the European Union’s internal market and, more broadly, in a stage at which structural convergence will probably still be under way. Under such circumstances, retaining some

<sup>1</sup> There have been three cases in which incumbent Member States – Spain, Italy and Finland – moved from floating regimes directly to the exchange rate mechanism.



leeway in monetary and exchange rate but perhaps also in fiscal policies may, in most cases, be useful to facilitate adjustment during the early years of EU membership. Forgoing this latitude would presumably require a very determined frontloading of wide-ranging structural and institutional transformation; moreover, the required macroeconomic stiffness in the early years of EU membership will have to act as a catalyst, spurring further transformation and real convergence rather than slowing it.<sup>1)</sup> Only under such framework conditions will it be possible to contain the risks of a fast monetary integration strategy, to fulfill the Maastricht criteria in a lasting manner and to reap the economic and financial gains that will accrue once these countries participate fully in EMU. In those cases in which the lead time for achieving a high degree of structural and nominal convergence turns out to be longer, monetary integration will necessarily be a more gradual and drawn-out process.

### Conclusions

Recent changes in exchange rate regimes in Central and Eastern European EU applicant countries do not display a uniform trend. Over time, the cases of typical intermediate exchange rate regimes have become smaller in number. Failures of standard-type exchange rate pegs in the Czech Republic and Slovakia can essentially be explained by shifts in domestic economic fundamentals. Where policies were broadly sound and consistent, intermediate exchange rate regimes performed reasonably well and weathered the storm of financial contagion after the Russian crisis. The Central and Eastern European experience does not support claims that intermediate exchange rate regimes are associated with higher borrowing costs over a longer time horizon than other arrangements; for immediate crisis periods the evidence is less clearcut.

The final destination for EU applicant countries, in terms of the exchange rate regime, is participation in the euro area. The challenge is to formulate and implement strategies for the intermediate period towards eventual full monetary integration which are both economically sound and institutionally fitting to the integration framework of the European Union in general and Economic and Monetary Union in particular. There is no standard single path of exchange rate regimes which would lead from the variety of today's regimes to EU accession, participation in ERM II and finally adoption of the euro. While a certain degree of exchange rate flexibility seems reasonable for most applicant countries during the remaining years of the preaccession period and beyond, alternative strategies relying on a fixed or quasi-fixed exchange rate also appear to be feasible, provided that the demanding preconditions for their viability are lastingly met. Monetary integration will presumably be a long-term process for most, if not all, EU candidate countries from Central and Eastern Europe; it can be completed successfully only after achieving comprehensive and in-depth structural convergence.

1 In Dabrowski's (1999) view, political economy considerations should be duly considered when the appropriate target date for joining the euro area is defined. In his view, setting a bold target date for full EMU participation will mobilize reforms, which will thus speed up the needed adjustment of the real sphere.

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S P E C I A L      R E P O R T S

# *Ukraine: Macroeconomic Development and Economic Policy in the First Eight Years of Independence*

Stephan Barisitz

## **I Introduction: Economic and Political Framework**

In terms of size Ukraine, with an area of 603,700 km<sup>2</sup>, ranks second among European countries, ahead of France, and is surpassed only by Russia. The country is rich in natural resources, and the standards of general education are high. With a population of approximately 49.8 million (as of October 1, 1999) Ukraine takes the fifth place in Europe behind Russia, Germany, the United Kingdom, France and Italy.<sup>1)</sup> Ukraine's black soil in the extremely fertile "Chernozyom" belt makes agricultural land the country's most important natural asset. Up to two thirds of the former Soviet Union's hard coal are to be found in Ukraine, though the most easily accessible resources have already been exhausted. In addition, large deposits of iron ore, manganese, uranium and other minerals contribute to the wealth of natural resources. Metallurgical and chemical products, food, minerals and machines feature among Ukraine's most important exported goods. The country's main imports consist of electricity and fuels (especially natural gas), machines and chemicals. Some three quarters of the population are of ethnic Ukrainian descent, one fifth are Russians. Russians mainly live in the heavily industrialized eastern regions of the country (the Donets basin or Donbass) and the Crimean peninsula, where they make up more than 60% of the population.

Since the collapse of the Soviet Union, the political framework has been marred by discord and power struggles between the president and government (the executive branch) on the one hand and parliament (the legislative branch) on the other. Despite a number of mediation attempts and agreements, reconciliation has not really been achieved, and as a result economic and structural reforms have been delayed or impaired. Three other issues may be viewed as important: The dichotomy between the eastern and the western parts of Ukraine, relations with Russia and cooperation with the IMF and other international financial institutions.

Ukraine's western regions (mainly around Lviv) were not part of the Soviet Union up until the end of World War II; there is a strong sense of national identity to be found here and a general openness for economic reform. The country's eastern and southern regions (e.g. Donbass and the Crimea), in which the Russian population, as mentioned above, is substantial, show a stronger slant towards communist ideas and close ties with Ukraine's big northern and eastern neighbor. The government in Kiev is hard put to reconcile these two differing orientations. Russia stands as the "big brother" among the Eastern Slavic nations in the CIS, as the ethnic origin of Ukraine's most influential minority, and as its main trading partner. Primarily, Ukraine depends on natural gas and oil deliveries from Russia, and also on income from transit fees for Russia's gas and oil exports to central and western Europe. Not least because its economy is so vulnerable and because there is an immense backlog of reforms, Ukraine needs to turn to the IMF and the World Bank for financial support and is thus forced to grant Western countries and organizations (in particular, the U.S.A. and the EU) a certain degree of influence in its economic policy.

*1* In 1989, the Soviet Socialist Republic of Ukraine was home to no less than 51.7 million inhabitants.

The old Ukrainian constitution, which dated back to the Soviet era, afforded greater power to parliament (the Supreme Soviet, Verkhovna Rada) than to the government and thus granted it a dominant position in the political arena. Parliament, among other things, had the power to veto any government decision and any appointment of a new member of the cabinet. As the parliamentary elections repeatedly produced majorities for the communist or leftist parties, the government's attempts to introduce reform policies to build a market economy were often quenched by the Verkhovna Rada in the early years of independence. After a provisional "Constitution Treaty" had been signed in mid-1995, the national constitution of Ukraine was adopted in June 1996. Among other improvements, it strikes a better balance between the legislative and the executive branches and lays down the right to private property, including land ownership. Despite the clearer emphasis on the president's leadership, the antagonism between the two branches persisted. In 1997, for example, views on that year's budget lay so far apart that Parliament failed to pass the Budget Act until the end of the second quarter.

Even though Ukraine is a founding member of the Commonwealth of Independent States (CIS), it has consistently opposed any substantive steps toward closer integration of the Commonwealth on an economic or political level, as the government fears that such a move could corroborate Russia's hegemony. Correspondingly, Ukraine is not a member of Russia's customs union with Belarus, Kazakhstan, the Kyrgyz Republic and Tajikistan. After slow and hard negotiations, the presidents of Ukraine and the Russian Federation finally signed the Treaty for Friendship, Cooperation, and Partnership between Russia and Ukraine in May 1997. This became possible after agreements had been signed on dividing up the former Soviet Union's Black Sea fleet and on Russia's access to the naval port of Sevastopol on the Crimean peninsula. According to the agreement, Russia is entitled to lease 80% of the port facilities, initially for a period of 20 years. The annual lease of USD 100 million is to cover part of Ukraine's liabilities to Russia for natural gas shipments.

Since the launch of a stabilization and structural reform package in the fall of 1994, Ukraine has received financial support from the International Monetary Fund and the World Bank. The credit facilities were repeatedly suspended because Ukraine did not comply with agreed program goals or failed to fully implement reforms. At the time of writing (December 31, 1999) a three-year Extended Fund Facility (EFF) granted in September 1998 was in place; however, disbursements have been withheld. Overall, Ukraine is striving to reinforce ties with Western Europe and the U.S.A. A Partnership and Cooperation Agreement between the EU and Ukraine was signed in June 1995;<sup>1</sup>) as of July 1997, a Charter of Special Partnership between the North Atlantic Treaty Organization and Ukraine governs cooperation with NATO on military and political levels. In December 1999 the European Council adopted a Common EU Strategy on Ukraine at the

*1 In this treaty, the EU grants Ukraine most-favored-nation status and loosens some quantitative restrictions on imports of sensitive products (coal, steel, textiles).*

### Main Economic Indicators – Ukraine

|                    | Real GDP           | Unemployment rate <sup>1)</sup> | Industrial output  | CPI <sup>2)</sup> | Current account | Trade balance | Total reserves minus gold  | Budget deficit <sup>3)</sup> | Gross debt in convertible currencies | Interest rate <sup>4)</sup> |
|--------------------|--------------------|---------------------------------|--------------------|-------------------|-----------------|---------------|----------------------------|------------------------------|--------------------------------------|-----------------------------|
|                    | Annual change in % | %                               | Annual change in % | %                 | USD million     | USD million   | USD million, end of period | %                            | USD million, end of period           | %                           |
| 1989               | x                  | x                               | 2.8                | x                 | x               | x             | x                          | x                            | x                                    | x                           |
| 1990               | - 4.0              | x                               | - 0.1              | x                 | x               | x             | x                          | x                            | x                                    | x                           |
| 1991               | - 8.7              | 0.0                             | - 4.8              | 161.0             | x               | x             | x                          | x                            | x                                    | x                           |
| 1992               | - 9.9              | 0.3                             | - 6.4              | 2,000.0           | - 621           | - 622         | 469                        | 12.5                         | 3,513                                | 80.0                        |
| 1993               | -14.2              | 0.4                             | - 8.0              | 10,155.0          | - 854           | -2,519        | 162                        | 9.7                          | 4,214                                | 240.0                       |
| 1994               | -22.9              | 0.4                             | -27.3              | 401.0             | -1,396          | -2,360        | 651                        | 8.5                          | 7,167                                | 252.0                       |
| 1995               | -12.2              | 0.6                             | -12.0              | 182.0             | -1,515          | -2,298        | 1,051                      | 4.9                          | 8,142                                | 110.0                       |
| 1996               | -10.0              | 1.6                             | - 5.1              | 39.7              | -1,184          | -4,296        | 1,994                      | 3.2                          | 9,170                                | 40.0                        |
| 1997               | - 3.0              | 2.9                             | - 1.8              | 10.1              | -1,335          | -4,205        | 2,375                      | 5.6                          | 11,807                               | 35.0                        |
| 1998               | - 1.7              | 4.6                             | - 1.5              | 20.0              | -1,295          | -2,584        | 782                        | 2.7                          | 11,700                               | 60.0                        |
| 1999 <sup>5)</sup> | - 0.5              | 5.2                             | 4.0                | 15.0              | ..              | ..            | 1,100                      | 1.8                          | 12,500                               | 45.0                        |

Source: IMF, WIIW.

<sup>1)</sup> Share of registered unemployed in total labor force.

<sup>2)</sup> Annual inflation (December to December) in %.

<sup>3)</sup> Percent of GDP; general government; on a cash basis.

<sup>4)</sup> Refinancing rate (annual basis) of the National Bank of Ukraine, end of period.

<sup>5)</sup> Forecast.

summit in Helsinki. One of the strategy's nonbinding goals is to create a free trade zone with Ukraine; as one of the preconditions the country has been called upon to intensify its efforts to join the WTO.

## 2 Macroeconomic and Economic Policy Developments

When the Soviet Union collapsed in 1991 and Ukraine gained its independence, the country commenced its efforts to establish a market economy. Transition has proven to be an arduous task – on a cumulative basis, output is estimated to have shrunk by more than 50% of GDP since 1992. So far, Ukraine is the only country in transition that has not achieved above-zero economic growth in a single year since reforms began. Although notable progress has been made in some areas, structural reform, above all, has been hampered by the longstanding rivalry between the executive and legislative branches and the potent position of special interest groups. As structural reform lags behind and the Ukrainian economy's competitiveness remains low, the macroeconomic progress that has been achieved is by no means fully secured. While inflation has been brought under control in recent years and a certain degree of monetary stability has been attained, Ukraine has run up twin deficits (shortfalls in the budget and the current account), which have quickly pushed up indebtedness and have made the economy vulnerable to external shocks.

Ukraine's economic development since independence (1991/92) can be roughly divided into three phases: An era of little impetus in reforms between 1992 and 1994, the period of stop-and-go policies from October 1994 to 1998 and, finally, the time after the Russian crisis in August 1998.

### 2.1 Unambitious Reform between 1992 and 1994

As the Soviet Union had disintegrated and centralized planning was abandoned, many government-led production and trade linkages with other former Soviet Republics collapsed. The breakup of the single economic area and



the ruble zone along with the deterioration of Ukraine's terms of trade (in particular the rise in the cost of fuel and electricity imports from Russia) accelerated the economy's nosedive. Furthermore, the Ukrainian authorities limited themselves to reacting to developments on an ad hoc basis and took a rather passive economic policy stance in the first years of independence. For some areas of public administration, government institutions needed to be newly established for Ukraine. Initially, Russian (Soviet) rubles, to which the Central Bank of Russia (the former Soviet Gosbank) held the sole right of issue, became scarcer and scarcer in Ukraine. In response to this, a parallel currency was introduced at the beginning of 1992 – a coupon currency consisting of reusable coupons was brought into circulation. Real GDP measured against the previous year dropped by 17% in 1992, by 14% in 1993 and by 23% in 1994. These figures are to be taken with a grain of salt, however, as the decline of the officially recorded economy since the early 1990s is mirrored by the expansion of the informal sector.

In reaction to the liberalization of prices in Russia in January 1992, the government imposed enhanced price controls and protectionist measures to prevent a spillover of the effects on Ukraine. A few months later, however, the authorities had no choice but to deregulate a large proportion of prices. On top of pent-up inflation dating back to the Soviet era, the loose monetary policy, which grew even more accommodating in 1993, drove down the value of money. Annual inflation (December to December) reached some 2,000% in 1992 and peaked at 10,155% (approximately 47% per month) in 1993, before it came down to 401% in 1994. Sizeable budget shortfalls (general government: 9.7% of GDP in 1993, 8.5% in 1994) were primarily financed through the printing press in these years. In addition, the government issued directed credit programs for a number of sectors, notably the agricultural sector. As structural reform was haphazard at best, the rate of unemployment, measured as the ratio of registered unemployed against the total labor force, remained at a more or less constant 0.3% to 0.4%.<sup>1)</sup> Private households' real cash income dropped by approximately 60% over this period. In November 1992, Ukraine left the ruble zone, which meant that the Russian (Soviet) ruble was no longer valid as a legal tender. In the following months, the karbovanets was introduced as a transitional official currency in addition to the existing provisional coupon currency. A permanent national currency was to be introduced once the economy had been stabilized.

Ukraine's trade deficit, which has persisted ever since the country became independent, ballooned from USD 620 million in 1992 to more than two billion dollars annually since 1993. At the same time, the country profited from rising transit fees on Russian oil and natural gas, which pass through Ukrainian territory in pipelines on their way to Central and Western Europe. As a result, the current account balance was not affected quite as badly, with the deficit growing from USD 620 million in 1992 to USD 1.4 billion in 1994. As foreign direct investment was insignificant and the

1 *Ukrainian-European Policy and Legal Advice Center: Ukrainian Economic Trends, Quarterly Issue June 1999, p. 24.*

capital account in general held little promise of offsetting the deficit, the shortfall was mainly “financed” through the accumulation of arrears vis-à-vis Ukraine’s main suppliers of fuels, Russia and Turkmenistan. The government has also relied on exceptional financing from international financial institutions. Accordingly, total foreign debt expanded from USD 3.5 billion (11% of GDP) in 1992 to USD 7.2 billion (20% of GDP) in 1994.

## **2.2 Stop-and-Go Policies from Late 1994 to 1998**

In the light of these unfavorable developments and the persisting economic instability, in the fall of 1994 the government adopted a program aimed at macroeconomic stabilization and structural reform. The authorities’ initial measures included a further deregulation of prices, foreign exchange markets and foreign trade. Most of the remaining price controls, with the exception of those on some food items and community services, were summarily removed. Interest rates were raised and directed loans reined in to slow down inflation. Budget policies were tightened and subsidies were cut. Export quotas on most products were lifted. In spring 1995, the government further tightened fiscal and monetary policies. Structural reforms, above all mass privatization and trade liberalization, were introduced or pushed ahead. These measures were the first to be substantially supported by the IMF, the World Bank and Western nations.

The measures brought about some comparative improvement in the macroeconomic policy environment in 1995 and 1996, even if no end to the economy’s contraction was in sight and the government did not always adhere to its plans with enough perseverance. GDP dropped 12% in 1995 and a further 10% in 1996. Although both monetary and fiscal policies were temporarily relaxed and thus delayed the progress of stabilization, inflation (December to December) was brought down to 182% in 1995 and 39.7% in 1996. The general government deficit was cut to 3.2% of GDP. However, the restrictive fiscal policy course was implemented primarily through the sequestration of government expenditure, i.e. public wages, pensions and social transfers were no longer paid in full. If the deficit is calculated on the basis of commitments rather than cash paid, the shortfall amounts to approximately as much in 1996 as in 1995, i.e. 6.1% of GDP.<sup>1)</sup> The example set by the government of course had negative effects on the payment behavior of businesses and households.

The current account stabilized at a deficit of USD 1.2 billion to USD 1.5 billion. The improved policy environment triggered a slight rise of foreign direct investment, which climbed to more than half a billion dollars in 1996. Still, this amount appears modest, if one considers the size and the potential of Ukraine. The current account deficit was predominantly financed through IMF loans and exceptional financing. This support also permitted the central bank to bolster its foreign exchange reserves. In September 1996, Ukraine took advantage of the relatively favorable situation to successfully implement a currency reform: The provisional currency, the karbovanets, was exchanged at a ratio of 100,000 : 1 against the hryvnia (UAH). A

*1* IMF Staff Report (SM/97/208): Ukraine – Recent Economic Developments, August 11, 1997, p. 8.

fluctuation band of UAH 1.7 to 1.9 against the U.S. dollar was introduced to stabilize the new currency and to boost its acceptance.

Toward the end of 1996, the government repeatedly issued higher volumes of Treasury bills, which it had introduced in 1995, to cover parts of the budget deficit. Though it started at a low initial level, this form of financing expanded rapidly in 1997 in a fashion which resembled developments in Russia. With this policy the government reduced the monetization of the deficit and contributed to bringing down inflation, but it allowed domestic public debt to soar. In 1997 foreign investors also started buying into the Treasury bill market and made it possible for the government to finance a major share of the budget deficit by issuing new debt. While in 1996 0.9% of GDP, i.e. just under a third of the budget deficit, was financed by government debt securities, this ratio leaped to 3.4% of GDP or approximately two thirds of the shortfall in the first half of 1997. Foreign investors' and speculators' optimism was reflected by the rapid growth of short-term capital inflows up until the summer of 1997. Since then, Ukraine's economic policy has been influenced significantly by developments in international capital markets.

The abovementioned capital flows are highly volatile, and within weeks of the outset of the Asian crisis (the devaluation of the Thai baht in August 1997) Ukraine was hit by contagion. Weak fundamentals, such as the persistent budget and current account deficits, along with Ukrainian products' poor competitiveness can be cited as the likely roots of this emerging market's vulnerability. Whereas short-term net capital inflows of USD 750 million had been recorded in the first half of 1997, approximately half a billion dollars were withdrawn in the second half of the year, followed by a further USD 1.3 billion in the first six months of 1998, despite measures undertaken by the National Bank of Ukraine (NBU). These measures included a tightening of monetary and lending policies; the NBU raised interest rates and intervened in the foreign exchange market to slow down the national currency's nominal devaluation.<sup>1</sup>) The refinancing rate (calculated on a per month basis) was brought up from 1.3% in October 1997 to 3.5% in February 1998 and 6.3% in July 1998. The UAH fluctuation band, which had stood at 1.75 to 1.95 UAH/USD in November 1997, was raised and widened to 1.80 to 2.25 UAH/USD in January 1998. The monetary authorities' efforts were rewarded by a decline of the twelve-month inflation rate to 10.1% in December 1997 and 7.5% in July 1998.

The GDP shrinkage slowed down to -3.0% in 1997 and in the first half of 1998 GDP posted zero year-on-year growth. Industrial output even grew by 0.6% in the first six months of 1998. The agricultural sector reported a good harvest, and the construction sector came to life. Thus the official figures seemed to indicate that the economy had bottomed out and was ready to recover. The budgetary expenditure arrears accumulated in previous years were partly settled, so that the cash deficit came to 5.6% of GDP in 1997 and 4.9% in the first six months of 1998. This loosening of the fiscal regime can be seen in the context of the parliamentary elections in March 1998.

*1* However, this induced a trend toward real appreciation and thus jeopardized Ukraine's external trade prospects.

Up until the autumn of 1997, the budget gap was bridged primarily with issues of Treasury bills; thereafter, the capital flows reversed and due to the retreat of foreign investors, the authorities were forced to raise additional funds to service the T-bill market. Although the government was able to launch two high-yield eurobonds (equipped with 16% and 15% per annum interest rates) in the first quarter of 1998 worth DEM 750 million and ECU 500 million, it had to turn increasingly to the central bank to finance the budget deficit.

The balance of payments, which had seen little change from previous years in 1997, was marked in 1998 by the financial account's turn into the red as short-term capital outflows soared to USD 1.8 billion. These outflows could not be offset by the foreign direct investment boost to USD 750 million in 1998, bringing the aggregate total of FDI since the beginning of 1992 to approximately USD 2.8 billion. Over the years, Ukraine's external trade has diversified to a certain degree, but Russia has remained the main trading partner, above all the main source of energy imports. The central bank reports that the share of exports going to Russia declined from 38% in 1994 to 22% in the first three quarters of 1998. Concurrently, while 55% of Ukraine's imports came from Russia in 1994, this share amounted to 46% in the first three quarters of 1998. The recovery of FDI stood somewhat in contrast to growing complaints, particularly from foreign investors, about bureaucratic encumbrances and spreading corruption. Despite vows from the president and the government that they were striving to combat corruption, little appears to have changed over the past few years.

Ukraine's current account deficit amounted to 3.0% of GDP in 1998 (USD 1.3 billion); the shortfall in the balance of payments was covered mainly by cutting into currency reserves, which melted down from USD 2.38 billion at the end of 1997 to USD 780 million at the end of 1998, and with the help of exceptional financing. By the end of 1998, gross foreign debt had risen to USD 11.7 billion, some 27% of GDP. According to official data, total investment in the economy has sagged every year since the collapse of the USSR and in 1998 in real terms corresponded to just a third of the volume invested in 1992.<sup>1)</sup> This can certainly be explained in part by the reallocation of capital expenditure, e.g. from agriculture to transport and telecommunications, as well as a reinforced focus on heavy industries. Given the extent of the decline in investment, however, there can be little doubt that companies' capital stock is wearing down and becoming obsolete.

The estimated total of businesses' payment arrears swelled from approximately two thirds of GDP at the end of 1996 to 85% in mid-1998. This is well above the levels in established market economies, where payment arrears are linked to trade credit and usually do not exceed one third of GDP. Among other things, this high level of arrears vividly reflects the slow progress of structural reforms, manifested by the persistence of soft budget constraints, insufficient implementation of insolvency laws and the like. Since arrears are so widespread, even well-run companies can be drawn into

1 *IMF Staff Report (SM/96/3): Ukraine – Recent Economic Developments, January 8, 1996, p. 41 and IMF Staff Report (SM/99/77): Ukraine – Recent Economic Developments, March 16, 1999, p. 77.*

the spiral of illiquidity or insolvency. In turn, the rise in unemployment from 0.6% in 1995 to 4.6% at the end of 1998 apparently reflects some first steps of structural reform taken in state industry and privatized companies as well as the severe cumulative output shrinkage. Households' real cash income fell by approximately 7% to 8% between 1994 and 1998.<sup>1)</sup>

### **2.3 After the Russian Crisis in August 1998**

When the Russian crisis flared in 1998, Ukraine's economic policy environment suffered a severe blow to its stability, and hope for at least some growth in 1998 evaporated. On the other hand, the Ukrainian authorities, unlike their Russian counterparts, have so far been able to stave off insolvency by merit of successful negotiations with creditors. Nonetheless, Ukraine is still under pressure and the situation remains particularly fragile.

In August and September 1998, the Russian ruble was drastically devalued and depreciated rapidly; investors' erosion of confidence spilled over to Ukraine and the hryvnia. In response, with currency reserves having reached rock bottom, the Ukrainian authorities in September 1998 tightened their monetary policy further, raised and expanded the hryvnia's fluctuation band to 2.5 to 3.5 UAH/USD and imposed a number of foreign exchange controls (interbank forex trading was suspended, companies were required to convert 50% of their proceeds from exports, banks' access to the Ukrainian forex market was restricted). The central bank temporarily refrained from intervening in the foreign exchange market to support the hryvnia. De facto, the central bank devalued the currency, but it did not completely surrender its control over the exchange rate. In the course of September, the hryvnia weakened from 2.25 UAH/USD to 3.4 UAH/USD and remained more or less stable at this level up until the end of the year, supported by the controls. After the situation had stabilized, monetary policy was relaxed again somewhat. M2, which had expanded by 25.3% in 1998, increased by another 18.2% in the first six months of 1999. The discount rate (calculated on a per month basis) was lowered to 5.0% in January and 3.75% in June 1999.

As mentioned earlier, the economy was poised for growth in the first half of 1998, but the Russian crisis and the collapse of the ruble severely hit Ukraine's external trade in general and exports to Russia in particular. Total foreign trade turnover contracted by 14% from 1997 to 1998, foreign trade turnover with CIS countries slumped by 23%. Despite the successful conclusion of negotiations with the IMF in September 1998,<sup>2)</sup> international financial markets remained essentially closed for Ukraine. From September on, year-on-year monthly growth rates dipped below zero and 1998 GDP growth was dragged down to 1.7%, with gross industrial output contracting by 1.5%. According to preliminary data, GDP declined a further 3% in the

1 *Ukrainian-European Policy and Legal Advice Center: Ukrainian Economic Trends, Quarterly Issue June 1999, p. 34.*

2 *The IMF Executive Board approved a three-year Extended Fund Facility (EFF) on September 4, 1998, under which SDR 1.65 billion were to be made available to Ukraine in quarterly tranches up until September 2001. The volume was later raised to SDR 1.92 billion (approximately USD 3.2 billion).*

first half of 1999. Over the same period, industrial output diminished by 1.2%, output in the agricultural sector fell by 1.5%.

Although some progress has been made in taking the informal economy into account in official statistics, the result is not yet satisfactory. Independent experts estimate the size of the total economy at approximately 120% to 130% of measured GDP, with the shadow economy accounting for about half of the total.<sup>1)</sup> As it is safe to assume that the informal sector has greater momentum, one can infer that actual total economic activity – unlike the officially recorded sector – more or less held its level over the past two to three years.

As a result of the currency depreciation, monthly inflation accelerated in the autumn of 1998 so that annual inflation (December to December) came to 20% in 1998. In the first months of 1999, the hryvnia continued to lose value, but at a slower speed than in autumn 1998. In February 1999, the NBU adopted a new fluctuation band of 3.4 to 4.6 UAH/USD, designed to remain in place until the end of the year. In March, most of the foreign exchange controls which had been introduced in the autumn were lifted. At the time, the U.S. dollar cost 3.66 hryvnia on a monthly average; by July the rate had weakened to 4.00 UAH/USD. In the second half of 1999 the currency depreciated somewhat more rapidly; the upper limit of the fluctuation band was breached in October, and in mid-December the exchange rate stood at about 5.0 UAH/USD. This represents a depreciation of the hryvnia against the U.S. dollar by some 60% since the end of August 1998.

While Ukraine's currency depreciated in real terms against the U.S. dollar, it appreciated against the Russian ruble in the autumn of 1998 and more or less moved in parallel until the summer of 1999. In the second half of 1999, the hryvnia lost some ground in real terms against the ruble. Calculated at official exchange rates, Ukraine's real wages, after lagging far behind in 1996 and 1997, moved closer to Russian levels in the second half of 1998. Inflation declined in the first months of 1999. In November 1999 twelve-month inflation had subsided to 15.0%. In the wake of the recurring contraction of the economy in the autumn of 1998, payment arrears between businesses mounted to approximately 100% of GDP by the end of the year. Energy suppliers and the transport sector accumulated net claims against other sectors, primarily the metal industry and agriculture.

Financing constraints forced the government to tighten its fiscal policy, especially in the second half of 1998. The cash deficit was cut to 2.7% of GDP for 1998 and budget expenditure was adjusted to bring down the commitment shortfall to 3.0% of GDP. The fiscal authorities gained some room for maneuver by agreeing with creditors on a restructuring of T-bill debt service obligations.<sup>2)</sup> Whether the relative austerity can be maintained over the coming years remains to be seen. In the first half of 1999, the authorities appear to have adhered to the restrictive fiscal policy plans.<sup>3)</sup> Despite the

1 *IMF Staff Report (SM/99/77): Ukraine – Recent Economic Developments, March 16, 1999, p. 14.*

2 *In fact, an agreement on "voluntary" rescheduling programs was reached with domestic and foreign creditors, under which short-term Treasury bills were converted to long-term government bonds (Eurobonds).*

3 *For the first half of 1999, preliminary data show a cash deficit of 1.8% of the six-month GDP.*

reductions in the deficit, the government still had to rely on the central bank to finance the lion's share of the shortfall.

As a result of the economic downturn in Russia, Ukraine's external trade turnover diminished further and mainly on account of the hryvnia's depreciation, the trade balance improved (though not vis-à-vis Russia). In the first half of 1999, the current account gap (according to preliminary data) narrowed to USD 410 million (2.7% of the six-month GDP) from USD 1.0 billion in the corresponding period of 1998. By limiting its intervention in the foreign exchange market and due to improvements in the external trade balance and the help of the IMF, the central bank augmented its foreign exchange reserves to USD 1.1 billion to USD 1.2 billion by mid-1999. Since then this level, which barely exceeds the volume held just before the outbreak of the Russian crisis, has been more or less maintained.

The rate of unemployment reached 5.2% in August 1999.<sup>1)</sup> There can be no doubt that this indicator fails to accurately represent the full scale of unemployment, as a large proportion of the workforce has been forced to accept (often unpaid) leave or part-time contracts. Employees often put up with such situations, as they continue to depend on "their" companies for a variety of social services, such as education, housing and medical care. In the first eight months of 1999, real cash incomes dropped a further 10% to 15% below the corresponding 1998 level – merely a third of the 1992 level.

In the second half of 1999 economic activity, especially industrial output, showed first signs of recovery, mainly because of the continuing devaluation of the hryvnia. According to preliminary data, GDP shrinkage decelerated to 1.7% year on year in the first three quarters of 1999. Industrial activity gathered enough momentum over the summer months to propel industrial output growth to 3.8% for the period from January to November 1999. Quite like the recovery in Russia, this uptick is largely carried by import substitution, as purchases from the West grow more expensive and foreign trade turnover declines. Consequently, some domestic products gained a competitive advantage and output accelerated, above all in the food, paper and metal industries.

### 3 Outlook

In 1999, Ukraine's economy recovered somewhat from the painful effects of the Russian crisis. Nevertheless, solvency risks for the years 2000 and 2001 remain, as Ukraine faces annual foreign debt service obligations of approximately USD 3 billion, including large sums for interest payments, while its external trade and FDI position will most likely remain weak and foreign reserves will be in short supply.<sup>2)</sup> As the government lagged behind in the implementation of structural reforms, the international financial institutions suspended their payments in October 1999. Reelected in November, President Kuchma announced he intended to start debt rescheduling negotiations

1 Ukrainian-European Policy and Legal Advice Center: *Ukrainian Economic Trends, Monthly Update August 1999*, p. 6.

2 These USD 3 billion of debt service obligations equal some 25% of annual export earnings or more than half of the budget expenditure scheduled for 2000.

with the country's leading foreign creditors. Despite the appointment of Viktor Yushchenko, who had been quite successful at helm of the central bank, as the country's new prime minister in December, it remains to be seen whether Ukraine will in any way graduate from the established policy of hesitant reforms.<sup>1)</sup>

Ukraine's exports are still dominated by goods requiring a high input of raw materials and energy as well as by standard products with very basic processing (e.g. metal and chemical products). In the medium and long term, sustainable economic expansion in Ukraine will become possible only if its products can match those of competitors in international markets. Such a development hinges on whether the government can finally implement long overdue institutional and structural reforms and will require a major investment drive which depends on success in persuading foreign investors to participate in enhanced privatization schemes and in attracting other forms of foreign direct investment. If Ukraine does not catch up on reforms – and sadly this appears to be the most likely scenario for the next few years – the macroeconomic stability that has been achieved at considerable social cost will soon be in jeopardy, and it will merely be a question of time until the economy runs into its next crisis.

Editorial close: December 31, 1999.

1 *In foreign policy, the Ukrainian authorities can be expected to continue their careful course of striking a balance between Russia and the West and gradually moving toward closer cooperation with the EU and NATO. Recently, President Kuchma even identified EU membership as a strategic goal of the country. Neue Zürcher Zeitung, December 1, 1999: Vereidigung des ukrainischen Präsidenten – Kutschma verspricht einen konsequenten Reformkurs.*



O E N B    A C T I V I T I E S

# Financial Crisis: A Never-Ending Story?

## The OeNB's East West Conference 1999

Doris  
Ritzberger-Grünwald

This year's East West Conference took place from November 21 to 23 at the Vienna Hilton. The broad variety of topics covered under the conference's title "Financial Crisis: A Never-Ending Story?" ranged from the possible causes of crises to their unpleasant tendency to spread rapidly from one country to the next.

Although the most recent bout of turbulence in global financial markets can more or less be said to be over, the lively interest and demand in this conference proved that the issue remains very much at the top of the international agenda. After all, experience has shown that financial crises can erupt basically at any time and in any part of the globe. This unpredictability, along with the enormous damage such crises can inflict on the global economy, make the issue particularly hard to handle.

In her introductory statement, OeNB Vice Governor *Gertrude Tumpel-Gugerell* pointed out that financial crises can appear more or less overnight and can affect any market, any country and any region in the world. During the past three to four decades financial crises have occurred much more frequently, with crises in banking systems most common in the 1980s and 1990s. The Vice Governor declared that the main aim of the conference was to understand financial crises better and to design appropriate strategies to combat crises in the future.

In the course of the two-day conference, internationally renowned economists and leading economic policymakers aired their views.

### **History and Causes of Financial Crisis**

The first day of the conference was dedicated to the history and the causes of financial crises. *Forrest Capie* (Professor of Economic History in the Department of Banking and Finance at City University Business School in London) gave an introduction to the historic background of financial crises. In particular he put the most recent emerging markets crisis of 1997/98 into a broader perspective.

As a first step in ranking crises, Professor Capie suggested distinguishing among different kinds of crisis. To this end, he presented definitions for asset booms and collapses, capital flight, debt crisis, currency crisis and financial crisis. For example, he labeled financial crisis "a threat to the money stock." Avoiding threats to the money stock would therefore be in the public interest. Different measures are used to determine how severe a financial crisis is, with GDP being a quite common measure. However, historical comparisons are quite problematical, as precise GDP estimates are difficult for historical periods; the figures are subject to a considerable margin of error. For instance, the GDP for the UK at the beginning of this century is subject to a margin of error of 25%. Another simple measure is the (relative) number of failed institutions. Larger numbers – e.g. 10% of all banks failed in England in 1925, 25% failed in the U.S.A. in 1929 – indicate a higher intensity of crisis, but as banks' cross-border activities have intensified, a historical comparison is, for all intents and purposes, impossible.

Searching for successful crisis prevention mechanisms, one can find examples for both sides of the coin – tighter or looser regulation. As a case in point, banking regulation in Scotland was quite successful at the beginning

of this century, whereas British banks functioned quite well even without any regulation at all. Overall, evidence suggests that the scale of crisis has risen over the long period, according to Professor Capie. Crises have certainly become more frequent in recent years. To sum it up, Forrest Capie suggested leaving the question mark out of the conference title; in his view financial crises have always been and will always be around.

*Philippe Aghion* (Professor of Economics at the University College in London, currently teaching at Harvard University) took over from Forrest Capie. Professor Aghion is well known in academia for his work in microeconomics, in particular on contracts and incentives. More recently he has done some interesting work on macroeconomic issues such as endogenous growth and transition economies. He is also associated with the EBRD as Senior Economist and has been editor of the EBRD's journal "Economics of Transition" since 1991.

In his very compelling lecture on "The Roots of Financial Crisis," in which he discussed the fundamentals which make a country vulnerable, Mr. Aghion argued for a closer integration of micro- and macroeconomic aspects in the assessment of financial crises. Therefore he combined a macro ISLM model with a micro banking model, and took into account several kinds of constraints economic agents or the IMF usually do not consider. He introduced wealth constraints to the ISLM model and credit constraints to the banking model. This underpinned Furman and Stiglitz's recent findings that rising foreign currency debt is not a sufficient reason to increase interest rates.

*Hubert Neiss* (Director of the Asia and Pacific Department at the International Monetary Fund) commented on developments in Asian countries hit by the financial market turbulences in recent years. Mr. Neiss presented his views on the Asian experience of banking crises over the last decade. He dealt, in particular, with the roots of the banking crisis in Japan and the events that eventually prompted concerted policy measures to restructure the financial system there. He came to the conclusion that while the systemic banking crisis in Japan was over, there was still a need for restructuring. The lessons to be drawn from the crisis are e.g. that the use of public money is necessary, that initial bank closures are essential, but must be properly handled, that corporate restructuring must be pushed from the beginning, and that private foreign investors must be brought in at the first opportunity. The last point is, by the way, one of the main issues in the discussion on the new financial architecture. In the discussion, Mr. Neiss rejected the assessment that Malaysia had chosen a completely different kind of policy by introducing capital controls. In fact, Malaysia followed the same principles as all other countries hit by crisis: First stabilize the financial market and then bring interest rates down.

In the afternoon, *George Kopits* (Assistant Director of the Fiscal Affairs Department at the IMF) explored a topic not frequently addressed in the context of crises. His contribution dealt with the role of fiscal policy in the prevention of financial crises with a presentation entitled: "How Can Fiscal Policy Help Avert Currency Crises?" Mr. Kopits argued that governments can mitigate an economy's vulnerability to an impending crisis by signaling a

phased fiscal adjustment supported with credible implementation of key structural measures. In this respect a clear budgetary framework is important to speed up the process of transparency and efficiency within the financial sector and thus in the economy as a whole.

### **The New Financial Architecture**

The focus for the rest of the afternoon was on the role of banking regulators and the development of a new international financial architecture. *John Heimann* (appointed Chairman of the Financial Stability Institute at the Bank for International Settlements after retiring from his post as chair of the Financial Institutions Group and member of the Executive Management Committee at Merrill Lynch in February 1999) elucidated the crisis-containing potential of banking supervision and the limits that regulators come up against. The presentation on “The Role of International Banking Supervision in the Context of Preventing Financial Crises” was keyed to the following panel discussion, as most experts at international financial institutions involved in building a new financial architecture suggest that banking supervision should be more efficient. To underline the need to upgrade financial supervisory systems, Mr. Heimann presented several examples from his many years of experience to show that inherent imperfections in financial markets create problems of moral hazard and adverse selection which often lead to an aggressive appetite for risk, resulting in unsafe and unsound practices.

Subsequently, *Wolfgang Ruttensstorfer* (State Secretary at the Austrian Ministry of Finance), *Morris Goldstein* (Senior Fellow at the renowned Washington-based Institute for International Economics) and *Svein Andresen* (Head of the Secretariat of the Financial Stability Forum) participated in a panel discussion on the new financial architecture chaired by *Ewald Nowotny* (Vice President of the European Investment Bank).

Morris Goldstein and Svein Andresen took the opportunity to present the main findings of their institutions, both of which are dedicated to reshaping the international financial architecture. Morris Goldstein related the seven key recommendations put forward by a 29-member independent task force sponsored by the U.S. Council on Foreign Relations: Joining the “good housekeeping club” should result in greater awards; capital flows are – in principle – a good thing, but only up to a point; fair burden-sharing and market discipline in the private sector should be promoted; pegged exchange rates merit disapproval; less is more in the case of IMF crisis lending; the IMF and World Bank should refocus and go back to basics; and – last but not least – a global conference of finance ministers should be convened.

Svein Andresen informed the audience that the Financial Stability Forum is a unique institution which can hardly be compared with others. In fact, the Secretariat of the Forum consists of six people only. However, the many organizations the members of the Forum represent are very well established, and – perhaps this is the Forum’s biggest advantage – it brings together key experts who hold the important puzzle pieces in their hands.

Wolfgang Ruttensstorfer observed that although economic conditions had improved, risks for further turbulences could not be excluded. Therefore he

welcomed international activities like that of the Financial Stability Forum designed to identify the sources of weakness and to find new solutions for ongoing problems. Ewald Nowotny confirmed this view, pointing out the extraordinarily high cost of financial crises to individuals, which have to be reduced as well.

At the dinner marking the end of the first conference day, OeNB Governor Klaus Liebscher welcomed *Tommaso Padoa-Schioppa* (Member of the Executive Board of the European Central Bank) as the dinner speaker. The guest of honor drew on the conference title for his speech to reflect on many issues raised by the potential Eastern enlargement of EMU.

### **Financial Crisis Aspects:**

#### **Sovereign Ratings, Contagion and Early Warning Signals**

The tight program arranged for the second day accommodated a broad scope of issues. In the morning, *Helmut Reisen* (Head of the Research Division at the OECD Development Centre in Paris) presented a lecture on the possible impact of the Basle II Accords on banks' ratings in emerging markets entitled "Revisions to the Basle Accord and Sovereign Ratings." This paper represents a first attempt to assess the impact of the Basle II Accord on the volatility of and the size of lending to emerging markets (in June 1999 the Basle Committee on Banking Supervision had issued a proposal for a new capital adequacy framework to replace the Capital Accord of 1988). Reisen pointed out that risk weights have been reduced significantly, but at the same time most of the emerging countries still had a 100%, some even a 150% risk weight, so that 12% of banks' capital are reserved for claims. Moreover, it is not clear yet what the Basle II Accord is going to do with split ratings, which are very common in emerging markets. These aspects make it difficult to identify the losers and the winners of the new Basle Accord.

On the issue of sovereign ratings, Reisen argued that although they do not independently lead the market, in general "they always come too late." Therefore sovereign ratings are lagging rather than leading indicators. A tendency which may be observed in the context of banking supervision is that banks are inclined to make rating agencies scapegoats. Therefore Reisen advises banking supervisory bodies to make their own decisions, to avoid herding behavior, and to keep in mind that sovereign ratings are based on publicly available information.

The focus of the conference then shifted to the spreading of financial crises, especially financial contagion affecting groups of countries. *Allan Drazen* (Professor of Economics at the University of Maryland) presented a well-structured lecture on contagion in which he used persuasive and accessible examples, like the one of two adjacent restaurants with one attracting a steady stream of customers, each on the simple conviction that the last customer must know what he was doing, while the other restaurant stays empty – a good example of the information cascade. Drazen divided his overview of theories on contagion into two parts, with contagion either being the result of a currency or a financial crisis, happening across financial institutions (such as bank runs), or happening across individuals (such as the herding behavior of investors). These theories are used to find explanations for seemingly

illogical phenomena, such as the currency crisis which spread among the Scandinavian countries at the beginning of the 1990s despite the weak bilateral trade linkages. Obviously there are mainly financial market spillovers, in which a crisis e.g. in Thailand makes a crisis in another country more likely, and the question of what type of information is transmitted arises. Here, cross-market hedging, self-fulfilling attacks and liquidity effects are the key concepts, none of which are linked to macroeconomic fundamentals.

*Ricardo Hausmann* (former Venezuelan Minister of Coordination and Planning, Chairman of the Joint Development Committee of the IMF and the World Bank, Director on the Board of the Central Bank of Venezuela, and currently Chief Economist at the Inter-American Development Bank) provided an analysis of the experience with and lessons gained from financial crises in Latin America. His presentation was based on a paper with the very promising title: "Latin America: No Fireworks, No Crisis?" Mr. Hausmann followed the arguments of Professor Drazen in asking the question "What does Russia have to do with Latin America?" His answer was: "Nothing, but we both have J.P. Morgan," meaning that investment houses have to sell in one location simply because they lose in another. In defense of dollarization, he argued that having a strong supranational currency is explicitly better than having a bad domestic one, which contrasted with Professor Aghion's contention that dollarization was a gimmick.

*Clinton Shiells* (Senior Economist in the European II Department at the IMF) complemented the picture with a report on recent developments in Ukraine under the heading "Causes of Financial Crises and the Role of Contagion: The Case of Ukraine." Ukraine was buffeted by financial crises in both 1997 and 1998. In 1997 the Asian crisis led many investors to reevaluate the riskiness of investments in emerging markets, including Ukraine. One year later the Russian crisis resulted in a significant shock to the Ukrainian economy. Although one can find several standard economic arguments to explain why Ukraine was severely affected, like excessive fiscal imbalances and inadequate market-oriented structural reforms, there are also some signs of contagion. The rapid exodus from the T-bill market, for example, may have partly reflected herding behavior, as foreign investors lost confidence in the emerging markets.

*Graciela Kaminsky* (former economist on the Board of Governors of the Federal Reserve System, currently Professor of Economics at George Washington University) related the difficulties involved in predicting financial crises accurately and well enough in advance to allow for efficient countermeasures. She presented her most recent findings in a lecture with the title "Experience with Early Warning Signals. How Reliable Are Models Predicting Currency Crashes?" Professor Kaminsky used data from more than twenty countries to establish good leading indicators for crises, setting particular store by determining the forecasting accuracy of each indicator in terms of its noise-to-signal ratio. Important questions in this respect are the definition of an appropriate interval, and the focus on fragility.

At lunch, Governor *Klaus Liebscher* set forth the OeNB's view, focusing on the role that central banks play in preventing financial crisis, and in managing crisis once it has struck.

### **Exchange Rate Regimes and Capital Controls in CEECs**

The main issues addressed during the afternoon session were the problem of choosing the right exchange rate regime for crisis-prone countries and the efficiency of capital controls. *Marek Dabrowski* (Professor and Vice-Chairman of the Center for Social and Economic Research in Warsaw) initiated the session with possible answers to the question "Are Exchange Rate Regimes and Capital Controls Effective in Preventing Financial Crises?" Marek Dabrowski stated that globalization and increasing sophistication of financial products and transaction techniques had increased the difficulty of exercising effective capital controls. He then examined the arguments raised in the debate on the proper speed and sequencing of capital account liberalization, concluding that capital controls are problematic both from the point of view of effective resource allocation and from the perspective of the political economy of the reform process.

On monetary and exchange rate regimes, Marek Dabrowski started out from the principle of the impossible trinity. As increasing capital mobility represents an irreversible trend, an increasing number of countries is being pushed to choose between monetary independence and exchange rate stability, and intermediate regimes are tending to disappear. He argued that free floating is not the optimal solution for small open economies and is very difficult and costly for countries suffering from high or chronic moderate inflation. Therefore, most non-key-currency countries will be compelled, sooner or later, to join one of the main currencies or currency blocks.

Dabrowski's presentation prepared the theoretical ground for the next two speakers, who dealt with practical exchange rate and capital control issues in Central and Eastern European countries. *Peter Backé* (economist in the OeNB Foreign Research Division) presented a paper on "Recent Changes in Exchange Rate Regimes in Central and Eastern Europe." Mr. Backé started with an account of the developments of exchange rate regimes in the Central and Eastern European EU applicant countries since the onset of the Asian crisis. While exchange rates have not developed uniformly across this group of countries, exchange rate policies have mostly been oriented towards the euro.

Peter Backé proceeded to analyze these developments against the backdrop of the recent emerging market crises and, more broadly, against the financial crisis theme of the conference in general. One of the tentative conclusions he drew from the experience to date is that at least at the current stage of transition, intermediate exchange rate regimes can be reasonably robust regimes if they are backed up by sound and consistent macroeconomic and structural policies (especially financial sector reform). Finally, he extended his analysis to current and future challenges for the exchange rate policies of Central and Eastern European countries on the way to EU and EMU integration. While the final goal, the adoption of the euro, is clear, the challenge is to formulate both economically sound and institutionally fitting strategies for the intermediate period towards eventual full monetary integration.

Finally, *Emil Ems* (Principal Administrator in the Directorate General for Economic and Financial Affairs at the European Commission and coordinator

of enlargement activities in the field of capital movements) reported on the progress achieved in the liberalization of capital transactions in the countries in transition. In his paper on “Capital Controls in View of Accession,” Emil Ems stressed that the full liberalization of capital movements is one of the core conditions Central and Eastern European EU applicant countries have to meet in order to join the European Union. Liberalization should be carried out in an orderly manner, and it would be appropriate to complete liberalization already before EU accession in order to facilitate adjustment.

Mr. Ems went on to report on the progress the individual applicant countries have already achieved on their way towards freeing capital movements. He argued that semiliberalized regimes (unrestricted medium- and long-term movements, restricted short-term movements) do not provide an efficient shield against external monetary shocks originating from contagion. What short-term restrictions can still accomplish is to render short-term flows more expensive and therefore to constrain the creation of domestic shocks occasioned by extensive short-term borrowing abroad. Ems concluded that the EU demands for free capital movements do not constitute a stumbling block for the economic development of EU accession countries.

Summing up the main findings of the conference, one can conclude that financial crises can no longer be attributed exclusively to errors in a country’s macroeconomic policy. Quite to the contrary; there is variety of combined factors and potential explanations, such as poorly administered public debt management, difficulties in selecting an appropriate exchange rate regime, insufficiently well prepared and too hastily implemented liberalization of capital transactions, a vulnerable banking sector and deficiencies in the supervisory system.

In her concluding statement on the interlinkages between developments in reform countries and industrialized nations, Vice Governor Tumpel-Gugerell pointed out that it is not solely the fault of countries in transition if they are hit by financial crisis. Thus, a one-sided call for sound economic policies in the countries in question is not optimally suited to finding a comprehensive solution. International financial institutions should strive to enhance stability in global financial markets, for instance by introducing better models of risk sharing.

In the eyes of the OeNB’s Vice Governor, the implementation of international standards in banking supervision is a pivotal issue in this context. As a result of the recent financial crises in Asia, Latin America and Russia, the general view on capital controls has changed somewhat over the past two years. There appears to be a consensus that countries which have already fully liberalized their capital markets should not introduce capital controls, but that developing countries and countries in transition should proceed with great care.

Despite the fact that the conference was a big success for the Oesterreichische Nationalbank – more than 150 participants from over 30 countries came to Vienna, and media coverage of the event was wide – a sad note remains. Olga Radzyner, who had headed the creative and managerial efforts behind the East West Conferences in recent years, who had also developed



the topic and started the preparations for this year's conference, was no longer with us to share this success.

At the outset of the conference, *Hans Flickenschild* (Advisor at the IMF known to many Austrians from the IMF's Article IV consultations) held a moving eulogy and reminded the audience of Olga's many achievements. In the presence of Olga's sister Joana, Vice Governor Tumpel-Gugerell announced that the OeNB had established an Olga Radzyner Award, which will be bestowed on young economists from Central, Southeastern or Eastern European transition countries for excellent research focused on monetary and finance issues in economics. A total of EUR 7,500 annually will be shared out to three award winners. Young economists are encouraged to submit applications for the first awards to be presented at the next East West Conference scheduled for November 2000.

# 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 by renowned economists and experts. Readers may benefit from the main insights drawn from the lectures, which are presented below. The speakers in the second half of 1999 were Emil Ems, of the European Commission, who described the prerequisites for and characteristics of candidate countries' catching-up process in the context of EU and EMU preparations; András Inotai, of the Hungarian Academy of Sciences, who gave an account of Hungary's preparations for membership in the EU; Richard Rose, of Strathclyde University, Glasgow, who described the current political situation in Russia in the run-up to the parliamentary and presidential elections; Zdravko Balyozov, of the Bulgarian National Bank, who discussed current economic and financial developments in Bulgaria; Martin Raiser, of the European Bank for Reconstruction and Development, who presented the EBRD's latest Transition Report; and Mojmir Mrak of the University of Ljubljana, whose lecture dealt with the current state of the financial integration of transition economies into the global economy.

The presentations are routinely rounded off by discussions that give participants an opportunity for an exchange with the speakers. Due to the constraints on the length of the Focus on Transition, the discussions are not recounted in detail in the brief overviews which follow.

## **Lecture by Emil Ems**

### **EMU, Accession and the Catching-Up Process**

On September 17, 1999, Mr. Emil Ems, Principal Administrator at the DG ECFIN (Directorate General "Economic and Financial Affairs") of the European Commission, gave a lecture at the OeNB on "EMU, Accession and the Catching-Up Process." Mr. Ems started out with some fundamentals of the catching-up process, which aims at raising the standard of living in the Central and Eastern European EU candidate countries to a level much closer to that in EU than today. Catching up entails 1. strong and sustainable growth rates for a prolonged period, 2. high and varying differences in productivity growth between sectors and regions (which in turn implies real exchange rate movements in the medium to long term), 3. continuing high investments in infrastructure, 4. a continued supply of foreign capital coupled with ample sources of domestic capital and thus exposure to external investors, and the ability to cope with endogenous crises and contagion, and 5. high credibility for the process both abroad and at home. EU accession, in turn, has to be seen against the EU Treaty's important ultimate aim to obtain "economic and social cohesion." During preaccession, priority has to be given to structural reforms. The immediate adoption of the single currency is not foreseen at accession. Mr. Ems then elaborated on the Copenhagen criteria for EU membership and the EMU-specific requirements in this context. He stressed that adopting the Community *acquis* at large has beneficial consequences, as it provides a major boost to credibility "borrowed" from the EU, encourages continued capital inflows and helps to limit the exposure to crises.

He then asked whether the EU accession demands in the areas of free capital movements, exchange rate policy, price stability and fiscal operations would constitute potential stumbling blocks to the greatly needed increase in living standards in Central and Eastern Europe. Mr. Ems concluded that economic obligations for EU membership are sufficiently flexible to allow for a sustainable catching-up. In the area of exchange rate policies, he stressed the flexibility of the ERM II arrangement and, in the fiscal realm, the leeway the Stability and Growth Pact grants countries which have not yet introduced the euro. The admissible budgetary latitude, which hinges on real growth and interest rate developments, should be utilized properly, namely to finance necessary infrastructural investments. Mr. Ems questioned whether in countries which have achieved an intermediate degree of capital account liberalization, the remaining restrictions (in particular on short-term movements) could still be enforced efficiently. Moreover, preparations for EU accession would contain most of the standard causes for financial and currency crises, namely unsound or inconsistent macroeconomic policies and distorted incentives for foreign borrowing, financial system fragilities and inappropriate corporate governance. Candidate countries should continue their disinflation policies; however, inflation targets should not be overly rigid in the catching-up phase. Mr. Ems recommended that the candidate countries should make use of the flexibility of the economic conditions for EU membership, where available and to the extent appropriate, and should not leave out of account that the main risk to catching up successfully would lie in accession countries attempting an early adoption of the single currency.

In the ensuing discussion, a number of issues were raised. One of the major topics of the debate was on the proper timing and sequencing of the freeing of capital movements. In this context, the current state of the financial sectors in the applicant countries was discussed. Exchange rate policies and real exchange rate developments were further themes of the debate.

### **Lecture by András Inotai**

#### **Hungary's Preparations for Membership in the EU: A Preliminary Assessment**

On October 20, 1999, Professor András Inotai, Director General of the Institute for World Economics of the Hungarian Academy of Sciences, addressed listeners at the OeNB with a lecture on "Hungary's Preparations for Membership in the EU: A Preliminary Assessment." Professor Inotai started by contrasting the advantages Hungary will reap from EU membership with the advantages of the country's current EU association status. Advantages would include Hungary's participation in the Community Agricultural Program (CAP), in addition to already free trade in manufactured goods (whatever barriers are still in place on the Hungarian side will be dismantled by 2001). Furthermore, the transfer of financial resources would greatly increase from EUR 240 million per year (in 2000) to approximately EUR 1.5 billion to EUR 2 billion a year, mainly through transfers from the EU's structural and regional funds. Moreover, membership would bring with

it the free flow of labor (possibly after a certain transition period) and participation in EU decision making on an equal footing.

According to Professor Inotai, Hungary is currently at a critical stage of economic development. The country has now reached the second phase of transformation, having overcome the problem of fluctuating economic growth, i.e. slower growth caused by imbalances arising in the wake of accelerated growth. Since 1996 the country has succeeded in achieving more sustainable growth. In order to be sustainable, growth must remain based on investment and exports, and arbitrary exercises should be avoided (aiming for unrealistically high growth rates, artificial inflation reduction).

Next, Professor Inotai ran through the preparatory steps the EU has taken or still has to take in order to become ready for enlargement (financial framework 2000-2006, institutional reform, agricultural reform). With respect to transitional arrangements and derogations, Hungary does not appear to have an overall accession negotiation strategy. Hungary has the advantage of having achieved advanced microadjustment, which is readily apparent when analyzing the structure of Hungary's exports to the EU (60% of Hungary's exports to the EU consist of technology-intensive goods, by far the highest share of all transition economies). In fact, the unit value of Hungarian industrial exports to Germany even appears to be 6% higher than the comparable indicator for Austrian industrial exports to Germany. At the same time, FDI in Hungary has reached a new stage, as investments have become profitable. 30% to 40% of these profits are repatriated. For Hungary, it will be instrumental for most of the generated profits to be reinvested domestically or from domestic locations of multinationals in other economies of the region. Legal harmonization in Hungary is basically on track, although there has been a certain slowdown in some areas recently. Here, institution-building, which includes streamlining and better coordination in the area of sectoral policies, represents the main challenge.

The agricultural sector declined to 5.5% of GDP in 1999. Only 8% of the active population are employed in this sector; half of them will retire over the next five years, which implies that the pressure on the labor market resulting from the transformation of the agricultural sector will be manageable. The environmental deficit in Hungary is high, as in other transition countries, while labor tends to be less mobile, even within the country. Therefore, real migration will probably be very low. Hungary's absorption capacity for structural funds is substantial, if quite uneven from region to region. Hungary will have to accept Schengen upon accession, as this is not negotiable for the EU. The country should give priority to EU membership and thereby export stability to the region, which will, by itself, improve the relations with the Hungarian minorities in the neighboring countries.

Professor Inotai then turned to the European Commission's regular reports on the candidate countries published on October 13, 1999. In his view, the Commission's proposal to open accession negotiations with all ten Central and Eastern European candidate countries constitutes a new strategy based on a political decision (as the reports themselves say). The question is whether thereby a convoy of all countries is created once again or whether the new strategy will in practice allow for more differentiation,

also within the “first group” of accession countries (Estonia, Hungary, Poland, Slovenia, the Czech Republic and Cyprus). As for the earliest possible date of accession, Professor Inotai stressed that the ratification of accession treaties would take at least 1½ years, which implies that there will be no enlargement in 2003, if negotiations are finished in 2002 at the earliest, as indicated in the reports. Furthermore, the reports do not dwell on the future of the common agricultural policy and how reforms in this area would impact on enlargement: Will it delay enlargement, if the upcoming WTO round (which will be decisive for these reforms) take longer than one to two years? Or would the Commission, in such a scenario, consider delaying the extension of the common agricultural policy to the applicant countries? In its report, Hungary received a very good grade overall. It has increased its lead because other countries have fallen back in relative terms. Professor Inotai concluded that Hungary had a good chance of being included in a, possibly fairly small, first round of enlargement, if it accelerates institution-building and develops a clear policy on transitional arrangements/derogations.

In the ensuing discussion, a number of issues were raised. One such issue was what sources Hungary would access to finance the investment needed for sustained growth and catching up. In Professor Inotai’s opinion, domestic private savings and foreign investment would not suffice. Fiscal savings will probably be needed to close the gap. Thus, the primary surplus might need to rise to 4% of GDP. Another question was related to the cofinancing needs Hungary will face when tapping structural fund money. Further issues were the role of small and medium-sized companies as well as regional disparities in Hungary’s overall economic development, and the role of Budapest as a potential regional hub for Central Europe. Finally, some aspects of the accession negotiations – institutional capacity, purchases of land, the implementation of the EU *acquis* on competition policy – were brought up.

### Lecture by Richard Rose

#### What to Look for in the Russian Elections

On October 28, 1999, Richard Rose, Director and Professor of Public Policy at the Center for the Study of Public Policy at Strathclyde University, Glasgow, held a lecture at the OeNB dealing with the current political situation in Russia and the upcoming elections. His talk combined an analysis of up-to-date opinion surveys and an exposition of the complexities of the Duma/presidential system. The opinion surveys were carried out by the Russian Center for Public Opinion and Market Research (VCIOM). According to Professor Rose, elections in Russia are the result of three elements: voters, electoral system rules and party elites. The threshold of 5% of votes for any party that wants to enter the Duma is important in that it gives a bonus to relative winners. At the last Duma elections in 1995 almost half of the vote went to small parties. This “magnified” the majority of the Communists. Fewer parties registered for the Duma elections in December 1999, therefore there would probably be less of a bias toward larger parties this time. The capacity of parties to organize nationwide is an important competitive advantage. According to a survey carried out in the first week of October,

the Communist Party (Zyuganov) remained the clear leader in public opinion (27% of likely votes), followed by Fatherland-All Russia (Luzhkov, 14%) and Yabloko (Yavlinsky, 9%). Market-oriented reformers, mostly represented by the Union of Right Forces (Kiriyyenko and Nemtsov) are discredited and would only fetch about 5%. The Liberal Democrats (Zhirinovskiy) are even more discredited and can only expect 3%. In general, the populace lends little trust to politicians and political parties.

The presidential elections in June 2000 will likely be held in totally different circumstances from the parliamentary ones. There are (still) many unresolved issues and options. Should Yeltsin become incapacitated before the election date, Putin would become acting President and could benefit or be disadvantaged by that more highly visible stance. The Luzhkov-Primakov alliance was a marriage of convenience up to the Duma elections and might not last until June; furthermore, it had not yet become known who of the two politicians would be chosen as the candidate or whether they would both run. As of the beginning of October, Putin had reached about the same popularity as Primakov. Putin's popularity was rising steeply due to the (at least as of October) widely popular war in Chechnya. Both men were followed in popularity ratings by Zyuganov. As to possible second-round choices for the Presidential elections, the failure to discredit Primakov was probably a big mistake on the part of Yeltsin. But whatever outcome the elections produce, ordinary Russians do not seem to think that much will change. For the time being, there are no expectations that things might get better. This is also a reason why, despite growing poverty and misery, there is no unrest in Russia.

The ensuing discussion focused on general questions related to the economic and political outlook for Russia. Professor Rose felt that the elections would lead to some consolidation and stabilization of the situation; he did not think that the country was in for any radical turns. On the other hand, the center's sway over the regions is likely to remain tenuous. The main factor holding back Russia in its development is the inherited lack of appropriate institutional infrastructure. Building this up takes time; therefore, Russian reforms are a long-haul project.

### **Lecture by Zdravko Balyozov**

#### **Current Economic and Financial Developments in Bulgaria**

On November 24, 1999, Zdravko Balyozov, Director of Statistics at the Bulgarian National Bank, gave a lecture on "Current Economic and Financial Developments in Bulgaria." Mr. Balyozov stated that, starting from mid-1998, the Bulgarian economy had slowed down due to external and internal factors. The drop in external demand for major exports like metals and chemicals as well as from major partners like EU countries, together with the Kosovo crisis, seriously affected Bulgaria's exports. At the same time, the ongoing process of state enterprise restructuring through privatization or liquidation further contributed to the decline of industrial output. The moderate real GDP growth of 0.5% experienced in the first half of 1999 came from private domestic consumption and investment. After a period

of deflation, the price level began to rise again in the second half of 1999 and, in October, twelve-month (year-on-year) inflation reached 3.1%. The factors pushing inflation up were one-time changes in administrative prices on some energy sources and the continuing adjustment in the service sector, while those determinants which keep it under control – and are actually stronger – are the external anchor of the fixed exchange rate and weak domestic demand.

From mid-1998 exports declined continuously due to the abovementioned factors, but in July and August 1999, a bottoming out followed by the start of a slow recovery was observed. The biggest reductions were recorded in exports of metals, metal goods and chemicals, while deliveries of clothes and furniture abroad increased moderately. The share of exports to EU countries expanded further to 54% at the expense of the narrowing shares of CIS countries. Imports in the first eight months of 1999 were almost the same as in the corresponding period of 1998, but the structure of imports shifted from raw materials and energy resources to investment and consumer goods, and the emphasis of imports moved from CIS countries to the EU region. The trade deficit impacted on the current account, which posted a shortfall of about 3.5% of GDP for the January to August 1999 period. The current account deficit is partially compensated by a stronger financial account fueled by growing foreign direct investment. The overall deficit of the balance of payments excluding changes in official reserves and lending by international institutions on the order of 1.7% of GDP was financed mainly by official BOP support and by a moderate drop in foreign reserves. At the end of the third quarter of 1999, total external debt amounted to USD 9.7 billion, close to 79% of GDP.

Despite weaker economic performance and lower than expected inflation in the first half of the year, the budget has not been undermined, because fiscal policy was tight. The consolidated state budget for the first ten months of 1999 was in balance. As net external finance was also almost balanced, the revenues from privatization and net redemptions of public sector securities freed bank resources, which can additionally be allocated to the real sector. However, total government debt remains high at 88% of GDP, 85% of which is external debt.

In October 1999, currency board reserves increased by 16% year on year; two thirds of the increment of DEM 750 million were automatically sterilized. Nevertheless, broad money (M3) grew by 8% in real terms in the twelve months to October 1999, reflecting a continuing return of confidence in the lev and banks. Credit aggregates grew even more, as additional resources became available on account of net returns from the government sector. Commercial banks allocated the entire increase in deposits to domestic assets, and new credits went mainly to the private sector, where year-on-year growth was 19% in real terms. Thus bank lending to the real sector has neither stopped, nor has it been squeezed, but it remains cautious. Real rates for deposits are marginally positive, which provides an incentive for savings. However, rates on credits can be considered a rather high burden for the real sector, because of the large margin reflecting high real sector risk as well as banking sector problems. The privatization of the six state-owned commer-

cial banks has continued, with a third of these banks recently being sold to a strategic foreign investor. Another bank is expected to become private by the end of 1999, and the remaining two state banks are set to be auctioned off by mid-2000. The state savings bank is to be privatized later. Selling all state banks to strategic foreign investors is expected to have positive effects for the banking system, as it will bring new capital, increase banks' efficiency and improve their credit expertise. Finally, privatization can compensate for the limited lender of last resort capacity of the Bulgarian National Bank (BNB) under the currency board arrangement, as additional funds may be provided from headquarters abroad in case of financial crisis.

In Mr. Balyozov's view, the major challenge in the short and medium term is to move to a sustainable path of 4% to 5% annual real GDP growth, which should sustain the already achieved financial stability. Growth has to be export oriented and based on intensive foreign investment, allowing for higher wages supported by productivity gains. The currency board is to stay at least until the country becomes a member of the EU. In such an environment, the budget has to be kept in balance so that no pressure is exerted on the development of the real sector. To further strengthen the banking system and improve its functions, full privatization, also of the state savings bank, to strategic foreign investors has to be finished in the coming two to three years.

Mr. Balyozov's lecture was followed by a question-and-answer session which focused mainly on bank lending to the private sector, the role of the BNB's base rate, Bulgaria's future debt service outlook and the recent development of different components of aggregate demand.

While official foreign exchange reserves went down slightly measured in U.S. dollars, they increased in euro terms.

In October 1999, the broad money-to-GDP ratio was 30%.

### **Lecture by Martin Raiser**

#### **The EBRD's 1999 Transition Report**

Martin Raiser, Senior Economist at the European Bank for Reconstruction and Development, presented the EBRD's latest Transition Report at a lecture at the Oesterreichische Nationalbank on December 6, 1999. Heiner Luschin, Member of the EBRD's Board of Directors, rounded off Martin Raiser's presentation with an analysis of the effects of the economic crisis in Russia on the EBRD's policy.

Mr. Luschin explained how the EBRD had coped with the difficulties in the wake of the economic crisis in Russia. After having posted a significant loss in 1998, the EBRD had shored up its finances and planned to close the year with a break-even result or a small profit. Mr. Luschin went on to describe how the EBRD had changed its approach since the crisis, assessing public-sector investment in a more positive light, and focusing its policy on the maximum transition impact of a project while retaining sound banking standards in line with its principles. The EBRD has set in motion important new impulses for policy dialogue (notably, investment councils in which investors and top-level policymakers discuss the investment climate) and



has begun to take into account project-related social assistance considerations.

Mr. Raiser then presented the Transition Report 1999, which gives a detailed account of the events during the first decade of the transition process. His statements are summarized below.

Mr. Raiser started out with a general review of the reform progress. Different emerging (formerly centrally planned) economies entered the transition process from very different starting positions. This fact strongly influenced each country's performance throughout the decade. However, economies which made all-out efforts to implement reforms were rewarded with success in the end and managed to overcome their initial disadvantage; the Baltics may be cited as an example. Other countries' half-hearted reforms made them vulnerable to instability, with Russia serving as a case in point. The CEECs made by and large comparable progress in their transition efforts, whereas the CIS countries posted widely divergent success in implementing reforms. In most cases, institutional reform lagged behind liberalization and privatization. Countries that took consistent and sustained liberalization steps were under growing pressure to establish institutions that are in conformity with market conditions. Mr. Raiser stated that the EBRD considered economic integration with the West crucial to the ultimate success of transition. The effects of privatization were less clear-cut in guaranteeing transition. While privatizing small and medium-sized enterprises secured the acceptance of reform by citizens, the sale of large companies to insiders strengthened interest groups that opposed reform. The sale of state-owned businesses to strategic investors abroad clearly had positive effects.

Martin Raiser continued by outlining the relationship between government and business, which determines the effectiveness of the reforms. Economic and political competition, he asserted, induces government to act efficiently. A survey of the investment climate in the transition economies (3,000 enterprises in 20 countries were polled) surprisingly showed that enterprises rated a lack of general economic stability and weaknesses in structural reforms (in particular reforms of the financial sector) as more important than deficiencies in establishing rule-of-law principles. Nevertheless, the businesses concluded that the more prevalent corruption was, the worse the investment climate was. Mr. Raiser explained that newly established firms suffer most from an unfavorable investment climate.

Moving on to the EBRD's forecast for the year 2000, Martin Raiser presented the following outlook: Real GDP growth was expected to accelerate from 1.6% in 1999 to 3.2% in Central and Eastern Europe, and from 0.0% to 1.1% in the CIS region. Inflation was set to pick up from 3.5% to 5.0% in the CEECs and to decelerate from 35.0% to 16.5% in the CIS.

The EBRD has pinpointed the following key challenges for the next decade: 1. promoting entrepreneurship and competition, 2. reducing interest groups' stranglehold on government, 3. improving the efficiency of social support facilities and 4. deepening international integration.

The West, above all the EU, faces the challenge of not just admitting into their circle the most advanced transition countries, but also of not cutting off the other countries in the region, especially not CIS countries.

International financial institutions are called upon to help activate investment, to promote small and mid-sized business and to help improve the investment climate.

The discussion which followed centered on various topics, such as privatization. Here participants pointed out the problematic approach to privatization adopted by Russia and the Czech Republic. On the issue of how to proceed with institutional reform, the question of whether liberalization actually helped create institutions was raised, as was that of the role of political freedoms in furthering institutional reform. The importance of having functioning markets in nearby countries to serve as an example for a transition economy was also examined. Other topics touched upon were overlaps in international financial institutions' activities (in the areas of policy dialogue and the establishment of social assistance facilities). Finally, the EBRD's proposals for reducing corruption, which include due diligence and transparent procurement rules, were outlined.

### **Lecture by Mojmir Mrak**

#### **Financial Integration of Transition Economies into the Global Economy: Where Do We Stand 10 Years After?**

On December 10, 1999, Professor Mojmir Mrak of the University of Ljubljana presented a lecture at the OeNB, assessing the current state of the financial integration of transition economies into the global economy. Professor Mrak outlined the experience with capital flows to Central and Eastern Europe since the beginning of transition, stating that the transition countries have become respectable players in the global economy within the last ten years. The implications of the Russian crisis for the Central and Eastern European countries (CEECs) received specific attention during the lecture and in the discussion. Mr. Mrak covered all CEECs and the countries of the former Soviet Union.

By way of introduction, Mr. Mrak gave a comprehensive survey of the capital inflows to the CEECs, distinguishing among three periods, notably the pretransition period (before 1990), the early transition period between 1990 and 1997 (before the Russian crisis), and the period following the Russian crisis. The speaker also differentiated between the types of capital flow – foreign direct investment, portfolio equity investment and bond issuance, and lending.

Prior to the economic reforms, the financial sector in the CEECs was underdeveloped. The allocation of financial funds by the central authority (the Central Planning Agency) did not result in any need for active financial intermediation in these economies. The controlled banking sector was the only provider of financial services. Furthermore, the centrally-planned economies were excluded from the international financial systems and largely also from global financial flows. When these countries embarked on the path of economic reform, they were not members of international financial institutions yet, and had no access to the international capital market.

The lecturer pointed out that early analyses of the transition in Eastern Europe viewed the region as if it consisted of uniform countries. Professor

Mrak, however, stressed the differences between the various Central and Eastern European countries. For example, the settlement of the debt of former Yugoslavia to its successor states has been a significant problem for Slovenia.

Mr. Mrak related that capital inflows to the CEECs had experienced significant changes since 1990. In the pretransition period, total annual capital inflows of about USD 5 billion were strongly concentrated on state debt. Between 1990 and 1997, capital inflows increased from USD 3 billion in 1990 to USD 61 billion in 1997, and the share of official flows declined from 75% in 1992 to 15% in 1997. After the Russian crisis, capital inflows roughly halved in the region as a whole (to an estimated level of USD 33 billion in 1999). The structure of capital inflows to Russia has become very different from that of capital inflows to Central Europe.

Foreign direct investment (FDI) has been the most important and the most stable type of capital inflow to CEECs. As measured in terms of GDP, FDI inflows increased from 0.1% of the region's GDP in 1990 to 0.7% in 1998. FDI inflows accounted for 10.5% of the region's capital formation in 1997.

Portfolio equity investment and bond issuance represent relatively new forms of capital inflows to CEECs. The Russian crisis entailed a significant drop of the level of portfolio investment and bond issuance and a rise in the volatility of such inflows.

Commercial bank lending was the major source of external funds in the pretransition period. The (partial) liberalization of capital account transactions and the narrowing of spreads allowed bank lending to surge from USD 1 billion in 1992 to USD 11 billion in 1996. However, the Russian crisis sparked a sharp drop in new lending by Russian banks, while lending by Central European banks remained largely unaffected. Spreads have increased for all borrowers in the region, although to significantly different degrees in different countries. Overall, Professor Mrak stressed the growing differentiation of the CEECs caused by differences in initial conditions and in the countries' geographical location (especially their proximity to EU countries).

Moving on to assess the level of financial integration, Mr. Mrak classified the CEECs as follows:

Countries with an advanced level of financial integration were those that had resolved pretransition debt problems, that had achieved full institutional integration, including EU membership talks, that relied only little on official flows, that had full access to funds in the private capital market (that had an investment grade rating) and that had achieved an advanced level of capital account liberalization. The next category was that of countries with an intermediate level of financial integration. The countries in this group exhibit some institutional integration, including a Europe Agreement, a strong reliance on official flows and limited access to the private capital market (a speculative grade rating). Countries with a low level of financial integration were those which had not yet resolved their pretransition debt problems, showed only poor institutional integration, relied completely on official flows and had no access to the private capital market.

The general discussion concentrated on the impact of the Russian crisis on capital inflows to the CEECs and Slovenia's experience in attracting capital inflows. The question of whether the drop in capital inflows to the CEECs after the Russian crisis was largely caused by "pull" factors (that is, the reduced attractiveness of host countries) or "push" factors (that is, changed conditions in home countries of international investors in relation to the CEECs) was raised, as was the fact that capital outflows from CEECs are currently increasing. Some questions centered on Slovenia's negotiations with the OECD and the EU and the liberalization of its capital account, especially FDI in the banking sector. Professor Mrak was also asked about his views on the future development of capital inflows, especially whether a stabilization of the economic situation in Russia was to be expected.

Professor Mrak stressed that small countries such as Slovenia have to be better prepared for EU and OECD negotiations than larger countries. With respect to capital controls in Slovenia, he expects that the currently increasing current account deficit, which is likely to have reached about 2% of Slovene GDP in 1999, will probably bring more openness towards foreign investors, including the banking sector. The decline of capital inflows to CEECs was largely caused by changed attitudes of international investors (risk aversion) after the Russian crisis. However, it would be very difficult to assess how soon the situation would stabilize after the Russian crisis.

# 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 June 18, 1999, and on October 22, 1999. 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 which is therefore given ample room on the agenda.

*Leopold Maurer*, the European Commission’s Chief Negotiator of the Task Force Accession Negotiations, presented a very topical lecture on “The Current State of Accession Negotiations – Specific Focus: EMU and the Free Movement of Capital” at the 35<sup>th</sup> East Jour Fixe, which took place on June 18, 1999. Mr. Maurer’s lecture was discussed by Peter Backé (Oesterreichische Nationalbank, Foreign Research Division). Christa Peutl, Director for European Affairs at Austria’s Federal Chancellery, was the cospeaker at the East Jour Fixe. Ms. Peutl’s contribution was entitled “The Current State of the Accession Process: Assessment and Challenges for Austria.”

*Alexandra Cas Granje*, Head of Unit D 1 Economic affairs and related issues within accession countries at the European Commission, focused her presentation at the 36<sup>th</sup> East Jour Fixe, which took place on October 22, 1999, on “The European Commission’s Economic Evaluation in the 1999 Regular Reports on the Enlargement Countries.” Ms. Cas Granje’s presentation was discussed by Mr. Andreas Wörgötter, Associate Professor and Head of the Department of Transition Economics at the Institute for Advanced Studies (Vienna), Mr. Sándor Richter, Senior Economist at The Vienna Institute for International Economic Studies (WIIW) and Mr. Wolfgang Nitsche, Deputy Director of the Division for Economic and Integration Affairs at Austria’s Federal Ministry of Finance. The main findings of the two most recent East Jour Fixe meetings are reported below.

## **Contribution by Leopold Maurer**

### **The Current State of Accession Negotiations – Specific Focus: EMU and the Free Movement of Capital**

The European Commission’s Chief Negotiator of the Task Force Accession Negotiations, Leopold Maurer, was the main speaker at the 35<sup>th</sup> East Jour Fixe, which took place on June 18, 1999, and was chaired by Olga Radzyner. Mr. Maurer gave a presentation on “The Current State of Accession Negotiations – Specific Focus: EMU and the Free Movement of Capital.” He pointed out that three groups of countries were involved in the enlargement process started by the European Council in December 1997. The first group encompasses those six countries with which the Union opened substantive accession negotiations in November 1998 (Cyprus, the Czech Republic, Estonia, Hungary, Poland, Slovenia). The second group comprises Bulgaria, Latvia,

Lithuania, Romania, Slovakia and Malta. In December 1999, the European Council in Helsinki was to decide whether to open negotiations with some or even all of the second group of countries. Thirdly, there is Turkey, a country vis-à-vis which the European Union has not defined a clear strategy. Mr. Maurer continued to report on the *acquis* screening as well as the substantive negotiations, outlining the procedural and institutional framework. He stressed that while in earlier enlargement rounds negotiations had focused only on the adoption of the *acquis*, now all rules and regulations should already be in place and applied in practice at the time of accession. This places a special emphasis on monitoring, in which the Task Force Accession Negotiations will play a central role. Only when the accession negotiations are well advanced will the European Union be in a position to announce a target date for the first round of Eastern enlargement. This will not be the case before the second half of 2000, when France takes over the EU presidency. 2003 would be the earliest accession date that is technically feasible. As of mid-1999, seven to ten of the 31 negotiation chapters were provisionally closed with the six countries of the first group.

Negotiations related to the chapters on EMU and the Free Movement of Capital were opened in the second half of 1999 under the Finnish EU presidency. As none of the candidate countries has requested transition periods for the EMU issue, this chapter may be brought to a provisional close relatively soon. All applicant countries will participate in EMU on their accession to the EU; they will not, however, immediately introduce the euro (rather, they will assume the status of "Member State with a derogation"). According to the Commission, applicant countries should retain sufficient exchange rate flexibility to restructure their economies both before and after EU accession. After joining the European Union, applicant countries should take part in ERM II but retain flexibility (with intervention bands of  $\pm 15\%$ ). Sound macroeconomic fundamentals together with the fulfillment of the convergence criteria are the condition for EMU membership. In this light, the introduction of the euro is still a remote perspective for the applicant countries of the first group.

On the issue of free capital movements, the situation is somewhat more complex. So far, only Cyprus, Estonia, Hungary and Slovenia have handed in their position papers dealing with this chapter. The politically sensitive issue of land purchases by foreigners in the applicant countries will be most difficult to resolve. Furthermore, a number of other specific issues are in need of clarification in all six countries. In mid-July, the European Commission intends to submit draft common positions on these two chapters, which will then be discussed by the Council.

It goes without saying that the EU also has to do its homework and brace itself for enlargement. The adoption of Agenda 2000 at the European Council in Berlin in March 1999 marked the most important step so far. An Intergovernmental Conference on institutional reforms will be kicked off at the end of 1999 and should be completed within a year.

Mr. Maurer's lecture was discussed by Peter Backé (Oesterreichische Nationalbank, Foreign Research Division). In his remarks, Mr. Backé concentrated on the two negotiation chapters EMU and the Free Movement

of Capital. The applicant countries' programs aimed at liberalizing capital movements are quite ambitious, with the completion of full liberalization envisaged in a few years' time at the latest. It is, thus, all the more important that liberalization take place under proper conditions so as to minimize potential risks. In this context it is favorable that, when assessing the progress achieved by candidate countries, the Commission will focus on sound macro-economic fundamentals, an efficient and well-supervised financial sector and the respective country's capability to withstand disturbances resulting from international capital flows. This is an improvement on the somewhat mechanistic approach the Commission has taken so far. The question remains, though, what instruments and analytical tools the Commission will use to verify compliance. On capital movements, Mr. Backé furthermore remarked that potential transition periods for land purchases would probably not cause any problems from a monetary or monetary integration point of view.

In the EMU area, one may distinguish between preaccession and postaccession issues. As to the former, the Commission's focus is rightly on the fulfillment of the economic criteria for EU membership and the adoption of EMU-specific parts of Community legislation. In addition, as Mr. Backé noted, applicant countries will have to ensure the effective functioning of monetary policy. Moreover, there is the question of whether there should be any room for preaccession exchange rate arrangements between the euro area and the applicant countries.

Several postaccession issues remain open. It seems that ERM II will be the institutional benchmark for integrating the applicant countries into intra-EU exchange rate policy cooperation; however, a formal decision has not been taken yet. What will the economic preconditions for joining ERM II be? How will the convergence criteria to be met for eventual participation in the euro area be interpreted for prospective members, especially the exchange rate criterion? Currency board countries raise some additional issues due to their absolute nominal exchange rate rigidity and some specific institutional features.

Christa Peutl, Director for European Affairs at Austria's Federal Chancellery, was the cospeaker at the East Jour Fixe. Ms. Peutl's contribution, in which she expressed her personal opinion, was entitled "The Current State of the Accession Process: Assessment and Challenges for Austria." Ms. Peutl emphasized that nobody had analyzed the enlargement challenge properly yet. In the runup to the Helsinki summit, the EU would again arrive at a crossroads. The "group model versus regatta model" question would resurface, and the West Balkans issue would have to be tackled.

On the issue of accession, Christa Peutl noted that it was more important to have a clear path than a predefined accession date. Opening negotiations with additional candidates will further underscore the enormous need for more resources to be devoted to enlargement issues, both in the EU and in the administrations of the Member States, she said.

Looking at how the European Union functions today, a good case can be made for the upcoming institutional reforms to go beyond a minimal package; matters such as language or the rotating principle underlying the EU presidency will probably have to be dealt with, too.

Austria will have to raise some specific issues in the accession negotiations, in particular regarding the free movement of persons (including the appropriate design of transition regimes in this area), transport, social standards, the environment and nuclear safety standards.

The ensuing general discussion covered a broad range of topics. Inter alia, it was stressed that it is important to avoid distortions when liberalizing capital movements; this process needs to be timed and sequenced in an appropriate fashion. Also, the question cropped up on how to reconcile the different levels at which integration proceeds (economic theory, administrative, business, political-intellectual integration). Various opinions on the appropriate degree of transparency of the accession process (in particular the negotiation process) were expressed.

### **Contribution by Alexandra Cas Granje**

#### **The European Commission's Economic Evaluation in the 1999 Regular Reports on the Enlargement Countries**

Ms. Alexandra Cas Granje (European Commission, ECFIN – formerly DG II, Head of Unit D 1 Economic affairs and related issues within accession countries) was the main speaker at the 36<sup>th</sup> East Jour Fixe, which took place on October 22, 1999, and was chaired by Doris Ritzberger-Grünwald (Foreign Research Division, Special Advisor). In her introductory remarks, Ms. Ritzberger-Grünwald recalled the instrumental role Olga Radzyner played in the East Jour Fixe series over the past years.

Ms. Cas Granje's presentation focused on "The European Commission's Economic Evaluation in the 1999 Regular Reports on the Enlargement Countries." By way of introduction, she outlined the main stations of the accession process so far. The Regular Reports 1999, she stressed, brought a change in strategy by proposing to open accession negotiations with all Central and Eastern European candidate countries in the year 2000. ECFIN would have preferred to link the opening of negotiations closely to the economic readiness of candidate countries, as this had been done in the 1997 avis and the 1998 regular reports, but did not succeed in pushing this view through. Ms. Cas Granje then turned to the main economic developments in the candidate countries since the publication of last year's Regular Reports, touching i.a. on the effects of the international financial crisis and the Kosovo conflict, macroeconomic developments and structural reforms in applicant countries (including FDI flows and trade integration). Subsequently, she reviewed the main conclusions and recommendations of the regular reports (see "Recent Developments" in this issue) and assessed them by elaborating on the different options the Commission had as well as the pros and cons of each of these options. Ms. Cas Granje underlined that under the former strategy, in which a positive recommendation for the opening of accession negotiations was based on the ability of a candidate to meet the Copenhagen economic criteria in the medium term, applicants had a genuine incentive to implement difficult structural reforms every year. Moreover, under the new strategy it may become more difficult to ensure that the economic criteria for EU membership are met



before accession. One possible way to deal with this problem would be to introduce a "suspense clause" into the Regular Reports procedure by which negotiations could come to a halt in countries where the economic reforms leading to the fulfillment of the economic criteria for EU membership go astray. Ms. Cas Granje argued that meeting the economic criteria for EU membership will be particularly important to secure a smooth integration of candidate countries in the field of Economic and Monetary Union.

Ms. Cas Granje's presentation was discussed by Mr. Andreas Wörgötter, Associate Professor and Head of the Department of Transition Economics at the Institute for Advanced Studies (Vienna), Mr. Sándor Richter, Senior Economist at The Vienna Institute for International Economic Studies (WIIW) and Mr. Wolfgang Nitsche, Deputy Director of the Division for Economic and Integration Affairs at Austria's Federal Ministry of Finance.

Mr. Wörgötter termed the 1999 regular reports "a right move into the wrong direction undoing a wrong move into the right direction." The Commission's original strategy was rightly based on differentiation but, according to Mr. Wörgötter, in implementing this approach, other reasons than those explicitly stated were driving the process. In 1997, the Commission proposed to open negotiations with Hungary and Poland, the two clear frontrunners, and with Estonia, the Czech Republic and Slovenia, thereby choosing one country from each of the three larger political entities which had fallen apart, i.e. from the Soviet Union, Czechoslovakia and Yugoslavia, thus giving a signal of being open for negotiations and eventual accession of other successor countries from these three areas. The Commission's new approach constitutes a proper basis for differentiation among candidate countries. However, this differentiation should be undertaken based on a multilateral approach, leaving room for special relationships between those applicants which enter the EU first and others which enter later. The Commission, however, pursues a bilateral approach that does not allow for such solutions. In Mr. Wörgötter's view, this has a number of disadvantages, which become evident when considering e.g. the effects of a scenario in which the Czech Republic would join the EU, while Slovakia would still have to wait for membership. Finally, Mr. Wörgötter asked what should be or should have been learned from the ten years of preaccession experience. He emphasized that applicants should not liberalize short-term capital movements prematurely, nor should they be pressed from the outside to do so. Furthermore, he argued that an undue preoccupation with macroeconomic stability appeared to be at odds with a dynamic catching-up process.

Mr. Richter underscored that the 1999 Regular Reports carry a very important positive message by clearly distinguishing between the Copenhagen criteria for EU membership and the Maastricht convergence criteria. This will help to refute views which claim that the EU implicitly requires candidate countries to fulfill the Maastricht criteria as a condition for joining the EU. A second message of the reports is that there will be only few transition arrangements in the core area of the single market while in other areas there is more room for such arrangements. In this context, Mr. Richter stressed that the real costs of adjustments in these other areas have not been properly assessed yet and that applicants may take on commitments which can barely

be fulfilled, thus adding to the shock EU accession will constitute anyway. Mr. Richter welcomed the Commission's proposal to phase out contingent protection instruments in industrial goods trade but questioned who would stand to gain from a further liberalization of agricultural trade, which the Commission has also suggested. In Mr. Richter's view, considering the target date of 2002 for the completion of internal reforms and the minimum duration of the ratification procedure for accession treaties, the earliest date for a first enlargement of the EU to the East is the year 2004. Finally, Mr. Richter summarized, in a comparative manner, the individual country assessments of the 1999 regular reports.

Mr. Nitsche raised the question of whether opening negotiations with all candidates would diminish the EU's leverage for reform. In his view, the evidence on this account has been mixed and, what is more, external pressure alone would not change much, if the internal preconditions for reform are not in place. Mr. Nitsche suggested that a thorough reform of EU support instruments, in particular PHARE, would be much more instrumental in strengthening the Union's impact on the reform process than the issue of opening negotiations or not. Mr. Nitsche then discussed the question of how the adoption of the *acquis* and the implementation of a dynamic growth strategy are interrelated. While some parts of the *acquis*, e.g. the rules on the supervision of the financial system, clearly promote growth, other areas, like the liberalization of short-term capital movements, may be disruptive to growth. In Mr. Nitsche's view, there is the danger that applicants do the easy things first. Candidates would therefore need more guidance by the Commission in order to get the timing and sequencing of the adoption of the *acquis* right.

In her reply to the discussants, Ms. Cas Granje stated that the consistency of the overall macro- and microeconomic policy mix is important for the success of the liberalization of capital movements and, in this context, referred to the case of Estonia. Capital controls, in turn, do not solve underlying problems. Also, she defended, from an economic viewpoint, the Commission's 1997 proposal to open negotiations with Estonia, given the bold implementation of reforms. As to the internal market, Ms. Cas Granje remarked that it would not be consistent to demand from the applicants to liberalize completely while the EU kept its labor markets closed. Potential restrictions on the purchase of real estate in the candidate countries would not cause concern in terms of macroeconomic stability nor with respect to the integration of applicants into EMU. As to the differentiation among candidates, Ms. Cas Granje expects that there will be some room for taking into account special relationships. She also stressed that the opening of negotiations will cause problems for several applicants, as they will have to allocate some of the already scarce public administration resources to the negotiations (and thus away from the adoption of the *acquis*).

In the ensuing general discussion, the issue of the liberalization of capital movements was brought up again and linked to the questions of current account sustainability and financial sector fragility. Furthermore, it was remarked that, as a consequence of opening negotiations with all Central and Eastern European candidates, it will be much more difficult to take in two or three applicants without reforming EU institutions beforehand.

# *Technical Cooperation of the Oesterreichische Nationalbank with Countries in Transition*

In 1999, the OeNB extended 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 continued its series of highly specialized seminars for central bankers started in 1997 with four one-week seminars on the following topics: 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), and EU/EMU – One Year of Experience (December 1999). In the year 2000, the Bank will offer seminars on Austria's First Five Years in the EU – Lessons and Experiences after One Year in EMU (March 20 to 24), Accounting in the OeNB as a Member of the ESCB (August 28 to September 1), Changeover to the Euro: Monetary Policy and Foreign Exchange Management – The OeNB's Experience with Monetary Policy Operations and Financial Reporting in the Eurosystem (September 11 to 15), and Payment Systems – Adapting to the ESCB Environment (October 9 to 13).

In addition to these seminars, bilateral contacts are upheld in a series of information visits and study tours. In May 1999, a delegation from Slovakia came to Vienna to gather information on open market operations. In August, a representative from the Albanian Ministry of Finance visited Vienna for two weeks to gain a broad insight into Austria's monetary policy. Moreover, an information visit on central bank controlling was organized for specialists from the Czech National Bank. A delegation of experts on electronic money from Belarus was welcomed in October 1999. In November, the OeNB and the National Bank of Hungary held a joint workshop in Budapest on central bank independence and related legal harmonization issues in the context of the preparations for Hungary's accession to the EU. For the first half of the year 2000, high-level workshops have been arranged with the Bank of Slovenia on central bank accounting and technical aspects of the introduction of euro coins and notes.

To further enhance the close cooperation with its counterparts in candidate countries, the OeNB in 1999 also invited specialists to participate in joint projects. An economist from the Czech National Bank came to Vienna in spring to conduct a research project on monetary transmission mechanisms in transition economies and a junior expert from the National Bank of Hungary spent a three-month internship in the OeNB's European Affairs Division.

On a multilateral level, the OeNB took part in the EU-financed technical assistance program for the Central Bank of Russia (CBR). In March 1999, the OeNB hosted a one-week study tour on balance of payments and financial statistics for employees of the CBR. This was followed by a one-week study tour on international accounting standards for a delegation of five representatives of the CBR.

In 1998, the Joint Vienna Institute's (JVI's) mandate was prolonged for another five years. For these second five years of operation of the JVI, the Austrian authorities were asked to increase their contribution to the academic program. Therefore, in 1999, the new course in Applied Economic

Policy (AEP), the successor of the former Comprehensive Course, for the first time had an "Austrian segment," which is jointly financed by the Austrian Ministry of Finance and the OeNB. In the first part of this segment, experts from a variety of academic and organizational backgrounds present 2½ days of lectures devoted to specific features of Austria's market economy, such as the political and economic structure, social partnership, issues of fiscal federalism, incomes policies, Austria's experience with EU accession and the introduction of the euro. In the second part, the so-called study tour, participants spend three days visiting companies, state and local government authorities, banks, media centers and the like to gain an insight into the structures of Austria's economy and administration.

The program for each study tour is organized by the OeNB. Moreover, Austria has agreed to 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 the Ministry of Finance have jointly organized two one-week seminars. The topics of these Austrian seminars in 1999 were as follows: The Changing Role of Government in Economic Reforms (October 1999), and Foreign Direct Investment and Privatization Policies (December 1999). On account of the overwhelming demand, these seminars will be repeated in May and June 2000, respectively. Austria's increased contribution to the JVI's academic program is a logical continuation of its long-standing support of the Institute.

S T A T I S T I C A L      A N N E X

## Gross Domestic Product

|                    | Bulgaria | Czech Republic | Estonia | Hungary | Latvia | Lithuania | Poland | Romania | Russia | Slovak Republic | Slovenia |
|--------------------|----------|----------------|---------|---------|--------|-----------|--------|---------|--------|-----------------|----------|
| Annual change in % |          |                |         |         |        |           |        |         |        |                 |          |
| 1989               | - 1.9    | + 4.5          | x       | + 0.7   | x      | x         | + 0.2  | - 5.8   | x      | + 1.0           | -1.8     |
| 1990               | - 9.1    | - 1.2          | x       | - 3.5   | x      | x         | -11.6  | - 5.6   | - 3.0  | - 2.5           | -4.7     |
| 1991               | -11.7    | -11.5          | x       | -11.9   | x      | x         | - 7.0  | -12.9   | - 5.0  | -14.6           | -8.9     |
| 1992               | - 7.3    | - 3.3          | -12.4   | - 3.1   | x      | x         | + 2.6  | - 8.8   | -14.5  | - 6.5           | -5.5     |
| 1993               | - 1.5    | + 0.6          | - 8.5   | - 0.6   | -14.9  | -16.2     | + 3.8  | + 1.5   | - 8.7  | - 3.7           | +2.8     |
| 1994               | + 1.8    | + 3.2          | - 2.0   | + 2.9   | + 0.6  | - 9.8     | + 5.2  | + 3.9   | -12.7  | + 4.9           | +5.3     |
| 1995               | + 2.9    | + 6.4          | + 4.3   | + 1.5   | - 0.8  | + 3.3     | + 7.0  | + 7.1   | - 4.1  | + 6.9           | +4.1     |
| 1996               | -10.1    | + 3.8          | + 3.9   | + 1.3   | + 3.3  | + 4.7     | + 6.0  | + 3.9   | - 3.4  | + 6.6           | +3.5     |
| 1997               | - 7.0    | + 0.3          | +10.6   | + 4.6   | + 8.6  | + 7.3     | + 6.8  | - 6.9   | + 0.9  | + 6.5           | +4.6     |
| 1998               | + 3.5    | - 2.3          | + 4.0   | + 5.1   | + 3.6  | + 5.1     | + 4.8  | - 7.3   | - 4.6  | + 4.4           | +3.9     |
| 1997               |          |                |         |         |        |           |        |         |        |                 |          |
| 1st quarter        | -11.7    | + 1.5          | +10.8   | + 2.1   | + 5.0  | + 5.2     | + 7.0  | x       | + 0.3  | + 6.3           | +3.2     |
| 2nd quarter        | - 8.3    | + 0.5          | +12.4   | + 4.3   | + 8.5  | + 9.0     | + 7.6  | x       | - 0.6  | + 6.2           | +5.4     |
| 3rd quarter        | -10.0    | - 0.1          | +11.5   | + 5.1   | +10.0  | + 6.4     | + 6.8  | x       | + 1.0  | + 6.6           | +3.0     |
| 4th quarter        | + 2.4    | + 2.2          | +13.5   | + 5.3   | +10.7  | + 4.5     | + 6.5  | x       | + 2.6  | + 6.9           | +6.5     |
| 1998               |          |                |         |         |        |           |        |         |        |                 |          |
| 1st quarter        | +18.5    | - 0.9          | + 9.3   | + 4.5   | + 8.9  | + 6.9     | + 6.5  | - 9.4   | - 0.1  | + 6.2           | +6.4     |
| 2nd quarter        | + 6.3    | - 2.4          | + 4.4   | + 5.1   | + 5.6  | + 9.7     | + 5.3  | - 1.0   | - 1.8  | + 6.1           | +3.0     |
| 3rd quarter        | - 5.9    | - 2.9          | + 1.7   | + 5.6   | + 2.2  | + 3.2     | + 4.9  | ..      | - 7.5  | + 5.1           | +4.0     |
| 4th quarter        | - 4.9    | - 4.1          | - 0.7   | + 5.2   | - 1.9  | + 0.2     | + 2.9  | ..      | - 7.8  | + 0.5           | +3.6     |
| 1999               |          |                |         |         |        |           |        |         |        |                 |          |
| 1st quarter        | - 0.7    | - 4.1          | - 5.6   | + 3.3   | - 2.3  | - 5.8     | + 1.5  | - 4.6   | - 2.8  | + 1.8           | +2.5     |
| 2nd quarter        | + 1.6    | + 0.4          | - 2.3   | + 3.8   | - 1.8  | - 4.0     | + 3.0  | - 3.2   | + 1.4  | + 2.9           | +6.4     |
| 3rd quarter        | ..       | + 0.8          | + 0.2   | ..      | ..     | ..        | + 4.9  | ..      | + 1.8  | + 0.6           | ..       |

Source: WIW (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 <sup>1)</sup> | Hungary | Latvia | Lithuania <sup>1)</sup> | Poland | Romania | Russia | Slovak Republic <sup>2)</sup> | Slovenia |
|--------------------|----------|----------------|-----------------------|---------|--------|-------------------------|--------|---------|--------|-------------------------------|----------|
| Annual change in % |          |                |                       |         |        |                         |        |         |        |                               |          |
| 1989               | - 1.1    | + 1.7          | x                     | - 2.1   | x      | x                       | - 0.5  | - 2.1   | + 1.4  | - 0.7                         | + 1.1    |
| 1990               | -16.7    | - 3.3          | x                     | -10.2   | x      | x                       | -24.2  | -19.0   | - 0.1  | - 4.0                         | -10.5    |
| 1991               | -20.2    | -21.2          | x                     | -16.6   | x      | - 4.9                   | - 8.0  | -22.8   | - 8.0  | -19.4                         | -12.4    |
| 1992               | -18.4    | - 7.9          | x                     | - 9.7   | -34.6  | -51.6                   | + 2.8  | -21.9   | -18.0  | - 9.3                         | -13.2    |
| 1993               | - 9.8    | - 5.3          | x                     | + 4.0   | -38.1  | -34.7                   | + 6.4  | + 1.3   | -14.1  | - 3.8                         | - 2.8    |
| 1994               | +10.6    | + 2.1          | - 2.1                 | + 9.6   | - 9.5  | -29.8                   | +12.1  | + 3.3   | -20.9  | + 4.8                         | + 6.4    |
| 1995               | + 4.5    | + 8.7          | + 2.0                 | + 4.6   | - 6.3  | + 0.9                   | + 9.7  | + 9.4   | - 3.3  | + 8.3                         | + 2.0    |
| 1996               | + 5.1    | + 2.0          | + 3.5                 | + 3.4   | + 1.4  | + 3.5                   | + 8.3  | + 6.3   | - 4.0  | + 2.5                         | + 1.0    |
| 1997               | -10.0    | + 4.5          | +13.0                 | +11.1   | + 6.1  | + 8.0                   | +11.5  | - 7.2   | + 1.9  | + 2.7                         | + 1.0    |
| 1998               | -12.7    | + 3.1          | + 0.8                 | +12.5   | + 2.0  | + 7.0                   | + 4.6  | -16.8   | - 5.2  | + 5.0                         | + 3.7    |
| 1998               |          |                |                       |         |        |                         |        |         |        |                               |          |
| July               | -14.0    | + 7.5          | + 1.3                 | +13.8   | + 3.0  | + 5.4                   | + 6.0  | -15.8   | - 9.4  | + 8.8                         | + 1.1    |
| August             | -15.0    | + 3.3          | - 2.2                 | +13.8   | + 3.3  | + 5.1                   | + 6.0  | -16.8   | -11.5  | + 9.3                         | + 8.6    |
| September          | -23.0    | + 1.3          | -10.7                 | +13.5   | - 7.8  | + 5.6                   | + 1.1  | - 5.4   | -14.5  | + 7.8                         | + 3.4    |
| October            | -19.0    | - 4.6          | -13.7                 | +12.9   | -12.1  | + 5.4                   | - 1.0  | -14.2   | -11.1  | + 1.0                         | + 0.9    |
| November           | - 9.0    | - 4.9          | - 8.4                 | +12.6   | - 9.0  | + 2.0                   | - 1.3  | -21.3   | - 9.1  | + 0.2                         | + 4.5    |
| December           | -15.6    | - 8.1          | + 3.6                 | +12.6   | -13.1  | -15.5                   | - 2.1  | -11.2   | - 6.6  | - 1.6                         | - 2.0    |
| 1999               |          |                |                       |         |        |                         |        |         |        |                               |          |
| January            | -23.0    | -11.1          | -15.2                 | + 7.3   | -14.2  | -11.3                   | - 6.0  | -12.1   | - 2.4  | - 4.3                         | - 1.0    |
| February           | -14.0    | - 8.1          | -11.7                 | + 6.2   | -12.0  | -13.0                   | - 5.8  | - 8.9   | - 3.0  | -11.4                         | - 7.7    |
| March              | -10.9    | - 7.9          | - 9.0                 | + 6.9   | -11.5  | - 4.3                   | + 3.3  | - 8.1   | + 0.4  | -11.8                         | - 0.4    |
| April              | -11.3    | - 4.8          | - 8.0                 | + 7.0   | -15.3  | + 3.1                   | + 0.3  | - 7.6   | + 0.6  | - 5.5                         | - 8.0    |
| May                | -14.9    | - 1.9          | - 7.4                 | + 6.2   | -16.0  | -11.1                   | + 2.2  | -10.0   | + 6.0  | -10.9                         | - 0.4    |
| June               | - 8.2    | - 3.2          | - 5.6                 | + 6.9   | -14.5  | - 5.5                   | + 1.0  | - 9.6   | + 9.0  | - 3.9                         | + 3.1    |
| July               | -16.1    | - 5.0          | - 6.7                 | + 6.6   | - 9.8  | -11.2                   | + 1.4  | - 9.6   | +12.8  | + 0.4                         | - 3.4    |
| August             | - 4.2    | + 1.5          | - 0.6                 | ..      | - 5.8  | -13.2                   | + 7.1  | - 9.6   | +16.0  | - 5.4                         | + 1.1    |
| September          | - 5.5    | ..             | + 3.4                 | ..      | - 1.1  | + 0.3                   | + 8.9  | - 9.6   | +20.2  | ..                            | ..       |
| October            | - 5.1    | ..             | + 5.2                 | ..      | - 2.1  | ..                      | ..     | + 0.0   | ..     | ..                            | ..       |

Source: Annual data: WIW; Estonia, Latvia, Lithuania: national sources. Monthly data: national sources.

<sup>1)</sup> Industrial sales.

<sup>2)</sup> In 1999 change in % against 1998 monthly average.

## Unemployment Rate

|                             | Bulgaria | Czech Republic | Estonia | Hungary | Latvia | Lithuania | Poland | Romania | Russia | Slovak Republic | Slovenia |
|-----------------------------|----------|----------------|---------|---------|--------|-----------|--------|---------|--------|-----------------|----------|
| <i>End of period (in %)</i> |          |                |         |         |        |           |        |         |        |                 |          |
| 1989                        | x        | x              | x       | 0.5     | x      | x         | x      | x       | x      | x               | 3.5      |
| 1990                        | 1.7      | 0.8            | x       | 2.0     | x      | x         | 6.3    | x       | x      | 1.6             | 5.8      |
| 1991                        | 11.1     | 4.1            | x       | 8.2     | x      | x         | 11.8   | 3.0     | x      | 11.8            | 10.1     |
| 1992                        | 15.2     | 2.6            | x       | 13.9    | 2.3    | x         | 13.6   | 8.2     | 5.2    | 10.4            | 13.4     |
| 1993                        | 16.4     | 3.5            | 4.1     | 14.0    | 5.8    | 3.4       | 16.4   | 10.4    | 6.0    | 14.4            | 15.4     |
| 1994                        | 12.8     | 3.2            | 4.1     | 12.0    | 6.5    | 3.8       | 16.0   | 10.9    | 7.7    | 14.8            | 14.2     |
| 1995                        | 11.1     | 2.9            | 4.0     | 11.7    | 6.6    | 6.1       | 14.9   | 9.5     | 9.0    | 13.1            | 14.5     |
| 1996                        | 12.5     | 3.5            | 4.3     | 11.4    | 7.2    | 7.1       | 13.2   | 6.6     | 9.9    | 12.8            | 14.4     |
| 1997                        | 13.7     | 5.2            | 3.6     | 11.0    | 7.0    | 6.7       | 10.3   | 8.9     | 11.2   | 12.5            | 14.8     |
| 1998                        | 12.2     | 7.5            | 4.0     | 9.6     | 7.6    | 6.9       | 10.4   | 10.3    | 13.3   | 15.6            | 14.6     |
| 1998                        |          |                |         |         |        |           |        |         |        |                 |          |
| July                        | 11.1     | 6.1            | 3.4     | 9.7     | 7.3    | 5.4       | 9.6    | 8.8     | 11.3   | 14.1            | 14.2     |
| August                      | 10.8     | 6.4            | 3.3     | 9.5     | 7.4    | 5.4       | 9.5    | 8.7     | 11.6   | 13.8            | 14.2     |
| September                   | 10.7     | 6.8            | 3.5     | 9.5     | 7.6    | 5.6       | 9.6    | 8.7     | 11.9   | 13.8            | 14.3     |
| October                     | 11.1     | 6.8            | 3.7     | 9.3     | 8.2    | 6.0       | 9.7    | 9.0     | 12.3   | 13.9            | 14.6     |
| November                    | 11.8     | 7.0            | 3.7     | 9.3     | 8.8    | 6.5       | 9.9    | 9.5     | 13.9   | 14.5            | 14.5     |
| December                    | 12.2     | 7.5            | 4.0     | 9.6     | 9.2    | 6.9       | 10.4   | 10.3    | 13.3   | 15.6            | 14.6     |
| 1999                        |          |                |         |         |        |           |        |         |        |                 |          |
| January                     | 12.9     | 8.1            | 4.5     | 10.3    | 9.4    | 7.7       | 11.4   | 11.1    | 13.8   | 16.3            | 14.5     |
| February                    | 13.2     | 8.3            | 4.8     | 10.5    | 9.8    | 8.1       | 11.9   | 12.0    | 14.1   | 16.5            | 14.3     |
| March                       | 13.2     | 8.4            | 5.3     | 10.4    | 10.1   | 8.5       | 12.1   | 11.9    | 13.6   | 16.7            | 14.1     |
| April                       | 13.3     | 8.2            | 5.3     | 10.0    | 10.2   | 8.1       | 11.8   | 11.6    | 13.0   | 16.4            | 14.0     |
| May                         | 13.0     | 8.1            | 5.2     | 9.6     | 10.1   | 7.8       | 11.6   | 11.4    | 12.4   | 16.5            | 13.7     |
| June                        | 12.8     | 8.4            | 5.0     | 9.4     | 10.0   | 7.5       | 11.6   | 11.3    | 12.0   | 17.7            | 13.4     |
| July                        | 13.0     | 8.8            | 5.0     | 9.5     | 9.9    | 7.8       | 11.8   | 11.3    | 11.8   | 18.3            | 13.4     |
| August                      | 13.6     | 9.0            | 5.0     | 9.4     | 9.8    | 8.1       | 11.9   | 10.9    | 11.7   | 18.2            | 13.3     |
| September                   | 14.2     | 9.0            | 5.2     | 9.4     | 9.5    | 8.4       | 12.1   | 10.8    | 11.7   | 17.8            | ..       |
| October                     | ..       | ..             | 5.2     | ..      | 9.3    | 8.9       | ..     | ..      | 11.7   | ..              | ..       |

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

## Consumer Price Index

|  | Bulgaria | Czech Republic | Estonia | Hungary | Latvia | Lithuania | Poland | Romania | Russia   | Slovak Republic | Slovenia |
|--|----------|----------------|---------|---------|--------|-----------|--------|---------|----------|-----------------|----------|
| <i>Period average (annual change in %)</i> |          |                |         |         |        |           |        |         |          |                 |          |
| 1989                                       | x        | + 1.4          | x       | +17.0   | x      | x         | +251.1 | + 1.1   | x        | x               | x        |
| 1990                                       | + 23.8   | + 9.7          | x       | +28.9   | x      | x         | +585.8 | + 5.1   | + 5.3    | +10.4           | x        |
| 1991                                       | + 338.5  | +56.6          | x       | +35.0   | x      | x         | + 70.3 | +170.2  | + 92.6   | +61.2           | x        |
| 1992                                       | + 91.2   | +11.1          | x       | +23.0   | +243.3 | x         | + 43.0 | +210.4  | +1,526.5 | +10.0           | +201.3   |
| 1993                                       | + 72.8   | +20.8          | +89.8   | +22.5   | +108.8 | +410.2    | + 35.3 | +256.1  | + 873.5  | +23.2           | + 32.3   |
| 1994                                       | + 96.0   | +10.0          | +47.7   | +18.8   | + 35.9 | + 72.2    | + 32.2 | +136.8  | + 307.0  | +13.4           | + 19.8   |
| 1995                                       | + 62.1   | + 9.1          | +28.8   | +28.2   | + 25.0 | + 39.7    | + 27.8 | + 32.3  | + 197.5  | + 9.9           | + 13.4   |
| 1996                                       | + 123.0  | + 8.8          | +23.1   | +23.6   | + 17.6 | + 24.6    | + 19.9 | + 38.8  | + 47.8   | + 5.8           | + 9.9    |
| 1997                                       | +1,082.3 | + 8.5          | +10.6   | +18.3   | + 8.4  | + 8.9     | + 14.9 | +154.8  | + 14.8   | + 6.1           | + 8.4    |
| 1998                                       | + 22.3   | +10.7          | + 8.2   | +14.3   | + 4.7  | + 5.1     | + 11.8 | + 59.1  | + 27.6   | + 6.7           | + 7.9    |
| 1998                                       |          |                |         |         |        |           |        |         |          |                 |          |
| July                                       | + 13.0   | +10.4          | + 8.1   | +14.1   | + 4.6  | + 5.1     | + 11.9 | + 56.0  | + 5.6    | + 7.0           | + 7.7    |
| August                                     | + 6.1    | + 9.4          | + 7.3   | +13.5   | + 3.7  | + 4.4     | + 11.3 | + 51.7  | + 9.5    | + 5.7           | + 7.6    |
| September                                  | + 5.5    | + 8.8          | + 6.7   | +12.5   | + 3.5  | + 3.7     | + 10.6 | + 50.8  | + 52.2   | + 5.9           | + 7.1    |
| October                                    | + 4.7    | + 8.2          | + 5.8   | +12.3   | + 2.9  | + 3.7     | + 9.9  | + 47.1  | + 58.8   | + 6.2           | + 6.9    |
| November                                   | + 3.2    | + 7.5          | + 4.9   | +11.2   | + 2.8  | + 2.7     | + 9.2  | + 43.8  | + 66.7   | + 5.9           | + 6.4    |
| December                                   | + 1.0    | + 6.8          | + 4.3   | +10.3   | + 2.8  | + 2.4     | + 8.6  | + 40.6  | + 84.4   | + 5.6           | + 6.5    |
| 1999                                       |          |                |         |         |        |           |        |         |          |                 |          |
| January                                    | + 0.5    | + 3.5          | + 4.5   | + 9.8   | + 2.6  | + 2.4     | + 6.9  | + 38.1  | + 96.9   | + 6.8           | + 6.1    |
| February                                   | - 1.9    | + 2.8          | + 3.8   | + 9.4   | + 2.6  | + 1.9     | + 5.6  | + 32.5  | + 103.2  | + 6.9           | + 5.6    |
| March                                      | - 2.8    | + 2.5          | + 3.6   | + 9.3   | + 2.3  | + 1.3     | + 6.2  | + 35.8  | + 107.6  | + 7.0           | + 5.1    |
| April                                      | - 3.6    | + 2.5          | + 3.3   | + 9.4   | + 1.5  | + 0.7     | + 6.3  | + 38.7  | + 113.1  | + 7.1           | + 4.6    |
| May  | - 4.7    | + 2.4          | + 3.3   | + 8.9   | + 1.9  | + 0.2     | + 6.4  | + 42.8  | + 116.7  | + 6.7           | + 4.3    |
| June                                       | - 3.3    | + 2.2          | + 3.1   | + 9.1   | + 1.9  | + 0.6     | + 6.5  | + 48.2  | + 120.5  | + 7.1           | + 4.3    |
| July                                       | + 1.3    | + 1.1          | + 2.6   | +10.1   | + 1.7  | - 0.2     | + 6.3  | + 48.6  | + 126.3  | +13.6           | + 6.0    |
| August                                     | + 3.2    | + 1.4          | + 2.6   | +10.9   | + 2.1  | + 0.2     | + 7.2  | + 49.5  | + 120.9  | +14.4           | + 6.8    |
| September                                  | + 1.7    | + 1.2          | + 2.8   | +10.9   | + 2.3  | + 1.4     | + 8.0  | + 50.2  | + 62.0   | +14.7           | + 7.5    |
| October                                    | ..       | ..             | + 2.8   | ..      | + 2.8  | + 0.2     | ..     | ..      | + 57.2   | ..              | ..       |
| November                                   | ..       | ..             | + 3.2   | ..      | ..     | + 0.2     | ..     | ..      | + 50.5   | ..              | ..       |

Source: WIW; Estonia, Latvia, Lithuania: IMF; Latvia: national source from September 1999; Russia: national source from October 1999.

## Trade Balance

|             | Bulgaria | Czech Republic | Estonia  | Hungary  | Latvia <sup>1)</sup> | Lithuania | Poland    | Romania   | Russia   | Slovak Republic | Slovenia |
|-------------|----------|----------------|----------|----------|----------------------|-----------|-----------|-----------|----------|-----------------|----------|
| USD million |          |                |          |          |                      |           |           |           |          |                 |          |
| 1989        | x        | x              | x        | 537.0    | x                    | x         | x         | x         | x        | x               | x        |
| 1990        | x        | x              | x        | 348.0    | x                    | x         | x         | -3,427.0  | x        | x               | x        |
| 1991        | x        | x              | x        | 189.0    | x                    | x         | x         | -4,790.1  | x        | x               | x        |
| 1992        | x        | x              | x        | -48.0    | -40.3                | x         | x         | -5,671.0  | x        | x               | 791.1    |
| 1993        | x        | 346.0          | -144.8   | -3,247.0 | 18.6                 | -153.1    | -2,293.0  | -6,060.0  | x        | -862.3          | -154.2   |
| 1994        | x        | -715.8         | -356.9   | -3,635.0 | -301.1               | -201.6    | -836.0    | -6,535.0  | 17,675.0 | 84.5            | -337.5   |
| 1995        | x        | -3,606.6       | -666.1   | -2,442.0 | -580.7               | -192.1    | -1,827.0  | -9,588.0  | 20,476.0 | -191.7          | -954.3   |
| 1996        | 187.6    | -5,811.2       | -1,019.4 | -2,645.0 | -799.1               | -896.2    | -8,154.0  | -10,780.9 | 22,933.0 | -2,284.1        | -881.7   |
| 1997        | 380.3    | -4,392.0       | -349.1   | -1,734.0 | -849.6               | -1,147.5  | -11,320.0 | -10,620.2 | 17,361.0 | -2,018.7        | -771.6   |
| 1998        | -380.7   | -2,434.8       | -1,115.3 | -2,121.0 | -1,126.8             | -1,518.3  | -13,667.0 | -11,143.6 | 16,851.0 | -2,288.6        | -774.9   |
| 1998        |          |                |          |          |                      |           |           |           |          |                 |          |
| July        | -45.2    | -288.0         | x        | -283.0   | x                    | x         | -988.0    | -367.0    | x        | -186.7          | -7.9     |
| August      | -53.0    | -145.5         | x        | -161.0   | x                    | x         | -780.0    | -210.9    | x        | -175.1          | -30.6    |
| September   | -41.0    | 4.8            | -314.4   | -281.0   | -214.2               | -411.6    | -1,528.0  | -432.0    | 4,794.0  | -124.7          | -7.8     |
| October     | -62.5    | -148.3         | x        | -207.0   | x                    | x         | -1,375.0  | -355.4    | x        | -302.1          | -59.0    |
| November    | -30.0    | -323.2         | x        | -269.0   | x                    | x         | -1,326.0  | -299.0    | x        | -180.4          | -58.3    |
| December    | -144.6   | -567.7         | -236.9   | -322.0   | -240.2               | -462.6    | -1,604.0  | -442.3    | 9,591.0  | -235.4          | -116.1   |
| 1999        |          |                |          |          |                      |           |           |           |          |                 |          |
| January     | -75.5    | -71.5          | x        | -96.0    | -56.5                | x         | -1,212.0  | -172.7    | x        | -76.9           | -4.3     |
| February    | -63.4    | -114.6         | x        | -83.0    | -67.9                | x         | -784.0    | -106.8    | x        | -109.2          | -80.1    |
| March       | -84.7    | -318.3         | -184.1   | -338.0   | -99.1                | -254.3    | -825.0    | -140.1    | 6,510.0  | -144.7          | -138.2   |
| April       | -107.7   | -98.4          | x        | -153.0   | -93.4                | x         | -1,036.0  | -204.1    | x        | -113.0          | -173.4   |
| May         | -101.2   | -16.6          | x        | -80.0    | -82.3                | x         | -1,031.0  | -215.2    | x        | -210.6          | -133.7   |
| June        | -94.6    | -86.3          | -198.1   | -295.0   | -107.2               | -406.1    | -1,303.0  | -181.0    | 6,413.0  | -8.8            | -265.3   |
| July        | -93.7    | -207.3         | x        | -167.0   | ..                   | x         | -1,322.0  | -64.3     | x        | -42.3           | -56.6    |
| August      | -43.7    | -92.2          | x        | -117.0   | ..                   | x         | -1,233.0  | 25.0      | x        | -33.2           | -23.4    |
| September   | -78.0    | 30.4           | ..       | -210.0   | ..                   | -312.5    | -1,275.0  | ..        | 8,380.0  | ..              | 49.8     |
| October     | ..       | ..             | x        | -217.0   | ..                   | x         | ..        | ..        | x        | ..              | -71.9    |

Source: national central banks; Latvia: Central Statistical Office.

<sup>1)</sup> Up to December 1998: quarterly data.

## Current Account

|             | Bulgaria | Czech Republic | Estonia  | Hungary  | Latvia | Lithuania | Poland   | Romania  | Russia   | Slovak Republic <sup>1)</sup> | Slovenia |
|-------------|----------|----------------|----------|----------|--------|-----------|----------|----------|----------|-------------------------------|----------|
| USD million |          |                |          |          |        |           |          |          |          |                               |          |
| 1989        | x        | x              | x        | -1,437.0 | x      | x         | x        | x        | x        | x                             | x        |
| 1990        | x        | x              | x        | 127.0    | x      | x         | x        | -3,337.0 | x        | x                             | x        |
| 1991        | x        | x              | x        | 267.0    | x      | x         | -1,359.0 | -1,012.0 | x        | x                             | x        |
| 1992        | x        | x              | x        | 324.0    | 191.4  | x         | -269.0   | -1,564.0 | x        | x                             | 926.2    |
| 1993        | x        | 455.8          | 21.6     | -3,455.0 | 428.0  | -83.5     | -2,329.0 | -1,174.0 | 12,792.0 | -601.2                        | 191.9    |
| 1994        | x        | -786.8         | -166.5   | -3,911.0 | 200.8  | -90.4     | -944.0   | -428.0   | 8,870.0  | 664.9                         | 600.1    |
| 1995        | x        | -1,369.1       | -157.9   | -2,480.0 | -17.9  | -56.6     | 5,455.0  | -1,774.0 | 7,778.0  | 391.4                         | -22.8    |
| 1996        | x        | -4,292.2       | -397.9   | -1,678.0 | -280.0 | -722.6    | -1,352.0 | -2,571.0 | 12,181.0 | -601.2                        | 39.0     |
| 1997        | 426.5    | -3,211.0       | -563.4   | -981.0   | -346.2 | -981.3    | -4,312.0 | -2,137.0 | 3,981.0  | -1,952.3                      | 36.6     |
| 1998        | -61.4    | -1,059.1       | -446.9   | -2,298.0 | -707.8 | -1,298.0  | -6,810.0 | -3,010.0 | 1,643.0  | -2,063.1                      | -3.8     |
| 1998        |          |                |          |          |        |           |          |          |          |                               |          |
| July        | -72.6    | x              | x        | -167.0   | x      | x         | -201.0   | -248.0   | x        | -149.2                        | 30.5     |
| August      | 7.3      | x              | x        | 61.0     | x      | x         | 281.0    | -155.0   | x        | -161.1                        | 58.2     |
| September   | -33.7    | -45.6          | -110.2   | -326.0   | -31.4  | -376.5    | -1,295.0 | -370.0   | 775.0    | -137.3                        | 72.7     |
| October     | -65.2    | x              | x        | -108.0   | x      | x         | -963.0   | -382.0   | x        | -266.7                        | 1.1      |
| November    | -11.5    | x              | x        | -159.0   | x      | x         | -830.0   | -286.0   | x        | -75.6                         | -4.9     |
| December    | -113.0   | -838.8         | -101.6   | -694.0   | -41.9  | -400.6    | -1,187.0 | -494.0   | 6,110.0  | -178.7                        | -51.3    |
| 1999        |          |                |          |          |        |           |          |          |          |                               |          |
| January     | -164.9   | x              | x        | -175.0   | x      | x         | -894.0   | -120.0   | x        | -28.6                         | 72.7     |
| February    | -42.2    | x              | x        | -64.0    | x      | x         | -512.0   | -72.0    | x        | -118.3                        | -30.9    |
| March       | -58.9    | -315.1         | -88.2    | -359.0   | -18.9  | -215.5    | -833.0   | -85.0    | 5,470.0  | -109.7                        | -73.1    |
| April       | -90.2    | x              | x        | -178.0   | x      | x         | -938.0   | -151.0   | x        | -134.2                        | -121.5   |
| May         | -52.4    | x              | x        | -59.0    | x      | x         | -690.0   | -162.0   | x        | -311.8                        | -116.9   |
| June        | -43.9    | 279.0          | -1,020.6 | -383.0   | -91.7  | -1,515.1  | -1,138.0 | -131.0   | 3,508.0  | -28.6                         | -213.6   |
| July        | -70.5    | x              | x        | -136.0   | x      | x         | -1,055.0 | -9.0     | x        | -28.8                         | 51.2     |
| August      | 54.6     | x              | x        | 154.0    | x      | x         | -786.0   | 22.0     | x        | ..                            | 34.6     |
| September   | -0.3     | -151.2         | 294.8    | -88.0    | ..     | -1,003.1  | -1,115.0 | ..       | 5,620.0  | ..                            | -34.3    |
| October     | ..       | x              | x        | -54.0    | x      | x         | ..       | ..       | x        | ..                            | -12.5    |

Source: national central banks; Latvia: Central Statistical Office.

<sup>1)</sup> Beginning with 1997: BOP Manual, 5<sup>th</sup> edition.



## Total Reserves Minus Gold

|                             | Bulgaria | Czech Republic | Estonia | Hungary | Latvia | Lithuania | Poland   | Romania | Russia   | Slovak Republic | Slovenia |
|-----------------------------|----------|----------------|---------|---------|--------|-----------|----------|---------|----------|-----------------|----------|
| End of period (USD million) |          |                |         |         |        |           |          |         |          |                 |          |
| 1989                        | x        | x              | x       | 1,246   | x      | x         | 2,314.3  | 1,859   | x        | x               | x        |
| 1990                        | x        | x              | x       | 1,069   | x      | x         | 4,492.1  | 524     | x        | x               | x        |
| 1991                        | 311      | x              | x       | 3,934   | x      | x         | 3,632.6  | 695     | x        | x               | 112.1    |
| 1992                        | 902      | 755            | 170.2   | 4,425   | x      | 45.3      | 4,099.1  | 826     | x        | x               | 715.5    |
| 1993                        | 655      | 3,789          | 386.1   | 6,700   | 431.6  | 350.3     | 4,091.9  | 995     | 5,835.0  | 415.7           | 787.8    |
| 1994                        | 1,002    | 6,144          | 443.4   | 6,735   | 545.2  | 525.5     | 5,841.8  | 2,086   | 3,980.4  | 1,691.2         | 1,499.0  |
| 1995                        | 1,236    | 13,843         | 579.9   | 11,974  | 505.7  | 757.1     | 14,774.1 | 1,579   | 14,382.8 | 3,363.9         | 1,820.8  |
| 1996                        | 484      | 12,352         | 636.8   | 9,720   | 654.1  | 772.3     | 17,844.0 | 2,103   | 11,276.4 | 3,418.9         | 2,297.4  |
| 1997                        | 2,249    | 9,733          | 757.7   | 8,408   | 704.0  | 1,010.0   | 20,407.2 | 3,803   | 12,894.7 | 3,230.3         | 3,314.7  |
| 1998                        | 2,831    | 12,542         | 810.6   | 9,319   | 728.2  | 1,409.1   | 26,432.3 | 2,867   | 7,801.4  | 2,868.8         | 3,638.5  |
| 1998                        |          |                |         |         |        |           |          |         |          |                 |          |
| July                        | 2,679    | 11,393         | 734.7   | 9,746   | 814.3  | 1,669.1   | 25,810.6 | 3,210   | 13,805.1 | 3,715.5         | 3,568.1  |
| August                      | 2,508    | 11,435         | 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    | 12,345         | 783.8   | 8,790   | 739.2  | 1,472.2   | 26,112.0 | 2,872   | 8,840.3  | 3,055.8         | 3,821.8  |
| October                     | 2,599    | 12,704         | 754.4   | 8,249   | 685.2  | 1,438.5   | 26,148.6 | 2,687   | 9,656.1  | 2,932.2         | 3,852.9  |
| November                    | 2,620    | 12,351         | 724.2   | 8,704   | 714.0  | 1,377.1   | 26,455.6 | 2,376   | 8,174.8  | 2,884.1         | 3,731.5  |
| December                    | 2,831    | 12,542         | 810.6   | 9,319   | 728.2  | 1,409.1   | 26,432.3 | 2,865   | 7,801.4  | 2,868.8         | 3,638.5  |
| 1999                        |          |                |         |         |        |           |          |         |          |                 |          |
| January                     | 2,623    | 12,409         | 759.0   | 8,983   | 724.3  | 1,309.7   | 26,141.6 | 2,746   | 7,078.2  | 2,805.8         | 3,543.8  |
| February                    | 2,629    | 12,077         | 730.3   | 9,432   | 720.1  | 1,284.6   | 25,858.7 | 2,397   | 7,284.2  | 2,855.6         | 3,523.3  |
| March                       | 2,599    | 11,874         | 705.0   | 8,834   | 746.0  | 1,339.2   | 25,674.2 | 2,393   | 6,678.5  | 2,759.8         | 3,868.1  |
| April                       | 2,575    | 11,958         | 816.8   | 8,680   | 736.6  | 1,379.7   | 25,459.6 | 2,430   | 7,074.3  | 2,677.1         | 3,760.0  |
| May                         | 2,539    | 11,715         | 634.8   | 8,746   | 871.9  | 1,302.0   | 25,257.3 | 1,938   | 8,033.7  | 2,250.3         | 3,531.0  |
| June                        | 2,581    | 11,693         | 728.3   | 9,339   | 887.0  | 1,261.8   | 24,985.9 | 1,825   | 8,189.5  | 2,898.5         | 3,310.8  |
| July                        | 2,454    | 11,999         | 811.7   | 9,770   | 879.3  | 1,231.3   | 25,479.2 | 2,007   | 7,826.9  | 2,810.0         | 3,290.2  |
| August                      | 2,572    | 11,872         | 789.4   | 9,762   | 814.3  | 1,183.0   | 25,299.1 | 2,391   | 6,823.8  | 2,750.4         | 3,191.9  |
| September                   | 2,689    | 11,938         | 780.6   | 10,275  | 767.6  | 1,167.2   | 25,042.3 | 2,601   | 6,633.5  | 2,880.0         | 3,195.3  |
| October                     | 2,690    | 13,135         | 786.6   | 10,199  | 856.4  | 1,191.8   | ..       | 2,672   | 7,080.9  | 2,897.6         | 3,170.4  |
| November                    | 2,709    | ..             | 707.1   | 10,850  | 854.0  | 1,315.5   | ..       | ..      | 7,598.5  | ..              | ..       |

Source: IMF.

## Central Government Surplus / Deficit

|             | Bulgaria | Czech Republic | Estonia <sup>1)</sup> | Hungary | Latvia | Lithuania | Poland <sup>2)</sup> | Romania <sup>3)</sup> | Russia | Slovak Republic | Slovenia <sup>4)</sup> |
|-------------|----------|----------------|-----------------------|---------|--------|-----------|----------------------|-----------------------|--------|-----------------|------------------------|
| % of GDP    |          |                |                       |         |        |           |                      |                       |        |                 |                        |
| 1989        | x        | -1.2           | x                     | - 3.1   | x      | x         | -3.0                 | +7.5                  | x      | -0.5            | x                      |
| 1990        | x        | -0.2           | x                     | - 0.1   | x      | x         | +0.4                 | -0.4                  | x      | -0.2            | x                      |
| 1991        | x        | -2.0           | x                     | - 4.6   | x      | x         | -3.8                 | -1.9                  | x      | -3.4            | +2.6                   |
| 1992        | - 5.8    | -0.2           | x                     | - 6.7   | -3.0   | x         | -6.0                 | -4.4                  | -10.4  | -2.8            | +0.2                   |
| 1993        | -11.0    | +0.1           | - 0.4                 | - 5.6   | -0.2   | x         | -2.8                 | -1.7                  | - 6.5  | -6.2            | +0.3                   |
| 1994        | - 6.2    | +0.9           | - 0.6                 | - 8.1   | -1.9   | -1.9      | -2.7                 | -4.2                  | -11.4  | -5.2            | -0.2                   |
| 1995        | - 6.6    | +0.5           | + 0.3                 | - 5.5   | -3.8   | -1.8      | -2.4                 | -4.1                  | - 5.4  | -1.6            | -0.0                   |
| 1996        | -10.9    | -0.1           | - 1.6                 | - 1.9   | -0.8   | -2.5      | -2.4                 | -4.9                  | - 7.9  | -4.4            | +0.3                   |
| 1997        | - 3.9    | -0.9           | + 1.5                 | - 4.0   | +1.2   | -1.0      | -1.3                 | -3.6                  | - 7.0  | -2.6            | -1.2                   |
| 1998        | + 1.5    | -1.6           | - 1.8                 | - 3.7   | +0.2   | ..        | -2.4                 | -3.1                  | - 5.0  | -2.7            | -0.8                   |
| 1997        |          |                |                       |         |        |           |                      |                       |        |                 |                        |
| 1st quarter | - 7.4    | -2.2           | - 0.7                 | - 5.8   | +1.4   | -0.5      | -3.5                 | -4.8                  | - 7.2  | -2.9            | x                      |
| 2nd quarter | - 3.8    | -1.5           | - 0.4                 | - 2.6   | +2.1   | -1.0      | -3.7                 | -2.1                  | - 8.1  | -6.0            | x                      |
| 3rd quarter | - 0.9    | +1.1           | + 4.6                 | - 3.8   | +1.4   | +1.3      | +1.7                 | -4.2                  | - 6.4  | -8.7            | x                      |
| 4th quarter | - 2.6    | -1.1           | + 2.3                 | - 4.2   | -0.1   | -3.5      | +0.1                 | -3.5                  | - 5.7  | -5.2            | x                      |
| 1998        |          |                |                       |         |        |           |                      |                       |        |                 |                        |
| 1st quarter | + 7.2    | +2.0           | - 0.7                 | - 7.6   | +3.1   | -0.7      | -3.0                 | -3.4                  | - 4.6  | +0.7            | x                      |
| 2nd quarter | - 5.7    | -1.3           | - 0.1                 | - 0.7   | +1.0   | -0.7      | -4.4                 | -4.9                  | - 5.6  | -2.7            | x                      |
| 3rd quarter | + 6.6    | +1.0           | - 1.5                 | - 3.0   | +0.8   | +0.3      | -0.8                 | -0.2                  | - 3.0  | -2.4            | x                      |
| 4th quarter | - 2.7    | -7.2           | - 5.1                 | -10.1   | -3.8   | -3.9      | -1.8                 | -3.0                  | - 6.1  | -5.9            | x                      |
| 1999        |          |                |                       |         |        |           |                      |                       |        |                 |                        |
| 1st quarter | + 1.8    | +0.5           | - 8.6                 | - 9.0   | +0.3   | -1.3      | -6.5                 | -2.0                  | - 4.4  | +0.6            | x                      |
| 2nd quarter | + 3.7    | -1.7           | -10.2                 | - 2.5   | -5.2   | -3.8      | -1.8                 | -5.6                  | ..     | -4.1            | x                      |
| 3rd quarter | - 6.5    | -0.6           | - 1.2                 | - 1.4   | -1.7   | ..        | +0.0                 | -3.4                  | ..     | -2.6            | x                      |

Source: WIW; Russia: IMF; Latvia, Lithuania: national sources; Estonia: national sources from 1996. Quarterly data: national sources.

<sup>1)</sup> Including social budget in 1993 and 1994.

<sup>2)</sup> Up to 1990: general government surplus/deficit; since 1998: privatization receipts treated as financing items.

<sup>3)</sup> 1990: including social insurance budget.

<sup>4)</sup> General government deficit; 1998: according to old methodology.

## Gross Debt in Convertible Currencies

|      | Bulgaria    | Czech Republic | Estonia | Hungary  | Latvia | Lithuania | Poland   | Romania <sup>1)</sup> | Russia    | Slovak Republic <sup>2)</sup> | Slovenia |
|------|-------------|----------------|---------|----------|--------|-----------|----------|-----------------------|-----------|-------------------------------|----------|
|      | USD million |                |         |          |        |           |          |                       |           |                               |          |
| 1989 | 9,201.0     | x              | x       | 20,751.0 | x      | x         | 40,800.0 | 1,062.0               | 52,400.0  | x                             | x        |
| 1990 | 10,007.0    | x              | x       | 21,505.0 | x      | x         | 48,475.0 | 1,140.0               | 56,200.0  | x                             | 1,954.0  |
| 1991 | 12,247.1    | x              | x       | 22,812.0 | x      | x         | 48,412.0 | 2,131.0               | 70,100.0  | x                             | 1,866.0  |
| 1992 | 13,805.7    | 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 | 13,836.4    | 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 | 11,338.4    | 12,209.7       | 186.0   | 28,526.0 | 373.8  | 494.0     | 42,174.0 | 5,563.0               | 121,600.0 | 4,310.0                       | 2,258.0  |
| 1995 | 10,148.0    | 17,190.3       | 286.4   | 31,660.0 | 462.6  | 763.0     | 43,957.0 | 6,482.0               | 120,500.0 | 5,827.0                       | 2,970.0  |
| 1996 | 9,601.6     | 21,180.5       | 405.3   | 27,617.0 | 472.2  | 1,286.0   | 40,558.0 | 8,345.0               | 125,000.0 | 7,810.0                       | 4,010.0  |
| 1997 | 9,760.2     | 21,616.5       | 658.0   | 23,747.0 | 503.0  | 1,541.0   | 38,495.7 | 9,502.0               | 130,800.0 | 10,700.0                      | 4,176.0  |
| 1998 | 10,241.6    | 24,347.7       | ..      | 26,746.8 | ..     | ..        | 42,687.2 | 9,658.0               | 145,000.0 | 11,800.0                      | 4,959.0  |

Source: WIW; Estonia, Latvia, Lithuania: World Bank; Czech Republic: national sources from 1997.

<sup>1)</sup> Medium- and long-term gross debt.

<sup>2)</sup> 1998: The official level of foreign debt was USD 9.9 billion; however, this figure was distorted by an accounting operation.

## Exchange Rate

|           | Bulgaria  | Czech Republic | Estonia | Hungary | Latvia   | Lithuania | Poland   | Romania | Russia   | Slovak Republic | Slovenia |
|-----------|---|----------------|---------|---------|----------|-----------|----------|---------|----------|-----------------|----------|
|           | Period average (ATS per 100 units of national currency) <sup>1)</sup> |                |         |         |          |           |          |         |          |                 |          |
| 1989      | 1,575.08  | x              | x       | 22.40   | x        | x         | 9,194.37 | 88.67   | x        | x               | x        |
| 1990      | 519.17  | x              | x       | 17.99   | x        | x         | 1,196.82 | 50.69   | x        | x               | x        |
| 1991      | 65.64   | x              | x       | 15.62   | x        | x         | 1,104.00 | 15.29   | x        | x               | 42.35    |
| 1992      | 47.08   | x              | x       | 13.91   | 1,492.10 | 619.88    | 806.49   | 3.57    | x        | x               | 13.52    |
| 1993      | 42.16   | 39.90          | 87.97   | 12.65   | 1,722.52 | 267.77    | 642.13   | 1.53    | 1,162.41 | 37.80           | 10.27    |
| 1994      | 21.10   | 39.68          | 87.92   | 10.86   | 2,040.34 | 287.14    | 502.65   | 0.69    | 516.66   | 35.64           | 8.87     |
| 1995      | 15.01   | 37.99          | 87.94   | 8.02    | 1,910.82 | 252.04    | 415.73   | 0.50    | 219.13   | 33.93           | 8.51     |
| 1996      | 5.95  | 39.00          | 87.97   | 6.94    | 1,922.04 | 264.67    | 392.66   | 0.34    | 204.87   | 34.54           | 7.82     |
| 1997      | 0.73  | 38.50          | 87.92   | 6.53    | 2,100.91 | 305.11    | 372.16   | 0.17    | 209.07   | 36.30           | 7.64     |
| 1998      | 0.70  | 38.33          | 87.95   | 5.77    | 2,098.86 | 309.48    | 356.19   | 0.14    | 127.55   | 35.13           | 7.45     |
| 1998      |   |                |         |         |          |           |          |         |          |                 |          |
| July      | 0.70  | 39.59          | 87.93   | 5.81    | 2,104.36 | 316.18    | 365.61   | 0.15    | 203.45   | 36.20           | 7.48     |
| August    | 0.70  | 39.12          | 87.99   | 5.68    | 2,086.73 | 314.58    | 350.99   | 0.14    | 186.43   | 35.70           | 7.46     |
| September | 0.70  | 39.00          | 87.94   | 5.44    | 2,041.60 | 299.61    | 332.29   | 0.13    | 82.50    | 34.38           | 7.44     |
| October   | 0.70  | 39.38          | 87.90   | 5.34    | 2,020.51 | 287.92    | 329.48   | 0.12    | 72.33    | 32.03           | 7.43     |
| November  | 0.70  | 39.75          | 87.97   | 5.43    | 2,060.85 | 295.73    | 367.47   | 0.12    | 71.82    | 32.79           | 7.39     |
| December  | 0.70  | 39.04          | 87.92   | 5.40    | 2,055.17 | 293.38    | 336.65   | 0.11    | 58.70    | 32.41           | 7.32     |
| 1999      |   |                |         |         |          |           |          |         |          |                 |          |
| January   | 0.05  | 2.81           | 6.39    | 0.40    | 151.14   | 21.54     | 24.33    | 0.01    | 3.87     | 2.34            | 0.53     |
| February  | 0.05  | 2.66           | 6.40    | 0.40    | 154.13   | 22.31     | 23.52    | 0.01    | 3.90     | 2.33            | 0.53     |
| March     | 0.05  | 2.64           | 6.40    | 0.39    | 156.54   | 22.97     | 23.30    | 0.01    | 3.91     | 2.26            | 0.53     |
| April     | 0.05  | 2.63           | 6.39    | 0.40    | 158.36   | 23.36     | 23.35    | 0.01    | 3.78     | 2.23            | 0.52     |
| May       | 0.05  | 2.66           | 6.39    | 0.40    | 158.68   | 23.53     | 23.90    | 0.01    | 3.85     | 2.18            | 0.52     |
| June      | 0.05  | 2.69           | 6.40    | 0.40    | 161.41   | 24.09     | 24.44    | 0.01    | 3.97     | 2.20            | 0.52     |
| July      | 0.05  | 2.74           | 6.39    | 0.40    | 161.59   | 24.16     | 24.89    | 0.01    | 3.98     | 2.22            | 0.51     |
| August    | 0.05  | 2.75           | 6.39    | 0.39    | 160.96   | 23.58     | 23.87    | 0.01    | 3.82     | 2.24            | 0.51     |
| September | 0.05  | 2.75           | 6.39    | 0.39    | 163.64   | 23.81     | 23.34    | 0.01    | 3.74     | 2.29            | 0.51     |
| October   | 0.05  | 2.74           | 6.39    | 0.39    | 162.15   | 23.35     | 22.73    | 0.01    | 3.63     | 2.30            | 0.51     |
| November  | 0.05  | 2.75           | 6.39    | 0.39    | 166.40   | 24.17     | 22.73    | 0.01    | 3.68     | 2.42            | 0.51     |

Source: IMF; Poland: OeNB from November 1999; Romania, Slovak Republic: OeNB, end of period from November 1999.

<sup>1)</sup> Up to December 31, 1998 in ATS; as of January 1, 1999, in EUR.

# Official Lending Rate<sup>1)</sup>

|                      | Bulgaria | Czech Republic | Estonia | Hungary <sup>2)</sup> | Latvia | Lithuania | Poland | Romania | Russia <sup>3)</sup> | Slovak Republic | Slovenia |
|----------------------|----------|----------------|---------|-----------------------|--------|-----------|--------|---------|----------------------|-----------------|----------|
| <i>End of period</i> |          |                |         |                       |        |           |        |         |                      |                 |          |
| 1989                 | x        | x              | x       | 17.0                  | x      | x         | 104.0  | x       | x                    | x               | x        |
| 1990                 | 4.5      | x              | x       | 22.0                  | x      | x         | 48.0   | x       | x                    | x               | x        |
| 1991                 | 54.0     | 9.5            | x       | 22.0                  | x      | x         | 36.0   | 18.0    | 5.0                  | 9.5             | x        |
| 1992                 | 41.0     | 9.5            | x       | 21.0                  | 120.0  | x         | 32.0   | 70.0    | 80.0                 | 9.5             | 25.0     |
| 1993                 | 52.0     | 8.0            | x       | 22.0                  | 27.0   | x         | 29.0   | 70.0    | 210.0                | 12.0            | 18.0     |
| 1994                 | 72.0     | 8.5            | x       | 25.0                  | 25.0   | x         | 28.0   | 58.0    | 180.0                | 12.0            | 16.0     |
| 1995                 | 34.0     | 9.5            | x       | 28.0                  | 24.0   | x         | 25.0   | 35.0    | 160.0                | 9.8             | 10.0     |
| 1996                 | 180.0    | 10.5           | x       | 23.0                  | 9.5    | x         | 22.0   | 35.0    | 48.0                 | 8.8             | 10.0     |
| 1997                 | 6.7      | 13.0           | x       | 20.5                  | 4.0    | 13.0      | 24.5   | 40.0    | 28.0                 | 8.8             | 10.0     |
| 1998                 | 5.1      | 7.5            | x       | 17.0                  | 4.0    | 13.0      | 18.3   | 35.0    | 60.0                 | 8.8             | 10.0     |
| 1998                 |          |                |         |                       |        |           |        |         |                      |                 |          |
| July                 | 5.2      | 13.0           | x       | 19.0                  | 4.0    | 13.0      | 21.5   | 40.0    | 60.0                 | 8.8             | 10.0     |
| August               | 5.1      | 11.5           | x       | 18.0                  | 4.0    | 13.0      | 21.5   | 35.0    | 60.0                 | 8.8             | 10.0     |
| September            | 5.1      | 11.5           | x       | 18.0                  | 4.0    | 13.0      | 21.5   | 35.0    | 60.0                 | 8.8             | 10.0     |
| October              | 5.3      | 10.0           | x       | 18.0                  | 4.0    | 13.0      | 20.0   | 35.0    | 60.0                 | 8.8             | 10.0     |
| November             | 5.1      | 10.0           | x       | 18.0                  | 4.0    | 13.0      | 20.0   | 35.0    | 60.0                 | 8.8             | 10.0     |
| December             | 5.1      | 7.5            | x       | 17.0                  | 4.0    | 13.0      | 18.3   | 35.0    | 60.0                 | 8.8             | 10.0     |
| 1999                 |          |                |         |                       |        |           |        |         |                      |                 |          |
| January              | 5.0      | 7.5            | x       | 17.0                  | 4.0    | 13.0      | 15.5   | 35.0    | 60.0                 | 8.8             | 8.0      |
| February             | 4.9      | 7.5            | x       | 16.0                  | 4.0    | 13.0      | 15.5   | 35.0    | 60.0                 | 8.8             | 8.0      |
| March                | 4.8      | 7.5            | x       | 16.0                  | 4.0    | 13.0      | 15.5   | 35.0    | 60.0                 | 8.8             | 8.0      |
| April                | 4.6      | 6.0            | x       | 16.0                  | 4.0    | 13.0      | 15.5   | 35.0    | 60.0                 | 8.8             | 8.0      |
| May                  | 4.4      | 6.0            | x       | 16.0                  | 4.0    | 13.0      | 15.5   | 35.0    | 60.0                 | 8.8             | 8.0      |
| June                 | 4.8      | 6.0            | x       | 15.5                  | 4.0    | 13.0      | 15.5   | 35.0    | 55.0                 | 8.8             | 8.0      |
| July                 | 4.8      | 6.0            | x       | 15.5                  | 4.0    | 13.0      | 15.5   | 35.0    | 55.0                 | 8.8             | 8.0      |
| August               | 4.8      | 6.0            | x       | 15.5                  | 4.0    | 13.0      | 15.5   | 35.0    | 55.0                 | 8.8             | 8.0      |
| September            | 4.5      | 5.5            | x       | 15.5                  | 4.0    | 13.0      | 15.5   | 35.0    | 55.0                 | 8.8             | 8.0      |
| October              | 4.4      | 5.0            | x       | ..                    | 4.0    | 13.0      | 15.5   | 35.0    | 55.0                 | 8.8             | 8.0      |
| November             | ..       | 5.0            | x       | ..                    | 4.0    | ..        | 19.0   | ..      | 55.0                 | 8.8             | 8.0      |

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

<sup>1)</sup> Due to currency board arrangements, the Bank of Estonia and the Bank of Lithuania do not lend to the government or enterprises. Therefore these two countries do not define or publish discount rates. On October 9, 1997, the Bank of Lithuania introduced an "official lending rate": weighted average rate on domestic currency lending to residents.

<sup>2)</sup> Base rate.

<sup>3)</sup> Refinancing rate.