CENTRAL AND EASTERN EUROPEAN FINANCIAL SYSTEMS: TOWARDS INTEGRATION IN THE EUROPEAN UNION

María Jesús Nieto Carol
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ABSTRACT

EU membership has become the primary goal for CEECs and the prospect of their eventual integration has already been taken into account by the European Council. In this context, the paper presents the substantial progress made on the macroeconomic stabilization as well as on the microliberalization and the institutional restructuring of the financial system. Against this background, the paper considers the challenges faced by CEECs' financial systems in the preparation for EU integration. Two key areas of pressure on fiscal and monetary prudence exist: substantial overhang of banking sector liquidity and incomplete transformation of inherited social programs. Also, it is still too soon even for those countries more advanced in the process of stabilization to lose autonomy in the management of exchange rate policy. As a consequence, transition to participation in monetary union may take a long time and when it happens cannot be but gradual because of the different development of the potential member countries.
"It must be remembered that there is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than the creation of a new system. For the initiator has the enemy of all who would profit by the preservation of the old institutions and surely lukewarm defenders in those who should gain by the new ones."

- Machiavelli

CENTRAL AND EASTERN EUROPEAN FINANCIAL SYSTEMS: TOWARDS INTEGRATION IN THE EUROPEAN UNION

1. INTRODUCTION

The dramatic changes in Europe which began with the removal of the Berlin wall in 1989 have clearly had an impact on the geographic and economic balance of the European Union (EU). Association agreements\(^\text{1}\) with some central and eastern European countries and membership acceptance of former European Free Trade Area (EFTA) countries seem to have shifted this balance more towards the east and the north of Europe. On the other hand, those changes are taking place when Western European countries are facing historical challenges in the process of deepening their economic and political relations via a closer integration. Although, at present, it does not seem clear the exact extent and direction of the political and economic implications of the transformation process in Central and Eastern European Countries (CEECs), no doubt exists that it will definitively have an impact on the changes expected to shape the future of Europe.

\(^{1}\) Agreements aimed to further the integration by lowering barriers to trade, establishing a framework for political dialogue, harmonizing legislation, cooperating on science and technology, and providing for technical cooperation.
The potential effects of integration of western Europe on the rapid opening of CEECs are expected to change dramatically global economic, political, and cultural relations. At the same time, wide consensus exists that the removal of trade, monetary and technical barriers within Europe and the liberalization of the economies of CEECs create challenges and opportunities from the policy making as well as private investment viewpoint.

In light of the desire of CEECs for EU membership, this paper presents in a non technical manner the major challenges which the CEECs already face in transforming their financial systems to those consistent with market oriented ones. These challenges, of course, should be viewed in the wider context of the full scale economic reforms which these countries are undertaking. Although many issues are common to all CEECs, it has been my goal in writing this paper to focus on those countries which have made the most progress with their stabilization and structural reforms: the Czech and Slovak Republics, Slovenia, Poland, Hungary, Romania and the Baltic Republics of Estonia, Lithuania and Latvia. At the same time, these CEECs have signed trade agreements with the EU aimed to further their integration, and have applied for EU membership or are in the process of doing so (Bulgaria and Lithuania). The prospect of eventual EU membership of the CEECs has been made explicit in 1993 at the Copenhagen summit of the European Council if and when certain basic political and economic criteria are fulfilled. The Essen summit in December 1994 and the Madrid Summit in December 1995 were already taking future enlargement eastward of the EU into account; the question had become when and how, rather than whether, the CEECs would achieve membership.

The four chapters of this paper start with the discussion of the concept of transition and, in this context, it presents some aspects of their progress in macroestabilization and the associated challenges given their potential effects on their financial system. Here, the paper considers the challenges faced with the introduction of indirect monetary policy instruments as well as the different exchange rate arrangements in CEECs. Against this background, progress in microeconomic liberalization and institutional restructuring is evaluated. Along those lines, the paper
presents the major challenges CEECs' financial systems (banks and markets) face ahead of the transition process.

Against this backdrop, the last chapter focuses on convergence issues: challenges faced by CEECs's policy makers in preparation for EU integration on the macro as well as the micro level.

2. TRANSITION ECONOMIES: FROM CENTRAL PLANNING TO ASSOCIATION AGREEMENTS WITH THE EU

The concept of transition can be broken down into three subsidiary concepts for analytical purposes to describe the subordinate processes associated with transition (Balcerowicz, 1993): Macroeconomic stabilization, microeconomic liberalisation and fundamental institutional restructuring.

Macroeconomic stabilization is the realm where more literature and more important experience existed and where international organizations had developed a large experience before the fall of the Berlin wall. Nevertheless, CEECs have shown three distinct characteristics from other stabilization processes (Blanchard et al., 1991): Firstly, pre-stabilization distortions in prices were much larger and widespread, and had been present for much longer; secondly, production and incentive structures were radically different from those of a market economy; and thirdly, the combination of money growth and partially fixed prices led in some countries to a combination of rationing and inflation.

Other important aspects of transition relate to microeconomic liberalisation and institutional restructuring. Both taken together can be called systemic transformation that encompasses the creation of markets, including financial markets, the institution and enforcement of a legal framework, and enterprise privatization and restructuring. In general,

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2 Although some authors (K. Bartholdy) disagree in this methodological classification arguing that transition concerns structural reform only since stabilisation has not been an equally great challenge in all countries.

- 7 -
any macroeconomic policy needs to be supported by adequate microeconomic conditions in order to be fully effective because of this duality between the two: microeconomic structures affect macroeconomic performance, and macroeconomic policies have microeconomic consequences. For example, macroeconomic shocks, particularly, but not only, in the monetary realm tend to cause stress on banks balance sheets (IMF, SM\96\40).

Against this background, the issue of maximum speed has been long and vehemently discussed by many economists who either defend or oppose the virtues of gradualist versus big bang strategies in the transition process. It should be understood that maximum speed is not always the optimal one and, moreover, that the design and sequencing is at least as important. According to Balcerowicz (1993), "what determines the maximum speed of a process of institutional or economic change is ultimately the inherent human limitations of information processing and learning." Thus, the financial sector, as distinct, for example, from agriculture, is a knowledge-intensive industry. As a consequence, changes in the regulatory framework and in the structure of incentive are not enough to bring about a radical change in behaviour. From a broader prospective, this issue of maximum speed is closely related to the differences in the speed of economic and institutional changes. In this context, the speed of macroeconomic stabilization and microeconomic liberalisation is much higher than that of changing existing institutions or creating new ones.

2.1. Progress on the macroeconomic stabilization: challenges and impact on the financial sector

The countries that started earliest with stabilization and structural reforms have made considerable progress with disinflation (Table 1). This has been the case of Poland and Slovenia; both initiated their market-oriented reforms during the 1980s. By 1993, Poland had reduced its

\[\text{3 However, in some instances (Poland), the discussion often refers exclusively to stabilization.} \]
<table>
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<td>-24.2</td>
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**Inflation rates (Period average)**

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<td>4.7</td>
<td>181.1</td>
<td>210.3</td>
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<td>136.0</td>
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<td>...</td>
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<td>...</td>
<td>32.3</td>
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<td>12.1</td>
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<td>...</td>
<td>120.6</td>
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<td>...</td>
<td>124.4</td>
<td>951.3</td>
<td>109.0</td>
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<td>25.0</td>
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**Fiscal balance (In percent of GDP)** (b)

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<tr>
<td>Czech Republic (2)</td>
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<td>-1.6</td>
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<td>-8.6</td>
<td>-6.7</td>
</tr>
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<td>-6.5</td>
<td>-8.8</td>
<td>-2.9</td>
<td>2.0</td>
<td>-2.7</td>
</tr>
<tr>
<td>Romania(1,2)</td>
<td>8.8</td>
<td>0.9</td>
<td>0.6</td>
<td>-4.6</td>
<td>-0.1</td>
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<td>-13.1</td>
<td>-7.5</td>
<td>-1.3</td>
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<tr>
<td>Slovenia (b)</td>
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<td>0.2</td>
<td>0.3</td>
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<tr>
<td>Estonia (b)</td>
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<td>Lithuania (b)</td>
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<td>0.6</td>
<td>-4.0</td>
<td>-3.4</td>
</tr>
</tbody>
</table>

Source: IMF, World Economic Outlook, October

(a) 1995 data are estimates
(b) For 1995 and 1996: Total revenue and grants minus total expenditure (including extra budgets funds plus net lending and for all other specifiers countries).

1. General government
2. Cash basis
3. Consolidated state budget
4. General government balance on a commitment basis, except external interest which is on a cash basis.
inflation rate significantly. Following the dissolution of the former Yugoslavia, Slovenia succeeded in rapidly reducing inflation to nearly 12 percent per annum by end of 1995.

Although in Hungary market reforms were gradually introduced in the late 1960s, the pace of reform only accelerated in the early 1990s when prices were freed, the currency was devalued and subsidies were reduced. As a result of these measures, annual inflation rates increased to 35 percent per annum in 1991 and still, as of 1995, the results of the fight against inflation were mixed. The case of the former Czechoslovakia was that of a prudently and tightly controlled economy when a bold market oriented reform program was launched in early 1991. This ambitious program was consistent with the continuation of stable macroeconomic policies. Against this background, and despite the break-up of the country in 1992-93, the Czech and Slovak Republics are among the more advanced and well-managed transition economies.

Bulgaria and Romania were suffering from large inherited macroeconomic imbalances at the start of their reform programs in early 1991. Prices were tightly controlled in spite of rising demand and declining output, so that when prices were freed, annual inflation rates peaked at 333 percent and 161 percent, respectively. However, stabilization programs have been reasonably successful in maintaining certain price stability and in bringing down inflation.

Among the Baltic Republics, Estonia pioneered the reform process in 1989. Latvia and Lithuania were relative late starters, embarking on a comprehensive reform program in mid-1992 when all three economies were shaken by the collapse of the former Soviet Union. Perhaps the most drastic measure that facilitated the stabilization effort in these countries was a currency reform. Estonia and Lithuania introduced currency boards in mid-1992 and 1994 respectively. Notwithstanding, Estonia and Latvia have been more successful in reducing inflation while inflation remains relatively high in Lithuania.

Tight fiscal policies (Table 2) are playing an important role in alleviating the burden on monetary policy (Czech Republic, Estonia and
Table 2: CEEC: General Government Budget Balance\(^1\)  
(In percent of GDP)

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<td>-3.0</td>
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<td>-6.7</td>
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Source: IMF, World Economic Outlook, 1996

\(^1\) Defined as total revenue and grants minus total expenditure (including extrabudgetary funds) plus net lending.

\(^2\) Central government balance.

\(a\) Estimates.
Lithuania) in the fight against inflation and in strengthening domestic savings which, in turn, are essential to sustain the pickup in investment to rebuild largely obsolete capital stocks inherited from the command system. However, progress in bringing down inflation has been slower than envisaged sometimes because of monetization of the fiscal (or quasi fiscal) deficit (Hungary) and excess credit provision to public enterprises (Romania and the Slovak Republic). Also, backward-looking indexation mechanisms have contributed to the inflation inertia (Bulgaria and Romania).

Large capital inflows from industrial countries have been one of the main challenges associated with relatively successful stabilization in CEECs. The inflows of foreign capital have increasingly been used to finance growing current account deficits which mainly reflect increases in private consumption rather than investment. Appreciation of the real exchange rate has been a common consequence of these capital inflows (Calvo et al., 1995). However, in spite of the negative aspects of the capital inflows in CEECs, it can also be argued that direct foreign investment in the region has not only improved living standards but has also fostered the development of human capital.

One major concern associated with this phenomenon has to do with the greater financial vulnerability that might be caused by (nonsterilized) capital inflows which, as a general rule, will find their way through the banking system and will most likely provoke an increase in bank deposits. This, in turn, will lead to an expansion in bank credit (unless subject to a 100 percent requirement). Banks flooded with liquidity may be prone to lend unsafely. Moreover, even if they do not do so, bank credits tend to be of a longer maturity than bank deposits. Thus, a large deposit withdrawal may generate a liquidity crisis. The probability of a crisis will be a function of the stability of funds channelled through the banking sector and, of course, of the extent of the deposits\loans maturity mismatch (Calvo et al., 1995).

Regarding the composition of capital inflows, net external borrowing accounts for the largest share. Since 1990, CEECs have received external assistance from official creditors and, more recently, some countries such
as Hungary, Estonia and the Czech Republic have raised funds in the international capital markets. Foreign direct investment has rapidly gained momentum during the 1990s as a consequence of the opening of these economies and the massive privatization of state enterprises. This has been especially the case in the Czech Republic and Hungary and, to a lesser extent in Poland (Table 3.)

Dollarization, a closely related phenomenon to that of capital inflows, has been another important challenge to macroeconomic policy in CEECs. Foreign currency deposits as a proportion of broad money were between 30 and 60 percent in 1992-93 (Sahay et al., 1995) and have been increasing rapidly in high inflation environments where trade regimes were substantially liberalized and where widespread regulations on interest rates rendered real returns on alternative saving instruments such as domestic-currency assets unattractive. Also, dollarization has often signalled the lack of public confidence in the banking system as well as fear of confiscation, especially during the first years of the reform (Dornbusch et al., 1989). In fact, dollarization appears to have fallen in those transition economies where inflation has been brought under control and real interest rates have reached positive levels. This has been the case in Estonia, Lithuania, and Poland; in contrast, in Bulgaria and Romania where real deposit rates have been negative and often declining, dollarization has remained high.

On the macro level, dollarization may obstruct the ability of policymakers to conduct monetary policy effectively. That, other things being equal, makes an exchange anchor more desirable. Both aspects are analyzed in section 2-1-2. On the micro level, dollarization may have a negative impact on the banks' balance sheet that might be brought about by deposits denominated in hard currency which are not matched by the corresponding assets. The financial vulnerability will be a function of the

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4 In general, currency substitution.

5 Countries with fixed exchange rate regimes generally have tighter foreign exchange controls. This may explain the low dollarization ratio in Hungary or the rapid decline in the dollarization ratio in Poland and Estonia which imposed such controls in 1990 and 1992 respectively.
Table 3: Foreign Direct Investment in Eastern Europe (million US Dollars)

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<td>412</td>
</tr>
<tr>
<td>Romania</td>
<td>340</td>
<td>400</td>
<td>933</td>
</tr>
<tr>
<td>Baltics</td>
<td>430</td>
<td>400</td>
<td>1,280</td>
</tr>
<tr>
<td>Others</td>
<td>1,904</td>
<td>3,088</td>
<td>7,779</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>4,791</td>
<td>10,475</td>
<td>27,140</td>
</tr>
<tr>
<td>E. Europe &amp; former USSR</td>
<td>6,952</td>
<td>13,788</td>
<td>35,694</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit, 1996.
size of exposed liabilities and the evolution of the exchange rate. In addition, dilution of banks capital denominated in local currency may impair the compliance with capital adequacy standards.

2.1.1. The mix of monetary policy instruments: the transition towards indirect tools

Under the command system, monetary policy reflected state plans so that planned direct credit allocation was linked to the planned growth of national income. In this context, credits to enterprises were directly allocated through a unitary banking system and risk was socialized (Hanousek et al., 1995). The introduction of a two tier banking system and the issuance of laws granting independence to the central banks of any instruction given by the government constituted the new institutional framework where these newly created institutions could conduct monetary policy.

At the beginning of the transformation process, the main tools of monetary policy were direct instruments, such as bank credit ceilings and controlled interest rates. These instruments were attractive to policy makers, among other reasons, because of their relatively easy implementation; the lack of an institutional framework suitable for market based instruments (unsound banking systems, inexistance of money and capital markets, inadequate payment systems); as well as for being a useful tool in channelling credit according to specific government goals. However, direct tools were difficult to administer and distorted the financial systems by hampering competition (credit ceilings) and fostering disintermediation and capital flight (interest rate ceilings).

---

6 As described in section 2-2-1.

7 However, not fully, for example, the Act of the Czech National Council N6/1993 amended by Act No 60/1993 CI according to which the Czech National Bank was created is partly harmonized with the EU law. Exemption- possibility to provide with a short term credit up to 5 percent of incomes the national budget income. Similarly, the Act No LX of 1991 on the National Bank of Hungary, allows for the provission of short term credit (up to a limit) to the government.
Against this background, direct instruments were replaced by indirect ones step by step in CEECs with different degrees of success depending mainly on: firstly, the soundness of the banking systems; secondly, the development of the money market; and thirdly, the institutional strength of the central banks. For example, in Poland, reserve requirements were introduced and interest rates were liberalized in 1989, and the National Bank of Poland (NBP) specified the refinance and the preferential loan rates. In 1991, the NBP introduced auctions of repurchase agreements for both NBP and treasury bills as instruments to adjust bank liquidity. In 1992, the Czech National Bank (CNB) issued bills to decrease the free reserves of commercial banks and at the same time required reserves and discount rate policy became the main tools of monetary policy. Later, the CNB introduced open market operations with treasury bills (Alexander et al., 1995 and Hanousek et al., 1995.) As of 1993, in both countries, the management of the money supply was entirely through indirect tools. In contrast, the Central Bank of Romania (CBR) uses, since 1993, direct credits called structural credits which are priced below the market rate. As of October 1995, the structural credits although decreasing, still accounted for 45 percent of the total balance sheet of the CBR. No open market operations existed as of that date although there is a primary as well as secondary market of government debt (OECD, 1995). Hungary counts with a full set of indirect instruments although their application is impeded by the large proportion of nonperforming loans (IMF, SM/96/40).

In CEECs, the introduction of indirect instruments took place in the framework of a broader set of reforms, which encompassed liberalization of the financial sector (restructuring and privatization of the banking sector as well as strengthening and integration of the money markets); macroeconomic stabilization (insulating monetary policy from fiscal deficit financing); and liberalization of the economy (freeing interest rates). In turn, the development of market based indirect instruments of monetary

---

8 Note also that reserve requirements have, in certain cases like Hungary, served much as a central planning device than as a monetary policy instrument. High reserve requirements were used in the late 1980s and early 1990s to provide a pool of finance which the central banks could allocate to the state owned banks.
policy has played a catalytic role in developing financial markets in
general, and money markets in particular. Furthermore, it has
contributed to increase the efficiency of the banking sector's intermediary
function (Alexander et al., 1995).

However, some aspects of the financial liberalization that accompany the
shift towards indirect tools of monetary policy have sometimes complicated
the conduct of monetary policy. The liberalization of interest rates and
the removal of credit controls destabilizes money or credit aggregates for
a time, making their control extremely difficult. The opening of the
capital account which stimulated large capital inflows, reduced
significantly the authorities' influence over interest rates. Also, interest
rates and exchange rates become more interdependent with fixed
exchange regimes typically requiring greater interest rate flexibility.

The unsoundness of the banking system is one of the major challenges
faced by the effectiveness of the monetary policy transmission mechanism
whether this is transmitted via credit channels and/or interest rate
channels (IMF, SM/96/40). In this regard, CEECs have not been an
exception at least in some stage of their transformation. Problem banks
often have shortfalls in required reserves that impair the control over the
supply of money and credit by the central bank (Latvia). Also, money
market segmentation is often the result of unsound banks tapping these
markets (Hungary). It has impeded the development of these markets as
well as limited the authorities' ability to implement monetary policy
efficiently. Furthermore, adverse selection and moral hazard issues may
arise since unsound banks are willing to borrow at any price and no limit
to avoid illiquidity.

2.1.2. Exchange rate policies in the context of external sector
developments

The evolution of the cross-border trade in CEECs had a turning point
in the beginning of the 1990s not only as a result of drastically shrinking
trade among the former Council for Mutual Economic Assistance (CMEA)
partners and among the former Soviet Union, but also as the result of
reorientation of the trade flows of these countries towards the Western market economies. This cross border trade was also influenced by the adverse terms of trade stemming mainly from market-determined raw material prices and exports of capital goods that could not hold their own in hard currency trade, as well as because of the political and economic uncertainties. In the course of the past three years, the share of trade with former CMEA economies has declined significantly while trade with western Europe has expanded dynamically. In this context, deficits narrowed significantly (Richter, 1996).

Trade policy reform in CEECs has been swift in dismantling explicit quantitative restrictions on imports and exports and in introducing liberal tariff regimes. Thus, import regimes, in general, have become highly liberal by international standards while, on the export side, the situation tends to be more restrictive although varies among CEECs. Only under particular circumstances, countries such as Poland partially reconsidered their tariff regimes and quotas, resulting in (limited) reintroduction of import protection9. One of the main features of existing trade laws on the import side is the considerable amount of discretion they leave to the authorities. In fact, no country of the region except for the Czech and Slovak Republics is fully subject to GATT disciplines (EBRD, 1994). All CEECs referred in this paper have entered in some sort of trade agreements with the EU. Such agreements are aimed at furthering their integration by lowering barriers to trade10 and by establishing a framework for cooperation (EBRD, 1994 and 1995).

9 The Estonian authorities have proposed measures aimed at eliminating virtually all remaining elements of trade taxation in the 1996 Budget. In contrast, in Poland, after the liberalization and the tariff suspensions in 1990, its average tariff fell from 18.3 to 5.5 per cent. In the first half of 1991, however, after the Zloty had appreciated significantly against other currencies, the government raised the average tariff to 16 per cent. In autumn 1991, further tariff revisions took place, and early in 1992 all tariff suspensions were ended and average weighted tariffs rose.

10 The agreements establish a free trade of industrial products over 10 years with the EU countries reducing, in general, protectionist measures at a faster pace than their east European counterparts.
Against this background of trade reforms, Poland and, later, Hungary, the Czech and Slovak Republics and the Baltics moved rather quickly toward current account convertibility, taking a major step forward in integrating their economies into the international economic system. Also the Czech Republic, Poland and Hungary\textsuperscript{11} are taking major steps in introducing capital account convertibility. This move towards convertibility has been largely motivated by the expectation of significant private capital inflows and, more precisely, of private foreign direct investment and its associated benefits.

Thus, the remarkable improvement in the capital account of CEECs (Table 4) mostly reflects a reversal in external borrowing beginning in 1992. In some cases, like Hungary and in the Czech and Slovak Republics, this has acquired important proportions. Notwithstanding, in a context of increasingly internationalized capital markets, the role of external factors such as low international interest rates and recessionary conditions in industrial countries cannot be underestimated in analysing capital flows in the CEECs. That was the case in late 1993 when Western investors poured money into emerging markets (Shadler et al., 1993).

One of the most significant developments in CEECs has been the rapid growth of net portfolio (bonds and equity) flows, which have become an important source of financing for certain countries like the Czech and Slovak Republics. More precisely, bond issuance in international capital markets has turned out to be an important avenue of external financing, with Hungary being the largest sovereign borrower\textsuperscript{12} among the CEECs.

\textsuperscript{11} This liberalisation aims to facilitate these countries' entry into the OECD. By virtue of it, their citizens and companies can transfer foreign currency to OECD countries to buy a minimum percentage of a foreign company's shares or purchase property abroad for economic activity. At the same time, foreigners can sell securities (or investment fund units) with a maturity of longer than a year, after obtaining permission from the Securities Commission, up to certain amount per year.

\textsuperscript{12} The Czech and Slovak Republics as well as Poland and Hungary have credit ratings by investors services.
Table 4: CEEC: External Sector Indicators, 1987-93

<table>
<thead>
<tr>
<th></th>
<th>Bulgaria</th>
<th>Czech Republic</th>
<th>Hungary</th>
<th>Poland</th>
<th>Romania</th>
<th>Slovak Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital Account Balance (In percent of GDP)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1987-91</td>
<td>-4.0</td>
<td>2.1</td>
<td>-5.2</td>
<td>-2.0</td>
<td>-0.5</td>
<td></td>
</tr>
<tr>
<td>1992-93</td>
<td>-8.5</td>
<td>4.5</td>
<td>9.3</td>
<td>1.1</td>
<td>6.8</td>
<td>1.3</td>
</tr>
<tr>
<td><strong>Capital Account, Net Direct Investment (In percent of GDP)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1987-91</td>
<td>0.2</td>
<td>1.3</td>
<td>0.0</td>
<td>0.0</td>
<td>0.5</td>
<td></td>
</tr>
<tr>
<td>1992-93</td>
<td>0.5</td>
<td>2.7</td>
<td>5.6</td>
<td>0.5</td>
<td>0.3</td>
<td>-0.6</td>
</tr>
<tr>
<td><strong>Cumulative Net Official Borrowing (In USD billions)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1988-91</td>
<td>1.0</td>
<td>2.5</td>
<td>3.9</td>
<td>-2.7</td>
<td>0.7</td>
<td></td>
</tr>
<tr>
<td>1992-93</td>
<td>1.4</td>
<td>0.1</td>
<td>-1.1</td>
<td>2.8</td>
<td>...</td>
<td></td>
</tr>
<tr>
<td><strong>Cumulative Net Commercial Borrowing (In USD billions)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1988-91</td>
<td>4.1</td>
<td>-0.4</td>
<td>2.0</td>
<td>-2.3</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td>1992-93</td>
<td>1.6</td>
<td>2.0</td>
<td>1.8</td>
<td>1.4</td>
<td>0.3</td>
<td>...</td>
</tr>
</tbody>
</table>

Source: IMF, World Economic Outlook.

Data for 1987-91 are for the former Czechoslovakia.
In contrast, equity placements by CEECs in these markets are still relatively smaller (Table 5.)

In CEECs, a variety of feasible exchange rates ranging from pegs to floats were put in place reflecting more realistic exchange rates and country situations. For example, the Czech Republic adopted a peg to a hard currency basket comprising the D-Mark and the US Dollar, and, as of the beginning of 1996, the authorities allowed for wider fluctuations either side of a central value. Estonia, Latvia, Lithuania, and the Slovak Republic have fixed exchange rates vis-à-vis either a hard currency or a basket of hard currencies. Poland and Hungary adopted a crawling band both vis-à-vis a basket of hard currencies. In contrast, Romania and Bulgaria use a managed floating and a free floating regime, respectively. The use of the exchange rates as an anchor has been common among CEECs, although with different degrees of effectiveness depending on the consistency of the supporting macroeconomic policies. The use of exchange rate as an anchor has especially been the case of highly dollarized and open economies where monetary policy losses effectiveness (Sahay et al., 1995.)

A common issue in a number of CEECs is the sometimes difficult balance between monetary autonomy, on the one hand, and the use of the exchange rate as an anchor for expectations, on the other. This has been particularly the case in the Czech Republic and Poland. In the first instance, large capital inflows have complicated monetary management in a framework of limited scope for sterilization and a reluctance to let the exchange rate appreciate. In this context, the introduction of wider bands of fluctuation of up to 7.5 per cent either side of a central value, (previously only 0.5 per cent) against the currency basket in February 1996 was aimed at reducing speculative inflows and easing money supply growth. In the case of Poland, pressures from a strong current account position complicated monetary control; the introduction of a crawling band exchange rate system in May 1995 was a response to the increasing pressure on the exchange rate.

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13 Under the crawling band, the central bank rate is devalued every day by a pre-announced rate and an intervention band around the central rate exists.
Table 5: International bond and equity issues
(in million US Dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INTERNATIONAL BOND ISSUES</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CZECH REP.</td>
<td>--</td>
<td>--</td>
<td>694</td>
<td>400</td>
<td>--</td>
</tr>
<tr>
<td>FORMER CZECHOSLOVAKIA</td>
<td>276</td>
<td>129</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>HUNGARY</td>
<td>1.235</td>
<td>1.485</td>
<td>4.801</td>
<td>1.729</td>
<td>1.778</td>
</tr>
<tr>
<td>POLAND</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>250</td>
<td>--</td>
</tr>
<tr>
<td>SLOVAK REP.</td>
<td>--</td>
<td>--</td>
<td>240</td>
<td>275</td>
<td>--</td>
</tr>
</tbody>
</table>

| **INTERNATIONAL EQUITY ISSUES** |      |      |      |      |
| CZECH REP.                  | --   | --   | --   | 10   |
| ESTONIA                     | --   | --   | --   | 7    |
| HUNGARY                     | 81   | 21   | 8    | 200  |
| POLAND                      | --   | 1    | --   | 14   |
| SLOVAK REP.                 | --   | --   | --   | 113  |
| ROMANIA                     | --   | --   | 1    | --   |

Source: Private Market Financing for Developing Countries. IMF, 1995
Given the foregoing, it can be argued that a typical sequence of exchange rate regimes for CEECs exists. In the initial stage of opening-up and price liberalization, those countries that had the ability to peg did so. This provided an anchor of international prices around which domestic prices could converge, at a time when all prices in these economies were distorted. In a second stage, the key requirement was to foster restructuring, while developing successful stabilization strategies. Then, greater flexibility in the exchange rate became necessary. Those countries that did not choose to peg their currencies were less successful in fighting inflation, furthermore the exchange rate volatility undermined the credibility of the domestic currency and encourage the use of parallel currencies.

2.2. Progress on microliberalization and institutional restructuring of the financial system

2.2.1 Break-up of the one tier banking system: role of banks in the transition to a market economy

The transition from the central planned to the present system of bank financing entailed a decentralization of decisions on the volume and price of credit aimed at giving market forces a greater role in these decisions. Generally, the initial step was the separation of central banking operations and creation of a number of commercial banks out of the single state bank. Additional efforts were aimed at developing a more efficient framework for monetary policy, to provide greater autonomy to the central banks, to strengthen operational capacities and competition in the banking system, to foster money and securities markets, and to overhaul the payments system. Against this backdrop, Hungary established a two tier banking system in 1987, Poland in 1989, and Bulgaria, former Czechoslovakia, and Romania in 1990.

However, because the break up of the old monobank was often accomplished along the geographic, activity and sectoral lines, there has
been little competition among the existing banks. Furthermore, the banking system is highly concentrated and this reflects the continued dominance of state banks and former state banks in CEECs (with the exception of Latvia) (Table 6). In this context, one of the most important obstacles to transforming the previously existing banks into authentic banking institutions was that, despite the formal separation from the state banks, these new commercial banks had inherited the *modus operandi* of their communist predecessors. This meant that these new commercial banks were not only unsuited to develop a competitive banking system and insure the monitoring of corporate performance, but also made them the main tool in the state enterprises' strategy of resistance to significant departures from the status quo. A major step in introducing competition in the banking system was the authorization of independent banks, some of which, were financed with an important component of foreign capital.

The transition towards a market economy requires an improvement of the allocation of financial resources based on the free and economically rational decisions of savers and borrowers. Furthermore, the efficiency and effectiveness of monetary policy depends on the ability of banks to perform as adequate conveyors of the signals given by monetary authorities (Guitián, 1993). And, last but not least, a sound and efficient banking system along these lines is also essential in the pursuit of structural transformation.

In order to make the transfer of funds efficient, banks in a market economy provide a variety of services such as transformation of maturities, diversification of risks and production of information about investments. In CEECs, these have been often inefficiently performed among other reasons because of the lack of confidence in the banking system and the inadequate managerial skills inherited from the centrally planned economy. Furthermore, high inflation and negative real interest rates have limited the relative size of banks' credits (EBRD, 1995). In addition, the dominant share of the outstanding bank credits (with the exception of the Baltics and the Czech Republic) is to government and state owned enterprises. Against this background, and in parallel to the stabilization process, the introduction of banking systems suited for a market economy has been a priority of policy makers in these countries.
<table>
<thead>
<tr>
<th></th>
<th>State</th>
<th>Former state (privatised)</th>
<th>Private banks</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Czech Republic</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top banks</td>
<td>4</td>
<td>67</td>
<td>0</td>
<td>71</td>
</tr>
<tr>
<td>Top five banks</td>
<td>0</td>
<td>65</td>
<td>0</td>
<td>65</td>
</tr>
<tr>
<td><strong>Hungary</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top banks</td>
<td>54</td>
<td>8</td>
<td>6</td>
<td>68</td>
</tr>
<tr>
<td>Top five banks</td>
<td>49</td>
<td>8</td>
<td>6</td>
<td>63</td>
</tr>
<tr>
<td><strong>Latvia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top banks</td>
<td>6</td>
<td>0</td>
<td>24</td>
<td>30</td>
</tr>
<tr>
<td>Top five banks</td>
<td>6</td>
<td>0</td>
<td>21</td>
<td>27</td>
</tr>
<tr>
<td><strong>Poland</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top banks</td>
<td>66</td>
<td>5</td>
<td>0</td>
<td>71</td>
</tr>
<tr>
<td>Top five banks</td>
<td>66</td>
<td>0</td>
<td>0</td>
<td>66</td>
</tr>
<tr>
<td><strong>Romania</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top banks</td>
<td>74</td>
<td>0</td>
<td>5</td>
<td>79</td>
</tr>
<tr>
<td>Top five banks</td>
<td>74</td>
<td>0</td>
<td>0</td>
<td>74</td>
</tr>
<tr>
<td><strong>Slovak Republic</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top banks</td>
<td>36</td>
<td>40</td>
<td>3</td>
<td>79</td>
</tr>
<tr>
<td>Top five banks</td>
<td>36</td>
<td>40</td>
<td>3</td>
<td>79</td>
</tr>
<tr>
<td><strong>Slovenia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top banks</td>
<td>52</td>
<td>37</td>
<td>0</td>
<td>89</td>
</tr>
<tr>
<td>Top five banks</td>
<td>48</td>
<td>22</td>
<td>0</td>
<td>70</td>
</tr>
</tbody>
</table>

Source: EBRD, Transition Report, 1995

(a) Shares of total banking assets held by top banks and top five banks by ownership.

(b) Ownership classification: A state bank is defined by state ownership of at least 51 per cent of shares (direct or indirect). Former state banks are privatised state banks. Private banks are banks that have never been state-owned. Figures in the table are shares of total banking assets in a given country. The figure for the top banks is the sum of the asset shares of banks with individual asset share of more than 3 per cent. The figure for the top five banks is the sum of the five largest banks, ranked by asset share.
and, consequently, reforms in the area of banking supervision and regulation, accounting, and bankruptcy have been tackled. Moreover, unsound state banks are being restructured and recapitalized.

One of the cornerstones of a well functioning payments system is a creditworthy banking sector which means that the banks having access to these systems are well capitalized and operate in a framework of adequate banking supervision. At the same time, countries that developed earlier large-value payment systems have more advanced money and foreign exchange markets which, in turn, benefit the effective and efficient implementation of monetary and exchange policies (Baliño et al., 1994). This has been the case, for example, in Poland where, in 1992, the interbank market started to develop and WIBOR (Warsaw interbank offered rate) has become the established benchmark for the cost of funds. Progress in monetary policy implementation and in the development of money markets created a demand for faster and more reliable payments systems in the central banks which have played a key role in the development of such systems. In this context, the improvement of both retail and large value systems has been an important objective in the overall restructuring of the banking system in CEECs.

Finally, banks are expected to play many roles in the privatization process of state owned enterprises. Firstly, they may be expected to take the lead in restructuring state owned enterprises. Secondly, they are expected to mobilize domestic and foreign funds and to make them available for financing ownership by the private sector and to provide working capital as well as investment finance to enterprises after they have been privatized. Thirdly, banks can provide advice and other specific services (e.g. payment services) and, last but not least, banks can play an important role in the monitoring and control of managerial activities. As an example, in Poland, the restructuring of enterprises is carried out by banks as part of their own restructuring and recapitalization. In this framework, the model of universal banking, most conspicuous in CEECs, seems the most suited to play the above mentioned roles (Calvo, Kumar et al., 1993).
2.2.2. Main structural problems of the banking system: non-performing loans and inadequate governance structures

The origins of the bad loan problem are to be found, although not exclusively, in the monobank structure where credit to state-owned enterprises was provided on a book entry basis for all investment projects approved under the central plan. Credit was always granted and created automatically with the planners' approval. As a consequence, the concept of non-performing loan was non existent. Even after initiating the reform process and after new commercial banks being launched, the state owned enterprises continued receiving credit because state banks did not have a clear incentive to maximize profits and, in the absence of adequate accounting rules, financial information and credit risk analysis skills, commercial banks granted credit on the basis of insider networks and customary relationships. To complete this picture, the financial needs of the state owned enterprises had grown because of the large shocks to which these enterprises were subjected in the early 1990s (Blanchard et al., 1991) as well as because of the problem of interenterprise claims which derived largely from arrears to suppliers and accounted for a sizable proportion of enterprises' debt (Rostowski, J. 1994). In this context, the practice of rolling over old loans at a higher rate (penalty rate) was common, thus eroding the benefit of high inflation for debtors.

To give an idea of the size of the bad loan problem, it is worth mentioning the case of Hungary where the banking system had non-performing loans equivalent to 17.2 percent of total loans (equivalent to 10 percent of GDP) in September 1992. At the end of 1991, in Poland, 25-60 percent of the portfolio of the seven largest banks was estimated to be substandard. And in Bulgaria, nonperforming loans were reported to exceed 40 percent of the banks' portfolios in 1993 (Calvo, Kumar et al., 1993). At the end of August 1995, in the Slovak Republic, non standard loans amounted to 44 percent of all loans. As of May, 1996, the Bulgarian

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14 The deep recession in the early 1990s when the two tier banking systems were device was also an important factor.

banking system is suffering severe stress, with about 74 percent of its assets represented by non-performing loans\textsuperscript{16}.

Against this background, a moral hazard problem could arise as managers of state owned banks have no incentive to lend prudently because that is not the basis on which they will be keep their jobs. In addition, as long as public banks were saddled with a large proportion of non performing assets, they could not be privatized and, hence, effective motivation and discipline on management to maximise profits could not be imposed. Restructuring was, in most cases, a condition to the privatisation because in a large number of cases these institutions were insolvent. At the same time, the underdevelopment and fragile state of the banking system was also hindering the development and functioning of the money and capital markets.

In response to all these problems, CEECs governments started to take measures for the restructuring of the larger state-owned banks. Although using different approaches, former Czechoslovakia, Bulgaria, Poland, Slovenia and Hungary took important steps toward banks' recapitalization and loan consolidation prior to their privatization (EBRD, 1995). This, in turn, facilitated the change to private ownership. The choice of recapitalization method often reflected the trade-off among conflicting objectives, in particular the maintenance of financial stability versus minimization of fiscal costs. In Hungary, for example, the magnitude of the restructuring and recapitalization was one of the largest in the region, due in part to the relatively strict bankruptcy law issued in 1992 and the state-owned banks benefited from several rounds of state-financed recapitalisation which was criticised mainly on the grounds of having helped the banking sector financially in the short term but failed to assist the enterprise sector and failed to force the economic decisions that would have allowed a quick reallocation of resources to where they might have been best used in the case of companies that were not viable.

\textsuperscript{16} Financial Times, "Bulgaria forced to bite bullet over reforms", May, 14, 1996.
In CEECs, not only was the state the sole effective owner of the state banks but managers and workers also claimed effective ownership rights and took economic and political actions to defend these rights. This inherited structure did not favour the necessary restructuring process. These insiders, management and labour, had a de facto unsupervised control over most decisions concerning state banks' rights and obligations. Often, government, management and labour exercised influence over state banks assets in their own interests so that their claims were conflicting and often overlapping and exercised in a poorly defined pattern of property rights. To make things even worse, incumbent managers of state banks did not have the necessary strategic planning, marketing, and financial skills.

Some of these problems are also common to the newly created private banks, where managers and employees maintain control either via the acquisition of shares issued on favourable terms (e.g. price, voting power), or via representation on the banks' governing bodies or both. Similarly, in the recently privatized banks, the initial ownership structure is sometimes the outcome of political compromise to gain the support of former managers for privatisation (Fries et al., 1994). Moreover, the state often retains significant residual shareholdings. This state of affairs sometimes leads to attempts at chaotic appropriation, the diversion of enterprise resources to private and inefficient uses, attempts to maximise present wages and employment, banks' decapitalization through lack of provisioning and overgenerous dividend distribution, etc. Therefore, consideration of the appropriate governance structures is crucial to the success of the privatization and market oriented financial sector in the CEECs.

2.2.3. Development of law: the banks' prudential policy framework

In parallel to the creation of a two tier banking system, CEECs developed a legal framework where financial institutions and more precisely banks started to operate according to market principles. In this context, most CEECs enacted legislation on property, contracts, companies, anti trust activities and bankruptcy which can be regarded as
vital to the banking development (EBRB, 1994). Furthermore, a basic set of prudential regulations along the lines of the Basle Committee or EU standards were issued in order to govern the entry, operation, and exit of banks. However, implementation and enforcement have been often slower, reflecting the need for institutional reforms. More precisely, the lack of an appropriate judicial system, an independent supervision and the dearth of adequately trained staff (EBRD, 1995) continue to be problematic.

Although specific regulatory practices vary across CEECs, there are several broad categories which contribute to ensure banks' soundness. These regulations contribute to reinforcing firstly, the operating environment (entry barriers, scope of activities); secondly, internal governance (capital adequacy); and, thirdly, market discipline (information disclosures) (IMF, SM/96/40). Regarding the first, legislation in most CEECs permits universal banking by allowing direct ownership of enterprises by banks, and allows banks to participate in the securities market on their own behalf. Hungary is an exception to this and legislation separates commercial from investment banks which cannot accept deposits. In CEECs, licensing policies and standards have been generally weak mainly because of the limited availability and poor quality of information; in addition, the minimum capital was frequently revised and often indexed to a hard currency to reflect inflation.

Regarding internal governance, prudential regulations give guidance to the maximum risks that managers can undertake by limiting risks and establishing capital standards. Against this backdrop, strict limits on credit exposure to a single borrower (or related group) have been adopted although the range varies largely. However, excessive credit concentration and insider lending are structural weaknesses of CEECs's banking systems because of the high concentration of the banking industry as well as the relative large size of the debtors to the country's GNP. CEECs have also, adopted the capital adequacy guidelines issued by the Basle Committee although in some countries, such as Bulgaria and the Czech and Slovak Republics, the requirements have been phased in over

17 From 20 percent in Romania to 60 percent in Latvia.
a fixed period to allow for a more even compliance. Other countries such as Latvia have established higher ratios to compensate for inadequate provisioning. However, the reliability of the capital ratio depends on a good asset classification and provisioning as well as adherence to international accounting practices.

Finally, accounting practices and financial information in CEECs are still not aimed at providing market participants with as much information to judge the banks' soundness. Nonetheless, significant efforts have been made in this regard during the last years with some countries requiring external audits of banks according to international accounting standards.

2.2.4. Development of non bank capital markets

Capital markets in CEECs have a potentially important role to play in the transformation towards a market economy. More precisely, capital markets may facilitate the process of privatization; provide long term financing for restructuring and expansion; provide mechanisms for corporate control; provide investors with instruments to diversify their portfolios; and encourage savings. However, intermediation via domestic capital markets has been limited for the same reasons that constrain the maturation of banks. In addition, time is required until households feel fully comfortable transferring personal savings from bank deposits to stocks or bonds and this further hinders the growth of non bank capital markets. However, as income disparities widen, savings are becoming more concentrated in a smaller group of households for whom this type of investments may seem more enticing (Schwartz, Stone et al., 1993). As a matter of fact, all CEECs have launched exchanges where equity and debt are negotiated; as of end of 1994, only Lithuania had not developed an equity market, and Romania and Estonia had not established a debt market (Table 7).

Government bond markets were the first capital markets to emerge in CEECs. Sales of government bonds directly to the public have resulted in a fairly active government securities market, which, in spite of the potential crowding out, is institutionally paving the way for corporate
Table 7: Non bank capital markets in CEEC as of end 1994

<table>
<thead>
<tr>
<th>Country</th>
<th>EQUITY</th>
<th>DEBT</th>
<th>TURN OVER(^{(1)}) RATIO (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BULGARIA</td>
<td>Y</td>
<td>Y</td>
<td>3.4</td>
</tr>
<tr>
<td>CZECH REP.</td>
<td>Y</td>
<td>Y</td>
<td>12.1</td>
</tr>
<tr>
<td>ESTONIA</td>
<td>Y</td>
<td>N</td>
<td>N/A</td>
</tr>
<tr>
<td>HUNGARY</td>
<td>Y</td>
<td>Y</td>
<td>21.6</td>
</tr>
<tr>
<td>LATVIA</td>
<td>Y</td>
<td>Y</td>
<td>N/A</td>
</tr>
<tr>
<td>LITHUANIA</td>
<td>N</td>
<td>Y</td>
<td>16.4</td>
</tr>
<tr>
<td>POLAND</td>
<td>Y</td>
<td>Y</td>
<td>176.7</td>
</tr>
<tr>
<td>ROMANIA</td>
<td>Y</td>
<td>N</td>
<td>N/A</td>
</tr>
<tr>
<td>SLOVAK REP.</td>
<td>Y</td>
<td>Y</td>
<td>11.2</td>
</tr>
<tr>
<td>SLOVENIA</td>
<td>Y</td>
<td>Y</td>
<td>62.3</td>
</tr>
<tr>
<td>U.S.</td>
<td>Y</td>
<td>Y</td>
<td>69.7</td>
</tr>
<tr>
<td>SPAIN</td>
<td>Y</td>
<td>Y</td>
<td>44.1</td>
</tr>
<tr>
<td>GREECE</td>
<td>Y</td>
<td>Y</td>
<td>3.1</td>
</tr>
</tbody>
</table>

(1) Stock turn over ratio calculated in local currency terms by dividing average market capitalization for the year by total value traded.

Source: Emerging Stock Markets Factbook 1995. IFC
bond and equity markets by making investors familiar with the intricacies of non bank capital markets (Schwartz, Stone et al., 1993). By providing a relatively safe and homogeneous asset with a range of maturities, the government is building up investors' experience with trading financial assets and, at the same time, facilitating pricing of longer term instruments. As a consequence, the bond markets are comparatively active and, indeed, the turnover on the Prague, Budapest and Bratislava Stock Exchanges is dominated by trading in bonds. With the exception of the Czech Republic and Poland, corporate bonds issues are still rare since, in the current inflationary environment, corporations are reluctant to issue bonds with yield that would make them attractive to investors; the few that have been issued tend to be privately placed.

Although activity in the stock markets has increased sharply since 1994, it is lower compared to the bond market, with the possible exception of the Czech Republic where the stockmarket has had its origin in mass privatization (Table 8). In addition, an important part of the securities trading involves only a few companies and much of the trading takes place over the counter. Against this backdrop, an partly as a consequence, markets are extremely volatile.

The scarce development of the capital markets, the difficulties of evaluating risks as well as the scarcity of domestic savings were the grounds on which the investment funds were created. These funds were intended to play several roles as instruments for: transferring ownership to large segments of the population; exercising corporate control in privatized companies (the needed expertise was sometimes contracted out to foreign experts); and raising funds for the restructuring of privatized companies (Blommestein et al., 1993). Investment funds have played an important role in the privatization programs of the Czech and Slovak Republics, Poland and, with less success in Romania. Despite these successes, investment funds have been severely criticized (Kornai, 1991).

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18 The notion of forming investment funds by state decree to manage private property are good illustrations of what Hayek termed a constructivist approach. They are artificial creations, whereas the vitality of capitalism development
Table 8: Number of Listed Domestic Companies (end of period) and Market Capitalization (USD millions, end of period)

<table>
<thead>
<tr>
<th>NUMBER OF LISTED DOMESTIC COMPANIES (end of period)</th>
<th>1992</th>
<th>1993</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>BULGARIA</td>
<td>--</td>
<td>--</td>
<td>16</td>
</tr>
<tr>
<td>CZECH REP.</td>
<td>--</td>
<td>--</td>
<td>1.024</td>
</tr>
<tr>
<td>HUNGARY</td>
<td>23</td>
<td>28</td>
<td>40</td>
</tr>
<tr>
<td>LITUANIA</td>
<td>--</td>
<td>--</td>
<td>13</td>
</tr>
<tr>
<td>POLAND</td>
<td>16</td>
<td>22</td>
<td>44</td>
</tr>
<tr>
<td>SLOVAK REP.</td>
<td>--</td>
<td>--</td>
<td>18</td>
</tr>
<tr>
<td>GREECE</td>
<td>129</td>
<td>143</td>
<td>216</td>
</tr>
<tr>
<td>SPAIN</td>
<td>399</td>
<td>376</td>
<td>379</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>MARKET CAPITALIZATION (USD millions)</th>
<th>% over GDP</th>
<th>GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>BULGARIA</td>
<td>--</td>
<td>0,6%</td>
</tr>
<tr>
<td>CZECH REP.</td>
<td>--</td>
<td>34,6%</td>
</tr>
<tr>
<td>HUNGARY</td>
<td>562</td>
<td>3,9%</td>
</tr>
<tr>
<td>LITUANIA</td>
<td>--</td>
<td>1,0%</td>
</tr>
<tr>
<td>POLAND</td>
<td>222</td>
<td>3,3%</td>
</tr>
<tr>
<td>SLOVAK REP.</td>
<td>--</td>
<td>7,9%</td>
</tr>
<tr>
<td>GREECE</td>
<td>9.489</td>
<td>15,5%</td>
</tr>
<tr>
<td>SPAIN</td>
<td>98.969</td>
<td>31,8%</td>
</tr>
</tbody>
</table>

Source: Emerging Stock Markets Factbook 1995. IFC
In parallel to the development of traditional financial instruments, derivative markets were launched by the Budapest Stock Exchange (stocks and bonds) and the Bratislava Stock Exchange (stocks); paradoxically, the last was opened days before the stock exchange opened.

3. CEECs FINANCIAL SYSTEMS AND EU INTEGRATION: THE CHALLENGES AHEAD

3.1. Restructuring and privatization of state-owned banks

Restructuring is, in most cases, a condition to the privatization of banks because of the large size of the non-performing portfolio. Furthermore, financial restructuring is necessary not only to prepare a bank for private ownership but also to enable state-owned institutions to operate on a commercial basis. Two common alternative approaches for the resolution of the bad loan problem are either to leave individual banks with the responsibility for sorting out the problem (decentralized approach) or to use a specialized agency responsible for administering the bad loan portfolio (centralized approach). The first approach has been adopted by Poland where non-performing loans have been segregated in their balance sheets and handed out to special work out departments where restructuring agreements are made between the bank and the borrower or bankruptcy procedures are initiated. In contrast, Hungary and the Czech and Slovak Republics have used the centralized approach by which part of the nonperforming loans were transferred to an agency created by the government for the purpose of resolving the problem (the Spanish Guarantee Fund uses a similar approach).

The choice of approach is based on different considerations (Fries and Lane, 1994): the centralized system allows for a relatively easier and

quicker valuation of the banks balance sheet that makes it preferable when a large proportion of the banking system's loans are non performing (Hungary); furthermore, the decentralized approach breaks more easily the vicious circle of lending-non paying back-lending again in which banks and state-owned enterprises are typically engaged. However, its large administrative demands are an important deterrent for adopting this type of approach in CEECs. As a matter of fact, successful resolution of the non-performing loans have been achieved through both approaches.

For the banking overhaul to succeed, however, state banks need to be recapitalized before being privatized. In parallel, the main source of bank losses -the lack of financial discipline in the state-owned enterprises- should also be tackled. Poland, Hungary and the Czech and Slovak Republics have already taken important steps towards banks' recapitalization. These capital injections have taken place via issues of domestic government bonds. However, additional efforts should be aimed at narrowing the interest rate spread between banks' deposits and loans, shifting the burden of reconstituting the banking sector from savers and borrowers to the government. As long as the advantages of enhanced intermediation exceed the costs associated with interest payments on government recapitalization bonds, the entire economy will benefit. Moreover, explicit recapitalization via capital injection makes the financial cost for the government transparent. However, any kind of recapitalization must be a one time only operation in order to avoid a moral hazard risk of expectations for government support. Furthermore, state banks' restructuring and recapitalization should be conducted as part of an appropriate package of macroeconomic adjustment policies. Politically, it remains an important question what degree of soundness must be achieved by the aspirants in the process of convergence towards EU.

Bank restructuring can be considered a pre-condition to privatisation or an end in itself19. However, risks of political meddling in the banks'

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19 Some authors (Blanchard et al., 1991) argued that, in CEEC, privatization must take place before firms are restructured on the grounds that the establishment of a clear system of ownership claims was urgent while restructuring by necessity had to proceed slowly. They defend, in turn, that privatization should take place mostly through distribution rather than through
credit allocation will remain as long as they remain state-owned; banks can only be expected to operate on a purely market oriented basis if they are privatized. That is, by placing private capital at risk, shareholders would have an incentive that the risks of investing are appropriately measured and priced. At the same time, banks can only enforce market behaviour in their customers if they themselves operate in a competitive fashion (Blommestein et al., 1993). Against this backdrop, governments should be committed to not protect the banks' shareholders since the expectation that public assistance will be forthcoming may provide an incentive to shareholders, managers and unguaranteed creditors to endanger the stability of the bank (Lane, 1993). Also government should make explicit that private capital invested in shares should serve as an initial buffer to absorb losses.

Against this background, for the privatization to be fully successful, it is important to ensure a transparent environment under which banks will operate in order to send a clear message to incumbents (shareholders, managers and creditors) that they are fully responsible for their decisions. This requires, a coherent set of broad parameters on: banks' involvement in securities trading; banks' prudential policy; and possibility as well as degree to which bank deposits will be insured (Kyei, 1995).

3.2. Improving governance of banks

CEECs face a double task: to create private owners and establish arrangements giving these owners and creditors some control over the enterprises. Here, the challenge is to create an incentive structure in which the interests of the managers, shareholders and creditors can be reconciled or the conflicts controlled. Until and unless private enterprises are subject to appropriate enterprise control, the benefits of private ownership will be modest and in some instances so precarious as to jeopardize the independence from the state. Thus, consideration of the sales of ownership claims. This has often proved not to be so in the case of the banking sector.
appropriate governance structure for the newly privatized banks is crucial for the success of the market economy in those countries.

In this context, the debate on governance in CEECs has partly focused on the feasibility of alternative approaches to particular institutions of enterprise control that would most efficiently encourage and facilitate outsider influence. Several mechanisms of corporate finance, not mutually exclusive, have been proposed (Phelps, Fryman et al., 1993), among which two deserve our special attention: active financial markets (stocks and bonds) and large outside investors.

Development of liquid secondary markets for shares can facilitate the concentration of outside ownership and give outsiders influence over the management of the banks. These markets are rapidly developing in CEECs particularly in the Czech and Slovak Republics, Poland and Hungary. Nonetheless, these secondary markets are not yet very liquid due among other reasons to the restrictions either de facto or de jure (as is the case in the Czech Republic) on the tradability of shares. It has been argued (Coffee, 1991) though, that even if there existed a possibility of instituting very liquid stock markets in the short term, it may not necessary create the incentives for shareholders to engage in the costly process of monitoring and fighting the management trying to defend themselves from external interference. Furthermore, reliance on takeovers for external monitoring increases job uncertainty of managers and this may be particularly dangerous when strong commitment of the new owners to restructuring and improvement of corporate performance is badly needed in this stage of the transition.

Debt markets and external financing in general\textsuperscript{20} may be also an important disciplinary mechanism, assuming that the recourse to bankruptcy exists. The important role that financial institutions, banks and capital markets play in the monitoring and control of corporation

\textsuperscript{20} Debt mechanisms have been credited with the exceptional performance of the German and Japanese corporations today and of the United States during the Morgan era at the turn of the century (Hosi, Kashyap et al., 1990 and DeLong, 1992).
managerial activities has been already discussed in sections 2-2-2 and 2-2-5. In this context, debt financing may not only limit the scope of managers' discretion for fear of bankruptcy but may also impose stronger accountability requirements according to international standards. The higher degree of enforceability of debt contracts as well as the reduction of risks premia in a framework of increasing stability in the CEECs' financial markets will allow for a higher degree of leverage and, hence, of management discipline via external financing.

An important mechanism throughout CEECs aimed at exercising outsider influence is that of core investors or large stockholders (at least two in order to guard against abuse). In this case discipline may be imposed via their involvement in the management. At present, given the lack of managerial expertise and, often, of financial resources in CEECs, foreign investors seem suitable to play this role. Frequently, foreign investment has been accompanied by technical assistance programs which can be rather comprehensive (twinning contracts). Foreign participation may also facilitate the entry by CEECs banks into foreign markets.

3.3. Increasing competitiveness of the financial system

In the early stages, when CEECs set about the task of creating a two-tier banking system, the priority was to ensure stability rather than promoting competition. Once the two-tier banking system was launched, competition was encouraged by privatizing state owned banks as well as readily granting licenses to new and often small banks (both domestic and foreign). The consequence of this strategy was that many banks have failed because the rapid changes did not allow for the strengthening of the banking system. Nonetheless, these failures are part of the maturing of banking systems that have been steadily acquiring breadth as well as depth. At the same time, foreign banks are becoming, in some instances, a major force in the local and investment market segments. This is posing a major competitive threat to domestic banks, and encouraging the emergence, through mergers, of a tier of middle-sized local banks as well as the creation of alliances with foreign partners. This could also be considered as a strategy to cope with the competitive pressures imposed
by a future membership of the EU since, as of today, CEECs banking systems are not competitive on an EU basis.

In CEECs, privatization of state owned enterprises has taken place via different methods: public offerings of shares; sales of shares to private buyers; free distribution of shares (e.g., via vouchers) as well as insider privatization. These methods all emphasize different financial institutions; banks have played and will continue playing an important role in the restructuring of enterprises before and after privatization. Yet, at the same time, the implementation of most of the above described privatization methods created a demand for the creation of a secondary market in equity. In turn, the development of an efficient capital market complements the development of a market-oriented banking system and yields important benefits, by mobilizing and channelling savings while also reducing the cost of capital. All of which renders important the development of banking systems in parallel with capital markets.

Privatization in a framework of appropriate macroeconomic policy and open foreign exchange regime could play a key role in the initial development of capital markets. However, further development would depend on the development of an appropriate regulatory framework in line with international standards, structural market reforms, and the broadening of the investor base.

On the regulatory side, further efforts should be aimed at drafting regulations on securities and creating an independent regulatory body such as a securities commission where this has not been done so far (Romania, Bulgaria, Estonia) or strengthening the existing ones in order to improve the supervision of the markets. These regulations should deal with minority shareholders protection (along these lines, the Czech authorities have recently drafted regulations) and information requirements to be provided by corporations. All of this would improve the transparency on the exchanges. On the structural side, improvements and modernization of the securities trading systems would enhance the reliability of markets, promoting investors confidence, increasing market liquidity and facilitating market surveillance. In this context, the reliability of clearance and settlement systems are a critical determinant
of international investors' willingness to place funds in CEECs' capital markets. Very often, in these countries, improvement of settlement facilities necessitates the establishment or strengthening of centralized depository or registry facilities for securities.

Further development of hedging instruments and markets, together with regulations covering their use, would enhance the liquidity and depth of the underlying markets. However, such derivatives can only provide the basis for effective hedging if liquid markets for the underlying instruments (currencies, government bonds, etc) are in place in order to give guidance for prices in the derivative markets. Furthermore, their premature introduction may pose a high risk for the banking sector if banks are not adept at evaluating the risks involved in these operations.

Deepening of the capital markets in CEECs also requires the broadening of the investor base. In this regard, additional liberalization measures need to be taken to facilitate foreign investors' access (both individual and funds) to domestic markets (e.g., eliminate restrictions on the maximum holding on any one company\(^2\)). Introduction of contractual savings schemes would increase the liquidity in local capital markets and broaden the range of investment possibilities available to domestic investors. So far, the privatization of public sector companies has been an important influence on activity in developing equity markets in most of these countries and it has provided the dominant source of equity listings and trading activity. For example, in the Czech Republic, the second and final wave of voucher privatization program was completed in May 1995, raising the share of country's gross domestic product generated by the private sector to more than 70 per cent\(^2\). Romania's parliament approved in 1995 a complex privatization program that aims to sell off, at least partly, 3,900 medium and large state companies in a coupon scheme. That same year, Poland launched its privatization program to sell 400 state companies through the issuance of participation certificates in national

\(^{21}\) Footnote 8 in page 11.

\(^{22}\) The Banker, February 1996.
investment funds to individual citizens and enterprise employees; and Bulgaria approved legislation to provide for privatization vouchers and other privatization instruments to be traded on the stock exchange.

3.4. Strengthening banks' prudential policy and harmonizing legislation

Although progress in developing a legal framework to assure contracts enforceability and a comprehensive set of banks' prudential regulations according to international standards has been significant in CEECs, the enforceability of these laws and regulations has evolved at slower pace. It reflects weaknesses both institutional and regulatory that have allowed a number of banking troubles to emerge.

In CEECs, banking legislation provides the authorities with enforcement powers. In this context, bank supervisors ensure that banks' regulations are enforced; but despite substantial progress, a fundamental problem of bank supervision remains its credibility. Several are the underlying reasons: on the one hand, the new supervisory bodies experience difficulties partly related to the dearth of experienced staff and absence of established procedures for off-site and on-site supervision. On the other hand, if banks cannot comply with the new regulations, perhaps because of the big gap between the original situation and the newly required standards, supervisors face either regulatory forbearance or banks closure. In the first case, deposit insurance may further facilitate forbearance by removing pressure from depositors (IMF SM/96/40). In the second case, the threat may not be credible because of the large costs associated with it (as in the Latvian banking crisis of 1995) and/or the inadequate conservatorship or liquidation procedures. Sometimes, political interference may prevent intervention or give rise to a conflict of interest. This has been a critical issue in Hungary where a large share of the banking system remained in hands of the state.

The achievement of economic efficiency and banking system stability requires that regulatory and supervisory policies enhance, rather than

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reduce, bank soundness and market discipline (IMF SM/96/40). This has been referred as to *market friendly supervision* (Padoa Schioppa, 1995). In CEECs, a recurrent problem is the unbridgeable gap between regulations and banking conditions which cause regulations to be ignored or banks to be forced to adjust in a way that diminishes their role in financial intermediation between savers and borrowers (EBRD, 1995). Phased in application of prudential standards inspired in EU Directives over a fixed period of time would allow for a smoother adjustment to international regulatory standards by banks. Furthermore, higher standards, as some countries require, can not compensate for generally unstable economic conditions (Nieto et al., 1995). Although international regulatory harmonization levels the playing field for competition and, as such, it is a condition to EU membership; it may be unrealistic in CEECs in the very short term.

Finally, the supervisory process has an important role to play in establishing confidence. If supervision is not adequate, or if gaps exists in it, confidence in the banking system could be undermined and this would certainly have a negative effect in attracting private investors. In addition, improved banks' financial disclosure will reinforce market discipline by providing market participants with as much information to judge the banks' soundness.

4. CONVERGENCE ISSUES

Full EU membership has become the primary goal for CEECs and to this end they have embarked, often with rivalry among themselves (Richter, 1996), on a transformation process by which they are seeking endorsement by the international community. In CEECs's view, EU membership would provide better opportunities for strengthening cooperation with other EU countries, attracting more foreign investors, and most importantly, introducing the new members to the strong political, legal and economic control imposed by EU institutions. Certainly, none of the CEECs economies is yet ready for full membership but they have made substantial progress in the last few years, proving their adjustment capabilities and transformation dynamics.
In the Copenhagen summit in the summer of 1993, a set of criteria were formulated in connection with EU enlargement. These criteria include a range of political, legal and economic conditions, including the stabilization of democracy and law, readiness to adopt the *acquis communautaire*, establishment of an effective market economy, and adoption and fulfilment of the convergence aims under the Maastricht Treaty. However, a more careful reading of the Copenhagen criteria seem to indicate the EU's interest in concentrating on the economic performance of the newcomers (Intoai et al., 1994). At the same time, it cannot be denied that CEECs are in a more complex initial position than earlier applicants, mainly for three reasons: first, they are still in a process of systemic transformation; second, they are joining in a moment of significant changes within the EU; and third, the depth of EU integration is much greater today. But it should also be said that both EU countries and CEECs are sharing new trends: somehow similar measures of privatization of state enterprises, as well as increased competition in an increasingly transparent legal and decision making framework, are also prevailing in Western Europe. Such shared trends should favour the integration of CEECs.

4.1. How far are CEECs from full EU participation?

Enlargement of the EU to the east raises questions that transcend their financial systems, and brings out broader issues such as security, foreign policy (especially if the new entrants were to join the EU's fledging defense arm) and economic adjustment given the sizable gap between the standards of living of CEECs and the existing members (Table 9). The scale of this gap seems to raise doubts about whether these economies could cope with the competitive pressures in general imposed by the EU's internal market.

At the present stage, as it has been shown in this paper, CEECs' financial sectors are not yet ready to compete on equal footing with those of the EU. They have a relatively small size and are rather shallow. As it has been said above, their banking systems continue to be largely dominated by inefficient state-owned banks (only in the Baltics there has
<table>
<thead>
<tr>
<th>Country</th>
<th>GDP per capita 1993 (in USD, at PPP)</th>
<th>% Share of agriculture of GDP as of 1994</th>
<th>% Share of industry of GDP as of 1994</th>
<th>% Private sector/GDP as of 1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>3.730</td>
<td>13&lt;sup&gt;(a)&lt;/sup&gt;</td>
<td>42.3&lt;sup&gt;(a)&lt;/sup&gt;</td>
<td>aprox. 15</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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<td>(mid 1995)</td>
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<td>(early 1996)</td>
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<td>38</td>
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<tr>
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<td>(1994)</td>
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<td>41&lt;sup&gt;(a)&lt;/sup&gt;</td>
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<td>35.1</td>
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Source: EBRD, Transition Report, 1995
World Bank, World Development Report, 1995-
OECD, Quarterly National Accounts
Eurostat, National Accounts, detailed tables by sector
The Banker, Feb 96

(a) As of 1993
(b) At constant 1991 prices
(c) At 1993 USD
(d) Value added by sector in % of GDP
(e) As of 1992
been an extensive creation of new private banks); furthermore, the pace of their privatization has been slow. Also, the scale of lending by banks (public and private) is small relative to the size of their economies and the dominant share of bank credit in most countries, with the exception of the Baltics and the Czech Republic, is to the government and state enterprises. In addition, banks' profitability is still very much conditioned by the large provisions for non-performing assets. On the other hand, securities activities are, in general, less developed than banking and have been largely shaped by privatization programmes. In those countries where mass privatization has taken place (the Czech and Slovak Republics), the stock market capitalization is high relative to the size of their economies; however, liquidity is low compared to their capitalization.

From the viewpoint of the EU countries, the two most sensitive issues on the road to full membership are agriculture and financial transfers. Both of them are calling for reforms of the Common Agricultural Policy as well as the EU financing structure. Furthermore, in the perspective of enlargement, EU institutions and procedures would have to be improved in order to preserve their capacity for action. At present, all the CEECs would be net beneficiaries of the EU's current transfer mechanism. Moreover, most but not all would be entitled to funds for agriculture; for example, Poland and Hungary are major exporters of agricultural goods, while agriculture is not a major negotiation issue for the Czech Republic. In addition, all the CEECs in their present situation would be receivers of structural and cohesion funds.

The EU Commission estimates that the CEECs would receive significant amounts of regional aid as a percentage of these countries' GNP. In fact, this has raised questions about the recipient countries' ability to put this financing to good use. In order to tackle this problem, the EU Commission has proposed setting a ceiling defined as a percentage over GNP on the structural funds that existing countries and future members

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24 Based on the experience of the Phare aide program, CEEC have encountered difficulties in finding suitable projects to fund, even though the resources were only a small fraction of the regional aid estimated.
can receive. The Commission has also argued that extending the Common Agricultural Policy to CEECs could trigger a rise in their food prices; to tackle this problem, lengthy transition periods lasting between seven and ten years are being recommended.

From all the above, it can be concluded that the transition from the present association agreements to full membership may take a long time. It also seems clear that EU enlargement to the east, when it takes place, cannot be but gradual because of the different development levels of the potential member countries and of the potentially high costs involved in entry of individual countries. Even so, the issue of the EU enlargement towards the east may lead some to advocate a multi-track approach to European integration. That is, a more flexible Union which would still preserve cohesion among its members.

4.2. How far are CEECs from full EMU participation?

According to the present calendar, the EU will move to a single currency by January 1, 1999. Hence, it seems most likely that EMU would be already in place by the time of EU enlargement to the east. In this context, there are two fundamental issues to be considered: the first is whether the CEECs need to be members of the EU before entering into any exchange arrangement with EMU members. The experience so far with the Exchange Rate Mechanism (ERM) is that only members of the EU have fully participated in the ERM. As a precedent, it is worth mentioning the case of Sweden whose request for membership in the ERM before joining the EU was denied. Furthermore, the Treaty provisions as of today do not contemplate any other possibility than membership in the EU before entering into the ERM.

The second issue centers on the ability of CEECs (all or some) to join EMU once they have joined the EU. This is, whether their economies are ready to absorb shocks of domestic (i.e. wage shocks) or foreign (i.e. more competitive neighbors) origin caused by their integration into the EU economy; and whether they will have the capacity to fulfil the convergence criteria. Both, in light of what has been discussed in this
paper, seem most unlikely. Furthermore, CEECs are at present far from being part of an optimal currency area with the EU.

Assuming that CEECs will not be in a position to participate fully in EMU from its beginning, it is difficult to predict whether they would wish and/or be able to enter any new monetary relationship between the participant and non-participant member states in the third stage of EMU (so called ERM2). It will very much depend on how that relationship is defined. In case that they are both able and willing, as other member states that do not irrevocably fix their exchange rates at the start of the stage three, CEECs (all or some) will be involved in the processes of co-ordination of economic policies with countries fully participating in EMU. This implies, firstly, the establishment of close monetary relations with countries fully participating in EMU as well as the treatment of the exchange rate policy as a matter of common interest and; secondly, the participation in EMU institutions (General Council of the European Central Bank (ECB)). However, the CEECs will be excluded from the appointment of members to the executive board of the ECB and from participation in the governing council of the Bank. They will also be excluded from decisions on financial matters such as the pooling of reserves at the ECB and the allocation of seigniorage.

In the policy making context, close monetary relations imply that CEECs will need to address institutional changes such as central bank independence and the adoption of price stability objectives although these countries still can maintain autonomous monetary policy. The scope of these close monetary relations can be broadened to include the development of a sound market oriented financial sector along the lines described in this paper. This encompasses: firstly, dealing with the inherited weaknesses of the banking system; secondly, increasing competitiveness of the financial system; and thirdly, strengthening

25 Although the widest possible membership of the new arrangement would be clearly desirable, participation should probably be on a voluntary basis.

26 At present, this issue is under discussion.

27 Article 109m of the Treaty of Maastricht.
institutions and rules which ensure soundness of the financial system. All of this, in turn, will increase the efficiency of monetary policy.

Coordination of economic policies also implies that CEECs as non participant members in the third stage of EMU should treat their exchange rate policy as a matter of common interest and may have to enter into some sort of exchange arrangement with other EU countries which do take part in the planned EMU. It is uncertain how this arrangement will be since definitive decisions on the issue do not need to be reached before 1998. Any hypothesis for a new exchange regime would, at this stage, be conceptual in nature. However, it can be argued that the tighter the relation (the narrower the band) between the Euro and currencies outside, the more problematic it will be for CEECs to move early towards the new exchange rate mechanism (ERM2). It remains to be discussed whether the band-width should be subject to particular arrangements.

Despite the success of nominal anchoring strategies (such as the Czech experience in bringing down inflation to single digits), this strategy does not suffice to achieve price stability in the longer run. To meet that objective requires a direct attack on the domestic sources of inflation and this means that monetary policy has to develop both the instruments and the credibility to influence inflation through domestic transmission channels. In this context, fiscal and other macroeconomic policies must be consistent with domestic price stability; that is, to provide the freedom that monetary policy needs to be effective. At present, CEECs are still in the process of institutionally strengthening their instruments to fight inflation. At the same time, there are some slippages from earlier consolidation, especially in the case of Bulgaria, Hungary and, to a lesser extent, Romania which threaten to erupt into credibility crises.

28 Along the lines made in the proposal of a remodelled ERM (ERM2) where the Euro will be at the center and where the new system would be more asymmetrical than the existing EMS, meaning that policy adjustments to stabilise currencies must primarily be undertaken by non participants in EMU.
Furthermore, as discussed before in section 2-1, one of the main challenges associated with successful stabilization and the related credibility improvement is that of capital inflows. To deal with them in the context of a fixed exchange rates and without introducing any sort of restriction on capital flows is an extremely difficult task, as the recent Czech experience has proved. The introduction of some degree of exchange rate uncertainty in both directions can be expected to reduce the scale of speculative capital flows and, hence, make monetary management somewhat easier. A switch to more flexible exchange rates arrangements may help a country to succeed in conquering inflation without losing competitiveness in the international markets. As shown before, inflation rates are still stubbornly high in most CEECs. With fixed exchange rates, their currencies would gradually appreciate in real terms. But more flexible arrangements such as band fluctuation, especially one of the crawling variety, allow the authorities to act against this through a controlled depreciation of its currency's exchange rate. Last, but not least, there is a credibility issue (Dornbush, 1991): fixing an exchange rate may not be possible if domestic agents believe that the policy will be abandoned if the costs of maintaining it are too high. Some other arguments (CEPR, 1990 and Davenport, 1992) could also be used to sustain that it is still too soon for CEECs, even for those more advanced in the process of stabilization, to lose autonomy in the management of exchange rate policy, but this subject is beyond the scope of this paper.

5. CONCLUSIONS

The prospect of eventual EU membership of the CEECs was made explicit in 1993 at the Copenhagen Summit of the European Council if and when certain basic political and economic criteria are fulfilled. The Essen Summit in December 1994 and the Madrid Summit in December 1995 were already taking future enlargement eastward of the EU into account; in this new context, the question had become when and how, rather than whether, the CEECs would achieve EU membership. However, CEECs are in a more complex initial position than earlier applicants, mainly for three reasons: first, they are still in a process of systemic transformation;
second, they are joining in a moment of significant changes within the EU; and third, the depth of EU integration is much greater today.

Although enlargement of the EU towards the east raises questions that transcend their financial systems; CEECs, in their goal of becoming EU members, are aiming to establishing closer monetary relations with EU countries. The scope of these close monetary relations can be broadened to include the development of a sound market oriented financial sector. This encompasses: firstly, dealing with the inherited weaknesses of the banking system; secondly, increasing competitiveness of the financial system; and thirdly, strengthening institutions and rules which ensure soundness of the financial system.

Two main weaknesses of the banking system have been referred to in this paper: the large proportion of non-performing loans in the banks portfolios; and their inadequate governance structures. The restructuring of the non performing loans is a daunting task given the size of the overhang but it is essential to achieve soundness. This, in turn, will enhance the effectiveness of the monetary policy transmission mechanism. However, any kind of recapitalization should be a one time only operation in order to avoid a moral hazard risk of expectations for government support. Politically, it remains an important and open question how sound the CEECs financial systems need to be before they are found acceptable by the EU. Appropriate enterprise control is a condition to ensure independence from the state and assure the full benefits of private ownership. Given the scarce development of efficient capital markets (stocks and debt), market oriented foreign investors may facilitate financial discipline, but the interest of various stockholders (managers, workers and shareholders) must often still be reconciled.

A less politically complex task is to create the proper environment for a new transformed financial system: efficient banks and capital markets. In this context, increase competitiveness of the banking system has been achieved through privatization and licensing of new banks both domestic and foreign. Often, rapid changes in the economic environment and in the institutional setting did not allow for the strengthening of the banking system and bank failures have been common. However, these failures are
part of the maturing of these institutions. At the same time, foreign banks are posing a major competitive threat to domestic banks, and encouraging the emergence, through mergers, of a tier of middle-sized local banks as well as the creation of alliances with foreign partners. However, as of today, CEECs banking systems are not competitive on a EU basis. Similarly, the privatization of state-owned enterprises created a demand for the development of an efficient secondary market in equities which, in turn, complements the development of a market oriented banking system. This yields important benefits by mobilizing and channelling savings while also reducing the cost of capital of market institutions. All of these factors render important the development of banking systems in parallel with capital markets. Notwithstanding, further development of the capital markets depends on the development of an appropriate regulatory framework; the implementation of structural reforms, and the broadening of the investor base. The later implies that additional liberalization measures need to be taken to facilitate foreign investors' access.

Although a regulatory framework of banks which provides the authorities with enforcement powers according to international standards has been enacted in all the CEECs; its uneven enforceability has demonstrated institutional and regulatory weaknesses. In CEECs, the achievement of economic efficiency and banking system stability requires that regulatory and supervisory policies enhance bank soundness and market discipline. Phased in implementation of prudential standards inspired in EU Directives over a fixed period of time would allow for a smoother adjustment by banks to international regulatory standards. Furthermore, higher standards, as some countries require, can not compensate for generally unstable economic conditions. Although international regulatory harmonization levels the playing field for competition and, as such, it is a condition to EU membership; it may be unrealistic in CEECs in the very short term.

These reforms, some of which (the institutional ones) are by their own nature of very gradual implementation, are to be accomplished within the framework of fiscal consolidation, monetary stability and exchange rate stabilization. Although progress has been significant in these areas in
some countries (Poland, the Czech and Slovak Republics, and Slovenia),
two key areas of pressure on fiscal and monetary prudence exist:
substantial overhang of banking sector liquidity problems and incomplete
transformation of inherited social programs. It is also still too soon even
for those countries more advanced in the process of stabilization to lose
autonomy in the management of exchange rate policy. Some degree of
exchange rate flexibility is required to reduce the scale of speculative
capital flows associated with successful stabilization and, hence, make
monetary management somewhat easier without imposing any restriction
on capital flows. Furthermore, flexible exchange rate arrangements may
help a country to succeed in fighting inflation without loosing
competitiveness in the international markets when inflation rates are still
stubbornly high.

Against this background, it can be concluded that the transition from
the present association agreements to full membership may take a long
time. Also, it seems clear that EU enlargement to the east, when it takes
place, cannot be but gradual because of the different development levels
of the potential member countries and of the potentially high costs
involved in entry of individual countries. Even so, the issue of the EU
enlargement towards the east may lead some to advocate a multi-track
approach to European integration. That is, a more flexible Union which
would still preserve cohesion among its members.


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