Part II

Central and Eastern Europe: The EU Convergence Challenges

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Banking Sector Development and Financial Stability in the Run Up to EU Accession

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The countries in Central and Eastern Europe (CEE) that are negotiating their entry into the European Union have seen their financial landscape change dramatically over the past decade. With the breakdown of the system of central planning, the need for an effective and efficient system of financial intermediation became apparent. Since banks were already present during the communist era, the transition countries took their monobanks as the starting point for creating bank-based financial systems. Although these systems in the EU accession countries are currently not yet on par with their western peers, remarkable progress has been made. In many countries almost all of the large state banks have by now been privatised. Foreign strategic investors, mostly Western European and American banks, have been among the most important buyers. Preceding or simultaneous with this privatisation process, governments have – to various degrees – started to deal with the problem of bad loans. Progress has also been made with regard to supervision and regulation, in part stimulated by the requirements of EU accession. All these restructuring efforts with regard to the banking system and its regulatory environment may have contributed

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to the fact that CEE has proven to be rather resilient during recent periods of international financial instability, such as the Asian and the Russian crises. Of course, this relative immunity can also be partly attributed to the fact that in many CEE countries (some) capital controls were still in place. In addition, the local banking systems – let alone bond and stock markets – are still relatively underdeveloped. A lot of work remains to be done to improve the accession countries' financial systems.

At present the banking sector is by far the most important part of the financial system in all transition economies and is, as a consequence, also the main source of risk for financial stability in this region. This is all the more so because the lack of well-functioning equity markets confronts banks with relatively high credit risks, as bank credit must to some extent substitute for equity. In order to consistently survey the risks for banking system stability, we apply the framework as described by Goldstein and Turner (1996). Whereas this framework mainly draws lessons from earlier banking crises, we use a more forward-looking approach by taking stock of the potential risks that may accompany a further development of the CEE banking sectors, taking into account the specific challenges posed by the EU accession process. Addressing such risks is probably the best method authorities of CEE countries can use to stimulate the development of the banking sector as well as financial markets. Given our focus on the specific issues related to transition countries, we will touch only briefly on the other two accession countries, Cyprus and Malta. Section 1 contains our assessment of the potential risks for the CEE banking sectors. Section 2 concludes and gives policy recommendations.

1 Financial Stability and EU Accession: An Assessment

Based on the framework as set out by Goldstein and Turner (1996), this section takes stock of what appear to be the main sources of risk for the accession countries' banking sectors during the pre-accession period. Of course, the characteristics of the transition countries' banking systems are to a large extent specific, the transition process being a unique historical process. Yet, on the other hand, the opening up of the still relatively underdeveloped markets in CEE also shares some important features with earlier experiences of connecting

countries to the global economic system. In the following, we take the relevant themes identified by Goldstein and Turner as a starting point to explore the specific conditions and challenges associated with the stable development of the banking sector in the CEE countries.

1.1 Macroeconomic Stability

A stable macroeconomic environment is important for banking sector stability, mainly because uncertainty about macroeconomic policies and fluctuating fundamentals, such as economic growth and inflation, makes it harder for banks to assess credit risks accurately.[2] Besides from its negative influence on the banking sector, (macro) economic uncertainty may also inhibit economic growth more generally. Lensink (2001) shows for instance that uncertainty with regard to inflation and government expenditures leads to lower per capita economic growth. Importantly, this negative effect of uncertainty appears to be less severe in countries with a more developed financial sector. Yet, subdued economic growth, due to macroeconomic uncertainty or for other reasons, may feed back to bank soundness as it reduces the debt servicing capacity of firms and households.

Table 1 shows the differences between the accession countries and the current EU members with regard to the volatility of both their GDP growth and inflation-rate. Over the period 1995-2001, macroeconomic volatility has been considerably higher in the accession countries, creating a relatively difficult environment for the local banking sector. On average, the difference in volatility has been more pronounced with regard to inflation than with regard to growth. Table 1 shows that, when excluding the outliers Romania and Bulgaria, there is a significant negative correlation between on the one hand the level of GDP per capita and on the other hand, respectively, the volatility of GDP growth and the volatility of inflation. As the convergence process progresses and sound economic policies are continued, macroeconomic volatility will therefore probably decrease further. Still, the convergence process implies that growth rates will stay at a higher level compared to the current EU

[2] Van der Zwet and Swank (2000). See also Boyd, Levine and Smith (2001) on the negative impact of inflation on the functioning of the banking sector.

Table 1 Volatility of Growth and Inflation in EU and Accession Countries: Standard Deviation of Yearly GDP Growth and Inflation over 1995-2001

	Growth	Inflation		Growth	Inflation
Austria	0.9	0.6	Bulgaria	6.1	360.5
Belgium	1.0	0.6	Czech Rep.	2.6	3.1
Finland	1.7	0.7	Estonia	3.1	9.3
France	0.8	0.5	Hungary	1.5	6.9
Germany	0.8	0.6	Latvia	3.1	8.2
Greece	0.8	2.3	Lithuania	3.2	13.8
Ireland	1.8	1.2	Poland	1.7	7.2
Italy	0.6	1.2	Romania	4.7	40.1
Luxembourg	2.2	0.8	Slovak Rep.	2.1	2.3
Netherlands	1.1	1.1	Slovenia	0.7	2.3
Portugal	0.9	0.9			
Cyprus	1.4	0.8	Spain	0.8	
1.0					
Malta	0.9	0.7	Denmark	0.6	0.3
Sweden	1.2	1.0	UK	0.4	0.3

Note:
Correlation coefficient with level of GDP per capita: -0.45 and 0.67 percent respectively (both significant at 5 percent level).

Source: IMF, *World Economic Outlook*.

members. Volatility of these growth rates will depend, among other things, on the credibility of government policies and the ability of authorities to prevent boom-bust cycles on domestic credit and asset markets.

It is also important to keep in mind that the level of inflation is likely to remain significantly above the EU level in the years to come. One reason for this is the Balassa-Samuelson effect, or the fact that during the catching-up process, faster productivity growth in the tradables sector will push up wages and prices in all sectors. Unfortunately, estimates of the size of this effect in accession countries vary widely because of data problems and theoretical limitations in the model that make it hard to quantify the relative importance of the effect.[3] However, other reasons for inflation differentials may be even more important. In a process of structural convergence, the structure of relative prices will have to change as

well. Such relative price changes are important as they stimulate a more efficient (re)allocation of production factors. In particular, prices of (new) products and services that are in demand have to rise vis-à-vis those of old and less sought-after products. Since the latter prices may to some extent be sticky downwards, relative price adjustments will often take place through price increases for new products and services. Consequently, a rise in inflation can be the result. Also, the carry-on effect of high inflation rates observed in the past disappears only gradually, while the continuing liberalisation process of administered prices puts upward pressure on the price level as well.[4] It should be noted that pure Balassa-Samuelson inflation will not harm a country's competitiveness, as the inflationary pressure is confined to the non-tradables sector. However, the other sources of inflationary pressure mentioned above can lead to a deterioration of competitiveness. Still, it is questionable whether these sources of inflation warrant restrictive policies aimed at short-term stabilisation, as they are natural elements of the transition process. An inordinate strict policy to fight such inflation may impede the much needed structural convergence process. An independent central bank is the obvious institution to assess the appropriate policies in this respect. By means of its policies an independent central bank will then contribute to a stable environment for the banking system. Whereas independence will eventually be guaranteed through its inclusion in the *acquis communautaire*, no single accession country has implemented all requirements up until now. Progress is especially needed in the personal independence of the members of the decision making bodies and in central banks' financial independence.

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[3] Pelkmans *et al.* (2000) estimate an average effect of 3.8%-point for all candidate transition countries, whereas De Broeck and Sløk (2001) estimate an effect of 0.8 to 1.6%-point for these same countries. The Balassa-Samuelson effect critically depends on the assumption of nominal wage convergence – wages in the non-tradables sector follow those in the tradables sector – as a result of complete labour mobility within a country. Insofar as labour mobility is limited, the Balassa-Samuelson effect will thus be less pronounced.

[4] On average, administered prices still have a weight of around 18% in the HICP baskets in accession countries (ECB – unpublished document).

1.2 Managing Capital Inflows and Preventing Lending Booms

In the coming years, as remaining entry barriers will be removed and investor confidence in the region increases, EU accession countries will most likely continue to receive significant capital inflows. In principle, such capital inflows (FDI, bank loans, debt issues and portfolio investments) will contribute to economic development by providing funding for investment projects that cannot be financed domestically. In this way, capital flows contribute to an improved resource allocation. At the same time, such inflows and the associated structural convergence, may lead to real exchange rate appreciation, which can be considered a normal "side-effect" of the convergence process. The same goes for the current account deficits that accompany substantial capital inflows (Table 2). Such deficits reflect the surge in aggregate domestic demand, for both investments and consumption, that results from the inflow of capital.

However, the Asian experience has shown that capital inflows, and particularly sudden reversals in such flows, may cause significant risks for the banking system. From a financial stability perspective it is therefore important that current account deficits remain within sound limits and are financed prudently, so as to minimise the likelihood of potentially harmful capital flow reversals. This likelihood increases as a larger proportion of total inflows originates from investors that are not so much interested in providing finance for long-term investments, but are rather focussed on exploiting short-term gains. Generally, it is assumed that investments with a short-term maturity, such as portfolio investments and short-term bank loans, are more often related to the latter motive, whereas long-term bank lending and especially FDI more often concern the former.[5] During recent years the financing of the current account deficit has been relatively prudent, as foreign direct investments (FDI) have played an important role. Still, short-term (portfolio) investments were significant as well in some countries, at least for a number of years (Table 3).

In the run-up to EU accession, the composition of capital inflows may change substantially. First, once the present privatisation wave

[5] Garibaldi *et al.* (2002) show that between 1991 and 1999 portfolio investment inflows into CEE were much more volatile than foreign direct investments, whereas bank lending took an intermediate position.

Table 2 Current Account in Accession Countries
(as percentage of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000
Bulgaria	-11.0	-0.3	-0.2	0.2	4.2	-0.5	-5.6	-5.8
Czech Rep.	1.3	-2.0	-2.6	-7.1	-6.8	-2.5	-2.9	-4.4
Estonia	1.3	-7.3	-4.4	-9.1	-12.1	-9.2	-5.8	-6.3
Hungary	-11.0	-9.8	-5.7	-3.7	-2.1	-4.9	-4.4	-3.3
Latvia	19.3	5.5	-0.4	-5.4	-6.1	-10.7	-9.9	-6.9
Lithuania	-3.2	-2.2	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0
Poland	-6.7	1.0	0.7	-2.3	-4.0	-4.3	-8.1	-6.3
Romania	-4.7	-1.5	-5.0	-7.3	-6.1	-7.0	-3.7	-3.7
Slovak Rep.	-4.6	4.6	2.1	-10.6	-9.6	-10.0	-5.9	-3.6
Slovenia	1.5	4.0	-0.5	0.2	0.1	-0.8	-3.9	-3.4
Cyprus	1.7	1.0	-1.8	-5.3	-3.9	-6.7	-2.3	n.a.
Malta	-3.4	-4.9	-11.0	-12.1	-6.1	-6.4	-3.3	-14.7

Source: International Financial Statistics (IMF).

comes to an end, FDI may decline in importance.[6] It remains to be seen whether the FDI flows attracted by the privatisation process will be fully substituted by FDI targeted at financing green field investments.[7] Secondly, the prospect of EU accession may lead to a significant increase of portfolio investments into the region, as the confidence of investors and international portfolio managers increases. The abolition of the remaining (short-term) capital controls will only facilitate this process.[8] Thirdly, the average maturity of foreign bank debt may decline as well. As a matter of fact, this has already happened to a certain extent during the last decade.

6 An example is Latvia, where the current account deficit amounted to 10.1% of GDP in 2001, partly as a result of strong consumption growth. In that same year, FDI was only sufficient to cover approximately 25% of this deficit (Bank of Finland, 2002).

7 Green field investments concern investments in new projects and firms that have to be started up from scratch (as opposed to taking-over already existing enterprises).

8 Garibaldi *et al.* (2002) show that portfolio investment into transition countries has been mainly determined by the quality of the financial infrastructure and by property rights protection. In as far as these institutions will further improve during the run up to EU accession, an additional inflow of portfolio investments might be expected.

Table 3 Private Net Capital Flows to Selected Accession Countries
(percentage total net inflow)

	Poland	Hungary	Czech Republic	Baltic States
		Bank loans		
1996	-1	-16	31	14
1997	28	38	32	34
1998	25	16	-1	32
1999	23	4	-2	-15
2000	-1	44	5	-12
2001*	—	-5	11	7
		Direct Investment		
1996	101	140	41	59
1997	57	108	44	44
1998	58	43	54	68
1999	70	47	78	65
2000	74	65	88	78
2001*	—	54	81	70
		Portfolio Investment		
1996	0	-24	27	27
1997	15	-46	24	22
1998	17	41	48	-1
1999	7	49	24	50
2000	27	-8	7	34
2001*	—	51	8	23

Note:
* First three quarters.
Sources: BIS, IMF. Bank loans could not be split in short-term and long-term loans.

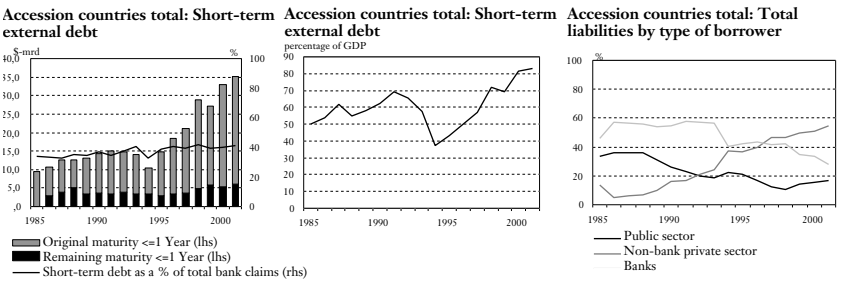
The first pane of Figure 1 shows that, on average, the accession countries have significantly increased their short-term debt owed to foreign (BIS-reporting) banks.[9] As a share of total bank debt, this short-term debt has increased from 34 percent in 1985 to 41 percent in 2001. As a percentage of GDP, short-term debt owed to foreign banks has risen even stronger: from a low of 37 percent in 1994 to 83 percent in 2001 (pane 2). A growing share of total foreign bank debt

[9] Short-term debt as a percentage of GDP has been *declining* in the Czech and Slovak Republic since 1999 and is now back on the average level.

is directed to the accession countries' non-bank private sector, while less credit goes to the public sector or to the local banking system (pane 3). Local banks have thus become less important as intermediaries in allocating foreign banks' funds to local businesses. Foreign banks increasingly allocate their resources directly to local firms, making use of the local branches and subsidiaries they have acquired during recent years.

In sum, it can be stated that in many accession countries current account deficits are substantial, while there is a tendency for the financing of these deficits to be increasingly short-term in nature. As this would make countries more vulnerable to sudden reversals in capital-flows, it is of great importance that their banking systems are adequately prepared for the consequences of such changes. In many accession countries significant progress has been made in financial reforms, often stimulated by the growing importance of foreign banks. Foreign (owned) banks intermediate an increasing share of external bank debt to local enterprises, which is an important difference with "pre-crisis" Asia, where the role of foreign banks in intermediating capital inflows was only very limited.[10] Furthermore, financial intermediation in transition countries has been expanding

Figure 1 External Debt Accession Countries: Liabilities to BIS Reporting Banks



10 McKinnon and Pill (1997) stress that emerging markets may be particularly prone to overborrowing as a result of excessive optimism. Consumers and investors then want to increase consumption and investment beyond sound levels, and banks, confronted with increased possibilities of foreign funding, may be willing to finance this. Up until now, this scenario has not materialised in the accession countries, partly due to the importance of foreign banks. By "importing" sound lending policies, foreign banks have thus to some extent contributed to a higher degree of financial stability.

fairly gradually from very low levels, in spite of good prospects of convergence towards EU levels of income. While too little credit growth might be an impediment to change in transition economies, at least the gradual growth of credit has given the accession countries some time to strengthen their banking sectors. Nevertheless, capital outflows could be triggered when markets no longer perceive the current account deficits and accompanying real appreciation as a sign of strength and structural convergence, but rather as a weakness and as a sign of badly intermediated foreign capital.

1.3 Suitable Exchange Rate Regimes

The accession countries are currently employing a broad range of exchange rate strategies, each with their own specific challenges in maintaining stability. The Czech Republic, Poland, Romania, Slovakia and Slovenia have opted for, either free or managed, floating arrangements. On the other end of the spectrum, Bulgaria, the Baltic States and Malta maintain either conventional fixed peg or currency board arrangements. Cyprus and Hungary are taking an intermediate approach by mirroring the ERM-II arrangement with 15 percent fluctuation bands around a central rate to the euro. The wide degree of regime diversity partially reflects historical factors,[11] but it also indicates that there is no single exchange rate regime that is optimal for all accession countries. Whereas a country's banking sector would be served best by a certain degree of exchange rate stability,[12] apparently both flexible and fixed exchange rate regimes have their advantages and disadvantages, and the specific circumstances in each country define the best choice.

A fixed peg arrangement provides the advantage of nominal exchange rate stability, but this stabilisation anchor comes at a price. As is well-known, countries with a fixed peg cannot use monetary policy, or nominal exchange rate changes, to counter an asymmetric economic shock or to maintain their competitiveness. Such a decline in competitiveness can for instance result from an appreciation of

[11] Bulgaria, for instance, installed its currency board as a means to stabilise its economy during the crisis of 1996/97.

[12] Substantial exchange rate volatility can inflict severe damage on bank balance sheets through the adjustment of the real value of assets that have been financed in foreign currencies (cf. Section 1.4).

their real exchange rate caused by a comparatively high rate of inflation. Subsequently they will have to remain fiscally prudent, and have to rely on wage and price flexibility as the sole adjustment mechanisms. At the same time, the perpetuity of a fixed exchange rate can never be guaranteed. Speculative attacks on the peg can be triggered by a sudden loss of confidence or other negative shocks. These can be costly in terms of reserves spent on defence, while a disorderly exit from the fixed regime, entailing a large shift in the exchange rate, can have severe economic repercussions, in particular for the banking sector. When such a scenario would unfold, it may turn out that the risks to banking sector stability have actually been augmented by the fixed peg, especially since a pegged currency can discourage hedging against currency risk, thus stimulating the build-up of unbalanced portfolios.

Whereas flexible arrangements cannot prevent damaging exchange rate volatility triggered by volatile capital flows, they do offer the potential benefits of an active monetary and exchange rate policy that can be used to manage these flows, to spur disinflation, maintain competitiveness and to support economic growth. And whereas fiscal prudence and structural flexibility will support the economic well-being of all accession countries, their importance increases along with the degree of invariability of the exchange rate. The Asian experience has shown that a pegged currency combined with large reversals in capital flows may lead to significant problems, as it is very painful and costly to adjust a fixed exchange rate regime in an orderly fashion. Flexible exchange rates are better able to adapt themselves to changes in capital flows and other economic shocks, and it seems therefore sensible for accession countries not to rush themselves in fixing their exchange rates as quickly as possible. Only countries that are confident that they can maintain strict fiscal prudence and that their wages and prices are flexible enough to safeguard competitiveness and to cope with asymmetric shocks, should consider a fixed rate regime.[13]

[13] The Baltic States are archetypal examples of countries that have many characteristics that will help to sustain a successful currency board arrangement. Up until now, their pegs have not come under severe stress, despite the facts that they already liberalised their capital accounts in the early 1990s and that they have shown large current account deficits over the past years. Sutela (2001) ascribes their success to both sound fundamentals and unintended consequences of policy decisions. On the one hand they have pursued sound fiscal policies and have

A new challenge for exchange rate policy will arise after the candidates have acceded to the European Union. Before a country can fully participate in EMU and introduce the euro, it will have to pass the test that was laid down in the Maastricht Treaty. Its public finances (deficit and debt), its levels of interest rates and inflation and its exchange rate will have to meet transparent criteria that help forestall inflationary tendencies within the monetary union and that can prevent tensions that might arise when the common monetary policy would fail to meet the needs of all individual participating member states. The exchange rate policy test that has to be passed, is successful participation in the ERM-II for at least two years, during which the exchange rate should remain within a band of +/- 15 percent around a central rate that has to be commonly agreed upon. In effect, ERM-II can be regarded as a relatively fixed exchange rate regime, as adjustments of the central parity will in practice be painful decisions which are not taken easily. On the other hand, the broad band around the central rate provides for some flexibility. Membership of ERM-II can thus be a useful tool to avoid excessive exchange rate fluctuations by anchoring exchange rate expectations, while at the same time providing the (limited) exchange rate flexibility needed to safeguard real convergence. It can also be a useful tool in identifying an equilibrium exchange rate that can be expected to be sustainable over the long term and that is supported by market forces. Still, already before entering ERM-II the central rate in this regime should be well-considered. Nevertheless, it cannot be excluded that – given the remaining large structural differences – the chosen rate may have to be adjusted at some point. As such adjustments are potentially painful processes, countries should be careful in giving up their exchange rate flexibility too early.

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created a high degree of structural flexibility in their economies. On the other hand exchange rate stability was supported by the fact that their financial markets are very small, leaving little room for capital flow reversals, and the fact that almost all of their banks were sold to solid foreign institutions. Despite their successful track-record, consistent good policies – especially a prudent fiscal policy – remain vital for the sustainability of these arrangements, given their relatively high current account deficits.

1.4 Limiting Currency Mismatches in the Banking System

Banks denominating part of their assets and/or liabilities in a foreign currency will be subject to risks arising from exchange rate changes. In principle, two cases can be distinguished. First, when a bank denominates more liabilities than assets in a foreign currency (or vice versa) it will be subject to a currency mismatch. When domestic compared to foreign interest rates are high, banks may for instance be tempted to use foreign currency denominated liabilities to fund their local currency denominated activities. Such a currency mismatch will subject banks to a substantial devaluation or depreciation risk, as in that case their foreign currency denominated liabilities will increase in value, eroding the bank's capital base.[14] The second case concerns banks that denominate the same amount of assets and liabilities in a foreign currency in order to avoid a currency mismatch.[15] Even then, the bank remains subject to risks linked to exchange rate fluctuations. On the asset side, currency risk is shifted to debtors with foreign currency denominated loans, and currency risk will accordingly be substituted by credit risk. After all, banks' customers may not be able to pay off such loans, the value of which will rise sharply in terms of the local currency after a downward exchange rate correction. Firms may be overly optimistic in assuming that the current exchange rate will also hold in the future, and thus demand a relatively high proportion of foreign currency debt. In Poland, Hungary and the Czech Republic, the importance of foreign-currency denominated lending to the corporate sector has indeed risen.[16] At the same time, the share of foreign currency denominated deposits has declined in these countries. As a result, the corporate sector has increased its net foreign exchange position against the domestic banking sector and may therefore be more vulnerable to downward corrections in the exchange rate.

During the run-up to E(M)U accession, it is conceivable that the importance of euro-deposits will increase. This may increase

[14] Additionally, a maturity mismatch will increase the bank's interest rate exposure or, more specifically, its exposure to changes in the yield curve.

[15] An alternative would be to use off balance sheet hedging instruments such as forward contracts.

[16] In these three countries, foreign currency denominated credit amounted to 24%, 38% and 19%, respectively, of total credit granted by the domestic banking system to the corporate sector in 2000 (Reininger *et al.*, 2001, pp. 13-14).

depositors' sensitivity to interest rate differentials between euro-deposits at home, international euro-deposits and local currency deposits. As a result, both cross-border and within-border capital mobility may intensify. With regard to the former, the threshold for depositors to shift from domestic euro-deposits into foreign euro-deposits may decline, leading to more volatile cross-border capital movements reacting to changes in international interest rate differences. Within borders, depositors may start to shift more frequently between local currency and euro-deposits depending on the interest rate differential. Insofar such shifting takes places within the same bank, risks will be limited. However, depositors will also take into account the safety of euro-deposits by (their estimate of) the capital adequacy of the bank and the ability of this bank to tap the international financial markets and to return deposits in euros. The ownership structure of a bank may be important in this regard, as depositors may find foreign-owned banks to be more reliable. Shifts between local currency deposits and euro-deposits may then boil down to shifts between local banks and foreign owned banks. This would imply an increase in liquidity risk for especially the local banks, stressing the need for the monitoring of banks' net open currency positions, both on and off balance sheet. Especially during crisis periods, depositors could decide to shift their deposits with local banks (both in local currency and in euro) to foreign owned banks, thus "doing their capital flight at home". Insofar that is the case, international capital mobility may actually decline.

Besides carefully monitoring banks open currency positions, risks can also be limited by making sure that banks do not try to reduce the currency risk associated with deposit euroisation by extending euro credit to customers who will not be able to service their debt obligations in case of sharp depreciations or devaluations. Finally, bank regulators can prevent undue transformation of currency by placing limits on banks' open foreign exchange positions when deemed necessary (see also Section 1.7).

1.5 Adequate Preparations for Financial Liberalisation

Financial liberalisation covers a whole range of deregulatory measures that loosen the constraints on the financial activities of banks and other economic actors, varying from lending restrictions to capital account liberalisation. Although financial liberalisation can

generate substantial long-term benefits, the new environment inevitably presents banks with new risks, which, without the proper precautions, may pose a threat to banking sector stability. The Asian experience has shown that getting the sequence right can be important in this regard. The positive effects of financial liberalisation will come within reach at a lower cost if banks and supervisory capacity are strengthened before reforms are implemented.

The CEE accession countries have come a long way in liberalising their financial systems since the beginning of the transition period, to a large extent stimulated by the institutional requirements of the EU accession process. Full liberalisation of the capital account is a part of the *acquis communautaire*, introduced to ensure a more efficient allocation of resources. However, even though EU rules allow for the temporal reintroduction (6 months maximum) of some capital restrictions under exceptional circumstances, full liberalisation might not necessarily benefit the accession countries at all times. It could be beneficiary to initially postpone the liberalisation of the most fluid capital flows, and thus liberalise longer-term flows before short-term flows, and direct investment before portfolio investment.[17] Thus, short-term capital controls might fulfil a positive role during the catching-up process when a country's credibility has not yet increased sufficiently to prevent large capital flow reversals due to speculative investors. Nevertheless, no country has requested any transitional periods for the liberalisation of short-term capital movements. Instead, the focus has often been on the postponement of the politically sensitive liberalisation of real estate purchases. The chapter on capital movement has now been closed by all accession countries, except Poland and Romania, and implementation of the liberalisation of capital movements has come a long way in most countries. Only Romania, Malta and Cyprus still maintain significant restrictions. Despite the fact that the adoption of the full *acquis communautaire* by new member states is an essential precondition for

[17] Although it may be unattainable to adequately distinguish between "productive" and "speculative" capital flows, making an – imperfect – distinction between short-term and long-term capital flows is in many cases possible. Limiting short-term capital flows will then inevitably also hinder productive short-term investments, such as trade credit. The resulting loss in allocative efficiency then has to be weighed against the increased financial stability that is gained by imposing the capital flow restrictions.

the continued success of European integration, a temporary derogation allowing the accession countries to maintain some barriers to short-term capital flows, might actually have been beneficiary.

With liberalisation of capital movements being reality in most of the accession countries at present, the most important instrument available to prepare the financial sector for EU accession is now the framework of prudential regulation and supervision. Banks could be encouraged to increase their loan-loss provisions and enhance their know-how in the fields of credit assessment, liquidity management and the pricing of risks. This last point goes in principle also for banks' clients and other (end) users of (intermediated) foreign capital, who will also need time to adapt their risk management systems. Additionally, banks' capital levels should be high enough to be able to cope with a more liberalised and market-based operating environment. When the capacity of banks to take on risks of various sorts is expanded, the capacity of supervisors to monitor these changes has to increase commensurately. The accession countries have generally introduced adequate laws and regulations to promote the soundness of individual banks, but that does not necessarily guarantee their actual implementation. It is also important that supervisors and the judiciary have adequate resources to perform their tasks (cf. Section 1.7). The development of the institutional capacity that is necessary to ensure the well-functioning of the prudential framework requires substantial financial resources and, inevitably, time.

1.6 Reducing Government Involvement and Connected Lending

Excessive government involvement in banks' credit decisions as well as connected lending to bank insiders, such as management or shareholders, may harm bank profitability and in the end, bank stability. After all, such lending is unlikely to be based on a commercial evaluation of risk and return, but rather on political objectives. Not surprisingly, recent research shows that related loans have higher default rates and lower recovery rates (La Porta, López-de-Silanes and Zamarripa, 2002). Government ownership in the accession countries has decreased remarkably during recent years, even compared with several EU member states (Table 4).

Table 4 Asset-Share of State-Owned Banks 1996-2001
(in percentages)

Country	2000	1996
Bulgaria	20	82
Czech Republic*	28	17
Estonia	0	7
Hungary	9	16
Latvia	3	7
Lithuania	39	54
Poland	24	70
Romania	50	81
Slovak Republic	49	54
Slovenia	42	41

Note:
* Excludes Ceska Sporitelna and Komercni Banka.
Source: EBRD, *Transition Report*, 2001.

During communist times, governments were in complete charge of banks' credit granting process. A first step in reducing this involvement was the privatisation of state banks. However, stakeholders in these newly privatised banks were often former members of the communist nomenclature. Insofar that was the case, the privatisation process was partly a substitution between government involvement and connected lending. Hersch *et al.* (1997) show for instance that former nomenclature members in Hungary had a higher chance of receiving bank credit than other firm managers. An important second step in reducing unsound lending practices, which in some countries partly coincided with the first one, was the selling of majority stakes in the largest banks to foreign strategic investors. With this, the problem of connected lending has most likely become less pressing as well.

The establishment of foreign bank branches and subsidiaries, whether through green field investments or by taking over local banks, has generally led to a higher efficiency of the domestic banking system.[18] Foreign bank penetration will for example lead to

[18] See for instance Claessens *et al.* (2001) for a comprehensive study into the effects of foreign bank entry on local banking markets.

improved bank management, the introduction of new financial services and the "import" of better regulation. However, for transition economies that open up their banking markets to foreign competition, the challenge lies in achieving such higher long-run efficiency without creating financial instability in the short run. Such instability may for instance be the result of very fragile local banks – burdened by large amounts of bad debt – that default when confronted with foreign competition.[19] In such cases, foreign bank liberalisation can best be preceded or combined with the cleaning and reforming of the local banking system and, importantly, the strengthening of the local supervisory authorities (cf. Section 1.5).

Strong and independent supervisory authorities are extremely important from the viewpoint of reducing connected lending and government involvement. Some authors even argue that regulatory and supervisory independence is important for financial stability just as central bank independence is important for monetary stability.[20] Only when regulators are independent – but at the same time sufficiently accountable – may they withstand political interference in the supervisory process. Supervisors may for instance consider to place tough limits on lending to insiders, as such lending is likely to lead to conflicts of interest. Strict enforcement of these connected exposure limits will be at least as important as the exact size of the limits.

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[19] Also, foreign banks may be inclined to reduce their credit supply during adverse economic times, leading to increased credit volatility in the host country. Results for Latin America show that even though cross-border foreign bank credit may indeed be withdrawn during an economic downturn, foreign bank subsidiaries' credit is much more stable and even increased during such a period (Peek and Rosengren, 2000). Comparable research for CEE suggest that this conclusion holds for this region as well (De Haas and Lelyveld, 2002).

[20] See Quintyn and Taylor (2002) who distinguish four dimensions of regulatory and supervisory independence. Firstly, regulators should have sufficient autonomy in setting rules and regulations, within the confines of the law (regulatory independence). Secondly, supervisors should be able to inspect, monitor, sanction and enforce sanctions without interference by the government or the supervised institutions (supervisory independence). Thirdly, the supervisory agency should be separate from the executive and legislative branches of government (institutional independence). Fourthly, the supervisory agency should be able to decide independently over the size and use of its budget (budgetary independence).

1.7 Strengthening the Legal, Supervisory and Accounting Framework

Adequate institutions, such as a legal framework that specifies the "rules of the game" for a market economy, are crucial for the development of a deep, stable and efficient banking sector. Legal rules provide for instance for creditor protection in case debtors default and collateral has to be liquidated. Without such protection banks may not be incited to expand their credit supply, as they hesitate to lend funds to any enterprise that is even slightly risky, and may instead seek recourse in investing in government bonds or other risk-free assets.[21] Likewise, banks will tend to ration credit if they have to operate in an environment with intransparent and unclear accounting rules as they cannot adequately judge the risks involved in lending. An incomplete implementation of internationally acceptable accounting standards and the subsequent low quality of consolidated accounts makes it difficult for supervisors as well to assess inter-affiliate lending and relationships between banks.

The challenges accession countries face over the coming years in improving their legal, supervisory and accounting frameworks are basically twofold. Firstly, the lack of sound creditor protection has been an important impediment for banks in transition economies to start lending to small, new and innovative enterprises, even when risk-return characteristics were satisfactory in themselves. A sound legal framework that effectively protects creditors when making loans to the private sector, would thus ensure that banks do not overprice the risks of private investments. It will then be conducive to the development of a local banking system that is able to efficiently allocate domestic resources to long-term productive investments. Additionally, an adequate supervisory framework ideally fulfils a complementary role in making sure that banks do neither start to invest funds in overly risky projects. Effective supervision thus warrants that banks do not underprice risks, for instance due to perverse incentives that lead to moral hazard. By providing banks with the right incentives, financial laws and supervision thus enable the banking system to deepen and to allocate the available resources more efficiently. The second, though related, challenge for the

[21] See also the contributions by La Porta, Lopez-De-Silanes, Shleifer and Vishny (1997, 1998 and 2000).

accession countries relates to the role of laws and supervision with respect to exogenous shocks, such as sudden reversals in capital flows. Effective legal and supervisory institutions contribute to a solid banking system that is able to efficiently intermediate the increasing flow of (short-term) foreign funding which will likely be the result of the full liberalisation of the capital account. These challenges may be more or less urgent for different countries, depending on both the expected amount of capital inflow during the coming years and the progress that has already been made in strengthening the legal and supervisory systems.

Since the beginning of transition, many EU accession candidates have shown a substantial improvement in their commercial laws, consisting of pledge, bankruptcy and company laws. As a result, the legal protection of creditors has advanced considerably in most of the countries. Although financial laws have been improved, the enforcement or effectiveness of such laws still leaves to be desired and has in some cases even worsened lately (EBRD, 2001). Table 5 illustrates that in recent years, in some countries both the effectiveness and the extensiveness of commercial law has slightly decreased again. For example, banks that want to liquidate collateral in some countries still have to wait a considerable amount of time before they are actually able to do so. Such inefficiencies are partly caused by ineffective courts and slow legislative systems and processes, as day-to-day legal practice has not been able to adapt itself to the rapidly changing legal environment.

Empirical results suggest that such poor law enforcement indeed hinders the development of the banking sector in transition economies (Pistor, Raiser and Gelfer, 2000). Simply "copying" western laws and aligning supervision with EU standards is thus not enough. This goes as well for improvements in the quality of bank regulation. Reiniger, Schardax and Summer (2001) find that formal supervisory power to prevent and correct problems in the banking sector are relatively high in Hungary, Poland and the Czech Republic when compared with the EU average. However, supervisory resources turn out be used rather inefficiently, as on-site examinations are rather infrequent and forbearance discretion is relatively high. Additionally, Neyapti and Dincer (2001) find a positive (negative) relationship between good bank regulation and supervision and growth (inflation), but also conclude that this relationship is stronger when countries have changed or improved

Table 5 Changes in Legal Transition Indicators 1997-2001: Commercial Law

Country	2001			1997		
	Extensive-ness	Effective-ness	Total	Extensive-ness	Effective-ness	Total
Bulgaria	4	4–	4–	3	3	3
Czech Republic	3	3	3	4	4	4
Estonia		3+	4	4–	4	4
4						
Hungary	4–	4–	4–	4	4	4
Latvia	4–	4	4–	3+	3	3
Lithuania	4–	4–	4–	4	3	3
Poland	4–	3	3+	4	4+	4
Romania	4	4	4	3	3	3
Slovak Republic	3+	3+	3+	3	3	3
Slovenia	4–	4–	4	3	4	3

Note: Scores range between 1 and 4+ (maximum) and are based on EBRD survey results which reflect how lawyers and region experts perceive the state of legal reform.
Source: EBRD, *Transition Report 1997* and *Transition Report 2001*.

their supervisory framework more than once since the beginning of transition. Apparently, legal institutions become more effective when they are adapted to the particular economic situation. Therefore, not only a better enforcement of legal and supervisory frameworks is of great importance for accession countries, but also further improvements to better embed these frameworks into their specific economic and institutional background. This is all the more important since some of the current weaknesses in financial market regulation in CEE, such as a lack of resources to monitor compliance, have been identified as having contributed to the Asian financial crises before (Ramasastry and Slavova, 1999).

1.8 Well-Balanced Incentive Management

A final point of interest in the quest for banking sector stability entails the need to instil the proper incentives in bank owners, managers and depositors. Such "incentive management" confronts policymakers with conflicting objectives. On the one hand, excessive risk taking by banks can be discouraged when owners, depositors and

others involved in a bank's business stand to lose from its bankruptcy. On the other hand, there are strong arguments to not always let unsound banks fail, nor to let depositors pay the price for their choice of bank. The fact that banks are important to the economy as a whole and that their failure may have severe repercussions for specific parts of the economy, argues for the more or less explicit existence of a lender of last resort. Likewise, the prevention of bank-runs, the difficulty depositors may face in distinguishing the best banks and the need to protect the public from bank failures, are all valid reasons for establishing a deposit insurance scheme. Nevertheless, the existence of a public safety net also creates moral hazard, as it incites actors to behave less responsible than they would have done otherwise.

Taking the above considerations into account, the members of the European Union have agreed to certain rules for deposit insurance in order to establish minimum prudential standards within the single market. They include a minimum level of protection of 20.000 euro per deposit and the principle that all branch depositors should be protected by the state where the head office is located (home country principle). As these agreements are part of the EU *acquis communautaire*, the candidate countries that have not yet done so, will have to harmonise their practices to meet EU standards before accession. However, this regulation might not be optimal for the accession countries. Demirgüç-Kunt and Detragiache (2000), and also Hermes and Lensink (1997), argue that whereas the moral hazard problem caused by explicit deposit insurance tends to be detrimental to bank stability in general, this is even more so in countries where the institutional environment is still relatively weak. They also conclude that the adverse impact of deposit insurance on bank stability tends to be stronger when the coverage offered to depositors is more extensive. The fact that accession countries lag behind the EU in terms of the development of the institutional environment and income levels, means that compliance with the EU regulation may actually raise moral hazard problems. A case in point is the minimum protection level of 20.000 euro in the current EU deposit insurance scheme, which is relatively high for the accession countries given their much lower income levels as well as average size of deposits. This stresses once more the importance of effective prudential regulation and banking supervision, in order to minimise moral hazard behaviour resulting from a relatively extensive deposit insurance system.

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After the candidates have acceded to the EU, the lender of last resort function will remain a national responsibility. Just like the other member states these countries will (continue to) apply a strategy of 'constructive ambiguity' to minimise moral hazard problems. A related issue is the fact that many banks in the accession countries have been acquired by financial institutions from current EU member states. This may have complicated the execution of the lender of last resort function as well as the practice of deposit insurance (but possibly made it less necessary as well). Both the home country principle for deposit insurance and similar EU regulations that stipulate that full responsibility for prudential supervision belongs to the 'home country', mean that important responsibilities for the financial stability of the accession countries will have to be borne by the authorities of other member states. Subsequently, to safeguard financial stability, it is of the utmost importance that the incentives of the home and host country supervisory authorities are fully aligned, and that both parties keep each other sufficiently informed. In order to achieve this, deepened bilateral and multilateral cross-border cooperation between the relevant authorities in different countries, as has been recommended by the Economic and Financial Committee (2000 and 2001) is essential.[22] Such cross-border cooperation becomes even more important as the number of EU banks of whom the headquarters are located in other member states increases during the accession process. Within the EU, Memoranda of Understanding form the main basis of bilateral cooperation. Whereas in the run-up to accession similar agreements are also becoming more commonplace in the relations between the financial authorities of accession countries and individual EU member states, more progress in this field is needed to instil the necessary incentives in all financial authorities involved in cross-border issues.

2 Conclusions and Policy Implications

The structural changes and adjustments that the EU accession candidates have made during recent years, party speeded up by the

[22] See also Enria and Vesala (2001).

accession requirements, have in many cases been impressive. Notwithstanding this progress, the financial and regulatory infrastructure in many accession countries still considerably lags behind the prevailing levels within the present Union. The much needed further development and deepening of the CEE banking systems may therefore also pose some risks to the stability of these systems as well as to the wider economy. These risks include for instance an unfavourable operating environment for the banking sector due to considerable macroeconomic volatility. Such volatility can result from consistently large current account deficits coupled with increasing short-term financing, such as portfolio investments and short-term bank debt. In addition, (unexpected) exchange rate changes may lead to substantial currency and credit risks in the banking system. Related lending and government involvement, especially when combined with a deficient regulatory and supervisory environment, will make banks more vulnerable as well.

Countries on the road to E(M)U-accession can take some important policy measures to limit the probability of the materialisation of the above-mentioned risks. In general, sound macroeconomic policies tailored to country-specific circumstances, combined with a further strengthening of the supervisory and institutional environment are key. More specifically, current account deficits should be kept in limits within which sound, long-term financing can be ensured to limit the vulnerability of the financial sector to international contagion and sudden sizeable outflows of foreign capital. In addition, the choice of the exchange rate regime should explicitly take into account the risks for financial stability, both in the run-up to EU and to EMU accession. The advantages of preserving some exchange rate flexibility during the coming years should not be underestimated, especially as many countries have already completed the liberalisation of (short-term) capital flows. As regards the institutional environment, the independence of the central bank is crucial, as is the independence of the supervisory authorities. Adequate cooperation of the central bank and banking supervisors, and possibly combining both within one organisation, is imperative as well, as in many accession countries financial knowledge is still relatively scarce and should thus be used as efficiently as possible. Consistent national and cross-border efforts are needed to continuously improve supervision and to keep up with the rapid developments in the financial sector. This should help

safeguard the general soundness of banks by stimulating the development of good risk management practices, for example in the field of currency risk. Finally the legal environment needs further strengthening, and enforcement should be tightened up.

The strengthening of the legal system and supervisory authorities will prove all the more important and pressing as there is in some areas an unequivocal tension between the requirements for EU accession and the lagging behind of the financial infrastructure. More precisely, the pursuit of banking stability in the short and medium term might be rendered more difficult by a premature and rash adoption of all EU requirements when striving for (too) speedy E(M)U-accession. An example is the fact that the adoption of the *acquis communautaire* implies that the accession countries have to liberalise their capital accounts in a dynamic economic environment where macroeconomic volatility and capital flow reversals cannot be excluded. Other examples include the adoption of relatively extensive deposit insurance schemes, which may encourage moral hazard, and the early (though voluntary) giving up of exchange rate flexibility. In the coming years all accession countries will face important decisions relating to their upcoming accession to the EU and EMU, ranging from the decision on when to fully liberalise the capital account, to the decision on when to adopt the euro. It is important that the possible implications of these decisions for banking sector stability are always considered carefully.

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7

Postscript to Henk Brouwer, Ralph de Haas and Bas Kiviet

Mark Teunissen

In December 2002, the European Council in Copenhagen concluded that ten candidate countries would be able to accede to the EU in 2004. In the history of the EU enlargement process, this is undoubtedly a unique step. The decision has intensified the debate on how quickly these countries should join the EMU after their accession to the EU. To be able to join the EMU, countries must comply with the (nominal) convergence criteria for inflation, public finances, long-term interest rates and the exchange rate, as laid down in the Treaty of Maastricht. The latter criterion stipulates that a country should observe the normal fluctuation bands within the European Exchange Rate Mechanism (the so-called ERM-II) for at least two years without devaluing against the currency of any other member state. In the ERM-II, the exchange rates of the currencies of the accession countries are pegged to the euro, with a standard fluctuation band of +/- 15 percent and with the possibility of realignments of this central rate. This minimum period of two years implies that the ten candidate countries would be able to join the EMU at the end of 2006, or early 2007, at the earliest. With this formal timeframe in mind, the authorities of most candidate countries, supported by several academics, seem to be in favour of entering the EMU as quickly as possible. On the other hand, the eurosystem authorities have been especially reticent to the idea of rapid EMU accession.

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The Road to EMU: Short Cut or Detour?

The proponents of rapid EMU accession generally base their view on three arguments. A first argument is that most candidate countries are already highly integrated with the euro area in terms of financial and trade flows, and as a consequence have more or less similar business cycles as compared to the euro area. As such, the common monetary policy of the eurosystem would not be inappropriate for the candidate countries. A second argument is that the prospect of rapid accession to the EMU would stimulate governments of the candidate countries to implement necessary, but painful reforms. Also, with EMU accession ahead, such reforms would likely be more acceptable to parliaments and the public at large. A third argument relates to the general antipathy towards the ERM-II. This mechanism is considered to be a mere waiting room before the adoption of the euro, while at the same time creating possible risks to financial stability. In fact, some academics even refer to the ERM-II as purgatory! One important reason for this view is that trying to maintain a fixed, but adjustable exchange rate in the context of large and volatile capital inflows, would unavoidably lead to speculative attacks on the new EU members' currencies. While fighting off such attacks is costly, giving in to them might be even more costly in terms of financial instability. Therefore, the quick adoption of the euro will eliminate exchange rate risk and, as such limit financial stability risks. Moreover, no exchange rate risk means lower risk premiums. This would of course be beneficial for trade and investment, which in turn would enhance the growth potential of the accession countries. All together, although acknowledging the formal requirement of the ERM-II participation after EU accession, most accession countries are likely to limit their stay in ERM-II to the shortest period possible. As they aim for rapid EMU accession, they might well consider the central parity chosen in the ERM-II to be the conversion rate for euro adoption.

The arguments against (too) rapid EMU accession are basically two-fold. First, rapid EMU accession would require the new EU member states to comply with the nominal convergence criteria at rather short notice. One could question the feasibility of such a steep adjustment path, especially with regard to the criterion for public finances. Currently, the budget deficits, particularly in the Central and Eastern European accession countries, are still significant.

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Moreover, substantial budgetary risks may emerge in the near future. For instance, the completion of the transition process and of the accession to the EU will entail significant government outlays. In the three Baltic countries, for example, annual public expenditures due to complying with the environmental requirements stemming from the EU *acquis communautaire*, are estimated to reach 2 percent of GDP. Although most of the current accession countries have made remarkable progress in inflation reduction, major risks in this area still lie ahead. In addition to the well-known Balassa-Samuelson effect, inflationary pressures might also arise from EU accession itself. For instance, regulated prices in the accession countries still constitute around 20 percent of the consumer price index on average. As most of these regulated prices are set below cost-recovery level, the process of price liberalisation as required by EU accession, will have an upward effect on price dynamics in the accession countries. Besides the question of feasibility, one could wonder whether a very ambitious nominal convergence path is desirable. In some countries, this adjustment path is only possible with very tight budgetary and monetary policies, which could slow down their already limited progress in real convergence towards the euro area.

A second argument against rapid adoption of the euro is that maintaining their currencies through participation in the ERM-II could be beneficial for the new EU member states. The ERM-II provides both stability and flexibility, and as such can foster the combination of nominal and real convergence. The exchange rate peg vis-à-vis the euro offers the new EU member states an anchor for macroeconomic stability in general, and for containing inflation in particular, as in a number of these countries with relatively limited financial markets, the exchange rate channel is the most effective monetary transmission channel. At the same time, the ERM-II offers flexibility through the relatively large bandwidth and the possibility of realignments, which could be advantageous for the new member states. After all, most of these countries are small open economies, which are still in the process of rapid structural transformation and catching-up. In this environment, nominal exchange rate flexibility could serve as a useful instrument to accommodate economic shocks or an appreciation of the real exchange rate. As such, *ex ante* guarantees about the euro conversion rate are impossible to give, even more so as last minutes revaluations are still possible – see, for instance, Ireland and Greece. If used in this way, the ERM-II could

both foster economic stability as well as provide an anchor for nominal stability.

To conclude, it is clear there is more than one ground for arguing both in favour and against rapid EMU accession by the new EU member states. It is important to note that the ERM-II is a multilateral arrangement with responsibilities for the authorities of both the participating country and the euro area. Therefore, in advance of accession of the new EU member states to the ERM-II, intensive discussions between these parties on the modalities of operating in this exchange rate mechanism seem warranted. Obviously, once participation in the ERM-II becomes a fact, both parties should carefully monitor the sustainability of the central rates.

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8

Comment on Henk Brouwer, Ralph de Haas and Bas Kiviet

György Szapáry

In my comment, I would like to touch upon three characteristics of the financial sector of the Central and Eastern European Countries of transition (CEECs), namely, the relatively low degree of financial intermediation, the dominance of the banking sector over the capital markets, and the high degree of foreign ownership. To a large extent, these features are a direct consequence of the transition process. I agree with the authors of the chapter that macroeconomic stability and a strong independent regulatory and supervisory authority are essential for reducing the potential risks to financial stability. However, the special features of the CEECs financial system need to be considered, since in some cases they mitigate, while in others they exacerbate the commonly known potential risks. To make my arguments, I will refer to the experience of Hungary, the country with which I am the most familiar, but most of the points I make are also relevant for the other CEECs.[1]

Low Degree of Financial Intermediation

A typical characteristic of the CEECs is the low level of bank intermediation. In the CEECs-10,[2] banking assets average about 50

[1] For details of the banking sector reform in Hungary see György Szapáry, "Banking Sector Reform in Hungary: What Have We Learned and What Are the Prospects?", In: *Comparative Economic Studies*, XLIV, No. 1, Spring 2002.

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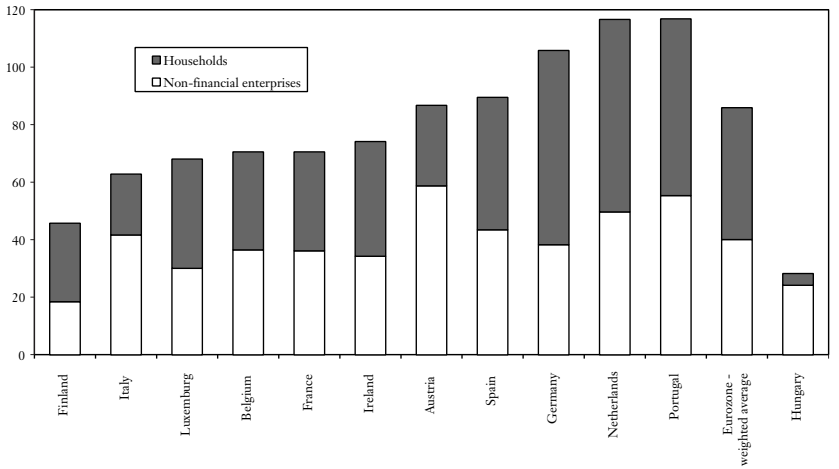
percent of GDP, compared with an average of 240 percent in the euro area. In Hungary that number is 70 percent. Even in Greece, where the depth of the financial sector is the lowest among EMU members, the corresponding figure is twice as high. The low ratio in Hungary is explained by the low level of credit to the private sector. As can be seen from Chart 1, loans extended by the banking sector to the corporate and household sectors totalled about 30 percent of GDP in 2000. That figure in the euro area ranges form close to 50 percent in Finland to almost 120 percent in the Netherlands and Portugal, the weighted average for the whole area being over 80 percent.

Several factors account for the low level of credit in Hungary. First, as a result of the privatisation of enterprises to strategic owners and the inflow of FDI to greenfield projects, a major part of the Hungarian GDP is produced by foreign invested companies, which account for about 70 percent of Hungarian exports, a main driving force behind the dynamic economic growth. These multinational companies tend to borrow from their mother companies or from

Chart 1 Credit to the Private Sector in the Euro Zone and in Hungary, 2000
(in percentages of GDP)



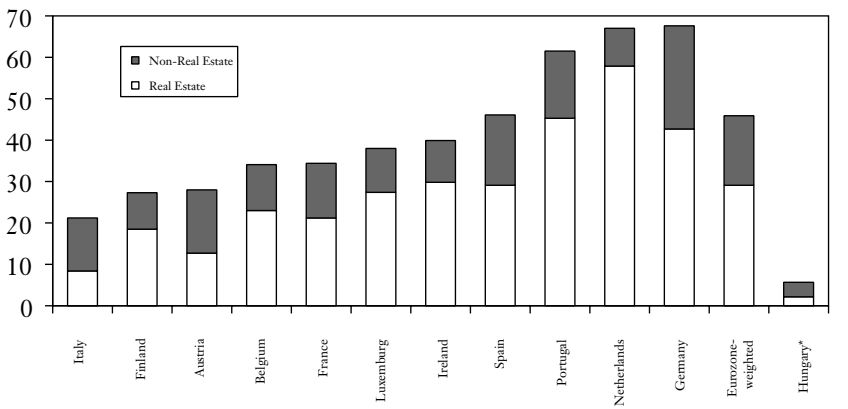
Source: National Bank of Hungary, *Report on Financial Stability*, June, 2002.

[2] All accession counties except Cyprus, Malta and Turkey.

their banks abroad, bypassing the domestic banking system. Second, as illustrated in Chart 2, lending to the household sector is very low by comparison to the euro zone. In the euro area, such loans average 46 percent (weighted) of GDP, while in Hungary they represent a mere 6 percent. Lending to households has been constrained by the low level of incomes and the high risks involved in lending to this sector. Third, the access to bank credit by domestic private firms has been impeded by the lack of sufficiently long track record that would make them acceptable credit risks for banks.

The low level of bank intermediation raises a number of issues from the point of view of potential risks. That situation is partly explained by the fact that banks have shied away from lending to the riskier small and medium-sized enterprise and household markets, concentrating on the more stable corporate sector. This sector is better capitalised and hence more able to withstand the fluctuations in market conditions. Therefore, there are less potential risks to banks from shifts in market conditions. On the other hand, the low level of credit also means that there is "room to expand" into the more risky market segments. This is already happening in Hungary, as the increased competition encourages banks to extend their activities into new markets, particularly the household market. Currently, the capital adequacy ratio of banks in Hungary is satisfactory (12,3 percent in 2001) and the bad loan portfolio is less

Chart 2 Credit to Households in the Euro Zone and in Hungary, 2000
(in percentages of GDP)



Source: National Bank of Hungary, *Report on Financial Stability*, June, 2002.

than 4 percent. As banks extend their activities to riskier markets, the quality of the loan portfolio might worsen and there might be a need to increase the capital of the banks in order to avoid an undue decline in the capital adequacy ratios. In this respect, it can be considered as an advantage that all but two of the 31 commercial banks are subsidiaries of well known foreign banks. However, there is no guarantee that the mother banks will not get into trouble, in which case they might be less willing to put additional capital into their subsidiaries abroad. Foreign ownership of banks can not, therefore, be an excuse for lax supervision at home.

The foreign currency denominated loans of the banks represent a relatively large proportion (38 percent) of total credit extended by banks in Hungary. Under the narrow-band preannounced crawling peg, there was an incentive to borrow in foreign currency to take advantage of lower interest rates. Since the widening of the exchange rate band in May 2001, foreign currency borrowings have been reduced in response to the appreciation of the Hungarian forint and to the increased exchange rate risk. As a prudential measure, the foreign currency open positions of banks are subject to limits imposed by the authorities, but the foreign currency exposure of domestic borrowers represent a potential risk for banks. That risk is mitigated by the fact that most of the foreign currency borrowing is done by exporting companies whose receipts are in foreign exchange. Nevertheless, the situation needs to be closely monitored since a depreciation of the currency can create problems for the borrowers with attendant implications for banks.

Dominance of the Banking Sector

In Hungary, as in the other CEECs, the financial sector is dominated by the banking sector. The average market capitalisation of the CEECs-10 amounts to 16 percent of GDP, compared to the euro area average of 84 percent. The turnover of the stock exchanges in the Czech Republic, Hungary and Poland *per year* is roughly equivalent to 2, 3 and 5 *days* of turnover at the stock exchanges of Paris or Frankfurt, respectively.[3] One reason for the low market

[3] See, European Central Bank, "Financial Sector Development and Convergence in Accession Countries: An Overview", Background Paper for the

capitalisation is the feeble income levels, another is the low level of institutional savings (e.g. pension funds, insurance companies). While these constraints are expected to loosen with the growth in incomes and the development of the private pension fund and insurance markets, there are impediments to the growth of the stock markets that will take longer to disappear. These impediments reflect the dominance of the Hungarian corporate market by multinational companies, which are naturally listed on the stock exchanges of London, Frankfurt, New York, etc. and not on the stock exchange of Budapest. This means that firms representing dynamic sectors of the economy are not present in the Hungarian stock market. Domestic firms which have the necessary size and a sufficient track record to borrow on the capital market are few and those which do borrow are often also listed on stock exchanges abroad. Another feature of the Hungarian stock markets is that non-residents account for about 70 percent of the market capitalisation, again a reflection of the low level of incomes and institutional savings. It is my view that the above constraints will slow down the development of the equity market in Hungary and the other CEECs for a long time to come.

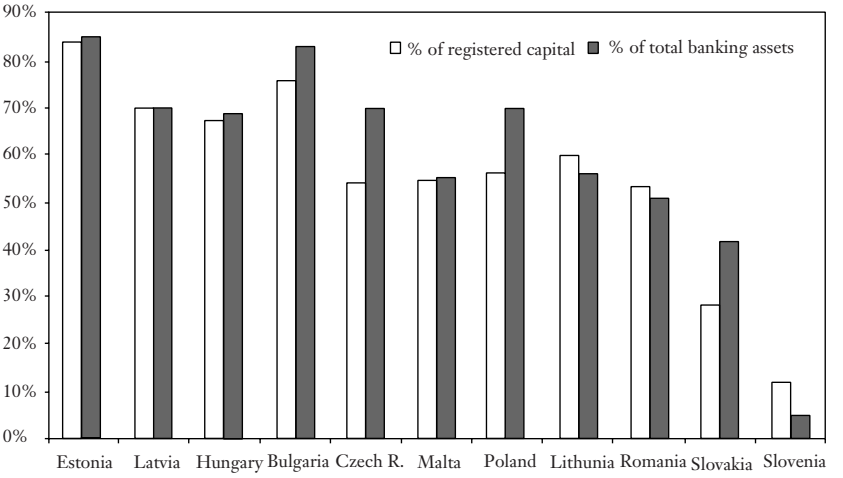
The small size of the equity market and its dominance by non-residents means that the wealth effects due to equity price fluctuations are limited. The potential risks to banks associated with price bubbles – overconsumption, overinvestment, excessive credit expansion – are thus reduced. On the other hand, the large share of non-residents renders the markets more easily subject to contagion, which can induce greater volatility in exchange rates and interest rates.

Foreign Ownership

As shown in Chart 3, foreign ownership of banks is important in most CEECs. In Hungary, it is one of the most important, with foreign ownership representing about 70 percent of the banking sector's registered capital. This is the result of both privatisation and the greenfield establishment of banks. By increasing competition, foreign ownership led to a remarkable improvement in services and to a

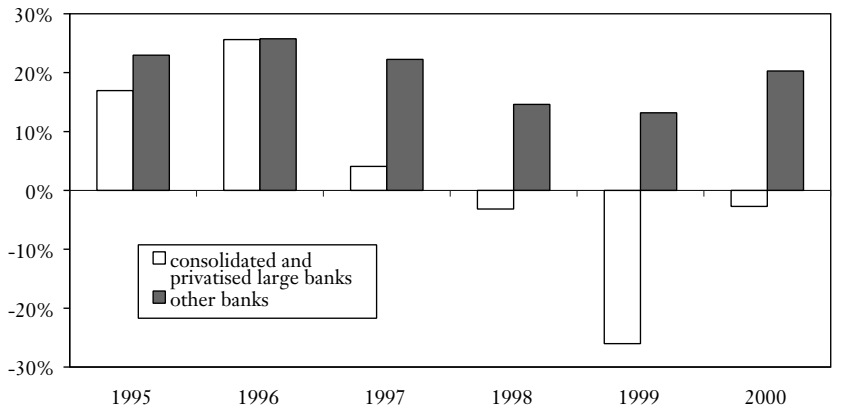
Eurosystem Seminar with Accession Countries' Central Banks, Berlin, December, 2001.

Chart 3 Foreign Ownership of Banks
(in percentages of GDP)



Source: European Central Bank, "Financial Sector Development and Convergence in Accession Countries: An Overview", background paper for the Eurosystem Seminar with Accession Countries' Central Banks, Berlin, December, 2001.

Chart 4 Hungary – Return on Equity of Commercial Banks
(in percentages)



Source: National Bank of Hungary, *Report on Financial Stability*, June, 2002.

compression of the spreads between deposit and lending rates. This has also helped to improve the monetary transmission process. An interesting lesson from the Hungarian experience is that the profitability of banks, as measured by the pre-tax return on equity (ROE), evolved very differently for large privatised banks and for banks established as greenfield projects (Chart 4). For the latter, the ROE fluctuated but remained positive throughout the period of 1995-2000. For the former, the ROE fell sharply and turned negative during 1998-2000, indicating that the foreign owners face a difficult task in restructuring the former state-owned banks. Bank supervision can play an important role in preventing that a protracted restructuring does not lead to more serious problems, a danger that foreign ownership does not necessarily eliminate.

9

Sources of Financial Fragility in the EU Candidate Countries

Marek Dabrowski

Although countries of Central and Eastern Europe have made impressive progress during the last decade in the sphere of both macroeconomic and microeconomic reforms, they cannot be considered fully mature market economies. In addition, their increasing openness connected with progressing integration of financial markets (globalisation) and the EU accession process brings, apart from obvious benefits, some additional risks.

Generally speaking, the potential financial fragility of the EU candidate countries can originate from microeconomic sources, including banking sector instability, corporate sector non-transparency and over-borrowing; and macroeconomic sources, including fiscal imbalances, inflation differentials, current account imbalances, and intermediate exchange rate regimes.

Banking sector instability can be caused either by political influence on lending decisions (mainly in the state-owned banks) or by connected and imprudent lending (mainly in the private and newly privatised banks). Both phenomena usually originate from the flawed ownership structure, insufficient prudential regulation and weak banking supervision. Remedies should be seen mainly in privatisation involving the key role of the first-class transnational financial institutions, avoiding government bailouts and building strong banking supervision and prudential regulations.

Problems in a non-financial corporate sector usually come from soft-budget constraints leading to over-borrowing ('too big to fail'

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approach or political sensitivity of some sectors), imprudent corporate and business practices (for example, lack of transparency) and currency mismatches in the corporation balance sheets. These unfavourable phenomena are usually concentrated in state-owned enterprises and conglomerates, but not exclusively. The experience of many emerging markets demonstrates the case of big private owners having an influence on government and its decisions and extracting various kinds of rent from this political connection.

Like the case of the banking sector, remedies can be seen mainly in avoiding government intervention and bailing-out practices (which lead to soft budget constraints and moral hazard behaviour), sound privatisation involving the first-class international investors and improving corporate governance, protecting property-rights, reporting and accounting standards. However, it is difficult to find a good remedy for currency mismatches in economies that lack sufficient macroeconomic credibility and, therefore, are unable to borrow internationally in their own currencies (the so-called 'original sin' problem – see Hausmann, 2001).

This leads us to the analysis of macroeconomic sources of financial fragility. The biggest danger of instability originates from fiscal imbalances, which in some EU candidate countries – particularly those belonging to the so-called Visegrad group[1] – have become chronic (see Table 1).

Table 1 General Government Balance (Cash Basis)
(in percentage of GDP)

	2000	2001	1997-2001[a]
Bulgaria	-0.7	1.7	0.5
Czech Rep.	-4.2	-5.5	-3.8
Estonia	-0.7	-0.4	-0.5
Hungary	-3.1	-4.1	-5.4
Latvia	-2.7	-1.6	-1.7
Lithuania	-3.3	-1.9	-2.9
Poland	-3.5	-3.9	-2.8
Romania	-3.8	-3.4	-4.0
Slovakia	-6.7	-5.6	-7.0
Slovenia	-2.3	-2.5	-2.3

Note:
[a] Average 1997 - 2001.
Sources: EU (2001), Annex 2; EU (2002), Annex 7.

As EU candidate countries continued substantial deficits in years of relatively high growth rates, their fiscal situation will further deteriorate when growth slows down for any reason (the recent example of Poland). Although for obvious methodological reasons it is almost impossible to estimate cyclically adjusted deficits in transition economies there are no doubts that their fiscal positions are very vulnerable to changes in real GDP growth rates.

In addition, the fiscal position of the EU candidates can deteriorate further in the first two years of their EU membership as the result of several accession-related factors such as:

1. Additional fiscal burden in national budgets coming from adoption of some specific *acquis communautaire*, particularly in such fiscally burdening areas as environmental protection, infrastructure, transportation, public administration, social policy, etc. On the other hand, one may expect some additional revenues coming from indirect tax harmonisation (increasing VAT and excise tax rates for certain groups of products).
2. Giving up part of the budget revenues (custom duties and part of the VAT) in favour of the EU budget, but these losses can hardly be compensated by the expected transfers from the EU budget since the latter relate mostly to items and programmes, that were not previously financed by the EU applicants from their national budgets. In addition, some of the EU funded programmes need co-financing of the national budgets.
3. Transition problems connected with launching the EU funding mechanisms in the first year (two years) of the membership. They will originate from a time mismatch between contribution to the EU budget (which must be done up front) and incoming transfers (*ex post* reimbursement of incurred expenses). Also, the institutional capacities of the new members to absorb EU structural funds will be very limited in the beginning.

Fiscal imbalances increase the country's financial fragility in various ways. First, a deteriorating fiscal balance must lead to a deterioration of the current account balance, other things being unchanged. Second, a fiscal deficit in period t automatically narrows the fiscal room of manoeuvre in periods t+1, t+2, etc., as it contributes to an increasing debt burden and higher debt service

[1] The Visegrad group consists of the Czech Republic, Hungary, Poland and Slovakia.

costs in the future. Finally, a higher fiscal deficit and a higher public debt increase the perception of country risk among investors and make them more reluctant to lend both to the government and private borrowers.

The available empirical experience shows the dominant role of fiscal imbalances in causing financial crises in transition economies (Dabrowski *et al.*, 2003). Hopefully, the disciplining mechanism of *The Stability and Growth Pact* and interest of most EU candidates to meet Maastricht criteria in order to enter the EMU at earliest possible date (see below), will force them to carry out serious fiscal adjustment in the coming years.

The role of inflation differentials is perhaps less obvious but certainly not less important. Moderate or high inflation discourages savings and distorts the allocation process. Under open capital accounts, it increases the international perception of country macroeconomic risk, particularly currency depreciation or devaluation risk, provoking sudden changes in direction of capital flows (closely related to changes in demand for local currency). Real interest rates are usually higher than in countries with a sustainable low inflation level.

Most of the EU candidate countries have experienced serious problems with breaking a well-rooted inflationary inertia (see Table 2). However, the last two years have brought some progress in this area. This progress will be even more visible if we consider the continuous disinflation trend in 2002 which is not reflected in

Table 2 End-of-Year Inflation in EU Candidate Countries, 1994-2001

	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	121.9	32.9	310.8	578.6	0.9	7.0	11.2	4.8
Czech Republic	9.7	7.9	8.6	10.1	6.8	2.6	4.0	4.1
Estonia	41.6	28.8	15.0	12.5	4.5	3.8	5.0	4.2
Hungary	21.2	28.3	19.8	18.4	10.3	11.2	10.0	6.7
Latvia	26.2	23.3	13.2	7.0	2.8	3.2	1.8	3.1
Lithuania	45.0	35.5	13.1	8.5	2.4	0.3	1.4	2.0
Poland	29.5	21.6	18.5	13.2	8.6	9.8	8.6	3.7
Romania	61.7	27.8	56.9	151.6	43.8	54.8	40.7	30.3
Slovakia	11.7	7.2	5.4	6.4	5.6	14.2	8.4	6.6
Slovenia	18.3	8.6	8.8	9.4	5.7	8.8	10.6	7.0

Source: IMF.

Table 2. The progress in the EU accession process radically improved the financial markets' perception of the macroeconomic fundamentals of the future EU members, stimulating increased capital inflows, appreciation pressure on national currencies, and convergence of nominal interest rates and inflation levels.

However, the disinflation trend cannot be considered sustainable as long as the currency depreciation or devaluation risk remains. And this risk is justified (in the eyes of financial market players) both by the remaining uncertainty concerning the timetable of the EU/EMU accession and by the expected high current account deficits.

High current account deficits can originate from many factors, including historically low domestic savings-to-GDP ratios in several countries, a negative rate of government savings (the consequences of fiscal deficits analysed above) and prospects of the EU accession itself. This last factor needs some additional comment.

Perspective of the near EU membership can stimulate additional capital inflows (a better perception of country risk and future rate of return) on the one hand, and discourage domestic savings (through a consumption smoothing effect) on the other. Both trends must lead inevitably to higher current account deficits and increasing appreciation pressures (see Rostowski, 2002a). From the long-term perspective, high current account deficits should not be considered the danger because the current EU candidates will eventually become members of the euro zone and balance-of-payments constraints will disappear. However, the transition period can be extremely difficult and risky, increasing the candidates' macroeconomic vulnerability and the danger of a sudden currency crisis.

Empirical observations support the concern related to current account imbalances and their possibly risky consequences. Most of the EU candidates record high current account deficits (Table 3). The above mentioned nominal convergence, which achieved momentum in Central Europe in 2002,[2] may involve elements of a speculative bubble, particularly in the case of Czech Republic, where short-term interest rates came down below the euro zone level.

[2] The intensive convergence play has been caused not only by the ongoing accession process but also by the very low level of interest rates in developed countries and high uncertainty in several emerging markets (Latin America, Turkey, and South Africa), that increased additionally attractiveness of Central Europe for potential investors.

While the balance of public savings (in fact, fiscal balance) can and should be subject of policy targeting, two other discussed factors, i.e. the rate of domestic private savings and capital inflows, are largely out of the control of national economic policies, at least in the short term. Moreover, defining what is the 'safe' level of a current account deficit is an intellectually tricky task, and the financial markets' perception of what level is 'safe' can easily change over time. Thus, the only way to eliminate the danger of a balance-of-payment (currency) crisis forever is to give up the national monetary policy and join one of major currency areas. If such a solution is not possible (for any economic and political reason), the current account balance and the factors influencing its changes must be subject to very careful monitoring.

However, keeping a current account deficit under control (i.e. limiting its magnitude) involves serious economic costs such as a lower rate of economic growth, as the recent experience of Poland (2001-2002) and the earlier experience of the Czech Republic (1997-1999) confirms.

These arguments should be considered in the debate on the timing of the EMU accession by the current candidates. While membership in the Economic and Monetary Union is not automatic upon joining the EU, the new EU members will have to do it at some point. The Maastricht Treaty did not grant them the same opt-out option as the UK and Denmark. However, as Sweden's case

Table 3 Current Account Balance in EU Candidate Countries
(as percentage of GDP)

	2000	2001	1997-2001[a]
Bulgaria	-5.0	-6.0	-1.5
Czech Republic	-4.7	-4.7	-4.3
Estonia	-6.7	-6.1	-7.8
Hungary	-3.3	-2.2	-3.4
Latvia	-6.9	-9.7	-8.6
Lithuania	-6.0	-4.8	-8.9
Poland	-6.3	-4.1	-5.4
Romania	-3.7	-5.9	-5.3
Slovakia	-3.7	-8.8	-7.4
Slovenia	-3.3	-0.4	-1.7

Note:
[a] Average 1997 – 2001.
Sources: EU (2001), Annex 2; EU (2002), Annex 7.

demonstrates, the EU member can effectively postpone the date of the EMU accession if it is not economically or politically ready to accede..

Another question relates to a specific EMU accession path which the future member can choose. Theoretically, there are four possible variants of transitional exchange rate regimes which the candidate can consider: (i) fixed but adjustable peg in the +/- 15 percent band (the 'classical' ERM variant); (ii) managed float; (iii) currency board; and (iv) earlier unilateral euroisation

The third and fourth option mean *de facto* earlier unilateral entering the euro zone although not the EMU because of the lack of influence on the ECB decisions and opportunity to use its 'lender of last resort' facility. While the third option is officially accepted by the European Commission and the European Central Bank, they oppose the idea of the unilateral euroisation as illegal or inappropriate (see Rostowski, 2002c). Formally speaking, these kinds of arguments do not sound convincing since the euro is a fully convertible and internationally tradable currency, and some small Balkan countries (Montenegro, Kosovo and partly Bosnia and Herzegovina) already use the euro as the official legal tender even though they are not, yet, EU candidates. The real arguments against a quick entry into the euro zone by the current EU candidates have a different character and are discussed below.

The two first variants of transition to the EMU represent the so-called intermediate or hybrid exchange rate regimes where the monetary authority tries to simultaneously manage both the exchange rate and the money supply. This kind of monetary/ exchange rate arrangement violates the principle of 'impossible trinity'[3] (see Frankel, 1999) and is particularly vulnerable to speculative attacks (see Obstfeld and Rogoff, 1995; McCallum, 1999; Eichengreen and Hausmann, 1999; IIE, 1999). Thus, this kind of arrangement does not eliminate sources of financial fragility in the economies of the future EU members.

Looking at the current arrangements (Table 4), six out of the ten candidates continue evident hybrid regimes. Romania, Slovakia and Slovenia do not have a clear nominal anchor at all. The Czech

[3] According to this principle a country must give up one of the following three goals: exchange rate stability, monetary independence, and financial market integration. It cannot have all three simultaneously.

Table 4 Monetary Regimes in EU Candidate Countries

	Monetary regime
Bulgaria	Currency board
Czech Rep.	DIT (managed float)
Estonia	Currency board
Hungary	DIT (horizontal band; narrow crawling band until 2001)
Latvia	Stable horizontal peg to SDR
Lithuania	Currency board
Poland	DIT (independent float from April 2000)
Romania	No clear nominal anchor (managed float)
Slovakia	No clear nominal anchor (managed float)
Slovenia	No clear nominal anchor (informal crawling band)

Sources: IMF Country Reports, central bank websites, author's own observation.

Republic and Hungary formally follow direct inflation targeting but have not fully abandoned the exchange rate targets – ad hoc anti-appreciation foreign exchange market intervention in the former and horizontal exchange rate band in the latter. Latvia consequently follows an exchange rate peg to SDR (which will require a re-pegging to the euro in some point) but does not abandon open market operations regulating domestic liquidity. Poland represents the case of a really free (independent) float under a direct inflation-targeting (DIT) regime. Estonia, Lithuania and Bulgaria run euro-denominated currency boards (Lithuania after successful re-pegging it from dollar to euro in early 2002).

The question of how quickly to join the euro zone is a subject of hot economic and political debate. While the idea of rapid euro zone accession becomes increasingly popular in the candidate countries, there is a lot of reservation on the EU side.[4] It seems that the main fears of the incumbents relate to the danger of weakening the euro, eliminating or limiting the policy conditionality related to the EMU accession of the new EU members and the fact that the ECB is not institutionally prepared to deal with 20+ members.[5]

[4] Brouwer, de Haas, and Kiviet's chapter in this book seems to be a good example of the western scepticism related to fast EMU enlargement.

[5] Rostowski (2002b) formulates additional hypotheses: (i) fear that new, fast growing euro zone members will create additional inflation pressure and (ii) some aspects of the discussed EU institutional reform (particularly strengthening prerogatives of the Euro Ecofin group).

Looking at the timing of the EMU accession from the candidates' perspective, the potential disadvantages of giving up monetary independence early relate to abandoning devaluation as a stimulating and corrective mechanism and increasing competitive pressure on several sectors of real economy. However, the big question is to what extent a small open economy can use exchange rate and national monetary policy as a shock absorber and anti-cyclical tool in an environment of free capital mobility and competition between currencies (see Dabrowski, 2001; Dabrowski, 2002). Obviously, national monetary and fiscal policies are not effective in influencing real exchange rate and current account deficits in such an environment (see Rostowski, 2002a; Dabrowski 2002).

On the other hand, one can list several potential advantages of rapid entry to the euro zone by the current EU candidates. First, it will forever eliminate the danger of a currency crisis by removing balance-of-payments constraints. Second, it will decrease the candidate countries' risk premiums, helping in sustainable interest rate and inflation convergence (by importing credibility). Third, it will force the governments and parliaments of candidate countries to carry out serious fiscal adjustments. Lower real interest rates will make this adjustment easier, particularly in countries with high public debt burdens (Bulgaria, Hungary, Poland and Slovakia). Fourth, early monetary unification will promote further trade and investment integration between new and incumbent members.

Incumbents can also gain from an early EMU enlargement. It will eliminate the danger of competitive devaluation and decrease the possibility of macroeconomic and financial instability inside the single European Market. The new members will have stronger incentives to comply with the macroeconomic convergence criteria and disciplining rules defined by the Maastricht and Amsterdam Treaties. Avoiding a long lasting phenomenon of a 'second class' EU membership in the case of new entrants will be beneficial for both sides in political and economic terms, supporting further stages of European integration.

Summing up, it is in the interest of both new members and incumbents to think about rapid accession of the former to the euro zone.

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