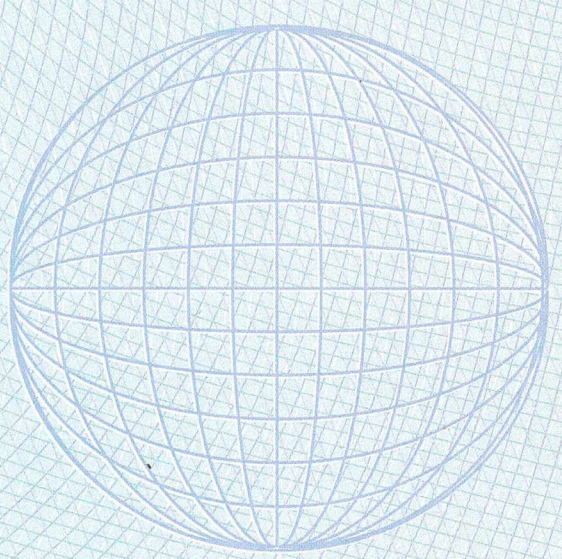
OESTERREICHISCHE NATIONALBANK

FOCUS ON TRANSITION

1/1996



OESTERREICHISCHE NATIONALBANK

FOCUS ON TRANSITION

1/1996

Published and produced by:

Oesterreichische Nationalbank

Responsibility according to Austrian media law:

Peter Achleitner, Secretariat of the Board of Executive Directors, Oesterreichische Nationalbank

Contributions:

Peter Backé, Kurt Mauler, Andreas Nader, Olga Radzyner, Sandra Riesinger, Ferenc Szabó
all Foreign Research Division of the Oesterreichische Nationalbank

Editorial work:

Gabriela Brandstetter, Olga Radzyner, Sandra Riesinger, Aurel Schubert, Irene Sperl-Mühldorf
all Foreign Research Division of the Oesterreichische Nationalbank

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

Set, print and produced by:

Oesterreichische Nationalbank, Printing Works

Orders:

If you are interested in regularly receiving the future issues of "Focus in Transition", please fill in the enclosed reply card or write directly to
Oesterreichische Nationalbank
Mail Distribution, Files and Documentation Division
P.O. Box 61
A-1011 Vienna, Austria

Fax: (+43-1) 40420-2399
Internet e-mail: http://www.oenb.co.at/oenb

Contents

Editorial

Since the very beginning of the transition process in Central and Eastern Europe, the Oesterreichische Nationalbank (OeNB) has been analyzing and supporting the economic developments there. Meanwhile, a number of these transition countries have concluded association agreements with the European Union and are preparing for future EU membership. In parallel, other transition countries have also embarked on economic reforms, some of them with remarkable results.

As Austria itself joined the European Union only one and a half years ago, it might perform a special role in an active dialogue between the European Union and the Central and East European transition countries.

In view of the growing international interest in the Central and Eastern European transition countries, the OeNB has decided to launch a new publication, the "Focus on Transition", to deal exclusively with the developments in the transition economies. "Focus on Transition", which will be published twice yearly, is targeted at interested experts (such as policy-makers or academics) both in the West as well as in the transition economies themselves.

"Focus on Transition" is prepared entirely by the staff of the OeNB and consists of four parts. The first part provides a concise and up-to-date survey of the recent economic developments in Central and Eastern Europe. The second part presents studies on special economic issues prepared by the staff of the OeNB. The third part is designed to give an overview of the many and diverse activities of the OeNB concerning transition economies (lectures, seminars, conferences, other cooperation activities). The fourth part is a set of statistical tables providing a comprehensive cross-country survey of important economic indicators for eleven transition countries. It will be updated in every issue of "Focus on Transition".

With this new journal we hope to contribute to and even to stimulate the discussion process on transition issues within and among the countries in transition and between the transition economies and the West.

Chief Executive Director
Adolf Wala

Recent Economic Developments

Developments in Selected Reforming Countries[1])

Kurt Mauler,
Peter Backé,
Olga Radzyner,
Sandra Riesinger[2])

1 Introduction

GDP growth in three of the five Central and Eastern European countries (CEECs) was quite strong in 1995; in Hungary and Slovenia, however, it was marginally slower[3]) than in 1994. Private consumption and investment activity appear to have been the engine for growth, also the pronounced increase in industrial production. Economic stabilization made progress: budget deficits were low, with the Czech Republic even posting a budget surplus.

The only country in which average inflation exceeded the year-earlier rate was Hungary. Inflation subsided to single-digit rates in the Czech and Slovak Republics. Nevertheless, the rate of price increase remains far above Western European levels in all of the CEECs. Many countries, above all the Czech Republic, struggled with monetary policy problems caused by the influx of capital from abroad. At the end of February 1996 the Czech National Bank (CNB) raised the fluctuation margin for the Czech koruna from ±0.5% to ±7.5%[4]) to contain speculative inflows of capital.

Industrial production augmented in 1995, averaging real-term growth of 8.4% across all countries. At 9.4% the rate of increase was highest in Poland, whereas Slovenia attained only 2%. Industrial labor productivity continued to rise in 1995, advancing most in Poland (+13.1%) and least in the Slovak Republic. The Czech Republic and Hungary each posted an increase of 10.5%, and Slovenia recorded a 3% rise. Labor productivity generally advanced faster than average wage costs, which should boost corporate profits. The unemployment rate declined slightly across the board, averaging 12% in the five countries.

The Czech Republic, Poland and Slovenia recorded substantially higher trade deficits[5]) in 1995 than a year earlier. Only in Hungary did the deficit contract from 1994, falling to USD 2.6 billion from USD 3.9 billion. Slovakia was the only country in the group to boast a surplus of USD 60 million. Exports by the five countries expanded by 24.5% in terms of U.S. dollars and by 9.5% in terms of Deutsche marks, while imports grew by 27.4% in terms of U.S. dollars and by 12.1% in terms of Deutsche marks. Apart from the real appreciation of domestic currencies, domestic demand appears to have been the main factor causing the higher trade deficits.

Poland and the Czech Republic posted considerably higher current account deficits, Slovenia's current account surplus turned into a deficit for the first time since 1991, whereas the shortfall on current account sank in Hungary. By contrast, Slovakia had a surplus on current account.

All five countries' gross foreign debt augmented. Hungary closed with the most sizeable per capita debt figure at USD 3,099 per capita, followed by the Czech Republic (USD 1,578), Slovenia (USD 1,486), Poland (USD 1,135) and Slovakia (USD 895).

Official reserves burgeoned in 1995 on account of the massive capital inflows. At the end of 1995, Poland's currency reserves stood at 2.5 times the end-1994 level, the Czech Republic's at 2.2 times, Slovakia's were twice as high, Hungary's 1.8 times and Slovenia's 1.2 times as high as at the end of 1994.

The total per capita level of inward foreign direct investment (FDI) ran to USD 1,298 in Hungary, USD 729 in Slovenia, USD 573 in the Czech Republic, USD 177 in Poland and USD 137 in Slovakia at the end of 1995.

1 *The countries covered in this report are Poland, Slovakia, Slovenia, the Czech Republic and Hungary; the period covered is 1995 and, where available, the first half of 1996.*

2 *All Foreign Research Division of the Oesterreichische Nationalbank.*

3 *If no other period is stated, the changes are from the analogous period of the previous year. The 1995 data are provisional.*

4 *Poland took a similar step as early as May 1995, expanding the range to ±7%.*

5 *The data on the trade balances and current account are not comparable with those in the statistical annex (the calculations in the text are based on flows of convertible currencies derived mainly from The Vienna Institute for Comparative Economic Studies and national sources).*

All five countries accepted the obligations of Article VIII of the IMF's Articles of Agreement, i.e. the full convertibility of their currency for current account payments, at the following dates: Poland on June 1, 1995, Slovenia on September 1, 1995, Slovakia and the Czech Republic on October 1, 1995, and Hungary on January 1, 1996. Moreover, these countries partly liberalized capital transactions when the amendments to the foreign exchange laws required for convertibility were put in force.

All in all, the five CEECs made marked progress in implementing structural reform. They are pushing ahead with privatization, and institutions are gradually being brought in line with EU requirements. Poland began its mass privatization program in 1995, Hungary is continuing its privatization by standard methods, and while the Czech Republic has scheduled the dissolution of its Privatization Ministry for July 1, 1996, the denationalization program will continue. Voucher privatization was canceled in Slovakia, but privatization by standard methods goes on. Although Slovenia's program got off to a hesitant start, it gained considerable momentum in the course of the year.

Most countries urgently require an overhaul of their banking system. In essence, the banking systems need to be consolidated, large state-owned banks have to be sold to the public, the issue of nonperforming loans has to be resolved and the statutory provisions governing banking and the capital markets need to be improved. An important factor in restructuring the banking sector in all countries is the strengthening of prudential supervision. Hungary and Poland have already embarked on the privatization of large, still government-owned banks. The Czech Republic and Slovakia have announced their intention of privatizing state-owned banks, and Slovenia has also made public that it will sell off two large banks after restructuring them.

The Czech Republic was the first Eastern European country to become a member of the OECD. On December 21, it was admitted as the Organization's 26th member, followed by Hungary on May 7, 1996, as the 27th member. Poland is scheduled to become the third member from Eastern Europe in the course of 1996. Slovenia submitted its formal application in March 1996.

2 Country Reports

2.1 Czech Republic

In 1994 real GDP rose for the first time since the beginning of transition (+2.6%), which was followed by a robust upturn in 1995, with GDP growth doubling to 4.8%. Industrial production surged by 9.2% in real terms, and construction output progressed by 8.5%. The agricultural sector also posted the first increase in output since the start of the transformation (4.2% in real terms). Investment, which had already been rising powerfully since 1992, shot up 15% in real terms. This spending activity could provide a solid basis for growth and corporate restructuring. 37% of imports consisted of machinery and transport equipment.

Retail sales advanced by 4.8% in real terms. Already very low, the unemployment rate subsided further to 2.9% at the end of 1995 (end of 1994: 3.2%). Wages mounted by 7.7% in real terms. Compared to 1994,

inflation ran to 9.1%, which is the lowest rate so far. As in 1993 and 1994, the budget posted a marginal surplus of 0.6% of GDP. The private sector's share of GDP is estimated to come to roughly 65%.

In the first quarter of 1996, GDP rose by 4.3% in real terms. In the first four months industrial production went up by 10.2% and construction by 1.2% (both in real terms); nominal wages increased in these two sectors by about 18%, far faster than consumer prices, which in the same period amounted to 8.7%.

In terms of U.S. dollars, exports surged by 19.6% in 1995, imports widened by 39.5%. The trade deficit came to USD 3.8 billion (1994: -USD 0.7 billion). In the first four months of 1996 exports rose by 12.5% and imports by 17%. The trade deficit amounted to USD 1.4 billion.

The current account showed a deficit of USD 1.4 billion in 1995. Capital inflows added up to USD 7.5 billion in 1995. The balance on current account registered a deficit of USD 0.5 billion in the first quarter of 1996, the capital account recorded inflows of about USD 0.1 billion.

Inward FDI totaled USD 5.8 billion from 1990 to end-1995, 44% of which (USD 2.6 billion) was invested in the Czech Republic just in the year 1995. The main sources of this capital were Germany (30% of the total), Switzerland (14.2%), the U.S.A. (13.6%), the Netherlands (13.6%), France (9.3%) and Austria (5.4%); other countries accounted for 13.9%.

The central bank's official reserves in convertible currency came to USD 14 billion on December 31, 1995. The commercial banks' currency holdings amounted to approximately USD 3 billion. Gross foreign debt summed up to USD 16.3 billion (equivalent to just under 36% of GDP). At the end of May 1996, official reserves stood at USD 12.6 billion (commercial banks: USD 3.6 billion). Foreign debt at the end of March 1996 amounted to USD 16.2 billion.

On October 1, 1995, the Czech Republic declared the koruna convertible for all current account transactions pursuant to Article VIII of the IMF's Articles of Agreement. In preparation for meeting these conditions, on June 21, 1995, the Czech Parliament ratified the cancelation of the clearing agreement in trade with the Slovak Republic as of September 31, 1995.

The koruna's nominal exchange rate has remained practically stable since December 1990, whereas the real exchange rate has appreciated by roughly a third since 1991. On February 28, 1996, the fluctuation band of the koruna was widened from ±0.5 to ±7.5% to prevent speculative capital inflows. This measure should enable a more flexible control of monetary aggregates and should increase the exchange rate risk for speculators. The basket of currencies to which the koruna is tied has consisted of 35% USD and 65% DEM since May 1993.

As of June 20, 1996, the Czech National Bank took measures to stem inflationary pressures in the economy. The discount rate was increased to 10.5 from 9.5% and the lombard rate was raised to 14 from 12.5%. In addition the minimum reserve ratio for primary deposits will be increased from 8.5 to 11.5% as of August 1, 1996. The CNB estimates that about CZK 30 billion will be removed from the banking system by these measures.

Three amendments to laws pertaining to the capital market will go into force on July 1, 1996. Among other things, the amendment to the Trade Act stipulates that every investor must notify the authorities of acquisitions or purchases of holdings in companies whenever these exceed a specific percentage. Investors whose shares surpass the prescribed limits are obliged to submit a public takeover offer at a specific floor price to minority shareholders. Disclosure requirements were tightened under the Securities Act, and new rules on derivatives trading were issued. Finally, more stringent disclosure requirements were introduced under the Investment Fund Act. As before, funds may hold only a 20% share of enterprises at most. If they wish to secure more control, they have to become holding companies. Some funds have already initiated such a conversion process.

After several smaller banks had run into difficulties, the Czech National Bank (CNB) decided to enforce a consolidation program in 1996. Classified credits had sunk to 38% of the total volume (-0.6 percentage points from the end of 1994) by the close of the third quarter of 1995. The CNB estimates the share of problem banks at about 5 to 8% of the total sector. The cost of consolidation is given at some CKK 10 to 25 billion. It is not clear yet how these funds are to be raised. Methods being suggested are capital increases, mergers, strategic investors, participations by the National Property Fund (privatization revenues), by the Consolidation Bank, the large banks or by a joint effort of the banking sector.

Parliament decided to dissolve the Privatization Ministry as of July 1, 1996. Its activities will be carried out by the Ministry of Finance. Until the end of 1995, 3,552 medium-sized and large companies with a total book value of CKK 958 billion were partly or wholly privatized. Denationalization has not been completed yet; in particular, the state still has sizeable stakes in large banks and a number of industrial and infrastructure companies.

2.2 Hungary

The stabilization package agreed in March 1995 had a decisive impact on Hungary's economic development by sharply reducing internal and external imbalances while dampening economic growth only marginally.

GDP expanded by 1.5% in real terms. Industrial production advanced by 4.8% in real terms. Construction activity contracted, and agricultural output stagnated. Investment hovered at the 1994 level, with the perceptible decline in public households' investment offset by enterprises' capital spending. Unemployment remained practically stable at a rate of 10.9% at the end of 1995. Net real wages shrank by 12%; industrial labor productivity improved by 11%. Inflation as measured by the CPI averaged 28.2% in 1995, and the budget deficit amounted to 5.5% of GDP, less than projected.

Hungary succeeded in reducing its trade deficit (based on customs statistics) from USD 3.9 billion in 1994 to USD 2.6 billion in 1995. Exports rose by 20%, imports by 6%. The current account deficit fell sharply from USD 3.9 billion to USD 2.5 billion. Inward FDI attained a record USD 4.5 billion in 1995, around USD 3 billion of which are attributable to proceeds from privatization. Official reserves totaled USD 12 billion at the end of

1995 (equivalent to 10 months of imports). Gross foreign debt ran to USD 31.7 billion at the end of 1995 (end of 1994: USD 28.5 billion).

The crawling peg exchange rate regime introduced in March 1995 has been successful so far: The forint has generally moved at the lower edge of the intervention band on the interbank forex market (±2.25%). Since mid-1995 the central bank has been pursuing a policy of gradual interest rate cuts. The minimum reserve ratio has since been lowered from 17 to 12% (June 1996).

Hungary's economic legislation has been directed toward EU requirements for quite some time now. In November 1995, Hungary's Parliament adopted a new Foreign Exchange Act, which went into force on January 1, 1996, the same day Hungary pronounced the forint convertible under Article VIII of the IMF's Articles of Agreement. While the liberalization of capital transactions was expanded by the Foreign Exchange Act, some restrictions nevertheless remain in place.

An amendment to the Banking Act passed on proposal of the OECD relaxed banking secrecy provisions (in force since March 28). From July 1, the establishment of credit institutions and nonresidents' purchase of investments in banks is no longer subject to authorization. Moreover, a new Insurance Act has been in force since January 1996 and new customs legislation came into effect in April 1996. On January 1, 1996, a Treasury was instituted to, among other things, execute and monitor payments by public institutions.

A number of public utilities and large-scale enterprises as well as two major commercial banks, the OTP (National Savings Bank and Commercial Bank) and the Budapest Bank, were privatized. The proceeds of this sell-off came to HUF 453 billion in 1995, three times as high as envisaged. The two last large banks still scheduled to go on the block are the Hungarian Credit Bank (MHB) and the Commercial Bank (K&H), whose sale is currently being prepared. The latter may prove difficult to privatize, as its customer structure is unfavorable and because it has a relatively large portfolio of nonperforming loans. The concentration process underway in the banking sector has gained momentum and has led to a perceptible reduction in the number of smaller institutions.

The Hungarian stabilization and reform policy is supported by a standby agreement concluded with the IMF on March 15, 1996. The IMF arrangement has 23 months to run and covers a total of SDR 264.18 million. The conditions under the program for 1996 are to keep the general government deficit from exceeding 4% of GDP and to contain the current account shortfall within USD 2 billion. The structural reforms to be tackled in 1996 focus above all on the social security sector. Hungary does not want to draw the tranches of the program, as the agreement is primarily supposed to signal confidence in the government's economic policy.

The development during the first months of 1996 shows a lower central government deficit than expected, but also a far higher social security system deficit than projected. The total public sector deficit is within the limits stipulated by the IMF. The current account closed the first four months of 1996 with a shortfall of USD 748 million. Thus the USD 2 billion deficit

targeted for the entire year seems to be within reach. Overall, Hungary's economy did not develop at a dynamic pace in the first months of the year. This can be attributed mainly to the stabilization course being steered and the rather unfavorable economic framework conditions in Europe. In the first quarter of 1996 industrial production advanced by 1.6% in real terms (compared to the like period of 1995) and construction output diminished. Investment dropped (by 8.6% in real terms in the first three months of 1996). The rate of unemployment ran to 10.7% at the end of May 1996. Consumer prices went up by 26.8% in the first four months of the year (compared to the January through April period of 1995), which means that inflation is sinking marginally. Net real wages continued to fall in the first three months of 1996 (by 9.5%).

On the subject of social security reform, Hungary's government elaborated a blueprint for pension system reform in May 1996. This program is to be submitted to Parliament for discussion in the form of draft legislation in September 1996. It provides for a gradual boost in the retirement age to 62 between 1998 and 2010 (the current age of retirement is 55 for women, 60 for men), an extension of the minimum coverage period entitling an insured person to retirement benefits and the transition to a three-pillar pension system under which the state pension system (basic pension) is to be complemented by private, state-supervised pension funds operating on the full funding principle and by voluntary pension funds, some of which have already been founded. This tripartite pension system is also scheduled to take effect in 1998 and will be mandatory for persons born in and after 1958; older insured persons will be able to choose between the current and the new system. The government also decided on a timetable for health care reform, educational reform and tax reform. The modification of the health care system centers on a reduction in the number of hospital beds, a measure the government already passed in April 1996. Parliament will debate the relevant bill in fall.

Finally, the government also resolved in April 1996 to gradually phase out the 8% import surcharge introduced in March 1995, cutting it to 7% from July 1, 1996, to 6% from October 1, 1996, to 4% from January 1, 1997, to 2% from April 1, 1997, and finally to eliminate it completely from July 1, 1997, as originally envisaged.

Hungary's accession agreement to the OECD was undersigned on March 29, 1996. The official admission to membership in the OECD was on May 7, 1996, when the accession agreement was deposited with the French government.

2.3 Poland

In 1995 Poland's economic growth accelerated sharply, the influx of foreign capital increased, the privatization process gained momentum, inflation subsided and the liberalization of capital movements made great strides.

Last year, Poland's GDP advanced by 7% in real terms; industrial production progressed by 9.4%, investment rose by 18.6% and construction output expanded by 11%. Inflation declined from 32.2 to 27.8% (yearly average) to reach the lowest rate since the transformation process was

initiated. Net real wages progressed by 4.6%, and retail sales went up by 2.5% in real terms. The unemployment rate eased from 16 to 14.9%. The central government budget posted a deficit ratio of 2.6% of GDP.

In 1995 Poland's exports (as measured by payment flows) shot up by 32.7% in terms of U.S. dollars, imports grew by 14.5%. The trade deficit ran to USD 1.8 billion. The current account posted a shortfall of USD 2.3 billion (equivalent to 2% of GDP), and the capital account (medium- and long-term transactions) was in surplus by USD 2.5 billion (1994: – USD 1.1 billion). The balance of short-term capital transactions reached a record surplus of USD 9.4 billion. At the end of 1995, gross foreign debt amounted to nearly USD 44 billion; official reserves came to almost USD 15 billion (1994: USD 6 billion).

The inflow of foreign direct investment (FDI) from the beginning of 1990 to the end of 1995 totaled USD 6.8 billion. The United States held the biggest share of FDI (32.7%), followed by multinational investors (18.7%) and Germany (8.9%). With a share of 3.7%, Austria ranks ninth in the list of investors.

Economic growth flagged somewhat in Poland in the first quarter of 1996, but was still high in a European comparison. Industrial production advanced by 8.2%. The unemployment rate stood at just over 15%. Inflation continued to fall (March 1996 year-on-year: CPI +20.4%). At 4 billion zloty, the budget deficit reached 42% of the deficit projected for 1996. The balance of trade worsened (deficit in the first quarter of 1996: USD 1.46 billion). In the same period the current account posted a surplus of USD 77 million because in January 1996 the central bank added a new item called "unclassified flows" (e.g. unregistered cross-border trade flows) to the current account, reclassifying flows that had been mainly registered in the capital account. (For the sake of comparison: Applying the new classification retroactively, the current account showed a surplus of USD 897 million in the first quarter of 1995).

The National Bank of Poland (NBP) zloty by 6% on December 22, 1995, to ease the inflationary pressure triggered by the influx of foreign capital. On January 8, 1996, the NBP reduced the maximum monthly devaluation rate of the zloty under the crawling peg system from 1.2 to 1%. The basket of five currencies to which the zloty is pegged and the intervention range on the foreign exchange market (±7% since May 1995) were left unchanged.

In view of the downtrend of inflation, the NBP continued its cautious policy of interest rate reductions: On September 18, 1995, it lowered the discount rate from 27 to 25%, the lombard rate from 30 to 28% and the rate for refinancing credits to commercial banks from 31 to 29%. The discount rate was reduced to 23% and the lombard and refinancing rates were lowered to 26% on January 8, 1996.

After the Czech Republic and Hungary, Poland is moving to become the third East European country to join the OECD in 1996. To prepare the ground for membership, it has passed a number of laws.

On January 1 and again on April 1, 1996, Poland took further measures to liberalize capital transactions. Polish firms may now hold stakes of at least 10% in enterprises in the OECD region, may purchase business property

(private individuals may now buy foreign real estate with a value of up to ECU 50,000) and may acquire foreign low-risk securities (above all Treasury bills and government bonds). Moreover, Polish companies are now allowed to take out foreign credits with maturities of more than one year or to place securities abroad. Finally, the Polish capital market was opened up to nonresident issuers of stocks, shares in investment funds and bonds with a term of at least one year, with such transactions being limited to a total volume of ECU 200 million in 1996. In March 1996 Parliament passed the Real Estate Act, which allows nonresidents to purchase without a license property of a size of up to 4,000 m^2 and residential units. Also, a law facilitating the foundation of joint ventures was adopted. Other reforms still in the pipeline are the long-planned passage of a new National Bank Act, the reform of the public administration and of the social security system. The current social security system risks becoming unfinanceable. The main measure being envisaged is to complement the public system by state-supervised private pension funds operating on the funding principle.

Mass privatization, initiated in 1995, was continued. In November 1995 the issue of shares in investment funds was launched. The sale of enterprises will continue, with some 150 to 200 companies scheduled for privatization in 1996. By the end of February 1996, some 1,700 of the 8,000 state-owned firms had been sold off, privatization in 3,550 undertakings had been started up and more than 1,000 companies had undergone bankruptcy proceedings. The private sector contributes over 60% to GDP.

The denationalization and consolidation process in the banking sector progressed further. In December 1995, the fourth largest bank, Bank Gdanski, was privatized. On April 12, 1996, the Sejm passed a Bank Consolidation Act under which large state-owned banks are to be merged or joined into groups. The aim is to enhance competitiveness and to ease privatization. A concentration process through liquidation and takeovers has been going on for some time among smaller banks.

2.4 Slovak Republic

For the first time since 1989 this country's GDP posted – in fact surprisingly brisk – real-term growth in 1994. GDP surged by 4.9% in 1994 and 7.4% in real tems in 1995. The main motor of the expansion was industrial production, which advanced by an animated 8.3%. Construction output rose by 4.2%, investment by 9.2% in real terms, and real wages augmented 4.4%. The recovery of the economy had positive repercussions also on the labor market. The rate of unemployment dropped from 14.8% in December 1994 to 13.1% in December 1995. Inflation averaged 9.9% in 1995, down from 13.4% the previous year; the year-on-year inflation rate came to 7.2% in December 1995. Retail sales enlarged by 8.9% in real terms in 1995. The budget deficit amounted to 1.6% of GDP.

In the first quarter 1996 real GDP increased by 7.3% against the same period of last year; the average inflation rate was 6.2%, in April it amounted 6% against the same period of last year and in May to 6.1%. The National Bank of Slovakia (NBS) issued bills to reduce the liquidity of the banking system.

The private sector's share of GDP widened from 58.2% in 1994 to 65% in 1995; broken down by sectors, it rose fom 57.5 to 64.6% in industry, from 74.2 to 81.8% in construction and from 73.2 to 87.9% in the service sector.

Turning to foreign trade, the trade balance had already improved significantly in 1994, when it posted a surplus of USD 81 million. Slovakia was one of the few transition economies to show a trade surplus. The trade surplus came to about USD 60 billion in 1995. In koruny, exports mounted by 18.5%, imports by 19.1%. The current account had a surplus of USD 649 million (1994: USD 665 million). In the first five months of 1996 exports rose by 2.2% while imports went up 28.7%. The trade deficit amounted to about USD 856 million. The import surcharge of 10% which Slovakia levies was lowered to 7.5% as of July 1, 1996, and is scheduled for elimination at the end of 1996.

At the end of November 1995 gross foreign debt in convertible currency amounted to USD 5.2 billion (slightly less than 30% of GDP). Currency reserves totaled some USD 5 billion at December 31, 1995; of this total, the central bank held USD 3.4 billion and commercial banks USD 1.6 billion.

At the end of 1995 FDI in the Slovak Republic came to a total of USD 733 million. With a share of 21.4%, Austria was the principal investor, followed by Germany (17.5%), the Czech Republic (16.2%), the U.S.A. (11.4%) and the UK (7.2%). Thus these five countries account for 74% of total FDI in Slovakia.

The National Bank of Slovakia's monetary policy program for 1996 is based on the following benchmark aims: Annual average inflation is to be reduced to between 6 and 7.5% and the nominal exchange rate is to remain unchanged. In order to prevent speculative capital inflows, the central bank widened the fluctuation band of the exchange rate from ± 1.5 to $\pm 3.0\%$ as of January 1, 1996, which corresponds to a fluctuation against the U.S. dollar of between SKK 29.10 and 30.90. The central bank forecasts 5.8% real GDP growth and a current account surplus of USD 200 million. Money supply is to grow by 13.2% and lending to the nonbank private sector to climb 6.6%. The central bank will be more liberal in granting licenses to Slovak companies to take out credits abroad, provided such credits boost the economy's production potential. In view of the fall in the inflation rate, the National Bank of Slovakia lowered the discount rate from 9.75 to 8.8% on January 13, 1996. In 1995 the discount rate had been cut on March 17 (12 to 11%) and on October 6 (to 9.75%).

On October 1, 1995, there were 24 commercial banks in Slovakia, two of which were state-owned and 14 of which had a foreign equity interest; also, there were 9 branches of foreign banks in Slovakia.

The banking system is still beset by a bad debt problem, but in recent years, banks have succeeded in accumulating reserves and provisions and have largely put up security for loans. An amendment to Slovakia's Banking Act was passed in January 1996. Its main provisions strengthen banking supervision, a duty incumbent on the central bank, and allow for the conduct of mortgage credit business. Parliament ratified the Deposit Insurance Act applicable to deposits made by natural persons in its session of March 20 to

22, 1996. Government is pressing for rapid privatization of the three largest banks, in which the National Property Fund holds interests: the General Credit Bank, the Investment and Development Bank (majority shareholder) and the Slovak Savings Bank (100% ownership). The form and timetable of this bank privatization is still under discussion, and no definitive decisions have been made so far. The second wave of voucher privatization had been canceled in 1995. The citizens who wished to participate in that program are to receive bonds of a value of SKK 10,000, which are then to be serviced by the National Property Fund from the revenue of conventional privatization.

2.5 Slovenia

Economic growth, which had already begun to rise in 1993, accelerated noticeably in 1994, only to lose some steam in 1995. Inflation subsided markedly in 1995. The country's foreign trade position deteriorated. Privatization is likely to be wrapped up in 1996. With an annual per capita GDP of USD 9,352, Slovenia ranks as one of the richest Eastern and Central European countries in transition.

Real GDP climbed by 3.5% in real terms in 1995, propelled chiefly by domestic demand. Industrial production went up by 2% in real terms, and construction output recorded the strongest sectoral growth rate with 7% in real terms. Investment climbed by 18.4% in real terms. Net wages gained 4.6%, and inflation (retail prices, annual average) was slashed from 19.8% in 1994 to 12.6%. The general budget deficit was very low and amounted to only 0.03% of GDP. At the end of 1995 the official unemployment rate stood at 14.5%; measured according to the ILO method, the jobless rate was just 7.4%.

In the first quarter of 1996, economic developments abroad as well as the comparatively slow pace of structural reforms seem to have contributed to a slowdown of economic activity. Real GDP as well as industrial production even recorded negative growth rates from January to March 1996, but economic activity seems to have picked up in April 1996. The year-on-year inflation rate remained unchanged in the first quarter of 1996, but started to go up in April and May. The official unemployment rate decreased somewhat and came to 13.9% at the end of March 1996.

The trade shortfall, which had come to USD 338 million in 1994, skyrocketed to USD 957 million in 1995.[6]) The current account turned from a surplus of USD 540 million in 1994 to a deficit of USD 36 million. The main reasons for this development were probably the rise in domestic demand and a loss of competitiveness after the real-term appreciation of the tolar until August 1995.

Capital inflows, which had ballooned in 1993 (USD 202 million) and further in 1994 (USD 545 million), were contained in 1995 (outflow 1995: USD 84 million). This effort succeeded especially on account of the following factors: the nominal exchange rate was kept virtually stable (real-term appreciation of the tolar) from mid-1994 to mid-1995; the central bank introduced capital inflow controls in February 1995,[7]) and the discount and lombard rates were decreased in April 1995 (from 16 and 17% to 10 and 11% respectively).

6 *Due to changes in the compilation methodology as of 1996, Slovene balance of payments data were revised retroactively for 1994 and 1995. The BOP data used in this issue are based on the new methodology.*

7 *These controls required borrowers to deposit 40% of foreign exchange loans with maturities of less than 5 years in unremunerated tolar bank accounts.*

The banking system's foreign exchange reserves totaled USD 3.4 billion at the end of 1995, with the central bank accounting for USD 1.8 billion. Foreign debt ran to roughly USD 2.9 billion at end-1995.

On September 1, 1995, Slovenia declared the convertibility of the tolar under Article VIII of the IMF's Articles of Agreement. The country has pursued a managed float exchange rate policy since the introduction of the tolar in October 1991.

The main achievement in the area of economic integration was the signing of the association agreement with the EU, which took place on June 10, 1996. At the same time, Slovenia submitted its official application for EU membership. On January 1, 1996, Slovenia joined CEFTA, and the country applied for OECD membership on March 14, 1996.

On February 28, 1996, Slovenia's parliament ratified in principle the agreement in concluded in June 1995 with ex-Yugoslavia's creditor banks in the London Club. Slovenia declared its willingness to take over all liabilities to banks directly assignable to Slovenia (allocated debt) plus 18% of former Yugoslavia's not directly attributable debt (unallocated debt; total amount outstanding: USD 822 million). On March 28, 1996, the Federal Republic of Yugoslavia filed a suit against Slovenia and the London Club with the London High Court contesting the legal validity of the agreement concluded. However, the agreement was implemented on June 11, 1996, when Slovenia issued four series of bonds in exchange for its portion of ex-Yugoslavia's debt owed to the London Club. As a result of this exchange, Slovene debtors were released from their obligations toward the London Club, which had included a "joint and several liability" clause.

Privatization of some 1,400 state-owned enterprises, which got off to a slow start in 1994, gained substantial speed in 1995 and should be largely wrapped up in 1996. As per June 1996, the state privatization agency had already approved 1,175 privatization proposals; 630 of these companies had already completed privatization.

Slovenia's banking sector currently comprises 32 commercial banks, 11 savings banks and 74 cooperative banks; the commercial banks control 98% of the market. Only 8 commercial banks have market shares in excess of 4%. Slovenia is overbanked in that there are too many institutions in view of the comparatively low volume of business. On October 1, 1995, more stringent minimum capital provisions went into force. Under these requirements, a full banking license is granted only if the bank has a minimum capital stock of SIT 4.08 billion (roughly equivalent to ATS 320 million). The result of this measure is that in May 1996, only 15 institutions had a full commercial banking license. A new Banking Act is in preparation.

Editorial close: June 30, 1996.

STUDIES

Exchange Rate Policy in Transition – Developments and Challenges in Central and Eastern Europe[1])

Olga Radzyner
and Sandra Riesinger[2])

I Introductory Remarks

The choice of an exchange rate regime in the process of economic transformation and implications of exchange rate policies for stabilization and reform have been a widely debated topic in the past years. Exchange rate policy cannot be seen as an isolated issue: It has to be part and parcel of a consistent and credible policy mix, designed to foster sound economic fundamentals. Moreover, exchange rate policy has to be seen in the context of the overall transformation process, especially structural reforms (e.g. financial sector reform, liberalization and deregulation measures).

Under the system of central planning, the economic role of the official exchange rate was in general very limited. While the exchange rate served as a unit of account for statistical purposes, its level had practically no impact on actual trade flows.[3]) It is only with the unification of previously multiple exchange rates and the liberalization of the trade regime that the role of the exchange rate changed fundamentally and started to perform the classical economic functions.

Since the beginning of economic reform the transition economies in Central and Eastern Europe have adopted a broad variety of different exchange rate regimes (see Table 1).

While some countries chose a fixed exchange rate regime from the outset (Czechoslovakia, later the Czech Republic and Slovakia; Poland until October 1991) and two opted for the extreme of a currency board (Estonia and later Lithuania), other countries decided to take a more flexible approach and introduced a crawling peg system (Poland from October 1991, Hungary from March 1995) or a fixed, but adjustable peg (Hungary until March 1995). The largest group of transition countries let their currencies float while maintaining some scope for central bank intervention (e.g. Slovenia, Bulgaria, Romania as well as several CIS republics). Although the exchange rate arrangements of most CIS republics are formally classified by the IMF as "managed floating", in practice the exchange rates have frequently

1 *A former version of this paper was prepared for the 3rd AGENDA Workshop on "Lessons from Transformation", which took place from April 12 to 14, 1996, in Vienna.*

2 *Both Foreign Research Division of the Oesterreichische Nationalbank. The standard disclaimer applies. We gratefully acknowledge the valuable comments of Peter Backé and Margarethe Quehenberger.*

3 *See Oblath (1994).*

Table 1

Exchange Rate Regimes in Selected Central and Eastern European Countries

as of June 1996

	Currency (ISO code)	Exchange rate regime	Basket
Bulgaria	lev (BGL)	managed float	–
Czech Republic	Czech koruna (CZK)	peg	65% Deutsche mark 35% U.S. dollar
Estonia	kroon (EEK)	peg to Deutsche mark	–
Hungary	Hungarian forint (HUF)	crawling peg	70% ECU 30% U.S. dollar
Latvia	lats (LVL)	peg (de facto)	SDR
Lithuania	litas (LTL)	peg to U.S. dollar	–
Poland	zloty (PLN)	crawling peg	45% U.S. dollar 35% Deutsche mark 10% pound sterling 5% French franc 5% Swiss franc
Romania	Romanian leu (ROL)	managed float	–
Slovak Republic	Slovak koruna (SKK)	peg	60% Deutsche mark 40% U.S. dollar
Slovenia	tolar (SIT)	managed float	–

been informally pegged to a single currency or a currency basket (implicit exchange rate target).

It is interesting to note that some countries maintained the exchange rate regime chosen at the beginning of the reform process (e.g. the Czech Republic, Estonia, Slovenia), whereas other countries adapted their regime to changing economic conditions and modified it at different stages of transition (e.g. Hungary, Lithuania, Poland).

We will restrict our analysis to five Central European transition economies, namely the Czech Republic, Slovakia, Poland, Hungary and Slovenia. The main part of this paper is devoted to the analysis of the exchange rate policies followed in these countries, especially how the choice of the exchange rate regime was motivated and how policy recommendations compare with policies implemented and the actual outcome.

We will argue that the adoption of a specific exchange rate regime is neither a necessary nor a sufficient condition for the achievement of desired macroeconomic results. Evidence from the countries examined suggests that different options including both extreme cases – a fixed exchange rate and a floating regime – can successfully contribute to macroeconomic stabilization, the Czech Republic on the one hand and Slovenia on the other being very illustrative cases for this argument.

Therefore, we further argue that we do not see one single "appropriate" exchange rate regime for transition economies, neither for the initial phase of reform nor for a more advanced stage of economic transformation. In our view, different exchange rate regimes can contribute to successful macroeconomic stabilization if the authorities pursue stability-oriented fiscal and monetary policies, if the regime adopted is compatible with the macroeconomic initial conditions of the country and if the regime is not changed too often so that the necessary credibility can be built up.

1.1 Czech Republic

At the outset of the reform program of January 1991, Czechoslovakia adopted a fixed exchange rate regime, which has been successfully maintained by the Czech Republic ever since the split of the monetary union between the Czech Republic and the Slovak Republic on February 8, 1993, and the subsequent introduction of the Czech koruna as the national currency.

The choice of a flexible or a fixed exchange rate system was a critical aspect of Czechoslovakia's stabilization program. A flexible regime entailed substantial risk, on the one hand because Czechoslovakia had no established foreign exchange markets and there was uncertainty regarding price and trade patterns in the aftermath of price and trade liberalization. On the other hand, an initial price jump or a possible initial surge in imports might have triggered speculative attacks on the koruna, depreciation, and, consequently, a rise in domestic inflation. Against this background, following three major devaluations of the Czechoslovak koruna in the course of 1990, the authorities decided to peg the exchange rate to a basket of currencies of five major trading partners in the West.[4]) This decision was fully supported by

4 *As of December 28, 1990, the basket comprised the following currencies: U.S. dollar (31.34%), Deutsche mark (45.52%), Austrian schilling (12.35%), Swiss franc (6.55%) and pound sterling (4.24%).*

After a minor revision in July 1993,[9]) the basket was completely redesigned one year later. From July 14, 1994, the basket has consisted of two currencies, namely the Deutsche mark (with a weight of 60%) and the U.S. dollar (40%). This decision was adopted after an analysis of the balance of payments showing that the Deutsche mark and Deutsche-mark-related currencies contributed to about 60% of the current account transactions. Furthermore, this step can be seen as a strategic move in the direction of EU approximation.

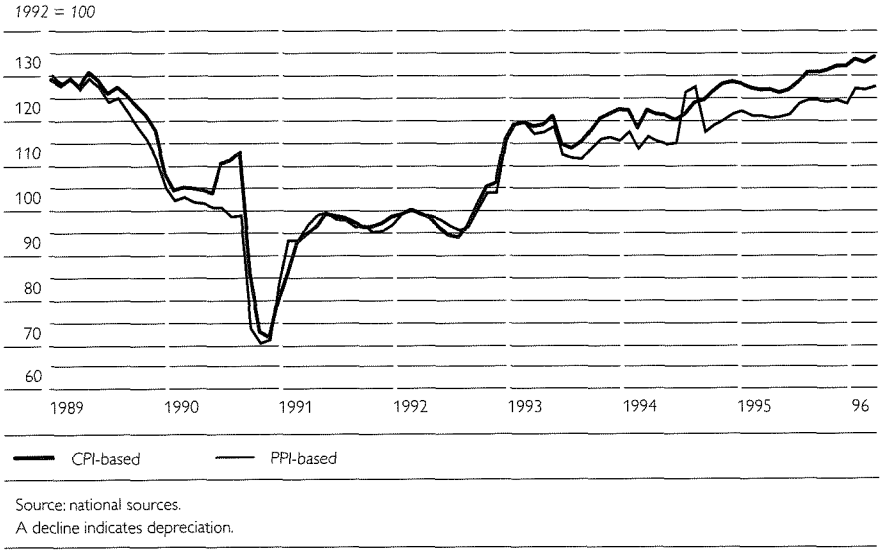
The exchange rate of the Slovak koruna is determined at daily fixing sessions conducted by the National Bank of Slovakia (NBS). The range within which the exchange rate is allowed to fluctuate amounted to ±1.5% and was widened to ±3% on January 1, 1996. As in the case of the considerations in the Czech Republic, this move aimed at introducing a larger element of risk for currency traders, thus dampening speculative capital inflows.

After the currency split in February 1993 the Slovak authorities decided to maintain the fixed exchange rate system adopted by Czechoslovakia and to use the exchange rate as a nominal anchor for stabilization policies. A formal wage agreement was not concluded (no explicit "wage anchor"). The Slovak Republic also inherited the system of "internal" convertibility introduced by Czechoslovakia in January 1991. The rapid depletion of international reserves, the accelerating trade deficit[10]) as well as a real appreciation of the currency in the first quarter of 1993 fueled discussions about abandoning the peg of the Slovak koruna or – at least – a strong nominal devaluation of the currency. On July 10, 1993, the central bank followed the recommendations of the IMF and devalued the koruna by 10%. The IMF had argued that this step, together with a continued restraint on real wages, would improve Slovakia's export competitiveness and contribute to a recovery of the external position already in the course of 1993.

Chart: 2

Slovak Republic

Real effective exchange rates



Source: national sources.
A decline indicates depreciation.

9 After the revision on July 10, 1993, the basket composition was as follows: 49.06% U.S. dollar, 36.16% Deutsche mark, 8.07% Austrian schilling, 3.79% Swiss franc and 2.92% French franc.

10 Whereas the foreign exchange reserves of the NBS had amounted to USD 356 million on the first day of Slovakia's independence, they had dropped significantly by the time of the currency split and amounted to only USD 132 million at the end of February 1993 (see Lukas, 1994).

But despite the introduction of several import restrictions in February and the devaluation in July, Slovakia's external position remained very weak in 1993. The trade balance recorded a deficit of almost USD 1 billion in 1993, and international reserves remained at a fragile level (6 weeks of imports). An impressive economic turnaround took place in 1994 and brought about surpluses of both the trade balance and the current account. This improvement of Slovakia's external position was due particularly to structural factors, such as the reorientation of trade flows towards Western markets and considerable progress in restructuring the domestic economy, as well as to the temporary introduction of a 10% import surcharge in March 1994.[11]) Notwithstanding the sustained real appreciation of the Slovak koruna since its introduction (due to the still considerable inflation differential against major trading partners), Slovakia's external position further improved in 1995, showing a modest trade surplus and a positive current account balance. A plausible explanation is the undervaluation of the domestic currency in terms of purchasing power parities,[12]) which is more pronounced for the Slovak koruna than for the currencies of the other four Central European transition economies examined, and which leaves some room for further real appreciation.

Although the Slovak Republic recorded an increase in capital inflows in 1995, the country is not yet facing the sort of inflationary pressure the Czech Republic is and therefore the current fixed exchange rate system is not being questioned for the time being. Nevertheless, the widening of the exchange rate band in January 1996 represents a move towards a more flexible exchange rate regime.

1.3 Poland

A key element of the Polish reform program instituted in January 1990 was the adoption of a fixed exchange rate regime and the use of the exchange rate as a nominal anchor for stabilization policies. The exchange rate peg was complemented by a wage anchor, which was implemented through a system of excessive wage taxation. At the beginning of the reform process the exchange rate of the zloty was pegged to the U.S. dollar, and from May 1991 to a basket of currencies. In October 1991 the fixed peg was abandoned and replaced by a crawling peg regime, which has remained in place – with some modifications – ever since.

The main reason for the choice of a fixed exchange rate system at the outset of the Polish reform program was the predominant macroeconomic objective of cutting down hyperinflation, which amounted to almost 30% a month at the end of 1989. Another argument against a flexible exchange rate regime was the absence of functioning foreign exchange markets. As the level of international reserves did not seem sufficient at the time the peg was introduced, international donors established a USD 1 billion stabilization fund in order to underpin the confidence in the zloty. This stabilization fund was never drawn upon.

On January 1, 1990, the fixed exchange rate of the zloty was set at 9,500 zloty per U.S. dollar, which involved a 31.6% upfront devaluation. At the same time, "internal" convertibility of the zloty was introduced.

11 This import surcharge was originally supposed to be abolished by the end of 1994, but the new government has postponed this step: the surcharge remained unchanged until June 1996, was reduced as of July 1, 1996 (from 10% to 7.5%), and is planned to be completely abolished by January 1997.

12 see Havlik, mimeo

Although the fixed peg was originally regarded as provisional and no announcement had been made about the duration of the arrangement, it could be maintained for almost one and a half years due to a comparatively strong underlying balance of payments position in 1990 and 1991. However, a number of economists criticized the authorities for having maintained the fixed exchange rate regime for too long.

Given the continuous tendency of real appreciation and the subsequent losses of external competitiveness, the exchange rate regime was changed in May 1991. The zloty was pegged to a basket of five currencies and at the same time devalued against this basket by 14.4%. The basket comprised the U.S. dollar (45%), the Deutsche mark (35%), the pound sterling (10%), the French franc (5%) and the Swiss franc (5%). This composition basically reflected the geographical pattern of Polish trade flows in 1990 and has not been altered since that time. Despite the devaluation of May 1991, the zloty continued to appreciate in real terms, so that the authorities further revised the exchange rate system.

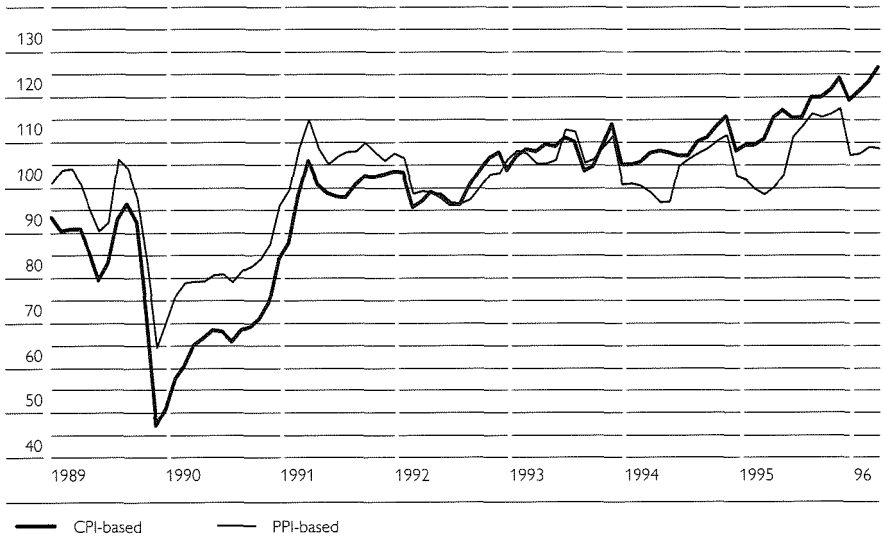
On October 15, 1991, the fixed peg was abolished and a preannounced crawling peg system was adopted. The maximum monthly rate of crawl was set at 1.8%, which was lower than the inflation differential vis-à-vis the currencies represented in the basket. Therefore the new regime carried an implicit tendency of real appreciation. The adoption of the crawling peg regime was a compromise solution between the two objectives of reducing domestic inflation on the one hand and compensating the export sector for losses of international competitiveness on the other hand. Through the preannounced monthly crawl rate, the authorities could preserve to some extent the signaling function of the exchange rate as a nominal anchor.

Chart 3

Poland

Real effective exchange rates

1992 = 100



Source: national sources.
A decline indicates depreciation.

As comparatively high inflation rates persisted in 1991 and 1992, the real appreciation of the zloty continued. Furthermore, the level of international reserves decreased significantly. Therefore, the National Bank of Poland (NBP) devalued the zloty by 11% in February 1992, while maintaining the monthly rate of crawl unchanged. After a brief recovery in 1992, the trade balance and the current account started to deteriorate again in 1993, and at the same time international reserves decreased. The difficult external position necessitated a further devaluation of the zloty by 7.4% in August 1993. Simultaneously, the rate of crawl was reduced to 1.6% per month. This move reflected the authorities' intention to actively use the crawling peg mechanism by setting the monthly rate in consistency with the declared objective of curbing inflation. As the inflation rate decelerated further in 1994 and 1995, the crawl rate was decreased in several steps to 1.5% a month in September 1994, 1.4% in November 1994 and 1.2% in February 1995. Due to the crawling peg mechanism and the devaluation step in August 1993, the real exchange rate of the zloty could be kept virtually constant until mid-1994, when the tendency of real appreciation recommenced.

Much as in the Czech Republic, the surge in capital inflows since mid-1994 and the subsequent problems controling domestic inflation have marked a turning point for Poland's exchange rate policy. The altered structure of the balance of payments therefore provoked demands for both a switch to a more flexible exchange rate system as well as for a possible revaluation of the zloty. In March 1995, the central bank undertook a first step towards a more flexible exchange rate system and widened the intervention band from $\pm 0.5\%$ to $\pm 2\%$. A more pronounced expansion of the band took place on May 16, 1995, when the NBP widened the margin to $\pm 7\%$. This move was intended to give the central bank more room for monetary policy maneuver and was seen as a major step towards a floating exchange rate regime of the zloty. The modified crawling peg mechanism is also referred to as a "crawling band". The IMF supported the widening of the band in principle, but expressed some scepticism about the effectiveness of this move in practice, the zloty having been allowed to appreciate to the outer end of the intervention range.

Against the background of still accelerating inflows of short-term capital, the central bank decided – for the first time since the beginning of the reform process – to revalue the zloty by 6% in December 1995, a step which had been recommended by the IMF in order to counteract the inflationary pressure resulting from the capital inflows. Since this revaluation, the exchange rate has been kept well within the band and has not moved to its outer edge, and for the time being the pressure for further revaluation seems to have been halted. As of January 8, 1996, the NBP once again reduced the monthly crawl rate to 1.0%. In principle, the authorities envisage a further slowing down of the monthly devaluation rate of the zloty.

Taking into account the nominal revaluation as well as the crawl rate, which does not fully offset the inflation differential with respect to the West, the zloty is likely to undergo a further real appreciation in 1996. However, its impact on the actual external position should be interpreted with caution,

because the official figures are to some extent misleading: Until the end of 1995 a substantial part of the capital inflows shown in the capital account consisted of unregistered exports (especially cross-border trade) which were of such a magnitude that they – according to OECD calculations – would have produced a positive current account, if recorded "correctly". As of 1996, Poland has reclassified these unregistered exports and included them in the current account. In this light, concerns about a loss of external competitiveness as well as about a possible further increase of capital inflows should not be overemphasized. This view is supported by the recent developments of the nominal exchange rate, which has – since the revaluation of December 1995 – remained well within the band.

1.4 Hungary

Since the introduction of a unified exchange rate in October 1981, the Hungarian forint has been pegged to a basket of currencies, and its value was – until March 1995 – adjusted at irregular intervals. The adoption of a fixed, but adjustable peg regime represented a compromise solution between the two extreme options of either a fixed exchange rate or a free float. On the one hand, the exchange rate served as a nominal anchor for stabilization policies via its fixed peg, on the other hand the possibility of unanticipated, discretionary devaluation steps enabled the authorities to compensate, at least partly, for the inflation differential vis-à-vis major trading partners, thus safeguarding external competitiveness to some extent.

Until 1991, the currency basket comprised all currencies attaining at least 1% weight in foreign trade. The composition of the basket was revised annually, and the number of currencies varied between 9 and 11 over the years. After the reforms of 1991, the system of yearly basket revisions was abolished, and the composition of the basket was completely restructured. In view of the changing trade patterns and of the strategic goal of EU membership, the National Bank of Hungary (NBH) established a basket with a 50/50% weight of the U.S. dollar and the ECU. In the wake of the EMS crisis in August 1993, the NBH modified the basket again and replaced the ECU with Deutsche mark. This peg turned out to carry a tendency of real appreciation of the forint, because the inflation differential vis-à-vis Germany was particularly large and a number of foreign trade transactions was invoiced in other Western European currencies (with higher domestic inflation rates) anyway. Therefore, on August 16, 1994, the central bank reintroduced the ECU with a weight of 70% into the basket, a 30% weight remaining with the U.S. dollar.

The economic reforms in Hungary between 1989 and 1991 were characterized by a gradual liberalization of imports, which was accompanied by infrequent discretionary devaluations of the forint. By January 1991, more than 90% of all imports had been liberalized and de facto current account convertibility for enterprises had been introduced. But the policy of infrequent, at times rather large, unanticipated exchange rate adjustments created further devaluation expectations and contributed to inflationary pressures. Therefore, after the completion of import liberalization, the authorities switched their strategy and pursued a policy of occasional minor

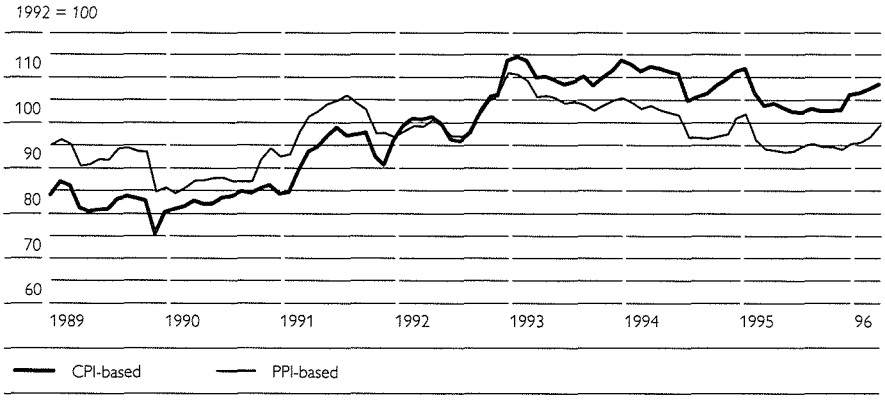
forint devaluations – in a range of between one and two percent each – in order to preserve export competitiveness.

As regards the developments of the real exchange rate, the forint has been facing a continuous real appreciation since the beginning of the 1990s. While Hungary's external position nevertheless remained favorable until 1992, Hungarian exports dropped sharply in 1993 and the current account deteriorated, even more so in 1994. Therefore, in 1993 and 1994 the authorities tried to protect export competitiveness and devalued the forint by considerably more than in the year before.[13]) Consequently, the level of the real exchange rate remained virtually constant in both years.

Chart: 4

Hungary

Real effective exchange rates



Source: national sources.
A decline indicates depreciation.

In order to overcome the persisting fiscal and current account deficits, the Hungarian government announced an austerity package on March 12, 1995. One centerpiece of the package was an upfront devaluation of the forint by 9% as of March 13, 1995, followed by a switch to a preannounced crawling peg regime. Between March 13 and June 30, 1995, the rate of devaluation against the basket was set at 1.9% a month, and it was reduced to 1.3% a month during the second half of 1995. Since January 1, 1996, the rate of crawl has been set at a monthly 1.2% and is not likely to be further reduced in the course of 1996.[14]) Until December 1994 the official exchange rate of the Hungarian forint was determined at daily fixing sessions within a margin of ±1.25%, and the central bank intervened in order to keep the peg against the currency basket. As of December 23, 1994, the intervention band was widened to ±2.5%. This move was designed to limit speculative capital flows under the fixed, but adjustable peg regime. In view of the improving macroeconomic performance, declining monthly inflation figures and a decreasing preannounced devaluation rate, speculative flows were boosted at the beginning of 1996. Therefore analysts recently recommended a further widening of the band in order to increase the exchange rate risk of foreign investors,[15]) a step which the central bank has rejected up to now.

13 Whereas in 1992 the overall devaluation of the forint amounted to 5.5% (cumulated to an annual figure), it attained 15% in 1993 and 16.8% in 1994.

14 Interview with Finance Minister Peter Medgyessy on June 13, 1996 (Reuters).

15 Peter Muszely, an analyst of the leading brokerage Concorde Securities, had recommended this step to the NBH (see Reuters, February 2, 1996).

The adoption of the crawling peg regime and the 9% devaluation were primarily intended to bring about the real depreciation of the forint required to restore external competitiveness. Furthermore, the main advantage of a preannounced crawling peg as opposed to the ad hoc exchange rate adjustments was seen in a stronger role of the exchange rate as a nominal anchor aiming at a reduction of inflation, thus enforcing the credibility of monetary policy. Moreover, decreasing inflation expectations should help to reduce the interest cost on a very large public debt burden. The strategic reason for introducing the crawling peg regime was Hungary's goal to join the EU and "to lock its exchange rate to the ERM".[16])

The introduction of the crawling peg in March 1995 was welcomed in principle by the IMF. According to the IMF, the policy of ad hoc exchange rate adjustments created uncertainty, thus encouraging short-term speculative flows, and prevented the exchange rate from acting as a nominal anchor. As regards the crawling peg regime, the IMF had emphasized the potential risk of adopting a crawling peg before a credible macroeconomic stabilization program was in place. Although the implementation of the austerity package brought about a substantial improvement of the current account and a recovery of the fiscal balance in 1995, the inflation rate remained at a disappointingly high level. Nevertheless, the IMF still supports the choice of the crawling peg regime and stresses the importance of sustained restrictive fiscal and incomes policies as well as the necessity of structural reforms.

1.5 Slovenia

Of the five Central European transition economies examined, Slovenia is the only one which has opted for a floating exchange rate regime from the outset of the economic reform program. Since the introduction of the tolar (SIT) on October 8, 1991, the exchange rate of the Slovene currency is determined freely on the foreign exchange interbank market, while some scope for central bank intervention is maintained ("managed float").

Although Slovenia has a number of structural characteristics (comparatively small size of the economy, high degree of openness) which in the literature are typically seen as preconditions for the adoption of a fixed exchange rate system,[17]) the authorities decided from the outset to introduce a floating regime. This decision was preceded by a "pegging versus floating" dispute in the months before the introduction of the tolar. In fact, there had been numerous proponents of a fixed peg who had suggested pegging the tolar to the Deutsche mark, the ECU or to a basket.[18]) It was argued that the use of the exchange rate as a nominal anchor could contribute to a consistent anti-inflationary policy and, simultaneously, help to build up the needed confidence in the new currency ("borrowed credibility"). The IMF also suggested the introduction of a nominal exchange rate rule as a good guide for monetary policy, mainly referring to the high degree of openness of the Slovene economy.

The main reason for Slovenia's decision was the lack of international reserves at the time it gained independence from former Yugoslavia. Furthermore, the authorities had serious doubts concerning the calculation

16 *See Kopits (1996).*
17 *See e.g. Frenkel, Goldstein and Masson (1991).*
18 *See Mencinger (1993).*

of an appropriate initial exchange rate. In this context it was feared that – given the environment of hyperinflation inherited from Yugoslavia – a too large upfront devaluation of the currency was likely to stimulate further inflation, thus jeopardizing the credibility of a fixed peg. On the other hand, an overvalued level of the initial exchange rate could have endangered export competitiveness. Another argument in favor of a flexible exchange rate system was its ability to adapt more easily to the rapidly changing trade patterns, which had to be fundamentally restructured due to the loss of traditional markets in former Yugoslavia.

On October 8, 1991, the exchange rate of the tolar was set at 32 SIT per Deutsche mark and depreciated in nominal terms until mid-1994. The extent of nominal depreciation was kept roughly in line with the inflation differential vis-à-vis the major trading partners, so that the real effective exchange rate remained virtually stable in this period. Between mid-1994 and mid-1995, the nominal exchange rate of the tolar against the Deutsche mark was held virtually constant, which implied an appreciation in real terms. In the second half of 1995, the nominal exchange rate of the tolar started to depreciate again, a tendency which did not continue in the first half of 1996, during which the exchange rate was kept nominally stable. In our view, the short-lived nominal depreciation of the tolar in late 1995 simply seems to have coincided with the declaration of current account convertibility in September 1995 rather than reflecting a causal relationship.

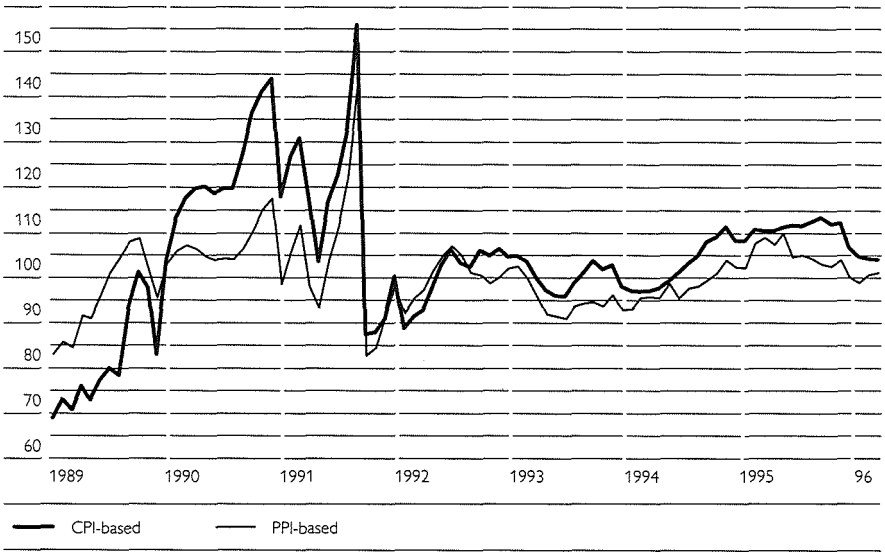
Since 1991, Slovenia's external position has been characterized by current account surpluses of varying magnitudes and large capital inflows since 1993. The trade balance, however, deteriorated in 1993 and 1994, and

Chart: 5

Slovenia

Real effective exchange rates

1992 = 100



Source: national sources.
A decline indicates depreciation.

the trade deficit grew even larger in 1995. The worsening trade results are mainly explained by the rapid growth of domestic consumption, which led to a surge in consumer goods imports (and by the recession in Western Europe in 1993).

The surge of capital inflows in 1993 and 1994 was addressed by the Slovene authorities from different angles. First, the central bank kept the nominal exchange rate stable between mid-1994 and mid-1995, which brought about some real appreciation of the tolar. Second, the Bank of Slovenia (BoS) imposed new capital controls in February 1995,[19]) and third, domestic interest rates were lowered,[20]) thus reducing the interest rate differential vis-à-vis other countries. While it is difficult to quantify the contributions of every single measure, the marked decrease of capital inflows in 1995 suggests that the central bank has successfully contained additional inflows.

With regard to macroeconomic stabilization, Slovenia is frequently referred to as one of the "success stories" among the Central and Eastern European transition countries and frequently compared to the Czech Republic in this context. With an impressive reduction of inflation, very moderate budget deficits (in a range of 0.5 to 1% of GDP), a sustainable current account position and a comfortable level of international reserves, Slovenia would now fulfill all the prerequisites needed for the implementation of a fixed peg. But the Slovene case has clearly shown that successful macroeconomic stabilization is also possible under a floating regime of the currency – provided the stance of fiscal and monetary policies is reasonable – and therefore Slovenia's choice is widely acknowledged. The Slovene authorities have indicated their willingness to stick to the existing exchange rate system also in the medium term, until eventually moving from a floating to a fixed rate before joining the European Monetary Union at a future date.[21])

19 *As of February 10, 1995, borrowers of foreign loans with less than 5 years maturity were required to make a non-interest-paying tolar deposit equivalent to 40% of the loan.*

20 *In April 1995, the lombard and the discount rates were reduced from 17 and 16% to 11 and 10%, respectively.*

21 *Interview with central bank governor France Arhar on April 11, 1995 (Reuters).*

2 General Considerations

The choice of the exchange rate regime is certainly one of the decisive issues faced by transition economies. In general, the choice made in the five examined countries has reflected, inter alia, the individual countries' different initial conditions as well as different priorities regarding economic objectives. It is interesting to note that the "classical" criteria found in the optimum currency area (OCA) literature were of little practical relevance for the decision.[22])

As to the macroeconomic initial conditions, there were considerable differences among the countries analyzed. While Poland and Hungary were confronted with serious macroeconomic imbalances at the beginning of their reforms, Czechoslovakia started with a virtually balanced macroeconomic position. Slovenia, which had been the richest republic of former Yugoslavia, nevertheless had to resolve several macroeconomic problems inherited from Yugoslavia (hyperinflation, unclear allocation of external debt, loss of traditional markets, lack of international reserves). As regards the structural initial conditions, Hungary had a comparative advantage, having started systemic reforms earlier than Poland and

22 *The "classical" prescription derived from the OCA literature would have argued for a fixed exchange rate regime e.g. in the case of Slovenia: In simplified terms, small, open economies with a diversified production structure and a high degree of integration with a geographic area are supposed to be ideal candidates for a currency union.*

Czechoslovakia. Slovenia and Slovakia, which had gained their political independence only recently, had to build up some economic policy institutions from scratch – in particular independent central banks – and to establish public confidence in them, while at the same time transforming their economic systems into market economies. The different initial conditions in the individual countries certainly had an impact on the economic objectives which were considered priorities, and therefore can explain to some degree the exchange rate regime chosen at the beginning of the reforms.

As the countries have now reached a more advanced stage of transition, the emphasis on different macroeconomic objectives has shifted and new challenges have to be addressed. In the following section, we want to briefly discuss the classical trade-off between the objectives of price stability and export competitiveness, the relative importance of these two goals in the Central European transition economies since the start of the reforms and their relevance for the choice of the exchange rate regime. Furthermore, we will discuss the issue of foreign capital inflows and possible policy responses, implications of the declaration of current account convertibility as well as the importance of the longer-term goal of EU accession.

2.1 Trade-off between Price Stability and Export Competitiveness

The trade-off between the objectives of external competitiveness and price stability has been a dividing issue among economic policymakers in transition economies since the beginning of the reform process and has influenced their choice of the exchange rate regime. While proponents of a fixed exchange rate system put more emphasis on the objective of price stability and hence on the reduction of inflation, defenders of a floating regime aim primarily at protecting the external competitiveness of the economy in order to promote output growth.[23]) The discussion in Central and Eastern Europe at the beginning of the 90s typically focused on economic policy priorities rather than on the evaluation of economic prerequisites as known from the OCA literature.

Evidence from the countries analyzed suggests that the preferences of policymakers have varied from country to country not only according to the political attitudes of the ruling parties, but have also been dependent on the level of inflation and the prevailing external position in their countries. Poland's different exchange rate regimes implemented since the start of the reforms are an illustrative example of changing policy preferences. While a fixed peg seemed advisable at the initial stage of transformation given the immediate need to fight hyperinflation and to import stability, Poland switched to a crawling peg mechanism one and a half years later in order to compensate exporters at least partly for the loss of competitiveness.[24]) The move to further increase the flexibility of the system by widening the band was basically a reaction to the increasing capital inflows into the country. A similar shift of policy preferences can be observed in the Czech Republic, which maintained its fixed exchange rate for more than four years, until the imbalances caused by capital inflows required the introduction of more flexibility by widening the intervention band.

23 However, this does not mean that inflation can only be tackled with a fixed peg and that a floating regime necessarily promotes growth.

24 Whereas the current account balance had shown a substantial surplus in 1990 (USD 668 million), it turned into a huge deficit in 1991 (USD 2.222 billion).

In this context the changing role of international organizations (like the IMF or the EU) in Central Europe might – to a certain extent – have an impact on the countries' decisions concerning exchange rate policy. As to the IMF, we can observe a decreasing activity of the Fund in the five countries recently. In the course of 1995, none of the countries analyzed concluded a new IMF agreement,[25]) the Czech Republic, Poland and Hungary even made early repayments of Fund credits. As regards the European Union, all of these countries have concluded EU Association Agreements and have applied for EU membership. Therefore, harmonizing exchange rate policies with those prevailing in the EU and especially with the future European Monetary Union (EMU) will certainly become a crucial issue in the near future.

In our view, the recent changes in the exchange rate systems of the Czech Republic and Poland clearly reflect a compromise made to take into account two diverging macroeconomic objectives. On the one hand, as the authorities are concerned with a further dampening of inflation, the peg of the currency to a basket was not completely abandoned, on the other hand, a more flexible approach had to be taken in order to stem additional capital inflows.

2.2 Problem of Short-term Capital Inflows

Depending on the exchange rate regime chosen, the problem of short-term capital inflows, which the Czech Republic, Poland and Slovenia have experienced since 1993, can be tackled in different ways.

If the country has adopted a (pure) fixed exchange rate regime and wants to maintain it, capital inflows will require the central bank to purchase foreign currency in order to keep the nominal exchange rate stable. Consequently, the level of international reserves will increase, which will be reflected in a growth of domestic money supply. This will create some inflationary pressure, which can be counteracted by sterilization measures (e.g. buying back domestic currency against government securities), but this is a costly procedure. However, in an environment of almost perfect mobility of international capital, sterilization measures can only buy some time.

In practice, a frequently used remedy against the inflow of foreign capital under a fixed regime is the widening of the exchange rate band, which brings about a higher degree of risk for speculators and, at the same time, enables the authorities to maintain their commitment to a peg. This approach was chosen by Poland in May 1995 and by the Czech Republic in February 1996. The risk of this measure is that the exchange rate simply moves to the outer edge of the band and the pressure for further appreciation of the domestic currency continues as observed in Poland. Therefore the Polish authorities opted for a further remedy against capital inflows, namely a nominal revaluation of the zloty in December 1995.

In the case of a (pure) floating regime, the inflow of foreign capital will trigger an appreciation of the domestic currency: Imbalances caused by capital inflows will be fully offset by exchange rate changes, and domestic money supply will not be affected. However, Slovenia has not adopted a float in its pure form, and hence the inflow of foreign capital was not simply reflected in an appreciation of the tolar. While keeping the nominal exchange rate stable, the Slovene authorities implemented a policy mix consisting of

25 Poland and Slovakia drew no additional tranches of the agreements concluded in 1994. However, Hungary concluded an IMF agreement in March 1996.

the introduction of capital controls in February 1995 and a reduction of domestic interest rates in April 1995. This combination of different remedies seems to have produced the desired results, as capital inflows decreased for the first time in the course of 1995. The exchange rate regime formally remained unchanged.

2.3 Convertibility and the Exchange Rate Regime[26])

While most countries had introduced some form of de facto convertibility already at the outset of the reforms, all of them officially assumed Article VIII status in the IMF in the course of the past year.[27]) According to Article VIII of the IMF's Articles of Agreement, the countries herewith are no longer permitted "to impose restrictions on [the] payments ... for current international transactions ..."[28]) In other words, the currencies have been declared convertible for current account purposes, while certain restrictions on capital account transactions can stay in place.

Although there is a broad consensus in the literature that the introduction of current account convertibility is advisable at a rather early stage of the reform process, a premature declaration of convertibility might nevertheless endanger the credibility of domestic policies, in particular of exchange rate policies. Therefore the official declaration had to be carefully prepared by the authorities. As the assumption of Article VIII status in the IMF sends a signal towards the international community and also to domestic residents, it may trigger in- or outward payment flows of unexpected magnitudes and thus makes the exchange rate regime more vulnerable. Therefore confidence in the domestic currency as well as a realistic level of the exchange rate are preconditions to the introduction of convertibility.

This consideration also applies – to an even larger degree – to a premature introduction of capital account convertibility. But in this case the magnitude of potential capital flows is much larger than for current account transactions, which are limited to actual trade flows, services and transfers. In the case of capital account convertibility, institutional investors, and hence enormous volumes of highly mobile speculative capital, come into play. In the context of the Mexico crisis, the IMF recently even discussed a possible temporary introduction of capital controls against speculative capital inflows. In view of these risks, the extensive liberalization of capital movements in the course of OECD accession (Code of Liberalisation of Current Invisible Operations; Code of Liberalisation of Capital Movements) and the preparation for EU membership (White Paper) represents a major challenge for monetary and exchange rate policies.[29])

2.4 Outlook: Possible Future Exchange Rate Regimes and Preparations for Accession to the EU

All five countries examined have already concluded Association Agreements with the European Union and have declared EU membership their longer-term strategic goal. While the European Union is preparing the introduction of a common European currency (the euro) in a few years, it made Eastern enlargement an explicit goal of the Union at the Copenhagen Summit in mid-1993. This goal has been reiterated at several other occasions.

26 The question of currency convertibility is covered in more detail by Peter Backé, "Progress towards Convertibility in Central Europe", also published in this issue.

27 Poland was the first country to undertake this step in June 1995 and was followed by Slovenia in September 1995 and by the Czech Republic and Slovakia in October 1995. Hungary officially declared the forint convertible in January 1996.

28 See "Articles of Agreement of the IMF", pp. 21–24.

29 The Czech Republic joined the OECD in December 1995, Hungary in May 1996, Poland will follow in the course of 1996, and Slovakia later on. Slovenia applied for membership in March 1996.

Although the European Union does not oblige new Member States to participate immediately either in the Exchange Rate Mechanism (ERM) or in Economic and Monetary Union (EMU), EU membership nevertheless suggests an orientation of monetary policies towards the process of European monetary integration. As the Eastern enlargement of the EU is most likely to take place between 2000 and 2010 at least for a first group of applicants, monetary union between some Member States will have materialized by then. Therefore, the arrangement currently being debated between the EMU participants known as "ins" and "outs" (EU members which do not participate in EMU) will be of paramount importance also for the five countries examined. From today's perspective, it can be assumed that the new Central European Member States will not immediately participate in EMU, but are more likely to join a possible successor system of the current ERM. Although the future mechanism of a possible "ERM II" has not yet been agreed upon in detail, we can assume that the participating currencies will in some way be pegged to the euro while fluctuating within a (probably rather wide) band around the central parity.[30])

These fundamental changes in the monetary system of the European Union suggest an adjustment of the existing exchange rate regimes in Central and Eastern Europe in the course of preparing for EU accession. One implication for the exchange rate policies might be a critical revision of the currency baskets, where the dollar still has a strong weight which could be further reduced in favor of a European currency. The changes in the composition of currency baskets in the Czech Republic, Slovakia and Hungary clearly reflect this tendency.[31])

Although the fulfillment of the Maastricht criteria is not a precondition for EU membership, it seems advisable also for applicants to pursue stability-oriented economic policies even before joining the EU in order to prepare their economies for the participation in the internal market. After having achieved full EU membership, the next logical step would be a participation in "ERM II", which would require the new Member States to bring their economic fundamentals even more in line with those of EMU members.

Notwithstanding the general direction of exchange rate policies in the countries analyzed, which shows a clear tendency towards a higher degree of flexibility of the exchange rate regimes (especially in Poland and the Czech Republic), in our view the countries might consider gradually adapting the actual exchange rate regimes to the arrangements prevailing in the European Union.

30 A widely discussed alternative to this scenario is the implementation of a generalized system of inflation targeting in Europe (see Persson and Tabellini 1996). The proponents agree that exchange rate stability is desirable in Europe, but such stability should be the result of successful monetary policies, not the target of such policies. They suggest a different route for monetary policy coordination in Europe – by targeting inflation.

31 The sole exception in this realm seems to be Poland, which has not revised its basket since May 1991. But also in the Polish case, the current geographical structure of trade flows would suggest an increased weight of EU currencies.

3 Conclusions

When comparing the macroeconomic performance of the five Central European transition economies, the Czech Republic and Slovenia are frequently referred to as "success stories". While Czech stabilization policies relied primarily on the use of the fixed exchange rate as a nominal anchor, Slovenia has adopted a (managed) floating regime and has achieved comparable macroeconomic results.

From the country analyses we conclude that the external performance of the five countries has been determined primarily by structural factors, such as the loss of traditional markets and the subsequent reorientation of trade flows and by changes in the economic situation in Western Europe. The type of the exchange rate regime adopted obviously played a rather subordinate role for the trade performance. By saying this, we do not mean that exchange rate policies have no impact on trade results. It is the level of the exchange rate and its changes that affect trade performance rather than the exchange rate regime.[32])

The surge in capital inflows witnessed by the Czech Republic, Poland and Slovenia since 1993 represented a major challenge for exchange rate policies and has contributed to the recent changes towards more flexible exchange rate arrangements.

While evidence from the countries examined supports our view that macroeconomic stabilization can be achieved with different exchange rate regimes, the countries will now enter a new stage which suggests an orientation of the exchange rate regime towards integration with the European Union. In view of the political and economic developments within the European Union, the countries examined could consider gradually returning from the rather flexible exchange rate systems presently adopted to a peg of their domestic currencies to a stability-oriented European currency.

32 *For Poland and Hungary empirical evidence suggests a high exchange rate sensitivity of exports to Western Europe, while exports to Eastern Europe react less to changes in exchange rate levels, and exports to developing countries are rather insensitive to exchange rate movements, as they are mainly based on longer-term contracts.*

A further distinction is frequently made between de facto and de jure convertibility. The former denotes the actual extent to which foreign economic transactions themselves are liberalized and free of foreign exchange restrictions. In turn, de jure convertibility refers to the official declaration of a country that its currency is (partially or fully) convertible. A specific form of de jure convertibility is a country's official acceptance of the obligations contained in Article VIII of the IMF's Articles of Agreement.[8]) The adherence to the obligations of Article VIII differs from a simple official declaration of convertibility in two ways. First, it has a precise content, namely the obligation to remove all restrictions on the making of payments and transfers for current international transactions both for residents and nonresidents. Second, it carries a binding international commitment. There are annual reviews by the IMF; temporary derogations are possible but only with the acceptance of the Fund. Article VIII relates to the financial convertibility concept, i.e. it does not hinder the respective country from restricting underlying transactions. Article VIII also forbids discriminatory currency practices – in particular multiple-exchange-rate practices and bilateral payments agreements – and provides for the convertibility of foreign-held domestic currency balances.[9]) For IMF members that do not accept the obligations of Article VIII, Article XIV contains "temporary arrangements" which allow to "maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect" at the inception of membership. Article XIV also calls for an early withdrawal of restrictions maintained on current transactions.

Compliance with the OECD Codes of Liberalization of Current Invisible Operations and of Capital Movements can be understood as another specific form of de jure convertibility. Unlike the IMF's Article VIII, these Codes refer both to the payments and transfers as well as to the underlying transactions. In practice, any country that wishes to become an OECD member must undertake an extensive liberalization of current invisible operations and capital movements. The maintenance of restrictions on specific transactions listed in the Codes requires that the membership candidate lodge a formal reservation, which has to be approved by the OECD Committee on Capital Movements and Invisible Transactions (CMIT) supervising the compliance with these two OECD Codes.[10]) Once accepted, most of the obligations taken on under the OECD Codes are binding with respect to the other OECD member states, the exception being a limited list of sensitive capital transactions. There are clauses of derogation which allow a withdrawal of already accepted liberalization measures only if these measures result in serious economic and financial disturbances. In case of serious balance of payments disequilibria, a temporary suspension is possible. All derogations have to be approved by the OECD, which also examines, in regular reviews, the member countries' adherence to the obligations.

The Code of Liberalisation of Current Invisible Operations basically relates to transactions registered in the service and transfer balances of the current account, dealing with business- and industry-related operations (repair and assembly, processing and finishing, technical assistance,

8 Until recently, only an Article VIII declaration was considered to be de jure convertibility in the true sense, while today also the broader understanding of de jure convertibility is in use (see e.g. Oblath (1993) versus Gács (1994)).

9 Article VIII obliges each member to buy balances of its currency held by another member, if the balances "have been recently acquired as a result of current transactions" or "their conversion is needed for making payments for current transactions".

10 Foreign investment regulations are supervised by the OECD not only from an international payments perspective but also with respect to national treatment for foreigners. Foreign investment issues are dealt with by a Joint Working Group of the CMIT and the Committee on International Investment and Multinational Enterprises (CIME). Recently, a practice of joint CMIT/CIME meetings has evolved, which cover not only foreign investment topics but all issues related to the two OECD Codes mentioned.

contracting, authors' royalties, patents, designs, trade marks and inventions, salaries and wages of nonresidents, other overhead expenses), foreign trade-related operations (e.g. commissions, charges for documentation, warehousing and storage, customs clearance, customs duties), transport, insurance, banking and financial services, income from capital, films, personal and public income and expenditure (e.g. pensions, immigrants' remittances) and general operations (such as advertising, court expenses, fines, professional services).

The Code of Liberalisation of Capital Movements covers practically all capital account transactions. Transactions can be grouped in five broad categories, namely (1) direct investment, (2) real estate operations, (3) portfolio investment (including operations in securities on capital markets, operations on money markets, other operations in negotiable instruments and non-securitized claims, operations in collective investment securities), (4) credit operations (including trade credits, financial credits and loans, sureties, guarantees and financial back-up facilities), and (5) other capital operations (operations of deposit accounts, operations in foreign exchange, life assurance, personal capital movements, physical movements of capital assets and disposal of nonresident-owned blocked funds).

Finally, another form of convertibility results from membership in the European Union and relates to intra-EU payments connected with the free movement of goods, services, persons and capital. With a view to a future Eastern enlargement of the Union, the free movement of capital, enshrined in Articles 73 b–h and 109 h–i EC Treaty, is of particular importance. These regulations incorporate earlier Council directives on capital movements containing, in contrast to the OECD regulations, compulsion and compliance dates. Full adherence can be temporarily delayed through transitional arrangements.

Currently, convertibility-related commitments vis-à-vis the EU result from Association Agreements concluded between the Union and ten Central and European countries, among them all five countries examined here.[11]) In the agreements, the associated countries commit themselves to convertibility for trade and service transactions with the EU, to the extent that the underlying transactions have been liberalized by the agreements. As for capital account transactions, inward and outward direct investment, including the repatriation of profits and capital, is to be liberalized with the entry into force of the agreements (with transition periods for inward direct investment in specified sectors), with the partial exception of Hungary, where outward direct investment is not freed. Finally, the Association Agreements with all countries but Hungary contain commitments to fully liberalize, at the time of adhering to Article VIII of the IMF's Articles of Agreement, short- and medium-term commercial credits related to international trade with the Union in goods and services. In case of serious balance of payments difficulties, temporary restrictions can be applied (except for direct investment).[12])

In the Association Agreements, both sides also declare, in rather general terms, their intention in principle to further liberalize capital movements. Much more specific on this issue is the White Paper on the Preparation of the

11 The EU Association Agreements with Poland and Hungary went into force in February 1994, the ones with the Czech Republic and Slovakia one year later. The agreement with Slovenia was signed in June 1996 and will enter into force most likely in the course of 1997, after completion of the ratification procedure.

12 As will be shown in subsequent sections, most of these commitments did not play a major role in practice in the sense that actual liberalization by the countries under consideration took place before commitments became or become binding.

exchange by private residents, other than the tourism allowance and money taken out from foreign exchange accounts.

Finally, all trade-related decentralization measures of that period only extended to transactions with market economies but not to trade with other centrally planned economies, which was, until the end of 1990, conducted within the CMEA and based essentially on a clearing system.[14])

4 The Move to Limited Convertibility in the Early Transition Period

In all countries examined, limited convertibility was introduced at the beginning of the transition process as part of comprehensive stabilization and reform packages. Besides partial convertibility, these packages contained sweeping liberalization of foreign trade and comprehensive price liberalization, tight macroeconomic policies, and also some institutional reform elements. The centerpiece of convertibility was the same in the whole region, namely convertibility for foreign trade and trade-related service transactions conducted by domestic companies (enterprises and incorporated private entrepreneurs). Liberalized trade-related service transactions typically encompassed also business- and industry-type as well as most transport services, if connected to foreign trade transactions, while other services, especially banking and insurance, remained largely exempt from liberalization. Regulations on the availability of foreign exchange for business travel were initially also rather restrictive. For private households (except for Poland), national currencies remained largely inconvertible: They continued to face major restrictions with respect to services and transfers, typically on education and study abroad, medical treatment, remittances for family expenses, the transfer of pensions, and on travel, where modest annual tourism allowances remained in place. This rigid set of regulations was, however, mitigated in practice, as private households retained the right to keep foreign exchange accounts with domestic banks. Some additional features were characteristic of initial limited convertibility. Repatriation of foreign exchange receipts from liberalized current transactions and full surrender to the domestic banking system was compulsory.[15]) Also, there was one element of nonresident capital account convertibility, namely inward direct investment (including repatriation of capital, in case a venture was wound up), and related to this, a further element of nonresident current account convertibility, namely (partial or full) repatriation of profits from joint ventures. Furthermore, trade and suppliers credits were to some extent liberalized (though not uniformly throughout the region). All other capital transactions remained largely restricted.

Apart from this basic conformity, there were some, though not substantial, differences as for speed and conceptual approaches as well as certain country-specific features with regard to the actual extent of convertibility for specific transactions beyond the core transactions liberalized in all countries. Clearly, these partial convertibilities were formally operated under Article XIV of the IMF's Articles of Agreement, as none of these countries fully complied with the obligations of Article VIII (in particular with respect to nonresidents). The introduction of convertibility

14 *There is only one analogous development, namely some experimenting with direct relationships between enterprises in the late days of the CMEA.*

15 *This meant that in Poland and the CSFR foreign exchange retention schemes were abolished. Related foreign balances which existed when partial convertibility was introduced could be used up successively.*

has been supported by IMF stand-by agreements and World Bank loans, by supplementary balance-of-payments support from a group of 24 industrialized countries (G-24) for the CSFR and Hungary, an EU structural adjustment loan for Hungary and, for Poland, a stabilization fund put together by several industrialized countries.

In Poland, partial zloty convertibility was declared as part of the Balcerowicz plan, which took effect on January 1, 1990. The distinct feature of Polish convertibility was that it related not only to resident companies but also to resident private persons (households), who retained the right to purchase unlimited amounts of foreign currency for current transactions on the legal parallel market introduced in March 1989.[16]) This specificity was clearly a consequence of earlier developments, and a backtracking on this issue was out of question, as it would have been politically detrimental and economically pointless, given the very high dollarization of the Polish economy at the time.[17]) In turn, Poland did not immediately fully liberalize the profit and capital repatriation for joint ventures established in the country. Trade and suppliers credits were liberalized up to volumes of USD 500,000.

In the CSFR, partial koruna convertibility was declared as of January 1, 1991. It comprised practically all current account transactions of resident companies. Liberalization went somewhat further for service transactions than in the other countries, as business- and industry-related services were largely freed, independently of related trade transactions. Czechoslovak convertibility also extended to full profit and capital repatriation for joint ventures (in place since 1989). Furthermore, trade and suppliers credits were largely liberalized. For private persons, annual tourism allowances, set at CSK 2,000 in 1990, were raised to CSK 5,000 in 1991.

Hungary's road to convertibility differed from Poland's and Czechoslovakia's approach in several ways. First, it started out from import liberalization which had been launched in 1989 and by which slightly more than 90% of all imports were liberalized at the beginning of 1991. Liberalization extended also to trade-related services. Thus, unlike in Poland and the CSFR, Hungary's reforms were primarily based on (import) commodity convertibility. It can be argued that this boils down to a variation in techniques which were applied to reach the same end, namely economic opening up, and thus this difference is of a secondary relevance.[18]) Secondly, unlike in Poland and in the CSFR, Hungary did not declare the forint to be convertible, thus following an approach resting on de facto convertibility.[19]) Thirdly, in Hungary foreign liberalization was not implemented in one stroke but in steps. It should be noted, however, that compared with the opening up of most other countries in the world, Hungary's liberalization pace was fast and, moreover, the successive freeing of imports was not coupled with an increase of the (relatively low) weighted average tariff level. Still, also on this issue, Poland and the CSFR took an even more radical stance: With their initial transition packages, they became, practically over night, two of the most open economies in the world (very low weighted-average tariff level, almost no nontariff restrictions.[20]) A fourth difference relates to exchange rate policies. While Hungary's external liberalization was achieved with a

16 *This market was separated by the provision that kantors could sell but not buy foreign exchange from the banking system.*

17 *In Hungary and the CSFR, the parallel market remained illegal but was largely tolerated. Consequently, access to foreign exchange for private persons was in reality easier than suggested by the regulations (see section 3), which remained in place for the time being. This, together with the right to hold foreign exchange accounts (and, in Hungary, to take foreign exchange from these accounts abroad without limitations), led several Hungarian economists to label foreign exchange regulations for private persons "hypocritical" (Bokros (1991), Kék Szalag Bizottság (1992), Oblath (1993)).*

18 *See e.g. Seidel (1991) or Toth (1992).*

19 *This divergence is also reflected by the fact that Poland and the CSFR adopted new foreign exchange laws (in 1989 and 1990), while Hungary continued to operate with an outdated decree from 1974 successively complemented (in fact modified) by a multitude of Finance Ministry and National Bank regulations.*

20 *This has to be slightly qualified for the CSFR, where the introduction of limited convertibility and trade liberalization was complemented by a temporary surcharge on consumer goods as well as agricultural and food imports (on the order of 20% from January 1, 1991, reduced to 10% as of January 1, 1992) and fully phased out one year later.*

fairly limited and somewhat belated devaluation of the forint, in the Polish and the Czechoslovak case, opening up was coupled with a drastic devaluation of the zloty and the koruna. The size of the devaluation in these two countries not only reflected the need to counterbalance the radical trade reform, it was also a direct consequence of using the exchange rate as a nominal anchor: To minimize the downside risk, policymakers opted for a deliberate exchange rate overshooting.[21])

For an analysis of these early-transition developments, it seems useful to start with a brief look at the effects of convertibility. It is generally agreed at a conceptual level that convertibility for trade and service transactions brings with it efficiency and welfare gains: Through convertibility, domestic relative prices are realigned with world market prices and competitive pressure in the domestic economy is increased. Also, convertibility widens the range of available goods and services for both producers and consumers. As a consequence, producers are thought to raise allocational and operational efficiency and to search for the country's comparative advantages. Finally, convertibility can play a role in macroeconomic stabilization, if it is combined with a nominal exchange rate anchor.

For policymakers in the countries examined, partial convertibility (be it de jure or de facto) became appealing because, due to its microeconomic effects, it was perceived as a means for overcoming some of the main legacies of the planning system, namely the distorted relative price structure, widespread monopolistic structures, and the isolation from the world market. In conjunction with the latter, convertibility was seen as a necessary step for a reintegration of these countries into the world economy in general and with Western European markets and integration structures in particular. Thus, convertibility appeared to be a suitable instrument for making progress towards a market system, a prerequisite for catching up with Western neighbor countries and a means for integration with the European Community. This being so, it corresponded well to the overall political aspiration of Central and Eastern Europe from the turn of 1989/90 onward, namely to "return to Europe" and to overcome the division of the continent.

Moreover, as Poland and Czechoslovakia, in their initial stabilization and reform packages, opted for a nominal exchange rate anchor, convertibility played a role in macroeconomic stabilization. In combination with tight financial and incomes policies, convertibility and the exchange rate peg served to reestablish confidence in the national currencies, both at home and abroad. This was especially important in inflation-ridden Poland, where it was perceived to be "very doubtful whether confidence ... in [the] ... extremely substituted ... zloty ... could have been restored, had the Polish government not declared ... convertibility".[22]) In Hungary, which had an adjustable peg until March 1995, the macroeconomic role of convertibility was much less pronounced. With macroeconomic imbalances being much less serious than in Poland, policymakers saw no need to resort to Balcerowicz-plan-type stabilization measures. Moreover, Hungarian policymakers kept a low profile on their progress to convertibility and, consequently, did not opt for a declaration of convertibility, because they were concerned that such a move could possibly lead to complications with

21 *For the sake of completeness, it should be added that there was another transition country in the region which introduced partial convertibility in 1990, namely former Yugoslavia. Yugoslav convertibility very much resembled the Polish type, as it too extended to private households without restrictions. As in Poland, the exchange rate was used as a nominal anchor. Yugoslav convertibility, however, proved unsustainable. It broke down towards the end of the year primarily due to grave macroeconomic mismanagement, which triggered inflation and, as the peg was not adjusted in time, a run on foreign exchange deposits by the population, leading to the exhaustion of the central bank's foreign exchange reserves.*

22 *Bokros (1991).*

respect to their overriding economic policy goal, namely to retain the solvency of their highly indebted country. In turn, the opting of Polish and Czechoslovak policymakers for a one-stroke introduction of partial convertibility and its official declaration was also influenced by the consideration that convertibility could be instrumental in enhancing the credibility of the overall policy and reform package, namely by signaling that this new "radical" package – through the inclusion of convertibility – was truly different from earlier reform attempts.[23])

The international academic discussion of the early 1990s on the issue centered primarily on the conditions for and the timing and sequencing of convertibility as well as on the question of what transactions for which economic agents should be liberalized in the early transition stage. Related issues of the debate were exchange rate regimes and policies as well as foreign trade policies. A majority of analysts argued that transition countries should first introduce limited convertibility, broadly along the lines depicted above, while full current account convertibility and thus Article VIII status should only follow in the medium term and full convertibility in the long run. Early capital account convertibility in particular, with the exception of inward direct investment, was perceived to be unwise, as it could lead to large capital flows and related complications for macroeconomic management, and, more specifically, it was argued that, against the backdrop of comprehensive structural adjustment needs, domestic savings should be invested at home. Thus, the transition countries were frequently advised "to treat unrestricted convertibility as a luxury to be delayed until reconstruction has been achieved".[24])

Also, agreement on the macro- and microeconomic conditions for introducing partial convertibility was fairly large, including the need for a sustainable foreign exchange position both in stock and flow terms (implying appropriate exchange rate policies), for sound fiscal, monetary and incomes policies (including the elimination of any existing monetary overhang), and for a critical mass of market-oriented reforms (in particular free prices and strengthening the financial discipline of enterprises).[25]) However, views differed on timing and sequencing, i.e. on how fast the conditions for convertibility could be established in the specific transition context and on the question of whether progress in meeting these criteria should already be well advanced before introducing (limited) convertibility or whether convertibility could be achieved simultaneously with the implementation of these conditions. Advocates of swift (partial) convertibility pointed at the distortions resulting from a temporary closed-economy equilibrium (after freeing domestic prices and before convertibility) and stressed that a commitment to early convertibility could indeed create the necessary momentum to implement the very conditions needed for its sustainability. Those not favoring an instant move towards partial convertibility were concerned that insufficient preparation of convertibility would force a drastic real devaluation, which would reinforce the transition-related negative impact on output and employment and generate intense inflationary pressures; restrictive monetary, fiscal and incomes policies designed to fight inflation would further aggravate the output decline, thus leading to a drawn-

23 See e.g. Gomulka (1990).

24 Bergsten and Williamson (1990).

25 See Williamson (1991a). Views differed on the question of whether (and, if so, to what extent) demonopolization and privatization were pre-conditions for convertibility. – In this context, one should also give due credit to Central and East European reform economists, who had defined, by and large, the pre-conditions for convertibility for their respective countries already back in the 1980s (see for example the literature review by Horcicová (1991)).

out recession. In this context, several proposals were made to mitigate the impact of early convertibility, most prominently by introducing temporary tariff protection for sectors which were hardest hit by liberalization but were perceived to be capable of adapting to the new environment in the medium run[26]) and/or to erect transient trade barriers for those goods not considered essential for economic restructuring. With respect to trade among CMEA countries, the establishment of an East European Payments Union along the lines of the European Payments Union in the 1950s was proposed.[27])

Overall, for Poland, Czechoslovakia and Hungary, the academic debate of 1990/91 served mainly analytical purposes, but had only little practical impact on the countries' actual steps toward convertibility – if only for the simple reason that, when the discussion took off, partial convertibility and trade liberalization were already a fait accompli in these countries: In Poland, partial convertibility was already in place, in Czechoslovakia, its introduction was accorded and in Hungary, de facto convertibility had reached a substantial degree. The payments union proposal, though made in due time before the CMEA trade moved to world market prices and settlement in convertible currencies in January 1991, never got off the ground, as it was not taken up, mostly because of fierce resistance from the CSFR, Hungary and Poland, which regarded such a union as a deviation from their integration endeavors.

While Poland's, Czechoslovakia's and Hungary's moves towards partial convertibility in the early 1990s received a great deal of international attention, Slovenia's headway in the direction of convertibility went almost unnoticed. A closer look at Slovenia's road towards convertibility shows that it has differed to some extent from that of the other countries examined: Right from the introduction of the tolar in October 1991, convertibility extended to practically all current account transactions conducted by residents but also by nonresidents. The minor exceptions pertained to bilateral payments agreements with Croatia and Russia and to limits regarding the transferability of tolar balances held by nonresidents. Another distinct Slovenian feature consists of exemptions from the compulsory full surrender of foreign exchange proceeds: Companies have had the right to sell foreign exchange proceedings from exports to other enterprises or use it for imports during the first two days after receipt, with full surrender being required only thereafter. As in the other countries of the region, inward direct investment was largely liberalized de jure from the outset. In addition, convertibility comprised inward and outward trade and supplier credits as well as some other inward capital transactions effected by companies (especially, up to certain limits, borrowing abroad), not however those by private residents. Liberalization did not extend to outward capital transactions (other than trade and supplier credits). Restrictions also pertained to the purchase of real estate both by residents abroad and by nonresidents in Slovenia, with the exception of transactions in conjunction with capital investment. A specific Slovenian issue was the treatment of foreign exchange deposits from the pre-independence period. These 'old' foreign exchange deposits (cutoff date: April 27, 1991) were temporarily

26 McKinnon (1991).
27 Van Brabant (1991).

frozen, with a commitment to lift restrictions successively until the end of 1995.

Overall, Slovenia's liberal stance on its foreign exchange system apparently reflects better initial microeconomic conditions, inherited from pre-independence days, a traditional high degree of openness and a comparatively advanced level of economic development, reflected in a strong structural balance-of-payments position. Also, the country adopted sound macroeconomic policies from the outset. Rampant inflation, a legacy from former Yugoslavia, was overcome quickly, interestingly and, unlike in Poland or the CSFR, without relying on a nominal exchange rate anchor. Slovenian analysts have argued that, as a result of the adoption of a (managed) floating exchange rate regime from the outset of monetary sovereignty, Slovenia had more flexibility with regard to relaxing restrictions on current account transactions.[28])

5 Experience with Limited Convertibility and Further Liberalization Measures

What was the experience of the countries examined with limited convertibility introduced in 1990/91? Based on sufficiently sound macroeconomic policies and sustained structural reforms, all countries under consideration were easily able to fulfill the obligations resulting from limited convertibility, and the exchange system functioned smoothly despite the external shocks of the early 1990s, namely a temporary surge of oil prices due to the Gulf War, the breakup of the CMEA, and, as for Slovenia, the disintegration of the Yugoslav market. In fact, foreign exchange reserves, replenished with Western loans (except for Slovenia), tended to rise and, in the Polish case, the stabilization fund was never used. The Polish kantor market also functioned well, and the parallel exchange rate on this market stayed close to the official rate.[29]) Confidence in the national currencies grew, and convertibility turned out to be the one element of economic policy which enjoyed far-reaching political consensus.[30]) Enterprise management behavior started to adapt to the new set of incentives, however more slowly than expected, which can be explained by the fact that property reforms took time and that, partly for policy failure reasons, the framework conditions for enterprise restructuring remained unsupportive in many respects.

With hindsight, it seems to be widely accepted that, in the short run, the fall in output and the surge in the price level was substantially exacerbated by early limited convertibility, as applied in Poland and the CSFR (namely combined with very liberal trade policies, a drastic devaluation and a use of the exchange rate as a nominal anchor). However, if one takes a longer-term perspective, there is no clear correlation between output, inflation and external performance on the one hand and a faster or a more gradual approach towards convertibility on the other. This view is backed by a recent comparative study concluding that the impact of trade and payments liberalization on economic performance in a broad range of transition countries cannot be sorted out persuasively, as too many changes both in the economies and in the external conditions happened simultaneously.

28 See Lavrac and Stanovnik (1995).

29 The same is true for the illegal parallel foreign exchange markets in the other countries.

30 For Poland see Jasinski (1991): "While nearly all the elements of the economic policy of all Polish governments after 1989 were criticized by the opposition, the internal convertibility of the zloty was an exception".

The findings suggest that countries which moved rapidly towards partial convertibility early on may have performed somewhat better overall than the others, "but the evidence is not conclusive".[31]) But even if one could trace a definite correlation, it would still be far from evident whether it was really the speed of external sector liberalization which caused varying economic performances.

Notwithstanding these qualifications related to issues of general economic performance, there are some more specific questions which could deserve further analysis (e.g. effects of partial convertibility on non-liberalized capital flows, on inward direct investment or on the structure of foreign trade).

After the initial leap towards partial convertibility proved to be sustainable, the countries examined adopted a twofold approach with respect to foreign exchange regulations. On the one hand, legal regulations were gradually adapted for specific transactions, thus extending convertibility incrementally. On the other hand, existing foreign exchange regulations were applied ever more flexibly by easing practices on issuing foreign exchange permits.

As for regulatory changes, tourism allowances in foreign exchange (where they existed) were increased, as were the terms in the related regulations on the physical export of foreign exchange by private individuals. In Czechoslovakia, the annual limit was raised to CSK 5,000 in 1991 and to CSK 7,500 in 1992. Later, it was increased in the Czech Republic to CZK 12,000 in 1994 and CZK 100,000 in 1995. In Slovakia, it was lifted to SKK 9,000 in 1994 and to SKK 16,000 in 1995. In Hungary, the tourism allowance was raised to an annual USD 350 in mid-1992 and further to USD 800 in April 1994. This was complemented by allowing private persons to pay for most services related to tourism in domestic currency, provided that these transactions were conducted through travel agencies. In Poland, private persons were allowed in 1991 to buy limited amounts of foreign exchange directly from the banking system,[32]) while retaining the right to buy foreign currency from the kantors. The limit on the physical export of foreign exchange was successively increased from USD 500 in 1990 to USD 5,000 in 1995. Furthermore, in all countries, the limits on the amount of domestic currency that could be taken out of the country by domestic persons were modestly raised during the first half of the 1990s. Concurrently, for companies, restrictions on business trips were relaxed somewhat over time.

Another feature was that surrender requirements for enterprises were lifted and firms received the right to keep foreign exchange accounts, first in the Czech Republic (as of March 1994), later in Hungary (as of April 1995) and in Poland (as of November 1995), not yet, however, in Slovakia and Slovenia.[33]) This measure was justified with the need to reduce enterprise costs related to exchange transactions; especially in Poland and the Czech Republic, an additional if not the primary impetus was to mitigate the impact of capital inflows (see below) on monetary and exchange rate developments.

Foreign exchange rules eased also with respect to capital movements and related transfers. In Poland, the joint venture law was amended in July 1991, from then on permitting full repatriation of profits and capital –

31 *Cooper (1996).*

32 *Despite this new provision, most transactions remained with the kantors, as the banks regularly set somewhat less favorable exchange rates than those prevailing on the parallel market.*

33 *Previously, only joint ventures had been given the right to hold foreign exchange accounts for depositing proceeds of foreign capital, interest and dividends to be transferred abroad.*

thus catching up with the regulatory standards of the other countries examined.

Regulations on trade and suppliers credits were made substantially more flexible over time. This was done, in Poland for example, by raising the limits on credit volumes. In the Czech Republic and Slovenia, trade and supplier credits were fully liberalized (provided a resident took part in the underlying transaction). Slovenia, in addition, abolished its former limits on loans from abroad taken out by domestic companies.

Also, inward equity investments were liberalized in the early 1990s or, rather more precisely, no substantial impediments to such transactions were imposed as capital markets in these countries developed. Initially, these transactions were typically coupled with limited dividend and capital gains repatriation possibilities, which were relaxed later on. In Hungary and Poland, there was also some progress concerning liberalization of inward investment in government papers, and related interest repatriation was made fully possible (e.g. in Poland in mid-1993). This issue was of much less relevance in Czechoslovakia/the Czech Republic and in Slovenia, where state budgets were generally broadly balanced during transition. Outward direct investment was liberalized only in Poland, the Czech Republic and in Slovakia, namely in the context of these countries' EU Association Agreements coming into force in early 1994 and early 1995 respectively. Consequently, this deregulatory measure related only to investment in EU countries.

Nonresidents were allowed to keep accounts denominated in domestic currency to facilitate their business activities. Initially, the range of permitted operations was narrow. Later on, it was gradually broadened and transfers abroad were allowed for selected transactions. In Hungary, for example, the scope of forint accounts of nonresidents (which had existed since January 1991) was broadened, when exporters were allowed to accept payments for exports in forint in mid-1992 and nonresident holders of such balances were permitted to open foreign trade forint accounts to be used for payments in forint. As of June 1994, foreigners were permitted to convert balances in such accounts in foreign exchange for transfer abroad. In parallel, other types of forint accounts for nonresidents were introduced, in particular for portfolio investment. These different types of so-called convertible forint accounts were unified in December 1994. From then on, all convertible forint revenues could be credited to a newly established unified convertible account, from which both conversion and transfer as well as all types of (re)investment otherwise open to nonresidents were made possible directly in forints.

Besides progress enshrined in legal provisions, licensing policies of the central banks in all countries became gradually more liberal with respect to a series of transactions not yet liberalized. Two prime examples of this relaxed policy stance are outward direct investment and inward medium- and long-term borrowing by companies. Taking Hungary as an example, the central bank has approved the establishment of more than 2,000 mostly small joint ventures (which are primarily situated in neighboring countries where a Hungarian minority lives). Company borrowing abroad has become quasi-

automatic in Hungary, provided that certain conditions on interest rates and creditworthiness are met.

It is interesting to note that in the countries concerned, as elsewhere, the actual timing and degree of foreign exchange deregulation, both with regard to changes in rules and practice, has not been fully at the discretion of policy- and rule makers, but it has been driven, to a substantial extent, by markets as well.[34]) It turned out that, frequently, authorities could do little else than adjust rules and/or policies to a changing environment. For example, relaxing policies on inward borrowing of companies was a consequence of mounting pressure of companies for cheap and long-term financing when domestic interest rates were high and loans with longer maturities hardly available. The liberal stance on inward portfolio investment was, to a significant extent, influenced by intra-regional competition: None of the countries examined wanted its fledgling share market to be marginalized as a consequence of capital controls. In Czechoslovakia, the nonstandard approach to privatization played an additional role: The openness about inward equity investment helped to stabilize share prices, when secondary markets were established, and thus contributed to the political and economic success of voucher privatization. Finally, the limits of discretion can also be inferred from the fact that existing regulation on specific flows has been circumvented in a number of cases.[35])

In the countries examined, measures for capital account liberalization took place against the backdrop of surging capital inflows from 1993 and 1994 respectively. Although the composition of these flows was different from country to country and changed also over time, the short-term component was always substantial. The main reason for inflows were interest rate differentials. Overall, these countries have coped with these inflows primarily by monetary and exchange rate measures. Initially, inflows were sterilized. Over time, this proved ever more costly and additional or alternative measures were sought. Typically, there were moves towards a more flexible exchange rate regime (Poland and Czech Republic) or a modification in exchange rate policies (Slovenia), both designed at injecting an element of uncertainty for speculators. Interest rate policy reactions to inflows differed from country to country. The reintroduction of temporary controls on short-term inflows was discussed intensely, but there were only few cases of countries actually resorting to reinstating inward capital controls. Rather, as indicated above, mounting capital inflows tended to induce policymakers to adopt more flexible licensing practices on capital outflows in general.

The Czech National Bank did not take measures to discourage short-term inflows until mid-1995, but instead focused on dampening the growth of monetary aggregates resulting from the inflows by means of sterilization and by raising interest rates in several stages from mid-1994 onward. Also, mandatory reserve rates were lifted somewhat. The policy stance began to change in August 1995, with the central bank imposing limitations on short-term foreign exchange positions of commercial banks towards non-residents,[36]) thus in effect putting a cap on these types of short-term inflows. This apparently had a dampening effect on the increase of short-term inflows

34 *This point is forcefully made by Dedek (1995). For the examples mentioned also see Dedek (1995).*

35 *In this context, one can mention the founding of joint ventures in order to purchase real estate for private purposes or in order to undertake portfolio investments not yet fully liberalized (e.g. investment in Hungarian government debt issues not open to nonresidents).*

36 *The net position of banks with respect to short-term liabilities towards nonresidents may not exceed 30% of the banks' short-term assets vis-à-vis nonresidents and must not be higher than CZK 500 million.*

in the latter part of 1995. The fight against inflows was significantly reinforced in February 1996, when the exchange rate regime (peg) was modified by widening the fluctuation band of the koruna from 0.5% to 7.5%. In March and April 1996, the net inflow of short-term capital dried up, which is attributed to the extension of the exchange rate band, but it is not clear yet whether this is a temporary or more permanent change.

Poland's main response to the inflows consisted in modifications to its crawling peg exchange rate system, namely an extension of the intervention band on the interbank foreign exchange market to 7% by May 1995 and a lowering of the automatic maximum monthly devaluation of the zloty, complemented in December 1995 by a one-step revaluation of 6% against the currency basket to which the zloty is pegged. Simultaneously, the central bank cautiously lowered interest rates over time. Poland has not used exchange controls to inhibite capital inflows.

Slovenia was actually the first transition country experiencing sizeable short-term capital inflows (from the turn of 1993 onward), which led to substantial capital account surpluses in 1993 and 1994 before abating in 1995. The decline of capital inflows coincides with an inward capital control measure introduced in February 1995, namely a zero-interest-bearing tolar deposit requirement at the central bank amounting to 40% of financial loans from abroad with a maturity of up to five years. The deposit requirement also extends to deposits (up to 5 years) of nonresidents with Slovenian banks. This measure was effective in the sense that borrowing shifted to longer maturities, but the dynamics of overall borrowing remained unchanged.[37]) The downturn of inflows was much more a result of a change in exchange rate and monetary policies: In the latter part of 1994, the central bank stopped buying foreign exchange on the interbank market and, in early spring 1995, it lowered interest rates rather substantially.

6 Taking on International Convertibility Commitments

In the mid-1990s, the countries reviewed took on international convertibility commitments by accepting the obligations of Article VIII of the IMF's Articles of Agreement. Recently, some countries of the region also achieved OECD membership, thereby entering into formal obligations with respect to the liberalization of invisible current operations and capital movements.

Between June 1995 and January 1996, all five countries declared their currencies to be convertible according to Article VIII of the IMF's Articles of Agreement, namely Poland as of June 1, 1995, Slovenia as of September 1, 1995, the Czech Republic and Slovakia as of October 1, 1995, and Hungary as of January 1, 1996. For all countries with the exception of Slovenia, the adoption of Article VIII meant progress primarily in the completion of current account convertibility for nonresidents, and in Hungary, the Czech Republic and Slovakia for private residents. Progress for private residents in the three countries was especially visible in the field of tourism, where access to foreign exchange was liberalized. Tourism allowances were abolished and access to foreign exchange for tourism was liberalized. Poland, in turn, unified its kantor market with the regular foreign exchange market in order

37 Kozar (1996).

to comply with Article VIII's ban of discriminatory currency practices. Furthermore, to achieve Article VIII status, the Czech Republic and Slovakia terminated their bilateral payments agreement in force since early 1993 as of end-September 1995. For Poland, the Czech Republic and Slovakia, adherence to Article VIII also implied, according to their Association Agreements with the EU, the removal of restrictions, wherever applicable, on short- and medium-term commercial credits related to international trade with the Union in goods and services.

The situation was different in Slovenia: It had achieved de facto convertibility for current transactions already by mid-1994, after terminating existing bilateral payments agreements and lifting limits regarding the transferability of foreign-held tolar balances. Thus, for Slovenia, reaching Article VIII status was solely an act of public international law not necessitating domestic legal adaptations. In all other countries, Article VIII status was achieved on the basis of new and modern Foreign Exchange Acts which were passed by national parliaments between December 1994 and November 1995.

Interestingly enough, the countries examined, though clearly in the vanguard of economic transformation in Central and Eastern Europe, were not the first transition countries to take on international commitments with regard to the convertibility of their currencies. In fact, they were preceded by the three Baltic states, which achieved Article VIII status between May and August 1994 as well as by Kyrgyzstan (March 1995) and Croatia (May 1995).[38])

In fact, the Czech Republic and Hungary declared Article VIII status at a point in time when their admission procedure to the OECD (see below) was already far advanced: In both cases the OECD membership agreements were signed less than three months after the declaration of Article VIII convertibility. As the fulfillment of Article VIII obligations is a precondition for OECD membership, both countries accepted Article VIII almost at the last moment. The IMF itself had started as early as 1993/94 to encourage some countries reviewed here to consider an early acceptance of Article VIII, but none of the countries followed this recommendation quickly.

What were the reasons for this somewhat belated adherence to Article VIII obligations? First, before accession to the OECD came within reach for the Czech Republic, Hungary and Poland, there was no pressing motive from outside for adhering to Article VIII status. Second, from a domestic perspective, the issue had no top priority in any of the five countries, as the main economic gains from convertibility had already been reaped from the countries' initial move towards convertibility in 1990/91, while related risks were perceived to be not negligible. Third, Poland and Hungary were not fully convinced that they had made sufficient headway towards solid macroeconomic stability, especially with respect to the balance of payments. In Hungary, these fears were especially pronounced before the stabilization package of March 1995. Consequently, concerns were more pronounced than elsewhere that a premature full liberalization for residents could open up loopholes for disguised capital outflows. A distinct policy position to avoid any backtracking with respect to convertibility, as this could have a

38 Furthermore, Moldova achieved Article VIII status only a few weeks after Poland (June 1995).

major negative impact on reforms in general, reinforced these concerns. Fourth, in some countries, discussions on the new foreign exchange law, on which the achievement of Article VIII status was to be based, proved lengthier than originally expected. Fifth, one can discern country-specific factors: The bilateral payments agreement between the Czech Republic and Slovakia was not terminated earlier, apparently due to foreign policy considerations, and the Slovenian authorities decided not to go for Article VIII status before the negotiations on an agreement with the London Club on the country's share of the unallocated debt of former Yugoslavia were completed in June 1995.

A further impetus to foreign exchange deregulation resulted from the quest of these countries for OECD membership. By now, the Czech Republic and Hungary have become OECD member countries, in December 1995 and May 1996 respectively, while Poland will sign membership documents in July 1996, suggesting that its membership will become legally effective around September of this year. On the other hand, the admission procedure for Slovakia is still at an early stage, and Slovenia turned in its application for membership only in March 1996. The following paragraphs will therefore focus on the Czech Republic, Hungary and Poland.

When comparing the foreign exchange regulations of these three countries and the reservations that have been lodged with respect to the two OECD Codes, it turns out that the main features of their current exchange systems are very similar, while in detail several interesting distinctions can be observed.

As for the liberalization of invisible operations, all three countries have fully liberalized business- and industry-related as well as foreign-trade-related invisibles. With respect to transport, they have lodged some reservations on inland waterway freight and road transport services. Reservations with respect to cross-border financial services are rather comprehensive. As for insurance, (1) social security and social insurance, (2) insurance relating to goods in international trade as well as (3) reinsurance and retrocession have been liberalized, as opposed to life and all other insurance. As for banking and financial services, only (1) payments services, (2) (a) advisory and agency services, (b) credit reference and analysis, (c) investment research and advice, (d) mergers, acquisitions, restructurings, MBOs, venture capital as well as (3) fees, commissions and other charges have been liberalized, but not other banking services.[39]) Also, for the time being, there are restrictions on branching in Hungary and Poland (as opposed to the Czech Republic): Nonresidents can provide financial services only through joint ventures (incorporated firms), but not via branches or agencies. The establishment of branches and agencies will however be permitted later (Hungary by end-1997, Poland by end-1998). A final reservation pertains to a few professional services. There are no reservations either with respect to travel[40]) or to public and personal income and expenditure. Thus, via the latter, pensions, too, have become transferable.

With respect to capital transactions, the foreign exchange regulations of the Czech Republic, Hungary and Poland typically contain the following

39 In Poland, advisory and agency services will be liberalized as of January 1, 1997.

40 The OECD Code of Liberalisation of Current Invisible Operations provides that residents can acquire and export foreign banknotes and travelers' checks up to an amount of SDR 1,250. The Hungarian regulation corresponds with this minimum requirement while in Poland and the Czech Republic there are no limits.

rules. As for capital inflows, restrictions on (1) direct investment are minor, relating only to very few sectors. (2) Real estate operations by nonresidents in the three countries are usually restricted, except for operations effected in conjunction with an inward direct investment. The official reasoning for these restrictions is that real estate markets are not yet fully developed and thus prices are not yet market-determined, but obviously there are also significant problems with political acceptability in this area. Restrictions on (3) inward portfolio investment are minor or nonexistent as regards the purchase of foreign shares, other securities of a participating nature, domestic debt instruments and collective investment securities by residents, while the admission of domestic securities on foreign capital markets has been liberalized only partially. Transactions with respect to other types of portfolio investment (money-market securities, negotiable instruments and nonsecuritized claims) continue to require permission in most cases. As for (4) credit operations, trade and supplier credits extended by nonresidents to residents are liberalized. The same is true for medium- and long-term financial credits and loans as well as for financial back-up facilities, sureties and guarantees. (5) Other capital operations have largely been liberalized. There are some restrictions on the operation of deposit accounts by nonresidents (primarily in order to prevent circumvention of other restrictions).

As for capital outflows, there are no restrictions on (1) outward direct investment. Regulations on (2) real estate operations by residents abroad vary from being restricted in Hungary to partial liberalization in Poland – up to ECU 50,000 per operation – and full liberalization in the Czech Republic. Some divergence is also characteristic for the rules on (3) outward portfolio investment, especially with respect to the right of residents to acquire securities abroad. Here again, the Czech regulations are most liberal. There, residents can buy quoted and unquoted foreign securities (equities and debt securities, including money market securities) through authorized resident banks. In Hungary, such transactions are restricted, except for government papers issued by OECD countries and equities with the highest credit rating. In Poland, resident companies (but not natural persons) are allowed to freely invest in bonds and treasury bills with original maturities of at least one year on recognized OECD markets up to an accumulated ECU 1 million per company; however, a full liberalization of outward portfolio investment with respect to capital market securities is to take place by end-1996. Both in Poland and Hungary, outward investment in money-market securities is restricted, the same is true for all three countries with respect to other negotiable instruments and nonsecuritized claims. In all three countries, domestic banks' scope to undertake outward portfolio investment transactions is considerably wider than that of other residents. The restrictions on other residents are usually based on a perceived need to protect domestic investors against excessive risk taking and on concerns related to sudden capital outflows. The admission of foreign securities and other instruments to the domestic capital markets requires approval in the Czech Republic and in Hungary, while in Poland the admission of securities has been liberalized up to a total amount of ECU 200 million in 1996.

Finally, the new Foreign Exchange Acts removed all remaining impediments on the liquidation of portfolio investments by nonresidents in the three countries. As for (4) credit operations, trade and supplier credits are liberalized, if at least one resident participates in the underlying transaction. Outward financial credits, sureties and guarantees as well as financial back-up facilities remain largely restricted (with exemptions for trade-related instruments and a wider scope of liberalized transactions for banks). (5) Other outward capital transactions have largely been liberalized. The two major remaining restrictions are the repatriation requirement for foreign exchange acquired abroad by residents (with few insignificant exceptions) and the operation by residents of accounts with foreign banks, with the partial exception of Poland, where no approval is needed in connection with authorized foreign investments, resident persons staying abroad and, with some limitations, foreign branches of Polish companies. Restrictions also remain for residents on the sale and purchase of domestic currency abroad in all three countries.

There are a couple of important country-specific variations from these stylized foreign exchange regulations. Two of them are of a rather general nature. The Czech law, for one, contains a rather comprehensive safeguard clause on the introduction of a deposit requirement for several inward capital transactions (proceeds from the issue of debt instruments, inward financial credits, inward borrowing through money-market instruments, deposits by nonresidents with Czech banks). This reflects the perceived need for having the policy option to reestablish capital controls temporarily in case of a sudden surge of capital inflows. The Hungarian regulations, in turn, incorporate extensive restrictions on short-term capital inflows, reflecting concerns about potential effects of these flows on the real exchange rate, monetary control, and foreign debt management. This is also the rationale for the Hungarian central bank's right to delay inward financial credits of more than USD 50 million for up to three months.

There are also some deviations from the stylized regulatory pattern with respect to specific transactions. To mention a few: As for inward direct investment, the purchase of shares in existing banks by nonresidents requires specific approval in the Czech Republic, but not in Poland and Hungary. With respect to inward portfolio investment, the admission of domestic securities to foreign capital markets is not restricted in Hungary, while in the Czech Republic and in Poland some related transactions require approval. While inward medium- and long-term financial credits and loans are liberalized in all three countries, this also extends to short-term financial credits and loans in the Czech Republic. As for outflows, in Poland trade credits are also liberalized, if no resident participates in the underlying transaction. Also for Poland, outward financial credits are liberalized, if their maturity exceeds one year. On the other hand, Poland has retained, for the time being, limits on the physical export of capital assets (except zloty-denominated shares and other securities of a participating nature).

When comparing the new regulatory status quo in Poland, the Czech Republic and Hungary with that in Slovakia and Slovenia, the following picture emerges. In Slovakia, the liberalization of capital movements has not

received substantial new momentum through the Foreign Exchange Act adopted last fall. Thus, it is still in a fairly early stage, with inward direct investment and Slovak direct investment in the EU remaining the only two significant areas already deregulated. In Slovenia, the capital account has been partially open on the inflow side from the beginning of monetary sovereignty and there has not been any major formal deregulation recently, except for some incremental liberalization steps.[41]) It is interesting to note that, through an amendment to the Banking Law in mid-1996, the establishment of branches by foreign banks in Slovenia was permitted.

All countries under review intend to remove successively all or almost all remaining restrictions to the free exchangeability of their national currencies in the medium run. In the case of the Czech Republic, Hungary and Poland, commitments to additional future liberalization in some areas have been reinforced by placing a time limit upon reservations lodged on the OECD Codes. Plans for further deregulation are broadly similar with respect to sequencing and timing. Typically, in a first stage, remaining restrictions on long-term inflows will cease, in the Czech Republic also the deposit-requirement safeguard clause, as well as most limitations on outward portfolio investment. Simultaneously or somewhat later, outward lending (with the possible exception of short-term lending) is to be permitted. This would be followed by the full admission of foreign securities on domestic markets and operations in derivatives as well as the liberalization of other short-term flows. At the end of the process, the opening of accounts abroad and the purchase of real estate by nonresidents without restrictions will be permitted. The time horizon for achieving full or near-full convertibility is apparently three to four years in all five countries.

For an evaluation of the progress towards capital account convertibility so far, it makes sense to review the benefits and risks of the liberalization of capital movements. Typically, the rationale for opening the capital account is based on the presumption that dismantling capital controls generates "economic benefits through increased opportunities for intertemporal trade and cross-border portfolio diversification in both assets and liabilities, by imposing macroeconomic discipline on national governments, and from the rising costs and ineffectiveness of controls as economic development proceeds".[42]) The main risk of capital account convertibility obviously relates to the fact that, as a consequence of liberalization, a country becomes much more vulnerable to changes in capital flows, which can lead to serious macroeconomic turbulences and financial sector crises. These risks have been highlighted by the mixed experience of advanced developing countries with liberalizing capital movements.

In order to minimize the downside risks of full capital account convertibility, it is generally accepted that two basic and interlinked conditions should be fulfilled, namely a lasting and solid macroeconomic consolidation, especially in the fiscal sector, and the existence of a well-developed domestic banking system and financial market. Functioning and sufficiently deep money and securities markets are needed as a precondition for the development of a fully-fledged set of indirect monetary policy instruments, thus enabling the central bank to react to shocks without being

41 *Two measures in particular deserve mention: In July 1995 the limit on the physical export of money for residents was tripled to the equivalent of DEM 3,000 in foreign exchange and SIT 300,000 in domestic currency; in addition, currency can be transferred without limits through credit cards. Also, since mid-1995, private nonresidents have been allowed to buy their foreign currency notes with tolar cash in the Slovenian exchange offices (Kozar (1996)).*

42 *Fischer and Reisen (1992b).*

forced to resort to the reintroduction of capital controls. Domestic banks must be sufficiently strengthened in order to avoid failure resulting from exposure of the sector to foreign competition. Eliminating financial sector imperfections in general is also important in order to narrow interest rate differentials which could induce capital inflows. Fiscal consolidation is considered necessary for several reasons corresponding to both outflow- and inflow-related risks. First, strong public finances take the pressure from monetary policy to accommodate public sector deficits which could induce residents to move funds abroad in order to escape the inflation tax. Second, fiscal deficits can raise a country's debt stock over time (depending on their size as well as on real interest and growth rates), this could eventually lead to doubts about the country's creditworthiness, again triggering capital outflows. Third, a consolidated fiscal position can help to narrow interest rate differentials in that they result from an upward pressure on domestic interest rates due to high public sector credit demand. It should be added that, while a sound fiscal position is definitely a condition for capital account convertibility, progress on strengthening public finances "may also exacerbate the problem of unsustainable inflows if confidence in economic policy grows strongly".[43])

To what extent have the examined countries fulfilled these conditions? Although there are some differences among countries, parallels are fairly strong for the whole region. As for the macroeconomic aspect, all five countries have made major progress in strengthening government finances, especially through tax reforms and cuts in expenditure, during the past few years. Fiscal accounts have been balanced or have shown only moderate deficits for several years, with the exception of Hungary, where the shortfall is somewhat larger, and Slovakia, which made headway to a low budget deficit only in 1995. Still, in order to assure the sustainability of fiscal consolidation achieved so far, there is a need for tackling existing structural problems, especially in the social security system. With respect to other macroeconomic indicators, a further reduction of inflation in Hungary and Poland, and an additional strengthening of the external accounts in Hungary would seem appropriate to reduce the potential risks connected with full convertibility.

In the financial sector, reforms have been substantial so far, although they cannot be considered to be fully completed in any of the five countries. Here, a further strengthening of the banking sector – with a focus on fostering competition, helping concentration in the banking sector, completing bank consolidation (in particular removing still remaining bad-loan problems), and strengthening prudential supervision – would seem as necessary as a further deepening of the financial markets (especially secondary markets for government debt). Also, central banks should be well equipped with marketable securities in order to be able to react properly to capital flows (by sterilization), which is not yet the case in the five countries.

In sum, all the countries examined have made major headway towards meeting the conditions for full capital account convertibility but, at this stage, the conditions have not been fulfilled wholly in every respect. From this, the countries have drawn the conclusion that instant full liberalization of

43 Quirk and Evans (1995).

capital movements would be premature and that a phased approach – further successive deregulation along with additional progress on macroeconomic stability and financial sector development – would be appropriate. Still, the question may be raised whether these countries could not, alternatively, move to full convertibility now and, simultaneously, further strengthen their macroeconomic position and their financial sectors. It may be argued that liberalization in the five countries has reached a stage where remaining capital controls may no longer be truly working and, in fact, "will be effective only to the extent to which economic agents lack incentive to circumvent them",[44]) implying that, in practice, capital flows are already highly liberalized today. It should, however, not be forgotten that controls, although being only second-best policy options, can have some merits in the short run (especially on the inflow side), as they allow time to be bought in situations where other short-term measures are not at hand or prove insufficient.

Equally important, it makes a difference whether controls, even if not very effective, are maintained or abandoned. There are two reasons for this. First, progress on convertibility so far has lent credibility to the overall transformation drive. Swift unlimited convertibility thus becomes a double-edged sword. On the one hand, it can help push through the conditions for it to succeed, provided that political framework conditions are supportive. On the other hand, if controls have to be reinstated (because of insufficient macroeconomic progress and financial sector development, for whatever reason), this could have a devastating effect on the credibility of the overall transformation process. Second, one should bear in mind that, in the context of the countries examined here where policies have been geared at a sustained though gradual progress on capital account convertibility, it would not be easy to come out with a major policy shift reversing the ingrained lines of argumentation. Thus, a sudden abandoning of the remaining controls, especially if such a move is not carefully prepared and explained, could have a perverse signaling effect to residents, inducing capital outflows. In sum, for the selected countries, potential advantages of swift full convertibility do not seem to outweigh risks, suggesting that the current policy stance is appropriate.[45])

This is not to say that existing plans for further deregulation should not be speeded up, if progress on macroeconomic stability and financial sector development turns out to be faster than expected. Neither is this to suggest that there is no room for further deregulation in the short run, namely on those operations which would not be likely to constitute major channels for capital flows. In fact, the purchase of real estate abroad by domestic residents or a widening of certain outward portfolio investment possibilities could be considered, with the liberal Czech regulation in these areas being a possible model.

44 *According to Dedek (1995), there is "a speck of truth" in such a suggestion for the Czech Republic. Similar views are also voiced in the discussion in other countries of the region.*

45 *Clearly, the situation is different at the beginning of transformation, when a policy stance has to be taken and credibility has still to be earned. At such a stage, the cost-benefit-analysis of full convertibility may yield different results. A case in point are the Baltic states, which, at the time of leaving the ruble area and introducing currencies of their own in 1992, moved to instant full convertibility (with only Estonia retaining a few minor restrictions until the end of 1993) amidst incomplete macroeconomic stabilization and before undertaking comprehensive financial sector reform.*

7 Future Prospects

Turning to future prospects, the first question is whether the intention of policymakers to achieve full or near-full convertibility until the year 2000 is realistic. From today's perspective, the answer to this question definitely tends to be positive. In all countries of the region (possibly with some qualifications for Slovakia), the commitment remains strong to continue stability-oriented policies and structural reforms in general and to meet the conditions for capital account convertibility in particular, all the more so as further advances on fiscal consolidation and on financial market development per se will be at the very heart of the decision whether a membership candidate is ready to join the EU from an economic viewpoint. After all, it should not be forgotten that the first thorough examination of the candidates' preparedness for membership will happen already in 1997, when the Commission drafts the avis on the countries' membership applications handed in between April 1994 and June 1996. Another positive factor is that the economic environment for further progress is promising: Macroeconomic framework conditions and especially growth perspectives are generally perceived to be good.[46])

This leads to the question of how the convertibility issue is related to further EU integration. In a best-case scenario, the first countries of Central and Eastern Europe will become EU members in 2002. At the core of EU integration is the Union's Internal Market and its four freedoms, one of them being the free movement of capital. Therefore, in its White Paper on the Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union, the EU attributes a major importance to the liberalization of capital movements by the membership candidates. In the White Paper, the Union lists the key measures to achieve conformity with the Internal Market. A distinction is made between Stage I and Stage II measures, with Stage I measures constituting basic and principal steps, which are preconditions for the effective functioning of the Internal Market. As for the free movement of capital, Stage I comprises an unconditional liberalization of current payments and medium- and long-term capital movements, i.e. with a maturity of more than one year. However, there is room for alternative sequencing paths "which take into account the specificity of the economy and the financial system". The achievements of the states under review so far suggest that they, especially the three OECD members, are very close to meeting the Stage I standard. Stage II measures encompass the liberalization of short-term capital movements. In this context, the White Paper explicitly refers to "admission of, and trade in, money market securities, the opening of deposit accounts abroad and the physical export and import of money" as well as to "real estate investment, in particular as regards residential real estate purchased by foreigners". In the view of the White Paper, full convertibility in particular will require a sufficient degree of macroeconomic stability, clear and reliable foreign investment regulations, a sufficiently efficient and open financial market, and – particularly important – an appropriate set of monetary policy instruments to cope with large capital flows and their repercussions on growth, inflation and the current account. Finally, as a consequence of full

46 See recent forecasts of The Vienna Institute for Comparative Economic Studies (Urban, Podkaminer et al. [1996]), World Bank (1996), OECD (1996), European Commission (1996).

liberalization, there will also be a need for an overhaul of several laws (e.g. on money laundering, tax evasion), as these norms will have "to stand alone and not depend exclusively on exchange control regulations."

As policy discussions in the countries reviewed here show, there is great awareness of all the issues raised in the White Paper with respect to Stage II and the intention to tackle them on the further road towards full convertibility. Thus, there is a good chance that convertibility, and in particular free capital movement, will not constitute obstacles in the way of EU membership. What is more, there is a good chance that these countries will need no substantial (only minor transient) reservations with regard to the free movement of capital. Indeed, full convertibility – introduced within a decade or so and thus much faster than in Western Europe – may well turn out to be a major asset in these countries' quest for EU membership early in the next decade.

Bibliography

Amtsblatt der Europäischen Gemeinschaften (1993a), L 347/93, Brussels.

Amtsblatt der Europäischen Gemeinschaften (1993b), L 348/93, Brussels.

Amtsblatt der Europäischen Gemeinschaften (1994a), L 359/94, Brussels.

Amtsblatt der Europäischen Gemeinschaften (1994b), L 360/94, Brussels.

Banka Slovenije (1995a), Annual Report, Year 1994, Ljubljana.

Banka Slovenije (1995b), Restrictions in the Foreign Exchange Operations in Slovenia, Ljubljana, February.

Banka Slovenije (1996), Regime of Capital Movements and Current Payments, Ljubljana.

Bergsten, Fred and Williamson, John (1990), Currency Convertibility in Eastern Europe, in: The Federal Reserve Bank of Kansas City (ed.), Central Banking Issues in Emerging Market-Oriented Economies, Kansas City, pp. 35–49.

Bokros, Lajos (1991), Hungary, in: Williamson (1991b), pp. 226–233.

Bolz, Klaus (1989), Konvertibilität der osteuropäischen Währungen nicht vor der Jahrtausendwende, in: Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik, 34. Jahr, 1989, J.C.B. Mohr (Paul Siebeck), Tübingen, pp. 225–233.

Brabant, Jozef M. van (1991), Convertibility in Eastern Europe Through a Payments Union, in: Williamson (1991b), pp. 63-95.

Chrabonszczewska, Elzbieta (1994), Convertibility and Exchange-Rate Regime in Poland, Russian and East European Finance and Trade, November/December, Vol. 30, no. 6, pp. 28–39.

Claussen, Carl Andreas and Pedersen, Kent Vincent (1995), Capital Account Liberalization in Transition Economies with a Brief Evaluation of Poland, Kiel Institute of World Economics, Kiel Advanced Studies Working Paper, November.

Cooper, Richard N. (1996), Currency Convertibility in Transforming Economies: Was it a Mistake?, mimeo, April.

Dedek, Oldrich (1995), Currency Convertibility and Exchange Rate Policies in the Czech Republic, Prague Economic Papers, Vol. 4, no. 4, Prague, pp. 291–319.

Devizakodex (1995), Supplement to Magyar Hírlap, Budapest, November 16.

Dezséri, Kálmán (1993a), A Proposed Approach for Introducing Currency Convertibility in Eastern Europe: A Multi-Phase Exchange Rate Policy During the Transition Period, Institute of World Economics, Hungarian Academy of Sciences, no. 20, Budapest, July.

Dezséri, Kálmán (1993b), First Practical Steps in Introducing Convertibility in the Eastern European Countries, Institute of World Economics, Hungarian Academy of Sciences, no. 22, Budapest, August.

European Commission, Directorate-General for Economic and Financial Affairs (1991), The path of reform in Central and Eastern Europe, Special edition no. 2, Brussels.

European Commission, Directorate-General for Economic and Financial Affairs (1996), Optimistic Outlook for Countries in Transition despite Slower Growth in Western Europe, in: European Economy, Supplement C, Economic Reform Monitor, no. 1, Brussels, May.

Facsády, Júlia (1992), A forint konvertibilitása, in: Bankszemle, Vol. 36, no. 1–2, pp. 18–24.

Fischer, Bernhard and Reisen, Helmut (1992a), Volle Währungskonvertibilität in Osteuropa? Währungs-, geld- und finanzpolitische Voraussetzungen, in: Wirtschaftsdienst, Vol. 72, no. 7, pp. 381–388.

Fischer, Bernhard and Reisen, Helmut (1992b), Towards Capital Account Convertibility, OECD Policy Brief No. 4, Paris.

Gács, János (1994), Trade Liberalization in the CSFR, Hungary and Poland: Rush and Reconsideration, in: Gács and Winckler (1994), pp. 123–151.

Gács, Janos and Winckler, Georg (1994) (eds.), International Trade and Restructuring in Eastern Europe, IIASA Laxenburg, Physica-Verlag, Heidelberg, Springer-Verlag New York, 1994.

Gomulka, Stanislaw (1990), Reform- und Haushaltspolitik in Polen 1989-1990, in: Kommission der Europäischen Gemeinschaften, Generaldirektion Wirtschaft und Finanzen (1990), pp. 139–149.

Greene, Joshua and Isard, Peter (1991), Currency Convertibility and the Transformation of Centrally Planned Economies, International Monetary Fund, IMF Occasional Paper, Washington D.C., June.

Havlik, Peter (1990), The Exchange Rate Policy of the CMEA Countries and Problems of Convertibility, in: Soviet and Eastern European Foreign Trade, Vol. 26, no. 3, Fall.

Horcicová, Milena (1991), Currency Convertibility as Understood by East European Countries: From Discussion to Program, in: Soviet and Eastern European Foreign Trade, Vol. 27, no. 2, Summer, pp. 17–46.

Hrncir, Miroslav (1994), Economic Recovery and Foreign Exchange Rate Regime: The Case of the Czech Republic, in: Gács and Winckler (1994), pp. 67–99.

International Monetary Fund (1988), Articles of Agreement, Washington D.C.

Janácková, Stanislava (1994), Transforming the Czech Economy: Role of Convertibility and Exchange Rate Anchor, CNB Institut Ekonomie, Working Paper no. 24, Prague, 1994.

Jasinksi, Leszek (1994), The Polish Exchange Rate Policy and Economic System Transformation, in: Gács and Winckler (1994), pp. 53–66.

Köves, András and Marer, Paul (eds.) (1991), Foreign Economic Liberalization: Transformations in Socialist and Market Economies, Westview Press, Boulder, San Francisco and Oxford.

Kohútiková, Elena (1996), Foreign Exchange Regime in the Slovak Republic, mimeo, Bratislava.

Kolodko, Gregorz, Ostrowski, Marian, Rosati, Dariusz (1990), Stabilization Policy in Poland – Challenges and Constraints, WIDER Working Papers, no. 81, Helsinki, February.

Kommission der Europäischen Gemeinschaften, Generaldirektion Wirtschaft und Finanzen (1990), Wirtschaftlicher Wandel in Ungarn und Polen, no. 43, Brussels, March.

Kozar, Anton (1996), The Convertibility of the Slovene Tolar was achieved gradually, mimeo, Ljubljana, January.

Lavrac, Vladimir and Stanovnik, Peter (1995), Monetary Policy under a Flexible Exchange Rate in Slovenia, in: Some features of the Slovenian financial system development, Banking Newsletter, Special Issue, Ljubljana, December, pp. 37–46.

Levcik, Friedrich (1991), The Place of Convertibility in the Transformation Process, in: Williamson (1991b), pp. 31–47.

Magyar-Nemzetközi Kék Szalag Bizottság (1992), A forint konvertibilitása: Hogyan, mikor és milyen típusú konvertibilitás vezethetö be Magyarországon?, Kék Szalag Bizottság Alapítvány, Budapest, June.

McKinnon, Ronald I. (1991), Liberalizing Foreign Trade in a Socialist Economy, in: Williamson (1991b), pp. 96–115.

Mencinger, Joze (1994), The Birth and Childhood of a Currency: The Experience of Slovenia, in: Williamson (1991b), pp. 101–119.

Mizsei, Kálmán and Török, Ádám (1990), Modified Planned Economies at the Crossroads: The Case of Hungary, WIDER Working Papers, no. 83, Helsinki, March.

Narodna Banka Slovenska (1995), Devízovy Zákon/Foreign Exchange Act, Bratislava, November.

Nuti, Domenico Mario (1996), Inflation, interest and exchange rates in the transition, in: The Economics of Transition, vol. 4, no. 1, pp. 137–158.

Oblath, Gábor (1993), Interpreting and Implementing Currency Convertibility in Central and Eastern Europe: A Hungarian Perspective, Kopint-Datorg Discussion Papers, no. 14, Budapest, October.

OECD (1995a), Code of Liberalisation of Current Invisible Operations, Paris.

OECD (1995b), Code of Liberalisation of Capital Movements, Paris.

OECD (1996), Economic Outlook, no. 59, Paris, June.

Oesterreichische Nationalbank (1995a), Entwicklung in ausgewählten Reformländern, in: Berichte und Studien, no. 2/1995, Vienna, pp. 35–46.

Oesterreichische Nationalbank (1995b), Entwicklungen in ausgewählten Reformländern, in: Berichte und Studien, no. 4/1995, Vienna, pp. 26–37.

Oesterreichische Nationalbank (1996a), Geschäftsbericht 1995, Vienna.

Oesterreichische Nationalbank (1996b), Entwicklungen in ausgewählten Reformländern, in: Berichte und Studien, no. 2/1996, Vienna, pp. 31–39.

Olechowski, Andrzej and Oles, Marek (1991), Poland, in: Williamson (1991b), pp. 155–168.

Polak, Jacques J. (1991), Convertibility: An Indispensable Element in the Transition Process in Eastern Europe, in: Williamson (1991b), pp. 21–30.

Portes, Richard (1991), The Transition to Convertibility for Eastern Europe and the USSR, CEPR Discussion Papers, no. 500, London, January.

Quirk, Peter J. and Evans, Owen (1995), Capital Account Convertibility, Review of Experience and Implications for IMF Policies, International Monetary Fund, Washington D.C., Occasional Paper no. 131, October.

Radzyner, Olga and Havlik, Peter (eds.) (1996), Monetary Policy in Central and Eastern Europe: Challenges of EU Integration, forthcoming.

Radzyner, Olga and Riesinger, Sandra (1996), Exchange rate policy in Central and Eastern Europe – prescription and reality, paper prepared for the 3rd AGENDA Workshop on Lessons from Transformation, Vienna, revised version June 28.

Rat der Europäischen Union (1996), Generalsekretariat, 8075/96 (Presse 168), June 10.

Rieger, Philipp (1990), Convertibility, in: Wala, Adolf and Fink, Gerhard (eds.), New Developments in Banking and Finance in East and West, Oesterreichische Nationalbank, Vienna.

Rosati, Dariusz (1990), Foreign Economic Policy and External Balance in the 1980s, in: Kolodko, Gregorz, Ostrowski, Marian, Rosati, Dariusz, Stabilization Policy in Poland – Challenges and Constraints, WIDER Working Papers, no. 81, Helsinki, February.

Rosati, Dariusz (1996), Exchange rate policies during transition from plan to market, in: The Economics of Transition, vol. 4, no. 1, pp. 159–184.

Rosati, Dariusz and Mizsei, Kálmán (1989), Adjustment through opening of socialist economies, WIDER Working Paper, no. 52, Helsinki, January.

Seidel, Hans (1991), Konvertibilität osteuropäischer Währungen, in: Socher, Karl, Lexa, Hans, Smekal, Christian (eds.), Europas Währungsgefüge, Schriftenreihe des Österreichischen Forschungsinstitutes für das Sparkassenwesen, no. 4, pp. 37–49.

Seifert, Michael (1996), Die Aufnahme der Tschechischen Republik, Ungarns und Polens in die OECD, in: Wirtschaft im Wandel, no. 5, pp. 15–19.

The Czech National Bank (1995), Foreign Exchange Act, no. 219/1995 of the Coll. of Laws of September 26, 1995, Prague.

The Czech National Bank (1996), Monthly Bulletin, no. 5.

Török, Ádám (1989), Stabilisation and Reform in the Hungarian Economy of the late 1980s, WIDER Working Paper, no. 54, March.

Tóth, G. László (ed.) (1992), Változatok a konvertibilitásra Kelet-Európában: Tapasztalatok és tanulságok négy országban, Kopint-Datorg, Budapest, December.

Urban, Waltraut, Podkaminer, Leon et al. (1996), Kräftiges Wachstum in Ost-Mitteleuropa, weiterhin Rezession in der GUS – Die Wirtschaft der Oststaaten 1995/96, in: WIFO Monatsberichte, vol. 69, no. 5, pp. 355–372.

Williamson, John (1991a), The Economic Opening of Eastern Europe, Institute for International Economics, Policy Analyses in International Economics no. 31, Washington, D.C., May.

Williamson, John (ed.) (1991b), Currency Convertibility in Eastern Europe, Institute for International Economics, Washington D.C., September.

World Bank (1996), World Development Report: From Plan to Market, Washington, D.C., June.

Zahradnik, Jaromir (1991), Czechoslovakia, in: Williamson (1991b), pp. 217–225.

OeNB Activities

Lectures Organized by the Oesterreichische Nationalbank

In the last months, the Oesterreichische Nationalbank organized a series of lectures held by experts on Central and Eastern European transition economies. Unlike the "East Jour Fixe", the audience invited is not restricted to a fixed circle of participants but varies from time to time and includes a broad range of people interested in transition countries, such as representatives from commercial banks, the press, researchers, officials from ministries and other government institutions as well as experts from the Oesterreichische Nationalbank. While the "East Jour Fixe" is intended to serve as a forum for intensive discussions, the lectures are typically followed only by a short question-and-answer session.

Lecture by Ivan Angelov

The Current Macroeconomic Situation in Bulgaria

On April 23, 1996, Prof. Ivan Angelov from the Bulgarian Academy of Sciences, an advisor to Bulgarian Prime Minister Videnov, gave a lecture at the OeNB on the current macroeconomic situation in his country. The main points of his presentation can be summarized as follows:

The economic developments of 1995 can be termed as fragile financial stabilization. In mid-1995 the government began to prepare structural reforms, especially (mass) privatization as well as banking and enterprise sector restructuring, reforms which had been delayed for years. The mass privatization is basically designed along the Czech pattern, with the distribution of vouchers to be completed in May 1996. Due to mass privatization and traditional privatization methods as well as greenfield investments, the share of the private sector in the economy is to grow from 30% at the end of 1994 to 45–47% in 1996 and 60-65% in 1998. As for the company sector, a number of enterprises have been selected for liquidation or restructuring, but the respective lists have not been finalized. Social programs, which are being elaborated in cooperation with the World Bank, are supposed to cope with the related layoffs. The World Bank has also indicated its readiness to participate in the (initial) funding of these programs. In December 1995 the government approved a bank rehabilitation program which is now in the process of being concretized: An agency is to be set up to collect the banks' bad loans, several state-owned banks will be closed, others merged and rehabilitated within two years by a Bank Consolidation Agency. Privatization at a later stage is envisaged. Bank supervision by the central bank is to be strengthened. These and other stabilization and reform measures have been broadly accorded with the IMF, negotiations on a stand-by agreement with the Fund are ongoing. Their swift implementation hinges, in many instances, upon the approval by Parliament and their acceptance by society.

In the discussion, the issue of the recent amendment to the Central Bank Act was raised. According to this amendment, the governor and the three deputy governors who are elected by Parliament can be dismissed by Parliament with a three-fifths majority before the end of their terms without a specific reason. It was argued in the discussion that this new provision

jeopardizes the independence of the central bank. In Prof. Angelov's view, these legal changes should not be dramatized; the new rules should be seen against the backdrop that in crime-ridden Bulgaria there is a principal need to have regulations in place which would allow the elimination of criminals in all areas of the economy.

Lecture by George Kopits

Hungary's Preannounced Crawling Peg

On March 1, 1996, Mr. George Kopits, Senior Resident Representative of the International Monetary Fund in Hungary, presented his ideas about the preannounced crawling peg exchange rate regime which was introduced on March 15, 1995, in Hungary. The audience invited by the Oesterreichische Nationalbank (OeNB) consisted of OeNB and commercial bank experts, researchers and government officials. The invited discussants for the topic were Messrs. Georg Winckler, Professor at the University of Vienna and Andreas Wörgötter, Senior Research Fellow at the Institute for Advanced Studies. The main ideas presented by Mr. Kopits are briefly outlined below.

The main goals of the new exchange regime are to restore and maintain external competitiveness, cool inflation expectations and enhance the overall credibility of economic policy. Recent developments in the spot and futures foreign exchange and government securities markets as well as macroeconomic developments confirm that the preannounced crawling peg had a successful start in Hungary. The experience of other countries (Southern Cone, Portugal, Israel and Poland) suggests that the future success of the preannounced crawling peg depends above all on fiscal restraint and wage discipline. In the near term it is also essential to follow a prudent interest rate policy. Another lesson from outside experience is that the authorities should avoid an additional step devaluation, an increase in the rate of crawl or a widening of the band before the credibility of the new regime has been firmly established. The preannounced crawl must be both ambitious and realistic. The intervention band around the central rate is intended to provide flexibility to the crawling peg, thus partly neutralizing the impact of unexpected exogenous developments. Over the medium term, the preannounced crawling peg, with periodic reductions in the crawl rate, should evolve into a fixed nominal exchange rate regime. The components of the Hungarian package of March 1995 were the 8.3% step devaluation, followed by the preannounced crawling peg (with 1.9% monthly devaluation through June, 1.3% through December and 1.2% from January 1996) within the unchanged band (2.25% around the central rate).

Ultimately, of course, an overarching goal for Hungary is to enter the European Monetary System. Lacking the favorable attributes of developed economies (large international reserves, low inflation, high savings), Hungary faces a prolonged period of macroeconomic and structural adjustment, which is a fundamental precondition for the eventual adoption and maintenance of a hard currency.

In all, the fact that since March 1995 the National Bank of Hungary has been able to continuously support the preannounced rate at the bottom of the band, reflecting pressures to appreciate, indicates that the system has been viable so far.

Lecture by János Kun

Seigniorage and Public Sector Debt

On April 26, 1996, Dr. János Kun, Head of Division of the National Bank of Hungary (NBH), delivered a lecture on "Seigniorage and Public Sector Debt" at the Oesterrichische Nationalbank. The discussants for Mr. Kun's presentation were Prof. Giovanni Rovelli (University of Milano) and Prof. Georg Winckler (University of Vienna).

In his introduction, Mr. Kun stated that today "seigniorage" is usually defined in two ways: monetary seigniorage, according to which any increment in the monetary base is the income of the treasury, and opportunity cost seigniorage, which identifies the term with the opportunity cost of holding money. In market economies with independent central banks, the concept of opportunity cost seigniorage is suitable for obtaining information about the monopoly profit of money creation. Seigniorage and inflation tax are related concepts but not identical, as seigniorage is generated even if there is no inflation.[1])

The most evident uses of seigniorage are the financing of central bank operations, the creation of reserves and the transfer of central bank profit to the owners and the state. In countries where the central bank carries out quasi-fiscal tasks, seigniorage is also spent on supporting the latter activities.

Mr. Kun presented calculations on seigniorage in Hungary for the period 1991–95. To calculate seigniorage, he used the interest rates for repos and deposit swaps with a maturity of under one year; this income made up 3–4% of GDP.

The NBH manages most of Hungary's external debt. This quasi-fiscal activity results in significant receipts and expenditures for the Bank. When identifying seigniorage, one has to separate out receipts of the NBH which do not fall under seigniorage. The most important factor is the increase in the revaluation differential of external debt. This is because the government does not pay market interest on a substantial proportion of its liabilities to the NBH; however, it takes over the increment in the net foreign exchange debt of the NBH which stems from the official devaluation of the forint and from cross-currency changes. These receipts come to twice or even three times the amount of seigniorage.

Another important source of receipts is the profit from the onlending of the net foreign exchange liabilities. In all but one year this revenue was positive and equal in magnitude to the amount of seigniorage.

In total, seigniorage income accounts for 20-30% of the receipts of the NBH. In addition to profits and the costs of operation, the areas for which NBH's receipts are used are interest rate subsidies on credits extended to the central government and the banking system as well as the costs of foreign

1 *Some central bank receipts are not connected with the money creation process. Such receipts are greater in countries where the central bank discharges quasi-fiscal tasks. These receipts do not constitute a part of seigniorage.*

exchange reserve holdings. The interest subsidies granted to the government, which account for 75–85% of the use, represent the largest item.

75–85% of seigniorage came in as inflation tax in 1991–95. Nevertheless, the profit of the central bank would not have changed much if there had been no inflation. The explanation for this is to be found in the fact that non-interest-bearing public sector debt at the NBH exceeded the monetary base.

Lecture by Nicolas Stern

Transition in Central and Eastern Europe

Mr. Nicolas H. Stern, Chief Economist of the European Bank for Reconstruction and Development (EBRD), delivered a lecture on "Transition in Central and Eastern Europe" at the Oesterreichische Nationalbank on February 2, 1996.

Mr. Stern's lecture was based mainly on the "Transition Report 1995" of the EBRD. Mr. Stern defines transition as institutional change, in particular in the economic, financial and legal institutions underpinning a market economy, involving not only progress in the private sector but also a fundamental transformation of the role of the state. While the past year has seen important advances in transition across the region, the most rapid change is now taking place in the countries of the CIS.

Measured against the key role that it should play in providing the infrastructure for private sector development, government investment is low in many transition economies. External financing is bound to be limited as a share of total financing for a region encompassing 400 million people. However, external participation, through finance and in other ways, can play a crucial role in developing and anchoring reforms and in transferring intangible forms of capital. In the Transition Report, three critical dimensions of the transition impact of projects are identified: the development of market-based relationships between enterprises, the promotion of market-oriented skills and learning, and the development of a competitive market environment. Mr. Stern emphasized in particular the importance of corporate governance in the transition period. Privatization programs have dramatically altered ownership structures in the countries of Eastern Europe and the former Soviet Union in recent years, but the early evidence suggests that these reforms have not necessarily improved corporate governance significantly. Small and medium-sized enterprises play a special role in transition, as vehicles for experimentation in product markets (discovering competitive advantage), and by providing demonstration effects, among other functions.

Mr. Stern emphasized that Poland is the only country in the region that has reached (97%) its 1989 level of GDP in 1995 (the aggregate figure for Eastern Europe and the Baltics is 88%).

The Transition Report forecasts a GDP growth of 3 to 6% for most countries in Eastern Europe and the Baltics in 1996. For the CIS as a whole, growth of 1% is predicted for 1996.

Lecture by Lucjan Orlowski

Exchange Rate Adjustments in Central Europe in Preparation for Accession to the EU

On March 15, 1996, the Oesterreichische Nationalbank and the Economic Transition and Integration Project of the International Institute for Applied Systems Analysis (IIASA) jointly invited Prof. Lucjan T. Orlowski from Sacred Heart University, Fairfield, Connecticut, to deliver a lecture on "Exchange Rate Adjustments in Central Europe in Preparation for Accession to the EU".

Prof. Orlowski focused his lecture on the question of whether maintaining the fixed exchange rate regime chosen by a number of Central European countries (the Czech Republic, Poland in 1990/91, Slovakia) was really necessary for such a long period. According to Prof. Orlowski, an exchange rate peg is only necessary if the authorities' credibility has been exhausted and therefore has to be reestablished or if there is a chronic inflation problem, which was not the case in Central Europe at the outset of the reforms ("Central Europe is not Latin America"). On the other hand, the implementation of floating exchange rate regimes may have helped to create functioning foreign exchange markets, to stem capital inflows and may have avoided a real appreciation of the national currencies. According to Prof. Orlowski's calculations, the level of the exchange rate has a major influence on the performance of exports to Western countries. Therefore maintaining a fixed exchange rate peg for too long has proved to be detrimental to export performance and has been reflected in deteriorating balances of trade in a number of Central European countries.

However, more recently a general trend toward more flexibility of the exchange rate regimes has been observed in Central Europe (e.g. widening of the fluctuation bands in Poland and the Czech Republic). At the same time, these countries have declared EU membership a longer-term strategic goal, which necessitates their return from rather flexible arrangements back to fixed exchange rate regimes. In order to prepare these economies for EU membership and eventually also for joining the European Monetary Union, an "exit strategy" back toward fixed exchange rate systems has to be defined. Against this background, Prof. Orlowski recommends a gradual preparation of the exchange rate regimes for the European Union by slowly narrowing down the existing fluctuation bands. This strategy has to be supplemented by prudent fiscal policies, which aim at cutting down budget deficits and at reducing inflation, in order to lay a sound basis for a credible exchange rate peg to a stability-oriented European currency.

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

In June 1991, the Foreign Research Division of the Oesterreichische Nationalbank invited about 50 participants to the first of a series of meetings titled "East Jour Fixe", the main purpose of which is to discuss current issues related to the economic and political transformation in Central and Eastern Europe. Since then, the East Jour Fixe, which is held in Vienna four to five times a year, has become a highly regarded forum for discussion between decision makers actually involved in the formulation of economic policies on the one hand and representatives from universities and research institutes on the other hand.

The East Jour Fixe primarily aims at encouraging discussions between researchers and economic policymakers on topical issues related to transition economies, thus elaborating a coordinated Austrian position vis-à-vis the international community.

Typically, the Oesterreichische Nationalbank invites a guest speaker to the East Jour Fixe to give a brief presentation on the main topic, which is followed by comments of one or two invited discussants. The guest speakers as well as the invited discussants are usually professionals from international organizations (IMF, BIS, European Commission) who actually deal with transition economies or researchers from Western or Eastern economic institutes or universities as well as experts from Eastern European central banks and from the Oesterreichische Nationalbank. The contributions of the guest speaker and the invited discussants are designed to provide an impulse to initiate a general discussion among all participants.

In general, discussions in the East Jour Fixe focus on the following topics:

- the current economic and political situation in the reforming countries and the ongoing reform process,
- micro- and macroeconomic aspects of economic transformation,
- EU Eastern enlargement: issues related to approaching the EU,
- Austria's relationship to reforming countries: support of the reform process; economic consequences of the opening up of Central and Eastern Europe.

The main results of the East Jour Fixe held since November 1995 will be briefly summarized below.

Contribution by Rutger Wissels, European Commission

"Pessimism Confounded? Recovery in Eastern Europe" Held at the 21st East Jour Fixe on November 10, 1995

At the East Jour Fixe held in November 1995, Mr. Rutger Wissels of the European Commission presented the latest EU forecasts for the ten Central and Eastern European reforming countries with EU Association Agreements, namely Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia.[1]) The presentation was followed by comments by three invited discussants, Mr. Fidrmuc (Institute for Advanced Studies), Mr. Gács (International Institute for Applied Systems Analysis) and Mr. Poeschl (The Vienna Institute for Comparative Economic Studies).[2])

In his address, Mr. Wissels compared the actual economic developments in the associated countries in 1994 and 1995 with the Commission's forecast made two years earlier and presented at the East Jour Fixe of November 1993. He related that the economies of all associated countries started to grow in fact at a considerably stronger pace than projected. While in the first years of recovery, economic growth had been primarily export-led, investments became the main driving force in 1994 and 1995. Despite positive growth rates, unemployment remained comparatively high in all countries with only one exception, the Czech Republic. Due to restrictive monetary and fiscal policies, almost all associated countries succeeded in decreasing inflation, and budget deficits were generally reduced. As to the external position, all associated countries increased their international reserves, which reached a sustainable level in terms of months of imports.

In the forecasts for 1996 and 1997, the European Commission revised its rather pessimistic view of two years previously and issued a more positive outlook, projecting a continuation of economic growth in all associated countries. However, Mr. Wissels stressed a number of factors which could slow down economic growth in these countries. First, increasing pressures on wages might jeopardize a further reduction of inflation. Second, surging capital inflows to some of the associated countries already pose serious difficulties to maintaining restrictive monetary policy. Third, Mr. Wissels emphasized the importance of structural reforms, where much less progress was made than in the area of macroeconomic stabilization. In particular, he mentioned the building of sound financial systems as an indispensable prerequisite for successful economic reforms.

1 *The association agreement between Slovenia and the EU was initialed in June 1995, but not yet signed.*

2 *The revised version of Mr. Wissel's paper as well as the written comments of Mr. Fidrmuc and Mr. Poeschl have been issued in Working Paper Nr. 22 of the Oesterreichische Nationalbank (Rutger Wissels, "Pessimism confounded? Economic recovery in Eastern Europe", March 1996).*

Contribution by Hans-Georg Heinrich

"Russia after the Elections"
Held at the 22nd East Jour Fixe on January 31, 1996

Another highlight of the OeNB's East Jour Fixe series was the presentation of the current political situation in Russia after the parliamentary elections of late 1995 by Professor Heinrich (University of Vienna). His lecture, which was commented by Gerhard Mangott (Austrian Institute for International Affairs) and Peter Havlik (The Vienna Institute for Comparative Economic Studies) and followed by a lively discussion, is briefly summarized below.

The Russian Communist Party's victory in the parliamentary elections on December 17, 1995, did not fundamentally change the power structure in the State Duma, which remains characterized by opposition and populist-nationalist attitudes. The Communists' success was the outcome of protest against the government camp fueled by the contradiction between propaganda and reality.

The election was also a test whose results will help determine the strategies that parties, groups and individuals will adopt all the way up to the presidential elections. Even future presidents will partly have to slip into Boris Yeltsin's role as a strongman and preserver of peace; Yeltsin, on the other hand, will have to make a name for himself as a protector of the socially disadvantaged. Most presidential candidates, perhaps excepting Vladimir Zhirinovsky, will thus portray themselves as statesmen. Parliament will take a constructive opposition line, and the President will continue to pursue a flexible course and his policy principle of "divide et impera".

Together with its allies, the Communist Party holds a blocking minority of some 40% in the Duma. Apart from experienced members of parliament, its group mainly embraces representatives of firms which produce for the domestic market. It is the party of those who have lost out in the redistribution of state property so far.

Irrespective of the intentions and concepts touted by the reformers, the effect of the reform thusfar was to reallocate trade capital, above all foreign trade capital. The interests of the manufacturing industry producing for the domestic market were neglected, and it was impossible to implement a structural reform. The simplest method – raw material and resource exports – was chosen to procure money. Instead of implementing structural reforms, the choice was made to fight inflation. This basic pattern was preserved by all governments and personalities.

The basic structures and the position of the Russian economy in the global context willl not change even if a Communist candidate carries the next presidential election. The constraints – dependence on commodity exports and on Western credits – also apply to a possible Communist government, which will be dependent on the cooperation of enterprises and of the West to cover its money needs. All the large parties accept the basic facts of the monetization of the economy and the pluralization of power.

Contribution by Vit Bárta and Thomas Url

"Economies in Transition: Long-Term Growth Potential, Capital Accumulation and Labor-Capital Substitutability in Five Central European Countries" Held at the 23rd East Jour Fixe on May 22, 1996

On May 22, 1996, a lecture was delivered by Vít Bárta and Thomas Url, both research fellows at the Austrian Institute for Economic Research, at the East Jour Fixe of the Oesterreichische Nationalbank. The discussants for the lecture were András Simon (National Bank of Hungary) and Friedrich Fritzer (Oesterreichische Nationalbank).

During 1993–1994, transition economies in Central Europe (Poland, Hungary, the Czech Republic, Slovakia and Slovenia) embarked on the path of economic growth. Resumption of growth is needed to demonstrate that economic reforms work and are capable of improving the well-being of a majority of the population in the foreseeable future.

Bárta and Url examined the patterns and the main driving forces of the current recovery in the abovementioned Central and Eastern European Countries (CEECs) and analyzed the major factors and conditions which are essential for attaining a sufficiently robust and sustainable improvement in their economic performance in the future. Within a simple conceptual framework of transformation, they developed and estimated an econometric model for potential output. The resulting production function is used to describe the first steps in the catching up process to reach Western European levels of per capita income.

With the support of empirical evidence, the researchers introduced their modeling results into their conceptually simple three-stage framework of transformation. They extended their framework on the relation between capital and labor and presented a hypothesis about the evolution of the capital-labor ratio and marginal productivities of both production factors during the transformation period. Finally, they presented estimates of investment ratio levels required for attaining different speeds of catching up.

Their main proposition is that potential output decreased together with aggregate demand during the adjustment period. During the subsequent restructuring phase they expect a growth in potential output which is equal to the amount of exogenous technological progress.

Two growth scenarios for CEECs were highlighted by the researchers: that of "catching up" and "poorer forever". Slovenia, the Czech Republic and Poland seem to qualify as promising candidates for catching up to European Union countries' income levels relatively fast. On the other hand, persistent and recurrent macroeconomic imbalances in Hungary may, according to Messrs. Bárta and Url, hamper efforts to follow suit in the medium run, putting long-term progress at stake. In spite of its spectacular growth performance at present, Slovakia's questionable political development makes it the most likely candidate for only a modest long-term growth path.

Conference on "Central and Eastern Europe: Directing Monetary Policy towards EU Integration"

Organized by the Oesterreichische Nationalbank and The Vienna Institute for Comparative Economic Studies

From November 26 to November 28, 1995, the Oesterreichische Nationalbank and The Vienna Institute for Comparative Economic Studies jointly held a conference in Vienna on "Central and Eastern Europe: Directing Monetary Policy towards EU Integration".

The conference focused on the monetary policies of those transforming countries in Central and Eastern Europe that have concluded Association Agreements with the European Union. Rather than discussing the questions of "when" and "how" the transforming countries will join the Union, the conference concentrated on the question of what activities central banks could and should undertake during the preaccession period in order to prepare their countries for EU membership. The conference consisted of four panels dealing with legal harmonization in the financial sector, convertibility, exchange rate policy, and monetary policy instruments. There was also a session on harmonizing monetary and financial statistics and a concluding round table on the convergence of monetary policies, developments and regulations.

Given the importance of the widely discussed future Eastern enlargement of the Union for the "new Europe" in general and its implications in the field of monetary policy upon EU central banks and the Oesterreichische Nationalbank in particular, we are convinced that this meeting of policymakers – mainly from central banks and from international organizations – and academics has contributed to sorting out the challenges monetary decision makers in the associated countries are facing now and will have to cope with on their way to full integration into the European Union.

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

Since the opening up of Central and Eastern Europe, the Oesterreichische Nationalbank has been actively supporting the transition process, especially via technical assistance and training, and increasingly via cooperation with central banks in Central and Eastern Europe.

At a multilateral level, the OeNB – together with the G-10 central banks – participates in the coordination of technical assistance extended to central banks of Central and Eastern Europe at the Bank for International Settlements (BIS). Within the framework of IMF-coordinated technical assistance, the OeNB has sent experts to IMF missions to Eastern Europe and to several CIS republics. Moreover, OeNB experts have given lectures at workshops held by the IMF for CIS republics, e.g. Turkmenistan ("human ressource management") and Kazakhstan ("central bank accounting"). As a result of Austria's EU membership, the OeNB recently joined the EU's PHARE and TACIS programs. Within this framework, the Oesterreichische Nationalbank participates in the EU-financed technical assistance program for the Central Bank of Russia (seminar "central bank accounting").

As to bilateral activities of technical cooperation, the OeNB frequently organizes short study and information visits as well as specific consultations for Central and East European central bankers at the Bank in Vienna, typically on request of the recipient central bank. Furthermore, the OeNB is currently hosting a one-year traineeship for an employee of the National Bank of Hungary. Another form of technical cooperation consists in bilateral workshops aimed at stimulating discussions on very specific topics of central banking. These two-day workshops are typically organized by the Central and East European central bank in its home country, and experts from the OeNB as well as experts from the hosting central bank are invited (e.g. workshop on "Benchmarks" in Slovenia in June 1996). Since the establishment of the Joint Vienna Institute (JVI) in October 1992, an intensive and most beneficial cooperation between the OeNB and the JVI has been developed. Apart from financial support for the JVI, the OeNB from time to time sends lecturers to or even organizes JVI seminars. Moreover, JVI course participants are invited to the Bank to gain insight into the practical aspects of central banking. Twice a year, the OeNB organizes and finances the study tour for the comprehensive courses held at the JVI.

STATISTICAL ANNEX

Gross Domestic Product

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	Annual change in %										
1989	– 1.9	4.5	x	0.7	x	x	0.2	– 5.8	x	1.1	– 1.8
1990	– 9.1	– 1.2	x	– 3.5	x	x	–11.6	– 5.6	– 3.0	– 2.5	– 4.7
1991	–11.7	–14.2	x	–11.9	x	x	– 7.0	–12.9	– 5.0	–14.5	– 8.1
1992	– 7.3	– 6.4	–12.4	– 3.1	–34.9	x	2.6	– 8.7	–14.5	– 6.5	– 5.4
1993	– 1.5	– 0.9	– 7.8	– 0.6	–14.9	–30.3	3.8	1.4	– 8.7	– 3.7	1.9
1994	1.8	2.6	..	2.9	0.6	1.0	5.2	4.0	– 12.6	4.9	4.9
1995	2.6	4.8	..	1.5	– 1.6	..	7.0	6.9	– 4.0	7.4	3.5

Source: WIIW (The Vienna Institute for Comparative Economic Studies); Estonia, Lithuania: IMF; Latvia: IMF, national sources.

Industrial Production

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania[1])	Poland	Romania	Russia	Slovak Republic	Slovenia
	Annual change in %										
1989	– 1.1	1.7	x	– 2.1	x	x	– 0.5	– 2.1	1.4	– 0.7	1.1
1990	–16.7	– 3.3	x	–10.2	x	x	–24.2	–19.0	– 0.1	– 4.0	–10.5
1991	–22.2	–24.4	x	–16.6	x	– 4.9	– 8.0	–22.8	– 8.0	–19.4	–12.4
1992	–15.9	– 7.9	x	– 9.7	–34.6	–51.6	2.8	–21.9	–18.0	– 9.0	–13.2
1993	–10.9	– 5.3	x	4.0	–38.1	–34.7	6.4	1.3	–14.1	– 3.8	– 2.8
1994	8.5	2.1	– 2.2	9.6	– 9.5	–29.8	12.1	3.3	–20.9	4.9	6.4
1995	5.4	9.2	4.7	4.8	– 6.3	1.0	9.4	9.4	– 3.0	8.3	2.0
1995											
January	5.4	8.7	– 4.6	9.5	– 4.6	–25.2	15.2	3.8	– 0.6	4.4	13.8
February	– 2.0	8.8	– 5.2	9.2	– 9.1	–17.6	14.2	11.0	– 4.0	6.6	10.3
March	– 0.6	7.2	– 4.1	9.4	– 9.9	–12.8	9.7	15.8	– 5.4	6.0	5.5
April	6.0	5.0	– 1.5	4.3	– 7.4	– 0.8	7.8	6.3	– 6.0	10.5	– 1.3
May	5.9	7.1	10.7	15.0	– 7.5	11.6	15.0	12.8	1.1	10.3	1.8
June	2.6	10.0	4.7	2.7	–14.8	3.6	11.8	5.5	0.0	7.8	4.0
July	12.7	7.0	14.2	7.5	– 7.4	5.3	11.1	9.0	2.1	5.4	1.3
August	5.5	7.4	17.7	2.5	– 1.2	22.6	9.1	8.0	0.0	10.7	– 5.1
September	– 1.6	8.2	9.5	2.4	– 1.8	5.8	7.3	10.1	0.0	12.3	– 0.2
October	7.8	19.5	16.4	4.7	– 4.7	7.8	14.2	14.6	– 3.0	12.7	0.0
November	2.9	13.1	7.7	0.7	– 2.3	8.7	9.6	10.4	– 7.0	9.9	0.5
December	–15.9	6.8	– 4.4	– 4.4	– 6.5	5.7	1.6	5.2	–10.0	2.7	– 5.7
1996											
January	4.7	12.0	5.3	0.2	0.3	17.3	9.6	8.4	– 7.0	14.4	– 5.0
February	– 8.4	13.3	5.0	4.4	0.0	14.7	8.7	7.0	– 6.9	12.2	– 4.0
March	– 9.3	4.7	2.9	– 1.6	– 5.8	..	7.0	10.0	– 7.0	1.1	– 6.4
April	– 3.0	11.2	..	..	..	..	14.8	4.2	0.4	1.6	11.5

Source: annual data: WIIW; Estonia, Latvia, Lithuania: national sources. monthly data: OECD; national sources.
[1]) iip – manufacturing.

Unemployment Rate

	Bulgaria	Czech Republic	Estonia[1])	Hungary	Latvia	Lithuania[1])	Poland	Romania	Russia	Slovak Republic	Slovenia
	End of period (in %)										
1989	×	×	×	0.4	×	×	×	×	×	×	3.5
1990	1.7	0.8	×	1.9	×	×	6.3	×	×	1.6	5.8
1991	11.1	4.1	×	7.8	×	×	11.8	3.0	0.1	11.8	10.1
1992	15.2	2.6	1,8	13.2	2.3	×	13.6	8.4	0.8	10.4	13.4
1993	16.4	3.5	1,9	13.3	5.8	3.4	16.4	10.4	1.2	14.4	15.4
1994	12.8	3.2	1,5	10.9	6.5	4.5	16.0	10.9	2.1	14.8	14.2
1995	11.1	2.9	1,8	10.9	6.6	7.3	14.9	8.9	3.2	13.1	14.5
1995											
January	13.1	3.4	..	11.9	6.7	..	16.1	10.9	2.4	15.2	14.1
February	12.8	3.3	..	12.1	6.7	..	15.9	11.1	2.6	15.1	13.9
March	12.5	3.1	2,0	11.8	6.7	5.7	15.5	11.0	2.7	14.6	13.8
April	12.0	2.9	..	11.7	6.3	..	15.2	10.9	2.8	13.9	13.7
May	11.2	2.8	..	10.7	6.1	..	14.8	10.3	2.8	13.3	13.4
June	10.7	2.8	1,9	10.6	6.1	6.0	15.2	10.1	2.8	13.3	13.4
July	10.9	2.9	..	11.0	6.1	..	15.3	9.8	2.9	13.5	13.8
August	10.7	3.0	..	10.9	6.1	..	15.2	9.4	3.0	13.3	13.8
September	10.5	3.0	1,6	10.8	6.0	6.3	15.0	9.3	3.0	13.2	14.2
October	10.4	2.8	..	10.5	6.0	..	14.7	9.2	3.0	12.8	14.4
November	10.8	2.8	..	10.6	6.3	..	14.7	8.8	3.1	12.8	14.4
December	11.1	2.9	1,8	10.9	6.6	7.3	14.9	8.7	3.2	13.1	14.5
1996											
January	11.6	3.1	..	11.3	6.6	..	15.4	8.9	3.3	13.7	14.4
February	11.4	3.1	..	12.3	6.8	..	15.4	9.3	3.5	13.7	14.2
March	11.4	3.0	2.2	11.6	7.0	8.3	15.4	9.4	3.7	13.3	13.9
April	11.0	2.8	..	11.2	7.1	..	15.1	8.7	..	12.5	13.8

Source: WIIW; Estonia, Latvia, Lithuania: national sources.
[1]) End of quarter.

Consumer Price Index

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia[1])
	Period average (annual change in %)										
1989	×	×	×	17.0	×	×	251.1	1.1	×	×	1,306.0
1990	23.8	9.9	×	28.9	×	×	585.8	5.1	5.3	10.6	549.7
1991	338.5	56.7	×	35.0	×	×	70.3	170.2	92.6	61.2	117.7
1992	91.3	11.1	1,076.5	23.0	243.6	×	43.0	210.4	1,526.0	10.0	201.3
1993	72.9	20.8	89.8	22.5	108.8	409.6	35.3	256.1	875.0	23.2	32.3
1994	96.2	10.0	47.7	18.8	35.9	72.1	32.2	136.8	307.0	13.4	19.8
1995	62.2	9.1	28.9	28.2	25.0	39.7	27.8	32.3	198.0	9.9	12.6
1995											
January	122.1	8.9	39.0	22.1	25.9	46.5	32.3	57.4	214.7	11.7	17.8
February	120.4	9.5	36.0	23.8	25.5	47.9	33.6	50.7	215.3	11.5	17.3
March	112.1	9.6	27.9	27.5	26.6	45.2	33.1	40.4	219.7	11.3	16.6
April	76.1	10.2	25.3	29.2	25.7	44.8	32.4	34.5	219.7	11.2	14.1
May	66.2	10.2	27.1	30.8	27.1	39.3	32.3	29.5	222.7	11.0	13.6
June	60.5	10.0	29.1	31.0	26.5	37.8	30.3	27.8	224.8	10.6	12.7
July	61.9	9.7	27.8	30.5	25.4	38.5	27.6	29.1	225.1	10.8	11.8
August	54.7	9.0	27.4	29.2	22.8	36.1	25.7	28.1	225.1	9.8	11.1
September	45.9	8.6	25.9	28.8	23.7	35.8	24.2	25.2	215.5	8.8	10.9
October	40.1	8.1	27.3	29.0	24.0	36.2	22.4	24.2	187.2	7.9	9.4
November	36.2	8.0	28.2	28.7	24.0	37.2	22.0	25.7	161.0	7.6	9.2
December	33.0	7.9	28.9	28.3	23.1	35.7	21.6	27.7	131.4	7.2	8.6
1996											
January	30.9	9.0	28.8	28.9	23.2	32.4	21.0	26.7	104.5	6.4	8.5
February	28.5	8.6	29.4	28.3	21.4	30.4	20.4	27.4	89.4	6.2	8.5
March	26.5	8.9	28.3	25.6	20.2	31.4	20.4	28.4	78.8	6.1	9.4
April	28.8	8.5	..	24.4	18.6	31.3	20.3	28.7	68.4	6.0	10.7

Source: WIIW; Estonia, Lithuania, Latvia: IMF; national sources .
[1]) Retail price index.

Trade Balance

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	USD million[1]										
1989	− 692	×	×	1,043	×	×	47	2,050	×	×	×
1990	−1,314	×	×	534	×	×	3,589	−3,344	×	×	×
1991	− 32	×	×	358	×	×	− 711	−1,106	×	×	×
1992	− 212	×	− 90.4	−11	− 40	×	− 131	−1,194	×	×	789.1
1993	− 885	−302	−144.9	−4,021	3	−154.7	−3,505	−1,128	×	−912	−154.2
1994	− 17	−918	−361.0	−3,716	−301	−204.9	−1,809	− 411	19,713	109	−179.7
1995	..	..	..	..	..	..	..	..	..	..	−781.9
1994											
1st quarter	− 273	152	− 86.0	− 560	− 80	−195.2	− 295	− 63	2,398	− 98	26.2
2nd quarter	105	−150	− 82.6	−1,036	− 75	− 69.3	− 128	− 41	5,888	134	− 73.2
3rd quarter	62	−448	− 76.8	− 928	− 47	122.0	− 53	108	6,750	29	− 9.1
4th quarter	89	−472	−115.5	−1,191	− 98	− 62.3	− 419	− 415	4,677	45	−123.6
1995											
1st quarter	46	..	−132.0	..	−115	−100.2	− 364	− 395	6,039	22	− 25.9
2nd quarter	129	..	..	..	−101	49.2	− 133	− 307	6,622	− 62	−367.9
3rd quarter	109	..	..	..	..	..	..	..	5,048	107	−126.3
4th quarter	..	..	..	..	..	..	..	..	..	..	−261.8

Source: IMF.

[1] *The data on the trade balances and current account are not comparable with those in the statistical annex (the calculations in the text are based on flows of convertible currencies derived mainly from The Vienna Institute for Comparative Economic Studies and national sources).*

Current Account

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	USD million[1]										
1989	−769	×	×	−588	×	×	−1,409	2,514	×	×	×
1990	−1,710	×	×	379	×	×	3,067	−3,254	×	×	×
1991	−77	×	×	403	×	×	−2,146	−1,012	×	×	×
1992	−360	×	36.1	352	191	×	−3,104	−1,506	×	×	978.3
1993	−1,098	681	23.3	−4,262	417	−85.7	−5,788	−1,174	×	−580	187.5
1994	−32	−81	−170.8	−4,054	201	−93.8	−2,545	−420	11,369	719	457.2
1995	..	..	..	..	..	..	..	..	..	..	41.7
1994											
1st quarter	−322	343	−45.6	−819	43	−182.7	−1,189	−93	2,454	18	137.3
2nd quarter	88	134	−23.5	−1,188	54	−48.8	−40	−35	2,939	262	69.8
3rd quarter	120	−247	−38.7	−814	81	163.4	−71	120	4,318	220	168.4
4th quarter	82	−311	−63.0	−1,233	23	−25.9	−406	−412	1,658	219	81.7
1995											
1st quarter	−84	..	−65.1	..	5	−69.4	−621	−434	6,014	183	150.5
2nd quarter	126	..	..	..	40	103.7	−196	−357	3,770	158	−100.1
3rd quarter	85	..	..	..	..	47.4	..	..	254	273	74.6
4th quarter	..	..	..	..	..	..	..	..	..	..	−83.3

Source: IMF.

[1] *The data on the trade balances and current account are not comparable with those in the statistical annex (the calculations in the text are based on flows of convertible currencies derived mainly from The Vienna Institute for Comparative Economic Studies and national sources).*

Total Reserves Minus Gold

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
	End of period (USD million)[1]										
1989	×	×	×	1,246	×	×	2,314	1,859	×	×	×
1990	×	×	×	1,070	×	×	4,492	524	×	×	×
1991	320	×	×	3,936	×	×	3,633	695	0	×	112
1992	902	755	170	4,428	×	45	4,099	826	2,000	409	716
1993	655	3,789	386	6,771	432	350	4,092	995	5,835	416	788
1994	1,002	6,145	443	6,810	545	525	5,842	2,086	3,980	1,691	1,499
1995	1,236	13,843	580	12,052	504	757	14,774	1,705	14,383	3,364	1,821
1995											
January	939	6,615	481	7,020	558	502	6,166	2,065	2,093	1,686	1,460
February	1,029	7,254	497	6,900	555	497	6,714	1,989	3,110	1,759	1,485
March	1,175	8,236	502	6,832	535	511	7,385	1,881	4,148	1,915	1,597
April	1,304	8,560	508	6,540	542	523	8,878	1,802	5,830	1,967	1,664
May	1,422	9,154	517	6,742	473	531	9,847	1,709	8,661	2,131	1,752
June	1,500	9,157	540	7,612	456	547	10,539	1,788	10,086	2,567	1,757
July	1,502	10,131	563	8,348	453	618	10,776	1,680	10,321	2,576	1,727
August	1,489	11,092	541	8,129	500	651	11,553	1,568	10,916	2,654	1,613
September	1,470	11,862	564	8,867	500	677	12,798	1,569	11,154	2,771	1,729
October	1,465	12,373	562	9,462	499	714	13,287	1,487	12,703	2,819	1,707
November	1,363	12,857	551	9,012	492	702	14,032	1,563	12,342	2,992	1,706
December	1,236	13,843	580	12,052	504	757	14,774	1,705	14,383	3,364	1,821
1996											
January	956	13,454	571	12,146	497	666	15,317	1,514	11,898	3,307	1,714
February	860	13,923	570	11,458	501	615	16,819	1,458	12,689	3,398	1,622
March	644	13,061	570	10,781	520	630	17,550	1,617	16,328	3,459	1,558
April	630	12,553	..	..	540	644	17,400	..	..	3,405	..

Source: IMF; national sources.

[1] SDR holdings of monetary authorities (central banks and, to the extent that they perform monetary authorities' functions, currency boards, exchange stabilization funds, and treasuries), reserve position in the Fund and foreign exchange.

Central Government Deficit

	Bulgaria	Czech Republic	Estonia[3]	Hungary[2]	Latvia	Lithuania	Poland[3]	Romania[4]	Russia	Slovak Republic	Slovenia[5]
	In % of GDP										
1989	×	−1.2	×	−3.1	×	×	−3.0	7.5	0.7	−0.6	×
1990	×	−0.2	×	−0.1	×	×	0.4	−0.4	1.3	−0.2	×
1991	×	−2.1	×	−4.6	×	×	−3.8	−1.9	− 2.7	−3.9	2.6
1992	− 5.8	−0.2	×	−6.7	−3.0	×	−6.0	−4.4	− 3.4	−2.8	0.3
1993	−11.0	0.1	−0,4	−5.6	−0.2	×	−2.8	−1.7	− 4.6	−6.2	0.3
1994	− 6.3	1.0	−0,6	−5.5	−1.9	−1.7	−2.7	−4.2	−10.3	−5.2	−0.2
1995	− 6.8	0.6	−0,5	−2.9	−3.8	−1.9	−2.6	−4.1	− 3.3	−1.6	−0.0

Source: WIIW; Latvia, Lithuania: national sources.

[1] Including social budget in 1993 and 1994.

[2] Including privatization revenues.

[3] Up to 1990 general government deficit.

[4] 1990 including social insurance budget.

[5] General government deficit.

Gross Debt in Convertible Currencies

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania[1])	Russia	Slovak Republic	Slovenia
	USD million										
1989	9,201	×	×	20,390	×	×	40,800	174	×	×	×
1990	10,600	×	×	21,270	×	×	48,475	230	56,200	×	1,954
1991	11,375	×	×	22,658	×	×	48,412	1,143	70,100	×	1,866
1992	12,087	7,869	13	21,438	66	66	47,044	2,479	80,200	2,981	1,741
1993	12,472	8,496	133	24,560	233	337	47,246	3,357	80,000	3,626	1,873
1994	10,363	10,694	175	28,521	359	505	42,174	4,543	112,800	4,310	2,258
1995	9,446	16,346	260	31,655	431	827	43,886	5,338	120,000	..	2,970

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

Exchange Rate

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland[1])	Romania	Russia	Slovak Republic	Slovenia
	Period average (ATS per 100 units of national currency)[1])										
1989	1,575.08	×	×	22.40	×	×	9,194.37	88.68	×	×	×
1990	519.17	×	×	17.99	×	×	1,196.82	50.69	×	×	×
1991	65.63	×	×	15.62	×	×	1,104.00	15.28	×	×	42.35
1992	47.08	×	×	13.91	1,492.10	620.86	806.49	3.57	×	×	13.52
1993	42.16	39.90	87.97	12.65	1,722.52	268.02	642.13	1.53	1.17	37.80	10.27
1994	21.10	39.67	87.92	10.86	2,040.70	286.98	502.65	0.69	0.52	35.65	8.87
1995	15.01	37.99	87.93	8.02	1,910.82	252.04	415.73	0.50	0.22	33.93	8.51
1995											
January	16.12	38.81	87.92	9.67	1,973.26	269.35	442.61	0.61	0.28	34.79	8.59
February	15.93	38.58	87.87	9.46	1,953.88	264.26	432.54	0.59	0.25	34.52	8.59
March	14.99	37.74	87.98	8.52	1,895.52	247.37	413.41	0.54	0.21	33.66	8.58
April	14.79	37.53	88.03	8.07	1,911.40	242.75	404.58	0.52	0.19	33.44	8.61
May	15.08	37.72	87.82	7.99	1,925.45	247.42	413.64	0.52	0.20	33.55	8.63
June	14.89	37.67	87.84	7.85	1,923.34	246.19	420.01	0.50	0.21	33.46	8.64
July	14.78	37.57	87.93	7.73	1,904.62	244.27	413.10	0.49	0.22	33.40	8.64
August	15.00	38.13	87.90	7.78	1,923.96	253.96	416.35	0.50	0.23	34.33	8.64
September	15.12	38.21	87.94	7.69	1,904.72	257.14	417.84	0.49	0.23	34.14	8.53
October	14.60	37.87	88.06	7.44	1,865.94	249.10	407.88	0.46	0.22	33.79	8.38
November	14.42	37.87	87.95	7.35	1,862.97	249.17	403.22	0.42	0.22	33.84	8.22
December	14.43	38.03	87.99	7.29	1,884.57	253.48	403.98	0.40	0.22	34.13	8.07
1996											
January	14.17	38.11	87.92	7.24	1,889.34	256.95	409.32	0.40	0.22	34.70	7.93
February	13.83	38.09	87.91	7.14	1,888.70	257.81	405.33	0.37	0.22	34.46	7.82
March	13.19	38.13	87.92	7.12	1,900.07	259.84	401.93	0.36	0.22	34.54	7.78
April	11.96	38.51	88.10	7.13	1,922.20	264.78	404.69	0.37	0.22	35.05	7.79
May	7.31	38.74	87.98	7.08	1,946.00	270.00	396.98	0.36	0.22	34.81	7.81

Source: IMF; Romania: monthly data: national sources; Russia: January to May 1995 national sources; OeNB, end of period.
[1]) The post-January 1, 1995, zloty is equal to 10,000 of the pre-January 1, 1995, zloty.

Discount Rate[1])

	Bulgaria	Czech Republic	Hungary	Latvia	Poland	Romania	Russia[2])	Slovak Republic	Slovenia
	End of period[1])								
1989	×	×	17.0	×	26.0	×	×	×	×
1990	4.5	×	22.0	×	48.0	3.0	×	×	×
1991	54.0	×	22.0	×	36.0	18.0	×	×	×
1992	41.0	9.5	21.0	×	32.0	70.0	80.0	9.5	25.0
1993	52.0	8.0	22.0	27.0	29.0	70.0	210.0	12.0	18.0
1994	72.0	8.5	25.0	25.0	28.0	58.0	180.0	12.0	16.0
1995	34.0	9.5	28.0	24.0	25.0	35.0	160.0	9.75	10.0
1995									
January	72.0	8.5	25.0	25.0	28.0	55.0	×	12.0	16.0
February	72.0	8.5	28.0	25.0	31.0	48.5	×	12.0	16.0
March	72.0	8.5	28.0	25.0	31.0	40.0	×	11.0	16.0
April	60.0	8.5	28.0	25.0	31.0	40.0	×	11.0	10.0
May	54.0	8.5	28.0	25.0	27.0	40.0	×	11.0	10.0
June	48.0	9.5	28.0	26.5	27.0	40.0	×	11.0	10.0
July	39.0	9.5	28.0	26.5	27.0	40.0	×	11.0	10.0
August	34.0	9.5	28.0	26.5	27.0	35.0	×	11.0	10.0
September	34.0	9.5	28.0	26.5	25.0	35.0	×	11.0	10.0
October	34.0	9.5	28.0	26.5	25.0	33.0	170.0	9.75	10.0
November	34.0	9.5	28.0	25.0	25.0	33.0	170.0	9.75	10.0
December	34.0	9.5	28.0	24.0	25.0	35.0	160.0	9.75	10.0
1996									
January	34.0	9.5	28.0	24.0	23.0	35.0	160.0	8.8	10.0
February	42.0	9.5	27.0	24.0	23.0	35.0	120.0	8.8	10.0
March	49.0	9.5	27.0	24.0	23.0	35.0	120.0	8.8	10.0
April	67.0	9.5	27.0	19.0	23.0	35.0	120.0	8.8	10.0

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

[1]) Due to currency board arrangements, the Bank of Estonia and the Bank of Lithuania do not lend to banks unless in exceptional circumstances. Therefore these two countries do not define and publish discount rates.

[2]) Refinancing rate.

OESTERREICHISCHE NATIONALBANK