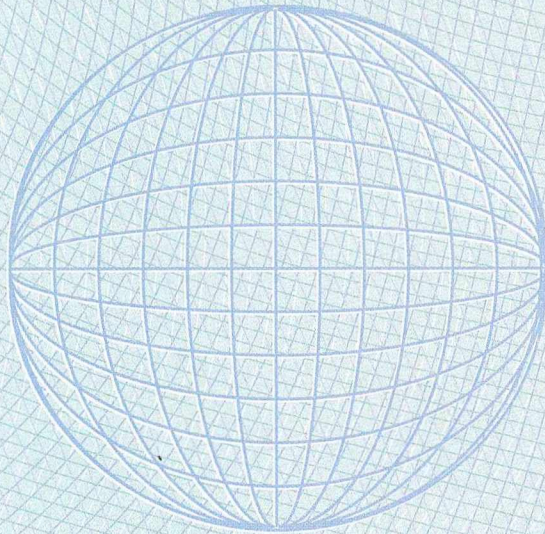




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F O C U S O N T R A N S I T I O N

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Editorial

This is the second issue of the Oesterreichische Nationalbank's new publication "Focus on Transition" dealing with the transition process in Central and Eastern Europe. The very positive response we received following the launch of the first issue encourages us to continue on the chosen path and to keep contributing to the discussion process on transition questions among interested experts (policymakers or academics).

This edition contains a study on the link between the planned European Monetary Union (EMU) and selected EU candidate countries from Central and Eastern Europe. As the countries of the European Union get ready to introduce the euro, the question of the repercussions of EMU on the accession ambitions of the Central and Eastern European countries (CEECs) is gaining increasing importance. This study addresses some of the relevant questions. The second study in this issue looks at the causes of the persistence of moderate inflation in Poland and Hungary. While some other of the most advanced transition countries have already successfully managed to achieve single-digit inflation rates, these two countries continue to live with double-digit increases in prices. This raises interesting (economic) policy questions, some of which are analyzed here.

Furthermore, I would like to draw your attention to the short report on our 1996 annual economic policy conference entitled "Monetary Policy in Transition: Strategies, Instruments and Transition Mechanisms", which the Oesterreichische Nationalbank organized in Vienna in November. This occasion brought together some of the leading international experts in the area of monetary policy to focus on the ongoing monetary transition processes in Western as well as Central and Eastern Europe. The proceedings of this conference will be available in spring 1997.

If you wish to receive future issues of "Focus on Transition" and you are not yet on the mailing list, please fill in and return the enclosed order form.

Adolf Wala
Chief Executive Director

RECENT ECONOMIC DEVELOPMENTS

Developments in Selected Reforming Countries¹⁾

Sandra Riesinger,
Peter Backé,
Maciej Krzak,
Kurt Mauler,
Olga Radzyner²⁾

I Introduction

As in 1995, *GDP growth* in all five Central and Eastern European countries was quite encouraging in the first half of 1996; in Hungary, Slovenia and Poland, however, it had slowed down from the year before. This can be attributed to the sluggish economic framework conditions in Western Europe, which resulted in a weakening of demand for exports from the reforming countries. The Czech Republic's economy continued to develop at a very dynamic pace, while Slovakia boasted a record growth rate of more than 7%, the most pronounced increase in the entire region. With the exception of the Czech Republic, all CEECs registered high *unemployment rates*.

Inflation developed along divergent lines in the first nine months of 1996. Slovakia, the Czech Republic and Slovenia posted single-digit rates in September 1996, the latter two countries for the first time. While inflation dropped somewhat in Hungary and Poland, it remained at a comparatively high level (around 20% in September 1996, year on year), however.

The *external position* of the five reforming countries in the first three quarters of 1996 was marked by a deterioration of trade balances (Hungary was the only exception), above all because of the slowdown in economic activity in Western Europe. Moreover, the current accounts of Slovakia, Slovenia and the Czech Republic worsened, whereas Hungary reported an improvement.³⁾ As regards *foreign direct investment (FDI)*, inflows to the Czech Republic, Hungary and Poland increased rapidly in the first months of 1996, whereas Slovenia and the Slovak Republic recorded declining inflows of FDI. In terms of FDI stocks, Hungary takes the lead (USD 13.1 billion), followed by Poland (USD 7.9 billion), the Czech Republic (USD 5.9 billion), Slovakia (USD 737 million) and Slovenia (USD 614 million).⁴⁾

Turning to relations with the *EU*, all Central and Eastern European countries with EU Association Agreements have meanwhile formally applied for membership and their countries' activities focused on responding to the *questionnaire* that the European Commission had sent them in spring. On the basis of this questionnaire, which deals with economic and political issues in each applicant country, the Commission will prepare its official statements ("avis") on the applications for EU membership. The EU's decision on potential members with whom negotiations can be started is expected for early 1997.

International financial markets' *assessment of the CEECs' creditworthiness* took a big step forward in September 1996: Leading international financial journals sharply upgraded the credit ratings of these countries by comparison to their assessment six months before, so that all five CEECs now rank several places higher. As to the individual country ratings, the Slovak Republic and Slovenia for the first time obtained investment grades from international rating agencies in April 1996 and May 1996 respectively, Hungary followed in October 1996.⁵⁾

In the field of *structural reform*, the restructuring of the *banking sector* has a priority status on the agenda of all reforming countries. The problems that have recently vexed banks in the Czech Republic may be seen as a serious warning which once more demonstrated both the importance of a sound financial sector for economic prosperity and the risks associated with an

1 The countries covered in this report are the Czech Republic, Hungary, Poland, Slovakia and Slovenia. Editorial close: November 30, 1996.

2 All Foreign Research Division of the Oesterreichische Nationalbank.

3 The development of the Polish current account in 1996 must be viewed against the background of a balance-of-payments revision (see section 2.3 on Poland).

4 FDI stocks as of March 1996.

5 The first reforming country in Central and Eastern Europe to be awarded an investment grade by a rating agency was the Czech Republic in October 1993, followed by Poland in June 1995.

ailing banking industry. All of the countries have embarked more or less rapidly on a reform of the financial sector, new banking legislation was passed (or is in preparation), prudential supervision was or is being strengthened, loss-making institutions were either closed down or placed under administrative control, and in some countries rescue programs were set up for high-risk banks. As to the liberalization of capital movements, the three countries that have already joined the OECD made considerable progress in spring 1996 (see Focus on Transition 1/1996), while the Slovak Republic is currently preparing a number of legislative steps in this realm.

2 Country Reports

2.1 Czech Republic

After a robust upturn in 1995, the Czech Republic again posted hefty real GDP growth in the first half of 1996 (+4.3%). Industrial production in the first three quarters 1996 advanced by 8.4% in real terms, continuing the strong performance of 1995, while construction activity rose by 6.4%. For 1996, estimates predict a GDP growth rate of about 5% in real terms.

As in the previous years, the *unemployment rate* was very low by comparison to other Central and Eastern European countries (end-September 1996: 3.1%).

Inflation, which had come down to single digits for the first time in 1995, amounted to 8.9% on a year-to-year basis in September 1996. Trimming the inflation rate further to a "Western European level" is proving difficult, because administered prices keep rising (e.g. energy, rent, transport), which is compounded by services' contribution to the upward trend of prices. The development of wages also has an impact on inflation. In the first nine months of 1996, nominal wages in the industrial sector surged by 17.4%, which exceeds the increase in labor productivity by a wide margin.

To stem inflationary pressures, the central bank took a number of measures. On June 21, 1996, the *discount rate* was raised from 9.5 to 10.5% and the lombard rate from 12.5 to 14%. On August 1, the minimum reserve rate for commercial banks was raised to 11.5 from 8.5%.

After having posted a marginal surplus in the past few years, the *budget* slipped into deficit for the first time in April 1996, widening to CZK 3.6 billion at the end of August. Under a cost-cutting program drawn up by the government for the rest of the year, most of the ministries had to trim 5% of their expenditures. In the first nine months of 1996, the budget balance turned into a surplus of CZK 0.1 billion. The 1997 budget adopted by the government in mid-September 1996 provides for a balanced budget.

In 1995, the *trade balance* had closed with a shortfall of USD 3.8 billion. In the first nine months of 1996, the deficit ran to USD 4 billion, with calculations predicting a further deterioration for 1996. The *balance on current account* registered a shortfall of USD 1.7 billion in the first half of 1996 (analogous 1995 period: -USD 721 million). *Foreign direct investment* inflows into the Czech Republic totaled USD 972.4 million in the first nine months of 1996. That compares with nine-month FDI inflows in 1995 of USD 2.0 billion, which included the USD 1.3 billion equity expansion by a Dutch-Swiss consortium in SPT Telecom a.s.

The *banking sector's* foreign currency holdings amounted to USD 16.1 billion on September 30, 1996, with the central bank accounting for USD 12.6 billion. *Gross foreign indebtedness* at the end of June 1996 totaled USD 16.7 billion (end-1995: USD 16.3 billion).

On July 1, 1996, *new capital market regulations* went into force. Among other things, every investor must notify the authorities of acquisitions or sales of holdings in companies whenever these exceed a 10% limit. Investors whose stakes surpass the 50% mark are obliged to submit a public takeover offer at a specific floor price to minority shareholders. Moreover, disclosure requirements for publicly traded enterprises and investment funds were tightened.

In the second half of 1996, the Czech banking sector again ran into difficulties. In August 1996, the medium-sized private bank Kreditni Banka in Plzen collapsed. On September 17, 1996, the central bank placed Agrobanka, the country's largest private bank, under temporary administrative control when it experienced liquidity problems, at the same time giving a guarantee for 100% of Agrobanka's deposits.⁶) Since 1994 the central bank, acting in its supervisory capacity, has dealt with eleven smaller problem banks, albeit only at a later stage when insolvency already loomed large. In most of the cases, winding-up or a takeover of the institution ensued. What is worrisome about the recent banking problems is their magnitude. With a balance sheet total of approximately CZK 70 billion as of end-1995, Agrobanka was the fifth-largest credit institution in the country, although it is still far smaller than the Czech Republic's four major banks, in which the state still holds a majority stake and which – measured in terms of their balance sheet total – make up roughly 63% of the Czech banking sector. On November 27, 1996, the Czech government approved in principle the proposal on the privatization of the "big four" state banks which had been submitted by the Czech National Bank at the end of October. The government announced that the third-ranking IPB (Investicni a postovni banka), where the state currently owns a share of 31.5%, will be the first to go on the block.

In view of the problems pointed out above, the Czech government approved a consolidation program on October 18, 1996, designed to enable smaller private banks to consolidate their balance sheet and to restore customers' somewhat shaky confidence in the banking sector. This effort covers 13 banks, whose balance sheet total equals roughly 5% of the aggregate balance sheet of the Czech banking system. There are also plans to establish an agency to aid small distressed banks, which is to be called Ceska Financni. This agency is to purchase, under certain conditions, bad loans at their nominal value from banks. On the one hand, this would reduce the amount of capital these institutions have to allocate to reserves and provisions; on the other hand, the banks concerned would receive fresh capital from the proceeds of the sales. Basically, this measure should help them to consolidate their finances and buy these loans back from Ceska Financni, which is obligatory in the medium term (duration of program: 5 to 7 years).

6 The Czech deposit insurance scheme introduced in July 1994 prescribes a deposit insurance of 80% for non-anonymous accounts, the amount of which may not exceed CZK 100,000.

2.2 Hungary

After moderate real growth in 1995, GDP stagnated in the first six months of 1996. Forecasts for the whole of 1996 predict an expansion by 1%. Industrial output advanced by 1.5% in the first nine months of 1996. Unemployment has remained practically stable at a rate of approximately 11% since 1994.

Inflation is declining slightly and came to 21.0% in October 1996 compared to October 1995.

Hungary's *favorable budget and external sector performance*, which is the outcome of the stabilization package of March 1995, continued in 1996. The *central government budget* developed much better than forecast, with the shortfall in the first ten months of 1996 reaching HUF 75 billion. Consequently, the total public sector deficit of 4% of GDP targeted for 1996 seems to be within reach in spite of a massive social security system deficit.

Hungary's *external position* in the first half of 1996 improved by comparison to the year before. The trade balance registered a deficit of approximately USD 1.9 billion for the first nine months of the year (analogous 1995 period: -USD 2.0 billion), while the current account closed with a shortfall of some USD 1.1 billion (January to September 1995: -USD 2.3 billion). This reduction of the current account deficit is mainly due to an increased surplus in tourism and lower interest payments on foreign debt. The government's goal for 1996 is a current account deficit of USD 2 billion; the actual outcome is likely to be lower. Inflows of *foreign direct investment* amounted to USD 1.3 billion from January to September 1996. Gross foreign debt was on the decrease⁷, running to USD 27.1 billion as of end-September 1996 (end-1995: USD 31.7 billion). Simultaneously, *official reserves* sank, but remained at a high level (end-August: USD 9.7 billion).

Under Hungary's accession agreement to the OECD, residents' portfolio investment abroad was partly liberalized with effect from July 1, 1996, and regulations pertaining to nonresidents' transfers of forint to Hungary were brought in line with OECD requirements. Moreover, from July 1, cross-border branching in the banking sector was liberalized.

Since mid-1995, the central bank has been pursuing a policy of gradual interest rate reduction. Between January and June 1996, the minimum reserve ratio was lowered in several steps from 17 to 12%. The monthly devaluation rate fixed under the crawling peg exchange rate regime remained unchanged at 1.2% in the review period. After having been approved in July, a *modification of the currency basket* to which the forint is pegged (ECU: 70%; USD: 30%) will become effective on January 1, 1997. The ECU share will be replaced by an equivalent Deutsche mark share.

Under a resolution passed by the government in April 1996, the 8% import surcharge introduced in March 1995 was lowered to 7% from July 1, 1996, and to 6% from October 1, 1996. It is to be phased out and ultimately eliminated from July 1, 1997.

Hungary's *economic legislation* continues to focus on harmonization with EU law. In November 1996, Parliament approved a new Banking Act as well as a new Securities and Stock Exchange Act, both of which will come into

⁷ This was due to early repayment and to the fact that expired debt was not rolled over.

force on January 1, 1997. At the heart of the two bills are strengthened prudential regulations. Furthermore, Parliament has recently passed a bill by which the banking and the stock exchange supervision authorities, which have been separate bodies so far, will be merged into a financial market supervision agency at the beginning of 1997.

In May 1996, Hungary's government designed a plan for *pension system reform*, which has as its core element the transition to a three-pillar system. In July 1996, Parliament passed legislation providing for a gradual boost in the retirement age, a phased extension of the minimum coverage period entitling an insured person to retirement benefits, and a bonus or deduction system for additional or lacking coverage periods. In May 1996, the government decided on a timetable for *health care and educational reform*. The implementation of the envisaged measures has been slow, however.

After the large-scale *privatization activities* at the end of 1995, privatization in 1996 has been noticeably less busy so far, apart from the sell-off of two large chemical enterprises and several other energy supply companies. The sale of the penultimate major state-owned bank – Magyar Hítel Bank (MHB) – was completed in November 1996. In early October 1996, the Hungarian privatization minister and the whole executive board of the state privatization agency were replaced on the grounds of irregularities in contract awarding. The newly appointed management has emphasized that there will be no changes in implementing the privatization program, neither in terms of strategy nor in terms of pace.

The Hungarian stabilization and reform policy is supported by a *standby agreement* concluded with the IMF in March 1996 (see Focus on Transition 1/1996). Hungary officially stated that it does not intend to draw tranches from the standby loan. During the first review of the program in July 1996, the IMF assessed Hungary's economic policy as generally positive.

2.3 Poland

With real GDP rising by 4.3% in the first half of 1996 (compared to the first half of 1995), Poland's economic performance did not quite come up to the high expectations nourished on the basis of the excellent 1995 result (7%). While investment and net exports had been the engines for growth in 1995, a rise in private consumption along with continued robust investment have provided the main stimuli in 1996 (investment grew by 26.5% in the first nine months of 1996). *Industrial production* kept on surging in 1996, albeit at a somewhat slower clip than last year. From January to October 1996, industrial production rose by 9.5% against an 11% increase in the corresponding period of the previous year. In the last months of the year, business activity will very likely regain momentum to a certain extent, bringing GDP growth to 5 to 6% in 1996 according to the forecasts.

Unemployment in Poland stood at 13.2% at the end of October 1996, which – despite a reduction with respect to last year – is one of the highest rates of all reform countries.

Inflation in 1996 has been reduced only slightly so far. In October 1996, the rate of price increase was 19.5% against the same period of last year. Of crucial importance is the high weight of food prices in the Polish CPI basket.

They account for close to 40% of the consumer price index and constantly fuel inflation as they are liberalized step by step under the reform program. Forecasts project an inflation rate of about 20% for 1996 (annual average).

Due to the inclusion of loans from the World Bank in the budget balance, the *budget deficit* 1996 is now calculated to run to PLN 10.2 billion instead of PLN 9.5 billion as previously forecast, which corresponds to a shortfall of 2.8% of GDP. From January to October 1996, the budget deficit was PLN 6.4 billion.

Poland's external situation in 1996 was characterized by a dramatic worsening of the *trade balance*. The cumulative trade deficit in the first nine months of 1996 amounted to approximately USD 5.3 billion (1–9/1995: –USD 0.9 billion). Exports in terms of U.S. dollars edged up only 6% (1995: +36.6%), while imports soared by 30.3% (1995: +40%). This development was primarily traceable to a slump in demand for Polish exports due to the recessionary tendencies in Western Europe (above all Germany), other factors being the real appreciation of the zloty, the reduction of the import surcharge⁸) from 5% to 3% on January 1, 1996, and the lowering of several customs tariffs in accordance with WTO recommendations. Since the trade deficit was largely compensated for by unregistered cross-border trade flows, the *current account* closed with a small deficit of USD 0.3 billion in the first nine months of 1996 (January through September 1995: + USD 4.2 billion).⁹

Poland received USD 2 billion in foreign direct investment in the first half of 1996; for the whole year it is estimated to reach USD 4 billion. On October 30, 1996, the central bank's *official reserves* came to USD 17.7 billion, providing cover for more than 6 months of imports.

The crawling peg exchange rate strategy, which has been pursued since 1991, was maintained in the first half of 1996. The monthly devaluation rate (1%) and the intervention range on the foreign exchange market ($\pm 7\%$ since May 1995) were left unchanged ("*crawling band*"). Due to the inflation differential, a real appreciation in CPI terms was registered in 1996 in relation to the basket of five currencies to which the zloty is pegged.

With effect from July 1, 1996, the *National Bank of Poland* (NBP) lowered its minimum reserve rate for sight deposits from 20 to 17%. According to the central bank, this move is a first preparatory measure for the planned liberalization of cross-border banking services, which will pit Polish banks against foreign competitors that are subject to far lower or no minimum reserve requirements. On July 15, the NBP reduced the discount rate from 23 to 22% and the lombard rate from 26 to 25%.

On July 11, 1996, Poland signed the *OECD accession agreement*, which makes it the third reforming country of Central and Eastern Europe to join the OECD. The membership became effective on November 22, 1996, when the ratified documents were deposited.

In the months before its accession to the OECD, Poland made great strides with regard to the liberalization of capital movements. Relevant legislation was passed in January and April 1996 (see Focus on Transition 1/1996 for details).

8 The import surcharge will be phased out and eliminated by January 1997.

9 Any assessment of Polish balance-of-payments data has to take into account that as of January 1, 1996, unclassified payment flows – basically cross-border trade between Poland and its neighbors (especially Germany) – have been recorded in the current account rather than as short-term flows in the capital account, as was the case until 1996.

As part of a government reorganization carried out at the end of September 1996, the privatization ministry was integrated into the newly established Treasury, an institution which is in charge of total state assets including privatization.

In mid-September 1996, the merger of four large state-owned *commercial banks* was initiated. The Warsaw-based Bank Pekao, Bank Depozytowo Kredytowy (Lublin), Pomorski Bank Kredytowy (Szczecin), and Powszechny Bank Gospodarczy (Lodz) were joined into a single group led by Bank Pekao. On October 8, the latter received 100% of the Polish state's shares in the three other institutions. Furthermore, two major Polish banks are scheduled for privatization in 1997.

2.4 Slovak Republic

Boasting real-term GDP growth rates of 7.4% in 1995 and 7.1% in the first half of 1996, Slovakia has taken the lead over the other reform countries. Real-term investment activity accelerated by 27%. Real wages have been rising virtually across the board. Domestic demand appears to have been the main motor of expansion in 1996, whereas the external position suffered a deterioration. Real GDP growth for 1996 is forecast to reach 6%.

The favorable business cycle had positive repercussions also on the labor market. The *rate of unemployment*, which had been around 13% at end-1995, contracted further in 1996, coming to approximately 12.2% at the end of September 1996.

Slovakia also posted considerable success in combating *inflation*. In 1995, inflation was slashed for the first time to less than 10%. In 1996 it receded further, with the year-on-year rate reaching 5.3% in October 1996. Inflation in 1996 is projected to be about 6.0% (annual average).

The *budget deficit* widened to more than SKK 6 billion in the first six months of 1996, which corresponds to 2.2% of GDP (analogous 1995 period: balanced budget). The estimate for 1996 as a whole provides for a shortfall of 5% of GDP.

Slovakia's *foreign trade* performance took a turn for the worse in the first eight months of 1996. In terms of U.S. dollars, exports practically stagnated, whereas imports augmented by roughly 24%. The *trade deficit* amounted to USD 1,160 million in the first eight months of 1996, which contrasts with a trade equilibrium the previous year. Over the same period, the *current account* turned from a surplus into a deficit of USD 957 million.

In the first quarter of 1996, *foreign direct investment* inflows slowed down as compared to the previous year and amounted to USD 25 million. Slovakia's total gross foreign debt amounts to USD 6.3 billion (end-September 1996). At the end of October 1996, the central bank's currency reserves totaled USD 3.6 billion, which cover 3.7 months of imports.

Since the Slovak Republic seeks to *join the OECD* in the first half of 1997, legislation on a *liberalization of capital transactions* is currently being prepared.

With liquidity abundant in the banking sector, the central bank took a number of *contractionary monetary policy measures* in July 1996. As of August 1, a minimum reserve rate of 9% has been applied uniformly to all commercial banks (previously, rates had varied between 3% and 9%). At the same time,

a provision was adopted that minimum reserves would bear interest at the rate of 1.5%. On July 17, 1996, the lombard rate was lifted from 13% to 15% and the *fluctuation band of the exchange rate was widened from $\pm 3\%$ to $\pm 5\%$.*

The *import surcharge* of 10% which Slovakia had introduced in March 1994 was lowered to 7.5% as of July 1, 1996, and is scheduled for reduction to 0% with effect from January 1, 1997 (no formal elimination is envisaged, however).

Voucher privatization, which was canceled in 1995 to concentrate instead on privatization by standard methods, has now been resumed in a modified form. The 3.3 million citizens who had wished to participate in the program received a government bond (nominal value: SKK 10,000) by way of compensation. In early August 1996, trading in these bonds began. Slovakia's citizens now have four options: a) to sell the bonds at the guaranteed price of SKK 7,500; b) to keep the bonds until maturity in five years; c) to exchange them for state property, or d) to use the bonds as a down payment for an apartment. Privatization has not been wrapped up yet, but will be continued with direct sales, the modality of which is not always transparent.

In the first half of 1996, the *private sector* accounted for 67% of industry, 83% of the construction sector, 84% of retail trade and 80% of transport. Some 80% of GDP derives from private sector activities.

On June 15, 1996, Slovakia's *banking sector* consisted of 24 commercial banks, 8 branches and 13 representative offices of foreign banks. At the beginning of 1996, Prime Minister Meciar announced the *privatization of Slovakia's four largest financial institutions*, in which the National Property Fund (FNM) holds major interests: Vseobecna uverova banka (VUB, FNM stake: 50.4%), the savings bank Slovenska sporitelna (97%), Investicna a rozvojova banka (IRB, 35.2%) and the insurance company Slovenska poistovna (50.6%). At the time, the sale of large stakes to major Slovak industrial enterprises was seen as the most likely method of privatization. In June 1996, Parliament passed a resolution postponing the privatization of the banking sector until end-March 1997.

2.5 Slovenia

After peaking in 1994, *economic growth* in Slovenia lost considerable steam in 1995 and in the first half of 1996. Factors causing this deceleration include flagging growth in Western Europe and the slow pace of structural reforms in Slovenia, above all with regard to privatization and the tax system. In the second quarter of 1996, economic activity in Slovenia picked up somewhat again, with the official forecast for 1996 predicting a GDP expansion of approximately 3% in real terms.

The official *unemployment rate* of 13.5% (end-August 1996), which is comparatively high, conveys a somewhat distorted picture, as a relatively large proportion of the labor force is employed in small and medium-sized enterprises, which are not covered by official statistics. Measured according to the ILO method, the jobless rate was just 7.3% (survey of May 1996).

While *inflation* had been successfully contained in 1995, a slight resurgence became noticeable in the first half of 1996, which, on the one

hand, may be a delayed effect of the nominal depreciation of the tolar in the second half of 1995, on the other hand may be traceable to the renewed relaxation of incomes policy in 1996. At the end of November 1996, the year-on-year inflation rate came to 8.6%. Inflation for the whole of 1996 is predicted to be about 10% (retail prices, annual average).

According to the official target scenario, the Slovene *budget* in 1996 will record a small deficit of about 0.6% of GDP. In the first half of 1996, the budget showed a surplus of SIT 24.8 billion. An important move in 1996 to promote entrepreneurial activity was the step-by-step reduction of employers' contributions to the social security system. However, due to the current problems in financing pension payments, Slovenia plans to pass legislation in 1997 for a comprehensive pension reform.

As in 1995, Slovenia's *external sector* recorded a rising trade shortfall in the first nine months of 1996 (trade deficit January-September 1996: USD 850 million), which – as opposed to previous years – was only partly compensated for by the surplus in the balance of services (especially tourism, construction and transport). The current account, which had posted a deficit for the first time in 1995, sharply deteriorated and the deficit amounted to roughly USD 200 million in the first three quarters of 1996.

As in the previous years, *foreign direct investment* remained at a low level. While FDI inflows had amounted to approximately USD 180 million in 1995, they shrank to only USD 40 million in the first seven months of 1996. The banking system's foreign exchange reserves remained relatively high in 1996, totaling around USD 4.2 billion at the end of September 1996, with the official reserves of the central bank accounting for approximately USD 2.3 billion.

The *managed float* exchange rate policy pursued since the introduction of the tolar in October 1991 was continued in 1996. After a period of nominal depreciation in the second half of 1995, the nominal exchange rate has been kept virtually stable in 1996, so that the inflation differential vis-à-vis the major trading partners resulted in a real-term appreciation.

Slovenia was the first successor state to ex-Yugoslavia to put its external debt relations on a completely new basis, paving the way for the country's unhindered access to international financial markets. As to former Yugoslavia's unallocated – i.e. not directly attributable – debt, Slovenia concluded an agreement in principle with the *Paris Club* in 1993 and has meanwhile signed a number of bilateral agreements with public creditors. The debt agreement concluded in mid-1995 with the London Club was *implemented* in June 1996, when Slovenia issued four series of bonds totaling USD 646 million and DEM 256 million in exchange for its 18% portion of ex-Yugoslavia's unallocated debt. 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.

Slovenian *privatization* is making only slow progress. More than 80% of the privatization plans submitted by enterprises have already been approved by the state privatization agency, but only half of them have actually been implemented. Of particular interest is the ownership structure of the newly privatized enterprises. As of May 1996, an average of 47% of the capital of

such companies was owned by their staff, 38% by investment funds, and 15% by small investors.

The restructuring of Slovenia's *banking industry* has also gotten off to a hesitant start. With 29 commercial banks operating, the banking sector continues to be too large in view of the comparatively low volume of business, although the number of institutions with a full commercial banking license has shrunk to 15. The rescue program initiated in 1993 for two major Slovene banks – Nova Ljubljanska Banka and Kreditna Banka Maribor – will be wrapped up in the course of 1997 at the earliest. On July 5, 1996, the Slovene central bank took measures to wind up Komerzialna Banka Triglav (KBT), which – after being temporarily closed on June 20, 1996, due to a cash shortage – could not be saved in the 15-day grace period. The market share of KBT had been 1.8%.

The most important and difficult challenge for the near future will be to wrap up the succession treaty with the other four successor states of ex-Yugoslavia. Negotiations to this effect are currently under way, with the division of assets being the main stumbling block.

S T U D I E S

European Monetary Union: Prospects for EU Member States and Selected Candidate Countries from Central and Eastern Europe

Peter Backé
and Isabella Lindner¹⁾

I Introduction

Establishing a European Monetary Union (EMU) and preparing the enlargement of the EU to the East are dominating the process of European integration at present. The aim of this study is to analyze these topics and to broaden the perspective by scrutinizing the interrelationship between EMU and selected Central and East European countries (CEECs).

The study starts by reviewing the current state of progress towards EMU. It then deals briefly with the question of which EU countries will most likely become members of the euro area right at the start of monetary union in 1999. The analysis focuses on the relationship between EU Member States participating in monetary union from the outset and nonparticipating EU countries and describes additional rules for budgetary policy after the start of monetary union (section 2). The study then turns to the implications of EU monetary union for the CEECs. In this analysis, we will concentrate on the Czech Republic, Hungary, Poland, Slovakia and Slovenia (CEEC-5), which has been the standard country focus for studies published in this periodical. Section 3 summarizes the headway made so far towards a future accession of Central and East European countries to the European Union, followed by a brief stocktaking of monetary cooperation between the EU and the CEECs to date. A scenario of the prospective principal directions of further enlargement is laid out in section 4. In the next two sections the study raises the question of what impact EMU has on the CEECs' EU accession prospects and what challenges for economic policymaking in the CEEC-5 result from the implementation of EMU. The main findings of the study are summarized in the concluding remarks (section 7).

2 The European Union and Its Progress towards Economic and Monetary Union

2.1 EMU Prospects for EU Member States

In the course of 1995 the process of monetary union gained momentum. At the European Council Meeting in December 1995 in Madrid, the EU Heads of State or Government decided on a detailed scenario on the changeover to the euro. The main points in this scenario are the following: As early as possible in 1998, probably in March or April, the EU Heads of State or Government shall decide which Member States will introduce the euro²⁾ on January 1, 1999. After this decision, the European Central Bank (ECB) and the European System of Central Banks (ESCB)³⁾ will be set up. On January 1, 1999, European Monetary Union will start. The EU economic and finance ministers (ECOFIN Council) will then decide on the irrevocably fixed conversion rates between the euro and the participating currencies. At that date, the European Central Bank will start its single monetary policy for the euro area. In the following three years between 1999 and 2002, the economies of the euro area (e.g. financial institutions, industry, small and medium-sized businesses, consumers and the public administration) will prepare for the changeover to the euro. In this period, the euro will exist only as a unit of account. The economies of the euro area will continue to use

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- 2) Euro is the name of the future European single currency. One euro will be divided into one hundred cents.
- 3) The ESCB comprises the ECB and the national central banks of all EU Member States. The EU national central banks are also the ECB's shareholders.

their national currencies as legal tender, which are different expressions of the euro. Euro banknotes and coins will be issued on January 1, 2002, at the latest. The national currencies of the euro area will lose their status as legal tender in their respective countries on July 1, 2002, at the latest. European Monetary Union will then be completed.

In the run-up to monetary union one question is becoming more and more important: Which countries will participate in Stage Three of EMU⁴) right at the beginning in 1999? According to Article 109 j of the EC Treaty⁵), this decision will be based on a progress report by the European Commission and the European Monetary Institute (EMI)⁶). Member States have to fulfill a high degree of sustainable economic convergence measured by low inflation rates, sound public finances, low long-term interest rates and stable exchange rates (for the exact wording of the EC Treaty on economic convergence criteria see Annex). The report also examines the legal compatibility between a Member State's national legislation, including the statutes of its national central bank, and the provisions of the EC Treaty. Crucial points for legal convergence are certainly central bank independence and prohibition of government financing by central banks. Based on these reports on legal and economic convergence and on a recommendation by the ECOFIN Council, the EU Heads of State or Government shall decide by qualified majority which countries will introduce the euro in 1999.

What are the prospects of EU Member States fulfilling the convergence requirements of the EC Treaty in time for the start of Stage Three of monetary union in 1999? In November 1996 the EMI published, for the first time, a progress report on convergence as laid down in the EC Treaty. It states very clearly "that at present a majority of Member States do not fulfil the necessary conditions for the adoption of a single currency", but "this year's procedure can by no means pre-empt the assessment to be made in early 1998", when a further report under Article 109 j will have to be drawn up. The state of convergence (see Table 1) is such that most Member States have achieved a high degree of price and exchange rate stability and a reduction in long-term interest rates. By contrast, progress in fiscal consolidation has generally been too slow. However, most Member States have made considerable efforts in reducing public debt and deficits. Clearly, the decision of EU Heads of State or Government on membership in Stage Three of monetary union will hinge upon the fiscal criteria. The EC Treaty gives a certain leeway (see Article 104 c [2] in Annex) for the evaluation of the fiscal criteria. EU Heads of State or Government will take into consideration the issue of sustainability of budget consolidation; a one-off reduction in debt and deficit achieved for example by accounting methods will not suffice. Attention will be paid to the structural aspects of budgetary consolidation.

Aside from the decision by politicians, financial market agents have formed their own opinion, which can be gleaned from long-term interest rate differentials. These long-term interest rate differentials have become very small between "hard core" EU countries. The markets seem to expect that six countries, i.e. Germany, France, the Benelux countries and Austria, will form EMU in 1999. Finland and Ireland – the latter has had remarkable success in consolidating its budget – stand a good chances of joining EMU

4 *European Economic and Monetary Union is to be completed in three stages: Stage One started in July 1990 and was marked by complete capital liberalization in the Community, the completion of the single market in 1992 and an ever closer coordination of economic policies by Member States. Stage Two started on January 1, 1994, with the foundation of the European Monetary Institute (EMI) in Frankfurt. Member States reinforce their efforts to achieve economic convergence in order to be able to introduce the single currency. Stage Three will begin on January 1, 1999, as decided by the European Council in Madrid in December 1995.*

5 *In the following, all articles mentioned refer to the EC Treaty.*

6 *The EMI started its operations in 1994 and is the forerunner of the future ECB. The EMI plays an important role in the preparation of EMU.*

Table 1

		Economic Indicators and the Convergence Criteria of European Monetary Union					Membership in the Exchange Rate Mechanism (ERM) of the EMS as of Nov. 25, 1996
		Inflation ¹⁾	Long-term interest rate ²⁾	General government lending (+) or borrowing (-) (deficit) ³⁾	General government gross debt ⁴⁾		
Belgium	1995	*** 1.4	*** 7.5	- 4.1	133.7	yes	
	1996 ⁴⁾	1.6	6.7	-3.3	130.6		
Denmark	1995	2.3	8.3	• -1.6	71.9 ⁵⁾	yes	
	1996 ⁴⁾	2.2	7.4	• -1.4	70.2		
Germany	1995	1.5	6.9	-3.5	• 58.1	yes	
	1996 ⁴⁾	*** 1.3	*** 6.3	-4.0	60.8		
Greece	1995	9.0	17.4	-9.1	111.8	no	
	1996 ⁴⁾	8.4	15.1	-7.9	110.6		
Spain	1995	4.7	11.3	-6.6	65.7	yes	
	1996 ⁴⁾	3.8	9.5	-4.4	67.8		
France	1995	1.7	7.5	-4.8	• 52.8	yes	
	1996 ⁴⁾	2.1	6.6	-4.0	• 56.4		
Ireland	1995	2.4	8.3	• -2.0	81.6 ⁵⁾	yes	
	1996	2.1	7.5	• -1.6	74.7 ⁵⁾		
Italy	1995	5.4	12.2	-7.1	124.9	yes	
	1996 ⁴⁾	4.7	10.3	-6.6	123.4		
Luxembourg	1995	1.9	7.6	• 1.5	• 6.0	yes	
	1996 ⁴⁾	1.3	7.0	• 0.9	• 7.8		
Netherlands	1995	** 1.1	** 6.9	-4.0	79.7	yes	
	1996 ⁴⁾	*** 1.2	*** 6.3	• -2.6	78.7		
Austria	1995	2.0	7.1	-5.9	69.0	yes	
	1996 ⁴⁾	1.7	6.5	-4.3	71.7		
Portugal	1995	3.8	11.5	-5.1	71.7	yes	
	1996 ⁴⁾	3.0	9.4	-4.0	71.1		
Finland	1995	* 1.0	* 8.8	-5.2	• 59.2	yes	
	1996 ⁴⁾	* 0.9	* 7.4	-3.3	61.3		
Sweden	1995	2.9	10.2	-8.1	78.7	no	
	1996 ⁴⁾	1.6	8.5	-3.9	78.1		
United Kingdom	1995	3.1	8.3	- 5.8	• 54.1	no	
	1996 ⁴⁾	3.0	8.0	-4.6	• 56.3		
Reference value	1995	2.7	9.7	-3	60 ⁶⁾		
	1996	2.6	8.7				

Source: EMI, Convergence Report 1996.

*, **, *** = first-, second- and third-best performers in terms of price stability.

• = public deficit not exceeding 3% of GDP; public debt not exceeding 60% of GDP.

¹⁾ Annual rates.

²⁾ Annual average.

³⁾ As a percentage of GDP.

⁴⁾ Twelve-month period ending September 1996 for inflation and long-term interest rate; general government lending/borrowing and general government gross debt for 1996 are European Commission autumn 1996 estimates.

⁵⁾ In 1994, 1995 and 1996 Ireland was not the subject of an EU Council Decision under Article 104 c (b) of the Treaty that an excessive deficit exists. In 1996 this was also the case for Denmark.

⁶⁾ Respect of normal fluctuation margins provided for by the ERM of the EMS without severe tensions for at least the last two years before the examination of convergence to enter Stage Three of EMU.

in the first wave as well. A second wave of countries might enter Stage Three of EMU even before euro banknotes and coins are introduced in 2002. The United Kingdom and Denmark both have an "opt-out clause", which confers upon their national parliaments the separate right to decide upon the introduction of the euro in their countries, whereas all other countries are bound by the EC Treaty to introduce the euro once they fulfill the convergence criteria.

A forecast upturn in economic activity in the European Union coupled with the political consensus reached at the European Councils in Madrid (December 1995) and Florence (June 1996) means that Stage Three of EMU will begin on January 1, 1999. And there is no doubt that the euro will be a strong and stable currency. The euro will be safeguarded by the European Central Bank, whose primary objective is to maintain price stability in the euro area. Moreover, the strict adherence to economic convergence guarantees that only countries with a stable economy can enter Stage Three of EMU.

Since the milestone summit in December 1995, EU Member States have proceeded with intense preparatory work for monetary union at all levels. Inter alia, the EMI is at present finalizing steps in the definition of the regulatory, organizational and logistical framework necessary for the ESCB to perform its tasks in Stage Three of EMU. In parallel, EU countries are discussing the exchange rate relationship between countries of the euro zone and the other EU countries, the strengthening and deepening of the coordination of budgetary policies of Member States, and a scenario for Member States joining the euro area after January 1, 1999.

2.2 Scenario for Member States Joining the Euro Area after January 1999

The European Council in Madrid in December 1995 requested that the ECOFIN Council together with the European Commission and the European Monetary Institute study the range of issues raised by the fact that some Member States might not participate in the euro area initially.

Before the decision is taken which countries will participate in Stage Three of EMU, the European Union has to make sure that the two-speed approach in monetary integration does not break up the Union as such. In order to ensure that monetary union gives momentum to European integration and that nonparticipating Member States agree that some Member States go ahead with the introduction of a single currency, the Union will have to set up a scenario for Member States joining the euro area after January 1999. The EC Treaty refers to these countries as "countries with a derogation" until they enter the euro zone.⁷⁾

The scenario looks on issues important to the lifting of a derogation of a Member State. Member States with a derogation conduct an independent monetary policy, they are committed to avoiding excessive deficits, their central bank is part of the ESCB; however, their central bank governors are only members of the General Council⁸⁾ of the ECB.

The procedure for lifting a derogation is laid down in Article 109 k (2). At least once every two years, or at the request of a Member State with a derogation, the European Commission and the ECB shall report to the ECOFIN Council on the progress made in economic and legal convergence

⁷ In the discussion, several other names have been coined for these Member States, most prominently "second-wave" countries or "Pre-Ins". In turn, the countries participating in the euro zone from the outset are often referred to as "Ins" or "first-wave" countries. The EC Treaty term "countries without a derogation" relates to euro zone countries no matter whether they join Stage Three in 1999 or later.

⁸ In contrast to the other ECB decision-making bodies – the Governing Council and the Executive Board –, the General Council comprises the President and Vice-President of the ECB and the Governors of the national banks of all EU countries. Among other tasks, it contributes to the preparations necessary for a Member State with a derogation to enter Stage Three of EMU.

by Member States with a derogation. Second-wave countries may enter Stage Three of EMU one by one.

The principle of equal treatment will ensure that, when the reports examine the degree of sustainable convergence of Member States with a derogation, the criteria are applied in the same way as they were to first-wave countries. However, some of these criteria will have to be adapted to the existence of a euro area. It is probable that the reference values for price stability and long-term interest rates will have to be adjusted (e.g. the euro-area-wide inflation rate plus 1.5 percentage points could be chosen as a reference value for price stability). The fulfillment of the criterion of stable exchange rates will depend on the participation in the exchange rate mechanism (ERM) of the European Monetary System II, the EMS II (see below). The criteria of sound public finances will remain unchanged.

When it is decided to lift a derogation, Article 109 k (2) implies that the abrogation becomes effective immediately. However, the technical and organisational preparations to enter Stage Three of EMU will take some time, especially in the financial sector. Probably the second-wave countries will follow as much as possible the scenario first-wave countries adhered to when introducing the euro.

As soon as the derogation is lifted, the governor of the second-wave national central bank becomes a member of the ECB Governing Council and the national central bank starts executing the decisions of the ECB Governing Council regarding monetary policy.

This scenario for second-wave countries, which will have to be discussed in further detail, is complemented by an exchange rate arrangement which will replace the present European Monetary System (EMS)⁹ once the euro area comes into existence. Close monetary policy coordination in the form of an EMS II between the euro area and the "Pre-Ins" is a vital precondition for the ultimate completion of monetary union in Europe. Also, in order to ensure the efficient functioning and development of the single market, it is important that exchange rate misalignments between the euro and non-participating EU currencies be avoided.

The lasting convergence of economic fundamentals is a prerequisite for sustainable exchange rate stability. Exchange rate policy cooperation can therefore not be a substitute for stability-oriented domestic policies with a view to entering monetary union.

EMS II may provide a reference for the conduct of sound economic policies and assist "Pre-Ins" whose currency has come under pressure to combine policy responses, such as interest rate measures, with coordinated exchange rate intervention.

Membership in EMS II and its Exchange Rate Mechanism would be voluntary. Nevertheless, "Pre-Ins" can be expected to join the mechanism once they have achieved a satisfactory degree of economic convergence in order to fulfill the convergence criterion of a stable exchange rate.

The setup of EMS II will follow five principles:

First, the euro will be the anchor of the exchange rate mechanism of EMS II. The mechanism would be based on central rates defined vis-à-vis the euro. A standard fluctuation band would be established around the central

⁹ *The European Monetary System was set up in 1979 and is an exchange rate system with relatively fixed but adjustable exchange rates. The aim of the EMS is to ensure a zone of monetary stability within the European Union. At the center of the EMS is the Exchange Rate Mechanism (ERM).*

rates of these currencies. The standard fluctuation band can be expected to be somewhere in the region of the current standard fluctuation bands of the present ERM, i.e. $\pm 15\%$.

Second, the statutory requirements for the European Central Bank to maintain price stability would need to be safeguarded. This implies that the ECB can interrupt exchange rate interventions if it comes to the conclusion that the stability of the euro would be endangered by continued interventions.

Third, a realignment of central rates would be possible and would have to be conducted in time to avoid significant exchange rate misalignments between the euro and the other currencies.

Fourth, the system has to be sufficiently flexible to accommodate different degrees of economic convergence and strategies of monetary policy in "pre-in" countries.

Fifth, setting up an exchange rate mechanism of EMS II will allow the European Union to continue with the principle of equal treatment of all Member States with respect to the fulfillment of the convergence criteria, including the exchange rate criterion.

The concrete setup of EMS II is presently under discussion.

2.3 Budgetary Policy in Stage Three of EMU

Sound public finances will be crucial for the overall success of EMU. In November 1995, the German government therefore presented a proposal on a "stability pact" to its European partners. The aim of the stability pact is to make sure that participating Member States will continue to adhere to the criteria of sound public finances once EMU is established in order to ensure monetary stability in the euro area.

The stability pact, which will take the legal form of a Council Regulation, is intended to consist of two main elements, namely stability programs and strengthened excessive deficit procedures both to prevent and dissuade excessive deficits for Member States without a derogation, i.e. those participating in Stage Three of EMU.

It has been proposed that participating Member States prepare annual stability programs that contain medium-term objectives for the respective governments' deficits and debt ratios and describe budgetary measures being taken to achieve such objectives. In this early-warning system, trends in public deficits and debts can be evaluated by the ECOFIN Council and correcting measures taken in time. Departures from the deficit objectives set in the stability programs would prompt a warning from the European Commission. This could lead to Council Recommendations to the Member States concerned to take the necessary steps to avoid breaching the deficit ceiling of 3% of GDP. Excessive deficit procedures will be accelerated, i.e. there will be a time limit for the steps taken to impose sanctions on a Member State. Should Member States fail to implement countervailing measures, fines could be imposed. This should have a deterrent effect on Member States without a derogation and put pressure on them to avoid excessive deficits. National sovereignty on budget policy will remain intact at all times.

Budgetary policy in Stage Three of EMU is under discussion at present; decisions can be expected in the first half of 1997.

Convergence efforts by the "Pre-Ins" will have to be reinforced in EMU in order to ensure their full participation in the euro area at the earliest possible date. The submission of convergence programs should become a formal obligation for these EU Member States in parallel with the obligatory stability programs proposed for euro zone countries. The convergence programs would include objectives for the inflation rates, public finances and clearly defined multi-annual adjustment paths towards these objectives. Convergence programs would be updated each year and the time horizon would focus on the medium term in order to facilitate the conversion of a convergence program into a stability program.

The implementation of the convergence strategy would be monitored on a regular basis at the Community level. Slippages from targets would be identified and the ECOFIN Council would make a recommendation, so that correcting steps could be taken in time for the update of the program.

"Pre-Ins" would submit to the excessive deficit procedure as laid down by the EC Treaty (Article 104 c). The European Commission will monitor the development of the budgetary situation and of the stock of government debt and examine compliance with budgetary discipline on the basis of two criteria. First, it will monitor whether the ratio of the planned or actual government deficit to GDP exceeds the reference value of 3%, unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value, or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value. Second, the European Commission will examine whether the ratio of government debt to GDP exceeds the reference value of 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

If a Member State does not fulfill the requirements under one or both of these criteria, the European Commission is to prepare a report. On the basis of this report the ECOFIN Council will decide whether an excessive deficit exists and will make a recommendation to the Member State concerned with a view to bringing the excessive deficit situation to an end.¹⁰⁾

3 The EU and the Countries of Central and Eastern Europe

3.1 Preparing for an Eastern Enlargement of the European Union

The relations between the Community and the CEECs began to develop in the late 1980s, after a joint declaration between the EC and the CMEA (June 1988), and intensified significantly after the secular changes in Central and Eastern Europe at the end of 1989. Initially, the EC concluded trade and cooperation agreements with most CEECs, thereby removing import quotas specifically applying to centrally planned economies as well as a few nonspecific restrictions. In the fall of 1989, the technical assistance program PHARE was set up initially for Poland and Hungary and, shortly thereafter, extended to the other CEECs. In January 1990, the Community granted GSP status¹¹⁾ to Hungary and Poland, one year later also to Czechoslovakia.

¹⁰ If the respective country does not take effective action in response to these suggestions within a preset period of time, the Council has only one sanction it can inflict on excessive-deficit countries with a derogation, namely publishing its recommendations. This decision must be taken with a weighted two-thirds majority.

¹¹ Under the GSP (General System of Preferences) of GATT, unilateral preferential tariffs are granted to third countries.

Towards the end of 1990, the Community started association negotiations with these three countries, which were successfully concluded a year later.¹²⁾ The centerpiece of the Association Agreements is a full liberalization of trade over a ten-year period, except for agricultural products for which market access remains restricted. The freeing of trade with industrial goods has been asymmetric, with the EC opening up faster than the CEECs. Still, the Community has enjoyed fairly lengthy (though subsequently somewhat shortened) transition periods for several groups of sensitive products. Also, the EC has retained an array of instruments to control trade flows, in particular anti-dumping and safeguard procedures. In subsequent years, the EU concluded similar Association Agreements with Romania and Bulgaria, the three Baltic states and, most recently, in June 1996, with Slovenia.¹³⁾

At the European Council meeting in Copenhagen in June 1993, the EC declared, for the first time, its readiness to accept the associated CEECs as new members, on condition that they meet a set of political and economic preconditions, namely “that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union... [and] the candidate’s ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.” In addition the Council stated that “[t]he Union’s capacity to absorb new members, while maintaining the momentum of European integration, is also an important consideration in the general interest of both the Union and the candidate countries.”

Hungary and Poland handed in their formal EU membership applications in April 1994, shortly after their Association Agreements entered into force. All the other associated CEECs followed suit until mid-1996, the last one being Slovenia.

In December 1994, the European Council in Essen approved a preaccession strategy for associated countries from Central and Eastern Europe. The mainstays of this strategy are the Association Agreements, a structured relationship which provides a frame for a policy dialogue on a multilateral basis, the PHARE program in a modified form¹⁴⁾ and a White Paper on the Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union to be worked out by the European Commission. The White Paper was presented in May 1995 and endorsed by the European Council in Cannes in June 1995.

The European Council in Madrid in December 1995 stated that EU “[e]nlargement is both a political necessity and a historic opportunity for Europe. It will ensure the stability and security of the continent and will thus offer both the applicant States and the current members of the Union new prospects for economic growth and general well-being.” The Council confirmed the Copenhagen accession criteria and referred to the need “to create the conditions for the gradual, harmonious integration of [the candidate countries], particularly through the development of the market economy, the adjustment of their administrative structures, and the creation of a stable economic and monetary environment.”

¹² After the breakup of Czechoslovakia at the end of 1992, new Association Agreements were negotiated and concluded with the Czech Republic and Slovakia in 1993.

¹³ Slovenia had had an upgraded trade and cooperation agreement with the Community since 1993.

¹⁴ From 1993 onward, PHARE has been adapted with a focus on medium-term (as opposed to the former one-year) programming, the inclusion of some financing for infrastructural projects and increased overall funding.

In order to prepare the accession talks with the CEECs, the Madrid Council assigned four tasks to the European Commission, namely firstly to draw up the opinions on the membership applications of the CEECs, secondly to come forward with a composite paper covering the horizontal issues of enlargement, thirdly to prepare a study on the impact of enlargement on EU policies, in particular with regard to agricultural and structural policies, and fourthly to put together a Commission communication on the future financial framework of the Union for the period after 1999 (when the current framework expires), having regard to the prospect of enlargement. All these documents shall be ready as soon as possible after the end of the current Intergovernmental Conference (IGC), which has the task to review the Maastricht Treaty and is scheduled to be concluded in mid-1997.

Finally, the Council expressed its "hope that the preliminary stage of [accession] negotiations [with countries from Central and Eastern Europe] will coincide with the start of the negotiations with Cyprus and Malta," which are to commence six months after the end of the IGC.¹⁵⁾

In line with the calls of the Madrid summit, the European Commission has begun to prepare opinions of the membership applications of the associated CEECs. To this end, it put together a detailed questionnaire and handed it over to the ten associated CEECs in April 1996. The CEECs' answers were received in July and are currently being sorted out and evaluated by the European Commission. This process should be finalized by the turn of the year. Subsequently, the European Commission will draft the opinions which it intends to have ready by the third quarter of 1997, together with the composite paper, the impact study and the financial framework communication.

3.2 Monetary Cooperation Between the EU and the CEECs to Date

Integration between the EU and the CEECs to date has been primarily a market rather than a policy integration.¹⁶⁾ This is particularly true for monetary policy: The Association Agreements do not contain any provisions on monetary policy cooperation. Nor does the structured dialogue incorporate a continuous monetary policy dialogue. In July 1994, the European Commission proposed that the associated CEECs adopt macroeconomic surveillance procedures along the lines of the corresponding multilateral procedures within the EU (Article 103) and that the Union participate in these mechanisms on a regular basis.¹⁷⁾ This initiative, which clearly would have had a monetary dimension, has apparently not gotten off the ground. More recently though, there has been a certain trend towards touching upon selected monetary (integration) matters at a few instances, although often in a broad context and fairly briefly. With individual countries, monetary issues have at times been raised at a sub-committee level within the institutional framework of the Association Agreements. On a multilateral plane, the EU finance ministers and their colleagues from the CEECs have discussed matters with a monetary dimension, e.g. the issue of macroeconomic convergence, which was covered at a meeting in March 1996.

A more intense dialogue on monetary matters is bound to come about with the preparation of the European Commission's opinions on the

¹⁵ *The perspectives of an accession of Malta and Cyprus to the EU have become fairly opaque, though. In November 1996, Malta's newly inaugurated government publicly stated that the country is no longer interested in joining the EU. For Cyprus, progress into the direction of membership requires tangible headway towards a settlement of the constitutional and territorial problems that beset the island.*

¹⁶ See also Bofinger (1995).

¹⁷ *Kommission der Europäischen Gemeinschaften (1994).*

membership requests of the associated CEECs. The questionnaires, which reportedly cover in considerable detail the EMU-related provisions of the EC Treaty and the detailed answers of the CEECs, constitute a starting point in this respect.

Against the backdrop of actual monetary cooperation so far between the EU and the associated CEECs, it is no wonder that academic proposals for establishing an institutionalized linkup between the EMS and the CEECs' national currencies or even an early EMS membership have not gained practical relevance.¹⁸) It should be added that these suggestions have not found undivided approval among economists analyzing the transition process. The opponents have argued that such steps could damage the quality of the EMS institutions and, in particular, have an inflationary impact on EU currencies.¹⁹)

It is interesting to note that even the issue of an ECU peg for CEECs has not had much impact on the exchange rate arrangements in Central and East European countries, although all countries under review, with the exception of Slovenia, have opted for basket-based pegging – despite a fairly supportive discussion of the issue in the literature.²⁰) All four peg countries discussed here opted in 1990/91 for baskets which contain a share of EU currencies on the order of 50% or more, while the U.S. dollar has made up all or most of the rest (30 to 50%). However, Hungary has been the only one of the four countries – and in fact the sole transition economy – to incorporate the ECU into its currency basket, though only temporarily. The ECU had been a basket currency in the periods 1991 to 1993 and 1994 to 1996 with a 50 and 70% share respectively, but as of January 1, 1997, it will be replaced by the Deutsche mark (as already in 1993).²¹) Czechoslovakia opted in late 1990 for a basket containing a 62% share of EC currencies and the schilling. Its successor states turned to a DEM-USD peg in 1993/94, with the DEM share roughly corresponding to the former share of all EU currencies and the schilling. Poland switched from a USD peg in May 1991 to a basket, half of which consists of EU currencies (predominantly DEM).²²)

4 A Scenario for Future Enlargement-Related Developments

Both processes – the move towards EMU and, even more so, progress towards Eastern enlargement – reach out into a more or less distant future. Therefore, any analysis of the interplay between the two processes must be based on assumptions about the likely developments in both areas. The following analysis is based on a scenario which is both optimistic and realistic. While acknowledging the future risks, it is assumed that decision-makers will be able to successfully cope with the challenges ahead. The main assumptions are:

First, *EMU will be implemented as envisaged*: Stage Three of monetary union will start in 1999 with a group of core countries and the euro area will be a zone of monetary stability.

Second, *reforms within the EU* in the coming years will be *sufficient* to make the Union ready for enlargement. In particular, the currently ongoing IGC will be concluded in time – or at least during the second half of 1997 – and it will

18 These far-reaching proposals went alongside even more radical suggestions like adopting an ECU-based currency board managed by a central bank from an EU country or replacing the national currencies of the CEECs by the ECU (see Schmiiedling, 1992; Frankel and Wyplosz, 1995).

19 See Bofinger (1991), Portes (1994).

20 See e.g. Bofinger (1991), who advises the CEECs to choose a fixed exchange rate system and opt for the ECU as an anchor currency. He argues that an ECU peg would be appropriate, as the ECU is a good proxy for trade patterns and EU inflation has been fairly low and stable over time. See also Davenport (1992).

21 In late 1991, the country switched from a trade-weighted multi-currency basket to a basket containing a 50% ECU and a 50% USD share. By this, Hungary wanted to underline its quest for full integration into the Community at the time it signed its Association Agreement. In the aftermath of the August 1993 crisis of the EMS, the ECU was replaced by the Deutsche mark. The ECU was dropped due to the "technical difficulties in following its movements" and the Deutsche mark was picked given the increasing role it played and currencies pegged to it in Hungary's international economic relations. In May 1994, the ECU was reintroduced into the basket with a 70% share, while the U.S. dollar weight was reduced to 30%. The reasons for returning to the ECU were economic and political. Due to the strength of the Deutsche mark, the 1993 basket had carried an unwanted tendency of appreciating the forint in real terms, and the ECU, meanwhile stabilized, had again become a viable alternative. The large weight given to the ECU reflected changing trade patterns. Politically, the ECU was again perceived to become capable of fulfilling the role of a future

achieve a critical mass of institutional reform in order to make sure that decision-making will be sufficiently efficient within a Community of 20-plus member countries. Also, the Union will agree in time upon a new financial arrangement for the years after 1999, based on a further reformed Common Agricultural Policy (CAP) and on an adjusted set of rules for structural policies, thereby making room to finance a first phase of Eastern enlargement. While the outlook of most analysts on institutional reform tends to be cautiously optimistic (despite the current slow pace of the IGC), the cost issue is often seen as an insurmountable stumbling block for enlargement in the foreseeable future. Recent estimates, however, suggest that the budgetary cost of an EU enlargement by the CEEC-5 will be substantially lower than suggested by earlier calculations, namely in the area of ECU 15 to 20 billion per year.²³) Notwithstanding the substantial uncertainties persisting with respect to quantifying the budgetary implications of enlargement, this order of magnitude seems to be manageable, especially against the backdrop of the size of the EU's GDP. Furthermore, it should not be overlooked that the budgetary cost issue is only one variable within a larger economic cost-benefit calculation which itself is only one component of the overall enlargement equation including also political considerations. It is therefore not purposeful to narrowly focus on budgetary costs when assessing enlargement prospects.

Third, the *CEEC-5 will continue their stability- and reform-oriented policies*. This assumption is supported by the CEEC-5's overall performance so far and by the fact that commitment in general remains strong to continue sound macroeconomic policies and structural reforms. Still, not in all five countries are policy pledges always fully reflected in comprehensive structural reform programs and in a dynamic implementation process. Wherever this is the case, a deepening of reforms is indispensable. Here, we assume that the necessary policy actions will be taken in due course.

Fourth, *Eastern enlargement will take place in phases, in line with the political and economic merits of the candidate countries*. A *first wave* is assumed to occur in 2002 or shortly thereafter. This time horizon implies that the opinions of the European Commission on the membership applications from the CEECs will be ready, as intended, shortly after the end of the IGC and that the European Council will approve the start of accession talks in late 1997 or early 1998. It further implies a concentrated negotiation effort in subsequent years, a conclusion of the negotiations at the turn of the decade and a fairly short ratification period for the accession treaties. The daunting task of the negotiators could be significantly facilitated if the membership candidates developed comprehensive national strategies to prepare for membership. With respect to the approximation of laws, such strategies should have a specific focus on identifying and tackling problem areas with respect to taking over the obligations of the *acquis communautaire*. In the macroeconomic realm, these strategies should be geared to sustained fiscal and monetary discipline. On the EU side, it would be helpful if the preaccession strategy were further broadened in the fields of trade, infrastructural investment and agriculture. In trade, this could mean opening the EU market beyond the concessions already granted and renouncing the

common European currency. In July 1996, Hungary decided to once more replace the ECU with the Deutsche mark as of January 1, 1997. According to the National Bank, the change is based on technical grounds, namely the cumbersome and time-consuming procedure of the ECU fixing, while the government argues that the new currency basket will be "more market-oriented" than the one in force since 1994.

22 For the current composition of the baskets see Table 3. For details of the developments since the beginning of the transformation see Radzyner and Riesinger (1996).

23 See e.g. Breuss (1995) or, in a similar vein, Inotai (1995). Interestingly, Baldwin, who came out in 1994 with costs of approximately ECU 60 billion per year in the case of an EU accession of Hungary, Poland, the Czech Republic and Slovakia, has recently revised his cost estimate to ECU 20 billion per year.

future application of instruments to control trade flows (especially anti-dumping and safeguard procedures), self-evidently in concurrence with the full acceptance of EU competition policy and state aid control standards by the membership candidates. Infrastructural investment in the candidate countries could be stepped up by turning PHARE into a structural-fund-type support instrument and by progress including the CEECs into Trans-European Network projects. Support for adjustment in agriculture could take the form of the proposed agricultural development fund for the CEECs²⁴) as a first step for subsequently phasing the CEECs in to the CAP.

The concentration of this study on the CEEC-5 (resulting from the standard country focus for studies published in this periodical) does not necessarily imply that a first wave of Eastern enlargement will embrace all of these countries under any circumstances. Nor do we a priori exclude that other associated countries might qualify for an early EU accession. Still, from today's perspective, the five countries under review here undoubtedly belong to the most likely candidates for a first wave of Eastern enlargement.²⁵)

Finally, the *CEEC-5 will join EMU only some years after having acceded to the European Union*, which means that the countries under review will be "countries with a derogation" for a while. Also, the CEEC-5 will *not necessarily enter monetary union as a group*; different speeds of convergence are well conceivable.²⁶)

There are several reasons why an entry into EMU simultaneously with EU accession is unlikely. First, despite all prospective progress in the macroeconomic realm, it is questionable whether any of the CEEC-5 will meet all the Maastricht convergence criteria for joining EMU in 2002, even though some of the CEEC-5 have apparently made it a top priority to meet these criteria. After all, this would imply that the year 2000 is the reference year for the fulfillment of the inflation, interest rate and fiscal criteria.

In addition, there is a legal problem with the convergence criterion relating to exchange rate stability, which requires two years of participation in the ERM (normal fluctuation margins) of the EMS without initiating a devaluation. Although the EC Treaty is clear in that this means formal membership in the Exchange Rate Mechanism (Article 109 j [1] indent 4), some Member States (namely the UK and Sweden) hold the view that actual exchange rate stability is sufficient to fulfill this criterion. Still, one can expect that, according to the EC Treaty, formal ERM membership will be required. In the academic discussion, a participation of selected CEECs in the ERM prior to EU accession has been proposed.²⁷) However, it is questionable whether such a proposal is realistic. The EU has traditionally not been very open for formally including nonmembers – also EU candidate countries – into its exchange rate arrangements.²⁸) It remains to be seen whether the EU takes a different stance if the issue of an early ERM II membership for the candidate countries comes up.

Finally, practical and technical reasons may turn out to constitute additional obstacles to a simultaneous joining of the EU and EMU. National central banks will have to execute from day one of their countries' membership in EMU all monetary and exchange rate policy decisions of the

24 Such a proposal was mooted by the EU Commissioner for Agriculture in August 1996.

25 In this context, three points deserve attention. First, most of the other CEECs with Association Agreements are, by and large, in a less favorable position with respect to meeting EU accession criteria than the CEEC-5. Second, an accession of all CEECs with Association Agreements as well as of other actual or potential candidate countries to the EU would mean that the Union would turn into a club of 30-odd Member States. In this case, the EU would clearly need a complete overhaul of its institutions and procedures in order to remain functional. It is not at all easy to see the political will for such a radical reform. Third, experience from earlier enlargements shows that both the Commission and the Council can only cope with a limited number of accession negotiations at a time. Clearly, the Union cannot negotiate in substance with twelve applicant countries simultaneously.

26 It is still too early to thoroughly discuss most issues related to the timing and the implications of the CEEC-5 joining Stage Three of monetary union and therefore this paper refrains from dealing with these questions in detail. Nevertheless, from today's view, the perspective of acceding to the euro zone may well be attractive for the CEEC-5, as it would further improve credibility and rid them of monetary management problems (e.g. related to capital inflows). In addition, economic benefits could be disproportionately high in some respects, especially as regards transaction costs and the interest rate levels for foreign debt (see Bofinger, 1996, Inotai and Palánkai, 1994).

27 Bofinger (1996).

28 See e.g. Austrian initiatives for an associated EMS membership in the late 1980s and early 1990s, which did not bear fruit.

ECB. This would imply that the CEEC-5 central banks would have to start the necessary comprehensive preparations very early in the process, namely in all likelihood even before the end of EU accession talks and thus presumably without clarity as regards their countries' EMU perspectives. In some cases, it may also be questionable whether the administrations and the financial sectors in these countries will be able to prepare and fully implement the introduction of the euro (in cash) within a timespan which will be at most three years and which will coincide with the initial phase of membership in the European Union and all the challenges resulting from it.

Based on these assumptions, we will address two main issues.

- Does EMU have a positive or negative impact on the EU accession prospects of the CEEC-5?
- What are the implications of EMU for the economic policies of the CEEC-5 and their preparations for EU membership in the coming years?

5 The Impact of EMU on the Accession Prospects of the CEEC-5

Looking at the impact of EMU on the accession prospects of the CEECs means posing the question of whether there is a conflict between a deepening of monetary integration within the EU and a future widening of the European Union to the East. In this context, technical, financial and adjustment issues have to be considered.

In analyzing *technical-procedural aspects*, one can ask whether the EMU implementation schedule will come into conflict with the enlargement timetable and thus lead to a slowdown of the enlargement process. Clearly, the European Union's agenda for the rest of the decade is a busy one. Nevertheless, a comparative look at the schedules for EMU and for enlargement shows that there should be no conflict between both processes in terms of timing. Accession talks will presumably be opened in early 1998 and will gain momentum in the second half of 1998. At this time, the preparations for Stage Three of monetary union will already be at a very advanced stage. After the beginning of Stage Three, EMU-related activities will most likely not preoccupy the EU machinery to an extent which could have a negative impact on the speed of accession talks with the CEEC-5. Moreover, it should not be overlooked that the main workload in the monetary sphere will be carried by the ESCB, while the brunt of accession negotiations will fall on the European Commission.

A second issue relates to the question of whether EMU will lead to additional *Community spending* and thus further complicate the task of finding solutions to the challenges of Eastern enlargement for the EU budget. In our view, the setting-up of EMU will in all likelihood not increase the pressure within the EU for additional intra-Community fiscal transfers and thereby narrow the Union's room for maneuver in the fiscal area. Additional transfers *within* the euro zone resulting from potential asymmetric shocks²⁹⁾ should be as improbable as further spending due to an – unlikely – process of divergence setting in *between* euro zone countries and the other Member States of the EU after the creation of EMU.³⁰⁾

29 For a detailed analysis of the issue of asymmetric shocks see Pauer (1996).

30 A divergence scenario is unlikely for a number of reasons. First, expected economic gains from monetary union are primarily of a dynamic nature and will thus unfold only in the medium to longer term. Second, gains from EMU will be moderated, if monetary union starts as expected with a relatively small number of countries. Third, in the initial phase, (net) gains will be reduced by the start-up costs of EMU.

A third issue relates to the question of higher *adjustment* needs for accession candidates as a consequence of monetary union. Despite being a major step towards deepening the Community, EMU does not put any substantial additional hurdles in front of the CEEC-5. EU accession is in no way linked to fulfilling the *macroeconomic* conditions for Stage Three of monetary union. Indeed, as already mentioned, the candidate countries will most probably join Stage Three of monetary union only some years after their entry into the EU. In the *legal* area, economic and monetary union does necessitate some additional adjustment for the CEEC-5 but, as will be argued in the subsequent section, the fulfillment of these requirements should not cause significant difficulties for the CEEC-5.

In sum, EMU does not and will not hamper the EU accession prospects of the CEEC-5. In fact, by keeping up the momentum of European integration, *EMU is creating a favorable climate for a future Eastern enlargement*, while an – unlikely – delay to complete monetary union or other implementation problems would substantially worsen the basic conditions for any widening of the Community.

6 Challenges for CEEC-5 Policymaking Against the Backdrop of EMU

EMU is becoming ever more important for the CEEC-5 and their policies. Contrary to widespread perceptions, the *Maastricht convergence criteria are not the main point of relevance* for the candidate countries *during* their EU *pre-accession* period. In fact, these criteria have less direct importance in that phase than other aspects such as institutional and legal issues or the ERM II.

6.1 The Maastricht Convergence Criteria

In recent years it has become popular for Central and East European policymakers to point out that their countries already meet some of the Maastricht convergence criteria. In most cases, these references have served as “evidence” of a perceived EU “maturity” of the Eastern membership candidates. Statements of this kind are understandable in the light of the fact that the preconditions for EU membership, as laid down in Copenhagen, remain vague about the necessary degree of monetary and fiscal convergence for joining the European Union. In their search for transparent and quantifiable benchmarks for membership, it apparently suggested itself to the CEEC-5 to use the convergence criteria as substitutes for transparently defined accession standards.

However, such references to the Maastricht convergence criteria may miss the point, given the fact that these criteria do not at all constitute benchmarks for EU accession. The convergence criteria are *not accession criteria*.³¹) Candidate countries have to share the aim of monetary union, as laid down by the Copenhagen summit, but they do not necessarily have to be very close to – let alone fulfill – the Maastricht criteria at the time of EU accession or even before. The convergence criteria enshrine macroeconomic standards that are clearly stricter than those one can reasonably apply to measure a candidate country’s readiness for membership in the fiscal and monetary realm. At the same time, the convergence criteria do not provide

³¹ Obviously as a response to the frequent statements from the CEECs related to the EMU convergence criteria, the EU took the opportunity of the structured-dialogue meeting between the EU finance ministers and their colleagues from the associated CEECs in March 1996 to underline this point.

adequate benchmarks for all other dimensions of EU “maturity”. Therefore, these criteria are both too strict and too narrow to be useful accession criteria. They may not be appropriate for countries set to catch up, and an excessive focus on these criteria may distract policymakers’ attention from the daunting challenge to iron out underlying *structural* weaknesses.

Consequently, the *convergence criteria will not play a major role in the accession process*. The Union will not look so much at quantitative indicators, but primarily at qualitative improvements, i.e. the capacity of the CEEC-5 to correct macroeconomic distortions with policies and instruments that are compatible with the market mechanism in general and EU rules in particular.³²⁾ This does not mean that the convergence criteria are of no significance whatsoever for the candidate countries. In fact, they should be viewed and indeed are increasingly being viewed as medium- and longer-term points of reference for stability-oriented economic policymaking.³³⁾

If one takes a look at the *actual state of the CEEC-5’s convergence* with the Maastricht criteria, bearing all these qualifications in mind, a rather favorable picture emerges by and large with respect to fiscal convergence, while monetary convergence appears to be a significantly more remote perspective. Some tentative data on the CEEC-5’s performance against the backdrop of the convergence criteria are contained in Tables 2 and 3. Substantial caveats have to be made as regards the interpretation of these figures. First, despite substantial progress in the statistical field in the CEEC-5, data are not always fully reliable and consistent. Second, in most cases calculation methods vary substantially from EU standards as well as among candidate countries. Thus, the figures presented below should be understood as rough indicators of a country’s possible approximate stance with respect to the criteria, but they can by no means constitute a basis for judging whether a country actually “fulfills” one or the other criterion (which, just like comparisons between the CEEC-5, for the time being do not have much meaning anyway).

Table 2

Macroeconomic Performance in the CEEC-5 in 1995

against the Backdrop of the Inflation, Interest Rate and Fiscal Convergence Criteria of European Monetary Union

	Average inflation	Average interest rates for long-term government bonds	Public sector deficit/GDP ¹⁾	Public debt/GDP
	in %			
Reference value	2.7	9.7	3	60
Czech Republic	9.1	app. 9	0.6 surplus	13
Hungary	28.2	app. 30	2.9 ²⁾	87 ³⁾
Poland	27.8	app. 22	2.6	58
Slovakia	9.9	app. 10	1.6	26
Slovenia	12.6	app. 12	0.0	31

Sources: WIW, national sources; for Slovenia: Lavrac and Lavrac (1996).

1) These figures are based on central government deficits and are therefore only proxies for the overall public sector debt to GDP ratios. Also, in some cases fiscal balances include privatization receipts on the revenue side, which does not conform to EU regulations. This is an especially relevant factor with respect to Hungary.

2) This figure includes extraordinarily high privatization revenues stemming primarily from the sell-off of substantial parts of Hungary’s public utilities. The deficit without privatization revenues stood at 5.5%. In 1996 there is a clear downward trend to below 3% of GDP (excluding privatization revenues).

3) Clear downward trend (reduction by close to 10 percentage points) in 1996.

32 See also Pearce (1995).

33 See e.g. Riecke (1996).

Table 3

Exchange Rate Regimes and Policies in the CEEC-5 in 1995/96against the Backdrop of the Exchange Rate Criterion of European Monetary Union¹⁾

	XR regime	Basket	Fluctuation bands	XR stability	ERM membership
Requirements	ERM	—	"normal" fluctuation margins of the ERM (until August 1993 $\pm 2.25\%$, since then $\pm 15\%$)	currency has to remain within the "normal" fluctuation bands, no initiation of a devaluation for 2 years	yes, according to Article 109 j (1) indent 4 EC Treaty
Czech Republic	fixed peg	65% DEM, 35% USD	$\pm 0.5\%$ until Feb. 28, 1996, since then $\pm 7.5\%$	stable against the basket	no
Hungary	adjustable peg until March 13, 1995, since then crawling peg	70% ECU, 30% USD (as of January 1, 1997: 70% DEM, 30% USD)	$\pm 2.25\%$	devaluations of 1.4% on January 3, 1995, of 2% on February 14, 1995, of 9% on March 13, 1995; since then automatic monthly devaluation rate 1.9% against the basket (until June 30, 1995), 1.3% (until December 31, 1995), 1.2% in 1996	no
Poland	crawling peg	45% USD, 35% DEM, 10% GBP, 5% FRF, 5% CHF	$\pm 0.5\%$ until March 1995, $\pm 2\%$ until May 16, 1995, since then $\pm 7\%$	automatic monthly devaluation rate 1.4% until February 16, 1995, 1.2% until January 8, 1996, 1% since then; in addition, step revaluation on Dec. 22, 1995 by 6% against the basket	no
Slovakia	fixed peg	60% DEM, 40% USD	$\pm 1.5\%$ until December 31, 1995, $\pm 3\%$ until July 17, 1996, $\pm 5\%$ since then	stable against the basket	no
Slovenia	float	—	—	tolar depreciated against ECU by 9% (in nominal terms) between January 1, 1995, and October 8, 1996	no

¹⁾ Cutoff date: October 17, 1996.

More interesting than the actual state are the *prospects* for macro-economic convergence. Most recent economic forecasts (e.g. by the World Bank, the European Commission, the OECD or the WIIW) contain a positive short-term outlook with fairly high and robust growth, slowly falling inflation and further fiscal improvement. It is, however, too early to say what the dynamics of convergence will be in the medium or long run. What is clear is that a *series of problems* will have to be tackled on the road to further convergence, in particular with respect to government finances and to inflation.

As Table 2 shows, 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 (excluding privatization revenues) is somewhat larger, but exposes a clear downward trend, 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 to tackle

existing structural problems, especially in the social security system (but also in other sectors like education). Further challenges relate to substantial prospective revenue losses from customs duties (in the wake of the reduction of tariffs and, in some cases, the phasing-out of import surcharges) as well as to potentially higher expenditures due to badly needed infrastructural investment, the costs of legal harmonization and administrative preparation for EU membership as well as the need to do away with financial sector weaknesses. Finally, in the wake of EU accession, the CEEC-5 will have to set aside substantial budgetary means to meet the cofinancing requirements for EU transfers from the structural funds.

Inflation has been substantially reduced and has already reached or come close to single-digit levels in the Czech Republic, Slovakia and Slovenia (see Table 2). A significant further lowering of inflation will, however, be an arduous task, taking into account in particular deeply entrenched inflationary expectations, the persistence of several elements of cost-push inflation (such as the full adjustment of energy prices to cover costs and allow for adequate profit margins or with respect to nominal wage pressures) and the monetary management problems resulting from capital inflows. Moreover, inflation pressures may intensify if widening trade and current account deficits of one or the other country prove to be unsustainable. Finally, as a consequence of accession to the Community, the CEEC-5 will experience a substantial upward adjustment towards EU price levels for agricultural goods and food products (in case agricultural trade is fully liberalized at the time of joining).

A last aspect relating to the Maastricht convergence criteria is the question of how the convergence criteria will be adjusted at the beginning of Stage Three of EMU. This issue, relating in particular to the prospective redefinition of the exchange rate criterion, but also to the adaptation of the inflation and the interest rate criteria (see above), is part and parcel of a comprehensive EMU *scenario for EU states joining the euro area after January 1, 1999*, which is currently under preparation.

While the convergence criteria will be decisive parameters for the CEEC-5 only at the time they get ready to join monetary union, several aspects of EMU will become directly relevant in the more immediate future, and in some respects they are important already today. On the one hand, the introduction of the euro and the establishment of an EMS II will have substantial implications for the monetary and exchange rate policies of the CEEC-5. On the other hand, the membership candidates will have to adjust their frameworks for economic policymaking to the Community's economic union with its policy coordination and surveillance mechanisms and its institutional and legal provisions.

6.2 Monetary and Exchange Rate Policy Implications

The *introduction of the euro* in 1999 will create wholly new framework conditions for the CEEC-5's monetary and exchange rate policies, given their high degree of economic integration with the prospective euro zone countries. The four countries under review, which have pegged their exchange rates, will have to adjust the basket to which their currencies are

pegged. This means replacing the Deutsche mark and, in the case of Poland, the French franc. Such adjustments could also offer an occasion for lowering the USD share in the baskets, which, in the light of trade patterns, is relatively high at least in the Czech Republic,³⁴) or even for opting for an outright peg to the euro. For Slovenia and its (managed) floating exchange rate regime, there will be no direct need for changes as a consequence of the introduction of the euro. Nevertheless, the policy-makers will have to tackle the basic issue of whether Slovenia should switch to a fixed exchange rate system in the context of preparing for EU membership or whether the float should be retained during the preaccession period. If the country opts for the former, questions of timing and regime designing will have to be answered. Apart from exchange rate considerations, the euro will influence the management of official reserves held by the Central and East European central banks as well as foreign debt management.

As a consequence of the CEEC-5's accession to the EU, their national banks will become members of the ESCB. The CEEC-5 will be formally included into the EU-wide monetary policy dialogue, most importantly via the participation of their central bank governors in the meetings of the General Council of the ECB. It will be primarily through this body that monetary policies between euro and non-euro countries will be coordinated.

EU membership will limit the CEEC-5 central banks' and their governments' room for maneuver with respect to exchange rate policies, as this policy field is a matter of common interest within the Community (Article 109 m). The question here will be whether the CEEC-5 will formulate and implement their exchange rate policies within or outside the Community's revamped Exchange Rate Mechanism. There are two main reasons why the countries under review may opt for participation in EMS II and its Exchange Rate Mechanism (ERM II) from the outset of their EU membership. First, EU institutions and most Member States will strongly expect the CEEC-5 to join EMS II and its Exchange Rate Mechanism. Second and even more important, taking part in EMS II and ERM II will be in the economic self-interest of the CEEC-5, as the balance of rights and obligations within the mechanism is more favorable than in the case of staying outside, even if intervention obligations are asymmetric. If the CEEC-5 continue to pursue stability-oriented policies and reforms (as assumed here), they should have reached sufficient convergence to join EMS II and its Exchange Rate Mechanism – which apparently will be fairly flexible – without major problems when entering the Union.

Participation in the ERM II will bring several changes for the exchange rate regimes of the Central and East European countries. Changing parity rates will no longer be possible unilaterally, but will require common consent. The latter is also true for the setting of initial parity rates. Intervention constraints will change. Still existing baskets will be replaced by a peg to the euro and there will be no room for crawling pegs any more. (This means that Poland and Hungary will have to devise a schedule for reducing their automatic monthly devaluation rates in time alongside with further advances towards price stability, so that they will eventually shift to a

³⁴ See Radzyner and Riesinger (1996). In order to make a judgment on the basket composition from a trade point of view, one would have to know the shares of the Deutsche mark and other currencies of the European stability zone as well as the USD share as regards the invoicing of foreign trade. (For example, the USD invoicing shares in the Czech Republic were 22.6% for exports and 24.4% for imports in 1995, while the USD share in the currency basket is 35%. In contrast, the 1995 USD invoicing shares for Hungary's and Poland's foreign trade corresponded very closely to the USD share in the currency baskets of these two countries.) Prospectively, the composition of baskets will also depend on the question of whether the euro will take on a vehicle currency role, i.e. whether it will serve as an invoicing currency for the CEEC-5's trade with countries not only within but also outside the euro area. However, it should not be overlooked that decisions on basket compositions are not only based on trade patterns, but on a broad set of economic and political considerations. In the economic realm, also the size and the denomination of existing foreign debt, debt management deliberations and the composition of foreign direct and portfolio investment stocks and flows can play a role. As for political aspects, the quest for integration or other foreign policy considerations may be of relevance.

fixed peg.) The width of the fluctuation margins should pose no problems, as the ERM II band will most likely be larger than the widest presently existing margins in Central and Eastern Europe.³⁵) Slovenia will have to give up the floating exchange rate system when it joins the ERM II at the latest.

6.3 Legal Convergence

Economic and monetary union embodies a set of *institutional and legal provisions*, particularly in the fields of central bank independence and the prohibition of budgetary financing by central banks, pertaining in principle to all EU Member States no matter whether they are countries with or without a derogation.³⁶) A related issue is full convertibility, which constitutes not only a main element of Stage One of economic and monetary union, but is also a precondition for joining the EU internal market.

Central bank independence in the sense of the EC Treaty means that “neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body” (Article 107). All EU Member States have to make their national legislation compatible with this provision at the latest at the date of the establishment of the ESCB (Article 108).

The CEEC-5 have basically fulfilled this precondition. However, the Polish situation is specific, as the country’s central bank law has been in force since 1989 and is thus the only remaining central bank act of the countries under review dating from pretransformation times. This law does not contain a clear regulation with respect to central bank independence. The discussion of a new central bank law by parliament, which has gone on for a while, has not yet led to resolving this issue fully. The main problem apparently lies in a clause of the draft law concerning the adoption of the monetary policy guidelines by the Sejm. This may, in the National Bank’s view, amount to receiving instructions from parliament. Still, one can expect that the Polish norms on central bank autonomy will be brought in line with EU standards in a not too distant future.³⁷)

The *prohibition of budgetary financing by the central bank* (Article 104) has been in force since the enactment of the Maastricht Treaty and will thus affect EU candidate countries from the outset of membership. In this area, the CEEC-5 have also made substantial progress. Lending to government is strictly limited in terms of amount and maturity³⁸), and it is the goal of the CEEC-5 to prohibit any such lending by law in the medium term. It should be noted that Article 104 also relates to debt outstanding. This means that dates for the eventual amortization of the debt stock will have to be set. The accepted practice in incumbent EU states is to find very-long-term solutions to the repayment of such debt. Hungary, where the outstanding debt of the state against the central bank is comparatively high for several reasons, has already begun to tackle this problem.³⁹)

In the area of *convertibility*, current account transactions have already been fully liberalized by all of the CEEC-5: The countries under review declared their currencies to be convertible according to Article VIII of the IMF’s Articles of Agreement between June 1995 and January 1996. The Czech

35 Concerning the extension of bands in Central and Eastern Europe see Radzyner and Riesinger (1996).

36 The only partial exception to these obligations relates to the United Kingdom. In case this country chooses to exercise its EMU opt-out clause, the United Kingdom will not be obliged to make the Bank of England independent.

37 See Hochreiter and Riesinger (1995). For Poland, see Reuters (April 22, May 30, June 12, July 3, 1996), PAP (September 30, October 2, 1996).

38 See Hochreiter and Riesinger (1995).

39 One reason for the size of the debt stock in Hungary is related to the National Bank having traditionally had the function of raising funds on the international capital markets. From this activity, the Bank has incurred sizeable losses due to subsequent forint devaluations, which have been recorded in the Bank’s balance sheet as (zero-interest) claims against the state. It is intended to remove all these losses from the Bank’s balance sheet and have them taken over by the central budget as of January 1, 1997.

Republic, Hungary and Poland have made major progress liberalizing invisible transactions and capital movements in the context of their OECD accession in 1995/96. Slovakia and Slovenia can be expected to achieve a similar degree of currency exchangeability when they join this organization. Full or almost full liberalization is envisaged in all of the CEEC-5 along broadly similar lines by the year 2000. The respective deregulation plans appear realistic and one may conclude that for most, if not all, of the CEEC-5 convertibility will not be a major problem in the context of a future EU accession.⁴⁰⁾

6.4 Policy Coordination and Surveillance

Finally, the policy coordination and surveillance provisions of the EC Treaty will affect the CEEC-5 after their accession to the European Union. Among these, the "excessive deficit procedure" (Article 104 c) is the most important. The CEEC-5, given their fairly good fiscal performance so far and their efforts to remedy structural weaknesses in their public sectors, should be able to comply with this procedure and to honor any EU recommendations under Article 104 c. At any rate, the liberalization of capital movements in the context of EU accession will provide a strong incentive for fiscal prudence.⁴¹⁾

In addition, the regular presentation of convergence programs will become relevant for the countries under review. What role these programs will actually play for the CEEC-5's policies will depend upon the result of the Union's endeavors to strengthen this mechanism. In any event, upgraded convergence programs could only be an advantage for the CEEC-5, as they could more effectively aid the preparations for an eventual joining of EMU than today's procedures.

7 Conclusions

This study has looked at the EMU prospects for EU Member States and selected candidate countries from Central and Eastern Europe. With respect to the latter, the focus has been on the Czech Republic, Hungary, Poland, Slovakia and Slovenia (CEEC-5), all or most of which are assumed to enter the European Union in 2002 or shortly thereafter while joining EMU only some years later. The main conclusions of the study are:

First, European Monetary Union will start on January 1, 1999. Preparations for the introduction of the euro are well under way. European Heads of State or Government have repeatedly stated their political will to take this very important step for European integration as planned and foreseen in the Treaty of Maastricht. This intention is supported by the fact that almost all Member States have made good progress in convergence with low inflation rates, low long-term interest rates and exchange rate stability. The efforts Member States have made to fulfill the convergence criteria of sound public finances are seen as credible, especially by financial markets.

Second, a first wave of probably six to eight Member States will introduce the euro in 1999 and could be followed one or two years later by a second wave of EU Member States.

⁴⁰ For a detailed analysis see Backé (1996).

⁴¹ See e.g. Backé (1996), Bofinger (1996).

Third, monetary cooperation between the European Union and the CEEC-5 has been fairly loose so far, but recently we can perceive a certain trend towards a more regular dialogue.

Fourth, there is not likely to be a conflict between a deepening of monetary integration within the EU and an enlargement of the Union to the East. In fact, by keeping up the momentum of European integration, EMU is creating a favorable climate for a future Eastern enlargement.

Fifth, EMU is becoming more and more relevant to the CEEC-5: The introduction of the euro will substantially change the framework conditions for their monetary and exchange rate policies. A subsequent EU accession by the CEEC-5 will imply further changes, in particular the inclusion of their central banks into the ESCB and a presumable participation in the ERM II. The candidate countries will probably not have major difficulties in adjusting to the institutional, legal and procedural conditions of economic and monetary union. The EMU convergence criteria are not EU accession criteria and will therefore not play a major role in the EU accession process of the CEEC-5, but only at a later time when these countries get ready to join monetary union. From today's perspective, these criteria can serve as medium- and longer-term points of reference for stability-oriented economic policymaking.

Annex

The Convergence Criteria

Extract from the Treaty on European Union

Article 109 j paragraph 1 of the Treaty on the European Union

The Commission and the EMI shall report to the Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union...

The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104 c (6);
- the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;
- the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels.

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to this Treaty...

Protocol on the convergence criteria referred to in Article 109 j of the Treaty establishing the European Community

Article 1

The criterion on price stability referred to in the first indent of Article 109 j (1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1¹/₂ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions.

Article 2

The criterion on the government budgetary position referred to in the second indent of Article 109 j (1) of this Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104 c (6) of this Treaty that an excessive deficit exists.

Article 104 c, paragraphs 2, 3 and 6 of the Treaty on European Union

2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

- a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless
 - either the ratio has declined substantially and continuously and reaches a level that comes close to the reference value;
 - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
- b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the Protocol on the excessive deficit procedure annexed to this Treaty.

Protocol on the excessive deficit procedure

Article 1

The reference values referred to in Article 104 c (2) of this Treaty are:

- 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;
- 60% for the ratio of government debt to gross domestic product at market prices.

Article 2

In Article 104 c of this Treaty and this Protocol:

- government means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts;
- deficit means net borrowing as defined in the European System of Integrated Economic Accounts;
- investment means gross fixed capital formation as defined in the European System of Integrated Economic Accounts;
- debt means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government as defined in the first indent.

3. If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State ...

6. The Council shall, acting by a qualified majority on a recommendation from the Commission, and having considered any observations which the Member State concerned may wish to make, decide after an overall assessment whether an excessive deficit exists.

Protocol on the convergence criteria referred to in Article 109 j
of the Treaty establishing the European Community (continued)

Article 3

The criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 109 j (1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.

Article 4

The criterion on the convergence of interest rates referred to in the fourth indent of Article 109 j (1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.

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Persistent Moderate Inflation in Poland and Hungary

Maciej Krzak¹⁾

I Introduction

Poland and Hungary belong to the most advanced group of transition²⁾ countries. Both countries have succeeded in stabilizing their economies, yet inflation has proven persistent. It has stayed within the so-called moderate inflation range, which is most broadly defined as 8 to 40%. This paper analyzes why this is so, attempting to forge together available evidence. The two answers, available in the economics literature, are that inflation in this range is too costly to be considerably reduced and/or is a result of a constraint on public finance, indicating the existence of monetized budget deficits. The paper investigates how these explanations square with the facts in examined countries. Policymakers in both countries pursue a gradual disinflation strategy. The issue of how viable in terms of lost output such policies are, and whether they suffer from a lack of credibility or not, is examined. Then the question about the pros and cons of a hypothetical cold turkey policy to break with the past is raised.

The paper is organized in the following manner. After the introduction, section 2 briefly discusses the concept of persistent, moderate inflation as distinct from low (up to 5%) single-digit inflation, a feature of the most developed economies in the 1990s, or hyperinflation, a phenomenon recorded at times in the less developed world. The major distinctive feature is the high inertia of the process; its sources are discussed. The cursory description of international evidence on how different countries coped with this type of inflation follows. In section 3, the Polish case is analyzed with the emphasis on evaluating the policies aimed at reducing inflation. Section 4 brings a similar analysis in the Hungarian case. Similarities and differences between inflationary processes in Poland and Hungary are underscored. Conclusions close the paper.

2 Moderate Inflation

2.1 Definition of Moderate Inflation

The description which follows is highly stylized to extract basic differences between two types of inflation: moderate inflation versus hyperinflation.³⁾

The term „moderate inflation“ was coined in the 1990s to distinguish it from hyperinflation, high inflation or low inflation. There is no universally accepted and clear-cut rate range to describe this kind of inflation; Dornbusch and Fischer (1993) suggested inflation rates between 15 and 30% annually, the IMF includes rates between 8 to 40%. The reason for this distinction is that moderate inflation proves to be persistent, i.e. that countries are trapped within its range and can reduce it only slowly. The persistence of such inflation results from the inertia⁴⁾ of the process, which is driven by inflationary expectations and widespread backward-looking indexation of labor contracts and financial assets.

Sharp fiscal and/or monetary restraint, which are standard counter-inflationary policies, do not suffice to tame moderate inflation without inflicting large output (unemployment) costs, as the inertia of the process is not broken easily. Inflation is anticipated and expectation formation is highly adaptive. The longer inflation persists, the more it fuels itself via entrenched expectations. Expectations strengthen inertia by means of institutional

1 The Vienna Institute for Comparative Economic Studies and Foreign Research Division of the Oesterreichische Nationalbank. I would like to acknowledge the valuable remarks of Peter Backé, Olga Radzyner and Aurel Schubert. The standard disclaimer applies.

2 Transition is a shortcut for the process transforming former centrally planned economies into market economies.

3 For more details see Bruno (1991) or Krzak (1994).

4 Inflationary inertia means that inflation reacts only slowly to changes in macroeconomic policy.

arrangements which in effect sanction them. In this way, a society learns to hedge against inflation. Special policies (see section 2.3) have to be designed to break the inertia. Since the public learns how to live with such an inflation by means of widespread indexation, it offers little support for a radical program. Moderate inflation also tends to characterize developing economies where the public finance explanation of inflationary roots may be valid. In such economies the informal sector usually has a significant share which evades taxation. If the inflationary tax is a relatively cheap way of raising government revenue, the political will to cut inflation is weakened.

In contrast to moderate inflation, hyperinflation brings such chaos to the economy (domestic money ceases to fulfill its functions) that the public and government perceive the situation as unbearable, so the support for a radical stabilization program is strong. Hyperinflations are short-lived because of the devastation they bring to the economy. The cure is rapidly applied. In a hyperinflationary episode, no past memory works as all prices and wages change in a matter of days or even hours.⁵⁾ Furthermore, these episodes are explosive, so that only forward-looking expectations make sense. Due to the lack of inertia, the costs of eliminating hyperinflation are relatively low in terms of output.⁶⁾

2.2 International Experience with Moderate Inflation

The international evidence on moderate inflation proves that rapid disinflation to levels below 5% annually is very unlikely. Dornbusch and Fischer (1993) cited 55 episodes of moderate inflation since the 1950s, out of which 28 started during the oil price shocks. Many of the episodes were caused by commodity price shocks. Most countries moved to the moderate inflation range from low inflation. When the countries left moderate inflation, the rates usually hovered in its neighborhood. They rarely fell to the low inflation range. According to the authors' evidence, in a few countries moderate inflation became a way of life: 56.4% of the episodes distinguished lasted 3 years and 21.8% lasted four years. 10.8% took more than 5 years. The longest spells were recorded in Colombia and Portugal, each lasting 12 years (the one in Colombia is still continuing). Chile's episode was only slightly shorter.

There is no space in this paper for a detailed account of numerous historical cases of moderate inflation.⁷⁾ The coverage is restricted to Chile because it is presented as a role model for countries in transition. However, no illusions should be left about the process of disinflation. The cost of stabilization has been high in terms of unemployment, and a violent political repression marked the beginning of stabilization. A dictatorship, installed by force in 1973, continued until 1990, which means that the government did not risk being unseated by tough policy through the results of popular vote. Disinflation was slow as the automatic, backward-looking indexation of wages frustrated the process and inflationary expectations were upheld. Chile was, in fact, a moderate-inflation country from 1978 to 1992, with the inflation rate falling to single digits only once in 1982.⁸⁾ At that time, the fixed exchange rate was maintained, which caused unsustainable real

5 Well-known hyperinflations occurred: in Austria, Germany and Poland in the early 1920s, in Greece, Hungary and China in the aftermath of World War II, in Israel and Bolivia in the 1980s and in Argentina, Brazil and Peru in the early 1990s.

6 See Sargent (1982).

7 See Dornbusch and Fischer (1993), IMF (1996), Végh (1992).

8 Therefore Dornbusch and Fischer (1993) split this episode into two separate ones.

appreciation in the environment of the world debt crisis; Chile's balance-of-payments constraint became binding, as it could not borrow enough to finance the current account deficit. In order to mend its current account position, the country had to devalue, which jeopardized disinflation. Once the confidence in the country was restored in the second half of the 1980s, capital inflows tended to undermine inflationary targets. Chile responded with the introduction of a crawling band and disincentives to inward portfolio investment. Only as late as 1994 was Chile able to reduce CPI inflation to single digits, despite having had a fiscal surplus since 1988. International organizations believe that the widespread indexation of wages and financial assets is a major obstacle to a more decisive disinflation toward the level of industrial countries. A floating exchange rate was recommended by the IMF in 1996 as an instrument of deindexing the economy, as it would introduce uncertainty about the future exchange rate of the currency and in this way eliminate the formation of inflationary expectations based on preannounced devaluation.

2.3 The Costs of Disinflation and Policies

The stylized description of Chile's disinflation touched on many policy issues. The standard, also dubbed *orthodox*, counterinflationary policies involve tight monetary policy and fiscal restraint. They are indispensable to start the process of disinflation. Monetary tightening is inevitable in the case of various supply shocks. Beyond that, the introduction of central bank independence is viewed in the economic literature⁹⁾ as a safeguard against an expansionary bias of the government and a condition to make tough policy credible. Politicians' terms are shorter than governors' terms, which allows the central bank to overcome the shortsightedness problem.

However, international experience, e.g. the case of Chile, shows that in the moderate inflation case demand-reducing policies would have to be overly restrictive and would inflict a high sacrifice ratio¹⁰⁾ to bring about decisive gains due to inflationary inertia. In addition, economic theory suggests that the short-term trade-off between unemployment and inflation is the more pronounced the lower inflation is, which makes the cost of marginal disinflation higher and higher. This is the case because increases in the general price level are mistaken for changes in relative prices. Now reverse the reasoning: disinflation is interpreted as a fall in the relative price of a product, so a firm cuts production because it expects lower profits. This fact makes the process of disinflation a nonappealing task for policymakers. The political will is further weakened by the fact that the public tolerates such inflation as it learns to hedge against it.

To break the inertia of inflation, supplementing policies are used. This involves cures carried over from high or extreme inflation cases, such as nominal anchors.¹¹⁾ Exchange rate or money rules are the two most popular. The pros and cons of exchange-rate- versus money-based programs are widely discussed in the literature.¹²⁾ Based on empirical evidence, exchange rate anchors are preferable, as sustainable exchange rate stability gives a clear signal which is well understood by the public and which dampens inflationary expectations. Furthermore, a country will normally peg the

9 See Alesina and Summers (1993) and Cukierman (1992).

10 Forgone GDP in percent per percentage point of disinflation.

11 For the exposition of the theory of nominal anchors see Bruno (1991).

12 See Bruno (1991), Claassen (1996), Végh (1992), Begg (1996).

domestic currency to one or more currencies of the partners noted for price stability. The money demand function may be too unstable to rely on in the conduct of monetary policy. In addition, monetary rules are too technical for the broad public.

A less binding variant of the exchange rate anchor, used even more often by moderate-inflation countries, is a preannounced crawling peg regime or a crawling band regime to allow for upward flexibility of the exchange rate. These instruments lose features of strong anchors for the price level, but maintain features of an anchor for inflationary expectations; the public knows that the currency is devalued at a given rate, usually lower than a projected inflation rate, so import prices are expected to rise in a predictable way. On a number of occasions a real appreciation resulting from the difference between the inflation rate and the rate of crawl defeated the counter-inflationary efforts of a country¹³), as it led to unmanageable current account deficits. They had to be remedied by devaluations, which fueled inflation. Inertia prevented inflation in the tradable sector to converge to the rate of depreciation of the domestic currency.

Single anchor programs (dubbed orthodox programs) were implemented in the 1960s and 1970s in Latin America.¹⁴) In the 1980s and 1990s so-called heterodox programs using multiple anchors became popular. Wage (incomes) policy is appended to orthodox programs to reinforce the impact of the primary anchor. Wage policy can take various forms ranging from a tax on excessive wage growth (e.g. Poland) to a freeze on wage and price increases. The latter, extreme policy does not allow for relative price movements and therefore has little appeal.

Another anti-inflationary policy is the deindexation of contracts, in particular of labor contracts. This is possible either in the public sector or if wage negotiations are centralized. The second-best alternative is to switch to a forward-looking indexation of labor and debt contracts. In many cases only this option is politically feasible.

Finally, sometimes supply-side policies are used to promote competition, which tends to keep in check price increases. Authorities work to remove rigidities at the microeconomic level, which makes wage and price formation unresponsive to deflationary pressures. However, these policies seldom have an immediate impact on the inflation rate, as it takes time to build a competitive environment. Policies to eliminate subsidies and dismantle monopolies, such as privatization, deregulation aimed at easing an entry for domestic and foreign firms and a reduction of tariffs, are used as well.

2.4 Transition as a Relative Price Shock

For a long time economists have been puzzled by the fact that relative price movements show more flexibility upward than downward. In other words, they are asymmetric. The debate has not settled yet. Ball and Mankiw (1994, 1995) offer an explanation for this fact, which also includes reasoning why this asymmetry tends to petrify inflation. Their model has high relevance for countries in transition, as this process can be modeled as a relative price shock due to liberalization of prices and removal of subsidies, the imposition of value added tax (VAT) and of other taxes.

¹³ Chile in 1982,
Uruguay in 1978.

¹⁴ See Végh, (1992).

The asymmetric response to cost shocks arises from the existence of "menu costs". Menu costs are shorthand for all costs associated with changing prices, from physical costs of reprinting restaurant menus or price lists to the costs of lost sales from reduced satisfaction of customers if the distribution of relative price changes is skewed. In the presence of menu costs, firms will only change their prices if the costs of inaction exceed the menu costs associated with changing prices. Small shocks to the economy will have little effect on the price level, since individual firms will be reluctant to change prices, as it would involve excess costs over benefits. Large shocks, however, will have a magnified effect on the price level. If shocks of both directions are symmetric, their impact on the general price level will cancel out. Suppose, however, that the distribution of relative price shocks is skewed positively. There is a small number of large shocks and a large number of small relative price reductions which would tend to offset the former if it were not for the menu costs. Under their presence, the large number of small shocks does not lead to price reductions, whereas the small number of large cost increases leads to an upward adjustment of prices. As a result, the general price index increases.

2.5 Inflation and Forgone Long-Term Growth

The calculation of costs of inflation versus costs of disinflation would not be complete without due regard to an analysis of the link between inflation and economic growth. The trade-off between inflation and growth in the short run is not disputed in mainstream economics. It supports the case for a gradual disinflation.

Recently, the focus has shifted to the link between inflation and long-term growth with a working hypothesis that inflation stifles growth. The inverse relationship between inflation and long-run growth is documented in various studies. According to Barro (1995), an increase in average inflation by 10 percentage points per year reduces the growth rate of real per capita GDP by 0.2 to 0.3% per year and lowers the ratio of investment to GDP by 0.4 to 0.6%, which in 30 years means a difference of 4 to 7% in per capita GDP. In the medium term of 5 to 10 years, this difference amounts to 2 to 3% of GDP. Bruno and Easterly (1995) found a weak correlation between long-run growth rates and inflation once the extreme inflation episodes are eliminated. Their threshold of when inflation starts hampering growth is a 40% inflation rate year on year. The corollary is that countries may live with moderate inflation for long periods and still experience robust economic growth. The growth differences are fairly subtle within the range of 0 to 20% inflation, but then growth falls monotonically as inflation becomes more extreme. The relation becomes negative when inflation exceeds 40% annually. On the other hand, Sarel (1996) found that inflation has nonlinear effects on growth. When the inflation rate exceeds 8%, inflation tends to hamper growth more and more, so that at high rates its destructive impact is powerful. His results show that the benefit of additional long-term growth thanks to disinflation in a low inflation country is negligible. In a recent paper Feldstein (1996) challenges this result. He concluded, on the basis of interactions of existing capital tax rules and inflation in the U.S.A., that the

annual welfare cost of a 2% inflation rate instead of 0% inflation is 1% of GDP. His evidence can be relevant for other low inflation economies with similar tax structures.

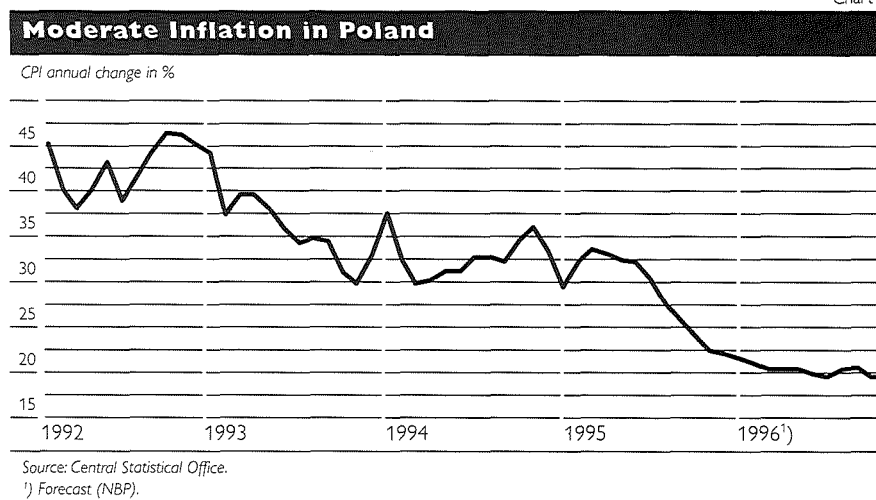
The bottom line of this short survey is that the international evidence on an inverse relationship between inflation and long-run growth is very clear for high rates of inflation but inconclusive for low to moderate inflation.

3 The Polish Experience

3.1 Inflationary Record

In Poland open inflation was an everyday phenomenon of the 1980s when it accompanied shortages of a variety of goods, among them staples. Lax wage policies under conditions of shortages of goods led to a monetary overhang. The authorities resorted to a routine of increasing state-regulated prices in periodical actions in an effort to partially eliminate the overhang. At the end of the decade, state budget deficits were financed by nearly unlimited interest-free credits from the central bank. Finally, the liberalization measures introduced by the last communist government, such as the freeing of food prices in the environment of loose monetary policy, ignited hyperinflation (39.5% monthly in August 1989), which continued to accelerate. In January 1990, Leszek Balcerowicz, minister of finance, launched a heterodox stabilization program that comprised two anchors: a fixed nominal exchange rate and wage controls. The program of 1990 was based on tight monetary policy (positive real interest rates from March 1990 on), elimination of the budget deficit by a drastic reduction of state subsidies, liberalization of prices, prohibitive surcharge taxes on excessive wage increases and a fixed exchange rate system. It also dismantled the indexation of wages in state firms, which had only been introduced in July 1989. As a result hyperinflation was eliminated. Despite a considerable drop (in the first quarter of 1990 consumer prices rose by 132% while in the second quarter of 1990 they increased by 16.1%), inflation did not fall to single digits as intended. The relaxation of incomes policy and monetary policy in the second half of 1990 compro-

Chart 1



mised this target, but the subsequent tightening of policies in the first quarter of 1991 arrested the visible acceleration of inflation. Since then, inflation has continued to ease only gradually, disrupted occasionally by supply and demand shocks. Poland entered the moderate inflation region in 1992 (see Chart 1), when the CPI increased by less than 40%. In June 1996 CPI inflation fell below 20% (year on year) for the first time in the transition period and is likely to stay around 18 to 19% at the year-end.

3.2 Why Inflation is Persistent in Poland

The inertia of Polish inflation is caused by entrenched expectations, relative price adjustments, the widespread indexation of contracts and the crawling peg system of the exchange rate. Monetary policy tends to accommodate aggregate demand, and the fiscal deficits are still partially financed by means of monetization.

Inflationary expectations are entrenched in Poland. There are several reasons for this. Inflation has persisted for many years; it has been a fact of life since the early 1980s, so it is expected to continue. Polish governments missed inflationary targets in each year of the Polish transition (see Table 1) so, by rule of thumb, the public expects actual inflation to exceed these forecasts. In opinion surveys, only poorly educated or uninformed strata of the public project inflation in single digits. This implies that inflationary expectations are highly adaptive. There is evidence that they are exhibiting more and more features of rational expectations,¹⁵ incorporating macro-economic policy variables and government projections for the future. The key element is that no change in either monetary or fiscal policy can be observed in Poland in recent years. It is rational to expect inflation, as the government does so, and it avoids a radical change in economic policy; the government committed itself to a strategy of gradual disinflation, which was formally adopted in 1994.¹⁶ The path of disinflation was specified until the year 2000 when the CPI inflation rate is to fall to 5 to 7% from current levels of 19 to 20% (19.5% in October 1996).

Table 1

Poland: Selected Indicators						
	1991	1992	1993	1994	1995	1996 forecast
% GDP						
Budget deficit	3.8	6.0	2.8	2.7	2.6	2.5
Targeted CPI growth Dec./Dec.	32.0	36.9	32.2	23.0	16.9	17.0
Actual CPI growth Dec./Dec.	60.4	44.3	37.6	29.5	21.6	18.2
%						
Annual rate of PLN depreciation		37.5	32.0	20.4	9.2	12.7
PLN billion						
Projected growth of total money supply		12.7	15.0	15.5-16.9	17.0	23.0-28.0
Actual growth of total money supply		15.0	14.8	21.4	26.9	28.0

Source: Central Statistical Office, NBP, own calculations.

15 See Bauc et al. (1996).

16 See Strategy for Poland (1994).

To go to the extreme, every year Poles hear the same dull story that the budget deficit must not rise as a percentage of the GDP, as it would entail the threat of more inflation and as the government would have to finance the deficit by more credit from the central bank. Plans to reduce the deficit further are ill-specified¹⁷⁾ and do not call for a radical removal (the deficit is projected to fall from 2.7% in 1995 to 1.7% of GDP in 2000). Fluctuations of the deficit share in GDP have only occurred on the first place behind the comma, so no signal of a change can be detected. Then Poles realize that money supply is going to rise in such a way as to accommodate economic growth of around 5%. In a number of recent years government missed its monetary target (Table 1). The central bank plan of monetary growth for 1997, like the previous plans,¹⁸⁾ does not call for money growth rates compatible with single-digit inflation, but for rates compatible with the gradual disinflation pursued by the government. *Thus a break with the past has not been announced; a gradual disinflation is keyed into government projections until 2000.* If no revision of the policy follows, it is rational to predict that inflation will stay within the same range; the present is the best predictor of the future if no new facts are available. Random events such as supply shocks are unpredictable and cannot be accounted for.

Another factor to uphold inflationary inertia in Poland is backward-looking indexation of pensions and wages. While explicit indexation of wages in industry is nonexistent, Griffiths and Pujol (1996) found evidence that implicit backward-looking indexation is widespread; the mean lag of wage adjustment to a CPI rise is two months. In 1995 the government made an effort to replace backward-looking indexation by forward-looking indexation of wages. Until the end of 1995 pension indexation had been based on the average nominal wage growth from the previous quarter; a minimal 10% rise automatically triggered an upward adjustment of pensions. This system was recently replaced with a price indexation scheme based on government projections of inflation in the same year the adjustment is made.

Incomplete adjustment of relative prices is an important part of the explanation of inflationary inertia in Poland. According to Czyzewski¹⁹⁾, Polish inflation was driven by corrective adjustment of relative prices until the end of 1992, when the structure of prices converged to market-clearing prices. Findings by Griffiths and Pujol (1996) point to the opposite; they suggest that the adjustment process has not ended yet and asymmetric relative price shocks will continue to frustrate disinflation. The argument is that prices of Polish goods are in many cases lower than their international counterparts. Exchange rate adjustment alone is not going to solve this problem, as relative price differentials are observed among various groups of goods, including nontradables. Subsidies in the housing sector are an example of this assertion. The relative rise of utility and energy prices for households has been substantial during the transition; however, the authors found that most of the relative price hikes took place until the end of 1992, which would square with Czyzewski's results. Nevertheless, their interpretation of this fact is different: After that period, household incomes were cushioned by the government, which froze the inevitable adjustment

17 See Pakiet 2000 (1996).

18 See NBP (1996).

19 See Bauc et al. (1996).

process to bring these prices to cost recovery levels. Thus, the completion of the adjustment process in the future will tend to uphold inflation. Periodical increases in prices administered by the central government or local governments (energy, rents, utilities, public transportation and postal rates) produce a series of supply shocks, which lift the price level up and are registered as statistical inflation. In an environment of accommodating monetary policy this will likely translate into additional inflationary pressure.

Inflationary expectations are also shaped by expectations of depreciation of the domestic currency, the zloty. The *crawling peg* exchange rate system is, in theory, supposed to reconcile the counterinflationary target of the government with the balance-of-payments constraint. The authorities conduct a policy of limited real appreciation, which would ideally be offset by gains in the labor productivity in the tradable sector. This is the policy the Polish government attempts to stick to. The preannounced rate of depreciation of the domestic currency sets the floor for inflationary expectations, as the pass-through of a devaluation to import prices is believed by the public to be high. Since the reduction in the preannounced rate of devaluation is gradual, the downward revision of these expectations cannot be substantially faster either. Economic theory says that this applies especially if the exchange rate has much bearing on wage negotiations, which is the case for small open economies. Therefore, disinflation is slow. Polish inflation is still higher than the annual rate of nominal depreciation, so inflation has room to fall before the crawling peg rate arrests the disinflation process. This is a remote perspective, as evidenced by moderate inflation cases in which inflation chases the crawling devaluation. In the meantime the authorities become impatient with the small progress with disinflation, so in order to cut inflation by a few points more, they rely on the advice that they should reduce the rate of devaluation. This course of events may bring about the unwelcome side effect of an unsustainable current account deficit, a sad end to a number of Latin American disinflations, and/or capital inflows which exacerbate the situation by exerting upward pressure on the currency and inflating money supply. This latter phenomenon becomes a problem once confidence in the country's macroeconomic policy builds up. It then faces an imminent inflow of portfolio investment due to real appreciation expectations. Money supply starts growing in an unintended way, which tends to compromise disinflation. This was the case for numerous stabilizations.²⁰) In this respect, the most advanced transition economies, among them Poland, are no exception. At the end of 1994 and throughout 1995 Poland absorbed more speculative capital than ever before (approximately USD 1.3 billion).²¹)

Inflation is fed by the *partial monetization of the budget deficit*, which validates the public finance explanation of its persistence. The authorities may also be tempted to use inflationary tax as an additional source of revenue. The inflationary tax revenue increases because of a surprise inflation, which is the Polish case (see Table 1). The budget revenues and expenditures every year are based on a certain projected rate of inflation. Since the indexation of expenditures is imperfect, they do not rise in line

20 See Végh (1992).

21 This estimate includes neither the unclassified currency inflow surplus (about USD 7.5 billion) nor foreign direct investment inflows (about USD 1 billion) in 1995.

with excess inflation over the government projection. On the other hand, tax revenue increases as economic agents report higher nominal incomes; tax brackets are not adjusted in the course of the year for unexpected inflation.

In addition, the persistence of inflation in Poland was fueled by several *adverse supply shocks* that hit the economy in 1994 to 1996. Foodstuffs have an almost 40% weight in the consumer basket, therefore CPI inflation is very sensitive to the rise in their prices. In 1994 a drought caused a decline in agricultural output, which coincided with an increase in the tariff and nontariff protection of domestic producers of food. Foodstuff prices rapidly increased in late 1994 and early 1995. In 1995 economic growth proved to be significantly higher than projected by the authorities because of strong external demand for Polish goods and buoyant investment. In 1995 and 1996 world grain prices rapidly increased and this increase spilled over to Poland, as it had to import grain; the price of wheat rose by over 60% year on year to September 1996. Paradoxically, this process can also be called relative price adjustment, as Polish grain prices rose to the world level and then stabilized. The harsh and prolonged winter of 1995/96 devastated the rapeseeds in the ground and the cold and wet summer led to a lower harvest of grain, which has had to be supplemented by imports.

3.3 Anti-inflationary Policies

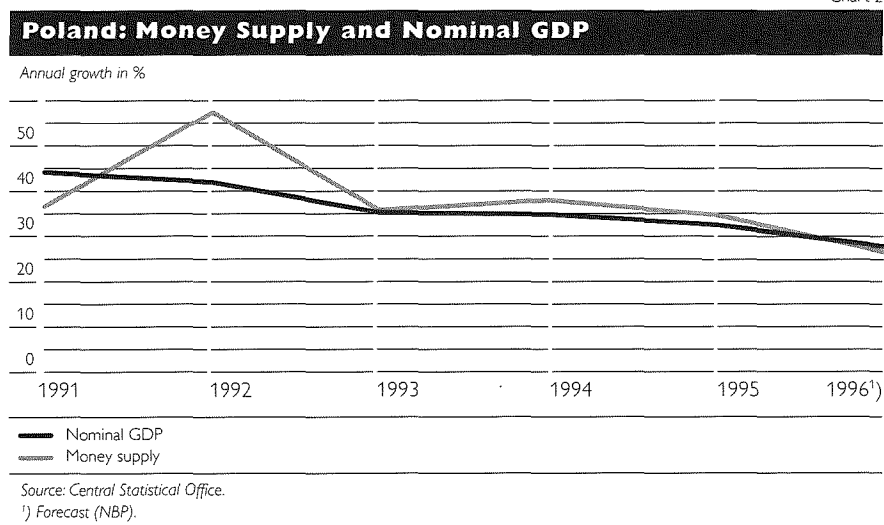
The priorities of the Polish authorities changed during the transition. Disinflation was a top priority at the outset in 1990 and 1991. If one were to use a standard welfare loss function of the government as a formal expression of its goals, the weight of inflation declined while the weight of economic growth increased in the course of transition. Since 1994 priority has been given to economic growth. Disinflation is only pursued to the extent that is believed not to conflict with the primary goal. Thus, inflation is there because it is too costly to remove it rapidly. As was noted in section 3.2, Poland intentionally moves along a gradual disinflation path, which is explicitly described in the medium-term government program. This setup determines the thrust of anti-inflationary policies.

In order to further reduce inflation at the early stage of transition, the state budget deficit had to be brought under control. At this time the deficit was mainly financed by credit from the central bank, as financial domestic markets were nascent and lacked enough liquidity. Marketable government securities were only introduced in 1991. In 1992 the deficit widened to 6% of GDP mainly due to rising pension and unemployment benefits. Since the bold adjustment in 1993, when the deficit was cut to 2.8%²², it has been kept below 3% of GDP (Table 1). Once the deficit reached this region, the authorities did not go for another decisive cut. Instead, they have been gradually eliminating the share which is financed by the central bank (Table 1). The draft of a new central bank act includes a provision which abolishes this inflationary form of financing.

Monetary policy was tough in 1990, when total money supply rose by 158.3% but nominal GDP grew by 373.6%. Since then money has not been tight (Chart 2), as its growth exceeded the growth of nominal GDP. The growth of money supply overshot the monetary projections of the central

²² Measured on a cash basis following the IMF methodology.

Chart 2



bank in 1994 to 1996 (Table 1). On the other hand, interest rates were reduced in line with decelerating inflation and since 1991 the central bank has maintained them at positive levels adjusted for actual and expected inflation. The central bank was even subject to government criticism²³) that it tended to reduce interest rates with a lag rather than in line with expected inflation, which reads that it should reduce them in line with the disinflation projections of the government. To comply with the target of strong economic growth, monetary policy accommodates the growth of aggregate demand (Chart 2). In 1997 this policy is to continue despite a verbally announced tightening, as money in real terms is projected to grow by 6.8 to 7.6% assuming that foreign currency reserves are unchanged and real GDP grows by 5.5%. The policy occasionally responded to adverse developments. In February 1995 interest rates were raised to mitigate the impact of rising food prices. In 1995 money supply grew unintentionally fast due to a massive inflow of foreign currency, which mostly represented a current account surplus. The bank attempted to sterilize the impact of this inflow on money supply by conducting open market operations, but despite the efforts over 59% of money supply growth in 1995 had foreign currency inflows at their source.

Beyond the standard policies, the government uses features of disinflation programs of moderate inflation countries such as: a crawling peg, an elimination of backward indexation and even the postponement of increases in regulated prices. A crawling peg policy involves a gradual reduction in the pace of monthly devaluation. The original rate of the preannounced monthly devaluation was 1.8% (October 1991). Starting in August 1993 the crawl rate was lowered in several steps to 1% in December 1995 as disinflation progressed. One-off devaluations in February 1992 and August 1993 compromised the anchoring feature of the preannounced devaluation. A revaluation in December 1995 by 6% against the basket had the same effect. The annual rate of devaluation against the basket was maintained below targeted inflation (and below actual inflation as well) in

23 See discussion "Gdzie leży klucz", *Gazeta Bankowa*, April 28, 1996.

1993 to 1996 (Table 1). In May 1995 the crawling peg was replaced by a crawling band of 7% (after having been allowed to fluctuate by $\pm 2\%$ from March) on either side of the middle rate in order to prevent a further surge in capital inflows by introducing more uncertainty about the potential course of the exchange rate.

In 1995 backward-looking indexation of pensions was replaced by forward-looking indexation based on inflationary projections of the government. Until 1995 a lid had been put on excess wage growth, which was later phased out. Since 1995, a trilateral commission of government, employer and trade union representatives has determined caps on quarterly and annual average wage increases based on government predictions for inflation and economic growth. Raises in wages in excess of reference wages entail sanctions for state-owned firm managers, including their dismissal.

Structural policies in the period of moderate inflation were timid by the standard of the policies of 1990 to 1992. They were geared to continuing privatization but also to spreading the cost of transformation more evenly among generations. In general, their direction has been market-oriented, though delays in privatization, particularly in 1994, and in opening infrastructure sectors to foreign competition as well as the tendency for a centralization of decisions under the current ruling coalition by creating large holding companies and expanding licensing procedures to new sectors, are visible. In 1994 a rise in the tariff protection of agriculture proved counterproductive, as it coincided with a severe drought. The ongoing need for a relative price adjustment will raise inflationary pressure, but further deferring of adjustment will lead to a distorted allocation of resources in the economy. The inevitability of relative price changes supports the case for a gradual strategy, as a radical one would require austere policies whose cost would fall excessively on the emerging private sector,²⁴) which borrows at market interest rates and is subject to a hard budget constraint.

A general weakness of a gradual strategy lies in its vulnerability to various macroeconomic shocks. This is well documented in the Polish case, as supply shocks (drought, recent oil price rise) or demand shocks (trade surplus in 1994 and 1995) tended to compromise such a strategy and to lead to an upward revision of inflationary expectations. In the environment of accommodating monetary policy, these shocks translated into an actual rise in prices, as everybody accommodated price increases in line with their neighbors or suppliers. The government response to these shocks in 1995 to 1996 was to defer scheduled increases in controlled prices. This policy has reached its limits in 1996, and for 1997 these increases are planned to exceed the projected CPI inflation rate by 2 to 3 percentage points.

3.4 The Costs of Inflation in Poland

The priority of economic growth justifies the gradual approach to disinflation in Poland. Its strong inertia implies that the forgone output under rapid disinflation could be high in the short run. Furthermore, the long-term benefits of this policy would not be high, as pointed out by the international evidence. Various institutional arrangements tend to alleviate the costs of inflation in Poland.

²⁴ See Griffiths and Pujol (1996).

3.4.1 The Costs of Anticipated and Unanticipated Inflation

The general approval of a gradual disinflation policy in Poland²⁵) is indirect proof that *the costs of rapid disinflation are perceived as larger than the costs of inflation*. Society has had enough time to learn to live with anticipated inflation. Reality is always far from a costless inflationary environment,²⁶) but numerous institutional arrangements in Poland were developed to make inflation "livable", which weakens the pressure for rapid disinflation.

Inflation is not perfectly forecast; therefore there exist welfare costs of unanticipated inflation to creditors and wage earners, which discourage the use of long-term debt contracts. The low proportion of credit to the economy, however, is a poor gauge of this phenomenon, as financial markets are still underdeveloped in Poland, despite remarkable progress during the transition. Moreover, there exists anecdotal evidence that banks lend reluctantly to the corporate sector and long-term loans are scarce. Furthermore, credit expansion suffered as the inflation premium, i.e. the compensation for the loss of value of the principal capital, is paid up front and constitutes a burden when inflation is high. The collapse of housing construction (the number of newly completed units fell to the level recorded in the 1950s, when Poland had 10 million fewer inhabitants), where credit financing is the rule, illustrates this cost. Lending to the corporate sector increased in real terms for the first time in transition as late as in 1995 while economic growth resumed in 1992.

Money holding as a share of GDP is lower in Poland than in other countries at a similar stage of development, not to mention among transition countries such as the Czech Republic, Hungary and Slovakia.²⁷) This, paradoxically, lowers the cost of holding money balances due to inflation relative to other countries with similar rates of inflation. The proportion of the population which keeps money balances with a bank is still low, which implies that inflation taxes it heavily, as it pays no nominal interest. Furthermore, people hold money accounts which pay rates below the market. These rates are adversely affected by the high required reserve ratio which banks are forced to keep on call money (currently 17%). On the other hand, deposits are relatively well cushioned against inflation because nominal interest rates are flexible, and though they react with a lag to inflation fluctuations, positive expected real interest rates for deposits are maintained. Inflation-indexed one-year bonds are issued to protect savers against inflation. Fixed-coupon medium-term government bonds offer high nominal interest rates with a positive real yield when compared with projected inflation.

Labor contracts also compensate for inflation. Wage and pension indexation is widespread, as described in sections 3.2 and 3.3. Since 1995 state employees have had salaries indexed according to the formula projected inflation plus a given real growth. The limits of tax brackets are adjusted every year for past inflation. Exemptions and deductions are raised as well.

25 See Bauc et al. (1996). The IMF stands for the gradual approach in the Polish case while at the same time it supports cold turkey programs in a number of moderate-inflation countries.

26 Expected inflation is not without costs either. Since moderate inflation is expected by and large, it makes sense to list the conditions under which it is theoretically costless. The assumptions are numerous (Gordon, 1987):

1. Inflation is fully anticipated by all economic agents.
2. All savings are held in financial assets that pay market nominal interest rates. In particular, nobody keeps money holdings.
3. Market interest rates are adjusted one-to-one for inflation.
4. Only real income is taxed.
5. Inflation raises the prices of all goods by the same proportion, i.e. relative price changes are the same as under the absence of inflation.

This list should be appended to include one more condition, namely that menu costs, i.e. costs of changing prices, gathering information and taking decisions to change prices, are zero (Briault, 1995).

These strong assumptions are not satisfied in reality; however, they are a useful benchmark against which inflationary costs in different countries can be measured.

27 See Wellisz (1995).

3.4.2 Inflation and Long-Run Growth

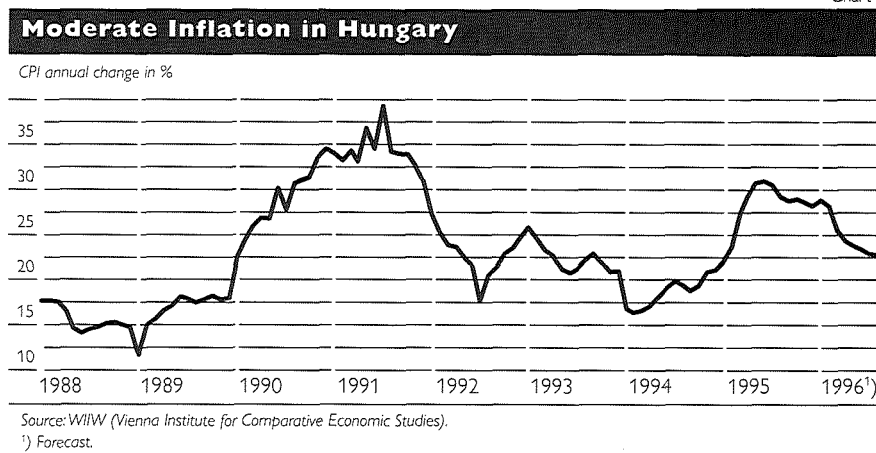
By pursuing gradual disinflation, Polish governments do not forgo too much in terms of output.²⁸⁾ The benefits of lower inflation could well be outweighed by the sacrifice ratio the authorities would have to bear if they went for a cold turkey strategy. In particular, these costs would be incurred now while benefits would have to be discounted. According to public finance literature, governments tend to embrace a short decision horizon, so their time preferences may heavily discount future gains. The Polish authorities are no exception in this respect. The medium-term strategy of the Polish government calls for the reduction of CPI inflation to 5 to 7% by the year 2000. Two factors should be considered. Firstly, this is not a remote perspective, so the long-run growth cost of inflation does not look outrageous, which weakens the motivation of the government to reduce it at one sweep. Secondly, the horizon may be short enough to involve a short-term trade-off between inflation and growth, which makes radical efforts to cut the inflation rate even less appealing.

4 Moderate Inflation in Hungary

4.1 A Brief History of Inflation

The distinctive feature of Hungarian inflation is its continuity from the 1980s when prices were gradually liberalized. At the end of the 1980s, thus still in the socialist environment, Hungary entered the region of moderate inflation; the CPI rose by 15.5% in 1988 and by 17.0% in 1989 to accelerate to 28.9% in 1990. Gradual and piecemeal reforms to loosen the corset of central planning started in 1968 and continued with ups and downs until the collapse of communism; by 1989 the prices of a majority of consumer goods had been freed. This explains why Hungary did not experience a surge in inflation of the magnitude observed at the outset of transition in other Central European countries. Hungary did not see the need for a big-bang approach at that time, since its economic situation was quite stable; inflation was under control, prices were largely free, shortages were almost eliminated, currency substitution was not problematic and a unified exchange rate had already been introduced in 1981. It postponed fiscal adjustment until 1995. After the 1991 peak of 35%, CPI inflation downtrended until 1994 (Chart 3).

Chart 3



28 See section 2.5.

The external debt, which has been serviced in a timely manner, posed a constraint on the balance of payments and economic growth. However, it did not come to the fore until the Mexican crisis in late 1994. In 1994 Hungary recorded a large current account deficit of almost 10% of GDP, which correlated with a high trade deficit. At the same time, Hungary's general government deficit surged to 8.5% of GDP, so the country faced the problem of twin deficits. The international crisis of confidence that followed the Mexican problems made this current account position unsustainable, and Hungary was forced in March 1995 to embark upon a harsh stabilization program to cope with the problem of twin deficits. This program included a large increase in controlled prices by the government, a devaluation of 9% and a switch to the preannounced crawling peg with the initial rate of monthly devaluation by 1.9% to the basket²⁹), and finally the introduction of an import surcharge of 8%. A side effect was an acceleration of inflation from 18.8% in 1994 to 28.2% in 1995 because of the increased devaluation rate of the forint, the increase in the VAT rates and hikes of government-controlled prices at unprecedented rates. The continuity of Hungarian disinflation, which had proceeded since 1991, was broken. In the second half of 1995 inflation resumed its downward trend, which continued in 1996 (Chart 3).

4.2 Causes of Persistent Moderate Inflation in Hungary

The roots of persistent moderate inflation in Hungary are typical. Inflationary inertia is high, as expectations are entrenched. This is the case because moderate inflation has persisted for years and the government did not embark on a radical program to eliminate it. Hungarian authorities pursued a gradual disinflation policy in which they formulated moderately ambitious annual targets. The lowest rate of CPI inflation between 1990 and 1996 was achieved in 1994 (18.8%). Since inflation has been above 20% for practically the whole period of transition, the threshold of 20% is the floor under these expectations. Unlike in Poland, the authorities met their annual targets during the transition with the exception of 1993, which was an outlier (Table 2).³⁰

The positive record until 1994 brought about gains in the credibility of this approach; government projections of inflation were believed, which in turn led to a downward revision of inflationary expectations. The public did not expect an abrupt change of policy either way. Resorting to a stabilization package in 1995 destroyed the reputation of successful gradualism in Hungary; higher surprise inflation in 1995 than in 1994 effectively curtailed domestic absorption; real wages fell by more than 10%. The focus of the program fell on the reduction of the twin deficits to manageable levels, and temporarily accelerated inflation was a byproduct of devaluation, the import surcharge and relative price changes.

The persistence of inflation, like in the Polish case, instigated a rise of institutional arrange-

²⁹ ECU 70%, USD 30%.

³⁰ In 1993 the 0% VAT rate was discontinued and replaced by 10%, introduced in two steps, then services were reclassified to the (basic) rate of 25%, which added unexpected inflationary pressure.

Table 2

Hungary: Projected vs Actual Inflation

	CPI inflation target annual average	CPI inflation outcome
1990	19-20	28.9
1991	34-36	35.0
1992	20-25	23.0
1993	15-17	22.5
1994	16-22	18.8
1995	26-27	28.2
1996 (forecast)	20	23.5

Source: National Bank of Hungary.

ments which are supposed to separate nominal changes of economic quantities from real changes. However, such arrangements as indexation of wages and pensions, an adjustable or crawling peg tend to strengthen the inertia of inflation. Relative price adjustment is a significant factor as well. Monetary policy accommodated aggregate demand increases between 1991 and early 1994. In contrast to Poland, the budget deficit is financed by bond issuance; nevertheless, it has also played a role in upholding inflationary expectations.

No formal indexation of wages exists in Hungary, but implicit contracts dominate the labor market. Their indexation is based upon annual upward revisions of the minimum wage by the government, which set the floor for decentralized wage negotiations. Pensions are indexed according to a backward-working formula. It is observed that real wages deflated by the PPI increased in Hungary throughout the transition while real wages deflated by the CPI were relatively stable until the end of 1994. The latter declined in 1991 to start recovering in 1992 while production continued to fall. This fed the inflationary process because enterprises passed increased labor costs on to consumers. The extent of the fall in real wages in 1995 due to surprise inflation brought the time inconsistency problem to the fore in 1996. Wage earners refuse to accept wage increases based on government projections of inflation, as they are afraid that the government will have an incentive to induce more inflation in order to further cut domestic absorption, and that employers will pass the effects through to consumer goods prices. Therefore, they demand higher wages than those proposed by the Interest Reconciliation Council, which will tend to fuel inflation.³¹⁾ In fact, real wages dropped by 7% in the first half of 1996 on the corresponding period and are forecast to lose over 4% year on year, whereas the government projected a fall of 2%. This behavior of negotiating parties would imply that either the public thinks that fiscal redressment has not been completed yet (a case of rational expectations) or that the policy has lost its credibility. Only a demonstrated commitment by the authorities to curb inflation could rebuild it. 1996 seems to be lost in this respect, as inflation will likely overshoot the government target of 20% by a few points; a 23 to 24% rate was expected in November.³²⁾ This will involve a higher sacrifice ratio than under credibility, as expectations will be revised downward with a lag.

Similarities to Poland are striking when one considers relative price shocks. Despite gradual liberalization in the 1980s, relative price shocks have hit Hungary. Reductions in price subsidies, the gradual decontrol of energy prices, changes in the VAT structure and increases in the VAT burden to consumers pushed prices up. The liberalization of service prices (under central planning they were kept at artificially low levels) had its impact as well. Household energy prices rose by about 350%, services by 240% and the CPI by 200% in 1990 to 1995. In March 1995 Hungary introduced an 8% import surcharge tax. The coverage of goods by the VAT was expanded. The basic 25% rate covered 60% of all goods in 1995 while the remaining part was taxed at 15%; in 1988 more than 40% of all consumer goods had a zero tax rate.³³⁾ In 1995 the cost of energy for households increased by

31 See Neményi (1996).

32 *Op.cit.* Neményi.

33 *Over the period of transition, the CPI rose faster than the PPI, which reflects, inter alia, rising VAT rates for consumer products and excise taxes.*

63.6%. More energy price hikes are planned in January 1997; the price of gas is to rise by 18.8% and that of electricity by 24.9%. If monetary policy is not tight enough, these increases will tend to uphold inflationary pressure. Their inflationary impact will be counteracted by the gradual phasing out of the import surcharge, which started in the second half of 1996, and the tariff reduction in compliance with requirements of the World Trade Organization.³⁴) Both Poland and Hungary resorted to deferring increases in controlled prices in order to cap inflation. In both countries this policy reached limits; a hike in energy prices in 1995 compounded the effect of delays which had improved the inflationary performance of Hungary in 1994.

Finally, in 1994 inflation was indirectly upheld by the budget deficit of the general government, which surged to over 6% of GDP in 1992 to 1993 and to 8.5% in 1994. It has already been mentioned that deficit growth to unsustainable proportions in the period of 1993 to 1994 increased the risk that at some point the government will simply inflate the economy to ease the burden of servicing the accumulating public debt. The "unpleasant monetarist arithmetic"³⁵) intervened to obstruct the disinflation process, proving that the intertemporal budget constraint is seen by the public as binding. In contrast to Hungary, Poland's government avoided such a situation by clamping down on social spending in 1993 after the budget deficit had risen to 6.0% of GDP in 1992.

4.3 Counterinflationary Policies

Hungary made a decision to introduce a so-called fixed, but adjustable peg system in 1991³⁶), which, by contrast to the preannounced crawling peg system, allows for sudden and unexpected devaluations. Until the end of 1991 Hungary had usually devalued the forint once a year, usually at year-end, which led to currency speculation and visible leads and lags in foreign trade receipts. The adjustable peg regime was supposed to overcome this weakness by instituting an element of unpredictability and at the same time assuring a flexible reaction to current account developments. Between January 1992 and August 1994 Hungary followed a policy of frequent but small 1 to 3% devaluations to maintain a competitive real effective exchange rate. The rationale of going for small devaluations in the exchange rate was that they would not feed back to inflation, since they raise costs negligibly. Flexibility did not come without a cost. These devaluations failed to provide a nominal anchor for inflationary expectations, as they were not preannounced and a compounded rate of devaluation was unknown at the beginning of a year. In August 1994 an 8% devaluation heralded a coming end to the policy of small devaluations, which was continued until February 1995. In March 1995 Hungary started its stabilization program and replaced this exchange rate system by a preannounced crawling peg following a one-off 9% devaluation. Initially, the forint was devalued at the rate of 1.9% monthly against the basket with the rate slowing to 1.2% in 1996 (15.4% annualized). With the change of the exchange rate system, Hungary introduced an anchor for inflationary expectations. Due to the high degree of openness, such an anchor has much stronger effects than in the Polish case.

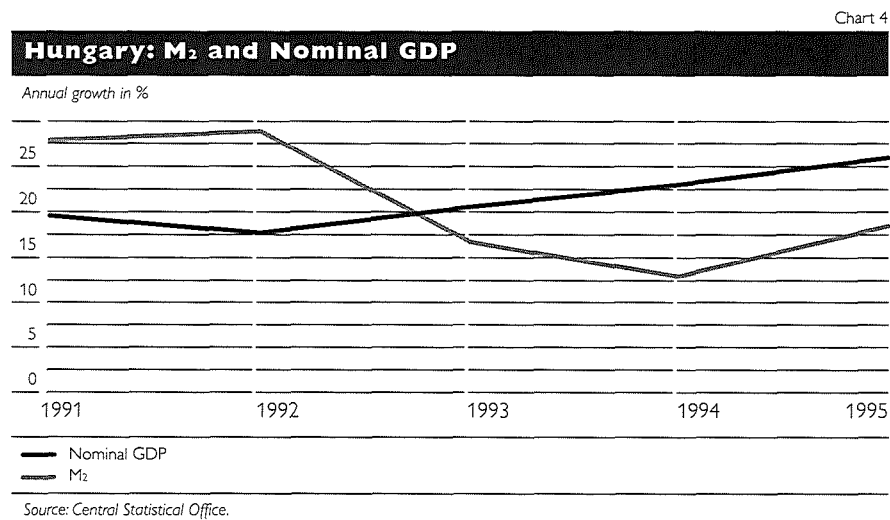
³⁴ *Op. cit.* Neményi.

³⁵ *The intertemporal budget constraint is binding, i.e. the public thinks that the government borrows too much and will be tempted to inflate the economy in the future in order to lower the cost of debt service. The term was coined by T. Sargent and N. Wallace in 1981.*

³⁶ *A unified exchange rate was introduced as early as 1981 and devalued at irregular intervals.*

This is particularly important in wage formation. Since the expected annualized rate of devaluation of approximately 28% in 1995 was much higher than in 1994 and 1993 when the actual rate reached 16.8% and 15%, respectively, it ratcheted up inflationary expectations at the outset of the program. During the second half of 1995 these expectations started easing after Hungary had cut the rate of devaluation to 1.3% monthly, and since then Hungary has adopted the typical approach of a country under a crawling peg regime, according to which the rate of nominal annual devaluation should be lower than inflation differential between Hungary and its main trade partners. In 1996 the rate of annual depreciation is 15.4% while CPI and PPI inflation rates are estimated to exceed 23%.

The Hungarian exchange rate arrangement until 1995 allowed for a more independent monetary policy than the crawling peg regime in Poland, and there is evidence that this avenue was explored by the authorities. After the initial tightening in 1991, monetary policy accommodated aggregate demand in 1992 to 1993, as the aggregate M₂ rose faster than nominal GDP (Chart 4).



This policy attempted to reconcile the balance-of-payments constraint with the requirements of gradual disinflation. Depending on the changing current account situation, it shifted from looser to tighter and vice versa. Changing priorities are reflected in the pace of devaluations. In 1994 monetary policy took a restrictive stance, which has been maintained since then. Nevertheless, inflation has been stubborn, which can be interpreted in a number of ways. First, there is a loose link between money and inflation, as inflation defies the monetary tightening with a considerable lag. Second, austere monetary policy was not able to break strong inflationary inertia when the loss of credibility occurred because of the break of disinflation in 1995.

The loss of credibility by a gradual approach to disinflation because of a sharp rise of inflation in 1995 does not, however, improve the case for a cold turkey approach. Inflationary expectations are too entrenched, so that a

radical anti-inflationary program would inflict a recession on the economy, whose growth under the recent stabilization has slowed considerably. The costs of rapid disinflation outweigh its benefits, as the poor growth track record relative to the countries of Hungary's peer group is visible. In this situation the government decided to resume the gradual disinflation process. It forecasts a fall in the annual average rate of CPI inflation to 18% in 1997 from the estimated 23 to 24% in 1996. The actual rate of inflation in 1996 will thus most likely overshoot the original projection of 20%. This discrepancy will not help restore the credibility of the anti-inflationary policy and put in question government projections for 1997, which will translate into sustained inertia of expectations. Hungary has fallen into the Polish track; the public believes that the government underestimates inflation because it wants to collect an inflationary tax. Therefore gradual disinflation in Hungary will become more tedious after its actual resumption in 1996.

5 Conclusions

This paper argued that the sources of persistent moderate inflation in Poland and Hungary are similar: Monetary policies accommodated aggregate demand at least during most of the transition, indexation of labor and debt contracts is widespread, exchange rate regimes incorporate mechanisms of devaluation to compensate exporters for inflation. There is one difference between both countries in the roots of moderate inflation. In Poland, the budget deficit was partially financed by credit from the central bank, whereas in Hungary such financing is prohibited. In the former country, where governments notoriously missed their inflationary targets, inflation brings additional revenue so the public finance argument for moderate inflation is valid. It can be argued that Hungary in 1995 and 1996 gives ground for this additional explanation as well because a surprise inflation tends to drive government revenue up.

Institutional setups sanction inflationary expectations, which are entrenched because inflation has been chronic in both countries and their feedback response upholds the inflationary process. This leads to a high inertia of inflation. Thus, moderate inflation is there because governments think it is too costly to be reduced to low levels by means of a shock treatment, as the inertia of the process is high.

In the environment of high inertia, a gradual approach to disinflation is the suitable option. No consistent theory exists to pinpoint the pace of optimal disinflation,³⁷) but at least the suppression of inflation should be rapid enough to countervail potential supply or demand shocks, which tend to offset the gains of price reduction and derail the economy from the projected disinflation path. Otherwise, a gradual approach risks a loss of credibility, which makes the process even slower. This is the case for both countries; their rate of disinflation is suboptimal, as inflation shows occasional jumps upward, not only because of periodical increases of regulated prices. Despite these qualifications, a radical therapy in the two countries examined would be a second-best solution, as an attempt to rapidly disinflate to e.g. single digits would involve high costs in terms of the forgone

37 See King (1996) for an attempt to construct such a theory.

output. Governments in these countries are good students of economic theory, which says that the costs of disinflation increase more than proportionately with the rate of disinflation (the Phillips curve describing a short-run trade-off between inflation and output is flatter at the lower end of inflation rates). The effects of the 1995 Hungarian austerity program lend support to this hypothesis, as inflation was higher than projected while GDP declined by more than projected. This situation is likely to repeat itself in 1996. One should qualify this piece of evidence for the inaccuracy of government projections.

Governments in both countries attach a large weight to growth in their welfare functions, which overshadows the weight of disinflation. Both countries aspire to catch up with western standards of living. Though recent evidence emphasizes, in general, an inverse relationship between long-term growth and inflation, it is inconclusive for the range of low and middle inflation. Both countries occupy the latter territory and project to disinflate toward low inflation within a five-year span. Hence, the forgone long-term growth of GDP is not decisive in their motivation to rapidly disinflate.

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O E N B A C T I V I T I E S

Lectures Organized by the Oesterreichische Nationalbank

Within the framework of a series of lectures on transition economies, the OeNB again hosted several lectures, notably by Prof. Bao Yao of the University in Shanghai and Mr. Balyozov of the Bulgarian National Bank. Moreover, two speeches were held on the occasion of a SUEF seminar at the OeNB. The topics covered in the speeches and some issues raised during the ensuing question-and-answer period are briefly outlined below.

Lecture by Yao Bao

China - A Comparison with other Transition Economies

On September 4, 1996, Professor Yao Bao of the Foreign Language University in Shanghai held a lecture entitled "China - A Comparison with other Transition Economies" at the Oesterreichische Nationalbank.

Professor Yao recounted that China has scored economic success by following a policy of gradual economic reform since the late 1970s. One of the first steps was the abolition of food stamps. Deng Xiaoping sought to implement a middle-of-the-road policy balanced between the conservative powers and the reformers. The reforms came to a halt with the events surrounding the Tiananmen Square incident. Not until Deng traveled through the southern provinces in 1992 could the reformers finally gain the upper hand in the party. Since then, the economy has been expanding again. In regional terms, the Guangdong province with its Shenzhen special economic zone is the bellwether for reform. Shanghai and the coastal provinces are currently experiencing a similar upswing.

The greatest experiment of the century, Soviet-style communism, came to an abrupt end after 50 years, while Chinese communism lives on. The credit goes to Deng's policy. Unlike Mao Zedong and other communist leaders, who rejected a market economy and assigned the highest priority to politics and the class struggle, Deng placed economic reform at the top of his agenda.

Incisive measures such as the reorganization of loss-making state-owned enterprises are conceived as long-term plans. Industrial restructuring harbors a large potential of hidden unemployment, so that steps initiated under the government's reform program must be taken cautiously and with an eye to establishing a social safety net. Professor Yao cited Shanghai's government-owned textile industry, where closure of unproductive factories dating from the 1940s triggered massive labor dismissals. Nevertheless, output rose on account of productivity gains.

Professor Yao viewed China's success as the result of continued step-by-step reforms carried out without changing the political fabric of communism. In pursuing this opening-up policy, China has attached a greater significance to achieving actual economic success than to sticking to political doctrine. Mr. Yao pinpointed the failures some post-communist transition economies have experienced to political reforms which left hardly any latitude for a positive economic development. Russia focused solely on pushing politically correct reforms while subjecting the economy to a shock therapy. In China, Professor Yao stated, it will remain necessary to uphold the

red flag of communism for political reasons, above all to maintain stability, but at the same time to continue with economic reform and the institution of free market measures under this banner.

China, the world's most heavily populated country, has stepped out of its isolation and has entered into regional and supraregional economic cooperation projects. Economic development has gained momentum in the wake of the reform measures, the opening of the country and modernization. Russia waited too long in implementing reforms. Professor Yao said that Russia should also stand to gain from gradual reform, considering that, unlike agricultural China, Russia is an industrial country with a wealth of natural resources. In this context, Mr. Yao cited Austria's failed reform policy of the late 18th century as a historical example, when Emperor Joseph II's ambitious reforms were too much during too short a reign.

Professor Yao rejected any hegemonic intention on the part of China. In his view, the standard of living will improve until it parallels that of the rich nations in the surrounding region before the issue of a closer political union is raised. The most important objective is to maintain the balance between politics and the economy. Here, Professor Yao called to mind the large gap between the living standards in eastern and western Germany which has been felt since the shock-like reunification of the two countries with their very different economies. Finally, Professor Yao compared China's reforms with the long and successful development of Europe, which went through a variety of first economic and then political phases after the end of World War II.

Lecture by Zdravko Balyozov

The Current Economic Situation in Bulgaria with a Focus on Monetary and Banking Sector Developments

On November 20, 1996, Dr. Balyozov, Member of the Board and Head of the Economics and Monetary Research Department of the Bulgarian National Bank, presented a comprehensive overview on economic developments in Bulgaria since the beginning of the reforms in early 1991. In a lecture at the OeNB, Mr. Balyozov stated that the past six years have seen numerous stop-and-go-phases of policymaking, especially as regards structural change. After the initial jump in the price level in 1991, associated with a far-reaching liberalization of the economy, the years up to 1993 were characterized by relative stability. After a currency crisis in March 1994 and a subsequent quickening of inflation, the country's macroeconomic performance improved significantly again in 1995. Simultaneously, the adjustment recession bottomed out and moderate rates of real positive growth were recorded in 1994 and 1995. The good macroeconomic framework conditions of 1995 were not, however, used to speed up structural reforms, so that the country missed a great chance for making the progress achieved that far sustainable.

The year 1996 has been marked by a profound financial crisis expressed in a loss of confidence both in the Bulgarian lev and in the country's banking system. In its wake, the authorities speeded up negotiations with the IMF for a standby agreement, and a comprehensive stabilization and structural reform program was hammered out. On this basis, the Fund approved a standby credit for Bulgaria in July. However, the second tranche of the loan, scheduled for September, has not been disbursed, primarily due to delays in structural reforms (mainly the closure of state-owned enterprises making large losses). Despite a substantial tightening of monetary policy, the lev has not stabilized. The central bank has taken several measures to sort out financial sector problems, namely by putting commercial banks under central bank conservatorship and subsequently isolating nonviable banks, but the courts' insolvency proceedings have been slow, which has retarded the process. In November 1996, the IMF offered the introduction of a currency board as the only choice to reestablish monetary confidence. The Bulgarian National Bank is taking a cautious view on this proposal, as a currency board would radically change the macroeconomic environment in the country. The bank is carefully studying the advantages and disadvantages of such an extreme option and is also exploring other possible alternatives. The bank still needs to be convinced that a currency board is the best framework which provides the adequate incentives for the badly needed microeconomic changes. Lastly, it should be borne in mind that the role of the bank in the move to a currency board is only of an advisory nature, as the respective decision will have to be made by parliament.

In Mr. Balyozov's view, the Bulgarian experience clearly shows that it is impossible to achieve a sustainable macroeconomic and financial environment to promote economic growth in the medium term by prudent monetary policy only, without the support of major changes in the real sector imposing effective hard-budget constraints on all economic agents.

SUERF Seminar**Corporate Governance by Banks
in Central and Eastern Europe**

On October 11, 1996, the Oesterreichische Nationalbank hosted a SUERF seminar as part of the program of the 1996 SUERF Council Meeting in Vienna. The session dealt with corporate governance by banks in Central and Eastern Europe and was chaired by Professor Dr. Georg Winckler (University of Vienna). The seminar contained two presentations.

First, Dr. György Mohai, Head of Research of Creditanstalt Securities Ltd., Budapest gave a speech entitled "The Role of Investment Banks in Corporate Restructuring in Hungary". Mr. Mohai's main finding was that investment banks have played a key role in introducing Western capital market standards to the companies being privatized in Hungary. Investment banks brought in lawyers, auditors, marketing and PR experts. Thus, investment banks have acted as a catalyst in many respects.

Second, Professor Dr. Gerhard Fink (University of Economics, Vienna) presented a paper on "Bank Restructuring and Corporate Governance by Banks in Central and Eastern Europe". In Professor Fink's view, corporate governance by nationally owned (private and state-owned) banks in Central and Eastern Europe has been rather weak. This is due to the small market size, underdeveloped bank supervision, and a lack of codes of conduct in the case of financial difficulties of banks. Foreign-owned subsidiaries of banks may constitute an exception, as they can exercise efficient corporate governance if the disclosure obligations of corporations listed on the stock exchanges are sufficiently tight.

The seminar was concluded by a luncheon speech by Mr. Dietmar Spranz, Executive Director at the Oesterreichische Nationalbank, on "Banking and European Monetary Union" focusing on the manifold challenges banks are facing in the context of the introduction of the euro in 1999.

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

The series of meetings initiated in 1991 was continued, with meetings held in June, October and December. The October meeting marked the 25th anniversary of this institution, which was celebrated by the invitation of an especially prominent guest speaker, Mr. Bokros, former minister of finance of Hungary. In the long-standing tradition of these meetings, the East Jour Fixes were opened with speeches about highly topical issues related to transition economies, which are presented by specialists in the field and commented by invited discussants. Top-level policymakers, analysts and researchers from institutes and universities have the opportunity for an exchange of views during the general discussion, which is a very important point on the agenda. A more detailed description of the history and purpose of the East Jour Fixe is available in "Focus on Transition 1/1996". The main findings of the abovementioned meetings are presented below.

Contributions by András Inotai and Maria Leitgeb

Hungary's Preparation for Membership in the European Union

The Austrian Approach to Eastern European Integration into the EU

Held at the 24th East Jour Fixe on June 21, 1996

On June 21, 1996, within the framework of the 24th East Jour Fixe, Prof. András Inotai, Director of the Institute for World Economics of the Hungarian Academy of Sciences, delivered a lecture on the Hungarian government's preparation for the country's planned accession to the EU and Hungary's first experiences in filling out the EU Commission's questionnaire. The main points emphasized by Mr. Inotai are summarized below.

Hungary's political circumstances are stable; the multiparty system is functioning smoothly, and no extremist parties are represented in parliament. At present the preparatory activities for Hungary's accession to the EU are proceeding along three main lines: First, the implementation of the second part of the Association Agreement between the EU and Hungary; second, the preparation and launching of an integration strategy, and third, the completion of the EU Commission's questionnaire.

Mr. Inotai observed that the main tasks Hungary has during this phase of the integration process are to: (i) work out a national strategy for integration into the EU (not limited to economic issues), (ii) strengthen investment by redistributing resources, (iii) implement a general reform, inter alia of public finances, in order to free cofinancing resources for EU facilities, (iv) establish the institutional framework for an efficient decision-making process.

The European Union is at present a very important modernization anchor of Hungarian society. The government has to concentrate on investment, the only way to increase productivity, stated Mr. Inotai. It is essential that a concept for modernization be worked out to further increase the competitiveness of the Hungarian products.

Before the negotiations on accession to the EU start, Hungary has to define its priorities. Moreover, it has to identify what kind of contribution it can make to the EU as a newcomer. The potential regional effects of the future accession of Central and Eastern European countries have to be analyzed at a multilateral level. Hungary's government must not forget that EU accession will affect also domestic policy processes - and will give rise to social challenges. The social costs of the extension of the EU towards the East are just as important as the economic costs, remarked Mr. Inotai.

The second lecture delivered at this East Jour Fixe was held by Ms. Maria Leitgeb of the Federal Chancellery, who presented Austria's approach to the integration of Central and Eastern European countries into the EU. Ms. Leitgeb underlined that Austria has an explicit interest in the eastward extension of the EU in the case of its neighbors, to whom Austria's economic ties are historically very close. Ms. Leitgeb stressed the need to examine the potential for regional cooperation.

Contribution by Lajos Bokros, The World Bank

Transformation in Central and Eastern Europe - Ambitions, Achievements and Challenges

Held at the 25th East Jour Fixe on October 25, 1996

On October 25, 1996, the 25th East Jour Fixe was held. The main speaker was Lajos Bokros, now Senior Adviser to the Vice President, The World Bank, previously Minister of Finance in Hungary. This lecture dealt with a variety of aspects related to the transition process in the CEECs, notably Hungary. His lecture was commented by Andreas Wörgötter (Institute for Advanced Studies) and Ewald Nowotny (University of Economics and Business Administration).

His approach was to analyze some puzzles concerning Hungary. The first puzzle was why the economy stagnated although Hungary had the reputation of being a leading reforming country. Hungary showed relatively high inflation and low growth, but at the same time it attracted half of all foreign direct investment and portfolio investment.

A further question Mr. Bokros raised was that of why stabilization has been postponed. Concerning the supply side, Hungary had a better position than the Czech Republic and Poland. Hungary did not introduce a shock therapy. A shock therapy was not necessary: The country had already opened its market for some time without triggering shortages, a black market, dollarization or multiple exchange rates. In contrast, countries which had these problems needed a shock therapy. It was right for Hungary not to privatize by the voucher method, because the method it chose attracted foreign capital and improved corporate governance.

For some time the government thought that a stabilization policy was not necessary. The government's strategy was to support growth by consumption expenditures (not investment), but this proved not to be possible. The outcome produced deficits in the trade balance, the current account and the state budget. Stabilization became unavoidable. It led to a strong depreciation

of the currency and the introduction of a crawling peg regime, which contributed to the credibility of the policy. An important task facing Hungary is the stabilization of the budget. Finally, Mr. Bokros discussed the issue of why Hungary shows such low growth. The stabilization package slowed growth down, and the social security system suffers from a huge deficit. Only a thorough reform of the public sector can bring about sustainable growth. Social benefits have to be adjusted, and much effort is needed to support investment.

Conference on Monetary Policy in Transition: Strategies, Instruments and Transmission Mechanisms

From November 17 to November 19, 1996, the OeNB held an international conference in Vienna on the topic of monetary policy in transition. The conference was structured around three issues: First, monetary policy in Western Europe; second, monetary policy and European Monetary Union and third, monetary policy in Central and Eastern Europe. High-ranking representatives from central banks, universities and research institutes participated in the conference.

Organized by the
Oesterreichische
Nationalbank

Monetary policy in Central and Eastern Europe was covered by representatives of the central banks of Hungary (Judit Neményi), Poland (Ryszard Kokoszczynski), the Czech Republic (Miroslav Hrnčíř) and Slovakia (Marián Nemeč) in a round table discussion led by Leslie Lipschitz of the IMF. In their statements, the invited speakers presented the monetary policy strategy chosen by their countries during the reform process, the move from direct to indirect instruments of monetary control and the workings of the transmission mechanism.

The speakers pointed out that the initial phase of transition was usually characterized by very large movements in nominal magnitudes; therefore successful stabilization required a strong nominal anchor. Some countries – e.g. Poland, the Czech Republic and the Slovak Republic – opted for an explicit exchange rate anchor after an initial devaluation. The advantage was that this regime signals a visible political commitment that helps to discipline other facets of economic policy, especially fiscal policy. In most cases there were also limits on nominal wage settlements.

The new two-tier banking system started out facing numerous problems: poor quality assets, inadequate capital, no interbank or secondary markets and a dearth of skilled personnel. The nominal exchange rate has succeeded in effectively disciplining prices and wages in much of the economy, but many countries have pockets of industries still operating in a regime in which price signals are ignored in wage settlements. Although fixed investment is financed largely by retained earnings, a banking system capable of evaluating and providing (collateralized) loans to new small ventures is of immense value to transition.

There are still many open questions, like inflation inertia in some countries that in many other respects are starting to look like Western Europe. Why, for example, are prices still rising so rapidly in the nontraded goods sector in Hungary when the traded goods sector is disciplined by the exchange rate commitment and demand in the economy as a whole seems fairly restrained? What are the links between monetary policy and the large informal sectors in many of the Central and Eastern European economies?

The OeNB will publish the proceedings of the conference in spring 1997.

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

In the second half of 1996, the OeNB continued its cooperation activities with Central and Eastern Europe and CIS republics both on a bilateral and on a multilateral level.

The OeNB staged a number of bilateral technical cooperation activities, organizing various short study and information visits as well as specific consultations for Central and East European central bankers at the OeNB. As a case in point, the OeNB organized a one-week training course on legal issues for ten employees of the National Bank of the Ukraine at the end of September. In October 1996, another one-week training course on payment systems was held at the OeNB for eight employees of the National Bank of the Republic of Belarus. A high-ranking delegation from the National Bank of Romania paid a two-week visit to the OeNB at the beginning of November 1996 to gather information on banking supervision, internal auditing and personnel management. Moreover, the OeNB held consultations with representatives from the National Bank of Armenia (foreign exchange dealing) and the Central Bank of Russia (banknotes and coins). Furthermore, the OeNB will continue to host one-year traineeships for employees of Central or Eastern European central banks. Under this program, an employee from the National Bank of Hungary has been appointed to a traineeship position for 1997.

In view of the new challenges the associated countries face in connection with EU accession, the OeNB devoted a one-day bilateral workshop to the topic of the organization of EU-related work of central banks, which was held in October 1996 together with the National Bank of Hungary in Budapest. At this workshop, the OeNB's experience in preparing Austria's EU membership from the central bank's view was presented and discussed with the Hungarian central bank. Moreover, starting in 1997, the OeNB will organize a series of four highly specialized seminars exclusively designed for central bankers with a duration of one week per seminar. These seminars, which will be held within the organizational framework of the Joint Vienna Institute, will be given in English and will cover the following topics: central bank accounting (February 1997), internal auditing and central bank controlling (July 1997), exchange rate and portfolio management (September 1997), payment systems (November 1997). Invitations to the first seminar have already been sent to the partner central banks.

At a multilateral level, the OeNB took part in the TACIS meeting of the EU-financed technical assistance program for the Central Bank of Russia in St. Petersburg from October 16 to 18, 1996. Under this program, the OeNB will contribute two one-week seminars in 1997, one on central bank accounting and one on human resource management. Within the framework of IMF-coordinated technical assistance, OeNB experts held two seminars for the People's Bank of China, one on central bank profits in July 1996 and one on accounting systems for central banks in August 1996. Turning to cooperation with the Joint Vienna Institute (JVI), the OeNB organized several lectures for seminar groups as well as individual meetings for JVI course participants at the Bank in the second half of 1996. Moreover, the OeNB – as in the previous years – organized and financed (jointly with the Ministry of Finance) a one-week study tour for the participants of the JVI comprehensive course in October 1996.

S T A T I S T I C A L A N N E X

Gross Domestic Product

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
Annual change in %											
1989	-1.9	4.5	x	0.7	x	x	0.2	-5.8	x	1.1	-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	-2.1	2.9	0.6	1.0	5.2	4.0	-12.6	4.9	4.9
1995	2.6	4.8	2.9	1.5	-1.6	3.0	7.0	6.9	-4.0	7.4	3.5
1995											
1st quarter	..	3.9	..	..	..	..	..	..	-5.0	5.8	..
2nd quarter	..	4.1	..	..	-2.1	..	..	..	-2.3	6.2	3.9
3rd quarter	..	6.3	..	..	-2.3	..	..	..	-3.7	8.2	2.9
4th quarter	..	5.0	..	..	-3.5	..	..	..	-4.3	8.5	1.6
1996											
1st quarter	-2.6	4.6	-0.3	0.0	2.3	..	3.9	..	-3.3	7.3	1.5
2nd quarter	-9.8	4.0	..	0.0	0.0	..	5.2	..	-5.7	6.9	1.8
3rd quarter	..	..	..	..	..	..	7.3	..	-7.3	..	..

Source: WIIW (Vienna Institute for Comparative Economic Studies); Estonia, Lithuania: IMF; Latvia: IMF; Hungary: national sources from 1994. Quarterly data: national sources.

Industrial Production

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania ¹⁾	Poland	Romania	Russia	Slovak Republic	Slovenia
Annual change in %											
1989	-30.3	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											
July	12.7	7.0	14.2	7.3	-7.4	5.3	11.1	9.0	3.1	5.4	1.3
August	5.5	7.0	17.7	2.6	-1.2	22.6	9.1	8.0	-1.9	10.7	-5.1
September	-1.6	7.1	9.5	2.3	-1.8	5.8	7.3	10.1	-0.1	12.3	-0.2
October	7.8	18.4	16.4	4.6	-4.7	7.8	14.2	14.6	-1.9	12.7	0.0
November	2.9	11.8	7.7	0.7	-2.3	8.7	9.6	10.4	-3.5	9.9	0.5
December	-15.9	7.7	-4.4	-4.4	-6.5	5.7	1.6	5.2	-1.9	2.7	-5.7
1996											
January	7.4	12.2	5.3	2.4	0.3	17.3	9.6	8.4	2.2	11.6	-5.0
February	-5.9	13.4	5.0	4.4	0.0	14.7	8.7	7.0	0.6	9.7	-4.0
March	-6.9	4.6	2.9	-1.7	-5.8	0.2	7.0	2.3	0.0	1.1	-6.4
April	-2.5	12.9	9.3	4.8	-1.9	-1.3	14.8	12.7	4.3	2.1	11.5
May	-6.2	6.0	5.2	-3.7	3.2	1.7	9.1	10.6	-5.9	-0.3	-0.5
June	0.9	1.5	-4.7	-0.2	1.2	-8.3	2.6	14.2	-8.3	-2.3	-11.4
July	-1.0	15.5	..	8.3	-8.5	..	13.2	8.4	-6.8	5.5	6.2
August	2.0	5.8	..	-3.2	-3.5	..	7.0	9.3	-8.5	-1.5	-1.8
September	-12.0	6.9	..	2.5	-5.3	..	7.9	10.5	-6.8	1.9	5.0
October	..	..	..	..	..	..	13.9	..	..	..	..

Source: annual data: WIIW; Estonia, Latvia, Lithuania: national sources. Monthly data: OECD; Bulgaria, Latvia: national sources from July 1996; Czech Republic: national sources from September 1996; Hungary, Romania, Russia, Slovenia: national sources from June 1996; Poland: national sources from May 1996; Slovak Republic: national sources from April 1996.

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	x	x	x	0.4	x	x	x	x	x	x	3.5
1990	1.7	0.8	x	1.9	x	x	6.3	x	x	1.6	5.8
1991	11.1	4.1	x	7.8	x	x	11.8	3.0	0.1	11.8	10.1
1992	15.2	2.6	1.8	13.2	2.3	x	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											
July	10.9	2.9	..	11.0	6.1	..	15.3	9.8	2.9	13.5	13.8
August	10.7	3.0	1.6	10.9	6.1	6.3	15.2	9.4	3.0	13.3	13.8
September	10.5	3.0	..	10.8	6.0	..	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	1.8	10.6	6.3	7.3	14.7	8.8	3.1	12.8	14.4
December	11.1	2.9	..	10.9	6.6	..	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	2.2	11.6	6.8	8.3	15.4	9.3	3.5	13.7	14.2
March	11.4	3.0	..	11.6	7.0	..	15.4	9.4	3.7	13.3	13.9
April	11.0	2.8	..	11.2	7.1	..	15.1	8.7	3.8	12.5	13.8
May	10.4	2.7	2.3	10.7	7.1	7.0	14.7	8.0	3.7	11.9	13.7
June	10.0	2.8	..	10.6	7.0	..	14.3	7.7	3.5	12.1	13.3
July	10.4	3.0	..	10.8	7.1	..	14.1	7.1	3.5	12.5	13.3
August	10.4	3.1	..	10.8	7.1	..	13.8	6.4	..	12.3	13.5
September	10.5	3.2	..	11.0	7.0	..	13.5	6.2	..	12.2	..
October	..	..	..	10.8	..	..	13.2	..	..	..	..

Source: WIW; Estonia, Latvia, Lithuania: national sources; Bulgaria, Hungary, Poland, Romania, Slovak Republic: national sources from September 1996; Czech Republic, Slovenia: national sources from August 1996.

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	x	x	x	17.0	x	x	251.1	1.1	x	x	1,306.0
1990	23.8	9.9	x	28.9	x	x	585.8	5.1	5.3	10.6	549.7
1991	338.5	56.7	x	35.0	x	x	70.3	170.2	92.6	61.2	117.7
1992	91.3	11.1	..	23.0	243.6	x	43.0	210.4	1526.0	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	28.8	28.2	25.0	39.7	27.8	32.3	198.0	9.9	12.6
1995											
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	46.1	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	28.4	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	33.1	7.9	26.5	28.3	23.1	35.7	21.6	27.7	131.4	7.2	8.6
1996											
January	31.1	9.0	28.8	28.9	23.2	32.4	21.0	26.7	104.5	6.4	8.5
February	28.7	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	9.3
April	28.9	8.5	29.4	24.4	18.6	31.3	20.3	28.7	68.4	6.0	10.7
May	42.3	8.7	26.7	23.9	17.4	28.9	19.8	34.1	58.6	6.1	10.9
June	70.2	8.4	24.7	23.6	17.6	28.1	19.5	33.7	50.2	6.2	10.5
July	106.8	9.4	23.0	23.0	17.7	24.9	20.4	40.3	43.5	5.5	10.7
August	140.9	9.6	21.8	22.9	17.4	24.3	20.5	44.2	36.9	5.6	10.3
September	172.9	8.9	20.1	22.2	16.1	..	19.5	45.3	31.4	5.2	9.4
October	..	..	..	21.0	..	..	19.5	..	..	..	9.7

Source: WIW; Estonia, Lithuania, Latvia: IMF; Hungary, Romania, Slovak Republic: national sources from August 1996; Poland: national sources from September 1996; Russia: national sources from June 1996; Slovenia: national sources from March 1996.

¹⁾ Retail price index.

Trade Balance

	Bulgaria ¹⁾	Czech Republic	Estonia	Hungary	Latvia	Lithuania ²⁾	Poland	Romania	Russia	Slovak Republic	Slovenia
	USD million										
1989	-1,199.0	x	x	537.0	x	x	240.0	2,559.0	x	x	x
1990	- 757.0	x	x	348.0	x	x	2,214.0	-1,743.0	x	x	x
1991	- 32.0	x	x	189.0	x	x	51.0	-1,254.0	x	x	x
1992	- 212.4	x	x	- 48.0	x	x	512.0	-1,420.0	x	x	791.1
1993	- 885.4	- 311.7	- 91.0	-3,247.0	37.0	-154.7	-2,293.0	-1,128.0	x	-932.0	-154.2
1994	- 16.9	- 888.9	-353.0	-3,635.0	-252.0	-204.9	- 836.0	- 411.0	19,711.0	58.5	-337.9
1995	131.6	-3,935.2	-707.1	-2,442.0	458.2	-698.0	-1,827.0	-1,231.0	22,754.0	24.1	-956.6
1995											
July	..	- 262.5	- 79.6	- 125.0	- 36.5	..	- 55.0	- 308.4	1,827	7.7	- 95.8
August	..	- 374.9	- 39.0	- 107.0	- 31.6	..	- 185.0	- 66.7	1,966	55.4	- 59.7
September	215.6	- 103.0	- 31.0	- 73.0	- 47.9	- 98.0	- 217.0	- 122.5	2,478	43.5	- 5.9
October	..	- 372.5	- 64.7	- 75.0	- 47.9	..	- 179.0	- 94.3	2,068	19.5	- 24.9
November	..	- 353.4	-101.9	- 111.0	- 52.0	..	- 214.0	- 65.3	2,284	- 3.1	-101.9
December	- 124.2	- 538.4	- 83.2	- 137.0	- 61.8	-249.6	- 504.0	- 76.6	1,600	- 61.3	-198.6
1996											
January	16.1	- 291.0	- 66.6	- 302.0	- 55.1	..	- 661.0	29.5	2,200	- 71.3	16.1
February	52.1	- 308.4	- 66.7	- 339.0	- 65.5	..	- 415.0	56.2	1,900	-367.7	- 98.7
March	63.7	- 398.6	- 85.9	- 180.0	- 65.6	-152.3	- 382.0	- 99.5	1,910	- 83.7	-143.2
April	- 49.8	- 454.4	- 84.3	47.0	- 61.3	..	- 520.0	- 155.7	1,460	-191.9	- 97.1
May	1.6	- 561.1	- 74.6	- 161.0	- 58.2	..	- 649.0	- 142.9	2,800	-128.9	-185.6
June	72.3	- 495.0	- 82.4	- 259.0	- 47.6	-142.2	- 535.0	- 113.5	1,840	- 46.1	-128.6
July	..	- 605.5	-106.4	- 244.0	- 42.8	..	- 537.0	- 131.2	..	-161.6	- 78.3
August	..	- 546.8	..	- 329.0	..	..	- 810.0	..	..	-131.9	-106.0
September	..	- 395.8	..	- 173.0	..	..	- 764.0	..	..	..	- 29.3

Source: national sources; Lithuania: IMF.

Unlike in issue 1/96 of Focus on Transition, the data are derived from national sources, which provide more up-to-date information.

¹⁾ 1995: quarterly data.

²⁾ Quarterly data.

Current Account

	Bulgaria ¹⁾	Czech Republic ²⁾	Estonia ²⁾	Hungary ²⁾	Latvia ²⁾	Lithuania	Poland	Romania	Russia ²⁾	Slovak Republic ¹⁾	Slovenia
	USD million										
1989	-1,306.0	x	x	-1,437.0	x	x	-1,419.0	2,864.0	x	x	x
1990	-1,152.0	x	x	127.0	x	x	716.0	-1,656.0	x	x	x
1991	- 76.9	x	x	267.0	x	x	-1,359.0	-1,187.0	x	x	x
1992	- 360.5	x	36.1	324.0	191.0	x	- 269.0	-1,564.0	x	x	926.2
1993	-1,098.0	114.6	23.3	-3,455.0	417.0	-85.7	-2,329.0	-1,174.0	x	-601.2	191.9
1994	- 31.9	- 49.7	-170.8	-3,911.0	201.0	-93.8	- 944.0	- 428.0	11,364.0	664.9	540.4
1995	- 43.3	-1,891.5	-187.9	-2,480.0	36.3	..	-2,299.0	-1,336.0	12,261.0	646.2	- 36.1
1995											
July	..	..	..	- 2.0	..	..	- 108.0	- 113.0	..	..	- 4.3
August	..	..	..	- 234.0	..	..	- 198.0	55.0	..	..	27.8
September	217.4	- 270.9	20.5	18.0	8.5	47.4	- 281.0	- 141.0	72.0	273.0	67.3
October	..	..	..	122.0	..	..	- 591.0	- 171.0	..	..	37.7
November	..	..	..	- 50.0	..	..	- 156.0	- 4.0	..	..	- 21.7
December	- 154.0	- 898.1	- 77.6	- 260.0	- 38.1	..	- 170.0	- 62.0	2,260.0	51.0	-154.2
1996											
January	- 112.8	..	..	- 294.0	..	..	- 162.0	- 39.0	..	- 19.6	85.4
February	62.2	..	..	- 313.0	..	..	169.0	9.0	..	-326.5	- 41.4
March	48.4	- 541.1	-111.5	- 219.0	- 88.8	..	70.0	- 126.0	5,846.0	- 73.5	- 88.7
April	- 60.6	..	..	78.0	..	..	- 408.0	- 152.0	..	-184.3	- 15.4
May	8.0	..	..	10.0	..	..	19.0	- 114.0	..	-105.0	-120.5
June	70.1	-1,163.7	..	- 196.0	- 96.7	..	40.0	- 98.0	..	- 28.2	- 44.6
July	..	..	..	- 33.0	..	..	262.0	..	..	..	- 4.0
August	..	..	..	- 99.0	..	..	58.0	..	..	..	3.1
September	..	..	..	- 44.0	..	..	- 358.0	..	..	..	29.1

Source: national sources.

Unlike in issue 1/96 of Focus on Transition, the data are derived from national sources, which provide more up-to-date information.

¹⁾ 1995: quarterly data.

²⁾ Quarterly data.

Total Reserves minus Gold

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
<i>End of period (USD million)¹⁾</i>											
1989	x	x	x	1,246	x	x	2,314	1,859	x	x	x
1990	x	x	x	1,070	x	x	4,492	524	x	x	x
1991	320	x	x	3,936	x	x	3,633	695	0	x	112
1992	902	755	170	4,428	x	45	4,099	826	2,000	x	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	1,579	14,383	3,364	1,821
1995											
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	490	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	1,345	12,703	2,819	1,707
November	1,363	12,857	551	9,012	492	702	14,032	1,439	12,342	2,992	1,706
December	1,236	13,843	580	12,052	504	757	14,774	1,579	14,383	3,364	1,821
1996											
January	956	13,454	571	12,146	497	666	15,317	1,392	11,898	3,253	1,714
February	860	13,923	570	11,545	501	615	16,819	1,343	12,689	3,343	1,622
March	644	13,061	570	10,876	520	630	17,363	1,499	16,331	3,404	1,558
April	628	12,649	608	9,729	542	644	17,207	1,381	14,269	3,352	1,588
May	600	12,689	599	9,592	566	654	17,824	1,716	12,004	3,300	1,517
June	573	12,633	592	9,876	570	673	17,451	1,869	12,792	3,322	1,658
July	480	12,835	605	9,494	583	739	17,608	1,848	12,497	3,449	1,769
August	548	12,900	589	9,738	598	791	17,797	..	12,089	3,623	2,294
September	480	12,600	589	..	598	774	17,554	..	..	..	2,277

Source: IMF; Czech Republic: national sources for monthly data; Hungary, Poland: national sources from August 1996; Slovenia: national sources from September 1996.

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 ¹⁾	Hungary ²⁾	Latvia	Lithuania	Poland ³⁾	Romania ⁴⁾	Russia	Slovak Republic	Slovenia ⁵⁾
<i>In % of GDP</i>											
1989	x	-1.2	x	-3.1	x	x	-3.0	7.5	0.7	-0.6	x
1990	x	-0.2	x	-0.1	x	x	0.4	-0.4	1.3	-0.2	x
1991	x	-2.1	x	-4.6	x	x	-3.8	-1.9	-2.7	-3.9	2.6
1992	-5.8	-0.2	x	-6.7	-3.0	x	-6.0	-4.4	-3.4	-2.8	0.3
1993	-11.0	0.1	-0.4	-5.6	-0.2	x	-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
1995											
1st quarter	-9.3	2.3	..	-11.7	-5.7	..	-4.7	-0.3	-3.5	-3.8	..
2nd quarter	-7.1	1.3	..	-3.3	-2.0	..	-1.3	-4.9	-3.2	3.2	..
3rd quarter	-7.2	1.2	..	-1.6	-1.9	..	-2.0	-4.1	-1.8	-2.2	..
4th quarter	-4.4	-2.3	..	5.5	-5.6	..	-2.5	-6.2	-3.7	-4.0	..
1996											
1st quarter	-10.6	0.5	-1.7	-3.1	-2.0	..	-3.4	-3.6	-3.4	-2.6	..
2nd quarter	-5.4	-0.8	-2.5	-4.4	-1.4	..	-3.0	-1.8	-4.6	-1.8	..
3rd quarter	-15.1	0.3	..	0.4	..	..	-1.0	-6.5	..	-4.8	..

Source: WIIW; Latvia, Lithuania: national sources. Quarterly data: 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	x	x	20,390	x	x	40,800	174	x	x	x
1990	10,600	x	x	21,270	x	x	48,475	230	56,200	x	1,954
1991	11,375	x	x	22,658	x	x	48,412	1,143	70,100	x	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	5,800	2,970

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

¹⁾ Medium- and long-term gross debt.

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)										
1989	1,575.08	x	x	22.40	x	x	9,194.37	88.67	x	x	x
1990	519.17	x	x	17.99	x	x	1,196.82	50.69	x	x	x
1991	65.63	x	x	15.62	x	x	1,104.00	15.29	x	x	42.35
1992	47.08	38.83	93.04	13.91	1,492.10	620.86	806.49	3.57	4.95	38.83	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											
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	0.48	0.23	34.14	8.53
October	14.60	37.87	88.06	7.44	1,865.94	249.10	407.88	0.45	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	34.37	7.93
February	13.83	38.09	87.91	7.14	1,888.70	257.81	405.33	0.37	0.22	34.39	7.82
March	13.34	38.13	87.92	7.12	1,900.07	259.84	403.47	0.36	0.22	34.53	7.78
April	12.99	38.51	88.05	7.12	1,922.20	264.78	404.03	0.36	0.22	34.84	7.79
May	9.03	38.93	88.34	7.10	1,950.89	269.71	403.82	0.37	0.22	34.90	7.80
June	7.51	38.66	88.00	7.03	1,939.93	268.68	395.92	0.36	0.21	34.63	7.82
July	5.88	39.08	87.99	6.92	1,918.73	264.79	390.15	0.35	0.21	34.45	7.85
August	5.44	39.33	87.94	6.78	1,903.30	260.75	382.19	0.33	0.20	34.34	7.89
September	4.72	39.94	88.00	6.76	1,919.46	264.89	381.40	0.33	0.20	34.50	7.88
October ¹⁾	4.43	39.53	88.06	6.70	1,919.00	266.00	377.79	0.31	0.19	34.30	7.76

Source: IMF; Romania, Russia: monthly data, national sources.

¹⁾ OeNB, end of period.

Discount Rate¹⁾

	Bulgaria	Czech Republic	Hungary	Latvia	Poland	Romania	Russia ²⁾	Slovak Republic	Slovenia
<i>End of period</i>									
1989	x	x	17.0	x	104.0	x	x	x	x
1990	4.5	x	22.0	x	48.0	3.0	x	x	x
1991	54.0	x	22.0	x	36.0	12.8	x	x	x
1992	41.0	9.5	21.0	120.0	32.0	61.8	80.0	9.5	25.0
1993	52.0	8.0	22.0	27.0	29.0	70.0	210.0	12.0	18.0
1994	72.0	8.5	25.0	25.0	28.0	66.1	180.0	12.0	16.0
1995	34.0	9.5	28.0	24.0	25.0	39.9	160.0	9.8	10.0
1995									
July	39.0	9.5	28.0	26.5	27.0	40.0	180.0	11.0	10.0
August	34.0	9.5	28.0	26.5	27.0	35.0	180.0	11.0	10.0
September	34.0	9.5	28.0	26.5	25.0	35.0	180.0	11.0	10.0
October	34.0	9.5	28.0	26.5	25.0	33.0	170.0	9.8	10.0
November	34.0	9.5	28.0	25.0	25.0	33.0	170.0	9.8	10.0
December	34.0	9.5	28.0	24.0	25.0	35.0	160.0	9.8	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
May	108.0	9.5	26.0	15.0	23.0	35.0	120.0	8.8	10.0
June	108.0	10.5	26.0	13.0	23.0	35.0	120.0	8.8	10.0
July	108.0	10.5	25.5	13.0	22.0	35.0	110.0	8.8	10.0
August	108.0	10.5	25.5	12.0	22.0	35.0	80.0	8.8	10.0
September	300.0	10.5	24.5	11.0	22.0	35.0	80.0	8.8	10.0
October	240.0	..	23.0	..	22.0	..	60.0	..	10.0

Source: IMF; Poland, Russia: national sources; Bulgaria, Lithuania, Romania: OECD; Bulgaria, Romania: national sources from May 1996; Hungary: national sources from July 1996; Latvia: national sources from September 1996; Slovenia: national sources from October 1996.

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.



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