

The financial sector, macroeconomic policy and performance



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1. Introduction

A healthy and developing financial sector is a key support to balanced and sustainable economic growth. And as the countries of central Europe –the Czech Republic, Hungary, Poland, Slovakia, and Slovenia– approach EU membership and ultimately adoption of the euro, the litmus test for financial sector performance will be its success in supporting such growth and the process of convergence to EU income levels.

But with the financial sector at the crossroads of the macroeconomy, it not only has immense potential to invigorate and broaden economic growth, it can also impair macroeconomic policy and stability. From the standpoint of transition, this is perhaps most evident in the fact that successful reform of the banking sector is a necessary condition for fiscal and monetary stabilization. A well-functioning banking sector can go far in containing quasi-fiscal losses and avoiding the soft budget constraints of the past. Meanwhile, underdevelopment and vulnerabilities in the banking system, and the financial sector more generally, can complicate the conduct of monetary policy, seriously limit the policy choices both in day-to-day operations and in response to external shocks, and impede the development of a reasonably predictable and effective monetary transmission. And in the run-up to EU accession and monetary union –a setting that is likely to be characterized by large, and possibly volatile, capital inflows– the importance of a healthy banking system with effective supervision, regulation, and risk management cannot be overemphasized: it is key to mitigating potential financial vulnerabilities associated with intermediating capital inflows of sizeable magnitude.

Empirical evidence has shown convincingly that countries with better-developed financial systems enjoy substantially faster and stable long-run growth. In the context of transition, foreign direct investment (FDI) will, of course, remain a central component of the growth process, including through the transfer of technology and management skills. But if a dual economy is not to take hold, domestic financing needs to mature and expand –and most importantly for viable enterprises, including small- and medium-size enterprises that engender entrepreneurship and innovation, that do not have access to international capital markets. The regulatory framework is important here. Sound financing requires, for example, a judicial framework within which collateral for lending is clearly defined, easily advanced, and securely realized in case of default. And appropriate securities, insurance, and pension regulation and reform can set the stage for a growing role of securities-based intermediation.

Many of the financial sector challenges facing the central European countries (hereafter referred to as the CEC5) are similar to those in existing EU members –but there is a particular need for institutional deepening and, to varying degrees, addressing residual legacies of the past. Slovakia

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and the Czech Republic suffered from weak banking sectors until recently, but are now engaged in major efforts to ensure a healthy financial structure. They have recently privatised the remaining state-owned banks –and made explicit quasi-fiscal costs, but completing the bad debt workout still lies ahead. Slovenia still needs to privatise its largest state-owned banks and move away from an oligopolistic banking structure. Hungary and Poland have the most advanced financial systems, but face increasing competition– which will narrow margins, impact profitability, and spur consolidation.

These pressures are becoming increasingly evident across the region, and will intensify as all five countries enter a common market for financial services. Adequate regulation and supervision will be essential to avoid excessive risk-taking, particularly in the presence of heavy capital inflows that can jeopardize financial and macroeconomic stability. In all five countries, the legal system and judiciary need to be strengthened in areas such as collateral enforcement, which provide key underpinnings to financial sector activity.

In exploring the inter-linkages between the financial sector and macroeconomic policy and performance in more detail, this paper charts the following course. Section 2 takes stock of the banking sectors of the five countries. This is followed in Section 3 by a discussion of some of the macroeconomic complications that can arise during the convergence process, with a view to discussing the associated implications for the financial sector. Recognizing that the relationship between the financial sector and macroeconomic policy is a two-way street, Section 4 turns to the issue of how the financial sector supports fiscal and monetary policies, as they deal with the macroeconomic complications that are identified. It emphasizes that, simultaneously, the growth and development of the financial sector also depends critically on sound monetary and fiscal policies, which lay the macroeconomic groundwork for stable financial conditions. Various measures to enhance financial stability are summarized in Section 5, before providing concluding remarks in Section 6. While the focus of this paper is on central Europe, the intent also is to provide material and analysis that is of sufficiently general interest to apply to other transition countries as well.

Given where they came from, accession countries have made major strides in setting up market-driven banking systems ...

2. Taking stock

More than a decade into transition, the banking systems in the CEC5 share a number of characteristics (see Table 1). Some of the main points include:

- Most of the CEC5 have made considerable progress in improving the quality of banking portfolios. In particular, both Hungary and Poland have seen sharp reductions in the share of classified loans, although Poland's share rose again in 2000. In the Czech Republic and Slovakia, the large share of non-performing loans and persistent negative average returns –at least until recently– pointed to a need for significant restructuring, which is now well underway. Most of the non-performing assets have been transferred to consolidation banks, and the remaining issue is how to dispose of those assets given the weaknesses of insolvency regimes.
- The efficiency of financial intermediation has room for further improvement. Net interest margins are higher than the EU average, reflecting higher spreads between deposit and lending rates. Corporate margins have been steadily declining, but those on household lending have increased substantially as this portfolio has grown and lenders have required a higher return to compensate for the greater risk.

- Competition, however, has strengthened as evidenced by declining intermediation spreads, a shift in bank portfolios from government securities to private sector lending, and declining bank profitability. Moreover, with the blue chip market saturated in some of the CEC5, lending to small- and medium-size businesses is on the rise. While these factors may increase risk, they also indicate that banks are increasingly playing their appropriate role of intermediation. The inroads of new information technology, competition from capital markets and inflows, and EU integration should all make the banking sectors of the CEC5 subject to increasing competition. Against this background of falling margins and needed heavy investment in information technology, banks in the CEC5 can be expected to struggle to maintain profits.
- Concentration in the banking sector is high. There is a particularly strong concentration of deposits, while the credit market is somewhat more fragmented. In the competitive setting outlined above –and taking into account some initial over-investment by foreign and domestic parties– pressures on profitability can be expected to spur further consolidation across the sector. Mergers among parents of foreign banks are likely to remain a driving factor behind consolidation in the CEC5 (e.g., the merger between Bank Austria Creditanstalt and Germany’s Hypovereinsbank, both of which already had an important presence in the CEC5, was a first step in this direction). However, high concentration may even be desirable given that upon EU accession, larger banks may be better placed to compete successfully.

... and privatisation to foreign strategic investors has been instrumental.

In bringing these changes, the rapid reduction in the state ownership of the banking sector has been a key factor. Privatisation of the banking sector has been largely completed in most of the CEC5, though they followed quite different approaches (1).

Hungary’s policy was to sell controlling shares in state-owned banks to strategic foreign investors as rapidly as possible, with more than 60 percent of assets now held by foreign investors. The remaining share of state-owned banks is now only about 12 percent of assets, most of which is concentrated in one bank (Postabank). The foreign parents brought with them skills for credit evaluation, risk management, and more sophisticated financial instruments, which increased knowledge and the efficiency of the banking sector as a whole. Currently, Hungary has one of the most modern and advanced financial systems among the transition economies (2).

In contrast, the voucher privatisation in the Czech and Slovak Republics left controlling ownership of the largest banks with the state. Banks assumed ownership stakes in their voucher-privatised clients, which led to continued soft lending practices and repeated bailouts. This magnified problems with connected lending and non-performing loans, complicating efforts to find strategic foreign owners in the absence of cleanups or guarantees. Moreover, persistent political interference in the banking system depressed foreign investor interest. Recently, however, the environment has changed. The bad debts have now been recognized and have been –or are in the process of being– transferred to consolidation banks in their respective countries, and privatisation has been largely completed, with foreign shares in total assets in excess of 80 percent, the highest in the CEC5.

1) Slovenia has maintained a high share of state ownership in the banking sector, resulting in an oligopolistic banking structure with limited competitive pressures. Foreign ownership remains quite limited. However, Slovenia passed a new banking law in 1999 that allows foreign banks to open up branches and permits foreign investors to purchase up to a 10 percent stake in Slovene banks. The authorities have recently started the process of privatizing the two state-owned banks.

2) Szapáry (2001) reviews the experience with banking system reform in Hungary.

Table 1. Banking sector statistics

	Czech Republic			Poland			Slovakia			Slovenia			Hungary		
	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000
Number of licenced (commercial) banks	45	42	42	83	77	73	25	23	21	24	25	25	37	36	33
<i>of which</i>															
Majority state owned (number)	5	4	4	13	7	7	5	5	4	2	2	2	2	2	...
As % of total assets	23.2	23.2	...	48.0	23.9	22.9	50.0	47.1	...	39.7	40.0	40.3	11.8	...	...
Majority foreign owned (number)	13	14	18	31	39	46	11	10	10	3	5	5	27	...	...
As % of total assets	15.5	26.8	...	16.6	47.2	69.6	28.9	30.2	...	4.9	4.8	15.6	61.4	65.4	66.7
Number of banks accounting for:															
25% of total assets	2	2	...	2	2	2	2	2	2	1	1	1	2	2	...
Asset share of the 3 largest banks	...	...	...	...	...	...	45.6	45.8	...	52	52	50	40	38.5	...
Asset share of the 5 largest banks	66.2	63.2	59.1	42.9	47.7	46.7	...	...	...	64	64	62.5	50.8	50.8	...
Total bank assets as % of GDP (excl. Central Bank)	174.0	181.3	...	58.0	59.4	62.3	111	100.4	95.5	72.2	78.7	79.1	68.6	67.8	65.2
FX denominated assets (as % of total)	19.9	21.5	...	...	...	...	...	16.0	18.3	29.7	30.2	32.8	36.1	37.0	36.4
FX denominated liabilities (as % of total)	18.2	18.3	...	15.2	17.5	18	16.2	16.2	17.4	30.6	31.2	34.1	36.9	36.1	36.5
Contingent and off-balance sheet accounts (as % of total)	78.2	81.0	...	52.6	74.5	153.3	...	...	...	32.3	35.1	37.3	44.1	38.8	40.8
Average lending spread (lending - deposit rate)	4.7	4.2	...	6.3	5.8	...	6.5	5.1	4.4	6.2	6.3	6.4	3.1	3.1	3.0
Non-performing loans (as % of total loans) (overdue 30 or more days)	26.4	32.1	29.5	10.9	13.7	15.3	31.7	23.7	15.2	10.4	11.5	12.6	10.4	8.8	7.9
Risk-weighted capital/asset ratio (in percent)	12.1	13.7	14.9	11.7	13.2	12.9	6.7	12.6	12.5	16.0	14.0	13.5	16.5	14.9	13.5

Sources: Data provided by desks; EBRD Transition Report; NBP, "Summary Evaluation of the Financial Situation of Polish Banks, 2000"; NBH, "The Hungarian Banking Sector, 2000"; Bank of Slovenia.

Poland's approach to restructuring resulted in the lowest overall fiscal cost among the CEC5. In the early 1990s, a bank-led enterprise restructuring program was implemented using debt-equity swaps through which banks acquired ownership stakes in their financially weak clients. The government attempted to minimize explicit guarantees and create incentives for market-based work-outs, which took place in the mid-1990s. In the last few years, Poland has attracted significant strategic foreign investment, and given the high proportion of foreign ownership of the share capital of banks with dispersed ownership, banks controlled by foreign capital effectively had a market share of about 70 percent by 2000.

Box 1. Economic growth and the financial sector

Well-developed banking systems and financial markets can have a significant positive impact on long-run growth, including through mobilizing and reallocating savings; facilitating the hedging, diversifying, pooling and trading of risk; and strengthening corporate governance in the enterprise sector. In view of the dominance of banks within the financial sectors of the CEC5, an important question is whether the type of financial system matters for growth. But empirical analysis of market-based versus bank-based financial systems has found no conclusive evidence that either type of system is preferable. While the presence of both types of financing can also allow for better diversification and risk sharing, more important than the debate on type of system is the recognition that effective and well-supervised financial structures can contribute significantly to achieving rapid and sustainable growth.

Over time, improving access to financing for households and SMEs—and fostering entrepreneurship and innovation through this avenue—will be an important element of supporting growth in the CEC5. When the financial sector is underdeveloped, it is primarily the smaller borrowers that suffer from inadequate financing. These more risky market segments still have only limited access to financial markets in the CEC5. These markets have recently, however, started to expand as banks—facing increasing competition for blue chip corporate loans—seek to broaden their client base in the underserved markets for mortgage lending, household loans, and SME financing. As this occurs, investment in housing and in fixed assets of firms should increase, while households' savings may tend to level off or decline as they become increasingly leveraged.

These market segments are, however, particularly prone to problems of asymmetric information—making risk assessment difficult for intermediaries. Asymmetric information can lead to adverse selection, moral hazard, principal-agent problems, and financial contagion, all of which can undermine efficiency and result in financial vulnerability. Banks are likely to remain of paramount importance for these smaller borrowers, since banks have a comparative advantage in screening projects and monitoring clients, mitigating problems of asymmetric information. Thus, one way to support development in these markets is to improve (and, in many cases, create) interbank information systems that can provide reliable and timely data on consumer and commercial credit information, including loans outstanding, collateral registers, past debt defaults, etc. These markets can also be supported by strengthening the legal framework, especially as regards creditor rights, bankruptcy laws, and recovery of collateral. Resort to government intervention—providing public guarantees for SME loans or subsidizing mortgage lending—should, however, be kept to a minimum. Such approaches can ultimately put pressure on the fiscal accounts and impede the healthy development of a fully market-based financial system.

Bank lending is often seen as the lowest cost (and perhaps only) financing source for SMEs with limited track records, while securities markets are sometimes viewed as the more cost-effective source for large, well-established firms. However, venture capital firms could find a firmer foothold in these economies through providing finance for new enterprises undertaking high risk, high return projects. This is due to the risk-sharing features of venture capital firms as opposed to bank creditors. Banks typically charge a pre-determined rate of interest and do not benefit from excess returns to successful high-risk projects. On the other hand, venture capital firms, as part equity holders, do share the benefits of the upside returns, and their losses are limited to their stake in the new enterprise. Indeed, the success of venture capital firms in Hungary suggests that, given a stable macroeconomic environment and strong legal system, venture capital may provide a viable source of funds for small entrepreneurs.

While the financial sector is clearly important, the policy implication of all this is not that the financial sector, by itself, can ensure the desired growth outcome. Also required are a combination of macroeconomic stability to support private investment, appropriate labor market policies that encourage a growing and productive labor force, and structural reforms that enhance growth potential. But a well-functioning and healthy financial system helps to allocate savings to the most productive investments and can contribute significantly to sound corporate governance.

Allowing reputable foreign banks to enter the domestic market has encouraged innovation and competition, while underpinning institutional soundness. Foreign owners often bring stronger corporate governance to the market, as well as more sophisticated risk management systems. While there are cases of longer-established foreign investors taking a passive approach and benefiting from high local margins, more typically they spur competition and render the sector more efficient—introducing new skills, products and technology. More intense competition leads to lower profits, and puts pressure on all banks to reduce costs. This prepares domestic banks to cope with competition in the single market after accession. The presence of reputable foreign banks may also reduce the risk of capital flight or widespread depositor runs, as they may be seen as more immune from a crisis in the domestic banking system.

In sum, the benefits of foreign ownership are well recognized and now seem to be well accepted. But, as exemplified by the experience with IPB in the Czech Republic (3), privatisation to foreign investors is not a panacea: appropriate incentive and supervisory structures need to be in place to ensure soundness.

3. Macroeconomics challenges and their implications for the financial sector

The importance of a healthy and well-regulated banking sector cannot be overemphasized in an environment of liberalised capital accounts ...

A key challenge is to avoid macroeconomic imbalances and vulnerabilities that can arise and thwart the growth process (see Box 1 for a discussion of economic growth and the financial sector). Thus, this section addresses the following question: as convergence advances on the road to EU accession and monetary union, what potential macroeconomic complications are cause for concern and, in this context, what are the financial sector implications? Coping with large, and potentially volatile, capital inflows is one critical concern. In recent years, the improving economic prospects and speculation on interest rate convergence have already led to a steady increase in capital inflows—including short-term debt and portfolio investment, which are most easily reversible (4). Another crucial issue is the higher investment needed to facilitate convergence and the considerable uncertainty regarding saving behaviour to finance such investment—thus raising the spectre of large current account deficits and external vulnerability, which would only be accentuated by weak banking systems.

Capital Inflows

Inflows are likely to be very sensitive to the perceived sustainability of policies in the run-up to accession. Contagion effects through trade and financial channels are also likely to intensify as the CEC5 increasingly compete in their main export markets and complete the liberalization of their capital accounts. Temporary surges in inflows during periods when interest rates are bid down

3) The case of *Investicni a Postovni Banka (IPB)* is discussed in Box 2 of Wagner and Jakova (2001).

4) Even FDI, which is typically viewed as the most stable form of capital inflow, could be increasingly vulnerable to reversals, since a growing proportion of FDI is coming in the form of inter-company loans and retained earnings.

toward euro zone levels can be quickly reversed once arbitrage opportunities disappear. A heavier reliance on the securities markets, in itself, may increase the vulnerability of capital flows to shifts in expectations and asset price volatility.

The benefits of capital flows are many, and liberalisation of the capital account can spur greater competition in the financial sector. Nevertheless, large capital inflows –if these flows are greater than the recipient economy’s ability to absorb them– can have a potentially negative impact on the financial sector and, ultimately, the real economy. Large capital inflows have been associated with rapid credit expansion and riskier lending practices in emerging markets. Short-term inflows are often driven by speculative considerations –exploiting an interest rate differential and/or expectations on the direction of exchange rate movements– and can be easily reversed if expectations change (5). Moral hazard distortions –such as an implicit exchange rate guarantee or expectations that the government would bail out the banking system– can also underpin short-term flows. Such flows have been responsible for many of the boom-bust cycles in emerging markets in the 1990s, as they are also the first to head for the exits at any signs of economic or financial distress. Heavy inflows can also lead to excessive real exchange rate appreciation, potentially eroding competitiveness and widening current account deficits, and resulting in a deterioration in performance of some of the banks’ clients, with possible negative repercussions on debt repayments.

... and is instrumental in mobilising domestic savings, thus promoting economic growth and macroeconomic stability.

Particularly in the case of a relatively fixed exchange regime, heavy inflows can result in currency (and maturity) mismatches for the financial sector’s assets and liabilities. If the fixed exchange rate regime is credible, there can be a shift toward foreign borrowing at lower interest rates, leading to large open foreign exchange positions for banks. This directly links the health of the banking system to the survival of the fixed exchange rate regime and increases the probability of speculative attacks. However, a robust financial system should reduce the likelihood of speculative attacks, since a strong system is known to be able to withstand an aggressive policy response.

More flexible exchange regimes –to which the countries of central Europe have now moved– allow more transparently for two-way risk, which can limit excessive foreign currency exposures and liquidity mismatches. Exchange rate volatility will change the incentives regarding hedging, naturally spurring the development of markets for hedging instruments. Nevertheless, a floating exchange rate regime does not prevent speculative inflows –there can still be excessive borrowing abroad if, for example, there are strong expectations of appreciation that are not fully reflected in the interest rate differential. Sufficient fiscal consolidation can relieve monetary policy of the burden of attempting to curb inflationary pressures with excessively high interest rates, which ultimately may attract capital inflows and create an unsustainable current account deficit. A premature opening of the capital account –against a background of immature financial markets and incomplete structural reforms– may magnify any underlying macroeconomic and structural weaknesses and heighten the risk of bank failures.

Capital controls have been progressively eased in the CEC5 in recent years, in part owing to OECD membership requirements for some of the countries and also as a result of EU Accession commitments. Most of the CEC5 have largely liberalized their capital accounts, although Poland

5) To the extent that EU membership leads to a higher degree of synchronization of macroeconomic performance and financial asset price movements between the CEC5 and other EU countries, there could be a stimulus for portfolio capital flows to leave the CEC5 in favor of other emerging markets (including some of the other transition countries) as investors try to maintain the desired diversification of their portfolios between assets with different yield-risk combinations.

and Slovenia continue to maintain a few controls. Upon accession, remaining controls will have to be removed –in the absence of derogations– potentially stimulating further capital inflows.

Fundamentally, while sound policies cannot be substituted by capital controls, to some degree speculative attacks unrelated to macroeconomic fundamentals can be considered as a form of market imperfections and there is a plausible case for the retention or reimposition of capital controls to counter these. In a situation of incipient major capital inflows or reversals that appear unrelated to policy slippages (for example, convergence plays or contagion effects), there may be a case for reintroducing capital controls on a strictly temporary basis (6). While the risks associated with many financial inflows can be reduced (but not eliminated) with sound financial institutions and well-functioning prudential supervision and regulation, in circumstances in which these are not fully in place, capital controls can be a supplementary tool to buttress prudential regulation and limit excessive risk taking.

Strengthened prudential supervision and regulation will be key as capital account liberalisation continues.

Effective regulation and supervision –that is, a sound legal framework not only on the books but also well implemented in practice– can provide the best insurance against capital inflows being intermediated through banks that are poorly equipped to deal with them. Strengthened supervision and regulation will be key as capital account liberalisation continues in a setting of high (and variable) capital inflows. In addition, financial market imperfections associated with asymmetric information (e.g., moral hazard, adverse selection, and herding behavior) –which can be magnified by an open capital account– can be limited by putting in place a bankruptcy framework that ensures budget constraints on enterprises, minimizing explicit and implicit government guarantees, and improving the integrity and availability of financial information as well as the corporate governance structure of financial institutions.

Investment and domestic savings

At the start of the transition more than a decade ago, investment-to-GDP ratios in the CEC5 bottomed out, in line with the drop in output (Figure 1). Moreover, much of the capital stock at that time became obsolete overnight. In the aftermath, investment rebounded, as the CEC5 struggled to transform their economies into market-oriented ones. This transformation continues today, as part of the process of real convergence, and investment ratios may have to rise further to maintain strong economic growth. This would include public investment, too, with needed infrastructure development and accession-related investment.

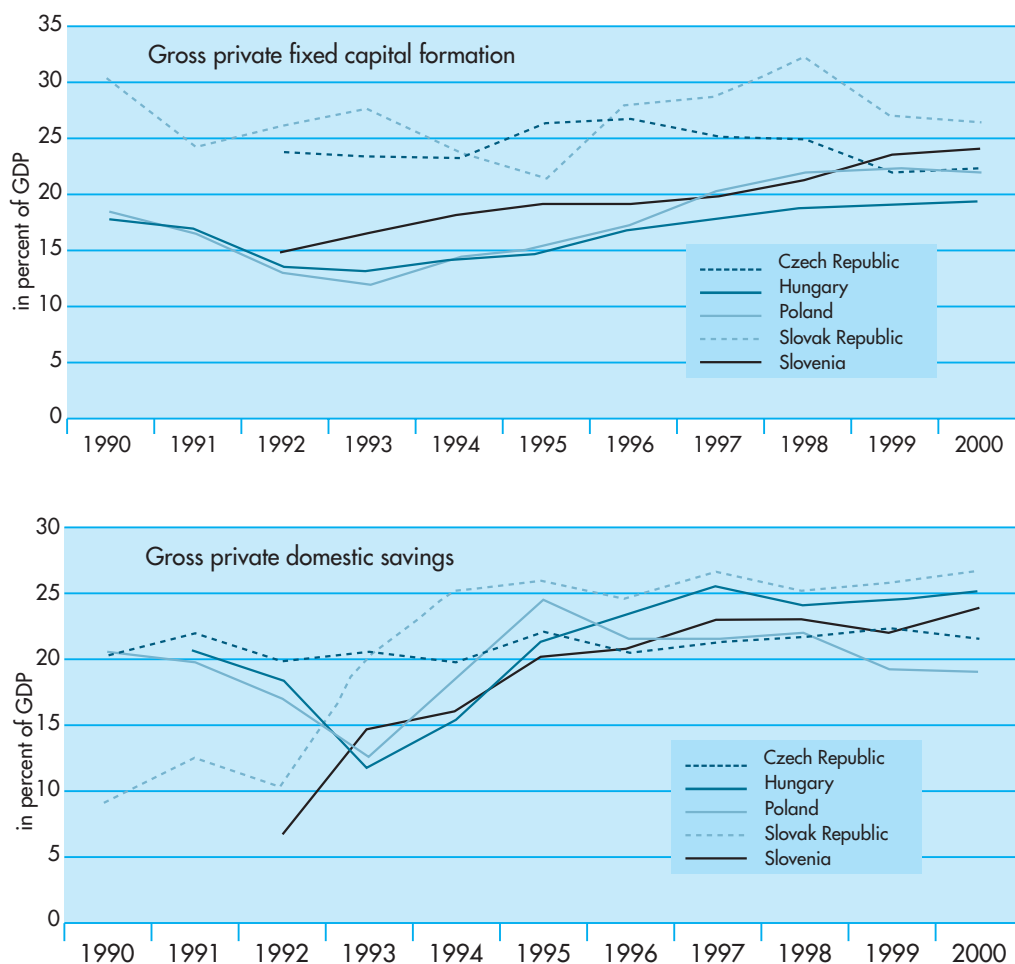
While capital inflows and, in particular FDI, will be crucial in supporting these countries' higher investment needs, domestic financial markets, through their intermediation and governance functions, will also be important in underpinning investment and for realizing growth potential. As amply demonstrated by the CEC5 prior to transition, heavy investment in fixed capital alone was not enough to ensure strong and sustainable economic growth; investment ratios were high in the 1980s, but TFP growth was lackluster, reflecting inefficiencies in investment decisions and fundamental misallocations of capital.

6) The safeguard clause of the Maastricht Treaty allows countries to introduce temporary restrictions, including on capital movements, in the case of serious balance of payments difficulties. These restrictions can be introduced overnight, but must subsequently be sanctioned by the Council. There may be instances in which this safeguard can be activated for countries wanting to prevent surges in capital inflows in order to avoid serious external difficulties, but the conditions under which this might be permitted, if at all, have not been tested for the CEC5.

It is in this respect that well-functioning financial markets help to ensure efficient and productive capital allocation, which also translates into faster Total Factor Productivity (TFP) growth. Indeed, Doyle, Kuijs, and Jiang (2001) highlight the key role of TFP growth in the most successful of the CEC5. Interestingly, the three countries –Hungary, Poland, and Slovenia– in which TFP contributed substantially to growth in the 1990s, also had lower investment ratios than the Czech and Slovak Republics, for which the TFP contribution was negligible. At the same time, the latter two countries had the least healthy financial sectors, heavily burdened by non-performing loans, and thereby incapable of fully playing the needed intermediation role.

In most of the countries, saving rates followed a pattern somewhat similar to that of investment ratios (Figure 1). They registered a marked drop at the start of transition, followed by a rebound. However, the rebound in saving still could not fully compensate for the sharp rise in investment, with foreign saving filling the ensuing gap associated with the current account deficit.

Figure 1. Gross capital formation and gross domestic saving.



Box 2 discusses the factors likely to influence the saving rate in the region. It suggests that the prospects are highly uncertain for substantially greater private domestic saving to meet the forthcoming investment demand, as many of the factors affecting private saving rates have offsetting effects. However, the offset in household saving owing to a rise in public saving is likely to be incomplete. Thus, a permanent increase in public saving would raise national saving. In addition, reforms of the tax system and public expenditure could be conducive to raising the private saving rate. Callen and Thimann (1997), for example, found that high income taxes and a heavy reliance on government transfers is associated with low saving. Other studies (e.g., Ul Haque *et al.*, 1999; Masson *et al.*, 1995) have also found that, for a given fiscal balance, a reduction in the current expenditure-to-GDP ratio tends to increase the private saving ratio. The empirical literature also suggests that expenditure-driven fiscal consolidation tends to increase private investment (and thereby support growth over the longer term), but the net effect on the private saving-investment balance is uncertain. Fiscal consolidation based on higher taxes, however, would be expected to significantly lower both private saving and private investment.

Fiscal policy needs to have a built-in degree of flexibility to counterbalance potential saving-investment imbalances.

Overall, in view of the uncertainties regarding saving and investment behaviour, fiscal policy needs to have a built-in degree of flexibility to counterbalance potential saving-investment imbalances and the vulnerability implied by large external current account deficits. In particular, expenditure-based medium-term fiscal consolidation might minimize the risk of potentially having to rely on excessive foreign financing to cover any saving-investment imbalance and, at the same time, set the stage for stronger long-term growth (7). And a weak financial sector can heavily constrain the flexibility and effectiveness of fiscal and monetary policy, and shift the policy emphasis away from long-run growth.

4. The financial sector and fiscal and monetary policies

Completing the reforms should facilitate the tasks of macroeconomic policy, e.g. by recognising and/or reducing quasi-fiscal losses, removing constraints on interest rate movements, and enhancing the effectiveness and predictability of the transmission mechanism. On the fiscal side, significant contingent liabilities—either related to the banking system or embedded in soft lending to enterprises—prevent credible fiscal planning, divert resources from productive investments, and may lead to debt sustainability issues. On the monetary side, the monetary authorities may be unwilling to tighten policy if that would threaten the health of financial intermediaries. More broadly, an underdeveloped financial system weakens the predictability of monetary transmission, thereby complicating the conduct of policy.

Fiscal policy issues

In view of the large share of insolvent banks at the start of transition, government intervention was unavoidable to provide a clean start for financial institutions and to remove incentives for risky behaviour. The state-owned banks in the CEC5 faced large volumes of non-performing loans—a legacy of central planning and directed lending—as they began the transition process. The cost of bank restructuring can be high, as shown in Table 2 for a selection of both emerging markets and industrial countries. In each of the CEC5, bank re-capitalisation required substantial fiscal resources in the early 1990s, and, in the case of the Czech and Slovak Republics, continues to have significant fiscal implications (8). Government involvement in bank re-capitalisation and restructuring has often

7) Christou and Daseking (2001) provide an in-depth discussion of choosing appropriately flexible medium-term fiscal strategies for the CEC5.

8) The IMF recently estimated the cost of cleanup in the Czech Republic at 15 percent of GDP over the 2001-2004 period. The estimate for the restructuring in the Slovak Republic, which took place in 2000, is about 12 percent of 2000 GDP.

Box 2. The outlook for savings in Central Europe

Saving reflects the choice between current and future consumption, and a key question is whether the saving rates in these countries will rise or decline as the economies become richer during the convergence process. Empirical evidence is mixed as to whether growth and saving are positively or inversely correlated. Many empirical studies indicate a positive correlation between per capita income and private saving rates, but this positive relationship is notably more evident in developing countries than in advanced economies (Masson *et al.*, 1995).

Other studies suggest that saving is primarily determined by intertemporal consumption smoothing (as in the permanent income hypothesis), which would predict a lower saving rate as private agents increase consumption now on expectations of higher income in the future. But uncertainty and liquidity constraints might play a significant role in preventing the full intertemporal smoothing of consumption and, hence, to a rising saving rate as income increases. In the case of the CEC5, however, the recent liberalization of financial markets and the steadily increasing access to credit for the domestic private sector in some of the CEC5 might argue for a declining saving rate, as liquidity constraints are eased.

More broadly, the impact on private saving of financial liberalization can be somewhat ambiguous. Clearly, the easing of liquidity constraints would likely reduce saving, but the wider array of instruments for financial saving would usually drive real interest rates on deposits higher, making saving more attractive than current consumption (substitution effect). For the CEC5, the easing of liquidity constraints is likely to dominate. In fact, Rodrik (2000) estimated that a 1 percentage point increase in the ratio of private credit to income lowers the long-term private saving rate by 0.74 percentage points.

Moreover, macroeconomic stabilization (and the easier access to credit) has lowered the uncertainty for private agents in CEC5, and consequently reduced the need for precautionary saving. These factors –and pent-up demand in the wake of the sharp drop in real incomes at the start of transition– could, therefore, point to a declining household saving rate in the CEC5 in the near to medium-terms.

Rising corporate profitability could, however, offset an expected decline in household saving. Indeed, high profits, on the back of strong productivity growth, have been a driving factor in preserving the private saving rate in the CEC5. But the rapid growth in business profits may well be curbed in the future by a limited supply of qualified labor in conjunction with continued strong domestic and foreign investment.

Jiang (2000) performs an econometric analysis to examine the possible impact of a number of determinants on private saving rates in the CEC5 and Estonia. The dependent variable in the regressions is the ratio of gross private saving (including both household and business saving) to GDP. Among his findings, growth had a negative effect on saving rates, but relative per capita income (measured in purchasing power terms relative to the United States) exhibited a strong and positive effect. The ratio of private sector credit to GDP (a rough proxy for financial liberalization) had the expected negative impact on the saving rate. Meanwhile, about half of any increase in government saving was expected to be offset by a decrease in private saving.

reflected substantial fiscal or quasi-fiscal transfers to banks, adding to the public debt and, through higher interest payments, restricting the flexibility of fiscal policy.

Nevertheless, there is no valid economic reason for delaying bank restructuring and, in a macroeconomic context, concern about the impact of a widening fiscal deficit that results from bank re-capitalisation and restructuring is often misplaced (9). The demand impact of re-capitalisation is usually fairly small, and delays or incomplete restructuring have proven to magnify the problem, ultimately leading to a higher present discounted value of government liabilities. From the standpoint of fiscal policy, most important is putting in place an incentive structure that minimized the need for further intervention—to avoid increasing the future tax burden and impairing the flexibility of fiscal policy to stabilize the economy and play its growth-enhancing role (10).

Monetary policy issues

Monetary policy in the CEC5 will still be confronted with several challenges until the financial markets mature more fully. In particular, the monetary transmission mechanism may not be fully understood. This is especially critical now, with most of the CEC5 having recently moved to an inflation targeting framework for monetary policy.

Table 2. The cost of bank restructuring in selected countries

	Country		Percent of GDP
Latin America	Argentina	(1980-82)	55
	Chile	(1981-83)	41
	Uruguay	(1981-84)	31
	Venezuela	(1994-95)	20
	Mexico	(1994-95)	20
	Brazil	(1994-96)	5-10
Asia	Thailand	(1997-)	42
	Indonesia	(1997-)	50-55
	Korea	(1997-)	34
Transition countries	Bulgaria	(1990s)	14
	Czech Republic	(1990s)	12*
	Hungary	(1991-2000)	13
	Poland	(1990s)	6
Industrial countries	Spain	(1977-85)	17
	Japan	(1992-98)	17
	Finland	(1991-93)	11
	Sweden	(1991)	4
	Norway	(1988-92)	8

Source: Szapáry (2002).

Note: * This number refers to the period up to the end of 1999 and therefore does not include the consolidation of the IPB bank, the largest bank in the Czech Republic.

9) See Wagner and Iakova (2001), Lane (1996) and Daniel (1997) for a deeper discussion on this issue.

10) The recapitalizations in the early 1990s often did not significantly change the behavior of the financial intermediaries. In the Czech Republic and Slovakia, for example, repeated government interventions created a perception of soft budget constraints and led to moral hazard behavior. Reforms in the economy were delayed, since enterprises which had relatively easy access to finance, independent of their creditworthiness, had little incentive to restructure. This lack of progress in enterprise restructuring, in turn, created a feedback effect leading to further deterioration of bank balance sheets.

The most obvious channel for the transmission of monetary policy is the direct interest rate effect. The responsiveness of lending and deposit interest rates to changes in policy rates depends on several factors, including the degree of competition in the banking sector, the depth of financial markets, and alternative sources of financing. Thus, for example, the banking sectors in Hungary and Poland are highly competitive with respect to the corporate lending market, so that policy rate changes are more likely to feed through quickly to loan interest rates. On the other hand, Slovenia's banking sector is oligopolistic in nature, so that the responsiveness of interest rates may be more sluggish (11). Furthermore, in Slovenia, and until recently in the Czech Republic and Slovakia, the banking sectors have been dominated by large state-owned banks, which could diminish the sensitivity of lending and deposit rates.

Further developing the financial sector will make monetary policy more effective.

The pattern of household consumption and the approach to corporate finance in the CEC5 reduces the effectiveness of the interest rate channel of monetary policy in influencing economic activity and domestic demand. With respect to household behaviour, much of consumption is financed through personal savings, and short-term consumption credits are only now growing at a rapid pace –but seemingly regardless of the level of interest rates– as a result of the catch-up effect after years of depressed consumption. In the corporate sector, much of investment is financed either through retained earnings, cross-border borrowing, or FDI. In Hungary and Poland, for example, foreign bank loans to the non-bank commercial sector account for 50 percent or more of all foreign loans directed toward those countries. With transition very advanced, foreign banks are often willing to bypass the local banking system and provide finance directly to the private sector. The Hungarian economy, in particular, with its heavy presence of multinationals, is characterized by a corporate sector with extensive access to offshore financing, which greatly reduces such firms' exposure to domestic monetary policy conditions. And, particularly in the Czech Republic, Hungary, and Poland, FDI inflows have accounted for a significant portion of corporate investment. Leasing has also grown substantially in some of the CEC5; for example, in the Czech Republic, leasing now exceeds 10 percent of lending to enterprises and households. Banks are, therefore, constrained in their ability to raise interest rates in the face of a policy tightening, since many of the blue chips will shift to foreign or other sources of financing.

In view of the relatively low interest-rate sensitivity of consumption and investment, the credit availability channel is likely to be a more important one for the CEC5. When monetary policy is tightened, banks are likely to not only raise lending rates but to also increase the standards for creditworthiness, since relying exclusively on the rationing effect of higher interest rates can result in an adverse selection problem of attracting the most risky borrowers. This channel is particularly important with respect to credit availability to SMEs, for which there are much higher costs for acquiring information. Similarly, a contractionary monetary policy is mostly likely to affect the household sector through a restriction in the supply of credit. Thus, a tightening in monetary policy in the CEC5 is likely to disproportionately affect the SME and household sectors, which usually do not have alternative sources of financing.

11) *The legacy of hyperinflation at the end of the 1980s (with inflation reaching 13,000 percent per year in 1989) led to a practice of widespread indexation for most financial contracts. The authorities have recently started the process of deindexation: as of January 1, 2002, all financial contracts of maturity up to one year are de-indexed, and the Banking Association started publishing a nominal reference interest rate that is intended to replace backward-looking inflation as a benchmark for market rates.*

The effectiveness of monetary policy is likely to improve naturally as the financial markets mature and once a stable legal environment has been established (12). Part of the maturation process would be a catching-up effect in the aftermath of repressed domestic demand. To this effect, the volume of outstanding credit to the private sector is likely to expand substantially over the medium term, especially credit to households and small businesses. Empirical research on advanced economies indicates that the most sensitive sectors to interest rate changes are residential investment and consumer durables purchases. As the share of consumer credit and mortgage loans increases in bank lending, this development should enhance the impact of monetary policy. In addition, as fiscal adjustment (and financial liberalization) in the CEC5 has increasingly released financial resources for the private sector, this should underpin the responsiveness of aggregate demand to monetary policy over time.

Aside from the everyday challenges facing monetary policy, banking sector crises can directly affect monetary stability. One channel is through the need to inject liquidity into banks. In addition, the monetary authorities could fear allowing the exchange rate to depreciate too far if there has been heavy unhedged foreign borrowing, or could avoid raising interest rates if banks are in poor financial condition. Raising interest rates to defend the currency can weaken the repayment capacity of banks' clients and lead to banking sector problems with liquidity and solvency. That is, the authorities can be caught straddling two horses –trying to maintain monetary stability but at a cost of financial stability or vice-versa.

The completion of legal and institutional reforms and the process of privatisation in the financial sector should increase market efficiency and strengthen the balance sheet of banks, both of which should lead to a more predictable transmission mechanism, and should help to mitigate the potential for banking sector crises. Indeed, the firm establishment of market discipline on financial intermediaries through limiting government intervention to its role as a regulator and supervisor, requiring better and more timely financial information disclosure, and improving the rights of creditors and stockholders, are among the most effective ways to improve market liquidity and strengthen the resilience of financial institutions to monetary and other shocks.

... and vice-versa

Of course, linkages work in both directions, as financial sector soundness not only affects the macroeconomic policy environment, but is also itself affected by the macroeconomic environment. Business cycles affect the financial sector through a number of channels, including: shifts in risks associated with asset prices, credit quality, interest rates, and liquidity; balance sheets, through changes in the amount and composition of indebtedness; and, ultimately, perhaps a boom-bust cycle precipitated by the bursting of an asset price bubble. Structural changes, particularly as embodied in financial liberalisation (whether domestic or external), can have a significant impact on financial vulnerability. Open economies, such as the CEC5, are even more exposed to external shocks, underscoring the importance of adequate risk management capacity in the financial sector. Overall, the soundness of the financial sector is, to a large degree, a reflection of the economy's health –which, in turn, is heavily influenced by macroeconomic policy.

Sound macroeconomic policies support financial sector development.

12) In the meantime, for the CEC5, the exchange rate may be one of the most important monetary policy channels.

An excessively expansionary or restrictive macroeconomic policy stance can exacerbate financial sector vulnerability. A loose policy mix, underpinning inflationary pressures, reduces the information provided by prices and interest rates, can lead to an overly rapid expansion of domestic credit (increasingly allocated to riskier market segments), and can distort asset prices or even create an asset price bubble. Eventual stabilisation or, similarly, a restrictive policy mix –particularly one heavily reliant on monetary restraint– can place strains on the banking system –including through balance sheet effects and rising credit risks– and could even induce a liquidity crisis in the banking sector. Large structural fiscal imbalances can severely complicate the achievement of macroeconomic stabilisation –placing the burden of adjustment on monetary policy and the banking sector, putting pressure on the exchange rate, increasing overall debt levels and associated vulnerability, crowding out credit to the private sector, and generally constraining the fiscal response to exogenous shocks. Moreover, an inappropriate policy mix can lead to a loss of foreign and domestic investor confidence, triggering sudden capital outflows or a significant deterioration in external financing conditions, either of which increases the vulnerability of the domestic financial sector.

The choice of macroeconomic policy instruments has important implications for financial sector soundness. On the fiscal side, tax policy –such as non-deductible loan-loss provisions, bank specific taxes, or heavy capital gains taxes– can undermine financial sector development. On the monetary side, unremunerated reserve requirements, sharp and frequent changes in reserve requirements, direct monetary instruments (e.g., interest rate ceilings), or the absence of a properly functioning lender-of-last resort mechanism could adversely affect banking sector soundness. And the choice of exchange regime can have important implications for financial stability, if, for example, it leads to a prolonged period of over- or under-valuation of the exchange rate or is subject to substantial volatility, particularly in the absence of sufficiently developed markets for hedging risks.

5. Enhancing financial stability

The EU accession process has guided reforms aimed at creating stable financial systems.

Enhancing financial stability and reducing the vulnerability of financial systems –with particular emphasis on the banking sector– are key aims in each of the CEC5. And they face additional challenges in securing the path to financial stability. More specifically, in addition to completing any remaining restructuring and privatisation, the outstanding agenda includes:

- enhancing the legislative framework and working toward effective implementation, including, in particular, streamlining the procedures for collateral liquidation;
- strengthening the independence of supervisory authorities and their legal powers;
- implementing effective consolidated supervision, which should forestall any trend to spin off riskier activities to affiliated non-banks subject to less regulation;
- developing supervisory skills relating to cross-border operations of banks—an especially important task in the integrated market;
- enhancing the laws and supervision abilities to meet the needs of a more sophisticated market place –including internet trading and derivatives;
- improving risk management practices, especially in the area of market risk management –but also with respect to credit, operational, and systemic risk;

Box 3. The Financial Sector Assessment Programme

The Czech Republic, Hungary, Poland and Slovenia have already participated in the Financial Sector Assessment Program (FSAP) and Slovakia's FSAP is scheduled for the 2002 fiscal year. The FSAP –developed as part of the effort to strengthen the architecture of the international financial system– assists the country authorities in identifying areas to further strengthen their financial systems.

In this connection, the FSAP assesses countries' progress in adopting and implementing international financial market standards, and, as confirmed by the outcomes of the FSAP exercises, each of the four participant countries in the CEC5 has made considerable progress with respect to these standards. Importantly, the CEC5 participants have voluntarily chosen to publish the associated Reports on the Observance of Standards and Codes (ROSCs). This transparency increases the accountability of policy makers and should improve the environment for market participants' investment decisions, ultimately leading to improved policy-making and economic performance.

In addition to assessing compliance with international standards, the FSAP takes a broad look at a wide range of factors that could affect financial stability and vulnerability, with a focus on the linkages between financial system developments and the macroeconomy. An FSAP, for example, typically includes a series of stress tests, conducted under a variety of macroeconomic scenarios and external shocks, in order to assess the banking system's vulnerability to market and credit risks. The stress tests for the participating CEC5 countries indicated that their banking systems could likely weather most external or domestic shocks. Nevertheless, an FSAP –and stress tests in particular– can only examine vulnerability at a point in time and should, therefore, not be construed as a "bill of health." For this reason, one of the most important aspects of an FSAP is to encourage the authorities to continue with such monitoring on its own. Indeed, the National Bank of Hungary (NBH) subsequently launched an excellent and comprehensive semi-annual *Report on Financial Stability*. And Slovenia followed up the FSAP with a detailed financial sector Action Plan and timetable, which had been almost fully implemented by end 2001.

In addition to the FSAP exercise, the Fund's regular surveillance also attempts to carefully monitor financial sector vulnerabilities, with an increased emphasis in the aftermath of the emerging market crises of the 1990s. As the Fund builds up experience in the broader framework of vulnerability assessments (including macro-prudential analysis, early warning systems, and analyses of reserve adequacy and debt sustainability), it has encouraged country authorities to assist in this effort by compiling and publicly disseminating macro-prudential information. The CEC5 have also been among the early subscribers to the IMF's Special Data Dissemination Standards, including, notably, the detailed template on international reserves and foreign currency liquidity.

- bringing accounting practices, such as asset valuation, in line with international practice: balance sheets should reflect market values as closely as possible;
- ensuring that a financial safety net (such as deposit insurance or lender-of-last resort facilities) is in place, but is limited so as not to engender moral hazard.

The EU accession process has been beneficial in accelerating the needed legal reforms in the financial sector and in providing clear guidance on the direction for such reforms. All of the CEC5 have either updated or developed banking and securities laws to achieve consistency with the

various EU directives, and the flow of capital and financial services has been significantly liberalised. But, as noted above, the enforcement of the legal framework could still be significantly improved, as the effectiveness of financial system regulations in the CEC5 typically lags their extensiveness. Box 3 describes how the Financial Sector Assessment Program, a joint Fund and World Bank initiative, which complements the Fund's surveillance activities, has assisted in the process.

6. Concluding remarks

As evidenced by past experience in the CEC5, the more comprehensive and forceful is the pace of financial sector reforms, the less is the uncertainty about growth and stability –easing the path to develop and adhere to a realistic macroeconomic framework. In a context of potentially heavy and volatile capital flows, moreover, the importance of sound banking and financial systems for stability cannot be overemphasized. This paper has not only illustrated the role of sound financial systems in supporting macroeconomic policy, but also indicated that the relationship is, of course, a two-way street: a setting of sound macroeconomic policy is crucial for supporting financial sector development.

The CEC5 have made remarkable progress in reshaping their financial sectors, and the last two years have been a period of stock-taking and further reforms, with all countries undertaking initiatives to address remaining problems. The challenge now is to build on this by deepening the legal framework and institutions that underpin financial stability –transparent accounting and auditing, comprehensive supervision, effective bankruptcy mechanisms, and adequate collateral registration and recovery mechanisms.

The remaining challenge is to build upon the remarkable progress to date by deepening the legal framework and institutions that underpin financial stability.

With restructuring and privatisation virtually finished in some cases, and well underway in others, completing the remaining agenda for financial sector reform would help ensure that the CEC5 approach EU accession with financial systems able to withstand most shocks. Key elements in this progress have been the effort to harmonize legislation with that of the EU, advances in implementing international financial standards, and participation in recent Fund and World Bank initiatives (such as the FSAP and publication of the associated ROSCs). These efforts should lay the basis for more effective monetary transmission, help parry capital account hazards, and avoid future threats to fiscal sustainability. By ensuring a stable financial environment, they are a critical foundation to allow the CEC5 to close their economic gap with the economies of the European Union.

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