

Banking sector development and financial stability in the run up to EU accession

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Abstract

The EU accession countries have made remarkable progress in developing their financial sectors. Nevertheless, potential risks to banking sector stability remain. We take stock of these risks, with a focus on the challenges posed by the EU accession process. Important potential risks we identify are consistently large current account deficits possibly combined with more volatile short-term financing in the future, imprudent financing of lending booms, increasing currency mismatches in the banking and corporate sector, substantial exchange rate volatility, and lagging legislation and supervision. Risks can be limited by taking advantage of the presence of foreign banks, keeping current account deficits within limits, taking financial stability considerations into account in determining exchange rate policies, guaranteeing the independence of the central bank and supervisory authorities, and strengthening the rule of law.

Keywords: EU accession, financial stability, banking system

JEL codes: E44, E61, F32, F36, G28

1. Introduction

The countries in Central and Eastern Europe (CEE) that are negotiating their entry into the European Union have seen their financial landscape change dramatically over the past decade. With the breakdown of the system of central planning, the need for an effective and efficient system of financial intermediation became apparent. Since banks were already present during the communist era, the transition countries took their monobanks as the starting point for creating bank-based financial systems. Although these systems in the EU accession countries are currently not yet on par with their Western peers, remarkable progress has been made. In many countries almost all of the large state banks have by now been privatised. Foreign strategic investors, mostly Western-European and American banks, have been among the most important buyers. Preceding or simultaneous with this privatisation process, governments have - to various degrees - started to deal with the problem of bad loans. Progress has also been made with regard to supervision and regulation, in part stimulated by the requirements of EU-accession. All these restructuring efforts with regard to the banking system and its regulatory environment may have contributed to the fact that CEE has proven to be rather resilient during recent periods of international financial instability, such as the Asian and the Russian crises. Of course, this relative immunity can also be partly attributed to the fact that in many CEE countries (some) capital controls were still in place. In addition, the local banking systems - let alone bond and stock markets - are still relatively underdeveloped. A lot of work remains to be done to improve the accession countries' financial systems.

At present the banking sector is by far the most important part of the financial system in all transition economies and is, as a consequence, also the main source of risk for financial stability in this region. This is all the more so because the lack of well-functioning equity markets confronts banks with relatively high credit risks, as bank credit must to some extent substitute for equity. In order to consistently survey the risks for banking system stability, we apply the framework as described by Goldstein and Turner (1996). Whereas this framework mainly draws lessons from earlier banking crises, we use a more forward-looking approach by taking stock of the potential risks that may accompany a further development of the CEE banking sectors, taking into account the specific challenges posed by the EU accession process. Addressing such risks is probably the best method authorities of CEE countries can use to stimulate the development of the banking sector as well as financial markets. Given our focus on the specific issues related to transition countries, we will touch only briefly on the other two accession countries, Cyprus and Malta. Section 2 contains our assessment of the potential risks for the CEE banking sectors. Section 3 concludes and gives policy recommendations.

2. Financial stability and EU-accession: an assessment

Based on the framework as set out by Goldstein and Turner (1996), this section takes stock of what appear to be the main sources of risk for the accession countries' banking sectors during the pre-accession period. Of course, the characteristics of the transition countries' banking systems are to a large extent specific, the transition process being a unique historical process. Yet, on the other hand, the opening up of the still relatively underdeveloped markets in CEE also shares some important features with earlier experiences of connecting countries to the global economic system. In the following, we take the relevant themes identified by Goldstein and Turner as a starting point to explore the specific conditions and challenges associated with the stable development of the banking sector in the CEE countries.

2.1 Macroeconomic stability

A stable macroeconomic environment is important for banking sector stability, mainly because uncertainty about macroeconomic policies and fluctuating fundamentals, such as economic growth and inflation, makes it harder for banks to assess credit risks accurately.¹ Besides from its negative influence on the banking sector, (macro)economic uncertainty may also inhibit economic growth more generally. Lensink (2001) shows for instance that uncertainty with regard to inflation and government expenditures leads to lower per capita economic growth. Importantly, this negative effect of

Table 1 Volatility of growth and inflation in EU and accession countries

Standard deviation of yearly GDP-growth and inflation over 1995-2001

	<u>Growth</u>	<u>Inflation</u>		<u>Growth</u>	<u>Inflation</u>
Austria	0,9	0,6	Bulgaria	6,1	360,5
Belgium	1,0	0,6	Czech Rep.	2,6	3,1
Finland	1,7	0,7	Estonia	3,1	9,3
France	0,8	0,5	Hungary	1,5	6,9
Germany	0,8	0,6	Latvia	3,1	8,2
Greece	0,8	2,3	Lithuania	3,2	13,8
Ireland	1,8	1,2	Poland	1,7	7,2
Italy	0,6	1,2	Romania	4,7	40,1
Luxembourg	2,2	0,8	Slovak Rep.	2,1	2,3
Netherlands	1,1	1,1	Slovenia	0,7	2,3
Portugal	0,9	0,9	Cyprus	1,4	0,8
Spain	0,8	1,0	Malta	0,9	0,7
Denmark	0,6	0,3			
Sweden	1,2	1,0	Correlation coefficient with level of		
U.K.	0,4	0,3	GDP per capita: -0.45 and -0.67, respectively		
			(both significant at 5%-level).		

Source: World Economic Outlook (IMF).

¹ Van der Zwet and Swank (2000). See also Boyd, Levine and Smith (2001) on the negative impact of inflation on the functioning of the banking sector.

uncertainty appears to be less severe in countries with a more developed financial sector. Yet, subdued economic growth, due to macroeconomic uncertainty or for other reasons, may feed back to bank soundness as it reduces the debt servicing capacity of firms and households.

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

It is also important to keep in mind that the level of inflation is likely to remain significantly above the EU-level in the years to come. One reason for this is the Balassa-Samuelson effect, or the fact that during the catching-up process, faster productivity growth in the tradables sector will push up wages and prices in all sectors. Unfortunately, estimates of the size of this effect in accession countries vary widely because of data problems and theoretical limitations in the model that make it hard to quantify the relative importance of the effect.² However, other reasons for inflation differentials may be even more important. In a process of structural convergence, the structure of relative prices will have to change as well. Such relative price changes are important as they stimulate a more efficient (re)allocation of production factors. In particular, prices of (new) products and services that are in demand have to rise vis-à-vis those of old and less sought-after products. Since the latter prices may to some extent be sticky downwards, relative price adjustments will often take place through price increases for new products and services. Consequently, a rise in inflation can be the result. Also, the carry-on effect of high inflation rates observed in the past disappears only gradually, while the continuing liberalisation process of administered prices puts upward pressure on the price level as well.³ It should be noted that pure Balassa-Samuelson inflation will not harm a country's competitiveness, as the inflationary pressure is confined to the non-tradables sector. However, the

² Pelkmans et al (2000) estimate an average effect of 3.8%-point for all candidate transition countries, whereas De Broeck and Sløk (2001) estimate an effect of 0.8 to 1.6%-point for these same countries. The Balassa-Samuelson effect critically depends on the assumption of nominal wage convergence - wages in the non-tradables sector follow those in the tradables sector - as a result of complete labour mobility within a country. Insofar as labour mobility is limited, the Balassa-Samuelson effect will thus be less pronounced.

³ On average, administered prices still have a weight of around 18 percent in the HICP baskets in accession countries (source: ECB – unpublished document).

other sources of inflationary pressure mentioned above can lead to a deterioration of competitiveness. Still, it is questionable whether these sources of inflation warrant restrictive policies aimed at short-term stabilisation, as they are natural elements of the transition process. An inordinate strict policy to fight such inflation may impede the much needed real convergence process. An independent central bank is the obvious institution to assess the appropriate policies in this respect. By means of its policies an independent central bank will then contribute to a stable environment for the banking system. Whereas independence will eventually be guaranteed through its inclusion in the *acquis communautaire*, no single accession country has implemented all requirements up until now. Progress is especially needed in the personal independence of the members of the decision making bodies and in central banks' financial independence.

2.2 Managing capital inflows and preventing lending booms

In the coming years, as remaining entry barriers will be removed and investor confidence in the region increases, EU accession countries will most likely continue to receive significant capital inflows. In

Table 2 Current account in accession countries (% GDP)

	1993	1994	1995	1996	1997	1998	1999	2000
Bulgaria	-11,0	-0,3	-0,2	0,2	4,2	-0,5	-5,6	-5,8
Czech Republic	1,3	-2,0	-2,6	-7,1	-6,8	-2,5	-2,9	-4,4
Estonia	1,3	-7,3	-4,4	-9,1	-12,1	-9,2	-5,8	-6,3
Hungary	-11,0	-9,8	-5,7	-3,7	-2,1	-4,9	-4,4	-3,3
Latvia	19,3	5,5	-0,4	-5,4	-6,1	-10,7	-9,9	-6,9
Lithuania	-3,2	-2,2	-10,2	-9,2	-10,2	-12,1	-11,2	-6,0
Poland	-6,7	1,0	0,7	-2,3	-4,0	-4,3	-8,1	-6,3
Romania	-4,7	-1,5	-5,0	-7,3	-6,1	-7,0	-3,7	-3,7
Slovak Republic	-4,6	4,6	2,1	-10,6	-9,6	-10,0	-5,9	-3,6
Slovenia	1,5	4,0	-0,5	0,2	0,1	-0,8	-3,9	-3,4
Cyprus	1,7	1,0	-1,8	-5,3	-3,9	-6,7	-2,3	n.a.
Malta	-3,4	-4,9	-11,0	-12,1	-6,1	-6,4	-3,3	-14,7

Source: International Financial Statistics (IMF)

principle, such capital inflows (FDI, bank loans, debt issues and portfolio investments) will contribute to economic development by providing funding for investment projects that cannot be financed domestically. In this way, capital flows contribute to an improved resource allocation. At the same time, such inflows and the associated structural convergence, may lead to real exchange rate appreciation, which can be considered a normal “side-effect” of the convergence process. The same goes for the current account deficits that accompany substantial capital inflows (table 2). Such deficits reflect the surge in aggregate domestic demand, for both investments and consumption, that results from the inflow of capital.

However, the Asian experience has shown that capital inflows, and particularly sudden reversals in such flows, may cause significant risks for the banking system. From a financial stability perspective it

is therefore important that current account deficits remain within sound limits and are financed prudently, so as to minimise the likelihood of potentially harmful capital flow reversals. This likelihood increases as a larger proportion of total inflows originates from investors that are not so much interested in providing finance for long-term investments, but are rather focussed on exploiting short-term gains. Generally, it is assumed that investments with a short-term maturity, such as portfolio investments and short-term bank loans, are more often related to the latter motive, whereas long-term bank lending and especially FDI more often concern the former.⁴ During recent years the financing of the current account deficit has been relatively prudent, as foreign direct investments (FDI) have played an important role. Still, short-term (portfolio) investments were significant as well in some countries, at least for a number of years (table 3).

Table 3 Private net capital flows to selected accession countries (% total net inflow)

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

*) First three quarters.

Source: BIS, IMF. Bank loans could not be split up in short-term and long-term loans.

In the run-up to EU accession, the composition of capital inflows may change substantially. First, once the present privatisation wave comes to an end, FDI may decline in importance.⁵ It remains to be seen whether the FDI flows attracted by the privatisation process will be fully substituted by FDI targeted at financing green field investments.⁶ Secondly, the prospect of EU-accession may lead to a significant increase of portfolio investments into the region, as the confidence of investors and international portfolio managers increases. The abolition of the remaining (short-term) capital controls will only facilitate this process.⁷ Thirdly, the average maturity of foreign bank debt may decline as well.

⁴ Garibaldi et al (2002) show that between 1991 and 1999 portfolio investment inflows into CEE were much more volatile than foreign direct investments, whereas bank lending took an intermediate position.

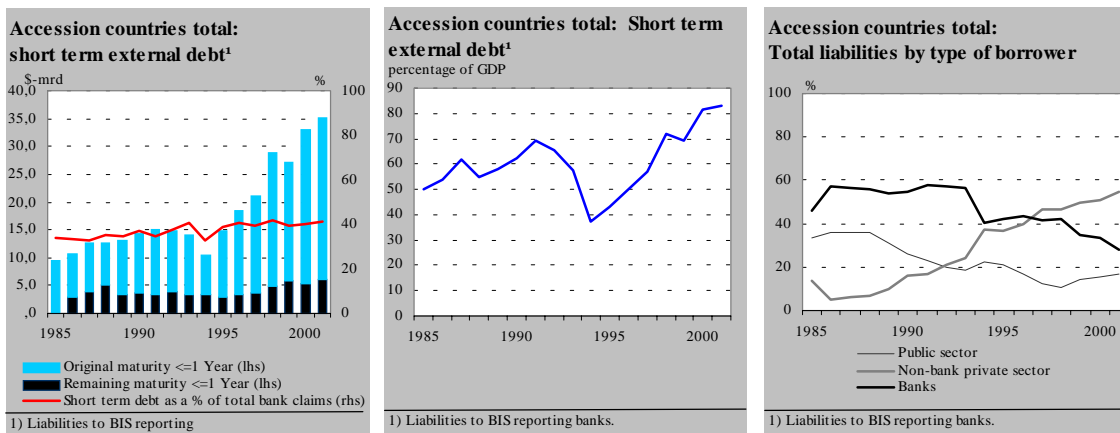
⁵ An example is Latvia, where the current account deficit amounted to 10.1% of GDP in 2001, partly as a result of strong consumption growth. In that same year, FDI was only sufficient to cover approximately 25% of this deficit (Bank of Finland, 2002).

⁶ Green field investments concern investments in new projects and firms that have to be started up from scratch (as opposed to taking-over already existing enterprises).

⁷ Garibaldi et al (2002) show that portfolio investment into transition countries has been mainly determined by the quality of the financial infrastructure and by property rights protection. In as far as these institutions will further improve during the run up to EU-accession, an additional inflow of portfolio investments might be expected.

As a matter of fact, this has already happened to a certain extent during the last decade. The first pane of figure 1 shows that, on average, the accession countries have significantly increased their short-term debt owed to foreign (BIS-reporting) banks.⁸ As a share of total bank debt, this short-term debt has increased from 34% in 1985 to 41% in 2001. As a percentage of GDP, short-term debt owed to foreign banks has risen even stronger: from a low of 37% in 1994 to 83% in 2001 (pane 2). A growing share of total foreign bank debt is directed to the accession countries' non-bank private sector, while less credit goes to the public sector or to the local banking system (pane 3). Local banks have thus become less important as intermediaries in allocating foreign banks' funds to local businesses. Foreign banks increasingly allocate their resources directly to local firms, making use of the local branches and subsidiaries they have acquired during recent years.

Figure 1 External debt accession countries: liabilities to BIS reporting banks



In sum, it can be stated that in many accession countries current account deficits are substantial, while there is a tendency for the financing of these deficits to be increasingly short-term in nature. As this would make countries more vulnerable to sudden reversals in capital-flows, it is of great importance that their banking systems are adequately prepared for the consequences of such changes. In many accession countries significant progress has been made in financial reforms, often stimulated by the growing importance of foreign banks. Foreign (owned) banks intermediate an increasing share of external bank debt to local enterprises, which is an important difference with “pre-crisis” Asia, where the role of foreign banks in intermediating capital inflows was only very limited.⁹ Furthermore, financial intermediation in transition countries has been expanding fairly gradually from very low levels, in spite of good prospects of convergence towards EU levels of income. While too little credit

⁸ Short-term debt as a percentage of GDP has been *declining* in the Czech and Slovak Republic since 1999 and is now back on the average level.

⁹ McKinnon and Pill (1997) stress that emerging markets may be particularly prone to overborrowing as a result of excessive optimism. Consumers and investors then want to increase consumption and investment beyond sound levels, and banks, confronted with increased possibilities of foreign funding, may be willing to finance this. Up until now, this scenario has not materialised in the accession countries, partly due to the importance of

growth might be an impediment to change in transition economies, at least the gradual growth of credit has given the accession countries some time to strengthen their banking sectors. Nevertheless, capital outflows could be triggered when markets no longer perceive the current account deficits and accompanying real appreciation as a sign of strength and structural convergence, but rather as a weakness and as a sign of badly intermediated foreign capital.

2.3 Suitable exchange rate regimes

The accession countries are currently employing a broad range of exchange rate strategies, each with their own specific challenges in maintaining stability. The Czech Republic, Poland, Romania, Slovakia and Slovenia have opted for, either free or managed, floating arrangements. On the other end of the spectrum, Bulgaria, the Baltic States and Malta maintain either conventional fixed peg or currency board arrangements. Cyprus and Hungary are taking an intermediate approach by mirroring the ERM-II arrangement with 15 percent fluctuation bands around a central rate to the euro. The wide degree of regime diversity partially reflects historical factors¹⁰, but it also indicates that there is no single exchange rate regime that is optimal for all accession countries. Whereas a country's banking sector would be served best by a certain degree of exchange rate stability¹¹, apparently both flexible and fixed exchange rate regimes have their advantages and disadvantages, and the specific circumstances in each country define the best choice.

A fixed peg arrangement provides the advantage of nominal exchange rate stability, but this stabilisation anchor comes at a price. As is well-known, countries with a fixed peg cannot use monetary policy, or nominal exchange rate changes, to counter an asymmetric economic shock or to maintain their competitiveness. Such a decline in competitiveness can for instance result from an appreciation of their real exchange rate caused by a comparatively high rate of inflation. Subsequently they will have to remain fiscally prudent, and have to rely on wage and price flexibility as the sole adjustment mechanisms. At the same time, the perpetuity of a fixed exchange rate can never be guaranteed. Speculative attacks on the peg can be triggered by a sudden loss of confidence or other negative shocks. These can be costly in terms of reserves spent on defence, while a disorderly exit from the fixed regime, entailing a large shift in the exchange rate, can have severe economic repercussions, in particular for the banking sector. When such a scenario would unfold, it may turn out that the risks to banking sector stability have actually been augmented by the fixed peg, especially since a pegged currency can discourage hedging against currency risk, thus stimulating the build-up of unbalanced portfolios.

foreign banks. By "importing" sound lending policies, foreign banks have thus to some extent contributed to a higher degree of financial stability.

¹⁰ Bulgaria, for instance, installed its currency board as a means to stabilise its economy during the crisis of 1996/97.

¹¹ Substantial exchange rate volatility can inflict severe damage on bank balance sheets through the adjustment of the real value of assets that have been financed in foreign currencies (cf. section 2.4).

Whereas flexible arrangements cannot prevent damaging exchange rate volatility triggered by volatile capital flows, they do offer the potential benefits of an active monetary and exchange rate policy that can be used to manage these flows, to spur disinflation, maintain competitiveness and to support economic growth. And whereas fiscal prudence and structural flexibility will support the economic well-being of all accession countries, their importance increases along with the degree of invariability of the exchange rate. The Asian experience has shown that a pegged currency combined with large reversals in capital flows may lead to significant problems, as it is very painful and costly to adjust a fixed exchange rate regime in an orderly fashion. Flexible exchange rates are better able to adapt themselves to changes in capital flows and other economic shocks, and it seems therefore sensible for accession countries not to rush themselves in fixing their exchange rates as quickly as possible. Only countries that are confident that they can maintain strict fiscal prudence and that their wages and prices are flexible enough to safeguard competitiveness and to cope with asymmetric shocks, should consider a fixed rate regime.¹²

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

¹² The Baltic states are archetypal examples of countries that have many characteristics that will help to sustain a successful currency board arrangement. Up until now, their pegs have not come under severe stress, despite the facts that they already liberalised their capital accounts in the early 1990s and that they have shown large current account deficits over the past years. Sutela (2001) ascribes their success to both sound fundamentals and unintended consequences of policy decisions. On the one hand they have pursued sound fiscal policies and have created a high degree of structural flexibility in their economies. On the other hand exchange rate stability was supported by the fact that their financial markets are very small, leaving little room for capital flow reversals, and the fact that almost all of their banks were sold to solid foreign institutions. Despite their successful track-record, consistent good policies - especially a prudent fiscal policy - remain vital for the sustainability of these arrangements, given their relatively high current account deficits.

regime should be well-considered. Nevertheless, it cannot be excluded that - given the remaining large structural differences - the chosen rate may have to be adjusted at some point. As such adjustments are potentially painful processes, countries should be careful in giving up their exchange rate flexibility too early.

2.4 Limiting currency mismatches in the banking system

Banks denominating part of their assets and/or liabilities in a foreign currency will be subject to risks arising from exchange rate changes. In principle, two cases can be distinguished. First, when a bank denominates more liabilities than assets in a foreign currency (or vice versa) it will be subject to a currency mismatch. When domestic compared to foreign interest rates are high, banks may for instance be tempted to use foreign currency denominated liabilities to fund their local currency denominated activities. Such a currency mismatch will subject banks to a substantial devaluation or depreciation risk, as in that case their foreign currency denominated liabilities will increase in value, eroding the bank's capital base.¹³ The second case concerns banks that denominate the same amount of assets and liabilities in a foreign currency in order to avoid a currency mismatch.¹⁴ Even then, the bank remains subject to risks linked to exchange rate fluctuations. On the asset side, currency risk is shifted to debtors with foreign currency denominated loans, and currency risk will accordingly be substituted by credit risk. After all, banks' customers may not be able to pay off such loans, the value of which will rise sharply in terms of the local currency after a downward exchange rate correction. Firms may be overly optimistic in assuming that the current exchange rate will also hold in the future, and thus demand a relatively high proportion of foreign currency debt. In Poland, Hungary and the Czech Republic, the importance of foreign-currency denominated lending to the corporate sector has indeed risen.¹⁵ At the same time, the share of foreign currency denominated deposits has declined in these countries. As a result, the corporate sector has increased its net foreign exchange position against the domestic banking sector and may therefore be more vulnerable to downward corrections in the exchange rate.

During the run-up to E(M)U accession, it is conceivable that the importance of euro-deposits will increase. This may increase depositors' sensitivity to interest rate differentials between euro-deposits at home, international euro-deposits and local currency deposits. As a result, both cross-border and within-border capital mobility may intensify. With regard to the former, the threshold for depositors to shift from domestic euro-deposits into foreign euro-deposits may decline, leading to more volatile cross-border capital movements reacting to changes in international interest rate

¹³ Additionally, a maturity mismatch will increase the bank's interest rate exposure or, more specifically, its exposure to changes in the yield curve.

¹⁴ An alternative would be to use off balance sheet hedging instruments such as forward contracts.

¹⁵ In these three countries, foreign currency denominated credit amounted to 24%, 38% and 19%, respectively, of total credit granted by the domestic banking system to the corporate sector in 2000 (Reininger et al, 2001, pp. 13-14).

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

Besides carefully monitoring banks open currency positions, risks can also be limited by making sure that banks do not try to reduce the currency risk associated with deposit euroisation by extending euro credit to customers who will not be able to service their debt obligations in case of sharp depreciations or devaluations. Finally, bank regulators can prevent undue transformation of currency by placing limits on banks' open foreign exchange positions when deemed necessary (see also section 2.7).

2.5 Adequate preparations for financial liberalisation

Financial liberalisation covers a whole range of deregulatory measures that loosen the constraints on the financial activities of banks and other economic actors, varying from lending restrictions to capital account liberalisation. Although financial liberalisation can generate substantial long-term benefits, the new environment inevitably presents banks with new risks, which, without the proper precautions, may pose a threat to banking sector stability. The Asian experience has shown that getting the sequence right can be important in this regard. The positive effects of financial liberalisation will come within reach at a lower cost if banks and supervisory capacity are strengthened *before* reforms are implemented.

The CEE accession countries have come a long way in liberalising their financial systems since the beginning of the transition period, to a large extent stimulated by the institutional requirements of the EU accession process. Full liberalisation of the capital account is a part of the *acquis communautaire*, introduced to ensure a more efficient allocation of resources. However, even though EU rules allow for the temporal reintroduction (6 months maximum) of some capital restrictions under exceptional circumstances, full liberalisation might not necessarily benefit the accession countries at all times. It could be beneficiary to initially postpone the liberalisation of the most fluid capital flows, and thus liberalise longer-term flows before short term flows, and direct

investment before portfolio investment.¹⁶ Thus, short-term capital controls might fulfil a positive role during the catching-up process when a country's credibility has not yet increased sufficiently to prevent large capital flow reversals due to speculative investors. Nevertheless, no country has requested any transitional periods for the liberalisation of short term capital movements. Instead, the focus has often been on the postponement of the politically sensitive liberalisation of real estate purchases. The chapter on capital movement has now been closed by all accession countries, except Poland and Romania, and implementation of the liberalisation of capital movements has come a long way in most countries. Only Romania, Malta and Cyprus still maintain significant restrictions. Despite the fact that the adoption of the full *acquis communautaire* by new member states is an essential precondition for the continued success of European integration, a temporary derogation allowing the accession countries to maintain some barriers to short-term capital flows, might actually have been beneficiary.

With liberalisation of capital movements being reality in most of the accession countries at present, the most important instrument available to prepare the financial sector for EU accession is now the framework of prudential regulation and supervision. Banks could be encouraged to increase their loan-loss provisions and enhance their know-how in the fields of credit assessment, liquidity management and the pricing of risks. This last point goes in principle also for banks' clients and other (end) users of (intermediated) foreign capital, who will also need time to adapt their risk management systems. Additionally, banks' capital levels should be high enough to be able to cope with a more liberalised and market-based operating environment. When the capacity of banks to take on risks of various sorts is expanded, the capacity of supervisors to monitor these changes has to increase commensurately. The accession countries have generally introduced adequate laws and regulations to promote the soundness of individual banks, but that does not necessarily guarantee their actual implementation. It is also important that supervisors and the judiciary have adequate resources to perform their tasks (cf. section 2.7). The development of the institutional capacity that is necessary to ensure the well-functioning of the prudential framework requires substantial financial resources and, inevitably, time.

2.6 Reducing government involvement and connected lending

¹⁶ Although it may be unattainable to adequately distinguish between "productive" and "speculative" capital flows, making an - imperfect - distinction between short and long term capital flows is in many cases possible. Limiting short term capital flows will then inevitably also hinder productive short term investments, such as trade credit. The resulting loss in allocative efficiency then has to be weighed against the increased financial stability that is gained by imposing the capital flow restrictions.

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

Table 4 Asset-share of state-owned banks 1996-2001

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

* Excludes Ceska Sporitelna and Komerčni Banka. Source: EBRD Transition Report 2001.

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

The establishment of foreign bank branches and subsidiaries, whether through green field investments or by taking over local banks, has generally led to a higher efficiency of the domestic banking system.¹⁷ Foreign bank penetration will for example lead to improved bank management, the introduction of new financial services and the "import" of better regulation. However, for transition economies that open up their banking markets to foreign competition, the challenge lies in achieving such higher long-run efficiency without creating financial instability in the short-run. Such instability may for instance be the result of very fragile local banks - burdened by large amounts of bad debt - that default when confronted with foreign competition.¹⁸ In such cases, foreign bank liberalisation can

¹⁷ See for instance Claessens et al (2001) for a comprehensive study into the effects of foreign bank entry on local banking markets.

¹⁸ Also, foreign banks may be inclined to reduce their credit supply during adverse economic times, leading to increased credit volatility in the host country. Results for Latin America show that even though cross-border

best be preceded or combined with the cleaning and reforming of the local banking system and, importantly, the strengthening of the local supervisory authorities (cf. section 2.5).

Strong and independent supervisory authorities are extremely important from the viewpoint of reducing connected lending and government involvement. Some authors even argue that regulatory and supervisory independence is important for financial stability just as central bank independence is important for monetary stability.¹⁹ Only when regulators are independent – but at the same time sufficiently accountable – may they withstand political interference in the supervisory process. Supervisors may for instance consider to place tough limits on lending to insiders, as such lending is likely to lead to conflicts of interest. Strict enforcement of these connected exposure limits will be at least as important as the exact size of the limits.

2.7 Strengthening the legal, supervisory and accounting framework

Adequate institutions, such as a legal framework that specifies the “rules of the game” for a market economy, are crucial for the development of a deep, stable and efficient banking sector. Legal rules provide for instance for creditor protection in case debtors default and collateral has to be liquidated. Without such protection banks may not be incited to expand their credit supply, as they hesitate to lend funds to any enterprise that is even slightly risky, and may instead seek recourse in investing in government bonds or other risk-free assets.²⁰ Likewise, banks will tend to ration credit if they have to operate in an environment with intransparent and unclear accounting rules as they can not adequately judge the risks involved in lending. An incomplete implementation of internationally acceptable accounting standards and the subsequent low quality of consolidated accounts makes it difficult for supervisors as well to assess interaffiliate lending and relationships between banks.

The challenges accession countries face over the coming years in improving their legal, supervisory and accounting frameworks are basically twofold. Firstly, the lack of sound creditor protection has been an important impediment for banks in transition economies to start lending to small, new and innovative enterprises, even when risk-return characteristics were satisfactory in themselves. A sound legal framework that effectively protects creditors when making loans to the private sector, would thus ensure that banks do not *overprice* the risks of private investments. It will then be conducive to the development of a local banking system that is able to efficiently allocate

foreign bank credit may indeed be withdrawn during an economic downturn, foreign bank subsidiaries' credit is much more stable and even increased during such a period (Peek and Rosengren, 2000). Comparable research for CEE suggest that this conclusion holds for this region as well (De Haas and Lelyveld, 2002).

¹⁹ See Quintyn and Taylor (2002) who distinguish four dimensions of regulatory and supervisory independence. Firstly, regulators should have sufficient autonomy in setting rules and regulations, within the confines of the law (regulatory independence). Secondly, supervisors should be able to inspect, monitor, sanction and enforce sanctions without interference by the government or the supervised institutions (supervisory independence). Thirdly, the supervisory agency should be separate from the executive and legislative branches of government (institutional independence). Fourthly, the supervisory agency should be able to decide independently over the size and use of its budget (budgetary independence).

²⁰ See also the contributions by La Porta, Lopez-De-Silanes, Shleifer and Vishny (1997, 1998 and 2000).

domestic resources to long-term productive investments. Additionally, an adequate supervisory framework ideally fulfils a complementary role in making sure that banks do neither start to invest funds in overly risky projects. Effective supervision thus warrants that banks do not *underprice* risks, for instance due to perverse incentives that lead to moral hazard. By providing banks with the right incentives, financial laws and supervision thus enable the banking system to deepen and to allocate the available resources more efficiently. The second, though related, challenge for the accession countries relates to the role of laws and supervision with respect to exogenous shocks, such as sudden reversals in capital flows. Effective legal and supervisory institutions contribute to a solid banking system that is able to efficiently intermediate the increasing flow of (short-term) foreign funding which will likely be the result of the full liberalisation of the capital account. These challenges may be more or less urgent for different countries, depending on both the expected amount of capital inflow during the coming years and the progress that has already been made in strengthening the legal and supervisory systems.

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

Table 5 Changes in legal transition indicators 1997-2001: commercial law

<i>Country</i>	<i>Extensiveness (2001)</i>	<i>Effectiveness (2001)</i>	<i>Total (2001)</i>	<i>Extensiveness (1997)</i>	<i>Effectiveness (1997)</i>	<i>Total (1997)</i>
Bulgaria	4	4-	4-	3	3	3
Czech Republic	3	3	3	4	4	4
Estonia	3+	4	4-	4	4	4
Hungary	4-	4-	4-	4	4	4
Latvia	4-	4	4-	3+	3	3
Lithuania	4-	4-	4-	4	3	3
Poland	4-	3	3+	4	4+	4
Romania	4	4	4	3	3	3
Slovak Republic	3+	3+	3+	3	3	3
Slovenia	4-	4-	4	3	4	3

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

Empirical results suggest that such poor law enforcement indeed hinders the development of the banking sector in transition economies (Pistor, Raiser and Gelfer, 2000). Simply “copying” Western laws and aligning supervision with EU standards is thus not enough. This goes as well for

improvements in the quality of bank regulation. Reiniger, Schardax and Summer (2001) find that *formal* supervisory power to prevent and correct problems in the banking sector are relatively high in Hungary, Poland and the Czech Republic when compared with the EU-average. However, supervisory resources turn out to be used rather inefficiently, as on-site examinations are rather infrequent and forbearance discretion is relatively high. Additionally, Neyapti and Dincer (2001) find a positive (negative) relationship between good bank regulation / supervision and growth (inflation), but also conclude that these relationships are stronger when countries have changed or improved their supervisory framework more than once since the beginning of transition. Apparently, legal institutions become more effective when they are adapted to the particular economic situation. Therefore, not only a better enforcement of legal and supervisory frameworks is of great importance for accession countries, but also further improvements to better embed these frameworks into their specific economic and institutional background. This is all the more important since some of the current weaknesses in financial market regulation in CEE, such as a lack of resources to monitor compliance, have been identified as having contributed to the Asian financial crises before (Ramasastry and Slavova, 1999).

2.8 Well-balanced incentive management

A final point of interest in the quest for banking sector stability entails the need to instil the proper incentives in bank owners, managers and depositors. Such “incentive management” confronts policy makers with conflicting objectives. On the one hand, excessive risk taking by banks can be discouraged when owners, depositors and others involved in a bank’s business stand to lose from its bankruptcy. On the other hand, there are strong arguments to not always let unsound banks fail, nor to let depositors pay the price for their choice of bank. The fact that banks are important to the economy as a whole and that their failure may have severe repercussions for specific parts of the economy, argues for the more or less explicit existence of a lender of last resort. Likewise, the prevention of bank-runs, the difficulty depositors may face in distinguishing the best banks and the need to protect the public from bank failures, are all valid reasons for establishing a deposit insurance scheme. Nevertheless, the existence of a public safety net also creates moral hazard, as it incites actors to behave less responsible than they would have done otherwise.

Taking the above considerations into account, the members of the European Union have agreed to certain rules for deposit insurance in order to establish minimum prudential standards within the single market. They include a minimum level of protection of 20.000 euro per deposit and the principle that all branch depositors should be protected by the state where the head office is located (home country principle). As these agreements are part of the EU *acquis communautaire*, the candidate countries that have not yet done so, will have to harmonise their practices to meet EU standards before accession. However, this regulation might not be optimal for the accession countries. Demirgüç-Kunt and Detragiache (2000), and also Hermes and Lensink (1997), argue that whereas the

moral hazard problem caused by explicit deposit insurance tends to be detrimental to bank stability in general, this is even more so in countries where the institutional environment is still relatively weak. They also conclude that the adverse impact of deposit insurance on bank stability tends to be stronger when the coverage offered to depositors is more extensive. The fact that accession countries lag behind the EU in terms of the development of the institutional environment and income levels, means that compliance with the EU regulation may actually raise moral hazard problems. A case in point is the minimum protection level of 20.000 euro in the current EU deposit insurance scheme, which is relatively high for the accession countries given their much lower income levels as well as average size of deposits. This stresses once more the importance of effective prudential regulation and banking supervision, in order to minimise moral hazard behaviour resulting from a relatively extensive deposit insurance system.

After the candidates have acceded to the EU, the lender of last resort function will remain a national responsibility. Just like the other member states these countries will (continue to) apply a strategy of ‘constructive ambiguity’ to minimise moral hazard problems. A related issue is the fact that many banks in the accession countries have been acquired by financial institutions from current EU member states. This may have complicated the execution of the lender of last resort function as well as the practice of deposit insurance (but possibly made it less necessary as well). Both the home country principle for deposit insurance and similar EU regulations that stipulate that full responsibility for prudential supervision belongs to the ‘home country’, mean that important responsibilities for the financial stability of the accession countries will have to be borne by the authorities of other member states. Subsequently, to safeguard financial stability, it is of the utmost importance that the incentives of the home and host country supervisory authorities are fully aligned, and that both parties keep each other sufficiently informed. In order to achieve this, deepened bilateral and multilateral cross-border co-operation between the relevant authorities in different countries, as has been recommended by the Economic and Financial Committee (2000 and 2001) is essential.²¹ Such cross-border co-operation becomes even more important as the number of EU banks of whom the headquarters are located in other member states increases during the accession process. Within the EU, Memoranda of Understanding form the main basis of bilateral co-operation. Whereas in the run-up to accession similar agreements are also becoming more commonplace in the relations between the financial authorities of accession countries and individual EU member states, more progress in this field is needed to instil the necessary incentives in all financial authorities involved in cross-border issues.

3. Conclusions and policy implications

The structural changes and adjustments that the EU accession candidates have made during recent years, partly speeded up by the accession requirements, have in many cases been impressive.

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

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

The strengthening of the legal system and supervisory authorities will prove all the more important and pressing as there is in some areas an unequivocal tension between the requirements for EU accession and the lagging behind of the financial infrastructure. More precisely, the pursuit of banking stability in the short and medium term might be rendered more difficult by a premature and rash adoption of all EU-requirements when striving for (too) speedy E(M)U-accession. An example is the fact that the adoption of the *acquis communautaire* implies that the accession countries have to liberalise their capital account in a dynamic economic environment where macroeconomic volatility

²¹ See also Enria and Vesala (2001).

and capital flow reversals can not be excluded. Other examples include the adoption of relatively extensive deposit insurance schemes, which may encourage moral hazard, and the early (though voluntary) giving up of exchange rate flexibility. In the coming years all accession countries will face important decisions relating to their upcoming accession to the EU and EMU, ranging from the decision on when to fully liberalise the capital account, to the decision on when to adopt the euro. It is important that the possible implications of these decisions for banking sector stability are always considered carefully.

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