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Article

Editor's introduction

EIB Papers

Provided in Cooperation with:

European Investment Bank (EIB), Luxembourg

Suggested Citation: Riess, Armin; Wagenvoort, Rien (2002) : Editor's introduction, EIB Papers, ISSN 0257-7755, European Investment Bank (EIB), Luxembourg, Vol. 7, Iss. 1, pp. 11-28

This Version is available at:

<http://hdl.handle.net/10419/44815>

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Editors' introduction

The financial integration of an enlarged European Union would be of little interest if finance did not matter for economic growth and development. But does it? And if finance matters, what type of financial system, dominated by capital markets or banks, would be more efficient in allocating resources in Central and Eastern European Accession Countries (CEECs)? Recent economic literature suggests that finance does matter for economic growth but that economies can prosper in both a capital market-based or a bank-based financial system. The development of CEEC financial sectors and their smooth integration with those of existing EU members is thus an important economic policy issue. This edition and its companion edition (Volume 7, Number 2) of the *EIB Papers* present contributions, made at the EIB conference on 17 January 2002, to policy debates related to this topic.

We start this introduction by reviewing the arguments regarding the causal relationship between the type and development of the financial system and economic development. After setting the stage, this article broadly follows the ordering of the papers in the two latest editions of the *EIB Papers*. Section 2 contains a review of banking in the CEECs. The purpose of this section is to bring out common features of the CEEC banking sectors but also to pinpoint country specifics. In Section 3 we turn to capital markets and essentially pursue the question of whether accession countries need to establish their own markets or whether they could use existing securities exchanges - in the EU for instance. The last section reviews the papers collected in the companion edition, which looks at interlinkages between financial sector development and the macroeconomy.

Does finance matter?

Is there a causal relationship between financial sector development and economic growth? Given that there is ample cross-country evidence for a positive correlation between the financial and real sector developments this may seem like a redundant question. However, observing an association between finance and growth does not inform on the direction of cause and effect. Indeed, as Arestis and Demetriades (1997) - for instance - reveal, economists hold startling views about the causality between financial development and sustained growth of per capita income.

One school of thought argues that financial institutions and markets foster the mobilisation and efficient allocation of savings and, thereby, raise economic growth. According to this view, financial development is a pre-condition for a thriving economy. The opposing view claims that economic growth stimulates the demand for, as well as the supply of financial assets and, thereby, the development of financial systems. According to this view, growth causes financial development.

With *a priori* reasoning providing conflicting predictions about the causality between finance and growth, the debate essentially needs to be addressed from an empirical angle. Although the literature has not reached consensus, the balance of evidence seems to support the hypothesis that finance leads economic growth (World Bank, 2001). What is more, that functioning financial systems enhance the efficiency of resource allocation seems to be more important than their role in

mobilising savings for investment. In fact, this is not entirely surprising given that planned economies did certainly not accumulate too little but rather the wrong type of physical capital, which - to make things worse - was not efficiently used.

What can we say about the link between growth and finance in CEECs? Berglof and Bolton (2002) point out that there has so far been little correlation between economic growth and financial sector development and that one cannot attribute the relatively better economic performance of some CEECs to a more developed financial system. But the lack of correlation, let alone causality, between growth and finance in the first decade of transition does not really come unexpected and can be explained by a variety of reasons.

To begin with, ten years of transition is likely to be too short a period for financial sector progress to show its impact on economic growth. Second, a bundle of economic policy measures and not only progress in establishing functioning financial systems determined the success, or lack thereof, of the transition to a market economy (Fischer and Sahay, 2000). What comes to mind includes macroeconomic stabilisation, price and trade liberalisation, enterprise restructuring and privatisation, and the creation of the legal underpinnings for a market economy. In this respect, success has varied from country to country in the early stages of transition and, therefore, economic performance has not been uniform across the region. Finally, it is not unreasonable to assume that in the early phase of transition, the most obvious investment and growth opportunities could be met without funds intermediated by domestic financial systems. Foreign direct investment, for instance, has played a crucial role in virtually all CEECs. Overall, the experience of the last decade does not weaken the argument in favour of mobilising and allocating domestic resources in an efficient way and, thus, further developing the financial system is a logical and essential step to sustain growth and development.

But which direction should financial sector development take? More specifically, does it matter whether finance comes predominantly from banks or capital markets? Historically, banks preceded capital markets and the eventual emergence of bank-based systems in some countries and market-based systems in others was due to historical reasons (1) and different policy responses to financial crises but did not reflect a choice based on a thorough assessment of the pros and cons of the two alternatives (Allen and Gale, 2000). Market-based financial systems emerged in the United States and the United Kingdom, for instance, and bank-based systems in continental Europe. But it is also clear that both systems co-exist in most countries albeit in different proportions.

That said, the question remains whether a capital market-based financial system is preferable over a bank-based system and, if yes, whether the CEECs, which had (the choice) to create financial systems from scratch, could skip the historical and, as it seems, accidental detour of relying too much on banks and too little on capital markets.

To answer this question, we note first that cross-country data show a positive correlation between per capita income, on the one hand, and the importance of capital markets relative to banks (World Bank, 2001). Against this background, one could argue that preferring markets to banks could help

1) David Landes (1998) argues that the outcome of financial system development depends on the stage of industrial development at the time financial sectors are created.

the CEECs to catch up with the West. In fact, as pointed out by Lavigne (1999) for instance, policymakers in the CEECs had a preference for market-based over bank-based financial systems at the beginning of the transition. But here again, one must not confuse correlation with causality. The research reviewed by the World Bank does not suggest a causal effect of a country's financial structure (i.e. the relative weights of markets and banks) on economic growth and development. There is evidence, however, that both banks and markets can foster growth and that success depends on whether or not the financial system - bank-based or market-based - is supported by an adequate legal, regulatory, and supervisory framework. If that is the case, economies can thrive under either system.

Recognising the importance of finance for economic growth, the creation of market-driven financial systems featured high on the economic policy agenda of all CEEC governments. Despite initial preference for capital market-based over bank-based financial systems, banks have turned out to dominate CEEC financial systems. Wagner and Iakova (2001) for instance, report that bank assets account for 85 to 95 percent of overall financial assets in the larger CEECs. Events therefore confirm those observers, such as Gros and Steinherr (1995) who have stressed that while prospering economies eventually need banks and capital markets, banking has to precede markets at an early stage of economic development.

A bumpy road towards creating market-driven banking sectors

The achievements and challenges of creating banking sectors are the subject of three country studies in this volume. **Dana Hájková**, **Jan Hanousek** and **Libor Němeček** take a look at the erratic development of the Czech banking sector in its transition period. They emphasise that the period has been marked with problems and large economic losses, mainly caused by an undefined strategy, lack of proper risk management systems, related-party lending, and by inadequate prudential regulation and supervision. The authors' key conclusion is that after an excessively lengthy period of restructuring - and many false starts and haphazard measures - the Czech banking sector has now been put on a firm footing for future growth.

Éva Várhegyi examines the more successful path taken by Hungary. She points out that the country had a head start because it already had a two-tier banking system when the Berlin Wall came down. Moreover, Hungary decided earlier than many other countries - including the Czech and the Slovak Republics - to privatise state-owned banks to foreign strategic investors who not only injected capital but also a wealth of expertise into the banking sector. Cognisant of Hungary's success in creating a functioning banking system, the author also notes that bank intermediation has not grown as fast as most observers might have expected at the beginning of the 1990s.

Peter Zajc discusses the case of Slovenia, which has been characterised by an absence of bank privatisation and limited foreign bank entry. As a result, state-owned banks continue to dominate the sector and the share of foreign-banks in total banking sector assets currently amounts to about 22 percent, which is low by CEEC standards. Nevertheless, the development of the country's banking sector has been encouraging: Bank intermediation increased and, subsequent to a comprehensive restructuring programme, bank failures have been avoided. However, as the author stresses, Slovenia's banks have benefited from a peculiar institutional setting, such as an inflation

indexation of financial contracts that worked in the banks' favour. This setting is now being revamped and it will be a challenge for banks to maintain their performance in the period ahead.

The country papers in this volume deal with a number of banking sector reform issues that are worth presenting in a more general fashion. To begin with, in creating market-driven banking sectors, most CEECs faced similar tasks. A rather basic one was to switch from a mono-bank model to a two-tier banking system where central banking functions are separated from commercial banking activities and where the latter are performed by a number of competing commercial banks. A far more complex task was to establish an incentive framework that induces banks to behave as they should in a well-functioning market economy. At the beginning of the 1990s, major obstacles to proper bank behaviour included the large amount of non-performing loans to enterprises with limited prospects of surviving in a market economy and the lack of bank capital. In these circumstances, banks had little to lose and faced the temptation to improve their fate by providing new loans to those enterprises in the hope that this would increase the chance of eventually recovering doubtful loans. Against this background, there was an urgent need for recapitalising banks and for restructuring their assets.

CEEC governments addressed the twin challenges of recapitalisation and restructuring by substituting government securities for non-performing loans (see, for instance, Bonin and Wachtel, 1999). There were, however, differences across countries in terms of how much of the bad debt was written off and, more importantly, who was put in charge of trying to restructure non-financial enterprises and, thereby, to recover the remaining non-performing loans. In Poland, for instance, non-performing loans stayed on banks' balance sheets even after recapitalisation; banks were responsible for loan workouts and could keep the proceeds in case of successful loan recovery. In other countries, including Hungary, Slovenia and the Czech and Slovak Republics, non-performing loans were largely transferred to government rehabilitation agencies, which assumed the task of trying to restructure non-financial enterprises and, thereby, to recover as much as possible of the non-performing debt. Van Wijnbergen (1998) pointed out that loan recovery was far better in countries like Poland where banks were assigned an active role in enterprise restructuring. Being involved in this process, banks also had an opportunity to gain expertise in assessing would-be borrowers. By contrast, loan recovery was poor in Slovenia and Hungary, for instance, where government rehabilitation agencies had this task.

Van Wijnbergen emphasised another important difference in the experience of various CEECs, namely whether banks perceived the initial recapitalisation and restructuring as a one-off measure and, thus, expected to operate under a hard budget constraint in the future. Restructured and recapitalised Polish banks seem to have understood this well, as they did not experience new bad loan problems. By contrast, banks in Hungary and the Czech and Slovak Republics continued to run into difficulties and the government bailed them out repeatedly, in Hungary until the mid-1990s and in the Czech and Slovak Republics well into the late 1990s (see Wagner and Iakova, 2001; Várhegyi and Hájková *et al.*, both this volume). Does this suggest that transferring bad debt to a rehabilitation agency inevitably gave the wrong signal to banks? The Slovenian experience illustrates that this would be the wrong conclusion. Although non-performing loans of the Slovenian banking sector ended up with a rehabilitation agency, banks did not encounter new problems in subsequent years but, on the contrary, built up a comfortable capital cushion (Zajc, this volume).

Overall, the behaviour of banks following rehabilitation was determined by whether or not they faced a hard budget constraint and this, in turn, did not depend on whether or not they were involved in enterprise restructuring and bad loan workouts.

It could be tempting to argue that setting a hard budget constraint was more credible if bank restructuring and rehabilitation went together with privatisation. In Hungary, for instance, bank restructuring-cum-privatisation took place in 1994-97 and no major government rescue operations have become necessary since then (Várhegyi, this volume). And then, there is the example of the Czech and Slovak Republics where state ownership of banks, which continued well into the late 1990s, has been singled out as probably the most important reason for the appalling performance of the sector and the accumulation of an enormous amount of non-performing loans (Hájková *et al.*, this volume). However, the failure of the privatised IPB in the Czech Republic is a reminder that privatisation is certainly not a panacea. Furthermore, in Slovenia, the creation of a sound banking sector went hand in hand with the state assuming, rather than relinquishing ownership in banks (Zajc, this volume).

In principle, if restructured and recapitalised banks - or any other enterprise - are exposed to the right incentives, the efficiency of these institutions should not depend on whether they are private or state-owned. Experience strongly suggests, however, that ownership matters a lot because it is difficult, if not impossible, to get the incentives right for state-owned enterprises. The transition environment - with entrenched links between the state, the management of state-owned banks, managers of state-owned non-financial enterprises, and owners or managers of privatised non-financial enterprises - have made it even more important to privatise banks and avoid the creation of very distorted incentive structures. Against this background, all CEECs - so far with the exception of Slovenia - have eventually embarked on bank privatisation programmes. In fact, restructuring and recapitalisation were often undertaken with a view to getting banks in shape for privatisation.

Three broad types of privatisation models were applied (Bonin and Wachtel, 1999): Direct sales to foreign strategic investors, initial public offerings and voucher privatisation. A prime example for the first approach is Hungary, which carried out its privatisation programme in 1994-97. Foreign investors, mainly banks - often from the EU - participated in bank recapitalisation and introduced modern banking sector technology, financial capital, independent governance and expertise. Moreover, the presence of foreign banks reduced the risk of capital flight and depositor runs and stimulated competition in the banking sector. The second model played an important role in Poland, for instance, where public offerings were combined with management buyouts and sales to foreign strategic investor. Czechoslovakia opted for voucher privatisation, which resulted in dispersed ownership and clearly failed in establishing a banking system that was independent from the state and entrenched insiders. Mirroring this failure and mounting banking sector problems, the Czech and Slovak Republics relaunched their privatisation programmes towards the end of the 1990s, this time with the involvement of foreign strategic investors.

In addition to the issue of how the CEEC banking sectors came into being, there is the question of how much they have contributed to the economic advancement of the region. **Armin Riess**, **Rien Wagenvoort** and **Peter Zajc** show that bank intermediation has remained shallow and they illustrate

that CEEC banks mobilise more funds than they can lend domestically, which effectively makes them net external creditors in a capital-importing environment. Furthermore, the authors argue that contrary to what a cursory look at nominal returns on equity may suggest, the profitability of the CEEC banking sectors is largely unsatisfactory. The so far limited - and not very profitable - role of banks in the CEEC economies is mainly due to of stiff competition from cross-border finance (i.e. intercompany loans and non-resident bank lending), banks' inadequate risk assessment and management capacity, and because of shortcomings in the legal environment, which dampen banks' willingness to lend. Improvements in the legal framework and further progress of banks in strengthening their risk assessment and management capacity are seen as crucial pre-conditions for making the sector live up to its potential.

That there is an enormous potential comes out clearly in the contribution of **Erich Hampel**, who provides an EU banker's perspective on banking in the region. He notes that the underdeveloped CEEC banking markets has become the number one target for the international, especially EU, banking community. In particular, the retail market segment holds considerable potential for expansion and, on the back of improvements in corporate governance of non-financial enterprises, the author also sees substantial scope for further developing corporate lending.

Functioning banking sectors obviously not only need banks but also an effective regulatory and supervisory framework. Given that banking, as known in market economies, did not exist under central planning, setting up a proper regulatory and supervisory framework has been as much a challenge as the creation of banks itself. In designing such a framework, the CEECs borrowed from rules and regulations applied in the EU. While this has surely accelerated things, putting in place an appropriate framework and implementing it effectively has nevertheless been a daunting task. And, as Hájková *et al.*, (this volume) point out with respect to the Czech and Slovak banking sectors, regulation and supervision have often developed through a learning-by-doing process where legislative changes were typically a response to problems that had arisen, rather than an attempt to prevent their occurrence in the first place.

In part, this has been due to a lack in personnel trained in bank regulation and supervision. Van Wijnbergen (1998) for instance, notes that to hide failures in their own operations, supervisors misreported problems at credit institutions for a while, hoping that future favourable developments at the problem banks could avoid damage of their own reputation. Another important element is likely to have been regulatory and supervisory forbearance, in particular at the beginning of the transition process when commercial bankers and their regulators and supervisors emerged from the same mono-bank system. In essence, newly appointed supervisors had to monitor previous colleagues who had become bank managers. In these circumstances, but also reflecting political interference, the implementation of new banking laws was seldom as rigorous as it should have been.

All CEECs have now put in place a regulatory and supervisory framework for the banking sector along the Basle guidelines and EU banking directives. What is more, shortcomings in the effective implementation of prudential regulation and supervision are certainly less severe today than they were in the early days of establishing banking in the region. Nevertheless, disparities between the design and the implementation of the regulatory and supervisory framework remain in some countries and will have to be further reduced.

To summarise achievements in the first decade of transition, all CEECs have advanced considerably in creating market-driven banking sectors that are well-capitalised and have significantly stronger loan portfolios than some five years ago. While the timing and specifics of the approach taken differed from country to country, the outcome that we can observe today is quite similar across the region. Probably the most striking structural feature is the large presence of foreign strategic investors, mainly from the EU, who dominate banking in all the countries except Slovenia. And then, the sector has essentially developed along the universal banking model known from continental Europe, which is not a surprise given the heavy involvement of EU investors. But it is also true that the role of banks is lagging behind that of banks in other middle-income countries and, of course, the EU.

In light of this, a very basic question that comes to mind is whether CEEC banks are ready to join the Single Market for financial services? In this context, it is worth noting that the capacity to cope with competitive pressures of the Single Market is one of the economic criteria that accession countries have to fulfil before joining the EU. That question clearly needs to be answered country by country. However, the low level of bank intermediation is not an obstacle to joining and even thriving in an enlarged EU. After all, most CEEC banking sectors have emerged in a process where foreign bank entry exposed domestically-owned banks to considerable competition. In addition, the CEEC banking sectors face substantial competition from the supply of funds from the EU, either in the form of intercompany loans or direct lending by non-resident banks. Against this background, the CEEC banking sectors can be considered better integrated within the EU than most of the banking sectors in the EU.

Nevertheless EU membership will bring new challenges, notably the need to fully adopt the regulatory and supervisory requirements called for under the *acquis communautaire*. In this context, two points are worth mentioning. First, the rules and regulations shaping the Single Market in financial services are constantly changing and, thus, constitute a moving target that needs to be tracked in the preparation for EU membership. For instance, the European Commission has presented a Financial Services Action Plan to further stimulate competition and efficiency of financial markets across the EU. This programme contains a series of measures designed to create a fully integrated European financial market by 2005. These measures include new rules concerning takeovers, cross-border banking charges, and publication of prospectuses. Complying with these rules requires additional efforts on the part of both current and new EU members.

Second, the existing EU regulatory and supervisory framework reflects the development stage of the economic and financial systems of current EU members. This framework is not necessarily consistent with the level of development in the CEECs. A case in point, discussed in this volume by Riess *et al.*, is the deposit insurance schemes stipulated under the *acquis*, which may be too generous given the level of income in the CEECs.

But apart from regulatory and supervisory challenges, what else does the future hold in store for the CEEC banking sectors and, more specifically, are there any messages arising from the experience of banking in the EU, or international banking in general? We briefly look at two issues, namely consolidation and disintermediation.

Like other mature banking sectors, those of the EU have experienced increasing consolidation and concentration in recent years. As a Group of Ten (G-10) report (2001) shows, the objective to save cost, enhance revenue and reduce risk has been a prime force behind this process. New scope for cost saving, revenue enhancement and risk reduction has materialised with advances in information technology and the globalisation of financial and goods and services markets, the latter receiving an additional boost with the introduction of the euro. Increased competition and shareholder pressure have forced banks, more specifically their management, to seize new scope for boosting profitability and consolidation has been one of the means to achieve this. Interestingly enough, in the EU, mergers have so far been largely a national or even regional matter.

What can we say about similar trends in the CEECs? Since the mid-1990s, the CEECs' banking sector has seen market exit and mergers. As a result, following a spurt in the early years of transition, the number of banks in the CEECs has fallen - in some countries substantially. Will this trend continue? On the one hand, the CEECs appear under-banked with room for more rather than fewer banks: The number of banks (and branches) per inhabitant is low in comparison to the EU and bank assets relative to economic activity is well below the level observed in other middle-income countries and the EU. On the other hand, as Riess *et al.*, (this volume) argue, the size of most CEEC banks is considerably below the level at which EU banks fully exhaust economies of scale. While the optimal bank size in the CEECs may be lower than in the EU, this nevertheless suggests that there is scope for further consolidation in the CEECs' banking sector even without considering possible gains from revenue enhancement and risk reduction. In addition to scale economies, mergers could result in cost savings that stem from reducing X-inefficiencies. Indeed, O'Brien and Wagenvoort (2000) show that large banks are usually better managed than small ones. In theory, reducing X-inefficiencies is possible without mergers. In practice, however, the bank merger event makes this more likely, with the new management of the consolidated bank being in a stronger position to carry out overdue cost saving measures. In sum, further consolidation in the CEECs' banking sector is rather likely and, interestingly enough, it is bound to have a more international flavour than so far in the EU given the presence of foreign banks from a wide range of countries in the sector.

Turning finally to bank disintermediation, we recall that it essentially means a substitution of capital market finance for bank loans. Simply put, instead of seeking loans from banks, would-be borrowers - firms but also local and regional authorities - issue debt securities such as bonds. Debtors take this route if they can attract capital market finance at lower cost than bank finance. This is the more likely, the more information about potential debtors is publicly available and the higher the quality of that information.

Disintermediation swept the US financial system in the 1960s through the 1980s (Beim and Calomiris, 2001) but it is still a relatively new phenomenon in continental Europe. However, even here bond issues seem to have been gaining ground relative to bank finance, in particular following the introduction of the euro in 1999. One indication for this is that in the euro zone, outstanding debt securities relative to GDP increased by 21 percent in 1998-2000. During the same period, bank claims on the domestic economy (again relative to GDP) increased only by 4 percent. Recent data collected by the European Commission indicate that the bond issuing activity in euro zone continued on a fast track in 2001.

These figures seem to indicate that bank disintermediation is making inroads into the euro zone financial system. Some qualifications are warranted, however. First, in many cases, banks bring large clients to the capital market. Thus, fee income partly offsets the loss in traditional interest income. In addition, part of the bonds issued may end up on bank balance sheets. While not constituting traditional bank lending, it is nevertheless finance intermediated by banks. Second, bank claims on the government have fallen, partly because local authorities have made increasing use of bond market finance, but there seems to be no moderation in the supply of credit to the private sector. In fact, while bank claims to GDP increased only by 4 percent in 1998-2000 (as mentioned above) bank claims on the private sector increased by 10 percent. Therefore, despite an apparent shift from bank to capital market finance, euro zone banks keep playing a central role in financial intermediation.

Is bank disintermediation also an issue for the CEEC banking sector? There are at least two reasons to believe that it is not. First, given the still emerging CEEC enterprise sector, the possibility to tap debt markets is likely to remain limited to a few large, well-established, creditworthy firms. The more general message here is that bank finance will remain in demand where information on those who seek finance is not widely available and/or of poor quality and where banks are better placed to monitor users of funds. Danthine *et al.*, (1999) have pointed out for developed economies that banks will keep the role as providers of funds for projects that are particularly difficult because of asymmetric information problems. Inevitably, such problems are more severe in the CEECs and banks should thus have a promising future.

Second, to the extent that firms circumvent banks, one cannot presume that this will necessarily come at the expense of the domestic banking sector. This is because creditworthy would-be borrowers currently constitute as much, if not more, the clientele of non-resident banks as of CEEC banks. It follows that possible disintermediation in the CEECs may affect EU rather than CEEC banks. Another reason one could possibly think of is that since CEEC capital markets are not yet sufficiently developed, they cannot effectively compete with bank finance. However, this presumes that capital market finance for CEEC firms has to come from CEEC capital markets. As we will see in the next section, this is everything but a forgone conclusion.

Capital markets in Central and Eastern Europe: To be or not to be?

Jens Köke and **Michael Schröder** in their contribution analyse how capital markets in the CEECs have evolved during the last decade. Since the beginning of transition, most CEECs have taken steps to develop capital markets. There has been a fair deal of heterogeneity in the way the process developed across countries. However, a good ten years after the start of transition, all CEEC capital markets are still in their infancy. Beyond the initial privatisation wave, the amount of funds raised through IPOs or secondary share offering has been relatively modest and the bulk of the bond market is made of securities issued by the central governments or other public sector issuers. Capital markets account for only a small portion of financial assets in these countries and thus are even less developed than the banking sector. The structure of corporate finance reflects this situation, with bank credit dominating external corporate finance. Debt securities play a non-negligible role for financing investment only in the Czech Republic. In addition, the amount of assets controlled by

institutional investors in those CEECs that belong to the OECD is considerably smaller than in the less developed countries of the current EU. These features obviously raise the question whether the local capital markets have the potential to become sufficiently large and deep to channel finance efficiently between investors and issuers.

The stand-alone strategy followed so far by many CEECs may turn out to be too narrow to create liquid markets and to attract foreign investors. Köke and Schröder suggest in their paper that CEECs should strive to develop a pan-Central and Eastern European exchange. They argue that by adopting the same trading, clearing and settlement systems, it will be easier and less costly for investors to operate. This should attract both foreign and domestic investors and indirectly lead to higher liquidity.

One could make a different proposal. It does not necessarily follow that CEECs have to develop fully-fledged and independent capital markets, either on a country-by-country basis or on a regional level. The ultimate goal for the authorities should be to support an efficient allocation of funds in the economy. In the end, one needs to make a clear distinction between the availability of capital market services and the local production of these services. The real issue is whether the development of a local capital market infrastructure is an efficient way to satisfy the needs of investors and issuers. To meaningfully address this question one has to look beyond current domestic considerations and to consider the broad evolution of the worldwide capital market and how the CEECs are likely to develop in the future.

The capital market landscape in developed countries has been changing rapidly in the last decade and there is no sign that the pace of change will abate in the coming years. Two essential factors are driving these changes. Firstly, advances in computer and telecommunication technologies have reduced geographical barriers to the integration of capital markets and to the diffusion of information. Secondly, the lifting of most restrictions on cross-border capital transactions, and globalisation in general, have led to a more intense competition between the main financial centres. In addition, standards in disclosure and accounting have emerged and institutional investors play an increasingly more important role. In Europe these changes were accompanied by the introduction of the euro. While each country of the euro zone had developed its own capital market infrastructure when it had its own national currency, the capital market landscape is being recomposed in the wake of the introduction of the euro. Stock exchanges are abandoning their mutual structure and are merging to provide more efficient services that issuers and investors require. Likewise, the clearing and settlement infrastructure inherited from the pre-euro era is inefficient and too cumbersome to survive unchanged. For example, the report of the Giovannini group (2001) for the European Commission, shows that the costs of cross-border clearing and settlement in the euro zone significantly exceeds that of the more integrated American market. While the process of adjustment is still in its early days, there can be little doubt that a substantial re-organisation of these services will be necessary in the medium-term.

CEECs, like most of the other emerging markets, have not been completely immune to these changes. Indeed, one of the most noticeable features of the effect of globalisation of capital markets on these countries has been the substantial migration of stock market activities to the largest

European and American exchanges, either in the form of cross-listing or depositary receipts. According to Claessens *et al.*, (2002), 49 percent of market capitalisation of the Eastern European region is listed abroad. Of course, a relatively small number of corporations account for this high and increasing share of market capitalisation listed on non-CEEC stock exchanges as typically it is the larger company that lists abroad. Irrespective of whether this process is driven by the reluctance of foreign investors to invest in securities listed only on the relatively illiquid CEEC stock exchanges or by the desire of firms to widen their investors' base, this clearly shows the importance of distinguishing between the local provision and availability of capital market services to investors and issuers.

The migration of stock listing of the largest companies to the world's most important financial centres questions the feasibility of developing/maintaining domestic capital market in Central and Eastern Europe as well as in many EU countries. It is unclear whether the significant costs of developing a domestic capital market infrastructure can be justified if the market size remains limited. Schmiedel (2001) analyses the technical efficiency of financial exchanges in Europe and finds statistically significant inefficiencies (about 20-25 percent), which are partially explained by size. As stock market consolidation in the EU develops further, it is likely that the larger markets will improve their efficiency, making it even more difficult for CEEC exchanges to compete.

With respect to the need for a national capital market, one cannot ignore the importance of having a separate national currency. Indeed, for domestic investors the domestic financial market would be the "place to be" as it would relieve them from having to bear exchange rate risk. This could possibly offer the critical mass and liquidity to justify the existence of a national capital market. However, if the national currency were to be replaced by the currency of a larger economic zone, the inherent advantage of having a national capital market would disappear. Since all CEECs will eventually adopt the euro after having joined the European Union, one cannot disregard that the short-term benefits of a domestically based capital market when the national currency still exists, might not justify the cost of developing and maintaining these markets once the national currency has disappeared.

The above discussion indicates that the future of independent CEEC stock exchanges is not obvious. It should be noted that the same applies to many domestic exchanges in the European Union. This does not mean that domestic firms and investors will not have access to capital market services. Quite the contrary, they could be better off relying on an international structure that can operate much more efficiently.

As a consequence, it may be better for countries not focusing on the development of full fledged local stock exchanges, but rather concentrate on creating the conditions, such as improving shareholders rights and legal system quality, that allow firms to issue and trade shares abroad efficiently. This facilitation will also need to involve harmonisation of corporate governance, accounting, listing and other rules with those in international financial centres, and in many CEECs improvements are required in the enforcement of securities markets' legislation. Like for banking, the institutional framework of capital markets remains of paramount importance.

Naturally, this does not mean that the current capital market infrastructure should be abandoned altogether. Instead, CEECs could continue to develop the infrastructure, not with the aim of developing it on a fully independent basis, but to encourage their local trading systems to be closely linked to and eventually merged with EU platforms. This is already happening in several cases as documented by Köke and Schröder (this volume). Likewise, as efficient clearing and settlement is also a key feature of a well functioning capital market, foreign clearing and settlement operators need to be given access to CEEC exchanges.

It might be politically unpalatable for the public authorities to endorse the view that capital market services should be outsourced internationally. If the authorities were to push for the development of a local independent market (or a regional one) they could try to achieve this by restricting the investment choices of domestic investors in order to tilt their resource allocation toward the local market. These investors would thus risk becoming captive to an inefficient market. This might, on a transitory basis, assure a cheaper funding for local fund-raisers (including the local governments), but this would not necessarily bring about a least cost capital market infrastructure and adequate liquidity. Doing so would eventually isolate local markets and drive down the returns accruing to local savers and investors and expose them to higher risks.

Naturally, the internationalisation process has been driven by larger corporations (except for Nasdaq listed technology companies). It is likely that in the future larger firms will continue to enjoy a better access to international capital markets than smaller businesses. This obviously raises the issue of what the authorities could do to help medium-sized and innovative firms to tap the capital market. These firms typically suffer from larger information problems as the provision of information is relatively more costly and available only at local level. Therefore one role for public authorities is to stimulate an active market for the financing of new or rapidly expanding firms by promoting venture capital and the like. However, this does not necessarily justify the existence of a domestic stock exchange.

Most of the discussion so far has mainly focused on the capital market for shares. One should not conclude from this that the challenge facing the bond market is different. If anything, the experience of the euro zone since the introduction of the single currency has shown that the integration of the bond market is progressing even faster than for the share market. Perée and Steinherr (2001) show that the introduction of the euro has opened the way for a truly integrated bond market characterised by intense competition among issuers and much more sophisticated pricing of risks. As the CEECs are expected to abandon their national currencies in favour of the euro, their bond markets will have to integrate this market too. Hence, the recommendation that CEEC authorities take the necessary steps to integrate their markets with the euro zone market as smoothly as possible is even stronger for the bond market.

In conclusion, there seems to be considerable potential for an efficient integration of capital markets in an enlarged EU. In deciding which road to take, CEECs as well as current EU members would be well-advised not to confuse the local production of capital market services with the availability of capital market finance. One thing should be clear, domestic users of capital market finance and investors would be better off with access to efficient foreign markets instead of having to rely on inefficient domestic capital markets.

Macroeconomic interlinkages

A sound financial system and macroeconomic stability are crucial factors that determine how fast relatively poor countries can catch up with richer ones. An essential observation is that financial sector development and macroeconomic stability support each other. Equally important, financial sector weaknesses pose a threat to macroeconomic stability and macroeconomic imbalances, in turn, could undermine the stability of a country's financial system.

A key macroeconomic decision concerns a country's monetary and exchange rate regime. In taking that decision, a variety of questions need to be addressed. A critical one is which regime is best for getting the country on a sustainable path of economic growth. Another question - obviously related to the first one - is which regime is most suitable for ensuring financial sector stability. In pondering this issue, crucial interlinkages between macroeconomics and the financial sector turn up again: Not only does the exchange rate regime choice bear on financial sector stability, but financial sector instability may adversely affect the viability of the chosen exchange rate regime. For the CEECs, the exchange rate regime choice poses an additional challenge, namely that the chosen regime should pave the way for a smooth entry into EMU.

In sum, the financial integration in an enlarged Union has an important macroeconomic dimension. The remainder of this introduction summarises the gist of the papers on this topic, which are published in a companion edition of the *EIB Papers* (Volume 7, Number 2).

Robert A. Feldman and **Nancy Wagner** (IMF) highlight in their paper "*The financial sector, macroeconomic policy and performance*" that the relationship between the financial sector and macroeconomic policy is a two-way street. Looking down the street in one direction, they argue that a healthy financial sector can enhance the flexibility and effectiveness of fiscal and monetary policy. As to fiscal policy, the authors stress that significant contingent liabilities - related, for instance, to the banking system - prevent credible fiscal planning, divert resources from productive investments, and may lead to debt sustainability issues. As to monetary policy, they point out that central banks may be unwilling to tighten policy if that would threaten the health of financial intermediaries. They furthermore reason that an underdeveloped financial system weakens the predictability of monetary transmission, thereby complicating the conduct of policy. An interesting observation is that large enterprises have access to funds other than domestic bank finance and, as a result, a tightening in monetary policy is likely to disproportionately affect small and medium-size enterprises and households, which usually do not have alternative sources of financing.

Looking in the other direction, Feldman and Wagner emphasise that the growth and development of the financial sector also depends critically on sound monetary and fiscal policies. They stress that an excessively expansionary or restrictive macroeconomic policy stance can exacerbate financial sector vulnerability. For instance, 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, 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 and could even induce a liquidity crisis in the

banking sector. And then, 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, the authors highlight that 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.

Paul De Grauwe and **Marianna Grimaldi** (Katholieke Universiteit Leuven) address in their paper "*Exchange rate regimes and financial vulnerability*" the interlinkages between foreign exchange and banking sector crises. They argue that under a fixed exchange rate regime, trouble in the foreign exchange market can easily spill over to the banking sector via skyrocketing interest rates. Mirroring the two-way-street notion of Feldman and Wagner, the authors also point out that cause and effect may be reversed, with a banking crisis inducing a massive injection of liquidity by the central bank and this, in turn, triggering a flight from the country's currency.

This suggests that a fixed exchange rate regime is conducive to banking sector crises. But is a flexible exchange rate regime preferable? De Grauwe and Grimaldi are not convinced, noting that there is very little empirical evidence indicating that banking crises have been more frequent under fixed than under flexible exchange rate regimes. On the contrary, for developing countries, they point to evidence that the probability of a banking sector crisis is higher under flexible exchange rate regimes. In this context, the authors also argue that contrary to what mainstream economic models predict, flexible exchange rates generally do not perform their stabilising role well and, worse, can be an independent source of instability, unrelated to the volatility of underlying macroeconomic fundamentals. In such an environment, flexible exchange rates increase the fragility of the balance sheets of local businesses and banks, in particular in countries with weak banking sector supervision.

De Grauwe and Grimaldi conclude that a flexible exchange rate does not necessarily provide for an environment conducive to financial stability but is more often than not a significant source of monetary and macroeconomic instability endangering the stability of the banking sector. At the same time, the authors leave no doubt - and this is the focus of the analytical model they develop in their paper - that while a strong commitment to a fixed exchange rate regime and high costs of abandoning it make such a system more credible, exogenous shocks are likely to undermine an even apparently credible fixed exchange rate regime before too long. This is particularly the case when countries move to full capital account liberalization, as the CEECs will have to upon EU membership. Overall, it seems pertinent to infer from this that credible fixed exchange rates would serve the CEECs well, but that the road to EMU should be a short one.

Willem Buiter and **Clemens Grafe** (EBRD) develop this theme further in their paper "*Anchor, float or abandon ship: Exchange rate regimes for the Accession countries*", arguing that from an economic point of view, euroisation or a currency board with the euro can make sense for all ten accession countries. They emphasise that important preconditions for the success of such an exchange rate

arrangement are fulfilled: All countries have (i) small, highly open economies that would peg to a currency that accounts for the lion's share of their external trade; (ii) sufficiently sound banking sectors; (iii) fiscal imbalances that do not appear worse than in the majority of existing EU and EMU members; and (iv) a 'strong-exit option' from such an arrangement in the form of EMU membership.

In their critical analysis of free floating - widely regarded as the only other credible exchange rate regime - Buiter and Grafe point out that national monetary autonomy is of limited value for small economies, highly open to trade and financial flows. Furthermore, they highlight the downside of monetary independence and exchange rate flexibility, including vulnerability to exchange rate shocks that can adversely affect domestic banking systems, especially when large parts of banks' balance sheets are denominated in dollars and other hard currencies. Finally, they observe that CEEC monetary and financial systems are undergoing rapid transformations and, as a result, monetary transmission mechanisms are both poorly understood and quite unstable, which increases the likelihood that central banks in the region may miss their announced policy targets.

Buiter and Grafe conclude with a practical suggestion for an efficient EMU entry procedure for successful EU accession countries. In essence, countries should be allowed to euroise at the earliest possible date, not unilaterally, but at an exchange rate that is negotiated and agreed upon between the responsible parties in the existing EMU member states and the accession country. Furthermore, accession countries should become EMU members at the earliest possible date, possibly (and preferably) on the same date on which they become EU members. The authors note that certain technical waivers or derogations from the Maastricht exchange rate and inflation criteria may be judged to be necessary for early EMU entry. In this context, Buiter and Grafe point out that the exchange rate criterion had been flexibly interpreted before, while still observing the Maastricht Treaty. As to the inflation criterion, they stress that there are sound economic reasons to redefine this criterion, for instance, in terms of the inflation rate for tradable goods rather than consumer price inflation.

With two papers coming out rather strongly in favour of credible fixed exchange rate regimes on the road to EMU and an early adoption of the euro, one may feel that there is too much praise for one extreme in a "bipolar view" of the world (Fischer, 2001) and too much enthusiasm for an early EMU entry of accession countries. To balance this impression, we think it is appropriate to briefly sketch the case for greater exchange rate flexibility and a more gradual approach to EMU membership as presented, for instance, in Feldman and Watson (2001).

A starting point is the observation that since the beginning of transition a number of countries have moved towards more rather than less flexibility and, at present, the group of countries with floating exchange rate regimes comprise the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia (with the Baltic countries and Bulgaria having, *de jure* or *de facto*, currency board arrangements). The main reason for a move towards greater flexibility seems to have been concerns about actual or expected massive capital inflows and associated worries about both inflationary pressures and a possibly abrupt reversal of capital flows.

While large and possibly volatile capital flows pose challenges for any exchange rate regime, it can be argued that regimes with significant exchange rate flexibility are likely to remain for some time to come a less risky option for those accession countries that currently have such systems in place. Two things should be clear though. First, CEECs with flexible exchange rates should not be indifferent to exchange rate movements, and macroeconomic policies have to contribute to avoiding too much exchange rate variability and an excessive currency appreciation that could lead to unsustainable current account balances. Second, as EU members, the CEECs will eventually have to join EMU. Therefore, countries with flexible exchange rates will ultimately have to move back towards greater fixity. As Feldman and Watson (2001) point out this process can be hazardous, calling for an appropriate mix of fiscal and monetary policies, progress in achieving a reasonable degree of price and exchange rate stability, and an exchange rate level upon entry into EMU that does not undermine a country's external competitiveness.

The general conclusion to be drawn from these two editions of the *EIB Papers* on the financial integration of an enlarged EU is that there are no major hurdles to EU membership. All CEECs have made enormous progress in creating market-driven banking sectors. Capital markets in the CEECs are still in their infancy but we argued that one needs to make a clear distinction between the availability of capital market services to issuers and investors of accession countries and the local production of these services. The paper in this volume concludes that CEECs would benefit from establishing a pan-CEEC capital market. We are sceptical, in particular when taking into account that the CEECs will eventually adopt the euro after having joined the EU. CEECs may consider to leap-frog by integrating their capital markets with major EU financial centres more rapidly. There are already strong links between CEEC and EU banks as foreign strategic investors dominate the CEEC banking markets. While the exchange rate regime choice has important implications for the soundness of the financial sector, it remains an open question which exchange regime the CEECs should choose on the road to EMU. The broad picture on CEEC accession is comforting. However, the transition is not over yet and new challenges will arise with enlargement. To withstand and prevent financial stress in CEEC financial sectors, further improvements are required in the legal framework and in the practice of bank supervision. As always the devil is in the detail.

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