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Sources of Financial Fragility in the EU Candidate Countries[1]

Although during the last decade countries of Central and Eastern Europe have accomplished an impressive progress in the sphere of both macroeconomic and microeconomic reforms they cannot be considered as fully matured market economies. In addition, their increasing openness connected with progressing integration of financial markets (globalization) and the EU accession process brings, apart from obvious benefits, some additional risks.

Generally speaking, the potential financial fragility of the EU candidate countries can originate from:

1. Microeconomic sources
    - banking sector instability
    - corporate sector non-transparency and over-borrowing
2. Macroeconomic sources
    - fiscal imbalances
    - inflation differentials
    - current account imbalances
    - ‘intermediate’ exchange rate regimes

Banking sector instability can be caused either by political influence on lending decisions (mainly in the state-owned banks) or by connected and imprudent lending (mainly in the private and newly privatized banks). Both phenomena usually originate from the flawed ownership structure, insufficient prudential regulation and weak banking supervision. Remedies should be seen mainly in privatization involving the key role of the first-class transnational financial institutions, avoiding government bailouts and building strong banking supervision and prudential regulations.

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[1] This paper contains the revised and updated version of my presentation delivered at the Conference on ‘Financial Stability and Development in Emerging Economies: Steps Forward for Bankers and Financial Authorities’ organized by the Forum on Debt and Development (FONDAD) in Amsterdam, June3-4, 2002.

Problems in a non-financial corporate sector come usually from soft-budget constraints leading to over-borrowing ('too big to fail' approach or political sensitivity of some sectors), imprudent corporate and business practices (for example, lack of transparency) and currency mismatches in the corporation balance-sheets. These unfavorable phenomena are usually concentrated in state-owned enterprises and conglomerates but not exclusively. Experience of many emerging markets demonstrates the case of big private owners having an influence on government and its decisions and extracting various kinds of rent from this political connection.

Like in the case of banking sector, remedies can be seen mainly in avoiding government intervention and bailing-out practices (which lead to soft budget constraints and moral hazard behavior), sound privatization involving the first-class international investors and improving corporate governance, property-rights protection, reporting and accounting standards. However, there is difficult to find a good remedy for currency mismatches in the economies lacking sufficient macroeconomic credibility and, therefore, unable to borrow internationally in its own currency (the so-called 'original sin' problem – see Hausmann, 2001).

This leads us to the analysis of macroeconomic sources of financial fragility. The biggest danger of instability originates from fiscal imbalances, which in some EU candidate countries (particularly those belonging to the so-called Visegrad group[2]) have become chronic (see **Table 1**).

Table 1: General government balance (cash basis), in % of GDP

Country	2000	2001	1997-2001[a]	Country	2000	2001	1997-2001[a]
Bulgaria	-0.7	1.7	0.5	Lithuania	-3.3	-1.9	-2.9
Czech Rep.	-4.2	-5.5	-3.8	Poland	-3.5	-3.9	-2.8
Estonia	-0.7	-0.4	-0.5	Romania	-3.8	-3.4	-4.0
Hungary	-3.1	-4.1	-5.4	Slovakia	-6.7	-5.6	-7.0
Latvia	-2.7	-1.6	-1.7	Slovenia	-2.3	-2.5	-2.3

Note: [a] – average 1997/2001

Sources: EU (2001, Annex 2; 2002, Annex 7).

As the EU candidate countries continued substantial deficits in years of relatively high growth rates their fiscal situation will further deteriorate when growth slows down for any reason (the recent example of Poland). Although for obvious methodological reasons it is almost impossible to estimate cyclically-adjusted deficits in transition economies there are no doubts that their fiscal positions are very vulnerable to changes in real GDP growth rates.

In addition, fiscal position of the EU candidates can deteriorate further in the first two years of their EU membership as the result of several accession-related factors such as:

1/ Additional fiscal burden in national budgets coming from adoption of some specific *acquis communitaire*, particularly in such fiscally burdening areas as environmental protection, infrastructure, transportation, public administration, social policy, etc. On the other hand, one

[2] The Visegrad group consists of the Czech Republic, Hungary, Poland and Slovakia.

may expect some additional revenues coming from indirect tax harmonization (increasing VAT and excise tax rates for certain groups of products).

2/ Giving up part of the budget revenues (custom duties and part of the VAT) in favor of the EU budget. These losses can hardly be compensated by the expected transfers from the EU budget as the latter relate mostly to items and programs, which were not financed by the EU applicants from their national budgets before. In addition, some of the EU funded programs need co-financing of the national budgets.

3/ Transition problems connected with lunching the EU funding mechanisms in the first year (two years) of the membership. They will originate from a time mismatch between contribution to the EU budget (which must be done up front) and incoming transfers (*ex post* reimbursement of incurred expenses). Also institutional capacities of the new members to absorb EU structural funds will be very limited in the beginning.

Fiscal imbalances increase country's financial fragility in various ways. First, deteriorating fiscal balance must lead to deterioration of current account balance, other things being unchanged. Second, fiscal deficit in period t automatically narrows a fiscal room of maneuver in periods t+1, t+2, etc., as it contributes to increasing debt burden and debt-service costs in future. Finally, higher fiscal deficit and public debt increase perception of a country risk among investors and make them more reluctant to lend both to government and private borrowers.

The available empirical experience shows the dominant role of fiscal imbalances in causing financial crises in transition economies (Dabrowski et al., 2003). Hopefully, the disciplining mechanism of The Stability and Growth Pact and interest of most EU candidates to meet Maastricht criteria in order to enter the EMU at earliest possible date (see below) will force them to carry out serious fiscal adjustment in the coming years.

The role of inflation differentials is maybe less obvious but certainly not less important. Moderate or high inflation discourage savings and distorts allocation process. Under open capital accounts it increases international perception of country macroeconomic risk, particularly currency depreciation/devaluation risk, provoking sudden changes in direction of capital flows (closely related to changes in demand for local currency). Real interest rates are usually higher than in countries with sustainable low inflation level.

Table 2: End-of-year inflation in EU candidate countries, 1994-2001

Country	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	121.9	32.9	310.8	578.6	0.9	7.0	11.2	4.8
Czech Republic	9.7	7.9	8.6	10.1	6.8	2.6	4.0	4.1
Estonia	41.6	28.8	15.0	12.5	4.5	3.8	5.0	4.2
Hungary	21.2	28.3	19.8	18.4	10.3	11.2	10.0	6.7
Latvia	26.2	23.3	13.2	7.0	2.8	3.2	1.8	3.1
Lithuania	45.0	35.5	13.1	8.5	2.4	0.3	1.4	2.0
Poland	29.5	21.6	18.5	13.2	8.6	9.8	8.6	3.7
Romania	61.7	27.8	56.9	151.6	43.8	54.8	40.7	30.3
Slovakia	11.7	7.2	5.4	6.4	5.6	14.2	8.4	6.6
Slovenia	18.3	8.6	8.8	9.4	5.7	8.8	10.6	7.0

Source: IMF

Most of the EU candidate countries have experienced serious problems with breaking a well-rooted inflationary inertia (see **Table 2**). However, last two years brought some progress in this area. This progress will be even better visible if we take into account the continuous disinflation trend in 2002 not reflected in Table 2. The progress in EU accession process radically improved financial markets perception of the macroeconomic fundamentals of the future EU members, stimulating increased capital inflow, appreciation pressure on national currencies, and convergence of nominal interest rates and inflation level.

However, the disinflation trend cannot be considered as sustainable as far as the currency depreciation/devaluation risk will not disappear. And this risk is justified (in the eyes of financial market players) both by the remaining uncertainty concerning the timetable of the EU/EMU accession and by the expected high current account deficits.

High current account deficits can originate from many factors, including historically low domestic saving-to-GDP ratio in several countries, negative rate of government saving (consequences of fiscal deficits analyzed above) and prospects of the EU accession itself. This last factor needs in some additional comment.

Perspective of the near EU membership can stimulate additional capital inflow (better perception of counties risk and future rate of return) on the one hand, and discourage domestic savings (through consumption smoothing effect) on the other. Both trends must lead inevitably to higher current account deficits and increasing appreciation pressures (see Rostowski, 2002a). From the long term perspective high current account deficits should not be considered as the danger because the current EU candidates will eventually become members of the Euro zone and balance-of-payments constraints will disappear. However, the transition period can be extremely difficult and risky, increasing, in fact, candidates' macroeconomic vulnerability and danger of a sudden currency crisis.

Empirical observations support the concern related to current account imbalances and their possibly risky consequences. Most of the EU candidates records high current account deficits (**Table 3**). The above mentioned nominal convergence, which got momentum in Central Europe in 2002[3], may involve elements of speculative bubble, particularly in the case of Czech Republic where short term interest rates came down below the Euro zone level.

Table 3: Current account balance in EU candidate countries as % of GDP

Country	2000	2001	1997-2001[a]	Country	2000	2001	1997-2001[a]
Bulgaria	-5.0	-6.0	-1.5	Lithuania	-6.0	-4.8	-8.9
Czech Republic	-4.7	-4.7	-4.3	Poland	-6.3	-4.1	-5.4
Estonia	-6.7	-6.1	-7.8	Romania	-3.7	-5.9	-5.3
Hungary	-3.3	-2.2	-3.4	Slovakia	-3.7	-8.8	-7.4
Latvia	-6.9	-9.7	-8.6	Slovenia	-3.3	-0.4	-1.7

Note: [a] – average 1997/2001

Sources: EU (2001, Annex 2; 2002, Annex 7).

[3] The intensive convergence play has been caused not only by the ongoing accession process but also by the very low level of interest rates in developed countries and high uncertainty in several emerging markets (Latin America, Turkey, and South Africa), that increased additionally attractiveness of Central Europe for potential investors.

While the balance of public savings (in fact, fiscal balance) can and should be subject of policy targeting two others discussed factors, i.e. the rate of domestic private savings and capital inflow are largely out of control of national economic policies, at least in a short term. Moreover, defining what is the 'safe' level of current account deficit is the intellectually tricky task, and the financial markets perception which level is 'safe' can easily change over time. Thus, the only way to eliminate a danger of balance of payment (currency) crisis forever is to give up the national monetary policy and join one of major currency areas. If such a solution is not possible (for any economic and political reason) current account balance and factors influencing its changes must be subject of very careful monitoring.

However, keeping a current account deficit under control (i.e. limiting its magnitude) involves serious economic costs, i.e. lower rate of economic growth, as recent experience of Poland (2001-2002) and earlier experience of the Czech Republic (of 1997-1999) confirms it.

The above arguments should be taken into consideration in the debate concerning the timing of the EMU accession by the current candidates. While the membership in the Economic and Monetary Union is not automatic upon joining the EU the new EU members will have to do it in some point. The Maastricht Treaty did not grant them the opt-out option as the UK and Denmark were given. However, as Sweden's case demonstrates the EU member can effectively postpone the date of the EMU accession if is not ready economically or politically to do it.

Another question relates to a specific EMU accession path, which its future member can to choose. Theoretically, there are four possible variants of transition exchange rate regimes, which the candidate can consider:

1. Fixed but adjustable peg in the +/- 15% band (the 'classical' ERM variant)
2. Managed float
3. Currency board
4. Earlier unilateral euroization

Third and fourth option means *de facto* earlier unilateral entering the Euro zone although not the EMU because of the lack of influence on the ECB decisions and opportunity to use its 'lender of last resort' facility. While the third option is officially accepted by the European Commission and the European Central Bank, they oppose to the idea of the unilateral euroization as illegal or inappropriate (see Rostowski, 2002c). Formally speaking, these kinds of arguments do not sound convincing as the Euro is the fully convertible and internationally tradable currency, and some small Balkan countries (Montenegro, Kosovo and partly Bosnia and Herzegovina) not being the EU candidates so far already use Euro as the official legal tender. The real arguments against fast entering the Euro zone by the current EU candidates have different character and will be shortly discussed below.

The two first variants of transition to the EMU represent the so-called intermediate or hybrid exchange-rate regimes where monetary authority tries to manage simultaneously both exchange rate and money supply. This kind of monetary/exchange rate arrangements violate the principle of 'impossible trinity'[4] (see Frankel, 1999) and are particularly vulnerable to

[4] According to this principle a country must give up one of the following three goals: exchange rate stability, monetary independence, and financial market integration. It cannot have all three simultaneously.

speculative attacks (see Obstfeld and Rogoff, 1995; McCallum, 1999; Eichengreen and Hausmann, 1999; IIE, 1999). Thus, they do not eliminate sources of financial fragility in economies of the future EU members.

Looking at the current arrangements (**Table 4**) six out of the ten candidates continue evident hybrid regimes. Romania, Slovakia and Slovenia do not have clear nominal anchor at all. Czech Republic and Hungary formally follow direct inflation targeting but did not abandon fully the exchange rate targets – ad hoc anti-appreciation foreign exchange market intervention in the former and horizontal exchange rate band in the latter. Latvia consequently follows an exchange rate peg to SDR (which will require re-pegging to Euro in some point) but does not abandon open market operations regulating domestic liquidity. Poland represents the case o really free (independent) float under DIT regime. Estonia, Lithuania and Bulgaria run Euro-denominated currency boards (Lithuania after successful re-pegging it from US dollar to Euro in early 2002).

Table 4: Monetary regimes in EU candidate countries

Country	Monetary regime
Bulgaria	Currency board
Czech Rep.	DIT (managed float)
Estonia	Currency board
Hungary	DIT (horizontal band; narrow crawling band until 2001)
Latvia	Stable horizontal peg to SDR
Lithuania	Currency board
Poland	DIT (independent float from April 2000)
Romania	No clear nominal anchor (managed float)
Slovakia	No clear nominal anchor (managed float)
Slovenia	No clear nominal anchor (informal crawling band)

Sources: IMF Country Reports, central bank websites, author's own observation

The question of how quickly join the Euro zone is a subject of hot economic and political debate. While the idea of fast Euro-zone accession becomes increasingly popular in the candidate countries there is a lot of reservation on the EU side[5]. It seems that the main fears of the incumbents relate to the danger of weakening Euro, eliminating/ limiting policy conditionality related to the EMU accession of the new EU members and the fact that ECB is not institutionally prepared to deal with 20+ members[6].

Looking at the timing of the EMU accession from candidates' perspective potential disadvantages of early giving up monetary independence relate to abandoning devaluation as a stimulating and corrective mechanism and increasing competitive pressure on several sectors of real economy. However, the big question is to what extent a small open economy can use exchange rate and national monetary policy as the shock absorber and anti-cyclical

[5] Brouwer, de Haas, and Kiviet (2002) paper seems to be a good example of the Western skepticism related to fast EMU enlargement.

[6] Rostowski (2002b) formulates additional hypotheses: (i) fear that new, fast growing Euro-zone members will create additional inflation pressure and (ii) some aspects of the discussed EU institutional reform (particularly strengthening prerogatives of the Euro-Ecofin group).

tool in an environment of free capital mobility and competition between currencies (see Dabrowski, 2001; Dabrowski, 2002). Obviously, national monetary and fiscal policies are not effective in influencing real exchange rate and current account deficit in such an environment (see Rostowski, 2002a, Dabrowski 2002).

On the other hand, one can list several potential advantages of fast entering the Euro zone by the current EU candidates. First, it will eliminate danger of currency crisis forever, removing balance-of-payments constraints. Second, it will decrease candidate countries' risk premiums, helping in sustainable interest rate and inflation convergence (through import of credibility). Third, it will force governments and parliaments of candidate countries to carry out serious fiscal adjustments. On the other hand, lower real interest rates will make this adjustment easier, particularly in countries with high public debt burden (Bulgaria, Hungary, Poland and Slovakia). Fourth, early monetary unification will promote further trade and investment integration between new and incumbent members.

Incumbents can also gain a lot from an early EMU enlargement. It will eliminate danger of competitive devaluation and decrease possibility of macroeconomic and financial instability inside the Single European Market. The new members will have stronger incentives to comply with the macroeconomic convergence criteria and disciplining rules defined by the Maastricht and Amsterdam Treaties. Avoiding a long lasting phenomenon of a 'second class' EU membership in the case of new entrants will be beneficial for both sides in political and economic terms, supporting further stages of European integration.

Summing up, it is in the interest of both new members and incumbents to think about fast accession of the former to the Euro zone.

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