Central and Eastern Europe and the New Financial Architecture

As the Central and Eastern European countries prepare to join the European Union, they are participating in worldwide efforts to strengthen the global economy by increasing the transparency of their economic policymaking and financial institutions, adopting internationally accepted standards, and strengthening their financial systems.

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ALARMED at the spate of international financial crises that erupted in the 1990s—Mexico in 1994, Asia in 1997, and Russia and Brazil in 1998—the international community has been searching for ways to make the world economy more stable—or, to use the current catchphrase, to strengthen the architecture of the international financial system. These initiatives have fallen into two broad categories: crisis prevention and crisis resolution (for a comprehensive discussion of the proposals and initiatives related to the new financial architecture, see the IMF's website at *www.imf.org*). The latter includes the introduction of a new IMF lending facility, the Contingent Credit Lines, and the ongoing discussion of the involvement of the private sector in the resolution of financial crises. Sound domestic policies, avoidance of exchange rate overvaluation, and pursuit of monetary and fiscal policies consistent with the exchange rate commitment are the foundation of crisis prevention. The experience of recent crises has added three pillars: increasing the transparency of national economic policies; fostering the development, dissemination, and adoption of internationally accepted standards in economic policy, finance, and business; and strengthening domestic financial systems. In all of these areas, the IMF has been working with its members and other international organizations, as well as changing its own policies, to strengthen the global monetary system's ability to avoid potential financial crises.

Ten years after transition

Over the past decade, the countries of Central and Eastern Europe have made tremendous progress in integrating with the world economy. Ten countries—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia—are candidates for accession to the European Union (EU); trade with the European Union has increased rapidly, accounting for as much as 60–70 percent of the total trade of many Central and Eastern European countries; and 10 years of foreign direct investment have changed the corporate and banking sectors of many of the countries beyond recognition.

Progress has not been even across countries, however. In some of the advanced transition economies of Central and Eastern Europe, policymakers are faced with the now familiar dilemma of fast-growing emerging markets coping with strong capital inflows, coupled with medium-term fiscal problems similar to those of the mature EU economies. In other countries, progress has been uneven in such important areas as cor-

porate and bank restructuring and reform of the legal and regulatory framework, and substantial work remains to be done on the transition to a market economy.

Integration into the global economy presents risks for the countries of Central and Eastern Europe. Capital flows can be fickle. Sudden changes in investor sentiment in reaction to perceptions of relative risk and return may trigger capital outflows, regardless of the soundness of a country's economy and policies. Central and Eastern Europe suffered less than other regions during the emerging markets crises of 1997–98. Nevertheless, during the Russian crisis, even countries that had little direct trade with Russia were affected, as international investors liquidated some positions to cover losses elsewhere. Temporarily, sovereign risk premiums rose, exchange rates came under pressure, and banking systems were subjected to severe stress, reflecting these countries' vulnerability to external shocks. Efforts to build up their defenses have focused on three elements of the new financial architecture: increased transparency and accountability, adoption of internationally accepted standards, and strengthening of domestic financial systems.

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Transparency—the first pillar

A key lesson from the financial crises of the 1990s is that information plays a vital role in maintaining the stability of the world economy. In a world of global capital flows, crises are, to no small extent, the result of information surprises that cause market participants to suddenly adjust their expectations. Transparency in the provision of timely and accurate economic data to the public can reduce uncertainty and improve the ability of markets to assess risks. Equally important, transparency promotes public understanding of, and debate on, economic policy and makes economic policymakers more accountable for their actions. Hence, more transparency is likely to encourage those responsible for economic policy to make earlier, and more fundamental, policy adjustments. Transparency may also help markets better differentiate between countries and thereby reduce contagion, the process by which crises spread, seemingly affecting even countries with good underlying policies.

Standards—the second pillar

Although transparency is a good thing, simply making more information available to the public is not enough. In an age of information overload, it is vital to have a yardstick against which to judge the information. International standards can play this role, and, in the past few years, both public and private sectors have made tremendous progress in developing and strengthening international standards in a variety of economic and financial areas (see Box 1).

Identifying emerging financial crises in their early stages requires timely and accurate economic statistics. To that end, the IMF introduced in 1996 its Special Data Dissemination Standard (SDDS), drawing on worldwide best practices in the preparation and dissemination of economic data (***http://dsbb.imf.org***). The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and the Slovak Republic are among the 50 countries that subscribe to the SDDS. In 1998, the IMF began developing codes of good practice in fiscal, monetary, and financial policies to serve as benchmarks.

Other areas of progress include the Basel Committee's Core Principles for Effective Banking Supervision and the Organization for Economic Cooperation and Development's Principles of Corporate Governance. The IMF is working with the World Bank and the United Nations Commission on International Trade Law (UNCITRAL) on developing international principles of corporate insolvency. Transparency initiatives in the public sector have been accompanied by accelerated efforts in the private sector, including ongoing work on International Accounting Standards and International Auditing Standards.

In addition to developing and disseminating internationally accepted standards, the international community has become increasingly involved in monitoring their implementation. The IMF and the World Bank have been developing an experimental series of studies entitled "Reports on the Observance of Standards and Codes" (ROSCs), which contain both information on country practices in various areas and assessments of countries' observance of international standards.

Box 1

The new financial architecture

International standards have led to improvements in many areas, including

Data dissemination
Fiscal transparency
Monetary and financial policy transparency
Banking supervision
Securities regulation
Insurance regulation
Payment systems
Deposit insurance
Accounting
Auditing
Insolvency regimes
Corporate governance

Box 2

Report on the Observance of Standards and Codes in the Czech Republic

The Czech ROSC, issued in 1999, had five chapters: data publication and dissemination, fiscal transparency, transparency of monetary and financial policies, bank supervision, and securities market regulation.

The IMF's overall assessment was that the Czech Republic had reached a high level of transparency in recent years. It already meets all the requirements of the IMF's Special Data Dissemination Standard. The Czech National Bank has brought its banking supervision practices close to international best practice and, in the context of its inflation-targeting framework, provides comprehensive and timely information on its operations to the general public. The ministry of finance has increased the transparency of fiscal policy, publishing more data, including on such matters as off-budget operations and contingent liabilities. The establishment of the Securities Commission was also a step in the right direction.

At the same time, the report identified several areas where there was room for improvement. While timely, some data, including those on the national accounts, could be better. Financial diversification will require banking supervision to advance in the area of consolidated supervision. In the fiscal area, the report was critical of some of the practices that allowed the government to change expenditures from the appropriated level and accumulate contingent liabilities through guarantees and off-budget spending. In a number of these areas, progress has since been significant, particularly with the amendment of the budgetary rules that now provide for more scrutiny and more transparency in budgetary practices.

Sound financial systems—the third pillar

Weak banking systems were a key ingredient in the Asian financial crisis, not least in the process of contagion. In addition to urging countries to adopt the Basel capital-adequacy standards—and monitoring compliance with them—the IMF and the World Bank have jointly launched the Financial Sector Assessment Program, whose objective is to examine the soundness and stability of domestic financial systems, focusing on factors that could make the systems vulnerable to instability. For the IMF, the program reflects the realization that, in an increasingly integrated world economy, domestic financial systems play a crucial role in the implementation—and ultimate effectiveness—of national macroeconomic policies. In addition, the sharp rise in international capital flows over the past decade increases the risk that financial distress in one country will trigger a regional or global financial crisis.

Progress in Central and Eastern Europe

The Central and Eastern European countries have been keen to increase transparency and adopt international standards, in light of the economic and political benefits of enhanced accountability. Also, increased transparency and adherence to internationally recognized norms can help countries seeking to borrow on the international capital markets by boosting confidence in national policymaking. EU accession, which tops the political agendas of most of the Central and Eastern European countries, will require some of them to make tremendous adjustments. Legislative harmonization—adjusting national laws and regulations to EU law—is a long and laborious process, but one that is already far advanced in a number of the candidate countries. Adopting international standards is complementary to this process, and, in many areas, such as fiscal and monetary policy transparency, requirements overlap.

All 10 countries now release a public information notice following their Article IV consultations (regular—usually annual—consultations between the IMF and government officials on the countries' economies). Those with economic programs supported by the IMF (Bulgaria, Estonia, Latvia, and Romania) have published program documentation, and Bulgaria, Estonia, Latvia, Lithuania, Poland, and Slovenia have published the full IMF staff reports on the state of their economies. (The Czech Republic has indicated its intention to do so after its Article IV consultation in 2000.) Countries of Central and Eastern Europe have also adopted international standards in many economic areas. Most subscribe to the IMF's Special Data Dissemination Standard, and several have participated in the preparation of IMF ROSCs. Bulgaria and the Czech Republic published their reports in September 1999. (The latter is discussed in Box 2.) More recently, Hungary initiated a fiscal transparency self-assessment, and Latvia completed a self-assessment of compliance with the Basel Core Principles.

Restructuring the banking system has been a massive task in all the transition economies and is still under way in a number of the Central and Eastern European countries. Several countries suffered severe banking crises during the 1990s as a result of both corporate distress and the absence of an effective regulatory and legal environment. Poor corporate governance and payments discipline exacerbated the problems. The Russian crisis of 1998 exposed the continued vulnerability to external shocks of some countries, especially those with close trade ties to Russia and those whose banks had high exposure to Russian debt instruments. Looking ahead, success in attracting high levels of foreign direct investment can also carry risks for these countries' banking systems if accompanied by a sharp increase in domestic credit expansion. Growing cross-border borrowing by financial institutions and corporations adds another dimension to

the risk. Effective supervision of banks' domestic and cross-border exposures, as well as the activities of other growing sectors, such as insurance and pension funds, will be critical to ensure financial stability.

Some countries have already made substantial progress. In Estonia and Hungary, for example, privatization, mostly by sale to foreign strategic investors, has supported the introduction of sound banking practices. Estonia and Hungary were among the first countries to participate in the two-step Financial Sector Assessment Program (the preparation of a comprehensive, confidential report for the authorities, followed by a discussion of financial stability issues in the context of the Article IV consultation at a meeting of the IMF's Executive Board). The reports include an assessment of the observance of standards and codes in the financial sector, which, in Hungary, for example, included compliance with the Basel Core Principles on Banking Supervision, the IOSCO (International Organization of Securities Commissions) Principles of Securities Regulation, the IAIS (International Association of Insurance Supervisors) Insurance Supervisory Principles, the IMF's Code on Transparency in Monetary and Financial Policies, and the Basel Core Principles for Systemically Important Payment Systems. It is up to member countries to decide whether or not to publish these assessments.

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The road ahead

For the countries of Central and Eastern Europe, there is considerable value in adopting international standards to help build the credibility of their young political and economic systems. Transparency, a cornerstone of democratic political systems, is increasingly recognized as a requirement for a stable market economy as well. Together, political transparency and economic and financial transparency should assist in a rapid second transition: from emerging markets to convergence with the economies of Western Europe. F&D

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