2002

Central Banking in Transition: an Overview of Main Issues Ten Years After.

Warren Coats, *International Monetary Fund*
Marko Skreb

Central Banking in Transition:
an Overview of Main Issues Ten Years After.

Warren Coats

International Monetary Fund

&

Marko Skreb[1]

Bank of Albania

July 2001

Abstract:

The aim of the paper is to analyze the significant changes Central and Eastern European central banks have undergone in the first decade of transition. In only a couple of years they have been completely transformed from socialist monobanking system to modern, independent central banks with the same functions as any central bank in a developed economy. Today, on average, *de iure* independence is very high and probably higher than the *de facto* one. Almost all central banks have price stability as their main mandate. Inflation was reduced significantly in the first couple of years. Monetary policy underwent crucial changes as countries switched from direct to indirect instruments of monetary policy (some with fixed exchange rate regimes e.g.,. currency boards, and some with flexible). The environment for monetary policy has changes as well (banking, money market, payment system), but in some countries a lot remains to be done in those areas. The future of central banks in transition depends very much on the relations of countries with European Union. But, even when (and for some if) transition central banks cede their monetary functions to the European Central Bank, they will have a very important role to play, like research and information dissemination, education on sound economic policy, systemic financial stability, and for most of them supervision of the banking system.

JEL Classification: P200, E580, E520

Keywords : Central Banking, Transition, Monetary Policy

Authors e-mails: wcoats@imf.org; mskreb@bankofalbania.org

1. Introduction

The undertaking to transform command economies into market economies, undertaken in parallel with the establishment of democratic political regimes, has been the largest social project of which we are aware. It was not, as some might have hoped, a simple matter of *turn them free and they will build.* The transition started in Central and Eastern Europe (CEE) after the fall of the Berlin Wall in November 1989. Before the mammoth physical rebuilding of these economies could hope to improve the standard of living, it was necessary to reestablish and modernize the infrastructure of market economies (legal, informational, attitudinal, relationship) that had been displaced over fifty years earlier—or over 80 years earlier in the case of the former Soviet Republics and the Baltic states, which joined the transition following the collapse of the Soviet Union in 1991. Depending on the perspective, the pace of transition has been painfully slow (only three CEE countries have recovered to the 1989 level of measured GDP—though it is fair to assume that the quality of output was overstated ten years ago), or amazingly fast (most of the required infrastructure is now in place, though not always functioning very effectively yet). Focusing on the monetary system, we take the latter perspective.

The timing of the efforts to transform CEE countries was fortunate in that a new consensus had recently been achieved in the developed market economies on many aspects of the design of monetary systems. These include the desirability of stable money, full currency convertibility, central bank autonomy, indirect instruments of monetary policy, and policy transparency. As a result, the transition countries were able to reinstall much improved legal and regulatory systems by adopting much of the best of current wisdom. The CEE countries have been able to develop modern systems in ten years that took established market economies centuries to develop. Of course, some very rough edges remain, and it may take another decade to bring judicial enforcement and market practice up to satisfactory levels. Substance is still a long way from form, but from the long view progress has been impressive.

In this study we add the three Baltic states to the CEE countries (jointly labeled CEEB) because their history is closer to that of the other CEE countries than to the other former Soviet Republics. They became part of the USSR later than the other republics and in some respects left earlier (or started their reforms more quickly, being the first, for example, to introduce their own currencies). In addition, their ties are closer to Europe. We have omitted Bosnia and Herzegovina and the Federal Republic of Yugoslavia because their transition has just begun.

Our focus is on central banks. Central banks contribute to transition by providing public goods like: stable money, financial discipline, and the oversight of that part of the financial sector most directly concerned with the monetary system, i.e. banks. At the most general level, the allocation of resources and direction of the economy through decentralized markets requires good information on the public's demands for goods and services and the resource costs of producing them and a profit incentive to respond to that information. Stable money and integrated and efficient markets for money (stable prices at the macro level and the rule of one price at the relative price, micro level) are the sources of such information and the payment system is the source of the hard budget constraint leading and/or forcing resource allocation to respond to those price signals.

Thus in the monetary area, the intermediate goals of transition strategy were to free prices, stabilize the price level, liberalize trade, unify markets (in particular, the foreign exchange and money markets) and thus prices (exchange and interest rates), and to reduce and make transparent political (government) allocation of resources. This later point required, in part, the elimination of credit directed by the government through the central bank and banking system and, thus, the adoption of indirect instruments of monetary control.

The aim of the paper is to analyze the tremendous change central banks have undergone in the first decade of transition. The paper is organized as follows. After the introduction, we depict the starting point of central banking reforms and describe the transition path that Transition Central Banks - TCB followed. After this, the paper focuses on two main issues: central banking and monetary policy in transition economies during the first ten years of transition from a centrally planned to a market economy. The central banking part deals mostly with legal and institutional settings and with the functions of the TCB. Monetary policy in transition economies is analyzed through the following parts: policy goals and choice of anchors, operational strategies and operational environment. The paper concludes with lessons drawn and with discussion of the possible future role of TCB.

2. The Starting Point and Transition Path of Central Banking

2.1. The Starting Point

The starting point concerning central banking and monetary policies in transition economies was relatively simple and very similar among them[2]. All transition economies inherited only a few important financial institutions such as banks, insurance companies, funds and capital markets. Centrally planned economies meant that money was simply passively accommodating central planning goals in the real sector, goals often expressed in physical, not financial quantities. The financial sector in general did not serve as the intermediator and prices neither reflected relative scarcities of goods (money) nor were used as an instrument of macroeconomic policy.

Money was basically a bookkeeping mechanism for centrally determined resource allocation to various sectors and/or enterprises. As a consequence, the usual monetary policy instruments used in market economies did not exist. It is important to note that the financial sector in central planning ignored the notion and pricing of risk completely. It is sometimes stated that socialism operated as a big insurance company. In such a system enterprises could not fail (they were always bailed out), and workers did not run the risk of loosing their jobs. Banks (if they could be called banks) did not have to worry about the usual risks like the credit risk or foreign exchange risk because their (accounting) losses were always socialized. Implicit insurance premiums were collected by the state (either by taxes or distorted relative prices) regardless of individual risks. The financial system was stable because no one was allowed to "go under" and money was always available by "printing".

Needless to say, in such a system moral hazard was very common and allocation of resources inefficient. This is an important element because in such a framework there was no need for prudential regulation and supervision of banks. Therefore, central banks did not perform their usual functions (monetary policy, banking supervision and payment system). Thus, there was no functional difference between the central bank and the existing commercial banks. In the so called monobanking system the overall credit allocation was guided from the central bank (i.e. central plan). The central bank was involved in "commercial activities" in lending to enterprises (sometimes through commercial banks) according to the central plan. Needless to say, in such a framework indirect instruments of monetary policy could not be used in macro-management of the economy.

Specialized banks (all state owned) served as a transmission mechanism for state allocation of resources to various sectors (agriculture, industry, etc.) according to ex-ante planned allocation. Enterprises (controlled through credit rationing) did not have to worry about financing new investment or working capital. Financing was ensured through the planning mechanism (and monobanking system) and they had no fears of exit from the market - in short they faced soft budget constraints and no bankruptcy risk.

The household sector was separated from financing enterprises. Workers were mostly paid in cash. Household financial assets comprised only of cash and savings in specialized saving banks (or sometimes through unofficial dollarization, i.e. cash foreign exchange was kept in “mattresses” outside the banking system). As goods and services prices were administratively determined, and with limited opportunities to spend, forced savings resulted in the so called “monetary overhang”.

At the beginning of transition these countries were faced with a tremendous task to transform their financial systems from passive residuals (monobanking system and administered prices) which were both narrow and shallow, to one whose role is to increase economic efficiency and have an active role in financial intermediation (two-tier banking system, indirect instruments of monetary policy, etc.). It seems quite obvious that the inherited systems could not serve as a proper foundation for either combating inflation (which became a problem in most transition economies as a consequence, among other factors, of rapid price liberalization and abolishment of hefty subsidies) or the development of the proper allocative role of commercial banks in decentralized market economies. So, transforming banking (including central banking) was definitely high on the agenda of all policy makers in these countries as a sound market-oriented financial system is essential for a market economy (see Blejer and Skreb, 1999a).

2.2. Transition Path

From these starting points, the path and pace of reform were influenced by a number of factors. The minimal list must include: the extent of political support, the pace of establishing the legal and institutional infrastructure of a market economy (laws, courts, corporate governance, accounting standards and profession, etc.), privatization of enterprise ownership, development of market friendly payment systems, development of money, debt, and capital markets, and development of a sound and efficient banking sector (and effective prudential banking supervision).

All of these infrastructural and organizational needs take many years to develop, as do the training, skills, ethics, standards, and practices of the market place required for an economy's efficient operation. The strategies of transition to a market economy involved the rapid development of these requirements by borrowing to a large extent from the laws and approaches of successful market economies. For the CEEB countries, their own pre-communist legal systems sometimes provided a helpful starting point for the return to market economies. One of the most intangible but essential elements — the ethics of the market place and business relationships — proved to be one of the most difficult and time consuming items from the list.

3. Central Banking

From the perspective of ten years of transition, it is clear that transition is a much more complex process than was thought at the very beginning. It encompasses, besides liberalization of markets (internally and externally), macroeconomic stability, and privatization (the usual elements), strong emphasis on institution-building and the legal and regulatory framework for a market economy. The additional problem was that, in spite of very limited human resources, all those efforts had to be undertaken almost simultaneously. Thus, policy makers were faced with the need for building up a new legal and institutional setting and developing central banking functions, amidst all other reforms.

3.1. Legal and Institutional Setting

Most transition economies that we examine in this paper adopted a new central banking law to change the monobanking structure in the period 1991-1992. After some years some of them either changed the laws and central bank functioning completely, like Bulgaria by introducing a currency board in 1998 or changed them significantly like Estonia, Poland or Croatia[3]. After ten years, all countries in our group have central banking laws that give them a high degree of independence.

At the very beginning of the transition path, transition economies were faced with monobanking systems (described earlier on) which were incompatible with decentralized decision-making of a market economy. So, their first priority was to transform the system into a two-tier banking system. There was a genuine need to institutionally distinguish between a central bank and commercial banks. Besides new laws about central banking activity and commercial banks (as well as numerous by-laws and regulations) there was a need for a change in behavior in both institutions. In the centrally planned economies there was no scope for commercial banking activities or central banking in a modern sense.

Some of transition economies started reforms toward the two-tier banking system before the fall of the Berlin Wall. Countries of former Yugoslavia did it after the mid-sixties and reforms in Hungary started in 1987. The first step in legal reform was to institutionally separate commercial banks-to be from the central bank. Another was to give the central bank a proper role in the economy and society. At the time that the TCB laws were adopted (on average 1991-92 period) it was already known in theory and practice of central banking that the central bank should have a high degree of independence (instrument, personal, goal, and financial independence, or in short independence from political influence). Today the central banks of transition economies enjoy a very high degree of independence when compared with those of other economies, especially when compared to central banks from advanced economies. According to Cukierman et al. (1998) this is a valid conclusion regardless of the type of aggregate index used to measure independence.

However we would like to warn that actual (de facto) independence is probably lower because the degree of law compliance in new transition societies is on average lower than in advanced economies with a long tradition of democracy. The recent experience of some countries confirm this opinion (like in the cases of the Czech Republic, Croatia, and Hungary).

From the existing experience it seems that the legal establishment of an independent central bank is a necessary step, but having a proper role for the central bank in society is much more than narrow institution-building. It may take time, courage, determination, political influence and a lot of patience to develop a central bank into a respectable institution with an important role in building a social consensus on sound policies even beyond narrow central banking questions.

It has been widely recognized that macroeconomic stability is a necessary precondition not only for low inflation and high growth, but for much needed financial sector reforms in transition (see Blejer and Skreb, 1997 and 1999a). There is a consensus that central banks' independence is essential in pursuing its role in fighting inflation. So, in spite of its relatively narrow mandate in economic policy it is important to note that the "right" legal framework is essential for sound macroeconomic policy in transition. But, so is the enforcement of the legal framework, which has to be done on a daily basis. In short, true independence has to be earned.

3.2. Functions of the Transition Central Bank

Central banking history is usually proud of its more than three hundred years time span, but modern central banking can probably be traced to the last 50 years (for more on central banking history see, for example, Capie et al. 1994).

The functions of the central banks in transition have been determined by: the state of central banking in advanced economies, the political and economic situation in their own economies (and societies), historical heritage, and trends in the world economy. In market economies central bank functions have changed in the last 30 years. Thus, transition, which started in 1989, has been taking place in a completely new international economic environment both in general and specifically concerning central banking.

The main trends in the world economy in the last two decades, and the challenges they possess for central banks today, can be described in a following way[4]:

- deepening of financial markets. There is a very strong increase in the volume of financial transactions, both measured by their number and average value (e.g., the volume of transactions in the payment system has increased a couple of times faster than the GDP). Such developments obviously influence monetary policy instruments as well as the payment system function in the TCB.
- globalisation of financial markets as measured by the fact that international transactions are increasing 10 to 20 times faster than domestic ones. Globalisation and integration of transition economies in the world obviously has a lot of positive elements. But, there are some dangers as well. With globalisation, the number of exogenous variables for policy makers is increasing and our degrees of freedom are decreasing. This trend affects the way TCB are handling capital flows and therefore the conduct of monetary policy.

- a lot of innovations, which have two basic forms. First is the appearance of new instruments (derivatives, but e-money and cybercash as well) and second is the development of new payment technology which enable completely different and much more efficient financial transactions (computers, telecommunications etc.). This affects not only monetary instruments but also makes the supervision function of TCB more complex.
- liberalisation and deregulation of financial flows. All over the world there is a strong trend towards more reliance on market forces. We obviously must not forget securitization and disintermediation as well.

These trends go far beyond central banking proper, but have affected the way central banks operate and are looked upon today. For example, global financial trends have forced central banks to look much more closely to capital flows. Increased transparency and the speed and quantity of information has forced them to be much less secretive than say 30 years ago. On the contrary, transparency is regarded as one of the greatest virtues of a modern central bank. E-money has forced central banks to think about loss of seigniorage and monetary policy in a new environment, etc.

When making a tremendous change (like transforming a monobanking system into a market-based financial system) it is important to have a clear goal - a standard to look at. Let us not forget that even 15 to 20 years ago administrative and selective measures to control money were applied in advanced countries (namely western Europe), as well as various forms of interest rate controls. The point we are making is that central banking (including the functions of the central bank) has changed rapidly in advanced economies. As a consequence, one could argue that had transition (i.e. the fall of the socialist economic system) happened 30 years ago we would have had a completely different approach to central banking in transition economies. Today's basic principles of central banks encompass common economic knowledge like: inflation imposes high costs on the economy, or the need for price stability (as a necessary condition for growth), efficient, but limited role of monetary policy and central banks (i.e. use in long-term price stability, but not sectoral allocation), the need of central bank independence to perform its main function, etc.

Central banks around the world today perform a vast array of different functions. These functions can be grouped in many different ways (see for example:

Fry, 1999, Fischer, 1994, Wagner, 1998) . In our view, a useful approach is to distinguish between the following activities :

- Monetary policy and exchange rate policy,
- Payment and settlement system,
- Banking supervision and regulation,
- Issuance of banknotes and coins,
- Banking services for the government and
- Miscellaneous functions.

The first three functions: monetary policy, payments systems, and banking supervision are usually considered the core functions of central banking.

- The conduct of monetary policy has always been regarded as the “core” function of the central bank. Central banks are usually the “bank of issue” and for some time have had a monopoly in providing bank notes and coins. Exchange rate policy is sometimes shared with the government or is exogenous (as in the case of a currency boards). Managing foreign exchange reserves is linked with the foreign exchange function. All TCB perform these functions[5].
- Central banks are getting more and more involved into payment systems.[6] Their involvement is based on two grounds: first, an efficient and reliable payment and settlement system enables smoother operation of monetary policy. The second one is that because of the central bank involvement in financial stability, and with the growing volume of transactions there is a need to limit payment and settlement risks. Therefore central banks either operate, regulate or supervise (or are involved in all three aspects) at least part of the payment system, such as the (relatively recent) introduction of RTGS (real time gross settlement) systems. Usually their role is much broader as the risks involved in payment systems are being better recognised than before.
- Central banks are very often associated with maintaining financial stability. The objective of maintaining financial stability is closely linked with supervision of (usually) deposit-taking institutions-banks. Even if central banks do not supervise individual deposit taking institutions, they are responsible for the systemic

stability of the financial system. In most of transition economies this is within the central bank, though in the case of Hungary it is outside.

As explained earlier, this function did not exist in transition economies before reforms. As a general rule it may be said that developments in the banking system were much faster than the development of banking supervision. It included not only completely new legislation on that area, but enforcement of it (which is much more difficult). Prudential regulation is a relatively new concept in developed county supervision systems and it simply takes time to develop skilled inspectors to achieve their goals. Besides, supervision relies on other areas like accounting (i.e. applying International Accounting Standards) and external audits, which has also been slow to reform.

- All central banks are in charge of the issuance of banknotes and coins. So are the TCB that we examine. Not all of them deal directly with the public. For example, after gaining independence newly founded countries of the former Soviet Union, Yugoslavia and Czechoslovakia all issued their own banknotes (through their central banks). Central banks are usually responsible for the distribution of banknotes and coins . Not all of them print and/or mint their money.
- Banking services to the government usually includes acting as a fiscal agent for the central bank and lending to the government. The main distinction here is whether a country is a currency board or not. The three currency boards (Bulgaria, Estonia, and Lithuania) may not lend to the government. It is very common that lending is restricted. Usually there is the upper bound of indebtedness and it is often only for bridge financing, not deficit financing (as in the cases of Slovenia and Croatia).
- Other functions include a vast array of functions some of which are historical, some more recent. They include: statistical function, economic advice to the government and developed research function, international relations. Some central banks are involved in foreign exchange controls or managing of the national debt.

To conclude, central banking functions in transition economies today are more or less the same as they are in modern, decentralized market economies. Not all TBC have developed all those functions equally, but the bottom line is that their functions are not significantly different from central banks in advanced economies.

4. Monetary Policy

In the early phases of transition, all CEEB reforms included price liberalization, foreign exchange market unification and liberalization, and price level stabilization.[7] Over the first ten years of transition, all CEEB countries moved from virtually all, to most, prices being centrally determined to virtually all, or substantially all, prices being market determined. In most countries the majority of prices were liberalized at the beginning of transition. Similarly, the liberalization and unification of foreign exchange markets occurred in most CEEB countries at or near the beginning of transition (along with the opening of external trade), but the development of these markets tended to progress somewhat more gradually. The exchange markets of all CEEB countries are unified today.

As noted above, all CEEB countries adopted new central bank laws that gave their central banks substantially more legal independence on average than was found in the average developed country central bank law at that time (early 1990s),[8] and mandated that they aim for some form of price stability. As a group, the inflation rates of the CEEB countries were reduced dramatically.

In market economies, the reduction of inflation almost always causes a temporary reduction in the rate of growth (or level) of income until the new equilibrium inflation rate is established. The duration and depth of this temporary income effect—monetary policy determines the rate of inflation and has no lasting effect on income—is thought to be closely related to the clarity (transparency) and credibility of the policy adopted.

In transition economies, this normal effect of a stabilization program was superimposed on dramatic direct changes in the real sector as well. Not only were the monetary and financial systems being remade, but also huge shifts in the organization and structure of the real economy were significantly effecting both the measured and actual output of these economies. Thus, it is impossible to say what independent impact monetary policy has had on output, beyond the critically important role of facilitating the market driven reallocation of resources and delivering the financial discipline markets require to be efficient. The expectation is, however, that at the end of transition a more productive economy will emerge that delivers a higher standing of living in a social and political environment that is fairer and more respectful of individuals[9].

4.1. Policy Goals and Choice of Anchors

In the first few years of transition, the goal of macroeconomic stabilization, and price level stability in particular, focused attention on how to reduce the high rates of inflation that had resolved the monetary overhang problem. The policies that were required to reduce inflation needed to be, and were, broadly supported. However, the lessons of the market economies were not wasted and new central bank laws, which as noted above gave the CEEB central banks the goal of price stability and considerable independence, were adopted early in the transition.

The transition economy central banks faced several difficulties in attempting to implement their price level stabilization goal. They lacked experience with their new powers and instruments and thus the technical ability to implement their policy objectives effectively. The environment in which they had to operate (weak tax systems and fiscal controls, weak banking systems, weak market discipline over the allocation of resources and behavior of firms, and weak legal systems and enforcement of property rights and contracts) was not conducive to the efficient transmission of policy. And they lacked a track record that might help establish public confidence in the credibility of their policies. The second of these (underdeveloped market infrastructure) weakens the link between monetary policy and prices, distort relative prices and resource allocation, and weakens the financial discipline (hard budget constraint) required in order to enjoy the full economic benefits of stable prices. The third difficulty (lack of credibility) results in a slower adjustment of public expectations of inflation, with the result that real interest rates rise or remain high longer, and the temporary, negative output response to a tightening of monetary policy is larger. In addition to these difficulties, there was a lack of support for reform from some still in positions of power (i.e. a lack of enthusiasm for surrendering power or privilege).

These conditions call for a simple and transparent monetary policy. The simplest to implement and most transparent monetary policy is a fixed exchange rate. A currency board version of a fixed exchange rate is the simplest to implement and carries the highest credibility (if the supporting conditions needed for it to work are in place and are credible). Thus, a fixed exchange rate can be particularly attractive for new central banks with no track record, poor market data, and little technical experience. In addition, the institutional changes that characterize transition economies also made money demand less stable and more difficult to empirically estimate (short time series under new regime, etc.) and such estimates are not needed for implementing an exchange rate anchor.

A fixed exchange rate is also the policy regime that is most demanding in terms of the other policies (especially fiscal policy) required for its viability; it is the regime most unforgiving of policy mistakes. The difficulties in establishing fiscal discipline and new, market economy taxation systems have been the most serious impediments to macroeconomic stabilization in transition economies. In addition, the defense of a fixed exchange rate against unjustified (or otherwise) attacks in the market requires sufficient foreign exchange reserves in the portfolio of the central bank. Where fiscal deficits are high and foreign exchange reserves are low, a fixed exchange rate is not a feasible option.

4.2. Intermediate Targets

Seven of the thirteen CEEB countries adopted exchange rate anchors in their efforts to establish price stability.[10] One central bank adopted currency board rules early in the transition (Estonia in 1992) and was followed later by two others (Lithuania in 1994 and Bulgaria in 1997).[11] Of the six countries that initially floated their currencies, two, as noted above, later adopted currency board arrangements, two later adopted fixed pegs (Latvia in 2/94 and Macedonia in 9/95) as a part of stabilization programs, and two continued to float (Romania and Slovenia).[12] On the other hand, of the currencies that were initially pegged, all (except for the currency board arrangement currency) moved to market (managed or freely floating) rates.[13] The two countries that began their reforms with adjustable pegs (Hungary and Poland) evolved into crawling band systems. Two peggers have recently adopted an inflation-targeting anchor (Czech Republic and Poland), while two others are considering similar steps (Hungary and Slovak Republic).

All of these countries except Slovenia (and Croatia in the beginning) had stabilization (and structural adjustment) programs supported by the IMF. Thus all of them, except Slovenia, at one time or another had monetary policies with explicit monetary performance criteria as part of the conditionality of IMF support. Slovenia also pursued similar monetary targeting policies (monetary anchor).

Despite the reliance on exchange rate anchors by seven CEEB countries, all of them (as is typical of IMF supported stabilization programs) generally also adopted explicit targets for the domestic credit of the banking system (base money targets were used briefly by Latvia and Lithuania) and international reserves, and for central bank lending to government and government deficits and foreign borrowing of various types.

In several CEEB countries, credibly fixed exchange rates, high domestic interest rates (partly because of the large amount of investment opportunities, and partly because of high fiscal deficits), and improving domestic conditions for investment, induced capital inflows beyond what could be easily or profitably absorbed (via increased imports). This increasingly put the goal of price stability at odds with fixed exchange rate anchors.

The excess capital inflows would expand the money supply, if the central bank intervened to defend the exchange rate. If these interventions were sterilized (as they often were in the CEEB), the pressure of higher domestic interest rates would be maintained, causing more capital inflows. This same interest differential generated large losses for central banks that sterilized their foreign exchange interventions (the foreign exchange purchased by central banks was invested abroad at “low” international interest rates, while the bills issued—or other sterilization tools used—bore the higher domestic interest rates).[14] The high profit that attracted foreign capital was paid for by the high cost of intervention by the central bank.

Some countries tried to slow capital inflows with capital controls (e.g., Slovenia, Croatia and the Czech Republic). As has been the experiences in other countries, such controls were of limited effectiveness, especially when balance of payments surpluses where the result of fiscal deficit induced capital inflows. In the end, domestic inflation objectives gave way to exchange rate objectives (Estonia) or pegged rates were replaced with market rates and other nominal anchors (Czech and Slovak Republics).

With the maturing of the transition in the successful early starters (Poland, Czech Republic, Hungary, and the Slovak Republic), the initial exchange rate anchors have given way to more flexible rates with monetary targets and or interest rate operating targets selected so as to achieve inflation objectives (so called inflation targeting). There are some advantages and considerable risks in this evolution. A more flexible exchange rate eliminated (or reduced) the one way exchange rate bet of international investors and thus removed an artificial inducement for capital inflows. It also allowed monetary policy to focus on domestic price stability. However, the increased demands on the technical skills of central banks of a monetary or inflation anchor are considerably more challenging than maintaining a fixed exchange rate and public confidence is potentially more difficult to maintain. The requirements for bringing inflation down to single digits were easier to understand and implement than those for reducing inflation from 10 percent to 0 to 2 percent (the latter has more demanding standards for the stability of money demand, for example). Nonetheless, it should be possible to carefully build on the credibility these central banks have developed with their track record of the last seven or eight years.

4.3. Policy Instruments

Almost all CEEB countries now implement monetary policy with indirect instruments (open market operations, market based lending, and reserve requirements). At the onset of transition, all CEEB central banks used direct instruments of control — administered interest rates on bank deposits and loans, and bank by bank ceilings on credit. The removal of these controls was an important part of the transition to a market economy. The more detailed description of the use and change of monetary policy instruments in transition can be found in de Melo and Denizer (1999).

The successful use of indirect instruments depends on the existence of financial markets and healthy banking system. On the other hand, the replacement of direct controls with indirect instruments facilitates the development of financial markets. Legitimate concerns for proceeding cautiously toward financial market liberalization and the use of indirect monetary policy instruments can easily be (and were often) exploited by political authorities to protect inefficient enterprises or artificially low borrowing costs for the government.

Nonetheless, the prompt, full-blown adoption of indirect instruments was not generally feasible in CEEB countries at the onset of transformation. The adoption of direct instruments first required the development of the market infrastructure and environment in which financial markets could function properly. Programs were launched to improve the legal foundation for financial markets (laws and banking, collateral, bankruptcy, corporate governance, financial instruments, etc), modernize payment systems to permit (and require) bank liquidity management,[15] adopt international accounting and disclosure standards, develop modern banking supervision capabilities and regulations, and to strengthen or eliminate weak and or insolvent banks.

While undertaking long-range programs of development in these areas, many CEEB countries made the tools of direct control more market friendly. Thus administered interest rates were set closer to market clearing (and positive in real terms) levels, and individual bank credit allocations were auctioned by banks with less credit demand to those with more (e.g., Bulgaria). Many CEEB central banks began to auction their credit rather than directly rediscount approved bank loans. And as reform progressed, the share of central bank credit auctioned was increased at the expense of directed credit. During this period, banks began to learn the techniques of biding in (foreign exchange, government security, and central bank credit) auctions, began to take responsibility for the credits they extended on the basis of auctioned credit or their own resources, and, thus, began to develop credit worthiness assessment skills. In short, banks began to become banks.

While overall central bank credit and hence base money was increasingly controlled in this way, it also became clear that in most transition economies large, state (or formerly stated owned) banks were taking the lions share of central bank credit at almost any interest rate. Distress borrowing by insolvent, but still operating, banks distorted the allocation of credit through financial markets and led to a variety of approaches by central banks to limit the concentration of such borrowing while banking supervision capabilities were trying to catch up with their need. The introduction of open market operations needed to wait not only for the development of the government securities market and all that that entailed (accounting, payment system, etc.), but also for the banking system and banking supervision to be strong enough to rely fully on the market allocation of credit.[16]

4.4. Operational Environment

The market environment in which monetary policy operates is critical to its success. With a monetary nominal anchor (or inflation targeting), market determined interest rates and reserve money allocation are needed to transmit central bank actions to the economy without serious distortions. The benefits of stable money depend on financial and real sector markets responding appropriately to market interest rate and price signals of public demand and resource scarcity. The health and efficiency of the financial sector, and especially of banks, is particularly important. The efficiency and structure of the payment system, is another critical component to the enforcement of market discipline (the hard budget constraint) and in the liquidity management critical to successful banking. It is beyond the scope of this overview to examine these areas, but establishing market economy banks and money markets with market friendly payment systems has been a major challenge to transition economies and deserve a brief mention.

In centrally planned economies, banks were administrative arms of the government for implementing the central plan. In a market economy, their resource allocating role (providing attractive payment and savings instruments for households, firms and governments and providing funds for consumption and investment to those with the most productive uses) needs to be guided by considerations of profit and safety.[17] For this purpose, banks needed to be freed from government control (privatized), and to develop new skills and risk management systems. Accounting standards and reporting systems need to reflect the true financial conditions of banks so that they can be properly managed and so that the public can make better judgements about their soundness. The importance and nature of banks (especially their role in the payments system), requires a special regime of supervision.

Privatizing banks has not been straightforward. In many transition economies, banks were freed (generally gradually) of obligations to lend for "social" purposes only to be bought up by enterprises (often still state owned) that continued the practice of using the public's funds collected by banks for their personal needs (pocket banks). Few transition economies have good laws for dealing with the exit or resolution of failed banks. Concern over systemic collapse of the banking system, i.e. widespread runs on banks, or the desire to continue exploiting banks to perpetuate the old system of "state" allocation of resources, has led to costly delays in supervisory intervention. Thus, the market process of weeding out poorly run or unprofitable banks has often been thwarted by state intervention to bail out insolvent banks (thus reestablishing the link between bank resources and the state treasury).

Developing all of the required elements needed to achieve and maintain a healthy banking sector (private ownership, proper accounting and disclosure, adequate supervision and prudential regulation, prompt and efficient exit for insolvent banks), have consumed considerable efforts in the transition economies. The process of transition is far from over, but most CEEB countries are past the worst and have increasingly healthy and efficient banks.

Efficient securities and money markets improve the allocation of resources by unifying the relevant prices (interest rates) of financial instruments, increasing the return from lending and reducing the cost of borrowing, facilitating the transmission of monetary policy, and by improving liquidity management in general (and for banks in particular). Thus efficient money and securities markets contribute to the soundness and efficiency of banks.

Many factors contribute to the development of these markets and considerable work has gone into their development as part of the transition. However, the role of the payment system is fundamental. It is the vehicle by which hard budget constraints are imposed on firms and its basic design and functioning either help or hinder the development of money and securities markets and bank liquidity management. Banks must be able to know and control their liquidity—e.g., reserve balances with the central bank—in as close to real time as possible. The redesign and modernization of the payment systems inherited from the central planning framework has consumed considerable effort in all CEEB countries, but some are much further along than other.

5. Conclusions and the Future of Transition Central Banks

5.1. Conclusions on Central Banking in Transition

Focusing on the role of the central bank, with its responsibility for price stability, the experience of each CEEB country has been unique, but certain general features can be found in almost all of them. So, out of the common experience of the developments of central banking in transition we draw the following conclusions:

- Transition in general was more difficult and is taking longer than expected. But, having in mind its starting position central banking was reformed speedily and efficiently. In only a couple of years they are completely transformed from socialist monobanking system to modern, independent central banks, which is a remarkable achievement. Besides, it seems safe to say that today central banks in transition on average are "relatively" more advanced than other institutions in transition economies.
- the central banks of transition economies enjoy a very high degree of independence when compared either with the past or with other economies, even when compared to central banks from advanced economies. But, *de iure* independence needs to be enforced with *de facto* independence.
- central banking functions in transition economies today are more or less the same as they are in modern, decentralised market economies. Not all central banks have developed all those functions equally, but the bottom line is that their functions are not significantly different from central banks in advanced economies.
- Almost all central banks have adopted price stability as their mandate. In all countries with the political will to stabilise and reform, stabilisation was rather quickly and easily achieved. The typical CEEB central bank launched its stabilisation program in "1992" by adopting a nominal anchor (exchange rate or money supply) usually with IMF support. Inflation was reduced rapidly from very high triple digit level per year at the start of the program to low two digits per year a couple of years after the start of the program
- All central banks switched from direct to indirect instruments of monetary policy. But, the pace with which indirect instruments of monetary policy could be introduced, especially open market operations, was constrained by the pace with which banking supervision and the banking sector could be developed to the point of handling the resulting market pressures on banks.
- Developing an efficient banking system, avoiding significant losses by banks, and avoiding banking crisis, proved more difficult than many expected. So has changing the overall environment for monetary policy (including money market and payment system).

- The most successful reformers have more or less succeeded in developing financial markets and central bank monetary and banking supervision expertise sufficiently to maintain reasonable price stability without a fixed exchange rate anchor by the time markets forced them to abandon fixed exchange rates.

5.2. Future Role of TCBs

In our judgement the TCBs have gone a very long way in a very short period of time. Central banks in advanced economies needed a much longer period of time to achieve the state of independence, knowledge (expertise) and role in the economy and society than the TCBs have achieved so far. An interesting question is in what direction will the TCB develop in the future? We divided the question into two parts: short and medium term perspective, which for most of them probably means operating within the existing framework and medium to long-term, which depends very much on their relations with European Union and membership in Economic and Monetary Union.

Within the short and medium term, the general institutional framework should remain the same for the TCBs. That would mean continuation of developments for the TCB in the same direction that they were developing in the past ten years of transition, with only some fine tuning to be done. But there is no place for complacency. One could think of some possible negative risks after ten successful years for TCB. They are: neglecting inflation, overburdening monetary policy, constant battle for independence and building credibility.

The first risk may be described in the following way. After achieving relatively low inflation, stability is sometimes given low priority on the list of economic policy goals in a country, or is completely neglected. This is likely to be dangerous in the long run. Inflation must be dealt with before it appears, and not only after we have spotted it. Once inflation revives, it is usually too late to avoid significant inflationary (and later disinflationary) costs for the economy.

Price stability[18] is a very important policy objective and should remain so for TCB. Without stability it is not possible to have efficient financial intermediation and high growth. So, our strong belief is that moderate inflation is not acceptable and that once achieved, price stability should be diligently preserved. It is equally true that stability *per se* is not enough to deliver increasing welfare (growth and equity). If transition is to be successful there is an obvious need to first sustain sound macroeconomic policies and second link macroeconomic policies with structural measures to achieve sustainable economic growth.

The second risk pertains to tendencies of overburdening monetary policies with tasks it can either not achieve or can achieve only poorly (at the expense of their primary objective). Sometimes it is argued that TCB should foster growth. It is, therefore, legitimate to ask whether central banks can foster growth? Most economists would answer: “No.”. And besides, by fostering growth from the central bank politicians would generally have in mind the relaxation of monetary policy stance (“printing more money”), which ultimately leads to higher inflation. The idea of central bank growth promotion may also be linked with the idea that central banks should be involved in sectoral allocation of resources (as they were before).

Central banks can deliver higher economic growth and prosperity only by ensuring necessary long term stability of the currency and of the financial system which are essential for higher savings and investment and efficient allocation of those investments, both necessary ingredients for higher sustained growth path. For that reason, central banks need a high degree of independence to ensure low inflation and this result is fully valid for transition economies (Cukierman et al., 1998, as well Loungani and Sheets, 1997).

The third danger lies in undermining the fact that central bank independence is a constant fight, on a daily basis. It is simply not enough to assume that what is written in the Law (if a Law gives a high degree of independence) will immediately transmit into an independent institution. We have already observed that enforcement of laws on average is probably lower in transition economies, than in developed ones. They still do not have a long tradition of democracy and "law abiding citizens". In short, transition economies need to develop social capital[19]. Therefore the fight for independence should be done on a daily basis.

The fourth danger that lies ahead for TCBs regards relations with the public and building up credibility. Credibility takes a very long time to be established but can be lost in a day. In our view, TCBs have a much larger role in transition economies (CEEB) than just focusing on low inflation and financial stability. They have to educate public at large, as well as decision-makers, on the benefits of low inflation, on the limited role that monetary policy can play, on the need for their independence, etc. They cannot afford to be passive, but need to be actively involved in public choice decision making.

To the best of our knowledge all countries in the group that we examine have expressed either formally or informally their wish to become part of the European Union (EU). As a consequence of countries becoming EU members, their central banks will (sooner or later) become members of the European System of Central Banks (ESCB) headed by the Frankfurt-based European Central Bank. That also means that monetary policy will no longer be conducted in the TCBs, and that monetary sovereignty will be transferred to the common central bank, once countries became members of the Economic and Monetary Union as well (EMU) as there is no "opt out" clause for new members.

That puts the TCB in a relatively unique and somewhat paradox situation in which, after being built as market economy monetary authorities in only the last decade, they might be victims of their own success. Only successful, low inflation countries can become members of the EMU (among other things), which will mean cessation of monetary independence.

Does it mean that sooner or later the raison d'etre of central banks will be lost? In our opinion the answer is no. After the introduction of the EURO, the 12 member countries of EMU have given up an independent monetary policy in a similar way as currency boards have, by creating a monetary union. Similar fate awaits (some) of the TCB. But, we believe that central banks should not be confined to a narrow monetary policy function. Central banks have to play an active role in the society, the role which is much broader than monetary policy conduct. They have to be involved in public choice problems, especially if there is a variety of views in the economy. They should not be neutral, but have a clear view on important economic issues. Besides, the important function of banking supervision will generally remain with national central banks (or within national authorities at least). TCBs should, when they will give up on providing the service of a stable currency continue their functions like: educating the public, educating professionals, developing strong research, collecting information from all around the world's globalize markets, promoting their country in the world and in world markets, and building its reputation both domestically and internationally. Financial markets are becoming more and more important for general opinion making. We believe that central banks should encompass in policy making, information dissemination, and educational and diplomatic roles.

In spite of all of that, what they should and will do depends very much on their common knowledge, education, political will and courage of the people at the central banks. That is why we think that, coming from similar backgrounds, there is scope for more exchange of views among central banks. Presently, cooperation among CEEB TCB (with the notable exception of some bilateral relations) is very poor. It could be appropriate to conclude by paraphrasing Benjamin Franklin: If TCB do not hang together more often, they could end up hanging separately.

References:

Begg, D. (1996): "Monetary Policy in Central and Eastern Europe: Lessons After Half a Decade of Transition," IMF Working Paper, WP/96/108 Washington: International Monetary Fund.

BIS, www.bis.org/publ/index.htm (Annual Report 67-71)

Blejer, M. and M. Skreb - editors (1997): "Macroeconomic Stabilization in Transition Economies." Cambridge University Press.

Blejer, M. and M. Skreb - editors (1999a): "Financial Sector Transformation: Lessons from Economies in Transition." Cambridge University Press.

Blejer, M. and M. Skreb - editors (1999b): "Central Banking, Monetary Policies and the implications for Transition Economies." Kluwer Academic Publishers.

Capie, F., C. Goodhart, S. Fischer & N. Schnadt: (1994) "The Future of Central Banking", Cambridge University Press.

Cukierman, A., G. Miller and B. Neyapti (1998), "Central Bank Reform, Liberalization, and Inflation in Transition Economies – An International Perspective," unpublished, Tel-Aviv University, New York University, Bilkent University, May.

De Melo, M. and C. Denizer (1999), "Monetary Policy During Transition: An Overview: In Blejer, M. and M. Skreb (1999a).

European Central Bank : www.ecb.int (Conference papers: Why Price Stability?).

Fry, M. (1999), "Central Banking and Economic Development" in: Blejer,M. and M. Skreb - editors (1999b) .

Fischer, S. (1994): "Modern Central Banking" in Capie et al. (1994).

Fukuyama, F. (2000): "Social Capital and Civil Society". IMF Working Paper 00/74.

Loungani, P. and N. Sheets (1997): "Central Bank Independence, Inflation and Growth in Transition Economies". Journal of Money, Credit and Banking , Vol. 29. No.3.

Skreb, M. (2001): "The Transition Process: It's All About People, Isn't it?". Zagreb International review of Economics & business, Vol. 4, No. 1 pp. 91-102 (Jacques de Larosiere Lecture at the EBRD Annual Meeting, Riga, Latvia.)

Wagner, H. (1998) "Central Banking in Transition Countries," IMF Working Paper WP/98/126 Washington: International Monetary Fund.

---

[1]The authors are respectively, an Assistant Director in the Monetary and Exchange Affairs Department of the International Monetary Fund and Advisor to the Governor, Bank of Albania and a former Governor of the Croatian National Bank. The authors wish to thank Mr. Hrvoje Dolenec who has done a significant piece of work in data collecting and data arranging. An earlier, longer version of this paper was presented at the Dubrovnik Conference on Transition Economies in Dubrovnik, Croatia, June 1999. It can be obtained on demand from the Croatian National Bank. The views expressed here are those of the authors and do not necessarily represent the views of their institutions.

[2] A more detailed description of money in socialism can be found in: de Melo and Denizer (1999) and Blejer and Skreb (1999b).

[3] For more details see Cukierman et al. (1998).

[4] Based on BIS Annual Report – various issues.

[5] Monetary policy function will be discussed in more details in the next part.

[6] For more details on the Central bank role in the Payment systems see Fry (1999).

[7] It goes without saying that the establishment and broadening of individual property rights and the legal infrastructure needed to protect them were a foundation of all reform strategies.

[8] See Cukierman at all (1998).

[9] On ultimate goals of transition process see: Skreb (2001).

[10]Albania, Croatia, Czechoslovakia (Czech Republic and Slovak Republic), Estonia, Hungary, and Poland.

[11]Bosnia and Herzegovina, adopted a currency board in August 1997 as part of the Dayton peace agreement.

[12]It might be argued that Romania and Slovenia maintain floating rates for opposite reasons: Romania because it has not succeeding in stabilizing well enough to defend fixed rates, and Slovenia because it

has established a sufficiently credible monetary policy that it doesn't need fixed rates and because floating rates help keep capital inflows under some control.

[13] Albania, Croatia, Czech Republic, and Slovak Republic.

[14] See Begg (1996) for an excellent and more complete discussion of these issues.

[15] Poland, the first of the CEEB transformers, taught the rest the importance of the payment system to a market economy as a result of a well publicized scam to profit from bank float.

[16] Credit auctioned by the central bank could continue to flow to distress borrowers as long as such banks were allowed to remain in operation. Credit from an open market purchase by the central bank would go only to banks that had t-bills or other securities to sell. The switch for credit auctions to open market operations resulted in a very large increase in market discipline of banks.

[17] These are not really separate or potentially competing goals, as long run profit maximization requires safety and attention to managing risks.

[18] we avoid the definition of price stability, i.e. the definition of optimal inflation, either a more general one or one for transition economies. For further discussions on the issue see for example papers from ECB Conference: Why Price Stability? at www.ecb.int .

[19] social capital can be described as features of social organization, such as norms, trust, networks that facilitate coordination and cooperation among the group (a group can be anything from a household to the nation). For more details see: Fukuyama (2000) or Skreb (2001).